IN SEARCH OF SUSTAINABILITY

# PRIVATE RETIREMENT SYSTEMS AND SUSTAINABILITY:

# AUSTRALIA

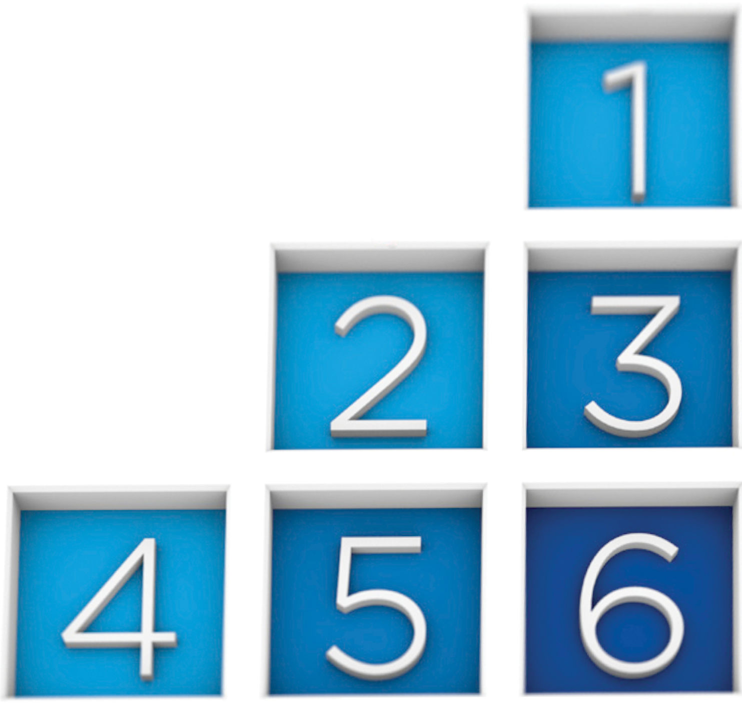
An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

# THE SIX PRINCIPLES

## PREAMBLE TO THE PRINCIPLES

As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with our fiduciary responsibilities, we commit to the following:

1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4. We will promote acceptance and implementation of the Principles within the investment industry.
5. We will work together to enhance our effectiveness in implementing the Principles.
6. We will each report on our activities and progress towards implementing the Principles.




## PRI's MISSION

We believe that an economically efficient, sustainable global financial system is a necessity for long-term value creation. Such a system will reward long-term, responsible investment and benefit the environment and society as a whole.

The PRI will work to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

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# INTRODUCTION

Australia's funded pension system (referred to as "superannuation") is based on a mandatory, occupational structure that performs well on international comparisons due to its professionalism and capacity to deliver good financial outcomes. There are three distinct types of superannuation fund: not-for-profit funds and retail funds, regulated by the Australian Prudential Regulatory Authority (APRA); and self-managed super funds (SMSFs) which are subject to oversight by the Australian Tax Office (ATO). Assets held in the different pension vehicles are almost 150% of GDP: APRA-regulated institutional funds manage almost AUS$2 trillion in assets, SMSFs hold AUS$750 billion and there is over AUS$200 billion in other types of fund.

The superannuation industry has seen significant structural change in the past 10 years, driven to a large extent by policy and regulation. There has been considerable consolidation among institutional funds (those with more than four members) and a steady growth in assets. Not-for-profit super funds have captured market share from retail funds, while default options have been reinforced and continue to receive the lion's share of new contributions. Many high-balance members have opened SMSFs, although this trend appears to have slowed recently. While there are 186 APRA-regulated institutional super funds in total (down from 5,000 in 1995), the top 15 funds dominate, accounting for more than AUS$50 billion in assets and managing 62% of assets and 55% of member accounts. There are nearly 600,000 SMSFs catering to around one million individual accounts (Table 1).

APRA has applied sustained pressure on super funds to improve their operational and investment efficiency and to make choices simpler for members, but has only recently started to address environmental, social, and governance (ESG) issues. Still, policy and regulation have not stood in the way of responsible investment. Indeed, the superannuation industry has taken meaningful steps towards developing such strategies, especially when compared with pension providers in other countries. This progress was initiated by the not-for-profit segment. However, for-profit super funds are following their lead, such that 81% of funds now have some form of responsible investment commitment in place.

Among service providers, there appears to be less concentration in both asset management and investment consultancy services than in other countries. One reason is that some of the larger super funds are bringing investment capabilities in-house, which is reducing their reliance on investment consultants and external asset managers.

**Table 1: Australia Market Structure. Sources: multiple**

| | SUPERANNUATION FUNDS | | | | | SELF-MANAGED SUPER FUNDS |
|---|---|---|---|---|---|---|
| | INDUSTRY | PUBLIC SECTOR | RETAIL | CORPORATE | EXEMPT PUBLIC SECTOR | |
| **Total assets (AUD billion)**[1] | 718.6 | 520.1 | 625.9 | 59.7 | 148.4 | 747.6 |
| **PRI signatories as % total assets** | 88% | 75% | 45% | 39% | 0% | n/a (no institutional ownership) |
| **Number of entities** | 37 | 18 | 112 | 19 | 19 | |
| **Sector concentration** | 10 biggest industry funds = 82% of sector assets, 3 biggest funds = 46% | 10 biggest public sector funds = 96% of sector assets, 3 biggest funds = 58% | 10 biggest retail funds = 73% of sector assets, 3 biggest = 37% | 3 biggest corporate funds = 76% of sector assets | n/a | 598,572 entities for 1,125,000 member accounts |
| **Service provider concentration** | Consultant and asset management markets competitive; increasing capabilities of large super funds is incrementally reducing role of external providers in some areas | | | | | |
| **Regulator** | APRA | APRA | APRA | APRA | State or Commonwealth governments | ATO |
| **Governance structures** | RSE Licensees (Trustee) | | | | Trustee | Member (Trustee) |
| **Asset allocation** | Listed equity 47%<br>Unlisted equity 5%<br>Bonds 19%<br>Property 10%<br>Infrastructure 9%<br>Cash 8%<br>Other 2% | Listed equity 39%<br>Unlisted equity 6%<br>Bonds 26%<br>Property 9%<br>Infrastructure 5%<br>Cash 9%<br>Other 5% | Listed equity 53%<br>Unlisted equity 2%<br>Bonds 21%<br>Property 7%<br>Infrastructure 2%<br>Cash 12%<br>Other 4% | Listed equity 43%<br>Unlisted equity 2%<br>Bonds 29%<br>Property 9%<br>Infrastructure 4%<br>Cash 9%<br>Other 5% | | Listed equity 36%<br>Bonds 6%<br>Property 21%<br>Infrastructure 1%<br>Cash 24%<br>Other 12% |
| **Key barriers to system sustainability** | APRA focus on costs and simplicity.<br>Performance measures (e.g. MySuper heat map) do not incorporate ESG risks or opportunities.<br>Prudential standards in general not prescriptive, but not supportive | | | | | Member objectives/ Advisor/ provider |

Sources: APRA Annual Superannuation Bulletin June 2019; concentration data from APRA Annual Fund-Level Superannuation Statistics June 2019; SMSF asset allocation is from Productivity Commission Technical Supplement 4

1 Responsible Investment Super Study 2019, RIAA

# SUPERANNUATION INDUSTRY OVERVIEW

Superannuation became mandatory for all qualifying workers in Australia in 1992, following the introduction of the Superannuation Guarantee. Under the Guarantee, employers must enrol workers into a super fund and make contributions of at least 9.5% of wages on their behalf.[2] Superannuation covers around 95% of the workforce and offers almost entirely defined contribution benefits, with the exception of a few categories of public sector employee. Over 80% of people between the ages of 25 and 54 hold a super fund account.[3 4]

