Australian Prudential Regulation Authority

SUBMISSION

TO THE

PRODUCTIVITY COMMISSION'S NATIONAL COMPETITION POLICY REVIEW

OF THE

SUPERANNUATION INDUSTRY (SUPERVISION) ACT

AND

CERTAIN OTHER SUPERANNUATION LEGISLATION

SUPERANNUATION SUBMISSION

Introduction

The Commission's *Issues Paper* summarizes the general history of the sector well. Suffice it to say that superannuation has evolved dramatically over the past 15 or so years – from a position where it represented mainly an employment benefit for public servants and white collar workers in large firms, to an industry that now covers around 90 per cent of the working population. This rapid development has been the product, largely, of active encouragement of superannuation-based savings as part of the retirement incomes policies of successive governments. For most in the labour force, superannuation is now compulsory and, together with home ownership, constitutes the major vehicle for achieving lifetime financial security. However, despite its size, growth and significance, it is fair to say that community understanding of superannuation is not high, in part due to the nature of the product, as well as the constant changes that have characterized superannuation arrangements over the years.

Supervisory Challenges

An important starting point is to recognize that superannuation is unlike any other sector prudentially regulated by APRA. The most significant distinction is that in the bulk of cases, unlike the situation in the banking or insurance sectors, the credit, market or operational risks arising from a fund's activities are borne directly by the fund members. Put another way, there is no "promise" from superannuation funds to fund members about the short or long term return they will receive from their superannuation investments. In that sense, superannuation more closely resembles the funds management industry than more traditional, prudentially regulated, financial institutions.

This raises the obvious question of why superannuation requires explicit prudential regulation, given that the funds management sector is effectively regulated by ASIC under a disclosure-based regime. The answer, alluded to above, relates to the overall significance of superannuation to the bulk of the community, the fact that it is compulsory and now forms a central part of the Government's broader retirement incomes policies. To engender public confidence in the system, it is therefore deemed appropriate, by governments and the community alike, that the level of regulatory intervention, and overall prudential safety and soundness, should be higher than for other managed funds.

For the prudential supervisor, however, this sector poses unique challenges. In this paper, we propose some changes to existing arrangements that we believe will address these challenges and serve to strengthen the existing prudential framework. However, before setting out policy recommendations, it is critical to understand clearly the nature of the superannuation "challenge" as we see it.

Superannuation Funds Supervised by APRA

Type of fund	No of funds	Amount Invested ($m)	Number of members (000's)	Average size of fund ($m)
Funds with Approved Trustees	**8,493**	**161,244**	**15,151**	**19.0**
Of which:				
Public Offer	399	154,403	12,363	387.0
Small APRA Funds	7,654	2,278	10	0.3
Other regulated funds[1]	440	4,563	2,778	10.4
Employer Sponsored Funds	**2,940**	**130,588**	**4,450**	**44.4**
Of which those with assets:				
< $1m	1,047	408	18	0.4
$1m - 5m	772	1,867	55	2.4
$5m - 10m	293	2,139	85	7.3
$10m	828	126,174	4,292	152.4
TOTAL	**11,433**	**291,832**	**19,601**	**25.5**

First is the problem of the overall size of the industry, and the number of funds involved in superannuation activities. Aggregate assets held by superannuation funds in Australia currently total around $500 billion, involving over 200,000 separate funds. Many of these small, individual or family funds do not require any formal prudential oversight, and are now managed as tax effective savings vehicles by the Australian Tax Office. However, after allowance for these small funds, and other funds not formally captured within the prudential regime[2], the volume of assets managed in prudentially regulated funds remains very large, at almost $300 billion. This total is distributed across 11,000 funds. Details are in the Table.

APRA-regulated funds can be categorized into two main groups:

- Those requiring approved trustees – these include a relatively small number of large public offer funds, and a much larger number of smaller funds managed directly by approved trustees. Together, these account for over half the assets held in this sector, and about three quarters of total fund members.

- Those that do not require an approved trustee - there are just under 3000 such funds (both industry and corporate) with assets totaling around $130 billion. Within this group, there is a large variation in fund size. They range from very large corporate funds, equivalent in size to the large public offer funds, to some very small company funds.

[1] Other regulated funds include approved deposit funds and eligible rollover funds.

[2] The gap between total superannuation fund assets of $500 billion, and prudentially regulated assets of around $300 billion, reflects those small superannuation funds reporting through the Australian Tax Office (around $70 billion), superannuation assets held in life office statutory funds (around $50 billion – these are implicitly covered in APRA's supervision of life offices), and superannuation assets in non-regulated public sector funds (around $90 billion).

