



APRA's current focus in Superannuation

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I. Introduction

Of late, prudential regulators have received a level of visibility that we are not used to, and would rather shun. The other day, I heard APRA being mentioned: instead of our better known, and popular, fellow organization with the shared acronym, the Australasian Performing Right Association, the reference was to us! Financial crises do have an abnormal effect on people.

Given the opportunity, it seems apt that I focus today on three topical areas relevant to the superannuation industry: licensing outcomes, finance remuneration, and fund research.

Never one to pass up the opportunity of a captive audience, I will conclude with a few other issues that are on our radar.

II Super, post introduction of RSE licensing

Three hundred and seven RSE licences were issued in the two year licensing transitional period which ended on 30 June 2006. The total number of RSE licensees has gradually reduced since that time due to ongoing industry rationalisation.

RSE licensees		
Type of RSE Licence	Nov 2007	Nov 2008
Non-Public Offer Licences	168	159
Public Offer Licences	103	104
Extended Public Offer Licences	16	16
Acting Trustee Licences	12	12
Total Licences	299	291

A. Investment Issues

Investment has been a major focus for APRA supervisors and trustees alike. The significant volatility and overall decline in domestic and global markets since October 2007 has had a dramatic impact on all segments of the industry.

Widespread negative investment returns for the year ended 30 June 2008 have been followed by further losses in the subsequent period. Investor confidence is fragile with a number of corporate collapses and near death experiences. The volatility of, and changes in, investment markets has adversely flowed through to the liquidity position of a number of superannuation funds.

Domestic and International Equity Market Performance

Index	2 July 2007 value	30 June 2008 value	% change	9 Dec 2008 value	% change 1/7/08 to 9/12/08	% change 2/7/07 to 9/12/08
ASX All Ords	6298.6	5332.9	(15.3)	3533.7	(33.7)	(43.9)
MSCI World	1616.9	1402.1	(13.3)	887.7	(36.7)	(45.1)

B. Unlisted Assets - Valuation

Valuation practices for unlisted assets have become a contentious issue in this climate. The valuation approaches used have ramifications for trustee considerations of investment option offerings, performance measurement, decisions on portfolio rebalancing and implications for the allocation of investment returns to members (including unit pricing / crediting rates). A significant concern relates to the mismatch where assets that are infrequently traded and revalued are included in funds with significant turnover that must be assessed more frequently. An increasing level of investment in unlisted assets over the last few years has exacerbated the concern.

Whilst it is not APRA’s role to prescribe valuation methodologies, trustees are expected to value assets at net market value using appropriate valuation approaches. This includes consideration of ‘the going concern’ status of the fund as well as reference to relevant industry based guidance whether in specific accounting standards, IFSA guidance, AVCAL guidance or other clearly established practices based on corporate finance principles. APRA has recently written to trustees to further encourage good practice and is actively engaging with both the industry and professional advisers. Tailored reviews are also being undertaken to gain an insight to trustee practices in respect of entities with a significant exposure to unlisted assets. As appropriate, APRA will communicate with the concerned trustees and the industry at large.

C. Solvency of Defined Benefit funds

Despite the dominance of accumulation plans in our superannuation landscape, the dramatic decline in investment markets has had significant implications on the financial position, and ultimately solvency (the ability to meet benefits as they fall due), of defined benefit (including hybrid) superannuation funds.

Defined benefit funds generally offer benefits that require higher contributions than the statutory minimum under SIS. Generally, employers are contractually obliged to employees meet the higher obligations. Where there are insufficient assets for trustees to pay members the defined amount as they fall due and the employer does not contribute sufficiently to cover the shortfall, the fund will fall into an unsatisfactory financial position. If the assets fall below the statutory minimum level, a technical insolvency position will arise, triggering under SIS, a statutory rectification process involving actuarial oversight.

APRA’s survey of all defined benefit and hybrid superannuation funds revealed that 15.9% of defined benefit funds and 19.7% of defined benefit/hybrid sub-funds were

in an unsatisfactory financial position as at 30 June 2008. With the further decline in the investment markets since that date, the number of affected funds has increased. APRA continues to work closely with the trustees of individual funds and sub-funds most affected, and where appropriate, their actuaries and contributing employers. It is gratifying to note that these issues are receiving proactive attention from the industry and the professions.

However, given the pervasive impact of market falls across asset classes as well as contributing employers and the decline in the discount rates used to value liabilities, a classic solvency squeeze has eventuated. Neither the industry nor APRA can afford to relax their guard.

