Prudential Guidance for Superannuation

July 2013

AIST Submission

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 $500 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'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 Introduction and overview

AIST appreciates the opportunity to make submissions concerning the draft prudential practice guides released by APRA for consultation on 9 May 2013.

AIST supports the intent of the prudential practice guides and this submission tries only to further clarify some of the concepts and guidance offered in the draft practice guides. In addition, this submission only deals with those prudential practice guides for which it has recommendations for improvement or where further clarification is required:

- SPG 160 Defined Benefit Matters
- SPG 222 Management of Reserves
- SPG 511 Remuneration
- SPG 532 Investment Risk Governance
- SPG 533 Valuation
- SPG 221 Adequacy of Resources
- SPG 270 Contribution and Benefit Accrual Standards
- SPG 280 Payment Standards

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2 SPG 160 Defined Benefit Matters

AIST notes its support for the intent of SPG 160 Defined Benefit Matters, namely providing practical guidance to assist funding defined benefit schemes to minimum levels.

AIST now turns to specific items within SPG 160.

Actuarial investigations

In its *Guidance Note 465 – Statements of Opinion relating to Defined Benefit Pensions SIS Regulation 9.31*, December 2000, the Actuaries Institute sets out a number of assumptions regarding future rates of e.g., pension increases used to determine projected likelihood of pensions being paid.

AIST recommends that while the professional standards and guidance issued by the Actuaries Institute are to be used (SPS 160, paragraph 20), that these assumptions should be incorporated into the proposed SPG 160 to provide greater clarity.

Further to paragraph 11 there is a potential for the triggering of multiple investigations where markets are volatile and funding levels are around the shortfall limits. AIST notes that although an investigation cannot be triggered while one is in process, there is still a possibility of multiple consecutive investigations. AIST recommends that SPG 160 be amended so that an investigation need not be triggered if there has been a previous investigation within (say) the past 6 months.

Shortfall limit

Paragraph 16 of proposed SPG 160 refers to the effect of market volatility on assets that may give rise to unsatisfactory financial positions on a short-term basis.

AIST recommends that paragraph 16 be broadened to include other matters that may give rise to such short-term issues, including e.g. timing of employer and member contribution payments.

AIST notes that paragraph 23(d) of SPS 160 states that the actuarial report can recommend whether the shortfall limit needs review.

AIST recommends that paragraph 17 of SPG 160 include guidance to Trustees as to when they (rather than waiting on the actuarial report) may need to consider reviewing the shortfall limit.

Paragraph 18 of proposed SPG 160 includes a list of items which a Trustee could “ordinarily consider” when setting a shortfall limit, including considering the impact of market fluctuations. AIST contends that this list includes some items that involve a degree of subjectivity. Further guidance is needed to help clarify this requirement. AIST understands that further guidance may come from the Actuaries Institute.

Paragraph 18 includes matters that involve a qualitative assessment by an RSE licensee which AIST believes are unreasonable and should be removed. It is the Trustee’s responsibility to administer the scheme in

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accordance with the scheme rules and applicable legislation. In a defined contribution scheme, if an employer does not remit SG, the matter is one that the member can take up with the ATO.

Paragraph 21 examines RSE licensees setting funding buffers in excess of 100%, and cites the example of a buffer of 105%, thereby triggering a response if the Vested Benefit Index falls below 105%.

AIST suggests that shortfall limits in excess of 100% requires further examination, given the consequences of breaching a shortfall limit. Perhaps further guidance could include taking into account issues such as employer contribution behaviour (e.g. where an employer takes contribution breaks but at times contributes proportionately large amounts on an irregular basis).

Restoration plans

Paragraph 34 of SPS 160 states that APRA may require or permit a variation to the period of a restoration plan. It isn't clear whether this statement – coupled with paragraph 30 of proposed SPG 160 – enables extinguishment of a restoration plan if the fund reached a satisfactory financial position.

3 SPG 222 Management of Reserves

AIST notes its support for the intent of proposed *SPG 222 Management of Reserves*, namely providing practical guidance for the management of any reserves within an RSE.

