Senate Select Committee on Superannuation and Financial Services

Main Inquiry
Reference (a)

Submission No. 23
Note: Also Submission No. 8 to Reference (b)

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30 March 2000

Ms Susan Morton
Secretary
Senate Select Committee on Superannuation and Financial Services
Parliament House
CANBERRA ACT 2600

Dear Ms Morton

INQUIRY INTO MATTERS PERTAINING TO SUPERANNUATION AND FINANCIAL SERVICES

Thank you for your invitation of 2 March 2000 to make a submission to the Committee's inquiry. Our comments address only those areas relating to prudential supervision since other matters fall outside our ambit and expertise.

Mr Thompson wrote to the Chairman of the Committee on various superannuation issues on 14 January 2000 and we ask that the Committee treat that letter as our submission on that topic.

I hope the brief comments attached on other aspects of prudential supervision are helpful. We would be happy to discuss them with the Committee or to assist its deliberations.

Yours sincerely

Thea Rosenbaum
Company Secretary

Encl.

Australian Prudential Regulation Authority

APRA

SUBMISSION TO SENATE SELECT COMMITTEE ON SUPERANNUATION AND FINANCIAL SERVICES INTO:

(a) **Prudential supervision and consumer protection for superannuation, banking and financial services**

(b) **The opportunities and constraints for Australia to become a centre for the provision of global financial services**

(c) **Enforcement of the superannuation guarantee charge**

Wallis reforms

The Government's Financial Sector (Wallis) reforms have resulted in a clearer delineation of the respective roles of the national financial regulators - APRA, the Reserve Bank and the Australian Securities and Investments Commission. APRA's core responsibility as the nation's sole prudential supervisor is to promote the safety and soundness of the financial sector, without unduly compromising competition or efficiency.

To the extent appropriate and practicable, APRA is also seeking over time (consistent with the Wallis vision and Government policy preferences) to:

- regulate more on a functional rather than industry specific basis and to integrate regulatory regimes and supervisory approaches across industry sectors - removing unnecessary differences and acknowledging fundamental ones - so that 'like risks' are treated more in a 'like manner', irrespective of which industry sector they arise in;

- improve progressively the efficiency and reduce the cost of prudential supervision, by ensuring that regulation is based on good industry practice and justified on cost-benefit grounds; and

- more specifically, accommodate conglomerate developments (entry by non-financial businesses, holding company structures), to create a single licensing and regulatory regime for authorised deposit-taking institutions (ADIs) under the *Banking Act*, to modernise the ADI regime in line with international regulatory developments, to bring friendly societies providing insurance products under the *Life Insurance Act*, and to modernise the (non-life) *Insurance Act*.

Supervisors in other countries with responsibilities which span the financial sector as ours do, have generally retained an organisational structure which mirrors the traditional industry divisions of banking, insurance and pension funds. APRA has formed the view that such a structure would not capture the synergies and efficiencies that are expected of a single prudential regulator. Accordingly, all policy development in APRA is the responsibility of a single division and for the purposes of frontline supervision the financial sector is divided into diversified institutions (conglomerates) and specialised institutions (those which operate mainly in only one of the traditional industry lines).

The following paragraphs summarise progress in various areas of our work.

Integration across industry sectors

The *Financial Sector (Shareholdings) Act* is already generic, spanning both the banking and insurance industries. In addition, APRA is having discussions with Treasury about the scope for harmonising - and preferably consolidating in one place - our data collection powers and enforcement powers, which currently reside in different Acts in somewhat different forms. In addition, APRA is seeking to harmonise its prudential standards (which sit under the legislation and are developed by APRA in consultation with industry) in the areas of licensing and operational risk, including outsourcing, auditing, and risk management systems generally.

Reducing the cost of supervision

APRA recognises that industry regulation should pass a cost-benefit test, and that there is an expectation in Government and industry that the cost of prudential supervision in a post-Wallis world will fall over time below its pre-Wallis levels - without compromising the safety and soundness of the financial system.

