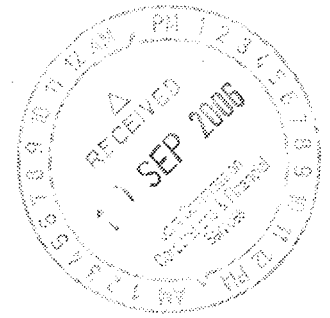




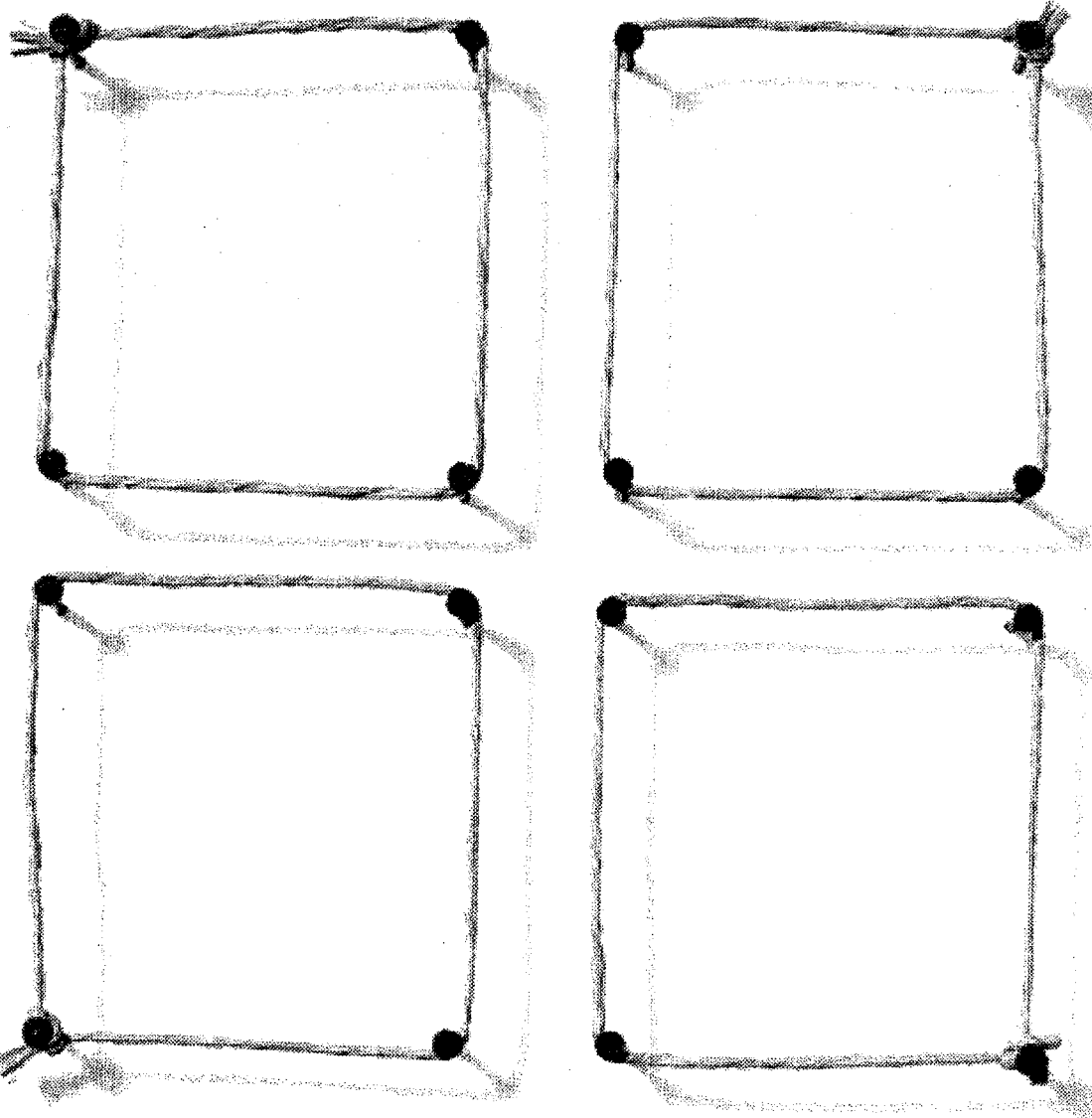
APRA



Superannuation

Submission to the Parliamentary Joint Committee on Corporations and Financial Services' Inquiry into the Structure and Operation of the Superannuation Industry

September 2006



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Introduction

The two year transitional licensing period for trustees of prudentially regulated superannuation entities ended on 30 June 2006. In addition to its ongoing supervisory activities in superannuation during this period, The Australian Prudential Regulation Authority (APRA) focussed on:

- providing guidance on the new standards and the registrable superannuation entity (RSE) licence application process;
- deciding the licence applications;
- registration of the licensees' funds, and
- monitoring the wind up or transfer of those funds whose trustees did not seek a licence.

