



# AIST submission

Response to APRA Discussion Paper:  
Prudential standards for superannuation



Australian Institute of Superannuation Trustees

## Introduction

The Australian Institute of Superannuation Trustees (AIST) would like to thank the Australian Prudential Regulation Authority (APRA) for the opportunity to make submissions on the proposed prudential standards for the superannuation industry.

AIST is committed to supporting the good governance practices and culture of not-for-profit superannuation funds. As such, AIST has established a specialised Trustee Governance and Professional Standards department to develop guidelines and suitable tools for its members, as well as assisting them with monitoring, measuring and benchmarking governance practices in the industry. In March 2011, AIST launched *A Fund Governance Framework for Not-For-Profit Superannuation Funds*.

AIST is committed to providing trustees with the tools to achieve greater efficiency, accountability and sustainability into the future and working together with government and regulators to strengthen Australia's superannuation system.

## AIST

The Australian Institute of Superannuation Trustees (AIST) is an independent, not-for-profit professional body whose mission is to protect the interests of Australia's \$450 billion not-for-profit superannuation sector. AIST's members are the trustee directors and staff of industry, corporate and public-sector superannuation funds, who manage the superannuation accounts of two-thirds of the Australian workforce.

AIST is a registered training organisation and has recently expanded its education program to encompass the growing and changing needs of all members of the not-for-profit superannuation sector.

AIST offers a range of services including compliance and consulting services, events - both national and international - as well as member support. AIST also advocates on behalf of its members to relevant stakeholders.

AIST has recently undergone a vast overhaul, elevating its status as a professional institute to further benefit our members. AIST's services are designed to support members in their endeavour to improve the superannuation system and build a better retirement for all Australians.

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## 1 Executive summary

AIST welcomes the introduction of enhanced oversight of governance related matters in the superannuation industry by way of prudential standards. AIST supports the standards' focus on prudential outcomes, rather than prescription, and supports the intent of the proposed standards. AIST agrees that the standards should apply flexibly to take account of the nature, scale and complexity of the Registered Superannuation Entity (RSE) licensee.

While we agree that there are some similar requirements at a high level between the banking, insurance, life insurance and superannuation industries, it is important that recognition of superannuation's foundation in trust law remains at the centre of any standards-setting development. Trustee directors owe fiduciary duties to the members of their funds, and this differentiates the superannuation industry from the banking and insurance industries in a significant way.

### 1.1 Release of consultation drafts

AIST strongly recommends that APRA give priority to the development and release of *Prudential Standard SPS 410 Transition to MySuper*, so that RSE licensees can be best placed to implement the introduction of MySuper.

As well as releasing the draft prudential standards, AIST urges APRA to consider simultaneously releasing the draft prudential practice guides (PPGs). In order to understand the full impact of the proposals, it would be beneficial to see the guidance that will be given to RSE licensees in order to comply with the new prudential standards.

### 1.2 AIST's position

AIST supports the substantive intent of each of the twelve prudential standards and in our submissions we make recommendations with regard to some of the envisioned detail.

AIST recognises that there is potential overlap between APRA and the Australian Securities and Investments Commission (ASIC) as regulators, particularly in relation to the proposed disclosure requirements. In so far as this overlap exists, AIST recommends that the requirements of both regulators be aligned.

An overview of AIST's recommendations on each of the prudential standards is summarised in the table below:

Prudential Standard	Notes
SPS 510 Governance	Recommend that guidance on independent directors/chairs focuses on prudential outcomes and allows for different models. Recommend review of the word 'independent' to describe non-aligned directors. Recommend a triennial external board review.
SPS 521 Conflicts of Interest	Support all conflicts being registered. Welcome guidance on 'materiality'.
SPS 520 Fitness & Propriety	Recommend that whistleblowing not sit in a Fit & Proper policy. For auditors and other outsourced responsible officers, suggest a pronouncement such as those from the Auditing and Assurance Standards Board on fitness and propriety.
SPS 220 Risk Management	Support 'incorporation by reference' rather than duplication. Recommend guidance in articulation of 'risk appetite'.
SPS 231 Outsourcing	Recommend APRA/ASIC cooperation for consistency. Recommend guidance on what is 'material'. Recommend due diligence on new contracts only. For outsourced service providers, suggest a pronouncement such as those from the

	Auditing and Assurance Standards Board for understanding adequacy/controls/risk management.
SPS 530 Investment Governance	FSC-ASFA Standard Risk Measure as a starting point; recommend the development of a template including member expectations, severity and potential risk factors. Support greater transparency and consistency in fee disclosure. Support an objective standardised test for performance fees, with alternative of proving 'in best financial interests of the members'. Recommend further consultation on after-tax/after-costs. Recommend that fee-adjustments should have some flexibility. Support IFM's valuation policy regarding infrastructure investment. Recommend greater investment responsibility for life-cycle investment MySuper members.
SPS 114 Operational Risk Financial Requirement	Recommend a target more closely correlating to operational costs rather than FUM. Recommend APRA measure appropriateness based on fund's probability ratings and the PAIRS score. Recommend APRA specify appropriate insurance level. Question need for DB funds to have operational risk reserves.
SPS 160 DB Funding and Solvency	Recommend five-year transition. Support actuarial certification of adequacy of self-insurance. Support transparent reporting to members and employers.
SPS 310 Audit & Related Matters	Recommend five to seven-year turnover of audit partners.
SPS 232 Business Continuity Management	For outsourced service providers, suggest a pronouncement such as those from the Auditing and Assurance Standards Board. GS007 is already being used by some service providers.
SPS 250 Insurance in Superannuation	Recommend flexibility for innovation, such as hybrid products. Recommend against closing the door on self-insurance.
SPS 410 Transition to MySuper	Recommend this be APRA's priority Standard and that it be released ahead of the others, if need be. Recommend that there be two sets of minimum requirements – immediate default transfers and delayed default transfers.

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## 2 Prudential standards and an industry code of governance

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As part of the Stronger Super roll-out, the Government will grant standards-making power to APRA. AIST recommends that the development of the prudential standards accordingly remains flexible and relevant to the nature, scale and complexity of different superannuation funds with a focus on prudential outcomes. The industry code of governance, together with Prudential Practice Guides can then sit along-side the standards to give RSE licensees increased guidance.

