



Discussion Paper

Prudential standards for superannuation


28 September 2011

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Preamble

This discussion paper describes APRA's proposed approach to introducing prudential standards for the superannuation industry to implement those elements of the Government's Stronger Super reforms that come within APRA's mandate.¹

The Assistant Treasurer and Minister for Financial Services and Superannuation announced on 21 September 2011 that APRA is to be given prudential standards-making power for prudentially regulated superannuation entities.

APRA is inviting comments on the proposals in this paper. Following consideration of submissions received, APRA will release for consultation, early in 2012, draft prudential standards and draft reporting standards, reporting forms and instructions.

The prudential standards for superannuation are expected to be finalised during 2012 with a view to commencement during 2013.

APRA expects to commence the authorisation process in the second half of 2012 for RSE licensees wishing to offer MySuper products. This will allow these products to be made available to beneficiaries from 1 July 2013 onwards. It is expected APRA will have power to authorise MySuper products from 1 January 2013, effective 1 July 2013.

This discussion paper is available on APRA's website at www.apra.gov.au. Written submissions on the paper should be forwarded to superannuation.policy@apra.gov.au by 23 December 2011 and addressed to:

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Important

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Submissions may be the subject of a request for access made under the *Freedom of Information Act 1982* (FOIA). APRA will determine such requests, if any, in accordance with the provisions of the FOIA.

Information in the submission about the regulated entity which is not in the public domain will be protected by section 56 of the *Australian Prudential Regulation Authority Act 1998* and therefore will ordinarily be exempt from production under the FOIA.

¹ <http://strongersuper.treasury.gov.au/content/Content.aspx?doc=home.htm>

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Executive summary

The Government has announced that it will release draft legislation to establish APRA's ability to make prudential standards in relation to superannuation in the *Superannuation Industry (Supervision) Act 1993* (SIS Act).² This discussion paper outlines APRA's proposals for prudential standards in superannuation.

APRA intends to introduce prudential standards covering topics common to other APRA-regulated industries as well as superannuation-specific topics.

Prudential standards extended to the superannuation industry from current banking and insurance prudential standards:

Governance
Fit and proper
Outsourcing
Business continuity management
Risk management
Audit and related matters

Prudential standards specifically for superannuation:

Investment governance
Conflicts of interest
Defined benefit funding and solvency
Operational risk financial requirement
Insurance in superannuation
Transition to MySuper

The proposals contained in this discussion paper include the Stronger Super reforms that the Government has recommended APRA implement in prudential standards. The proposals also include relocating some current requirements and guidance into the new prudential standards. APRA intends to harmonise the requirements for superannuation with those applying to other APRA-regulated industries, where appropriate.

APRA recognises that the nature, size and complexity of entities vary across any industry. Determination of prudential requirements in the form of prudential standards allows APRA to apply appropriate flexibility to reflect that variation, avoiding a 'one-size-fits all' approach. APRA's emphasis is on achieving sound prudential outcomes, without specifying or prescribing the exact manner in which those outcomes are achieved. This approach should result in prudential requirements that are more likely to effectively address the risks faced by participants in the industry and avoid unnecessary compliance costs.

APRA's practice is to issue guidance material in prudential practice guides (PPGs) to accompany prudential standards. Details of some key areas of proposed guidance are outlined in this paper. APRA will consult on the detail of the draft prudential standards and PPGs in due course.

Governance-related prudential standards

Chapters 3, 4, 5 and 11 of this discussion paper outline APRA's proposals for governance-related matters.

Stronger Super highlights that registrable superannuation entity licensees (RSE licensees) should be required to meet heightened obligations relative to current requirements. This reflects both the fiduciary obligation owed to beneficiaries and the mandatory character of superannuation. APRA's proposals focus on minimum requirements for the processes and policies that RSE licensees should have in place as robust governance arrangements. These include a board renewal policy, a board performance assessment process, a conflicts management framework, a 'fit and proper' policy and an internal audit function.

² <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2011/131.htm&pageID=003&min=brs&Year=&DocType>

Risk management-related prudential standards

Effective risk management is a cornerstone of APRA's prudential requirements across all APRA-regulated industries.

Chapters 6, 7, 9 and 12 of this discussion paper provide proposals for risk management, outsourcing, the operational risk financial requirement and business continuity management respectively. The existing requirements for risk management and outsourcing in the SIS Act and *Superannuation Industry (Supervision) Regulations 1994* provide a basis for prudential requirements in these areas. Stronger Super recognises that the requirements inadequately reflect industry risks as they have evolved over time, and so need updating and strengthening.

APRA's proposals for risk management shift the emphasis from documenting risk management strategies and plans to implementation of a holistic risk management framework. The framework includes comprehensive documents but would also require RSE licensees to articulate their risk appetite, align business planning with risk management and maintain a dedicated risk management function. These requirements will assist RSE licensees in achieving better identification, management and monitoring of their risks.

Superannuation is a highly outsourced industry. Stronger Super supports heightened requirements for RSE licensees that rely upon outsourced service providers. APRA proposes a prudential standard on outsourcing that will apply to RSE licensees dealing with outsourced providers of material services. In addition to the existing outsourcing requirements, which focus on the content of the outsourcing agreement for material business activities, APRA's proposals include broader requirements for due diligence, approval and ongoing monitoring of service providers by RSE licensees.

Stronger Super includes a risk-based financial requirement for managing operational risk. Chapter 9 of this discussion paper provides APRA's proposals to support this new obligation. In particular, APRA proposes that RSE licensees determine the appropriate level of financial resources to address the operational risks in registrable superannuation entities (RSEs) under their trusteeship. This is to better ensure that the costs of resolution, if and when these risks eventuate, are not entirely borne by the current members of an RSE.

Under Stronger Super, RSE licensees will be required to develop and implement a strategy for managing and maintaining these financial resources. APRA's proposals for this strategy require RSE licensees to document the processes and policies that they adopt for identifying operational risks and assessing the amount of operational risk financial resources to be held in relation to those risks. The strategy will also need to outline the policy for maintaining the target amount of operational risk financial resources and determining the manner and circumstances in which they may be applied to meet operational risk losses.

Investment governance prudential standard

Managing the investments of an RSE is a core responsibility of RSE licensees. Stronger Super includes heightened requirements for RSE licensees when managing all investment options and provides for higher obligations for RSE licensees that manage MySuper investments.

APRA's proposed prudential requirements for investment governance complement the Stronger Super reforms. As Chapter 8 of this discussion paper describes, the investment governance standard will require RSE licensees to document clear investment objectives for all investment options, the processes and criteria used when formulating an investment strategy, including the selection of investment managers, and the processes for monitoring investments in each investment option. These requirements support legislative obligations of RSE licensees to formulate and give effect to investment strategies.

Stronger Super places a greater emphasis on liquidity management and the accuracy and timeliness of valuations. APRA's proposals require RSE licensees to consider liquidity risks and the independence and integrity of valuation information when selecting investments, and on an ongoing basis, so that benefits can be paid when they come due.

APRA will also consult on other elements of the implementation of Stronger Super in 2012, including the authorisation process for RSE licensees to offer MySuper products and enhancements to the statistical collections and publications for superannuation.

Other prudential standards

Although the majority of superannuation funds offer accumulation benefits, some RSE licensees operate defined benefit funds. Certain obligations are unique to defined benefit funds and Chapter 10 of this discussion paper provides the details for the proposed prudential standard on defined benefit funding and solvency. The proposals include requirements to raise the required funding level to the vested benefits level, in accordance with the announced Government policy, as well as introduce requirements for self-insurers and defined benefit funds in technical insolvency.

Stronger Super requires that life insurance and total and permanent disability insurance be offered to all members on an opt-out basis.³ Chapter 13 of this discussion paper provides details of the proposed prudential standard on insurance in superannuation, in particular, minimum requirements for an insurance strategy.

Next steps

APRA is seeking comments on the proposals for the suite of superannuation prudential standards outlined in this discussion paper. Subject to the passage of the legislative amendments proposed by the Government and feedback received in response to this discussion paper, APRA intends to release draft prudential standards for consultation in early 2012, with a view to finalising the prudential standards later that year. APRA will also consult on draft PPGs to support the proposed prudential standards in due course.

³ Refer to Stronger Super Information Pack, 21 September 2011, pp6-7; http://strongersuper.treasury.gov.au/content/Content.aspx?doc=publications/information_pack/default.htm

Glossary

APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ATO	Australian Taxation Office
BCM	Business continuity management
BCP	Business continuity policy
CEO	Chief Executive Officer
Corporations Act	<i>Corporations Act 2001</i>
DB fund	Defined benefit fund
FSCODA	<i>Financial Sector (Collection of Data) Act 2001</i>
MySuper RSE licensee	An RSE licensee that has an authorisation to offer MySuper products
PPG	Prudential practice guide
The Review	<i>Review into the Governance, Structure and Operation of Australia's Superannuation System</i> also known as <i>The Super System Review</i>
RMP	Risk management plan
RMS	Risk management strategy
RSE	Registrable superannuation entity as defined in s. 10 of the SIS Act
RSE licensee	A constitutional corporation, body corporate, or group of individual trustees, that holds an RSE licence granted under s. 29D of the SIS Act
SG Act	<i>Superannuation Guarantee (Administration) Act 1992</i>
SIS Act	<i>Superannuation Industry (Supervision) Act 1993</i>
SIS Regulations	<i>Superannuation Industry (Supervision) Regulations 1994</i>
SMSF	Self-managed superannuation fund
Stronger Super	Government's response to the Review (December 2010) and additional Information pack (September 2011)
TPD insurance	Total and permanent disablement insurance

Proposed prudential standards

SPS 114	<i>Prudential Standard SPS 114 Operational Risk Financial Requirement</i>
SPS 160	<i>Prudential Standard SPS 160 Defined Benefit Funding and Solvency</i>
SPS 220	<i>Prudential Standard SPS 220 Risk Management</i>
SPS 231	<i>Prudential Standard SPS 231 Outsourcing</i>
SPS 232	<i>Prudential Standard SPS 232 Business Continuity Management</i>
SPS 250	<i>Prudential Standard SPS 250 Insurance in Superannuation</i>
SPS 310	<i>Prudential Standard SPS 310 Audit and Related Matters</i>
SPS 410	<i>Prudential Standard SPS 410 Transition to MySuper</i>
SPS 510	<i>Prudential Standard SPS 510 Governance</i>
SPS 520	<i>Prudential Standard SPS 520 Fit and Proper</i>
SPS 521	<i>Prudential Standard SPS 521 Conflicts of Interest</i>
SPS 530	<i>Prudential Standard SPS 530 Investment Governance</i>

Chapter 1 – Introduction

On 29 May 2009, the Government commissioned the Super System Review (the Review) to comprehensively examine and analyse the governance, efficiency, structure and operation of Australia's superannuation system. The Review was conducted with a focus on the concepts of the best interests of beneficiaries and maximising retirement incomes for Australians. The Review's objectives were also to improve regulation of the superannuation system, whilst also reducing business costs within the system.⁴ The Review's final report was provided to the Government on 30 June 2010.

The Government's response to the recommendations of the Review (Stronger Super) aimed at delivering better outcomes for members and their employers through a range of measures. These include enhancing requirements and responsibilities for superannuation trustees and providing APRA and other regulators with improved tools and powers.⁵

1.1 Prudential standards and associated guidance material for superannuation

Stronger Super supports the Review's recommendation that the Government give APRA the power to issue prudential standards in relation to superannuation. The Government has announced that it will release draft legislation to establish APRA's ability to make prudential standards in relation to superannuation in the *Superannuation Industry (Supervision) Act 1993* (SIS Act).⁶ The Review recommended that APRA be provided this power as it recognised the need for a more finely calibrated capacity for APRA to supervise and regulate the superannuation industry.

This paper introduces APRA's proposed approach to implementation of prudential standards for superannuation. It sets out, in particular, the range of

topics to be covered in prudential standards and the key requirements APRA expects to include in each standard.

APRA expects that draft prudential standards will be released for consultation in early 2012. Final prudential standards are expected to be released later in 2012, subject to the passage of legislative amendments proposed by the Government.

APRA's practice is to provide guidance material to accompany prudential standards. In superannuation there is a range of existing guidance material, including prudential practice guides (PPGs), circulars, letters and frequently asked questions. APRA no longer issues guidance notes or circulars. Instead, all guidance material is issued as PPGs. PPGs assist APRA-regulated entities in complying with requirements outlined in the prudential standards and, more generally, outline prudent practices. PPGs do not contain enforceable requirements.

APRA proposes that some elements of existing guidance will be included as mandatory obligations in prudential standards. Remaining guidance material will, where appropriate, be revised and consolidated into a set of PPGs.

Details of some key areas of proposed guidance material are outlined throughout this discussion paper. APRA expects that draft PPGs will be released for consultation in 2012 and will be finalised once the prudential standards have been finalised.

1.2 Other reforms

1.2.1 MySuper

A new superannuation product called MySuper is one of the major reforms to be introduced under Stronger Super. MySuper products will be able to be offered to members from 1 July 2013 and will replace the current default investment options from 1 October 2013.

⁴ www.supersystemreview.gov.au/content/terms_of_reference.aspx

⁵ <http://strongersuper.treasury.gov.au/content/Content.aspx?doc=publications.htm>

⁶ <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2011/131.htm&pageID=003&min=brs&Year=&DocType>

The majority of the proposed content of the prudential standards applies to RSE licensees regardless of whether they offer MySuper products, choice products⁷ or both. MySuper requirements relating to investment governance and insurance management are addressed in Chapters 8 and 13 of this discussion paper, respectively.

APRA proposes to introduce a transitional *Prudential Standard SPS 410 Transition to MySuper* to outline requirements for all RSE licensees during the transition period from 1 July 2013 to 1 July 2017, by which date all existing balances of their default members must be in a MySuper product except in limited circumstances. This standard is expected to include, at a minimum, requirements:

- to identify default members and their existing default balances;
- for those registrable superannuation entities (RSEs) with default members and their existing default balances, to develop and execute a transition plan that, among other things, determines when existing default balances will be transferred to a specified MySuper product;
- to explain how the transfer will be in the best interests of beneficiaries; and
- to develop and execute a communication plan to members and employers about the MySuper transition plan.

APRA also expects to introduce reporting requirements to assist the transition to MySuper. These requirements are likely to cover data items related to the transfer of default member contributions and existing default balances, and will be consulted on as part of the consultation on draft reporting standards and forms.

1.2.2 MySuper authorisation

Existing licensing framework

The SIS Act and SIS Regulations empower APRA to issue RSE licences that entitle an RSE licensee to act as the trustee of various classes of RSEs or of named entities. These licences permit the holder to be the RSE licensee of one or more RSEs of the type, or types, specified in the licence. The current licence classes are public offer, non-public offer, extended public offer and acting trustee. This framework ensures that RSE licensees need only hold one licence, regardless of how many RSEs might be under their trusteeship.

Authorisation for MySuper

APRA will authorise, under new legislative provisions in the SIS Act, RSE licensees to offer MySuper products. RSE licensees will be able to apply for authorisation to offer MySuper products in an RSE where that RSE is not a pooled superannuation trust, eligible rollover fund or an approved deposit fund or a fund with fewer than five members. RSE licensees that meet specific legislative criteria may apply to offer more than one MySuper product per RSE. The RSE licensee's authorisation would specify the MySuper product that the RSE licensee is permitted to offer. RSE licensees that are granted the necessary authorisation to offer MySuper products are referred to throughout this paper as MySuper RSE licensees.