Relationship with SPG 235

Proposed SPG 222 covers the same area as covered by SPG 235 – *Use of reserves in superannuation funds*. Proposed SPG 222 does not however acknowledge (or explicitly replace) SPG 235. While SPG 235 has remained in draft form, it has been used to assist RSE licensees in complying with the *Superannuation Industry (Supervision) Act* provisions relating to the maintenance and management of reserves, and to provide guidance on sound practice. (See also CCH's *Master Superannuation Guide* ¶3-400.)

The largest area of change is that an Operational Risk Reserve is now mandatory, with detailed requirements contained in prudential standard SPS 114. Notwithstanding this, AIST submits that the specific guidance provided in SPG 235 on self-insurance reserves (paragraphs 21 to 25) and insurance fluctuation reserves (paragraphs 25 to 32) should be incorporated into proposed SPG 222. At the very least, APRA should clarify the status of SPG 235 and the guidance therein.

In particular, SPG 235 provides useful guidance on the risks associated with a negative investment fluctuation reserve. It would be unfortunate if this guidance was removed.

Intergenerational issues

Paragraph 4 notes that a prudent RSE licensee must act fairly in its dealings with different beneficiaries when determining its reserve strategy, with paragraph 5 specifically addressing inter-generational costs and

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benefits. Paragraph 5 concludes that, “In this scenario, an RSE licensee may form the view that all members benefit from being part of an RSE with appropriate and prudently managed reserves, even if the contingencies do not eventuate during the membership of a particular cohort.”

AIST supports this view and suggests that it be strengthened by the relevant sentence being amended to read: “In this scenario, APRA expects an RSE licensee to form the view…”

The purpose of some reserves may be to spread potential costs across different ‘generations’ of members. This may lead to circumstances where some members who contributed to the development or replenishment of a reserve leave the RSE before the occurrence of the contingent events for which the reserve has been established. In this scenario, an RSE licensee may form the view that all members benefit from being part of an RSE with appropriate and prudently managed reserves, even if the contingencies do not eventuate during the membership of a particular cohort.

Zero investment reserve

AIST submits that the commentary in paragraph 12 contains an error or overstatement and should be corrected. The text is almost identical to the text in paragraph 28 of SPG 235. However, SPG 235 addresses risks associated with a negative investment fluctuation reserve, while proposed SPG 222 addresses supposed risks associated with a zero investment reserve, that is, different circumstances.

The risks associated with a negative investment fluctuation reserve are different and greater than those associated with a zero investment reserve. A fund may expend or build up its investment returns at different times according to market circumstances; it is not necessarily something that only happens when a fund has zero or negative reserves. While a member could reasonably assume that a fund with a negative reserve would act to redress this situation (and so have less funds to allocate to members’ accounts), it would be more difficult for a member to manipulate this to their advantage when the fund has zero or positive reserves. For example, a fund may decide to continue to maintain a zero investment reserve for an extended period, and it may ‘top up’ its reserves in a period of high returns.

4 SPG 511 Remuneration

AIST notes its support for proposed SPG 511 on Remuneration, namely providing practical guidance for the remuneration practices of an RSE. AIST believes that the matters expressed in SPG 511 provide practical assistance and guidance to RSE licensees particularly its focus on limiting risk.

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5 SPG 532 Investment Risk Governance

AIST notes its support for the intent of proposed SPG 532, namely providing guidance for the investment governance practices of an RSE. AIST's concerns with regards to this draft PPG are minor.

There are concerns around what is 'expected' by APRA compared to what is required. The concerns relate to areas such as sign-offs and evidence and/or documentation required for each of these.

Concerns also relate to the overall intended nature of this document. Is it a best practice statement? Is it a minimum standards document? While prudential practice guides are intended to convey minimum standards, there are suggestions that some of this document is attempting to recommend some best practice guidelines which may have the unintended outcome of skewing the industry towards those practices.

- This is considered to be undesirable, as in some cases there are practices that are equally valid; and
- To follow some of the practices recommended in this document, funds may have to engage in process re-engineering.

