

29 May 2019

Ms Heidi Richards
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By email: superannuation.policy@apra.gov.au

Dear Ms Richards

Industry Super Australia (**ISA**) appreciates the opportunity to provide comment on the draft Prudential Standard SPS 515 Strategic Planning and Member Outcomes (**draft SPS 515**) released by APRA on 29 April 2019.

Summary

The passing of the Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No.1) Bill 2017 (**Bill**) into law on 4 April 2019 amended the Superannuation Industry (Supervision) Act 1993 (**SIS Act**) by adding additional covenants relating to regulated superannuation funds annual outcomes assessment.

The amendments to the SIS Act mean that the current Prudential Standard SPS 515 Strategic Planning and Member Outcomes does not accurately reflect the new law and requires revision. The SIS Act amendments, together with the proposed Superannuation Industry (Supervision) Regulations 1994 (**Regulations**) (amendments yet to be released for consultation) and the prudential standards need to be considered collectively in order to ensure an appropriate and effective outcomes assessment regime is created.

APRA has commenced its consultation on draft SPS 515 and in summary has stated that the purpose of issuing the draft SPS 515 is to (amongst other things):

1. Secure alignment with legislated outcomes assessment and to avoid industry uncertainty.
2. Clarify how the legislated outcomes assessment interacts with the APRA requirements.
3. Specify additional factors to be addressed.

ISA has a significant concern that the release of draft SPS 515 pre-empts the release of Regulations which, amongst other things, are expected to set out the benchmarks which determine whether the financial interests of the beneficiaries are being promoted by the RSE licensee. By releasing the draft SPS 515 now, it is impossible to determine whether the draft SPS

515 is appropriate and covers all relevant matters to enable an appropriate and robust comparison exercise, as was envisaged by the amendments to the SIS Act¹.

In addition to the pre-emptive release of draft SPS 515, the draft contains significant flaws:

1. it fails to prioritise the promotion of the financial interests of beneficiaries. It does this by not requiring that an RSE licensee attach greater weight to net returns than the other factors to which it must have regard to, as required by sections 52(10) or (10A) of the SIS Act when determining (and documenting) the methodology it applies in undertaking its annual outcomes assessments; and
2. it fails to provide an objective assessment framework and instead provides a subjective framework which is open to self-serving manipulation by trustees. This would in effect dilute the intent of the Bill. The member outcomes assessment should instead be based on objective criteria.

ISA's submission focuses on the key concerns mentioned above and highlights some additional concerns with the current draft SPS 515. Importantly, given that this consultation is occurring in the absence of crucial information, it is likely further consultation and amendments will be required to the draft SPS 515 after the release and finalisation of the Regulations.

1. Pre-emptive release of draft SPS 515

ISA is a strong supporter of ensuring member outcomes are at the forefront of trustee's and regulator's minds. Providing for member best interests is central to ISA's advocacy efforts. In support of ensuring members interests are protected and promoted it is vital that the legislative and regulatory regime setting out the legal responsibilities of those who are entrusted to serve member interests is well thought out and avoids ambiguity or opportunities for distorted outcomes.

In April 2019, new covenants were introduced in the SIS Act relating to annual outcomes assessments. These covenants are intended to improve member outcomes by promoting the financial interests of members. The new covenants, together with appropriate Regulations and prudential standards have the potential to create a strong member outcomes regime. However, unless the new covenants, proposed Regulations and proposed prudential standards align there is a real risk that they will fail to operate in members' best interests.

To this end, it is premature to release for consultation (and/or finalise) draft SPS 515 before the Regulations in relation to the SIS Act amendments are released and finalised. It is unclear how anyone can be certain that the draft SPS 515 aligns with the legislative regime and where necessary covers matters that need to be addressed to ensure that the member outcomes regime best services members. It would be reckless to create a regime that does not ensure members are being served by good quality funds. In order to have meaningful comparisons which help determine which funds are good quality funds, the member outcomes regime needs to be objective and robust.

While the draft SPS 515 is a positive step towards strengthening the member outcomes assessment and includes positive initiatives, in the absence of finalised Regulations, it is at risk of being incomplete, ambiguous and misaligned with the intention of the outcome assessment regime. Given the importance of the outcomes assessment regime it is vital that we do not leave

¹ See Section 10 and section 10(A) of the SIS Act.

room for divergent approaches to be adopted. One way to achieve consistency is to provide for detailed rules and a standardised assessment regime based on objective criteria. Unfortunately, the draft SPS 515 is at risk of failing to deliver a robust and objective regime.

ISA Recommendation

That draft SPS 515 be **deferred** for finalisation until:

1. the final Regulations are adopted; and
2. industry and consumer groups have had the opportunity to consider the member outcomes assessment holistically, including the proposed Regulations and draft SPS 515.

