Options for Improving the Safety of Superannuation

Issues Paper
2 October 2001
MINISTER’S INTRODUCTION

As the Minister responsible for the prudential and consumer protection aspects of superannuation policy, I am pleased to present this Issues Paper on Options for Improving the Safety of Superannuation.

Superannuation is a key element of the Government’s policies to address the long term consequences of an ageing population. Because of the compulsory and long term nature of superannuation savings, it is imperative that the community has full confidence that the regulatory framework is strong and robust.

There is heightened community interest in the safety of superannuation following the highly publicised negative returns of some superannuation funds. Notwithstanding this, in the main, superannuation funds are safe. The Australian Prudential Regulation Authority (APRA) regulates over 11,000 funds. Given ever-changing economic conditions and market innovations the supervisory regime should be reviewed given that it is eight years since its introduction.

This Issues Paper canvasses options for reform in two key areas: updating the prudential and legislative framework; and fund governance including enhancing trustee accountability to fund members.

A Superannuation Working Group has been established comprising representatives from APRA, the Australian Securities and Investment Commission and the Treasury, to conduct the public consultation on this Issues Paper and to develop legislative options to be put to Government. I am pleased that Mr Don Mercer has agreed to chair the Group.

The deadline for submissions is 1 February 2002, and I encourage industry and community input to this process.

The Hon Joe Hockey MP
Minister for Financial Services & Regulation
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# Contents

**Minister's introduction** ........................................................................................................ iii

**Executive summary** ........................................................................................................ 1

1.1 Timetable ......................................................................................................................... 2

**Options for Improving the Safety of Superannuation** ................................................. 3

1.1 Introduction ...................................................................................................................... 3

1.2 Background .................................................................................................................... 4

1.3 Industry structure .......................................................................................................... 6

1.4 Community expectations ............................................................................................... 8

1.5 Supervisory challenges ................................................................................................. 9

1.6 Options for reform ......................................................................................................... 10

1.7 Consistency with other regulatory frameworks ........................................................... 21

1.8 Financial assistance to failed superannuation funds ................................................ 21

1.9 Longer term options for reforming the regulatory framework ............................... 23

1.10 Conclusion ................................................................................................................... 25
EXECUTIVE SUMMARY

The superannuation industry is growing rapidly (currently with $500 billion in assets) and is a key element of Government policies to address the long-term consequences of an ageing population. Comprising both compulsory and voluntary arrangements, superannuation is a long-term savings vehicle designed to allow people to set aside sufficient income during their working lives to achieve a higher standard of living in retirement than would be possible from the Age Pension alone. After home ownership, superannuation savings represent the most important asset of Australian households.

Regulatory responsibility for superannuation is split between three regulators. The Australian Securities and Investments Commission (ASIC) is responsible for consumer/investor protection (including disclosure) for all superannuation funds, the Australian Taxation Office (ATO) supervises the compliance with retirement income standards of around 211,000 self managed superannuation funds (funds with less than five members all of whom must be trustees), and the Australian Prudential Regulation Authority (APRA) prudentially supervises the balance of superannuation funds (over 11,000), with the exception of exempt public sector schemes, the majority of which are run by State and Territory governments.

Current legislation providing for prudential regulation of the industry became effective in 1994. Since that time there have been a range of amendments to the legislation but it has not been extensively reviewed to assess whether, as a package, it is operating as effectively as it could.

In light of some recent superannuation fund failures, there has been an increasing focus on regulation of the industry. A number of inquiries have been held into the industry, including a review by the Senate Select Committee on Superannuation and Financial Services into prudential supervision and consumer protection of superannuation, banking and financial services, and a National Competition Policy review by the Productivity Commission of the Superannuation Industry (Supervision) Act 1993 and certain other superannuation Acts. These reviews have provided a range of recommendations for reform.

The purpose of this Issues Paper is to provide industry and other stakeholders with an opportunity to comment on a number of proposals which would impact on the supervision and governance of superannuation entities. This Paper includes proposals relating to licensing of all superannuation funds, providing APRA with a prudential standards-making power, changes to the
Options for Improving the Safety of Superannuation

legislative framework, and in relation to financial assistance for failed superannuation funds.

A Superannuation Working Group, chaired by Mr Don Mercer, and involving Treasury, APRA and ASIC representatives, will conduct the consultation process and develop legislative options arising from this Paper.

Written submissions on the issues raised in this Paper are welcomed, but should be restricted to the matters raised in it.

1.1 Timetable

Closing date for submissions is 1 February 2002. Submissions should be sent to:

Superannuation Issues Paper
Superannuation Working Group
C/- The Treasury
Langton Crescent
CANBERRA ACT 2600

By facsimile: 02 6263 3866
By e-mail to: superissuespaper@treasury.gov.au

Inquiries concerning the Paper can be made to:

Sue Vroombout: 02 6263 3048
1.1 Introduction

The superannuation industry is growing rapidly (with currently $500 billion in assets) and is a key element of Government policies to address the long-term consequences of an ageing population. Comprising both compulsory and voluntary arrangements, superannuation is a long-term savings vehicle which aims to encourage people to set aside sufficient income during their working lives to fund improvements in their retirement income and reduce their reliance on the publicly-funded age pension. After home ownership, superannuation savings represent the most important asset of Australian households.

In light of some recent superannuation fund failures, there has been an increasing focus on regulation of the industry. A number of inquiries have been held into the industry and these have provided a range of recommendations for reform.