The industry structure is constantly changing. The most notable trend over recent years is industry consolidation, which has been driven by specialization, economies of scale and other economic efficiencies. The outcome is a steady reduction in the number of funds and a corresponding increase in average fund size. Another product of this trend is the growing financial sophistication of the superannuation industry. For the reasons outlined below, this trend will in all likelihood simplify the supervisory task over time.

Despite these trends, however, the number of funds remains large in absolute terms compared to the rest of the prudentially regulated financial sector. Moreover, the diversity of funds (measured in terms of both size and sophistication) means that the overall supervisory task remains complex and highly resource intensive.

The twofold distinction described above - between funds requiring approved trustees, and those that do not - is also the relevant basis on which to consider the challenges we face in supervising this industry. In principle, funds using approved trustees can be supervised in much the same way as other more traditional types of financial institution. This segment of the industry is characterized by an established licensing regime, some limited capital coverage for operational risk, and annual attestations from external auditors as to the presence of effective risk measurement and management systems. In the larger funds, risk measurement and management systems are highly developed, and comparable to those found in the trading operations of the larger banks. These arrangements have not, of course, removed all the potential risks facing fund members. Problems still arise and some of the most serious - involving large numbers of small funds managed by approved trustees – have been observed in recent times. However, notwithstanding recent events, prudential problems and losses arising out of public offer funds, and other funds utilizing approved trustees, have historically been very low in overall terms[3].

It is the second category of funds, those mainly without approved trustees (and numbering around 3000), where there are no licensing arrangements in place and where funds are often managed by amateur trustees, where potential problems have been the greatest. Most regulatory enforcement actions over the past six years have involved funds in this category. Experience shows that by far the highest risk resides in those funds with less than $5 million in assets. As shown in the Table, the number of funds in the < $5 million group is in the order of 1800, with assets totaling around $2.3 billion (less than 1 per cent of the aggregate assets held in prudentially regulated sector). Many of these are well managed with active trustee (employer and employee representative) involvement. Nevertheless, as noted above, where problems have been detected in the superannuation sector they tend to be concentrated in this area. Where serious problems occur, the financial implications for affected fund members involved can be devastating.

[3] Currently there are APRA enforcement actions against two approved trustees – EPAS and CNA.

Typical problems encountered in these funds include:

- Non-arm's length transactions and poor investment decisions resulting often in large capital losses. Frequently, problems can flow from a failure to develop and implement a proper investment strategy in accordance with legislation;
- Concentration of assets and inadequate procedures for securing the fund's interest in holdings;
- Delays in remitting contributions (Superannuation guarantee, additional employer contributions, voluntary and salary sacrifice contributions);
- Problems with systems capability and capacity; and
- Trustee/directors' use of fund assets for their own benefit.

The key challenge, therefore, is to devise an effective set of prudential arrangements to deal with these matters in the relatively small proportion of funds, without imposing unnecessary and inefficient constraints on the bulk of well-run superannuation entities.

Community Expectations

Any reassessment of the supervisory framework covering the superannuation sector must take into account community expectations - expectations that have evolved with the growth and significance of the sector. Notwithstanding the compulsory nature of superannuation, and the size of the assets held in the sector, the fundamental principle underlying policy in this area is that investment risk ultimately resides with the investor. Just as there is no guarantee at present covering the depositors of banks, or the policyholders of insurance companies, there is no guarantee associated with members' superannuation balances[4].

Nevertheless, many continue to believe that superannuation is guaranteed. Even terminology used in the sector, including expressions such as the "Superannuation Guarantee Contribution (SGC)" tends to reinforce this misconception[4]. The fact that there is no guarantee suggests the need for better education of fund members, to alert them to the risks they face as fund members. However, the problem goes much deeper than the need for education.

Even accepting the general misunderstandings surrounding the extent of any "guarantees", most fund members nevertheless seem to accept the possibility that superannuation returns from year to year may be volatile, and possibly even negative at times. Far less acceptable, however, is the idea that individual funds may experience very large losses, or that savings be lost in their entirety close to retirement, as a consequence of obviously poor portfolio selection by trustees and fund managers, or as a result of gross mismanagement on the part of managers. One policy response to the problem of poor portfolio or asset selection by trustees/managers might be to impose more rigid prudential controls over fund

[4] Although the *Superannuation (Financial Assistance Funding) Levy Act 1993* does have a provision for the Treasurer to levy regulated superannuation funds to cover a loss in a fund resulting from fraudulent conduct or theft.

