

23 December 2011

Ms Helen Rowell
General Manager, Policy Development
Policy, Research and Statistics
Australian Prudential Regulation Authority
GPO Box 9836
SYDNEY NSW 2001

Dear Ms Rowell

FSC SUBMISSION – DISCUSSION PAPER: PRUDENTIAL STANDARDS FOR SUPERANNUATION

Thank you for the opportunity to provide a submission on this discussion paper.

The Financial Services Council (FSC) represents Australia's retail and wholesale funds management businesses, superannuation funds, life insurers and financial advisory networks. The FSC has over 130 members who are responsible for investing \$1.8 trillion on behalf of more than 11 million Australians.

The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Stock Exchange and is the fourth largest pool of managed funds in the world. The FSC promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

The FSC welcomes APRA's commitment to a lengthy and multi-staged consultation on the development of prudential standards for the superannuation industry.

We value the opportunity to provide comments on the discussion paper ahead of the provision of legislative authority and the exposure of draft prudential standards in 2012.

Please find our submission enclosed. We look forward to discussing the contents with you. I can be contacted on 02 9299 3022.

Yours sincerely



ANDREW BRAGG
SENIOR POLICY MANAGER



PRUDENTIAL STANDARDS FOR SUPERANNUATION

Context

Australia's pool of managed funds is valued at \$AUD1.8 trillion, the fourth largest in the world. The superannuation industry contains \$1.4 trillion of the total amount.

The corporate governance and transparency standards of superannuation funds are critically important in maintaining confidence in the system. Members want to know that their savings are secure and that they are able to access relevant information about their investment.

The FSC views appropriately balanced prudential standard making powers in superannuation as both overdue and necessary. Our submissions to the Super System Review of 2009-10 included recommendations which have been captured in the proposed changes under Stronger Super.

The rationale behind imposing prudential standards in superannuation is compelling, particularly given harmonisation with other APRA regulated industries, the compulsory nature of superannuation and broader community expectations.

The FSC strongly supports the Government's proposed Stronger Super reforms which will increase governance requirements in regulated superannuation vehicles.

The FSC believes the proposed changes are consistent with APRA's role as a prudential regulator as stated in APRA's Statement of Intent to the Treasurer in 2007:

APRA's role is to promote prudent behaviour by financial institutions through a robust prudential framework of legislation, prudential standards and prudential guidance, which aims to ensure that risk-taking is conducted within reasonable bounds and that risks are clearly identified and well managed.¹

In practical terms, we believe APRA should remain focused on prudential risk. This is the appropriate focus which should not be widened. We are therefore supportive of the Government's direction that APRA should not become an efficiency regulator. The proposed standards are correctly focused on prudential (risk) matters.

APRA discussion paper: prudential standards for superannuation

APRA issued a discussion paper for prudential standards for superannuation on 28 September 2011. The proposed prudential standards for superannuation funds rely on the passage of legislative amendments to provide APRA with this capacity. These legislative amendments are expected to be introduced into Parliament in early 2012.

¹ Australian Prudential Regulation Authority – *Statement of Intent (Letter to the Treasurer, the Hon Peter Costello MP)* 18 May 2007 – available <http://www.apra.gov.au/AboutAPRA/upload/Ltr-to-Treasurer-Statement-of-Intent.pdf>

The discussion paper draws heavily upon the Stronger Super consultation with the superannuation industry which occurred from February to July 2011. It primarily canvasses the proposed governance arrangements but also some of the MySuper provisions.

Whilst the FSC is supportive of enhancing the current framework through raising standards across the superannuation industry, we are mindful of imposing additional requirements where they create additional cost.

FSC submission

This FSC submission identifies and provides comments on the substantive issues in the discussion paper. The submission follows the structure of the discussion paper in addressing relevant matters in sequential order.

Recommendations are only provided where the FSC believes a varied approach to the definition and, or the application of the prudential standards is necessary. Under the section on operational risk reserves, further information is sought – accordingly questions are posed.

Generally, we support the manner in which APRA has proposed it will impose prudential standards on the industry. There are areas in the discussion paper where we are concerned that the suggested approach will not achieve the objective or could produce unintended consequences.

Our comments outlining the detail of these matters follow.

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SUMMARY OF RECOMMENDATIONS

1. Superannuation prudential standards should not be applied to RSEs which are restricted to operating a pooled superannuation trust.
2. APRA establish a formal multi-faceted process of review and consultation when seeking to alter prudential standards which must include a Regulatory Impact Statement.
3. The responsible person definition should solely capture trustee directors and responsible officers as determined by the trustee. Service providers should be excluded from being designated as responsible persons.
4. Remuneration paid from the superannuation trust to responsible persons should be disclosed.
5. In defining “independence”, a materiality threshold should be applied to ensure minor shareholdings do not disqualify an individual from being deemed “independent.”
6. “Senior management” should be limited to those persons engaged by RSE licensees who are either subject to the “responsible person” provisions or based on an existing definition (refer to comments on responsible person).
7. The outsourcing prudential standard (SPS231) should be aligned with CPS 231 provisions which would require risks and benefits to be identified by an RSE licensee and addressed appropriately in assessing the options for outsourcing a material business activity.
8. The newly created choice architecture model with its associated varying trustee responsibilities should be reflected in the investment governance prudential standard.
9. Uniform investment governance diligence provisions should be applied across choice and MySuper investments.
10. Non-MySuper investment options should not subject the trustee to the same diversification provisions as a MySuper investment *“including where a beneficiary may choose to concentrate their interest in the fund in a single, undiversified option”*
11. Operational risk reserve targets must be met within three years of commencement.

