

March 2021

# Strengthening Financial Resilience in Superannuation

All superannuation trustees must be financially resilient to ensure they can deliver on their promises to consumers. The best interests of superannuation fund members need to be at the forefront of all considerations as trustees go about ensuring they are financially resilient. Failure to do so will lead to inefficiencies, poor fee design and inappropriate cross subsidisation. This will mean consumers will pay more than they need to and ultimately lower their retirement savings.

When it comes to setting aside reserves for the payment of future fines, we need to make sure the system has the right incentives by appropriately targeting those who have caused these penalties to be incurred. This targeting problem creates an issue in the context of a superannuation fund, where the source of these reserves come directly from members. This is the case in both for profit and profit to member funds, where direct fees or profits derived from fees ultimately come from members. There is a risk in this design that the victims of mismanagement are punished for this mismanagement in the form of higher fees. This is why measures like the Financial Accountability Regime (FAR) are so important in targeting those responsible for consumer harm. The system needs to be appropriately adapted and regulators given tools to ensure those who cause harm are held accountable. To effect this, the Financial Accountability Regime (FAR) must be passed as a priority.

The FAR Bill requires accountable persons to

- act with honesty and integrity, and with due skill, care and diligence; and
- deal with the Regulator in an open, constructive and cooperative way; and
- take reasonable steps in conducting those responsibilities to prevent matters from arising that would adversely affect the prudential standing or prudential reputation of the accountable entity; and
- take reasonable steps in conducting those responsibilities to prevent matters from arising that would or would be likely to result in a material contravention by the accountable entity of any financial services legislation.<sup>1</sup>

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<sup>1</sup> Financial Accountability Regime Bill 2021, Part 3—Accountability obligations

The FAR will ensure failures of governance will be examined by the regulator and made the subject of the appropriate regulatory response. As Commissioner Hayne said “this is necessary if executives are to be held properly accountable for their failures.”<sup>2</sup> Without a disincentive to harm consumers placed on individuals, the community remains vulnerable to decision-making that trades off consumer welfare for excessive profits, personal gain or mere indifference because the cost of the penalty is borne by members. Without the FAR we are likely to see a repeat of the same harmful practices that resulted in the Banking Royal Commission. This will leave consumers paying for the misconduct of their superannuation fund.

Super Consumers Australia welcomes APRA’s efforts to gather more information about how trustee’s fund their operations, including planning for contingent expenses like penalties. We are interested in APRA’s findings and look forward to APRA’s insights from this process. We have limited our feedback to additional factors we recommend APRA should take into account.

## Setting a fee

Fee design and setting must support member outcomes and meet obligations to act in the best financial interests of beneficiaries and comply with the sole purpose test. We support APRA’s expectation that funds ensure that their level of fees are appropriate and proportionate, and regularly reviewed.

When determining fee appropriateness, we recommend APRA expect trustees turn their mind to managing potential cross-subsidisation across fund membership. For example, cross-subsidisation may occur where existing members are required to fund a financial levy for a certain purpose and new members are not, yet both enjoy the benefits of its existence. This should also prompt trustees to consider models such as those that provide reimbursements or credits to certain members where this is appropriate. Ensuring funds are required to turn their mind to cross-subsidisation when assessing what is in the best financial interests of members will ultimately improve the fairness of how these fees are levied.

We also support APRA’s expectations that any reserve generated by a fee would not be excessive, and expect 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. APRA should continually review this evidence to monitor fund behaviour.

### Recommendation

A fund be expected to consider the fairness of cross-subsidisation across different cohorts of members (e.g. new members vs long term members) when setting a fee.
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<sup>2</sup> Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, p 264

## Insurance

We urge APRA to assess the system wide and fund level impact of trustees using insurance to protect against risk. This should be informed by a long term, system wide cost-benefit analysis.