[5] The SGC concept refers simply to the fact that a certain proportion of income/salary must be paid into a superannuation fund. The term carries no connotation as to the safety or otherwise of funds.

managers' activities. Unfortunately, excessively tight prescription of investment classes allowed in superannuation portfolios, or other such regulation designed to alleviate the problem of potential losses, could dramatically reduce the returns produced by funds over a long time frame, to the detriment of fund members.

This dilemma is at the heart of the supervisory problem.

There are many ways that this dilemma may be addressed, and different countries have adopted various strategies in relation to this specific question, and the more general issue of the design and structure of a superannuation or pension fund system. We believe that in the long term, it will be important to consider fully all the possible alternatives that have been adopted in other countries, and measure our own system against those alternatives. However, our experience also points to the need to address a range of issues in the short to medium term, and these cannot await any more fundamental reassessment of the entire system. Therefore, we are focusing at present on those innovations and improvements that we believe would enhance prudential soundness in this sector without resorting to actions that unnecessarily distort market outcomes or reducing the efficiencies that characterize the bulk of the industry. We are posing the question of whether such changes necessarily imply significant legislative amendment, or whether they can be reasonably accommodated by changing APRA's own supervisory procedures and practices. Where changes are identified, should they be targeted at all superannuation funds supervised by APRA, or only that sub-group of funds where risks to fund members are obviously higher?

We are still developing our views on the areas where the need for short to medium-term reform is most pressing. What follows is a broad, though not yet definitive, indication of our current thoughts. Some longer-term issues confronting the superannuation sector will be the topic of further work down the track. For the purposes of presentation, our thoughts on short to medium-term issues are organized under the headings set out in the Commission's *Issues Paper*. This is followed by some discussion on matters not covered explicitly in the Commission's paper.

Matters Raised in the *Issues Paper*

1. Under the heading, "**General Issues**", the Commission poses the following questions:

"How well does the legislation cope with contemporary problems?"

"Is the legislation too prescriptive and unnecessarily complex? If so, what are the main areas of complexity?"

"Should the legislation be restructured such that the enabling Act is confined to guiding principles for regulators, with additional detail contained in regulations?"

On the question of legislation, our view is that there may be merit in delineating more clearly the retirement income aspects of the present legislation (such as release of benefit provisions) from those requirements dealing specifically with prudential supervision of the sector. We would argue that separate legislation dealing solely

with prudential supervision could be more targeted, with the resulting structure ultimately better serving the interests of fund members.

Since APRA's inception, we have favoured the development of a common framework for the prudential supervision of all financial institutions and entities. The preferred framework comprises:

- Generic legislation setting out the broad objectives underlying the prudential regulation of a sector or industry;
- Flexible, plain English standards issued by APRA setting out the prudential requirements governing the sector or institutions concerned; and
- Explanatory guidelines that provide additional detail on the application of the standards.

This three-tiered supervisory regime has been applied for a number years to Authorised Deposit-taking Institutions ((ADIs) – comprising banks, building societies and credit unions), and is the framework soon to be introduced in the general insurance sector. While the preferred regime has all necessary checks and balances in place – changes to standards must be accompanied by extensive consultation with the industry concerned, and the standards themselves may be disallowable instruments by the Parliament – it is a structure that nonetheless permits quick responses to technological, market, industry or single institution developments. We see such a regime as the cornerstone of modern risk-based supervision, and consistent with the rapid changes that characterise the financial sector.

2. Under the heading "**Legislation – specific issues**", the Commission poses a range of questions. Selected questions are noted and we offer the following comments.

Trustee Rules

"Is it appropriate that the SIS Act focuses on trusts as the principal legal structure of superannuation funds? Could other legal structures for superannuation funds be contemplated – for example, incorporated financial institutions that are prudentially supervised under other legislation?"

There is scope in our view to investigate this possibility further. At present, a small proportion of all superannuation assets are written in the statutory funds of life offices (as deferred annuities). A further proportion is written under a trust structure where the trustee is either a subsidiary of a life company or a third party. The business is written on the clear understanding that all assets of such trusts will be invested in the statutory funds of the life company. This creates an additional layer of regulation that serves no good purpose and, in the case of the subsidiary trustee, creates the illusion that the subsidiary sits on top of the parent life company and statutory fund.

