FSC Guidance Note No. 29

Standard Risk Measure Guidance Paper for Trustees

July 2011

FSC FINANCIAL SERVICES COUNCIL

asfa the voice of super

FSC Guidance Note No. 29

Table of Contents

FSC Guidance Note No. 29

1. Background and context

On 29 June 2010, APRA issued a letter to superannuation trustees advising that APRA would be providing guidance on the disclosure of superannuation investment risk to fund members.

The letter to trustees states that risk should be measured as the likely number of negative annual returns over a 20 year period.

As this letter remains principles-based guidance, APRA has asked the FSC and ASFA to develop industry guidance for the disclosure of investment risk, based on a consistent methodology (the "Standard Risk Measure").

In response, the FSC and ASFA formed a joint working group comprising representatives of major asset consultants as well as investment specialists from a number of superannuation funds to develop this guidance paper.

Adoption of the Standard Risk Measure is strongly recommended by APRA, ASIC, ASFA and the FSC.

2. Commencement

The Standard Risk Measure is to be applied in superannuation fund Product Disclosure Statements (PDS) issued on or after 22 June 2012. This is consistent with the application of the Shorter PDS reforms and is expected to provide sufficient time for trustees to undertake the necessary risk measure assessments across all of their funds' investment options.

3. Purpose of the Standard Risk Measure

The purpose of the Standard Risk Measure is to provide members with a descriptor to assist in comparing investment options (both within and across superannuation funds) utilising a simplified risk measure.

The Standard Risk Measure is not a complete assessment of risk. For example, it does not detail important issues such as the potential size of a negative return or that a positive return could still be less than a member requires to meet their investment objectives/needs.

<u>Disclosure</u>

From 22 June 2012 trustees will need to disclose the Standard Risk Measure for each investment option offered in a PDS. For this purpose, the Standard Risk Measure means the relevant Risk Band number and Label as set out in the table in Section 4. It is appropriate that trustees also disclose (somewhere in the PDS) what the Band and Label actually mean, i.e. the likely number of negative years that relate to each of the Risk Bands.

Where a trustee discloses the Standard Risk Measure it must be accompanied by a description which includes an explanation of what it is and its limitations.

In order to assist superannuation fund members, trustees are encouraged to use the following description:

> *The Standard Risk Measure is based on industry guidance to allow members to compare investment options that are expected to deliver a similar number of negative annual returns over any 20 year period.*
>
> *The Standard Risk Measure is not a complete assessment of all forms of investment risk, for instance it does not detail what the size of a negative return could be or the potential for a positive return to be less than a member may require to meet their objectives. Further, it does not take into account the impact of administration fees and tax on the likelihood of a negative return.*

Members should still ensure they are comfortable with the risks and potential losses associated with their chosen investment option/s.

Additionally, so that members and interested stakeholders are in a position to assess the risk assessment methodology, trustees will need to document their methodology and make it publicly available on their website. The disclosure should include any “if not, why not” explanation where the trustee has deviated from this Guidance. The methodology is discussed in Section 7 of this guidance paper.

4. Labeling of Risk Measures and Categories

Utilising the numeric Standard Risk Measure APRA has indicated that they would also like investment options to be grouped into categories with appropriate labels.

APRA’s guidance states that this classification system should help members “readily distinguish the characteristics of each investment strategy”. To achieve this, there needs to be sufficient categories to meaningfully differentiate between various options based on risk.

The Joint ASFA/FSC Working Group determined to move forward with a seven level classification system to provide sufficient granularity and also lend itself to the naming system shown in the table below. Analysis also showed that the number of annual negative periods over any 20 year period is likely to fall in the range of 0 to 7 for the majority of investment options.

Risk Band	Risk Label	Estimated number of negative annual returns over any 20 year
1	Very Low	Less than 0.5
2	Low	0.5 to less than 1
3	Low to medium	1 to less than 2
4	Medium	2 to less than 3
5	Medium to high	3 to less than 4
6	High	4 to less than 6
7	Very high	6 or Greater

In order to ensure true to label disclosure, the investment option label “Conservative” should only be utilized where the estimated number of negative annual returns over any 20 year period is less than 2.