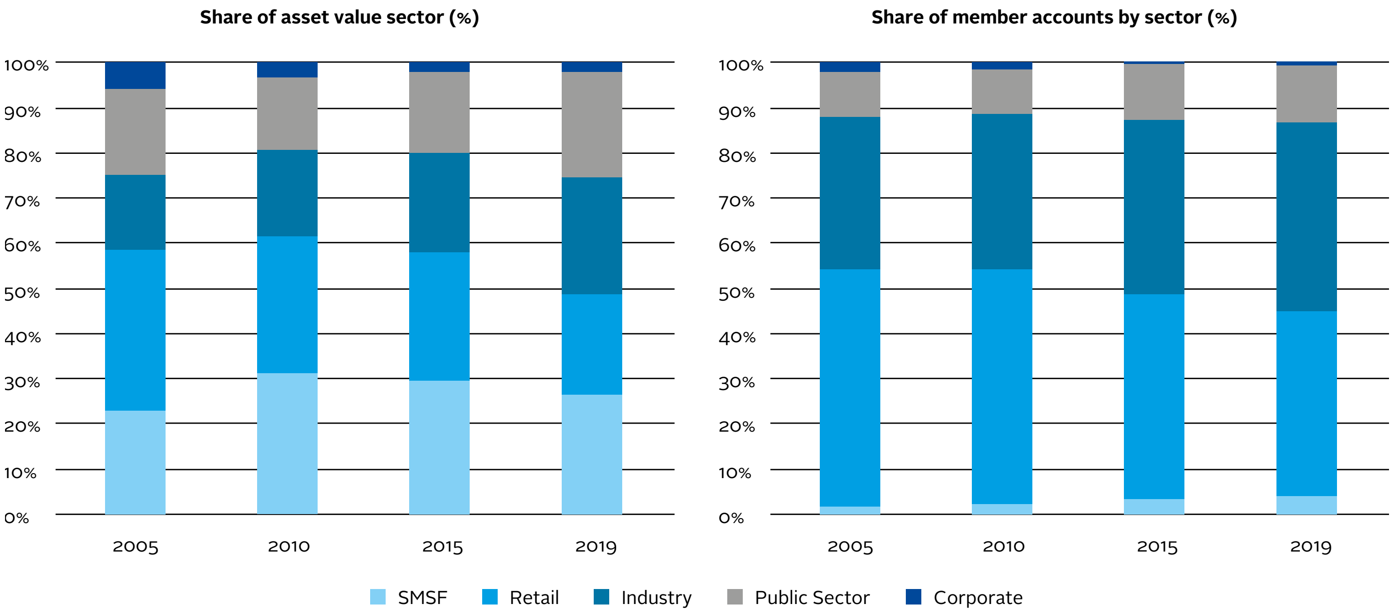
Most assets and members belong to APRA-regulated institutional funds (Figure 1). APRA classifies these funds according to their historic membership base: industry, public sector, corporate, and retail. However, since 2005 most employees have been able to choose their super fund and a more relevant distinction today is whether the fund is not-for-profit (industry, public sector and corporate) or for-profit (retail).

Not-for-profit super funds are operated solely for the benefit of their members or beneficiaries and generally were established to look after the superannuation savings of workers in particular industries (industry funds) or particular employers (public sector funds and corporate funds).

Retail funds are operated at least in part for the benefit of shareholders.[5] Most of the assets under management in the retail segment are in funds owned and operated by Australia's financial institutions.

Industry funds have grown fast and are now the largest category in terms of institutional assets under management and the second largest in terms of membership. Assets and accounts in corporate super funds have declined sharply, contributing to the ongoing consolidation of the industry that has been encouraged by the regulator. Faced with declining membership and weak operational efficiency, many smaller corporate schemes joined retail master trusts, while the number of super funds across other sectors has also fallen as funds have combined to achieve economies of scale. The public sector data in the charts below includes Exempt Public Sector Superannuation Schemes, which act as default funds for some public sector employees; these funds are not APRA-regulated – they are publicly accountable to the relevant state or territory – but they comply with super fund regulations.

**Figure 1: Investment and member accounts by sector. Source: APRA Superannuation bulletins**

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2 Rising to 12% by 2025

3 The Australian Approach to Choice in Superannuation/Pensions, Prof H Bateman, 2019

4 Superannuation: Assessing Efficiency and Competitiveness, Productivity Commission Inquiry Report No.91, December 2018

5 See, IBISWorld, Industry Report K6330: Superannuation Funds in Australia (September 2014) (stating that "It is only retail funds that generate profit to distribute to shareholders. Importantly, the operators of the retail funds (i.e. the major financial institutions) earn most of their profit through super fund support services such as funds management, financial advice and asset investment. Essentially, the fund is just a means to attract savings to earn money from.").

There has been rapid growth in non-institutional assets since 1995, although this has slowed in recent years. SMSFs now account for a quarter of assets in the superannuation system. SMSFs are generally used by wealthier savers: the average balance in an SMSF is over AUS$600,000 compared with less than AUS$100,000 for APRA-regulated institutional accounts, although this number may be skewed by a relatively small number of large SMSFs (Table 2).

**Table 2: Funds Profile. Source: APRA Annual Superannuation Bulletin, June 2019**

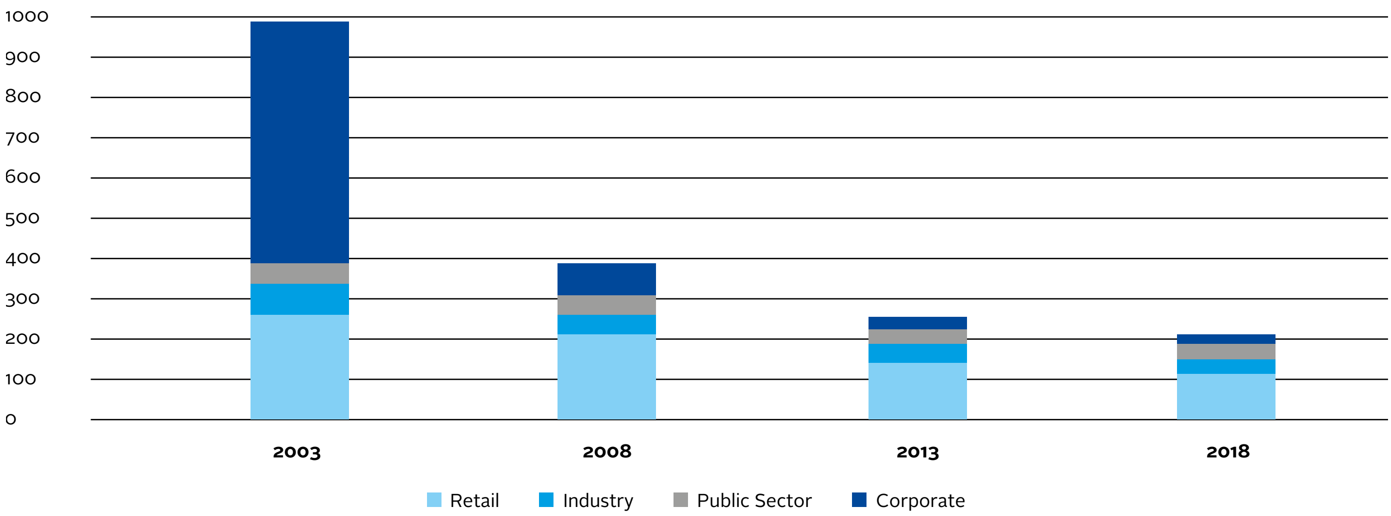
| | CORPORATE | INDUSTRY | PUBLIC SECTOR INCLUDING EXEMPT | RETAIL | SMALL* |
|---|---|---|---|---|---|
| **Total assets (AUD billion)** | 58.1 | 719.6 | 668.5 | 625.9 | 747.6 |
| **Number of member accounts ('000)** | 286 | 11,348 | 3,601 | 11,125 | 1,125 |
| **Average balance (AUD)** | 291,000 | 60,000 | 186,000 | 56,000 | 638,000 |

* SMSF, small APRA funds and single member approved deposit funds

## SUPER FUND CONCENTRATION

While assets in institutional super funds have grown rapidly, from AUS$444 billion in 1995 to AUS$1,968 billion in 2019, the number of funds has fallen at an even faster rate, resulting in an increasingly concentrated superannuation industry (Figure 2).[6]

**Figure 2: Number of funds by sector. Source: APRA Superannuation Bulletin June 2019**




6 Annual Superannuation Bulletin xls June 2018

The top 15 funds control 62.5% of institutional superannuation assets and 55.1% of member accounts; the top 20 control 72.2% of assets and 66.8% of member accounts. Nine of the top 15 funds are PRI signatories (Table 3).

