

08/02/2022

General Manager Policy Development
Policy and Advice Division
Australian Prudential Regulation Authority Address

Dear Sir / Madam

Re: Discussion Paper: Strengthening Financial Resilience in Superannuation

I write in response to the above discussion paper released by APRA in November 2021. The paper poses a series of questions relating to financial resources in the superannuation sector. While those questions are answered in the appendix to this letter there are a number of overarching matters noted below which are important to address in the first instance and should in EQT's view, be APRA's and the Government's primary focus.

Background

Equity Trustees was established as an independent trustee and executor company in 1888 and has grown to become one of Australia's leading specialist trustee companies supervising ~\$150bn of assets in some thousands of trusts. By offering a diverse range of financial and fiduciary services, we help our private, corporate and superannuation clients grow, manage and protect their wealth now and for generations to come. Our position as a leading independent trustee gives us a unique position in the sector;

- we do not face the same conflicts of interest as vertically integrated market participants.
- by providing trustee services in a number of contexts beyond superannuation we are able to bring a broad insight that single trustee, single fund superannuation models cannot replicate.
- our non-superannuation licensed trustee entities and our parent holding company hold capital that is at risk to the benefit of beneficiaries and invested to the benefit of shareholders.

Equity Trustees holds two Registerable Superannuation Entity Licences (Equity Trustees Superannuation Ltd (ETSL) and HTFS Nominees Pty Ltd (HTFS) acting as trustee for eighteen superannuation funds with assets of ~\$35bn. ETSL holds an Extended Public offer license.

1. Indemnity to trustees from members' funds

While the Financial Sector Reform (Royal Commission Response) Act 2020 has clarified the appropriate uses of trust assets in the SIS Act, it is difficult to see how any competent professional trustee could previously have concluded it was an appropriate use of trust assets to pay fines and penalties arising from breaches of the law. Prima facie such breaches and their financial consequences suggest negligence by the trustee. Accessing trust assets to pay fines would already have constituted a breach of the Corporations Act for AFSL holders and under general trust law. It would have clearly resulted in members paying for trustee negligence. It is an indictment on the industry that no action was taken for such serious breaches of trust.



Just as concerning is the response of many thinly capitalised trustees to effectively raise capital from members. The act of doing so is against member's interests and puts the trustee in an obvious conflict situation, when such actions have not been disclosed to members, or other parties directly contributing to the fund

2. Absence of capital in the superannuation system

The absence of capital in the superannuation system is a fundamental and systemic flaw. It is an anachronism and were one designing a superannuation system from first principles in 2022 it is inconceivable it would be designed without regulatory capital. All other significant licensed financial entities in Australia are required to hold regulatory capital, including banks, insurers, custodians and Responsible Entities.

The Operational Risk Financial Requirement (ORFR) is sometimes thought of as quasi-capital. This is not the case if it is held as a reserve within the fund given it has been built using member monies. In this format, it is simply a mechanism for the inter-generational spreading of operational risk events. The inter-generational spread dissipates in the event of rapid replenishment after drawing on the reserve. As a result, in some segments of the market, there is no capital backing the superannuation system.

APRA should recommend to Government that capital needs to be held by trustees. It is deeply concerning that for such an important financial segment of the market, overseeing \$2.3 trillion on behalf of members in the APRA regulated sector, that the legislation doesn't require trustees to hold capital.

- In holding that capital its objective should be clear. The following matters are pertinent in this regard:
- The main unfunded risk for the member in the APRA regulated space relates to the agency risk of appointing a trustee and their performance of the role with due care and skill.
- The purpose of trustee capital should be to protect the member against failure to perform this role with appropriate diligence and provide adequate funding for orderly wind down of their affairs if necessary.
- The ASIC minimum capital requirements for custodians or Responsible Entities may be a useful starting point noting, those sectors have not had the same issues the superannuation sector has experienced

3. Lack of governance and oversight by engaged shareholders

Member fees should not be the solution to the absence of capital in the system.

Recent court actions by trustees completely invalidate the principle of the Financial Sector Reform Act clarifications that a member should not in any way finance the negligence of a trustee. The raising of fees to build a reserve in this instance is simply a circuitous route to access fund assets.

The only appropriate source of capital to protect members is from the shareholders of the trustee. Those shareholders should perform an important function as a check and balance over the board and management.