CHAPTER 2: PRUDENTIAL STANDARDS

Application

The superannuation industry is characterised by varying legal and product structures. The FSC understands the focus of these reforms is upon superannuation providers offering products in the retail marketplace. That is, products typically considered to be public offer Registrable Superannuation Entities (RSEs).

The standards should be applied to all public offer RSEs but not RSEs which are solely Pooled Superannuation Trusts (PSTs). The key distinction is that wholesale investment vehicles should not be subject to the “retail” provisions applicable to public offer RSEs contained in the discussion paper.

RECOMMENDATION

Superannuation prudential standards should not be applied to RSEs which are restricted to operating a PST.

Standard making power

Under the respective Banking, Insurance and Life Insurance Acts, APRA is provided with prudential standard making powers in respect of these industries. The Stronger Super reforms will equip APRA with similar powers in superannuation.

The prevailing superannuation legal framework includes provisions of the *Superannuation (Industry) Supervision Act 1993* (SIS Act), *Superannuation (Industry) Supervision Regulations 1994* (SIS Regulations), prudential practice guides, circulars and letter to trustees. APRA’s principal regulatory capacity lies within the SIS Act and SIS Regulations, both of which require legislative amendment to effect change.

In the case of amendments to the primary Act, Parliamentary approval is required, which entails a substantive review process. This typically involves the release of draft legislation by Treasury for consultation, Parliamentary legislative inquiry and ultimately a positive vote in both Parliamentary chambers.

This multi-faceted review and consultative process is both well-established and strongly supported by the superannuation industry.

Under the proposed framework, the principal SIS Act and Regulations will remain in an amended format, however the prudential standards will be imposed as subordinate legislation. In effect this means that APRA will have the capacity to issue binding standards (via subordinate legislation) at its discretion.

This represents a significant change as Parliamentary approval will not be required for material legal amendments. Accordingly, the long-standing legislative consultation and review processes which Treasury has presided over will no longer apply in this area.

Whilst the superannuation industry is supportive of APRA being equipped with this capacity, the FSC seeks a commitment to increased consultation and review processes. Consultation processes and procedures should therefore be formally outlined and consulted upon.

RECOMMENDATION

APRA establish a formal multi-faceted process of review and consultation when seeking to alter prudential standards which must include a Regulatory Impact Statement.

CHAPTER 3: GOVERNANCE

The FSC supports a higher regulatory standard of governance in the superannuation system. Broadly we support the conceptual approach outlined in the discussion paper. In particular, the FSC is comfortable with APRA's approach to independence, board review / renewal, dedicated board subcommittees and transparency provisions.

Our comments in the governance section are restricted to the definition of a "responsible person" and the disclosure of remuneration. We believe that defining a responsible person for the purposes of this exercise is a critical framing question in implementing the prudential standards. The persons captured by the definition will ultimately be held to account by APRA for the activities of the RSE licensee and compliance with the prudential standards. It is therefore important that the definition captures only the key personnel.

Defining the provisions for remuneration disclosure is important as financial disclosures to members should be relevant to their superannuation investment.

Definition of a responsible person

Section 5.4.1 of the discussion paper canvasses APRA's desire to introduce a definition used in other regulated industries such as Authorised Deposit Taking Institutions (ADI) known as a "responsible person". This definition exists in Prudential Standard CPS 520 Fit and Proper which applies to ADIs.

The proposed definition of a responsible officer / person is provided in Section 5.4.1 as:

'Responsible person' would be defined to include a director, individual trustee or 'senior manager' of an RSE licensee (a person who exercises the senior management responsibilities set out in the prudential standard), auditor or, for defined benefit funds (DB funds), an actuary appointed by the RSE licensee. A person need not be an employee of the RSE licensee to be a responsible person. This means that in some circumstances a consultant, contractor or employee of a subsidiary or otherwise related company may be a responsible person.

The reach of the provision will undermine the legal position of the superannuation trustees as being held to a fiduciary standard. The proposed definition is particularly wide in that it captures service providers, senior or executive staff and the trustee directors.

By limiting this provision to senior officers of the trustee, there will be transparency and clear accountability of the trustee and those senior officers of the trustee. This will not dilute the responsibility of the trustee.

The FSC believes the definition of a responsible person should be confined to trustee-directors and responsible officers as determined by the trustee.

Service providers should not be included in this definition as it dilutes the trustee relationship and the capacity for APRA to hold the trustee and responsible (internal) officers to account. Service providers must be responsible to the trustee and the trustee must be satisfied that it is presiding over a robust process of appointing and overseeing external parties (such as a material service provider). Such professions have professional membership provisions which are designed to ensure the sanctity and good governance of the profession.

The trustee’s engagement of a service provider such as an auditor or an actuary will be subject to new prudential regulation via the proposed standards for outsourcing and risk management. Trustees will be required to procure such services in accordance with those standards.

