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Draft Financial System and Regulator Metrics Framework Submission

July 26, 2023

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About The Conexus Institute

The Conexus Institute is an independent, not-for-profit research institution focused on improving retirement outcomes for Australian consumers. Philanthropically funded, The Institute is supported by the insights of a high-quality advisory board, whereby each member's involvement is on a pro-bono basis. The Institute adopts a research-for-impact model and frequently collaborates with researchers from academia, associations, and industry. Research is generally made open source to create transparency and accountability. The Conexus Institute exists with no commercial relationships. Further information here.

About David Bell

Dr David Bell is Executive Director of The Conexus Institute. Bell's career has been dedicated to the investment and retirement sector. He has worked with both commercial and profit-for-member firms, and ran his own consulting firm. Bell worked with APRA in the development of the APRA Heatmap. Academically, Bell taught for 12 years at Macquarie University and in 2020 completed his PhD at UNSW which focused on retirement investment problems. Full bio here.

About Geoff Warren

Dr Geoff Warren is Research Director with the Consensus Institute and an Associate Professor at the Australian National University, as well as a member of various investment and research advisory boards. Warren's research focuses on investment-related areas specially including superannuation and retirement, and is widely published in leading journals. He has a prior career in the investment industry spanning over 20 years. Full bio here.

***** The authors are willing and able to participate in further consultation. *****

Executive summary

This short submission is compiled through the lens of superannuation, which is our area of expertise. We make two general points, and then comment on the metrics for superannuation:

1. Performance under many (but not all) of the proposed metrics that aim to assess broader financial system outcomes can be explained by factors over which the regulators have limited influence. These metrics thus have limited effectiveness as performance indicators in this context, and should be considered for removal or replacement.

2. The metrics focus on present rather than future challenges. In the case of superannuation, there are no metrics that aim to gauge the effectiveness by which the regulators are developing frameworks that support development of retirement income strategies.

3. We believe the metric set for superannuation can be improved. We offer assistance should the FRAA wish to explore this area further.

We believe that addressing these areas would help to create clarity for regulators, a more efficient and effective financial system, and better consumer outcomes in retirement.

1. Proposed metrics largely explained by broader factors

The performance of many (but not all) of the proposed metrics for assessing financial system outcomes can be largely explained by broader factors that are not under the influence of the regulators. We note that the FRAA consultation paper self-identifies this issue[1]. However, its importance cannot not be understated.

One rule of performance evaluation is that it should be framed around what the person or entity being reviewed is able to control. In superannuation, we are particularly concerned about the risk adjusted rate of return (RARR) metric. Performance under this metric will be dominated by movements in financial markets, in particular equities and other 'growth' assets as the most volatile component of any portfolio. Through a traditional performance attribution framework, this is equivalent to overall performance being dominated by beta (i.e. market) exposure that is a function of economic trends. Meanwhile, superannuation funds, and by implication regulatory activity, may influence asset allocation, generation of alpha (i.e. relative performance), and fees and expenses. The majority of funds are thus likely to experience good (poor) total performance at the same time.

In addition, we also note that risk adjustment is fraught for two reasons. First, the importance of risk varies at different points of an individual's lifecycle[2]. This implies that the degree of risk adjustment might vary at different life stages. Second, superannuation is a long-term investment.

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[1] *"Some metrics could be used to provide broader context and insights on the financial system in the FRAA's reports, including the environment within which APRA and ASIC operate, rather than being explicitly used by the FRAA to directly assess the effectiveness and capability of the regulators."*

[2] Broadly, life-cycle theory suggests that young people, with many years of additional contributions to make, should rationally take more risk than an older person drawing down on retirement savings.

The risks that matter over long time frames include failure to generate sufficient long-run returns to support adequate income in retirement and (relatedly) the risk of permanent loss of capital rather than short-term volatility. This increases the hurdle of implementing the FRAA metric in a meaningful way.

2. Metrics focus on present rather than future challenges

Most metrics seem to focus on the present state rather than whether the regulators are addressing future challenges. In the superannuation space we identify a range of challenges for the future that are not addressed in the FRAA consultation paper:

- **Retirement** – We believe effective shaping and regulation of the decumulation phase of superannuation is a crucially important challenge. The nature of this ‘retirement challenge’ is significant: converting a predominantly scaled homogenous service (accumulation) into a more engaged tailored service to serve the heterogeneous needs of retirees. It reflects the efficiency characteristic identified in the FRAA consultation paper.

- **Member experience provided by funds** – This is identified by Minister Stephen Jones as the most important challenge for the sector[3].

- **Impacts of size of superannuation funds** – Increasing size is occurring at both the system and individual fund level, driven by the inflows under the superannuation guarantee and consolidation that has been encouraged by APRA. Large size raises issues such as ability to allocate capital to attractive investment opportunities (partly captured in the FRAA consultation paper through tracking changes in asset class holdings), liquidity challenges and issues related to managing increasing large and global financial organisation. At the other end of the scale, there remain a number of funds that are sub-scale.

3. Offer of assistance on superannuation metrics

We believe the metric set for superannuation can be improved. We offer assistance should the FRAA wish to explore this area further. Potential for improvement comes in the two above-detailed areas of feedback, as well as making full use of analysis already undertaken by APRA (e.g. APRA Heatmaps).

[3] See for example: https://www.investmentmagazine.com.au/2023/07/government-will-move-jones-threatens-trustees-on-member-engagement/