

CHAPTER FIVE: REGULATING THE SUPERANNUATION SYSTEM FOR MEMBERS

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CHAPTER 5: REGULATING THE SUPERANNUATION SYSTEM FOR MEMBERS

APRA has regulated the superannuation system predominantly from a prudential perspective, focussing on the financial stability of funds and any limited systemic risks. Generally, APRA has taken an industry-neutral approach to supervision of superannuation: many of its policies and supervisory tools are broadly the same as those used for banking and insurance. APRA has not sufficiently acknowledged that differences in the superannuation industry require a different approach to supervision. APRA's prudential approach may have led it to under-resource its oversight of superannuation.

APRA needs to give more priority and tailor its approach to superannuation. It needs to refocus its attention to regulating trustees to deliver good retirement outcomes, while still ensuring that trustees carefully and diligently manage member funds. The Panel believes this is best achieved through a structural change to create a superannuation-specific division in APRA and more cross-industry analysis. While APRA has made some progress on member outcomes it needs to embed that focus into its broader superannuation regulatory framework.

Regulation of superannuation in Australia

The Wallis Inquiry recommended that superannuation be regulated by APRA rather than only ASIC, because 'the implications of compulsory contributions and tax assistance for superannuation...imply that government should provide greater regulatory assurance in relation to superannuation than would normally apply for market linked investments'.¹⁰²

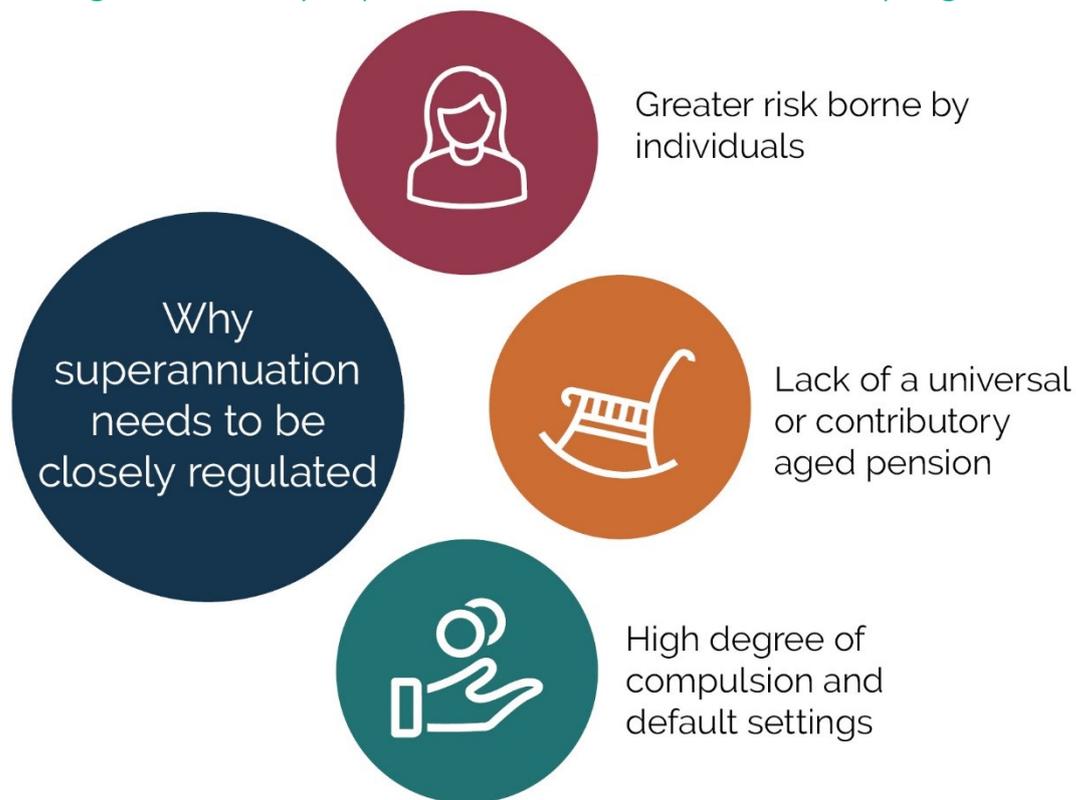
However, APRA's role in superannuation has also been different to its role in other industries: the Wallis Inquiry stated 'APRA's role is more than prudential regulation.' The Wallis Inquiry confirmed that APRA's role goes to retirement income policy: 'it is efficient to link prudential regulation of superannuation...with regulation to ensure compliance with government retirement income policies.'¹⁰³ The Hayne Royal Commission articulated this more clearly '[U]nlike other financial products ...the regulatory focus for superannuation must extend to the outcomes that will be delivered to members.'¹⁰⁴ Figure 5.1 demonstrates why superannuation needs to be closely regulated in Australia. While the 'member outcomes' language is recent, and linked to recently passed legislation, the role of superannuation has always been to support members' incomes in retirement and APRA has always been responsible for regulating this role.

