HERBERT SMITH FREEHILLS

APRA'S 'GUIDING' HAND

06 September 2017 | Australia
Legal Briefings – By **Sarah Yu**

Australian Prudential Regulation Authority (**APRA**) has written to Registrable Superannuation Entities (**RSE**) licensees indicating that 'it is essential that RSE licensees are continuing to act in the best interests of beneficiaries to deliver quality outcomes on an ongoing basis' (see the letter from APRA dated 31 August 2017). This is an interesting departure from the view of the best interests covenant in *Manglicmot v Commonwealth Bank Officers Superannuation Corporation* [2010] NSWSC 363 that it is 'concerned with process, not outcome' although not a controversial aim for a RSE licensee.

However, putting that issue to one side, APRA indicates that RSE licensees should be:

- considering the process to achieve that aim (ie how their RSE(s) will deliver quality outcomes for members both on an ongoing basis and into the future); and
- measuring whether they achieve that aim (ie measuring performance against appropriately established targets and like-for-like comparisons against peer offerings, where possible).

APRA's view is that it is not sufficient for an RSE licensee to 'simply comply with their legislative and prudential obligations' but rather RSE licensees should be developing a framework for assessing member outcomes in a manner which suits their individual business operations.

APRA'S ASSESSMENT

In its own assessment, APRA has identified some RSE licensees that ‘appear not to be consistently delivering quality member outcomes’. APRA has conducted its assessment on:

- quantitative factors of historical outcomes and indicators for future sustainability that are assessed on an absolute and relative basis as appropriate; and
- qualitative factors of APRA’s knowledge of each RSE and RSE licensee.

Historical outcomes	• net returns, on an absolute basis and relative to risk/return targets • costs per member for MySuper products • insurance costs, noting in particular the rate at which insurance premiums are likely to have reduced member’s account balances • administration and operating expenses as a percentage of average net assets (operating cost ratio)
Future sustainability	• net cash flows as a percentage of average net assets (net cash flow ratio) • net member benefit outflow ratio • net rollovers as a percentage of average net assets (net rollover ratio) • trends in membership base • active member ratio
APRA supervisory knowledge of each RSE and RSE licensee	This incorporates APRA’s view of: • the adequacy of the RSE licensee’s governance and risk management frameworks; • strategic and business planning practices; and • business operations.

The expansion beyond the more traditional qualitative characteristics to include quantitative measurements indicates a shift in APRA’s focus that was flagged in APRA’s *Insight Issue Two 2017*.

Some examples of metrics used by APRA to assess the quantitative factors of historical outcomes and indicators for future sustainability are:

- for historical outcomes, where a RSE’s current cost per MySuper member is in the top 25% and annualised net returns for a MySuper member in the last 3 financial years is in the bottom 25% (ie the MySuper product costs are high and the annualised net returns are low);
- for future sustainability:
    - where a RSE’s current net cash flow is negative and net cash flow for the current financial year is less than the net cash flow for the last 3 financial years (ie the net cash flow is negative and deteriorating); and
    - where a RSE’s current active membership ratio is less than 80% and the number of member accounts has decreased by more than 5% in the current year (ie the members are not engaged and are leaving); and
- for historical outcomes and future sustainability, where the RSE’s current operating cost ratio is greater than 0.5% and the current net cash flow is negative (ie the operating costs are in APRA’s view expensive and the RSE is losing scale).

These examples raise some interesting issues concerning:

- the timeframe in which a RSE’s net returns will be judged (eg 3 years) considering the length of time that a member must retain their superannuation in the superannuation system;
- APRA’s view of what are expensive costs (ie an operating cost ratio is greater than 0.5%);
- APRA’s assessment on an absolute basis of declining membership in the context of Australia’s aging population; and

- the assessment of RSE's based on historical net returns when ASIC in RG 168 requires that a statement about past performance in a PDS be accompanied by a prominent warning that past performance is not necessarily a guide to future performance.

However, APRA indicates that its approach to assessing fund performance and sustainability is only a 'starting point in a more holistic assessment process'. Nevertheless, APRA's quantitative measures are important because it is those RSEs that have performed badly on the majority of the quantitative metrics that have caused APRA concern.

APRA will shortly be meeting with those RSE licensees to require them to develop a robust and implementable strategy to address their weaknesses. APRA has indicated that where it is clear that a particular product or RSE is unlikely to be able to continue to operate in the best interests of members, APRA expects the RSE to ensure a timely transfer to another suitable product or RSE.

IMPACT FOR RSE LICENSEES

The letter from APRA indicates to RSE licensees the need to consider the quantitative measurements for its RSE(s) as well as the qualitative characteristics of adequacy of governance and risk management frameworks, strategic and business planning practices and business operations. RSE licensees will need to consider the quantitative and qualitative factors discussed above in determining:

- what member outcomes they wish to achieve;
- the process of achieving those outcomes; and
- how they will measure whether they have achieved those outcomes.

Those RSE licensees that do not achieve appropriate member outcomes should note that under the exposure draft of the Treasury Legislation Amendment (Improving Accountability and Member Outcomes Implementation) Bill 2017 (if it is passed in its current form):

- RSE licensees will have to annually issue a publicly available determination of whether the financial interests of MySuper members are being promoted by the RSE with that assessment being made based on:

    - a number of absolute matters (eg features, investment strategy, insurance and scale); and
    - a number of relative matters (eg fees, costs and taxes, return target, annual return and investment risk) on which the MySuper product is compared with other MySuper products;

- APRA will have the power to refuse or cancel a RSE licensee's authority to offer a MySuper product if APRA has reason to believe that the RSE licensee may fail to comply with its obligations (which represents a change from an assessment based on the balance of probabilities to one based on APRA's reasonable belief); and
- APRA will have the power to direct a RSE licensee to do 'anything else' in relation to the affairs of a RSE (eg undertake a successor fund transfer) if APRA has 'reason to believe' that, for example:
    - the direction is necessary in the interests of the RSE beneficiaries; or
    - a failure to issue a direction would materially prejudice the interests or reasonable expectations of the RSE beneficiaries.

Although the exposure draft of the Bill will likely to be passed with some drafting refinements, APRA's 'guiding' hand may result in APRA directing a RSE to the exit.

LEGAL NOTICE