The lack of significant capital at risk leads to a passive approach by shareholders which is at the expense of ensuring good governance. For example, it is likely that no shareholder of an RSE Licensee took any action, up to and including the removal of directors, involved in suspicious trading in March and April 2020. This highlights that passive shareholders lead to poor governance practice.



At present, there are a number of different governance models in operation in the superannuation sector. In some instances, shareholders provide both capital and oversight and in others they are more passive or enjoy only the benefits of Director nomination rights and potentially some influence without bearing the financial responsibility for the Directors conduct.

A prudent shareholder will typically be cautious and alive to trustee malpractice given their capital will be at stake. This will likely improve the quality of trustee directors given it is clearly in the shareholders best financial interest to ensure appropriately qualified individuals fulfil the roles.

It is recommended that in the event of minimum capital requirements being introduced for superannuation trustees this capital be provided only by shareholders.

There will be opponents of this recommendation who will say that some shareholders of RSE Licenses should not be required to provide any capital because they extract no financial return. This may be true; however, they participate as a shareholder of an RSE License for a reason; be that simply for the privilege of nominating a director, influence over the RSE Licensee or for the betterment of employees. Either way, the role is a privilege and shareholders can easily decide whether to fund capital to continue to enjoy the privilege.

4. Regulatory

The regulatory position regarding external capital being at risk in the superannuation system is at odds with the Banking, Insurance and Investment systems and appears to stem from the accommodation of not-for-profit trustees in the superannuation system.

Of particular concern in the current system is the potential threat to regulatory integrity which arises from the knowledge that actions taken by a regulator against a not-for-profit trustee by APRA or ASIC will be defended using member monies. This provides a sizable disincentive for regulators to pursue not-for-profit trustees for transgressions of the law which undermines the integrity of the system. Quite simply this disincentive should not exist. The existence of ringfenced capital provided by shareholders in the sector would remove any such disincentive for APRA and ASIC.

5. Conclusion

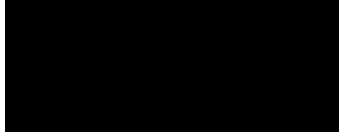
In summary Equity Trustees recommends:

- 1) APRA advises the Government to legislate for minimum capital requirements (with clear objectives) to be held by all RSE Licensees to:
 - a. Fund the agency risk a member takes in outsourcing the oversight of their retirement savings to a trustee
 - b. Provide an appropriate protection from negligent trustee decision making resulting in financial loss to members
 - c. Enable wind up and orderly exit of the RSEL should this be required
- 2) Such capital be provided only by shareholders of the trustee creating an appropriate nexus between ownership and risk to shareholder funds.



Equity Trustees is comfortable for this submission to be published on the APRA website. In addition, we would welcome the opportunity to meet with you in person to discuss our submission.

Yours Faithfully,



Managing Director

EQT Holdings Limited

Appendix 1: Discussion paper questions

No.	Question	EQT Response
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Sources of financial resources

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| 1 | <p>What sources of funding and support are used by RSE licensees to address each of the three purposes of financial resources set out in 2.1? Is this likely to change in the near term, and if so, how?</p> | <p>The sources of funding listed by APRA at 2.2 of the discussion paper encompass the sources of funding available. EQT would distinguish between operating capital (and indeed that to deliver the business plan) and contingent capital required to address remediation issues.</p> <p>Operating capital should be covered by fee revenue. In some instances in Equity Trustees Superannuation Ltd (ETSL) fund portfolio the trustee seeks a contractual underwriting of the member benefits by the fund promoter to protect the members interest.</p> <p>Contingent funding sources depend on the purpose of the funding but include indemnity provisions from service providers (the most common funding source for remediation costs), ORFR, insurance (purchased through a Group programme reducing the cost to members) and ultimately shareholder capital to fund any matters for which the trustee is liable and due to negligence or some other restriction not allowing recovery from members.</p> <p>EQT’s observation of the industry is that this last source of funding is missing in the industry</p> |
| 2 | <p>When establishing or reviewing a trustee fee to be charged to members, how do RSE licensees determine the appropriateness and level of the fee? How do the sources of funding influence fee design?</p> | <p>The trustee establishes a fee that is appropriate to provide the required trustee services, plus an appropriate profit margin to ensure the shareholder is rewarded for the risk it takes in acting as an RSE Licensee. The fee may also be subject to negotiation and agreement with a fund promoter to ensure the fund promoter believes the overall superannuation fund offer is competitive in the market.</p> |



3 Are there additional relevant considerations to those detailed in the table that affect how and when RSE licensees can access external financial resources? If so, please provide details. No

Implementation of SPS515

4 How do RSE licensees determine the adequacy of their financial resources to address each of the three purposes of financial resources set out in 2.1? Are further enhancements to these processes anticipated?