The long term trend of non-self managed fund industry consolidation continued during the transitional licensing period. A total of 307 trustee applicants were licensed, responsible for around 600 superannuation funds, approved deposit funds and pooled superannuation trusts, as well as a further 6300 small APRA funds (funds with fewer than five members and operated by a trustee with a public offer licence). Collectively, trustees that have been granted an RSE licence manage combined assets of \$566 billion out of a total of \$905 billion in super funds.¹ Exempt public sector schemes (mostly state-based schemes) and self-managed super funds, neither category of which is APRA-regulated, account for the remainder.

The APRA regulated sector of the superannuation industry is now licensed in a way that is broadly similar to banking and insurance. Consolidation of the superannuation sector has led to larger and more complex financial institutions. APRA expects to supervise these more sophisticated entities in a manner similar to other complex institutions in the APRA regulated financial sector.

With the completion of the licensing transition period, the immediate supervisory tasks for APRA are two-fold. Firstly, a considerable amount of work remains in resolving the many issues created by the exit of a large number of trustees and funds. The 145 trustees that had not completed the wind up of their funds by 30 June 2006 have entered into enforceable

undertakings to do so within a specified period and a further five trustees were replaced by acting trustees appointed by APRA.

Secondly, APRA will have to closely monitor the undertakings made by licensed trustees in regard to the policies and procedures put in place prior to the grant of an RSE licence. When APRA undertook a comparable relicensing exercise of General Insurers some years ago, it was found that some licensees were not able to adapt, on an ongoing basis, to the new obligations imposed by the general insurance reforms. Similarly, it can be expected that some newly licensed trustees may have difficulty in meeting the new operating standards and ongoing risk management requirements.

APRA expects to have more ongoing interaction with industry advisers, such as auditors and actuaries, in areas such as the audit of trustee risk management statements and the risk management plans of funds. APRA also plans to review guidance material issued in the licensing period and to continue the ongoing program of revising superannuation circulars to ensure they remain relevant.

Looking further ahead, current supervisory practices will be expanded to cover the operations of service providers and the risks to which they expose fund members. Outsourcing of material business activities such as administration and investment management is the norm for many trustees. The importance of the relationship between licensee and service provider has been recognised in the outsourcing operating standard. The standard requires this relationship to be conducted on a commercial basis and for APRA and the licensee to be given access to the premises and records of the service provider. APRA does not expect to undertake any extensive analysis of outsourcing issues in the superannuation industry until 2007–2008 due to the workload for 2006–2007 in dealing with exits and following up licence related conditions and other issues post-licensing.

Against this background, APRA will continue to supervise the industry via its cycle of supervision activity, both proactive and reactive, with current supervisory tools updated to cover the new risks and complexities of the more highly consolidated industry.

¹ Based on APRA data as at 31 March 2006. To avoid double counting, the figure of \$566 billion excludes \$49.5 billion managed by pooled superannuation trusts.

Response to the inquiry's terms of reference

1. Whether uniform capital requirements should apply to trustees.

Background

Under the *Superannuation Industry (Supervision) Act 1993* (SIS Act), trustees that hold a registrable superannuation entity (RSE) licence of the public offer or extended public offer class are required to meet capital requirements. The requirements may be met directly by the licensee having \$5 million net tangible assets (NTA) or an approved guarantee of \$5 million, or indirectly by ensuring all fund assets are held custodially by a custodian that has \$5 million net tangible assets or an approved guarantee of \$5 million. Trustees that hold an RSE licence of the non-public offer class are not subject to these, or any, specific capital conditions.

These provisions maintain the status quo that existed for approved trustees of public offer entities prior to the amendments to the SIS Act made by the *Superannuation Safety Amendment Act 2004*. Those amendments implemented the Government's response to the recommendations contained in the 2002 report of the Superannuation Working Group (SWG).

The SWG had recommended that, as a part of the licensing process, APRA should determine the amount of resources, including capital, required to be held by each trustee to address the operational risks relevant to that trustee.

In its response, the Government noted its in-principle support for a risk-sensitive framework for the holding of capital to address operational risk, but considered that the combination of requirements that each trustee be licensed by APRA, and prepare a risk management plan, would substantially address concerns relating to operational risk. One of the provisions introduced as part of the licensing and risk management reforms was the operating standard requiring **all** licensed trustees to have adequate resources including adequate financial resources.

Application of legislative requirements for capital

At the end of the RSE licensing transition period on 30 June 2006, 121 applicants had been granted

a public offer or extended public offer licence. Of these, 41 met the capital requirements under the SIS Act directly with \$5 million NTA, and a further 10 by means of an approved guarantee for \$5 million. The remainder met the capital requirements indirectly by having all assets custodially held.