If all superannuation in life office statutory funds was written by way of direct contract between the member and the life company, rather than via an interposed trustee, then supervision of this portion of the industry could be conducted in the same low cost way as it is now for retirement savings accounts (RSAs). That is, supervision for safety and soundness would be part of APRA's life company prudential regulation with supervision for compliance with the retirement income

standards made the responsibility of the life office board under a strict self assessment and certification process. This would remove unnecessary duplication and complication in current arrangements.

We believe that there would be some merit in exploring this approach with industry and government.

"Should all trustees be subject to some form of licensing?"

At present, licensing arrangements in the sector are limited to say the least. While present arrangements require that certain entry and other prudential standards are in place for those seeking "approved trustee" status, there is no such requirement for superannuation funds *per se*. Yet, in no other part of the prudentially regulated financial sector are entities or persons permitted to accept funds from the public without a formal licensing procedure.

Effective licensing arrangements are, in our view, essential to any prudential regime. With tight licensing arrangements in place, special conditions can be applied to particular industry players, where prudential circumstances dictate. Formal licensing arrangements also have the far more practical benefit of allowing the regulator to accurately keep track of the regulated population. Without a clear licensing regime, there is no way of knowing with any certainty which entities are accepting superannuation funds. This poses a significant threat to fund members and needs to be addressed at the earliest opportunity.

Investment Rules

"Does the SIS legislation, particularly the application of its investment covenants and other investment restriction, unduly restrict investment strategies, or the investment process, to the detriment of fund members?"

We would address this issue from a different perspective. In the absence of fraud, the single biggest determinant of fund performance is a portfolio strategy and asset selections of the trustee. As noted above, current legislation is built on the assumption that risks and portfolio outcomes of a fund ultimately rest with fund members. However to safeguard members, the legislation requires that trustees take into consideration a range of factors likely to influence a fund's performance. These include assessment of all the likely risks associated with the fund, the benefits of portfolio diversification, the need for portfolio liquidity, and the extent to which a portfolio is likely to meet the needs of members. These criteria are not only sensible, but essential to the financial wellbeing of fund members.

For the majority of superannuation funds, investment strategies are generally well founded with portfolio and asset selections broadly consistent with the objectives of the Act. In a good minority of cases, however, the same cannot be said.

Obviously, balancing the right of funds to make their own portfolio decisions against the need for reasonable prudential requirements and safeguards that minimize the probability of very large investment losses for fund members, will always be difficult. Few would subscribe, for example, to the view that government or prudential

regulators should dictate the portfolio choices of the community. However, on balance, we believe that a more stringent approach to issues such as portfolio and asset concentrations, is required in the interests of enhancing soundness in the sector.

Specifically, we believe that additional prudential requirements or guidelines covering portfolio strategy, asset selection and potentially large concentrations of risk, should be introduced. Prudential policies on portfolio concentrations and large exposures form part of the prudential regime covering ADIs and the insurance sector. These industries have accepted the balance of advantage that such core prescription provides in obviating excessive risks. In these cases, prudential rules do no more than what might reasonably be expected to be found in well-managed institutions.

As a first step, therefore, we will be amending existing advice to trustees on asset and portfolio selection, to emphasize the need for funds to follow more diversified strategies where they do not already do so. Further, we intend to act more forcefully in requiring better portfolio balance in those cases where trustees have not taken the spirit of the SIS requirements on investment strategy and portfolio determination into account. This will inevitably involve APRA in fine judgement about whether certain assets or portfolios are appropriate, often while those assets are still performing satisfactorily. But there seems no alternative if a more pre-emptive approach is to be adopted, rather than one that responds to adverse outcomes after the event. We will be considering the case for more formal legislative amendments to confirm our powers in this area.

Regulated Superannuation Service Providers

"Would the achievement of the overall aims of the SIS Act be enhanced if the legislation were extended to other key service providers - for example, to administrators?"

Outsourcing is widespread in the superannuation sector. It allows trustees access to more expertise than is available in-house. Outsourcing can also generate cost savings for funds, largely because specialist service providers can benefit from economies of scale. It is one of the factors behind the trend toward industry consolidation, discussed above. However, outsourcing also gives rise to risks such as fraud or mismanagement by the external parties; the emergence of unforeseen technical problems; or additional layers of costs through related-party service providers. It is important, therefore, that trustees have robust arrangements in place to evaluate and monitor the performance of the service providers. APRA supports the establishment of minimum standards for trustees to follow in contracting the services of external parties and has already provided guidance in this area.

