Response to Submissions

Prudential guidance for superannuation

July 2013

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Preamble

APRA has, since 2011, been working to implement a new prudential framework for the superannuation industry in Australia, as part of the Government's Stronger Super reforms. This has included introduction of prudential standards for superannuation, finalised in June 2013 and the release for consultation of ten draft prudential practice guides (PPGs) on 11 December 2012 and a further eight draft PPGs in May 2013.

APRA invited comments on the ten draft PPGs released in December 2012 and received a significant number of submissions. This paper describes APRA's response to the main issues raised in submissions on those draft PPGs. Final versions of eight of these PPGs are released with this paper.

Contents

Glossary

APRA	Australian Prudential Regulation Authority
December 2012 discussion paper	*Prudential guidance for superannuation* accompanied by ten draft prudential practice guides and a summary of the proposed treatment of existing superannuation guidance (released on 11 December 2012)
FOIA	*Freedom of Information Act 1982*
ORFR	operational risk financial requirement
PPG	prudential practice guide
the Review	*Review into the Efficiency, Governance, Structure and Operation of Australia's Superannuation System*
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
RSE licensee's business operations	all activities as an RSE licensee (including the activities of each RSE of which it is the licensee), and all other activities of the RSE licensee to the extent that they are relevant to, or may impact on, its activities as an RSE licensee.
September 2011 discussion paper	*Prudential standards for superannuation* (released 28 September 2011)
SIS Act	*Superannuation Industry (Supervision) Act 1993*
SIS Regulations	*Superannuation Industry (Supervision) Regulations 1994*
SPS 114	*Prudential Standard SPS 114 Operational Risk Financial Requirement*
SPS 160	*Prudential Standard SPS 160 Defined Benefit Matters*
SPS 220	*Prudential Standard SPS 220 Risk Management*
SPS 231	*Prudential Standard SPS 231 Outsourcing*
SPS 521	*Prudential Standard SPS 521 Conflicts of Interest*
SPS 530	*Prudential Standard SPS 530 Investment Governance*
Stronger Super	Government's response to the Review (December 2010) and additional information pack (September 2011)

Executive Summary

APRA is releasing prudential practice guides (PPGs) for superannuation to support the release of prudential standards and consolidate existing superannuation guidance material.

On 11 December 2012, APRA released a discussion paper, *Prudential guidance for superannuation* (December 2012 discussion paper) and ten draft superannuation PPGs for consultation. Eight additional draft superannuation PPGs, including two covering additional investment governance-related matters, were released for consultation on 9 May 2013.

This response paper provides APRA's response to the 15 submissions received on the first ten superannuation PPGs. The main topics covered in submissions were the operational risk financial requirement, outsourcing and investments.

Eight of the PPGs have been updated to address issues raised in submissions and are released as final with this response paper. The remaining two PPGs, *Prudential Practice Guide SPG 530 Investment Strategy – Formulation* (SPG 530) and *Prudential Practice Guide SPG 531 Investment Strategy – Implementation* (SPG 531), will be finalised once consultation on the PPGs released in May 2013 is completed. This will allow all investment governance-related PPGs to be finalised together. This paper provides details on the comments received on SPG 530 and SPG 531 and APRA's response to those comments. APRA expects industry to consider this response paper and the draft PPGs as an indication of APRA's guidance regarding investments.

Prudential practice guides

SPG 114	*Prudential Practice Guide SPG 114 Operational Risk Financial Requirement*
SPG 220	*Prudential Practice Guide SPG 220 Risk Management*
SPG 231	*Prudential Practice Guide SPG 231 Outsourcing*
SPG 232	*Prudential Practice Guide SPG 232 Business Continuity Management*
SPG 250	*Prudential Practice Guide SPG 250 Insurance in Superannuation*
SPG 510	*Prudential Practice Guide SPG 510 Governance*
SPG 520	*Prudential Practice Guide SPG 520 Fit and Proper*
SPG 521	*Prudential Practice Guide SPG 521 Conflicts of Interest*

Chapter 1 – Introduction

As part of the Government's Stronger Super reforms[1], the *Superannuation Industry (Supervision) Act 1993* (SIS Act) was amended on 8 September 2012 to provide APRA with prudential standards-making power for superannuation. On 15 November 2012, APRA issued eleven final prudential standards and, a response paper *Prudential standards for superannuation*. On the 28 June 2013, APRA released final versions of three prudential standards for superannuation that had previously been released in proposed final version.