The purpose of this Issues Paper is to provide industry and other stakeholders with an opportunity to comment on a number of proposals which would impact on the supervision and governance of superannuation entities. This Paper includes proposals relating to licensing of all superannuation funds, providing Australian Prudential Regulation Authority (APRA) with a prudential standards-making power, changes to the legislative framework, and in relation to financial assistance for failed superannuation funds.

The Paper has the following structure:

- background
- industry structure
- community expectations
- supervisory challenges
- options for reform — prudential and governance
- consistency with other regulatory frameworks
- financial assistance
- longer term reform options
- conclusion
Options for Improving the Safety of Superannuation

1.2 Background

Superannuation is essentially a managed investment with special characteristics that collectively place an onus on Government to ensure proper governance frameworks and a robust prudential framework. These special characteristics include compulsion, preservation rules that restrict members’ access to their investment until their retirement, limited choice and portability, and information asymmetries which mean that members do not always have sufficient information to assess or manage the financial risks associated with their superannuation investment, including over time.

For managed investments, Government intervention is limited to addressing information asymmetry through strict disclosure, sound governance arrangements and rules about structure. However, the long term compulsory nature of superannuation, the inability of some members to transfer investments from a poorly performing fund and the substantial tax revenue ‘invested’ in superannuation, necessitate Government intervention to address credit risk (the risk that a fund could fail) through a prudential framework.

Regulatory responsibility for superannuation is split between three regulators:

- the Australian Securities and Investments Commission (ASIC) is responsible for consumer/investor protection (including disclosure and advice) for all superannuation funds;
- the Australian Taxation Office (ATO) supervises the compliance with retirement income standards of around 211,000 self managed superannuation funds (funds with fewer than five members all of whom must be trustees); and
- the APRA prudentially supervises the balance of superannuation funds (over 11,000), with the exception of exempt public sector schemes, the majority of which are run by State and Territory governments.

References in this Paper to superannuation funds refer to those supervised by APRA and not those funds supervised by the ATO.

Prudential regulation is not aimed at preventing the failure of institutions (that is, there is no Government guarantee), but rather to minimise the chance of failure. The main elements of the superannuation prudential regime are the trust structure (where trustees bear the primary responsibility for the viability and prudent operation of the fund), investment guidelines, disclosure requirements to APRA and regulator scrutiny. There is no uniform licensing
regime and fewer entry, ownership and asset/capital adequacy requirements than with other prudentially regulated regimes (banking, life and general insurance).

The Superannuation Industry (Supervision) Act 1993 (the SIS Act) provides the regulatory framework for superannuation and currently contains retirement income, investor protection and prudential requirements. Funds that comply with it become eligible for concessional taxation treatment. From 11 March 2002, the conduct and disclosure arrangements in the SIS Act will be brought within the disclosure requirements for all other financial services and products in the Corporations Act 2001 through the Financial Services Reform Bill 2001 (FSR).

1.2.1 Reviews of Superannuation

There are two key reviews of superannuation currently underway, or recently completed.

- The Senate Select Committee on Superannuation and Financial Services, chaired by Senator Watson (Watson Committee), released its first report on 20 August 2001. In summary, it recommended enhancing APRA’s enforcement culture, improving communication between APRA, ASIC and the community, improving trustee training, more effective resourcing of the regulators and reviewing aspects of the SIS Act referred to in the report. A second report, released on 30 August 2001, examined a number of ‘case studies’, and a third, released on 24 September 2001, examined the role of auditors in superannuation funds.

- The Productivity Commission released its draft report on the National Competition Policy review of certain superannuation Acts on 19 September 2001. The key recommendations of the report were to amend the SIS Act with a view to removing unnecessary restriction of competition, to reduce compliance costs, and to require that all superannuation entities be licensed by APRA subject to such matters as trustee capacity, operating capital and appropriate investment strategy.

Related to these specific reviews of superannuation, the Government is also undertaking a comprehensive review of auditor independence in Australia. Professor Ian Ramsay of Melbourne University has been asked to make recommendations on this issue, drawing on recent overseas experience and consultations with stakeholder groups. He is expected to provide advice to the Minister for Financial Services & Regulation in early October 2001. As a result,
issues relating to auditor independence in relation to superannuation funds have not been canvassed in this Paper.

1.3 Industry structure

The overall size of the industry and the number of funds regulated create challenges for supervision of the sector. Aggregate assets held by superannuation funds in Australia currently total around $500 billion, involving over 220,000 separate funds. Many of these small, individual or family funds do not require any formal prudential oversight, and the ATO now regulates these funds' compliance with retirement income standards as self managed superannuation funds. However, after allowance for these small funds, and other funds not formally captured within the prudential regime, the volume of assets managed in prudentially regulated funds remains very large, at over $300 billion, distributed across over 11,000 funds. Details are in Table 1.

Table 1: Superannuation funds supervised by APRA (as at 30 June 2001)