102 Wallis Inquiry, p. 192.

103 Wallis Inquiry, pp. 332-333.

104 Hayne Royal Commission, p. 254.

Figure 5.1: Why superannuation needs to be closely regulated



The superannuation system is currently largely regulated by APRA, with 97 per cent of members (representing over 18 million individuals in the superannuation system) having an account in the APRA-regulated sector.¹⁰⁵ APRA regulates trustees of superannuation funds, who are required to act in the best interests of their members. APRA is also responsible for ensuring that trustees of default products comply with 'enhanced trustee obligations'.¹⁰⁶ ASIC is the regulator responsible for regulating disclosure and financial advice.¹⁰⁷ Following the Hayne Royal Commission, the Government intends to give ASIC greater responsibility for regulating the conduct of trustees,¹⁰⁸ with APRA remaining responsible for regulating system performance.

105 Based on 2016-17 Australian Taxation Office (ATO) data. About 2 percentage points of these people also have self-managed superannuation accounts. Source: Treasury

106 Section 6, SIS Act.

107 Section 6, SIS Act.

108 Australian Government, 2019, *Restoring Trust in Australia's Financial System: The Government response to the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*, p. 32.

BACKGROUND ON SUPERANNUATION

WHY IS SUPERANNUATION DIFFERENT TO BANKING AND INSURANCE?

- The nature of the promise is different to other industries
- A conceptual blurring of prudential and conduct regulation
- The trust structure
- A much lower risk of a run / failure
- No capital requirements
- High risk of conflicts of interest

WHAT ARE MEMBER OUTCOMES?

- Retirement outcomes for members ultimately depend on long-term net returns
- Returns, fees, costs and insurance all affect net returns
- Trustees are now required to compare their products' returns, fees, costs and insurance strategy
- Member outcomes do not include benefits unrelated to retirement outcomes

WHY IS REGULATING SUPERANNUATION SO IMPORTANT?

- Members are highly disengaged due to:
 - Behavioural biases
 - Product complexity
 - System settings
- System inefficiencies cause lower retirement incomes
 - The PC found poor performing products can lead to 13 years' lost income

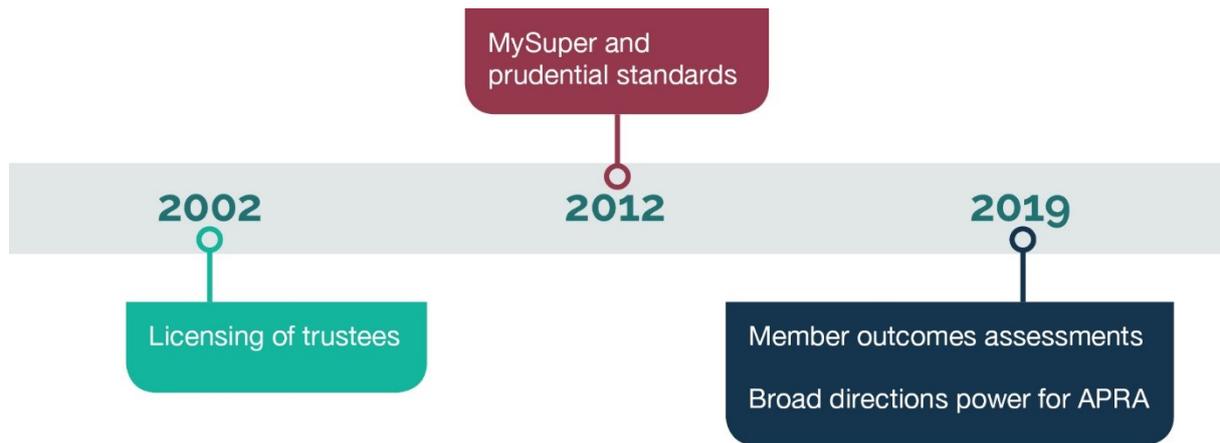
The regulatory environment for superannuation has strengthened over time. APRA has progressively gained more powers to regulate the sector (Figure 5.2):

- The Stronger Super reforms in 2013, coming out of the Cooper Review, were designed to tackle inefficiencies in the system, including product proliferation and rising fees. The reforms gave APRA the power to authorise default products¹⁰⁹ and make prudential standards. They also imposed limits on the charging of certain fees;
- The 2019 Member Outcomes legislation gave APRA comprehensive powers to direct trustees and greater control of the owners of superannuation trustees.¹¹⁰ This legislation will significantly strengthen APRA's leverage over trustees.