Application of the operating standard for adequacy of resources

Compliance with operating standards was assessed by APRA during the licensing transition period by taking into account the nature, scale and complexity of each trustee's operations. In particular, adequacy of financial resources was assessed on a risk basis tailored to each licence applicant, rather than on a standard basis. In general, APRA maintained its previous practice of requiring public offer trustees that use the custodian option to meet the capital requirements of the SIS Act to have a minimum of \$100,000 liquid assets available.

The risk based assessment approach resulted in approximately two-third of these licensees being required to have \$100,000 available liquid assets and one-third in excess of that amount.

Review of requirements

In 2004 the Joint Committee of Public Accounts and Audit recommended in its 402nd report that APRA review the effectiveness of the new prudential provisions set out in the *Superannuation Safety Amendment Act 2004* and implement corrective action targeting funds deemed to still be at high risk due to an inadequate capital base. The Committee recognised the need to allow time for the measures to take effect.

APRA stated in response that it 'supports in principle such a review with the qualification that it should not take place prior to mid-2007, a year after the end of the transitional period for trustee licensing through which the measures are being implemented.'

APRA continues its in-principle support for such a review. While a decision to hold a review would be a matter for Government, timing should also take into account other events that have occurred since the Joint Committee made its recommendation and their impact on industry.

2. Whether all trustees should be required to be public companies

Subsections 19(2) and (3) of the SIS Act set out that a regulated superannuation fund must have a trustee and that either the trustee must be a constitutional corporation under the governing rules of the fund or the governing rules must provide that the sole or primary purpose of the fund is the provision of old-age pensions. In the latter situation it is not a requirement that the trustee be a constitutional corporation – it may be a group of individuals. These rules apply to all regulated superannuation funds, including self managed funds.

A constitutional corporation is defined in the SIS Act as a body corporate that is a trading or a financial corporation formed within the limits of the Commonwealth (within the meaning of paragraph 51(xx) of the Constitution).

The directors and officers of companies that are trustees of superannuation entities are subject to the *Corporations Act 2001* (*Corporations Act*) provisions relating to the duties and obligations of directors.

While the SIS Act requires the trustee of a public offer superannuation entity to be a constitutional corporation, there is no requirement for the body corporate to be a public company. Indeed, it is not clear to APRA whether requiring trustees of superannuation funds to be public companies, similar to the requirement for the responsible entity of a managed investment scheme, would provide additional protections for members and beneficiaries of superannuation funds.

While the majority of trustees that obtained an RSE licence are corporate entities, APRA also granted licences to eight groups of individuals and to a small number of public sector schemes whose trustees are statutory corporations. All licensees are subject to SIS Act covenants relating to trustee fiduciary duties and operating standards for trustee behaviour, including in relation to fitness and propriety. These apply to all trustees of prudentially regulated funds, whether the trustee entity is a body corporate or a group of individuals. In its guidance², APRA stated that:

27. APRA expects that trustees will identify and appropriately manage any conflict of interest between an individual's trustee duties and the individual's other commercial interests. Examples of such conflicts of interest would include a situation where a responsible officer of the trustee company is also a director, officer or major shareholder of a service provider, including a related party service provider, or where the trustee company is a subsidiary of an entity that is also the major service provider to the superannuation entity, and there are material financial or other benefits flowing from the service relationship¹³. APRA will consider whether the person, contrary to the legal, professional or ethical obligation which applies to the person:

- (a) failed to disclose a conflict of interest; or
 - (b) failed to disqualify himself or herself because of a conflict of interest;
- or
- (c) participated in deliberations relating to a matter in which he or she had a conflict of interest; or
 - (d) acted in his or her own interests in preference to the interests of the beneficiaries of the superannuation entity.

As a further protection for members, APRA has imposed additional licence conditions that assist in the transparency of trustee operations, regardless of corporate structure. For example, APRA requires an RSE licensee that holds a public offer or extended public offer licence to report on its operations on a general purpose accounting basis even if the trustee entity is a proprietary company. The licence condition requires provision of annual audited financial statements of the licensee entity, prepared to the standard for general purpose accounts. RSE licensees are also restricted in the undertaking of other business or commercial activities without the approval of APRA.

In summary, additional protections for members from requiring all trustees to be public companies are not readily apparent to APRA especially given the preference for less prescriptive rule-making.