APRA expects that the applicants seeking to offer MySuper products will largely comprise existing RSE licensees. RSE licensees that receive authorisation to offer a MySuper product will not be prevented from also offering choice products. Further, MySuper products will be able to be provided in both non-public offer RSEs and public offer RSEs.

APRA will consult on proposed MySuper authorisation requirements in mid 2012.

⁷ A choice product is any superannuation product offering that is not a MySuper product.

1.2.3 Scale and efficiency

One element of Stronger Super is that MySuper RSE licensees will be required to actively examine and attest on an annual basis whether their MySuper product(s) and RSE(s) have sufficient scale.

APRA proposes that scale and efficiency would be reviewed as part of its prudential supervision, with the RSE licensee to consider whether both the MySuper product and RSE continue to fulfil the RSE licensee's obligation to act in the best financial interests of beneficiaries. Supervisory oversight of trustee governance, investment governance, risk management, operational risk financial requirements, business continuity management (BCM) and fitness and propriety will also take into account the size and nature of the MySuper product. APRA's supervision will provide the RSE licensee with the opportunity to demonstrate how they have concluded that the MySuper product continues to meet the obligations in the legislation.

1.2.4 Enhanced data collection

In May 2009, APRA consulted on proposed amendments to the reporting obligations for superannuation. These proposals were put on hold pending completion of the Review. APRA will recommence its work on enhanced data collection in light of the data requirements supporting Stronger Super. The revised data collection proposals will be subject to separate consultation in mid 2012.

1.3 Structure of this paper

This discussion paper provides:

- an overview of the proposed prudential framework, including an introduction to the role and structure of prudential standards (Chapter 2); and
- a more detailed discussion of key issues in each of the topic areas for the proposed prudential standards and PPGs (Chapters 3 – 13). These chapters do not cover all of the proposed content of the prudential standards and related PPGs. Consultation on the draft prudential standards and PPGs will be undertaken in 2012.

Chapter 14 contains a request for information on the cost-benefit impacts of APRA's proposals.

Chapter 2 – Prudential standards

2.1 Objectives of prudential standards

The Government has announced that APRA is to be given a general prudential standards-making power in relation to superannuation in the SIS Act.

APRA therefore proposes to determine new prudential standards for superannuation that will apply to RSE licensees. Prudential standards will not apply to the trustees of self-managed superannuation funds (SMSFs) or exempt public sector superannuation schemes, which are not regulated by APRA.

A number of factors have influenced the proposals contained in this paper:

- Stronger Super has referred to APRA a number of specific reforms to be implemented in prudential standards. Further, there are a number of proposed amendments to the SIS Act that will be supported by the principles-based requirements that APRA determines in prudential standards;
- APRA seeks to harmonise requirements applying across APRA-regulated industries, where appropriate;
- the absence of a prudential standards-making power in superannuation has meant that a number of prudential requirements are currently located in legislation and operating standards. Subject to the necessary amendments to the SIS Act and SIS Regulations being made, APRA proposes to bring those obligations into prudential standards to the extent feasible. In a number of areas, the substance of the prudential requirements will not change even though the location and presentation of the requirements will be amended; and
- APRA's previous guidance to industry has taken many forms, such as PPGs, circulars, letters and frequently asked questions. APRA intends to review the entire suite of guidance material. Some matters will become requirements in the prudential standards. The remainder of the guidance material that continues to be relevant will be incorporated into PPGs.

In determining prudential requirements, APRA recognises that the nature, size and complexity of entities vary across any industry. Prudential standards allow for appropriate flexibility, avoiding a 'one-size-fits all' approach to regulation. APRA's emphasis is on sound prudential outcomes, without specifying or prescribing the exact manner in which those outcomes are to be achieved.

APRA will consult extensively on the draft prudential standards, as well as any necessary transitional arrangements, in 2012.

2.2 Stronger Super: Prudential standards-making power

The Government's announcement of a new prudential standards-making power in the SIS Act will provide APRA with similar powers in superannuation to those it has been granted under the *Banking Act 1959*, the *Insurance Act 1973* and the *Life Insurance Act 1995* (the industry specific Acts).

APRA's power to issue prudential standards is based on the concept of 'prudential matters'; standards can be determined where they cover topics that fall within the definition of prudential matters. It is expected that the definition of 'prudential matters' in the SIS Act will be broadly consistent with the industry-specific Acts.

2.3 Current framework

Stronger Super confirms the approach of managing the superannuation benefits of Australians within a trust structure, where additional legislative requirements reinforce the trust law duty of trustees to act in the best interests of their beneficiaries.

The current superannuation framework includes primary legislation in the form of the SIS Act, subordinate legislation in the form of the SIS Regulations and modification declarations, and a collection of non-enforceable supporting guidance material issued by APRA.

Section 6 of the SIS Act sets out which provisions are administered by APRA, the Australian Securities and Investments Commission (ASIC) and the Australian Taxation Office (ATO). Requirements in the SIS Act administered by APRA can be loosely grouped into four categories: high-level obligations for trustees; prudential matters; high-level definitions; and enforcement powers.

Some of the operating standards contained in the SIS Regulations administered by APRA can be described as primarily relating to prudential matters. Some of the modification declarations issued to date also cover prudential matters.

Existing material issued by APRA focuses on providing guidance on a wide range of prudential matters. If APRA previously had prudential standards-making power for superannuation, a number of these matters would have been determined as enforceable requirements in prudential standards rather than being issued as guidance.

2.4 Proposed framework

The proposed framework for the prudential regulation of superannuation reflects the three-tiered approach that applies in other APRA-regulated industries, namely:

- primary legislation, being the SIS Act, which outlines high-level obligations, high-level definitions and enforcement powers;
- subordinate legislation, in the form of relevant SIS Regulations and prudential standards, which contain more detailed requirements on prudential matters; and
- guidance material, in the form of PPGs, which supports the obligations and requirements contained in the primary and subordinate legislation, in particular, APRA's prudential standards.

Under the proposed framework, existing high-level obligations in the SIS Act administered by APRA in relation to the activities of RSE licensees (e.g. s. 52 and s. 56), high-level definitions (e.g. s. 10) and enforcement powers (e.g. Part 17) would remain in the SIS Act.⁸

The Government has announced that it will release draft legislation to make necessary consequential amendments to legislation and regulations to support APRA's prudential standards. This will enable APRA to reframe legislative provisions as requirements in the prudential standards. Provisions in the SIS Act administered by ASIC and the ATO would not be directly affected by the introduction of APRA's prudential standards.

It is expected that the consequential amendments to the SIS Regulations will allow APRA to determine in prudential standards provisions that can be classed as prudential matters. SIS Regulations administered by ASIC and the ATO would not be affected. Where a regulation is expressed to apply to both APRA-regulated funds and SMSFs, it is expected that the regulation would be restated to apply only to SMSFs.

The content of some modification declarations, certain licence conditions and matters currently contained in APRA's guidance material that APRA believes should be mandatory, are proposed to be included within prudential standards. Material that APRA considers should remain as guidance will be moved into new or revised PPGs.

2.5 Suite of prudential standards

APRA's prudential standards applying to other APRA-regulated industries can be broadly classified as behavioural standards and technical standards.

⁸ The provisions that apply to trustees of SMSFs will be amended only to the extent necessary to implement other relevant Stronger Super reforms applying to SMSFs.

The behavioural standards cover risks that relate to the behaviour of the board and management of APRA-regulated entities. These risks are essentially identical across the APRA-regulated industries and, to the extent appropriate and achievable, 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.

APRA recently released cross-industry prudential standards for the authorised deposit-taking institution (ADI) and insurance industries relating to outsourcing, BCM, governance and fitness and propriety.⁹ These consolidated prudential standards will apply to ADIs, general insurers, life companies (including friendly societies) and authorised and registered non-operating holding companies. APRA does not propose to apply these consolidated standards to the superannuation industry at this stage. However, as discussed in the following chapters of this discussion paper, APRA proposes to harmonise the requirements for superannuation with these consolidated standards where appropriate.

Technical standards cover risks that are specific to each industry and hence are most appropriately addressed in prudential standards that are specific to each industry.

Attachment A of this discussion paper compares the proposed suite of prudential standards for superannuation with the behavioural prudential standards applying to the other APRA-regulated industries.

⁹ *Prudential Standard CPS 510 Governance (CPS 510), Prudential Standard CPS 520 Fit and Proper (CPS 520), Prudential Standard CPS 231 Outsourcing (CPS 231) and Prudential Standard CPS 232 Business Continuity Management (CPS 232).*

Chapter 3 – Governance

3.1 Objectives of governance prudential requirements

Governance has been described as ‘the framework of rules, relationships, systems and processes within and by which authority is exercised and controlled’ within an entity.¹⁰ This encompasses the mechanisms by which a board¹¹ and individuals who control the entity are held accountable, set and achieve objectives, monitor and assess risks and optimise performance.

In the context of RSE licensees, effective governance arrangements promote the interests of beneficiaries of RSEs. They ensure that RSE licensees and their individual directors meet their legal obligations in a manner that meets the reasonable expectations of beneficiaries.

Stronger Super confirms that RSE licensees, as trustees, should be required to meet heightened obligations relative to current requirements. This reflects both the fiduciary obligation owed to beneficiaries and the mandatory character of superannuation.

RSE licensees must maintain governance arrangements that are appropriate to the nature, scale and complexity of their operations.

The proposals outlined in this chapter incorporate requirements arising out of Stronger Super. They also harmonise where appropriate the governance obligations applying to superannuation with those applying to other APRA-regulated industries.

3.2 Existing requirements

There is a range of existing requirements that influence the governance of RSE licensees and the RSEs under their trusteeship. These encompass general law duties, the covenants contained in s. 52 of the SIS Act, general director duties as articulated in the *Corporations Act 2001* (Corporations Act) and the trustee composition obligations for standard employer-sponsored funds contained in Part 9 of the SIS Act. Also relevant to an RSE licensee’s governance are obligations to manage conflicts of duty and interests and fitness and propriety considerations.

Section 29H(2)(a)(i) of the SIS Act further requires that the risk management strategy of an RSE licensee must set out reasonable measures and procedures such that the board is able to identify, monitor and manage the risks associated with governance and decision-making processes. APRA imposes further obligations in standard licence conditions relating to board size and composition. These obligations are supported by APRA-issued guidance.¹²

3.3 Stronger Super

Stronger Super has announced a number of reforms that will affect the governance arrangements of RSE licensees. These include greater clarity about the duties of both RSE licensees and their individual directors, as well as the management of conflicts of interest and fitness and propriety of key persons. In addition to the proposals in this Chapter, these recommendations are discussed in Chapters 4 and 5 of this discussion paper, respectively.

¹⁰ Refer to *Corporate Governance Principles and Recommendations with 2010 Amendments*, (2nd edition, ASX Corporate Governance Council) page 3 and the Review, page 49.

¹¹ Throughout this paper, references to the board should be read to include both boards of trustee corporations as well as groups of individual trustees. In addition, references to a director should be read to include directors of trustee corporations as well as individuals in a group of individual trustees.

¹² Refer to *Superannuation Circular III.A.2 Trustee Arrangements for Superannuation Funds other than Public Offer Funds and Superannuation Circular III.A.3 Trustee Arrangements – Public Offer Superannuation Funds*.

Stronger Super also affirmed the role of equal representation requirements for RSE licensees of standard employer-sponsored funds. The rules for equal representation, as contained in Part 9 of the SIS Act, vary depending on the type and size of the fund, including whether or not the fund is a public offer fund. RSE licensees of RSEs that are not standard employer-sponsored funds do not have to comply with the equal representation requirements.

The Government has also expressed support for a voluntary code of governance developed by industry.

3.4 Proposed Prudential Standard SPS 510 Governance

An RSE licensee is ultimately responsible for the sound management of each RSE under its trusteeship in the interests of beneficiaries. Accordingly, the RSE licensee must manage the RSE to meet the requirements imposed by the general law, legislation, prudential standards and the governing rules of the RSE.

The focus of APRA's proposed governance prudential standard is on establishing minimum requirements for how RSE licensees govern themselves to ensure that they conduct their affairs with a high degree of integrity. A framework that promotes good governance benefits beneficiaries of an RSE and helps to maintain public confidence in the RSE licensee's operations. The proposed minimum requirements reflect good practice and, where appropriate, the obligations that apply to other APRA-regulated industries.¹³

Key matters that APRA proposes to include in draft *Prudential Standard SPS 510 Governance* (SPS 510) and related guidance are outlined below.

3.4.1 Independence of directors

Stronger Super confirms that, beyond the existing regulatory framework, board composition is a matter that should be left to the discretion of the RSE licensee. Accordingly, APRA does not propose to include a requirement in SPS 510 that RSE licensees have a minimum number of independent directors on its board. However, APRA does consider it appropriate to encourage a higher standard of governance through guidance. This guidance would apply equally to all RSE licensees to the extent that it is consistent with the equal representation requirements in the SIS Act.

Proposed PPG guidance

APRA proposes to issue guidance to support an RSE licensee's considerations when determining the composition of its board.

At present s. 10 of the SIS Act contains a definition of 'independent director' that applies specifically in the context of equal representation requirements. This definition considers a director will only be eligible to act as an independent director on an equal representation board where they are not associated with either the employer-sponsor or the member representatives. It also precludes members of the fund from serving as an independent director.

APRA proposes to introduce (in a new PPG) an objective, principles-based concept of independence with broader application than the existing definition of 'independent director' in s. 10 of the SIS Act.

Specifically, in the context of the PPG, an independent director would be one who is not, and in recent years has not been:

- in an executive role with an employer-sponsor;
- an official or representative of a body that has the right under the governing rules to nominate or appoint directors (or individual trustees) to represent either member or employer interests;
- a director, employee or shareholder of a company related to either a standard employer-sponsor or to the RSE licensee (other than in the case of a wholly owned subsidiary of the RSE licensee); or

¹³ Refer to CPS 510.

- a director, employee or shareholder of a material service provider, whether related or not.

APRA's proposed guidance on independence differs from the definition in the SIS Act. Under APRA's proposed guidance, a director may be considered independent even when they are or were a member of the RSE, as long as they meet the other criteria for independence. Directors that are also members of the RSE can be well-suited to act in the best interests of beneficiaries because there is a natural alignment of interests.

3.4.2 Independence of the Chair

Noting the Government's position on board composition, APRA does not propose to include a requirement in SPS 510 that the Chair of an RSE licensee's board be independent.

Proposed PPG guidance

APRA's guidance will encourage a higher standard of governance by suggesting RSE licensees consider an independent Chair. In particular, APRA does not consider that the Chief Executive Officer (CEO) or a former CEO (within three years of ceasing employment) would be sufficiently independent to act as Chair.

3.4.3 Tenure and renewal policies

The ongoing renewal of boards is central to ensuring that they continue to operate effectively.

Proposed SPS 510 prudential requirement

APRA recognises that benefits arise from having experienced directors on a board. However, there also needs to be appropriate recognition of the benefits that can flow from having new thinking and perspectives on a board.

APRA does not propose to specify in SPS 510 a maximum tenure for directors. This is consistent with the approach taken in other APRA-regulated industries.