2. Annual outcomes assessment

Below we outline concerns with the draft SPS 515 in its interactions with the annual outcomes assessment.

(a) Net returns not given prominence

The overarching objective of the superannuation system is to support the financial wellbeing of retirees. Generating good retirement outcomes over time is why the products exist. Members expect their superannuation fund to make every reasonable effort to provide a retirement benefit that will contribute to supporting a comfortable standard of living. The objective of promoting the financial interest of members, from a member perspective and from a trustee's point of view, must give priority to achieving strong long-term net returns.

Draft clause 20(a)

Relevant to SPS 515 draft clause 20(a) SIS section 52(9)(a)² which states:

*'to determine, in writing, on an annual basis, for each MySuper product or choice product offered by the entity, whether the **financial interests of the beneficiaries** of the entity who hold the product are being promoted by the trustee.....' [Emphasis added]*

In undertaking its outcomes assessment draft clause 20(a) requires an RSE licensee to, at a minimum, document the relative weight given by it to the SIS section 52(9) factors to which it must have regard in making that determination. The relevant factors are stated in sections 52(10) of the SIS Act for MySuper products and (10A) for choice products. They are the fees and costs that affect the return, the return for the MySuper product (after the deduction of fees, costs and taxes), the return for choice products³, the level of investment risk and any other matter specified in the prudential standards.

Draft clause 20(a) is silent as to the weight an RSE licensee should ascribe to each factor to which it must have regard. This level of discretion will inevitably undermine the robustness of any comparisons, enabling the RSE licensee to weight factors in a manner to justify products that would be regarded as substandard if net returns were prioritised.

² Sections 52(11) & (12) similarly refer to whether the financial interests of the beneficiaries are being promoted by the trustee.

³ Which is silent as to whether the return is after the deduction of fees, costs and taxes or before.

ISA submits that whilst factors other than net returns as required by SIS sections 52(10) or 52(10A) should be considered and are important, the greatest weight should be given to net returns over a period of 10 years, or the life of the product if it has existed for less than 10 years. Minimum time periods are necessary because some products can appear to have high net returns over the short-term because of positive bounces in listed markets yet perform poorly over longer periods.

If an RSE wishes to assert that factors other than net returns should have equal or greater weight, they should be required to provide evidence in support of this view. In any case, by failing to give priority to net returns an RSE licensee will be in breach of the new SIS subsection 52(12) which provides that the covenants referred to in subsection (1) include a covenant by each trustee *'to promote the financial interests of the beneficiaries of the entity who hold a MySuper product or a choice product, in particular returns to those beneficiaries (after the deduction of fees, costs and taxes).'*

The primacy of net returns was clearly parliament's intention as reflected in second reading speeches in support of the Bill and the Explanatory Memorandum. Similarly, the Productivity Commission and Royal Commission reports endorsed the view that securing strong long-term net returns should be a priority for trustees.

Parliament's Intention

In her second reading speech in support of the Bill, Shadow Minister for Financial Services, Ms O'Neil said:

'The major feature of this bill is the member outcomes test, which would require trustees to assess on an annual basis whether the outcomes that have been delivered by their products are promoting the financial interests of the members. It's a pretty straightforward thing⁴.

Similarly, Mr Thistlewaite speaking in support of the Bill stated:

*'Labor's amendments have ensured that the annual MySuper outcomes assessment gives **priority to net returns to members**, that provision of the bill covers choice products as well as MySuper products....⁵ [Emphasis added]*

Finally, the Assistant Treasurer, Mr Robert in commending the Bill to the House said:

'Schedule 1 creates a requirement for both MySuper and choice products to consider the appropriateness of their product on an annual process via the new outcomes test. It also creates an obligation on all trustees to promote the financial interests of members⁶.

⁴House of Representatives Hansard, Thursday 4 April 2019, page 3

⁵ Ibid page 4

⁶ House of Representatives Hansard, Thursday 4 April 2019, page 8

The Supplementary Explanatory Memorandum to the Bill states inter alia:

*'The new obligation that the trustee 'promote the financial interests' of beneficiaries reinforces and builds upon the existing trustee obligation to act in the best interests of beneficiaries⁷ and 'The framework for the outcomes test endeavours to support the trustee's primary obligation to promote the financial interests of their members, in particular the **net returns to those members**⁸. '[Emphasis added]*

The Productivity Commission Inquiry Report

In its final report into assessing the efficiency and competitiveness of the superannuation system the Productivity Commission stated that:

*'**Delivering investment returns** to members (net of all fees and taxes) is the most important way the system contributes to delivering the best possible retirement outcomes⁹. '[Emphasis added]*

and that:

'The most relevant outcome for members is the returns they receive after taxes and fees¹⁰.'

