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PATHWAYS TO SUCCESS

Under the APRA Scale Test

Ben Walsh

Introduction

The Australian Prudential Regulation Authority (APRA) is increasingly scrutinising whether Registrable Superannuation Entity (RSE) Licensees are adequately focused on delivering long-term quality and value to their members.

APRA’s challenge is to ensure that members are not disadvantaged by weak investment performances, excessive costs and poor business models.

APRA has signalled that funds struggling to meet its scale test, introduced in 2012, will be subject to heightened supervisory attention going forward. To ensure that members’ best interests are protected, it says it is likely to require these funds to develop and implement plans to quickly address areas of underperformance – or to come up with a plan to merge or wind-up.

Presently, APRA has only had the benefit of detailed statistical reporting for a few years and is learning and developing its strategy as it gains greater understanding. Thus, the scale test can be considered a work in progress and is likely to evolve further. It could also be influenced by any changes recommended in the Productivity Commission’s final report on its inquiry into alternative default models for super funds, to be released in August.

Despite limited information about the scale test’s future direction, super fund trustees should not wait for certainty from APRA but begin implementing strategies that can provide long-term stability. They can already be acting in the best interests of members by asking some important questions and weighing up the different pathways to sustainability. These include rebranding, repositioning, seeking support in areas outside core-competencies, partial or full mergers, acquisitions and other types of partnerships.

Uncertainty is Creating Immobility

Fifty-eight percent of funds surveyed in the Mercer 2020 Super Fund Executive Report regard government regulation and the Productivity Commission inquiry as their top risk. In addition, 65% believe that consolidation will be the top influencer of how the market will look by 2020 and 71% believe that forced mergers will occur in the industry. Given the scant information on how the scale test will ultimately work, the research found most funds have become somewhat immobilised in the face of uncertainty.

APRA Focused on More than Scale

According to its recent statements, APRA regards sustainability as more than just maintaining growth in assets and membership, or sustaining the trustee’s business. It requires a broader assessment of investment performance, fees or costs, and the quality of benefits and services provided to members.
APRA expects trustees to ensure their fund remains “fit for purpose” and to implement sufficiently robust strategic and business planning processes to promote high-quality, long-term outcomes.

Mercer’s work with clients responding to APRA’s scale test has involved measuring and reporting on Funds Under Management (FUM), management fees, costs, spreads and other expenses to members; cash-flow positions (benefit outflow compared to contributions); net investment returns; and performance to strategy and plan.

**Magnitude of the Scale Problem**
Mercer’s research suggests that about 36% of Australia’s super funds should be taking serious action now to ensure they continue to deliver member benefits long into the future.

A close look at funds with $1 billion or less in FUM (36% of all APRA-regulated funds) shows that over half (56%) have experienced negative net member-benefit flows in the past year. Of those funds with FUM of $500 million or less, 52% experienced negative net member-benefit flows. Figures 1 and 2 show the magnitude of this problem with a large cluster of funds associated with smaller FUM and negative benefit flows.

**A Question of Sustainability**
Although APRA’s scale test looks at more than just FUM, funds experiencing negative net member-benefit flows can expect to be squarely in the regulator’s sights.

The boards of these funds should be asking: “Can we survive? What do we do best and what elements could others do better for less cost or less risk? Should we consider strategic partnerships or mergers? If so, with whom and when?”

By addressing these questions, boards will be in a better position to satisfy APRA that they are acting in members’ best interests. If action isn’t taken, some funds could be in a downward spiral in which payment outflows lead to lower FUM, resulting in lower income for the fund and rising costs to members. This in turn negatively impacts member outcomes and ultimately threatens fund sustainability. See Figure 3 for an illustration of this downward spiral.

**Pathways to Success – Where Members are the Test that Matters**
With APRA’s scale test in a state of policy evolution, funds should use the member-outcome test as a guide for moving forward: How can we provide members with the best outcomes for their retirement? Figure 4 illustrates three clear pathways funds can take to address sustainability issues and meet member needs.

**Pathway 1: Multi Segment Outsourcing**
Most superannuation funds already outsource many functions of their operations, technology, investment and client services. However, a reliance on multiple providers makes it difficult for these funds to maximise economies of scale and operating efficiencies. By combining multiple functions with one provider, funds can maintain their decision-making power, brand and trusteeship, and gain significant cost savings in the order of 20-50% per annum through a tailored solution that complements their fund’s needs.

**Pathway 2: Branded Total Outsourcing Solution**
Funds that are focussed on maintaining brand but require significant scale, can look to the advantages of a branded total outsourcing solution model. Here, funds design the structure of what their members require, but share the delivery and management with a third party supplier who can provide all elements with significant cost efficiencies. In this model, risk passes to the outsource partner, ongoing costs reduce significantly, whilst funds maintain control over their ultimate strategic direction.

**Pathway 3: Consolidation / Merger**
Consolidation shouldn’t be considered a failure, but a courageous move to improve future member outcomes (rather than waiting for the fund
to somehow return to growth). APRA is keen to see boards take tougher and more realistic decisions in this area and funds owe it to members to ensure their assets find homes that can deliver more for their members in retirement.

**Conclusion**

APRA’s scale test has launched much debate in the industry. It remains a work in progress and is part of a broader approach that looks at member outcomes and a fund’s ability to deliver member outcomes and remain sustainable.

The principles of the test should provide the basis for funds to make real, long-term decisions on how they will be structured and how they wish to meet the long-term needs of members.

In a climate of continuing regulatory uncertainty, funds should not wait for absolute clarity, but rather follow pathways to growth that are in the interests of members and their retirement outcomes.

Several pathways to success are available. The time for action is now! fs