<table>
<thead>
<tr>
<th>Type of Fund</th>
<th>Number of Funds</th>
<th>Amount Invested</th>
<th>Number of Accounts</th>
<th>Average Size of Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>%</td>
<td>$m</td>
<td>%</td>
<td>($000’s)</td>
</tr>
<tr>
<td>Funds with approved trustee</td>
<td>8,498</td>
<td>74.8</td>
<td>164,013</td>
<td>54.7</td>
</tr>
<tr>
<td>Of which:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Public Offer</td>
<td>391</td>
<td>3.4</td>
<td>156,752</td>
<td>52.2</td>
</tr>
<tr>
<td>Small APRA Funds</td>
<td>7,699</td>
<td>67.8</td>
<td>2,254</td>
<td>0.8</td>
</tr>
<tr>
<td>Other Regulated Funds</td>
<td>408</td>
<td>3.6</td>
<td>5,007</td>
<td>1.7</td>
</tr>
<tr>
<td>Funds without approved trustee: employer sponsored funds</td>
<td>2,862</td>
<td>25.2</td>
<td>136,203</td>
<td>45.3</td>
</tr>
<tr>
<td>Of which those with assets:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>&lt;$1m</td>
<td>1,070</td>
<td>9.4</td>
<td>431</td>
<td>0.1</td>
</tr>
<tr>
<td>$1m — 5m</td>
<td>789</td>
<td>7.0</td>
<td>1,927</td>
<td>0.6</td>
</tr>
<tr>
<td>$5m — 10m</td>
<td>250</td>
<td>2.2</td>
<td>1,812</td>
<td>0.6</td>
</tr>
<tr>
<td>&gt;$10m</td>
<td>743</td>
<td>6.6</td>
<td>132,033</td>
<td>44.0</td>
</tr>
<tr>
<td>Total</td>
<td>11,360</td>
<td>100</td>
<td>300,216</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: APRA, 2001

The industry structure is constantly changing. The most notable trend over recent years is industry consolidation, which has been driven by specialisation, economies of scale and other economic efficiencies. The outcome is a steady
Options for Improving the Safety of Superannuation

reduction in the number of funds regulated by APRA, and a corresponding increase in average fund size. Another product of this trend is the growing financial sophistication of the superannuation industry. This trend will, in all likelihood, simplify the supervisory task over time. Despite this, the number of funds remains large compared to the rest of the prudentially regulated financial sector, and the diversity of funds (measured in terms of both size and sophistication) means that the overall supervisory task remains complex and resource intensive.

APRA-regulated funds can be categorised according to whether or not the entity is required to have an Approved Trustee.

Approved Trustees are those trustees that have been approved by APRA to manage superannuation funds that make ‘offers’ of superannuation to the public, generally by promoting their product in the market place. Approved Trustees also manage a large number of small funds (colloquially called Small APRA Funds) where members do not wish to be trustees and be supervised by the ATO, and approved deposit funds and pooled superannuation trusts. The approval process for such trustees is intended to provide for enhanced prudential supervision in this sector, in recognition of the fact that such funds are publicly offered, and members may exercise a choice about membership of such a fund (unless signed up by their employer). The trustee approval process requires satisfaction of legislative tests relating to financial substance, and qualitative tests relating to history, business plans, administrative systems and personnel. The purpose of the approval process, particularly the financial requirements, is to assess whether Approved Trustees are committed, competent and viable players and that they have capital at their disposal to remedy funding, administrative and compliance problems if, and when, they arise.

There are currently 158 Approved Trustees licensed by APRA, responsible for around 8,500 (74 per cent) of APRA regulated funds and $164 billion of assets.

The other 3,000 funds ($136 billion in assets) are not required to have an Approved Trustee and are regulated but not licensed by APRA. Most APRA enforcement action is concentrated on 60 per cent of these funds (only $2 billion in assets) — corporate funds whose trustees are subject to equal employer/employee representation rules, and who possess varying degrees of financial expertise. APRA and ASIC have identified problems with these funds that relate to inadequate fund governance, insufficient competence of trustees and managers, and inappropriate or poor investment and risk management strategies.
Options for Improving the Safety of Superannuation

With the implementation of the FSR, all persons, including product issuers, who deal in (issue) or give advice on financial products will need to be licensed by ASIC. All superannuation funds will be required to be licensed to advise on superannuation interests, but consistent with current practice and in the absence of choice of fund, only public offer funds will be required to be licensed to deal/issue interests in the fund.

1.4 Community expectations

Despite its size, growth and significance, it is fair to say that community understanding of superannuation remains low. In part, this is due to the nature of the superannuation product, but it can also be linked to the changes in administrative and taxation arrangements over the years. Arguably the expression ‘superannuation guarantee’ in the context of compulsory contributions may reinforce public perceptions of a Government guarantee.

Prudential supervision does not guarantee that a fund will not fail, but rather tries to minimise the chance of that failure. As with the provisions for other prudentially regulated regimes — banking, life and general insurance, where there are no guarantees covering bank depositors or policyholder entitlements — there is no guarantee associated with member’s superannuation balances. Importantly, in accumulation funds, investment risk resides with the investor. This reinforces the need for accountability to members by trustees, investment managers, custodians and auditors.

There is heightened community interest in the safety of superannuation following the failure of the HIH Insurance Group, the well-publicised failure of some superannuation funds, and comments by the Reserve Bank Governor (as an APRA Board member) about the inadequacy of supervision in some parts of the industry. Because of the compulsory nature of superannuation, fund members expect that their savings will enjoy an adequate level of protection and, in particular, not be lost as a result of fraud, theft or inept investment strategies.

The options canvassed in this Paper will assist in clarifying community expectations about what the regulators can deliver, in terms of safety and soundness, as a result of their supervisory activities, and will also provide a basis for better education of fund members. The role of industry and public disclosure in policing ‘rogue’ operators could also play a valuable role in raising governance standards.
1.5 Supervisory challenges

The superannuation sector poses unique challenges for supervision by the regulator. There are two main reasons. First, the industry is highly diverse — much more so than in any other prudentially regulated sector. Figures contained in Table 1 illustrate this point. Second, there is a relatively wide range of superannuation products and, while all have certain common characteristics, the actual degree of risk transfer varies quite markedly across the range of available superannuation products. Some products approximate pure managed funds where the member assumes all the risk, while the implied promises attaching to some other types of superannuation products leave much of the risk with the provider, particularly in defined benefit schemes.