Insurance at its core is designed to defray cost across a pool of insured and across time, it is not a magic pudding. There are costs associated with running insurance pools as well as profit extracted by insurers. These are all costs which would ultimately be borne by consumers in the form of fees to cover the cost of insurance premiums. Given these facts APRA should weigh the additional value insurance may offer over a fund directly provisioning for contingencies.

Another factor which should weigh in this consideration is the moral hazard that may flow from a trustee being able to rely on insurance to cover certain losses. Again we reiterate the importance of the FAR in driving industry standards to ensure the individuals responsible for consumer harm can be held accountable for their actions.

Finally, reliance on insurance may lead to an inefficient allocation of costs. An insurer needs to ensure its pool remains solvent, it does this through measuring risk and collecting sufficient premiums to cover these risks. This can lead to cross-subsidisation between insured entities and the potential for relatively low risk trustees to be cross-subsidising high risk trustees. The end result is a misallocation of costs, which may punish funds that are well managed. This also sends weaker cost signals to those that are generating the most risk and undermines the corrective function penalties are meant to play.

### Recommendation

That APRA use the data received in this consultation to do a cost-benefit analysis of using insurance markets to strengthen financial resilience compared to other sources of finances.
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## Reserves

APRA has identified a number of issues with the management of reserves. These include trustees being reluctant to call on operational reserves when they are entitled to do so, a lack of reporting data and a lack of clearly articulated trustee process for reviewing reserves. The changes to Section 56(2) of the SIS Act and subsequent court cases has raised more questions than answers because it has lifted a lid on the source and purpose of certain reserves funds have built. The last official holistic reserve focused consultation in super funds occurred in 2009. APRA currently does not have the appropriate data or tools to ensure reserves are working efficiently. We recommend that a review of reserves, their purpose and use is conducted to ensure funds are using member money in their best financial interests.

### Recommendation

That APRA conducts a review into reserves in superannuation to determine their purpose and ensure funds are acting in the best financial interests of members.

## Penalties

Super funds require financial resources to cover costs in the event they are penalised for misconduct. The sources for these financial resources are likely to vary across superannuation sectors and within superannuation sectors. Regardless, it is consumers who ultimately provide this funding. That is why a disincentive for consumer harm is so important.

As we state above, in order to mitigate penalties, proper governance and accountability on senior executive and board decision makers is needed. This places a direct onus on funds to administer their fund in the best financial interests of members. Without it, decision makers will be left off the hook, and consumers will be left to pick up the tab. The FAR is a crucial element in ensuring penalties are left to a minimum.

As APRA expects for fee-setting, decision making with regards to sourcing penalties should be diligently explored and exhaustive. Full details of alternative avenues pursued for building or using financial resources for penalties should be clearly evidenced and actively challenged by the Board.

***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?***

Leaving aside current industry practice, it is important that similar principles be applied to fee-setting that are applied to the sourcing of funds for the payment of civil and administrative penalties. That is, the source of funding is transparent and evidence-based. Evidence such as publicly disclosed documentation which details why a chosen source is appropriate and an exploration of alternative sources should ensure funds are making justifiable decisions and are accountable to their members.

***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?***

The sector could benefit from greater transparency of the provisioning funds have made for paying penalties and why. Transparency is likely to put pressure on outliers to either justify their provisioning in relation to their peers. This reporting would also assist APRA in setting reasonable expectations among industry participants about the appropriate provisioning. Recent reports have shown wide variation in how funds are provisioning for penalties with

AustralianSuper building a \$36.7 million penalty reserve equal to a maximum of 0.015 per cent of the net assets of the fund. By contrast CBUS is putting aside \$93.4 million to a maximum of 0.14 per cent of the fund.<sup>3</sup> Requiring funds to publicly disclose and justify should improve the overall quality of decision making and mitigate against over provisioning.

### **Recommendation**

The FAR should be passed as a priority to ensure financial resilience decision making is in the best financial interests of members.

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<sup>3</sup><https://www.afr.com/politics/super-funds-get-green-light-to-pay-fines-with-members-cash-20220118-p59p2a>