The challenge facing superannuation funds and other financial institutions to transform their business models whilst delivering enhanced value for members.
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Introduction

As has been widely anticipated, the past 12 months have again seen merger activity across the superannuation sector continue to increase. The announcements of intent to merge by many funds, particularly profit-for-member funds - with expectations of more to come, perhaps even more so as the industry faces into new challenges brought about as a result of COVID-19 - combined with the significant business model transformation underway within retail funds, herald the beginning of a significant transformation era for the industry.

This report follows our 2019 report, ‘Superannuation Fund Merger Insights’, and seeks to further explore the business transformations occurring across the superannuation sector with an additional focus on retail funds, key changes observed and what it means for those organisations committing to significant change.

The focus for those pursuing transformation now shifts to effective planning, execution and delivering value to members. The scale of what lies ahead is unprecedented in many respects, and it is absolutely critical that funds successfully navigate the challenges this entails as the cost of failure could be significant.
What we have seen?

Financial institutions pursue separation whilst consolidation intensifies

The past three years have seen significant structural shifts and business model transformations across the superannuation (and broader asset and wealth management) sector in Australia involving many superannuation funds and impacting a significant number of members and accounts. Australia’s major retail banks and diversified wealth managers have all announced significant overhauls of their business models, whilst merger activity continues to increase following a slowdown across the period 2014 – 2016.

Merger activity
Predominantly occurring across the industry, public sector, and corporate funds, we have witnessed a continued increase in the number of funds entering merger discussions and agreements. Importantly, mergers are notably changing from smaller funds consolidating into larger funds, to recent announcements of large scale mergers which may have the impact of changing the landscape of the superannuation system as we know it today.

Merger announcements continue apace
A total of 17 major merger announcements have taken place over the period 2017 – 2019 (excluding Successor Fund Transfers (SFTs) <$500m and merger discussions that have not progressed). In comparison to previous years, the announcements in 2019 were characterised by significantly larger prospective transactions, with the average size of funds seeing a significant increase. This demonstrates funds are becoming increasingly ambitious in their pursuit of scale. Targeting smaller sub-scale funds may no longer be an immediate priority for large funds looking to achieve a material outcome in regard to scale and its associated benefits.

Figure: Superannuation Successor Fund Transfer (SFT)/Merger Announcement Summary (2017 – 2019)

Recent SFT/Merger Announcements

<table>
<thead>
<tr>
<th></th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of major merger announcements</td>
<td>7</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>Average size of successor/receiving fund: Members</td>
<td>0.4m</td>
<td>0.6m</td>
<td>0.6m</td>
</tr>
<tr>
<td>Average size of successor/receiving fund: $ billion (FUM)</td>
<td>$17bn</td>
<td>$27bn</td>
<td>$57bn</td>
</tr>
<tr>
<td>Average size of transferring fund: Members</td>
<td>0.2m</td>
<td>0.04m</td>
<td>0.4m</td>
</tr>
<tr>
<td>Average size of transferring fund: $ billion (FUM)</td>
<td>$8.6bn</td>
<td>$1.5bn</td>
<td>$22.3bn</td>
</tr>
<tr>
<td>Number of members moving to a larger fund</td>
<td>1.4m</td>
<td>0.2m</td>
<td>2.1m</td>
</tr>
</tbody>
</table>

Note:
1) Successor/receiving fund = fund that remains in existence post-merger
2) Transferring fund = fund that consolidates into the successor fund (members and FUM transferred)
For unknown successor funds (yet to be determined) the larger of the two funds has been used for analysis. The above analysis excludes SFTs <$500m.
Source: APRA Annual Fund-level Superannuation Statistics Back Series June 2019, KPMG Analysis
A new era for retail wealth management

The majority of Australia’s major retail banks have announced radical changes to their vertically integrated business models. This primarily involves the organisation separating their wealth management businesses (e.g. superannuation, financial advice, insurance, fund administration) from core banking operations and creating standalone wealth management entities. Following this transition, the separated entity, or group in control of it, will determine the future superannuation arrangements and business model. At this time, there have been two confirmed/announced sales or arrangements of superannuation businesses, with the other retail banks still to finalise plans for separating their wealth management businesses.