D. Outsourcing

Superannuation is characterised by a high level of outsourced service provision in the areas of investments, custody and administration. APRA's outsourcing standard provides for regulatory access to key service providers. Pursuant to this, an APRA-wide project of reviewing a number of administrators commenced in 2008. A similar project involving reviews of custodians has commenced in 2009. APRA will communicate its findings to the industry to encourage further migration of good practice and to ensure any identified issues are resolved.

E. Breach Notifications

On 1 January 2008, harmonised breach reporting requirements were incorporated into the prudential requirements for approved deposit-taking institutions (ADIs), life insurers and general insurers. In addition, a 'significance test' (incorporating materiality) was introduced across all industries. This was a major improvement to the superannuation breach reporting obligations of trustees given, prior to 1 January 2008, no materiality test applied.

A new version of APRA's online breach reporting system was introduced covering all industries and was released on 11 March 2008. Superannuation trustees were still able to use the previous online breach reporting system during the January to March 2008 period. The online breach reporting system is fully integrated and automatically notifies APRA supervisors by email when a breach notification is received and includes a separate database for reporting and data analysis purposes. The online system also allows APRA-regulated institutions to submit dual reports to APRA and ASIC simultaneously.

The introduction of the 'significance test' reduced the number of breach reports lodged with APRA. During calendar year 2008, 212 superannuation breach reports were received, which was 83% down on the previous year. APRA supervisors examine all breach reports and determine whether supervisory follow-up action is necessary.

F. Liquidity survey

Given the market stresses which became evident in late 2007, APRA was concerned that trustees of superannuation funds may not be adequately prepared to deal with liquidity issues. A questionnaire was issued to trustees to assist APRA to gain a better understanding of liquidity management practices and the effectiveness of the trustee implementation of the 'illiquid investment' provisions of the SIS

portability regulations. Trustee responses provided valuable insight to APRA across all fund types (retail, industry, corporate and public sector).

The overall findings from analysis of the questionnaire responses are that trustees need to focus on strengthening and improving their current practices. In particular, trustees should:

- manage liquidity at the investment option level (as opposed to the whole of fund level) and demonstrate a better understanding of the factors that can affect their ability to redeem investments at the investment option level (particularly as they relate to the payment of pensions that have commenced and portability of benefits);
- undertake more comprehensive and adequate liquidity stress-testing (i.e. including crisis scenarios);
- expand their cash flow budgeting parameters to cover all aspects of liquidity management, not just managing the monthly cash flow rebalancing activities, and look to implementing longer term strategies;
- avoid over-reliance on the historic positive cash flow from contributions into the fund in order to meet benefit obligations and manage liquidity risk.
- gain a better understanding of the impact of 'illiquid investments' for the purposes of portability and the payment of benefits;
- better utilise membership data and its linkages to the investment structure of the fund so that obligations to pay benefits to members can be met; and
- achieve a more robust balance between member investment choice and the ability to meet payment requests in the context of such choice.

This exercise also provided APRA the opportunity to explicitly rank the adequacy of the liquidity management practices of superannuation funds.

G. Portability of superannuation benefits

The portability provisions of SIS require RSE licensees to generally transfer benefits to another fund within 30 days of receiving a member request. However, there may be circumstances, both foreseen and unforeseen, where a trustee cannot transfer a redemption request within the required time period. The portability rules include provision for a trustee to apply to APRA to suspend or vary the obligation to rollover an amount to another fund, and for APRA to unilaterally suspend or vary the obligation.

Factors that APRA must take into account include whether the payment would have a significant adverse effect on the financial position of the fund or the interests of other members of the fund. In taking into account the effect on the interests of other members of the fund, APRA considers whether cashing of other liquid investments would unfairly concentrate the exposure of remaining members to the frozen assets.

During 2008 a number of managed investment schemes (MIS), predominantly mortgage and property schemes, suspended or froze redemptions from the MIS, or gave notification of the providers' intention to terminate certain offerings. This has affected superannuation funds invested in those schemes, whereby previously liquid investments have now become illiquid. Consequently, trustees are unable to

meet the 30 day portability requirements or accommodate internal switching between investment options. It has also affected the ability of trustees to pay member lump sum benefits and, in some cases, pension benefits.

APRA has assessed a number of trustee applications for relief from the portability requirements and granted relief on a case-by-case basis. In doing so APRA has responded to practical pressures felt by trustees in a timely fashion but has also ensured that trustees have adopted a proper process of consideration and decision-making around their decision to seek portability relief. Experience in this area has suggested that it is appropriate for APRA to continue to consider relief on a case-by-case basis. Our findings in relation to trustee risk management practices will continue to be assessed as part of normal supervision.