APRA proposes to require in SPS 510 that an RSE licensee must put in place a Board renewal policy. Under this requirement, an RSE licensee would be required to define an appropriate maximum term for its directors. Where an RSE licensee considers it appropriate for an individual director to serve a term longer than the maximum stated in its policy, the board needs to be able to demonstrate to APRA why this longer term is appropriate.

The RSE licensee's board renewal policy would be reviewed as part of APRA's normal supervisory processes. In addition to the requirement to specify a maximum tenure, APRA proposes that the minimum features of such a policy include:

- a clear statement of how the RSE licensee intends to ensure that the board remains open to new ideas and independent thinking while retaining adequate expertise;
- consideration of whether the period of service of a director could reasonably be perceived to materially interfere with their ability to act in the best interests of beneficiaries; and
- the process for appointing and removing directors (or individual trustees), including member or employer representatives.

3.4.4 Board assessment processes

Ongoing assessments of performance and effectiveness, both of the board as a whole and of individual directors, are critical to ensure that duties are discharged effectively – in particular, the duties that both RSE licensees and their individual directors owe to beneficiaries.

Proposed SPS 510 prudential requirement

APRA proposes to include a requirement in SPS 510 that an RSE licensee maintain formal procedures for completing a regular independent and objective assessment of performance. This would cover performance of the board (including any committees of the board) and individual directors. This requirement is consistent with the requirements that apply to other APRA-regulated entities.

This assessment would take place at least annually. The detail of the assessment procedures would be left to the discretion of RSE licensees, with the adequacy of these arrangements to be reviewed as part of APRA's supervision.

Proposed PPG guidance

In APRA's view, external assessments can provide more robust assessments of performance because of the greater independence of the assessor. However, APRA does not propose to mandate that RSE licensees engage external assessors.

Internal assessments would be undertaken following a suitably independent process, where possible. APRA intends to provide guidance on better practice processes that improve the effectiveness and objectivity of such assessments.

3.4.5 Use of Board Committees

Entities in other APRA-regulated industries are required to have in place a Board Audit Committee. This committee is responsible for monitoring compliance with a board's policies, prudential and statutory requirements, as well as for oversight of financial reporting, internal and external audits and the appointment of the external auditor. APRA places requirements on the composition of this committee to assist the board by providing an objective, non-executive review of the effectiveness of the entity's risk management and control processes. These requirements are consistent with the approach contained in the ASX Governance principles.¹⁴

Proposed SPS 510 prudential requirement

APRA proposes to include a requirement in SPS 510 that RSE licensees have a Board Audit Committee, comprising only non-executive directors of the RSE licensee. This reflects the requirement in CPS 510 and supports suitable independence of this oversight function from the management of the RSE licensee. The Board Audit Committee would be required to have a charter that clearly sets out its roles and responsibilities, including responsibility for:

- monitoring compliance with the board's policies and prudential and statutory requirements;
- ensuring appropriate systems and controls are in place to identify and address the risks arising from the RSE licensee's activities;
- instilling a strong risk management culture throughout the RSE licensee; and
- overseeing financial reporting, internal and external audits and recommending external auditor appointments.

Consistent with the requirements applying to other industries, it would be open to the RSE licensee to nominate the entire board to act as the Board Audit Committee, subject to discussion with APRA. Further, to facilitate the objective oversight role of the committee, APRA proposes to require that the Chair of this committee be a person other than the Chair of the board, unless the Chair was the sole independent director.

Proposed PPG guidance

Reflecting the fact that not all boards have independent directors, APRA does not propose to require independent directors on the Board Audit Committee. Where a board has one or more independent directors, APRA's expectation is that the Board Audit Committee would include at least one of these independent directors, and that the Chair of the Board Audit Committee be an independent director.

¹⁴ *Corporate Governance Principles and Recommendations with 2010 Amendments*, (2nd edition, ASX Corporate Governance Council).

APRA recognises that a range of board committee structures is employed across the superannuation industry. Accordingly, the RSE licensee would be free to determine whether the minimum functions of the Board Audit Committee might be performed in part by a Board Risk Committee, subject to the requirements of the prudential standard being met. APRA intends to provide guidance on factors RSE licensees may consider in determining whether multiple committees are appropriate.

Further, APRA expects that RSE licensees would ensure that the Board Audit Committee has at least one member with financial, auditing or accounting qualifications, skills and relevant experience.

3.4.6 Remuneration

Remuneration practices should not encourage unsound risk-seeking behaviour. APRA has included principles and guidance for the effective management of remuneration arrangements in the governance prudential frameworks for its other regulated industries.

CPS 510, which sets out APRA's governance standards applicable to the other APRA-regulated industries, requires each regulated entity to establish a Board Remuneration Committee comprised of a majority of independent directors with the requisite skills and knowledge to perform its functions. This Committee must review the regulated institution's remuneration policy periodically and make recommendations to the board on the policy and the remuneration of all responsible officers.

Consistent with this approach, APRA proposes a principles-based approach for superannuation aimed at encouraging compliance with the intent and substance of APRA's remuneration requirements. The requirements will not be completely harmonised with those for other APRA-regulated industries due to the different composition of boards as well as the trust structure of superannuation. APRA's view, however, is that having a Board Remuneration Committee, ideally with separate leadership, is important to enable focussed attention on, and separate review of, remuneration matters.

For other APRA-regulated industries, a regulated institution's remuneration policy must ensure that the performance-based components of remuneration encourage behaviour that supports both the entity's long-term financial soundness and its risk management framework. Where there is a contractual arrangement between a regulated entity and its customers, the financial well-being of the customer is dependent on the financial well-being of the entity. Remuneration practices are therefore directed at maintaining the health of the entity directly in the interests of the depositor or policyholder.

The trust structure in superannuation creates a different relationship between the regulated entity and beneficiary. The financial interests of beneficiaries depend upon the financial returns of RSEs rather than being directly tied to the health of the RSE licensee. Also, as an RSE licensee has a right of indemnity from the assets of the RSE in certain circumstances, there is not necessarily congruence between the interests of the RSE licensee shareholders and those of beneficiaries. Including non-executive directors within the scope of the entity's remuneration policy would better align these interests.

Proposed SPS 510 prudential requirement

APRA proposes to require all RSE licensees to establish and maintain a Board Remuneration Committee with the same responsibilities as in CPS 510. Recognising that many RSE licensees lack independent directors, the structure of the Board Remuneration Committee for RSE licensees would not require a majority of independent directors in all circumstances. However, the members of the Board Remuneration Committee must be non-executive directors of the RSE licensee. Further, the Chair of the Board Remuneration Committee would be required to be a person other than the Chair of the Board unless the Chair was the sole independent director. In that case, the question of whether the Board Chair could also chair the Remuneration Committee would be a matter for determination by the board. Boards would be permitted, as discussed in the context of the Board Audit Committee, to nominate the entire board to act as the Board Remuneration Committee.

APRA also proposes that each board would need to have in place a remuneration policy that covers the requirements in CPS 510. This would include 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. The remuneration policy would cover the same parties as stated in CPS 510, but would also cover non-executive directors.

Consistent with Stronger Super's endorsement of enhanced systemic transparency in superannuation, APRA also proposes that SPS 510 require the RSE licensee's remuneration policy to be published in the public section of each fund's web site.

To ensure that beneficiaries, as key stakeholders in superannuation, have access to the same type of remuneration information as is available to shareholders of listed companies, APRA proposes that SPS 510 require publication of the remuneration of responsible officers. Further consideration will be given to the nature of the disclosure to take account of the variety of ways that directors are remunerated in the superannuation industry.

Chapter 4 – Conflicts of interest

4.1 Objectives of prudential requirements on conflicts of interest

Appropriately managing conflicts of duty and interest is essential to ensure that RSE licensees comply with their overarching obligation to act in the best interests of beneficiaries. A robust conflicts management framework should be appropriate to the nature, scale and complexity of an RSE licensee's operations.

APRA's proposals for the management of conflicts incorporate requirements arising out of Stronger Super and consolidate existing guidance relating to conflicts management for RSE licensees.

4.2 Existing requirements

At present, RSE licensees and their individual directors are subject to a number of legal requirements for the management of conflicts of duty and interest that might otherwise impede the sound management of RSEs. These requirements include obligations arising from the statutory covenants in Part 6 of the SIS Act, in particular, the covenants to act in the best interests of beneficiaries and to exercise care, skill and diligence. The activities of RSE licensees are also subject to the general law fiduciary obligations of trustees.

Further, under s. 52(9) of the SIS Act, individual directors of an RSE licensee must exercise a reasonable degree of care and diligence for the purpose of ensuring that the RSE licensee complies with its statutory covenants. Directors must also comply with duties imposed under the Corporations Act and the general law duties of company directors.

APRA's current guidance about the management of conflicts is set out in *FAQ 13.1 – Conflicts of interest*. In 2009, APRA released a draft PPG, *Prudential Practice Guide SPG 521 Conflicts of Interest (SPG 521)* for public consultation but deferred finalising this PPG pending the outcomes of the Review. In developing the requirements for the draft *Prudential Standard SPS 521 Conflicts of Interest (SPS 521)*, APRA intends to take into account the material contained in that draft SPG 521 and the feedback received from the 2009 consultation.

4.3 Stronger Super

Stronger Super implements a number of reforms that affect how RSE licensees manage conflicts of duty and interest.

The key reform is the introduction of requirements applying to directors of RSE licensees and individual trustees to give priority to the interests of beneficiaries where a duty to those beneficiaries conflicts with an interest or other duty of the director or trustee. This obligation to prioritise beneficiaries' interests would apply equally to all RSE licensees.

The Stronger Super reforms will also amend the SIS Act to include a new provision that overrides any provision in the governing rules of an RSE that requires the RSE licensee to use a specified service provider in relation to any services in respect of the RSE. The main effect of this reform is that RSE licensees will no longer be constrained in their duty to act in the beneficiaries' interest because of trust deed provisions that mandate use of a related-party service provider.

The Government has asked APRA to consider whether a prudential standard that covers conflicts of interest and conflicts of duties would assist RSE licensees and their directors to observe their duties to beneficiaries. This chapter outlines the key requirements proposed to be included in APRA's prudential standard.

4.4 Proposed Prudential Standard SPS 521 Conflicts of Interest

An RSE licensee must fulfil its fiduciary and related statutory duties in managing RSEs under their trusteeship. A conflict of duty or interest can arise when an RSE licensee is required to take a decision where a separate personal interest or a duty owed to another party may interfere with the RSE licensee's obligation to act in the best interests of beneficiaries. A conflict may be actual, perceived or potential in nature.

APRA recognises that some conflicts are inherent in the superannuation model and does not seek to eliminate all conflicts. The purpose of the proposed prudential standard is to require RSE licensees to develop appropriate processes to manage these conflicts. RSE licensees must be alert to the circumstances that may give rise to a conflict and hence have the potential to adversely affect their ability to carry out their duties.

APRA proposes to support the prudential standard with guidance material in the form of a revised version of SPG 521, which would include examples of arrangements that may give rise to conflicts.

Key matters that APRA proposes to include in draft SPS 521 and SPG 521 are outlined below.

4.4.1 Conflicts management framework

An RSE licensee must adopt a holistic approach to managing potential and actual conflicts.

Proposed SPS 521 prudential requirement

Similar to the requirement for a risk management framework, APRA proposes that an RSE licensee develop and maintain a conflicts management framework, which comprises a comprehensive system of internal controls and reporting.

This framework would require the RSE licensee to:

- ensure that all directors or individual trustees of the RSE licensee clearly understand the circumstances that might give rise to a conflict, the content and purpose of the conflict management policy (as discussed further below) as well as their obligations as a director of the RSE licensee;
- undertake regular and thorough enquiry to identify any conflicts arising from existing or prospective service providers to the RSE (refer also to the proposals on outsourcing in Chapter 7);
- undertake regular and thorough enquiry to identify any conflicts of duty or interest for existing or prospective service providers where these have the potential to affect the service provider's performance in respect of the RSE (refer also to the proposals on outsourcing in Chapter 7);

- adopt procedures to require the disclosure of interests both at the time of appointment of responsible persons and on an ongoing basis;
- maintain up-to-date registers of relevant gifts, interests and benefits, and other fiduciary and non-fiduciary roles of the RSE licensee and each director (as discussed further below); and
- maintain a record of how actual conflicts are managed at a minimum, in the minutes of Board meetings.

4.4.2 Minimum requirements for a conflict management policy

The Government has indicated that RSE licensees should be required to have a conflicts policy that covers all relevant issues. The purpose of this policy would be to provide a definitive statement about identifying and managing actual, potential and perceived conflicts.

Proposed SPS 521 prudential requirement

APRA proposes that an RSE licensee must have a comprehensive conflict policy containing appropriate measures to satisfy the core obligation to identify and manage conflicts.

APRA proposes that the conflict management policy would cover, at a minimum:

- effective processes to ensure that the RSE licensee monitors and assesses on an ongoing basis all material conflicts, both potential and actual, and takes action as necessary;
- how the RSE licensee identifies and responds to conflicts, e.g. by requiring individual directors to absent themselves from certain affected decisions; and
- adequate disclosure of actual conflicts to members of the RSE, with active consideration of the need for alternative measures where disclosure does not adequately address the risk of a conflicted decision being made.

Proposed PPG guidance

To support the obligation on RSE licensees to identify and respond to conflicts, APRA proposes to include in SPG 521 examples of situations that may give rise to conflicts. These include, for example, where an individual director holds multiple RSE licensee directorships, a single corporate entity is both an RSE licensee and a responsible entity of a managed investment scheme, or where a director who sits on the board of a service provider also sits on the Board.

4.4.3 Registers of duties and interests

Stronger Super supports in principle the recommendation that RSE licensees should be required to develop and maintain a register of all gifts, emoluments and benefits. This includes that the register be subject to a materiality threshold, cover RSE licensees, individual directors and senior management, and be disclosed to APRA annually. This register, and the additional register of duties discussed below, are considered a logical extension of the duty on RSE licensees and individual directors or trustees to avoid conflicts of interest.

The Government has also announced that conflicts registers will be required to be made available to beneficiaries, preferably on the fund website. APRA intends to work with ASIC to develop the most effective means of implementing this requirement.

Proposed SPS 521 prudential requirement

APRA proposes that RSE licensees should be required to maintain two registers: one that outlines all duties of the RSE licensee and duties of each individual director, and the other that lists all material interests of individual directors and senior management (where interests include matters such as gifts, emoluments and benefits).

These conflicts registers are designed to provide an additional layer of rigour in an RSE licensee's conflict management policy. A register of duties creates a centralised list that defines the duties owed to related parties of the RSE licensee that give rise to, or have the potential to give rise to, conflicts of duty. It would also act as a living record of other duties owed by individual directors (including all directorships, executive positions and material shareholdings of companies). The register of interests, on the other hand, would identify all material gifts and benefits provided to directors and senior management. Together these conflicts registers would provide the RSE licensee, as well as APRA, detailed information about where potential conflicts might arise.

These registers would not be required to be submitted to APRA on an annual basis. Instead, APRA proposes that RSE licensees be required to make these registers available to APRA on request.

APRA does not intend to require in SPS 521 that all interests and gifts be disclosed on the register of interests. Only those that are determined by the RSE licensee to be material should be included on the register. The RSE licensee would be required to have a defensible process in place for determining materiality.

Proposed PPG guidance

APRA expects to issue guidance on the types of conflicts of interest and duty that may appear on conflicts registers.

