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asfa
the voice of super

23 December 2011

Helen Rowell
General Manager, Policy Development
Australian Prudential Regulation Authority
GPO Box 9836
Sydney NSW 2011

Email: superannuation.policy@apra.gov.au

Dear Ms Rowell,

DISCUSSION PAPER: Prudential standards for superannuation

The Association of Superannuation Funds of Australia (ASFA) is pleased to provide this submission in response to the above paper dated 28 September 2011, which outlines APRA's proposed approach to introducing prudential standards for the superannuation industry.

About ASFA

ASFA is a non-profit, non-political national organisation whose mission is to protect, promote and advance the interests of Australia's superannuation funds, their trustees and their members. We focus on the issues that affect the entire superannuation system. Our membership, which includes corporate, public sector, industry and retail superannuation funds, plus self-managed superannuation funds and small APRA funds through its service provider membership, represent over 90% of the 12 million Australians with superannuation.

General comments

ASFA has for some time supported APRA having a standards-making power for the superannuation industry. We are generally supportive of the proposal to relocate some current requirements and guidance into the new prudential standards as well as APRA's intention to harmonise the requirements for superannuation with those applying to other APRA-regulated industries, where appropriate (although we note that this may be difficult to achieve in some instances).

As an overall comment, ASFA considers that the prudential standards should consist of high-level principles which are flexible enough to cater for different arrangements/models (i.e. they should not be overly prescriptive). We do, however, believe that a risk-based approach is appropriate and that a consistent treatment should apply to similar risks. In general, ASFA's position is that trustees should have policies and procedures in place to meet the principles outlined in the standards and these policies and principles must reflect the size, scale and nature of the organisation and their outcomes must be tested and reviewed.

Our concern is that if the prudential standards are overly detailed/prescriptive, the industry will end up with a one-size-fits-all approach which is neither efficient nor best practice. We note that this view is consistent with APRA's intended approach as outlined in the discussion paper. Where matters are open to interpretation (either by APRA or within the industry), ASFA's view is that appropriate guidance should be provided within the relevant Prudential Practice Guide (PPG).

In addition, ASFA considers that each of standard should include a short "purpose statement" articulating what the standard is intended to achieve. The contents of the standards should then be consistent with the stated purpose.

Key initiatives / recommendations

ASFA has made a range of recommendations in our submission to the discussion paper. Details of these recommendations are outlined in an Appendix to this submission. However, there are five key issues which we believe are the most important and are discussed below.

1. *Board tenure and renewal policies*

ASFA supports the prudential standard requiring an RSE licensee to have a tenure and renewal policy that sets a maximum term. However, we believe that Boards should have the capacity to extend the maximum term of an individual director (where warranted by the circumstances) and that a transitional rule should be included so that the Board renewal process can be managed with minimal disruption – i.e. by avoiding the immediate wholesale change of Board members when the new rules commence.

ASFA is concerned that the process of managing the transitioning of those directors whose Board membership term currently exceeds any maximum term established under the requirements of the prudential standard, if not managed appropriately, could seriously jeopardise the functioning of the Board. ASFA is particularly concerned about the impact of a sudden exodus of experienced members and the associated loss of corporate knowledge.

We believe that the guidance should address the issues of Board tenure and renewal, including the regulator's expectations in relation to transitioning the Board's membership, implementation of the tenure and renewal polices and the factors to be considered before seeking to extend a director's term.

ASFA recommends that the guidance provide a 'safe harbour' maximum board membership term which a trustee may choose to adopt. For example, the guidance might provide a safe harbour for trustees where a maximum board tenure of three 3-year periods (i.e. a total of 9 years) was set. However, Boards would retain the capacity to demonstrate that a different maximum term was appropriate.

For Board members whose current tenure exceeds the safe harbour provision, there should be a three-year transition period from the commencement date of the standards.

2. *Remuneration of directors*

ASFA considers that an effective remuneration policy should free up the directors to act with the necessary independence of mind when acting as the trustee in order to act in the best interests of the members of the fund concerned. That is, the remuneration should reflect both the amount of effort and skill that the person is required to apply to their trustee director duties and that the person's focus should be on delivering appropriate outcomes for the RSE beneficiaries whilst ensuring that the RSE licensee meets its legal obligations as a regulated entity.

Our concern is that, unless directors of trustee boards are remunerated for being a trustee, where they are appointed by virtue of a relationship between their employer and the RSE licensee they will have conflicting priorities and will not be in a position to act with the required independence of mind.

However, a requirement to disclose the remuneration of responsible officers should not focus on the person's total remuneration, but rather on that component of their remuneration that is recognised as being remuneration for carrying out their duties, functions and responsibilities as a trustee director.

ASFA suggests that the disclosure of Board member's remuneration be by way of a series of bands, that the disclosure also includes soft-dollar payments from all sources and that, for transparency, there be separate disclosure of the total remuneration paid either directly or indirectly by the RSE.

3. *Tied service provider arrangements*

ASFA supports the principle of SIS overriding a trust deed's tied service arrangement. However, ASFA cautions against mandating a requirement that all outsourcing agreements be subject to a competitive tendering process. Our concern is that such a process may prove both costly and counter-productive.

ASFA's preference would be for a requirement in the standard that any outsourcing arrangement (whether it is a tied arrangement or otherwise and whether it is proposed or existing) be subject to a process that considers whether it is in the best interests of beneficiaries and is consistent with the RSE licensee's other duties.

Guidance could then be provided as to the range of permitted ways in which this objective assessment process could be conducted such as by way of tender, or by benchmarking surveys of a range of potential providers or by other processes.

4. *Application of investment governance standard*

The discussion paper acknowledges that the majority of the requirements and guidance on investment governance will apply equally to all RSE licensees, including those that offer MySuper products. However, the paper also contains sections that propose different requirements for MySuper RSE licensees from those applying to RSE licensees more generally.

The proposed standard would appear to be problematic if it applies to all RSE licensees, not just those licensed to offer a MySuper product. This is because the obligations encompassed in the standard are too broad.

Member Investment Choice is a fundamental feature and strength of the Australian superannuation system as it accommodates the differing risk appetites of substantial numbers of members of superannuation funds. ASFA contends that the standards should not threaten in any way the ability of RSE licensees to offer Member Investment Choice, especially substantial investment menus that are constructed primarily to facilitate Member Investment Choice.

Requiring those RSE licensees (who offer the underlying investment options to enable Member Investment Choice) to be satisfied that each underlying investment option is appropriate for selection by beneficiaries "as a single undiversified option" would eliminate many of the single asset class investment options which are on current superannuation platforms, and possibly some of the current partly diversified Member Investment Choice options.

ASFA supports the overarching concept of an Investment Governance standard to clarify what (if any) investment related duties must be retained by RSE licensees, and therefore what can be delegated to managers or operators, and also to clarify any specific investment governance which applies to a MySuper product. However, ASFA recommends that the proposed Investment Governance standard initially be applicable to these two areas only.

5. *Operational risk financial requirement*

ASFA supports the development of risk-based financial requirements for the superannuation industry to deal with operation risks. Enhanced operational risk standards will promote member confidence and stability in Australia's superannuation system. We believe APRA's proposed framework should be consistent with requirements for industries that experience similar risks.

ASFA considers that any requirements as to an operational risk financial obligation must determine the appropriate level of financial reserve / capital as a function of the residual operational risk that is faced by the entity. Due to the large variety of administration and operational arrangements in the superannuation industry, we believe there is a need for extensive guidance for RSE licensees.

Although the discussion paper states that there is no intention to set a minimum level of operational risk financial resource, ASFA considers that there may be merit in setting, in guidance, a safe harbour level minimum reserve amount, expressed as a percentage of assets, that would be applicable to all superannuation entities (with perhaps the exception of corporate funds, which could have a different level). Guidance could then be provided as to the circumstances in which this amount may be varied down and the circumstances where a higher amount may be appropriate.

With regards to transferring risk to service providers, ASFA considers that, in the absence of regulatory supervision of external service providers, there should be no capacity for an RSE licensee to permit an unlimited risk transfer to a service provider. However, ASFA sees a need to recognise that the absence of a trustee capacity to transfer risk to a service provider may result in service providers not appropriately addressing their own operational risks, thus increasing the operational risk of the RSE licensee and hence the level of required reserves.

