



Prudential Practice Guide Draft

SPG 110 – Capital

14 August 2009

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About this guide

The *Superannuation Industry (Supervision) Act 1993* (SIS Act) and Regulations set out requirements for certain registrable superannuation entity licensees (RSE licensees) in relation to capital and net tangible assets held to meet public offer licence conditions.

This Prudential Practice Guide (PPG) provides practical guidance on the measures APRA would expect an RSE licensee and its directors to take to satisfy obligations under those requirements. It replaces Superannuation Guidance Note 150.1, July 2004 and information previously contained in 'Frequently Asked Questions – Capital' published on APRA's website.

A reference to a trustee in this guide should be taken as a reference to the RSE licensee of an APRA regulated superannuation fund, approved deposit fund (ADF) or pooled superannuation trust (PST).

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Introduction

1. This prudential practice guide aims to assist Registrable Superannuation Entity (RSE) Licensees (alternatively referred to in this guide as trustees) in complying with rules and requirements relating to capital and the definition of 'net tangible assets' as set out in the SIS Act and Regulations.
2. This guide also provides an outline as to how APRA will assess whether a trustee or an applicant for an RSE licence meets the net tangible asset requirements.
3. As an operating standard under the SIS Act, all trustees and new licence applicants at all times must have access to adequate financial and other resources to enable them to satisfy their fiduciary obligations to the beneficiaries of the entities under their trusteeship.
4. The separate capital requirements imposed on trustees of public offer entities have several purposes. They provide a basic level of financial resources to act as a buffer against risk, they evidence a commitment on the part of a trustee to its superannuation business and they act as an incentive to the trustee to manage the entity well. It is necessary that a trustee has ready access to these resources especially at times of stress. This can be best demonstrated where net tangible assets are kept in a form which can be promptly and unambiguously used to support the financial needs of the trustee as they arise.
5. The capital requirements apply to trustees whose licence conditions include a requirement to meet specified capital conditions; ordinarily those with licences to operate either public offer or extended public offer funds¹. For ease of reference these classes of licensees are referred to collectively as 'public offer trustees' throughout this guide.
6. Section 29DA of the SIS Act sets out the methods by which trustees can meet the capital requirements. The net tangible asset requirements apply to trustees and licence applicants that satisfy ss. 29DA(2) or (4) of the SIS Act and hence this guidance on net tangible assets requirements is relevant to trustees who meet the capital requirements through either of these methods.
7. Approved guarantee requirements will apply to trustees that satisfy either ss. 29DA(3) or (4) of the SIS Act and guidance on the requirements relating to approved guarantees is relevant to trustees who meet the capital requirements through either of these methods.

Capital requirements to be satisfied at all times

8. Subsection 29E(3) of SIS imposes as an additional licence condition for each public offer trustee that it must continue to be a constitutional corporation that meets the capital requirements under s. 29DA. It follows that any failure to maintain the capital requirements at any time will constitute a breach of a licence condition, and, if significant, should be reported to APRA within 10 business days of its identification.

Interaction with the adequacy of resources operating standard

9. One of the operating standards which each trustee is required to meet relates to the adequacy of resources of, or available to, it². This operating standard requires, among other things, that trustees have adequate financial resources to ensure their solvency and to have adequate liquidity to support their business operations. Trustees should refer to SPG 230 for more detailed guidance on how the adequacy of resources standard interacts with the legislated capital requirements which apply only to public offer trustees.

¹ Refer to 29D(1)(g) of the SIS Act

² Refer to s34 of the SIS Act and SIS regulation 4.14.

10. While APRA would not routinely impose as a licence condition a specified minimum level of financial resources to be held by a trustee, it is open to APRA to do so on a case by case basis. This may arise if, in the context of its supervisory assessment, APRA were satisfied neither that the trustee's demonstrated financial resources were adequate for the nature of its business, nor that the trustee's proposed response to that perceived inadequacy was sufficient in the circumstances.
11. SPG 230 also provides guidance on APRA's practice of requiring a minimum level of net tangible and liquid assets on the part of public offer trustees which rely on custodian conditions to meet the capital requirements³. Where such a condition is imposed on a trustee, a reference to net tangible assets will mean net tangible assets as set out in SIS Regulation 3A.04.

Definition of net tangible assets

12. All trustees that are subject to minimum capital requirements as a condition of their licence should give consideration to their net tangible assets as defined in SIS regulation 3A.04. In general this means all trustees of public offer funds.
13. The definition of net tangible assets is based on identifying total assets from which certain assets and all liabilities are deducted. Terms within the definition delineate what is to be deducted.

