Superannuation Industry Trends 2020

February 2020

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2019 – A YEAR IN REVIEW

- Fees and Costs (RG97)
- Product Design
- Productivity Commission
  - Low Balance Members
  - Member Outcomes (SPS 515)
    - Business Performance Review
    - APRA Heatmap
- Royal Commission
  - Grandfathered Commissions
  - Sole Purpose (hawking, treating)
  - Responsibility And Accountability
- Retirement Income Review
  - Adequacy, Equity, Sustainability, Cohesion

2020 – KEY THEMES

Consolidation	Business & Strategic Planning	Culture & Governance
Climate Change	Retirement Income Review	Transparency

Consolidation

CONSOLIDATION – BACKGROUND

- APRA has been clear that one of its key priorities will be improving member outcomes in superannuation, which includes maintaining its focus on cleaning up the *"unsustainable and underperforming tail of the industry"*
- Funds with a large proportion of low balance, inactive members will be negatively affected by requirement to transfer these members to the ATO
- Throughout 2019, we have seen the beginning of a transformation of the superannuation industry, with a shift towards mergers and joint ventures observed
  - We expect this to be a ongoing trend in 2020 as the regulatory and political landscape continue to shift in favour of consolidation
- Merger activity announced *(status)*[1]
  - Statewide, Tasplan and WA Super *(not proceeding)*
  - Tasplan & MTAA *(in progress)*
  - First State Super & VicSuper *(in progress)*
  - Hostplus & Club Super *(complete)*
  - Equipsuper and Catholic Super – joint venture *(complete)*
  - Sunsuper & QSuper *(in discussion)*

1. Based on publicly available information

CONSOLIDATION – ACTION ITEMS

What practical steps can RSE licensees consider?

- ✓ We think it is important for Funds to think about their competitive strengths. It should not be a question of size or scale necessarily, often small to mid-sized funds have their own unique and powerful competitive advantages
- ✓ When considering potential merger partners, having aligned investment beliefs will be key. Unaligned beliefs will result in higher consolidation costs, as assets are bought and sold
- ✓ Investment design will also be important, especially for the MySuper/default option. Considerations include:
  - Lifecycle or single default
  - Fees charged to members
  - Level of investment risk, growth/defensive ratio
  - Strategic asset allocation and use of dynamic asset allocation
  - Investment manager selection (active/passive, liquid/illiquid)

Business & Strategic Planning

BUSINESS & STRATEGIC PLANNING – BACKGROUND

- In early April 2019, the Superannuation Industry (Supervision) Act 1993 was amended to replace the MySuper scale test with an annual outcomes assessment. The Member Outcomes Reforms are centred around ensuring the financial interests of members are being promoted
- The aim of the Members Outcomes Reforms is to instil Trustees with a more strategic focus – there is no right or wrong approach. The reforms are about setting the bar higher, elevating the use of meaningful metrics and putting a firmer focus on outcomes for members and organisational efficiency
- The requirements of APRA's new prudential standard SPS 515 Strategic Planning and Member Outcomes came into force on 1 January 2020. This new standard, amongst other things, requires Trustees to undertake a Business Performance Review (BPR), which includes results of the new legislative outcomes assessment
  - The outcomes assessment provides a point-in-time picture
  - The BPR is intentionally designed to be forward-looking
  - The outcomes assessment and the BPR are intended to be complementary
- The BPR is effectively a self-assessment and a demonstrated understanding of the Fund's performance and its relative success in the market
  - APRA supervisors will be seeking an understanding of each fund's proposed design and plans for the timing of their first BPR, required to be undertaken by 31 December 2020 (funds are encouraged to complete a trial BPR prior to this date)