### 2.1 Prudential Standard SPS 510: Governance

AIST supports the intent of the proposed governance standard and agrees that RSE licensees should maintain governance arrangements appropriate to their nature, scale and complexity. Similarly, AIST supports appropriate flexibility in SPS 510 to allow for the differences that exist between superannuation funds where governance arrangements are concerned.

The composition of a RSE licensee board should be in accordance with the fund's governing documents and where appropriate, at the discretion of the board. AIST agrees that APRA should not be prescriptive in this regard. All trustee directors should meet the fitness and propriety requirements both individually and collectively, and govern with integrity and in the best interests of members.

*The board should be comprised of individuals who are able to work together effectively to lead a viable, well-performing, and efficient fund. Board members should have diverse backgrounds (e.g. age, core experience) and have a high degree of competency, integrity, skill, capacity, experience, and commitment to discharge their duties and responsibilities.<sup>1</sup>*

#### Independence of directors and chairs

AIST supports a RSE licensee's board having the discretion (where the governing documents allow) to decide on how to best configure their board taking into account the nature, scale and complexity of the fund as well as any skills gaps. We therefore support APRA's position not to mandate a minimum number of independent directors or an independent chair.

While the discussion paper indicates at 3.4.1 and 3.4.2 that APRA will not require that boards have independent chairs or a minimum number of independent directors, the paper appears to suggest that independent director appointments lead to a higher standard of governance. AIST does not support this inference, nor do we support, in this context, the use of the word 'independent' as prescribed in the discussion paper or the *Superannuation Industry (Supervision) Act 1993*.

AIST is concerned with the confusion that the word 'independent' brings to discussions around trustee directors in the superannuation industry. The concept of independent directors in a corporate sense relates to directors being independent of the management. AIST supports a system where trustee directors are independent of the management of the fund and any material service providers. In this context, all directors on equal representation boards meet the independence test. However, the definition of independent trustee is much broader in section 10 of the SIS Act. The suggestion in the discussion paper is much broader again, requiring independence from an employer-sponsor, member-sponsor, related entity, shareholder or material service provider (at 3.4.1).

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<sup>1</sup> A Fund Governance Framework for Not-For-Profit Superannuation Funds, AIST/IFF, March 2011, p. 15.

Equal representation boards have both employee-sponsored and employer-sponsored directors. These directors are aligned with the sponsoring organisation, but are independent of the fund. Section 89 of the SIS Act allows for an equal representation board to have one additional independent director as per the SIS Act definition. This director, while independent of the management also, is not aligned with an employer- or employee-sponsor organisation. AIST strongly recommends that in Prudential Standard SPS 510, Governance, APRA clarify what prudential outcomes it seeks to achieve and where possible, clarify the terminology without confusing the concept of 'independence'.

The independent director definition in the legislation is currently not applicable to non-equal representation boards. AIST welcomes an approach whereby the potential conflicts of equal representation boards and non-equal representation boards are treated alike by including related entities, shareholders and material service providers to the definition.

In exercising their duties directors are required to apply an independence of mind where the priority consideration is always the members. Directors will be subject to fitness and propriety requirements as well as strengthened conflicts of interest and conflicts of duty policies (Prudential Standards SPS 521 and SPS 520), further strengthening the duties and expectations on them.

The not-for-profit superannuation sector, with its equal representation board model, has continuously outperformed its retail counterparts on long-term returns for members. This superior performance has been achieved in most cases, without non-aligned directors on those boards. Independence alone does not guarantee enhanced governance or decision making, however, AIST recognises that often non-aligned directors are appointed to add a specialist skill to the board. Having a non-aligned director with a specialist skill may lead to reliance on the skill and expertise of that individual and diminish the questioning nature of other directors in areas where they consider the non-aligned director to have superior knowledge. This would be an unfortunate and unintended consequence of the appointment of such a director. Accordingly, AIST submits that APRA focus its prudential standard and PPG on the prudential outcomes sought.

With regard to the chairs of trustee boards there are various board models that have been proven to work effectively. In the representative trustee model some boards have rotating chairs; for example, the chair position rotates between a member-sponsored trustee and an employer-sponsored trustee. Other boards have appointed co-chairs to overcome any perception of partiality, or chairs can be elected or appointed from the board. In all cases, the chair is a non-executive director and removed from the influence of management in carrying out their duties as chair, and we submit, sufficiently 'independent' to act in the best interests of members.

AIST recommends that the proposed prudential standard and PPG on governance carefully outline the independent director/chair principles without giving the impression that independent chairs and directors are the panacea for good governance. Trustee directors and chairs should have appropriate competencies for their board functions and should be continually improving their skills and expertise, whether they are aligned or not.

AIST supports the notion that a director who is also a member of the RSE can still be independent (proposed PPG 3.4.1).

### **Tenure and renewal policies**

AIST agrees that tenure restrictions should be at the discretion of the board (where the governing framework allows). We support the idea that boards should have clear policies in place setting out their expectations with regard to board terms and succession planning. This should also include expectations in relation to the minimum term served, so as to avoid frequent turnover of directors.

*Provided directors are significantly contributing to the board and the functions of the fund, and are appropriately representing the members' interests effectively, their length of service should not be a determinant to their suitability to serve on the board. Boards are to actively think about succession planning as a part of their board composition and turnover and engage with their nominating bodies in relation to the identification of future potential directors. Issues of continuity should also factor into director succession decisions. We firmly believe in the need to evaluate and report on individual director performance and the application of high standards when considering reappointment, rather than the arbitrary measurement of time served.<sup>2</sup>*

It is proposed that SPS 510 would require RSE licensees to define an appropriate maximum term for its directors. AIST supports this proposal with the proviso that, a director may serve a longer term where appropriate, and in circumstances that satisfy APRA. Setting maximum terms in a RSE licensee's governance policy will set expectations about board renewal and provide an appropriate mechanism for this to occur.

### **Board assessment processes**

AIST supports a formal requirement for boards to review their performance annually. However, AIST questions the need for at least annual 'independent' and 'objective' reviews of the board, individual directors and any board committees.