109 Products where members have not chosen their superannuation fund.

110 *Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No. 1) Act 2019.*

Figure 5.2: Timeline of superannuation regulation



Assessment of APRA’s regulation of superannuation

APRA was aware of the...drag on superannuation returns due to conflicts of interest — but never did anything about it.

— Industry expert

APRA’s role in superannuation is to ensure trustees prudently manage their business operations in a manner consistent with their member best interest obligations and the delivery of quality member outcomes.¹¹¹ Its performance should be assessed against this. Staff working on superannuation in APRA report that they are focussed on member outcomes but this does not seem to be broadly reflected in APRA’s approach or resourcing.

APRA fundamentally is a bank supervisor, in terms of culture...With a bank you really can’t afford to do in public what you need to do in private because you might inadvertently cause a run...but when you’re supervising superannuation and insurance companies you don’t have the same run-risk... APRA should be much more public...whether a given superfund is working in the members interests.

— Industry expert

The Panel believes that APRA has under-resourced superannuation and not approached it with an appropriate regulatory focus. This is due to its focus on financial system stability, with large ADIs and insurers being primary drivers of systemic risk. Member outcomes and superannuation have often taken a ‘back seat’ — as they rarely raise financial stability issues. As an example, APRA’s vision statement — ‘to deliver a sound and resilient financial system, founded on excellence in prudential supervision’ does not reference superannuation and the non-financial stability drivers of member outcomes.

APRA’s challenges in superannuation require further effort to embed the changes underway in APRA to strengthen the focus on member outcomes, including structural change in the organisation.

111 APRA and ASIC, 2018, *Regulation of superannuation entities by APRA and ASIC*.

Findings of recent reviews

The PC was highly critical of APRA's approach to superannuation, stating that APRA 'steadfastly regulates through a prudential lens' whereas superannuation 'is not a market characterised by prudential risk'. The PC Superannuation Inquiry found that APRA was focussed on superannuation funds and their interests, rather than the needs and interests of members, which are not always aligned. The PC Superannuation Inquiry also criticised APRA for focussing its data collection on fund-related data and not member-focussed data.¹¹²

The PC Superannuation Inquiry criticised APRA for focussing on adherence to process over outcomes. It recommended that ASIC take responsibility for regulating the conduct of trustees and appropriateness of products while APRA take responsibility for ensuring high standards of system and fund performance, including licensing and product authorisation. The Inquiry also noted that APRA should have a more explicit 'member outcomes' mandate to replace its misplaced prudential mandate. Questions about APRA's ability to promote member outcomes were a key factor behind the PC's call for a capability review — stating 'APRA will also need an exponential uptick in dedicated expertise and resources to deliver on what is expected of it.'¹¹³

The Hayne Royal Commission, which overlapped in timing with the PC Superannuation Inquiry, ultimately concluded that ASIC should take a greater role in superannuation, finding that APRA's traditional regulatory approach was not always appropriate for superannuation:

APRA is predisposed to methods of regulation that rely on 'supervisory suasion' conducted 'behind closed doors', rather than to public deterrence. The prudential regulator may wonder whether public denunciation of an entity might disturb the stability of an entity or the system. But, as I have said, deterrence of misconduct depends upon visible public denunciation and punishment. ASIC's core work is consistent with that objective. APRA's is not.¹¹⁴

112 PC Superannuation Inquiry, p. 28.

113 PC Superannuation Inquiry, p. 43.

114 Hayne Royal Commission, p. 452.

APRA's approach to regulating superannuation

Figure 5.3: APRA's approach to regulating superannuation



Resources are industry light, inconsistent in approach and constantly changing.

[APRA] significantly underinvested in the wealth teams in the big institutions.

Superannuation is the poor cousin of APRA.

— Industry experts

APRA regulates superannuation entities similarly to its other regulated entities (Figure 5.3). Supervision is predominantly conducted on an entity basis. Risk assessments are conducted using APRA's PAIRS framework which is based on traditional prudential concepts taken from ADIs. This vertical orientation is supported by thematic prudential and industry reviews that look across the industry. Policies in the form of prudential standards are developed to support these processes. Supervision staff working on superannuation are spread between supervision divisions (SID and DID), with support from relevant policy, risk, data and legal teams in PAD and RDA.

The Panel acknowledges that some aspects of the traditional prudential lens should be applied to the regulation of superannuation, including an ex-ante approach and a focus on outcomes over a focus on compliance. The focus on governance, fitness and propriety, and risk management is also appropriate. However, the risks in superannuation are not like-for-like with other APRA-regulated entities. Governance issues in superannuation can manifest in different ways to issues in banking and insurance. Also, the nature of risks are different. For example, banking and insurance capital and liquidity risks are central concepts, but these are not central to regulating superannuation. Prudential regulation of banking and insurance has a different focus on the end user. The Panel's view is that APRA's approach of harmonising across its regulated industries, and departing from this approach when it considers it 'appropriate', does not sufficiently take into account of differences in the superannuation industry.

