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Prudential Practice Guide Draft SPG 516 – Business Performance Review

The Australian Prudential Regulation Authority (APRA) has revised the *Draft Prudential Practice Guide SPG 516 Business Performance Review* (SPG 516) and is seeking feedback on the guidance on the legislated outcomes assessment.

The Actuaries Institute (the Institute) has a long history of assisting superannuation fund trustees achieve better member outcomes. We have been actively engaged in previous related consultation with APRA through our submission to the *Draft Prudential Standard SPS 225 – Outcomes Assessment* (SPS 225) dated 29 March 2018 and subsequent discussion.

Overall the Institute is supportive of the revised draft SPG 516. Our submission primarily focuses on inclusion of further guidance by APRA in SPG 516 to encourage Trustees to include **projections of member retirement outcomes** when making the assessments required by Section 52(11) of the Superannuation Industry (Supervision) Act.

APRA currently recognises the importance of retirement incomes as a potential member outcome for funds in the guidance issued supporting SPS 515, including the following references:

- Paragraph 9(a) of SPG 515, which states “APRA also expects that targeting achievement of certain retirement benefit levels would be a key consideration for all RSE licensees in articulating member outcomes”;
- Paragraph 26 of draft SPG 516 provides retirement income as an example of a member outcome that may be adopted by a RSE licensees in accordance with the SPS 515 requirements, and states “Where an RSE licensee uses retirement income as an outcome for members (e.g. MySuper lifecycle strategies, retirement products), this may be benchmarked against industry standards or replacement rates (e.g. two-thirds of a member’s final salary)”.

We support the inclusion of this guidance, as it is consistent with the Institute’s belief that projections of member retirement outcomes should be an important consideration when RSE licensees consider their member outcomes assessments required by Section 52(11) of the Superannuation Industry (Supervision) Act.



However, we recommend that the guidance provided in SPG 516 be further strengthened in this respect by encouraging Trustee to use outcomes projections as part of the process of reaching an overall determination (paragraph 107) as the projections would incorporate all the following components in the guidance:

- **MySuper Investment Strategy** encompassing all lifecycle stages and the comparison against relevant single strategy products (paragraphs 84 to 89);
- **Insurance strategy** and corresponding insurance costs and its impact on erosion of retirement income of its members (paragraphs 90 to 94); and
- **Fee and cost structures** and the lifetime impact of fees and costs charged to members in promoting members' financial interest (paragraph 101 and 102).

Our more detailed feedback is contained in the Appendix to this submission. Our earlier submission to APRA on SPS 225 dated 29 March 2018 contains additional details and examples of use of projections to assess member outcomes.

We hope our response provides a valuable perspective and will assist APRA with the consultation process. We would be happy to discuss this issue with you if required.

Please do not hesitate to contact Convenor or the Chief Executive Officer of the Actuaries Institute, if you would like to discuss any aspect of this letter or if you need further information.

Yours sincerely,

Convenor, Superannuation Practice Committee



Appendix: Suggested enhancements to draft SPG 516 in relation to use of projections

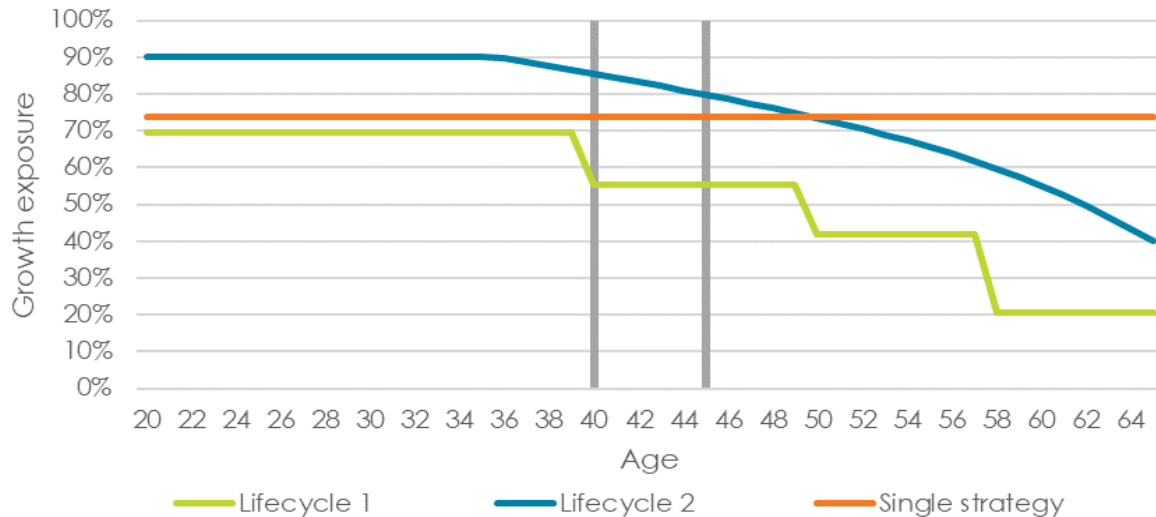
MySuper Investment Strategy (Section 52(11)(b) of SIS Act)