**Table 3: The 15 largest super funds by assets under management. Source: APRA Annual Fund-Level Super statistics June 2019**

| | | SECTOR | AUM | MEMBER ACCOUNTS | PRI SIGNATORY |
|---|---|---|---|---|---|
| 1 | AustralianSuper | Industry | 172,409,105 | 2,155,463 | Yes |
| 2 | QSuper | Public | 115,308,453 | 588,434 | No |
| 3 | First State Superanuation Scheme | Public | 103,129,286 | 861,118 | Yes |
| 4 | Public Sector Superranuation Scheme | Public | 83,259,316 | 223,147 | No |
| 5 | Unisuper | Industry | 83,242,826 | 474,772 | Yes |
| 6 | MLC Super Fund | Retail | 82,014,371 | 1,180,621 | No |
| 7 | Colonial First State FirstChoice | Retail | 80,286,062 | 720,423 | Yes |
| 8 | Sunsuper Superranuation Fund | Industry | 72,584,595 | 1,613,865 | Yes |
| 9 | Retirement Wrap | Retail | 69,947,235 | 811,389 | No |
| 10 | CSS Fund | Public | 64,136,797 | 111,894 | Yes |
| 11 | Retail Employees Superranuation Trust | Industry | 58,156,117 | 2,026,582 | Yes |
| 12 | AMP Superranuation Savings Trust | Retail | 55,494,937 | 1,501,221 | No |
| 13 | Military Superranuation & Benfits Fund No 1 | Public | 54,716,285 | 179,862 | No |
| 14 | Health Employees Superranuation Trust | Industry | 53,818,727 | 858,438 | Yes |
| 15 | Costruction & Building Unions Superranuation | Industry | 53,168,127 | 766,494 | Yes |

At the other end of the scale, there are 52 super funds with under AUS$1 billion in assets. These funds collectively account for just 1% of the total assets of APRA-regulated institutional funds and just under 3% of member accounts.

The 90 funds with less than AUS$5 billion of assets hold nearly 6% of system AUM and 17% of member accounts. Most are retail funds, operated by a provider offering multiple funds.

## NOT-FOR-PROFIT SUPER FUNDS

The PRI is strongly represented among not-for-profit super funds, particularly in the industry sector, which is the fastest-growing segment of the superannuation system (Table 4).

The majority of not-for-profit funds follow an equal representation trustee model, whereby both employees and employers are represented at board level. The culture of not-for-profit funds means that they have traditionally been interested in social and governance issues. This has made them more responsive to broader sustainability issues than both for-profit super funds and workplace pension providers in other countries.

Many industry funds were established to cater for employees in specific industries and hold default status as part of the industrial relations "awards". Although workers can now choose their super fund, few do so, and industry funds still benefit from this default status.

**Table 4: Biggest not-for-profit super funds (APRA-regulated i.e. excludes Exempt funds). Source: APRA Annual Fund-level Superannuation Statistics, June 2019**

| | AUM (AUD BILLIONS) | % TOTAL INSTITUTIONAL ASSETS | PRI SIGNATORY |
|---|---|---|---|
| INDUSTRY SUPER FUNDS | | | |
| **AustralianSuper** | 172.4 | 9.0% | Yes |
| **Unisuper** | 83.2 | 4.3% | Yes |
| **Sunsuper** | 72.6 | 3.8% | Yes |
| **REST** | 58.1 | 3.0% | Yes |
| **HESTA** | 53.8 | 2.8% | Yes |
| **Cbus** | 53.1 | 2.8% | Yes |
| **HOSTPLUS** | 46.0 | 2.4% | Yes |
| **Care Super** | 19.9 | 1.0% | Yes |
| PUBLIC SECTOR SUPER FUNDS | | | |
| **QSuper** | 115.3 | 6.0% | No |
| **First State** | 103.1 | 5.4% | Yes |
| **Public Sector Super** | 83.3 | 4.3% | Yes |
| **CSS Fund** | 64.1 | 3.3% | Yes |
| **Military Benefits Fund No 1** | 54.7 | 2.8% | Yes |
| **Victorian Super** | 25.2 | 1.3% | Yes |
| **Public Sector Superannuation Accumulation** | 14.7 | 0.8% | Yes |
| **LGIAsuper** | 12.9 | 0.7% | No |
| CORPORATE SUPER FUNDS | | | |
| **Telstra** | 22.5 | 1.2% | Yes |
| **Commonwealth Bank Group** | 12.7 | 0.7% | No |
| **Qantas** | 8.8 | 0.5% | No |
| **ANZ Australian Staff** | 4.7 | 0.2% | No |

## RETAIL SUPER FUNDS

The retail segment of the superannuation system has historically been dominated by Australia's big four banks and one wealth management firm, which were able to use their captive or aligned distribution channels to cross-sell super funds.

Retail super funds were typically launched within a vertically-integrated financial services organisation, encompassing retail asset management, retail super funds, product manufacturing, master trust structures, and distribution and advice networks. This gave incumbents significant advantages in terms of scale and barriers to entry, while customers rarely switched providers because of low engagement and the complexity of choosing a new product.

However, this picture has started to change as banks have pulled out of insurance and superannuation-related business lines and there has been a notable shift towards non-aligned advice. Westpac, for example, sold its financial advisory business to a non-aligned advisory-only company in 2019, and there have been a number of acquisitions of Australian insurance companies without their advice channels.

These trends have been accelerated by the various government-initiated reviews into the Australian financial and retirement systems since 2013.

The Productivity Commission Inquiry Report into Superannuation, published in 2018, and the Final Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, published in 2019, highlighted that the ownership structure of retail super funds created conflicts of interest and shortcomings in their governance structures. This meant they were more expensive and achieved lower returns relative to not-for-profit funds (although they identified issues in all sectors). Misconduct by retail funds and financial advice firms revealed during Royal Commission hearings, and detailed in a Royal Commission report, accelerated a switch by retail account holders into not-for-profit funds, especially larger industry funds.

A number of the biggest retail super funds are PRI signatories through their parent group (Table 5).

**Table 5: Retail super funds and PRI signatory status. Source: APRA Annual Fund-level Superannuation Statistics, June 2019; PRI**

| RETAIL SUPER FUNDS | AUM (AUD BILLIONS) | % TOTAL INSTITUTIONAL ASSETS | PRI SIGNATORY |
|---|---|---|---|
| **MLC Super Fund** | 82.0 | 4.3% | No |
| **Colonial First State FirstChoice** | 80.2 | 4.2% | Yes |
| **Retirement Wrap** | 69.9 | 3.6% | Yes |
| **AMP Super** | 55.5 | 2.9% | Yes |
| **Wealth Personal** | 45.4 | 2.4% | No |
| **Retirement Portfolio Service** | 39.4 | 2.0% | No |
| **IOOF** | 29.7 | 1.5% | No |
| **Mercer** | 25.4 | 1.3% | Yes |
| **ASGARD** | 23.0 | 1.2% | Yes |
| **Macquarie** | 22.6 | 1.2% | Yes |
| **MLC Superannuation Fund** | 20.7 | 1.1% | No |
| **AMP Retirement Trust** | 16.7 | 0.9% | Yes |

## ASSET ALLOCATION

Asset allocation in institutional superannuation is growth-oriented, reflecting the fact that over 90% of accounts are in the accumulation phase.[7] Super funds are more heavily exposed to equities, infrastructure and property than workplace DC funds in the UK and the US (Table 5). Retail funds tend to have more liquid assets than not-for-profit super funds because of their more mobile distribution strategy.

