

ASIA-PACIFIC REGULATORS' AND INDUSTRY DIALOGUE

Session 5

The Role of Regulators

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SUMMARY PAPER

Context

- Unlike bank deposits, conventional life or general insurance policies and defined benefit funds, the nature of the financial promise in accumulation super that dominates the Australian market is quite fuzzy. As long as the trustee complies with the law the outcome is at the risk of the members. The regulator is therefore limited to focussing on robust processes and controls.
- Conventional wisdom is that super is thinly capitalised, if at all. The ability of funds to absorb shocks is thus limited.
- No change to the previous capital regime, but may be reviewed in future.
- This conventional wisdom is turned on its head when it is recognised that unlike any other industry, super alone has access to a unique form of capital that provided by the captive tax-payer in terms of tax concessions: at contribution, during the earning period and at benefit payment.
- Fraud losses are covered through a post facto insurance scheme funded by special levies.
- If all else fails the social security net, funded again by the taxpayer kicks in.

Super Landscape:

- *Past record* – Despite occasional mistakes, the Australian Superannuation industry is strong and mature. A number of satellite service-providers have grown around it.
- *Market reaction* – The industry has seen significant market declines in 2002/03 and more recently 2007/08. Interestingly, there has been no panic reaction from members. Why?
- *Compulsion* – The Super industry is an industry used to ‘compulsion’ and thriving on it. Ever wondered why private industry that always baulks at prescriptive regulation is happy with the mother of all prescriptions - the 9% compulsory super guarantee contribution, and is asking for opt out soft compulsion?
- *DB funds* – improved solvency levels during the last few years, but working with the actuarial profession

Investment Choice:

- Trustee has a fiduciary obligation to set appropriate strategies. Members also have a right to investment choice. The choice regime is now firmly established. This creates some tensions.
- Just because investment choice is offered, Trustee's legal responsibility to set appropriate strategies for the Fund cannot be abdicated.
- In buoyant times, we saw consistent double digit, when any one in the market got carried away with its momentum. What will distinguish acceptable Trustees from Great trustees will be their ability to provide strong returns in more difficult times.

Operational Risk:

- 'New ground' for the superannuation industry, but all pervasive.
- Heavily outsourced industry, and hence multiple sources of operational risk.
- Unit pricing and crediting rate errors well-known, and the general industry response has been satisfactory
- Fraud risk endemic – the need for strong controls and insurance
- Establishing a robust risk management framework eg stringent criteria for service providers [SGN 130.1]

Simpler Super – Introduced in July 2007

- Along with portability and investment choice, has made the industry more sophisticated, hence the need for commensurate regulatory intensity.
- New super reforms have changed former minimum and maximum requirements for allocated pensions.
- If over 60, there is no maximum on the amount can withdraw – raises liquidity concerns. We are still unsure of how people will react with this new 'freedom'.
- Important to note that with freedom comes the freedom to make mistakes. The Government has sought to mitigate this risk by allocating funding for consumer education and improving disclosure regulation.
- New system continues to wean people away from 'lump sum' payments.
- Risk of longevity - pensioners outliving their pension and therefore re-joining the dole queue. Increases the burden on 'explicit' equity shareholders (ie the tax payer). This will become increasingly important in the future (given the worsening trend for dependency ratio)

Teaser:

- Is it time for policy makers/academics to think about compelling pensioners to take out life insurance in the event they outlive their pensions? That is, in order to qualify for the pension tax concessions, should members be forced to use a proportion of their pension (\geq social security payments) so that they do not rejoin the dole?

- Raises questions regarding who will bear the risk, pricing etc.
- Note - this is a policy, rather than prudential, issue.

APRA approach

- Primarily risk based, rather than rules based. To the recalcitrant rump, we need to wield the enforcement stick.
- Industry full of conflicts of interest – require strong controls. In some cases avoidance is the only way.
- Competition will put pressure on trustees to outperform their competitors as well as industry benchmarks. Where this involves taking on additional risk there should be explicit recognition and controls.
- Difficult to conclude that the trustee is acting in the best interest of members if narrow or risky choices are made available without regard to the proportion of the member's interest that the trustee will allow to be placed in a particular strategy. For example our investigation into super and CDO exposures.
- Prudential regulators tend to be 'pathologically pessimistic', being invariably judged by their failures. They are unimpressed by defensive arguments such as 'As no disaster has actually befallen us, we should be safe'.