3. The relevance of APRA standards

APRA's stated mission is to establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by supervised institutions are met within a stable, efficient and competitive financial system.³

² Superannuation Guidance Note SGN 110.1 Fit and proper, July 2004, paragraph 27

³ APRA home page

There is no prudential standard making power in respect of regulated superannuation entities. A recommendation by the Superannuation Working Group in 2002 to give APRA such a power was not supported by the Government. Rather, the Government's preference was to support 'the development of appropriate operating standards and the application of conditions to a trustee's licence, as well as using other tools such as superannuation circulars, to ensure that the regulatory framework meets its objective of ensuring appropriate risk management systems are in place to minimise the chance of fund failure.'⁴

APRA provides guidance on the manner in which it interprets and assesses compliance with the operating standards set out in the SIS Regulations. Guidance is provided in several ways, including comprehensive circulars and guidance notes. These are developed in consultation with industry associations and relevant government agencies.

APRA's guidance is non-binding. It aims to assist trustees of APRA-regulated superannuation entities to comply with legislative requirements and, more generally, to encourage prudential good practices in relation to specific issues. APRA has an active program to ensure that this material is updated to reflect changed requirements flowing from amended legislation and/or to provide further guidance in response to industry developments. Recent revisions include the circulars on investment management and member investment choice, contributions and benefit accruals standards and payment of benefits standards.

APRA endeavours to provide guidance on relevant issues in a timely manner. For example, the framework of operating standards was expanded in 2004 to incorporate RSE licensing matters such as the requirement for licence applicants to meet fit and proper criteria and to have adequate resources. APRA developed guidance notes in consultation with industry and released them at the beginning of the transitional licensing period.

The Government's Taskforce on Reducing Regulatory Burdens on Business recently recommended that APRA review its guidance material to ensure it provides effective guidance on good practice in

meeting regulatory requirements and does not impose additional or inflexible regulatory requirements.⁵ APRA's approach to providing guidance, as outlined above, is consistent with the thrust of this recommendation.

APRA also expects to continue the current practice of providing input to the Government in respect of necessary changes to operating standards so that they adequately address emerging prudential risks.

4 and 6. The role of advice in superannuation, and the responsibility of the trustee in a member investment choice situation

The administration of legislative requirements relating to advice and market conduct and disclosure is within the remit of the Australian Securities & Investments Commission (ASIC).

In relation to advice about choice of investment within an APRA regulated superannuation fund, APRA has set out its approach in Superannuation Circular II.D.1 issued in March 2006.

It is APRA's firm view that the SIS Act requires that the trustee must properly develop each investment strategy offered and provide the necessary information about each, in accordance with the SIS Act and Regulations, and cannot abrogate responsibility in relation to investment strategies by requiring members to seek their own financial advice.

APRA stated in the Circular that:

'Trustees of some funds that offer a wide array of investment strategies require the member to attest to having obtained advice from a financial adviser before accepting contributions or rollovers or instructions regarding allocation of the member's interest in the fund. While it may be normal practice for a financial adviser to consider the assets of an individual member held outside the fund when providing advice on the allocation of the member's investments within the fund, that approach is generally not available to a trustee when developing an investment strategy for the fund. Accordingly, and as noted previously, investment strategies must be developed in a whole of fund context.'

APRA would be concerned if a trustee held the view that a financial adviser's involvement in the member's investment choice relieved the trustee of the duty to formulate and implement appropriate investment strategies for the fund. Such a view would be wholly unsupported by the SIS legislation which is based on the concept that the trustee is the sole responsible entity in relation

⁴ Government response to SWG recommendations, 28 October 2002, page 8, Recommendation 15

⁵ Recommendation 5.5 of 'Rethinking regulation', report of the Taskforce on Reducing regulatory Burdens on Business, January 2006

to the fund. The fact that members may, in limited circumstances, direct their investments does not relieve a trustee itself of the requirement to act prudently, nor can it divest the trustee of its duty to have regard to diversification, risk, liquidity and other factors when setting investment strategies.⁶

APRA believes that trustee deliberation and involvement in offering investment options to ensure ongoing compliance with fiduciary duties is at the core of a robust superannuation system that engenders market confidence. The potential consequences of trustee failure in this regard, which could only be assessed with hindsight, on directly affected and other members, trustees and the system are unacceptable.

5. The meaning of member investment choice

In accumulation superannuation funds, members bear the investment risk. Under the SIS legislation, trustees may (and most do) offer investment choice to members. In doing so, they must balance the objective of providing choice while ensuring they invest fund assets in a prudent and responsible manner. Neither the legislation nor APRA prescribes any investment limits for funds or individual members (apart from the legislation imposing a five per cent in-house asset limit). However, APRA does expect trustees to take responsibility for mitigating particular risks such as concentration risks and demonstrate that they have done so on an ongoing basis. In its prudential reviews, APRA seeks to understand how trustees have assessed such risks and addressed them in an acceptable manner.

APRA's approach to member investment choice is set out in Superannuation Circular II.D.1 issued in March 2006.