Fund
The annual Business planning review considers operating and business plan expenses
The ORFR is typically set at 25bps which experience, and industry data suggests is sufficient for remediation of any operational risk events.
Insurance coverage is reviewed annually with advice sought from broker

RSE Licensee
The company undergoes an annual Business planning review and its plans are incorporated into the EQT Group's plans.

5 How do RSE licensees monitor the adequacy of financial resources? Which factors would trigger a review of resources?

Budgets are tracked in line with business plans. Extraordinary costs would trigger a review of financial resources.

6 To what extent does scenario testing inform the financial projections in the business plan? How does scenario testing

Incorporated into the annual business plan review.



inform the determination and assessment of the adequacy of financial resources?

ORFR questions

- 7 Have there been instances where an RSE licensee experienced an operational risk event that would have permitted them to call on the ORFR financial resources? a) If so, did the RSE licensee use the ORFR financial resources to make good any loss experienced by members?
b) If the RSE licensee decided to not call upon the ORFR financial resources, what were the factors that influenced the decision?
- There have been no recent events requiring a call on the ORFR. In the event of an operational risk event the trustee would first consider:
- the cause of the event and who should bear the cost of remediation
 - whether there is contractual recourse to a service provider in the event of error
 - whether it is appropriate that the members bear the cost
 - if so, how that cost is most equitably borne
- 8 Are RSE licensees likely to change their approach to the use and maintenance of the ORFR?
- No
- 9 Are there any other views you wish to provide about the role of the ORFR in supporting RSE licensee financial soundness, including any potential improvements?
- We recommend that the concept of ORFR be reviewed.
- At the moment, the ORFR basically serves to manage cross-generational equity but, given the need for relatively short-term replenishment plans, it does not make a meaningful contribution to that objective. In reality, ORFR essentially underwrites the lack of financial capacity of 'at fault' service providers and we



suggest that might be handled another way, potentially by increasing regulatory scrutiny and requirements on those providers.

- 10 To what extent are reserving policies driven or limited by requirements in trust deeds? Please provide reserving policies, where possible. None.
- 11 How often are reserving policies reviewed? Is there a defined framework and what factors are considered in the review process? Annually
Reserving policies are fully dependent on the Business plan for the relevant Fund
- 12 For all reserves held by RSE licensees:
a) For what specific purpose are the reserves held and used? Vary by fund – administration, expense and ORFR reserves are in place across the fund cohorts
They are held for funding administration expenses and operational risk events
b) How are these reserves initially funded, maintained and replenished? There are maximum and minimum reserve amounts set and permitted use is documented in each instance.
c) How is the target amount for these reserves held? How are financial projections and stress testing utilised in determining target amounts? The Reserves in the Fund are funded by the members. Reserves or funding may be provided by a promoter, service provider or RSE Licensee and this funding is provided by shareholders of those organisations.
d) How are reserves invested, and how does the RSE licensee ensure that the investment strategy for each reserve aligns with the purpose of the reserve? They are funded from member fees and investment earnings on the reserve and the investment strategy is typically cash and cash equivalents for administration and expense reserves given their intended use. The ORFR where held as a reserve and fully funded is typically invested in line with the default investment option of the relevant fund
How do liquidity management considerations inform these decisions? The reserving policy outlines permitted usage and the methodology to build and use equitably



e) What controls are in place to ensure reserving approaches are equitable for members in both how the reserve is built (e.g. fee), managed and used?

13 Are RSE licensees likely to change their approach to the type and purpose of reserves held? If so, why? No

14 How have the RSE licensee's reserving practices and policies been amended to ensure compliance with the best financial interests duty? N/a – they have always met that test.

