



29 May 2018

TO: RSE LICENSEES

RELATED PARTY ARRANGEMENTS THEMATIC REVIEW

The prevalence of outsourcing in the superannuation industry and its centrality to RSE licensees' business operations makes the management of service provider relationships critical in ensuring the delivery of appropriate member outcomes. This is particularly the case where an outsourced service provider is considered to be a related party of the RSE licensee.

In 2014 APRA completed a conflicts of interest thematic review, which examined how the superannuation industry was implementing *Prudential Standard SPS 521 Conflicts of Interest* (SPS 521). APRA has recently undertaken a further thematic review specifically examining the RSE licensees' management and governance of related party arrangements. This letter provides to the industry an overview of the outcomes from the review, including areas where APRA expects to see industry-wide improvement.

The thematic review was prompted by APRA's observations of weaknesses in how some RSE licensees govern and manage aspects of their outsourced arrangements with related party service providers. These weaknesses can lead to lower quality service provision which may ultimately affect outcomes for members.

As reflected in APRA's recent proposals on strengthening superannuation member outcomes, APRA is seeking enhanced industry practices in strategic and business planning, including expense management.¹ The prevalence of related party service providers to supply key services means that these arrangements are central to delivery of member outcomes. This review, in conjunction with the board governance thematic review, complements APRA's broader prudential policy and supervisory focus on RSE licensee delivery of sound outcomes to members.

The review covered a sample of RSE licensees representing a cross-section of fund type, size and ownership structure. APRA found that for the sampled RSE licensees there have been improvements in the governance and management of related party arrangements since the conflicts of interest thematic review, with a number demonstrating effective approaches to managing related party service provider arrangements. However areas for improvement were also identified.

- The overwhelming majority of arrangements considered were of an acceptable standard in terms of legal enforceability and clearly defined services and specified prices. APRA observed a number of instances of better practice in decision making and contract management, including the use of independent analysis to appoint related party providers and assess performance.

¹ APRA Discussion Paper, *Strengthening superannuation member outcomes*, 13 December 2017.

- APRA identified areas for improvement in the management of some related party arrangements, including ensuring that contracts are for a set period, contain clear termination provisions and include clear and measurable performance indicators.
- Mixed practice was observed in RSE licensees' decision making on engaging a related party provider. Areas for improvement included the analysis of the materiality of the arrangement and being able to demonstrate that such arrangements are conducted on an arm's length basis and in the best interests of members, including through utilising rigorous market testing or benchmarking.
- For some RSE licensees, there were gaps evident in how conflicts with respect to related party arrangements were reflected in the RSE licensee's conflict management framework.
- APRA also identified instances of inaccurate and inconsistent reporting of related party arrangements under the relevant reporting forms.

Attachment A details observations and recommendations from the thematic review which are relevant for all RSE licensees to consider with a view to ensuring their related party arrangements are in the best interests of members and contributing to the delivery of sound member outcomes.

Through its supervision activities, APRA will continue to engage with RSE licensees in relation to the robustness of their policies and practices for management and oversight of related party arrangements. APRA will also, in time, consider whether amendments to the prudential framework and reporting standards are warranted.

Please contact your responsible supervisor if you wish to discuss any of the matters highlighted in this letter in further detail.

Yours sincerely,



Helen Rowell
Deputy Chairman

ATTACHMENT A - Findings

APRA undertook a thematic review of related party service provision arrangements across 2016 and 2017 in conjunction with APRA's recent board governance thematic review.² The review was prompted by APRA's supervisory identification of weaknesses in the approach by some superannuation entities to the selection and monitoring of, and outcomes from, arrangements with related party service providers.

In the sampled RSE licensees APRA did observe improvements in the governance and management of related party arrangements since the conflicts of interest thematic review conducted in 2014.³ However, there was inconsistency in practices and weaknesses in the approaches by some RSE licensees in the sample to managing related party arrangements.

APRA's approach to conducting the thematic review relied on data collected by APRA and supervisory knowledge of individual entities. The main component of the review was a detailed analysis of a sample of 14 RSE licensees' policies, procedures and past practice in the management and oversight of related party arrangements. The sample RSE licensees represented a cross-section of industry sectors, related party relationship types and services provided.

The better practices highlighted below reflect practices that APRA considers will assist RSE licensees in ensuring that their related party arrangements are in the best interests of members.

1. Contract management

A focus of the thematic review was how the sampled RSE licensees structured, monitored and enforced contracts with related parties. A robust and rigorous approach to contract management will assist in ensuring that the service provision is aligned to the delivery of sound outcomes for members.

The review found that legally binding contracts were in place for all service arrangements assessed as material, however the standard of these agreements varied across the sample of entities covered by the review. Some agreements lacked important provisions, such as termination triggers and rights, and were also open-ended in term, thereby lacking a timeframe for market testing or benchmarking the arrangement and assessing performance.

Whilst APRA observed general improvement in the use of key performance indicators in related party service contracts, there was significant variance amongst the sampled RSE licensees in the adequacy of the criteria, the reporting of performance and the options to address performance issues, including penalty provisions. APRA also noted an absence of clear termination triggers in a number of the agreements reviewed. For example, related parties providing investment management services were unlikely to be terminated for poor net performance against benchmarks; this was more likely to be managed through negotiation as long as the investment manager was adhering to the mandate (e.g. asset exposure and investment style). Better practice would be to have clear performance-based triggers for considering termination.

² APRA letter to RSE licensees, *Board Governance Thematic Review*, 17 May 2018.