We recommend paragraphs 84 to 89 of SPG 516 be updated to suggest projected member retirement outcomes be used as the basis for determining the investment strategy that is adopted for MySuper products.

An appropriate way to assess MySuper investment strategies, including lifecycle strategies, is through carrying out projections of the expected member balances at retirement (or member incomes throughout retirement) as a result of adopting the particular lifecycle or single strategy investment strategy (see Figure 1 for some examples of the different designs of lifecycle and single strategy products). Projection of the expected retirement balances can be carried out for different lifecycle products and single strategy products for comparison. Because MySuper products are default strategies, the RSE licensee can, based on its membership, decide on the investment strategy that gives the best outcome.

Projections of retirement balances can be used to assess outcomes for different age-based cohorts in a consistent way. For example, to assess the outcomes for an age 20s cohort, projection can be carried out from age 20 to an assumed retirement age of say 65. Similarly, to assess the outcomes for an age 40s cohort, projection can be carried out from age 40 to 65 instead.

Figure 1: Examples of growth asset allocation of lifecycle and single strategy products

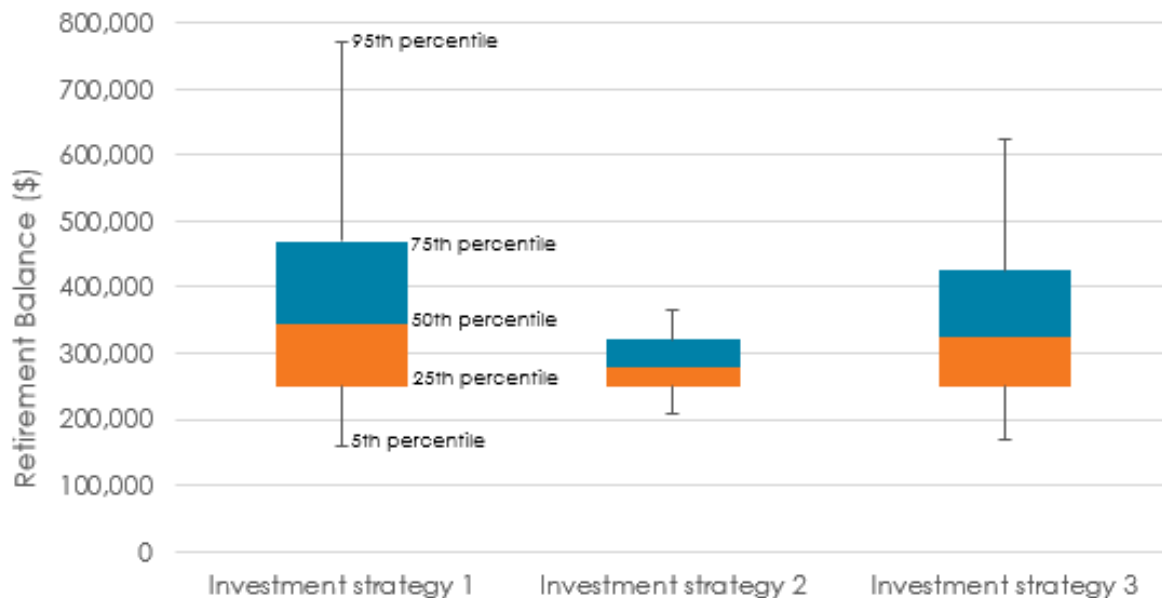


The Institute believes the impact of different level of investment risks in MySuper investment strategies can best be assessed through performing stochastic projections of member retirement outcomes (outcomes based on historic returns can also provide useful insights). Figure 2 shows an example to compare the range of projected retirement balances for different investment strategies with different level of investment risks. One investment strategy is considered superior to another if it produces a higher expected retirement balance with a narrower range of outcomes (defined by selected percentiles).