Supervision documents prepared by APRA supervisors and provided to the Review mostly focus on risk management and compliance with prudential standards. Some sampled internal supervision documents showed little focus on member outcomes and whether trustees had complied with legal requirements designed to protect members' savings, including the sole purpose test, MySuper obligations or fee requirements under the SIS Act. Additionally, sampled documents showed that while APRA looked at potential conflicts of interest between individual directors and the trustee, the

supervisors paid little attention to the risk of conflict of interests between trustees and related parties in their broader group structures and the members of the fund.

The shift to member outcomes

Despite an increasing focus on member outcomes, APRA's progress has been insufficient, especially in relation to system efficiency, fees and transparency. As a senior APRA staff member noted:

Investing in member outcomes is a work in progress.

— APRA senior staff

The Panel believes that APRA is headed in the right direction in beginning to tackle underperformance and improve member outcomes. APRA demonstrated its commitment to member outcomes when releasing its draft prudential standard *SPS 515 Strategic Planning and Member Outcomes* in December 2018 and through its advocacy for the Members Outcomes Act.

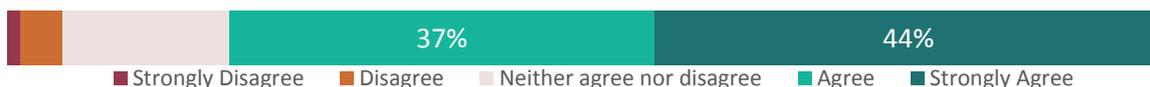
Internal documents show that consideration of member outcomes is now more prominent in APRA's work. APRA has set up an internal subgroup dedicated to member outcomes. Underperformance is the key risk identified in its Superannuation Risk Register, with causes clearly identified (inefficient operations and conflicts of interests leading to non-arm's length arrangements). APRA plans to create a centralised team to support supervisors and plans to improve assessment methodology, identify data gaps and explore obtaining data from other sources, improve transparency of performance and collaborate more closely with ASIC. The creation of a member outcomes dashboard will also assist supervisors to focus on outcomes. Helen Rowell has also clearly communicated a focus on member outcomes in a recent speech to industry:

Our superannuation analysts will harness data-driven insights to identify underperforming funds, products and options, and that 'outlier' list will be regularly reviewed and updated. The trustees of these funds will be targeted with intensified supervision, with APRA seeking prompt action to address areas of weakness or concern. If trustees are unable or unwilling to respond appropriately, we will be urging them to seriously consider whether restructuring or exiting the industry is in their members' best interests.¹¹⁵

Furthermore, 81 per cent of APRA staff working on superannuation agreed member outcomes were front of mind.

Capability Review Staff Survey — Member outcomes

Proposition: For those involved in superannuation matters, superannuation member outcomes are 'front of mind'.



While APRA is taking action on member outcomes, the Panel questions whether APRA has yet sufficiently embedded this focus into its frameworks. Stakeholders questioned whether APRA's rhetoric would be reflected in action to address underperformance. Supervisory documents also show that in practice, the focus on member outcomes is inconsistent. Supervisors appear to focus on

115 Rowell, H, 2019, *Opening the door to greater transparency in superannuation*, 13 March 2019.

factors contributing to outcomes for fund health rather than the outcomes themselves. This was evidence in some internal APRA documents reviewed:

- One supervisory document only showed concern for whether the trustee was ready to comply with the Member Outcomes Act assessment process and not whether the trustee was delivering on outcomes for members;
- Another example was work done by a supervisor in relation to a small fund with an aging membership and heavy net outflows. The work focussed on metrics around fund retention and inflows rather than addressing whether the fund was a viable vehicle to produce appropriate outcomes for its members; and
- In a letter to a fund in 2017 on member outcomes, APRA encouraged trustees to look at metrics such as brand loyalty and member identity, as well as member services provided, rather than focussing on issues pertinent to member outcomes in retirement — the key purpose of superannuation.

Structure of superannuation within APRA

Create a superannuation division that includes frontline, SAS, Policy and legal to support, integrate and strengthen depth of expertise.

— APRA staff

APRA needs to shift its focus, develop its policy and supervision framework and build its skills and resources to improve its work on superannuation. This will be more difficult to achieve in APRA's existing structure (Figure 5.4). The creation of industry-aligned branches within DID and SID is a recent enhancement of APRA's structure. However, the current structure, with superannuation spread across multiple divisions, may not have created a strong enough voice for superannuation in APRA. It may constrain APRA from building and maintaining its superannuation expertise. The Panel acknowledges that APRA has a dedicated member for superannuation and welcomes the addition of a new General Manager for superannuation.