BUSINESS & STRATEGIC PLANNING – BACKGROUND

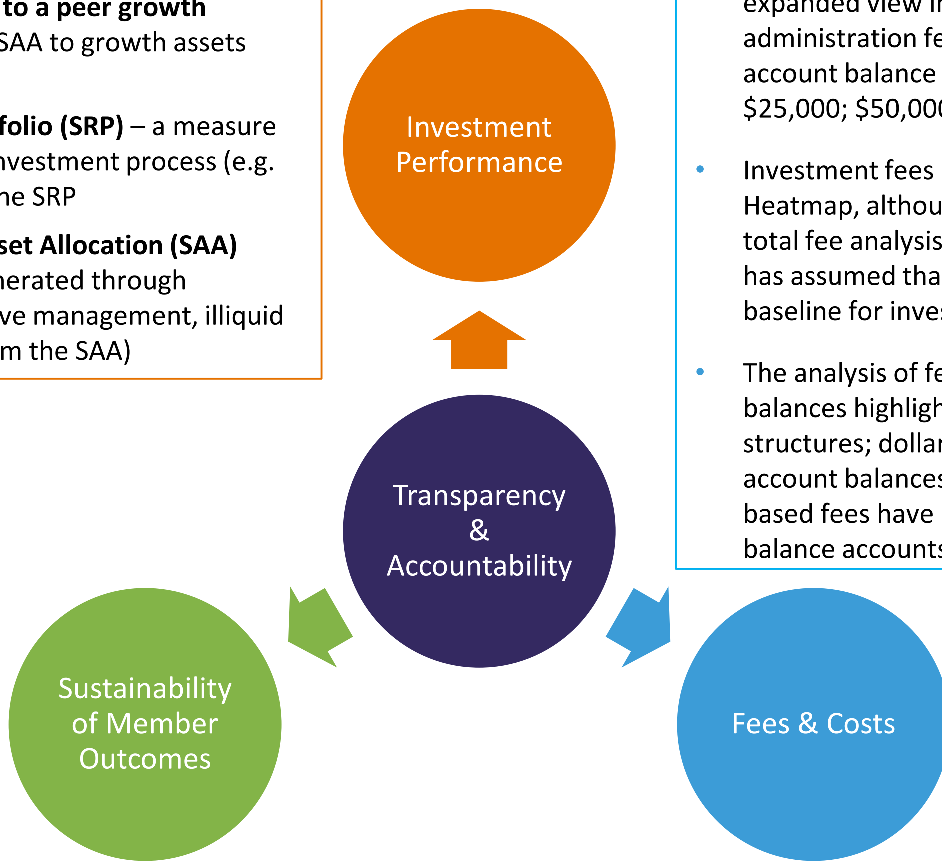
- The new MySuper Heatmap is one element of the Members Outcomes Reforms package. The Heatmap uses a graduating colour scheme to indicate how a Fund's MySuper Option fares across investment performance, fees and costs and sustainability. Over time, this will be expanded to cover Choice Options and an assessment of insurance-related member outcomes

Rationale	• Improve transparency • Provide stakeholders with insights about the outcomes delivered - in a way that is comparable across all MySuper products
Intended audience	• Wide range of stakeholders; including policymakers, advisors and employers. Results will be released publicly
Measurement	• Outcomes delivered on a relative basis, compared to peers and benchmarks, across three key areas; investment performance, fees and sustainability
Potential implications	• Increasing peer focus • Benchmark herding risk • Short-term focus for investment strategy

BUSINESS & STRATEGIC PLANNING – BACKGROUND

- There are three measures of investment performance used. The concise Heatmap only uses five year returns. The expanded Heatmap includes both three and five year periods
  - **Net Investment Return (NIR) compared to a peer growth allocation trend line** (based on average SAA to growth assets over a specified timeframe)
  - **The NIR versus a Simple Reference Portfolio (SRP)** – a measure of overall value generated through the investment process (e.g. strategic asset allocation) compared to the SRP
  - **The NIR relative to a Listed Strategic Asset Allocation (SAA) benchmark** – a measure of the value generated through implementation of the strategy (e.g. active management, illiquid investments and decisions to deviate from the SAA)

- The Heatmap will outline three metrics which APRA believes are likely to impact sustainability of member outcomes over a three year rolling average basis and includes:
  - **Total Accounts Growth Rate:** a measure of the member growth rate
  - **Net Cash Flow Ratio:** a measure of overall growth in member benefits
  - **Net Rollover Ratio:** amounts transferred between different RSE's. It is a measure of the ability of the RSE to attract and retain members



- The Heatmap (concise view) will include metrics for administration fees and total fees for $10,000 and $50,000 account balances. The expanded view includes metrics for administration fees and total fees for a range of account balance levels, including $10,000; $25,000; $50,000; $100,000; and $250,000.
- Investment fees are not an explicit metric of the Heatmap, although they are incorporated in the total fee analysis. It appears evident that APRA has assumed that 0.80% p.a. is a reasonable baseline for investment related fees
- The analysis of fees for different account balances highlights the impact of different fee structures; dollar-based fees impact low account balances more heavily; and percentage-based fees have a greater impact on high balance accounts than dollar-based fees

