Dear Commonwealth Government,

Thanks for the opportunity to contribute. I am an actuary with experience working with Trustee Boards around their SPS220 risk management responsibilities.

Traditionally Trustees have taken their fiduciary duty as solely relating to their management of the member financial capital entrusted to them. I believe that if Trustees take a broader and longer term approach to capital and risk management, including taking into account a broader range of stakeholder views, this will naturally lend itself to greater consideration around longer term social impact investing on behalf of members. Indeed under SPS220 and the overriding SIS sole purpose test, an element of social impact investing may well be a logical risk management strategy to address new and emerging risks associated with long term degradation in social / natural / human capital on which a superannuation fund and its members will ultimately rely. The ability to measure such impacts is important, which appears to be well supported by your proposed principles in section 4.2.

Three key insights for Superannuation Fund Trustee entities in relation to social impact investing:

1. its capital management responsibility is broad and long term, particularly with respect to the social / natural / human capital on which their fund relies and/or impacts

2. within the context of SPS220 risk management responsibilities
   
   (a) the risks to long term fund returns associated with an adverse impact to social / natural / human capital is best considered by using scenario analysis

   (b) the ERM framework needs to be reviewed in the context of the link between long term member interest, sustainability of returns, and the management of social / natural / human risks and capital.

3. social impact investing, when considered as part of a longer term perspective around risk and capital management, is indeed congruent with their fiduciary duties under law.

With respect to point 3, I believe that social impact investments conforming to the principles in section 4.2 would be sufficient to give Trustee's confidence they are meeting their fiduciary and legal responsibilities. As such Government support for this framework, including help to ensure a "fair sharing of risk and return", will be a critical enabler to expanding social investment through the superannuation industry.

A major impediment in my mind to increasing social impact investing is the resistance of incumbent Trustee Directors to change their historical investment philosophies. As such education and superannuation industry leadership (including advocacy from APRA) will be critical to shift these views. After a recent presentation I gave that touched on this issue (attached), a Trustee Director commented that their fiduciary duty under law made it difficult for them to think much belong member interest in relation to a satisfactory investment return. My counter to this legacy perspective is that if the assumption that social, natural and human capital are critical for members in the long term, then it is in members interests to contribute to projects investing for a long term return through social initiatives. This will also help reduce downside risk to Australian Superannuation members from long term costs (i.e.
ensuing impacts to financial capital) associated with a degradation to social / natural / human capital. I have also observed that socially conscious members will be increasingly attracted to a Trustee that sees an element of social impact investing on their behalf as appealing and in their long term interest, of which I use Aussie Super as a case study of a super fund that is structuring it's investment approach to appeal to such members.

Regards, Tim

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Superannuation Fund Trustee Capital Management

Tim Gorst

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Outline

• Trustee Purpose and Sustainability
• Capital Management Responsibility
• Stakeholder Expectations (AustralianSuper Case Study)
• Enhancing Risk Management
• Scenario Analysis (Operational Risk Case Study)
• Key Insights
Trustee Purpose and Sustainability

• The government has now agreed the objective of superannuation will be to “provide income in retirement to substitute or supplement the Age Pension.”

• Under law, a superannuation Trustee exists to deliver the objective of superannuation for the members it represents. This fiduciary obligation requires a Trustee take a strict member perspective, concerned with the management of the financial capital entrusted to them by members.

• More generally the Trustee purpose is to ensure a longer term perspective is taken around member interests, with the appropriate management of the capital resources for which it is either directly responsible, able to impact through its decision making, or relies on to be sustainable.
Traditional Super Fund Capital Management – Driven By Standards

- **Operational risk** – ORFR Reserve per SPS114 and Trustee ORFR Strategy
- **Defined Benefit (market risk, assumption risk)** – per SPS160 and DB Funding Policy
- **Change (IT, regulatory) risk** – General Reserving policy might consider need for reserves to cover significant fund costs (e.g. reg change implementation, etc.)
- **Insurance (including self insurance)** – per SPS250, SPS160 and the Trustee’s Insurance Management Framework
- **Liquidity risk** – redemption account float, fund cash liquidity structures as governed by a Liquidity Management Policy
- **Working Capital** – sufficient to meet day to day expenses including payment of dividends to shareholders, per Trustee Working Capital / Dividend Policy
## Capital Management Responsibility

<table>
<thead>
<tr>
<th>Capital</th>
<th>Where a Trustee focused on sustainability will ensure their decisions result in a long term…</th>
</tr>
</thead>
<tbody>
<tr>
<td>Natural</td>
<td>positive impact on the quality and productivity of the natural environment</td>
</tr>
<tr>
<td>Human</td>
<td>positive impact on health, knowledge, skills and motivation of people (e.g. members, business employees)</td>
</tr>
<tr>
<td>Social</td>
<td>positive partnerships with key business stakeholders and other communities</td>
</tr>
<tr>
<td>Manufactured</td>
<td>effective management of infrastructure, buildings and technology needed to run, or impacted by, the business</td>
</tr>
<tr>
<td>Financial</td>
<td>effective management of financial capital entrusted by members, and used to run the business</td>
</tr>
</tbody>
</table>

