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Dear APRA

Strengthening Financial Resilience in Superannuation

Discussion Paper, ***Strengthening Financial Resilience in Superannuation***, released in November 2021, summarises APRA's current expectations and calls for submissions from RSE licensees and other industry stakeholders.

As one of the leading consultancy firms in the superannuation industry, Deloitte welcomes the opportunity to respond and provide feedback into an important, complex issue for the industry, which we are comfortable with APRA making available publicly.

We note that APRA has asked specific questions in relation to six subject matter areas. We have not sought to specifically answer each question, but rather to provide our observations on how we consider that APRA might consider providing guidelines or regulatory frameworks to the industry.

In particular, our purpose in making this submission is to draw attention to the emphasis that superannuation funds should have on their approach to risk management and that this should be aligned to funds' risk appetite statements, which should, in turn, be publicly available and accessible to all members and stakeholders of the funds.

An organisation's risk appetite statement should recognise that having a zero probability of "failure" is unlikely to be realistic, nor is it likely to be in the best interests of its various stakeholders. In this regard, superannuation funds should consider where risks are likely to emerge and then what is the appropriate approach to managing these risks.

There are a variety of strategies for an organisation to manage its exposure to risk, including:

- It can seek to avoid the risk completely.
- It can endeavour to pass some or all of the risk to a counterparty via outsourcing or insurance.
- It can accept that there is a level of risk which is inherent in its required activities and seek to mitigate this with the help of appropriate skills, technology, processes and controls.

- It can accept that there are elements of risk where management strategies need to include holding reserves and / or capital so that when something goes wrong, there is a source of funding available that can be used to help address the issue.

Effective risk management requires using a combination of strategies as appropriate to the organisation and the nature of the risks.

The overall risk management strategies (avoidance, mitigation, insurance, outsourcing, holding reserves and / or capital) should be in line with the organisation's risk appetite. The interaction of these should result in a level of reserves and / or capital that is appropriate for the organisation and its risk appetite. It is appropriate that an organisation's risk appetite changes over time as the resources, size and complexity of its business and operations evolve with the changing nature of the market and its membership.

Background

Over the 30 years since the Superannuation Guarantee was introduced, and following wide-spread industry consolidation, the number of APRA-regulated superannuation funds has fallen and total assets in the system have trended upwards, and there has been a commensurate increase in the average size of funds.

This trend has accelerated in recent years and further consolidation will continue to occur as funds are challenged to meet increasingly onerous regulatory obligations, including to document evidence that demonstrates that they are always acting in their members' best financial interest and the introduction of the Your Future, Your Super (YFYS) performance tests.

In December 2021, Deloitte issued its latest projections of the superannuation market. The report highlights the remarkable growth of the average fund size. Within a short timeframe, the largest ten funds will hold over $100 billion each and, depending on merger activity, another 10 could hold more than $30 billion each.

As the APRA regulated funds grow, it will be important to ensure they remain financially resilient both against adverse shocks and against periods of adverse conditions. With a smaller number of larger funds managing the retirement savings for most Australians, the ability for these remaining superannuation funds in the industry to bounce back from a financial shock will be important.

To this end, APRA now seeks insight into:

- the adequacy, purpose, and management of financial resources;
- the financial resources available to RSE licensees;
- financial projections in business planning practices; and
- RSE licensees' provisioning for contingencies.

APRA now regulates banks and other Approved Deposit-taking Institutions (ADIs), life and general insurance companies, private health insurers (PHIs) and superannuation funds (excluding SMSFs). It has established capital and reserving policies for all these groups, and changes are made continuously as market forces change.

The requirements for ADIs follow international capital requirements under Solvency II. Life & General Insurance Capital (LAGIC) uses similar processes to set up capital requirements for the insurance industries. The PHI rules are currently under review and will likely be based on similar processes.

However, superannuation in Australia is different in that accumulation funds do not make any express promises, nor do they provide guarantees for their products. As a result, members take on most of the investment and other risks themselves.