APRA has also made it clear (in consultation with ASIC) trustees must approach APRA for dispensation notwithstanding that in certain circumstances section 155 of SIS allows public offer fund trustees to depart from internal provisions to achieve a fair and equitable outcome for beneficiaries. APRA has made it clear through a number of industry communications that it does not believe these provisions apply in the case of frozen underlying investments.

III. Executive remuneration

Executive remuneration has drawn great interest from the public, from politicians and governments, from investors and shareholders and from regulators, economists and other commentators.

For the public, executive remuneration is an easy target when share prices are falling and some individuals appear to have been highly rewarded, for there is a clear public outrage at large remuneration of executives of loss-making businesses,. Nevertheless the public has a well justified general sense of unease around the topic of executive remuneration.

Politicians and governments, in responding to the public, are rightly concerned at excessive risk-taking, conflicts of interest and apparent examples of individual greed taking priority over the interests of shareholders and customers.

Investors and shareholders have become concerned that the arrangements have contributed to risk-taking that has undermined the quality of corporate decisions and strategy, creating conflicts of interest and compromising shareholders.

Regulators need to consider how they may influence the debate. Where can they act so that boards of companies implement more appropriate and better balanced remuneration arrangements? There is the possibility of influencing directly the boards of financial institutions regulated by APRA.

Let us consider how the debate has evolved recently in terms of chronology:

Date	Initiative
13 October 2008	FSA (UK) wrote to bank CEOs in the UK outlining good practice and poor practice in remuneration
15 October 2008	Prime Minister Rudd announced government concerned at excessive risk-taking, asked APRA to explore
November 2008	APRA invited to join FSF work stream preparing for G20 leaders meeting on 2 April 2009

9 December 2008	APRA announced its approach -- see media release attached
11 February 2009	AICD announced new guidelines on executive remuneration
18 February 2009	ASA a released exposure draft on executive remuneration
27 February 2009	FSA (UK) released a draft code of practice
6 March 2009	CEBS announced draft principles on executive remuneration
12 March 2009	FSF issued a press release regarding the recommendations it would be making to the G20 meeting on 2 April 2009

When the Financial Stability Forum met in London on 11 and 12 March in preparation for the G20 meeting on 2 April, its press release stated that "The FSF endorsed a set of principles that will reinforce sound compensation practices in the financial industry. The principles aim to ensure effective governance of compensation, alignment of compensation with prudent risk-taking, and effective supervisory oversight and stakeholder engagement in compensation."

Section 300A of the Corporations Act has required for some years that registered corporations in Australia make disclosures on executive remuneration. In addition, the Australian Securities Exchange (ASX) has had disclosure guidelines regarding executive remuneration in listed companies.

The existing regime has relied essentially on disclosure. There are major constraints on disclosure: such as 'form over substance', effectiveness of incentive arrangements, and the ability to engender balanced behaviour.


The additional players are predominantly prudential regulators who often go beyond disclosure. Prudential regulators can use principles-based approach rather than the prescription required in most disclosure arrangements, and they can simultaneously oblige compliance with the intent and the substance of their prudential requirements.

It is useful here to recount how APRA operates. Our primary requirements for financial institutions relate to capital (or more broadly, adequacy of resources), risk management and governance, supported by regular reporting. Regarding governance, APRA requires that each board accepts responsibility for the entity's actions and performance. Generally boards accept and indeed are supportive of APRA's requirements. APRA can take various actions if the board is not playing the game, especially if we believe that the company's risk profile is high.

APRA also engages in active supervision. We undertake regular prudential reviews, whereby teams of APRA supervisors review closely the operations of each regulated institution. When we observe high or increasing risk, we increase the intensity of supervision. APRA has the resources to operate this way, on the basis that prevention (before trouble occurs) is better than punishment after the horse has bolted.

It should be evident from this description that APRA's modus operandi is to let companies work out their own approach, within the ambit of APRA's prudential standards, and for APRA then to challenge any company which is not, in APRA's opinion, operating appropriately.

The table below identifies ten dimensions of executive remuneration. It illustrates the range of possibilities available to regulators for each dimension and in each case it also shows the choice that APRA will be applying when we introduce prudential requirements on financial institutions later this year.

