FSC FINANCIAL SERVICES COUNCIL

Strengthening Financial Resilience in Superannuation

FSC Submission on APRA discussion paper

March 2022

FSC FINANCIAL SERVICES COUNCIL

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1 About the Financial Services Council

The FSC is a peak body which sets mandatory Standards and develops policy for more than 100 member companies in one of Australia's largest industry sectors, financial services.

Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, life insurers and financial advice licensees. Our Supporting Members represent the professional services firms such as ICT, consulting, accounting, legal, recruitment, actuarial and research houses.

The financial services industry is responsible for investing $3 trillion on behalf of more than 15.6 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange, and is the fourth largest pool of managed funds in the world.

2 Summary

- Financial service businesses, including superannuation trustees, need to have sufficient capital to operate their business.
    - It is clearly not appropriate for a superannuation trustee to hold negligible capital, particularly given the view held by the industry and regulators that there is significant harm caused by the insolvency of a trustee.
- Trustees with substantial capital and strong balances sheets are better placed to deal with risks and unexpected costs, and are much less likely to become insolvent than trustees with minimal capital.
- A superannuation trustee should not receive money from fund assets (including a fund reserve) unless this is specifically permitted by the trust deed under a remuneration or indemnification power.
    - If the trust deed does not specifically permit a reserve to be used for remuneration, then the assets in the reserve should not be used to pay remuneration to the trustee.
- The superannuation law does not regulate how a superannuation trustee can use its own (personal) assets, even where the assets are originally sourced from a superannuation fund, for example by the receipt of remuneration.
    - If a trustee holds a reserve on its own balance sheet, then this is the trustee's own assets, and the superannuation law generally does not apply to the reserve.
    - The superannuation law generally does not require superannuation trustees to apply their own assets to the benefit of members of the superannuation fund.
    - There is no requirement under superannuation law that a trustee must obtain resources from other entities in the same corporate group.
- The superannuation law and general law place limits on the situations where a trustee can use fund assets to pay a liability it has incurred.
- Trustees that receive remuneration from a fund to maintain and increase their capital should not be penalised for taking this action, and conversely trustees that have failed to build up capital should not receive a lenient approach to complying with the law solely because they have failed to build up capital to protect against unexpected expenses.
- The superannuation law equally applies to superannuation fund assets, assets in a fund reserve, and to income earned on fund assets and fund reserves.
- The requirements of the superannuation law do not apply to the decision of the superannuation trustee to receive remuneration from the fund, nor the level of the remuneration, as permitted by the trust deed.
- Consistent with the approach taken in the Discussion Paper, there are good arguments for increased flexibility in the way trustees can approach the Operational Risk Financial Reserve (**ORFR**).

3 Introduction

The FSC thanks the Australian Prudential Regulation Authority (**APRA**) for the opportunity to provide a submission on the Discussion Paper: Strengthening Financial Resilience in Superannuation (**Discussion Paper**), released by APRA in November 2021.

This FSC submission is providing general feedback and context on the issues raised in the Discussion Paper. The FSC has limited its submission to areas that do not require specific information from individual funds. However, in some cases the FSC has comments on the specific questions in the Discussion Paper – these are included in Section 8 of this submission.

[redacted]. However, the attachments to this submission are not confidential.

