Prudential standards for Superannuation

UniSuper is pleased to make this submission on the draft Prudential Standard for superannuation. We refer you to our earlier submissions dated 22 December 2011, on APRA’s Discussion Paper: Prudential Standards for Superannuation, and 28 June 2012, on the MySuper authorisation and transition standard.

UniSuper comments on specific Prudential Standards

SPS 114 Operational risk financial requirement (ORFR)

Paragraph 10 would make the Board responsible for ensuring that the RSE licensee holds, and has unfettered access to, financial resources to meet the ORFR. Paragraphs 12, 13 & 14 then goes on to outline the composition of the ORFR and the form in which financial resources will need to be held. We would like to see more information as to how this applies to defined benefit funds and, in particular, the manner in which they will be required to deal with this obligation in an equitable way. We would also like to see appropriate cross-referencing to the proposed prudential standard for defined benefit funds, SPS160 defined benefit matters, which itself makes scant reference to the ORFR.

SPS 160 Defined benefit matters

Paragraph 9 will require an RSE licensee to establish a shortfall limit. We are supportive of the inclusion of the shortfall limit and think that it addresses several potential issues that we raised in our initial submission (22 December 2011).

However, it is unclear whether the shortfall limit can be reviewed and modified following an actuarial investigation or new funding restoration plan. We submit that it would be helpful if the shortfall limit could be reset if a new funding restoration plan is put in place, as this would act as a safeguard to ensure the

---

1 We note that you have published two FAQs (18 & 20) on this matter.
plan remains on track, while taking into account that market volatility may result in fluctuations around the planned recovery trajectory.

Paragraph 16 will require an RSE licensee to arrange interim actuarial investigations, in certain circumstances. An actuarial investigation is required every time the fund is in an Unsatisfactory Financial Position, the shortfall limit is breached, and the next valuation is more than 6 months away.

Under the current wording, there could potentially be a situation where valuations are triggered multiple times in a short time horizon if the financial position is near the shortfall limit and markets are volatile. For example, one day the shortfall is breached and an investigation is triggered, then markets recover the next day and the financial position recovers above shortfall only to again breach the shortfall limit the following day. This second breach should not trigger another actuarial investigation.

To avoid this, clarification is needed that the interim investigation is not required if last valuation was less than six months away.

In addition, we submit that it is more challenging to gather data at an unplanned point in time that does not fall at a quarter end in the event of a shortfall breach; therefore, timeframes to prepare the actuarial investigation should be lengthened to allow for this.

Paragraphs 29 through 32 outline RSE licensee requirements for when a fund is an unsatisfactory financial position. Under 29(c), the actuary is required to give advice in regard to the determination of any benefit payments from the fund during the period; however there is no power to make a reduction under this standard or the SIS Regulations without APRA approval.

There is still the potential for significant inequity between exiting and remaining members during a shortfall period (i.e. members exit on full benefits, leaving a weaker position for remaining members). This issue could be mitigated by including the power to make part payments that are linked with the VBI level if the fund is in a shortfall position.

SPS 160 raises number of issues that are specific to UniSuper. We look forward to continuing to discuss the application of this standard to UniSuper’s unique circumstances.

**SPS 220 Risk Management**

Paragraphs 19 & 20 outline the minimum requirements for a risk appetite statement which must cover each category of material risk in an RSE licensee’s business operations, the degree of risk that a licensee is willing to accept and the maximum level of risk within which a licensee will be willing to operate. Licensees will have to document processes for ensuring that risk tolerances are set at an appropriate level, the process for monitoring these including timing.
As a licensee will be required to have this in place when making an application to APRA for MySuper authorisation, in practice this will mean that UniSuper will need to have all internal reviews and Committee and Board approvals completed beforehand. We submit that a longer period to undertake this work is required as this is a sizeable piece of work that deserves thorough and proper attention and should not be rushed.

**SPS 231 Outsourcing**
We believe that many super funds in the future will have business dealings with software providers who themselves rely on arrangements such as “cloud computing”. Therefore, paragraph 19 may present some problems because it will require all outsourcing arrangements to be contained in a documented legally binding agreement that is subject to Australian law. It is our understanding that most software providers in the USA require contracts to be enforceable in the USA. We seek guidance from APRA why this part of the standard is being applied specifically to superannuation funds and not other regulated entities.

Paragraph 21 will require RSE licensees who enter into outsourcing arrangements to include an indemnity. We foresee a potential issue arising where it will be difficult to get a complete indemnity. In particular, we see potential problems where an outsourced service provider uses subcontractors but refuses or does not have adequate indemnity insurance. We are concerned that this will limit the number of service providers that could be utilised. Subcontracting arrangements may already be in place, historically, and some existing arrangements may be difficult to amend. We submit that a good way to deal with these issues is for APRA to have the ability to exempt RSEs in certain and limited circumstances.

Paragraphs 34 to 36 contain the commencement and transition arrangements. UniSuper is concerned at the short timeframe to meet this requirement. Outsourcing policies will have to be ready in time for the lodgement of an application for MySuper authorisation, at the beginning of 2013, which in practice means the deadline is actually in time for the draft application for submission. Giving effect to the appropriate policies to comply with the standard will require a wholesale internal review of outsourcing arrangements and would need to take place before this date. We submit that a longer period of transition to undertake this work is required.

