Mercer

welcome to brighter

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Subject: Strengthening Financial Resilience in Superannuation

Dear Sir/Madam

Mercer welcomes the opportunity to comment on APRA's Discussion Paper issued in November 2021 entitled *Strengthening Financial Resilience in Superannuation*.

Mercer supports much of the content within the Discussion Paper. In particular, we agree that:

- Superannuation funds (including both the RSE licensee and the RSE itself) require adequate financial resources that are available to fund a range of activities from day-to-day business operations to unexpected contingency expenditure.
- There exist a range of financial and corporate structures within the superannuation industry and this diversity should be acknowledged and encouraged. Future policies should not require a single type of corporate structure. However it must also be recognised that a particular external event, such as a piece of legislation of government decision, may have different impacts or consequences for members of superannuation funds with different structures.
- There exists a range of financial sources available to superannuation funds and none of these should be excluded from supporting financial resilience.
- Robust planning and preparation for the unexpected (including scenario and stress testing) are important features of ensuring future financial resilience. Of course, it must also be accepted that significant unexpected events will arise and failure (in whatever form) can occur in such circumstances. We should not develop policies that are so strong that failure cannot occur. Such a development would be very costly and reduce member outcomes significantly.

Before commenting on our suggested approach, we will make some comments on particular topics mentioned in the Discussion Paper.

<u>The setting of fees</u>

The management and operation of a superannuation fund needs to be paid for; it is not a free good. Therefore it's appropriate that fees are charged for the services provided.

Fees may be charged by the RSE (the super fund itself) to members, the RSE licensee (i.e. the trustee) to the fund or both. There is no single 'correct' answer and flexibility is therefore required in any future policy as the ‘best’ approach for long term resilience will depend, at least in part, on the corporate structure.

Of course, and as noted in the Discussion Paper, the fees charged to members must support member outcomes and be in the best financial interests of beneficiaries. However, these objectives, while obviously desirable, are subjective in nature and do not equate to a precise formula or simple expression.

Fees are also required for a variety of purposes from the costs of day-to-day operations through to unexpected expenditure. In addition, it is important to set fees in an equitable manner so that a particular cohort of members are not paying excessive fees or being unreasonably subsidised by other members, as mentioned in the Discussion Paper.

It is also worth noting that fees may have both a short term and long term perspective. For example, some fees are necessary to cover immediate costs whereas others are needed for strategic development or in response to new legislation, which may have costs and consequences over many years.

In respect of longer term resilience, it may also be appropriate for the RSE and/or the RSE licensee to charge fees in order to establish reserves to reduce the possible impact of future uncertain events.

The Discussion Paper notes on page 10 that:

> “Prior to charging a trustee fee, APRA expects that an RSE licensee would have diligently explored and exhausted all other avenues for raising or using financial resources.”

This approach seems to limit the circumstances whereby an RSE licensee could charge such a fee, as it suggests that the charging of such a fee should be the very last option considered; that is, the last resort. In certain circumstances, such an approach may actually reduce the future resilience of the superannuation fund as other financial resources may be required to be used. It is also worth noting that an RSE licensee may have the option to charge a fee from an existing reserve (say within the RSE) rather than directly deducting from members’ accounts. Every situation is different and each option needs to be carefully considered in light of the longer term interests of members. Flexibility is an important feature of ensuring long term resilience. A particular or required order relating to the use of financial resources is therefore not appropriate.

<u>Financial projections</u>

Financial projections represent an important tool for RSE licenses to plan for the future and establish long term resilience of their superannuation fund.

It must be recognised that most superannuation funds do not offer any guarantees (unlike insurance companies and banks), so that most of the apparent risks relate to the operations of the fund and should be covered by the required risk management framework and risk appetite statement. However financial resilience, while related to some aspects of risk management, is different and requires a more holistic approach.

That is, it requires consideration of the unexpected and/or unknown risks. Most of these are external to the fund's operations and could come from Government intervention, a war or pandemic, a major market correction or some other significant event. It is therefore suggested that APRA should assist the industry in their scenario or stress testing by describing these extreme events, even with a general description of possible outcomes.

Operational risks

The Discussion Paper notes in Section 3.2 that:

> "it is evident that RSE licensees are reluctant to call on these financial resources (i.e. the ORFR), even when they would be entitled to do so under the provisions of the standard."