## DEFAULT FUNDS AND MYSUPER

Super fund members have two decisions to make about their participation in the system: which super fund to join and which investment option(s) to select. In practice, very few people exercise choice.

Fewer than 9% of people choose their super fund – and then mostly when they change jobs – and fewer than one-third have ever switched their investment options.[8] Most super fund members are therefore defaulted into an option chosen by their employer, or one that forms part of the industrial relations awards system.

Since 2013, the majority of default members (those who do not exercise choice) have been allocated to a MySuper option. MySuper was introduced in response to concerns that default members were placed into underperforming products that they never left. MySuper funds have a standardised structure to facilitate comparison. They can only offer one of two investment strategies, either a balanced fund or a lifecycle fund; fees are controlled by regulation; product features are kept simple, and APRA imposes transparency requirements including presenting key financial and performance information on a one-page "product dashboard".

**Table 6: Super fund asset allocation. Source: APRA Quarterly Superannuation Performance Statistics, September 2019**

| | INDUSTRY FUNDS | PUBLIC SECTOR FUNDS | CORPORATE FUNDS | RETAIL FUNDS |
|---|---|---|---|---|
| **Cash** | **8%** | **9%** | **9%** | **12%** |
| Fixed income | 19% | 27% | 28% | 21% |
| Australian fixed income | 10% | 17% | 19% | 12% |
| International fixed income | 10% | 10% | 10% | 9% |
| of which: currency hedged | 65% | 40% | 70% | 62% |
| **Equity** | **52%** | **45%** | **44%** | **54%** |
| Australian listed equity | 22% | 17% | 16% | 27% |
| International listed equity | 26% | 22% | 26% | 25% |
| of which: currency hedged | 38% | 35% | 29% | 20% |
| Unlisted equity | 5% | 6% | 2% | 2% |
| **Property** | **10%** | **9%** | **10%** | **7%** |
| Listed property | 2% | 2% | 2% | 5% |
| Unlisted property | 8% | 7% | 8% | 2% |
| **Infrastructure** | **9%** | **5%** | **4%** | **2%** |
| Listed infrastructure | 2% | 1% | 1% | 2% |
| Australian unlisted infrastructure | 4% | 3% | 3% | 0% |
| International unlisted infrastructure | 3% | 2% | 1% | 0% |
| of which: currency hedged | 62% | * | * | 57% |
| **Commodities** | **0%** | **0%** | **1%** | **0%** |
| **Other** | **2%** | **5%** | **4%** | **4%** |
| of which: hedge funds | 1% | 2% | 3% | 2% |

7 Productivity Commission

8 The Australian Approach to Choice in Superannuation/Pensions, Prof H Bateman, 2019

Just under half of APRA-regulated Super funds (Table 7) offer a MySuper option – there are 91 generic MySuper products available and 14 large employer MySuper products. Some 58% of institutional superannuation members and 38% of assets are now in MySuper accounts.[9] A lower proportion of retail super members are in MySuper accounts, which is a reflection of the distribution model; participation in a retail super is more likely to be the result of sales, financial advice, or member choice.

**Table 7: MySuper assets, 2018. Source: APRA Annual Superannuation Bulletin, June 2018**

| SECTOR | NUMBER OF ENTITIES | NUMBER OF MYSUPER PRODUCTS | OF WHICH, LIFECYCLE | MYSUPER ASSETS (AUD BILLION) | % TOTAL SECTOR ASSETS |
|---|---|---|---|---|---|
| **Industry** | 38 | 39 | 5 | 404.4 | 64.0% |
| **Public Sector** | 37 | 12 | 4 | 138 | 22.8% |
| **Corporate** | 24 | 13 | 2 | 19.9 | 35.5% |
| **Retail** | 118 | 42 | 22 | 115.2 | 18.5% |

MySuper asset allocation is similar to that of APRA-regulated institutional super funds overall, with a greater allocation to infrastructure and property than UK default funds or a US qualified default investment alternative (QDIA) (Table 8).[10] MySuper options are not subject to the same pressure to minimise costs as UK or US DC default strategies, which may explain the differences in asset allocation. The superannuation industry can also point to its long track record of delivering positive outcomes through diversified strategies to justify including more expensive asset classes than the passive funds often used in UK and US defaults.

**Table 8: Asset allocation. Source: ASFA December 2019**

| | APRA-REGULATED INSTITUTIONAL FUNDS% OF TOTAL ASSETS | MYSUPER FUNDS % OF TOTAL ASSETS |
|---|---|---|
| **Australian listed equity** | 22 | 20 |
| **International equity** | 25 | 28 |
| **Unlisted equity** | 4 | 5 |
| **Australian fixed interest** | 13 | 13 |
| **International fixed interest** | 9 | 9 |
| **Listed property** | 3 | 2 |
| **Unlisted property** | 5 | 7 |
| **Infrastructure** | 6 | 8 |
| **Hedge funds** | 2 | 0 |
| **Cash** | 10 | 4 |
| **Other** | 1 | 3 |

9 APRA Annual Superannuation Bulletin, June 2018

10 QDIA is the US Employee Benefits Security Administration term for a 401(k) default option

For super fund participants who do want to choose their investments, the median number of options offered by industry funds is 16, with most not-for-profit choice members selecting one of four diversified options – high growth, growth, balanced or conservative. For-profit super funds may offer hundreds of choices but 30 investment options account for three-quarters of all assets in the retail segment.[11] Trustees remain ultimately responsible for the products they design and offer to members.

The Productivity Commission found that product proliferation led to poorer outcomes for members, despite in theory offering them greater control over their investment strategy. This could be attributed to over-confidence on the part of choice members, extra administrative or compliance costs, confusion resulting from too many options (potentially also making people susceptible to poor advice), and profit extraction by product providers. The Productivity Commission was clear that ethical funds (sic) were not problematic in this respect:

"...notwithstanding specific instances where returns and fees are out of kilter with well-performing funds, the long-run Australian empirical evidence suggests a positive (but small) impact on returns for funds that negatively screen investments in parts of the economy often perceived as unethical...In any case, it can be rational for an informed member to base investment decisions on their ethical preferences as well as net returns."

However, it did raise some concerns about the transparency of the investment process of some ethical funds and about trustees' oversight of such strategies, for example whether they fully understood any potential risks arising from an ethical strategy, such as suboptimal diversification.

## SELF-MANAGED SUPER FUNDS

The SMSF segment is highly fragmented in terms of trustees and somewhat fragmented in terms of administration, platforms, advisors, and other service providers.