Independent and objective board assessments suggest the use of external experts as it may be difficult for RSE licensees to satisfy APRA that an internally-conducted review is sufficiently independent and objective. External consultants come at a cost which, if incurred every year, may not provide the commensurate benefit for members. The time that some reviews may take can also be prohibitive. The assessment process, followed by the compiling and tabling of a report and then an action plan to tackle any highlighted areas for improvement takes time to complete, leaving little opportunity for the implementation of the action plan before the next assessment is again due. Accordingly, AIST recommends conducting internal reviews annually and using an external assessment service at least every three years.

### **Use of board committees**

AIST supports the need for RSE licensees to have both an audit committee and a remuneration committee, comprised only of non-executive directors. Where these already exist, they should be allowed to continue to operate or take on additional related functions should their terms of reference currently not meet the proposed standard.

An industry code of governance should support the proposed standard. AIST's Fund Governance Framework says:

*A committee should have equal representation and should be of a reasonable size. Boards should develop terms of reference or charters outlining the scope and responsibilities of these committees. This might include, for instance, a policy regarding board expectations about the number of meetings that should occur in the year and include details of any delegated powers. The document should be clear about what is being delegated to the committee, including any relevant decision-making power, and what reporting expectations the board has of the committee. This information should also be disclosed, for example in annual reports or the fund's website. In addition, board committees should be provided with adequate staffing and the ability to obtain external advice where necessary, to facilitate committees delivering*

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<sup>2</sup> Ibid.



*outcomes. All committees should maintain a record of their proceedings, and report these to the board regularly.*

*Having a committee of the board around a specific area does not absolve the board or individual trustees from responsibility. They are required to make independent decisions regarding delegated powers, and make appropriate enquiries as and when necessary. Boards should vet any appointment of service providers or advisers made by a committee under delegation from the board.<sup>3</sup>*

## Remuneration

AIST supports the disclosing of both the remuneration policy and remuneration paid to all directors and the top executives of a RSE licensee, where the size of the staff makes this appropriate. In a small fund with a handful of staff, it may be appropriate to only disclose the remuneration of the chief executive officer.

*We recommend funds disclose in their annual report the total remuneration paid to the top five executives of the fund. This disclosure should be in 'bands'. We recommend that bands of \$50,000 should be used. A fund's policies for remuneration of executives should also be disclosed, including its relationship to the fund's performance.*

*Remuneration of directors should also be disclosed to members. Each individual director's remuneration should be disclosed including reference to any additional committee or chairperson fees paid.<sup>4</sup>*

## 2.2 Prudential Standard SPS 521: Conflicts of Interest

AIST supports the requirement that all RSE licensees develop and maintain a conflicts management framework comprising a comprehensive system of internal controls and reporting as well as a comprehensive conflicts policy. Directors' material interests and gifts should be declared and all external duties should be well known to the board and senior management. AIST agrees that all conflicts of interest and duty should be registered.

AIST has already provided guidance to its members on conflicts of interest and conflicts of duty in its Fund Governance Framework.

*Boards should have a clear policy on the acceptance of gifts, such as attendance at corporate sporting events and the like. A gift register is an appropriate vehicle for keeping track of hospitality enjoyed by trustee directors and executive staff. The policy should be disclosed to members and boards should consider disclosing any material gifts received throughout the course of the year.<sup>5</sup>*

AIST supports the elements mooted for inclusion in SPS 521 and welcomes the development of a PPG providing examples of conflict situations and what constitutes a material gift.

## 2.3 Prudential Standard SPS 520: Fitness and Propriety

AIST supports the creation and maintenance of a fitness and propriety policy as well as documented processes for assessing and taking action on fit and proper requirements for responsible officers.

AIST however has concerns with the practicality of requiring RSE licensees to conduct fit and proper assessments of auditors and actuaries as well as responsible officers within outsourced service providers. While AIST supports

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<sup>3</sup> Ibid., p. 20.

<sup>4</sup> Ibid., p. 24.

<sup>5</sup> Ibid., p. 17.



greater accountability measures for material service providers, this is perhaps best achieved through legislative amendment to the relevant provisions, or alternatively, a pronouncement system as developed by the Auditing and Assurance Standards Board (AUASB). (See Appendix A)

Various statutory duties already apply to auditors and actuaries and AIST submits that RSE licensees should not be required to conduct extensive fit and proper investigations of persons already subject to higher standards of care. Therefore, AIST recommends that RSE licensees be issued with pronouncements which give the necessary assurance under a system of carefully defined controls declaring that responsible officers possess “competence, character, diligence, honesty, integrity and judgement to perform properly the duties of the responsible person position” and that they are “not disqualified under an applicable prudential Act from holding the position” and if that person has a conflict of interest “that the conflict will not create a material risk”.<sup>6</sup>

Furthermore, AIST supports the development and maintenance of a whistleblowing policy with appropriate awareness training. However, AIST recommends that whistleblowing should not be buried in a fit and proper policy which relates only to responsible officers. AIST strongly recommends that all RSE licensees be required to have a whistleblowing policy and that this policy should stand alone.

## 2.4 Prudential Standard SPS 220: Risk Management

### Risk management framework

AIST welcomes the requirements around the risk management framework and the removal of the requirement for a Risk Management Plan (RMP), separate from a Risk Management Strategy (RMS).

Existing standards for life and general insurers (GPS 220 and LPS 220) specify requirements for controls along with managerial responsibilities. AIST however supports the inclusion of a provision for ‘incorporation by reference’ for some of the detail so that the RMS remains a manageable sized document. The RMS should not duplicate the contents of every policy and procedure of the trustee, but rather, remain a master plan for all risk areas. An RMS should contain sufficient specification of the controls and direction to the location of more detailed processes and procedures.

AIST supports the alignment of the risk management framework with the business strategy and plan.

### Requirement to articulate risk appetite

‘Risk appetite’ is not defined in the discussion paper or any of the related industry standards. Some detail is provided in GPS 220 around what goes into this measure however no actual definition is articulated. The term ‘risk appetite’ should be defined to provide guidance to RSE licensees or, at a minimum, provide some examples by way of assistance to the industry. For example, a RSE licensee states that it chooses to outsource a material service; identifies the risks in that choice; that it is willing to accept those risks and how it will manage them; including any triggers for action. AIST submits that this should satisfy the requirement for an expression of risk appetite.

AIST is concerned that with the tight risk measures that APRA sets under its supervision program that any articulation of a fund’s risk appetite may be overly conservative. Accordingly, APRA guidance around this requirement would be welcomed. Funds will have investment risk appetites, separate from a fund’s overall risk appetite. AIST submits that investment risk will be strictly regulated in new legislative requirements and that accordingly Prudential Standard SPS 220, Risk Management, should focus on operational risk appetite only.