It should also be emphasized that the heavily concentrated nature of the firms providing these services to the superannuation industry, with a limited number of asset consultants, fund administrators and custodians servicing a large number of funds, gives rise to potential systemic effects. Serious mismanagement or fraud by a prominent third-party service provider could adversely impact a large number of funds. This is a further reason as to why regulators need to satisfy themselves that third-party service providers are being managed prudently. Against that background,

there may be a case to provide in legislation for APRA's explicit regulatory access to, and oversight of, service providers where systemic issues potentially arise.

We will be considering these issues over coming months. In the immediate future, we will be developing guidelines on outsourcing, which will have application not only to superannuation funds, but all industries supervised by APRA.

Other Matters

Of the many issues that arise in relation to the prudential supervision of superannuation, three additional are worthy of attention.

Capital Adequacy

In the case of traditional financial institutions, the principal role of capital (or a minimum capital requirement) is to permit an institution to continue to operate in the face of losses (and thus protect depositors). Superannuation funds are, of course, not typical institutions. In applying minimum capital requirements in the superannuation industry, therefore, the line has traditionally been drawn between funds with approved trustees, which are subject to certain minimum capital requirements (although not necessarily applied to the approved trustee itself), and superannuation funds which are not. In effect, funds with approved trustees are deemed to be more "institution like" – with a more "arm's length" relationship to the member than is in case where industry or single company funds are involved.

We see the need for improvements to existing capital adequacy arrangements. In the case of approved trustees we believe that there is a case for a more robust and risk-focused minimum capital regime than the flat $5 million charge applied at present (and even the $5 million requirement includes legislative concessions that make its efficacy questionable). We will be discussing these matters fully with industry over coming months. More generally, we will be considering the size and structure of existing capital requirements, and the feasibility of broader application of capital charges across the superannuation sector (to funds not presently required to hold minimum capital levels). This will include, for example, whether it is possible to establish broad capital charges aimed at covering operational risks.

Prudential Reporting

Prudential supervision and effective public disclosure of funds' activities and performance are important allies. However, prudential reporting to the supervisor is also critical, and it is fair to say that the quantity and quality of regulatory reporting is not high. At present, information received by APRA is neither timely nor comprehensive by comparison with the range of information collected from other entities supervised. Late reporting by some superannuation funds has become almost endemic. The case for a major upgrading of prudential reporting arrangements – across the full range of superannuation funds - is compelling.

We have begun to address this important matter. More rigorous processes have been introduced to reduce the incidence of late reporting of existing prudential returns. Furthermore, improved data returns and collection techniques, currently being

developed, will lead to a significant improvement over time in the quality and detail of information provided by superannuation funds. A regular flow of such data is an integral part of building risk profiles of individual institutions which, in turn, is critical to a risk-based approach to allocating supervisory resources. These matters have been (and will continue to be) discussed with industry.

Governance

The trend in modern supervisory practice is for increased emphasis on the development of effective internal risk measurement and management practices within financial institutions and entities. It is generally accepted that the complexity of these practices should be commensurate with the size and risk characteristics of the institutions and entities in question. Issues of risk management practices, however, form part of a much broader set of considerations that fall under the general heading of "governance", and these matters are in principle as relevant to the operations and activities of a superannuation fund as they are of an ADI or an insurance company. Very importantly, in many cases, poor governance standards represent the single most fundamental failing in superannuation funds and the largest cause of fund member losses. At present, governance requirements form part of the SIS legislation (for example, limited fit and proper tests, equal representation rules etc). However, we believe there is a strong case for strengthened governance requirements and we will be moving to introduce improved guidance to trustees on current best practice in relation to governance.

Work on this matter has commenced.

Conclusion

The review of existing superannuation legislation by the Commission provides an important opportunity to air prudential issues facing the sector. As the prudential supervisor, APRA's interests are, of course, more narrow than those of the Commission.

As outlined above, we believe that from a prudential perspective, the immediate term focus should be on five key areas. Our priorities are:

- Targeted portfolio and investment guidelines, particularly focusing on asset concentrations.
- Improved supervisory reporting and tightened reporting standards by superannuation funds;
- Consideration of more structured capital requirements for approved trustees and possibly superannuation funds more generally;
- Increased focus on improving governance standards;
- More effective licensing of superannuation funds.

In the medium term, we will be discussing with government and the industry the suitability of the current legislative structure, the need to address issues posed by third-party service providers, and possible increased use of contractually based superannuation arrangements.