ASFA considers that an approach of allowing expected operational risk losses to be transferred to an outsourced administrator could be adopted with a simple approach to prudential supervision. The approach could require outsourcing contracts to have annual financial limits in relation to risk transfer and to include a requirement for the outsourced administrator to maintain a minimum financial reserve to cover expected operational risk losses. The only other risk transfer that should be allowed in the outsourced administration contract are losses that are covered by the outsourced administrator's insurance contract.

In addition, ASFA considers that trustees should have discretion as to how they apply their operational risk reserves, rather than limiting its use only to risks identified in the risk management framework (RMF), which would not address “black swan” events. Trustees are subject to fiduciary and other equitable and trust law duties, which will serve to ensure that trustees apply reserves appropriately. We do not consider that there is a need for the prudential standard to restrict the circumstances in which the trustee can use such reserves.

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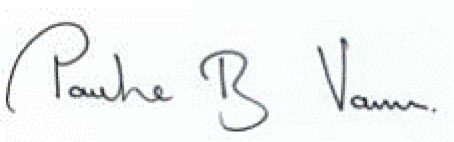
I trust that the information contained in this submission is of value. We would be pleased to meet with you to discuss our submission.

If you have any queries or comments regarding the contents of our submission, please contact Jon Echevarria, on (02) 8079 0859 or by email jechevarria@superannuation.asn.au .

Yours sincerely



Pauline Vamos
Chief Executive Officer

Appendix

Detailed summary of ASFA's recommendations

Our key propositions / recommendations are listed below under various chapter headings in the discussion paper.

Chapter 3 – Governance

Consistent with ASFA's overall view, the prudential standards should consist of high-level principles which are flexible enough to cater for different arrangements/models. However, a risk-based approach is appropriate whereby similar risks are treated consistently. In this regard the discussion paper states:

> "…APRA seeks to apply a consistent approach to their prudential regulation and supervision. This ensures that like risks are treated in a like manner and no significant differences arise in the regulatory treatment of entities with similar risks operating in different industries."[1]

Where a matter in a prudential standard is open to regulatory interpretation, the detail on possible implementation methods should be addressed in the PPG guidance. For example, a standard would contain a requirement for a Board tenure and renewal policy (including the basic topics the policy is to address), whilst the guidance would include the detail of possible ways in which the policy requirements may be met.

ASFA considers that, where possible, the guidance should provide a 'safe harbour' requirement, with any deviation triggering the possibility of an enquiry from the regulator. Such an approach would ensure that the standard's overall objectives could be met by all trustees, but in a manner that is appropriate given the specific characteristics of the RSE licensee and its associated RSEs.

(i) Independence of directors

There needs to be a clear statement as to what is meant by 'non-executive director' and what is meant by 'independent director' as a clear understanding of these terms will be critical in establishing the appropriate composition of the governing Board and for Board committees.

At present, some confusion exists on the correct interpretation of these terms as used in various parts of the discussion paper. It is ASFA's understanding that, generally, 'non-executive' director refers to a person who is not a paid employee of the RSE or an associated entity, whilst an 'independent' director is a person who does not fail the test set out in the four dot points on pages 19 and 20 of the discussion paper. ASFA notes and supports the intention to permit a person who is a member of the RSE to be considered independent provided they do not fail the other tests of independence.

There is also a need to clarify what appear to be inconsistencies in the use of the terms 'independent director' and 'non-executive director' in the discussion on the composition of Board Audit and Board Remuneration Committees. Our concern in these areas is set out in our comments below in sections *(v) Use of Board committees* and *(vi) Remuneration*.

ASFA considers that provision should be made in the prudential standards and the guidance for the appointment of more than one independent director and for appropriate modifications to be made to the requirements for the composition of the Board Audit and Board Remuneration Committee to address the situation where there is only one independent director.

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[1] Section 2.5, page 17.

ASFA notes that there will be a need for legislative changes to accommodate the appointment of more than one independent director.

Consideration also needs to be given to the definition of the term ‘standard employer sponsor’ in the context of who may be an independent director. Many Australians are small shareholders in a significant number of Australian companies as a result of the demutualisation of organisations such as AMP and NRMA and the floating of Telstra. This has led to an increasing interest in share ownership by Australians, and large organisations such as Woolworths now have significant numbers of shareholders with small holdings. This, combined with the operation of the choice of fund rules may have implications for who may be considered ‘independent’.

A broad definition of standard employer sponsor and the absence of a materiality test on share holdings may, in combination, result in a significantly reduced pool of available independent directors, particularly for RSE licensees operating in the retail space. ASFA seeks a clear definition of a ‘standard employer sponsor’ as well as a materiality test for the shareholding restriction.

Where it is not considered possible to provide clarity in the prudential standard on the items set out above, ASFA seeks the inclusion of clarifying material in the guidance.

ASFA also seeks a clear statement in the guidance as to what is meant by ‘in recent years’ in reference to the appointment of an independent director. It is suggested that a fixed period of exclusion (as per the ASX requirements) be established in order to avoid the possibility of variation in the interpretation of this requirement by APRA.

(ii) Independence of the chair

ASFA seeks a clear statement in the guidance as to the minimum term required before an ex CEO could be considered for appointment as an independent director.

It is suggested that a fixed period of exclusion (as per the ASX requirements) be established in order to avoid the possibility of variation in the interpretation of this requirement by APRA.

(iii) Tenure and renewal policies

ASFA seeks the inclusion of a transition rule such that the Board renewal process can be managed, thus avoiding the potential of requiring a wholesale change of Board members when the new rules commence.

ASFA is concerned that the process of managing the transitioning of those directors whose Board membership term currently exceeds any maximum term established under the requirements of the prudential standard, if not managed appropriately, could seriously jeopardise the functioning of the Board. ASFA is particularly concerned about the impact of a sudden exodus of experienced members and the associated loss of corporate knowledge.

ASFA supports the prudential standard requiring an RSE licensee to have a tenure and renewal policy that sets a maximum term. However, we believe that Boards should have the capacity to extend the maximum term of an individual director where circumstances are warranted.

Whilst supporting the requirement for tenure and renewal policies, ASFA sees the need for PPG guidance on the regulator’s expectation of funds in managing the transition of Board membership, implementing the tenure and renewal policies and the factors to be considered before seeking to extend a Board member’s term.

ASFA considers that the guidance should provide a ‘safe harbour’ maximum board membership term that an RSE licensee may adopt without being subject to regulator scrutiny. For example, the guidance could suggest a maximum board membership term as being, say, three 3-year periods (i.e. a total of 9 years). The guidance could then indicate that APRA may question an RSE licensee where a Board member commences a 4^{th} term and may issue a show cause notice to the RSE licensee where a Board member commences a 5^{th} or subsequent term. ASFA considers that such a structure would provide a degree of regulatory comfort to RSE licensees managing the competing, and sometimes conflicting, obligations of tenure renewal policies and an appropriately qualified and knowledgeable Board.

ASFA suggests that for Board members whose current tenure exceeds the safe harbour provision, there should be a three-year transition period from the commencement date of the standards. We believe it would be helpful if guidance was provided as to how to best manage a complete Board membership change in a manner that does not result in the same exercise having to be conducted at a future point in time.

(iv) Board assessment process

ASFA considers that the Board assessment process requirement should be for a 'regular' assessment of performance. It should not be interpreted as requiring an 'annual' process. The general process for a review cycle (design of review process, board approval, conducting of review, analysis of findings, consideration of findings by board, determination and implementation of any remedial processes etc) are such that a one year period in which to do this would be too short.

Consideration could be given to the guidance providing a ‘safe harbour’ review period (say 2 years) with a longer review period perhaps triggering an APRA inquiry. There needs to be a link made between the Board renewal process and the Board assessment process such that Board competence is not weakened by the forced retirement of directors.

ASFA considers that considerable PPG guidance will be required so that an acceptable balance can be achieved between the cost of the process, achieving appropriate independence of assessment and dealing with the outcomes of the assessment process such as additional education / training or replacement of a director.