APRA has already reduced the running costs of prudential regulation compared to the sum of the costs of the predecessor agencies. As one rough indicator, the former agencies employed close to 550 people on prudential supervision (including support); APRA's staff numbers are in the low 400s. Measuring compliance costs and efficiency gains, is however, more complex. APRA is grappling with the methodological problems involved. Of course, other supervisors such as the Financial Services Authority in the United Kingdom and the Office of the Superintendent of Financial Institutions in Canada face similar challenges, and we will be sharing our work in this area. We note in this regard that Wallis-related increases in economic efficiency, due to more consistent and accurate measurement of risks (improving the neutrality and transparency of regulation), are potentially large but extremely difficult to quantify.

Conglomerate groups

APRA is developing standards to deal with the advent of diversified conglomerates in the global marketplace. First, it is intended to liberalise entry into the local ADI sector by accepting under appropriate conditions non-financial activities in ADI groups, and suitably transparent non-operating holding company structures. These will be subject to certain group-wide prudential controls being put in place (previous banking policy precluded non-financial business and required the bank to be top holding company).

Second, and more generally, we aim to address the contagion risks for depositors and policyholders (which are a feature of diversified conglomerates) by applying a range of new prudential safeguards, including group-wide risk measurement and management. APRA issued Policy Discussion Papers on its conglomerate proposals in March and November 1999, and plans to issue final advice on the new arrangements shortly.

A single regime for deposit-takers

Around 280 ADIs (banks, building societies, credit unions and special service providers) are now regulated under the *Banking Act*. APRA is currently harmonising the industry-specific standards inherited from the Reserve Bank for banks, and the State based Australian Financial Institutions Commission (AFIC) in respect of non-bank deposit-takers. These two sets of standards were already broadly similarly, so that changes in content will be minimal at this stage, although the 'look and feel' of the standards will be altered in some cases.

Where the standards provide for alternative approaches - generally a simple, prescriptive option or a more sophisticated, tailored one - APRA will be actively encouraging institutions to move to the more sophisticated options over time. The harmonised ADI standards should be in effect by mid-year and, generally speaking, institutions will be regarded as being automatically compliant for a transitional period.

International developments in banking regulation and markets

Following the financial sector strains of the late 1990s - including the Asian disturbances, Russian defaults and Long Term Capital Management bail-out - the community of banking regulators has come under pressure internationally to strengthen prudential supervision. Relevant standards include the Basel Committee on banking Supervision's *Core Principles*, the IMF *Transparency Code for Financial Agencies* and reforms (not yet in place) to the 1988 *Capital Accord* for banks. APRA is actively involved in these international developments and intends to modernise its ADI regime over time, in consultation with industry, to keep pace with them. At the same time, prudential supervision needs to accommodate market developments so that the regulatory environment remains conducive to competition and innovation. Accordingly, the ADI standards under the Banking Act are regarded as 'living instruments' which will continue to evolve.

Friendly societies under the Life Insurance Act

When friendly societies that conduct insurance business were brought under the Life Insurance Act on 1 July 1999, their requirements under the previous AFIC arrangements were preserved for a period (generally taken to be two years) through transitional provisions in the relevant actuarial standards. The Life Insurance Actuarial Standards Board (LIASB) issued these after consultation with APRA and the industry. This transitional arrangement had regard to the fact that the national scheme for friendly societies administered by AFIC commenced only in October 1997, and some societies were only partway through the transition to that scheme (for example, Western Australian societies joined the national scheme only in mid-1999).

Our intention is that from July 2001, life companies and friendly societies with comparable operations will be subject to broadly equivalent actuarial standards under the Life Insurance Act, although existing friendly societies will be able to retain the name 'friendly society' for marketing purposes.

Modernising the (non-life) Insurance Act

The Insurance Act covering the Australian general insurance sector was introduced in 1973. While the Act has served well over that period, APRA considers it now should be modernised in line with contemporary developments in regulatory techniques and market practices. For example, there is scope to develop more objective standards for risk measurement and management in general insurance, and to borrow from the more sophisticated approaches in life insurance and banking. Reform of the insurance legislation is not an APRA responsibility, but rather rests with the Treasury and Government. Nonetheless, we have considered it appropriate to initiate a dialogue with the insurance industry and actuarial profession with a view to developing realistic reform proposals for submission in due course to Government. This dialogue has included the issue of Policy Discussion Papers by APRA in September 1999, and it is intended to issue a second round of papers in April this year for further industry consultation.