On 11 December 2012, APRA released a discussion paper, *Prudential guidance for superannuation* (December 2012 discussion paper). This paper outlined APRA's proposed release of a new suite of PPGs for consultation (refer to Attachment A). The first set of ten draft PPGs was released for consultation with the December 2012 discussion paper, and the second set of eight draft superannuation PPGs was released for consultation on 9 May 2013.

The December 2012 discussion paper also outlined APRA's review of existing superannuation guidance material and proposed removing guidance that is no longer required as it had been superseded or had otherwise been incorporated into the SIS Act, *Superannuation Industry (Supervision) Regulations 1994* (SIS Regulations) or prudential standards as mandatory requirements.

This response paper provides APRA's response to submissions on the first set of superannuation PPGs. Eight of these PPGs have been updated to address issues raised in submissions and are released in final form with this response paper. The status of the remaining PPGs is discussed below.

Consultation on the second set of PPGs closed on 4 July 2013. After a review of submissions APRA intends to release the PPGs in the second set as final in the last quarter of 2013.

1.1 Overview of submissions

APRA received submissions on the ten draft PPGs released in December 2012. Feedback received was largely positive, supporting the proposed guidance and raising few substantive issues.

1.2 Role of PPGs

Submissions indicated some uncertainty regarding the role of PPGs in the new prudential framework for superannuation. In particular, some questioned whether the use of different phrases in the draft PPGs implied that some expectations were more important than others, with some words creating an impression that some guidance in a PPG is enforceable. Similarly, it was suggested that language such as 'an RSE licensee would ordinarily' may be viewed as a form of words that was too limiting, so that an RSE licensee may feel that a reasonable alternative would not be acceptable to APRA.

The framework for the prudential regulation of superannuation encompasses requirements in the SIS Act, the SIS Regulations, prudential standards and guidance material.

PPGs are designed to provide guidance on APRA's view of sound practice in particular areas. PPGs frequently discuss legal requirements from legislation, regulations or APRA's prudential standards, but do not themselves create enforceable requirements. The purpose of a PPG is not to impose requirements beyond those set out in the law and prudential standards. APRA has now included a set of standardised words in each of the PPGs to clarify the purpose of the guidance material.

1.3 PPGs without substantial change

Prudential Practice Guide SPG 510 Governance, *Prudential Practice Guide SPG 520 Fit and Proper* and *Prudential Practice Guide SPG 232 Business Continuity Management* received only minor comments and, as a result, include only minor amendments.

Prudential Practice Guide SPG 250 Insurance in Superannuation (SPG 250) received a number of comments, particularly suggestions to reflect common practices within the superannuation and insurance industries. SPG 250 therefore includes a number of minor changes to reflect these suggestions.

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

Prudential Practice Guide SPG 220 Risk Management includes a number of minor amendments and clarifies APRA's expectations regarding the difference between the comprehensive three-year review and the annual review of the risk management framework. Whilst *Prudential Standard SPS 220 Risk Management* (SPS 220) does not require the annual review to be carried out by someone who is operationally independent, APRA expects an RSE licensee to consider what would be an appropriate degree of objectivity for the person or persons conducting the annual review. An RSE licensee may decide that resources from the internal audit or risk management function have the appropriate skills and experience to perform the annual review of the risk management framework.

PPGs with substantive changes are discussed in Chapter 2.

1.4 Investment governance-related PPGs

Draft *Prudential Practice Guide SPG 530 Investment Strategy – Formulation* (SPG 530) and draft *Prudential Practice Guide SPG 531 Investment Strategy – Implementation* (SPG 531), which were released in the first set of draft PPGs with the December 2012 discussion paper have not been finalised.