ASFA supports the proposal to not mandate the use of external assessors but to instead provide guidance on better practice processes to improve the effectiveness and objectivity of such assessments. Some examples of such better practice to consider may be having the process established by an independent external party with the assessment conducted by internal staff and also including a mixture of external and internal reviews over an appropriate period of time.

ASFA suggests that the guidance in this area should provide a connection between the Board renewal policy, the relevant skills knowledge and competencies of departing and joining Board members and the need for the Board as a whole to possess the necessary skills and knowledge to fulfil its obligations as a trustee.

(v) Use of Board Committees

Currently the paper indicates that Board Audit Committees can only be composed of non-executive directors. We question whether the omission of independent directors from the Board Audit Committee is an oversight, whether APRA contemplates that there will only be one independent director on the Board and, as chair of the Board, this person cannot sit on the Board Audit committee, or whether APRA considers that it is possible for a person to be both a non-executive and an independent director.

A requirement in the standard that the Board Audit Committee comprise only non-executive directors appears to be inconsistent with the proposal to provide guidance that the entire Board may sit as the Board Audit Committee and to permit a sole independent director to chair both this committee and the Board.

When read as a whole, the discussion paper appears to be leaning towards a view that the regulator has a strong preference for more than one independent director on the Board and that this would be encouraged. If so, this may lead to very large Boards in some cases.

ASFA requests that when drafting the standard, careful consideration be given to the link between the membership requirements for the Board, the Board Audit Committee and the Board Remuneration Committee and that guidance is provided on how the membership requirements are to be managed on small boards.

(vi) Remuneration

ASFA's primary concern centres on the remuneration of directors of the RSE licensee and appropriate disclosure of that remuneration.

APRA proposes to require all RSE licensees to establish and maintain a Board Remuneration Committee and that each Board would need to have in place a remuneration policy. This remuneration policy would need to "ensure the alignment of remuneration arrangements with the ongoing capacity of each RSE under the RSE licensee's trusteeship to meet the reasonable expectations of its beneficiaries as well as the RSE licensee's risk management framework."
ASFA notes the recognition by APRA that the relationship between an RSE licensee and an RSE beneficiary is different to that for other APRA regulated entities and that the remuneration arrangements for directors of an RSE licensee should reflect this.

The fundamental purpose of a trustee Board is that of a fiduciary, with a statutory duty to act in the best interests of members. In carrying out that purpose the Board must also ensure that the RSE licensee is compliant with the regulatory requirements imposed on such entities.

ASFA considers that an effective remuneration policy should free up the directors to act with the necessary independence of mind when acting as the trustee in order to act in the best interests of the members of the fund concerned. That is, the remuneration should reflect both the amount of effort and skill that the person is required to apply to their trustee director duties and that the person's focus should be on delivering appropriate outcomes for the RSE beneficiaries whilst ensuring that the RSE licensee meets its legal obligations as a regulated entity.

Our concern is that, unless directors of trustee boards are remunerated for being a trustee, then where they are appointed by virtue of a relationship between their employer and the RSE licensee, they will have conflicting priorities and will not be in a position to act with the required independence of mind.

Situations of misalignment of duties typically occur where an entity has an entitlement to appoint a trustee director and it is considered that the appointment of an employee or some other related party is appropriate. Such situations may arise in the broad spectrum of APRA-regulated trustee Boards. In such circumstances it should be a requirement that, as part of the appointment process, the person's remuneration arrangements are revisited to ensure that the remuneration structure reflects their requirement to undertake trusteeship duties. That is, the remuneration arrangement should reflect both a requirement to meet the business strategy imperatives of the primary employer and a requirement to expend time and effort in carrying out their fiduciary obligations as a superannuation trustee director. ASFA considers that formal recognition of this duality of purpose is particularly necessary where their performance indicators as an employee currently relate principally to their activities for the non-RSE licensee entity.

ASFA considers that a remuneration policy for trustees would be better aligned with their duty to act in the best interests of fund members if they were paid to carry out the functions of being a trustee. This could be a separately identified component of a salary paid by another entity – it does not necessarily have to be paid out of the fund. It would need to be disclosed as trustee remuneration without disclosing the entire salary of the employee.

A requirement to disclose the remuneration of responsible officers should not focus on the person's total remuneration, but rather on that component of their remuneration that is recognised as being remuneration for carrying out their duties, functions and responsibilities as a trustee director.

ASFA suggests that the disclosure of Board member's remuneration be by way of a series of bands, that the disclosure also includes soft-dollar payments from all sources and that, for transparency, there be separate disclosure of the total remuneration paid either directly or indirectly by the RSE.

Separately, we note that the proposed standard would require that the Board Remuneration Committee comprise a majority of independent directors where those are present on the Board. For such a Committee to consist of more than one member requires that at least two independent directors be present on the Board. Such a requirement is inconsistent with the stated policy that there will be no mandated requirement for an independent director on the Board and the current requirement that, absent APRA approval, there can be no more than one independent director. ASFA requests that the issues around independent directors be clarified.

ASFA recommends that this prudential standard should be superannuation specific. If it is to be workable in the superannuation context for the majority of superannuation funds then we consider there will be a need for departure from some of the CPS 510 requirements.

Chapter 4 – Conflicts of interest

(i) Conflicts management framework

The use of the term 'holistic' suggests that this is an area where significant guidance will be required. The requirement for regular and thorough inquiry seems to have considerably raised the bar from a process where conflicts were merely advised.

ASFA suggests that the standard require the development and maintenance of a conflicts management framework and that the guidance deal with the mechanics of establishing a system of internal controls and reporting that addresses the listed six dot points.

(ii) Minimum requirements for a conflict management policy

Clarification is required around the goal of the policy to address concerns about whether too much disclosure will be counter-productive to the policy. Whilst ASFA recognises the importance of ensuring directors and individual trustees of RSE licensees give priority to beneficiaries where a duty to those beneficiaries conflicts with an interest or other duty of the director / individual trustee, full disclosure of actual and perceived conflicts without the contextual information could lead to misinterpretation.

ASFA considers that the focus should be on adequate disclosure of actual conflicts. Guidance material is required on what is considered to be 'adequate disclosure'.

(iii) Registers of duties and interests

ASFA considers that the standard should permit the creation of a materiality test by trustees. Guidance material should be provided on the creation and implementation of any materiality test, including the extent of details to be disclosed.

Whilst ASFA supports the publication of the conflicts of interest policy on a fund's website and the provision of the register to APRA on request, we do not support the publishing of the register itself on the website due to privacy concerns.

(iv) Tied service provider arrangements

ASFA supports the principle of SIS overriding a trust deed's tied service arrangement. However, ASFA cautions against mandating a requirement that all outsourcing agreements be subject to a competitive tendering process. Our concern is that such a process may prove both costly and counter-productive.

ASFA has been provided with information indicating that, as a guide, a tender process of the magnitude that would be required would take between 5 and 6 months to complete and cost between $500,000 and $600,000. This estimate takes into consideration the time taken to tender for a consultant, to design the tender process, to seek responses and assess these responses and to finally make a choice on an appropriate service provider. This estimate also includes the costs of responding to the tender.

Where there are a limited number of potential respondents in the market and a large number of potential tender issuers, the overall costs of the exercise may fall disproportionately on those responding to the tenders. Additionally, where the calling for tenders is viewed as a 'window dressing' exercise to merely meet a regulatory requirement, there may either be limited or no respondents to a request for tender or those who do respond may provide an arbitrary but high tender in the knowledge that a full tender will incur unnecessary and unrecoverable costs.

ASFA's preference would be for a requirement in the standard that any outsourcing arrangement (whether it is a tied arrangement or otherwise and whether it is proposed or existing) be subject to a process that considers whether it is in the best interests of beneficiaries and is consistent with the RSE licensee's other duties.

Guidance could then be provided as to the range of permitted ways in which this objective assessment process could be conducted such as by way of tender, or by benchmarking surveys of a range of potential providers or by other processes.

ASFA notes that under the various legislative changes being made, including the new disclosure requirements on the costs, fees and charges of each fund and proposed additional reporting requirements to APRA, the regulator will have much greater visibility of the industry and will be better placed to identify those cases where costs might not be in line with those in the broader industry. Having identified such cases, the regulator would be in a position to make appropriate enquiries of the RSE licensee.

