Mercer

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General Manager, Policy
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Via email to: Redacted [redacted]

29 April 2022

Subject: Response to CPS190 Proposal for Superannuation

Dear Sir/Madam

Mercer welcomes the opportunity to comment on APRA's Discussion Paper issued in December 2021 entitled *Strengthening crisis preparedness* and APRA's plan to develop two new cross-industry prudential standards; namely CPS 190 *Financial Contingency Planning and* CPS 900 *Resolution Planning.*

Introduction

This submission relates to the relevance and appropriateness of these plans to superannuation licensees and superannuation funds only. We have not considered their relevance and suitability to banks and insurers. Our reason for this concentration is that superannuation is very different from banks and insurers for the following reasons:

- There are no guarantees or fixed promises in superannuation. Of course, it could be argued that defined benefit funds may represent a promise from the sponsoring employer but even then, the relevant trust deed normally permits a reduced benefit to be paid under extreme circumstances. It must also recognised there are now very few open defined benefit schemes remaining in Australia.
- Given the absence of guarantees, there are no risk-based capital requirements for superannuation licensees in Australia. This is a reasonable outcome but it also means that the risks and stresses faced by superannuation licensees are quite different from many of the stresses faced by banks and insurers. Hence CPS 190 will need to recognise these differences.
- Superannuation is compulsory in Australia for nearly all employees, given the removal of the $450 threshold from 1 July 2022. This compulsory nature means that it is critical that the industry delivers good member outcomes, and is both stable and sustainable. However, it also means that the Australian system is very different from most other G20 countries where occupational-based pensions are not compulsory. This contrast also means that the comment on page 5 of the Discussion Paper referring to the progress in the majority of G20 jurisdictions is not relevant to contingency planning for pension or superannuation funds. For example, fifteen of the twenty G20 countries (including Spain) have assets in retirement savings plans of less than 35 per cent of GDP according to Table 9.2 in the OECD's publication *Pensions at a Glance 2021.* Hence

these pension industries are much less developed than Australia's superannuation industry where the assets are now more than 150 per cent of GDP.

- Another important difference between superannuation contributions and bank deposits or insurance premiums is that superannuation money for most employees must be preserved within the super system for many years. That is, it cannot be paid back or returned to members upon the closure of an entity. A transfer of the funds to another superannuation fund represents the only realistic option, should the RSE licensee decide that the most appropriate option is to close. This means that the contingency plans for a superannuation licensee must be developed within that unique context.

Section 2.1 of the Discussion Paper correctly notes that:

> "These threats can come from a range of sources, and for financial institutions are most typically associated with an economic downturn."

Yet the consequences of an economic downturn are much more restricted for most superannuation operations due to the following reasons:

- An economic downturn increases credit risk and raises the probability of default. Yet, should this occur, the consequences for the majority of superannuation funds would be a reduction in the market value of the fund's investments which would be passed directly onto members.
- An economic downturn may also lead to depressed capital markets and a reduction in the value of equity, property and other investments. However, as with the previous point, such reductions would be passed directly onto members.
- An economic downturn often increases the level of disability and/or sickness claims. Yet superannuation funds do not bear this risk directly as such risks are passed onto insurance companies.
- An economic downturn also increases the level of unemployment which can lead to increased consumer behaviour to access their available funds. Yet, given the preservation rules within superannuation, superannuation fund members cannot access their funds or quickly generate a "run" on the fund. Of course, members are able to access some of their funds in the more extreme circumstances of severe financial hardship but this represents a much more gradual process.

Of course, it is recognised that the cash inflow into a superannuation fund may be reduced during an economic downturn due to lower contributions and reductions in the level of dividends, interest payments and property rentals. These events could lead to a liquidity squeeze. However this risk should already be considered by the liquidity management plan required under SPS 530.