There is, however, some protection for members against adverse events:

- There are government guarantees to protect members in the event of fraud or theft by the Trustee. This is funded by an industry levy on funds, although:
  - SMSF funds are not covered by this protection.
  - Identity fraud and (other) cyber related risks will not be covered by this levy. As a result, funds will need to ensure they have strong controls and risk management processes, as well as insurance and reserves in the event those controls and risk processes are not successful.
- Many funds (described as 'retail' by APRA) have shareholders which provide capital to the funds and, in some cases, various guarantees.
- Funds set aside reserves as contingencies. Practice varies between funds and reserves can be specific such as the Operational Risk Financial Requirement (ORFR) which is a legislative requirement, or they can be aggregated to cover a range of contingencies.
- Funds can "insure" against some contingencies. The most common form is life insurance where the benefit (apart from the account balance) is fully insured. Another example is currency hedging to protect foreign investments from changes in currencies against the Australian dollar in which assets are valued.
- Some funds have an element of recourse against third party providers should the providers be at fault for a loss. These providers may in turn hold financial reserves and insurance.

Defined benefit funds hold reserves to ensure there is a high likelihood of promised benefits being paid in future. These funds are stringently regulated separately from defined contribution (accumulation) arrangements and are outside the scope of this consultation.

History of reserving

Until the introduction of compulsory employer superannuation, there were two major types of superannuation fund in Australia. The first was defined benefit funds provided in the main by governments and large companies. The second were policies issued by life insurance companies.

The latter were Whole of Life or Endowment participating policies ('traditional business') for retail customers. The life companies, most of which were mutuals, held reserves to back this business. Actuaries declared bonus rates annually using smoothing techniques to ensure long term viability and that policyholder outcomes were less volatile.

For company superannuation, many large companies ran their own schemes or life companies issued Deposit Administration schemes which were unitised and were like investment schemes issued today. Many of the early arrangements paid simple interest to members and / or had capital guaranteed investments which involved smoothing of investment returns. Over time, these arrangements ('managed funds') replaced the traditional business and the introduction of computers to superannuation administration enabled the calculation of compound rates of return.

These policies came under pressure in the late 1980s as the changing mix of business, including selling large single premium capital guaranteed policies, made it difficult to allocate reserves equitably.

Initially, the new industry superannuation funds invested in capital guaranteed products. As they grew, they shifted to investment-linked policies. Later, they managed their own portfolios of investments with many using life office techniques to smooth annual earning rates. Smoothing the returns led to inequities between members or between cohorts of members, particularly with large rollovers into or out of funds. APRA first discouraged and then ultimately banned these practices and the whole industry moved to a position where investment values were "marked to market value" continuously, at least for liquid assets.

Through the 2000s, the mutual[1] ('not for profit') superannuation funds built their own reserves. There were several sources used:

- Many funds had with-profit group insurance arrangements. The profits were added to reserves rather than used to adjust premium rates.
- Funds deduct an allowance for tax from contributions and investment earnings and set this aside as a reserve from which the tax is later paid. Where the deductions are too high, the fund will generate a surplus from the lower tax paid. This surplus would then usually be added to general reserves.
- Where funds grow quickly, their fee income can often exceed their costs. The surplus is added to reserves.
- Fund mergers increased reserves by combining them from both funds. Costs were reduced whilst maintaining fees at the level of the larger fund. This led to further surpluses.
- In addition, many funds had already started to develop financial management capabilities that relied on business planning and pricing models to consider likely and potential future scenarios including scenarios in which declines in investment values lead to asset-based fees being lower than expected. In particular, the more prudent funds planned ahead with a view to generating fee revenue slightly more than the planned annual expenditure. These practices were consistent with APRA requiring funds to have a 3 year forward plan that considers expenditure on strategic initiatives and projects.

Where funds need capital to grow, unlike their commercial counterparts that could seek a capital injection from their shareholders or could take on debt, the not-for-profit superannuation funds only have a few options:

- They could use existing reserves.
- They could introduce a special levy, as many funds did when the ORFR was introduced.
- They could outsource projects or services to a third-party (for example, administration of the membership) and this party would charge a high enough fee to pay for its own research and development.
- Development or acquisition of operations providing additional capabilities could be financed outside the reserving framework through investments on behalf of members, subject to the specific investments being in the best financial interests of members.
- They could develop services within the fund using member fees as the source of finance, provided that where this is the case the fund is careful not to breach the sole purpose test.