4.4.4 Tied service provider arrangements

As outlined above, Stronger Super amends the SIS Act to override provisions in trust deeds that require the RSE licensee to outsource particular functions to specified service providers.

This proposed legislative amendment would not prevent RSE licensees from retaining the services of a related service provider. It will become necessary, however, for RSE licensees to ensure that the arrangement is in the best interests of beneficiaries and consistent with the RSE licensee's other duties, as is the case for non-tied arrangements. The RSE licensee would have to comply with the requirements in SPS 521 and the proposed *Prudential Standard SPS 231 Outsourcing* (SPS 231) (as discussed in Chapter 7) regardless of whether the decision is influenced by a tied arrangement. The combination of these requirements will mean that RSE licensees may only use a related service provider when a wide range of potential providers has been considered and it is determined that the related service provider offers a service that best reflects the interests of beneficiaries.

4.5 Interaction with ASIC obligations

For those RSE licensees that are also responsible entities licensed by ASIC, *Regulatory Guide 181 Licensing: Managing conflicts of interest* (RG 181) is designed to assist understanding and compliance with their obligations under s. 912A(1)(aa) of the Corporations Act. Under this requirement, a financial services licensee must have in place adequate arrangements for the management of conflicts of interest. While RG 181 is not specifically concerned with conflicts of interest in the context of the SIS Act, and does not cover all relevant issues in a SIS Act context, some of the elements that a typical conflict of interest policy would contain are already expressed in RG 181. It is not intended that dual licensees duplicate these in separate documents where they achieve similar outcomes. APRA will have regard to the content of RG 181 when developing both the draft SPS 521 and SPG 521.

Chapter 5 – Fitness and propriety

5.1 Objectives of prudential requirements on fitness and propriety

There are numerous examples of financial institutions that have suffered material losses or have failed due to the incompetence or dishonesty of management, board members, auditors and actuaries. Compliance with fitness and propriety obligations can reduce (though not eliminate) the risk of failure arising from incompetent or dishonest responsible persons.

The fitness and propriety of any RSE licensee depends on the fitness and propriety of each individual who acts as a director, responsible person or as one of a group of individual trustees. This is reflected in the fact that an essential condition for the granting of an RSE licence at present is that APRA must be satisfied that the applicant meets the fitness and propriety standard in r. 4.14 of the SIS Regulations.

The aim of the existing fitness and propriety requirements is to ensure that responsible persons of RSE licensees have the technical competence and integrity necessary to perform these roles. The focus of APRA's proposed fit and proper prudential standard is similar. The prudential standard would set out the minimum requirements for RSE licensees determining the fitness and propriety of individuals to hold positions of responsibility within the RSE licensee.

A secondary purpose of the standard is to support APRA's ability to seek the disqualification of unfit persons. The fitness and propriety criteria are also the criteria that APRA would apply when considering exercising its powers to direct the removal of a responsible person, or when seeking a Federal Court disqualification order under s. 126H of the SIS Act. An RSE licensee is responsible for taking appropriate steps when a person is not fit and proper for a responsible person position. However, this legislative provision allows APRA to seek the removal of a responsible person who is not fit and proper where an RSE licensee is unable or unwilling to remove this person.

5.2 Existing requirements

Current requirements relating to the fitness and propriety of RSE licensees and individual directors of such entities are contained in r. 4.14 of the SIS Regulations, and are supported by *Prudential Practice Guide SPG 520 Fitness and Propriety* (SPG 520).

Regulation 4.14 of the SIS Regulations requires an RSE licensee to possess relevant attributes that enable it to properly discharge its duties and responsibilities in a prudent manner. These include character, competence, experience, integrity, honesty, judgement and relevant technical qualifications, knowledge and skills. An RSE licensee is not fit and proper if it is a disqualified person or is aware that a director or individual trustee is disqualified and fails to inform APRA or remove the person.

5.3 Stronger Super

Stronger Super has announced the replacement of the existing 'prudent person' covenant in s. 52(2) (b) of the SIS Act (the care and diligence covenant) with a more demanding 'prudent person of business' test. Under this amendment, RSE licensees and their directors would be required to exercise the care, skill and diligence that an ordinary prudent person of business would exercise in dealing with the property of another for whom the person felt morally bound to provide. A similar amendment is expected to be made to s. 52(9), which relates to the duty of the directors of RSE licensees to take steps to ensure that the RSE licensee meets its s. 52 covenants.

Stronger Super envisages a strengthening of APRA's administration of the 'fitness' test. This would require RSE licensees to ensure that individual directors are fully informed about their obligations and responsibilities prior to accepting appointment and that the Board can demonstrate on an annual basis that it has the collective skill set to govern the RSE(s) for which it is responsible.

5.4 Proposed Prudential Standard SPS 520 Fit and Proper

APRA proposes to determine a new prudential standard, *Prudential Standard SPS 520 Fit and Proper* (SPS 520). It is expected that these requirements will be largely consistent with the fitness and propriety standard currently contained in r. 4.14 of the SIS Regulations, as well as APRA's existing guidance in SPG 520.

The proposed fit and proper requirements outlined in this chapter reflect APRA's view that primary responsibility for sound and prudent management resides with the board and senior management of an RSE licensee. RSE licensees are required to ensure that persons who are responsible for the management and oversight of their RSEs have the appropriate skills, experience and knowledge to do so and that they can reasonably be expected to act with honesty and integrity. A minimum mandatory standard for acceptable behaviour and practice in the appointment of responsible persons is expected to reduce the possibility that the interests of beneficiaries are put at risk.

APRA intends to align the requirements in the proposed SPS 520 with those in CPS 520, where appropriate. Extending this harmonised framework to the superannuation industry would promote equity for responsible persons in all APRA-regulated industries and assist APRA in its supervision of both individual entities and those that operate within a group structure.

There are a number of important differences between key provisions in the SIS Act and their equivalents in other APRA-administered industry Acts. These provisions mean that complete harmonisation with the provisions in CPS 520 is not possible. The proposals contained in this chapter reflect the law as it currently stands in the SIS Act.

Key matters that APRA proposes to include in draft SPS 520 and related guidance are outlined below.

5.4.1 'Responsible person'

At present under s.10 of the SIS Act, 'responsible officer' is defined as a director, a secretary or an executive officer of the body corporate. 'Executive officer' is further defined as a person, by whatever name called and whether or not a director of the body corporate, who is concerned, or takes part in the management of the body corporate.

Proposed SPS 520 prudential requirement

CPS 520 includes a concept of 'responsible person' that has a broader application than the SIS Act definition. This standard outlines the senior management responsibilities that make an individual a 'responsible person'.

An RSE licensee's fit and proper policy is expected to cover all responsible persons. In order to harmonise the requirements that apply to all APRA-regulated entities, APRA therefore proposes to include in SPS 520 a concept of 'responsible person' that reflects the definition contained in CPS 520.

'Responsible person' would be defined to include a director, individual trustee or 'senior manager' of an RSE licensee (a person who exercises the senior management responsibilities set out in the prudential standard), auditor or, for defined benefit funds (DB funds), an actuary appointed by the RSE licensee. A person need not be an employee of the RSE licensee to be a responsible person. This means that in some circumstances a consultant, contractor or employee of a subsidiary or otherwise related company may be a responsible person.

APRA would also have the right to determine that a person is a responsible person where APRA is satisfied that the person plays a significant role in relation to the RSE licensee or one or more RSEs.

Proposed PPG guidance

At present there is guidance for APRA-regulated entities as to how the concept of 'responsible person' might apply in different scenarios in the industry-specific PPGs on fit and proper. APRA will consider the extent to which this guidance might be reflected in an updated SPG 520 to assist RSE licensees to comply with the new requirements in SPS 520.

5.4.2 Fit and proper policy

APRA's view is that RSE licensees should be required to maintain a fit and proper policy that sets out requirements about the fitness and propriety of its responsible persons. This would enhance the Board's oversight of the entity's compliance with the obligations contained in SPS 520 and would reduce the risk that people who are not fit and proper cause loss to beneficiaries.

Proposed SPS 520 prudential requirement

APRA proposes that, at a minimum, the new SPS 520 would include a requirement for an RSE licensee to document a fit and proper policy and processes for assessing and taking action on fitness and propriety.

Proposed minimum requirements for this fit and proper policy, which reflect the requirements GPS 520 currently applying to other APRA-regulated industries, include:

- coverage of all persons acting in 'responsible person' positions;
- processes to be undertaken in assessing whether a person is fit and proper for a responsible person position;
- specification of the actions to be taken where a person is assessed as not fit and proper after their initial appointment; and
- adequate provisions relating to whistleblowing.

An RSE licensee would be required not only to undertake an annual assessment of the fitness and propriety of all responsible persons, but also undertake a separate assessment as to whether the Board has the collective skill set required to effectively govern RSEs under their trusteeship. The standard would also include a requirement to report to APRA about both fit and proper and board skill assessments.

5.4.3 Criteria to determine whether a person is fit and proper

At present, r. 4.14 of the SIS Regulations lists the attributes that, if possessed by an RSE licensee, allow them to meet the fit and proper standard. These attributes go to both the character of the RSE licensee (including individual directors) and their technical qualifications.

CPS 520 also includes a list of criteria that apply for the purposes of determining whether a person is fit and proper to hold a responsible person position. While these largely reflect the attributes listed in r. 4.14 of the SIS Regulations, there are additional criteria in CPS 520 that relate to conflicts of interest.

Proposed SPS 520 prudential requirement

To ensure appropriate harmonisation of requirements across all APRA-regulated industries, APRA proposes to include in SPS 520 a list of criteria consistent with those in CPS 520. This list would include eligibility criteria for auditors and actuaries.

These provisions would have the effect of placing an appropriate emphasis on considering these criteria when the RSE licensee is assessing whether a person is fit and proper. This should serve to reinforce the RSE licensee's duty to act in the best interests of beneficiaries.

Chapter 6 – Risk management

6.1 Objectives of risk management prudential requirements

A risk management framework comprises policies and procedures, risk management methodology and processes, the system of internal controls and reporting, and independent review processes. It also includes appropriate mechanisms for governance and oversight. Robust risk management is a cornerstone of APRA's prudential requirements in superannuation.

An RSE licensee's risk management framework should be appropriate to the nature, scale and complexity of its operations, and address the material risks, financial and non-financial, identified by the RSE licensee.

6.2 Existing requirements

The existing framework for prudentially sound risk management in superannuation is articulated as both mandatory obligations within legislation and as guidance in PPGs.

The SIS Act and SIS Regulations currently contain prudential requirements for all RSE licensees to have a risk management strategy (RMS) and for all RSEs to have a risk management plan (RMP). Part 2A, Division 8 and Part 2B, Division 5 of the SIS Act set out the broad requirements for the content, maintenance and review of the RMS and RMPs. Division 4.1A of the SIS Regulations expands on the required content of the RMS and RMP, including the requirement to consider material risks and to develop processes to address all identified risks.

Guidance on APRA's expectations of RSE licensees for risk management in superannuation is provided in *Prudential Practice Guide SPG 200 Risk Management* (SPG 200), *Prudential Practice Guide SPG 233 Pandemic Planning and Risk Management* (SPG 233), *Prudential Practice Guide SPG 234 Management of Security Risk in Information and Information Technology* (SPG 234) and the joint APRA-ASIC *Unit Pricing: Guide to Good Practice*.

6.3 Stronger Super

Stronger Super includes a number of reforms to risk management by RSE licensees. It will no longer be mandatory for RSE licensees to maintain a separate RMP for each RSE where the RMS is considered to adequately cover all risks applicable to the particular RSE. It is proposed this requirement will be replaced by a requirement in the prudential standard for RSE licensees to determine whether their RMS adequately addresses all risks attributable to their fund or funds or, alternatively, that a separate RMP is required.

RSE licensees will no longer automatically be required to make a copy of the RMP available to all fund members or to employer-sponsors in the case of a DB fund. Finally, RSE licensees will be required to explicitly include a liquidity management component in their RMS. This includes giving consideration to the liquidity characteristics of investment options offered or proposed to be offered to members, including in the retirement phase.

To enable the transition of existing prudential requirements into prudential standards, the Government has announced that it will release draft legislation to make necessary consequential amendments. This will allow the redetermination of certain requirements in a number of relevant SIS Act provisions in a prudential standard.¹⁵ SIS Regulations made under these provisions will also be reviewed to assess the need for any amendment.

6.4 Proposed Prudential Standard SPS 220 Risk Management

An RSE licensee is responsible for the effective management of all risks of the RSE licensee and RSEs under its trusteeship, especially those that can affect the interests of beneficiaries. The proposed *Prudential Standard SPS 220 Risk Management* (SPS 220) focuses on the minimum requirements for the management of risks, drawn from a range of sources and reflecting industry good practice.

¹⁵ APRA expects these provisions to include ss. 29E(1)(c) and (e); Part 2A, Division 8; and Part 2B, Division 5.

APRA's approach continues to be principles-based and harmonised with the requirements in other APRA-regulated industries, where appropriate. This includes requiring RSE licensees to develop a risk management framework appropriate to their entities and operations.

Key matters that APRA proposes to include in draft SPS 220 and related guidance are outlined below.

6.4.1 Risk management framework

The current SIS Act obligations focus RSE licensees' attention on the documents required (namely, the RMS and the RMP), rather than on developing an adequate and appropriate framework for RSE licensees to effectively manage all material risks to which they are exposed.

Developing and maintaining a holistic framework for risk management is expected to result in RSE licensees having better oversight of their RSEs, thus enabling them to better make decisions in the best interests of beneficiaries. Consistent with other APRA-regulated industries, this framework would comprise a range of processes and procedures relating to risk management, including a documented RMS.

Removing the obligation for RSE licensees to prepare a separate RMP for each RSE (where the RMS adequately covers all relevant risks) does not remove their obligation to comprehensively manage the risks associated with each RSE on behalf of beneficiaries.

Proposed SPS 220 prudential requirement

APRA proposes that RSE licensees be required to develop a risk management framework that includes, but is not limited to, the following elements:

- an RMS (and, if the RMS does not cover the risks of a particular RSE, an RMP for that RSE);
- Board-approved risk management policies, controls and procedures to identify, assess, monitor, report on and mitigate all material risks likely to be faced by both the RSE licensee and RSEs under its trusteeship, having regard to such factors as the size, business mix and complexity of its operations;
- a Board-approved business plan;

- clearly defined responsibilities and reporting requirements for managing risk; and
- a process for regular review to ensure that the risk management framework remains effective.

6.4.2 Requirement to articulate risk appetite

It is sound practice for RSE licensees to explicitly indicate their appetite and tolerance for the various risks to which they are exposed. A clearly expressed risk appetite is a key component in a sound risk management framework.

Proposed SPS 220 prudential requirement

APRA proposes to include in SPS 220 a requirement to articulate risk appetite as part of an RSE licensee's risk management framework, at both the level of the RSE licensee's operations as a whole (including all RSEs) and for individual risks.

APRA proposes that the risk appetite would be developed by the Board and would need to be consistent with the current and future operations of the business. It would take into account resource needs and availability. This would involve the RSE licensee:

- articulating the risks that the entity is comfortable being exposed to and those that it seeks to avoid;
- estimating the possible maximum impact on beneficiaries in the event that a particular risk is realised; and
- demonstrating, where risk mitigation measures are inadequate to reduce a residual risk to below the tolerances expressed in the risk appetite, that the RSE licensee will either pursue further risk mitigation measures or remove itself from exposure to this risk.