APRA released as part of the second set of PPGs, two further draft investment governance-related PPGs – draft *Prudential Practice Guide SPG 532 Investment Risk Management* (SPG 532) and draft *Prudential Practice Guide SPG 533 Valuation* (SPG 533).

APRA now considers it more appropriate to release all investment governance-related PPGs as a final suite of guidance at the one time. This will enable APRA to consider submissions received on draft SPG 532 and draft SPG 533 to ensure that guidance provided on investment governance matters is consistent across the PPGs.

Once submissions on SPG 532 and SPG 533 have been received, APRA will also consider consolidating relevant guidance in SPG 530, SPG 531 and SPG 532 into one comprehensive guidance document.

Submissions received on draft SPG 530 and draft SPG 531 welcomed the guidance material and recognised that the PPGs addressed, where appropriate, the different business models and investment approaches of RSE licensees. As a result, APRA does not intend to substantively change the content in these draft PPGs other than to address the specific matters discussed below.

1.4.1 Investment objectives

Draft SPG 530 provided guidance on the requirement for an RSE licensee to set investment objectives when formulating an investment strategy. Draft SPG 530 noted that an RSE licensee that offers a single security option or an externally managed investment option may not be able to directly set investment objectives. The guidance proposed that an RSE licensee could, after due consideration, adopt existing investment objectives where they were available. A number of submissions sought clarity regarding the extent of consideration expected of an RSE licensee when reviewing existing objectives, while others submissions questioned how an RSE licensee might adopt existing objectives for a single security option.

APRA response

APRA intends to amend its guidance to indicate that it expects that an RSE licensee would determine the level of review and consideration of existing investment objectives for externally managed investment options following an RSE licensee's due diligence process. APRA's guidance provides RSE licensees with detailed sound practice on due diligence.

The guidance will also clarify that where the adoption of an existing investment objective is not possible, as is the case for a single security option, APRA expects that an RSE licensee would describe more generally how the expected returns and risk exposures of a single security option may affect retirement benefit outcomes.

1.4.2 Defined benefit investment strategy

When formulating an investment strategy for a defined benefit RSE, draft SPG 530 outlined a number of factors that an RSE licensee would typically consider in addition to internal and external matters that are likely to influence an investment strategy for all RSEs. Submissions generally agreed with this approach in draft SPG 530, with a number of submissions suggesting additional factors a prudent RSE licensee might consider. In addition, submissions suggested that the matters addressed in draft SPG 530 would be equally valid where formulating an investment strategy of a defined benefit sub-plan.

APRA response

APRA intends to extend its guidance to include matters arising from *Prudential Standard SPS 160 Defined Benefit Matters* that are relevant for an RSE licensee to consider during the formulation of an investment strategy for a defined benefit fund or defined benefit sub-fund. These include the shortfall limit, the probability of continued employer support 'via a restoration plan or a pre-arranged funding plan' and the outcomes from any stress testing undertaken.

1.4.3 Stress testing

Draft SPG 530 and draft SPG 531 provided high-level guidance regarding stress testing of an investment strategy, both at formulation and on an ongoing basis. Submissions indicated that RSE licensees sought further detailed guidance on stress testing, particularly with respect to conducting stress testing of externally managed investment options.

APRA response

APRA has released, for consultation, more detailed guidance on stress testing in draft SPG 532. APRA intends to review the guidance provided in draft SPG 530 and draft SPG 531 in light of submissions on SPG 532.

1.4.4 Asset allocation rebalancing

Draft SPG 531 provided guidance on sound practice approaches where an RSE licensee would need to rebalance the asset allocation in an investment option to align with the investment strategy for that option. Some submissions indicated that, where an RSE licensee offers externally managed investment options, it would not be in a position to reallocate investments underlying that option in order to rebalance the asset allocation as this would be undertaken by the external investment manager.