Further, the FSC’s proposed definition recognises varying legal structures within the superannuation industry. RSE licensees have trustee directors but not all have similar executive structures; while all RSE licensees have responsible officers who may not be solely trustee directors.

Responsible officers, as determined by the trustee, should be defined as having a degree of control over the superannuation entity. As stated in the discussion paper, APRA should leverage one of the applicable existing definitions from the SIS Act, the Corporations Act or existing ADI prudential standards to avoid confusion and to assist in compliance. For example,

- (a) “responsible person” as defined in the CPS 520 (referred to in the discussion paper) with some modifications which recognise the fiduciary nature of the superannuation structure which differs from ADI legal provisions;
- (b) “executive officer” as defined in the *SIS Act* “in relation to a body corporate, means a person, by whatever name called and whether or not a director of the body, who is concerned, or takes part, in the management of the body”; or
- (c) “senior manager” as defined in the *Corporations Act* in relation to a trust is defined to mean a person (other than a trustee) who:
 - (i) makes, or participates in making, decisions that affect the whole, or a substantial part, of the business or affairs of the trust; or
 - (ii) has the capacity to affect significantly the financial standing of the trust.

RECOMMENDATION

The responsible person definition should solely capture trustee directors and responsible officers as determined by the trustee. Service providers should be excluded from being designated as responsible persons.

Disclosure of remuneration

The FSC’s comments on remuneration in this section are solely focused on the remuneration of responsible persons. This recognises the central role of trustees and senior management in the superannuation industry and that funds paid into the trust may be used to remunerate these persons. The Super System Review considered remuneration in superannuation funds and made the following statement:

In relation to the trustee and executive, the fund website would have to contain at least:

- *The trustee’s remuneration policy in relation to both the trustee-directors and executives of the trustee; and*
- *Remuneration details similar to that required for major listed entities.*

In coming to this view, the Panel recognises that the requirements for board and executive remuneration would need to deal with structural issues in the superannuation

*sector, including that responsible executives may or may not be employees of the trustee and that remuneration may be paid from fund assets or from other sources.*²

Despite making this statement, the Review did not make an explicit recommendation on remuneration. The public release of the Stronger Super consultation on 21 September 2011 does not directly reference the final policy position on remuneration disclosure.

In terms of relevance, remuneration of responsible persons which is paid from the trust is most relevant to members. Remuneration of responsible persons which is drawn from the trust should be disclosed to members. Remuneration which is not paid from trust assets should not be disclosed unless it is captured under other disclosure provisions.

For instance, where executives are required to disclose their remuneration under the *Corporations Act 2001* or the ASX Corporate Governance Guidelines, this should continue to apply to listed entities which contain RSE licensees.

RECOMMENDATION

Remuneration paid from the assets of the superannuation trust to responsible persons should be disclosed.

Definition of an independent person

The discussion paper notes that s.10 of the SIS Act contains a definition of 'independent director' that applies specifically in the context of equal representation requirements. It goes on to say that APRA intends to 'introduce (in a new PPG) an objective, principles based concept of independence with broader application than the existing definition of 'independent director' in s.10 of the SIS Act'; and that an independent director would be one who is not, and in recent years has not been:

- in an executive role with an employer-sponsor;
- an official or representative of a body that has the right under the governing rules to nominate or appoint directors (or individual trustees) to represent either member or employer interests;
- a director, employee or shareholder of a company related to either a standard employer-sponsor or to the RSE licensee (other than in the case of a wholly owned subsidiary of the RSE licensee); or
- A director, employee or shareholder of a material service provider, whether related or not.

Large retail master trusts can have many different employer sponsors contributing to the RSE on behalf of employees, sometimes numbering in the hundreds. It appears that the third bullet point above, as it stands, means that any current or recent shareholder of any of these employers, or a company related to any of these employers, would be precluded from being an independent director of the RSE licensee.

Similarly the fourth bullet point would exclude any current or recent shareholder of a material service provider. It appears APRA's proposed guidance could mean that conceivably millions of individuals would be excluded from being appointed as independent trustees of some RSE licensees.

² Super System Review - http://www.supersystemreview.gov.au/content/content.aspx?doc=html/final_report.htm

The FSC contends that this exclusion is far too broad, and that such a severe narrowing of the pool of potential independent directors would in effect be contrary to APRA's stated goal of encouraging 'a higher standard of governance'.

It is requested that APRA consider removing the exclusions applying to current and recent shareholders of employer sponsors (and related parties) and material service providers, as set out in the bullet points above. A materiality threshold based on the size of an individual's shareholdings, expressed either as a flat dollar value or as proportion of the entity's share capital should be included.

RECOMMENDATION

In defining "independence", a materiality threshold should be applied to ensure minor shareholdings do not disqualify an individual from being deemed "independent."

CHAPTER 4: CONFLICTS OF INTEREST

The FSC is generally supportive of APRA’s proposed conflicts management framework. In particular, we welcome the introduction of a duty applying to trustee directors to “give priority to the interest of beneficiaries where a duty to those beneficiaries conflicts with an interest or other duty of the director of trustee.” Although this concept has previously been well understood, prescribing the duty in the law provides clarity and certainty.

Further, we support the provision to override the requirement that a trustee use a particular service provider in a trust deed on a prospective basis. This reflects contemporary commercial practice where regular assessments of such matters frequently occur.