APRA will also review the existing guidance in SPG 200 to support these requirements.

6.4.3 Risk management framework alignment with business strategy and plan

APRA has long considered that there is a clear link between an RSE licensee's risk management framework and the RSE licensee's overall strategic plan and business plan. Aligning the risk management framework to a sound business plan indicates a rigorous approach to risk management.

While this explicit link between the risk management framework and business plans is reflected in prudential requirements applying to entities in other APRA-regulated industries, no such requirement currently applies to RSE licensees. APRA relies on guidance in SPG 200 to suggest that risk management frameworks are better developed within the context of the business planning process.

Proposed SPS 220 prudential requirement

APRA proposes that RSE licensees be required to include, as part of their business planning cycle, their identification and consideration of risks. These risks are to be explicitly addressed and managed within the risk management framework.

6.4.4 Risk management and corporate/ownership structure

RSE licensees have varying ownership structures. For example, an RSE licensee may be owned by a nominal holding company or by shareholders representing member and employer interests; it may be a stand-alone entity or form part of a conglomerate group; or it may comprise a group of individual trustees rather than a corporate entity. These ownership structures give rise to differing risks, challenges and potential conflicts for RSE licensees as they manage their fiduciary obligations to beneficiaries and any competing corporate objectives.

As discussed in Chapter 4 of this discussion paper, Stronger Super includes heightened obligations on RSE licensees and their directors. This includes a new legislative duty to give priority to their duty to beneficiaries, in particular when that duty conflicts with any other duty to shareholders or related parties.

Proposed SPS 220 prudential requirement

APRA proposes to include in SPS 220 a specific requirement for all RSE licensees to ensure that they specifically consider, identify and address any risks that might impact on their duty to beneficiaries. These risks may arise from their ownership structure or from inherent conflicts. It is expected the requirement would also include identification of control measures to be used to mitigate those risks.

Proposed PPG guidance

The proposed PPG will provide RSE licensees with further details on managing conflicts in the risk management framework including: the control measures used to ensure that priority is given to beneficiary interests over any other corporate objective; transparency in the use of any related party service providers; and consistency and fairness in dealings with all beneficiaries.

6.4.5 Dedicated risk management function

Entities in other APRA-regulated industries are required to maintain a dedicated risk management function. This function reports to the board or a board committee and has responsibility for the oversight of the risk management framework.¹⁶ The risk function may be fulfilled by incorporating responsibilities into an existing role or, for larger or more sophisticated entities, by a specialist risk management team.

¹⁶ Refer to Chapter 3 for further discussion about board committees.

Proposed SPS 220 prudential requirement

APRA proposes to require that RSE licensees maintain a specific function with direct responsibility for the management and oversight of risk management within the RSE licensee.

RSE licensees would need to demonstrate that they have appropriately dedicated resources to monitor current and emerging risks within the business, to develop control measures, and to assist the Board in maintaining an effective risk management framework.

The form of this function would not be mandated. APRA recognises that there are a range of business practices and structures across the superannuation industry. This requirement would provide RSE licensees with sufficient flexibility to determine how best to meet this obligation.

Further, some RSE licensees are part of a larger corporate group or engage the services of an external service provider for risk management purposes. In these circumstances, the RSE licensee may use a risk management function provided by such parties, rather than having an internal risk management function. In such cases, the RSE licensee would be required to demonstrate that this risk management function provides it with the necessary oversight of the risks to which it is exposed.

6.4.6 Risk management attestations

Prudential standards in other APRA-regulated industries require attestations as to compliance with certain requirements. At present, because of the lack of prudential standards in superannuation, RSE licensees are required to attest compliance with their legal obligations as part of a reporting form under *Reporting Standard SRS 260.0 Trustee Statement (2005)* (SRS 260.0), made under the *Financial Sector (Collection of Data) Act 2001* (FSCODA). These attestations relate to the RSE licensee's compliance with their obligations under the SIS Act and SIS Regulations, FSCODA, relevant provisions of the Corporations Act, as well as to the accuracy of all financial information submitted to APRA.

Proposed SPS 220 prudential requirement

APRA proposes to move the attestation requirements from the reporting form to SPS 220. It is proposed that the Board be required to provide a risk management declaration annually to APRA stating that:

- the RSE licensee has systems in place for the purpose of ensuring compliance with the relevant Acts, Regulations, prudential and reporting standards, FSCODA, and any other authorisation conditions, directions or other requirements imposed by APRA;
- the Board is satisfied with the efficacy of the processes and systems surrounding the production of financial information;
- the RSE licensee has in place a risk management framework, developed in accordance with the requirements SPS 220; and
- the systems for managing and monitoring risks, and the risk management framework, are appropriate to the size, business mix and complexity of the entity.

Although the broad subject matter of the attestation would be largely the same as currently contained in SRS 260.0, the requirements in SPS 220 would also focus on the RSE licensee's processes for ensuring their ongoing compliance with their prudential obligations.

Chapter 7 – Outsourcing

7.1 Objectives of outsourcing prudential requirements

An RSE licensee remains responsible at all times, for all of its functions, and the functions of all RSEs under trusteeship, even where the operations of these functions are outsourced. Superannuation is an industry that relies heavily on outsourcing, with many core functions outsourced, including administration, custody, investment management and other support functions (such as secretariat and information technology (IT) support). It is critically important that RSE licensee governance over these arrangements is sound. All outsourcing arrangements involving material business activities must be subject to appropriate due diligence, approval and ongoing monitoring.

7.2 Existing requirements

Current requirements relating to outsourcing for RSE licensees are contained in ss. 29H and 29P of the SIS Act, and r. 4.16 of the SIS Regulations. These obligations are supported by guidance material in *Superannuation Guidance Note 130.1 Outsourcing* (SGN 130.1), SPG 200, *Frequently Asked Questions (FAQs) on Outsourcing*, *Cross Industry Circular No.1 – Custodian Requirements* and APRA letters to the superannuation industry.¹⁷

The guidance documents contain APRA's views as to which service provider relationships are covered by the operating standard in r. 4.16 of the SIS Regulations and which ones are not. APRA does not propose to fundamentally alter the types of relationships that are considered to be outsourcing.

These include relationships with administrators, custodians, investment managers, promoters, implemented asset consultants, financial planners and the non-investment components of life policy arrangements. APRA proposes that arrangements with providers of investment functions and insurance functions should be subject to similar obligations even though they are not outsourced arrangements (refer to Chapters 8 and 13 of this discussion paper for further details).

The current requirements in r. 4.16 of the SIS Regulations cover the content of the outsourcing agreement. While the agreement must address ongoing monitoring of service providers, there are no requirements that address the selection process for service providers or the need for a policy governing the use of service providers.

7.3 Stronger Super

The Review contained one recommendation directly related to outsourcing: that administrators and clearing houses providing administration services be licensed by APRA. This recommendation was not supported by the Government. It did, however, support heightened requirements for RSE licensees that deal with administrators and referred to APRA the need for prudential standards in this area. APRA proposes introducing a prudential standard to articulate the requirements for RSE licensees that outsource material activities to service providers, including administrators.

¹⁷ APRA wrote to the industry on 15 November 2010 about specific considerations for offshoring and the use of cloud computing services. This letter reiterated APRA's expectations for practices that constitute sound management of outsourcing risk.

7.4 Proposed Prudential Standard SPS 231 Outsourcing

APRA proposes to determine a new prudential standard, SPS 231, that, as a starting point, will be based on the content of CPS 231. APRA's view is that outsourcing risks and their effective management are broadly the same, regardless of the industry in which an entity operates. An approach that harmonises the requirements for superannuation with those applying to other APRA-regulated industries is therefore proposed. The majority of the requirements in CPS 231 translate readily to the superannuation environment.

In relation to outsourcing, APRA expects that the Government's announced plans to make consequential amendments to legislation and regulations will include provisions in ss. 29H and 29P and r. 4.16 of the SIS Regulations.

APRA will also consider which elements of guidance in SGN 130.1 and APRA's other guidance material should become mandatory requirements in the prudential standard. In general, matters that are proposed to be moved from non-enforceable guidance into prudential standards (and therefore become enforceable) are those matters that are already accepted as good practice in the industry.

Key matters that APRA proposes to include in draft SPS 231 and related guidance are outlined below.

7.4.1 Outsourcing policy

An RSE licensee remains responsible for all operations, even where these activities might be outsourced. It is therefore essential that RSE licensees structure their outsourcing arrangements to ensure that they have complete and continuing oversight over the outsourced activities.

APRA's outsourcing guidance suggests RSE licensees should be able to demonstrate how they remain accountable for each outsourced activity, including their due diligence considerations. Current guidance does not specifically mention the benefits of having a written and Board-approved outsourcing policy in place.

CPS 231 requires entities to maintain an outsourcing policy approved by the Board, relating to the outsourcing of material business activities and including a detailed framework for managing all outsourcing arrangements.

Proposed SPS 231 prudential requirement

APRA proposes to require that the RSE licensee has a written outsourcing policy consistent with the requirement for other APRA-regulated industries.

The policy should focus primarily on the material business activities of the RSE licensee, but can also consider non-material outsourcing arrangements. The policy should cover requirements for establishing new outsourcing arrangements as well as requirements in respect of current outsourcing arrangements.

APRA proposes that this Board-approved policy would include a detailed framework for managing all outsourcing of material business activities, possibly as a sub-set of the RSE licensee's risk management framework. Particular requirements would apply where outsourcing is undertaken by related parties or by service providers outside Australia.

7.4.2 Minimum requirements for outsourcing agreements

Regulation 4.16(4) of the SIS Regulations contains the minimum requirements for material outsourcing agreements, including, but not limited to, that the agreement must be made in writing, contain default and termination provisions, contain a pricing, fee and payment structure and audit, monitoring and assessment procedures.

Proposed SPS 231 prudential requirement

APRA expects that the requirements currently contained in r. 4.16(4) of the SIS Regulations, which largely reflect those applied in CPS 231, will be removed from the SIS Regulations so they can be reflected in the new SPS 231.

APRA proposes that all material outsourcing agreements be made by a written, legally binding agreement. This differs from the requirements in CPS 231, which do not require formal documented outsourcing agreements with related parties. The predominance of outsourcing in the superannuation industry, particularly with related parties, warrants a level of legal certainty across all agreements. This is particularly important in light of the difficulties associated with characterising a provider as related or unrelated in some circumstances.

Proposed PPG guidance

APRA intends to retain and update existing guidance on outsourcing in SPG 231 to support the obligations in the prudential standard. This would include guidance on sub-contracting arrangements, offshoring and cloud computing.

7.4.3 Due diligence and ongoing monitoring obligations

Regulation 4.16 of the SIS Regulations focuses on the content of material outsourcing arrangements and includes an obligation to monitor the agreement. However, it is silent as to the processes an RSE licensee must follow when entering into outsourcing arrangements with a service provider. CPS 231 contains specific and detailed obligations on assessing which activities are suitable for outsourcing, selecting service providers and monitoring the relationship with the service provider.

Using related-party service providers brings added risk, including concentration, contagion and conflict of interest risks. Additional risks can also arise where a director sits on both the Board of the RSE licensee and a related party service provider, resulting in possible pressure on the RSE licensee to achieve corporate goals which may be in conflict with duties to beneficiaries.

Proposed SPS 231 prudential requirement

The processes that create outsourced arrangements, as well as the ongoing monitoring of service provider performance, are as important as the formal content of the agreement itself. As such, APRA proposes that SPS 231 contain obligations for due diligence and monitoring that are based on those in CPS 231.

These requirements would be designed to facilitate the RSE licensee having a greater understanding of the risks of the function itself and any further risks from outsourcing the function. This might be achieved by a greater understanding of the circumstances of the outsourced service providers, including capital/financial resources, adequacy of insurance arrangements, data integrity controls and the adequacy of the governance and risk management frameworks of the service provider. The RSE licensee would also be required to undertake regular and thorough enquiry to identify any conflicts that have the potential to affect an existing or prospective service provider's performance in respect of the RSE. This would include conflicts arising for the RSE licensee or its directors, as well as conflicts for the service provider (refer also to the proposals on conflicts of interest in Chapter 4 of this discussion paper).

Chapter 8 – Investment governance

8.1 Objectives of prudential requirements on investment governance

Sound investment governance is essential to support the fiduciary responsibility of RSE licensees to their beneficiaries. Managing an RSE's investments is a primary function of an RSE licensee.

An RSE licensee is entrusted with governing the RSE's investment operations. The Board of an RSE licensee, in conjunction with management, must formulate policies and strategies to manage the RSE's investments in the best interests of beneficiaries.

APRA's proposals for investment governance incorporate requirements arising out of Stronger Super and consolidate existing guidance on prudential requirements relating to investment governance for RSE licensees and their RSEs.

8.2 Existing requirements

The primary requirement relating to investment governance applicable to RSE licensees is contained in the covenant in s. 52(2)(f) of the SIS Act. This provision requires RSE licensees to formulate and give effect to an investment strategy that has regard to the circumstances of the entity as a whole including, but not limited to, a number of specified factors. This covenant is supported by r. 4.09 of the SIS Regulations and is affected by the operation of s. 52(4) of the SIS Act and r. 4.02 of the SIS Regulations, which relate to member-directed investments.

The obligation in s. 52(2)(f) is further supported by *Superannuation Circular II.D.1: Managing Investments and Investment Choice*. APRA has also issued a number of other circulars on investment-related matters that support SIS Act requirements in relation to investments.¹⁸

8.3 Stronger Super

Stronger Super includes a number of reforms that relate to the investment governance arrangements of RSE licensees.

The key proposed reforms are for additional requirements to be added to s. 52(2)(f). An RSE licensee will need to consider the expected costs and taxation consequences of its investment strategies. It will need to conduct appropriate due diligence in selecting and monitoring investment options made available to beneficiaries. An RSE licensee will also need to have regard to the availability of independent and timely valuation information when setting and implementing investment strategies.

APRA also expects that requirements in relation to performance fees applying to MySuper products will be implemented by changes to the SIS Act. This will be supported by a prudential standard and guidance issued by APRA.

Stronger Super also provides that, where an RSE licensee chooses to offer a range of investment options outside MySuper, it must provide a range of options that is sufficient to allow beneficiaries to obtain a diversified asset mix if they choose to do so.

A key investment governance requirement is that RSE licensees offering MySuper products develop a single, diversified investment strategy for each MySuper product. Life-cycle investment strategies will be permitted within this structure.

¹⁸ Refer to *Superannuation Circular II.D.2 Lending and Provision of Financial Assistance to Members of Superannuation Entities*, *Superannuation Circular II.D.3 Acquisition of Assets from Related Parties*, *Superannuation Circular II.D.4 Borrowing by Superannuation Entities*, *Superannuation Circular II.D.5 Investments to be on an Arm's Length Basis* and *Superannuation Circular II.D.6 In-house Assets*. Additional guidance issued by APRA includes: the joint APRA/ASIC *Unit Pricing Guide to Good Practice*, draft *Prudential Practice Guide SPG 235 Use of Reserves in Superannuation Funds* and various letters to trustees about valuation of unlisted assets.

8.4 Proposed Prudential Standard SPS 530 Investment Governance

APRA envisages that the proposed *Prudential Standard SPS 530 Investment Governance* (SPS 530) will address issues relating to investment governance drawn from a range of sources and designed to complement the new legislative obligations. APRA anticipates 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 heightened responsibilities that attach to MySuper products will create additional expectations and constraints on investment behaviour, most notably the need for diversification and governance of performance fees. Where APRA proposes different requirements for MySuper RSE licensees from those applying to RSE licensees more generally, this is indicated below.