APRA response

APRA does not expect an RSE licensee to be able to rebalance the asset allocations of externally managed investment options. However, APRA intends to include guidance to assist an RSE licensee to implement prudent practices in reviewing and assessing whether the asset allocation of an externally managed investment option has deviated from the original allocation when the option was first selected by the RSE licensee.

APRA also intends to provide additional guidance regarding an RSE licensee's use of an investment option as a liquidity provider to other investment options. This is where an RSE conducts internal trades with other investment options in the RSE to rebalance the other options back to their strategic asset allocation.

Chapter 2 – Issues relating to specific PPGs

2.1 Operational risk financial requirement

Prudential Practice Guide SPG 114 Operational Risk Financial Requirement (SPG 114) provides guidance to assist an RSE licensee to comply with *Prudential Standard SPS 114 Operational Risk Financial Requirement* (SPS 114).

2.1.1 Guideline ORFR target amount

Draft SPG 114 included a guideline operational risk financial requirement (ORFR) target amount of at least 0.25 per cent of funds under management (FUM). This guideline received a small number of comments expressing different views. It was noted that the guidance provided the superannuation industry with a convenient starting point; however, some submissions questioned and sought transparency on the basis for the ORFR guideline amount, including details of the risk tolerance or confidence level upon which the guideline is based. These submissions also suggested that an ORFR target amount that is too high may have a negative impact on members.

APRA response

APRA recognises that the ORFR is a new concept for the superannuation industry and the frequency and scale of operational risk events is uncertain due to a lack of superannuation-specific data and shared experience across the industry. APRA remains of the view that the lack of data will make it difficult for RSE licensees to develop sophisticated modelling approaches that accurately reflect the risks that are particular to the superannuation industry. During the initial implementation phase of SPS 114, therefore, APRA encourages simple, but prudent approaches to setting an ORFR target amount.

Over time, APRA expects some RSE licensees will develop and refine more risk-sensitive approaches to setting an ORFR target amount based on experience in implementing SPS 114 and SPS 220. APRA also expects that some RSE licensees may continue to rely on a guideline ORFR target amount. APRA therefore is not proposing to change its guidance regarding the guideline amount of 0.25 per cent of FUM at this time.

2.1.2 Impact of different investment structures on the ORFR target amount

Draft SPG 114 provided guidance on the impact of different investment structures on the ORFR target amount. This guidance suggested that where an RSE invests in another entity that is subject to a similar financial requirement, it may only be appropriate to consider the impact of another APRA financial requirement on the ORFR target amount when an RSE licensee 'fully invests' the assets of its business operations in another 'related' entity. Some submissions questioned whether this restriction on who may consider the impact of another APRA financial requirement is appropriate, necessary and fair.

APRA response

APRA has revised the guidance on taking into account another APRA financial requirement when determining an ORFR target amount. The revised guidance provides more explicit expectations of the circumstances when such consideration may be appropriate and the steps that would justify a reduced ORFR target amount. APRA's view is that typically, it will only be possible to justify a reduced ORFR target amount when the other entity is within an RSE licensee's business operations or is closely related to the RSE licensee.

APRA is also of the view that regardless of the strength of the relationship and level of oversight and assurance, there will inevitably be additional operational risks that result from transactions between the two entities. Further, not all of the operational risks of an RSE are likely to be able to be addressed by the APRA financial requirement applying to another entity. SPG 114 now includes guidance that, where an RSE invests in another entity that is subject to SPS 114 or another APRA financial requirement relating to operational risk, the ORFR target amount that an RSE licensee could conclude as being necessary would be at least 0.10 per cent of FUM of that RSE. SPG 114 also explains how this may be applied when the other entity is within the RSE licensee's business operations.

2.1.3 ORFR reserves – investment strategy

SPS 114 requires that the ORFR strategy include an investment strategy for maintaining an operational risk reserve. Some submissions sought further guidance on APRA's expectations for this investment strategy, and in particular, whether APRA expected ORFR reserves to be invested in cash assets or similar.