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<sup>6</sup> Prudential Standard CPS 520 Fit and Proper (CPS 520)

### **Dedicated risk management function**

AIST supports the requirement for a dedicated risk management function. If this does not exist already, RSE licensees should be able to incorporate this responsibility into a current executive function rather than creating a specific role. This should be appropriate to the nature, scale and complexity of the fund.

### **Risk management attestations**

Attestations currently exist in *Reporting Standard SRS 260 Trustee Statement* (SRS 260) which applies to APRA regulated superannuation funds under the *Financial Sector (Collection of Data) Act 2001* and the SIS Act, though we note that there will be some additional requirements around the trustee's processes.

AIST supports the requirement in SPS 220 for the board of the fund to approve risk management attestations.

## **2.5 Prudential Standard SPS 231: Outsourcing**

AIST recommends sourcing input from ASIC with regard to the development of SPS 231, so that there may be consistency in satisfying both regulators in relation to outsourcing requirements. There is existing ASIC regulatory guidance that discusses outsourcing in some detail.<sup>7</sup>

### **Outsourcing policy**

AIST supports the requirement for RSE licensees to maintain an outsourcing policy approved by the board relating to the outsourcing of material business activities, including a detailed framework for managing all outsourcing arrangements.

### **Minimum requirements for outsourcing agreements**

AIST supports the removal of r.4.16 (4) of the *Superannuation Industry (Supervision) Regulations 1993* (the SIS Regulations) and including this information in SPS 231 and supports the requirement that all material outsourcing agreements be made using a written, legally-binding agreement. AIST also supports the inclusion of criteria around materiality in SPS 231. That is, how big does an outsourcing arrangement need to be before it can be considered 'material'?

AIST's Fund Governance Framework states:

*Trustee directors should ensure that any functions it delegates or outsources are within their powers under the trust deed and other governing documents. They should be sure that any service provider or person to whom they delegate is competent, reliable and acting in accordance with the fund's code of conduct and any other relevant standards and policies the fund ascribes to.*

*All delegated functions should be carefully documented, monitored and evaluated by the board on a regular basis to ensure compliance with fund policies. A register of delegated functions is recommended for keeping track of responsibilities. Trustee directors should remember that the ultimate responsibility for the fund rests with them, and despite their delegation to others, they remain liable in the event of loss or damage. The SIS Act covenants set out at section 52 (2) continue to apply to trustees regardless of whether or not others were engaged by the fund to conduct a particular function.<sup>8</sup>*

<sup>7</sup> See for example RGs 94, 104, 165 and 200.

<sup>8</sup> AIST, op. cit., pp. 12-13.

## Due diligence and ongoing monitoring obligations

AIST supports the due diligence and ongoing monitoring obligations proposed for SPS 231. AIST recommends however that SPS 231 should only apply to new contracts and not existing ones in so far as it relates to obligations on assessing which activities are suitable for outsourcing, selecting service providers and monitoring the relationship with the service provider. AIST submits that grandfathering provisions are appropriate here.

The discussion paper also suggests that RSE licensees should have a greater understanding of outsourcers' "capital/financial resources, adequacy of insurance arrangements, data integrity controls and the adequacy of governance and risk management frameworks". Obtaining this level of information from outsourced service providers may not be practical, and even impossible, and AIST recommends against making this a requirement in SPS 231. Alternatively, pronouncements such as those developed by the AUASB may be an appropriate method of providing the required assurances to a RSE licensee. (See Appendix A)

## 2.6 Prudential Standard SPS 530: Investment Governance

The heightened responsibilities associated with Stronger Super will create additional expectations and constraints on investment behaviour, with SPS 530 to require diversification and performance fee governance. More broadly for all investment options, trustees will be required to explicitly consider investment costs and taxation consequences, obtain timely and independent valuations, and offer a range of investment options.

AIST supports enhanced responsibilities for MySuper products, and is concerned to ensure that these be regulated by SPS 530 in a way that is simple, effective, appropriately disclosed, and in alignment with the best financial interests of both MySuper and Choice fund members. Accordingly AIST recommends that trustees are able to access all appropriate investments, and that SPS 530 does not operate so as to effectively ban or limit legitimate investment opportunities.

### Investment objectives

The requirement to set clear investment objectives and investment strategies for each investment option already exists, and the principle will be no different for MySuper.

### Investment strategies

AIST supports the development of a requirement for the articulation of realistic return objectives in specific and comparable terms, based on rolling, long-term (10 year) net returns. This methodology should be developed in parallel APRA's statistics collection and reporting project. The outcome should provide comparability between MySuper and a reasonable range of Choice products (with standardised labelling) without limiting the opportunity for trustees to also offer a wider (and possibly less standardised) suite of investment offerings.

AIST supports the use of the Standard Risk Measure proposed in the FSC-ASFA Guidance Paper as a starting point; however we consider it inadequate to convey the potential severity of risk factors. AIST recommends that SPS 530 should provide a template for best practice risk disclosure covering member expectations, severity, and the full disclosure of potential risk factors. These should include market risk, operational risk, and liquidity risk, and will therefore be more comprehensive than the Standard Risk Measure.

Obligations relating to effective and appropriate due diligence for investment options already exist, and AIST recommends that these be incorporated into SPS 530 at the same level for Choice products, noting the additional disclosure requirements in relation to investment fees, liquidity and valuations.

AIST recommends that SPS 530 provides guidance on what constitutes an appropriately diversified strategy for MySuper products, in principle terms. As diversification is concerned with reducing risk within a portfolio, the diversification requirements in SPS 530 should be linked to risk measures. SPS 530 should also make it clear that the requirement for diversification relates primarily to diversification between, rather than within, asset classes.

### **Investment management processes**

AIST submits that SPS 530 should prescribe the same level of rigour for investment management processes regardless of whether a trustee insources or outsources investment management, or uses implemented consulting.

