

(By email)

Quantitative
Strategies

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My submission to the Consultation on Strengthening Super Outcomes follows.

Should you wish to discuss any aspects of this proposal with me, my phone number is +61 425 291 833.

Yours sincerely

A handwritten signature in black ink, appearing to read 'F. Ashe', with a long horizontal flourish extending to the right.

Dr Frank Ashe

Introduction

My submission gives my opinion on the specific questions that APRA raises in its discussion paper of 13 December 2017. Additional points are raised after the specific questions have been addressed.

Answers to specific questions on SPS220 etc

Amendments to SPS 220: business planning	1. Are there additional or alternative strategic and business planning requirements APRA should consider?
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For RSE's that have a relationship with another party, commercial or by some degree of ownership, there may be material resources supplied either as cash income or in-kind. These should be explicitly mentioned in the business plan.

Amendments to SPS 220: expense management	2. Are there additional or alternative expense management requirements APRA should consider? 3. Is the concept of 'significant' expenditure in SPS 220 consistent with how RSE licensees currently undertake delegated expenditure decisions?
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Further requirements would prove too prescriptive.

New SPS 225: outcomes assessment	4. Are there additional factors or considerations that should be included in the outcomes assessment?
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I have a number of points on this section. For simplicity, I have included paragraph 18 from draft SPG 225

18. Depending on the outcomes that an RSE licensee seeks for beneficiaries, APRA expects an RSE licensee would consider using various metrics, including but not limited to:

- a) net returns, on an absolute basis and relative to risk/return targets;*
- b) costs per member for MySuper products;*
- c) cost of insurance cover;*

- d) *administration and operating expenses as a percentage of average net assets (operating cost ratio);*
- e) *net cash flows as a percentage of average net assets (net cash flow ratio);*
- f) *net member benefit outflow ratio;*
- g) *net rollovers as a percentage of average net assets (net rollover ratio);*
- h) *trends in membership base; and*
- i) *active member ratio.*

Appropriate metrics

These metrics interact with each other in complex ways, and miss out on the most important metric of all: how long is it likely that a comfortable, or basic, level of income will last in retirement, before reverting to the age pension.

Such metrics require *stochastic projections* to be done to properly take into account the various uncertainties in investment returns and the interaction of various costs and fees. There are various software products available, at a reasonable price, that can do these projections at a granularity much greater than envisaged in the current consultation document.

Stochastic projections can provide information on the outcome of representative members of various invested in the current fund in comparison to investment in a peer fund. This would give better information to Trustees on the suitability of outcomes, and the source of different outcomes compared to peers.

But it would be better if an analysis was made of every active member in the fund. Why? It may be that the representative member of a cohort has a suitable outcome, but when we examine every member we find that 40% of members have an unsuitable outcome. Of course this may mean we haven't suitable granularity in our definition of a cohort, but where do we stop in granularity?

Absolute net returns

Absolute net returns are suitable for historical comparison to peer funds, but are not suitable for any sort of suitability in projection of outcomes. The future is too uncertain, and this uncertainty must be investigated.

In addition, comparing an absolute historical return to the value expected for that period is spurious – there is too much short-term volatility for the comparison to be valid.

We may also find that a recent period of good returns (brought about for instance by a drop in interest rates) may precede a future period of lower returns. It is much better to only use historical returns in a peer comparison, and to use projections for future returns.

Various costs

See my comments on stochastic projections.

Net cash flows, benefit outflow etc

While net outflows and cash flows are important, it is also important to model the stochastic behaviour of the gross inflows and outflows. The additional work to do

this is relatively small compared to the original data collection and analysis to understand the net flows.

Once more, it is essential to understand the uncertainty present in projections of cashflows in order to do appropriate risk management.

Commencement	5. Will the proposed commencement date of 1 January 2019 provide RSE licensees appropriate time to prepare for implementation of SPS 220 and SPS 225? If not, why not?
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It should be possible. If not possible then it may indicate the fund has insufficient resources allocated to risk management.

New SPG 221 and new SPG 225	6. Is there any additional guidance APRA should consider including in the new SPG 221 and SPG 225 to assist RSE licensees in meeting the requirements in SPS 220 and SPS 225?
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No comment

Amendments to existing prudential guidance	7. Has APRA incorporated in new SPG 221 sufficient guidance to enable existing SPG 221 and SPG 222 to be withdrawn? 8. Does Circular No. III.A.4 remain relevant to industry?
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No comment

Reporting Framework - Consultation questions

Alignment with AASB 1056	<p>1. What have been the material changes to the way you categorise and report expense information under AASB 1056?</p> <p>2. In what areas would it be appropriate for APRA to require expense information that diverges from AASB 1056 to ensure adequate comparability and transparency?</p>
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No comment.

Look-through	<p>3. Drawing from experience gained from reporting investments data on a look-through basis, what material operational challenges and costs are envisaged from reporting expense information on a look-through basis?</p> <p>4. To what degree do you use bundled service arrangements? Are there material impediments for you in attributing or estimating the value of each component service in the bundle and, if so, how could they be addressed?</p>
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If there is significant difficulty in doing this look-through, then it indicates that there are deficiencies in management information systems.

SRS 331.0: updated items	<p>5. On SRS 331.0, do the roles listed on items 1-2 and expense types listed on item 4 provide a complete coverage of current industry arrangements? If not, what suggestions do you have for additions to the list?</p>
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No comment.

Definition of associate	<p>6. What areas should guidance on the definition of associate cover in order to support consistent reporting under SRS 331.0?</p>
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No comment

RSE licensee financial statements	7. What are the key challenges for you in reporting of RSE licensee level financial statements information? How might these be affected by designing requirements based on AASB 101?
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No comment

Pilot testing	8. What are the key issues that a pilot or trial of expanded expense information reporting should focus on?
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No comment

Transition timeframe	9. If APRA were to change the reporting requirements as described in this chapter, what would be an appropriate transition period to enable you to implement these changes? If the transition needs would be different across different proposals, please specify this in your response.
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No comment

Additional comments

Projection methodology

Stochastic projection methodology to do the analysis implied by APRA in Strengthening Super was added to a Masters course – *Risk and Portfolio Construction* - I was running for Macquarie University Applied Finance Centre in 2003. This was not presented as an academic exercise, but as the minimum that people needed to do if a proper analysis of retirement incomes was to be undertaken.

The need for stochastic projections has slowly moved into the marketplace but is still not appreciated by many practitioners. Banks and insurers have similar methodology available, so the skills are out there in the marketplace.

Off the shelf software is also available to do this analysis – I am a non-executive director of one company providing such a tool. I would be happy to demonstrate this to APRA executives.