



Discussion Paper

Guidance for superannuation licensees: Capital, Risk Management, Adequacy of Resources, Fitness and Propriety

14 August 2009

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Preamble

This discussion paper addresses draft APRA guidance on measures it regards as sound practice for RSE licensees to take in satisfying licence conditions and operating standards imposed under the *Superannuation Industry (Supervision) Act 1993* ("the SIS Act") and Regulations in respect of:

- capital and net tangible assets;
- risk management
- adequacy of resources; and
- fitness and propriety.

The guidance is set out in draft *Prudential Practice Guides PPG 110, 200, 230 and 520* respectively. The draft PPGs are available on the APRA website at www.apra.gov.au/policy.

APRA proposes to issue a final version of each of the guides later in 2009.

Written submissions on each of these draft guides should be forwarded not later than 14 September 2009 to:

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Submissions will be treated as public unless clearly marked as confidential and the confidential information contained in the submission is identified.

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Glossary

AAT	Administrative Appeals Tribunal
ADF	Approved deposit fund
AFSL	Australian financial services licence
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
Corporations Act	<i>Corporations Act 2001</i>
PPG	Prudential Practice Guide
PST	Pooled superannuation trust
RMP	Risk Management Plan
RMS	Risk Management Strategy
RSE licensee	Registrable superannuation entity licensee
SIS Act	<i>Superannuation Industry (Supervision) Act 1993</i>

Chapter 1 – Introduction

Prudential Practice Guides (PPGs) provide practical guidance on those measures which might be employed by an RSE licensee and its directors and which APRA would regard as sound practice in order to satisfy obligations imposed under legislated licence conditions, operating standards or other provisions under the SIS Act and Regulations.

It is APRA's intention to progressively issue Prudential Practice Guides to replace the various existing Superannuation Guidance Notes and information previously contained in 'Frequently Asked Questions' prepared in the context of the licensing of superannuation trustees, as well as the earlier Superannuation Circulars.

The need for updated APRA guidance has arisen from changes to the structure of the industry and the increase in size and sophistication of funds in the period following the licensing of trustees. Where appropriate, APRA will seek to harmonise guidance provided for entities across all APRA-regulated industries.

This discussion paper seeks comment on draft Prudential Practice Guides on Capital, Risk Management, Adequacy of Resources and Fitness and Propriety.

Other than as indicated in this discussion paper, the draft PPGs now released for consultation do not represent a departure from guidance previously provided by APRA.

The PPGs will be applicable to the trustee of any APRA-regulated superannuation entity. For convenience, RSE Licensees are referred to as trustees, and, depending on context, a reference to a fund or fund members or beneficiaries may be taken to be a reference to ADFs and their members or to PSTs and their unit holders.

Chapter 2 – Draft guidance on Capital

This chapter addresses the guidance contained in draft PPG 110 which will replace Superannuation guidance note 150.1, July 2004 and information previously contained in 'Frequently Asked Questions – Capital' published on APRA's website.

Introduction

Under the SIS Act, trustees whose license conditions permit them to act as trustee of a public offer or extended public offer fund are required to hold or have access to specified levels of net tangible assets.

The draft PPG provides guidance on the ways by which trustees may satisfy these requirements. Points of difference from previous guidance are noted below.

Maintenance of capital is a licence condition

The draft PPG notes that any failure to maintain the capital requirements at any time will constitute a breach of a license condition, and should be immediately reported to APRA. This conforms with the existing practice within the industry.

RSE licensees satisfying the capital requirement by use of a custodian

Where, under standard public offer license conditions, a trustee satisfies its capital requirements by reliance on a custodian to hold fund assets the trustee must itself still hold a minimum of \$100,000 in cash or cash equivalents with an additional amount to cater for risks arising from activities such as in-house administration.