Stochastic projection of retirement balance can be used to assess both lifecycle strategies and single strategies. The appropriateness of the glide path design can be assessed in a consistent way by examining the expected level and the range of projected retirement balances.

Figure 2: Example projection of retirement balance with different investment strategies



Insurance costs (Section 52(11)(d) of the SIS Act)

We recommend paragraphs 90 to 94 of SPG 516 be updated to suggest projected member retirement outcomes could be used as the basis for determining whether the insurance fees charged in relation to a product inappropriately erode the retirement incomes of those beneficiaries. A projection will provide greater insight into the ultimate erosion effect than examination of year by year insurance costs. Furthermore, a target to limit the erosive impact on the projected member retirement outcomes will provide greater flexibility and control than a simple limit on year by year insurance costs.

As noted in paragraph 91, an RSE licensee should assess the appropriateness of the entity level insurance strategy (set out under SIS Act and *Prudential Standard SPS 250 Insurance in Superannuation* (SPS 250)) and the impact of the corresponding insurance costs in erosion of retirement incomes. The Institute believes the most appropriate way to assess the impact of the insurance costs to retirement income is through projection of retirement benefits including retirement balance and income.

Expected retirement balances can be projected with the members' expected insurance costs deducted from the accounts each year. As illustrated in Figure 3, this can be compared against the projected expected retirement balance without insurance. The difference quantifies the expected "erosion" of retirement balance and this could be used to compare against the expected benefit of having the insurance cover.

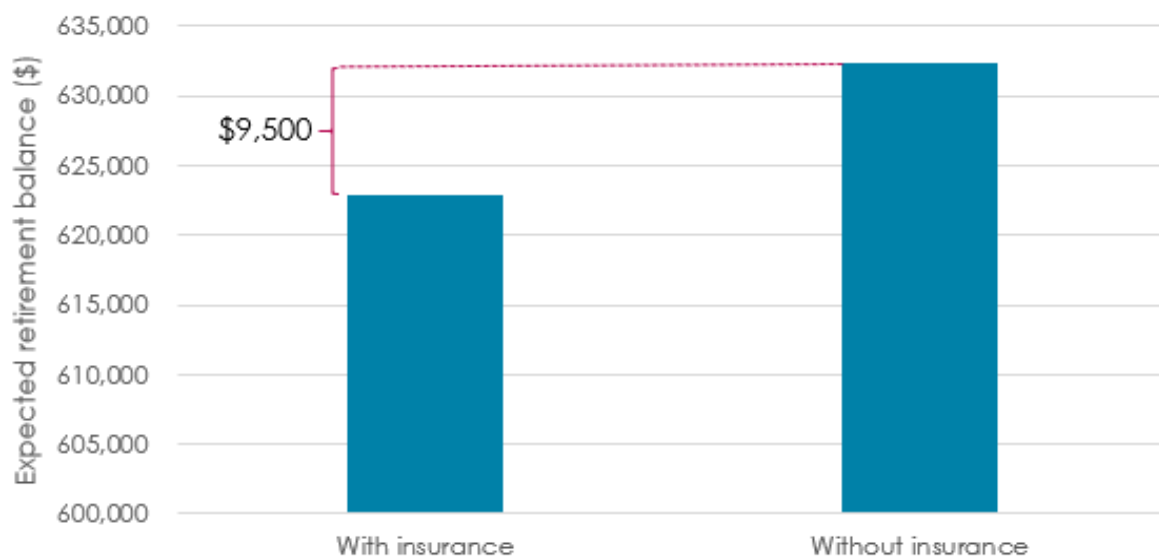


Paragraph 94 recognises the importance of assessing affordability of insurance policies under the context of unique member characteristics including balance levels and contribution rates. Projection of expected retirement outcomes allows the assessment of insurance affordability to consider the changing nature of balance levels as a result of contribution and expected investment returns over time.

As a result, the Institute believes insurance affordability can then be assessed in a consistent manner for members in different age-based cohorts, balance-based cohorts or demographic-based cohorts using projection of expected retirement outcomes.

We note that the Insurance in Superannuation Voluntary Code of Practice which has been adopted by a number of funds recommends determining insurance affordability by ensuring premiums will be set at a level that generally does not generally exceed 1% of salary for a fund's membership. Our proposed methodology above could be employed in addition to this, to further analyse balance erosion, particularly in instances where insurance premiums over different ages do not necessarily vary in line with salary inflation (e.g. premiums that start at a low/high rate but increase at a more rapid/slower pace than salary inflation).