APRA stated in the Circular that:

'Trustees of APRA-regulated funds that offer investment choice are expected to:

- recognise their statutory responsibility to set each investment strategy offered by the fund;
- consider the circumstances of the fund when formulating each investment strategy;
- ensure that appropriate controls are in place to manage risk, diversification and liquidity; and

- recognise that if it fails to fulfil its obligations, it leaves itself open to loss of the statutory defence available under s. 55(5) of the SIS Act against claims for the investment losses.

The offer of investment choice does not remove the obligation to formulate and implement each investment strategy. Provided a trustee has properly developed each investment strategy offered to beneficiaries and has disclosed the necessary information about each strategy and the range of directions that may be given in respect of each, a beneficiary may then, and only then, direct the trustee to allocate his or her interest in the fund to one or more of the trustee-determined investment strategies. It follows that the trustee is, in such circumstances, entitled to accept a direction coming from the member without contravening the requirement that a trustee must not be subject to direction.⁷

7. The reasons for the growth in self managed superannuation funds

APRA does not regulate self managed funds.

8. The demise of defined benefit funds and the use of accumulation funds as the industry standard fund

The share of superannuation benefits in defined benefit funds has declined in Australia over the past decade. This is demonstrated in the following extract from APRA's *Annual Superannuation Bulletin* for the year to June 2005 released in April 2006:

Structure of retirement benefits

Of funds with more than four members, \$271.0 billion were held by accumulation funds. The assets of accumulation funds increased over the last ten years from 43.8 per cent of total assets in June 1995, to 49.9 per cent of assets at June 2005. At June 2005, defined benefit funds held 3.6 per cent (\$19.3 billion) of superannuation assets, down from 21.7 per cent in June 1995. The assets in hybrid funds (funds with a combination of accumulation and defined benefit members) comprised 46.6 per cent of superannuation assets (\$253.2 billion) at June 2005.⁷

The expression 'hybrid fund' is not a term defined in SIS. APRA uses the expression to refer to funds that have both accumulation and defined benefit members although technically, under SIS, these funds are defined benefit funds.

Consistent with the increased share of benefits held by accumulation funds is a reduction in the number of defined benefit funds, however industry consolidation has not been confined to defined benefit funds. Recent APRA statistical publications show that, at

⁶ APRA *Superannuation Circular No II.D.1 Managing Investments and Investment Choice*, paragraphs 48-49

⁷ *Statistics Annual Superannuation Bulletin*, June 2005 (issued 20 April 2006), page 6

30 June 2004, of the funds with more than four members, there were 120 defined benefit funds, 1,292 accumulation funds and 374 'hybrid' funds.⁸ At 30 June 2005, the number of defined benefit funds with more than four members was 88, compared to 876 accumulation funds and 360 'hybrid' funds.⁹ Revisions to collection and presentation of statistical information means that earlier counts based on the structure of funds are not entirely comparable over time and accordingly are not provided here.

During the licensing transition period, a number of corporate defined benefit funds transferred to master trusts, which by virtue of their mixed accumulation and defined benefit membership are categorised as 'hybrid' funds. Accordingly, some further decline in the number of 'pure' defined benefit funds and increase in the assets of hybrid funds may be shown by statistics as at 30 June 2006.

9. Cost of compliance

APRA's approach to regulation is principles based and founded on what it considers to be good practices for the industry. In this regard, it is interesting to note a recent study¹⁰ examining the incremental costs attributable to individual Financial Services Authority rules by UK firms in three finance sectors. One of the main conclusions was that much of what regulation requires is, in fact, regarded by firms as good business practice. That is, the measures mandated by regulation would, in the absence of compulsion, represent good industry practice if adopted and implemented voluntarily.

The cost of regulation that is represented by annual levies and one-off licence application fees forms a part of the overall cost of compliance by trustees and should be distinguished from other costs that might be incurred for commercial reasons.

In the prudentially regulated superannuation sector, ongoing industry consolidation and the recent licensing exercise have resulted in a smaller number of larger and more sophisticated financial institutions than was previously the case. The value of assets

under regulation has continued to increase and recent budget announcements (2006) are unlikely to slow the trend. The licensing reforms introduced new requirements which must be complied with on an ongoing basis. Much of the cost impact of addressing these requirements can be attributed to investment in risk management systems that are appropriate for trustees' responsibilities as opposed to the mere compliance processes of the past. In this respect, the APRA regulated superannuation sector is catching up with the rest of the prudentially regulated financial sector.

With the exception of the Financial Assistance Levy, the levies collected by APRA from the financial sector are used for supervision of the sector. Each year, the amount of the levy is determined by the Minister for Revenue and Assistant Treasurer after industry consultation with representative bodies. In each industry, the total costs of supervision are shared across supervised entities in that industry. There is a capped component based on the cost of supervision and an uncapped component that varies according to asset size and takes into account the systemic impact of particular entities. While the total amount levied on each industry is designed to meet the cost of resourcing supervision, the allocation to individual entities does involve an element of risk pooling. In other words, the system eschews an allocation basis that correlates levies with the risk rating of each entity.