For those retail banks and diversified financial services companies remaining in wealth, various communications (to market) have been made in regard to improved trustee arrangements (including separation of RSE and RE functions), governance models and risk management practices, product and operational simplification programs, digital capability uplifts and ongoing customer remediation programs.

Figure: Spectrum of Retail Transformation

Retail fund transformation

Driven by the major retail banks and wealth managers, significant transformations have been announced as these organisations look to separate the superannuation and wealth management parts of their businesses from core banking in order to improve trustee and governance arrangements, improve risk profiles and simplify their business models (including products).
What is driving transformation across the sector?

The ‘tailwinds’ or drivers compelling superannuation funds and the major financial institutions are broadly the same. Despite this, major financial institutions begin their transformation journey (i.e. vertically integrated business models) from a distinctly different starting point to other superannuation funds (i.e. predominantly/solely focused on superannuation business) and therefore face into different business imperatives and challenges.

Regulatory pressure, scrutiny and oversight

Applicable to all superannuation funds and financial institutions, the recent Royal Commission, Productivity Commission and sustained focus and scrutiny from government and regulators (including the announced Retirement Income Review) is resulting in:

- Increased focus on member outcomes (e.g. Prudential Standard SPS 515 on strategic planning and member outcomes)
- Increased focus on fit for purpose Product offerings (e.g. Design, Distribution and Intervention Powers Act)
- Increased focus on fees, costs and performance (e.g. RG97 on disclosing fees and costs and the MySuper Heatmap)
- Implemented change to inactive accounts, fee caps and bans (Federal Budget 2018, implemented July 2019)
- Continued discussion on default arrangements and enhanced prudential oversight
- Impending implementation of the Financial Accountability Regime

Risk, governance and operational sustainability

Regulatory pressures, combined with the need and corresponding investment to deliver enhanced member outcomes and in due course comply with design and distribution obligations across products, services and engagement, is resulting in an environment straining business models, where funds are expected to provide ‘more for less’:

- Requirement to better understand and more meaningfully engage members (i.e. through both traditional and more contemporary digital channels)
- Requirement to develop and bring to market products tailored to distinct and evolving demographic target markets (across accumulation, pension/retirement income, insurance and financial advice)
- Heightened competition to compete for and retain members, driving funds to invest in underlying capabilities
- Heightened focus on risk management and governance arrangements (board independence, executive accountability, and strong service levels in vertically integrated environment)
- Revenue and fee model pressure (in consideration of account consolidation, scrutiny on fees and competition across the sector)
- Underlying pressure to improve cost bases (whilst enhancing capabilities, products and services)
- Potential impact of changes to preservation rules allowing limited early release of funds (as a result of COVID-19)

Demographic shifts and changing customer preferences

Applicable to all superannuation funds and financial institutions, members are demanding more personalised engagement through digital channels. This must be balanced by the increased proportion of members and funds under management entering the retirement phase (i.e. drawn down from superannuation funds) and the consequent requirement for high quality, fit for purpose retirement income products that are supported by advice capabilities:

- Heightened public awareness of fund performance, or lack thereof (i.e. as most recently highlighted through APRA’s Heatmap)
Business imperatives and challenges

Despite most drivers outlined above impacting both profit-for-member and retail funds similarly, the two sectors (and the main players within them) are compelled to resolve these issues and undertake transformation from inherently different business models – i.e. profit-for-member funds are, in general, simpler businesses than the typically highly complex, vertically-integrated financial institution. Therefore, each sector is facing different business imperatives and challenges.

As can be noted to the right, retail superannuation funds, in addition to the common business imperatives outlined, have other commercial business imperatives, including shareholders, and may have additional requirements to demonstrate improved governance standards following the findings of the Royal Commission.