However, we seek clarity on the potential duplication of conflict of interest obligations as to how the additional obligations interact with existing RSE licensee obligations.

Tied service provider arrangements

We acknowledge the Government’s intention under Stronger Super to override the requirement that a trustee use a particular service provider in a trust deed. This reflects contemporary commercial practice where regular benchmarking of such matters would frequently occur.

However we have identified a number of historical legacy (closed) funds where it would not be in the members’ best interest to go to tender to a wide range of service providers. These vehicles were structured in a particular way so that members enjoyed the benefits of security associated with the arrangement. Members who entered these products were provided with specified arrangements, an expectation of future entitlements, and appropriate disclosure based on the future on-going commitment from the embedded service provider, while they remained members of the relevant fund.

Moreover some of these products have been absorbed on commercial terms by the current trustee and service provider, following fund mergers, who were required to match existing arrangements according to ‘equivalent rights’ to ensure no members are adversely treated and to ensure their entitlements and future expectations are continued to be fully met.

We welcome APRA’s statement that the ‘proposed legislative amendment would not prevent RSE licensees from retaining the services of a related service provider’. Accordingly, we encourage APRA to follow a flexible and risk based approach to this requirement, particularly where the nature and complexity of the arrangements are such that they are difficult and costly to unwind.

We suggest that in these circumstances, the members’ interests are likely to be better served through a benchmarking process.

Alignment with existing requirements

The FSC appreciates that APRA has noted the existing requirements applicable to RSE licensees in respect of conflicts of interest, including under the general fiduciary obligations of trustees, and the statutory obligation to act in a beneficiary’s best interests under section 52 of the SIS Act and where the RSE licensee also holds an Australian Financial Services Licence (AFSL), the obligation to have in place adequate arrangements for the management of conflicts of interests in accordance with section 912A(aa) of the *Corporations Act 2001*.

However, the FSC notes that despite such recognition, the Discussion Paper does not clearly state how APRA’s proposed prudential standards in respect of conflicts of interest will interact with the existing obligations it identifies.

The FSC therefore seeks clarity that the additional regulation in the form of the proposed prudential standards for conflicts of interest:

- (a) should not be inconsistent with existing requirements under trust law, the SIS Act and Corporations Law (and other foreign rules and standards); and
- (b) will not result in multiple sources of regulation for the same subject matter which will only serve to increase compliance costs for the superannuation industry.

The FSC suggests APRA consider in detail how the prudential standards will interact with existing obligations on RSE licensees, in particular those who also hold an AFSL.

In respect of any prudential practice for conflicts of interests, although APRA has mentioned that it will “have regard” to existing guidance, it is unclear how APRA will actually address such guidance in practice. That is, how the existing guidance from regulators as to the management of conflict of interest, including those contained in ASIC’s *Regulatory Guide 181 Licensing: Managing conflicts of interest*, will be managed. The discussion paper is also unclear as to whether or not there will be any departure from the existing guidance.

We also note the view expressed in the discussion paper (proposed SPS 231 prudential requirement):

The RSE licensee would also be required to undertake regular and thorough enquiry to identify any conflicts that have the potential to affect an existing or prospective service provider’s performance in respect of the RSE. This would include conflicts arising for the RSE licensee or its directors, as well as conflicts for the service provider (refer also to the proposals on conflicts of interest in Chapter 4 of this discussion paper).³

The FSC notes that section 4.5 of Chapter 4 referred to the ASIC Regulatory Guide 181 Licensing: Managing conflicts of interest. In doing so the Discussion paper acknowledged that dual RSE and AFS licensees were not expected to maintain duplicate conflicts of interest policies. The FSC agrees, and commends this practical approach.

Registers of duties and interests

The FSC is supportive of the proposal to only require registers to disclose interests that are considered to be “material” rather than all interests. However, the FSC would appreciate further guidance as to what it means to have a “defensible process in place for determining materiality”, and whether this suggests APRA has a view as to how “materiality” should be considered.

Senior management – conflicts register

In Section 4.4.3 of the discussion paper, APRA proposes to require the registers of duties and interests to record the duties and interests of “senior management”, without defining or otherwise indicating who “senior management” will be.

³ See section 7.4.3 Due diligence and ongoing monitoring obligations
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RECOMMENDATION

“Senior management” should be limited to those persons engaged by RSE licensees who are either subject to the “responsible person” provisions or based on an existing definition (refer to comments on responsible person).

CHAPTER 7: OUTSOURCING

The FSC strongly supports robust outsourcing standards. Outsourcing of services should only occur on a commercial basis in the beneficiaries' best interest. It is critical that RSE licensees develop and maintain strong and transparent outsourcing processes and controls.

Outsourcing policy

The Discussion Paper states

APRA proposes to require that the RSE licensee has a written outsourcing policy consistent with the requirement for other APRA-regulated industries.

The policy should focus primarily on the material business activities of the RSE licensee, but can also consider non-material outsourcing arrangements. The policy should cover requirements for establishing new outsourcing arrangements as well as requirements in respect of current outsourcing arrangements.

APRA proposes that this Board-approved policy would include a detailed framework for managing all outsourcing of material business activities, possibly as a sub-set of the RSE licensee's risk management framework. Particular requirements would apply where outsourcing is undertaken by related parties or by service providers outside Australia.