**Specific investment manager outsourcing issues**
While most of the proposed outsourcing requirements seem to be directed towards the outsourcing of custodial and administration functions, some of the proposed requirements (and, in particular, several of the newer requirements which do not originate from SIS Regulation 4.16) would be difficult or onerous to comply with in the context of investment management agreements and do not appear to be as relevant as they perhaps are in other contexts. For example:

- Paragraph 19, as previously stated, requires agreements to be subject to Australian law. This may be difficult to comply with in the case of specialist offshore managers who have no other Australian clients (or very few) and who may not have targeted Australian clients and who therefore refuse to enter into an agreement which, from their point of view, is governed by a foreign law.
- Paragraph 20 requires an agreement to deal with “end dates”. Whereas an investment management agreement would deal with the handover and transition responsibilities that apply from the end date, it would be unusual for such an agreement to specify an end date, because they are typically open ended relationships that can be terminated at any time (i.e. on short notice) by the superannuation fund client.
- Similarly, paragraph 20 requires an agreement to prescribe the form in which data is kept, but this is not relevant in the case of an investment management agreement since the custodian is a trustee’s primary record keeper.
- Paragraphs 25 and 31 would require APRA to be notified after entering or terminating a material outsourcing agreement. We query whether APRA really requires notification every time an investment manager is appointed or terminated, as this may potentially be a frequent occurrence. We also note that there is a difference between entering into an agreement and actually funding the relevant portfolio, and a difference between terminating an agreement or just removing all funds from the portfolio. In the case of the latter, the intention may be to redeploy funds to a different investment manager in the meantime, but leave the agreement in place so that funds can be transferred back at a future date. Similarly, the legal arrangements may be put in place so as to facilitate the potential allocation of funds at an unknown future date. It is unclear how / when the notification obligations would operate in this context.
- For similar reasons, the obligation under paragraph 27 to consult with APRA prior to appointing an offshore investment manager poses an additional burden. This is something which would potentially occur relatively often and may be commercially sensitive, especially if the proposed appointment might signal an imminent termination of an existing arrangement with an incumbent investment manager.

**SPS 510 Governance**

SPS 510 will require that an Audit Committee have at least three members, and that all of them must be non-executive directors – i.e. trustees cannot have other members of the committee who are not non-executive directors without specific consent from APRA (relying on the ‘adjustments & exclusions’ discretion). Many trustees currently have non-directors, who are specialists in their fields, as independent members of their committees (e.g. external lawyers). This has previously been viewed as constructive and appropriate but the SPS appears to view as something that will only apply on exceptions basis.

**SPS 530 Investment governance**

Paragraph 5 requires certain investment-related functions to be conducted by the Board. It is current practice in larger superannuation funds for several of these functions to be carried out by an expertly constituted investment committee which reports through to the Board. We presume the intention of SPS 530 is to directly involve boards in these matters, without necessarily excluding investment committees from the process. Ideally this principle would be confirmed by APRA in explanatory materials which accompany the release of the prudential standards once finalised.
Whereas investment objectives would typically change infrequently, investment strategies (depending on what is meant by that term) potentially change relative frequently and it is therefore important for paragraph 5(b) to be clearer about which aspects of investment-strategy decision-making a board must be involved in. The following examples illustrate the potential ambiguity and logistical challenges arising from the current drafting of that paragraph.

1. Under a conventional (static) strategic asset allocation approach, for each investment option, a percentage is notionally assigned to each asset class in which the investment option invest. This constitutes the strategic asset allocation for the investment option. Actual allocations would rarely be precisely in line with the strategic asset allocations for a number of reasons, including market movements. It is therefore not unusual for actual allocations to be permitted to deviate from the strategic allocation within a prescribed range which has been approved for that purpose. This then creates scope for actual allocations to be altered within the bounds of these prescribed ranges as a result of conscientious investment (rebalancing) decisions. (In approving a prescribed range, the view would have been taken that any allocation within the bounds permitted by those ranges would be suitable for the investment option, having regard to the statutory criteria.) Paragraph 5(b) is unclear as to which of these concepts are covered by the paragraph and would therefore require specific approval from the board. On the one hand, requiring a board to approve the strategic asset allocation and the prescribed ranges (within which actual allocations may deviate) would strike a reasonable balance. However, in our submission, it would be going too far and would be impractical to expect boards to be involved in every investment decision that results in actual allocations being increased or decreased within the parameters set by the board in establishing the prescribed ranges. This would amount to involving the board in day-to-day cash flow and rebalancing decisions at the portfolio level. In our submission, it is unrealistic to expect boards to be responsive within the time frames this would require and it is questionable whether this is an appropriate function for a board of directors.