On a few occasions, as a special licence condition, APRA had permitted a related third party service provider to hold the minimum liquid assets in its own name. However, the AAT has found that in such cases there could be no higher obligation on the trustee than to ensure that its contract with the service provider imposed the minimum liquid asset requirement. The AAT noted that the trustee's remedy against the service provider for failure to maintain this would be an action for breach of contract. It is APRA's view that there is a compelling prudential need for the trustee to have immediate access to a minimum amount of cash at all times. In light of this, APRA does not expect to permit such arrangements in future.

Chapter 3 – Draft guidance on Risk Management

A continuous process of effective risk management is critical to the safety and soundness of the operations of each trustee. For all superannuation entities where the trustee holds or applies for an RSE licence, the SIS legislation requires that the trustee must develop, implement and maintain a sound and prudent risk management framework, comprising a Risk Management Strategy at the trustee level and a Risk Management Plan for each RSE under trusteeship.

This chapter addresses the guidance contained in draft PPG 200 which will replace SGN120.1, Frequently Asked Questions in relation to RMS and RMPs and guidance in relation to fraud control.

The draft PPG provides guidance on the ways by which trustees may satisfy these requirements. Points of difference from previous guidance are noted below.

Risk Management Framework

Trustees are invited to give consideration to issues of business resilience; that is, the capacity of the organisation to adapt to and conceivably benefit from significant events which materially change the business operating environment. While this concept is not explicitly addressed in previous guidance it is arguably implicit and forms part of current mainstream risk management literature.

The draft notes that it is a licence condition for all trustees that their RMS satisfies the legislated requirements and that they comply with its terms at all times. Further, they must comply with each measure and procedure set out in the RMP for each registrable superannuation entity for which they are trustee. A range of consequences can flow from a breach of a licence condition. The observation simply makes explicit in the guidance the legislated links between the licence conditions and the potential consequences of breaching them.

The draft PPG also notes that it is open to the trustee to determine whether a Derivative Risk Management Statement is required and if so whether it should be prepared separately from the RMP, or whether it could be incorporated within the RMP.

Consistent with the consolidation within the industry over the past years, and the increased size of funds, the draft PPG demonstrates a closer alignment of APRA's expectations of sound prudential practices in the superannuation industry with those in other APRA-regulated sectors.

Identifying risks

The draft PPG offers expanded commentary on approaches that trustees may adopt in developing a rigorous risk assessment process, and aligns that with guidance offered in relation to other APRA-regulated industries. The draft explicitly notes risk areas associated with processes for project management, including transitions when functions are moved between in-sourced and outsourced arrangements or between outsourced service providers. It also considers risks associated with the structures of executive and service provider remuneration.

In considering issues specific to the RMS, the draft PPG identifies risks associated with benefit design, including particularly the investments underpinning any explicit or implied capital guarantee offered to members. In particular, it observes that trustees would generally have regard to the potential for members to take advantage of arbitrage opportunities if unit prices or crediting rates for members switching between investment strategies are set using historic rather than forward pricing¹. In a similar vein, it notes the risks that arise if the frequency of valuation is inconsistent with the frequency of establishing crediting rates or unit prices; the risk of incorrect valuation of assets for which there is not a deep or liquid market; and the risk of incorrect assessment of the tax implications associated with particular assets.

¹ See Joint APRA/ASIC "Unit Pricing – Guide to Good Practice"

For defined benefit funds, the draft PPG notes risks to the financial position of the fund including those associated with the solvency of an employer sponsor as well as those associated with the investments supporting the fund's defined benefit liabilities.

While this material has not been included in previous guidance, it reflects current sound practice observed by APRA supervisors.

Risk mitigation and control

The draft PPG offers expanded guidance, consistent with that provided in respect of other APRA-regulated industries, on control mechanisms, and on information systems, communication and escalation procedures to support the trustee's management of its risk processes. It notes the risk inherent in moving staff over time from control to operational functions, where they may apply knowledge of control features in order to circumvent them. It also describes as prudent practice the identification of the officer responsible for implementing risk controls, and draws attention to the monitoring of low level breaches which, while not significant in themselves, in the aggregate may be symptomatic of systemic weakness in the trustee's risk management processes.

The draft PPG expands existing guidance on the need for appropriate information systems to aid in risk mitigation and control, and aligns that with guidance to other industries.