Common business imperatives and challenges across all superannuation funds

- Improve member outcomes through:
  - Enhanced scale; consolidation of sub-scale funds (and legacy products)
  - Lower administration and operating costs
  - Improved net investment performance
  - Improved member services and engagement
  - Ongoing management of trustee, governance and risk management requirements/arrangements
  - Diversification of customer membership

Additional business imperatives of profit-for-member funds

- Build/establish greater internal organisational capability to strengthen propositions (e.g. financial advice and internal investment management)
- Establish a greater focus on retail distribution to support member growth and retention (shifting reliance on traditional distribution models linked with work place agreements and employer relationships)

Additional business imperatives of major retail superannuation funds/financial institutions

- Rationalise and simplify, where necessary, products offered to members
- Strengthen, where necessary, trustee, governance and risk management arrangements
- Reinforce and/or rebuild, where necessary, brand and reputation
- Improve shareholder value
- Realise, where applicable, commercial value from separated businesses/entities
- Undertake, where applicable, customer remediation activities
What we expect to see?

Success to be defined by demonstrable member outcome improvements

The industry transformation occurring over the next 12 – 24 months will be characterised by the sustained, ongoing momentum of consolidation activities and the transition of retail funds to a new retail wealth management environment largely separated from the major banks.

In our 2019 Super Insights report, we predicted that the number of funds in the sector would more than halve over the next decade with an acceleration of industry consolidation in the short to medium term. Indeed, we have seen this acceleration over the past 12 months and remain confident that these projections still hold true despite the recent economic environment and COVID-19 implications. Early indications are that some funds may be compelled to engage in merger discussions earlier that they had planned, whilst others will naturally pause discussions to focus on addressing immediate priorities for the fund – KPMG will continue to closely monitor current market sentiment and update our forecasts appropriately if required.

As outlined below, we expect ongoing material consolidation of superannuation funds across the sector, including retail. The result of the above consolidation, combined with natural system maturity and growth, will result in a distinctly different industry landscape characterised by:

- Significantly fewer retail funds overall
  1. Fewer ‘Small’ funds with low membership bases: the push to enhance the scale of funds will continue
  2. Increasing number of ‘Large’ funds: the average fund size to grow considerably
  3. Increasing size of existing ‘Mega’ Funds: Funds of significant, globally comparative scale to emerge

Importantly, an increasing number of Australia’s superannuation funds are going to achieve a scale over the coming years unprecedented in our economy, positioning a number of these funds as some of the largest globally. With this growth, comes significant implications and opportunities for our economy, political environment and the retirement outcomes of all Australians.

### Anticipated industry structure

<table>
<thead>
<tr>
<th>Fund Type</th>
<th>Current</th>
<th>2024</th>
<th>2029</th>
<th>% Change</th>
</tr>
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<tbody>
<tr>
<td>Corporate</td>
<td>24</td>
<td>14</td>
<td>6</td>
<td>-75%</td>
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<tr>
<td>Industry</td>
<td>38</td>
<td>21</td>
<td>12</td>
<td>-68%</td>
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<tr>
<td>Public Sector</td>
<td>37</td>
<td>29</td>
<td>15</td>
<td>-59%</td>
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<tr>
<td>Retail</td>
<td>118</td>
<td>74</td>
<td>52</td>
<td>-56%</td>
</tr>
<tr>
<td>Total APRA Regulated</td>
<td>217</td>
<td>138</td>
<td>85</td>
<td>-61%</td>
</tr>
<tr>
<td>SMSFs</td>
<td>592K</td>
<td>691K</td>
<td>771K</td>
<td>+30%</td>
</tr>
</tbody>
</table>

Source: KPMG Superannuation Insights 2019
Options for mergers/consolidation amongst superannuation funds

As outlined in our 2019 report ‘Super Fund Merger Insights’, the merger options for Superannuation Funds to pursue consolidation and achieve their business imperatives remain the same:

Who to merge with?
– Larger merger partner
– Equivalent or smaller partner
– Operationally aligned
– Industry aligned
– Fund type aligned
– Strategic growth option
– Culture and Values aligned

Merger Structures
– JV/Strategic Alliance
– Successor Fund Transfer (SFT)
– Extended Public Offer
– Member Consent Model

Retail options and opportunities

The options available to the major financial institutions separating their retail wealth management and superannuation businesses are slightly more complex; due to the operational complexity and scale, legacy technologies and requirements to manage and strengthen trustee, risk management and governance practices. Additionally, these institutions will also be focused on the commercial imperative to realise value from their assets.