These most recent statements reiterate the Commission's previously stated position that:

'Maximising net returns (after fees and taxes) is the most important way in which the superannuation system contributes to adequate and sustainable retirement incomes¹¹.'

The Royal Commission

In discussing governance, regulation and supervision of superannuation funds, Commissioner Hayne said:

'Proper governance of a fund is critical to the fund's performance. That is, proper governance is necessary in order to fulfil the basic promise of a superannuation fund that the trustee will administer the fund in the best interests of members, and in particular, the best financial interests of members¹².'

Making the point that the strong performance of superannuation funds is important not only to members but to society as a whole, he stated:

'Superannuation performance directly affects the public purse by reducing the call on social security payments and other public welfare measures....¹³'

⁷ Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No.1) Bill 2017 Supplementary Explanatory Memorandum 2016-2017-2018-2019 page 7

⁸ Ibid, page 8

⁹ Productivity Commission Inquiry Report, Superannuation: Assessing Efficiency and Competitiveness, 21 December 2018 page 108

¹⁰ Ibid page 109

¹¹ Productivity Commission How to access the Competitiveness and Efficiency of the Superannuation System, November 2016 page 7

¹² Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Volume 1 page 264

¹³ Ibid, page 256

While not explicitly referring to a fund's net returns, it is implicit in Commissioner Hayne's commentary that members' net returns should take priority over all other factors to which a trustee should have regard.

A trustee's common law fiduciary duty to act in the members best financial interests

In considering a trustee's fiduciary duty to act in members best interests the common law has considered whether this duty boils down to members financial best interests.

Various cases have considered the meaning of a trustee's duty to act in the "best interests of the beneficiaries", and specifically whether acting in the best interests of members distils into acting in their best financial interest.

The English case *Cowan v Scargill* [1985] Ch 270 is the seminal authority, and clearly elevated financial interests above others in the pension fund context:

*'The starting point is the duty of trustees to exercise their powers in the best interests of the present and future beneficiaries of the trust, holding the scales impartially between different classes of beneficiaries. This duty of the trustees towards their beneficiaries is paramount. They must, of course, obey the law; but subject to that, they must put the interests of their beneficiaries first. When the purpose of the trust is to provide financial benefits for the beneficiaries, as is usually the case, the best interests of the beneficiaries are normally **their best financial interests**'¹⁴. [Emphasis added]*

*'In particular, the trustees of a pension fund are subject to an overriding duty to do the best they can for the beneficiaries...'*¹⁵

Some RSE licensees may argue that they are not seeking high option level net returns, but instead are positioning their products as 'luxury' or 'platinum service' offerings. Some RSE licensees may also assert that some cohorts of its members are best served by more conservative asset allocations and hence lower net returns. These positions are not only contrary to a trustee's common law fiduciary duty to act in members' best financial interests but also new SIS subsection 52(12).

ISA Recommendation

Clause 20(a) should reflect the law, and prioritise financial interests, evidenced by long term net returns above other possible "benefits", by requiring that the methodology used in an RSE licensee's annual outcomes assessments attach the greatest weight to long term net returns to members.

(b) Misalignment with the choice outcomes test

Draft clause 20(b)

As it is currently drafted clause 20(b) requires an RSE licensee to document how it has determined the comparable choice products under the SIS Regulations when undertaking its annual outcomes assessment. This draft clause presupposes that the SIS Regulations will permit an RSE licensee such discretion and is therefore pre-emptive.

As noted previously, SIS sections 52(9) (i) and (ii) require comparisons between MySuper and choice products with any other benchmarks specified in the Regulations. Not mandating the

¹⁴ *Cowan V Scargill* [1985] Ch 270 at 286-287

¹⁵ *Ibid* at 292

indicators to which an RSE licensee must have regard in its annual outcomes assessment allows an RSE licensee too much discretion to determine its comparator choice product/s and, if permitted, has the potential to undermine and make ineffective any such comparisons. This discretion risks trivialising the outcomes assessment for choice products. Instead choice products (just as MySuper products are) should be compared to benchmarks which reflect their asset allocation¹⁶.

Moreover, an effective comparison of choice products will necessarily need to occur at the choice investment option level so that like for like comparisons can be made. For example, the trustee should be required to compare cash investment options available to choice members with similar cash investment options available to choice members in other funds.

Additionally, APRA should make it clear that in relation to comparing a choice options/product with other choice options/products, in comparing the return for the choice options/products trustees should do so after the deduction of fees, costs and taxes.