The draft PPG addresses the role of internal auditors in assessing the effective implementation of the risk management processes and attesting to their continuous and effective implementation, and in doing so aligns guidance for superannuation trustees with that provided for other industries.

Chapter 4 – Draft guidance on Adequacy of Resources

This chapter addresses the guidance contained in draft PPG 230 which will replace SGN140.1 and Frequently Asked Questions in relation to adequacy of financial resources.

Inadequate resources available to the trustee, whether human, technical or financial resources, may interfere with the capacity of a trustee to properly carry out its fiduciary duties.

The draft PPG provides guidance on the ways by which trustees may satisfy requirements in relation to the adequacy of resources. Points of difference from previous guidance are noted below.

The draft PPG notes several matters not included in previous guidance, but which reflect current understandings of both funds and APRA supervisors. Specifically, it states that a trustee's Risk Management Strategy would ordinarily set out how the trustee will monitor and maintain the adequacy of resources available to it.

It also notes that, in substantiating trustee claims of adequacy of resources, APRA may seek evidence of appropriate due diligence which supports the trustee's satisfaction with the capacity of material service providers, including satisfaction with:

- their financial capacity to remedy any failings in providing the contracted services; and/or
- agreements under which an employer sponsor or other party commits to providing on-going material support to the trustee.

When operations are conducted in-house, APRA would expect a prudent trustee to demonstrate appropriate recruitment and induction processes, as well as succession planning for key roles.

These inclusions reflect current sound industry practice observed by APRA supervisors.

The draft PPG states that, while it would not be the norm for APRA to impose a specified minimum level of financial resources to be held by a trustee as a licence condition, it is open to APRA to do so on a case by case basis if it is satisfied neither that:

- the trustee's demonstrated financial resources are adequate for the nature of its business; nor that
- the trustee's proposed response to that perceived inadequacy is sufficient in the circumstances.

Chapter 5 – Draft guidance on fitness and propriety

This chapter addresses the guidance contained in draft PPG 520.

PPG 520 will replace SGN 110.1 (Fit and Proper) and information previously contained in the Frequently Asked Questions on fitness, propriety and police checks which appear on APRA's website.

The fitness and propriety of the trustee as a collective entity depends on the fitness and propriety of the individuals who act as directors, responsible officers or as one of a group of individual trustees. This PPG therefore provides guidance as to what is expected of individuals in this context. The focus is on trustee policies designed to ensure that the trustee meets the operating standard at all times.

The draft PPG provides guidance on the ways by which trustees may satisfy these requirements. Points of difference from previous guidance are noted below.

General

The draft PPG provides expanded guidance on matters which a prudent trustee would include in its Fit and Proper policy, aligning this with guidance provided in respect of other APRA-regulated industries. It introduces guidance in relation to the treatment of whistleblowers, which is also consistent with that applying to other industries.

Fitness

The draft PPG extends to individual officers a minimum expectation in relation to skills and knowledge equivalent to that previously expressed for the trustee as a whole. This reflects the increased size and complexity of the industry over the period since implementation of licensing of trustees, and is consistent with APRA's observations of current standards of practice within the industry generally.

Propriety

The PPG varies previous advice by noting that APRA would most likely move to suspend a trustee which failed to act promptly to remove a responsible officer known or reasonably suspected of being a disqualified person, pending resolution of that person's status.

This position indicates a readiness for APRA to take swifter action under the SIS Act if a trustee was tardy in removing a disqualified person. Previous guidance stated that APRA would not replace a trustee in such circumstances before going through a process of imposing a specific license condition and then issuing direction to comply with that. APRA now considers that it would be inconsistent with the intent of the SIS legislation and not in the interests of members to leave a disqualified person in place through such a potentially lengthy process, especially as each step in the process is reviewable.

Chapter 6 – The consultation process

APRA is undertaking an external consultation process via its website. Comments received in submissions will be taken into account in finalising each of these guides.

APRA proposes to issue final versions of these PPGs in the fourth quarter of 2009.



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