8.4.1 Articulating clear investment objectives

There are many investment approaches across the superannuation industry, especially for choice products. These range from RSE licensees that offer a limited set of multi-sector or single-sector options, to those that offer a wide-ranging menu (platform) of multi-sector, single-sector and single-asset options from which beneficiaries are typically free to choose.

A fundamental principle of sound investment governance is that each investment option made available to beneficiaries has clear investment objectives determined by the RSE licensee. Although the processes and criteria that apply to a MySuper product are likely to have a different character from the processes and criteria behind an investment option provided in a choice product, all decisions must be bound by the requirement for clear investment objectives.

Irrespective of the approach adopted, it is proposed that RSE licensees would be required to set clear investment objectives and investment strategies in respect of every option available to beneficiaries. This would ensure that RSE licensees explain to beneficiaries what the RSE licensee aims to achieve through each investment strategy.

Proposed SPS 530 prudential requirement

APRA proposes that RSE licensees be required to set clear objectives that align each investment option with the investment philosophy of the RSE licensee. These objectives must take into consideration the nature of the RSE in which the investments reside.

At a minimum, APRA proposes to require RSE licensees to articulate realistic investment objectives in a specific and measurable way. This would include a requirement to articulate an expected return objective or objectives, a risk objective or objectives, and a relevant benchmark or benchmarks against which realised returns and risks may be assessed. The recent release of industry guidance on a standard risk measure provides an example of a measurable risk objective.¹⁹

The proposed requirement for all RSE licensees to explain their investment objectives is designed to supplement the high-level covenants that are contained in s. 52(2)(f), regardless of whether a MySuper or a choice product is being offered. This means that RSE licensees offering choice will be required to set objectives at the individual investment option level, as well as at the whole-of-fund level.

RSE licensees would also be required under SPS 530 to maintain and monitor objectives on an ongoing basis.

¹⁹ Refer to 'Standard risk measure guidance paper for trustees' July 2011, Financial Services Council and ASFA, www.superannuation.asn.au/ArticleDocuments/116/FSC-ASFA_StandardRiskMeasures_July2011.pdf.aspx

8.4.2 Formulating investment strategies

In line with its current practice, APRA proposes that SPS 530 contain requirements relating to the setting, and ongoing management, of investment strategies. Meeting this requirement supports RSE licensee compliance with s. 52(2)(f), which requires RSE licensees to 'formulate and give effect to an investment strategy'. Stronger Super indicated that this obligation would be extended to include 'the fund as a whole and each investment option'.

Subsection 52(4) allows beneficiaries to give direction to RSE licensees about the strategy for investment of particular assets of the entity in specific circumstances.²⁰ If such a direction is made, RSE licensees would nevertheless still be required to meet minimum requirements when setting investment objectives and strategies and undertake adequate due diligence on investments made available to beneficiaries.

Proposed SPS 530 prudential requirement

APRA proposes that each RSE licensee be required to articulate the processes and criteria used to select investments to implement each of its investment options. This would include obligations relating to effective and appropriate due diligence for any investment option included in an investment menu available to beneficiaries at the time of selection. RSE licensees offering choice products would be expected to be satisfied that each option is appropriate for selection by beneficiaries, including where a beneficiary may choose to concentrate their interest in the fund in a single, undiversified option.

In order to meet due diligence obligations, APRA proposes to require that RSE licensees have the ability to understand and explain to beneficiaries the fundamental risks posed by any investment option. Furthermore, RSE licensees must be able to understand and explain whether these options are aligned with their investment philosophy and objectives, the nature and appropriateness of fees and charges, the liquidity of the underlying portfolio and how valuations are struck.

APRA proposes that a MySuper RSE licensee setting a single, diversified strategy would be required to give particular consideration to including an appropriate mix of assets from a range of asset classes in this option.

Factors that APRA proposes to require RSE licensees to identify and manage might include setting strategic asset allocations, determining an allowance for reasonable variation around those asset allocation targets, and setting benchmarks for asset classes, including the circumstances in which benchmarks can be altered.

8.4.2 Investment management processes for implementing investment strategies

As articulated in the requirements of s. 52(2)(f), implementing an investment strategy is as important as formulating that strategy.

Proposed SPS 530 prudential requirement

APRA proposes that RSE licensees be required to document the processes and criteria used for ongoing monitoring of investments in each investment strategy. This would include obligations relating to monitoring and correcting deviations from asset allocation targets within a reasonable time, monitoring the performance of investment managers and ongoing consideration of the liquidity and cash flow needs of the investment strategy. It would also include ongoing monitoring and maintenance of diversification.

²⁰ Regulation 4.02 of the SIS Regulations sets out the circumstances in which a member may give direction to an RSE licensee about choice of investment strategies.

8.4.3 Features of investment management

Stronger Super states that the existing sub-covenants in s. 52(2)(f) should be supplemented by additional sub-covenants requiring the RSE licensee to consider the expected costs, taxation consequences and the availability of timely and independent valuation information when setting investment strategies. The list of sub-covenants in s. 52(2)(f) is, and will continue to be, non-exhaustive.

The section below outlines APRA's views about valuation information and consideration of fees and costs. In the development of SPS 530, APRA will also consider how best to reflect consideration of taxation consequences.

Investment fees and costs (including performance fees)

Investment costs are a substantial component of an RSE's overall costs and, when passed on as member fees or deducted from investment returns, directly affect the financial outcomes of beneficiaries. Consideration of investment costs, both at the time of choosing an investment and on an ongoing basis, is a crucial component of effective investment governance. Reflecting Stronger Super, this would also include consideration of the taxation consequences of investment strategies.

Proposed SPS 530 prudential requirement

APRA proposes that SPS 530 will, at a minimum, require RSE licensees to consider how investment costs will impact on fund returns to beneficiaries over time. Performance fees are one component of this consideration. Their relationship to manager behaviour and appropriate levels of investment risk, in the context of the RSE licensee's overall investment philosophy, is an important component of investment costs.

Requirements contained in SPS 530 relating to performance fees are expected to apply only to MySuper RSE licensees, with similar considerations set out in guidance material for all RSE licensees. APRA's prudential standard would support the SIS Act provision relating to performance fees. It is not APRA's intent to ban or limit investments involving performance fees but to ensure that RSE licensees clearly understand these fees and can demonstrate that they are in the best interests of beneficiaries.

Proposed PPG guidance

APRA expects to provide guidance on typical inclusions in various categories of fees, including administrative fees and investment fees, as well as guidance on what might constitute cost recovery for the purposes of the proposed fee obligations in the SIS Act. Guidance on fees and costs would address considerations in relation to the payment of performance fees by RSE licensees for choice products. This may include matters such as what is meant by outperformance and the benefit of considering outperformance on an after-tax basis.

Liquidity management

Effective liquidity management is essential for RSEs to ensure that benefits can be paid as they become due. Liquidity management should be considered both when selecting investments and on an ongoing basis.

Proposed SPS 530 prudential requirement

For each investment option, APRA proposes to require RSE licensees to consider the liquidity risks of the assets and the alignment of these risks to the cash flow needs of that investment option. This would also include ongoing monitoring and management of the liquidity of an investment option.

Proposed PPG guidance

APRA proposes to issue guidance to assist RSE licensees with the management of liquidity issues. Better practice guidance that might be included in a PPG includes factors to be considered when managing liquidity (such as membership demographics and the volatility of the investment option under consideration) and the benefits that can flow from a clearly articulated liquidity management plan. It is also likely to include key considerations that should govern the management of fund liquidity, including managing liquidity across multiple investment options.

APRA also intends to issue guidance to assist RSE licensees of DB funds in their liquidity management including, but not limited to, consideration of the fund's membership profile, employer sponsor funding plan agreements and managing asset/liability mismatches.

Timely and independent valuation information

Accurate and timely valuations are necessary components of effective investment management. In setting valuation requirements, APRA expects RSE licensees to have regard to the minimum requirements of accounting standards. Valuation that facilitates meaningful performance assessment and allows accurate compliance with concentration limits can help to ensure equity between continuing and exiting members. Valuation would normally be considered in conjunction with liquidity, as reliable and appropriately frequent valuations assist in mitigating liquidity risks. When calculating investment returns at the fund and investment option level, RSE licensees must consider the reliability of the valuations provided.

Proposed SPS 530 prudential requirement

APRA proposes that RSE licensees be required to consider, at a minimum, the frequency of trading of assets, whether assets are listed or unlisted, the independence and integrity of the provider of the valuation in determining valuation of assets, and the suitability of any valuation model when faced with extreme volatility in relevant markets. An RSE licensee would also be required to ensure that the valuation obtained can be substantiated, i.e. there is sufficient evidence and reasoning to support the validity and accuracy of the valuation.

Proposed PPG guidance

APRA proposes that guidance on valuation practices would address how frequently various asset classes should be valued, as well as what might constitute an 'independent valuation'. Further guidance on APRA's expectations about valuation practices might include where a lack of true independence could be supplemented by thorough and critical review of the valuation. APRA also intends to provide guidance in relation to investment valuation reserves.

Chapter 9 – Operational risk financial requirement

9.1 Purpose of a prudential operational risk financial requirement

Currently there are no risk-based capital requirements for superannuation. Public offer RSE licensees are subject to a capital requirement, but this amount is not linked to the risks faced by these RSE licensees in their trusteeship of RSEs.

Stronger Super seeks to improve the safety of the superannuation system by introducing a risk-based financial requirement for operational risk, and for this requirement to apply to all RSE licensees. APRA's proposals for an operational risk financial requirement complement the legislative obligations arising out of Stronger Super.

9.2 Existing requirements

At present, public offer RSE licensees are required to hold \$5 million in capital under the requirements in s. 29DA of the SIS Act and r. 3A.04 of the SIS Regulations. Further, s. 29DA permits RSE licensees to meet this capital requirement by holding capital in their own right, by obtaining an approved guarantee, by retaining a custodian that has at least \$5m capital or by holding a combination of capital and approved guarantee.

Prudential Practice Guide SPG 110 Capital provides guidance on the capital requirements for public offer RSE licensees.

Regulation 4.15 of the SIS Regulations requires all RSE licensees to have adequate financial, human and technical resources. 'Adequate financial resources' includes adequate resources to ensure ongoing solvency, and adequate liquidity to support the business operations of the RSE licensee. APRA has provided guidance in *Prudential Practice Guide SPG 230 Adequacy of Resources* (SPG 230) to assist RSE licensees to meet these obligations.

All RSE licensees may maintain reserves within their RSEs. Obligations relating to the management of any reserves reside in s. 52(2)(g) of the SIS Act, with s. 115 confirming that a trustee may maintain a reserve, subject to the governing rules. APRA issued draft *Prudential Practice Guide SPG 235 Use of Reserves in Superannuation Funds* for public comment in 2009, but did not finalise this guidance pending the outcomes of the Review.

9.3 Stronger Super

Stronger Super proposes a number of reforms that relate to new requirements for financial resources to be held against operational risk.

The key reform proposed is that all RSE licensees must hold adequate financial resources to respond to operational risks. This operational risk financial requirement is designed to be risk-based and may be met by fund reserves or trustee capital. It is also proposed that RSE licensees must develop and document a strategy for managing and maintaining financial resources for operational risk, in addition to documenting the fund's overall reserving strategy as required under s. 52(2)(g).

Stronger Super intends to implement the reforms through legislative change to the SIS Act. This will be supported by a prudential standard to be developed by APRA. APRA is proposing that the requirements for a risk management framework and strategy outlined in SPS 220 (refer to Chapter 6 for detailed discussion of this requirement) would apply equally to the management of operational risk.

Stronger Super supports the repeal of the current capital requirements applying to public offer RSE licensees. These requirements will be replaced by the new risk-based operational risk financial requirement. This new requirement will apply to all RSE licensees, regardless of whether they are public offer or non-public offer RSE licensees.

9.4 Purpose of APRA's operational risk financial requirement

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. This definition includes legal risk but excludes strategic and reputational risk.²¹

A non-exhaustive list of operational risk examples from the Review²² includes: poor selection and monitoring of external service providers; inadequate insurance; failure to meet compliance obligations; data integrity; damage to member records; computer failure; failure of software to perform to expectations; fraud, negligence and misconduct; miscalculation of benefits such as unit pricing errors; and loss of key staff.

In considering the interests of beneficiaries, RSE licensees would be required to assess the operational risks faced by each RSE for which they are responsible. They would then be required to ensure that, in the event that these risks eventuate, the costs of resolution are not entirely borne by the current beneficiaries of the relevant RSE. In the absence of explicit financial resources for operational risk, there would be no financial buffer that would allow the costs of resolution to be appropriately spread across different generations of beneficiaries. The operational risk financial requirement would ensure that RSE licensees set aside resources to absorb losses that are incurred as a result of an operational risk being realised. These financial resources would then enable the RSE licensee (and RSEs under its trusteeship) to continue to operate in a sound and viable manner while the problems are being addressed and resolved.

9.5 Proposed structure of APRA's operational risk financial requirement

APRA proposes that an RSE licensee will be required to hold an amount of financial resources that the RSE licensee determines as adequate to meet operational risk losses facing it and the RSEs under its trusteeship.

The amount would be determined based on the operational risk exposure of each RSE for which the RSE licensee is responsible and to address risks at the RSE licensee level. RSE licensees may choose that (at least) the amount calculated in respect of each RSE be held as a reserve within that RSE. If, however, the amount is held by the RSE licensee as capital, it would need to be available for use only in respect of operational risks realised within the RSE for which the amount was determined.

APRA would expect the actual amount of resources held to fluctuate around (i.e. above and below) a target level set by the RSE licensee in the normal course of the RSE's operations, as funds are applied to rectify losses from operational risk events. Any fluctuations below the target level would be expected to be restored to the target level within a reasonable period.

APRA proposes that there be a transition period to allow RSE licensees sufficient time to build up operational risk financial resources to the target level. A public offer RSE licensee that currently satisfies the SIS Act capital requirement by the direct holding of \$5 million in net tangible assets would be able to use existing capital towards satisfying the new operational risk financial requirement. In addition, an RSE licensee that currently maintains general reserves may determine it is appropriate to allocate some of those reserves to meet the operational risk financial requirement where the RSE licensee considers those reserves are held specifically for the purpose of meeting operational risk losses.

21 Refer to 'Sound Practices for the Management and Supervision of Operational Risk', Basel Committee on Banking Supervision, 2003, www.bis.org/publ/bcbs96.htm.

22 Super System Review – Final Report – Chapter 6 – Integrity of the system—page 165.

9.6 Proposed Prudential Standard SPS 114 Operational Risk Financial Requirement

APRA envisages that the proposed *Prudential Standard SPS 114 Operational Risk Financial Requirement* (SPS 114) will address a range of issues relating to the calculation, use and maintenance of financial resources for operational risk. Key matters that APRA proposes to include in draft SPS 114 and related guidance are outlined below.

9.6.1 Minimum features of the operational risk financial requirement

At this time, APRA does not propose to set a minimum target level of operational risk financial resources. However, in other industries and policy proposals, an amount of 0.25 per cent of funds under management is proposed as APRA's minimum requirement.²³ As such, APRA expects that RSE licensees would typically have a target level for operational risk financial resources of at least 0.25 per cent of funds under management.