These factors mean that the development of prudential policies, aimed at providing safeguards to the 19 million superannuation fund member accounts regulated by APRA, is inherently complex. Perhaps more than in any other prudentially regulated sector effective prudential policies need to be closely tailored both to the particular industry segment in question and to the particular type of superannuation product.

Recent legislative changes have enhanced APRA’s enforcement powers. These include the introduction of strict liability penalties, the power to accept enforceable undertakings, and more responsive powers to require detailed financial information. However, in the main, the focus of the SIS Act is on enforcement action following breaches of the Act. Designed to deal with retirement incomes policy and taxation of superannuation, the SIS Act may be inadequate as a framework for risk-based prudential supervision.

APRA has indicated it considers the existing SIS provisions relating to trustee approval, investment reporting to APRA and general fund governance provisions to be inadequate, and the legislative framework insufficiently flexible to cope with market developments. Further, it believes that the current framework is not sufficiently robust to deal with the challenges posed by smaller funds and their diversity.

These concerns stem primarily from APRA’s experience with some of the smaller corporate funds, where most of its enforcement action is concentrated. Typical problems encountered in relation to these funds include non-arm’s length transactions and poor investment decisions, resulting in large capital losses. Other problems stem from a failure to develop clear investment objectives and implement appropriately matched investment strategies to the fund’s member profile; poor asset selection and heavy portfolio concentrations in a narrow range of assets; fraud or serious misrepresentation, sometimes
Options for Improving the Safety of Superannuation

associated with trustees' or directors' use of fund assets for their own benefit; and delays in remitting various contributions.

While some of these deficiencies can be addressed through powers available to APRA in the SIS Act, the structure of the industry makes detection and enforcement difficult. For example, most of the superannuation funds in the highest risk categories are not licensed by APRA and are presently subject to ASIC's non-enforcement policy regarding non-public offer superannuation funds. Consequently, portfolio selection or other weaknesses can be entrenched before APRA is aware of the problem, given the exceptionally large number of funds relative to APRA’s inspection resources, and a poor record by these funds for timely reporting.

1.6 Options for reform

In summary, current concerns about superannuation supervision go to two key issues:

(a) an outdated prudential and legislative framework which limits APRA’s ability to identify and respond quickly and effectively to perceived difficulties in funds; and

(b) fund governance (including the competence and probity of trustees especially in corporate funds) which are in part ASIC-related functions, but which also have a prudential element.

The following options for change to address these weaknesses are explored in this Paper:

• a universal licensing regime, including bringing superannuation fully into both a prudential licensing regime and the FSR net;

• a power for APRA to make prudential standards;

• a requirement for superannuation funds to hold annual general meetings; and

• making superannuation fund annual statements available to the public.
1.6.1 Universal licensing regime

At present there is a two-tier licensing structure for superannuation funds. All trustees, on the face of the law, are required to have an ASIC licence (which will be an Australian Financial Services Licence or AFSL after 11 March 2002) to issue interests in the fund. However, ASIC has a ‘no action’ policy of enforcing this requirement for non-public offer funds on the basis that corporate funds do not ‘induce’ persons to become fund members, as do public offer entities. This approach is being carried over in the FSR framework by way of regulations. The AFSL operates as an investor protection tool. If the fund is an approved deposit fund, public offer fund or fund with fewer than five members (other than a self managed superannuation fund), it must also apply to APRA for a licence to be an Approved Trustee. This prudential licence imposes additional duties on trustees, including requiring limited capital coverage for operational risk, and requirements for effective risk measurement and management systems. The licensing systems are therefore not universal, and around a quarter of superannuation fund trustees are not actively licensed.

In contrast, ‘responsible entities’ of registered managed investment schemes (those with more than 20 members, there being around 2,800) must, after 11 March 2002, have an AFSL from ASIC to operate and issue interests in the scheme and meet requirements such as demonstrating their competence to run the fund, train and supervise their staff, have adequate compensation arrangements and be of good fame and character. A similar licensing requirement for all superannuation trustees to issue interests and operate the fund would address some of the governance and competency problems that have been observed in corporate funds, and would have the added benefit of harmonising the consumer protection licensing provisions for superannuation funds with managed investments.

The AFSL imposes a range of investor protection requirements that could be extended to all trustees of superannuation funds, not just public-offer funds as is currently the case. For example, trustees must act honestly, efficiently and fairly; ensure that staff and others to whom they outsource functions are adequately trained and competent to perform those functions; have internal and external dispute resolution arrangements; have adequate compensation arrangements; and comply with conditions on the licence. ASIC must also be satisfied that the trustees are of good fame and character. An ASIC licence requirement could be implemented by the making of regulations under the Corporations Act, and would require additional resources for ASIC to implement the regime (funded from consolidated revenue, in line with current practice). However, such a licensing regime would not obviate the need for increased prudential oversight of smaller funds.
Options for Improving the Safety of Superannuation

Another licensing option would be for a specific prudential licence to be required for all superannuation funds, either in place of, or in addition to, an AFSL. Requiring a prudential licence would bring superannuation into line with practice in other parts of the financial sector where there are prudential requirements in addition to the requirements imposed under the Corporations Act.

A prudential licence generally requires institutions to have adequate capital, skills and risk management systems to undertake their business, over and above those required under general company requirements.