BUSINESS & STRATEGIC PLANNING – BACKGROUND

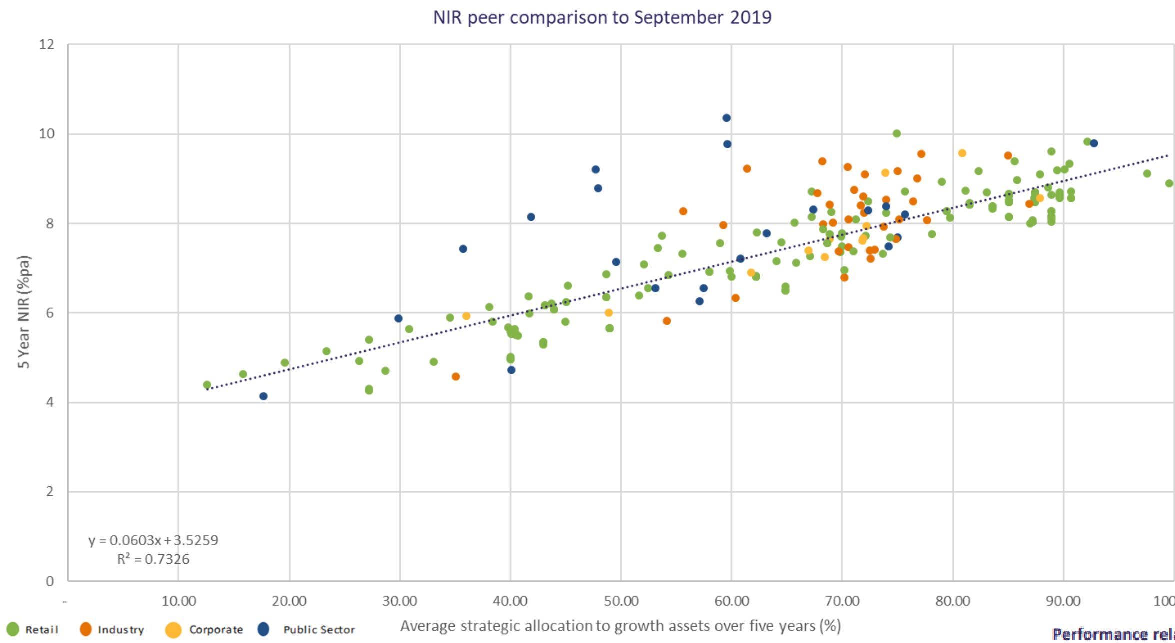
- We have identified some limitations to the Heatmap in its current form that provide fruitful areas for future improvement, we summarise these below

APRA has indicated that it is choosing to "call out underperformers" via the public reporting of the Heatmap results	This could risk instability for individual funds and a further erosion of trust in the system, at least in the short term
The Heatmap approach is predicated on the idea that funds which will underperform in the future can be identified based on past performance	As we have explored previously, identifying persistently underperforming funds accurately is a challenging task. Our view has been that a robust assessment across a wide variety of factors is needed. In relation to investment performance, we believe this requires measurement across multiple time periods and consideration of the level and nature of investment risk. (In contrast, ASIC warns of the risks of relying on past performance as an indicator of future performance)
The Heatmap measurement period is impacted by when MySuper was incepted (in 2013/14)	The inclusion of five years is a positive development relative to the prior three-years based outcomes test. However, it is shorter than preferred for the assessment of long-term investment strategies. This limits the ability of the Heatmap to identify real, long-term persistent underperformers. It may also lead to an increase in the use of short term and peer aware strategies
There is a reliance on a simple growth/defensive classification to proxy investment risk and on SAA settings across multiple metrics	While we view the addition of risk adjustment into peer assessments positively as a principle, the Heatmap does not sufficiently address the multi-faceted nature of investment risk. This reduces the collective robustness of the investment performance Heatmap component. The reference portfolio specification also adds an additional dimension to risk management that funds may seek to manage

- The Heatmap risks downplaying the benefits of more robust portfolios by focusing attention on short term returns, listed market relative risk and peer-oriented framing of risk. We would not like to see these issues reduce the willingness or ability of funds to implement differentiated long term investment strategies that leverage their specific competitive advantages for the benefit of members

BUSINESS & STRATEGIC PLANNING – BACKGROUND

- Frontier has undertaken initial analysis on the Heatmap metrics, with a particular focus on the investment performance metrics
  - This is an area we continue to further develop to assist our clients, including the recent addition of our "Heatmap Calculator"



Performance relative to Peer trend line	Proportion of Fund Options	
	Five Years	Three Years
Exceeds	38%	48%
Trails < 0.38%	34%	21%
Trails > 0.38% but <0.75%	15%	19%
Trails > 0.75%	13%	12%

Source: APRA September 2019 data, Frontier calculations

BUSINESS & STRATEGIC PLANNING – ACTION ITEMS

What practical steps can RSE licensees consider?