### **Investment costs**

Because there are a range of inconsistencies and inadequacies in the area of fee disclosure in the superannuation industry, AIST submits that the full, thorough and comparable identification of fees is important. The areas of concern include:

- Lack of consistency regarding the inclusion or exclusion of some costs in the disclosed investment management expense ratio (MER);<sup>9</sup>
- Separation of operating costs and investment costs – lack of consistency in treating in-house investment teams;
- Lack of consistency in disclosure of hidden fees, bundled fees in funds-of-funds and some pooled vehicles (e.g. trusts, implemented consulting solutions);
- Lack of disclosure of performance fees paid to underlying managers;
- Lack of clarity regarding the relationship between fees, tax and risk profile for investment options;
- Lack of clarity regarding treatment of non-investment-related operational costs (e.g. handling of contributions tax); and
- Lack of comparable industry data to assist trustees to benchmark the fees they are paying.

AIST recommends that SPS 530 should include requirements to improve the overall transparency and consistency of fee disclosure:

- Inclusion of MER statements in the audited financial statements produced by funds;
- Development of a MER standard within SPS 530, to ensure consistent and full disclosure of all investment-related costs, including full disclosure of look-through fees;
- Mandatory inclusion of an approved MER statement in the trustee annual report to members; and
- Collection by APRA of manager level data for each fund and publication of aggregate data across the APRA fund-type classifications.

### **Performance fees**

The Cooper Report<sup>10</sup> recommended that APRA develop a performance fee standard, with the body of the report identifying the eleven issues and principles to be included. Cooper concluded that trustees should be able to negotiate performance based fees if they believe it is in the best interests of members. This recommendation

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<sup>9</sup> Mainly custody and asset consulting

<sup>10</sup> Super System Review: Final Report, Commonwealth of Australia, 2010.

received support in the Government's December 2010 response, and was a commitment made by the ALP during the 2010 election campaign.

Five requirements were identified for performance fee arrangements by the Government in September 2011, or meet the requirement that it be otherwise shown to be in the best financial interests of MySuper members. This is the formulation developed by the MySuper Working Group and AIST submits this should be incorporated into SPS 530. AIST supports an objective and standardised test with the option to use the best financial interests of the members test as an alternative.

The standard should identify a preferred performance fee model, such as a manipulation-proof, risk adjusted performance fee model. The APRA Working Paper by Sy & Lui, *Investment performance ranking of superannuation firms*, proposed an objective risk measure based on the ex-post volatility of the corresponding benchmark portfolio. They called this the risk-adjusted value-added metric (RAVA). AIST supports further consultation with the industry about the adoption of this metric for investments in some (if not all) asset classes.

SPS 530 should make it clear that the purpose of a reduced fee base is to have appropriate risk-sharing in place. AIST submits that APRA should test this on both a prospective and retrospective basis and this should be included in SPS 530. AIST recommends that the base fee should not be directly related to the assets under management, and preferably should be set on a dollar basis.

AIST notes the support for after-tax and after-cost criteria as part of the performance measurement while noting that this is a complicated and technical area that has been only partly addressed in the Cooper Review and by the Stronger Super consultations. We recognise that it also remains unresolved in the wider superannuation industry. Prior to the issuance of any standard covering after-tax and after-cost reporting, AIST recommends that there be further consultation with the superannuation industry to define processes and approaches including the methodologies and key assumptions required.

AIST submits that the standard should recognise that it is legitimate and appropriate for tax to be incorporated into a crediting rate on an assumed tax rate (and subsequently adjusted if necessary).

In setting benchmarks against which a hurdle is assessed, the standard should also have regard to the alpha generated by the investment and have a timeframe that is relevant for the asset class.

The Government has called for the performance fee standard to have an appropriate testing period. The wide variation in most asset classes over a one-year period supports the view that results are dependent on the measurement period. However, the relative consistency over the five-year periods suggests that it is reasonable to draw some conclusions from the longer term data.

The Government has identified a number of provisions for fee adjustments to recoup any prior or subsequent underperformance. The prudential standard should allow for appropriate flexibility, avoiding a 'one-size-fits all' approach. Accordingly, the adjustments should not specify or prescribe the exact manner in which those outcomes are to be achieved. Rather, APRA should develop appropriate options for the application and setting of high watermarks, clawbacks and vesting arrangements, with the expectation that trustees would choose most but not necessarily all of these. This should allow for the difference in nature, scale and complexity of the fund.

SPS 530 should also address the inconsistencies in disclosure of the impact of performance fees on the fund (e.g. some funds show last year's performance fee, others show expected long-term averages).

## Liquidity management

AIST supports the factors that APRA proposes to require for consideration in liquidity management appear appropriate. Of these, AIST recommends that fund membership profile should be given the greatest priority.

Within this context, SPS 530 should recognise that strong positive inflows of superannuation guarantee contributions into funds may be a significant factor in appropriate liquidity management. In addition to management of liquidity at a whole of fund level, SPS 530 should prescribe liquidity requirements at a MySuper level. Liquidity management, however, is relatively less important for those Choice options where any lack of liquidity is clearly and fully disclosed to prospective members of the Choice option.

SPS 530 should require that liquidity management is a separately identified risk within a fund's RMP/RMS and include requirements for stress testing of assets for liquidity. In this regard, liquidity management should be identified by SPS 530 as an integral part of cash flow management.

SPS 530 should also avoid formulations that would artificially and unnecessarily require trustees to sell assets to meet formulaic liquidity requirements, especially if the sale was not otherwise in the best financial interests of members.<sup>11</sup>

## Valuations

The underlying value of assets is far more important than the use of unit pricing or pricing using crediting rates. Indeed, it is important that the use of say, daily unit pricing, not be allowed to mask or provide false validation for unreliable or untimely valuations.

It is also the case that not all assets pose the same valuation challenges, with issues of illiquidity and unlisted assets posing particular questions.

Many not-for-profit funds invest in infrastructure through Industry Funds Management (IFM). It is recommended that SPS 530 incorporate the principles upon which IFM's valuation policy is based in relation to infrastructure assets. That is:

- Quarterly valuation of infrastructure investments;
- Regular and routine review of valuations, with each asset being graded as having a low, medium or high position in a valuation range, and significant valuation changes being escalated for board consideration; and
- Regular rotation of valuers.

Furthermore, AIST submits that SPS 530 should also ensure that there are valuation methodologies appropriate for each asset class, and that a one-size-fits-all approach is explicitly avoided.

## Life-cycle investment strategies

An existing strength of not-for-profit funds has been the level and nature of active management of default investment options. This strength will be incorporated into the heightened responsibility of trustees in relation to MySuper products.