Figure 3: Example projection of retirement balance with and without insurance



Fee and cost structures (Paragraph 23(c) of SPS 515)

We recommend paragraphs 101 to 103 of SPG 516 be updated to suggest projected member retirement outcomes could be used to assist determination as to whether the basis for setting fees is appropriate for those beneficiaries.

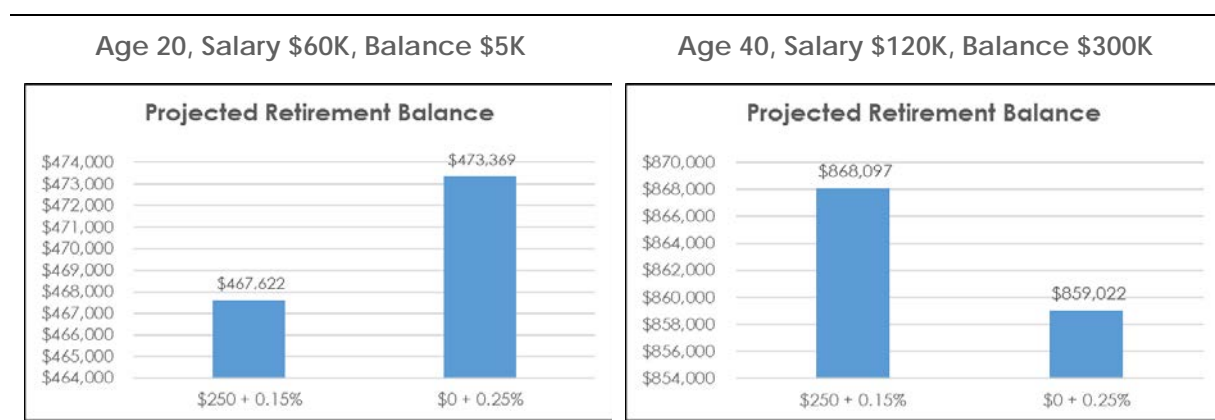
As explained in paragraphs 101 and 102, fee and cost structures (split between flat dollar fees and asset-based variable fees or costs), any fee caps, the timing of fee charges and any fee discounts or rebates should be considered in assessing the appropriateness of the basis for setting fees and costs. By considering the changing nature of member balances over time and considering projections of retirement outcomes, the Institute believes an RSE licensee is better able to assess the lifetime impact of fee and costs charged to members in promoting members' financial interests.



For example, consider a fund that has two proposed fee structures: one consists of a fixed dollar fee of \$250 and a 0.15% fee on balances; the other one is a 0.25% fee on balances only. Figure 4 shows the projected retirement balances for two different member cohorts.

The members in the age 20s cohort with a lower starting balance and salary would accumulate a higher retirement balance under the higher percentage driven fee (0.25%) compared to the combined fixed dollar fee (\$250) and a lower percentage fee (0.15%). On the other hand, the members in the age 40s cohort with a relatively higher starting balance and salary would prefer the combined fee structure due to their consistently higher account values.

Figure 4: Projected retirement balances for two member cohorts based on different administration fee structures.



In practice, it would also be desirable to consider some sensitivity analysis, for example the impact on the projections of potential future changes in fee structures in line with the trustee's objectives for growth of the fund and future fee levels.

Overall determination (Section 21(a) of SPS 515)

APRA's letter of *Response to submissions – proposed revisions to SPS 515* clarifies that RSE licensees are not required to specify numerical weightings for each element (e.g. investment, insurance and fees) of the assessed outcomes. As explained in paragraph 62, RSE licensees are required to document the analytical approach to explain how changes in factors impact the overall product determination.

The assessment steps detailed under the SIS Act focuses on the assessment of factors such as investment, insurance and fees individually and the Institute believes subjective weighting on factors should be avoided for appropriate assessment and overall product determination.

In addition, the Institute believes different factors such as investment, insurance and fees (and costs) interact with each other and will generate different outcomes for different members under different scenarios. As a result, one appropriate way to provide an overall assessment to assist with product determination is using outcome projections (e.g. projected retirement balances) that incorporate all these factors.

By undertaking projections of member retirement outcomes, an RSE licensee can understand the relative impact of investment strategy, insurance and fees on the retirement outcomes. For example, the impact on projected retirement outcomes of realistic variation in investment returns, insurance and costs could help assess the balance between these factors in the RSE licensee's assessment.