5. What other issues should trustees consider for best practice risk disclosure?

For the purposes of clarity, this guide does not outline all of a trustee’s responsibilities in considering and disclosing investment and other risks for each investment strategy. Compliance with this guide does not of itself fulfill a trustee’s responsibilities in relation to managing and disclosing investment risk.

Trustees are still expected to consider all aspects of investment risk as part of their Risk Management Plan, which may include (but is not limited to) consideration of factors such as:

- the size of any potential negative return;
- the chance a return may be positive but less than expected (either in an absolute or a relative sense), or is insufficient to meet member expectations/needs;
- the investment risks associated with each investment strategy, including market risk, hedging risks, liquidity risk, inflation risk, credit risk, valuation risk, counterparty risk and settlement risk;

- whether members are treated equitably within the investment option (e.g. are the unit prices fair and equitable); and
- other risks as identified by the trustee in formulating and giving effect to an investment strategy, such as regulatory risks, conflicts of interest and operational risks.

Trustees must be able to identify, monitor, measure (where possible) and manage the risks associated with their chosen investments and investment strategies.

Trustees may also choose to communicate details of their expectations on one or more of the risks in the list above (or others) to members in addition to the Standard Risk Measure – indeed communication of more than one suitable risk measure would be considered better practice.

6. Scope

The Standard Risk Measure (expected frequency of negative annual returns over a 20 year period) is to be applied to each investment option within a superannuation fund.

7. Methodology

Guiding Principles:

i. The methodology should support the purpose of the Standard Risk Measure, which is to provide members with a descriptor to assist in comparing investment options (both within and across superannuation funds).

ii. Underlying assumptions should be structured to reflect a conservative bias (i.e. in favour of overstating risk) and be subject to review by APRA as a normal part of its normal supervision activities.

iii. The Standard Risk Measure is non-proprietary. No single service provider or proprietary methodology is recommended above any other in relation to constructing the Standard Risk Measure.

iv. Trustees should be permitted to deviate from the methodology outlined in this paper (i.e. following an alternative approach to developing a risk measure) provided they document and can explain the reasons for their deviation (referred to as the “if not, why not” reporting framework).

As stated above, a well-reasoned “if not, why not” explanation from a trustee is considered a valid response to questioning from the regulator. An effective “if not, why not” reporting practice involves:

- identifying the calculation methodology that the trustee has not followed;
- explaining why the trustee has not followed the relevant approach; and
- explaining how its practices accord with the ‘spirit’ of this guide, and that the trustee understands the relevant issues and has considered the impact of its alternative approach.

Calculation methodology

The parameters listed in the points below provide a framework for how a trustee would undertake the task of determining the specified risk measure for each superannuation investment option included in a PDS.

The risk measure is defined as the number of negative annual returns which could be expected over any 20 year period.

1. The methodology is forward looking.

- The implication is that a trustee would need to develop a set of capital market assumptions (return, volatility, correlation) for the asset classes which make up the investments of the specified superannuation option/s.
- Trustees may use internal expertise or an external consultant/adviser to develop these assumptions.
- Trustees should be aware that return, volatility and correlation measures may not fully capture the characteristics of some investments for a variety of reasons, such as less frequent valuations, non-linear pay-off structures and active management (alpha). Trustees should use a conservative approach in establishing assumptions for these investments, particularly in relation to their potential to avoid short term negative returns.
- Having developed a set of asset class assumptions the trustee should then:
  - calculate the forward looking return distribution of the overall investment option;
  - then draw from that distribution the probability of a negative return over one year; and
  - then multiply the probability by 20 to achieve the number of negative years in 20.

2. The Standard Risk Measure should be calculated gross of administration fees but net of investment management fees. For the sake of clarity, where a fund charges an all inclusive fee with no specific administration fee then this will result in a need to write back the notional component of the fee that relates to administration for the purpose of the modeling.