ASFA requests that APRA, in developing the requirements, keeps in mind that changing service providers can be a costly exercise and that these costs will be met by the beneficiaries of the trust.

ASFA also requests that specific consideration be given to the need for transitional arrangements where such contracts are to be unwound, and that specific consideration be given to arrangements that are established by law.

Chapter 5 – Fitness and propriety

ASFA notes the move to the higher 'prudent person of business' test. Currently there are trustees who bring other skills and experiences that enable them to make a valuable contribution to the Board. So as not to lose these skills and experience, ASFA requests a transition period that provides sufficient time for training plans to be developed and delivered to enable otherwise effective trustees to meet this obligation.

(i) Responsible person

ASFA notes that there is a much broader class of persons identified then previously captured. ASFA has concerns about the cost involved in undertaking the required checks.

Information received from an ASFA member reveal the following (conservative) costs involved in undertaking a "fit & proper" process on an individual:

> A Level 2 background screening search (which is normally undertaken for all Responsible Persons before they are initially assessed as Fit & Proper) costs $660. Additional searches in other states or where the person had changed their name adds another $65/search. Where the person has recently lived overseas, there are additional costs of between $170 and $840 depending on the countries. These costs are inclusive of GST.
>
> In addition to the above is the cost of the time spent collating the information. The Responsible Person would typically spend an hour answering the questionnaire, contacting referees etc. The administrative assistant who liaises with the outside search provider would spend approximately half an hour per person being researched. Reviewing and collating the papers and organising the assessment panel would require half hour of effort if the case is straightforward. The assessment panel members (3 persons) would each spend about 10 minutes per candidate reading the papers and 10 minutes per candidate meeting to discuss the findings.

The broadening of the class of persons captured as a Responsible Person could significantly increase the costs incurred by funds in undertaking the required “fit & proper” checks on these individuals. In many cases these additional costs would ultimately be borne by fund members.

ASFA seeks clarity on whether the reference to ‘auditor’ is to both internal and external auditors. It is unclear as to what value would be gained from this requirement with respect to an external auditor and an actuary, particularly given the existing appointment process with respect to these roles and the existing requirements for membership of a professional body. An additional concern is assessing the fitness and propriety of an external auditor where the auditor appointment is of a company and the company uses various individuals to perform the audit.

There is a question as to whether the appointment of these persons and the appointment of contractors should be covered in this standard or in standards dealing with outsourcing or service provider agreements.

We note that by aligning this standard with CPS 520, which has a requirement about conflicts of interest in performing a role, it will require an RSE licensee to identify and address the issue of whether conflicts (perceived or actual) exist where senior managers are performing dual roles for several entities across the licensee’s business.

(ii) Fit and proper policy

ASFA seeks a standard reporting timeframe under this prudential standard of 28 days, but with a 14-day timeframe for reporting where a person has been found to be 'not fit and proper'.

On the requirement for reporting to APRA on its assessment of whether the Board has the collective skill set required to effectively govern the RSEs under their trusteeship, ASFA recommends that this be in the form of an ‘attestation’ by the RSE licensee that the assessment has been completed (with supporting evidence available to APRA on request).

A similar requirement should apply with respect to fit and proper assessments.

(iii) Criteria to determine whether a person is fit and proper

ASFA is comfortable with the general criteria as set out in the discussion paper, but notes that generally, the broader the range of people that are captured the more onerous the obligation on RSE licensees.

ASFA suggests that guidance be provided on how frequently this process is to be undertaken. Our preference is for the RSE licensee to determine their own timeframe and for differing timeframes being permitted between various classes of people depending on the nature of their role.

Chapter 6 – Risk management

A general overarching comment regarding Chapter 6 *Risk Management* is that it needs to be cross-referenced with Chapter 9 *Operational Risk Financial Requirement*. The two chapters are inextricably linked. We note that Chapter 6 does cross-reference Chapter 4 *Conflicts of Interest* insofar as recognising the varying ownership structures of RSE licensees.

(i) Risk management framework

The requirement for RSE licensees to develop a risk management framework is an existing function and requirement for licensees today.

The proposed prudential standard indicates that the risk management framework needs to undergo "a process for regular review to ensure that the risk management framework remains effective". ASFA believes that this level of detail (i.e. what is the process and how often is "regular") is more suitable to APRA guidance as opposed to being included in the prudential standards.

(ii) Articulating risk appetite

The concept of "risk appetite" is a new and evolving one for the superannuation industry. For this reason ASFA believes that there is need for flexibility to facilitate that evolution. Risk appetite is dependent on a number of things including the size, complexity and overall scale of the fund. It comes down to what is right for a particular fund.

ASFA's view is that, whilst the concept of setting a risk appetite sits well within prudential standards, they should not be prescriptive in this regard. Greater guidance around estimating the possible maximum impact on beneficiaries in the event that a particular risk is realised is more suitable to associated guidelines.

ASFA also believes that, with regard to this standard, an appropriate transitional period is required to allow trustees to firstly determine their risk appetite and then articulate it appropriately.

(iii) Alignment of risk management framework with business strategy plan

ASFA prefers to see such a standard – considered quite reasonable – to be supported with specific examples in guidance. In particular, guidance is needed around specifically what type of risks are envisaged by the regulator – i.e. how far should the risk assessment go (eg. should trustees be required to consider big picture risks such as what if there is another GFC, risks associated with the implementation of Stronger Super etc)? Guidance from APRA around these issues would be helpful for trustees.

(iv) Dedicated risk management function

Section 6.4.5 in the discussion paper proposes that trustees be required to maintain a dedicated risk management function with direct responsibility for the management and oversight of risk management within the fund (in line with entities in other APRA-regulated industries).

However, ASFA believes that such a standard is better served by changing the word “dedicated” to “designated”. The term "dedicated" is too prescriptive and is counter to other parts of this section that also talks about flexibility. The term “designated” still allows for proper accountability and is not limiting. For example, would a “dedicated” risk management function allow for a combined risk and compliance manager or should the two functions be separate?

ASFA understands that smaller financial institutions tend to combine these roles. As with most issues in the discussion paper, the size, complexity and scale of the entity needs to be considered. Flexibility through appropriate guidance is preferable.

Chapter 7 – Outsourcing

(i) Need for transition period

In order to allow the industry to make all of the changes necessary to comply with the prudential standard, ASFA believes there should be a sufficient transition period (ideally two years) during which funds are able to put processes and procedures in place. In addition, existing arrangements should be able to be grandfathered such that they do not need to comply until they are renewed or renegotiated (subject of course to proposals with respect to tied service provider arrangements).

(ii) Diversity of size and complexity of funds

Superannuation funds and schemes vary considerably in size and diversity of structures and product offerings – significantly more so than Authorised Deposit-Taking Institutions and insurance companies. Accordingly, so do their outsourcing arrangements, which vary considerably depending on the nature of the function that is being outsourced and the characteristics of the fund. As such, one size does not fit all.

Consistent with our general comment, it is important that the standards are high-level and principles-based to allow flexibility in application to differing circumstances. The guidance material would then have a role in illustrating how the standards could apply in diverse situations.

(iii) Exception for circumstances where not possible to have compliant written agreement

There will need to be recognition that there may be circumstances where it is not possible to have a compliant written agreement in place – in particular where a trustee has had to transfer certain functions to another service provider quickly in the case of some failure or issue on the part of the first service provider. In some circumstances there will be a need for the trustee to be able to move quickly and it may increase the level of risk faced by the superannuation fund if the change in service providers was unduly delayed due to the length of time absorbed in negotiating and drafting a compliant written agreement.

(iv) Outsourcing to other APRA regulated bodies

Another possible area where consideration could be given to an exception to the need for a compliant written agreement may be where the service is outsourced to another body regulated by APRA. In particular, as insurance companies are bodies regulated by APRA, there may be little need to impose an obligation on superannuation trustee to ensure any agreement with insurance companies complies with a prudential standard.

(v) Cost / benefit and risk-based approach

The increased costs involved in complying with some of these enhanced regulatory requirements need to be identified and balanced against any expected benefits which are derived from such compliance. In particular, some of the obligations will prove to be especially onerous with respect to small funds, especially in light of the risks that they face.