Refer “5 capitals model” – www.forumforthefuture.org
## Stakeholder Expectations

<table>
<thead>
<tr>
<th>Stakeholder</th>
<th>Says of the successful superannuation business that it …</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shareholders</td>
<td>“delivers adequate returns on our business investment”</td>
</tr>
<tr>
<td>Members</td>
<td>“delivers good investment returns”</td>
</tr>
<tr>
<td>Employer Groups</td>
<td>“has helped me with my Corporate Super needs”</td>
</tr>
<tr>
<td>Service Providers</td>
<td>“is a good partner that delivers on our contracts with them”</td>
</tr>
<tr>
<td>Staff</td>
<td>“is a great place to work and develop”</td>
</tr>
<tr>
<td>Competitors</td>
<td>“is good for the industry”</td>
</tr>
<tr>
<td>Regulator</td>
<td>“meets fiduciary obligations”</td>
</tr>
<tr>
<td>Community</td>
<td>“is responsible and trusted”</td>
</tr>
</tbody>
</table>
Case Study – AustralianSuper

Understanding stakeholder views ...

+ commitment to sustainability

“Over recent years there has been an increasing focus on the role that large institutional investors play in influencing social policy outcomes, mostly notably in relation to climate change and coal. AustralianSuper’s primary focus is to provide adequate retirement incomes for our members. The Fund does not, however, do this in isolation .... (and understands) that the responsibility to assess issues around environmental, social and governance risk needs a proactive approach.”

(Australian Super annual report 2014-15)

(1) Brand differentiation

“Australian super fund comes second in global green rankings”

The Age - 2 May 2016

(2) Preparing for future changes in stakeholder expectations

(3) Keeping member interest (in particular investment risk and outcomes) first and foremost
### Case Study – AustralianSuper

The AODP Global Climate 500 Index rates the world’s 500 biggest asset owners on their success at managing climate risk within their portfolios, based on direct disclosures and publicly available information.

Only 6 Australian asset owners were ranked as leaders (A rating or above) with AustralianSuper ranked 7th out of 500.

<table>
<thead>
<tr>
<th>2016 RATING</th>
<th>2016 RANK</th>
<th>2016 / 2015 CHANGE</th>
<th>ASSET OWNER NAME</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>2</td>
<td>▼ 1</td>
<td>Local Government Super (LGS)</td>
</tr>
<tr>
<td>AAA</td>
<td>7</td>
<td>0</td>
<td>AustralianSuper</td>
</tr>
<tr>
<td>AAA</td>
<td>12</td>
<td>▲ 1</td>
<td>First State Super</td>
</tr>
<tr>
<td>A</td>
<td>21</td>
<td>▼ 6</td>
<td>Victorian Superannuation Fund (VicSuper)</td>
</tr>
<tr>
<td>A</td>
<td>24</td>
<td>▲ 3</td>
<td>BT Financial Group (BTFG)</td>
</tr>
<tr>
<td>A</td>
<td>28</td>
<td>▲ 10</td>
<td>Cbus Super</td>
</tr>
</tbody>
</table>

The Asset Owners Disclosure Project (AODP) is an independent global not-for-profit organisation that recognises the specific financial risk attributes of climate change. AODP has developed the world’s leading reporting framework for institutional investors encompassing the disclosure and management of climate risk.
Enhanced Risk Management Links To Long Term Capital Management Responsibility

• A Trustee purpose that has an explicit focus on sustainability can start to identify and discuss new risks that have the potential to impact members in the long term, and manage these for the long term benefit of members.

• Effective risk management will strongly link to the Trustee’s agreed long term capital management responsibility, whilst also ensuring it delivers its more immediate fiduciary obligations.
Enhanced Risk Management Links To Long Term Capital Management Responsibility

<table>
<thead>
<tr>
<th>Capital …</th>
<th>Is exposed to risk where the business has potential to …</th>
</tr>
</thead>
<tbody>
<tr>
<td>Natural</td>
<td>Degrade the natural environment and resources</td>
</tr>
<tr>
<td>Human</td>
<td>Degrade the health, knowledge, skills and motivation of members and other people impacted by the business</td>
</tr>
<tr>
<td>Social</td>
<td>Breach the trust of, or adversely impact on, the key business stakeholders or communities impacted by the business</td>
</tr>
<tr>
<td>Manufactured</td>
<td>Degrade infrastructure, buildings and technology needed to run the business, or impacted by the business</td>
</tr>
<tr>
<td>Financial</td>
<td>Diminish financial capital entrusted by members, and used to manage financial risk in the business</td>
</tr>
</tbody>
</table>
Case Study – Operational Risk Capital Scenario Analysis

• SPS114 is the Australian prudential standard around Operational Risk (Op Risk) capital management. It takes a member centric perspective on an Op Risk event that causes a reduction in member benefits.