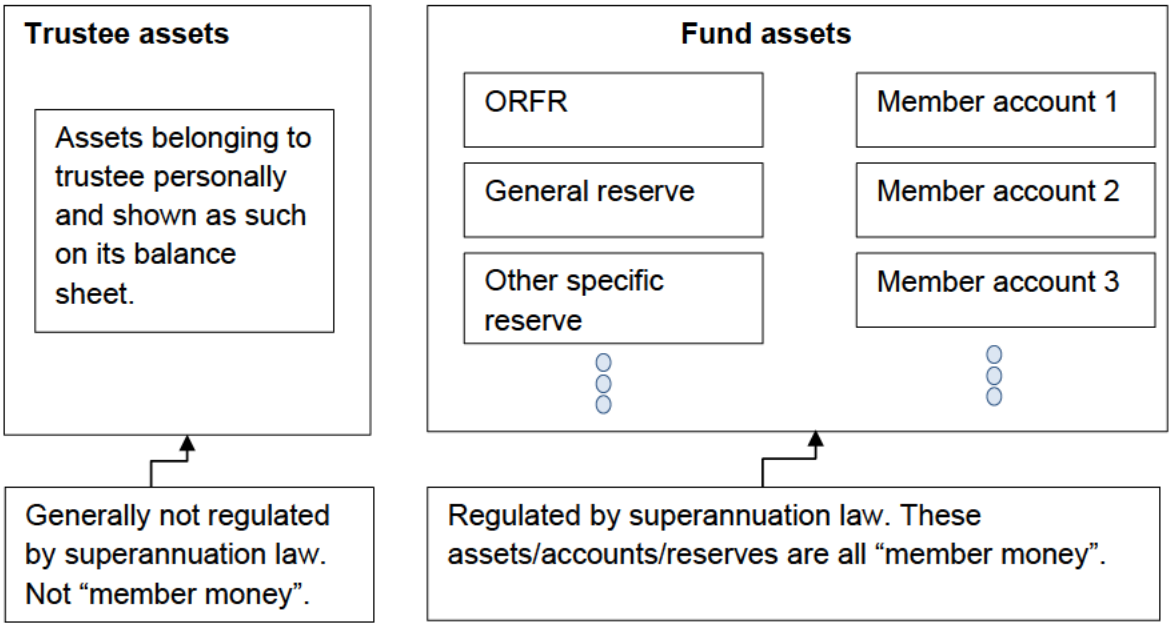
Given the complexities of the issues raised in the Discussion Paper, and the various queries the FSC has about the approach taken in the Paper, the FSC requests a meeting of our members with APRA to discuss the issues described in this submission.

In this submission, we use the term 'trustee' to mean a Registrable Superannuation Entity (**RSE**) licensee.

The submission distinguishes between two distinct concepts:

- **Fund assets** or trust assets are all the assets that are held on trust by a trustee for the benefit of the members of the superannuation fund. This is "member money".
- **Trustee assets** are the assets of the trustee that are entirely separate from the fund assets. Trustee assets are the 'personal' assets of the trustee. This is not "member money".
    - A trustee can receive remuneration from the superannuation fund it operates, in accordance with the trust deed. Fund assets are no longer "member money" once they are paid as remuneration to the trustee, and the superannuation law does not apply to this remuneration once it is received by the trustee.

These concepts are illustrated in the diagram below.


Trustee assets
Assets belonging to trustee personally and shown as such on its balance sheet.
Fund assets
ORFR
General reserve
Other specific reserve
Member account 1
Member account 2
Member account 3
Generally not regulated by superannuation law. Not “member money”.
Regulated by superannuation law. These assets/accounts/reserves are all “member money”.

4 Recommendations

The FSC **recommends** that APRA provide guidance that:

- The duties imposed by superannuation law on trustees do not apply to the personal assets of a trustee, including any amount that the trustee has properly received as remuneration from a superannuation fund, and any reserve the trustee may have set up using its personal assets.
- A trustee can take remuneration from a fund that they operate but only to the extent permitted by the trust deed of the fund.
- Fund assets (including fund reserves) cannot be used to pay remuneration unless expressly permitted in the trust deed.
- The decision of a trustee to take remuneration is not subject to the duties imposed on trustees by superannuation law.
- All reserves inside a superannuation fund are member money and cannot be used by a trustee to meet personal liabilities of the trustee without express authority of the trust deed. In particular, fund assets (including fund reserves) cannot be used to pay penalties that are referred to in subsection 56(2).
- In practice, superannuation trustees need to hold sufficient capital or a sufficient third party guarantee.

The FSC **recommends** that APRA acknowledge that trustees that already hold sufficient capital in their personal capacity are better prepared for the contingencies raised by APRA in its discussion paper, particularly reducing the risk of trustee insolvency.

The FSC **recommends** that APRA state that the law applies the same way to trustees regardless of how the trustees have historically acted towards the building up of capital.

The FSC **recommends** that APRA provide guidance that a trustee has no obligation to obtain resources from other entities in the same corporate group, unless a guarantee or similar is expressly provided.

The FSC **recommends** that APRA provide guidance that the income earned from the investment/management of the assets held in a fund reserve is subject to the same regulations as the reserve itself.

The FSC **recommends** that APRA consider removing the fixed minimum ORFR level of 25 basis points and instead allow RSE licensees to make (and justify) their own determinations on this issue.