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<sup>11</sup> The existence of a market can be established other than by an actual sale.



SPS 530 should explicitly require that trustees of MySuper products offering life-cycle investment strategies have the same or greater investment responsibilities towards their members as other MySuper products. For example, SPS 530 should require that life-cycle investment strategies not operate mechanistically in adverse and volatile market circumstances, so as to inadvertently crystallise losses for members, nor should trustees be allowed to imply that they have a “set and forget” strategy that somehow affords greater investment security to members within such a MySuper product.

## 2.7 Prudential Standard SPS 114: Operational Risk Financial Requirement

Operational risk reserves do not necessarily reduce the risk profile of superannuation funds. They provide a source of capital following operational errors and failures, without the need to fulfil the financial requirement from other sources (e.g. member accounts). They are useful in ameliorating the impact of risk events and should sit alongside a robust management framework. AIST supports flexibility in the calculation of individual funds’ operational risk reserves, appropriate to their nature, scale and complexity.

### Minimum features of the operational risk financial requirement

The cost of remedying an error is more closely correlated with the costs of running the fund than with the funds under management (FUM), and so it may be preferable to have a target based on operating costs rather than FUM. FUM and operating costs are correlated but not absolutely; with increased economies being evident as scale increases (i.e. lower comparative operating costs for larger funds).

Rather than looking firstly to the reserves proposed for other industries, AIST recommends that the operational risk reserve be set objectively. APRA has had risk assessment tools that could be used for this purpose in place since 2002, and in an enhanced version since 2010: The Probability and Impact Rating System (PAIRS). This already comprehends a wide range of risk categories, involves consideration of inherent risk, management and control, net risk and capital support.

Similarly, each RSE licensed fund also has a RMP/RMS that includes probability ratings for all material risks faced by the fund.

A PAIRS score calculated by APRA and the fund’s risk probability rating together with the fund’s operating size could therefore be major considerations in the appropriateness of a RSE licensee’s calculation of their operational risk reserve.

However, the guidance provided by the discussion paper in proposing an initial indicative target of 0.25% is useful, and an appropriate first step for those funds that have not yet established an operational risk reserve.

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

SPS 114 anticipates that the operational risk financial requirement can be met by fund reserves or trustee capital. However, the requirement could also be met (in part) by insurance arrangements as the proposed PPG suggests. SPS 114 should not only allow this and require it in relation to third party risk, but should also state the level to which insurance can cover this requirement.

It is implied that SPS 114 will in the first instance include a number of expectations rather than minimum levels of operational risk financial requirements. The interim nature of proposed SPS 114 should be made explicit, and SPS 114 should therefore be issued as a transitional standard.



This would facilitate further consideration and consultation with the superannuation industry of an objective, comparable methodology for the setting of operational risk financial requirements.

### **Strategy for meeting the operational risk financial requirement**

AIST supports the minimum considerations in a strategy for meeting operational risk financial requirements. However, AIST recommends that these should be explicitly aligned with fund's risk probability rating and its appropriateness can be measured, as suggested, against the APRA PAIRS score.

### **Reporting requirements**

AIST supports the comments in the discussion paper about the requirement to report on operational risk reserves, and the publication of these in aggregate (for example, grouped per FUM or type of fund). However, AIST would not support the publication of this information at an individual fund level. We note that APRA does not publish the ratings from PAIRS assessments.

### **Transition arrangements**

Operational risk reserves should be built up over time as the discussion paper suggests, however, SPS 114 should not set fixed periods for this. The prevailing investment market environment will determine how quickly reserves can and should be built up, and so this is an area where APRA should provide guidelines and expectations. AIST submits that a three year transition period would be appropriate if regarded in this way.

### **Defined Benefit Funds**

AIST recommends that APRA clarify operational risk reserve requirements in relation to DB funds and DB sub-funds, that is, are operational risk reserves required at all for DB fund and DB sub funds where the employer is already at risk for 100% of member benefit entitlements?

## **2.8 Prudential Standard SPS 160: Defined Benefit Funding and Solvency**

AIST supports the proposed standard in relation to the funding and solvency of defined benefit (DB) funds.

With regard to the requirement that funding of DB funds and sub-funds will be required at the vested benefit level rather than the current requirement of minimum *Superannuation Guarantee Contribution Act* funding requirements, we recommend a five-year transition period. Given the recent volatility in investment markets we suggest that a five-year period takes into account the potential financial impact on employers of such a change. We also note that such a transition period would effectively run in parallel with the proposed increase in superannuation guarantee contributions from 9% to 12%.

We understand that the prudential standard would also set requirements for the restoration to a satisfactory financial position if funding falls below vested benefits including requirements on agreeing restoration plans between the trustee and the employer.

We note that the proposed funding requirements would apply equally to both DB funds and DB sub-funds, with actuaries and auditors having the same reporting obligations regarding DB sub-funds as those that are currently in place for DB funds.

AIST supports the requirement for actuarial certification of the adequacy of self-insurance arrangements of a DB fund or DB sub-fund.

AIST further submits that employees/members should be provided with transparent reporting of DB funds and DB sub-funds that are less than 100% of vested benefits and in particular when an employer is not contributing in accordance with the actuarial recommendations.

## 2.9 Prudential Standard SPS 310: Audit and Related Matters

### Internal audit function

AIST supports the proposed standard and understands that it is proposed that it effectively replicates all existing audit requirements under SIS legislation.

AIST supports the requirement for all funds to have an internal audit function and that at a minimum, the scope of the internal audit function should be to certify that all policies, processes and controls comply with APRA's prudential requirements. If the role is insourced, the individual's relationship with the CEO and senior management should be considered in the objectivity and independence that the individual can bring to the role. Whether the internal function is insourced or outsourced however, the individual should have direct access to the board, the chair of the audit committee and the chair of the board.

### Heightened minimum auditor requirements

AIST also supports the auditors' independence requirements. Auditors should comply with the various accounting and auditing requirements of the professional bodies. However, AIST also believes that external auditors of public offer funds should comply with similar rules to public companies which require partner rotation every five years. For non-public offer funds we believe that partner rotation should be within seven years unless otherwise approved by APRA and the trustee.