The FSC believes that it is important that the proposed prudential standards should be principles-based (not prescriptive) to allow RSE licensees the flexibility to apply the Standards to their own arrangements. We noted that this has been the pattern with the drafting of APRA's CPS 231 Outsourcing Standard and believe that there should be consistency between the two outsourcing standards.

The FSC agrees with the proposal for each RSE licensee board to prepare and approve a written Outsourcing Policy.

Minimum requirements for outsourcing agreements

The FSC agrees that all material outsourcing agreements be made in the form of a written legally binding agreements and that those agreements should contain minimum requirements such as: default and termination provisions, contain a pricing, fee and payment structure and audit, monitoring and assessment procedures.

Due diligence and ongoing monitoring obligations

We are concerned about the view expressed in the discussion paper:

Using related-party service providers brings added risk, including concentration, contagion and conflict of interest risks. Additional risks can also arise where a director sits on both the Board of the RSE licensee and a related party service provider, resulting in possible pressure on the RSE licensee to achieve corporate goals which may be in conflict with duties to beneficiaries.⁴

⁴ See section 7.4.3 Due diligence and ongoing monitoring obligations

Many FSC members are also ASIC Australian Financial Services (AFS) licensees. ASIC too has expressed its views on *related-party service providers*' arrangements. Rather than 'related party', ASIC used the terms 'third party' and 'corporate group'; and suggested that it might be helpful for AFS licensees to consult a publication of the International Organisation of Securities Commissions (IOSCO).⁵ IOSCO used the term 'affiliated entities' by way of reference to related bodies corporate in the following observations on risk. The emphasis below is ours.

*Firms should consider several factors as they apply these principles to activities that fall under the outsourcing definition. ... Second, as discussed in section II.C, firms should consider any affiliation or other relationship between the outsourcing entity and the service provider. **While it is necessary to apply the Outsourcing Principles to affiliated entities, it may be appropriate to adopt them with some modification to account for the potential differing degrees of risk with respect to intra-group outsourcing.***⁶

*While the Outsourcing Principles apply regardless of whether such outsourcing is performed by an affiliated entity of a corporate group or by an entity that is external to the corporate group, the risks associated with outsourcing activities to an affiliated entity within a corporate group may be different than those encountered in outsourcing to an unaffiliated external service provider. **In certain cases, risks may not be as pronounced within an affiliated group.** For example, there may be an ability by the outsourcing firm to control the actions of the service provider, and the outsourcing firm may have a high familiarity with the service provider's business attributes. Such factors might reduce the risks involved in outsourcing. However, intra-group outsourcing may be less than an arm's-length relationship, and the outsourcing firm (and its customers) may have different interests than the affiliated service provider. Moreover, in some cases, the intra-group relationship may as a practical matter restrict the outsourcing firm's ability to control the service provider. These factors may increase the potential risk in certain instances. **Accordingly, while it is necessary to apply the Outsourcing Principles to affiliated entities, it may be appropriate to adopt them with some modification.***⁷

That is, IOSCO concluded that where *the outsourcing firm* [has the ability] *to control the actions of the service provider*, **risks may not be as pronounced within an affiliated group**.

The FSC considers that this matter highlights an important issue. Each potential service provider will bring with them a unique range of risk characteristics. Whilst it is important to recognise and manage outsourcing risks that are a hazard to the RSE licensee, it is as important to recognise and embrace risks that optimise the performance of the RSE licensee. A related party arrangement can provide such an opportunity.

The FSC agrees that the risks and benefits should be identified by the RSE licensee and addressed appropriately in assessing the options for outsourcing a material business activity. CPS 231 provides that:

A regulated institution must be able to demonstrate to APRA that, in assessing the options for outsourcing a material business activity to a third-party, it has:

- (a) prepared a business case for outsourcing the material business activity;
- (b) undertaken a tender or other selection process for service providers;

⁵ see ASIC RG 104 Licensing: Meeting the general obligations, paragraph RG 104.36

⁶ IOSCO February 2005 publication *Principles on Outsourcing of Financial Services for Market Intermediaries*, section I

⁷ *Ibid*, section II.C

- (c) undertaken a due diligence review of the chosen service provider;
- (d) involved the Board, Board committee, or senior manager with delegated authority from the Board, in approving the agreement;
- (e) considered all the matters outlined in paragraph 25, that must, at a minimum, be included in the outsourcing agreement itself;
- (f) established procedures for monitoring performance under the outsourcing agreement on a continuing basis;
- (g) addressed the renewal process for outsourcing agreements and how the renewal will be conducted; and
- (h) developed contingency plans that would enable the outsourced business activity to be provided by an alternative service provider or brought in-house if required.

The FSC agrees with this approach, and feels that it should be applied in the assessment of all RSE licensees' service providers regardless of whether they are a related or non related party. For this reason the FSC would support the incorporation of paragraph 22 of CPS 231 into the proposed superannuation standard.

RECOMMENDATION: The outsourcing prudential standard (SPS231) should be aligned with CPS 231 provisions which would require risks and benefits to be identified by an RSE licensee and addressed appropriately in assessing the options for outsourcing a material business activity.

CHAPTER 8: INVESTMENT GOVERNANCE

The FSC believes the adoption of the choice architecture model as recommended by the Super System Review will clearly segment the superannuation industry into “MySuper” and “Choice” regulatory spheres. Each sphere will have identical processes for making selecting investment options on a menu (such as a wrap platform) however the MySuper and choice segments will be characterised by varying legal obligations for trustees.