³ APRA letter to RSE licensees, *Managing conflicts of interest in superannuation*, 19 March 2015.

APRA did observe better practice examples in monitoring performance, such as the use of a business-wide model to track related party service provision, including monitoring of actions undertaken to improve areas of poor performance. Additionally, other RSE licensees engaged external advisors or consultants to conduct objective benchmarking and review of the pricing and agreement terms for related party service providers.

Better practice was also observed in managing poor performance through the use of a remediation plan overseen by the audit committee and regular performance reporting by the related party service provider.

Recommendation – Contract management

1.1 That RSE licensees ensure that related party arrangements are formalised, contain clear and objective performance measurements, and appropriate termination and penalty provisions, and a fixed term for review. Reporting against the relevant measures and triggers should be timely, rigorous and subject to appropriate review and oversight by the RSE licensee.

2. Service provider benchmarking

APRA views benchmarking and market testing as essential to an RSE licensee demonstrating that the arrangements it enters into with related service providers are in the best interests of members. While this need not involve formal tendering processes in all cases, RSE licensees should have a credible process for testing whether the pricing and terms from the related party service provider are commensurate with others available in the market. Among the RSE licensees reviewed, there was clear room for improvement in this area.

Some of the sampled RSE licensees were not ensuring that their selection or benchmarking processes for related party service providers was comprehensive and rigorous. While a number of RSE licensees did engage external advisors and conduct thorough market testing, others indicated it was difficult to benchmark performance against potential alternate providers as useful and relevant data from third parties was not readily available. In a limited number of cases, RSE licensees selected a related party without having documented any comparison of alternatives. Better practice included RSE licensees actively addressing barriers in the service and contract design to ensure that the incumbent provider was not advantaged and a competitive tender could be conducted.

Recommendation – Benchmarking

2.1 That RSE licensees undertake rigorous market-based benchmarking of pricing and services prior to engaging a related party service provider, including utilising independent advice and assessment where appropriate.

3. Materiality, documentation of decision making and conflict management

Within the sample, APRA found inconsistent interpretation and application by RSE licensees of the prudential requirements in relation to related party arrangements in the key areas of:

- assessing materiality of the service provision;
- documentation of decision making on related party arrangements; and
- reflecting related party arrangements in conflicts of interest policies.

Prudential Standard SPS 231 Outsourcing (SPS 231), with supporting guidance in *Prudential Practice Guide SPG 231 Outsourcing* (SPG 231), requires RSE licensees to determine whether an arrangement is material and hence triggers the heightened prudential and reporting requirements for such arrangements.

APRA observed within the RSE licensees reviewed a wide variety of approaches to assessing materiality. For example, it was common for distribution arrangements with related parties not to be deemed material despite the strategic importance and potential conflicts of interest that arise in these relationships. APRA's expectation, as reflected in SPG 231, is that RSE licensees adopt a conservative approach where there is a level of uncertainty as to whether a business activity is material.

SPS 231 requires that an RSE licensee that has engaged an associated entity (i.e. related party) is able to demonstrate that such arrangements are conducted on an arm's length basis and in the best interests of members. APRA found mixed results in the degree to which the sampled RSE licensees documented meeting these requirements. APRA observed in some instances, particularly where the related party arrangement was long standing, that it was not clear that alternatives had been thoroughly considered and documented. This was often the case for RSE licensees that did not have comprehensive benchmarking or market testing arrangements in place.

The conflicts management framework is a central tool in managing the conflicts inherent in related party arrangements. Where directors or responsible officers of RSE licensees also hold responsible officer roles or have relationships, either directly or through family relationships, with service providers, there is likely to be an inherent conflict of interest. APRA found that while this potential conflict was reflected in a number of the sampled RSE licensees' conflict management frameworks, there were examples where the potential conflict had not been comprehensively reflected in the framework.

APRA noted better practice was for an RSE licensee to have policies in place to ensure that, where a director has a conflict they are excluded from governance of related party arrangements.

Recommendations – Materiality, documentation of decision making and conflict management

3.1 That decision-making by RSE licensees on the use of related party providers is documented, including assessing materiality and demonstrating that the arrangement is in the best interests of members.

3.2 That RSE licensees review their conflicts management frameworks to ensure they are current and appropriately reflect existing related party arrangements.

4. Data reporting

As part of the review, APRA examined RSE licensee reporting on related party arrangements. The review indicated that there is considerable inconsistency in, and varying quality of, data reported under *Reporting Standard SRS 331.0 Services* (SRS 331.0), which is APRA's primary reporting standard for RSE expenditure on related party arrangements.

SRS 331.0 requires classification of certain expenses into those with associates (the definition that captures most related party arrangements) or non-associates. Some RSEs did not accurately classify services with a related party as being with an associate, or incorrectly reported the services provided by the associate. These data quality issues inhibit APRA's ability to efficiently and effectively assess any prudential concerns that may arise in relation to related party arrangements.

In some cases, the quality of reporting may be the result of uncertainty about how the definition of 'associate' should apply to certain arrangements. APRA is considering potential amendments to SRS 331.0 as part of the current member outcomes reforms and will consider further guidance, where necessary, to assist application of the definition of associate in the prudential and reporting frameworks.⁴

Recommendation – Data reporting

4.1 That RSE licensees review their processes for ensuring that arrangements with related party service providers are accurately reported as 'associates' on the relevant reporting forms and consistent with the reporting form guidance.

⁴ APRA Discussion Paper, *Strengthening superannuation member outcomes*, 13 December 2017.