Executive Remuneration - Ten Dimensions				
Dimension	Range of possibilities			
1. Application	All corps	Listed corps	All prud regulated*	Regulated banks
2. Scope	Senior executives		All significant staff*	
3. Emphasis	Structure*	Quantum	Structure & quantum	
4. Regime	Legal prescription	Guidance	Prudential principles*	
5. Accountability	Disclosure	Non-binding vote	Supervisory*	
6. Governance	Bd/rem cttee*	Strict on independence etc*	Board discretion	
7. Components	Fixed*	STI payments*	LTI payments*	
8. Risk adjustment	Requirement*	Guidance	No guidance	
9. Time horizon	One year	Multi-year*	Deferred payment*	Deferred vesting*
10. Performance measurement	Guidance*	No guidance		

**APRA's direction*

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1. Application only to prudentially regulated institutions
2. Scope: Guidance to extend to those with a material impact
3. Emphasis on structure not quantum: we will not be involved in whether some institutions pay too much
4. Regime: principles rather than black letter prescription
5. Accountability through supervision
6. Governance through Board structures, building on existing requirements
7. Components: to cover fixed as well as variable (short and long term)
8. Risk adjustment: as we do with other areas
9. Time: longer than annual
10. Measurement: Further guidance including measurement methods

APRA will release a public consultation document shortly so that we can move to implementation in an agreed time frame.

As the superannuation industry becomes more sophisticated in adapting to public expectations, it is appropriate that trustees pay attention to the outcomes of this debate. Areas of special focus will include arrangements with outsourced service providers, especially those with related party links.

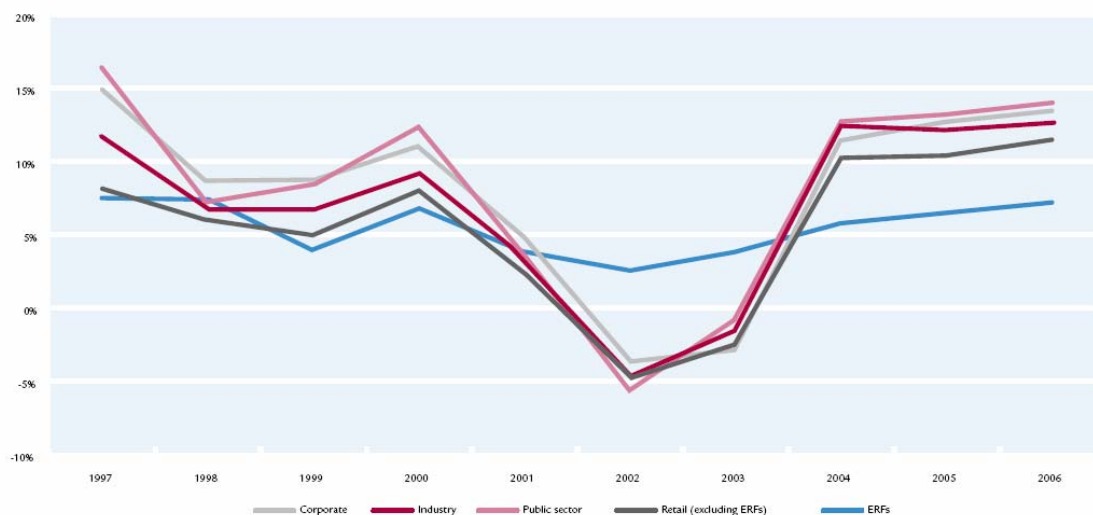
IV Fund performance

APRA is a national statistical agency, as well as a prudential regulator. In its statistical role, APRA has for many years collected and published statistics, and

undertaken considerable research and statistical analysis on the superannuation industry.

In June 2007, APRA published a special edition of *Insight*, containing 10 years of superannuation data (1996-2006). APRA classifies superannuation into four major types or sectors: Corporate, Public Sector, Industry and Retail. The first three are described as 'not for profit' funds while Retail funds offer superannuation to the public on a commercial basis. One of the features of the published statistics was the systematic difference in investment returns between the four sectors over the ten-year period.

Return on assets from 2007 special edition of *Insight* ^a



^a Entities with at least \$100 million in assets.

The Council of Financial Regulators (a body composed of the Reserve Bank of Australia, the Australian Securities and Investments Commission, APRA and the Treasury) commissioned APRA to undertake further research on the reasons for the differing performance between fund types.

Two surveys were involved in the research. The first examined superannuation fund governance and the second examined the components of fund returns - asset allocation, investment performance and expenses.

A. Superannuation fund governance

The research on the governance practices of APRA-regulated superannuation funds was based on a detailed survey of superannuation trustees. The governance survey found that in many areas of trustee policies and practices, there was little difference between sectors. In other areas there were statistically significant differences between the sectors, with Retail trustee practice more often different from that of the other sectors. Some of the findings were:

- Trustee directors of the large funds in the survey were typically well qualified, experienced and reasonably well trained in their trustee duties.
- Most boards (76 per cent) have both independent audit and regular self-assessment to review compliance with the Superannuation Industry (Supervision) Act 1993 and other regulations.
- Service providers are widely used in the superannuation industry, with the average fund using more than 13 service providers. Over 60 per cent of Retail directors have one or more associations with service providers, a figure that is

double that for directors of Corporate funds and almost three times that for Public Sector or Industry funds.