The discussion paper notes a trustee’s duties in relation to investment of the fund assets are largely articulated in the investment strategy covenant in section 52(2)(f) of the SIS Act, which is supported by SIS Regulation 4.09. SIS Regulation 4.09(2) itself incorporates member-directed investment choice in accordance with SIS Regulation 4.02. APRA has issued a number of circulars that relate to various aspects of investment, as well as other guidance.

The FSC is concerned that the prudential standards will not reflect the new architecture. The following comments are directed at the distinction between the two spheres.

RECOMMENDATION

The newly created choice architecture model with its associated varying trustee responsibilities should be reflected in the investment governance prudential standard.

Overview of proposed investment governance standard (SPS 530)

The theme underpinning the proposed investment governance standard SPS 530 is that, to supplement their obligations under the amended investment strategy covenant, trustees will have an obligation to maintain a policy that:

- (a) articulates clear investment objectives;
- (b) provides increased focus on measurement and explanation in formulating investment strategies;
- (c) document the investment process;
- (d) gives particular consideration to certain features of investment management.

Existing investment provisions

The context within which section 52(4) operates was well documented in the IFSA/ FSC letter dated 10 May 2005 to Treasury entitled ‘SIS Act – Asset Diversification and Trustee Discretion’. The views of the industry addressed in that paper are more relevant today, given the prominence of investment choice through platforms in the industry and the creation of the choice architecture model.

SIS Section 52(2)(f) provides that the governing rules of a superannuation entity must include a covenant to the effect that the trustee must formulate and give effect to an investment strategy that has regard to the whole of the circumstances of the entity.

The requirements of section 52(2)(f) are directed at the trustee in its management of the superannuation fund and do not permit member investment choice. The obligations for the formulation of an investment strategy and asset diversification are provided in the context of

the superannuation entity as a whole (i.e. not at the individual member level) and are intended to ensure that the trustee is able to meet cash flow requirements and discharge liabilities.

Member investment choice is permitted through section 52(4) and regulation 4.02. SIS Section 52(4) provides:

An investment strategy is taken to be in accordance with paragraph (2)(f) even if it provides for a specified beneficiary or a specified class of beneficiaries to give directions to the trustee, where:

- (a) the directions relate to the strategy to be followed by the trustee in relation to the investment of a particular asset or assets of the entity; and*
- (b) the directions are given in circumstances covered by regulations made for the purposes of this paragraph.*

In other words, subject to satisfying the regulations, a trustee is deemed to have satisfied its obligations under section 52(2)(f) where member investment choice is offered. It should be noted that for legal purposes, section 52(4) does not modify section 52(2)(f), it satisfies the covenant in its entirety. That is, where member investment choice is offered, member direction satisfies the obligation of the trustee to formulate and give effect to an investment strategy for the fund.

Trustee obligations for diversification in the Choice Architecture (MySuper and Choice)

APRA states as follows in the Discussion Paper:

‘Stronger Super also provides that, where an RSE licensee chooses to offer a range of investment options outside MySuper, it must provide a range of options that is sufficient to allow beneficiaries to obtain a diversified asset mix if they choose to do so’.

APRA proposes that SPS 530 includes a requirement that

‘each RSE licensee be required to articulate the processes and criteria used to select investments to implement each of its investment options. This would include obligations relating to effective and appropriate due diligence for any investment option included in an investment menu available to beneficiaries at the time of selection. RSE licensees offering choice products would be expected to be satisfied that each option is appropriate for selection by beneficiaries, including where a beneficiary may choose to concentrate their interest in the fund in a single, undiversified option’.

The wording of this last sentence is not consistent with Recommendation 1.27 of the Super System Review, which stated:

*Choice trustees must offer a range of options sufficient to allow members to obtain a diversified asset mix if they choose, **but members can choose to be undiversified and the trustee would have no obligation to assess the appropriateness of the investment strategy chosen by the member.** Trustees would be subject to new express duties in selecting and monitoring options.⁸*

⁸ Australian Government Super System Review response - http://strongersuper.treasury.gov.au/content/Content.aspx?doc=publications/government_response/recommendation_response_chapter_1.htm

The Government supported this recommendation. Further, the Review clearly outlined the difference of individual control and risk in MySuper and Choice options respectively:

MySuper members would receive the protection afforded by the duties imposed on a traditional trustee who is a fiduciary acting single-mindedly in the best financial interests of members. They would be in a product with a single, diversified investment strategy, insurance would be offered, but few other product features. There would be a limited role for external advice because intra-fund advice would be ‘embedded’ in the product and there would be limited choices to be made by the member;

On Choice:

Choice members would bear substantial responsibility for the investment choices or fund choices that they made. They would be in a product with potentially an unlimited menu of investment options, but with trustee responsibility for reasonable due diligence on investment options offered, with some limitation of liability for investment choices made by individual members. Effective disclosure would therefore be of paramount importance. Members would be likely to rely on advice or disclosure and other information about their options.

The proposed SPS 530 is inconsistent with the Review’s recommendation 1.27 and imposes an obligation on trustees to ensure each investment strategy offered to members is appropriate, including if the member chooses not to diversify. This is not consistent with section 52(4) as it relates to member-directed investment choice.