- ✓ Consider what quantitative and qualitative (internal and external) data your fund needs and how you will go about obtaining it (noting the focus on demonstrating a comprehensive understanding of the membership)
  - APRA is currently underway in its multi-year project to upgrade the breadth, depth and quality of its superannuation data collection. This initiative aims to drive better industry practices and improve member outcomes by significantly enhancing the comparability and consistency of reported data
- ✓ Complete a trial business performance review (BPR) before the 31 December 2020 due date
  - The BPR is the performance narrative for the Fund. It should show genuine consideration of performance against various objectives and agreement of areas for improvement. The Heatmaps provide one source of data but the Fund will need to consider other metrics (e.g. cohort analysis)
- ✓ Consider your BPR communication strategy and how you will present the results to your members ahead of time. The 2020 due date is about getting the data and approach finalised – funds will need to publish the BPR results by February 2021
  - The publication should be clear, concise and in plain English
- ✓ Ensure, going forward, that the most recent BPR is considered by the Board when setting/reviewing its objectives or revising its business plan
  - Both the BPR and the outcomes assessment are encouraged to be a process of continual improvement

Culture & Governance

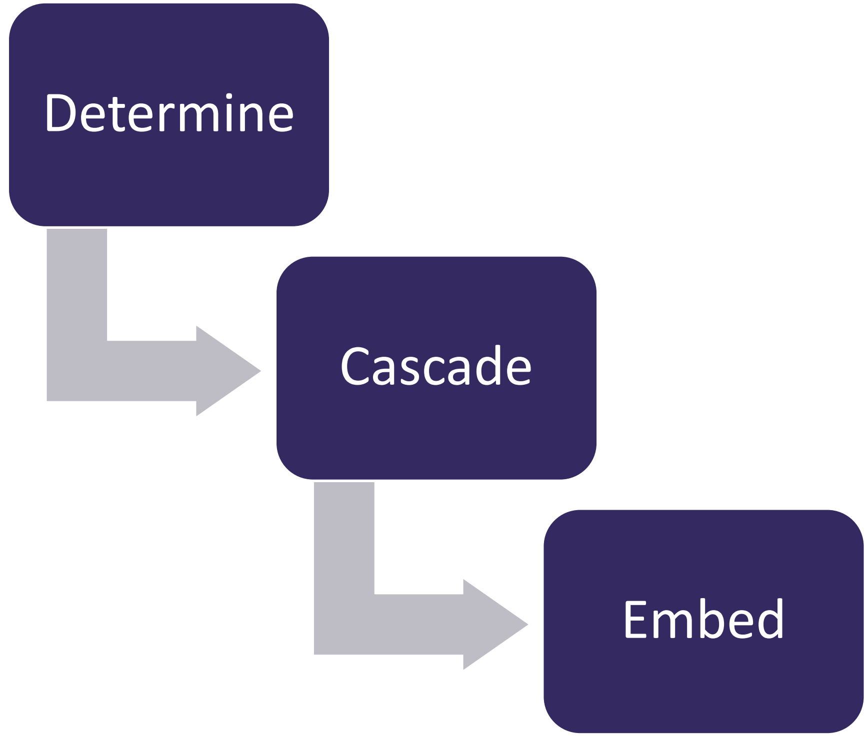
CULTURE AND GOVERNANCE – BACKGROUND

- The 2018-19 Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry and the prudential inquiry into the Commonwealth Bank of Australia highlighted that the health and reputation of a regulated entity (and hence the outcomes it delivers) can be seriously damaged by weak leadership, misaligned remuneration structures, and/or a lack of accountability for operational or other failings
  - APRA's more intensive approach to Governance, Culture, Remuneration and Accountability (GCRA) is in response to recommendations from the Royal Commission
- Poor governance, remuneration structures and accountability mechanisms, leading to and reinforcing a poor risk culture, can undermine the prudential soundness of an entity and the outcomes for its customers
- Key attributes of APRA's GCRA approach are:
  - **Strengthening the prudential framework** (e.g. remuneration and risk management) – incorporating the wider use of governance declarations and self-assessments
  - **Sharpening its supervisory focus** - by increasing its internal resourcing and capabilities; adopting new tools to make such assessments; and holding entities more forcefully to account when deficiencies are identified
  - **Sharing insights** to better inform both the boarder industry and the public about APRA's work, promote better GCRA practices, and drive increased accountability amongst boards and management