The issues described above are best addressed by way of an example.

The draft PPG appears to recommend risk factors be used for portfolio construction and stress-testing, which is consistent with the existing draft guidance that was issued in late 2012 (draft PPGs *SPG 530 – Investment Strategy – Formulation* and *SPG 531 – Investment Strategy - Implementation*). Historically, super fund investment portfolios can have been constructed based on allocations to asset classes, rather than risk factors. Quantitative risk factor models in these instances may not been necessary for constructing adequately diversified investment portfolios which have successfully achieved their long-term risk and return targets.

AIST supports an in-depth understanding of how various risk factors interact in diverse market environments as a plausible objective from a theoretical perspective. However, it has been pointed out to us that this may be, in some instances, detached from practical reality. We believe that the historical relationships between asset classes adequately account for risk factor correlations and Modern Portfolio Theory (MPT) remains an appropriate approach to ensure adequate portfolio diversification.

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6 SPG 533 Valuation

AIST notes its support for proposed SPG 533 on Valuation and advises that AIST's member funds report general satisfaction with this draft PPG.

We note that the PPG advocates quarterly valuations of each unlisted asset which would be challenging from a practical perspective, as well as costly. Our current preference is to consider valuation that is timely, but also appropriate to the asset class and type, as well as the practical issues that may be associated with specific assets and asset classes.

7 SPG 221 Adequacy of Resources

AIST notes its support for the intent of SPG 221 *Adequacy of Resources* but believes that guidance could be provided on additional matters raised in Prudential Standard SPS 220 *Risk Management* which would be of assistance to an RSE licensee. AIST raises these possible additional matters below, as well as first providing comment on matters outlined in SPG 221.

Financial Resources

AIST recommends that the following additional items be included at paragraph 6 for an RSE licensee to consider regarding its adequacy of financial resources:

- Forecasts of net flow of members because this is a substantial driver of income.
- Consideration of the financial impact of governmental reform on the RSE licensee.

AIST recommends that the following additional items be included at paragraph 7 with regard to demonstrating an adequacy of financial resources:

- An amendment to paragraph (a) to reflect that net flow of members is also an important consideration, particularly within the not-for-profit sector.
- Operating costs per member since this is an important signal of organisational financial efficiency.

Human resources

AIST recommends the addition of examining adequacy of human resources against the RSE licensee's Strategic Plan at paragraph 12 of proposed SPG 221.

Technical resources

AIST recommends that the following be added to paragraph 15 of proposed SPG 221:

- Reasonable access to RSE licensee records.
- Resources to manage data (collection, storage, movement and management of data).

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Other matters where guidance in SPG 221 would assist

There are a number of other matters raised within Prudential Standard SPS 220 Risk Management about which further guidance in SPG 221 would assist. AIST outlines these issues below.

Risk appetite statement

While AIST notes comments made by APRA in its *Response to Submissions, Prudential standards for superannuation* (15 November 2012) that there is nothing in SPS 220 precluding an RSE licensee from undertaking stress testing, APRA did also note that it would review this issue in the forthcoming guidance material.

AIST recommends that further guidance is needed regarding the risk appetite statement outlined in SPS 220. For example:

- Is stress testing an additional issue that RSE licensees could undertake (and if so, what issues should the licensee take into account)?
- In expressing a 'measurable limit of risk', what types of issues should the licensee take into account?
- Should licensees consider dollar values, percentages, and qualitative issues when setting a 'measurable limit of risk'?

Materiality

AIST believes that proposed SPG 221 should include further guidance on the meaning of material risk, and that guidance be consistent with the definition of 'material risk' in SIS Regulation 4.07B.

As with our comments relating to the risk appetite statement, SPG 221 could give guidance about the concept of materiality – for example, is it determined by dollars, percentage, as well as qualitative measures.

Risk management declaration

AIST recommends that SPG 221 should contain guidance on signing of the risk management declaration:

- What are the consequences if the declaration is signed and it is subsequently found to have errors in it?
- Can the risk management declaration contain qualifications (similar to audit reports)?