As part of its revised data collections, APRA expects that RSE licensees would be required to report the level of operational risk reserves or capital held, and that these would be reported by APRA in its statistical publications.

APRA will review, over time, whether it is appropriate to set a minimum target level for operational risk financial resources in prudential standards. Regardless, APRA proposes that SPS 114 would contain discretion for APRA to set a minimum target level for operational risk financial resources for a specific RSE licensee. This would occur if the RSE licensee is unable to satisfy APRA that it has set a target level that appropriately addresses the operational risks of the RSE licensee and RSEs under its trusteeship.

It is expected that resources held to meet the operational risk financial requirement could only be called on to respond to operational risk losses. Although RSE licensees would be permitted to determine the operational risk losses that the resources can be used to meet, APRA would expect RSE licensees to have appropriate liability insurance in addition to operational risk financial resources. APRA proposes to prohibit use of operational risk financial resources to address a failure to meet legislative requirements (e.g. failure to meet covenants specified in s. 52 of the SIS Act) or other administration deficiencies that were not identified by the RSE licensee as an operational risk.

Where operational risk financial resources are used, SPS 114 would require the RSE licensee to have in place a plan for communicating with APRA. In addition, as noted above, resources would be expected to be restored to the target level within a reasonable period.

9.6.2 Operational risk financial requirement can be met with fund reserves or trustee capital

APRA considers that a specific fund reserve, trustee capital or a combination of both would be appropriate to fulfil an operational risk financial requirement. APRA does not propose to allow the current custodian or approved guarantee arrangements to satisfy this new requirement. These arrangements do not represent readily accessible sources of funds that an RSE licensee could call on to quickly make good an operational loss.

Proposed SPS 114 prudential requirement

APRA proposes that the operational risk financial requirement must be met by a specific fund reserve, trustee capital or a combination of both.

All RSE licensees would have the capacity to meet the operational risk financial requirement by setting aside a specific fund reserve for each RSE.

²³ Refer to www.apra.gov.au/Policy/Pages/Supervision-of-conglomerate-groups.aspx and www.apra.gov.au/CrossIndustry/Pages/review-of-capital-standards-for-general-insurers-and-life-insurers-may-2010.aspx for further information about these proposals.

Trustee capital, built up by charging a member fee or from shareholder equity provided by a parent entity, is appropriate to partially or wholly meet the operational risk financial requirement. RSE reserves built up over time by a reduction in the returns allocated to members are also appropriate to meet the operational risk financial requirement.

APRA proposes that, where an RSE licensee chooses to use trustee capital to partially or wholly satisfy the operational risk financial requirement, this capital needs to be specifically allocated to meet only operational risks of its RSEs.

9.6.3 Strategy for meeting the operational risk financial requirement

Similar to the requirement under s. 52(2)(g) for a reserving strategy, RSE licensees would be required to maintain a strategy for managing and maintaining operational risk financial resources. APRA's view is that RSE licensees should have such a strategy regardless of whether the operational risk financial requirement is met by a specific fund reserve, trustee capital or a combination of both.

Proposed SPS 114 prudential requirement

APRA proposes that a strategy for meeting the operational risk financial requirement would, at a minimum, cover the following matters:

- identification of all relevant operational risks and mitigants and the resulting residual risks, as identified in the risk management framework;
- the approach adopted to determine the size of a target amount, tailored to the circumstances of each RSE, to provide a buffer for operational losses arising from the identified residual risks of that RSE;
- an assessment of any additional amount required at the RSE licensee level to take account of wider group needs arising from an operational risk event in one or more RSEs under its trusteeship;

- the approach adopted for maintaining operational risk financial resources at the RSE licensee's target amount, including processes to monitor on an ongoing basis the amount of operational risk reserves or capital available relative to the RSE licensee-determined target amount;
- quarantining specific operational risk reserves from general reserves and, where relevant, quarantining specific operational risk trustee capital from general trustee capital;
- if fund reserves are used, an investment strategy for the reserve that provides for adequate protection of the reserve, keeping in mind that the assets designated to meet the operational risk financial requirement must be available for use at short notice. RSE licensees would need to particularly consider the liquidity of the assets and whether their investment provides adequate access to the funds in the event of an operational loss;
- policies and procedures for calling on the resources set aside to meet the operational risk financial requirement, including a clear articulation of how they will determine when operational risk financial resources can be called upon; and
- policies and plans for replenishing operational risk financial resources should they be called upon to make good an operational loss. In this context, APRA proposes to require an RSE licensee to identify trigger levels that would result in action being taken to replenish resources, including an alert to the Board and communication with APRA.

Proposed PPG guidance

APRA intends to issue a PPG that supports the requirements contained in SPS 114. This would include guidance on possible operational risks and mitigants that might be relevant to the circumstances of RSE licensees and their RSEs and considerations in setting the target level for operational risk financial resources for an RSE.

Further, good practice suggests that operational risk financial resources should not be exposed to the same investment and other risks as the RSE itself, or to the same operational risks that the requirement is intended to cover.

APRA expects that an RSE licensee would consider how to maintain its target amount if the assets that support the operational risk financial requirement do not earn the same return as the funds under management, or if the RSE's level of funds under management is growing disproportionately to the rate at which assets that support the operational risk financial requirement are growing.

9.6.4 Managing operational risk

The proposed operational risk financial requirement can protect beneficiaries from losses caused by the realisation of operational risks where risk mitigants have not worked.

Operational risk is a core risk area to be addressed in an RSE licensee's risk management framework. As part of the risk management framework requirements proposed for SPS 220, an RSE licensee would be expected to have systems, policies and processes in place to assess, monitor and report on operational risk in addition to the SPS 114 requirements for the operational risk financial requirement. Chapter 6 of this discussion paper provides further detail on the proposals for SPS 220.

Proposed PPG guidance

When assessing exposure to operational risk, RSE licensees would need to consider those risks that involve third parties, and those risks that are within the RSE licensee's operations. For risks within its operations, the RSE licensee would be expected to determine whether to insure against those risks and also consider the likelihood of full and prompt payment on any insurance claim. For risks that involve third parties, APRA would expect an RSE licensee to perform appropriate due diligence on the third-party provider, including an assessment of the third party's risk management framework and capital and other financial resources. An RSE licensee would also need to consider the extent of the third party's insurance coverage and whether or not that coverage provides partial mitigation against operational losses.

9.6.5 Transition arrangements

APRA proposes that, where reserves already held by the RSE licensee do not already meet the operational risk financial requirement, the RSE licensee be required to develop and implement a plan to build up the resources to the required level. While many RSEs already have general reserves, RSE licensees would need to determine any component of those reserves specifically set aside for operational risk purposes and which would likely be eligible for meeting the operational risk financial requirement.

APRA's view is that a reasonable transition period is one that appropriately considers beneficiary equity issues. There is a need to consider the potentially high costs to beneficiaries that would result from operational losses that may occur if operational risk financial resources are built up over a very long time period. APRA considers that a three-year transition period would be reasonable for most RSE licensees.

Chapter 10 – Funding and solvency for defined benefit funds

10.1 Objectives of defined benefit prudential requirements

A number of RSE licensees operate DB funds. While employers have primary responsibility for funding the benefits of DB fund members, prudential oversight of DB funds remains important because of the nature of the obligations of the RSE licensees of such funds. In a DB fund, the RSE licensee is required to pay a specific retirement benefit from the fund, whereas in an accumulation fund the RSE licensee is required to prudently manage the balance in each account but the amount of the retirement benefit is not specified. 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.

APRA's proposals for DB funds focus on requirements for funding and solvency that are vital to the RSE licensee's ability to fulfil obligations to its beneficiaries.

10.2 Existing requirements

Current requirements relating to funding and solvency for DB funds are contained in Part 9 of the SIS Regulations and Modification Declaration 23 which modifies the SIS Act and SIS Regulations. Part 9 deals with the financial management of funds with a focus on funding and solvency issues. Part 9 also deals with actuarial investigations required for determination of funding and solvency positions.²⁴

The legislation is not supported by any specific current guidance with respect to DB funds, although DB fund requirements are discussed in some of APRA's older or more general guidance materials.²⁵

²⁴ Part 9 also deals, to a minor extent, with calculation of 'pre-1 July 1988 funding credits and debits' dealt with under section 342 of the SIS Act and Part 12 of the SIS Regulations.

²⁵ Refer to Superannuation Circular V.D.1. *Guidelines for Determination of Timing of Actuarial Investigation under Part 9*, SPG 200 (in relation to DB risks and documentation of these) and SPG 520 (in relation to the link between complex DB funds and the expected fitness standard of RSE licensees).

10.3 Stronger Super

Stronger Super improves the funding position of DB funds by increasing funding requirements to the vested benefit level.

Stronger Super confirms that a DB fund or a DB sub-fund that otherwise complies with the *Superannuation Guarantee (Administration) Act 1992 (SG Act)* (for receipt of contributions) will automatically qualify as a default fund in respect of the defined benefit provided to beneficiaries, without being required to meet all the MySuper obligations in the SIS Act. RSE licensees will need to apply for authorisation to offer a MySuper product if they wish to receive default contributions into the accumulation sub-fund of a fund that also includes a DB sub-fund, and will not be permitted to use the term 'MySuper' for the DB sub-fund.

Where a member has an interest in both an accumulation sub-fund and a DB sub-fund, and death and disability cover is provided in the DB sub-fund, the RSE licensee will not be obliged to offer additional insurance cover in respect of the accumulation benefit of that member.

10.4 Proposed Prudential Standard SPS 160 Defined Benefit Funding and Solvency

APRA proposes to determine a new prudential standard, *Prudential Standard SPS 160 Defined Benefit Funding and Solvency (SPS 160)*.

The proposed requirements in SPS 160 will be drawn from Part 9 of the SIS Regulations, Modification Declaration 23 and from relevant parts of APRA's existing guidance materials, subject to the Government's consideration of removing existing legislative requirements in the Regulations. New requirements will be included to implement the Stronger Super position of funding at the vested benefit level.

10.4.1 Funding to vested benefit level

Stronger Super supports in principle prudential requirements that focus on funding at vested benefit level rather than at the lower minimum benefit level (which is the SG Act funding requirement for employers). This is designed to enable the funding level of DB funds to better match the obligations of the RSE licensee in relation to payment to members of the level of benefits specified in the trust deed.

Proposed SPS 160 prudential requirement

APRA proposes to require that the RSE licensee take all necessary steps to ensure that the financial position of a DB fund or sub-fund is such that the liabilities under the trust deed can be met as they fall due. This would include a funding plan agreed between the RSE licensee and the employer, and suitable actuarial investigation and certification to monitor the funding level. The prudential standard would also set requirements in respect of restoration to a satisfactory financial position if funding falls below the vested benefit level, including requirements on agreeing restoration plans with the employer.

10.4.2 Treatment of sub-funds

Modification Declaration 23 currently alters the operation of certain legislative provisions in the SIS Act and SIS Regulations to ensure that DB sub-funds are treated in a similar manner to DB funds in terms of requirements for solvency, satisfactory financial position, and reporting obligations. APRA proposes that this treatment be incorporated into SPS 160 to permanently clarify the responsibilities of RSE licensees and actuaries in relation to the operation of DB sub-funds.

Proposed SPS 160 prudential requirement

APRA proposes to apply funding requirements equally to both DB funds and DB sub-funds, with actuaries and auditors having the same obligations regarding DB sub-funds as those currently in place for DB funds. APRA also proposes to extend requirements for actuarial investigations to DB sub-funds, including required content and timing of investigations, with relevant differences in respect of DB sub-funds paying pensions.

10.4.3 Self-insurance

Under Stronger Super, RSE licensees of DB funds or DB sub-funds that are currently permitted to self-insure benefits for beneficiaries, either wholly or partially will be allowed to continue to self-insure. This is discussed further in Chapter 13 of this discussion paper.

Proposed SPS 160 prudential requirement

To support the Stronger Super reforms, APRA considers it appropriate that RSE licensees of DB funds be required to demonstrate the adequacy of their self-insurance arrangements in order to provide an appropriate level of protection to beneficiaries. Therefore, APRA proposes that SPS 160 (in conjunction with obligations to be included in *Prudential Standard SPS 250 Insurance (SPS 250)*) would require actuarial certification of the adequacy of the self-insurance arrangements of a DB fund or DB sub-fund.

10.4.4 Technical insolvency and wind-up priorities

In a situation where a DB fund is technically insolvent, APRA's view is that additional prudential requirements to adequately monitor progress to solvency would assist in protecting the interests of beneficiaries.

Proposed SPS 160 prudential requirement

APRA proposes to require RSE licensees of technically insolvent DB funds or sub-funds to actively monitor progress towards restoring solvency. This would involve undertaking regular reviews of solvency levels, regular reporting to APRA, establishment of satisfactory triggers agreed to by the employer and corresponding measures to respond to a lack of progress towards restoring solvency.

Chapter 11 – Audit requirements

11.1 Objectives of audit prudential requirements

Audits evaluate the reliability of financial information and internal controls, and in turn provide a level of assurance to beneficiaries and other stakeholders of an entity. Introducing a prudential standard on audit will support the need for RSE licensees to have effective governance processes. An audit prudential standard will also assist the RSE licensee to establish a structure within which an auditor can comply with its audit obligations.

11.2 Existing requirements

At present, RSE licensees must comply with Part 4 of the SIS Act and Part 8 of the SIS Regulations with regard to their audit obligations. These provisions govern the audit of RSEs, including provisions that deal with accounts, audit and reporting obligations for RSE licensees. Section 35C(1) of the SIS Act requires an RSE licensee to ensure an approved auditor is appointed to provide a report in the approved form about the operations of both the RSE and the RSE licensee for the year. Further, s. 35C(5) of the SIS Act refers to the content of the approved form. APRA has previously issued guidance on how the approved form should be completed, which is usually updated on an annual basis.

Part 16 of the SIS Act and certain provisions in Part 9 of the SIS Regulations deal with the obligations of actuaries and auditors, whistle-blowing provisions and liability provisions relating to disqualification and offences by actuaries and auditors.

11.3 Stronger Super

Stronger Super contains no recommendations directly related to audit requirements. However, APRA considers a prudential standard covering audit requirements would supplement the role of a sound audit function in improving governance and contributing to a reduction in risks for beneficiaries.

11.4 Proposed Prudential Standard SPS 310 Audit and Related Matters

APRA proposes to determine a new prudential standard, *Prudential Standard SPS 310 Audit and Related Matters* (SPS 310). The Government has indicated that the material contained in a number of relevant legislative provisions may be repealed and re-determined in a prudential standard. This may include certain provisions in Part 4 of the SIS Act and Part 8 of the SIS Regulations pertaining to audit. These requirements, and relevant guidance on how the approved audit form should be completed, are expected to form the basis of the requirements in SPS 310. Consideration will be given to which existing guidance should become mandatory requirements in the standard.

APRA intends to align the requirements in the proposed SPS 310 with those applying to other APRA-regulated industries to the extent appropriate. This is because audit issues are essentially the same, regardless of the industry in which an entity operates.

The provisions dealing with the obligations of actuaries and auditors, whistle-blowing provisions and liability provisions relating to disqualification and offences by actuaries and auditors (within Part 16 of the SIS Act) will remain in the legislation.