Operational Risk Financial Requirement

The Stronger Super changes introduced some prudential standards for the industry to improve financial resilience for all funds. An ORFR was introduced from July 2013[2]. This needs to be determined by trustees as part of their risk management framework, but APRA considered a minimum level for all funds was 25 basis points (0.25%) of assets (funds under management). Some allowance is given for investments in other RSE products (such as pooled superannuation trusts) which have their own ORFR.

The ORFR could be taken from existing reserves if available. A few funds initially used a bank guarantee. Many funds, without the initial financial resources, built their ORFR by deductions from member accounts over three years.

The ORFR remains the reserve most commonly held by APRA-regulated funds. At the time it was introduced, Deloitte issued a note on the implications for member equity[3]. Many of these points remain relevant today. We also note the growing maturity of funds in relation to the management of this reserve from the initial creation, which sees the ORFR locked away for permitted use and to be replenished in an orderly manner, as and if required, which should aid intergenerational equity.

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[1] Technically, the funds are not mutuals as they are incorporated as companies. However, they hold a nominal number of shares in trust and never pay dividends. They also have no access to capital.
[2] Superannuation Prudential Standard SPS 114.
[3] Deloitte – ORFR and Member Equity, Some Practical Considerations, 2014. deloitte-au-hc-orfr-member-equity-011014.pdf

Areas where we see opportunities for further development in both regulatory guidance are:

- Differentiation of ORFR levels by level of the risks against which capital should be held, taking into account overall risk levels and other mitigation strategies.
- Clarity on what are the appropriate and allowable uses of the ORFR.
- Clarity on approaches following a drawdown from the ORFR. We suggest that areas for consideration should include:
  - target level of ORFR following the drawdown including situation-specific consideration of whether it should be the same as before, higher in response to any evidence of risks being higher than previously assumed, lower due to an issue having been resolved;
  - speed of replenishment of ORFR; and
  - the extent to which replenishment of the ORFR can be deferred while obtaining visibility on any recoveries from other parties such as third-party providers or insurers.

General issues

Where a fund builds up very strong reserves (as did the life insurance industry prior to 1990), the generations building these reserves could receive lower returns as they are built up. Conversely, funds which build inadequate reserves may lead to future members getting lower returns. There is a fine balance between building the right level of reserves against under/overcharging members as they are accumulated. When members leave a fund, they do not receive their share of any reserves as these are held for the collective benefit of the fund.

It is also possible that some funds have not developed sufficient reserves for potential future needs. Such needs could be in relation to developing new products, taking more direct responsibility for more activities including member engagement. It could also be in relation to having optionality to pursue strategic initiatives such as mergers when potentially suitable opportunities arise. Other areas which could cause challenges include needing to change key service providers or delivery models on short notice, and unexpected remediation requirements.

As an increasing proportion of Australia's retirement savings are held by superannuation funds, we anticipate that key aspects of the superannuation system will increasingly come into focus. In particular, with increasing fund size we are seeing corresponding increases in each of:

- Private markets investments;
- Internal investment management; and
- Directly held investments, both in terms of the number of directly held investments as well as the increasing asset size of the directly held investments for each fund.

Superannuation funds need to consider Members' Best Financial Interests in all their activities, including the management of any capital and / or reserves or other methods of building financial resilience. In this way, it could be useful to think about reserves along the same lines as an insurance company thinks about its layers of capital requirements. In this case, superannuation funds might think about their capital and / or reserve requirements as including:

1. Reserves / provisions, for costs that are expected to be incurred or which are planned. This could include the ORFR, life insurance provisions, tax provisions, etc.

2. Capital loadings, for variance in expectations and contingencies.

3. Target capital, which might be an amount to be held above requirements to ensure the fund is meeting its internal risk appetite, over and above any regulatory requirements.