The Panel believes that there may be differences in understanding around the importance of promoting retirement outcomes between staff working on superannuation and the broader organisation. APRA should create a new Superannuation Division under a dedicated EGM. Its primary focus should be on member outcomes. There should be more focus on regulating at an industry level rather than on an entity-by-entity basis.

This will complement APRA's recent heightened attention on member outcomes. The effectiveness of that work may be constrained with superannuation resources spread across many other functions. Embedding APRA's changes on member outcomes across all relevant divisions may diffuse the impact of those changes. Staff already note that this sharing of resources between divisions has created inconsistencies in approach.

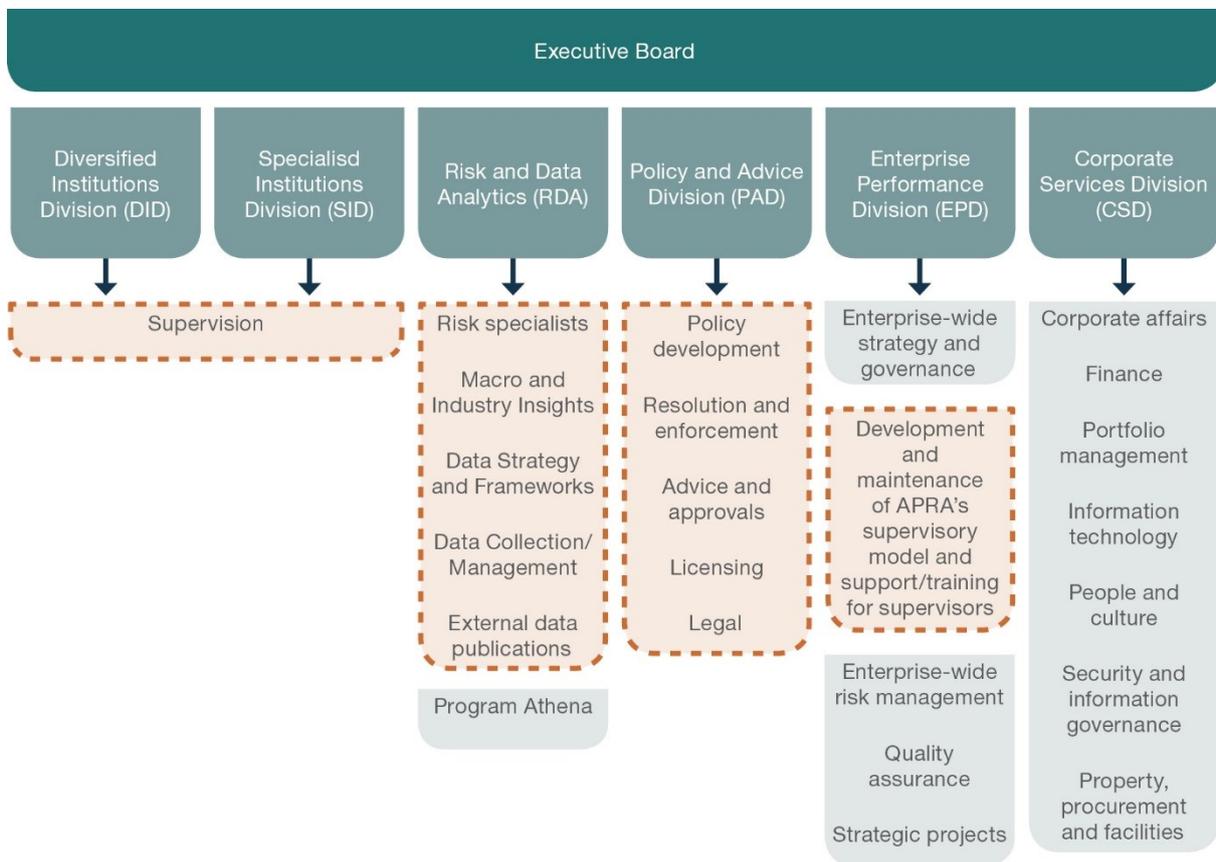
The Panel believes that such a restructuring of APRA will promote the development of a critical mass of expertise in superannuation, support APRA to develop a career path for those working in superannuation and encourage better supervision of superannuation. It is also of the view that the creation of a superannuation division would encourage greater consideration of superannuation in APRA's internal decision-making, including the prioritisation of APRA's resources. Following the Hayne Royal Commission, APRA and ASIC are working more closely on superannuation issues. It is likely that the creation of a dedicated superannuation division in APRA, with clear lines of industry expertise and accountability, would make that collaboration more effective. In addition, creating a separate superannuation division inside APRA would achieve some of the benefits discussed in the

Hayne Royal Commission of creating a standalone superannuation regulator without many of the costs.