The prescriptive nature of some of the obligations, and the governance / documentation involved, largely represents a fixed cost and, accordingly, a greater impost on smaller funds. This is especially pertinent in the Stronger Super environment where there is increased focus on reducing costs, especially with the transition to MySuper.

Accordingly, ASFA requests that a risk-based approach be adopted when developing the standards so that the cost of any measures which need to be put in place are commensurate with the risk which is being mitigated. Risk factors could include the size and complexity of the fund and the nature of the services being outsourced.

(vi) Risk of bias towards performing functions in-house

Concern has been expressed that if the cost of complying with the standards is too onerous, this may create a bias towards performing functions in-house as opposed to outsourcing them, which may not suit all funds. For smaller funds, the loss of access to external expertise that this may represent may also pose a risk to fund operations.

(vii) Selection process – best practice

ASFA supports the idea that there should be best practice with respect to the selection process. This should be addressed in the guidance material.

(viii) Related party arrangements

ASFA supports the requirement for RSE licensees to have a written outsourcing policy.

Given the particular risks posed with respect to outsourcing to related parties, any requirements with respect to these should be specified in the standards. However, considerations with respect to off-shoring, sub-contracting and cloud computing should be in the guidance material.

(ix) Prudential Standard CPS 231

ASFA has some concerns with respect to the application of some aspects of the current CPS 231 to trustees of superannuation funds.

In particular, we query the requirement to use an internal auditor. Having another party critiquing a trustee's proposed decision to outsource would prove to be both costly and of little value. This may prove to be a considerable barrier to outsourcing or to changing providers, even if this were to be in the best interests of members.

Furthermore, we have concerns that a trustee's decision as to whether or not to off-shore may be unduly adversely influenced by the need to have APRA endorsement and that this may act as a significant barrier to off-shoring. Instead, we believe it should be sufficient for a copy of the final agreement to be sent to APRA.

Chapter 8 – Investment governance

(i) Statement of purpose

With regard to the proposed standard in *Chapter 8 – Investment Governance* that, if the standard is to relate to investment governance issues alone, then the content of the standard needs to be at a high (i.e. governance related) level with supporting Guidelines.

ASFA considers that a clear statement of purpose as to the policy intent of the Investment Governance standard is required so as to enable the industry to understand the regulatory intent. Clarification is also required as to what matters will be dealt with in the legislation and what by the promulgation of standards and supporting Guidelines.

ASFA is concerned that the proposed requirements of the Investment Governance standard contain issues that appear to include management and operational matters as well as governance. An appropriate statement of purpose in regard to the Standard should provide clear guidance as to what responsibilities must be retained by the RSE licensee (i.e. governance) and what aspects can be delegated by the RSE licensee either to management or to service providers (i.e. management and operational issues).

(ii) Application of the standard

The discussion paper acknowledges that the majority of the requirements and guidance on investment governance will apply equally to all RSE licensees, including those that offer MySuper products. However, the paper also contains parts that propose different requirements for MySuper RSE licensees from those applying to RSE licensees more generally.

The proposed standard would appear to be problematic if it applies to all RSE licensees, not just MySuper. This is because the obligations encompassed in the standard are too broad.

Member Investment Choice is a fundamental feature and strength of the Australian superannuation system as it accommodates the differing risk appetites of substantial numbers of members of superannuation funds. ASFA contends that the standards should not threaten in any way the ability of RSE licensees to offer Member Investment Choice, especially substantial investment menus that are constructed primarily to facilitate Member Investment Choice.

Requiring those RSE licensees (who offer the underlying investment options to enable Member Investment Choice) to be satisfied that each underlying investment option is appropriate for selection of beneficiaries "as a single undiversified option" would eliminate many of the single asset class investment options which are currently on superannuation platforms, and possibly some of the current partly diversified Member Investment Choice options.

It is noted that as these issues need to be disclosed to members, this will add considerably to the disclosure challenge and the potential exposures for licensees. This exposure increases with the number of investment options, and compliance mechanisms will need to be scaled up – see *(vii) Disclosure* below.

ASFA supports the overarching concept of an Investment Governance standard to clarify what (if any) investment related duties must be retained by RSE licensees, and therefore what can be delegated to managers or operators, and also to clarify any specific investment governance which applies to a MySuper product.

Chapter 3 of the Final Report of the Super System Review covered Investment Governance. The content of this Chapter was restricted to investment related fees, investment related taxation, valuation of investments and voting rights. The Government's Stronger Super response package accepted that changes are to be made to SIS to address the first 3 of these issues. The Super System Review and the Government's response to that review would appear to support a view that there is no need to impose further legislative or regulatory requirements in the area of investment governance beyond the two areas which have been specified in this submission. ASFA recommends that the proposed Investment Governance standard initially be applicable to these two areas only.

The proposed standard references "whole-of-fund" issues in a number of places. This wording does not reflect the Member Investment Choice environment of Australian superannuation where a "whole fund" is the total of a number of investment options, and therefore no particular investment logic is able to be applied at a whole-of-fund level.

Attention needs to be paid when drafting the proposed standard to differentiate between the investment of amounts which are allocated to member account balances, and unallocated amounts.

(iii) Drawdowns

It is unclear whether the proposed prudential standard applies to investments set aside for drawdowns. If this standard only applies to MySuper this would be clear, as MySuper initially will not have a pension product attached. However, if the prudential standard is to apply to more than just MySuper then the treatment of investments held for drawdown needs to also be considered.

(iv) Investment philosophy

The concept of setting clear investment objectives is a sound one and is supported by ASFA. However, requiring every RSE to have an investment philosophy is confusing and the term "philosophy" is unhelpful. The proposal that RSE licensees be required to set clear objectives that align each investment option with the investment philosophy of the RSE licensee does not differentiate between a manufacturer of investment options, a provider of platform options and those that are a hybrid.

ASFA recommends that subjective concepts such as "investment philosophy" be, at this early stage, included in guidance as opposed to the standards.

(v) Defined Benefit (DB) funds

Investment risk in DB funds is generally an employer issue and not a member related issue. Although needing to be covered, ASFA recommends that all DB standards appear under *Chapter 10 - Funding and solvency for DB funds* and, as a result, DB funds would be specifically exempted from the proposed Investment Governance standard to the extent that the investment / funding risk is covered by a sponsoring employer.

(vi) Benchmarks

The proposed standard includes a requirement to set a benchmark for each investment option and to specify the circumstances under which the benchmark would be changed. ASFA believes that the setting of all of: a return objective, a risk objective and a specific benchmark for each investment product is not consistent with sound investment practice, which generally focuses on either a return objective, or on a risk objective and a benchmark, depending on the nature of the particular product.

ASFA considers that specifying in advance the circumstances in which a benchmark might need to be altered is an inappropriate use of a superannuation fund's resources in the world of investment management, which is subject to continuous substantial change.

(vii) Disclosure

In an investment choice environment where the trustee offers a menu of investment options for members to choose from, trustees should be able to adopt (where relevant and appropriate) the underlying fund manager's disclosure on risk objectives, investment objectives, fees and costs for each investment option where required to do so under the proposed standard.

This is currently the case and to move away from this practice has the potential to create either added complexity (in that the trustee may have a slightly different investment objective for an option than the underlying fund manager) or doubling up of disclosure to members (in that trustees will have to provide the same information that is contained in the underlying fund manager's investment option PDS).

As well, there is concern that the specific investment covenant in proposed new subsection 52(6) of the SIS Act, when combined with the proposal that the current defence in section 55(5) will be amended so that it will only be available to trustees where they comply with all of the covenants in sections 52 and 53 (or prescribed under new section 54A) and all of the obligations referred to in sections 29VN and 29VO, represents a significant additional disclosure requirement and increased potential exposure for trustees.

Chapter 9 – Operational risk financial requirement

(i) Recognition of diversity of superannuation

ASFA notes the discussion paper's recognition that the superannuation industry contains a considerable range of RSEs of various sizes and degree of complexity of product offerings and significantly more so than with respect to Authorised Deposit-Taking Institutions and insurance companies. Accordingly, a prescriptive approach may lead to difficulties in application to different circumstances and unintended consequences.