This does not reflect the clear policy underpinning the choice architecture model which permits increased control and associated risk with non-MySuper investment options. That is, a trustee of a choice product who has satisfied the due diligence provisions of setting investment choices on a menu should not be responsible for discretionary member investment selection and associated diversification.

Where trustees of APRA regulated superannuation funds are unable to offer the required investment choice to members within the regulatory structure, it raises the likelihood that members seeking greater control will rollover account balances to Self Managed Superannuation Funds (SMSF). SMSFs are not subject to any of the above prudential standards and are regulated by the ATO.

RECOMMENDATIONS

Uniform investment governance diligence provisions should be applied across choice and MySuper investments.

Non-MySuper investment options should not subject the trustee to the same diversification provisions as a MySuper investment “including where a beneficiary may choose to concentrate their interest in the fund in a single, undiversified option”

CHAPTER 9: OPERATIONAL RISK

We strongly support the development of robust and risk-based capital requirements for the wealth management industry. We recognise the importance of capital in providing a mechanism for maintaining the performance of the financial system, enhancing member confidence and protecting investors' funds in this growing and important part of the broader financial services industry.

Accordingly, we welcome Government's commitment to introduce a risk based financial requirement for superannuation funds. In particular, we support APRA's proposed approach of requiring an RSE 'to hold an amount of financial resources that the RSE determines as adequate to meet operational risk losses facing it and the RSEs under its trusteeship'.

Competitive neutrality and the need for consistency

As APRA would be aware, there are currently numerous capital related reforms underway that will impact the financial services sector, including Basel III, APRA's Level 3 (conglomerate) proposals, changes to capital requirements for life and general insurers and increased capital requirements for Responsible Entities. In order to ensure competitive neutrality and avoid the risk of regulatory arbitrage, it is critical that there are consistent capital requirements across the superannuation and funds management industries.

We are concerned about the inconsistency with ASIC's recently released financial resource requirements, based on an un-capped 10% of a Responsible Entity's (RE) revenue. This creates not only a point of inconsistency between REs and RSE licensees, but also between fund managers operating within a conglomerate group and those outside a conglomerate group. The proposals may also mean that RSE licensees and REs operating within a conglomerate group will be subject to different requirements if APRA do not amend their conglomerate proposals for fund managers.

Moreover, we understand APRA is in the process of consulting and developing new capital requirements for conglomerates. APRA has considered, among other things, that it would have regard to regulated capital already held within various entities in a conglomerate forming the basis of any new capital requirement applying to conglomerates. The rationale for avoiding capital duplication applies equally to conglomerates. Additional capital that is required overall should be proportionate to the increase in the overall operational risk within conglomerates. Again, unnecessary capital duplication should be avoided.

Minimum features of the operational risk financial requirement

The Government's response to the Super System Review (Review) under its Stronger Super Reforms has given approval to new capital requirements for trustees calculated on a risk weighted basis. The FSC supports this approach.

We welcome APRA's intention not to specify a minimum target level of financial resources. We do acknowledge, however, as APRA has in the discussion paper, that in other industries and policy proposals a figure of 0.25% of FUM is proposed as APRA's minimum requirement. As such, APRA expects that RSE licensees would typically have 0.25% of FUM as their target level for operational risk financial resource requirements.

Reporting and publication of capital or reserves -we note that as part its requirements, APRA expects that RSE licensees will be required to report the level of operational risk reserves or capital held, and that these would be reported by APRA in their statistical publications.

In other industries, APRA specifically prohibits companies from disclosing any 'pillar 2' capital requirements and such additional requirements set by APRA for a specific RSE licensee would appear to fall within that category.

In our view, APRA's approach should be consistent with other regulated industries. Accordingly their proposal to publish this information should be removed.

Non-operational risk matters

APRA proposes to prohibit the use of the financial resource requirement to address a failure to meet legislative requirements (e.g. SIS requirements) and other administrative deficiencies that were not identified by the RSE licensee as an operational risk.

However APRA's discussion paper stipulates that where operational risk financial resources are used, SPS 114 would require the RSE licensee to have in place a plan for communicating with APRA. The way this has been drafted in the discussion paper seems to permit the use of funds for other non-operational risk matters (subject to advising APRA) and is somewhat contradictory.

Operational risk financial requirement can be met with fund reserves or trustee capital

We wish to clarify the treatment of superannuation funds where the trustee is part of a conglomerate. Does the RSE licensee determined financial requirement merge into the overall calculation? How does this then work in terms of consistency with the requirements for fund managers who are not RSE licensees?

Strategy for meeting the operational risk financial requirement

APRA will require RSE licensees to develop and document a strategy for managing and maintaining financial resources for operational risk. This is consistent with the requirements in other industries, but would suggest that in superannuation it is particularly important to consider how the funds set aside for capital will be invested and how returns on those funds will be distributed / used.

The FSC accordingly supports APRA's proposals with additional guidance on the treatment of funds set aside for capital and their returns.

Managing operational risk + third parties

APRA's Prudential Standard 222 provides an existing framework for authorised deposit-taking intuitions (ADIs) to manage contagion risk. The Prudential Standard specifically aims to ensure that ADIs give due consideration to the risks associated with the corporate group of which they are a member and are not exposed to excessive risk as a result of their associations and dealings with related entities. We believe these principles could be tailored for superannuation funds (regardless of whether they are part of a conglomerate) and could further inform APRA's position in this area.