5 Legal position

In preparing this submission, the FSC obtained expert legal advice from Herbert Smith Freehills (**HSF**). The advice is at Attachment A which provides important context for the FSC's submission, along with earlier HSF advice at Attachment B.

Importantly, although this submission refers to advice obtained by the FSC from HSF as set out in Attachments A and B, this submission is made by the FSC and should not be attributed to HSF.

The advice raises several important points of law relevant to the issues raised in the Discussion Paper, including in summary:

- A trustee cannot use fund assets to pay a liability incurred by the trustee in its personal capacity, unless there are express authorisations in the trust deed. Any express authorisations are subject to s 56(2) of the SIS Act and restrictions arising under general law based on the nature of the conduct.
    - A personal liability of a trustee includes liabilities that the trustee is required to pay from its own assets due to the operation of s56(2), and the cost of any insurance the trustee purchases for these liabilities.
    - An express authorisation in a trust deed could include, for example, a clause authorising the trustee to reimburse itself from fund assets for the fees paid by the trustee to its directors.
- A trustee cannot use fund assets to pay a liability incurred as a result of a breach of trust or acting beyond its powers. The trustee would generally have to pay this liability from its own assets (see previous point).
- The regulatory context has evolved so that trustees will find that more of their actions can cause liabilities that are not indemnifiable from fund assets, and the trustee must fund these liabilities from their own assets.
- The Operational Risk Financial Requirement (**ORFR**) can only be used for an operational risk event, not for other types of events. If the ORFR can be used, then a trustee should consider whether to take an action of recovery against a third party that caused the operational risk event.
- A general reserve cannot be used to circumvent the limits on the use of fund assets outlined above because assets held in a general reserve are fund assets.
- Payment from a reserve (including the ORFR) that is outside the purpose of the reserve (unless authorised by the trust deed) would be a breach of trust and the trustee would ordinarily have to replenish the fund from its own assets.
- A trustee cannot use fund assets (including from a reserve) to pay for indemnity insurance for liabilities incurred by the trustee that would not themselves be indemnifiable from fund assets, unless the trust deed expressly authorises this.
- A trustee can only pay itself remuneration from fund assets if permitted in the trust deed, and can (but need not) use this fee to build up capital.
    - A trustee cannot circumvent this rule by building up capital by withdrawing amounts from a reserve in the fund, even a reserve whose purpose is to

satisfy liabilities incurred by the trustee, unless the trust deed explicitly authorises the application of the reserve to remunerate the trustee.

- The decision by a trustee to take remuneration from the fund, and the amount of the remuneration, is not subject to the duties imposed on trustees by superannuation law.
- A trustee cannot establish a fund reserve whose purpose is to provide assets to the trustee as this would create a clear conflict between the trustee and fund members and is unlikely to satisfy the obligation to prioritise members' interests.
- The superannuation law does not regulate how a trustee can use its own (personal) assets, including any capital or reserve that the trustee has established on its own balance sheet, even where the assets are originally sourced from fund assets (such as through the payment of remuneration authorised by the trust deed).
    - The only exception to this general position is that where the trustee holds ORFR amounts as trustee capital, superannuation law applies to a limited extent.
- While there is no longer a specific requirement for a trustee to hold capital, the various limits outlined above mean that in practice a trustee will need to hold capital or a third party guarantee.
- The introduction of the Best Financial Interests Duty to the superannuation law does not materially change the above findings.

Based on this advice, the FSC requests that APRA provide guidance to trustees on the operation of the superannuation law in this area, going beyond the comments made in the Discussion Paper.

The FSC **recommends** that APRA provide guidance that:

- The duties imposed by superannuation law on trustees do not apply to the personal assets of a trustee, including any amount that the trustee has properly received as remuneration from a superannuation fund, and any reserve the trustee may have set up using its personal assets.
- A trustee can take remuneration from a fund that they operate but only to the extent permitted by the trust deed of the fund.
- Fund assets (including fund reserves) cannot be used to pay remuneration unless expressly permitted in the trust deed.
- The decision of a trustee to take remuneration is not subject to the duties imposed on trustees by superannuation law.
- All reserves inside a superannuation fund are member money and cannot be used by a trustee to meet personal liabilities of the trustee without express authority of the trust deed. In particular, fund assets (including fund reserves) cannot be used to pay penalties that are referred to in subsection 56(2).
- In practice, superannuation trustees need to hold sufficient capital or a sufficient third party guarantee.