At present, the licensing requirements under the SIS Act are limited to the licensing of Approved Trustees. These entities are subject to a similar type of authorisation process to all other prudentially regulated entities including a set of operational guidelines established by APRA which require the assessment of adequacy of resources; suitability of the applicant; adequacy of corporate governance; experience and business planning capabilities; adequacy of risk management systems; and legislative compliance. Applicants must provide information about their history, financial position and future plans. In addition, Approved Trustees must hold a minimum of $5 million net tangible assets (or an equivalent guarantee from an authorised deposit-taking institution (ADI) or appropriate custodian arrangement, or combination of these elements). This capital requirement pays no regard to the size of the funds under management nor does it take into account any other risk factors, such as operational risks, to which funds managed by the trustee might be exposed.

The licensing process provides the regulator with an opportunity to impose conditions when it has concerns about the operation of the fund, and provides a franchise value that is at risk if an institution fails to comply with prudential requirements. In other regulated sectors, APRA has power to transfer business but this does not exist in the SIS Act (there is only a limited power to replace trustees). Licensing is a central element of prudential regulation of all other areas of the financial system. Included in a licensing regime would be the power for APRA to revoke a licence and transfer business to another superannuation entity, a powerful prudential tool in other sectors. Further, the Government sees merit in including requirements for minimum capital adequacy and professional indemnity insurance as licensing conditions. Approved Trustee conditions contain a general requirement for such cover, which needs to be strengthened and have wider application as a general licensing condition.

The current lack of a general licensing power means that new corporate or industry superannuation funds can commence operations without APRA’s
knowledge. However, in order for the fund to become regulated under the SIS Act and receive tax concessions, superannuation funds must make an election under section 19 of the SIS Act within 60 days of the fund becoming established. Importantly, this process does not require prior assessment of the capacity of the trustee.

The recent draft report of the Productivity Commission on the review of certain superannuation legislation recommended that all superannuation funds be licensed and their trustees be required to meet certain entry and operating standards.

To implement and enforce a universal APRA licensing regime would require legislative change and would need to be funded through superannuation industry levies (as this is how APRA is funded).

In considering both the APRA licence and AFSL, the Government acknowledges that the benefits to fund members in terms of additional security of imposing licensing requirements and more effective prudential oversight have to be carefully balanced against the costs that may arise.

The Government invites comments on whether to apply a universal licensing regime to superannuation funds and, in particular, on the options:

- of requiring trustees to hold an Australian Financial Services Licence to operate and issue interests in a fund (similar to the obligations on responsible entities of managed investment schemes); and/or

- of requiring trustees to hold an APRA licence similar to the obligation on all other prudentially regulated financial institutions; and

- relating to the form of minimum entry and operating standards that might be set by APRA.

### 1.6.2 Prudential Standards

Consideration could also be given to providing APRA with a power to enable it to develop prudential standards, that could include capital and risk management standards.

Section 31 of the SIS Act provides a power to make operational standards through regulations applicable to the operation of regulated superannuation funds. These have generally been used to provide additional explanations of the provisions within the SIS Act, or to further spell out the intent of the legislation. Such a process raises the practical difficulty that regulation making
under the current arrangements can be time-consuming and inflexible, and relies on access to scarce Parliamentary drafting resources. While the existing power is broad, it may be subject to certain limits which prevent coverage of the full range of areas of prudential concern, including outsourcing and capital adequacy.

Unlike other areas of regulation, which rely primarily on enforcement of the law, prudential supervision is based on addressing and resolving problems before they reach the stage of legal breach. This implies that the prudential regulator should have the power to set prudential standards and to exercise its enforcement powers consistent with those standards. These standards should be capable of evolving quickly to keep pace with evolution in the financial markets and with community expectations.

The power to set prudential standards has long been a centrepiece of banking regulation and was introduced into the life insurance framework in 1999. The General Insurance Reform Bill 2001 recently passed by the Parliament gives APRA standards-making powers for the general insurance industry.

The Government invites comments on whether APRA should be given a specific standards-making power similar to that provided to APRA in relation to the general insurance industry in the General Insurance Reform Act 2001.

As noted above, the standards-making power for the general insurance industry is one element of a more modern and streamlined legislative framework, consisting of an Act containing high order prudential principles, subordinate prudential standards (disallowable instruments) and under these guidance notes issued by APRA.

The introduction of a prudential standards-making power to the SIS Act could precede a process to streamline the prudential requirements for superannuation, by putting in place the three-tiered model adopted by other prudential legislation.

The recent Productivity Commission draft report on superannuation legislation recommended a number of specific amendments to the SIS Act, but concluded that the three-tiered model might not reduce overall complexity and compliance costs and could contribute to greater uncertainty. The Government considers that such concerns need to be weighed against the benefits of a more responsive and flexible prudential regime.
The Government invites comments on whether the SIS Act should be amended to the three-tier structure of: the Act containing high order principles, subordinate prudential standards (disallowable instruments) and guidance notes from APRA.

Proposed Prudential Standards

If it is decided in principle to give APRA a standards-making power, APRA will conduct consultation with industry on the detail of such standards as it does with other industry sectors. It is proposed that prudential standards be developed for the following items:

- investment rules;
- capital adequacy;
- outsourcing; and
- governance and operational risks.

Investment rules

It is highly desirable to develop clearer rules governing the diversification and liquidity of investments — while this has been a source of problems in a number of funds, APRA currently lacks the power to discipline obvious breaches of the intent of the SIS Act in this respect.