Insurance questions

15 Please provide a summary of the insurance coverage held by the RSE licensee and/or the RSE licensee directors.
a) How is this insurance held (by the RSE licensee directly or by a related entity)? Where it is held by a related entity, please describe any contingencies in place in the event the insurance becomes unavailable.
b) For any director's liability insurance (such as Directors and Officers Insurance and Professional Indemnity), please provide information about the terms of

The EQT Group insurance programme comprises of:

- Professional indemnity / comprehensive crime
- Directors and officers
- Company Securities
- Cyber liability insurance
- Statutory liability
- General and Products liability
- Industrial special risks
- Travel

ETSL and HTFS participate in the EQT Group insurance programme noting that all EQT group entities have a common purpose – to act as a fiduciary. As a result, ETSL and HTFS benefit from being part of a Group with greater buying power and an ability to secure greater sums insured than would otherwise be the case



the contract, such as: limits, deductibles, exclusions and the basis of cover (Losses occurring or Claims Made form).

Noting this submission will be made public it is inappropriate to provide detail of cover – noting insurers specifically prohibit such disclosure

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| <p>16 What factors are considered when making decisions regarding the types and levels of insurance acquired? How are these factors prioritised when deciding on insurance arrangements?</p> | <p>EQT works closely with its broker in reviewing its insurance programme and ensuring it is appropriate. There are a wide variety of considerations including business size, mix, complexity, Risk exposures, historical losses and claims experience, availability of cover (capacity available from insurers), economic cost of cover (total cost of insurable risk), ASIC and APRA regulatory requirements (which are significantly exceeded) and balance sheet strength are all considered in determining appropriate insurance arrangements.</p> |
| <p>17 What are the challenges, if any, in obtaining and renewing insurance coverage and how are RSE licensees managing these challenges?</p> | <p>The insurance market is cyclical meaning pricing and capacity is highly volatile particularly as a result of industry experience or indeed capacity elsewhere. The experience of the Royal Commission is a useful recent example with a number of insurers retreating from the market or markedly restricting capacity in certain insurance categories. While EQT has not suffered any of these consequences directly, necessarily it alters the availability and pricing of cover.</p> |
| <p>18 How does the RSE licensee and/or the RSE licensee directors determine the types and levels of insurance coverage needed to address risks that could impact their resilience?</p> | <p>The RSEL benefits from the experience and access to Group expertise purchasing cover for exposure in a number of fiduciary contexts. In addition to this the RSEL benefits from the advice of the independent guidance of the broker in building the programme</p> |
| <p>19 How does the RSE licensee and/or the RSE licensee directors assess the continuing adequacy of insurance coverage, and how often is this assessment undertaken?</p> | <p>Annually</p> |



- 20 What contingencies are in place for a scenario in which an insurance claim is unsuccessful, or if insurance becomes unavailable or is perceived as not representing value for money? The RSE Licensee may build up administrative and expense reserves for certain contingencies. Consideration of responses is part of the annual business plan review
The RSE Licensee may also build up retained profits within its balance sheet or seek commitments from its shareholders for contingency expenditure items.
- 21 Please provide any other information that may be relevant to inform APRA's understanding of the insurance coverage held by the RSE licensee and/or the RSE licensee directors. N/A

Contingency expenditure questions

- 22 How do RSE licensees provision for contingency expenditure items? To what degree does this form part of the RSE licensees' business planning process? These would be built into administration and expense reserves if known. If large expenditure items they will be considered by the trustee as part of the annual business plan review.
- 23 How do RSE licensees fund restructures of their business operations? Varies but typically shareholders of the promoter and / or trustee will bear the costs of restructuring their business operations. At times (for example as a result of regulatory change) it may be appropriate to pass this onto members which would be done through the annual business plan review and an appropriate review of fees
- 24 How are RSE licensees sourcing funds for the payment of civil or administrative penalties from 1 January 2022? To what degree have alternate avenues been No change – as a trustee company EQT has a fundamental understanding of trust law and what are permissible charges to pass onto members. **It is not and never has been legal to charge members for trustee negligence. The shareholder would fund such costs**



considered when settling on the source of funding?

- 25 If intending to build financial resources of the RSE licensee by deducting amounts from existing reserves, how would affected reserves be replenished and how might this approach affect fees charged to members? N/A – this should not be permitted – members should not pay for trustee negligence. EQT is of the firm view shareholders, irrespective of their historic position or contribution should provide capital for such purposes. If they enjoy control and nomination of Directors they should bear financial responsibility for their conduct
- 26 How are RSE licensees estimating the quantum of funds to be held at the trustee company level for the purpose of paying penalties? What options would be available for reducing a surplus at trustee company level in the event that the provisioning requires adjustment? This should not be being considered by the regulator. Shareholder capital should be the answer not member funds.