This structural change should be accompanied by a shift in APRA’s supervisory philosophy in two ways. The first is that APRA’s analysis should focus more on industry trends and the benchmarking of funds’ delivery for members. This will sharpen APRA’s ability to identify funds that persistently underperform and the characteristics of those funds. It may also assist in anticipating and responding to emerging industry trends. Staff noted that a restructure along industry lines would ‘significantly enhance strategic industry focus, improve efficiency and break down inherent inadequacies in collaboration that currently exist’. The second, is that APRA should discontinue its use of PAIRS as a supervisory tool for superannuation (see below).

As part of this restructure, APRA should consider whether there is merit in embedding relevant staff from RDA, PAD and legal in the new division. This could enable it to develop a specific superannuation approach in its policy design, supervision and enforcement functions but could also reduce economies through fragmentation.

Figure 5.4: Location of superannuation in APRA’s current structure



The Panel acknowledges that there are some benefits to APRA’s existing approach and organisational structure. Many stakeholders appreciated that the entity-based approach allowed them to develop an ongoing relationship with supervisors and educate individual supervisors about their business along the way. However, submissions also noted that the entity-based approach to supervision (with some teams supervising as few as two funds) meant that staff did not understand the superannuation system as a whole.

While APRA does conduct thematic reviews, and does have support for cross-industry issues through RDA, submissions and stakeholders noted that APRA’s research capability had diminished over time,

resulting in less capacity to identify emerging trends. APRA has begun more thematic reviews in superannuation and has developed dedicated teams to conduct those reviews.

Prioritisation and resourcing of superannuation

APRA’s prioritisation of superannuation has had a variety of consequences:

- Reduced ability of APRA to attract, retain and develop staff with superannuation expertise;
- The long-term application of ADI-focussed supervisory tools to superannuation; and
- Insufficient focus on member interests.

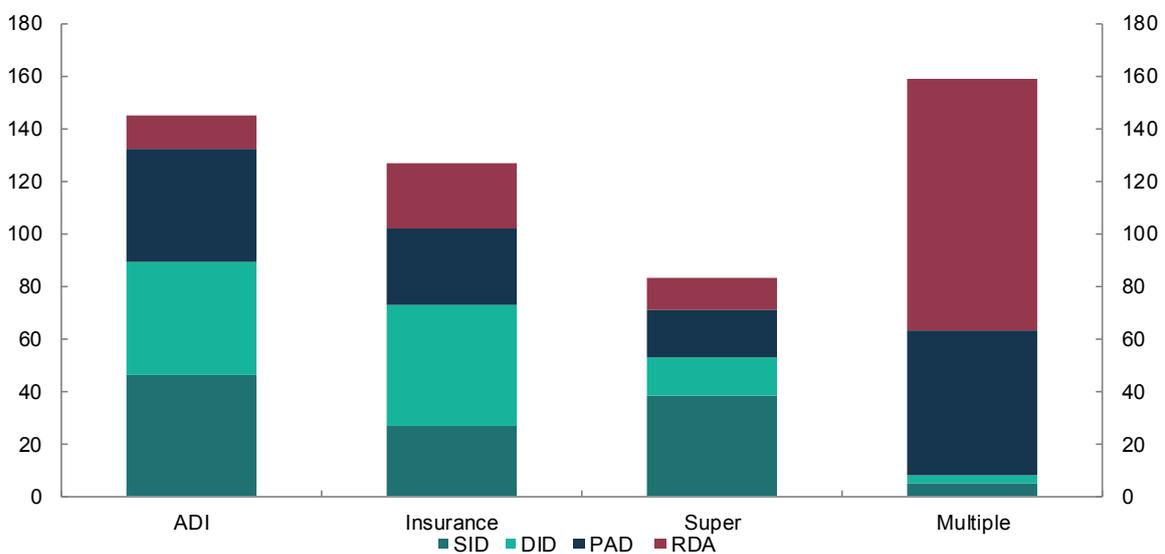
Superannuation is secondary to banking.

APRA can feel very ADI focussed.

— APRA staff

APRA devotes more resources to regulating the banking and insurance sectors than the superannuation sector (Figure 5.5). While Figure 5.5 aggregates the three insurance industries, on entity per supervisor basis, superannuation has fewer resources dedicated to each entity. In recent years, APRA’s staffing numbers have increased, but not for superannuation.¹¹⁶ In an internal APRA document, APRA notes the ‘lower promissory intensity and the lower potential for financial sector contagion’ as a reason for the lower resourcing.