8 SPG 270 Contribution and Benefit Accrual Standards

AIST supports improvements to all regulatory guidance, and broadly supports the updates to this PPG. We offer these suggestions for minor improvement.

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The purpose of this PPG

We welcome the improved wording of this PPG around the scope, including the replacement of 'superannuation fund' with RSE licensee. We believe this to be prudent and consistent with APRA's supervisory oversight of the superannuation industry.

We note throughout the draft PPG the use of the terminology 'RSE licensee more broadly' to refer to duties assigned to trustees, their staff and anyone acting on behalf of the fund. Whilst we also welcome this in the interests of simplifying the terminology in the paper, care should be undertaken as certain duties will fall to some of these entities that may not be appropriate to all audiences.

Whilst we understand the reasoning behind moving the purpose of this PPG into the 'About this guide' section, we are mindful that this section is in the PPG to provide a context around the guidance. However, we believe that it would be better for end users to have this information in the Introduction section.

Introduction

AIST welcomes the inclusion of paragraph 4 in proposed SPG 270. AIST believes that there will be more arrangements in future, such as those between Australia and New Zealand and further, note the success that many funds have had with acceptance of UK amounts under QROPS. We agree, for example, that just because an amount has come in from overseas, there should be no difference to how a fund processes these, compared to contributions received from within Australia.

AIST has concerns about how proposed SPG 270 is to work with the new SIS regulation 7.07E, which specifies that employers must provide a significant amount of personal information to the fund in relation to employees. This is contrary to current practice where members of superannuation funds undertake the updating of personal details with funds directly, and raises the question, what takes precedence in the instance of a member updating details with a fund, but not with their employer? Would the new feed of old information from an employer revert the fund's data?

Although addressing this may be a regulatory issue, we believe that a statement in the PPG will go some way to addressing this.

Risk management framework

AIST cautions against the more prescriptive approach to the risk management framework contained in this section of the proposed SPG 270. Whilst we understand that this section should address requirements which now reside in *Prudential Standard SPS 220 Risk Management* (SPS 220), there should be an acknowledgement that RSE licensees will have a number of approaches to this measure.

Contributions made in error

AIST welcomes amendments to this section in the proposed SPG 270. However, we do not support the removal of the existing paragraph 30 as we believe this formed valuable guidance to RSE licensees on what

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should not be considered to be 'extraordinary circumstances' for the purposes of the operation of the new paragraphs 28 and 29.

We believe that the new paragraph 30 may need to be modified in view of the new legislation regarding breaches of the concessional contributions cap.

Receiving a contribution

We welcome the acknowledgement in paragraph 36 that discretion may be exercised on behalf of members who do not presently meet age or gainful employment requirements and that may fall outside the two examples given at subparagraphs (a) and (b).

We welcome the changes made at proposed paragraph 32(d), where the requirements are now reflected in the superannuation data and payment regulations and standards. However, we believe that the usefulness of this section would be further enhanced with reference (such as a footnote) to the ATO's Superannuation Data and Payment Standards legislative instrument. Similarly, whilst we also welcome this in paragraph 36, the same would apply here, too.

At subparagraph (e), we notice that the best practice example with regards to unit pricing has been removed. Whilst we understand that recommendations around disclosure to members such as the previous example (formerly paragraph 35(e) of the existing PPG) would normally be a responsibility of ASIC, we believe that such guidance would still be valued by funds and AIST recommends its re-insertion.

9 SPG 280 Payment Standards

AIST appreciates the further guidance contained in SPG 280 and believes that there are some additional matters upon which further guidance would be welcome. The matters where further guidance would assist include successor fund transfers and this is addressed below.

Additionally, AIST is seeking inclusion of support for the development of Gateway Standards and the concept of a Gateway Network Governing Body (a project that is well underway). AIST believes that such support would further enhance the efficiency of SuperStream, since both the Gateway Standards and the Gateway Network Governing Body promote standardisation and clarity of gateway interoperability.

Risk management framework

AIST believes that further guidance would be useful in the following areas in paragraph 8 of proposed SPG 280:

- Watch points for concern in respect of cash flow risk
- Watch points with regard to both operational and outsourcing risk.