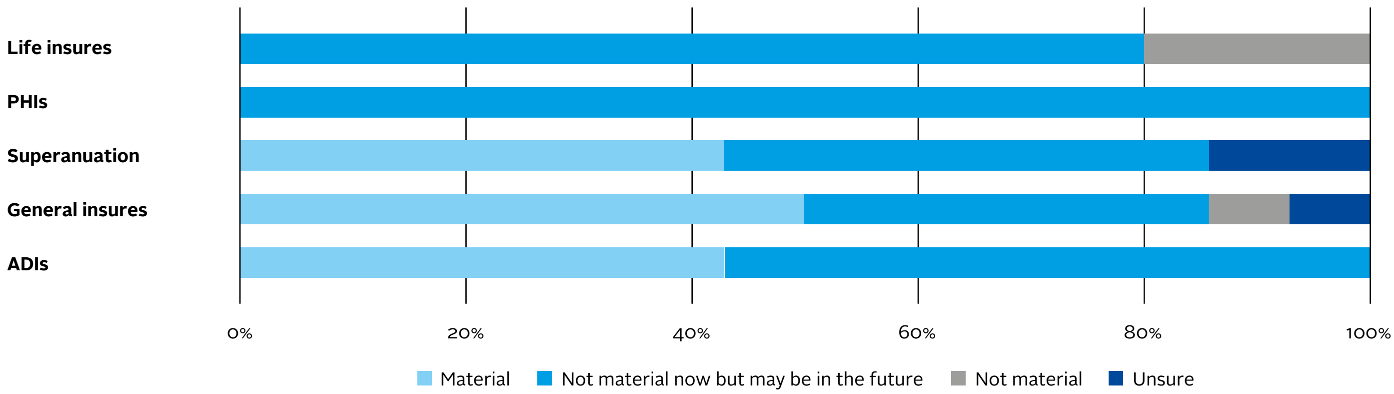
SMSFs offer savers full control over their assets, although in practice the operational and investment management of the majority of SMSFs are outsourced to financial advisers or other professionals.[12] They are relatively complex and expensive to set up and administer, so they have primarily attracted people with higher levels of investable assets. According to the ATO, 36% of SMSFs had balances of over AUS$1 million in 2016-17.[13] SMSFs can have up to four members, who can take on the role of trustee themselves or who can use a corporate trustee.

The ATO estimates that in March 2019, over two-thirds of SMSF assets were invested directly in cash, shares, or direct property as opposed to managed funds or other investment products.[14]

## RESPONSIBLE INVESTMENT BY SUPER FUNDS

In March 2019, APRA conducted a survey of 38 large entities across all regulated industries to examine how they were assessing and mitigating climate risks.[15] It found that all the funds surveyed were taking steps to increase their understanding of climate risks and most considered them material (Figure 3).

**Figure 3: Organisations considering climate-related financial risk to be material. Source: Climate change: awareness to action, APRA 20 March 2019**




11 Superannuation: Assessing Efficiency and Competitiveness, Productivity Commission Inquiry Report No.91, December 2018
12 Retirement Income in Australia (Part iii), CEPAR Research Brief, November 2018
13 ATO, SMSF Quarterly Statistical Report, Total Asset Range Tables
14 ATO, SMSF Quarterly Statistical Report, Asset Allocation $ tables
15 Climate change: awareness to action, APRA 20 March 2019

The organisations included in APRA's research had sufficient resources to employ dedicated responsible investment staff for climate-related activities. However, board endorsement and oversight was necessary for climate-change risk management policies and principles to be adopted and implemented across the organisation.

These findings were echoed in a 2019 survey by the Responsible Investment Association of Australasia (RIAA), which included 50 APRA-registered institutional funds and select other super funds, covering 91% of APRA-regulated super fund assets and 60% of superannuation assets.[16] The RIAA highlights three factors driving large asset owners to make responsible investments:

- Greater awareness that ESG factors are a critical part of investment analysis, because of their impact on risk and returns
- Growing consumer awareness of and interest in ESG
- A clear steer from regulators that ESG issues are relevant to investment decision-making

RIAA found that 72% of funds integrated ESG factors into their financial analysis and 60% undertook active ownership (although they did not necessarily disclose their engagement activity). Fund-wide exclusions were applied by 60% of funds. Super funds were more likely to take ESG factors into account at the instrument-selection level, rather than in determining their top-down asset allocation.

Fifty-one percent of funds employed one or more full-time responsible investment-focused employee, and most looked to their asset consultants or external managers to provide some expertise on ESG issues.

Although retail super funds were previously slower than not-for-profit funds in developing responsible investment policies, the RIAA found that there was now little difference between the retail and industry sectors. In keeping with the nature of their respective sectors, industry super funds tended to have fewer responsible investment options but were more likely to integrate ESG issues across their investment process, while retail funds offered more ESG options but were less likely to apply a fund-wide responsible investment integration approach.

Four smaller super funds have received certification in RIAA's whole of super category, meaning that at least 75% of their total assets, across all their investment options and default funds, are managed under at least two responsible investment strategies (Table 9). All four are PRI signatories. A growing number of responsible investment options are also certified by the RIAA. RIAA calculates that certified funds have outperformed their peers; Super Review's analysis of the 10 top-performing Australian equity super funds over the 10 years to September 2019 showed that four were ethical or responsible funds.[17]

**Table 9: RIAA Whole of Super certified providers. Source: RIAA, Super websites, APRA statistics**

| | SECTOR | ASSETS (AUD MILLIONS) | PRI SIGNATORY |
|---|---|---|---|
| **Australian Ethical** | Retail | 2,319 | Yes |
| **Christian Super** | Industry | 1,670 | Yes |
| **Future Super** | Retail | 470 | Yes |
| **Local Government Super** | Exempt Public Sector | 12,235 | Yes |

The growing adoption of responsible investment is reflected in the superannuation industry's public activities. A number of super funds are involved in developing Australia's Sustainable Finance Roadmap, two super funds had reported against TCFD as at November 2019, and 14 are signatories of the Australian Council of Superannuation Investors' Stewardship Code (ACSI is only open to not-for-profit funds; 10 of the signatories are industry funds). FSC Standard No. 20 Superannuation Governance Policy (March 2013) requires super funds that are FSC members and offer a default product, including MySuper, to implement and disclose to members an ESG Risk Management Policy for the product.[18]

However, ASFI notes that, "Across the value chain, there remains a misalignment between long-term investment horizons, particularly those of superannuation trustees, and the short-term timeframes over which entities' performance are measured and rewarded".[19] Incentive structures and market and peer benchmarking may weaken the alignment of the superannuation industry's investment strategies with sustainable outcomes. ASFI further found that super funds do not prioritise sustainability or necessarily take into account the changing sustainability preferences of consumers in their product design. Financial advisers also neglect these issues.

16 Productivity Commission

17 The Australian Approach to Choice in Superannuation/Pensions, Prof H Bateman, 2019

18 Productivity Commission

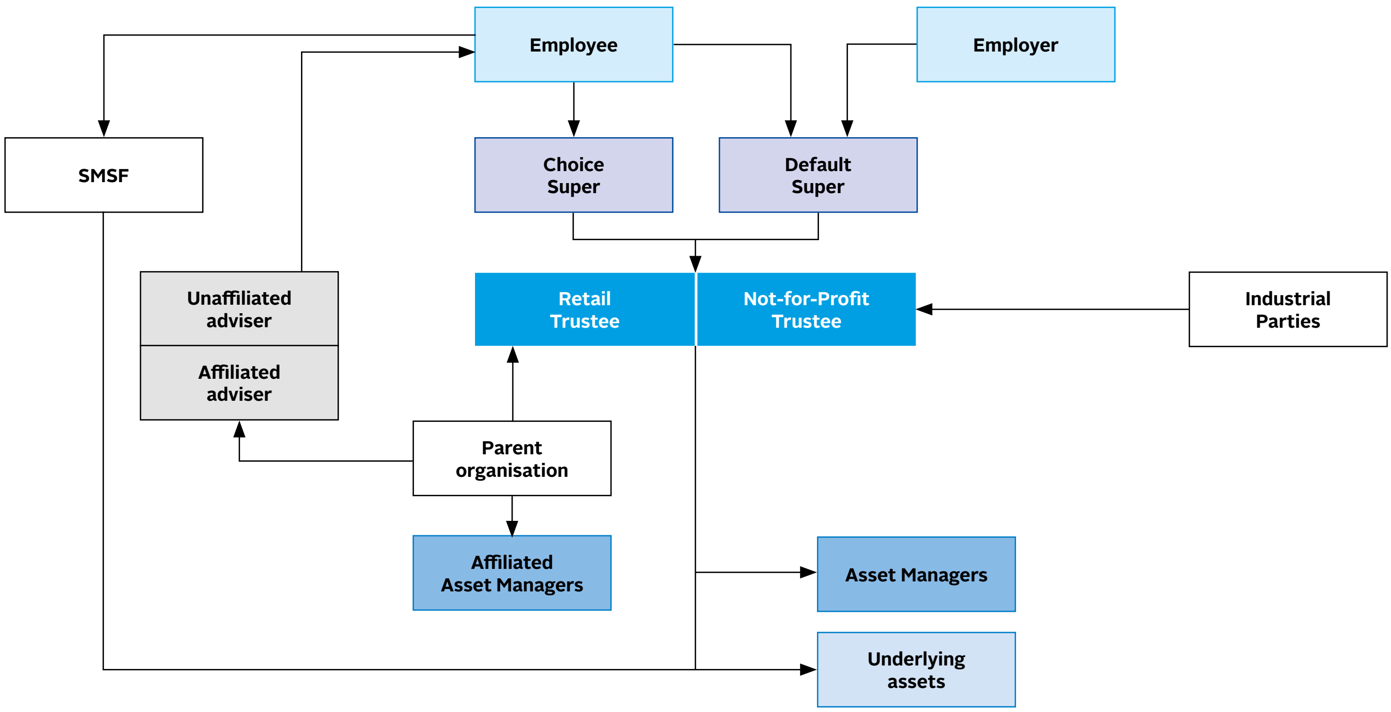
19 The Australian Approach to Choice in Superannuation/Pensions, Prof H Bateman, 2019