Figure 5.5: APRA staff by industry



Staff noted that ‘some frontline superannuation analysts are responsible for portfolios 2-3 times larger than a typical banking analyst.’ The Panel noted the high turnover of staff with superannuation experience, with the loss of 14 out of 77 superannuation-related staff in 2018. The Panel also noted staff observations in the Capability Review Staff Survey that a lack of resources supporting superannuation was a reason for these departures.

Consultation with industry representatives and participants revealed a concern about lack of expertise or experience on superannuation. A few knowledgeable supervisors were the notable

116 APRA internal data.

exceptions. One stakeholder noted that only one member of APRA’s supervision team had been there for 18 months. Submissions received by the Review observed that where supervision staff had little expertise in superannuation they paid little attention to outcomes for members.¹¹⁷

The Panel considers that issues around attracting and replacing staff, the high turnover rate and lack of superannuation expertise are, at least in part, symptomatic of APRA’s treatment of superannuation relative to other industries.

RECOMMENDATION 5.1

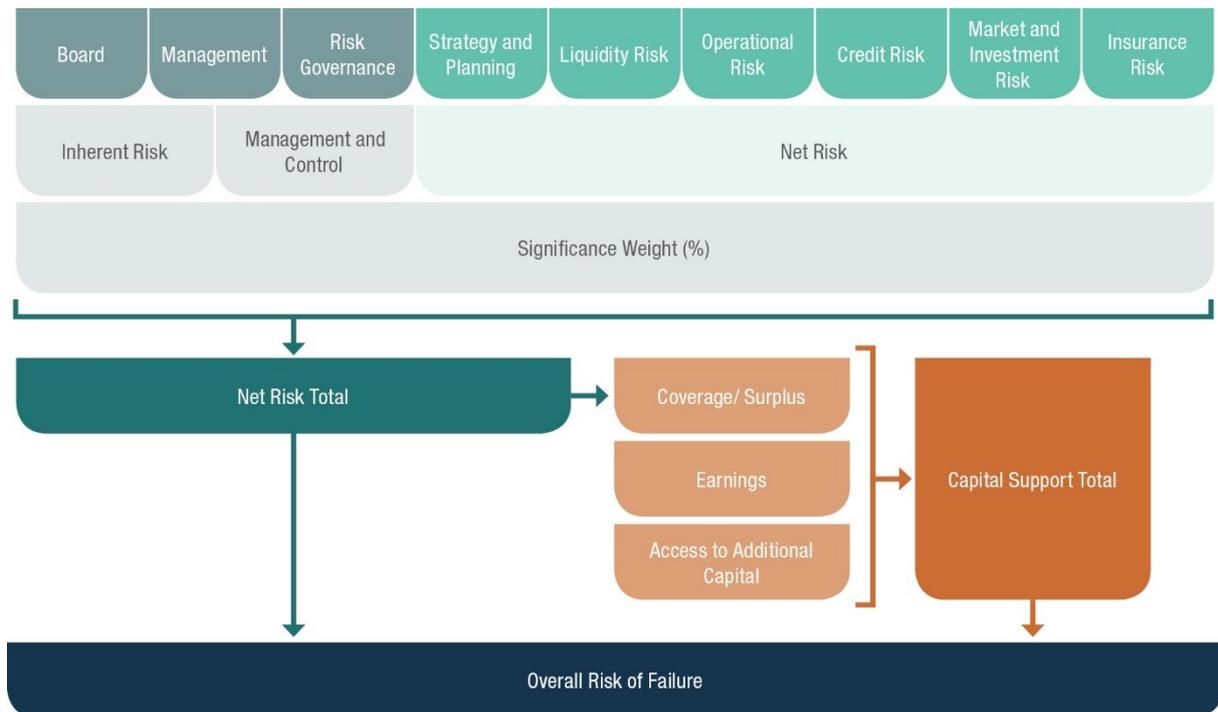
APRA should create a new Superannuation Division, headed by an Executive General Manager. A key focus of the Division should be the overall performance of the superannuation system for members.

Superannuation supervision tools

Tools available for superannuation are limited as is the data that we collect.

— APRA staff

Figure 5.6: Stylised image of the current PAIRS framework



The Panel believes that APRA’s use of the supervisory tool PAIRS is inappropriate for superannuation due to three main reasons:¹¹⁸

117 Australian Institute of Superannuation Trustees, 2019, *AIST Submission to the APRA Capability Review*, p. 11.

118 Note, PAIRS categories have different ‘significance weights’. The default significance weight for ‘credit risk’ for superannuation entities is nil.