As such, ASFA recommends that a principles-based approach to the implementation of the operational risk financial requirement be adopted so as to permit the tailoring of the financial requirement to the circumstances of each RSE.

(ii) Risk-based approach and recognition of risk mitigation and transference

ASFA notes that in determining an appropriate level of operational risk reserve, an RSE licensee should consider:

- For each RSE, the likely financial cost of rectifying the occurrence of a treated operational risk;
- For each RSE, the need for an appropriate buffer amount to provide for the likely financial cost of rectifying the occurrence of a residual operational risk (where residual risks are those risks remaining after appropriate mitigation has been applied); and
- An appropriate additional amount to take account of wider group needs arising from an operational risk event in one or more RSEs under its trusteeship.

ASFA considers that, due to the large variety of administration and operational arrangements in the superannuation industry, there will be a need for extensive guidance for RSE licensees.

Although the discussion paper states that there is no intention to set a minimum level of operational risk financial resource, ASFA considers that there may be merit in setting, in guidance, a safe harbour level minimum reserve amount, expressed as a percentage of assets, that would be applicable to all superannuation entities (with perhaps the exception of corporate funds). Guidance could then be provided as to the circumstances in which this amount may be varied down and the circumstances where a higher amount may be appropriate.

For example, in determining the level of financial operational risk for the purpose of creating a reserve, guidance could be provided as to the extent to which a risk may be transferred, and therefore the financial reserve requirement reduced, through a contractual arrangement with an external service provider. Similarly, guidance could be provided on the extent to which the actual required level of the reserve be reduced through an insurance policy arrangement.

With regards to transferring risk to service providers, ASFA considers that, in the absence of regulatory supervision of external service providers, there should be no capacity for an RSE licensee to permit an unlimited risk transfer to a service provider.

However, ASFA sees a need to recognise that the absence of a trustee capacity to transfer risk to a service provider may result in service providers not appropriately addressing their own operational risks, thus increasing the operational risk of the RSE licensee and hence the level of required reserves.

To address this issue, ASFA suggests that the guidance provide that where an operational risk lies with an outsourced service provider, unless the service provider carries reserves to cover normal expected operational risk loss events[2] then the RSE licensee's operational risk reserve would be required to cover this. Thus, through contracting out, the RSE licensee would only be required to maintain reserves sufficient to meet the residual operational risks associated with the outsourcing arrangement. The need for guidance, rather than placing a rule in the standard, arises due to a perceived difficulty in defining, legally, the difference between expected and unexpected operational risk losses.

The guidance may also need to establish a cap on the amount of 'expected operational risk losses'. For example, if the cost of insurance and expected operational risk events for an external administrator is between 1% and 1.5% per annum of revenue then, if this is normally distributed by excluding unexpected operational risk events, a financial cap of 2% to 3% may be appropriate. Thus, for the RSE licensee to be able to transfer the expected operational risk to an external service provider (and thus remove its reserving requirement) would require the service provider to hold its own financial risk reserve of 2% to 3% of annual revenue.

ASFA considers that an approach of allowing expected operational risk losses to be transferred to an outsourced administrator could be adopted with a simple approach to prudential supervision. The approach could require outsourcing contracts to have annual financial limits in relation to risk transfer and to include a requirement for the outsourced administrator to maintain a minimum financial reserve to cover expected operational risk losses. The only other risk transfer that should be allowed in the outsourced administration contract are losses that are covered by the outsourced administrator's insurance contract.

(iii) Reserves only used for risks identified in the risk management framework (RMF)

This approach raises the question as to how an RSE licensee is to address a "black swan" event, which by definition is a matter which, given the state of knowledge at a particular time, was impossible to foresee. Were such a risk to materialise it should be no less worthy of being redressed from the capital reserves than an anticipated risk would be.

If the proposed approach were to be adopted, this may result in RMFs becoming significantly more general and all-encompassing, to ensure that the capital reserve could be utilised in the event of a risk materialising. ASFA considers that the production of less specific RMFs would be an adverse outcome.

ASFA is concerned that if the capital reserves can only be used with respect to risks that have been identified in the RMF, then a trustee may face difficulty in financing the cost of treating a realised but unforeseen risk event, particularly in the case of "all profit to member" funds.

ASFA is concerned that while the inability to use the capital reserve is being used as an incentive to encourage trustees to correctly identify all known risks in their RMF, or as a form of punishment for trustees who have failed to do so, In certain circumstances the restriction may actually serve to penalise the members of the fund.

[2] In practice, expected losses are by definition expected and occur on a regular basis in the management of a superannuation fund, so are in a non-systemic or individual member category and are typically small and financed from cash flow as 'business as usual' from current budgets. Unexpected losses are infrequent and by definition unexpected. They are typically large and systemic or impacting multiple members and are financed from operational risk reserves. By doing this, the administrator is accountable for operational risk loss events that are expected, non-systemic, individual member-based and limited in size. By contrast, the fund remains responsible for operational risk loss events that are unexpected, systemic, multiple member-based and large / unlimited.

ASFA considers that trustees should be permitted a degree of discretion as to how they apply their reserves. They are subject to fiduciary and other equitable and trust law duties, which will serve to ensure that trustees apply reserves appropriately. We do not consider that there is a need for the prudential standard to overly restrict the circumstances in which the trustee can use such reserves.

(iv) "Conglomerate" trustees who are part of ADIs or life companies

Trustees that are part of an ADI or a life company conglomerate arrangement may have access to capital reserves by virtue of their corporate ownership structure.

Accordingly, there should be recognition of a conglomerate's economic capital model when determining the level of capital that need to be held by individual trustee companies within that group where such reserves exist and are quarantined for the exclusive benefit of the RSE licensee.

ASFA requests that guidance be provided regarding the circumstances under which an RSE licensee could rely on its ability to call on the reserves of the conglomerate as a reason for reducing its requirement to hold its own reserves or reserves in an RSE for which it acts as trustee.

(v) Intergenerational equity

The discussion paper refers to a period of three years over which to build up operational risk reserves. Given that the cost of this will be borne by members who are in the fund during this period but the benefit will primarily accrue to future members, ASFA considers that a longer period may be more appropriate. ASFA is concerned that a cohort of beneficiaries will pay for the build-up of reserves but will exit the fund prior to it ever being called upon.

Consideration may also need to be given as to whether the wind-up or successor fund transfer of a fund that is part-way or completely through building up a reserve, may give rise to any issues with respect to the ownership and distribution of such reserves.

(vi) Communication to members

Given the diversity of funds within superannuation system generally, there appears to be three main options as to how a trustee can build up an operational reserve:

- unit priced funds can marginally adjust unit prices to generate a reserve;
- similarly, crediting rate funds can decrease their crediting rate to build up a reserve;
- funds which invest through a unitised PST (generally small, especially corporate and industry funds) – who will have no ability to adjust unit prices – may have to impose a fee payable directly from members' accounts.

While the first two methods are not visible to members, an explicit fee clearly would be. Concern has been expressed that any such fee is not likely to be readily understood by members, especially as only a minority of funds will need to utilise such a fee.

In particular, if a member were to compare their fund (which charges a fee) with other funds (which adjust their unit price / crediting rates), they may perceive their fund as being more expensive and not appreciate that they are receiving higher returns than they otherwise would have been. This is especially the case in the Stronger Super environment, with its increased emphasis on costs and transparency / comparability of funds in the transition to MySuper.

Accordingly, to avoid any potential confusion amongst members, there may be a need for ASIC-prescribed wording with respect to the legislative requirement to create capital reserves, the various methods funds can employ to build up reserves and the need to exercise caution if comparing funds using different methods or funds which have varying levels of reserves.

(vii) Difficulty in quantifying operational losses

Experience has shown that it is not always possible to quantify the losses that may be incurred as a result of the realisation of a risk. As such, we believe a degree of flexibility in approach may be necessary.

(viii) Defined Benefit funds

We submit that, as operational risks are generally faced by the fund as a whole, there should only be a need to create one operational risk reserve across both defined benefit and accumulation members.

Further, operational risk reserves should not be included in any solvency measures.