• An SPS114 Op Risk Reserve needs to be sufficient to cover any member compensation assuming any recoveries (e.g. insurers, third parties) are delayed.

• With reference to “5 Capitals Model”, SPS114 is relatively narrow focussing mainly on the impact of an Op Risk event on member financial capital.

• A Trustee needs to set a suitable target reserve level of capital “reflecting the size, business mix and complexity of the Trustee’s business operations”, and is subject to a minimum of 0.25%.
LFHI Op Risk Event Loss History is Rare and Non Public

- Using historical losses or advanced modelling to determine an Op Risk capital target is limited by the scarcity of Low Frequency, High Impact (LFHI) event data.

> LFHI events are rare, and superannuation events are not broadly shared across the industry.
Op Risk Capital Scenario Analysis - SPS114 Perspective

- Scenarios are therefore critical to supplement sparse historical data, and engage stakeholders in a conversation around Op Risk exposures and management.

Op Risk scenarios identified in the RMF

Compensation

Also include Op Risk events not covered in the RMF (e.g. by including a broader stakeholder perspective on what can go wrong) per 8(b) of SPS114.
Op Risk Capital Scenario Analysis
- Broader Trustee Capital Perspective

Remediation costs that need to be covered outside the SPS114 Op Risk Reserve (e.g. by shareholders, other fund reserves, third parties, insurers)

Scenarios (in addition to SPS114 scenarios) that could result in material Trustee remediation costs without directly impacting members benefits.
Op Risk Capital Scenario Analysis
- Long Term Sustainability Perspective

<table>
<thead>
<tr>
<th>Stakeholder</th>
<th>Natural</th>
<th>Human</th>
<th>Social</th>
<th>Manufactured</th>
<th>Financial</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shareholders</td>
<td></td>
<td></td>
<td></td>
<td>Trustee capital focus</td>
<td>Trustee capital focus</td>
</tr>
<tr>
<td>Members</td>
<td></td>
<td></td>
<td></td>
<td>Trustee capital focus</td>
<td>SPS114 focus</td>
</tr>
<tr>
<td>Service Providers</td>
<td></td>
<td></td>
<td></td>
<td>Trustee capital focus</td>
<td>Trustee capital focus</td>
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<tr>
<td>Community</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**What is Impacted**

**Sustainability perspective**
From the perspective of what is important to the different Trustee stakeholders, what events might adversely impact on capital resources, and the sustainability of the business in the long run?

**Example** – could an operational risk event that the Trustee, Trustee service providers or Trustee shareholder is responsible for degrade natural, human or social capital? What would be the long term impact on fund members?
More generally, a Trustee can use scenarios to better understand long term impacts to business sustainability, and agree a risk appetite. For example:

- **Investment Approach** – impact on natural, human or social capital from an unethical, socially irresponsible, or unsustainable investment approach

- **Insurance Processes** – impact on human or social capital from a failure to pay out claims members and the community otherwise feel entitled to

- **Strategic Choices** – impact on natural, human or social capital from a poorly chosen strategy or business partnership

- **Reputation Issues** – impact on social capital, and member financial capital (cost of regulatory change) from bringing the industry into disrepute
Insight 1 : Sustainability Driven By Trustee Acceptance That It’s Capital Management Responsibility is Broad and Long Term

• Stakeholder expectations with respect to the responsible management of natural, social and human capital are likely to increase over time. Trustee’s should start repositioning their purpose now.

• When a Trustee is explicit on the need for long term sustainability (e.g. AustralianSuper), it should consider referencing the management of capital resources for which it is either directly responsible, able to impact through its decision making, or rely on to be sustainable. This can all be done congruent with it’s fiduciary obligations under law.

• This broader perspective on capital management responsibility will lead to the identification of new risks that have the potential to impact members in the long term, and increase the importance of risk management more generally.
Insight 2: Scenario Analysis Is A Practical Tool to Engage Stakeholders Around Long Term Risks To Capital Resources

- The scarcity of LFHI event history (e.g. for Op Risk) means scenario analysis is critical to better understand “tail risk” exposures and capital sufficiency.

- The annual SPS114 ORFR Strategy review provides a great opportunity to incorporate broader stakeholder perspectives (i.e. not just members), and expectations with respect to the long term capital management (i.e. not just member financial capital) needed to make the business sustainable.

- More generally a longer term “sustainability perspective” can be applied to the assessment of other risk types to drive a longer term perspective to risk management.
Insight 3: Strong ERM Connects Risk, Return, Capital and Purpose

- RMF Risks
- Other Risks
- Scenarios
- Appetite
- Settings

- Natural
- Human
- Social
- Manufactured
- Financial

- Shareholders
- Regulator
- Members
- Employers
- Service Providers
- Staff
- Competitors
- Community