# SUPERANNUATION VALUE CHAIN

The Productivity Commission found that “principal-agent relationships abound in Superannuation”. For example, members could be defaulted into a fund chosen by their employer, or be encouraged by a tied retail agent to select a retail fund for which the trustees were not sufficiently independent of the parent organisation. These problems were exacerbated by the fact that consumers were disengaged (Figure 4).

These agency problems showed up in industry-wide and individual super funds’ performance data and cost structures. There was also evidence of herding behaviour by funds as they tried to avoid underperforming their peers in the short term, even if members are better served by a longer investment horizon. As noted by ASFI (see above), these characteristics are not supportive of long-term, responsible investment behaviour.

**Figure 4: Superannuation governance and value chain**




The regulatory response has been to prioritise member financial outcomes, focusing on operational efficiency and fees, and to empower consumers by simplifying and standardising disclosures.

## SUPERANNUATION FUND TRUSTEES

Super funds are governed by trustees who are the legal owners of assets and assume both common law fiduciary duties and statutory responsibilities for safeguarding members' interests. They have ultimate responsibility for fund operations and investment.[20]

Superannuation trustees generally take on the form of a corporation, so trustees have shares in the corporate trustee and are subject to corporation law. In not-for-profit super funds, trustee-directors' shares are usually held by the employer and employee sponsors, who have a non-beneficial shareholding and do not receive dividends. In retail funds, trustee-directors may find that there is a conflict between their duties to shareholders under the Corporations Act and their duty to members under the Superannuation Industry Supervision (SIS) Act. In 2014, the SIS Act was amended to clarify that trustees must act in beneficiaries' best interests and that members have priority in the event of a conflict.

Over 90% of retail assets and member accounts (at both total fund and MySuper levels) are managed by trustee boards that are in some way affiliated to the parent organisation, creating the potential for conflicts of interest. Indeed, the governance of the superannuation system has come under considerable scrutiny and there have been several proposals for improving the quality of trusteeship. The Productivity Commission and the Royal Commission both found evidence that trustees of retail super funds lacked independence, and that this was damaging member outcomes to the extent that it meant that services were outsourced to related parties without a competitive tender.

There is no evidence that governance issues have had an impact on responsible investment. That said, responsible investment in the superannuation industry has been spearheaded by the industry funds, which follow the "equal representation" model and have been the strongest proponents of responsible investment.

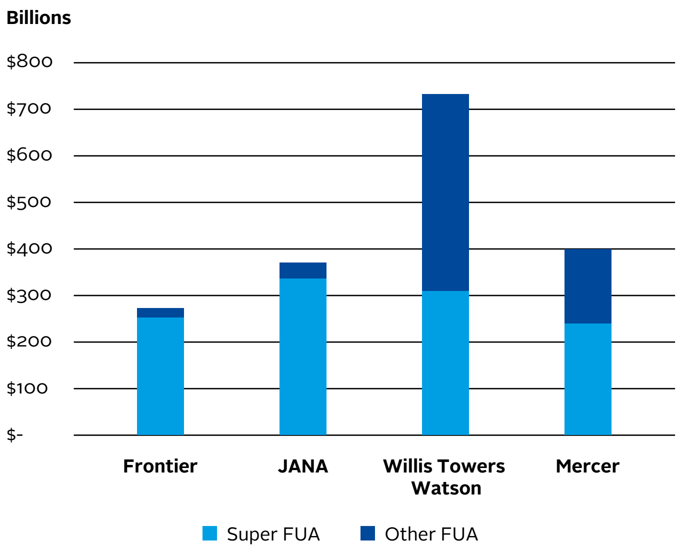
The SIS Act requires most not-for-profit funds to apply the equal representation model, and there have been claims that this makes it more difficult to recruit board members with the appropriate mix of skills and who represent the interests of the full range of members in an evolving market.[21] However, Financial Systems Inquiry proposals to require all trustee boards to be composed of a majority of independent directors and have an independent chair were not taken up by the government of the day; Parliament rejected related legislation to require one-third of directors to be independent of the sponsoring organisation.

## ASSET CONSULTANTS

Asset consulting is a relatively small proportion of superannuation costs, reaching AUS$64 million in 2017-18, compared with AUS$160 million spent on custodians.[22] Nevertheless, consultant services are widely used by super funds – around one-third of institutional superannuation assets access investment consulting advice.[23] The Productivity Commission found that the markets for actuarial and asset consulting were moderately concentrated. However, there is anecdotal evidence that consultants are losing influence as a result of consolidation – taking potential clients out of the market – and the insourcing of investment capabilities by larger super funds.

The market for investment consulting is dominated by four large consultants, Frontier Advisers, Willis Towers Watson, Mercer, and JANA, all of which are PRI signatories (Figure 5). Frontier is owned by not-for-profit funds while JANA was formerly part of National Australia Bank. Frontier and JANA focus on advising superannuation and pension asset owners, and Willis Towers Watson and Mercer have a mix of super funds and other asset owners as clients.

**Figure 5: Consultant assets. Source: PRI Investment Consulting – Australia report by QMV**




20 When boards use related parties: outsourcing and superannuation fund performance, Liu & Ooi, Accounting and Finance Association of Australia and New Zealand 2018

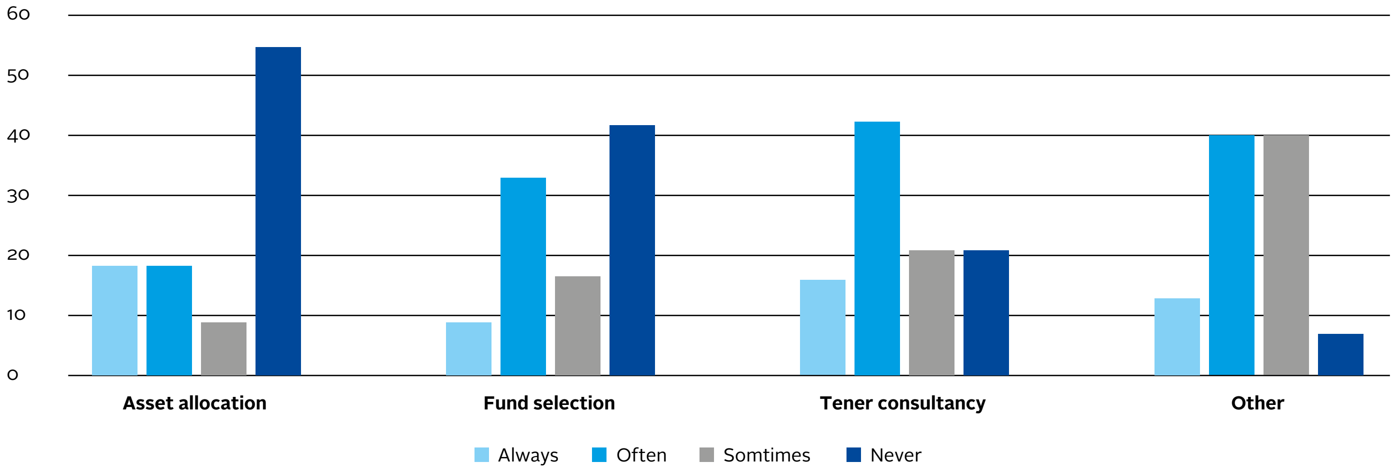
21 Royal Commission Background Paper 25, July 2018