APRA is committed to supervising the superannuation industry as efficiently as possible. APRA statistical returns indicate that the APRA supervisory levy represents about one per cent of the reported operating expenses of APRA regulated funds.

Based on levy revenue for 2005–06 and the number of member superannuation accounts, the average cost of APRA regulation amounted to \$1.14 per account for the year, or less than three cents per week. This may be compared with industry costs such as fees and administration charges which amounted to \$2.64 billion or \$1.86 per week per member account in 2005.¹¹

⁸ *Statistics Annual Superannuation Bulletin*, June 2004 (issued 4 May 2005), Table 12, page 23

⁹ *Statistics Annual Superannuation Bulletin*, June 2005 (issued 20 April 2006), Table 13, page 29

¹⁰ See *Costs and benefits of financial regulation: FSA research*

¹¹ *Statistics Annual Superannuation Bulletin*, June 2005 (issued 20 April 2006), Table 8, page 24 and Table 6, page 22

Part of the total levy collected by APRA is on behalf of the Australian Taxation Office (ATO) and ASIC, recovering costs for various consumer protection, enforcement and Superannuation Complaints Tribunal activities, lost member and unclaimed superannuation arrangements. The total levy collection for 2006–2007 will rise by three per cent from \$101 million to around \$104 million. Of this total, the amount collected for APRA supervision across all regulated industries will rise from \$83 million to \$83.5 million, an increase of 0.6 per cent. For 2006–2007, the amount of levy collected on behalf of the ATO and ASIC is expected to amount to \$16.9 million.

APRA engages in regular liaison at working group and executive levels under a Memorandum of Understanding (MoU) with each of these agencies. The MoU between APRA and the ATO establishes a framework for co-operation to facilitate co-ordination between the agencies in relation to superannuation matters. The MoU with ASIC also sets out a framework for co-operation in areas of common interest where co-operation is essential for the effective and efficient performance of respective financial regulation functions.

10. The appropriateness of the funding arrangements for prudential regulation

The Assistant Treasurer and Minister for Revenue released the 2006–07 financial sector levy rates on 11 July 2006 after a process of industry consultation on the paper 'Proposed Financial Sector Levies for 2006–07'.¹²

The Minister noted that in recognition of the significant structural changes currently being experienced by the superannuation sector, the Government has decided to extend the transitional levy arrangements that applied to superannuation entities in 2005–06 for one more year in 2006–07.

The Minister further noted that improvements in operational risk management in the superannuation sector resulting from the licensing reforms, industry consolidation and the emergence of larger, more

complex superannuation entities have longer term implications for how superannuation might be regulated into the future.

The Minister said 'the Government is taking a forward-looking approach and is committed to working with both the regulator and the superannuation industry on these issues. APRA and the Treasury will soon be releasing a discussion paper canvassing the issues and seeking industry views.'

Whilst APRA's general supervision activities are funded via the various industry levies, there are some costs that are separately funded by Government and not imposed on industry. A notable example is funding received for implementation of recommendations of the HIH Royal Commission.

11. Whether promotional advertising should be a cost to a fund and, therefore, to its members

In the run-up to the introduction of Choice of Fund on 1 July 2006 there were a number of references in the media to planned expenditure on advertising by funds.

APRA wrote to trustees of all APRA regulated superannuation funds on 14 March 2005 to explain its approach to advertising in the context of both the legislative sole purpose test to which trustees must adhere, and the trustee's duty to act in the best interests of members. The letter from Ross Jones, Deputy Chairman of APRA, is available on the APRA website¹³ and is reproduced here:

LETTER TO ALL TRUSTEES OF APRA REGULATED SUPERANNUATION FUNDS

I have noted references in the media to planned expenditure on advertising by funds in the run-up to the introduction of Choice of Fund on 1 July. It is timely to explain APRA's approach to advertising in the context of both the sole purpose test to which funds must adhere, and the trustee's duty to act in the interests of members.

We have previously stated, in Superannuation Circular No III, A.4 'The Sole Purpose Test', that the test is broad enough to encompass the normal activities of superannuation fund trustees, including those activities necessary to enable funds to provide retirement benefits to fund members. As a guiding principle, 'there should always be a reasonable, direct and transparent connection between a particular scheme feature or trustee

¹² See Discussion Paper on Proposed Financial Sector Levies for 2006–07 – Australian Government, The Treasury

¹³ See <http://www.apra.gov.au/Superannuation/loader.cfm?url=/commonspot/security/getfile.cfm&PageID=8431>

action, and the core or ancillary purposes. The more tenuous the linkage between a service or activity and the retirement savings objective, the greater will be the difficulty in the fund meeting the sole purpose test.¹⁴ Whether there has been a breach of the sole purpose test is determined in the light of the specific circumstances of the particular fund.