Superannuation

APRA's submission is contained in the attached letter of 14 January 2000 to Senator J. O. Watson from Mr G. J. Thompson

Australian Prudential Regulation Authority

APRA

Closing comments

APRA believes that the Wallis reforms are working well and meeting all reasonable expectations. We are working to integrate its prudential standards and supervisory approaches across industry sectors; to progressively improve the cost efficiency of supervision; and to modernise its regimes in line with international regulatory trends and contemporary commercial practices. To avoid costly mistakes and allow for meaningful industry consultation APRA is proceeding in a staged and measured way.

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14 January 2000

Senator J.O. Watson
Chairman
Senate Select Committee on Superannuation and Financial Services
Parliament House
Canberra ACT 2600

Dear Senator,

PRUDENTIAL SUPERVISION OF SUPERANNUATION

At APRA's meeting with the Committee on 23 November 1999, members expressed concern about investment practices in certain superannuation schemes which had come to their attention, and queried APRA representatives on the adequacy or otherwise of the Superannuation Industry (Supervision) Act 1993 (SIS) to minimise the scope for speculative or careless investment strategies by funds. The Committee also asked for our views on how the SIS regime might be "tightened up" to safeguard member interests. We have given this matter some thought and offer the following comments. Of course, as you know, APRA is not in a position to comment on broader retirement income policy issues which are a matter for Government policy.

We would like to offer a few general comments, then come to some specifics.

The SIS regime has been in place for some five years. Over this period, superannuation supervision has become progressively more efficient as we have gained more experience, and the industry has become more familiar with its statutory obligations. We can point to significant efficiencies in the process of trustee reviews, while targeting for review purposes is now more sophisticated and risk based. As a result, the focus of reviews has shifted from a mechanical identification of technical breaches to assessment of an entity's overall soundness.

Under earlier (ISC) practice, industry funds and public offer funds operated by approved trustees were visited once every three years, and other non-excluded funds once every five years on average, with the exact order depending on market intelligence and risk assessment. By refining our review process, we now aim to visit each of the several hundred large funds (with assets in excess of $60 million) once every financial year. Other funds remain in the 3/5 year cycle. The magnitude of the visit program in superannuation can be seen in the following statistics: over the first five years of the SIS regime, APRA/ ISC inspected 4,884 super funds, 243 approved trustees and some 800 accounting practitioners. The process is highly resource-intensive, and the large number of players (over 4,000 regulated entities, excluding self managed funds), means that even maintaining regular contact between visits is impractical.

The diversity of the superannuation sector, with sophisticated large funds on the one hand and small amateur operations at the other end, makes it inherently difficult to supervise. The industry's structure is complex and volatile with the result that the regulator needs to devote considerable resources to the task of tracking market developments, identifying new players, monitoring innovative (not to mention creative and contrived) commercial practices, and finetuning supervisory requirements. This will, no doubt, continue to be the case. For example, one recent development of interest is the trend toward offering 'member investment choice', which to some extent shifts responsibility for investment risk away from the trustee.

Further complicating this landscape are the layers of service providers lying between the trustees who receive the flows of contributions and earnings, and the markets where ultimately the moneys are invested and the records are maintained. The complexity of the trustees' relationships with service providers and the wide range of technical expertise involved in the industry make soundly based prudential regulation more challenging. Nonetheless, we are coming to grips with these 'outsourcing' issues through the development of new standards and guidelines, such as our recent guidelines on the prudent use of custodians.

Overall, we believe the investment arrangements in the SIS regime work well and have produced outcomes consistent with the objectives of Government policy. Investment returns have easily outpaced inflation on average, while losses have been confined to relatively minor, isolated instances. Of course, investing on a commercial basis means there will inevitably be individual losses from time to time, as well as higher returns on average.

In such a system, fund earnings are also influenced by fluctuations in investment markets. From time to time these will fall and funds will experience losses. Some fund members may not readily understand that they themselves ultimately bear this investment risk. No doubt, some members expect too much - viz, the returns of a market-linked system with the safety of a capital guaranteed one - but this is simply unrealistic. A market-linked system will maximise returns on average, but members bear the risk of general market movements and the poor performance of particular investments that are speculative. (A system that was somehow capital-guaranteed would offer more protection to fund members, but long-term returns would on average be far lower.)