"Lifting GCRA practices was an essential step in restoring community trust and confidence in the financial system" – John Lonsdale, Deputy Chair, APRA

CULTURE AND GOVERNANCE – WHAT TO EXPECT

- Expect to see **MORE**
  - More intensive supervision of GCRA (more frequent and deeper engagement)
  - More prescriptive set of GCRA-related regulatory requirements
  - More public scrutiny (through greater sharing of APRA's findings and observations)
- The intended outcome is to drive genuine change across the industry
  - ✓ Strong governance frameworks and process (with robust oversight)
  - ✓ Understand and enable risk culture that supports effective risk management practices
  - ✓ Remuneration arrangements that reflect a holistic performance and risk management assessment (and reduced incentive for misconduct)
  - ✓ Clear individual and collective accountability for outcomes



APRA has noted, amongst its 2020 priorities includes, *"conducting a range of GCRA-related supervisory reviews and deep dives, and using entity self-assessments to drive greater accountability"*

Climate Change

CLIMATE CHANGE – BACKGROUND

What are the SIS Act requirements?

- *"The SIS Act requires an RSE licensee, when formulating an investment strategy, to give regard to the risk and the likely return from the investments, diversification, liquidity, valuation and other relevant factors. An RSE licensee may take additional factors into account where there is no conflict with the requirements in the SIS Act, including the requirement to act in the best interests of the beneficiaries. This may result in an RSE licensee offering an 'ethical' investment option to beneficiaries to reflect this approach"*

What are APRA's expectations?

- In 2017, APRA first signalled that rather than viewing climate risks as a future and non-financial problem, it made clear that some climate risks are distinctly financial in nature and more immediate
- There is growing acceptance that climate change related (CCR) risks and opportunities can potentially have direct financial impacts on items on balance sheets and in income statements. In recognition of this, there is also growing acceptance that climate change needs to be considered as part of an investor's forward-looking analysis
- For APRA regulated entities, the consideration of CCR risks and the implementation of mitigation and management policies is now expected, rather than optional. In due course, APRA expects to see more sophisticated scenario based analysis of climate risks

CLIMATE CHANGE – ACTION ITEMS

- In 2019, APRA published an information paper that detailed the results of its first climate change financial risk survey of regulated entities. The paper also included a stocktake of actions and initiatives underway in Australia and internationally in response to growing awareness of the physical, transition and liability risks of climate change
  - Industry leadership and engagement will be critical in developing innovative options that industry and regulators can draw upon in their efforts to better understand and address climate-related financial risks
- In 2020, one of APRA's supervision priorities includes *"more closely assessing institutions' capability to deal with emerging and accelerating risks, such climate change"*
  - To encourage regulated entities to better prepare for climate risks and clarify regulatory expectations, APRA intends to publish a prudential practice guide. This guidance will assist entities in developing frameworks for the assessment and monitoring of climate-related risks, including aspects of governance, strategy, risk management, metrics and disclosure. **Consultation is expected to commence in mid 2020**

What practical steps can RSE licensees consider?

✓ Consider your ESG/climate change-related investment beliefs. Have they been established? Are they formally documented? Are they still current/relevant?

✓ Consider how the ESG/climate change-related investment beliefs link to the investment strategy

Retirement Income Review

FRONTIER ADVISORS

RETIREMENT INCOME REVIEW – BACKGROUND

- In September 2019, as recommended by the Productivity Commission, the government commissioned an independent review of the retirement income system. The review will report to the Government by June 2020, but will not make any recommendations
- The review will establish a fact base of the current retirement income system. It aims to identify:
  - How the retirement income system supports Australians in retirement
  - The role of each pillar (age pension, superannuation and voluntary savings) in supporting Australians through retirement
  - Distributional impacts across the population and over time
  - The impact of current policy settings on public finances
- The review invited submissions on the issues and material it should examine in establishing the “fact base” that will help improve understanding of the retirement income system and the outcomes it is delivering. Importantly it is seeking not just views, but supporting evidence for any views expressed in submissions
- It has identified four principles it proposes to use to assess the performance of Australia’s retirement income system – adequacy, equity, sustainability and cohesion
- The review will seek to establish evidence to assess how the system performs against each of the principles, as well as where trade-offs exist between them