Broadly, we consider that expenditure on education of members about their interest in their fund is acceptable within certain confines (as set out in the Circular), and that expenditure on member retention and recruitment may be appropriate in limited circumstances.

In more detail, our views in relation to the purpose of the expenditure and how it is financed are as follows:

- **member education:** whilst we consider that it is reasonable to provide information to members on the features of the fund and on broad superannuation issues, we are of the view that funds should not be using the retirement savings of members for broad financial literacy campaigns that extend beyond a member's interest in the fund; the means by which information is provided to members is a decision for trustees and if trustees consider that education about the fund via the print or electronic mass media is the most cost effective way of reaching members, rather than individual communications, that is acceptable to us;
- **marketing to retain existing members and/or recruit new members:** In our view, imposing marketing expenses on current members primarily to attract new members is difficult to justify; imposing marketing expenses on current members where the benefit of such expenses falls primarily to the trustee (by way of enhanced remuneration) or other parties would be inconsistent with the sole purpose test and may give rise to inequities among generations of members;
- **joint campaigns:** where trustees join together in shared educational and promotional campaigns, we expect each participating trustee to do its own assessment as to the benefits of the campaign for its membership, and to be able to justify its decision in the member interest;
- **external financing:** our prudential concerns do not normally extend to the level of marketing expenditure where it is financed by third parties, or where the trustee funds it out of its existing trustee fees or assets held in its own right, rather than out of the members' accounts or fund earnings prior to setting the fund crediting rate; in such cases APRA would not expect that trustee fees would be increased implicitly or explicitly to cover the marketing expenditure;
- **selection of service providers:** in accordance with the intent of the standard that prescribes requirements for outsourced material business activities, we expect that material expenditures and decisions associated with marketing and advertising, such as selection of the advertising agency, should be made on an arms length basis and with the best interests of members in mind, particularly where potential or actual conflicts are involved.

In the past, APRA has taken action where advertising or promotional expenditure has not been primarily to inform and educate existing members. Expenditure on marketing and promotional activities will continue to be considered in the normal course of our supervision activities in regard to the superannuation industry.

Yours sincerely
Ross Jones
Deputy Chairman

A trustee has a fiduciary and statutory obligation to act in the best interests of current members and any expenditure by the trustee of fund monies should be consistent with this obligation.

In making an assessment about the benefits of a campaign for membership or the most cost-effective way to provide information to members, APRA also notes that a trustee should be able to demonstrate that the expenditure has been considered in the context of the specific circumstances of the fund and its current members. If advertising or marketing is being considered in order to obtain or maintain economies of scale, the trustee should be able to demonstrate a good understanding of the behaviour of the fund costs which it considers would be influenced by economies of scale. Often the main costs incurred by superannuation trustees are for outsourced administration and investment services and these costs may already reflect scale economies on the part of the service provider.

12. The meaning of the concepts 'not for profit' and 'all profits go to members'

The expressions 'not for profit' and 'all profits go to members' are not used in the SIS legislation.

APRA has used the expression 'not for profit' in a very limited context of setting out the conditions under which certain trustee applicants for a licence to operate a public offer fund may meet the SIS operating standard relating to adequacy of resources (in this case, financial resources).

In its response to a Frequently Asked Question (FAQ) on the APRA website¹⁴:

'What licence conditions will be imposed on RSE licensees who are trustees of public offer funds and meet the capital requirements of section 29DA of the SIS Act by using a custodian?'

¹⁴ See Frequently Asked Questions – Adequacy of financial resources

APRA has stated:

Where an existing trustee applying for a public offer fund licence and using the custodian conditions to meet the capital requirements of section 29DA of the SIS Act operates on a not-for-profit basis and does not have the minimum amount of liquid assets in its own right, APRA will take into account financial resources available to the trustee through the following arrangements:

- **An administration reserve account in the fund** provided that the reserve account is able to be used by the trustee to ensure its solvency and support its business operations and the reserve has a minimum balance of \$100,000 or such higher minimum amount specified by APRA in the licence condition.
- **A line of credit from an Approved Deposit Taking Institution (ADI)**, including where a third party provides the ADI with security for the line-of credit. APRA will no longer recognise guarantees given by external service providers but, where necessary, will allow a short transitional period for trustees who currently use this type of guarantee under their Instrument of Approval as an Approved Trustee.
- **The minimum amount being made available by an external service provider.** APRA would expect a service provider to maintain a deposit of the required amount in an at call account with an ADI in the sole name of the trustee for the use of the trustee to ensure the ongoing solvency of the trustee and to support the business operations of the trustee. The required amount must be sourced from monies of the service provider and not be monies of the fund. Specific conditions will require this arrangement to be agreed to in writing by the service provider as part of the service agreement with the trustee.