22 APRA Annual Superannuation Bulletin, June 2018

23 PRI Investment Consulting – Australia report by QMV

One 2019 survey found that super funds were more likely to use consultants for advice on tenders and other non-investment services than asset allocation and fund selection advice, their traditional areas of strength (Figure 6).[24]

**Figure 6: What services do you most frequently use external consultants for? Source: Rating the superannuation consultants, Super Review**




The high proportion of survey participants that say that they "never" use consultants for asset allocation or fund selection reflects the increased capacity of larger super funds in these areas, and the insourcing of a growing proportion of their asset management activities. This also helps to explain the more extensive use of consultants for other services, such as ad hoc projects relating to strategy, marketing, governance, business and systems analysis, or member services. The "tender consultancy" category includes tenders for external providers such as insurers, administration specialists, and technology companies and custodians. The big four consultants do not necessarily dominate these non-investment-related services. As larger firms rely less on consultants, smaller super funds remain relatively engaged. However, trustees may lack the expertise to challenge the investment advice they are given.

## FINANCIAL ADVISERS

The Royal Commission found that advice on superannuation, retirement and SMSF-related matters accounted for over half of financial adviser revenues in 2016-17 with those switching into a retail fund or SMSF most likely to seek advice from financial advisers or accountants.[25]

The largest 20 dealer groups had approximately 50% market share in August 2009, and 85% of financial advisers at the time were associated with a product manufacturer, according to ASIC.[26]

The Future of Financial Advice reforms initiated in 2013 imposed a "best interests" requirement on financial advisers and pushed for fee-based compensation rather than asset-based or commission-based fees, driven by concerns that advice was not always impartial or value-adding.

Advisers have since become more independent. By 2018, the number of financial advisers had increased by around 40% from 2009 levels, to over 25,000, and although 44% of advisers operated under a license controlled by the largest 10 financial institutions, they were not necessarily aligned to that institution (i.e. bound to its product range). Around 30% of advisers on ASIC's Financial Advisers Register in October 2017 worked for one of the major banks. Nonetheless, when it investigated the advice channels of the leading Australian financial institutions, ASIC found a worryingly high level of both non-compliant advice and of funds buying in-house products.[27]

The majority of financial advisory firms are small – 78% of advice licensees operate a firm with fewer than 10 advisers – and there are concerns that the additional compliance standards required by the proposed Financial Standards and Ethics Authority regime could lead to a decline in the number of financial advisers. This would likely impact SMSF growth.

24 When boards use related parties: outsourcing and superannuation fund performance, Liu & Ooi, Accounting and Finance Association of Australia and New Zealand 2018

25 Royal Commission Background Paper 25, July 2018

26 APRA Annual Superannuation Bulletin, June 2018

27 PRI Investment Consulting – Australia report by QMV

## ASSET MANAGEMENT

According to the Productivity Commission, APRA-regulated funds both invest directly and use external investment managers. At the end of March 2018, according to APRA data, 38% of assets were directly held by funds, but this included externally managed assets held in the fund's name (Table 10). The Commission calculated that the true share of internally-managed assets was around 6%, and that 60% of these investments were managed by ten of the larger super funds, although nearly 80% of funds undertook some direct management of their assets.

The proportion of funds managed internally is rising. AustralianSuper manages 40% of assets in-house and plans to increase this to 50% by June 2021 especially Australian equities (it already manages half of this asset class internally).

UniSuper manages 70% of its assets internally, First State Super manages 20% (Australian equity, real estate, infrastructure, credit, cash, fixed interest all have some internal and some external management), and Cbus Super manages14% with plans to increase this to 31% by 2022. By contrast HostPlus is sticking with external managers.[28] All are PRI signatories. Another PRI signatory, IFM Investors, is not an asset owner itself but is owned by a number of not-for-profit Super funds and manages AUS$113 billion.

Despite this trend, the superannuation sector still accounts for 54% of the AUS$2.9 trillion of assets placed with Australian managers.[29] The market for external investment management is not highly concentrated: the top 10 managers have an over 50% share of the overall managed funds market, albeit constituents and their market shares change each year.

**Table 10: Australian Investment Managers Size at 31 December 2015 and December 2009. Source: Australian Managed Funds Industry, FSC/Morningstar July 2016**

| | PRI SIGNATORY | 2015 RANK | 2015 MARKET SHARE | 2009 RANK | 2009 MARKET SHARE |
|---|---|---|---|---|---|
| **State Street Global Advisors** | Yes | 1 | 12.4% | 5 | 5.8% |
| **AMP Group** | Yes | 2 | 7.5% | 4 | 6.2% |
| **Commonwealth/Colonial Group** | Yes | 3 | 7.0% | 1 | 11.4% |
| **Vanguard** | Yes | 4 | 6.6% | 3 | 6.5% |
| **IFM Investors** | Yes | 5 | 5.0% | 12 | 2.2% |
| **Macquarie Bank Group** | Yes | 6 | 4.9% | 2 | 8.2% |
| **BlackRock** | Yes | 7 | 4.6% | 17 | 1.7% |
| **Schroder Investment Management** | Yes | 8 | 3.8% | 19 | 1.6% |
| **UBS Asset Management** | Yes | 9 | 3.3% | 20 | 1.5% |
| **BT Investment Management** | Yes | 10 | 2.7% | 7 | 4.4% |
| **Top 10** | | | 57.7% | | 56.9% |
| **Top 20** | | | 77.0% | | 75.7% |
| **Top 30** | | | 87.6% | | 87.1% |

The RIAA calculates that AUS$980 billion of professionally managed assets, 44% of the total in Australia, are responsibly managed.[30] This represents a big increase from 2013 (AUS$178 billion, 13%). In its survey of major asset managers, fewer respondents cited lack of understanding as a barrier to responsible investing than in previous years, but a number of deterrents remained, including performance concerns (45% of responses), lack of public awareness (31%), and lack of viable products/options (29%).

According to the RIAA, the majority of super funds expect their external investment managers to undertake at least some responsibility for addressing ESG issues on their behalf, but the majority of funds implement their own voting policies. Super funds usually use segregated accounts rather than pooled funds, so have control over the voting rights, in contrast to UK pension providers.

28 IPE 26 November 2019

29 FSC State of the Industry Report, 2019

30 Responsible Investment Benchmark Report, RIAA 2019

# POLICY AND REGULATION

Regulation of superannuation is split between APRA, which is responsible for prudential standards, and ASIC, which oversees conduct regulation. SMSF are subject to oversight by the ATO. Policy advice on the superannuation system is also provided by the Australian Treasury, the Department of Social Services, and the Department of Employment.

The size of the superannuation industry and its importance in providing retirement income means that it has been subject to extensive policy review and regulatory scrutiny. Policy reviews and reforms relating to the governance and investment habits of super funds have focused on ameliorating the primary risks of a compulsory, defined contribution set-up: investment decision-making and risk being pushed onto disengaged consumers and funds engaging in rent-seeking activity.