6 General comments

6.1 Conceptual issues raised by the Discussion Paper

The FSC submits there are clear distinctions at law that are fundamental to the matters covered in the Discussion Paper, in particular:

1. The distinction between the trustee and its related parties within a group structure;
2. The distinction between money, assets and other property:
    a. owned beneficially by the trustee (the 'personal assets' of the trustee);
    b. belonging to related parties of the trustee; and
    c. held by the trustee on trust as assets of a regulated superannuation fund (or other RSE). This is 'member money'.

These distinctions are central to the distinctions made in the HSF advice, and a number of FSC comments below.

6.2 Trustee capital – general comments

Historically, some trustees have been able to build up capital by receiving remuneration from the funds that they operate, in accordance with the trust deed (in addition to the other mechanisms for building up capital outlined in the Discussion Paper). The receipt of remuneration by trustees has meant these trustees were able to be well capitalised for future developments, including the situations where the trustee may incur a liability that could not be indemnified from the fund assets – for example because of s56(2). Funds that have taken this approach, generally 'retail' funds, are in a better position to deal with the issues raised in the Discussion Paper.

While some commentators have been critical of the payment of remuneration to trustees, the better capitalisation of trustees as a result of remuneration means these trustees are in a better position for contingencies, and have much lower risk of insolvency compared to trustees with negligible capital. The FSC considers that the stability benefits of this capitalisation should be acknowledged.

The FSC **recommends** that APRA acknowledge that trustees that already hold sufficient capital in their personal capacity are better prepared for the contingencies raised by APRA in its discussion paper, particularly reducing the risk of trustee insolvency.

Given the need for trustees to have sufficient capital (or a sufficient third party guarantee, see the the HSF advice), the FSC trusts that there will no longer be arguments that it is inappropriate for superannuation trustees to receive remuneration in accordance with the trust deed. The receipt of remuneration by a trustee can contribute to the capital of the

trustee and acts to protect the members of the relevant fund from insolvency of the trustee, which APRA argues can cause significant harm (see section 6.3 below).[1]

The FSC also submits that trustees that receive remuneration to maintain and increase their capital should not be penalised for taking this action, and conversely trustees that have failed to build up capital should not receive a lenient approach to complying with the law solely because they have failed to take appropriate steps to build up capital to protect against unexpected expenses at the trustee level.

The FSC **recommends** that APRA state that the law applies the same way to trustees regardless of how the trustees have historically acted towards the building up of capital.

6.3 Trustee capital – existing practices

We acknowledge that APRA argues that the insolvency of a trustee could cause substantial harm, including major cost and disruption to members. See in particular these comments from APRA:[2]

> *The disorderly failure of an otherwise sound and sustainable trustee would be likely to be severely detrimental to members as it would likely impose material costs and create significant operational risks.*
>
> *In the case of insolvency, APRA would be required to appoint an acting trustee to prevent adverse impacts on members and ensure stability of the governance of the fund until a new long-term trustee could be identified and be ready to take over. The route to Acting Trustee is complex, requires a specific licence, and certain triggers to be satisfied.*
>
> *Distinct from an Acting Trustee, to install a long-term future trustee to run the fund as a viable going concern takes considerable time. Given legal requirements, including ensuring its existing members are not disadvantaged, such a trustee will need to engage in due diligence. It will also need to be ready to harmonise operations, technology and platforms used for administration. It is not a quick or easy fix.*

Given these arguments that insolvency will have substantial costs and risks, it is surprising that APRA does not appear to have comprehensive data on the financial strength of trustees.

[1] There are other reasons for the trustee to take remuneration which are not the subject of this submission – including appropriate reward for the capital and skills of the trustee and group to which the trustee belongs.

[2] Margaret Cole Opening Statement to House of Representatives Standing Committee on Economics - February 2022– see https://www.apra.gov.au/news-and-publications/opening-statement-to-house-of-representatives-standing-committee-on-3

We note a number of funds have recognised the urgency and importance of the issue, which is why they have applied to courts to permit them to address the issue. The questions asked by APRA in the current consultation process will address this information gap to a limited extent.