This brings me to some more specific points.

- *Investment strategies, diversification and Risk Management Statements*

It is accepted that diversification (ie holding a broad spread of asset classes) reduces investment risk, but we would not favour *mandating* diversification for superannuation funds. It should, however, be possible to *strengthen the obligation on trustees to invest prudently* - including through diversification - by expanding the scope of Risk Management Statements.

As you know, the ISC introduced Risk Management Statement (RMS) requirements in late 1995 in response to concerns about the possible imprudent use of derivatives for gearing and speculation. To ensure that trustees are aware of, and focus on, the impact derivatives can have on the investment profile of a fund, trustees of funds investing in derivatives are required to disclose the risk management practices and controls adopted for derivatives in a RMS. The RMS sets the framework for derivative investment, explains its links to the fund's investment strategy, and details all aspects of derivatives use and control. This measure is now firmly entrenched in the regulatory arrangements and, in our view, has worked very well in practice.

We propose to consider broadening the RMS requirement to encompass all aspects of funds' investment strategies.

- Off-site analysis

Surveillance (off-site and on-site) is a key supervisory technique. In conducting off-site analysis of each institution's soundness, regulators rely on financial information provided in the latest statutory returns. At the moment superannuation funds submit statutory returns only annually, and with a lag of some months for receipt and processing. This is unsatisfactory, and significantly reduces the usefulness and relevance of the resultant analysis.

Having more accurate and timely data will greatly enhance the quality of APRA's off-site surveillance output. Already, the major funds (360 of them with assets in excess of $60 million) are required to provide more up-to-date (albeit unaudited) financial results in a quarterly survey. We see merit in extending this quarterly survey to cover the entire non-self managed fund sector (about 4,000 funds). APRA is assessing the practicability of this option as part of its three year project to comprehensively re-engineer its statistical collections. We would be happy to brief the Committee on the scope and timing of this major Statistics Project.

- Enforcement powers

Experience in applying the SIS regime has highlighted deficiencies in the enforcement provisions. In a number of cases, APRA has found existing powers insufficient and/or ineffective when unexpected circumstances arose. The main lesson from this experience is the need for a wide spectrum of enforcement options to choose from so that supervisory action can be better tailored and targeted to the particular circumstances.

A number of enforcement improvements are being considered, including:

- discretionary powers for APRA to disqualify certain persons from acting as trustees, investment managers or custodians of superannuation entities. This would be consistent with ASIC's powers under the Corporations Law to prohibit certain persons from being involved in the management of a corporation;

- enabling APRA to accept enforceable undertakings from trustees. Such powers are currently available to the ACCC and ASIC and have been found to be effective in restraining or remedying less 'serious' contraventions. It would be particularly useful if APRA could make trustees undertake corrective action when problems first surfaced, and not have to wait until significant breaches and loss have occurred;

- changing certain 'fault liability' provisions to 'strict liability' provisions. Most of the offence provision of the SIS Act require proof beyond reasonable doubt that the contravention was reckless or deliberate; securing such proof has been almost impossible. Converting offences to strict liability would make prosecutions and convictions easier, and have a stronger deterrent effect.

Another possibility could be pursuing the notion of a 'contribution freeze' which could be invoked when APRA has concerns with the operations of a fund/trustee that falls short of the trigger for trustee replacement. At present, this power exists only where funds do not have equal employer-employee representation on the trustee board.

The enforcement powers are reviewed within government on a more or less continuous basis, having regard to APRA's experience in the field. Any legislative changes will, of course, require policy approval from the Government.

- *Related party transactions*

At the meeting on 23 November Committee members raised the matter of related party dealings.

In our view a total ban of related party transactions would be regulatory overkill as the bulk of such transactions are legitimate. For our part, we would see broadening the Risk Management Statement as one measure for discouraging inappropriate related party activities in a commercially non-intrusive way. Enhanced disclosure requirements regarding such transactions could also be worth considering.

I hope these comments are helpful in the Committee's work.

Yours sincerely