The goal of these interventions has been to improve financial outcomes in retirement for superannuation members. None has directly addressed responsible investment issues. However, the overall policy impetus towards asset concentration in the larger, not-for-profit funds has probably, albeit unintentionally, helped to support the development of responsible investment. By contrast, some of the targeted reforms introduced to resolve specific challenges, in particular the introduction of low-cost default funds, could work in the opposite direction. The underlying prudential framework leaves scope for – but does not require – super funds to consider ESG-related risks and opportunities.

## PRUDENTIAL REGULATION

APRA regulates the majority of institutional funds, issuing licenses to Registrable Superannuation Entities ("RSE") – an RSE may offer more than one super fund. Superannuation is a trust-based system and APRA's role is to ensure that trustees can and do manage funds in the best interests of members, with the SIS Act setting out the principles of "best interest" and "sole purpose". RSEs that offer consumer products or advice must also hold an AFS license from ASIC.

APRA does not regulate exempt public sector schemes or SMSFs. Since SMSF members can be their own trustees, there is no risk of a conflict of interest – SMSFs are regulated by the ATO for compliance with tax and superannuation law.

To some extent, the SIS Act may have hampered ESG considerations in superannuation investment because these could fail the "sole purpose" test.

For example, in March 2019 there were press reports that the Chair of APRA was cautioning super fund trustees against engaging in "activism" on social issues as this could mean that they were pursuing political objectives at the expense of members' interests.[31] Cbus' intention to set a minimum quota for its investment in climate-related initiatives has also been queried on the grounds that a quota was a non-financial criterion.[32]

However, there are several examples of licensed super funds that make sustainability-related investments. Good Super, for example, has 100% of its assets in impact investments, and all of Christian Super's investments are subject to a social impact test. The SIS Act requires that trustees consider financial criteria (risk and likely return from investments, diversification, liquidity, valuation and other relevant factors) but does not prohibit them from considering additional factors provided that there is no conflict with the required analysis.

Nonetheless, APRA's language has not been encouraging of responsible investment. For example, Prudential Standard SPS 530 Investment Governance (SPS 530), which sets out APRA's requirements in relation to investment governance, "expects that RSE licensees have an appropriate rationale and analysis for determining that the investment strategy formulated for an environmental, sustainability, social and governance (ESG) investment option is in the best interests of their members." Product disclosure requirements also guard against trustees making investment decisions for purely non-financial reasons: the Financial Services Reform Act of 2001 notes that a Product Disclosure Statement should include, where there is an investment component, information about "the extent to which labour standards or environmental, social or ethical considerations are taken into account in the selection, retention or realisation of the investment".[33]

APRA's own 2019 review of its prudential framework acknowledged the importance of ESG considerations for some super funds and members and said that it could consider enhancing its standard and guidance to reflect global developments and to provide greater clarity on the obligations of RSE licensees in relation to the integration of ESG factors in their investment strategies. These enhancements could include:

- "clarifying or strengthening the factors that RSE licensees are required to consider for member directed (choice) investment options;
- considering additional guidance or requirements to enhance the application of investment strategy stress testing; and
- reviewing and updating the guidance on consideration of ESG factors in formulating an investment strategy."[34]

31 IPE 26 November 2019
32 FSC State of the Industry Report, 2019
33 IPE 26 November 2019
34 FSC State of the Industry Report, 2019

## POLICY REVIEWS

In 2013 the Australian government established a Financial Systems Inquiry which raised a number of concerns over the efficiency of Australia's retirement income system. Its findings have laid the foundations for subsequent policy reviews and regulatory responses: a clear focus on financial outcomes for members, charges that can be deducted from superannuation balances, default investment strategies, and transparency around fund performance.

The Financial Systems Inquiry argued that the system was operationally inefficient because it lacked strong, price-based competition. In response, the Australian government requested its Productivity Commission to review the efficiency and competitiveness of the superannuation system. The Productivity Commission confirmed the lack of competition in the superannuation industry, which it put down to poor trustee governance and lack of member empowerment. This meant that there was significant underperformance by some funds, especially in the retail segment, excessive and unjustifiable fees, product complexity, and lack of simple, impartial advice.

In 2018, a Royal Commission was established to investigate claims of misconduct in banking and this was extended to cover superannuation. Its analysis covered some of the conclusions of the Productivity Commission and exposed failings related to conflicts of interest in the retail segment, in particular, where the vertically-integrated value chain could cause trustees to fail to act in members' best interests.

## MEMBER OUTCOMES

Although there is a growing focus on member outcomes, the key metrics for measuring success in these terms are purely financial – net investment performance, fees and costs, insurance, scale, and financial sustainability. Policymakers have not been concerned with a broader measure of sustainability. This is exemplified by two recent developments:

- APRA published its first MySuper Heatmap in 2019. This compares fund performance over three and five years, potentially creating an artificially short-term horizon for lifecycle and balanced funds.
- *Prudential Standard SPS 515 Strategic Planning and Member Outcomes was finalised in 2019.* From January 2020, trustees have a duty to consider the long term (financial) sustainability of their funds based on quantitative and qualitative metrics of value for members. These do not include an ESG metric.

## FOCUS ON CLIMATE CHANGE

Australia's different financial regulators have begun to acknowledge the systemic risks posed by climate change. In a speech to the Insurance Council of Australia Annual Forum in 2017, APRA's Executive Board Member Geoff Summerhayes highlighted that "climate change is likely to have material, financial implications that should be carefully considered".[35] In 2019, he signalled that "APRA is embedding the assessment of climate risk into our ongoing supervisory activities. We intend to probe the entities we regulate on their risk identification, measurement and mitigation strategies. We expect to see continuous improvement in how entities are preparing for the transition to the low-carbon economy and encourage regulated entities to adopt the TCFD recommendations".[36]

This was underlined by the publication of an information paper, "Climate change: awareness to action", in March 2019 in which APRA advised regulated entities not to use uncertainty about when or how climate-related financial risks will manifest themselves as an excuse for inaction.[37] In February 2020, APRA announced new initiatives to understand and manage the financial risks of climate change across the sectors it regulates.[38] Of most immediate relevance for the superannuation industry was that APRA plans to develop and consult on a climate change financial risk prudential practice guide. This will assist regulated entities in complying with their prudential requirements. APRA also intends to update Prudential Practice Guide SPG 530 Investment Governance (SPG 530), which aims to assist a registrable superannuation entity licensee in complying with requirements in relation to the formulation and implementation of an investment strategy, including in relation to ESG considerations. In this announcement, APRA reiterated that regulated entities "should be proactive in taking steps to assess and mitigate climate change financial risks now, and not delay action until further guidance or scenario analysis from APRA is released."

35 Australia's new horizon: Climate change challenges and prudential risk, Geoff Summerhayes, February 2017

36 Buy now or pay later, Geoff Summerhayes, June 2019

37 Climate change: awareness to action, APRA information paper, March 2019

38 Letter to all APRA-regulated entities, Understanding and Managing the Financial Risks of Climate Change, 24 February 2020

## CREDITS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### The Principles for Responsible Investment (PRI)

The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

More information: www.unpri.org

PRI Principles for Responsible Investment

## The PRI is an investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact.

### United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP FI is a unique partnership between the United Nations Environment Programme (UNEP) and the global financial sector. UNEP FI works closely with over 200 financial institutions that are signatories to the UNEP FI Statement on Sustainable Development, and a range of partner organisations, to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations.

More information: www.unepfi.org

UNEP FINANCE INITIATIVE

### United Nations Global Compact

The United Nations Global Compact is a call to companies everywhere to align their operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to take action in support of UN goals and issues embodied in the Sustainable Development Goals. The UN Global Compact is a leadership platform for the development, implementation and disclosure of responsible corporate practices. Launched in 2000, it is the largest corporate sustainability initiative in the world, with more than 8,800 companies and 4,000 non-business signatories based in over 160 countries, and more than 80 Local Networks.

More information: www.unglobalcompact.org

United Nations Global Compact