RETIREMENT INCOME REVIEW – PRINCIPLES

Principle	Description	Frontier Key Issues
Adequacy	Whether the system allows for Australians to achieve an adequate standard of living in retirement	• Increasing SG rate to 12%
Equity	Whether the system produces fair outcomes for different groups of Australians	• Gender disparity • $450 threshold • Targeted tax concessions
Sustainability	Whether the system is able to continue to meet its objectives into the future and maintain broad community support	• Agreeing an objective • Aging population
Cohesion	Whether the incentives across the system reinforce or conflict with the system's objectives both before and during retirement	• Age Pension taper rate

Next steps?

✓ Keep a watching brief

✓ For now, retirement product design continues to be a challenge for individual funds to develop/evolve

Transparency

TRANSPARENCY – BACKGROUND

- Transparency is a critical input for the sustainability of superannuation funds and the integrity of the broader retirement system
- Enhanced transparency in the superannuation industry will come from
  - Enhanced superannuation data collection (greater coverage, enhanced consistency and better quality data)
  - Greater transparency from the regulator on the industry's operations, performance and deliver of outcomes
  - Greater transparency from the regulator on its actions to lift behaviour and practices across the industry and within individual trustees
- **The ultimate goal?**
  - To make information easier to understand for fund members
  - To improve comparability for fund members

ASIC Finds Lack Of Transparency On Superannuation Websites

The new age of transparency for Australia's superannuation funds

Push for easier super fund comparability

TRANSPARENCY – ACTION ITEMS

What are the key transparency initiatives that RSEs should be aware of?

- ✓ APRA's multi-year Superannuation Data Transformation package, launched in November 2019
- ✓ Updated fees and costs disclosure (RG 97) guidance (release November 2019) provides revised guidance about existing fees and costs disclosure requirements
  - Applies to PDSs published on or after 30 September 2020 (no early opt in available)
  - Applies to Periodic Statements (ongoing or on exit) for a reporting period that commences on or after 1 July 2021 (early opt in available in certain circumstances from 1 July 2020)
- ✓ The portfolio holdings disclosure requirements, which enforces the provision of information about fund holdings on the fund website, has been extended to 31 December 2020
  - Under this requirement, disclosures are to be made no later than 90 days after the first reporting day and each reporting day after that. These disclosures must identify investment items (being assets and derivatives) allocated to investment options of the fund at the end of the reporting day. Reporting days occur on 30 June and 31 December each year
- ✓ Funds are already required to provide key information to members via product dashboards for MySuper products. The extension of the product dashboard requirements to include choice products has been deferred until 1 July 2023

Governance Outlook

2020 and beyond

GOVERNANCE OUTLOOK – 2020 AND BEYOND

- Following the Productivity Commission and Royal Commission, the financial services industry is now trying to regain public trust and we expect to see a continuation of the "constructively tough" approach adopted by the two key financial regulators, APRA and ASIC. There continues to a focus on meeting community expectations; member outcomes; accountability and transparency; and risk culture
- In the year ahead, we expect the key focus of the regulator will continue to include:
  - **Governance arrangements**: ensuring appropriate resources/skills/capabilities, structures, delegations and oversight
  - **Board arrangements**: ensuring an appropriate skills matrix, succession planning, detailed charter and documented governing rules (e.g. appointment criteria and term limits)
  - **Conflicts management**: enhanced expectations to manage or avoid conflicts of interest
  - **Corporate culture and risk culture**: demonstration of values and behaviours of a high community standard
  - **Accurate and timely data and reporting:** to help enhance transparency across the industry. Upgrading the breadth, depth and quality of superannuation data collection
  - **Accountability and remuneration:** ensuring appropriate incentives, improved accountability and support of effective management of financial and non-financial risks. This includes the expected extension of the Banking Executive Accountability Regime (BEAR) to superannuation and other regulated entities
- We expect to see a continued trend of transformation of the superannuation industry, as the regulatory and political landscape continues to shift in favour of consolidation

CONTACT

- If you have any questions or would like further detail on any of the key themes presented, please contact a member of Frontier's Governance Advice, Risk, Decisions and Strategy (GARDS) team

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