Thursday, 22 December 2011

Ms Helen Rowell
General Manager, Policy Development
Policy, Research and Statistics
Australian Prudential Regulation Authority
GPO Box 9386
SYDNEY NSW 2001

Dear Ms Rowell,

Re Discussion Paper: Prudential standards for superannuation

On behalf of the Board and Management of UniSuper, I am pleased to make this submission on APRA’s Discussion Paper on Prudential Standards for Superannuation.

Part 1: Background on UniSuper

UniSuper is the industry superannuation fund for employees in Australia’s higher education and research sector. The Fund in its present form came into being with the merger of the Tertiary Education Superannuation Scheme and the Superannuation Scheme of Australian Universities in September 2000.

UniSuper offers both defined benefit and accumulation plans to its members. The Defined Benefit Division, which remains open to all new permanent employees in the sector and is portable across all participating employers, requires a fixed 14% employer contribution and standard after tax 7% member contribution. On joining UniSuper, eligible members are automatically enrolled into the Defined Benefit Division and have a period of twelve months to decide if they want to move to an accumulation plan in which they would receive the same level of contributions and insurance benefits.

UniSuper members also include those members who have changed sectors and elect to defer their benefits or those who elect to crystallise their benefits into an accumulation plan into which they can request their new employer make contributions. Other members include casual employees and those employed by ‘related bodies’ that are not universities; these members generally receive accumulation contributions at the Super Guarantee rate, with the capacity to supplement their savings through voluntary contributions, salary sacrifice and, where applicable, access to the Government’s co-contribution scheme.

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Trustee: UniSuper Limited
ABN 54 006 027 121

Administrator: UniSuper Management Pty Ltd
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Part 2: General comments

UniSuper is supportive of many of the elements of Stronger Super, and is broadly supportive of APRA's proposed prudential standards and ancillary guidance. We note that six out of twelve of the prudential standards are already being applied to other APRA-regulated industries, so there is comfort in seeing how APRA has already applied these standards over the years. Of the proposed superannuation-specific standards, two in particular: Defined benefit funding and solvency and Insurance in superannuation have the potential to adversely affect the operation of UniSuper to the prejudice of its members giving rise to some issues that we hope you will consider when drafting the prudential standards for early 2012.

Part 3: Specific comments
Chapter 3: Governance
3.4.6 Remuneration

APRA proposes that SPS 510 will require publication of the remuneration of responsible officers to ensure that beneficiaries have access to the same types of remuneration information that is available to shareholders of public companies.

UniSuper’s view is that moves to enhanced transparency are consistent with the direction the industry is heading and we think these changes are probably inevitable. Thus, we believe that the rules around remuneration disclosure should be tightly drafted to ensure full disclosure and transparency. For example, in some large, multi-faceted organisations where responsible officers wear “many hats”, there may be scope to assign the cost of remuneration across those functions that receive less scrutiny. Clearly, that is not the intent of the Standards.

Chapter 4: Conflicts of interest

4.4.3 Registers of duties and interests

We believe that Conflict of Interest Registers would be useful for RSE licensees, but we believe that they would be much more beneficial when used as an internal management tool.

The proposal to make a Register open to the public / members may, in fact, make the Register less useful. It is possible that some licensees will get defensive about what they put in their Register so there is a potential for the entries to become generic and high level. We appreciate that some members may wish to review the Register; however, in practice, we think it will be only a small number of members meaning that this policy has the potential to be an administrative burden with a cost borne by all members for a public register viewed by only the few.

From the Discussion Paper, it is not clear if licensees will be required proactively to provide Registers to APRA annually, or whether Registers will just be available on request. We believe that having them available on request would be better as this would allow the Register to be a “living, breathing and working” document and not something that gets updated once a year just because licensees have to provide it to APRA.

Another important consideration is any potential overlap with existing obligations imposed where the trustee has both an RSE licence and an AFSL (and possibly a credit licence). We suggest, therefore, that wherever possible, existing processes be followed rather than creating new requirements.
Chapter 5: Fitness & Propriety

5.4.1 ‘Responsible person’

The definition of responsible person is wide – for UniSuper this would include our executive managers, the fund’s Actuary and possibly other service providers e.g. auditors. We would argue that this list should be carefully defined so it’s manageable, and it should not include too many third parties over which licensees have far less control.

5.4.2 Fit and proper policy

We believe that having a policy on “fit and proper persons” and a policy to conduct board assessments is worthwhile. We feel, however, rather than an RSE licensee being required to separately report the outcome of its skills assessment, we suggest that this be addressed as part of APRA’s ongoing prudential review process. Further, we query the benefit of a board being required to conduct a skills assessment annually, and suggest that a requirement for a trustee to conduct the assessment every two years, and in a manner considered appropriate by the RSE, would strike an appropriate balance.