In Section 5, the FSC recommends that APRA provide guidance that in practice there is a need for a superannuation trustee to hold sufficient capital or a sufficient third party guarantee.

6.4 Personal assets of superannuation trustees

The FSC notes the advice from HSF that the superannuation law does not apply to the personal assets of a corporate trustee (or licensee) and related parties.

In this context, the FSC queries the following comments in APRA's Discussion Paper which seem to suggest that the requirements of superannuation law do in fact apply to the personal assets of a trustee:

- "An RSE licensee needs to ensure that resources held in reserves…as a personal asset of the trustee company, is managed efficiently. Such efficient management…gives rise to questions about the appropriate use of the income consistent with the RSE licensee's fiduciary obligations." (page 9).
- "For a financial contingency reserve at the trustee company level, an RSE licensee would have safeguards in place to ensure prudent management of the capital generated for that purpose. This would, at a minimum, include a capital management plan which would restrict the permitted use of this capital." (page 10). See also Section 7.3.
- "Prior to…using RSE licensee capital…for contingency events, APRA expects that an RSE licensee would have diligently explored and exhausted all other avenues for raising or using financial resources." (page 10).
- "An RSE licensee will raise and manage fee revenue prudently and transparently, including in respect of its subsequent disbursement and its management as trustee capital. For a financial contingency reserve at the trustee company level, an RSE licensee would have safeguards in place to ensure prudent management of the capital generated for that purpose. This would, at a minimum, include a capital management plan which would restrict the permitted use of this capital." (Page 10).
- "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?" (question 26 on page 19).

In relation to fund assets (2c in the list in Section 6.1 above), the trustee owes a fiduciary duty, as well as the extensive statutory duties imposed by the SIS Act. The HSF advice is these duties do not apply to the trustee when it deals with money and assets that are held by it in its personal (or corporate) capacity (2a in the list in Section 6.1 above). The only exception is where the trustee holds ORFR amounts as trustee capital, superannuation law applies to a limited extent.

Similarly, the HSF advice is superannuation law requirements generally do not apply where a trustee is considering the exercise of a personal right such as a right to remuneration conferred on the trustee by the trust deed.

Nonetheless, a corporate trustee is subject to regulation under the Corporations Act and the board of the corporation will owe significant statutory and fiduciary duties to the shareholders of the corporation. These requirements are different from the requirements under the superannuation law.

Therefore, the FSC requests that APRA clarify the comments in the above quotations. The FSC's recommendations for guidance by APRA (see recommendations in section 4 above) would help clarify this issue.

Separately, we also note that on pages 8–9, the Discussion Paper states "trustees can obtain financial resources used to fund their activities and contingency events from a number of sources external to the trustee company…[including] investment of assets held in the personal capacity of the trustee". The FSC queries whether this quote is effectively stating that the personal assets of the licensee (or trustee) are external to the trustee.

6.5 Use of fund assets for personal liabilities of trustee

The HSF advice states that fund assets, including fund reserves, cannot be treated by a trustee as its own personal assets, and cannot be used to meet the personal liabilities of the trustee. The only exceptions are when the trustee has a right of indemnification or remuneration from fund assets under the trust deed.

On this basis, the FSC queries the following quotes from the Discussion Paper which seem to state a trustee can manage or use fund assets for its own purposes:

- "Sources of financial resources [of a trustee] include…management of reserves in the fund" (page 4)
- "RSE licensees can obtain the financial resources used to fund their activities and contingency events from a number of sources…[including] income derived from the management of reserves in the fund" (pages 8–9). See also discussion in Section 7.1 below.
- "RSE licensees may hold surplus revenue…in a fund reserve." (page 9)
- "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?" (question 25 on page 19).

The HSF advice is that a trustee cannot deal with fund assets as their own personal assets, and can only take resources from fund assets under a remuneration or indemnification power (the exercise of which is not subject to the trustee duties imposed by superannuation law – see Section 7.3).

The FSC's recommendations for guidance by APRA (see recommendations in section 4 above) would help clarify this issue.