APRA response

SPG 114 explained that the primary purpose of an operational risk reserve is to provide an unrestricted commitment of financial resources to address losses arising from operational risk events in a timely manner. APRA does not intend to provide any guidance on particular assets classes for the investment strategy. APRA has, however, added guidance regarding the appropriateness of an operational risk reserve investment strategy that mirrors the investment strategy of the RSE.

2.1.4 Use of the financial resources held to meet the ORFR target amount

Draft SPG 114 explained that the financial resources held to meet the ORFR may be used to address an operational risk event, but not the costs to correct the cause of the event. APRA has continued to receive questions on whether the payment of particular costs would be permissible uses of the ORFR.

APRA response

APRA recognises that some transaction or other process-related cost(s) may only materialise as a result of an operational risk event and, in some circumstances, payment of these costs in a timely manner is essential to ensure that the loss is properly addressed and members do not incur large one-off expenses. APRA expects any payments to be consistent with the requirements of SPS 114 and the RSE licensee's ORFR strategy.

APRA does not consider it appropriate to specify the types of transaction costs that can be met using ORFR financial resources; whether or not they are appropriate uses of the ORFR will depend on the particular circumstances. Instead, APRA has amended SPG 114 to articulate the factors that it expects an RSE licensee would consider when determining whether a particular transaction cost may be justified as a permitted use of the ORFR in accordance with SPS 114.

2.2 Outsourcing

Prudential Practice Guide SPG 231 Outsourcing (SPG 231) aims to assist an RSE licensee to comply with *Prudential Standard SPS 231 Outsourcing* (SPS 231) and is based on similar guidance provided by APRA for its other regulated industries. Submissions generally welcomed this guidance material and made a number of suggestions for improvements that have led to some changes to the content of SPG 231 in addition to the more substantive changes discussed below. These changes include:

- clarification that the RSE licensee's conflicts management framework may cover conflicts related to outsourcing, or the outsourcing policy itself may do so;
- that it may be appropriate to adopt a different selection process for the renewal of an agreement than the process used when the agreement was initially entered into; and
- that whilst the RSE licensee is responsible for setting the framework for managing outsourced services, it may be appropriate to utilise or adopt a service provider's detailed policies where these are considered congruent with the RSE licensee's policy framework.

2.2.1 Investment arrangements

Outsourcing agreements in respect of material business activities are subject to the outsourcing requirements of SPS 231, which requires that APRA be consulted prior to a material business activity being conducted offshore.

Draft SPG 231 explained that investment management functions under a formal agreement or mandate (including implemented asset consulting) would typically be considered to be material business activities. Some submissions sought further guidance on the SPS 231 requirement for prior consultation with APRA for investment-related offshoring agreements.

APRA response

APRA's view is that the superannuation industry should be subject to the same requirements as other APRA-regulated industries.

APRA has amended SPG 231 to clarify that investments in pooled investment vehicles would not typically be considered to be outsourcing for the purposes of SPS 231.

APRA intends to take a practical approach to administering the requirement for consultation prior to offshoring, particularly for those RSE licensees that may need to engage in prior consultation on a high-frequency basis. APRA encourages such RSE licensees to engage with their APRA supervisor to discuss an appropriate approach that satisfies the intent of the prior consultation requirement. APRA may consider an alternative approach if an RSE licensee can demonstrate that it has in place a robust investment policy, formal structured review and appointment processes are consistently followed for the appointment of offshore investment managers, and the relevant risks are adequately captured in the RSE licensee's risk management framework. If agreed, this would lessen the extent of engagement required between the RSE licensee and APRA when an individual change occurs.

2.2.2 Use of professional actuarial services

Draft SPG 231 indicated that the use of advisory services or professional services, including an RSE actuary, will not generally constitute a material business activity and as such will not fall within the definition of outsourcing for the purposes of SPS 231. Some submissions suggested that this guidance be revised to clarify the distinction regarding advisory or professional services to improve clarity about APRA's expectations.