4. Excess assets, some of which might be held back for other strategic purposes. For example, future investment, mergers, internalisation or insourcing objectives.

As a result, it will be important to look at the total financial position of the fund including any other capital requirements and guarantees before arriving at an appropriate quantum.

Where a reserve is simply a provision such as the Tax Reserve, it is sensible to hold it as a specific amount as the best estimate of the amount required. It may be necessary for some funds to build excess assets in the event that a fund will incur expected costs of specific initiatives, such as replacing legacy administration systems with a new system.

Today, we have a mixture of mutual and proprietary funds with the latter group using shareholder capital or guarantees as an additional protection.

Trustees must consider several questions:

- Should they aggregate reserves or hold separate allocations of capital?
- What size should the reserves be?
- If they need to be increased, where should the funds be sourced from and over what period?
- When should the reserves be used?
- Should the reserves be held in cash, or can they be invested in (say) the MySuper investment strategy?
- In the event that funds start to hold layers of reserves and / or capital, these layers might all be invested differently, with some layers invested even more aggressively. For example, excess assets above requirements that are expected to be maintained for some longer term could be invested more aggressively. In fact, this might even be an outcome of applying the members' best financial interest test.

The size of reserves held by a fund should be sufficient to cover the risks that the RSE licensee is exposed to, consistent with the risk appetite adopted by the Trustee. It is unlikely that any fund could, or indeed should, target a 100% likelihood of not failing in all areas.

Risks can also change over time, so it is sensible to be prudent in setting a reserve necessary to cover all risks. In doing so, the RSE licensee needs to be careful not to set too high a level as this will be an impost on current members.

It would be useful to obtain clarity on what are the allowable and appropriate mechanisms for repatriating those reserves to members and avoiding tax leakage.

Sources of Financial Resources

APRA has categorised the areas where an RSE licensee requires adequate financial resources to support their business as:

- continuing to operate the business, including its administration and implementation of APRA's Contingency and Resolution Planning Framework;
- delivery of the fund's business plan; and
- fund contingency expenditure items.

APRA has asked what sources of funding and support are used to address the above areas and how they might change in future.

Fund administration

The administration of an Australian superannuation fund is complex. While maintaining a simple accumulation account is now standard, it is the constantly changing requirements which add the complexity and lead to higher costs. In particular, constant regulatory change (including in relation to taxation), in conjunction with the continual development in the market offerings and evolving customer needs, means that the risks associated with fund administration need to be carefully managed.

Fund administration today has evolved from record-keeping, fund accounts and member statements to a much broader portfolio that also provides member services, communications, Call Centres, financial advice, life insurance, and retirement accounts.

Some large funds undertake all their administration in-house whereas others outsource the basic administration functions and some of the communications services. In the past, some funds have built and managed their own proprietary technology, usually within a related party (administration) service company. There are also examples of funds that have acquired the rights to the technology and for ongoing maintenance to be the responsibility of the fund. As such, it is worthwhile noting that self-administration should separately consider the risks of the administrator from the risks associated with the technology.

Where a fund undertakes all the work themselves, they will also be solely liable for the cost of any administration failures. A common example is remediation for delays in effecting investment switches. Where the work is outsourced, the fund should manage the outsourcing relationship so as to be in a position to rely on the resources of the contracted administrator to cover any financial penalties.

At present, we consider that in-house administrators hold minimal reserves expressly as a contingency for administration failures. Some funds will hold insurance against adverse events, but industry practice is not uniform. As a fund conducts more functions inhouse, it should be required to purchase insurance against these events or demonstrate that it has sufficient internal resources and reserves to make good any financial losses.

In theory, those funds outsourcing services to third parties should manage the outsourcing relationship so as to be able to rely on the resources of the third-party administrator (TPA) to make good any remedial payments and the associated costs. However, some problems will not be clear-cut and the fund could be part of the problem. Further, there is always a risk that a TPA will dispute the issue, thereby shifting the problem back to the fund. In rare cases, the TPA could even exit the business leaving the problem behind.