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Early release of benefits

Given that early release of benefits – even in cases of emergency situations such as domestic and family violence or large-scale adverse events such as flood and bushfires – can only occur if the applicant meets strict conditions, AIST suggests that paragrpah 23 be reworded to reflect this. AIST suggests that paragraph 23 could include encouragement for funds to place priority on such requests, provided that the strict conditions of release are met.

Rectification of errors – employer refunds

AIST believes that guidance on the matter of employer over-payments should be included in the PPG. Especially, the issue of employers using negative contribution amounts to offset overpayments should be handled within the PPG so that negative contribution amounts may not be used.

Additional item - Gateways

There are two key issues which AIST wishes to recommend to APRA for inclusion within this Prudential Practice Guide.

1. Gateway Standards

We recommend to APRA that the following text along the following lines be included in the PPG:

The engagement of a gateway service is considered by APRA to be a material outsourcing activity. Gateway services are a matter in which the trustee Board should take a particular interest – whether the trustee Board is engaging a gateway service directly or indirectly through an administrator.

The *Superannuation Data and Payments Standard 2012* does not deal with either the services surrounding transmitting the data, such as inter-operability (how gateways transact with one another) or the establishment of a centralised register which would enable gateways to easily establish their identity. To overcome this, the Australian Institute of Superannuation Trustees, Association of Superannuation Funds of Australia, Industry Super Network and the Financial Services Council (the peak bodies) have worked with the Affiliation of Superannuation Practitioners (ASP) and the industry to create an industry endorsed gateway standard: Superannuation Data and Gateway Services Standards for Gateway Operators transacting within the Superannuation Transaction Network ("Gateway Standards").

From a superannuation fund perspective, development of the Gateway Standards has been a major step forward in ensuring the efficiency and sustainability of the gateway system. The Gateway Standard may be found at http://www.aspaustralia.org/Home/?page=publications as can the model agreement that a gateway may sign to adopt the Gateway Standard – Memorandum of Understanding for participants in the Superannuation Transaction Network ("Model Agreement"). A list of gateways that have signed the Model Agreement and have adopted the Gateway Standard can be found at the same location.

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For RSEs outsourcing gateway services

The Trustee should review the proposed contract with its administrator with regard to:

- Compliance with the Superannuation Data and Payments Standard 2012.
- The steps the administrator is taking to ensure that it is able to deliver the required service. APRA expects that, as a minimum, this would include consideration of the signing the Model Agreement to adhere to the superannuation industry's Gateway Standard.

For RSEs establishing themselves as a gateway

The Trustee should consider how it would comply with the Superannuation Data and Payments Standard 2012 and form part of an efficient cohesive gateway network. APRA expects that this would, at a minimum, include giving consideration to signing the Model Agreement in order to comply with the Gateway Standards.

While superannuation funds still need to conduct their own due diligence processes, the Gateway Standards provide superannuation funds with a sound starting point when considering the capability of an outsourced service provider to facilitate compliance with the requirements of the Superannuation Data and Payments Standard 2012. An RSE seeking to establish itself as a gateway should also consider how it may meet its obligations should it not adopt the agreed industry standard.

2. Gateway Network Governing Body

We recommend to APRA that the following text be included in the PPG:

The Superannuation Data and Payments Standard 2012 currently does not include gateway governance arrangements. The peak bodies are currently working on the establishment of a representative governing body to maintain and further develop the Gateway Standards, the Model Agreement and the centralised registers of gateways. While at the date of issuing this PPG the Governing Body is yet to be constituted, APRA notes that such a centralised governing body (once established) will assist the efficient, standardised operations of gateways. Once the governing body has been established, this PPG will be updated.

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10 Conclusion

Overall AIST supports the intent of the draft prudential practice guides and believes that the guidance offered will greatly assist RSE licensees to comply with the new prudential standards.

While some issues require further clarification, the draft guides will be a useful tool for superannuation funds.

AIST would be pleased to provide further information, if required.

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