6.6 Parent entity of a corporate trustee (and other group entities)

In general, a parent entity has no obligation to satisfy liabilities incurred by its subsidiary (and similarly for other entities in the same corporate group). This is a fundamental principle underpinning the concept of a limited liability corporation. There may be exceptions where the conduct of the parent has given rise to the liability such as where the parent company, in relation to a particular matter, has acted as a "shadow director". In the absence of these special circumstances, there should be no expectation that liabilities incurred by a trustee ought to be met by the parent of the trustee should the trustee be unable to satisfy them from its own resources.

On this basis, we query the following comments in the Discussion Paper implying that a parent would or should provide capital for a subsidiary:

- "RSE licensees can obtain financial resources used to fund their activities and contingency events from a number of sources external to the trustee company [including] capital injections from shareholders or other parties" (page 8).
- "Prior to…using RSE licensee capital…for contingency events, APRA expects that an RSE licensee would have diligently explored and exhausted all other avenues for raising or using financial resources." (page 10).

Therefore, FSC requests that APRA clarify this issue.

The FSC **recommends** that APRA provide guidance that a trustee has no obligation to obtain resources from other entities in the same corporate group, unless a guarantee or similar is expressly provided.

Even though there is no obligation on parent entities to provide capital to trustees, this can occur in practice – the FSC's recommendation above indicates that there is no obligation for this provision to occur.

7 Specific comments

7.1 Income from reserves

The basis for a reference in the Discussion Paper to "income derived from the management of reserves in the fund" (page 9) as a potential source of funds for a trustee is unclear.

If a reserve is a source of funding for certain types of trustee expenditure, for example the ORFR in relation to costs associated with operational risk events, then the FSC submits that the resource (ie the reserve) available for expenditure would not be limited to income accruing to the reserve. The entire value of the reserve, plus the income derived on the reserve, is available for the specified expenditure.

On the other hand, income accruing to a reserve that is set aside for a particular purpose, not related to providing financial resources for a trustee, in general will be unable to be provided as remuneration to the trustee. Neither the reserve, nor the income from the reserve, could be used for that purpose.

So in general, there are two options: (a) both the reserve and the income derived from the reserve can be used for particular expenditure, or (b) neither can be used for that particular expenditure.

In addition, the superannuation law applies both to a fund reserve as well as the income derived by the fund from the management of reserve. Again, there is no distinction between the reserve and the income derived from the reserve. The duties under superannuation law apply to both.

The FSC **recommends** that APRA provide guidance that the income earned from the investment/management of the assets held in a fund reserve is subject to the same regulations as the reserve itself.

7.2 Reserves outside a fund

The Discussion Paper (in Table on page 9) states that the governing rules of a fund must permit the trustee to establish reserves outside the fund. However, the HSF advice is that the governing rules of a fund are (generally) not able to regulate what happens outside the fund – see summary of advice in in Section 6.4 above stating that the superannuation law does not regulate the personal assets of a trustee.

7.3 Trustee remuneration (or trustee fees)

The HSF advice is that a superannuation trustee's power to receive remuneration from the superannuation trust (if permitted by the trust instrument) is generally not subject to the requirements of superannuation law.

On this basis, we query the following comments in the Discussion Paper which state or imply that this power is in fact subject to regulation by superannuation law (noting the Discussion Paper generally uses the term 'trustee fee' for trustee remuneration).

- "In the event that an RSE licensee is building a financial contingency reserve by way of charging a fee…APRA expects the reserve generated would not be excessive, and expects that the purpose of the fee and level of this reserve would be transparent, evidence-based and aligned with the stated purpose of the reserve." (page 10).
- "Legal duties: An RSE licensee must be satisfied that the proposed exercise of their powers to: (i) amend their trust deed in order to introduce a power to charge a trustee fee; and/or (ii) exercise such a power, is in the best financial interests of beneficiaries." (page 10)
- "Evidence of purpose: When seeking a new trustee fee power, or using an existing power for the first time, an RSE licensee will document how the power is to be used, and that proposed use of the fee power is to be approved by the Board." (page 10)
- "Prudent management: An RSE licensee will raise and manage fee revenue prudently and transparently, including in respect of its subsequent disbursement and its management as trustee capital. For a financial contingency reserve at the trustee company level, an RSE licensee would have safeguards in place to ensure prudent

management of the capital generated for that purpose. This would, at a minimum, include a capital management plan which would restrict the permitted use of this capital." (page 10)