We anticipate that as superannuation funds grow, they will bring more services in-house. When this occurs, the internalisation of activities should be consistent with the fund's risk appetite, with the risks acknowledged and fully accepted by the fund, and no longer passed on to a 3rd party to manage. Even if a 3rd party accepts the risk, the fund should consider an appropriate counterparty risk level.

<u>While it might be useful to have a regulatory framework that establishes a minimum risk appetite level and therefore framework for risk mitigation and reserving, this would still require each Trustee body to assess itself based on its own risk appetite.</u> Key issues to resolve include:

- Should a framework be provided by the regulator for determining how funds should assess their own risk appetite?
- What other guidance should the regulator provide?
- Should a minimum be set for certain activities?

Funds should also take into account that insurance policies do not always respond in the way that might have been hoped or intended. For example, there may be large deductibles, claims may impact future premiums and the timing of receipt of the claim may be an issue. For the larger funds, maximum levels of cover available may not be sufficient to cover scenarios such as extreme operational risk events. All of these point to funds not being able to rely solely on insurance policies, but also needing to have some ability to rely on their own financial resilience.

Strategic initiatives

Most RSE licenses recognise the benefits of scale and have ambitious plans to grow the fund membership and assets.

Fund mergers typically incur significant costs initially, however funds tend to absorb and meet these costs from their fee income. As there are ongoing cost savings from the increased scale and need for fewer resources than the two funds had separately, surpluses can often be built up from the amalgamation.

Contingency expenditure

Where retail funds were seen to have broken the law, such as in cases of charging fees for no service, the shareholders paid for penalties and remediation.

In the case of not-for-profit funds, however, any penalties and / or remediation costs are effectively paid by members. The irony of this is that while the impact is diluted, some of these are the same members that were already charged fees for no service in the first place.

Where administration errors occur, funds (or third party administrators) pay for these. As with penalties and remediation, the nature of the fund will usually dictate whether the costs are ultimately paid by members or shareholders. Substantial amounts are typically covered by insurance policies.

Trustee fees

In simple terms, RSE licensees set fees at a level which will cover their expected costs as well as providing a buffer against any unexpected costs. They will also have regard to the costs of any proposed new activities and any research and development activities.

In general, funds do not like to notify members of fee increases so they seek reasonable certainty in managing their costs. In the past, improvements in productivity or scale benefits (such as a merger with another fund) may have not led to reduced member fees, at least in the first instant; rather, the savings may have been applied to improving member services or to fund the cost of regular legislative change.

Superannuation funds are conscious of the fees charged by competitors. These have become more public with the ATO's *YourSuper* comparison tool website and APRA's YFYS Performance Assessment. We expect that RSE licensees will become more conscious of their costs as they will want to ensure member fees remain competitive. One potential change is to remove some of the services being provided, or to seek to recover the cost of providing these services by applying a charge to those members that avail themselves of the service, such as intra-fund advice.

Investment management and investment operations

As funds increasingly seek to internalise investment management and the associated investment operations, errors and omissions relating to these activities will need to be considered.

For example:

- Where a fund fails to act on the corporate actions associated with a buy-back or a rights issue.
- Where a fund incorrectly applies the foreign exchange hedging.
- Where a fund incorrectly effects a buy trade when it meant to effect a sell, or vice versa.

These are all examples of errors that are often quickly fixed and that do not have a material impact on the total return of a fund. The reality is that they do happen and that there is an actual cost that is incurred by funds (and by extension, fund members) to correct for their occurrence.

As funds increasingly seek to internalise investment management and the associated investment operations, errors and omissions relating to these activities will need to be considered.

Additionally, unit pricing and asset valuations should also be considered given the potential significance of impact that any errors can have on member outcomes and the judgements involved. While most funds will outsource the unit pricing to their custodian, the process will normally rely on some inputs which are dependent on the trustee (for example, tax provisions, investment cost provisions) and for which the trustee retains responsibility and is ultimately exposed to a degree of risk. In this regard, outsourcing does not remove all of the risks and some trustees may be blind to the retained risks for which they are liable. Even where the custodian undertakes the unit pricing, counterparty risk should also be considered.