The Discussion Paper does not cover in detail the overlap where an RSE licensee also holds an AFSL with Responsible Managers, or where a licensee also holds a Credit Licence, so also has to have Responsible Managers, and already does fit and proper checks on directors. It would be helpful if these regulatory obligations were aligned, rather than a new obligation created.

Chapter 8: Investment governance

8.4.1 Articulating clear investment objectives

There is some indication that SPS 530 Investment Governance will require RSE licensees to set investment objectives that align with the RSE licensee’s investment philosophy as well as articulating the expected returns and relevant benchmarks.

The prudential standards would ideally revisit an assumption which underpins the current legislation: that investment objectives are always set first, with the investment strategy always being determined second so as to achieve the objective. While this sounds logical, and is an appropriate practice in the case of defined benefit funds and default options, we query whether it accurately reflects the reality in the case of all choice options offered by all RSE licensees, especially single asset class options. When designing choice options, we query whether alternative strategies and the associated objectives might, in appropriate cases, be developed concurrently with (or possibly in advance of) the specific performance return objective (or performance return expectation). For example, the decision by some RSE licensees to offer a particular kind of investment option may be driven by a desire to offer access to a particular kind of investment strategy (rather than a desire to offer access to a particular investment objective), with the investment objective being an outworking of the strategy. For example, the decision to offer a property option might, in the case of some RSE licensees, arise from a view that it is in the best interests of members to offer a means of achieving exposure to the property sector, rather than an option which focuses solely on property investments being the consequence of the strict pursuit of a particular return objective. The RSE licensee would naturally be responsible for both the investment objective and the investment strategy at all times. Our query is simply whether, in terms of the genesis and origination of a new investment option, the conception of the investment objective always precedes the conception of the investment strategy (even if, as a formal matter, formal Board and/or Investment Committee approvals do follow the traditional sequence).
It would be problematic if there were to be a requirement for all investment strategies to align with the RSE licensee’s investment philosophy, simply because different strategies might be specifically targeted at (and based on) different philosophies – indeed that may well be the purpose of offering the relevant choice.

It would be preferable if the prudential standard merely required the disclosure of objectives, rather than requiring the disclosure of “expected returns”, because the latter potentially increases the risk of liability for underperformance by virtue of the fact that it explicitly creates an expectation on the part of members.

The requirement to disclose a benchmark would only seem to serve a purpose in cases where the investment objective is defined with regard to a benchmark.

In cases where benchmarks are merely used for the purposes of measuring or comparing performance, there should be no general requirement to disclose the benchmark. Benchmarks are in the eye of the beholder, so mere disclosure of benchmarks (for measurement / comparison purposes) does not necessarily serve any particular purpose, especially if different RSE licensees all use different benchmarks. The important consideration is to ensure that, when promoting outperformance against benchmark, the relevant benchmark should be referenced. Inter-fund comparisons against a standard benchmark may well be something which is better achieved through ratings agencies (e.g. SuperRatings) or through enhanced APRA data collection and reporting on investment performance (which is currently under consideration).

It should be noted the benchmarks can be complex composites which are difficult to explain in specific terms that are likely to be readily understood by lay readers. The prudential standard should recognise this and allow appropriate flexibility as to the level of detail. For example, the benchmark for a particular investment option may be a composite benchmark reflecting different benchmarks for each asset class (and possibly multiple benchmarks for certain asset classes or sub-asset classes), with the weighting attributed to each benchmark varying according to the assets invested in each asset class (or sub-asset class) from time to time.

It should also be noted that benchmarks often change for a variety of reasons. For example, a change in strategy might warrant a change in benchmark (for example, if the strategy changes to include a new sector) or because the RSE licensee has changed benchmark providers (for example, because comparable benchmark data can be licensed at a lower cost). It is important that the prudential standard (in requiring advance disclosure) does not inhibit the ability of RSE licensees to make quick changes to their benchmarks in appropriate cases, because this could inadvertently inhibit the ability of RSE licensees to make investment strategy changes or lock them into arrangements with particular (more expensive) benchmark providers.

8.4.2 Formulating investment strategies

Proposed SPS 530 would require RSE licensees to articulate the process and criteria used in the selection of investments to implement each of its investment strategies. Every choice option must be “appropriate for selection by beneficiaries, including where a beneficiary may choose to concentrate their interest in the fund in a single, undiversified option”.

UniSuper offers members eight pre-mixed investment options with a diverse mix of assets and / or asset classes. We also offer self-select investment options that allow members to “mix” any of the pre-mixed options with diversified, single asset class options i.e. Australian Shares, International Shares, Listed Property & Australian Fixed Interest. We believe that this offers sufficient investment choice for those members who are more engaged with their super investments. In developing these investment options, UniSuper went through a rigorous due diligence process. We disclose the risks
of each investment option in an investment booklet that, among other things, explains the benefits of diversification.