This outcome is not surprising for several reasons, including:

- As set out in SPG114, APRA expects a soundly run RSE licensee that has implemented an effective risk management framework to have an ORFR target amount that is equivalent to at least 0.25 per cent of funds under management (FUM). For many funds, particularly larger ones, this amount is in excess of what may reasonably be expected to be needed. Hence the ORFR is 'parked' and may not be considered to be part of broader and more holistic capital or reserving considerations. In effect, the ORFR is a rather blunt instrument and does not recognise different approaches.
- SPG114 describes the ORFR tolerance limit as one that "is intended to enable an RSE licensee to manage immaterial fluctuations below the ORFR target amount without the need for a replenishment plan." Yet small payments, which are described as an example of "immaterial fluctuations", can normally be paid from general reserves thereby avoiding the need to involve the ORFR.
- The use of the ORFR may set in train a process as set out in SPS114, including the implementation of a replenishment plan. Yet, on many occasions, it is easier to make the required payments from other reserves thereby negating the need to establish a replenishment plan.

These comments are not meant to imply that operational risk reserves are unnecessary. Operational risk events will happen so that compensation or remediation payments will be necessary from time to time in the operation of all financial services organisations. However, the establishment of the ORFR with its own requirements and separated from the other financial resources available to RSE licensees, means that these resources are not considered to be part of the RSE licensee's broader approach to capital and reserving. In that respect, it can lead to inefficiency within the overall operations.

We recognise APRA's concern that a reluctance to call on ORFR potentially reduces the efficiency of operational risk data. On this point we believe that the establishment of an operational risk reserve, without the current requirements set out in SPS114, but as part of the broader reserving management approach, is likely to lead to improve the collection of operational risk data.

One final point in respect of operational risks. While the potential cost of some operational risk events may be in proportion to the size of the FUM, many risks have a natural cap in terms of the total potential cost. Hence as many superannuation funds increase in size, it seems unreasonable to have the same target amount for all RSE licensees. It would be preferable to have a risk-based approach whereby stronger governance and processes can lead to a reduction to the required level of ORFR for some RSE licensees. Such an approach should also encourage improved governance and lead to better outcomes for members.

A holistic approach to capital and reserves

As the Discussion Paper notes in Section 3.3, there can be several types of reserves including general, administration, insurance and investment reserves. In addition, funds may set up a strategic reserve for future large expenditures such as new IT systems. These reserves represent an important part of establishing financial resilience of a superannuation fund.

However resilience also implies the need for some flexibility as future events which may threaten the future sustainability of a particular superannuation fund cannot be predicted with accuracy. It should also be recognised that a particular event is unlikely to have the same impact on all superannuation funds. The early release of superannuation benefits during the COVID-19 pandemic is a case in point.

Hence, tight regulations and reserves set aside for particular purposes only (i.e. in silos) do not represent the best solution for encouraging and maintaining financial resilience in superannuation. However, this does not imply that APRA should not be involved in overseeing the establishment and management of reserves. Ensuring the ongoing sustainability of superannuation funds is an important role for APRA.

As currently occurs within SPG 515 paras 58-64, Mercer agrees that APRA should establish some principles for the establishment and management of reserves within an RSE or RSE licensee or both. This should lead to a more integrated approach to capital and reserve management within some overarching framework, rather than discrete approaches for each reserve.

For example, we recommend that:

- Each reserve should have a clear purpose approved by the RSE licensee as suggested by SPG 515 and, in effect, required by S52(2)(i) of the SIS Act
- The size of each reserve should have a minimum and maximum, either expressed as an absolute amount or as a percentage of FUM, which would reduce the possibility of inequity between different cohorts of members
- These minima or maxima for the reserves, including the operational risk reserve, should be established objectively and reviewed by the RSE licensee at least every three years, taking into account the RSE licensee’s risk profile and risk appetite.
- Within the range of the minima and maxima, there should be no external restrictions of transfers between reserves, thereby allowing for changing conditions. This flexibility will also enable a more holistic and strategic approach to capital and reserving by RSE licensees, rather than considering each reserve in isolation which can lead to over-reserving to the detriment of member outcomes.

In summary, successful integration of a holistic capital and reserving approach by the RSE licensee and the RSE, together with a related focus on risks, is likely to lead to better outcomes for members and stronger financial resilience of superannuation funds.

This broader holistic approach would also place RSE licensees in a better position to consider financial contingency readiness which, as outlined in a separate APRA Discussion Paper, has lagged in the superannuation industry compared to the banking and insurance industries. That is, the management of possible future stress points needs to incorporate the integration of all financial resources available to the licensee. This comprehensive approach is also appropriate in the development of a prudently calibrated trigger framework which would become part of a financial contingency plan under CPS 190.

Whilst this approach must ultimately be the responsibility of the trustees, we suggest that it would be appropriate for the RSE licensee to receive independent advice from an appropriately qualified individual from outside the organisation.

Naturally, we would be pleased to discuss any of these matters with you and members of the APRA team. Please do not hesitate to contact me on [redacted].

Yours sincerely,

[redacted]

[redacted]
Senior Partner