Financial advice

Financial advice has been, and continues to be, an area of major financial risk for many funds and major remediation costs have been incurred by numerous superannuation funds in relation to financial advice issues.

Any financial advice model would need to carefully consider the risk appetite of the trustee and appropriately manage the commensurate risks.

Focus areas for APRA

In recent years, the superannuation environment has seen:

- A shift in ownership of retail funds away from banks and insurance companies to specialist owners of wealth management services.
- An increasingly competitive landscape between Funds to attract and retain members, coincident with less cooperation between funds in relation to co-investment opportunities.
- Rapid growth in Fund assets – at the system level as well as within individual funds.
- Evolving member preferences and community expectations.
- Legislative change that has resulted in greater scrutiny and transparency of actions and outcomes.

The adequacy, purpose and management of financial resources

In determining the adequacy, purpose and management of financial resources, it will be important to consider where risks emerge in the whole value chain of the superannuation fund's operation, who is bearing the risks and how these are being managed. Some of the issues to address will include:

- The nature of the fund and its operations. That is, the extent to which it is:
  - Self-administered or third party administered.
  - Internal investment management or externally managed.
  - Accumulation or retirement benefits as well as cash flows to/from and within the fund – as this goes to the liquidity requirements.
- What existing reserves are currently held and for what purpose.
- How these existing reserves were generated and over what time period.
- How new reserves are established, funded and maintained over time to ensure intergenerational equity is maintained.
- How costs for managing products in run-off, for example defined benefit, Term Allocated Pensions or any new products which fail to reach critical mass, are to be financed over the long term.
- How any reserves are invested.

The financial resources available to RSE licensees

As discussed above, the financial resources available to RSE licensees are essentially a combination of:

- Reserves that already exist; and / or
- Future surplus income that the trustee collects from members; and / or
- Outsourcing services to the extent that this can reduce risk and therefore "free up" reserves otherwise being held under the RSE's risk and / or capital management framework; and / or
- Suppliers essentially providing a spread of funding through making investments in services but charging back through additional fees in the future; and / or
- Insurance policies held by the RSE licensee and / or its directors
- Capital injections from shareholders where and if this option is available.

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Financial projections in business planning practices

The objective of Prudential Standard SPS 515 Strategic Planning and Member Outcomes is to ensure that an RSE licensee manages its business operations in a sound and prudent manner in order to achieve its strategic objectives, including rigorously assessing its performance and taking action to improve its operations consistent with its obligations under the SIS Act.

The key requirements of this Prudential Standard are that:

- the Board approves strategic objectives that support it in achieving the outcomes it seeks for beneficiaries and the sound and prudent management of the RSE licensee's business operations;
- the RSE licensee maintains a Board approved business plan that sets out the approach for implementation of the RSE licensee's strategic objectives;
- the RSE licensee annually reviews its performance in achieving its strategic objectives and incorporates any actions to improve its performance in its business plan;
- decisions to incur significant fund expenditure support the RSE licensee in achieving its strategic objectives and those decisions are monitored against their expected outcomes; and
- the outcomes assessment required under section 52(9) of the SIS Act addresses the additional factors set out in this Prudential Standard.

Deloitte considers that compliance with the requirement for sound and prudent management of the RSE licensee's business operations would also include financial projections taking into account 'business as usual' activities and operations as well as various scenarios that test the sensitivity of the financial projections to various assumptions, including in relation to net member growth rates and net cash flows, in conjunction with broader scenario planning.

RSE licensees' provisioning for contingencies

A consequence of the sensitivity analysis and scenario planning being undertaken in relation to financial projections would be that Boards will be in a better position to ascertain the appropriateness of their reserves and liquidity exposures to meet their financial obligations as and when they fall due. These financial obligations should consider:

- Member benefit payments, including rollovers and regular retirement income payments.
- Suppliers, including significant service providers.
- Staff salaries, property rentals and associated expenses.

Contingent financial obligations should consider:

- Future growth, including in relation to staff and property requirements.
- Future technology requirements and changes in these.
- Future changes in material / significant service providers and the associated transition costs.
- Other strategic initiatives, including possible merger or other inorganic activities.

Yours sincerely

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