Chapter 10 – Funding and solvency for defined benefit funds

(i) Funding to the vested benefit level

ASFA is supportive of the requirement for defined benefit (DB) funds to be funded to the vested benefit level rather than the lower minimum benefit level and for trustees to develop a restoration plan where funding falls below vested benefit level. However, in line with our overall comment, the prudential standards should consist of high-level principles which are flexible enough to cater for different circumstances (i.e. they should not be overly prescriptive). That is, whilst we support the requirement for trustees to agree a restoration plan with the employer if funding falls below vested benefit level, the standards should not be overly prescriptive in relation to the restoration plans themselves.

For instance, the standards should not prescribe the timeframe that trustees should set within their restoration plan to restore the funding to vested benefit level, since circumstances will vary from fund to fund and employer to employer. Certainly, the prudential standards should not prescribe a return to vested benefit level within 12 months – we believe that such an immediate (and inflexible) timeframe for the restoration to vested benefit level would be overly onerous in many instances and may not be in the interests of members. Rather, it should be up to each trustee to develop an appropriate restoration plan (in consultation with the fund actuary and employer), within the framework of guidance provided by APRA.

The guidance from APRA could include the following considerations:

- The timeframe for restoring the funding to vested benefit level – eg. the trustee could have a 3-year restoration plan (or some other suitable timeframe) which has been endorsed by the fund actuary and is acceptable to the employer.
- The circumstances in which the restoration plan can be amended / re-set by the trustee – eg. where subsequent adverse market event(s) occur during the restoration period which has a detrimental impacts on the pre-agreed funding plan.
- The various funding agreements that trustees and employers could consider entering into – eg. regular (quarterly) lump sum payments by the employer, payments consisiting of a set percentage of members' salaries or a combination of the two.
- Guidance around what trustees should do if they encounter difficulties in agreeing an appropriate restoration plan with the employer – eg. the trustee could, in conjunction with actuary, present several different funding arrangements to the employer and allow the employer the select the one that best suits them (so long as each of the restoration plans has been endorsed by the actuary as one that will likely return the funding to vested benefit level within an acceptable timeframe).

Whilst early notification to the regulator of the existence of a funding issue is supported, ASFA considers that trustees should be allowed a reasonable timeframe to develop their restoration plan (including sufficient time to consult with the actuary and employer) before having to provide this to APRA. Somewhere in the vicinity of 3 to 6 months from the time the trustee first becomes aware that the funding has fallen below vested benefit level would seem to be a reasonable timeframe.

(ii) Technical solvency and wind-up priorities

ASFA supports the requirement for trustees of technically insolvent DB funds or DB sub-funds to actively monitor progress towards restoring solvency. Consistent with our comments above regarding the requirement for trustees to agree a restoration plan with the employer if funding falls below vested benefit level, the standard in this regard should not be overly prescriptive. It should be up to each trustee to develop an appropriate plan to restore the fund to solvency (in consultation with the fund actuary and employer), with appropriate guidance provided by APRA.

In addition, this requirement should be viewed in conjunction with the trustee's overall funding and solvency plan. That is, the issue of inadequate funding (i.e. below vested benefit level) and technical insolvency should, to the extent possible, be considered in conjunction by trustees and the process streamlined as much as possible. Ideally, the restoration plan developed by trustees would cover both these circumstances.

(iii) Segregation of assets

Section 10.1 of the discussion paper states that "where a DB fund is a sub-fund of a fund with both accumulation and DB beneficiaries, it is also important that the DB sub-fund is appropriately segregated so that there is no contagion risk for the accumulation beneficiaries".

Whilst no reference is made to this comment elsewhere in the discussion paper in terms of a proposed requirement in the prudential standard, we believe the comment in and of itself needs clarification. ASFA seeks clarification as to whether a physical segregation of assets is required or merely a segregation for accounting purposes.

We note that some trust deeds may not allow segregation of DB assets in the manner proposed. Additionally, some fund's trustees may not be able to amend their trust deed in a manner that adversely impacts members' entitlements. For example, by isolating the DB assets from the accumulation assets, accumulation beneficiaries could lose an entitlement to the fund's assets on wind-up of the fund, which they may have had under an unsegregated arrangement.

In addition, an enforced segregation of assets could in many instances severely impact economies of scale by creating two smaller sub-pools of assets. It could also act as a disincentive for employers to maintain a 'healthy' funding position (i.e. above the vested benefit level) if the surplus DB assets cannot be applied as contributions for accumulation beneficiaries, which many trustees currently do. It should be noted that sections 6A and 6B of the Superannuation Guarantee (Administration) Act 1992 permit employers to use the surplus generated from funding a DB sub-fund to be applied as contributions for the accumulation members of the fund. ASFA endorses this flexible approach to the treatment of surplus funding being applicable to the fund as a whole (as opposed to the less flexible approach that would result from an enforced segregation of DB assets).

Chapter 11 – Audit requirements

(i) Internal versus external audit requirements

The discussion paper contains a statement that "*an audit prudential standard will also assist the RSE licensee to establish a structure within which an auditor can comply with its audit obligations*". ASFA considers that this comment is only relevant with respect to driving the internal audit function of a fund – that is, the external audit function is governed by the auditing standards. As such, consistent with our general comment that each prudential standard should include a short purpose statement, we believe this objective should be clarified as being relevant only to internal audit.

As well, ASFA considers that where there are different requirements with respect to the internal and external audit functions, the prudential standard should clearly specify which requirements are applicable to each function (i.e. which requirements are applicable to the internal auditor and which are applicable to the external auditor).

(ii) Requirement to have an internal audit function

ASFA is supportive of the requirement for all RSE licensees to have an internal audit function. However, the discussion paper states that this function can be outsourced with APRA approval. Our understanding is that the desire by APRA to approve outsourced internal audit functions is a consistency matter rather than a particular concern APRA has with outsourcing per se. ASFA considers that APRA should not have the final decision on the outsourcing of this function. We believe it should be the role of trustees, as part of their governance responsibilities and based on their knowledge of the fund, to assess whether the outsourced arrangement is appropriate (and in accordance with the outsourcing and fit & proper standards). Many funds already outsource their internal audit functions – in general, these arrangements should be allowed to continue (i.e. without the need for APRA approval) if the arrangement is assessed by the trustee to be appropriate.

ASFA considers that very few funds will have, or want to maintain, internal audit staff with the capacity to certify all the trustee's policies, process and controls. Given the heightened obligations, it is likely that more funds will outsource their internal audit function. Therefore, if (contrary to ASFA's view) APRA is to have final approval of the outsourcing arrangement, we believe this process should not be overly restrictive/onerous for trustees.

Whilst we support the requirement to have an internal audit function, ASFA contends that the decision of whether this function is insourced or outsourced should be up to the trustee.

ASFA considers that it would be helpful for the industry if APRA were to address separately the requirements relating to an outsourced internal audit function vs an insourced internal audit function within the prudential standards/guidance.

(iii) Scope of the internal audit function

In section 11.4.1 of the discussion paper "APRA proposes, at a minimum, that the scope of the internal audit function be to certify all policies, processes and controls as complying with APRA's prudential requirements".

It should be noted that, in the superannuation sector, internal auditors do not currently perform a certification role. Such a requirement would be a significant, and perhaps costly departure from current practice. ASFA is concerned that replicating the insurance sector requirement, which generally involves the production of a comprehensive audit opinion (often some 4 or 5 pages) by the internal auditor, may result in a substantial cost imposition for funds for little discernible benefit to fund members.

ASFA questions whether the internal auditor is best placed to undertake this certification or whether in fact it should be part of the external audit function. For instance, the process could potentially be linked to current certification undertaken by the external auditor of the trustee's internal controls, which directors already sign-off on. ASFA considers that if this certification process is introduced for the superannuation industry, it should be undertaken exclusively by either the internal or external auditor (but not both), otherwise an extra layer of complexity would be added to the process and the potential for duplication would result in unnecessary additional cost for funds (and members).

ASFA seeks, clarification in relation to what is meant by 'all policies, processes and controls'. Our view is that the requirement should be limited only to those policies, processes and controls covered by an APRA prudential standard (eg. adequacy of resources etc).

