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Ms Helen Rowell
Deputy Chair
Australian Prudential Regulation Authority
1 Martin Place
Sydney NSW 2000

Dear Ms Rowell

RE: STRENGTHENING OPERATIONAL GOVERNANCE OF RSE LICENSEES – UPCOMING CONSULTATION

We refer to APRA's letter dated 11 August 2017, to all RSE licensees concerning APRA's intention to consult on changes to the prudential framework to strengthen operational governance. In particular we note "*APRA intends to consult on a proposal to require all RSE licensees to regularly assess whether the RSE licensee has provided, and is likely to continue to provide, quality, value for money outcomes for beneficiaries in all of its RSEs and products. The proposed assessment would include consideration of net investment returns, expenses and costs, insurance, and other benefits and services provided.*

Where, as part of undertaking the assessment process, an RSE licensee identifies factors that are inhibiting it delivering appropriate quality, value for money outcomes for beneficiaries, the RSE licensee would be required to put in place specific actions to address these factors".

ISA is supportive of a regime that supports better outcomes for all members, regardless of whether they are invested in a Choice or MySuper product. We understand that APRA's priority at this stage is to obtain views on fund-level operations, policy and best practice that could help shape draft prudential standards on topics such as the quality of business planning processes and the control of fund expenditures.

Individual RSEs will express their own views on these. ISA will comment further once APRA has published a discussion paper or draft standards for further consultation.

However, we want to register our concerns of immediate relevance to the processes that the Government and APRA have now initiated.

1. Implementation Framework of the "outcomes" test.

A guiding principle that has been applied in the past to the regulation of RSE licensees has been the adoption of a common approach to markets and products, unless there is clear grounds for a different approach. Where there has been a different regulatory framework applying to licensees or the products a rationale has been offered for the divergence of approach.

We note that for MySuper products the outcomes test would be established through the Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No. 1) Bill 2017 (the **Bill**), whereas for other products the outcomes test would be established through the proposed changes to the prudential standards. There seems to be no good basis for differentiating between MySuper and other products in relation to how the outcomes test is established.

APRA's operational governance proposals must be considered in light of the decision by Government to introduce a series of superannuation reforms. The Bill has explicitly limited application of the outcomes assessment in a way that excludes from the vast majority of retail products, through limiting its operation to MySuper products. Two implementation channels – with concomitant variances in methodology, weighting and factors for superannuation products -- creates confusion, will result in different levels of member protection, and will not drive positive outcomes for members.

There is little that APRA can do via prudential standards to overcome what is a fundamental policy failure by Government. Adjusting existing or adding new operational standards will not correct a fundamental problem that there is a conscious decision by Government to omit Choice products from the outcomes assessment – products in which the majority of bank-owned retail fund assets are invested and which have lower average net returns than MySuper products.

2. Assessing outcomes for beneficiaries

APRA is proposing to "*require all RSE licensees to regularly assess whether they have provided and are likely to continue to provide, quality, value for money outcomes for beneficiaries in all of its RSEs and products. The proposed assessment would include consideration of net investment returns, expenses and costs, insurance, and other benefits and services provided*."

If, as part of such a periodic assessment, an RSE identifies factors that are inhibiting it from delivering "appropriate quality" then "the RSE licensee would be required to put in place specific actions to address these factors."

ISA supports RSE licensees being required to regularly assess the outcomes they are delivering to members. The manner in which this assessment is performed will determine the efficacy of the requirement. When developing the content of the assessment in prudential standards or guidance, APRA should have regard for the following:

- The financial interest of beneficiaries must be prioritised, which necessarily requires such assessments to give priority weighting to long-term net returns.

- Trustees determine not only the choice products that are offered, but also the distribution strategy that results in members obtaining those products, and the execution of that strategy. Therefore, in assessing the member outcomes for Choice products, the trustee would need to consider not just the value-for-money of the product, but also the distribution strategy and execution of the product, to ensure the product is in the best interests of those beneficiaries who are in it.

  In practice, a trustee would need to assess: (i) the relative value-for-money of its options against substantially similar options in terms of performance, fees, and the like, and (ii) whether the trustee's distribution strategy and execution of in respect of a Choice products result in beneficiaries being in Choice products that are in the beneficiaries' financial interests.