- Relative to the other trustees, Retail trustees have fewer directors, shorter (but just as frequent) board meetings, and rely more on fund executives to take the initiative on most key decisions. By contrast, trustees in the other three sectors mostly make the decisions with the main input coming either from themselves or from their consultants.
- More than half of all Retail trustee directors are employed by related parties or by the fund itself, and very few are nominated by fund members. By contrast, many Industry, Corporate and Public Sector trustee directors are member-nominated.
- More than half of Corporate, Public Sector and Industry trustee directors are themselves members of their funds. About one in five Retail trustee directors are members of their funds.

B. Superannuation fund performance

The research on the superannuation fund performance was based on a study which examined a representative sample of 90 corporate, industry, public sector and retail superannuation funds, each with more than \$200 million in assets as at 30 June 2005.

The research examined the components of net returns to determine the main drivers of differences in average net returns across corporate, public sector, industry and retail superannuation funds over the five-year period. The components examined were asset allocation, investment manager skill, fees, investment expenses and taxes.

The fund performance study found that there are few statistically significant differences in returns between corporate, public sector and industry funds (not-for-profit funds); however retail funds sometimes displayed significant differences when compared to the other fund types.

Some of the findings were:

- While some retail funds earned relatively high net returns and some not-for-profit funds earned relatively low net returns over the five-year period, retail trustees using balanced or growth investment strategies for default investment options generated significantly lower net returns on average than not-for-profit trustees using balanced or growth investment strategies.
- The study found that the main component of differences in net returns between fund types is expenses. Retail fund expenses, explicit and embedded, lower the net earnings of the retail sector relative to the not-for-profit sector.
- The study also found that neither asset allocation nor investment manager skill explained differences in net returns between fund types. The study also examined the net return and fees for an investor with a \$50,000 starting balance in each fund type. This confirmed the net under-performance of retail funds compared with not-for-profit funds and showed that retail funds have higher fees (annual, entry and exit) than other fund types on average.

C. Fund level publication and new statistical collection

In recent years, APRA's statistical publications and research on fund performance including return on assets, has attracted considerable interest. Several groups, including industry representatives, media, and academics have suggested there is

merit in APRA expanding its publications to include performance information about individual superannuation funds.

Recently the Minister for Superannuation and Corporate Law, Senator Nick Sherry, also requested that APRA consider how it might publish performance data which is disaggregated to the individual fund level.

APRA has concluded that there would be benefit in expanding our publications to include data on individual fund performance, while further investigating options for performance measures at the investment option level. APRA released a discussion paper in late 2008 which outlined the issues and questions to be resolved in creating a new fund performance publication, and will be releasing the new publication in mid 2009.

APRA is also considering a broader update to both its superannuation statistical collections and its publications, including asset allocation and investment option level collections. There will be an initial discussion paper released in mid 2009 which will outline the issues and questions relating to changes to APRA's superannuation collections and publications. Any changes from this consultation would be for possible implementation in 2010.

V Issues on the horizon

APRA has been asked to clarify the role of environmentally sustainable considerations in setting investment strategies and options, and in doing so would clarify the existing investment guidance in the context of the tensions between member investment choice and trustee obligations.

Reserving guidance has been issued in draft form for public consultation. I note that Mercers have also issued material following their survey. APRA will take into account all input in refining its draft.

Anti-detriment provisions enable lump sum death benefits to be topped up, to compensate for the impact of contribution taxes on benefits and claimed by the fund as a grossed up tax deduction. In our interactions with the industry, we will explore trustee practices in this regard and working with other stakeholders such as the ATO, ASIC and the professions, to develop guidance regarding best practice.

Recent market volatility has rekindled the issue of the level of deferred tax assets that can be prudently and equitably recognized in funds. APRA is working with the professionals to ensure unit pricing and crediting rate practices are appropriate.

With the announcement of the long awaited exposure draft on AAS 25, the accounting standard for reporting superannuation entities, APRA looks forward to providing its input, in particular on the prudential implications of the proposals.

VI Conclusion

The governance requirements on trustees are significant and growing. There is no doubt that the Australian industry, committed to member interests, will rise to the challenges now, as in the past. As Robert Browning said:

*'Ah, a man's reach should exceed his grasp,
Or what are the heavens for?'*