These comments are not to suggest that Contingency Planning should not be carried out by superannuation licensees. Mercer supports the proposed requirement for RSE licensees to develop a contingency plan and to develop policies and processes to prepare for possible future stresses. However the proposed prudential standard must recognise that superannuation funds have very different features from banks and insurers. Furthermore, the global development of such plans for pension funds is not well developed and has had limited experience. Hence considerable caution is appropriate in the development of CPS 190 for superannuation entities to prevent any undesirable outcomes.

Some comments on Contingency Planning

As noted in the Discussion Paper, it is not appropriate to develop a prescriptive approach for contingency planning. Every organisation is different and is able to respond to stresses in different ways. Therefore Mercer supports the principles-based approach so that the most appropriate contingency plan relating to the organisation's business model and associated risk profile can be developed.

Given the absence of guarantees, certain risks that face banks and insurers do not exist within superannuation. It is therefore to be expected that a contingency plan for an RSE licensee should be simpler than that required for most banks and insurers.

As noted in the Discussion Paper and mentioned above, stresses and strains on a financial institution can come from a variety of sources (internal and external) and can include both financial and non-financial causes. Indeed, it could be argued that one of the most significant potential causes of stress to the Australian superannuation industry could be a snap decision by the Government, as occurred with the early release of superannuation benefits in the first year of the COVID-19 pandemic. Whilst this decision limited the size of the payout to individuals, and therefore the strain placed on most superannuation entities, there is no guarantee that a future decision may be so limited. Hence, it is critical that the federal government and the Treasury understand the potential consequences of certain decisions relating to the availability of superannuation benefits, which could go beyond any contingency plans that may be developed by individual superannuation plans.

A holistic approach is necessary

The Discussion Paper focuses on the need for each RSE licensee to develop a contingency plan. However it must be recognised that an RSE licensee does not operate in isolation. They are managing and operating a Registered Superannuation Entity (i.e. a superannuation fund). As discussed in our submission responding to the financial resilience Discussion Paper, it is critical that the contingency plan take into account all the resources available to the RSE licensee, including those from within the fund itself.

As an example, let us consider the stress caused by an idiosyncratic issue such as fraud or a cyber-attack as mentioned on page 11 of the Discussion Paper. These are operational risks and the consequences of such risks could be mitigated (either in part of in full) through the use of assets held to meet the Operational Risk Financial Requirement (ORFR). These assets may be held by the entity and/or by the licensee. That is, the potential threat to the viability of the RSE licensee could be reduced or removed by the use of any these funds held by the RSE. This approach highlights the need for the Contingency Plan to consider the full range of responses and financial resources and not to limit itself to a restricted set of possible resources. In circumstances similar to those outlined in the Discussion Paper, it may be in the best financial interest of fund members for the RSE licensee to use the ORFR or other reserves held within the RSE and to subsequently replenish them gradually over time.

We also recognise that CPS 190 needs to be developed so that it is consistent with both SPS 515 and the draft of SPS 530. Hence we support the comment in the Discussion Paper that CPS 190 “would support the objectives of SPS 515”.

In respect of SPS 530, we note that this prudential standard requires the following:

- A stress testing program (paras 29-34);
- A liquidity management plan (paras 35-37); and
- An effective valuation governance framework (paras 38-40).

Each of these requirements could form part of the input into an effective and efficient contingency plan. Hence, there is no need to add additional requirements in these areas.

Finally, and as noted above, an RSE licensee cannot close their business. Indeed, as shown in Table 2 in the Discussion Paper, which considered two hypothetical examples of financial contingency planning for RSE licensees, each outcome represented a form of transfer; either as a successor fund transfer or a transfer of the RSE licensee. This suggests that if the contingency plan is to be able to operate without a significant disruption to the superannuation fund members, then all forms of transfer should be able to be completed relatively simply whilst at the same time protecting the members’ accrued benefits. The current rules for successor fund transfers do not always enable such transfers to occur as easily as may be desirable.

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]

Dr David Knox
Senior Partner