- "Other avenues: Prior to charging a trustee fee (or using trustee capital generated from such a fee for contingency events), APRA expects that an RSE licensee would have diligently explored and exhausted all other avenues for raising or using financial resources. Full details of alternative avenues pursued for building or using financial resources should be clearly evidenced and actively challenged by the Board." (page 10)
- "APRA expects an RSE licensee would, when demonstrating that a fee charged to build a financial contingency reserve meets the obligation to act in the best financial interests of beneficiaries, ensure full details of alternative avenues pursued for building or using financial resources are clearly documented." (page 18)

A professional trustee will be subject to competitive pressures in relation to the remuneration it charges from a fund and will seek to ensure that its remuneration is at levels which are competitive and demonstrably provide value for money. In addition, the trust deed may specify or constrain the ability of the trustee to receive remuneration. However, these restrictions are not related to the requirements of superannuation law.

7.3.1 Surplus fee revenue

The Discussion Paper discusses 'surplus revenue' in the table on page 9 as a source of financial resources. We note a fee can be charged against assets of a fund, in accordance with the trust deed, irrespective of revenue levels or the existence (or otherwise) of any 'surplus'. Conversely, if a fee is paid to the trustee, it ceases to be an asset of the fund and does not have the character of 'retained earnings' of the fund.

Based on the HSF advice, if any 'surplus revenue' is held in a fund reserve, then the requirements of the superannuation law apply to it. By contrast, if 'surplus revenue' is held outside the fund as the trustee's retained remuneration then generally the requirements of the superannuation law do not apply.

7.4 Insurance

In relation to section 3.4 of the Discussion Paper, dealing with insurance, we note there is additional information that is relevant to this issue, in addition to the questions APRA has asked of trustees in that section. This includes information about the source of funding to pay for insurance premiums and any limitations on using fund assets to pay premiums, whether arising under the fund's governing rules or general law.

The HSF advice at Attachments A and B provide further comment on the ability of trustees to fund insurance from fund assets.

7.5 Flexibility of operational reserve

The Discussion Paper states the following:

- "Every RSE licensee must form a view of their required level and structure of financial resources and manage these to suit their particular circumstances." (page 4).
- "An RSE licensee can structure their financial resources in a manner that best suits their particular circumstances" (page 12).

We query how to reconcile these comments with the less flexible approach APRA has taken with a minimum level of Operational Risk Financial Requirement (**ORFR**) of 25 basis points for all trustees, despite the law requiring trustees to undertake their own assessment of risks and determination of appropriate ORFR requirements. We query why a fixed minimum requirement is set for the ORFR, not taking account of the different risk profile and circumstances of particular RSEs, while there are sound arguments for adopting a more flexible approach to financial resources more broadly (as outlined in the Discussion Paper).

The FSC **recommends** that APRA consider removing the fixed minimum ORFR level of 25 basis points and instead allow RSE licensees to make (and justify) their own determinations on this issue.

While the RSE licensee needs to ensure it has adequate financial resources, it is also an important consideration for APRA when considering the exercise of its various powers. This includes the power to grant RSE licences and impose conditions on those licences and in approving change of control applications in relation to RSE licensees.

The FSC notes the Discussion Paper noted trustees may be reluctant to use the ORFR to address operational risk events.[3] In this context, APRA may wish to consider broadening SPS 114 to provide further guidance around assessing operational risk events and when trustees can access the ORFR.

We also note that if trustees choose to use their own capital instead of the ORFR to address operational risks, this is in the best financial interests of members since fund assets are not being used. In this situation, fund members are clearly better off since any depletion of the ORFR will require replenishment which implies transferring funds from members' own accounts to the ORFR.

8 Response to APRA questions

The FSC has a response to some of the questions raised in APRA's Discussion Paper as outlined below.

[3] "Whilst these financial resources were intended to be used by RSE licensees to make good any losses to members caused by operational risk events, it is evident that RSE licensees are reluctant to call on these financial resources, even where they would be entitled to do so under the provisions of the standard." (page 14).

1. 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?

2. 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?

FSC comment: See Section 7.3 of this submission. The HSF advice is that trustee remuneration (ie a trustee fee) can only be paid if this is permitted under a trustee remuneration power in the trust deed, and if this power is in place then the superannuation law duties do not apply to the exercise of this power.

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.