In AIST's Fund Governance Framework it says:

*Auditors should discharge their duties and responsibilities without being influenced by factors that could impede their independence.<sup>12</sup>*

*Where the law permits, the partners signing off on the audit should be rotated every five to seven years. The audit committee should be involved in an ongoing review of the audit firm and its services, with active consideration given to rotating the audit firm at least every ten to twelve years. Where the audit firm is rotated, the personnel who assume responsibility for conducting the audit should not be the same personnel so that if an audit partner moves firms he or she cannot continue to be responsible for auditing the fund.... We support the auditor providing an annual statement that no circumstance has existed during the year that has affected the independence of the audit engagement team or audit firm. This statement should be included in the financial reports of the company.<sup>13</sup>*

AIST also believes that the external auditor should be required to provide an annual sign-off on each fund's MER calculations. We see this as being very important so that APRA and fund members can rely on reported MER disclosures in order to compare funds from a cost perspective.

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<sup>12</sup> AIST, op. cit., p. 28.

<sup>13</sup> Ibid., p. 29.

## 2.10 Prudential Standard SPS 232: Business Continuity Management

### Business continuity plan

AIST supports the requirement for RSE licensees to have appropriate Business Continuity Plans (BCPs). AIST is concerned however with the proposed requirement for RSE licensees to have access to the BCPs in place for their outsourced service providers.

Much of the information required by the proposed standard is generally considered “commercial-in-confidence”. AIST submits that a requirement on RSE licensees to ensure that their service providers have satisfactory BCPs and assessing the adequacy of these arrangements is therefore impractical, if not impossible.

The AUASB has a series of pronouncements available that apply when entities are required to report on controls when assurance is to be provided (See Appendix A). AIST submits that these sorts of pronouncements should be considered for extension to material outsourced service providers in the superannuation industry. AIST understands that some service providers in the industry are already using GS 007 to assure their clients about robust controls.

AIST recommends that material outsourced service providers be required to report on controls when assurance is to be provided through a mechanism like the GS 007 reports in satisfaction of APRA requirements.

## 2.11 Prudential Standard SPS 250: Insurance in Superannuation

### Insurance strategy

AIST supports the development of an insurance strategy and supports the need for each RSE licensee to have an appropriate policy on insurance. AIST recommends however that SPS 250 should not be overly prescriptive. Trustees should retain their discretion to make decisions on what is in the best interest of their members.

AIST supports the requirement for a dedicated insurance function provided this role can be incorporated into an existing executive function. This should be appropriate to the nature, scale and complexity of the fund.

### Permitted insurance within superannuation

AIST believes that the focus of insurance in superannuation should be on the purpose of the benefit with the trustee able to determine the best method of payment to achieve the retirement outcome for the individual. This may allow funds to develop hybrid products which combine many types of insurance, even including elements of trauma cover so a partial payment could be made to help a member pay for an operation or make a workplace modification. A hybrid model may allow for a payment to retrain or rehabilitate a member for a period, and then if this approach is unsuccessful, lead to a decision of Total Permanent Disability (TPD) and a lump sum could be paid.

Similarly, AIST does not endorse restrictions on definitions that lead to unintended or adverse outcomes. For example, ‘own occupation’ cover, if provided by an insurer, should be allowable in a superannuation context.

### Limitations on self-insurance

With regards to self-insurance, the current legislative framework forces funds to outsource their insurance arrangements. Commercially, this means that RSE licensees are potentially paying a profit to the provider which could be returned to members if it was managed in-house.

As superannuation funds increase in size through mergers, inflows and investment growth, they should not be restricted from considering self-insurance as the premium will become an increasingly smaller % of FUM. We

recognise that this would need to be done with a strict reserving policy. It is highly possible that some large funds will actually have better credit ratings than the insurance provider which challenges the point of insuring at all. If the insurance provider fails, inevitably the fund would step in to cover the loss.

AIST submits that any Government policy relating to insurance in superannuation should not restrict product development or an organisational structure that could well be in the best interest of members.

## 2.12 Prudential Standard SPS 410: Transition to MySuper

APRA have indicated that they will consult on proposed MySuper authorisation requirements in mid-2012. It is anticipated that this will involve the issuing of a draft authorisation form and identification of required documentation and information in support of the application.

The form will be given context by SPS 410. AIST recommends that in addition to the draft standard being released for consultation in early 2012, APRA should commit to releasing SPS 410 in its final form by mid-2012. Its release should be given priority over the release of other standards.

AIST recommends that APRA issues a model authorisation application, and includes this as a schedule to SPS 410, so that there is alignment between APRA and applicant RSE licensees on what constitutes a complete, comprehensive and appropriately structured application.

### Minimum requirements

It is recommended that the minimum requirements for transition be divided into two streams according to the treatment of default fund balances: immediate and delayed transition of default balances. The purpose of this is to ensure that the purpose of MySuper is realised and that no member is disadvantaged by the unnecessary overpayment of fees because of the deliberate delay in transitioning members. AIST makes the following recommendations:

#### 1. Immediate transition of default balances

In circumstances where:

- (a) Existing default fund balances are transitioned to the fund's MySuper product at the time of that product's authorisation; and
- (b) There is no significant difference between the fees, investments and insurance of the previous default fund and the MySuper product (i.e. the transition appears to be a re-naming from the perspective of the default fund members);

Then, the transition shall be deemed by APRA under SPS410 to be in the best interest of beneficiaries.

#### 2. Delayed transition of default balances

In circumstances where existing default fund balances are transitioned to the fund's MySuper product in a process separate from and subsequent to the product's authorisation, the fund's trustee, should as a minimum, be required

to justify how the two-stage transition process is in the best interests of beneficiaries, and, in particular, demonstrate that:

- (a) the member will not pay any additional administration, investment and insurance fees as a result of having their superannuation interests split into two products. (i.e. there should be consideration of overall cost in the best interest test); and
- (b) managing assets in this staged way does not result in higher costs or lower returns than if the assets were all in the MySuper product; and
- (c) member benefit statements will be structured so as to allow members to receive a complete record of their existing superannuation benefit with the fund (i.e. pre-MySuper balances and post-MySuper contributions) in one statement, and as a consolidated record; and
- (d) member communications about member's pre-MySuper balances and post-MySuper contributions are consolidated so as to not cause confusion; and
- (e) any fees or commissions payable on the existing default option that are not payable on the MySuper option are clearly identified to the member in a directed disclosure.