ASFA considers that the scope of the internal audit function in the prudential standard should not be overly prescriptive. Consistent with our overall view, there needs to be sufficient flexibility in the standards to cater for different arrangements/models. However, we believe that appropriate guidance, by way of a Prudential Practice Guide, should be provided by APRA in relation to setting the scope of the internal audit.

(iv) Heightened minimum auditor requirements

In section 11.4.2 of the discussion paper, APRA proposes fit and proper and independence requirements for superannuation auditors. Whilst ASFA does not disagree with these heightened requirements, we question whether they are absolutely necessary. Comments from ASFA's membership question whether the cost associated with this requirement will actually provide any additional protection to members.

Chapter 12 – Business continuity management

(i) Overlap of BCM with Risk Management and Outsourcing

Given the degree of overlap between this standard and both the Risk Management and Outsourcing standards, care will need to be taken to ensure that there are no inconsistencies between the various standards.

(ii) Standard should be principles-based and not prescriptive

The standard will need to be principles-based and not prescriptive to ensure that it is sufficiently flexible to accommodate the differing sizes, complexity and needs of superannuation funds and their varying circumstances (consistent with our overall comment regarding the prudential standards).

ASFA has received numerous comments from our members querying the need for a separate stand-alone prudential standard on business continuity management specifically for the superannuation industry given the very different nature of superannuation funds from other APRA-regulated institutions. There is a strong feeling from some sections of our membership that the proposed requirements should be subsumed into the Risk Management and Outsourcing standards (with appropriate cross-referencing where required). That said, we have also received comments suggesting that, whilst business continuity is part of risk management, it is such an important component that it warrants a stand-alone prudential standard.

On the basis of APRA's intention to harmonise the prudential standards across all the APRA-regulated industries, ASFA is not uncomfortable with a separate standard for superannuation (subject to the comments above regarding flexibility and the avoidance of duplication).

Chapter 13 – Insurance in superannuation

(i) Excessive focus on price (at the expense of long-term sustainability)

ASFA is concerned about the excessive focus placed on price in relation to trustees negotiating their group risk insurance arrangements. That is, trustees are excessively focused on trying to get the lowest premium rates for their members, often to the exclusion of other important factors such as the sustainability of premium rates being offered by insurers. Indeed, comments provided to ASFA suggest that trustees often feel pressured to focus on price – i.e. there is a general perception from the industry that APRA is focusing too much on trustees achieving the lowest premiums possible (or risk facing scrutiny from the regulator). This in turn is putting pressure on insurers to cut their margins (potentially to levels that are unsustainable in the long term) in an effort to win/retain clients.

ASFA considers that, rather than focusing on achieving the lowest price, trustees (and APRA) should be focusing on value to members. The long-term sustainability of premium rates needs to be strongly considered in this whole process. Cost effectiveness of insurance should be determined by the trustee over the longer term, and profit share and other mechanisms should be explored to support this longer term focus.

The prudential standards may provide an opportunity to encourage trustees to focus on matters other than costs when reviewing their insurance arrangements.

(ii) Statutory duty to act in beneficiaries' best interests

ASFA contends that now is an appropriate point in time for "best interests" to be clearly defined. It is a well-worn phrase used by industry participants, but is highly problematic due to lack of clarity of what it actually means. Without a clear definition, this concept is subject to different interpretation by different people.

The courts have already determined that it is an amalgam of 2 existing legal concepts:

- The loyalty that the trustee owes to the beneficiaries of the trust (i.e. duty to act in the interests of members); and
- The duty to exercise a reasonable/appropriate level of skill and care in the performance of the trustee's duties.

We believe that APRA should endorse the view that "best interests" has the same meaning above as applied by the courts. In particular, best interest should focus on the process undertaken by the trustee to act in the best interest of ALL members, not the outcome for any individual member.

However, notwithstanding the overarching "best interests" definition that APRA is developing, ASFA considers that trustees should be responsible for determining what is in the best interest of their particular members.

To assist trustees in this regard, guidance will need to be provided as to what trustees should consider in determining whether an insurance arrangement is in the members' best interests. Matters to be covered could include:

- Pricing (but this should not be the major determinant)
- Member experience
- Ability to service and transact through the fund
- Level of technology
- Financial stability / capacity of the insurer
- Pandemic risk cover
- Ability of member to apply online, etc.

This guidance should be included in the proposed Prudential Practice Guide (PPG) on the development of an insurance strategy.

(iii) Development and maintenance of an insurance strategy

ASFA is supportive of the requirement for trustees to develop and maintain an insurance strategy that is appropriate to the membership of their fund.

However, in our view, the insurance strategy should be sufficiently broad/high-level to cater for different arrangements/models. As stated above, there needs to be less focus on price – i.e. there should be a balance between price and sustainability as well as a balance between providing members with sufficient cover without overly impacting their retirement savings. The prudential standard and accompanying guidance should make it clear that achieving the lowest premiums possible is not the main issue trustees should be focusing on. Rather, trustees should take a holistic approach in setting their insurance strategy.

Also, ASFA supports the position that trustees should regularly test the appropriateness of the insurance arrangements. However, based on feedback from our membership, trustees in some cases feel they are compelled to go the market every 3 or 6 years or face scrutiny from APRA. We believe the standards should be sufficiently flexible in this regard and should not include a requirement for trustees to re-tender at specific intervals.

ASFA considers that guidance should be provided as to what trustees should consider in setting an insurance strategy. We note that a number of checklists have been developed by various industry participants which can used as a basis for the APRA guidance.

(iv) Permitted insurance within superannuation

ASFA is supportive of the Government's position to end the practice whereby some members are being charged premiums for own occupation cover in TPD (and other types of insurance) that may not be released to them when an insurance payment is made because the circumstances do not meet a condition of release. This means that an 'own occupation' definition will not be allowed for TPD insurance, only an 'any occupation' definition. However, ASFA contends that the prohibition of 'own occupation' for TPD should not in any way impact the definitions used for income protection (IP) contracts. We believe that either 'any occupation' or 'own occupation' definition for IP cover should continue to be allowed.

In addition, liability issues associated with a forced move from 'own occupation' to 'any occupation' as well as members no longer being covered by other types of 'non-core' insurance (eg. trauma) following the unwinding process will need to be addressed in the APRA guidance (i.e. trustees and insurers need to be indemnified).

Also, the timeframe for unwinding 'non-core' insurance cover needs to be sufficiently long (eg. 3 to 5 years) to allow current arrangements to be unwound and give members who wish to continue to be covered by such policies the opportunity to obtain cover elsewhere. This issue should be addressed in the APRA guidance.

(v) Limitations on self-insurance

Section 13.4.3 of the discussion paper requires trustees that currently self-insure benefits for accumulation members to unwind any existing self-insurance arrangements "within a short period of time".

We reiterate our position that the ability to self-insure should not be limited to DB funds that are currently allowed to do so. Whilst there has been a big shift away from funds self-insuring in recent years, there may be certain circumstances where it would be advantageous for funds to self-insure (eg. if funds are large enough). As stated in our submission to phase 3 of the Cooper Review, ASFA considers that the decision of whether or not to self-insure should be left to trustees, subject to the prudential supervision of APRA and the trustees having appropriate pricing, management and risk framework in place to effectively operate a self-insurance arrangement (including sufficient reserves to ensure they can pay any death or disability benefits). With continued supervision by APRA, arguably there is no need to require the unwinding of self-insurance arrangements that are currently working effectively (particularly given that the number of funds that self-insure is continuing to reduce).

However, if self-insurance is to be limited to DB funds that are currently allowed to self-insure, we believe appropriate guidance should be provided to trustees regarding:

- The timeframe for unwinding their existing self-insurance arrangements;
- Situations where the trustee is unable to obtain competitive cover from an insurer (or at all) – eg. due to a poor claims history; and
- The issues trustees should consider in determining whether it is in the best interests of members to move away from a self-insurance arrangement (i.e. guidance on weighing up the pros and cons). For example, trustees may need to consider issues around moving away from the definitions they currently use under the self-insured arrangement (which may be less restrictive) to different definitions under a commercial contract and whether this is in the best interests of members.