APRA response

SPG 231 has been amended to clarify that, even where an advisory or professional service is provided under an ongoing or regular arrangement, e.g. for review or amendment of trust deeds or actuarial services in respect of a defined benefit fund, the arrangement is unlikely to be considered outsourcing unless the service could reasonably be performed by an RSE licensee. It is APRA's view that, where the advisory or professional service extends beyond the recognised advisory or professional role, e.g. in the form of additional consulting services, this may be considered to be outsourcing.

2.2.3 Liability and indemnities in subcontracted arrangements

Draft SPG 231 included references to the use of sub-contracting arrangements. Concerns were raised that providing for sub-contracting in the outsourcing agreement may potentially compromise the RSE licensee's ability to recover damages from the primary service provider who, in the absence of any provisions, is ultimately liable for the provision of services and for the conduct of any sub-contractor.

APRA response

APRA's view is that SPS 231, paragraph 22, protects an RSE licensee such that any subcontracting remains the responsibility of the primary service provider. SPG 231 has therefore not been amended in this regard.

2.3 Conflicts of interest

Prudential Practice Guide SPG 521 Conflicts of Interest (SPG 521) aims to assist RSE licensees to comply with *Prudential Standard SPS 521 Conflicts of Interest* (SPS 521) as well as the general law requirements of the SIS Act and duties in the *Corporations Act 2001*.

Draft SPG 521 provided guidance on the requirement for RSE licensees to develop, implement and review a conflicts management policy, including how the conflicts management framework might be implemented and reviewed.

Some submissions sought further guidance on APRA's expectations of how the conflicts management framework might be implemented and what could be included within it.

APRA response

PPGs provide guidance that is aimed at all RSE licensees, noting the wide variety of business models within the APRA-regulated superannuation industry. Conflicts of interest and duty are matters that are specific to the circumstances of each RSE licensee's business operations. APRA's view is that an RSE licensee is, therefore, best placed to manage the conflicts of interest and duty that arise within its business operations. APRA's view is that more specific guidance on potential conflicts of interest or duty would not enhance SPG 521, but has amended it to further clarify APRA's expectations about the process an RSE licensee might undertake to assess and manage conflicts, highlighting the ongoing nature of this process.

In addition, SPG 521 has been updated to clarify APRA's expectations regarding the review of the conflicts management framework. APRA's expectation is that, in addition to the requirement in SPS 521 that a comprehensive review be undertaken every three years, an RSE licensee would take steps to ensure that the annual review is also objective. This change aligns SPG 521 with the guidance relating to the risk management framework outlined in SPG 220.

Attachment A - New and updated superannuation related PPGs as at July 2013

Prudential Practice Guide	Status
SPG 114 Operational Risk Financial Requirement	Released July 2013
SPG 160 Defined Benefit Matters	Draft released May 2013
SPG 220 Risk Management	Released July 2013
SPG 221 Adequacy of Resources	Draft released May 2013
SPG 222 Management of Reserves	Draft released May 2013
SPG 231 Outsourcing	Released July 2013
SPG 232 Business Continuity Management	Released July 2013
CPG 233 Pandemic Planning	Updated May 2013
CPG 234 Management of Security Risk in Information and Information Technology	Updated May 2013
PPG 235 Managing Data Risk	To be released August 2013
SPG 250 Insurance in Superannuation	Released July 2013
SPG 270 Contribution and Benefit Accrual Standards	Draft update released May 2013
SPG 280 Payment Standards	Draft update released May 2013
SPG 310 Audit and Related Matters	To be released in quarter 3 2013 for consultation
SPG 410 MySuper Transition	Released February 2013
SPG 510 Governance	Released July 2013
SPG 511 Remuneration	Draft released May 2013
SPG 520 Fit and Proper	Released July 2013
SPG 521 Conflicts of Interest	Released July 2013
SPG 530 Investment Strategy - Formulation	Draft released December 2012
SPG 531 Investment Strategy - Implementation	Draft released December 2012
SPG 532 Investment Risk Management	Draft released May 2013
SPG 533 Valuation	Draft released May 2013

Telephone
1300 55 88 49

Email
info@apra.gov.au

Website
www.apra.gov.au

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

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