The SIS Act and regulations set out the need for investment objectives and strategies that align with member needs. In particular, the SIS Act requires that investment strategies take into account portfolio composition, diversification and liquidity. This requirement has been difficult to translate into practice, given the subjectivity involved in determining what constitutes a sufficiently diversified and liquid portfolio, and indeed what constitutes appropriate goals or strategies for funds. In practice, provided trustees can argue that they have taken diversification into consideration in forming an investment strategy, and that the resulting investment strategy has been appropriately disclosed to members, then they are deemed to have satisfied the requirements of the Act (irrespective of whether any resulting fund is, in fact, either diversified or liquid).

This cannot be considered a sufficient response to the potential problems associated with portfolio concentration. While not wanting to be overly prescriptive — supervisors should not dictate investment strategies to any regulated entity — a strong case can be made for some sensibly framed
portfolio limits to address excessively large exposures and concentrations of risk, and generally better requirements on asset management. Virtually all other prudentially regulated financial institutions face constraints on their activities, and there is little reason to view superannuation funds as exceptions.

The extent to which portfolio constraints are required would in practice depend heavily on the type of fund concerned. As noted above, the extent of risk transfer found within different types of superannuation fund varies widely, as does the financial sophistication of the trustee and the fund member. A ‘one size fits all’ approach to portfolio concentration and investment management would not be appropriate, but a more tailored, or graduated, approach to the management of fund assets could be justified, together with closer supervisory scrutiny of fund objectives and strategies. Consideration should be given to the mechanisms in place to ensure adherence to prudential rules in this area, including enhanced use of external audit arrangements.

The Government invites comments on the development of a set of prudential standards covering the investment activities of a range of types of superannuation funds. The main aims of these standards could be to ensure:

- that the investment objectives and strategy of the fund are consistent with the expectations of fund members;
- that fund investments are sufficiently diversified so excessive risks are not borne by fund members;
- the appropriate management and oversight of delegated activities; and
- that the appropriateness of investments, and the risk/return profile of the fund are assessed on a regular basis.

Capital adequacy

Capital adequacy is a central feature of APRA’s broader regulatory regime. In superannuation, Approved Trustees are currently required to meet limited (and relatively weak) capital requirements. This may be by the trustee holding minimum capital of $5 million, or alternatively, capital may be held by a custodian who holds all the funds assets, or by the trustee having the benefit of an ADI guarantee (‘custodial concession’). In its current form, however, this is a blunt requirement in which the capital requirement has no direct relationship with the size of the fund or its underlying operational risk.
For funds without Approved Trustees, there is presently no capital requirement. This was seemingly based on the grounds that fund members ultimately carry the risk associated with fund investments. While there is some logic in this position, operational risk is a reality for such funds, and in theory, capital to address such risks could be required. Assessing the appropriate level of capital in the case of corporate or industry funds would be difficult, and would raise a range of conceptual issues (including the appropriate source of capital and the period over which it might be built up). Nevertheless, setting aside these practicalities, it is hard to rationalise a supervisory structure that does not include some form of appropriate capital backing.

The Productivity Commission in its draft report considers that there is a case for amending the capital adequacy requirements for Approved Trustees. It argues that there has been extensive use by trustees of the custodial concession and that there is reason to believe that it does not provide sufficient capital adequacy. It argues that trustees should have substance in their own right. Accordingly, it has recommended that the current requirements be strengthened such that trustees have a minimum amount of net tangible assets regardless of their custodial arrangements (draft recommendation 4.1).

The Commission has also argued that there is a need for all Approved Trustees to have adequate liquidity and working capital in order to fund operational requirements and cover the risk of operational failure. Accordingly, it recommends that operating capital requirements for all Approved Trustees should be revised so that they represent a specified proportion of an Approved Trustee’s operating costs (draft recommendation 4.2).

The Government invites comments on the following issues relating to capital:

1. the need to reassess capital requirements for Approved Trustees with a view to aligning those requirements with the size of the fund and the actual operational risks in each fund. This could include a capacity for APRA to vary the minimum capital standard for different types of superannuation funds;

2. the role of capital in funds without Approved Trustees, and means of raising such capital if it is considered appropriate; and

3. whether the option allowing the substitution of capital held in custodians is appropriate to ensure that capital is available to meet the needs of fund members.
Options for Improving the Safety of Superannuation

Outsourcing

There are currently no comprehensive standards covering the outsourcing activities of superannuation funds. Requirements can be placed on Approved Trustees who use third-party administrators and custodians through the instrument of approval, and there are some specific requirements in the SIS legislation in relation to the duties of investment managers, custodians and auditors.

The increasing role of third-party service providers for superannuation funds allows superannuation funds to tap into levels of specialisation and expertise that would not be available to them directly in normal circumstances. However, use of external resources can also mean that important aspects of trustee activities effectively fall outside supervisory reach of APRA. Use of third-parties, therefore, raises specific risks. This problem is not peculiar to superannuation, and is becoming increasingly important in other regulated sectors. Specific powers for the regulator in respect of outsourced activities exist in the United States of America, and are being considered in a number of other countries.

APRA will shortly be issuing a prudential standard for ADIs on outsourcing. It is possible that the principles in this standard could be extended to all regulated institutions.

The Government invites comments on whether a prudential standard on outsourcing should be extended to superannuation funds, and whether the forthcoming ADI standard provides an appropriate model.