Key considerations will include:

Strategic intent

What components of value chain to separate?
– Superannuation
– Financial Advice
– Platforms
– Life Insurance
– Investment Management

Operationalising separation

How can the initial transition be managed?
– Holding Company
– New Co
– In-house/Outsourced Arrangements
– Partnership/Joint Venture

Value creation/realisation

What options are available to realise value?
– Partnership/Joint Venture
– IPO
– Trade Sale
Approaching transformation – ensuring success

Transformation takes time and will require careful planning and preparation

It is important for key industry stakeholders, as well as the funds themselves, to realise the anticipated changes across the sector will take time – years – to be executed effectively. Successful execution will require a robust, well defined plan. There will be more mergers of an unprecedented size, scale and complexity than what has been seen before, and importantly, for many funds and institutions undertaking change (i.e. a significant merger or business unit separation), it will be their first experience in doing so.

We strongly believe that organisations must commit to a robust approach, with rigorous assessment and planning at each stage of the merger/transformation journey. Importantly, the Regulators have set the expectation to funds that due process is followed and demonstrated. This will require a considered and structured approach and will also likely require a considerable uplift in maturity in a fund’s program management capabilities.
Key considerations and activities to undertake/manage across this journey include:

1. **Define strategic intent**
   - **Develop strategic objectives and principles**
     - Organic and inorganic growth objectives and principles
   - **Develop performance based outcomes that can be effectively measured**
     - Growth outcomes
     - Organisational outcomes (operations and capability)
     - Member benefit outcomes (MySuper and Choice products)

2. **Identify and assess opportunities**
   - **Build an assessment framework to effectively identify suitable merger/acquisition partners**
   - **Develop robust assessment framework to assess:**
     - **i. Enhanced Member Outcomes**
       - Fees
       - Net investment outcomes
       - Service enhancements
       - Insurance
       - Design and Distribution Obligations (DDO) compliance
     - **ii. Financial Benefits/Synergies**
       - Administration
       - Trustee operations
       - Investment operations
       - Service provider rationalisation & synergies
       - Tax
     - **iii. Strategic Benefits**
       - Member services and capability enhancements
       - Operational capability enhancements (e.g. administration platform or DB capability)
       - Investment opportunities
       - Access to new member cohorts/segments
     - **iv. Commercial Value (if applicable)**
       - Valuation
       - Exit options/strategy
       - Ongoing service arrangements

3. **Undertake robust due diligence, transition planning and execution activities**
   - **Undertake robust due diligence activities that assess:**
     - Counterparty risk
     - Merged/transitional entity options
     - Merged/transitional entity portfolio options
     - Merged/transitional product and service options
     - Benefit and business case assumptions
     - RSE/trustee obligations
     - Tax, asset rollover relief, loss rollover relief, tax costs
   - **Determine the future state operating model**
     - Governance arrangements
     - Trustee operations and administration arrangements (including technology environment)
     - Investment operations arrangements (including technology environment)
     - Future product and service catalogue
     - Third party service provider arrangements
   - **Ensure Member Best Interest and Equivalent Rights requirements are met, as applicable:**
     - Continually re-evaluate member outcomes
     - Preliminary and final equivalency assessments
   - **Develop detailed separation/integration/transition plan**
     - Day 1, 2 and 3 milestones
     - Transitional services arrangements
     - Member, product and brand strategy
     - Legal considerations
     - Asset transition planning and execution
     - Workforce transition and change management
     - Communications strategy and stakeholder management
     - Contingency and risk mitigation
     - Performance monitoring