Transitional arrangements

Given the extent and nature of the proposed reforms, and in order to allow institutions an orderly and smooth transition to the new requirements, it is critical that the implementation timetable of APRA’s operational risk financial requirements are aligned with other significant international and domestic reforms relating to capital requirements, including APRA’s Level 3 (conglomerate) proposals. As noted above, a consistent implementation approach will also address our concerns over regulatory arbitrage and competitive neutrality.

The FSC welcomes an adequate transition period that takes into consideration the time it will take for institutions to adjust their balance sheet and minimise any disruption to capital markets.

RECOMMENDATION:

Operational risk reserve targets must be met within three years of commencement.
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Treatment of hybrid arrangements (defined benefit & accumulation funds)

We wish to clarify how the requirements apply to RSE licensees that have hybrid arrangements i.e. defined benefit funds and accumulation funds? Will they be subject to the funding and solvency requirement only in respect of the defined benefit funds and the operational risk financial requirement in respect of the operational risks associated with the accumulation funds only?

Treatment of operational risk reserve in a successor fund transfer

We wish to clarify the treatment of a superannuation fund’s operational risk reserve in a successor fund transfer? Would the transferring fund’s reserve merge into the receiving fund’s reserve?

CHAPTER 13: INSURANCE IN SUPERANNUATION

Requirement to develop and maintain an insurance strategy

The FSC supports the introduction of an obligation on RSE licensees to develop an insurance strategy. We see this as a positive development, raising the profile with trustees of the need to consider a strategy for the insurance they offer to members and creating alignment between insurance arrangements and the existing requirements for licensees to develop an investment strategy.

In order to ensure the introduction of this requirement occurs as efficiently as possible, the FSC seeks clarification from APRA on a number of issues raised in the discussion paper.

Fund level insurance strategy

The discussion paper states:

In developing and maintaining an insurance strategy, RSE licensees would be required to demonstrate that any insurance products offered are in the best interests of beneficiaries, having regard to the characteristics of the membership of the RSE.

The FSC recommends that the insurance strategy apply at a fund level, where trustees arrange to make insurance cover available to members of a fund, and not at an individual member level.

At a fund level, licensees must act in the best interests of members and beneficiaries in putting in place insurance arrangements to make cover available to members of the fund. Consideration of the factors listed in the draft paper would be appropriate in most cases.

However, it would be impractical and inconsistent with current industry practice to place an obligation on trustees to consider whether, each time an individual member takes up insurance cover within a superannuation fund, the cover applied for or given is in the individual member's best interests. In particular such a requirement would appear to be completely incompatible with current practices regarding large employer sponsored plans, where the insurance arrangement often includes an 'automatic acceptance limit' and members are provided with cover on joining the plan.

The FSC seeks APRA's clarification that the insurance strategy applies at the fund level.

'Cost effectiveness' of insurance coverage

The paper also states:

This would include an assessment of the insurer that is to provide the insurance cover, the insurance policy's benefits and conditions and the cost effectiveness of the insurance coverage, among other relevant factors.

The requirement to assess potential insurers and the 'cost effectiveness' of insurance coverage may necessitate trustees obtaining specialist advice, which itself would add to fund costs.

The FSC seeks guidance from APRA as to the extent to which it expects trustees will go in performing the above mentioned assessments.

Proposed PPG guidance

Proposed PPG guidance outlined in the discussion paper indicates that APRA's guidance in respect of SPS250 might include 'an approach to management of insurance claims'. We recommend that given the marked differences in the circumstances of different trustees, any guidance in relation to managing claims should avoid being overly prescriptive, and allow trustees sufficient scope to develop processes to suit their particular situation.

We welcome the opportunity to consult further with APRA in the development of this guidance material.

Permitted insurance within superannuation

The FSC broadly supports the proposals in this section of the discussion paper. However, the requirement that certain forms of insurance currently provided to members of some funds be 'unwound' could create difficulties for trustees.

The FSC has previously submitted that appropriate grandfathering arrangements are necessary to ensure that existing policies that are not life, TPD or income protection products funded via superannuation monies may be gradually phased out over time without unnecessary disruptions.

Without appropriate grandfathering, existing insurance arrangements in superannuation, that may be more generous from a member's perspective, will be lost. As insurers' reinsurance arrangements have also changed over time, the absence of appropriate grandfathering may also cause a member to be underwritten again, potentially restricting the types and levels of cover available to them or increasing the cost of their cover above the current arrangements.

For these reasons, the FSC strongly recommends appropriate grandfathering is the most appropriate mechanism to allow for an orderly phasing out of existing arrangements.

The FSC would welcome further discussions with APRA in relation to these issues including the following:

- clarification whether this requirement would apply to existing cover, and not just new arrangements;
- whether the withdrawal of such benefits would be consistent with trustee legal and fiduciary obligations (e.g. would this be regarded as reducing a member's accrued benefit), and what protection would be available to trustees from potential litigation;
- over what timeframe would the unwinding process be expected to be completed; and
- whether there is any scope for relief (such as exemptions) to be granted from the unwinding requirements.