APRA also expects the trustee to hold trustee liability and professional indemnity insurance so it can meet any trustee liabilities not reimbursable from the fund.

13. Benchmarking Australia against international practice and experience

There are no agreed international benchmarks in relation to structure of pension or superannuation systems and their regulation and supervision. Australia has a compulsory, decentralised, privately managed and prudentially regulated superannuation system. It is not easy to validly compare our system with the wide variety of systems in other countries, particularly those, like many in western Europe, that centre on a mandatory and publicly managed 'first pillar' system.

However, APRA has been closely involved with, and participated in, OECD working groups engaged in the development of guidelines on regulation, supervision, investment practices and other related subjects, from which international benchmarks may eventually

emerge. APRA's experience to date is that there is nothing in the prudential regulation of superannuation in Australia that is contrary to trends in best practice that are emerging internationally.

APRA is a foundation member of the International Organisation of Pension Supervisors (IOPS) and was a member of its predecessor the International Network of Pension Regulators and Supervisors. APRA has contributed to the IOPS Principles of Private Pension Supervision which are close to completion. These principles could facilitate benchmarking across systems, at least within the countries of the IOPS membership. APRA is currently involved in a joint IOPS and OECD Working Party on Private Pensions project relating to development of licensing guidelines and has drawn on its recent experience to assist in setting standards in this area.

APRA also actively engages with international groups and fora which are pursuing reforms to international regulatory frameworks, and meets annually with integrated supervisory agencies from a number of countries. APRA undertakes a range of activities in the Asia-Pacific region targeted at development of financial sector regulatory architecture and capacity building for domestic prudential supervisors.

14. Level of compensation in the event of theft, fraud and employer insolvency

Superannuation is the only industry that APRA regulates which has a formal compensation mechanism at present.

Part 23 of the SIS Act enables the trustee of a superannuation fund to apply to the Minister for a grant of financial assistance where the fund has suffered loss as a result of fraudulent conduct or theft, subject to certain conditions. The Minister must be satisfied that loss has caused a substantial diminution in the fund's assets leading to difficulty in paying benefits, and that the public interest requires a grant to be made. The Minister must ask APRA for advice in relation to an application for assistance.

The SIS Act allows the Minister a discretion as to whether an 'eligible loss' claimed should be paid in full, or in a lesser amount, if the Minister determines that assistance should be granted at all. Section 232

of the SIS Act states that the Minister cannot grant assistance in excess of the amount determined to be the eligible loss. However, the SIS Act does not prohibit granting less than the determined eligible loss.

The Financial Sector (Wallis) Inquiry recommended that any grant be limited to 80 per cent of the original entitlement of beneficiaries as determined by APRA (recommendation 55). However current Government policy, where a determination is made to grant financial assistance, is that 90 per cent of the determined eligible loss be granted as financial assistance.

Generally, the Government has taken the view that an eligible loss includes the principal amounts and certain related charges and costs that, had the fraudulent conduct or theft not occurred, would not have been incurred by the fund. This loss may include a reference to an estimate of future outgoings on account of that loss. The Government has also taken the view that eligible loss does not include forgone investment returns as the Government does not intend to guarantee investment losses.

The level of compensation was one of the matters considered in the 2003 review into Part 23. The Government concluded that there was general support for the maintenance of the 90 per cent cap, noting that 'the existing arrangements promote an equitable outcome between members suffering losses and members funding the financial assistance as all assistance granted is recovered from the superannuation industry by way of a levy.'¹⁵

Eligibility for compensation was also considered in the review and the Government subsequently decided that the distinction between accumulation and defined benefit funds for the purpose of defining 'eligible loss' should be removed. The Government also decided that the definition of eligible loss should be amended to clarify that financial assistance should only be available in circumstances where the trustee has assumed responsibility for the money, that is, it should not be available to remedy a failure by an employer-sponsor to maintain contributions to a defined benefit fund at actuarially determined levels.

APRA's principal role in the provision of compensation under Part 23 is to provide advice to the Minister in relation to an application for assistance, and to administer the *Superannuation (Financial Assistance Funding) Levy Act 1993* and the *Superannuation (Financial Assistance Funding) Levy and Collection Regulations 2005*.

To date, APRA has administered three separate collections for recovery of amounts paid out as financial assistance under Part 23. A total of \$44.7 million in compensation payments has been recovered from industry over three financial years (2001–2002 to 2004–2005).

APRA has advised trustees that the Commonwealth has already made grants of financial assistance to superannuation funds that have suffered a financial loss due to fraud or theft in the 2005–06 financial year, and accordingly there will be another financial assistance levy in 2007.

¹⁵ Outcomes of the review into Part 23 of the *Superannuation Industry (Supervision) Act 1993*, 7 July 2004, page 7