Guidance in applying Regulation 3A.04

14. In demonstrating to APRA that net tangible assets are at the appropriate level, it would be sufficient for trustees or licence applicants to provide APRA with the most recent audited annual financial statements of the trustee corporation⁴, provided they were not more than one year old, together with a board resolution certifying that any material change to the financial position of the trustee corporation had been disclosed and that any event that had, or had the potential to have, an adverse effect on the financial position of the trustee corporation had been quantified and disclosed. A copy of the most recent management accounts submitted to the board would also be useful in such circumstances. APRA may seek clarification as necessary.
15. With input from the auditor, the trustee is primarily accountable for determining whether individual items count as net tangible assets as defined. If the trustee were unable to persuade APRA that the requirements relating to net tangible assets were being met, that would give rise to a breach of a condition of its licence. In allowing individual items to count towards net tangible assets, the trustee must consider and evaluate the individual attributes of each asset as necessary on a case-by-case basis. The individual attributes to be considered and evaluated include the asset's ownership, arms length valuation and marketability or liquidity.
16. If the trustee has entered into an agreement charging the assets of the trustee and the agreement involves an unspecified liability, all the assets of the trustee are taken to be encumbered. In line with accounting standards, subordinated debt is counted as a liability.

³ Refer to SPG 230, paragraph 17(a)

⁴ Audited interim statements for a more recent period may also be submitted where available, as well as the most recent annual statements.

17. For the purpose of defining 'illiquid assets' (being assets that are not capable of being converted into cash in the short term) APRA considers that 'short term' generally means within one month. Accordingly, items such as plant and machinery or capitalised software expenses should be assessed as illiquid assets. Inclusion of property assets, to the extent they could be converted to cash in the short term on an exceptional basis, would typically require consultation with APRA.
18. This interpretation recognises and attempts to deal with scenarios which have arisen in APRA's experience, where the residual net tangible assets have consisted of such items as capitalised software expenses, office furniture etc – items which are either not convertible into cash at book value or the disposal of which would leave the trustee without the means to carry out its functions.
20. APRA envisages that the trustee's risk management strategy will encompass risks to the trustee's net tangible asset position that would threaten its ongoing compliance with this condition of its licence. Detailed processes should be in place to regularly monitor the level of net tangible assets in order to ensure ongoing compliance.⁶ In particular, trustee policies and procedures should clearly demonstrate how potential breaches would be identified in time and remedial action taken to avoid such breaches, rather than merely reacting to them after the event.

Small APRA funds

21. Funds which are not self managed superannuation funds but which have fewer than 5 members are included among entities for which trustees are required to hold a public offer licence⁷. These funds are referred to as small APRA funds (SAFs). Trustees of SAFs are generally required to satisfy the capital requirements by meeting the conditions of s.29DA(2) i.e. by holding the prescribed amount of net tangible assets in their own right. APRA places considerable reliance on the capital adequacy, solvency and operational capacity requirements that must be met by public offer trustees to ensure the prudent management of SAFs. Unless there are extenuating individual circumstances which warrant departure from this position without detriment to prudential safety, trustees which undertake the trusteeship of SAFs will not be able to use an approved guarantee or custodian to meet the capital requirements. In assessing adequacy, APRA will have regard among other things to the number and nature of SAFs under management.

Ongoing requirements

19. The minimum net tangible asset requirements under r. 3A.04 must be met on an ongoing basis by trustees as well as at the time a trustee makes its licence application⁵. It is a standard condition on each RSE licence of a public offer class that the trustee continues to meet the requirements under section 29DA at all times. APRA will also continue to require annual audit certification to the effect that the trustee has met at all times during the reporting period the particular net tangible asset requirements under which it was licensed.