ISA Recommendation

1. Finalisation of draft clause 20(b) be deferred until the SIS Regulations are adopted.
2. Draft clause 20(b) should be drafted to reflect an objective framework.
3. Comparisons for choice products should occur at the choice investment option level so that like for like comparisons can be made.
4. Comparing the return for the choice options/products should be done after the deduction of fees, costs and taxes.

(c) Operating costs

Draft clause 21(b)

Clause 21(b) requires an RSE trustee to assess whether its operating costs 'inappropriately affect the financial interests' of members.

It is unclear why the draft only requires assessment of a fund's operating costs, a term which is not defined in any relevant legislation (or Regulations)¹⁷. While the concept of operating expenses, or similar, have been referred to by APRA in its publications, there is a need to define the term in this context. Otherwise, an RSE licensee will be able to determine what is and what is not an operating cost for the purposes of its assessment thus enabling an RSE licensee to selectively choose those costs that show its operating costs do not inappropriately affect members' financial interests.

Other costs are incurred by superannuation funds to administer and manage members' retirement savings including investment costs, which cover direct and indirect investment management costs, custodial costs, asset consultant costs as well as general administration costs and advice costs. The cumulative effect of all these costs are ultimately what determines

¹⁶ ISA's submission dated 29 March 2018 on APRA's Strengthening member outcomes consultation package provided examples of option level based comparable options at page 7.

¹⁷ Transactional and Operational costs are defined Schedule 10 of Corporations Regulations, paragraph 103 and apply solely to investment transactions.

whether the RSE licensee's business operations inappropriately affect the financial interests of beneficiaries.

ISA Recommendation

That draft clause 21(b) be amended to clearly articulate what is included in the term operating costs to which an RSE licensee must have regard when assessing whether these costs inappropriately affect the financial interests of members.

3. Business performance review

ISA welcomes the inclusion of the requirement that an RSE licensee must undertake an annual performance review to determine whether it has achieved its strategic objectives and provide the results of that review to its board.

Currently SPS 515 requires an RSE licensee to obtain board approval of its strategic objectives and maintain a written business plan that sets out the planned approach for their implementation. It is one thing for an RSE licensee to be required to develop and obtain board approval of its strategic objectives and have a business plan setting out its approach to implementing those objectives – but quite another to undertake a review of them. By requiring an RSE licensee to undertake an annual performance review of its business plan this current shortcoming in the current SPS 515 is addressed. Importantly, the changes will require an RSE licensee to holistically determine whether it has achieved its strategic objectives and use the outcome of its review to report the results to its board and make any necessary changes to its business operations.

Clause 14 of draft SPS 515 requires that the annual business performance review analyse performance against strategic objectives. However, there is need for refinement to this initiative as set out below.

Draft Clause 14(a)(ii)

This requires, amongst other things an analysis of an RSE licensee's performance in achieving its strategic objectives having regard to the outcomes achieved for *different cohorts* of beneficiaries (such that all beneficiaries are covered), *relative* to the outcomes sought, and against *objective benchmarks*.

The limitations with this requirement are as follows:

1. Cohorts – if the term “cohorts” is not defined trustees will be able to apply the term differently and allow some participants to game the system to meet their interests rather than those of members. There should not be significant flexibility in how “cohorts” are defined or treated. If the intention of “different cohorts” is to differentiate between MySuper and choice members and/or accumulation and pension members, then this should be made clear.
2. Relativity of outcomes- relativity allows for trustees to set outcomes which are less ambitious and easier to achieve, resulting in a misalignment of the objective of the outcomes assessment test. It follows that objectives must clearly align with the broader benchmarks.
3. Benchmarks – it is unclear whether the objective benchmarks in this context relate to the proposed benchmarks in the Regulations or some other trustee determined benchmarks. No reason(s) has been provided as to why these benchmarks should be different from those

specified in the Regulations regarding the comparative analysis. If they are intended to be different then this needs to be clearly articulated.

ISA Recommendation

That draft clause 14(a)(ii) be amended to provide an RSE licensee with greater clarity about:

1. What is meant by the term “cohorts” or at least rules around formulation of cohorts should be clearly articulated.
2. What are the range of outcomes being sought and that any outcomes should align to the benchmarks in the Regulations.
3. Confirm that the relevant objective benchmarks are determined by the Regulations.

Conclusion

If the intention is to have a member focused approach and an appropriate member outcomes assessment regime, then it is imperative that the SIS Act, proposed SIS Regulations and prudential standards be considered holistically. Revising SPS 515 is a positive initiative but it is premature and needs to be deferred until the Regulations supporting the SIS Act amendments are finalised. Above, we have highlighted some proposed revisions to SPS 515 but in order for the assessments regime to become a useful and meaningful regime the Regulations must be finalised.

Should you wish to discuss any of the above I can be contacted on [REDACTED]

Yours sincerely

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Litsa Tsitsis
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