Section 35C of the SIS Act requires the provision of an audit report in an approved form. To support this, APRA currently issues a guidance note containing direction on use of the approved form of audit report. The guidance covers a range of matters, including that the report must reflect the Auditing and Assurance Standards Board (AUASB) standards, the auditor is accountable for the scope and materiality of the audit, and procedures to report non-compliance. At this stage, the Government has not indicated whether there will be changes to these provisions. Should amendments to the relevant provisions be made in the future, APRA will review whether amendments to the prudential standards would be appropriate.

11.4.1 Internal audit function

Objective and independent advice to the Board and management on efficiency and effectiveness of the entirety of an RSE licensee's operations can enhance an RSE licensee's capacity to operate. An internal audit function can assist by providing a means to conduct an independent review of risks, controls and processes, and to identify and address potential and actual operational matters that may compromise efficiency and effectiveness of business activities.

Proposed SPS 310 prudential requirement

APRA proposes to require RSE licensees to have an internal audit function that is appropriate to the nature, scale and complexity of the RSE licensee's operations. An RSE licensee may determine that it is appropriate to outsource the internal audit function, subject to APRA's approval.

As is the case in other APRA-regulated industries, 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.

11.4.2 Heightened minimum auditor requirements

RSE licensees are responsible for ensuring that auditors are fully informed about their obligations and responsibilities prior to accepting appointment.

APRA considers that fitness and propriety and independence of auditors are necessary to properly govern an audit of an RSE licensee and RSEs under its trusteeship. To support this obligation, APRA proposes fit and proper and independence requirements for superannuation auditors.

At present, an approved auditor is required to comply with independence requirements outlined in auditing guidance statements issued by various accounting and auditing industry and professional bodies. Proposed SPS 520 on fitness and propriety will contain the minimum criteria for fitness and propriety of responsible persons, including auditors. Proposed SPS 510 relating to governance will contain requirements pertaining to independence of responsible persons, including auditors.

Proposed SPS 310 prudential requirement

APRA intends to include cross-references in SPS 310 to aid RSE licensee compliance with the fit and proper and independence obligations in SPS 510 and SPS 520, rather than duplicate the requirements in SPS 310.

Chapter 12 – Business continuity management

12.1 Objectives of business continuity management prudential requirements

Business continuity management is an important component of risk management frameworks and is essential to ensure that an RSE licensee is able to meet financial and service obligations to beneficiaries at all times.

An RSE licensee is responsible for the business continuity of all RSEs under its trusteeship. BCM requires the RSE licensee to have a whole-of-business approach to business continuity, including procedures and controls, so that the RSE can continue to operate effectively in the event of business disruptions. A whole-of-business approach means the RSE licensee must address and manage the ongoing continuity of business functions at the RSE level and the RSE licensee level (where relevant), and address all material outsourced business functions. Given the high level of outsourcing in the superannuation industry, ensuring the business continuity of material outsourced functions is necessarily a key component of the BCM function for RSE licensees.

12.2 Existing requirements

Existing BCM requirements and guidance material for superannuation are minimal. The only legislative provisions dealing explicitly with BCM are the obligations in rr. 4.15–4.16 of the SIS Regulations. Regulation 4.15 requires an RSE licensee to ensure the adequacy of financial, human and technical resources, including disaster recovery and business continuity planning. Regulation 4.16 requires an RSE licensee to ensure that its material outsourcing agreements provide for business continuity planning, including transfer protocols relating to the handover of functions on the cessation of the material outsourcing agreement.

To date, APRA has issued some limited guidance to the superannuation industry about BCM. SPG 230 outlines APRA's expectations of business continuity plan (BCP) arrangements arising from the technical resource requirements (in respect of both the RSE licensee itself and outsourced service providers). SPG 200 outlines the importance of considering BCM risks as part of operational and outsourcing risks, and SGN 130.1 supports the requirements in r. 4.16 of the SIS Regulations.

APRA has also issued guidance on BCM applicable to all industries, including PPG 233 and PPG 234.

12.3 Stronger Super

Stronger Super contains no recommendations related to BCM and no specific recommendations have arisen from the consultation process. However, APRA considers it appropriate to determine BCM prudential requirements given that BCM is an intrinsic part of a risk management framework for all APRA-regulated industries. Further, BCM risks could be a significant factor in the determination of an operational risk financial requirement.

12.4 Proposed Prudential Standard SPS 232 Business Continuity Management

APRA proposes to determine a new prudential standard, *Prudential Standard SPS 232 Business Continuity Management* (SPS 232). The proposed requirements in SPS 232 will be drawn from rr. 4.15–4.16 of the SIS Regulations, SPG 230, SPG 200 and SGN 130.1, with consideration given to which elements of these should become mandatory requirements in the standard. Where appropriate, it is intended that the proposed SPS 232 will reflect the requirements applying to APRA's other regulated industries, currently contained in CPS 232, which will commence on 1 July 2012. APRA will, however, take into account relevant differences between superannuation and other APRA-regulated industries, particularly the high level of outsourcing that occurs within superannuation and the effect that this might have on BCM requirements.

APRA proposes to support the prudential standard with additional guidance material in the form of a new PPG to clarify APRA's expectations of RSE licensees regarding practical approaches to effectively meeting the requirements in SPS 232.

12.4.1 Oversight of business continuity management

CPS 232 contains a number of obligations that ensure that responsibility for oversight of all business continuity risks remains in the hands of the regulated institution, even where business operations are outsourced. Specifically, a board of a regulated institution must approve a continuity policy and ensure that there is a BCP in place. The Board must also ensure that the BCP is reviewed and tested regularly, where testing includes a range of adverse impact scenarios including higher impact scenarios, combinations of scenarios, and scenarios involving the entity itself and the material outsourced service providers.

Proposed SPS 232 prudential requirement

APRA considers it appropriate to state explicitly the minimum requirements that an RSE licensee must meet around BCM. APRA therefore proposes to include in SPS 232 Board and senior management obligations that reflect those in CPS 232.

12.4.2 Business Continuity Plan

A key provision in CPS 232 requires the regulated entity to put in place a BCP that meets certain minimum criteria.

Proposed SPS 232 prudential requirement

At a minimum, APRA proposes that RSE licensees develop and implement a BCP that:

- is developed on a whole-of-business basis designed to maintain service levels;
- includes a Disaster Recovery Plan that seeks to keep core information technology and telecommunications functions operating, or able to be recovered in a reasonable time frame if they cease operations;
- identifies critical business functions and a range of adverse impact scenarios, and their impact on the critical business functions; and
- contains appropriate recovery arrangements that form part of the RSE licensee's BCP testing processes.

In addition to having a current BCP in place for the RSE licensee and the RSEs themselves, an RSE licensee would also be required to ensure that all material outsourced service providers have a satisfactory current BCP in place. In particular, RSE licensees would be responsible for making an assessment of the adequacy of the material service providers' BCP testing processes and the adequacy of the recovery arrangements in place. This is important to ensure that the RSE licensee has confidence that risks that are not under their immediate, day-to-day oversight are being appropriately mitigated.

Chapter 13 – Insurance in superannuation

13.1 Objectives of insurance prudential requirements in superannuation

Life and disability insurance coverage provided via superannuation is an important benefit to beneficiaries. A clear strategy for the provision and management of insurance benefits is essential to support the legislative requirement of RSE licensees to provide insurance coverage in the best interest of beneficiaries.

APRA's proposals around insurance aim to incorporate requirements arising out of the Stronger Super reforms, in particular, the requirement to develop and maintain an insurance strategy and heightened responsibilities for RSE licensees of DB funds or DB sub-funds that self-insure.

13.2 Existing requirements

Current guidance for RSE licensees on the provision of insurance largely centres on what insurance can be offered, with the sole purpose test in s.62 of the SIS Act permitting benefits to be provided on death and on cessation of work due to ill-health. Further, the SIS Regulations allow RSE licensees to deduct insurance premiums from member accounts and provide the conditions for release of superannuation benefits upon death, disability or temporary incapacity.

APRA issued guidance to industry on its expectations regarding self insurance in *Superannuation Frequently Asked Questions FAQ 10.1 – Self-insurance by Superannuation Funds* to support the licensing of RSE licensees.

For RSE licensees that operate a public offer superannuation fund, a standard licence condition requires that any life insurance benefits for accumulation members, including disability benefits, must be provided through policies issued by a registered life insurance company.

RSE licensees that operate a non-public offer superannuation fund are currently permitted to self-insure.

The SG Act provides that all RSEs that are default funds receiving superannuation guarantee contributions must offer members at least a minimum level of life insurance cover. That minimum level is specified in regulations.

13.3 Stronger Super

Stronger Super specifies a number of reforms that relate to insurance to be offered to members. The key reforms are:

- the introduction of a statutory duty for all RSE licensees to manage insurance in the best interests of beneficiaries;
- a new requirement for RSE licensees to develop and maintain an insurance strategy, addressing the types and attributes of the insurance to be offered, as well as managing the insurance offering in the interests of beneficiaries;
- RSE licensees to be required to offer life and total and permanent disablement (TPD) insurance for all members, subject to members being able to opt-out of the cover; and
- self-insurance will not be permitted except for DB funds or DB sub-funds that are currently permitted to self-insure.

Stronger Super also confirms that RSE licensees can offer income protection insurance in MySuper and choice products on an opt-in or an opt-out basis, or not at all.

13.4 Proposed Prudential Standard SPS 250 Insurance in Superannuation

APRA envisages that the proposed SPS 250 will set out APRA's expectations of RSE licensees for the provision and management of insurance benefits in the best interests of beneficiaries. The proposed prudential standard will cover the insurance requirements arising out of Stronger Super and consolidate existing guidance on insurance in superannuation, where appropriate. SPS 250 is proposed to apply to all RSE licensees regardless of whether the RSE licensee is a public offer or a non-public offer RSE licensee.

13.4.1 Requirement to develop and maintain an insurance strategy

While insurance is a key benefit for members, neither legislation nor current guidance makes reference to RSE licensees considering any strategy for the insurance offered to members.

As Stronger Super supports all RSE licensees having an insurance strategy, APRA is proposing to require RSE licensees to develop, implement and maintain an insurance strategy that is appropriate to the membership of the RSE.

Some RSE licensees already have insurance strategies in place, but this is not the case across the industry and there is wide variation in the form and content of such strategies. The requirements in the proposed SPS 250 are intended to ensure that all RSE licensees have in place an insurance strategy that meets minimum requirements.

Proposed SPS 250 prudential requirement

APRA proposes that the insurance strategy of an RSE licensee include, at a minimum, consideration of the types and default levels of insurance to be offered, and the process for selecting and monitoring an insurer. The selection of insurance providers would also be subject to the conflicts of interest requirements in the proposed SPS 521.

The strategy would be required to cover all types of insurance offered to members of both MySuper and choice products.

As part of the administration and ongoing implementation of this insurance strategy, APRA proposes to require that RSE licensees identify particular roles with responsibility for maintaining the strategy, implementing and monitoring reporting requirements for insurance, and performing a periodic review of the insurance strategy.

In developing and maintaining an insurance strategy, RSE licensees would be required to demonstrate that any insurance products offered are in the best interests of beneficiaries, having regard to the characteristics of the membership of the RSE. This would include an assessment of the insurer that is to provide the insurance cover, the insurance policy's benefits and conditions and the cost effectiveness of the insurance coverage, among other relevant factors.

Proposed PPG guidance

APRA's expectations of better practice in the development of an insurance strategy would be developed in a new PPG. This might include a process for selecting and monitoring insurers and an approach to management of insurance claims.

13.4.2 Permitted insurance within superannuation

Given the terms of s. 62, life and disablement insurance (which includes both TPD cover and income protection cover) are the only forms of insurance permitted within superannuation.

APRA is aware that some RSE licensees also currently offer other forms of insurance as ancillary benefits to members. Stronger Super announced that only life, TPD and income protection insurance may be offered through superannuation for MySuper and choice products. An RSE licensee that currently offers other forms of insurance to members will be required to undertake an orderly unwinding of these other insurance offerings in order to comply with the new legislative obligation.

Beyond the minimum levels of life insurance required under the SG Act for a fund to qualify as an eligible choice fund, APRA does not propose to constrain RSE licensees' judgement as to the appropriate default levels of life and TPD insurance to be offered.

These factors should be actively considered and factored into the RSE licensee's insurance strategy. APRA does not propose to introduce quantitative limits or ceilings on the amount of cover offered.

Proposed PPG guidance

APRA expects that the PPG will include guidance on how an RSE licensee might select an appropriate level of default insurance to be offered, as well as factors that influence arrangements for members to opt out or opt back in to insurance cover.

13.4.3 Limitations on self-insurance

Stronger Super supports RSE licensees being prohibited from self-insuring member benefits, except where they are currently permitted to self-insure benefits for members of a DB fund or DB sub-fund. RSE licensees that currently self-insure benefits for accumulation members will be required to unwind any existing self-insurance arrangements within a short period of time.

Proposed SPS 250 prudential requirement

APRA proposes to include in the prudential standard requirements in relation to permitted self-insurance, including that the RSE licensee:

- attest annually that the self-insurance continues to be in beneficiaries' best interests;
- obtain a regular independent assessment of the adequacy of resources to meet current and future self-insurance liabilities; and
- develop arrangements for an orderly transfer of insurance assets and obligations in the event that the self-insurance is deemed to be no longer in the best interests of beneficiaries as a whole.

Where an RSE licensee has determined that it is no longer in the best interests of beneficiaries to continue to self-insure, APRA proposes that they be required to develop a plan for the orderly transition to new insurance arrangements and for the equitable distribution or use of any residual self-insurance assets.

Chapter 14 – Cost-benefit analysis information

To improve the quality of regulation, the Australian Government requires all proposals to undergo a Preliminary Assessment to establish whether it is likely that there will be business compliance costs associated with the proposals. In order to perform a cost-benefit analysis, APRA welcomes information from interested parties.

As part of the consultation process, APRA requests respondents to provide an assessment of the impact of the proposed changes and, specifically, any marginal compliance costs that APRA-regulated entities are likely to face.

Given that APRA's proposed requirements may impose some compliance costs, respondents may also indicate whether there are any other relevant regulations that should be improved or removed to reduce compliance costs. In doing so, please explain what they are and why they need to be improved or removed.

Respondents are requested to use the Business Cost Calculator (BCC) to estimate costs to ensure that the data supplied to APRA can be aggregated and used in an industry-wide assessment. APRA would appreciate being provided with the input parameters to the BCC as well as the final result. The BCC can be accessed at: www.finance.gov.au/obpr/bcc/index.html.

Attachment A – APRA’s prudential standards

	Superannuation (proposed)	Authorised deposit-taking institutions	General insurers	Life companies
Behavioural standards				
Governance	SPS 510	CPS 510	CPS 510	CPS 510
Fit and proper	SPS 520	CPS 520	CPS 520	CPS 520
Outsourcing	SPS 231	CPS 231	CPS 231	CPS 231
Business continuity management	SPS 232	CPS 232	CPS 232	CPS 232
Risk management	SPS 220		GPS 220, 221	LPS 220
Audit and related matters (actuarial, where relevant)	SPS 310	APS 310	GPS 310, 311	LPS 310, 320
Standards specific to superannuation				
Investment governance	SPS 530			
Conflicts of interest	SPS 521			
DB funding and solvency	SPS 160			
Operational risk financial requirement	SPS 114			
Insurance in superannuation	SPS 250			
Transition to MySuper	SPS 410			



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