Governance and operational risks

Operational risk can be defined as the risk of loss as a result of inadequate or failed internal processes, people and systems or from external events. It includes risks relating to the risk of error or failure in the administrative procedures of the business, risk related to error or failure of technology, the risk of fraud, compliance risk and any penalties associated with failure to meet legislative requirements and the legal risks associated with the many contractual arrangements entered into by a fund. In contrast to most other regulated sectors, operational risk is the largest risk faced by most superannuation funds. Although operational risk is covered in various aspects of the SIS legislation, there is no all-encompassing standard requiring superannuation funds to identify, assess and deal with the full range of operational risks which they face.
The current requirements for the external auditor focus on the accounts and financial position of the fund and compliance with a limited number of requirements of the SIS Act. There are no requirements to report on operational risk issues such as the appropriateness of internal controls. Specifically, no requirements exist for internal risk management, formalised compliance arrangements or compliance committees (the latter being a key requirement of the Managed Investment Act 1998).

The trend in modern supervisory practice is for increased emphasis on the development of effective internal risk measurement and management practices within financial entities. It is generally accepted that the sophistication of these practices should be commensurate with the size and risk characteristics of the entities in question. Issues of risk management practices, however, form part of a much broader set of considerations that fall under the general heading of 'governance', and these matters are in principle as relevant to the operations and activities of a superannuation fund as they are to an ADI or an insurance company. In many cases, poor governance represents the single most fundamental failing in superannuation funds and the largest cause of fund member losses. At present, some limited governance requirements form part of the SIS legislation (for example, limited fit and proper tests and equal representation rules).

Financial entities with strong and effective internal governance arrangements tend also to be sound from a prudential perspective. It is in the interests of supervisors, therefore, to encourage and, where necessary, impose good governance requirements on regulated institutions. The superannuation sector is no exception — indeed, given the diversity of the industry described above, the need for strong governance requirements is all the greater.

The Government welcomes comments on a reassessment of existing governance requirements on superannuation trustees and funds.

1.6.3 Annual meetings

A further option to enhance governance could be to provide fund members with a mechanism to question trustees on the supervision, performance and investment strategies of their fund. A meeting of members could empower members and give them a suitable forum in which they could become more involved in the operation of the superannuation funds. Mechanisms that facilitate greater scrutiny and involvement by primary stakeholders in the performance of their fund would provide a powerful addition to existing supervisory arrangements. There are two broad options: funds could be required to hold annual general meetings (as companies are required to do); or
Options for Improving the Safety of Superannuation

members could be given the right to request a meeting at any time (as registered managed investment schemes are required to do).

The Government welcomes comments on these options, including the extent of powers that members could have (for example, voting powers to remove trustees or fund managers, or whether members could only seek, through a meeting, more detailed information and explanations from trustees and managers).

1.6.4 Public disclosure of annual returns

Prudential supervision and effective public disclosure of funds’ activities and performance are mutually reinforcing mechanisms for oversight of the financial sector. Unlike other parts of the industry, however, the regularity and detail of financial reporting required of superannuation funds reporting to APRA is not high. At present, information received by APRA is neither timely nor comprehensive in comparison with the range of information collected from other supervised entities. Late reporting has become almost endemic in smaller funds.

As part of good governance, it is essential that fund members have the ability to regularly assess trustee activities and fund performance. From APRA’s perspective, it is equally important that prudential reporting by funds is effective and timely. Amendments to the legislation in 2000 to insert strict liability offences for late lodgment, and the new statistical reforms being introduced by APRA over the next 12 months, will progressively deliver much better quality statistics than have been available to date.

However, there is also merit in considering whether superannuation funds should be required to make their financial statements more accessible to the public and market at large. Responsible entities for managed investments are required to make their annual reports to members of registered schemes publicly available through ASIC. Requiring public disclosure by all superannuation fund trustees would enable the market to scrutinise fund operations and provide valuable ‘sunlight’ and market discipline on the trustee. Superannuation funds already provide some form of audited financial statements to their members. It would be possible for these to be made publicly available through either APRA or ASIC. This may require legislative change and small funds (for example, funds with fewer than five members) may need to be excluded on privacy grounds.

The Government welcomes comments on whether all superannuation fund annual returns be made public either through ASIC or APRA.
1.7 Consistency with other regulatory frameworks

As noted in the introduction, superannuation funds are in many respects very similar to managed investment schemes that are regulated under the Corporations Act. There are a number of elements of the regulatory arrangements for registered managed investment schemes that could usefully be applied to superannuation funds to address current concerns. In particular, registered managed investment schemes are required to prepare and lodge with ASIC a compliance plan setting out adequate measures for ensuring compliance with the Corporations Act and the scheme’s constitution. Such plans are also subject to audit obligations. ASIC has indicated that this is one of the most useful tools available to it in its regulation of registered managed investment schemes.

Further, registered managed investment schemes are subject to related party transaction provisions in the Corporations Act. Under those provisions, subject to a number of exceptions, members must approve the giving of benefits to related parties by the responsible entity of the scheme. Consideration would need to be given to the practical application of these kinds of provisions to superannuation funds, in particular, the relative costs and benefits of requiring meetings of members to approve the payment of such benefits.

The Government welcomes comments on whether:

- compliance plans should be required for superannuation funds; and
- members must approve the giving of benefits to related parties by the superannuation fund trustee.

1.8 Financial assistance to failed superannuation funds

Prudential regulation of superannuation does not aim to prevent the failure of institutions, but rather to minimise the chance of that failure. This is consistent with the approach taken in relation to other investments such as deposits with banks and other financial institutions, where the legislation and supporting regulatory framework aim to protect such investments but stop short of providing a formal guarantee.
As discussed previously, fund members generally bear the investment risk in a fund — that is the risk that the market does not perform to expectations. Prudential regulation attempts to address credit risk — that is the risk that a fund could fail. However, it is the case that funds do occasionally fail — although historically the chance is low with APRA and the former Insurance and Superannuation Commission having replaced only 11 trustees since the inception of the SIS Act. Where failure is a result of fraud and/or theft, there is a case for Government intervention to provide compensation, given the special characteristics of superannuation in respect of illiquidity and compulsion.