   Calculating the Standard Risk Measure net of administration fees would likely result in unintended differentiation of identical investment options, for example, where the same investment option is offered by different superannuation funds or even by the same superannuation fund at different administration fee levels.

   Moreover, the Standard Risk Measure is not a tool to disclose and compare fees. The relationship between fees and risk should be disclosed by trustees with wording to the effect that, all other things being equal, higher fees will increase the probability of a negative return.

3. The Standard Risk Measure should be gross of tax (ignoring the impact of franking credits).

   While a net of tax calculation would best represent the experience of a member, there are several reasons why a gross of tax methodology is more appropriate, namely:

   - The potential confusion created by having the same underlying investment option sitting in different risk classifications for superannuation and pension options.
   - Differing assumptions about various tax issues (e.g. the future realisation of capital gains and franking levels) impacting relative risk classifications between funds.
   - A belief that this particular assumption would not materially impact the relative risk classification of options as it would relate mainly to the size of a negative return as opposed to the incidence of a negative return.
   - The Standard Risk Measure is likely to also be adopted for non-superannuation and pension investments.

4. As outlined previously, the trustees' process and methodology should be made publicly available on their website. It is expected that APRA will review the methodology through its normal supervision activities for individual funds, and the wider benchmarking review process proposed in this guidance paper.

5. Trustees are permitted to use alpha (active management) assumptions. However, where such assumptions are used, Trustees should be cautious about using any assumptions that materially reduce the expectation of negative returns.

6. Asset class weights for diversified options should be based on the current strategic asset allocation parameters of the option. Where options have no specific strategic asset allocation, trustees should apply their estimate of a neutral position for each option.

7. Trustees will need to calculate and disclose a separate Standard Risk Measure for each discrete asset allocation pool within a lifecycle and target date fund.

8. For the purposes of establishing assumptions, asset class granularity should be considered such that the different characteristics and drivers of sub-asset classes are reflected in the assumptions, such as government and corporate debt, or listed and unlisted assets. The use of separate assumptions for the same asset class solely on the basis of different active management approaches should only be undertaken where those active approaches are conservatively expected to substantially alter the risk and correlation expectations of the investment.

9. Each trustee should review the calculation of the Standard Risk Measure at least annually or earlier if and when the trustee believes there has been a material change to the underlying risk and return characteristics of the investment option. In this event Trustees will need to consider whether such a change constitutes a reportable significant event.

8. Review process for the risk descriptions over time

Achieving the objective of establishing common risk descriptors for superannuation investment options will require ongoing review to ensure it remains relevant to the industry and incorporates any new research, standard industry conventions and evolving best practice.

A structured review process will also enable validation of any metrics or assumptions that are prescribed in this Guidance and also provide a forum for the APRA and ASIC to refer any material feedback from their surveillance of superannuation funds for consideration.

Instituting a process of ongoing review is therefore likely to facilitate greater confidence in the Standard Risk Measure. ASFA and the FSC will therefore work with APRA, ASIC and other relevant stakeholders in developing a review process to ensure that this guidance is being applied appropriately across the industry.

9. Acknowledgement

The Association of Superannuation Funds of Australia (ASFA) and the Financial Services Council (FSC) would like to acknowledge the contribution of each of the members of the Joint Working Group.
The Joint Working Group comprised:

Lorraine Berends (Marvin & Palmer), Kim Bowater (Frontier), Andrew Bragg (FSC), Steven Carew (JANA), Brett Elvish (Financial Viewpoint), Martin Goss (Towers Watson), Alex Harken-Yumru (AMP), Stephen Highfield (AllianceBernstein), Brad Holzberger (Q Super), David Hutchison (MLC), Paul Kessell (PAS), Keith Knapman (Russell), Peter Labrie (CFS), Graeme Mather (Mercer), Andrew Payne (BT), John Pinkerton (ASFA) and Anthony Serhan (Morningstar).

Martin Codina
Director of Policy
Financial Services Council

David Graus
General Manager Policy and Industry Practice
ASFA