2. Some funds are now adopting dynamic strategic asset allocation approaches, pursuant to which the strategic asset allocation may change in response to particular variables: for example, the strategic asset allocation for a defined benefit fund might be modelled to change in response to movements in the vested benefit index. We query whether paragraph 5(b) is intended to require board approval on each occasion on which a strategic asset allocation changes in line with the broader model which has previously been approved by the board, or whether changes in line with the model are something that can be considered by an investment committee.

Paragraph 13, taken literally, would appear to suggest that any person whose role includes monitoring investments will not be permitted to have any involvement in implementing investments. Depending on what is meant by ‘monitoring’ and ‘implementing’, this requirement potentially gives rise to some anomalous outcomes. We therefore submit that the drafting of paragraph 13 should be revisited. The following examples illustrate the difficulties arising from the proposed drafting.

1. Naturally, any person who makes an investment will inevitably track how that investment performs: indeed, it is difficult to see how a superannuation fund
would benefit from forbidding any person who makes an investment decision from ever enquiring how that investment performed. As a general principle, we would submit that paragraph 13 should only require there to be at least some (i.e. not all) persons who monitor investments who are not involved in implementing the investments they are monitoring (in other words, recognise that people who implement decisions may monitor those investments, as long as there are some other persons who also monitor those investments but who were not involved in their implementation).

2. Greater clarity is required around precisely what it means to 'monitor' and 'implement' investments. For example, under a broad interpretation, a board (or an investment committee) is ultimately responsible for both monitoring and the implementation of investments, which adds to the confusion around paragraph 13 because there is no getting away from a board’s ultimate responsibility for both functions. Under a more narrow interpretation, a view might be taken that an external custodian undertakes monitoring functions and perhaps external investment managers are responsible for implementing investments; but even this narrow interpretation creates doubts around functions such as manager selection, rebalancing decisions and the allocation of funds between different external investment managers, given that these matters would typically require some internal involvement and because the relevant decisions cannot be divorced from the issue of how different managers have performed (which is a monitoring-related function). Similarly, the fact that the external custodian and investment managers might be supervised by the same internal personnel ought not to be considered problematic or objectionable in itself.

For similar reasons, greater clarity is required around paragraph 23 insofar as it would require investment return and monitoring calculations to be performed by persons who are 'operationally independent' from investment decision making. For example, it is unclear what degree of independence is required and whether it merely requires different personnel to be involved, or whether it requires different personnel with different reporting lines to be involved (which, in itself, would be an imperfect concept given that all personnel ultimately report through to the chief executive officer). Greater clarity is also required around what it means to be "responsible for investment decision-making", because ultimately the board is responsible for investment decision making, but we suspect that paragraph 23 might be aiming at a more granular concept of being involved in decision making (as opposed to having the ultimate responsibility for investment decision making).

In our submission, APRA ought to be satisfied that there is sufficient independence for the purposes of paragraph 23 if the relevant calculations are primarily performed by an external custodian, even if those aspects of the custodian's services are overseen by personnel who are otherwise involved in investment operations. It should also be borne that there are many inputs going into the calculation of investment returns: for example, listed assets would be valued according to market values recorded in the custodian's books and which have been reconciled with the various external managers; and unlisted assets would have been valued by an independent valuer or otherwise in accordance with the relevant valuation policy. Even if the personnel responsible for collating the data (or managing the custodian's collation of that data) have some involvement in some investment decision making, this does not mean that the relevant calculations lose their character of independence, having regard
to the wide range of data inputs, each of which have their own arrangements for ensuring an appropriate degree of independence and/or reliability.

Paragraph 16 would potentially require the identification of all risk factors, all associated sources of returns and the target exposure for all risk factors. We query whether the paragraph is intended to impose such broad, strict and onerous obligations. From an investment perspective, there is considerable scope for funds to view and approach risk in different ways. Some funds may choose to focus on particular risks, or to adopt particular categories of risks. Not every risk necessarily has an associated return, and not every risk has a target level of exposure associated with it. For example, liquidity risk is an example of a risk which might have a quantifiable return associated with it (e.g. an x% liquidity premium) and a target exposure for illiquid assets might conceivably be specified in quantitative terms. However, political risk is another relevant risk which impacts many superannuation funds, but which would not typically have an associated return or a target exposure level (at least not in quantitative terms). For these reasons, in our submission, paragraph 16:

1. should only require the identification of key risk factors which are inherently of an investment nature (as opposed to more generic risks);
2. should recognise that not all risk factors are necessarily associated with a particular source of return;
3. should recognise that a target exposure is not necessarily set (in quantitative terms) for all risk factors; and
4. should permit the approach to risk factors, sources of returns and target exposures to be explained in qualitative terms (rather than quantitative terms).

Conclusion

We thank you for the opportunity to participate in the consultation and we ask that you give consideration to the issues we have raised in all three of our submissions. As mentioned above, SPS 160 on defined benefit matters will present UniSuper with some specific challenges that we look forward to continuing discussions with APRA about how this standard will apply to UniSuper's unique circumstances. If you require clarification on any of these issues, I can be contacted on 03 9910 6100 or our National Technical Adviser, Benedict Davies, can be contacted on 03 9910 6670.

Yours sincerely,

Terry C. McCredden
Chief Executive Officer