- PAIRS is fundamentally directed towards estimating the probability of an entity failing (Figure 5.6). However, a (defined contribution) superannuation fund cannot fail in the way that a bank or insurer can fail. More importantly, members could experience poor outcomes long before their superannuation fund is at risk of failure;
- PAIRS calculates the overall risk of failure by considering the capital support (including coverage surplus, earnings and access to additional capital) available to entities. While superannuation funds maintain reserves, there is no robust framework or reference for these concepts because there is no capital framework for superannuation. Earnings and access to capital do not translate to superannuation entities; and
- PAIRS directs attention to superannuation trustees, as opposed to the outcomes for members. PAIRS does not explicitly assess member outcomes or related issues such as: conflict of interest risks between the trustee and members; related party transactions; or net returns. This has encouraged some supervisors to incorporate concepts relating to member outcomes into the tool. However this piecemeal approach to tailor the PAIRS framework can lead to different treatment of the industry within APRA.

The Panel welcomes APRA's decision to review the PAIRS framework. However, the PAIRS framework should not be used as a starting point for a new supervisory tool for superannuation. APRA requires a new superannuation-specific tool which has a primary focus on member outcomes, on a trustee-level and product-level basis. This tool could incorporate some elements of the current PAIRS tool, such as board and risk governance.

Policy approach

APRA's recent review of its prudential standards for superannuation concluded that the standards largely met their objectives but need further enhancements. APRA found that the standards may not always be achieving their policy intent.¹¹⁹

Stakeholders commented that APRA should have published more detailed guidance on benchmarking to accompany its draft prudential standard on member outcomes to enable consistent reporting of returns across the industry. The Panel believes that APRA could improve the outcomes focus of its prudential standards and should develop a methodology for public benchmarks to enable APRA to tackle underperformance and promote member outcomes.

APRA's approach to superannuation data

APRA is the principal financial sector data collection agency in Australia and has broad powers to make reporting standards to collect data and collects data on behalf of other agencies. APRA has a number of reporting standards relating to superannuation trustees.

The Panel notes two concerns about APRA's collection of superannuation data: the type of data APRA collects; and the fact that APRA does not ensure that it is provided with accurate data (i.e. data quality).

On the first issue, in relation to choice products (which represent around half of all accounts, and a substantial portion of underperformance),¹²⁰ APRA collects information on the prudential health of superannuation funds and does not collect product-level data. For example, APRA collects data on

119 APRA, 2019, *Information paper: Review of APRA's 2013 superannuation prudential framework*.

120 PC Superannuation Inquiry.

net earnings, administration fees, investment fees, flows of members and investment expenses. However, this data is only aggregated at the fund level. APRA only collects product-level data on default or MySuper products. This means members in choice products cannot always compare the returns and costs of their product with benchmarks or with other products.

There are issues around the quality of data that APRA collects and publishes. The PC Superannuation Inquiry noted that ‘non-reporting has been apparent in APRA data at least since 2004...the regulator appears to have enabled this non-reporting.’¹²¹ In the Capability Review Staff Survey, staff observed that the current data gaps and data errors impeded their ability to supervise. APRA has not issued an infringement notice or begun court proceedings for breaching reporting standards since at least 2013.¹²²

APRA is in the process of developing a new data strategy and is part way through its Project Athena data project (see Chapter 2) which will make data collection processes easier to change in future. APRA has publicly stated that it will use ‘data-driven insights to identify underperforming funds.’ Internal documents show that APRA plans to update its reporting standards to ensure that fit-for-purpose data is available in four years’ time. This would include choice and platform-level data that would enable benchmarking of product performance, and facilitate the informed decisions by superannuation members. The Panel questions whether this timeframe is acceptable, given that the need for action to address underperforming funds in order to safeguard members’ retirement savings has been recognised for some time.

RECOMMENDATION 5.2

APRA should embed and reinforce its increasing focus on member outcomes, and continue to ensure that trustees prudently manage member funds.

Consistent with this change of approach, APRA should:

- a. publish objective benchmarks on product performance and publicly take action to demonstrate its expectations for member outcomes;
- b. develop a superannuation performance tool that replaces PAIRS by the end of 2019. The tool should be focussed on member outcomes;
- c. update its superannuation reporting standards and collect product level data that facilitates accurate assessments of outcomes and comparability across funds; and
- d. increase the resourcing dedicated to the superannuation industry.

RECOMMENDATION 5.3

In accordance with recommendation 23 of the Productivity Commission’s Superannuation Inquiry, the Government should legislate to make APRA’s member outcomes mandate more explicit. The Government should consider clearly outlining its expectations for APRA on superannuation in its next Statement of Expectations.

121 PC Superannuation Inquiry, p. 182.

122 APRA Enforcement Strategy Review, p. 14.