FSC comment: This submission makes various comments on the content of the table on page 9. In general terms, there needs to be a clear distinction between the assets held on trust inside the fund, which are subject to the requirements of superannuation law, and the assets held by the trustee outside the fund in its personal capacity, which are generally not subject to superannuation law.

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?

FSC comment: See Section 6.3. In practice there is a need for a superannuation trustee to hold sufficient capital or a sufficient third party guarantee.

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

6. To what extent does scenario testing inform the financial projections in the business plan? How does scenario testing inform the determination and assessment of the adequacy of financial resources?

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?

8. Are RSE licensees likely to change their approach to the use and maintenance of the ORFR?

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?

FSC comment: See Section 7.5 of this submission.

10. To what extent are reserving policies driven or limited by requirements in trust deeds? Please provide reserving policies, where possible.

11. How often are reserving policies reviewed? Is there a defined framework and what factors are considered in the review process?

12. For all reserves held by RSE licensees:

FSC comment on all parts of question 12: based on the HSF advice, any assets to be held by a trustee in its personal capacity (including any trustee reserves) can only be sourced from the fund to the extent there is a remuneration power or an indemnification power in the trust deed.

The HSF advice is a reserve that is held at the trustee level is generally not subject to regulation by the superannuation law. See Section 6.4.

a) For what specific purpose are the reserves held and used?

b) How are these reserves initially funded, maintained and replenished?

c) How is the target amount for these reserves held? How are financial projections and stress testing utilised in determining target amounts?

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? How do liquidity management considerations inform these decisions?

FSC comment: Based on the HSF advice, there is no requirement for a reserve held by a trustee in its personal capacity (other than an ORFR) to have a 'purpose' or an investment strategy, as the superannuation law does not apply to it. The trustee can create a reserve using its own assets with a purpose (including in response to other requirements), but other than in relation to an ORFR, there is no requirement at law for such a purpose.

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?

FSC comment: Based on the HSF advice, there is no requirement for reserves held by a trustee in its personal capacity (other than an ORFR) to be used for the benefit of fund members. Assets held by a trustee in its personal capacity are for the trustee's benefit, not for the benefit of fund members. As a result, there is no requirement for the management and use of assets held by a trustee in its personal capacity to be equitable for members.

The HSF advice is that the remuneration paid to a trustee (called a trustee fee in the Discussion Paper) is not subject to superannuation law.

13. Are RSE licensees likely to change their approach to the type and purpose of reserves held? If so, why?

14. How have the RSE licensee's reserving practices and policies been amended to ensure compliance with the best financial interests duty?

FSC comment: The HSF advice is that the superannuation law (including the BFID) does not regulate the reserving practices of a trustee in its personal capacity, with a limited exception when an ORFR is held at the trustee level.

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

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?

17. What are the challenges, if any, in obtaining and renewing insurance coverage and how are RSE licensees managing these challenges?

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?

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?

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?

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.

22. How do RSE licensees provision for contingency expenditure items? To what degree does this form part of the trustees' business planning process?

FSC comment: We note the HSF advice is that a trustee cannot build its financial resources from trust assets (including reserves) unless this occurs under a remuneration power or an indemnification power.

We also note that a trustee holding capital in its personal capacity will provide protection against contingency expenditures – see Sections 6.2 and 6.3.

23. How do RSE licensees fund restructures of their business operations?

FSC comment: We note the HSF advice is that a trustee cannot build its financial resources from trust assets (including reserves) unless this occurs under a remuneration power or an indemnification power.

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 considered when settling on the source of funding?

FSC comment: The HSF advice is that the law does not require a trustee to determine alternate sources of funding. See also Section 6.6.

25. If intending to build financial resources of the RSE licensees by deducting amounts from existing reserves, how would affected reserves be replenished and how might this approach affect fees charged to members?

FSC comment: the HSF advice is that a trustee cannot build its financial resources from fund assets (including reserves) unless this occurs under a remuneration power. In general, the exercise of a remuneration power by a trustee is not subject to the duties imposed by superannuation law. See Section 7.3.

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?

FSC comment: the HSF advice is that the superannuation law generally does not regulate funds held by trustees (trustees) in their personal capacity (see Section 6.4 above). Once assets are the personal property of the trustee, there is no requirement at law for a ‘surplus’ to be returned to the trust.