These requirements should be specified in SPS 410.

AIST submits that SPS 410 should include a process to ascertain when an existing default account becomes inactive (by reference to the member's corresponding MySuper account), and to ensure that the account is included in account consolidation processes. The associated APRA supervision process should also monitor and ensure that existing default balances are not manipulated to avoid inclusion in account consolidation processes.

The communication plan to members in these circumstances should also be required to include a requirement that any fees or commissions payable on the existing default option that are not payable on the MySuper option are clearly identified. In specific communications sent to all members in a directed disclosure specified in SPS 410 prior to the establishment of the MySuper product, this should be disclosed.

The communication plan should also require that trustees advise members of the transfer date prior to the establishment of the MySuper product.

## Scale

Where a RSE licensee elects to delay the transition of its default members to a new MySuper product, AIST recommends that APRA require the licensee to furnish reasons for the delay. The reasons should require the inclusion of a business plan and projections that detail how and when the MySuper product will develop sufficient scale. As the MySuper product may offer services such as advice and insurance, APRA should be satisfied that there is sufficient scale to warrant the MySuper authorisation and no cross-subsidisation by the non-MySuper members. AIST recognises that there may be good reasons for delaying the transfer of default members to the MySuper product; however, we submit that the bona fides of the delay should be subject to review by APRA.

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### 3 Conclusion

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AIST recognises that the proposed APRA prudential standards raise the bar for the governance of superannuation funds and supports the intent of the prudential outcomes sought.

AIST recommends that Prudential Standard SPS 410 Transition to My Super be expedited ahead of the other prudential standards to facilitate the smooth and effective implementation of MySuper. AIST recognises that the timelines around MySuper implementation across a variety of stakeholders are already tight and the release of any early guidance will help to facilitate a smoother process.

AIST also recommends that where overlap with ASIC is likely, that APRA liaise closely with the regulator so that any requirements of RSE licensees are aligned.

AIST also recommends that the legal framework in which RSE licensees operate remain at the centre of the development of the prudential standards. Prudential regulation must at all times recognise the underpinning law of trusts and the unique operating structures of superannuation funds.

AIST has taken the initiative to develop the Fund Governance Framework for its members with a view to expanding these principles to develop an industry-wide Code of Governance. AIST will ensure that its own governance framework is updated to take into account the new prudential standards and will incorporate them into its draft industry code.

AIST is available to assist APRA further in relation to the development of the prudential standards and PPGs and looks forward to further consultation.



## Explanation of the Applicability of AUASB pronouncements when conducting Internal Control Engagements

Assurance engagements to report on controls at an entity may be conducted and reported on by the assurance practitioner under a number of different pronouncements depending on the subject matter and the whether or not assurance is being provided. The objective of this explanation is to assist the assurance practitioner in determining the appropriate pronouncement to apply in any given circumstance.

The following pronouncements may be applicable when conducting an engagement on controls:

- ASAE 3000 *Assurance Engagements other than Audits or Reviews of Historical Financial Information*
- AUS 810 *Special Purpose Reports on the Effectiveness of Control Procedures*
- ASAE 3402 *Assurance Reports on Controls at a Service Organisation*
- GS 007 *Audit Implications of the Use of Service Organisations for Investment Management Services*
- ASRS 4400 *Agreed-Upon Procedures Engagements to Report Factual Findings*

The overarching standard for engagements to report on controls when assurance is to be provided is ASAE 3000, which provides the broad requirements for all assurance engagements, other than audits or reviews of historical financial information. Consequently, ASAE 3000 will need to be applied in all assurance engagements on controls.

In addition, AUS 810, which was issued under a previous framework by the former AuASB in 2002 and predates ASAE 3000, is applicable to certain assurance and agreed-upon procedures engagements to report on controls and provides additional requirements relating specifically to controls. AUS 810 requires updating and is expected to be replaced with a new Assurance Standard in the 2011-12 financial year. Consequently, AUS 810 may be applied only to the extent that the requirements of ASAE 3000 are also met. Where inconsistencies are identified, the requirements of ASAE 3000 take precedence over AUS 810.

For engagements to conduct agreed-upon procedures on controls and report factual findings, AUS 810 is applied alongside ASRS 4400.

Where a controls engagement relates to reporting on a service organisation for use by user entities and their auditors, ASAE 3402 specifically applies. AUS 810 does not need to be applied in these circumstances as ASAE 3402 provides all of the necessary requirements. Further guidance is provided by GS 007 where the services provided by the service organisation are investment management services.





The following table summarises the applicability of the AUASB’s pronouncements when conducting internal controls engagements:

<b>AUASB Standard or Guidance</b>	<b>ASAE 3000</b>	<b>AUS 810</b>	<b>ASAE 3402</b>	<b>GS 007 (2011)</b>	<b>ASRS 4400</b>
<b>Title</b>	<i>Assurance Engagements other than Audits or Reviews of Historical Financial Information</i>	<i>Special Purpose Reports on the Effectiveness of Control Procedures</i>	<i>Assurance Reports on Controls at a Service Organisation</i>	<i>Audit Implications of the Use of Service Organisations for Investment Management Services</i>	<i>Agreed-Upon Procedures Engagements to Report Factual Findings</i>
<b>Applicable to reporting periods commencing ON or AFTER</b>	1 July 2007	July 2002	1 July 2010	1 January 2012 <sup>1</sup>	1 July 2011
<b>Applicable practitioners</b>	Assurance practitioners	Auditors (generally)	Assurance practitioners engaged to report on service organisation controls (service auditor)	Service auditors for investment management services organisations	Assurance practitioners
<b>Subject matter of assurance engagement</b>	Other than Historical Financial Information (including controls)	Design and operating effectiveness of control procedures	Description, design and/or operating effectiveness of controls at a service organisation	Description, design and/or operating effectiveness of controls at an investment management service organisation	Any subject matter subject to agreed-upon procedures
<b>Nature of Report</b>	Reasonable or limited assurance	Reasonable or limited assurance or factual findings	Reasonable assurance	Reasonable assurance	Factual findings
<b>Issue date</b>	9 July 2007	July 2002	29 June 2010	25 October 2011	June 2011

<sup>1</sup> The superseded GS 007 (2008) was operative for reporting periods commencing on or after 1 July 2008.

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