The primacy of net returns

The sole reason for the existence of compulsory superannuation is to improve the wellbeing of retirees by providing income in retirement. Whether this outcome is being achieved is first and foremost a quantitative matter best assessed by the quantum of long term net returns fund members receive.

That particular funds may or may not offer a suite of associated services of varying quality is a secondary matter; indeed, the provision of such services is arguably only justifiable where they reasonably likely to result in higher levels of retirement income.

If net returns are accorded an indeterminate status in a compulsory outcomes assessment, the risk is that funds which deliver comparatively low net returns will evade having to take action to improve those returns (perhaps by reducing the quantum of profit they pay to a corporate parent) by instead focusing on secondary issues. Performance will remain comparatively poor and members will retire with less.

This is an entirely foreseeable pattern of behaviour and an outcome that APRA can act to prevent.

Fund-level assessment

The relative long term net returns of a fund reflect the amalgam of financial outcomes of beneficiaries, and are a result of the trustee's strategy (including the products it selects and offers, the distribution strategy, the trustee's business model, and financial relationship with third parties, including related-parties) as well as execution quality, such as manager selection.

For these reasons, among others, APRA has stated that "APRA considers that fund net ROAs [return on assets] are the best starting point from which to assess trustee performance."[1]

APRA guidance makes clear that trustees are responsible for the investment strategies of a fund (not just products) and that this responsibility persists regardless of member investment choice, including where a financial advisor is involved.[2]

APRA should therefore require a fund-level assessment of the financial outcomes of beneficiaries.

RSE licensees should be required to give first priority to assessing their long term net returns by reference to a prescribed benchmark, such as the median net returns attained by a cohort of good performing funds as reported in APRA 10 year fund performance figures.

RSEs that do not meet this benchmark should be required to formulate a detailed plan comprising actions that can be reasonably expected to improve net returns in a sustained and risk-appropriate manner.

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[1] Australian Prudential Regulation Authority, A Response to Review of APRA's Investment Performance Statistics of the Australian Superannuation Industry, September 2008 at 3

[2] See, Australian Prudential Regulation Authority, Superannuation Circular No. II.D.1 Managing Investments and Investment Choice (2006) (stating that "APRA would be concerned if a trustee held the view that a financial adviser's involvement in the member's investment choice relieved the trustee of the duty to formulate and implement appropriate investment strategies for the fund.")

A fund's financial relative performance (or underperformance) can be attributed to a range of factors such as business model, asset allocation, manager selection, and margins. But sometimes strength or weakness in these areas only tells part of the story about a trustee. This is because culture, and values such as loyalty to beneficiaries, are easily overlooked and not readily subject to financial analysis. Put another way, fund-level performance assessments, together with attribution analyses, are useful tools, but interpreting them requires consideration of non-financial aspects that influence trustee behaviour and quality. APRA should consult on requiring assessment of non-financial factors – especially culture – if a fund is found to be a relatively poor performer.

In addition to prioritising fund-level net returns, and benchmarking them as suggested above, as part of the outcomes assessment trustees should also be required to undertake a number of specific evaluations:

- Benchmarking of whole of fund net returns to asset class benchmarks based on the fund's actual asset allocations to identify the efficiency of the fund in delivering net returns to members based on the exposure to underlying assets. Such analysis would reveal potential deficiencies in investment manager selection and disclosed and undisclosed costs of investment and operational expenses;

- Whether the product's fees are appropriate to the asset allocation and investment approach being utilised;

- Whether the scale benefits that may accrue to a fund are being fully passed-on to beneficiaries;

- Benchmarking of product net returns to other products with similar fees, costs and taxes;

- Benchmarking of fees and costs to others with similar asset allocations and risk profiles;

- Benchmarking product net returns to asset class benchmarks based on the product's actual asset allocation to identify the efficiency of the product;

- Benchmarking of product net returns to system averages or naïve portfolios to ensure the product is sufficiently efficient to be a reasonable instrument of social policy consistent with system policy objectives.

ISA looks forward to working with APRA to help achieve better member outcomes.

Yours sincerely

David Whiteley

DAVID WHITELEY
CHIEF EXECUTIVE