Such safety net provisions are provided in Part 23 of the SIS Act, which provides a framework for providing financial assistance to superannuation funds that suffer a substantial diminution in assets through either fraudulent conduct or theft.

Specifically, Part 23 enables a superannuation fund trustee to apply to the Minister for a grant of financial assistance for a fund that has suffered an eligible loss. For an accumulation fund, that is a loss due to fraudulent conduct or theft, and for a defined benefit fund it is so much of a loss due to fraudulent conduct or theft that a standard employer-sponsor is required to pay to the fund but would be unable to without becoming insolvent. The loss has to have led to a substantial diminution of the fund leading to difficulties in the payment of benefits. The Minister must be satisfied that it is in the public interest to make a grant, and he is also to determine whether it be financed from consolidated revenue or from a levy on certain superannuation funds. The Minister must seek APRA’s advice on the application, and this request must be tabled in the Parliament after a determination has been made.

This part of the SIS Act has never been tested, and the first application under it has only been received recently. No determination has yet been made.

The recent failure of an APRA Approved Trustee, Commercial Nominees of Australia Limited (CNA), with significant losses to some 500 funds that invested in the Enhanced Cash Management Trust has turned the spotlight on whether provisions for financial assistance are too narrow. There have been some suggestions that the test should be widened to include cases where it can be established that trustees have misled investors to the detriment of members. This would not include investment losses arising from movements in market prices.

Such a proposal raises a number of key issues. These would include questions as to how misleading or deceptive conduct would be demonstrated, and who would make that decision. It would substantially expand the grounds for assistance, and requires careful examination of how such assistance should be
Options for Improving the Safety of Superannuation

funded — from consolidated revenue or industry levies. It also raises issues about the interaction with existing criminal and civil remedies for misleading or deceptive conduct, particularly in relation to disclosure.

It has also been argued that the current provisions do not contain sufficient intermediate provisions, nor any differentiation of compensation according to the risk structure of the fund.

Under the ASIC licensing option, the obligation to have adequate compensation arrangements would cover losses incurred as a result of failure to comply with the Corporations Act in relation to the operation of the fund. This might address some of the concerns that have been raised in the context of the current arrangements under Part 23 of the SIS Act. However, it should also be noted that ASIC’s current compensation requirements do not have an expectation that losses can be fully compensated — for example, insurance requirements are capped at $5 million.

The Government invites comments on the circumstances under which Part 23 could be broadened, and how any compensation should be funded, including whether funding of broader compensation arrangements by industry levies would be supported.

1.9 Longer term options for reforming the regulatory framework

The SIS Act includes provisions directed towards improving the prudential, investor/consumer and retirement income regulation of superannuation. Over the long term, there may be merit in reorganising the administration of these aspects of superannuation.

APRA administers the provisions of the SIS Act concerning prudential regulation. The retirement income standards are jointly administered by APRA and the ATO (in the case of self-managed superannuation funds) and are designed to ensure that superannuation savings are directed towards improving the retirement incomes of fund members by, for example, ensuring that superannuation savings are preserved until retirement. Some provisions in the SIS Act designed to protect the interests of fund members, such as those regulating transactions with related parties, are also jointly administered by APRA and the ATO. ASIC administers provisions in the Corporations Act designed to improve the interests of the members of managed investments schemes, including, for example, provisions concerning related party
transactions. Arguably, ASIC could undertake a similar role in relation to superannuation funds.

The triple targeting of the SIS Act towards prudential, investor/consumer and retirement income regulation has arguably resulted in legislation that is both poorly designed to achieve desired outcomes and unnecessarily complicated. The joint administration of some provisions also impedes transparency and accountability for the achievement of regulatory outcomes.

An alternative to the existing arrangements would be to clearly target the arrangements implementing prudential, investor/consumer and retirement income regulation by placing them in separate legislation with their own regulator. This would represent an extension of the Financial System Inquiry reforms (Wallis reforms) directed as promoting clear accountability for the administration of different limbs of the regulatory framework.

As part of the Wallis reforms, the FSR would move to the Corporations Act, administered by ASIC, investor/consumer regulation concerning the disclosure of financial information to existing and prospective fund members. The remaining SIS provisions relating to investor/consumer regulation could be moved to the Corporations Act and administered by ASIC. This would assist any harmonisation of these provisions with those relating to managed investments considered appropriate. The establishment of the Corporations Act under powers referred from the States would facilitate implementing this option, as it would no longer be necessary to rely on the taxation power to provide a sanction for non-complying funds.

The provisions relating to prudential regulation could similarly be removed to new legislation administered by APRA. These provisions could be amended to reflect any improvements to APRA’s powers to prudentially regulate superannuation funds arising from issues considered elsewhere in this Paper.

The existing retirement income standards could remain in the SIS Act, perhaps renamed and administered by the ATO.

The Government seeks views on the separation of the prudential and retirement income provisions of the SIS Act.
1.10 Conclusion

In the main, the superannuation industry is well managed and does a good job of helping Australians prepare for retirement. However, the size, complexity and rapid growth of the industry means that a reassessment of the regulatory framework is appropriate.

Current concerns about superannuation supervision go to two key issues: an outdated prudential and legislative framework and fund governance. The options outlined in this Paper aim to address these concerns and to enhance what is already a strong framework.