4. **Embed accountability and performance monitoring**
   - **Define ongoing executive accountability**
   - **Develop benefits realisation monitoring and assessment framework**
   - **Identify transformation successes and failures**
Overview of key tax considerations

Tax may be a barrier to implementing a successful merger. Thankfully, Division 310 of the Income Tax Assessment Act 1997, has now made loss relief and asset rollover relief a permanent provision within the tax legislation. This works well where assets are directly held by a superannuation fund (or life company or PST). Unfortunately, relief under Division 310 does not yet extend to scenarios where assets are held in underlying trusts and tax and/or capital losses are trapped in those underlying trusts.

Accordingly, it is important to address key tax issues prior to finalising the form of the merger.

**There are a number of key tax issues that will need to be addressed when considering either an extended public offer or merger by way of a successor fund transfer. These include:**

- Income tax on the transfer of assets;
- Availability, if any, of rollover relief under Division 310;
- Impact on the entitlement to franking credits;
- Impact on the entitlement to CGT discount;
- Impact on tax losses;
- Impact on capital losses;
- Availability, if any, of the rollover of tax and capital losses;
- The need for Private Ruling;
- Transfer stamp duty;
- Availability of any transfer stamp duty relief;
- Foreign income tax on the transfer of assets;
- Availability of any relief;
- Impact on any pre-emptive rights;
- Whether private rulings previously obtained can continue to apply and be relied upon.

**Additional issues will include:**

- Tax treatment of merger costs;
- Impact on master custody in relation to transfer of assets and ensuring complete and accurate transfer of tax data;
- Tax and tax in unit pricing;
- PAYG instalments;
- PAYG withholding;
- Entitlement to FITOs;
- Tax due diligence;
- Tax and impact on equivalent rights.

Typically a fund considering a merger will conduct a tax due diligence on the other fund. It will then access the appropriate structure from a tax point of view, including which fund (or even a newly established fund) should be the successor fund. Having agreed the structure it will then work through the key issues as outlined above including obtaining any advice, private rulings and/or meetings with the superannuation specialists at the ATO.
Implications and risks of failure – importance of demonstrating member outcomes

The consequences in the current financial services environment of failure could be severe given the shift to both individual and organisational accountability. To help ensure success, boards and management teams within organisations must develop robust assessment frameworks and document how they are implemented, including the assessment of the key risks that are relevant to their particular transformational journey.

Overview of key risks

Applicable to all superannuation funds pursuing change

i. Not delivering against member best interests:
   - Financial benefits/synergies
   - Strategic benefits
   - Product Improvements
   - Member outcomes/business performance
   - Operational Improvements
   - Governance Improvements

ii. Not attaining regulatory approval and endorsement

iii. Negative impact to brand and reputation

iv. Remediation

v. Realising transition risks:
   - BAU impacted during transition/BAU resourcing
   - Underestimating transition complexity
   - Data quality issues
   - Program and cost overruns

Applicable to retail only

vi. Not realising value from separated/integrated entity
   - Identification of suitable options for asset sale
   - Determining sale price and future service arrangements
   - Managing the transition
   - Not achieving business model simplification

Outcomes that may materialise for individual organisations

- Brand damage
- Poorer member outcomes
- Member growth and retention negatively impacted
- Business model sustainability (profitability) negatively impacted
- Share price negatively impacted
- Remediation exposure
- Director and executive accountability implications

Implications on the sector

- Lower confidence and trust across financial services and in Australia’s retirement systems
- Collective set of poorer, less competitive outcomes
Conclusion

The imperative over the next few years across the superannuation industry will be for many funds to successfully deliver on the committed transformation and merger activity announced. Indeed, we expect more funds will initiate discussions and commit to change of their own. Change of this magnitude must follow rigorous assessment of member outcomes and, importantly, to be delivered effectively, must be followed by robust due diligence and transition planning activity. The implications of getting it wrong at any stage of this journey are potentially severe and can only be avoided through considered planning.