⁵ Refer to s. 29E(3) of the SIS Act

⁶ Refer to SPG 200 Risk Management

⁷ Refer to r. 3A.01(a), s. 29B(2)(b) and s. 10(1) of the SIS Act

Trustees satisfying the capital requirements by using a custodian

22. The SIS Act permits trustees holding a public offer class of licence to meet capital requirements through the appointment of a custodian to hold fund assets, provided that the licensee has agreed in writing to comply with written requirements given it by APRA in relation to the custody of assets of each of the RSEs for which it is, or is proposing to be, trustee.⁸
23. In all circumstances where a trustee appoints a custodian, the custodian must be a body corporate which meets the capital requirements specified in s123 of the SIS Act. The custodian agreement should comply with the requirements contained in the APRA Cross Industry Circular No. 1 released in November 2000.
24. Where, under standard public offer licence 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. Where fund administration is undertaken in-house, the indicative minimum amount of liquid assets APRA is likely to impose by way of licence condition is \$250,000, but this may be set at a higher level depending on the nature of the trustee's activities.
25. APRA expects any new entrant to trustee operations applying for a public offer licence and using the custodian conditions to meet the capital requirements of s. 29DA of the SIS Act to have at least the minimum amount of \$100,000 in liquid assets.
26. Where an existing not-for-profit RSE licensee applies to vary its licence class to permit it to act as trustee of a public offer fund and seeks to use the custodian conditions to meet the capital requirements of s. 29DA of the SIS Act but does not have the minimum amount of liquid assets in its own right, APRA will take into account financial resources available to the trustee through the following arrangements:
 - (a) An administration reserve account in the fund provided that, under the governing rules of the fund, the reserve account is able to be used by the trustee to ensure its solvency and support its business operations and that, even after such use, the reserve has a minimum balance of \$100,000 or such higher minimum amount specified by APRA in the licence condition.
 - (b) A line of credit from an Approved Deposit Taking Institution (ADI), including where a third party provides the ADI with security for the line-of credit. No direct or indirect recourse to fund assets would be permitted in such cases.
 - (c) The minimum amount being made available by an external service provider, generally by way of a bank account in the name of, and under the control of, the RSE licensee.
27. APRA may consider a proposal whereby a service provider was to maintain a deposit of the required amount in an at call account with an ADI in the sole name of the trustee for the use of the trustee to ensure the ongoing solvency of the trustee and to support the business operations of the trustee. APRA would expect the required amount to be sourced from monies of the service provider and not directly or indirectly by calls on the monies of the fund. Specific licence conditions would require this arrangement to be agreed to in writing by the service provider as part of the service agreement with the trustee. APRA would also expect the trustee to hold trustee liability and professional indemnity insurance at a sufficient level so it can meet any reasonably foreseeable trustee liabilities not reimbursable from the fund.⁹

⁸ Refer to s.29DA(5) of the SIS Act

⁹ See also SPG 200 Risk Management

28. In a case where APRA had permitted a related third party service provider to hold the minimum liquid assets in its own name, the AAT found¹⁰ that there could be no higher obligation on the trustee than to ensure that its contract required the third party to meet the minimum liquid asset requirement. It noted that the RSE licensee'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. On this basis, APRA does not expect to permit such arrangements in future.
29. Where APRA accepts one of the arrangements outlined in paragraphs 26 and 27 above as an alternative to the requirement to hold the minimum amount of liquid assets, the standard RSE licence condition will be replaced by a specific condition tailored to the circumstances of the trustee.
30. Where a trustee levies ongoing trustee or administration fees, and these fees are paid to the trustee by the fund, they represent revenue of the trustee. To the extent the trustee does not use this fee revenue to meet its immediate expenses, the accumulated operating surplus would be available to the trustee to meet the APRA minimum liquid assets requirement.
31. It would be inconsistent with a trustee's fiduciary obligations for it to seek to apply a one-off administration levy or trustee fee on a fund in order to obtain the minimum level of liquid assets set by APRA for licensing purposes. APRA does not consider that the deduction of money from a fund and the giving of it to the trustee for the purposes of assisting the trustee obtain a licence or to restore it to a state of compliance with its licence conditions can be reasonably characterised as the expenditure of money to meet the operational expenses of the fund or as an expense which meets the standard trustee indemnity provisions in a fund's governing rules.
32. An RSE licensee which uses the appointment of a custodian to meet the capital requirements of section 29DA will not be permitted to be trustee of Small APRA Funds (SAFs) and will have the entities for which it may be trustee listed on its licence. Where the licensee wishes to undertake trusteeship of any entities not listed on its licence the RSE licensee will need to apply to APRA for a variation of its licence.

Approved guarantees

33. One of the options by which the SIS Act permits RSE licensees of a public offer class to meet capital requirements is through the licensee being entitled to the benefit of an approved guarantee. Further, where a holder of a public offer RSE licence meets the capital requirements through the use of a custodian, the custodian's capital requirement may be met in whole or in part by way of its entitlement to an approved guarantee. The definition of approved guarantee within the SIS Act enables APRA to determine requirements for such guarantees¹¹. Determinations made for this purpose for both licensees and custodians, together with the relevant explanatory memoranda, can be found on the APRA website at:

<http://www.apra.gov.au/Superannuation/Superannuation-Legislation.cfm>

under the heading SIS Act – Determination of requirements for an Approved Guarantee.

¹⁰ AATA 580 of 2008, VCA et al and APRA

¹¹ Refer to s. 10(1) and s.11E of the SIS Act



Telephone
1300 13 10 60

Email
contactapra@apra.gov.au

Website
www.apra.gov.au

Mail
GPO Box 9836
in all capital cities
(except Hobart and Darwin)