We submit that there is no reason to impose a requirement on trustees to ensure that all of their options are suitable for members to invest 100% of their account balance in, especially if the trustee expressly limits the proportion of a member’s account balance that can be invested in a particular option or otherwise discourages members from investing a disproportionate part of their account balance in the option.

8.4.3 Features of investment management

Proposed SP 530 will require RSE licensees to consider how investment costs will affect fund returns over time.

We feel it would be unhelpful if APRA were to prescribe mandatory methodology for the calculation of performance fees. That is because it is critical that the prudential standard recognise that large superannuation funds will likely have many performance fee arrangements in place which are highly sophisticated and which have been negotiated so far as possible to favour the RSE licensee. If the prudential standards were to prescribe a different approach to performance fees, this would involve a substantial transition burden (all fee arrangements would have to be renegotiated) and potentially result in an inferior outcome for RSE licensees that had sophisticated arrangements in place which were different from those prescribed.

If it is the intention to only regulate performance fees for MySuper products, the proposed prudential standard is likely to affect all investment options offered by an RSE licensee in cases where all options have exposure to the same pool of underlying investments. For example, if a particular investment manager has been appointed to manage Australian Equities and is entitled to receive performance fees, in many cases all investment options offered by the RSE licensee would have an indirect exposure to the portfolio of assets being managed by that particular investment manager. In that situation, regulating the performance fees paid to the manager will have ramifications beyond the MySuper product.

Chapter 9: Operational financial risk requirement

9.6.1 Minimum features of the operational risk requirement

Proposed SPS 114 will require RSE licensees to hold adequate financial resources to respond to operational risks. The Discussion Paper suggests an amount in the vicinity of 0.25% of funds under management. We submit that 0.25% might be the right figure but not right for all Funds. Applying a single, industry-wide percentage of funds under management for reserving is not appropriate. Larger funds that receive larger contributions have higher than average account balances are likely to be disadvantaged by this measure. We submit that operational financial risk is not scaled to funds under management; rather, operational risks are influenced by many factors including the operational practices of a Fund, the number of participating employers and the industry in which they operate, the number of members, the presence of legacy systems and so on. We believe further industry consultation is required to arrive at an appropriate measure that reflects the different operational risks experienced by different funds.

This measure is also likely to have a greater impact on not-for-profit super funds because those RSE licensees that are part of a broader financial services business may either call on their parent to provide the funding for the operational reserve (i.e. decreasing their return on capital), or they may be able to quarantine part of their existing capital base (the proposal is not clear on whether this

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1 UniSuper members typically receive 14% or 17% from participating employers for permanent employees
would be permitted). Corporate and Public sector super funds may also be able to call on their sponsoring employer(s).

In addition to this, the period of time in which RSE licensees have to build up this operating risk reserve is critical. We submit that three years is far too short and raises the issue of inter-generational equity. We submit that a more appropriate timeframe would be - at a minimum - five years.

Chapter 10: Funding and solvency for defined benefit funds

UniSuper’s defined benefit fund is a unique collective scheme, where unlike typical defined benefit funds, there is no ability to receive additional contributions from employers – i.e. the employers’ contributions are at a fixed level. However, benefits may be reduced in specific circumstances where funding of benefits by those fixed contributions is considered insufficient (Clause 34 of the Trust Deed allows benefits to be reduced after a four year monitoring process). As such, flexibility is required both in provisions related to funding to a VBI of 100% as well as in Technical Insolvency.

10.4.1 Funding to vested benefit level

Stronger Super supports in principle prudential requirements (proposed Prudential Standard SPS 160 Defined Benefit Funding and Solvency) that focus on funding at vested benefit level rather than the lower minimum requisite benefit (MRB) level.

We submit that that funding to vested benefit level is a very onerous requirement.

Where funding is below the vested benefit level, but above the MRB level, this is not the same thing as technical insolvency and should not be treated as an equivalent event. This is because this outcome could be expected to occur at various points in time with investment market fluctuations.

The prospect of winding up a defined benefit fund if funding cannot be restored in a set time frame, along with potential impediments to entering new contracts or continuing existing contracts, are among the most severe implications of being technically insolvent (under current legislation). We submit that these restrictions should not apply simply because funding falls below the vested benefit level.

If this Prudential Standard came into force, some funds, including UniSuper, could be forced to take actions resulting in poor outcomes for members.

Potential actions that would need to be considered include:

- In order to achieve restoration of the VBI to 100% (i.e. assets covering vested benefits) within a set time period, and noting that employer contributions are fixed, UniSuper may be forced to reduce benefits when it otherwise would not have done so. This action may not be in the best interests of members if the VBI was expected to improve over time (albeit slower than set under the standard);
- If a timeframe is prescribed in the Prudential Standard to restore the VBI to 100% and this timeframe is less than around five years, winding up could occur. This is because if the VBI is not expected to return to 100% within the prescribed time frame without benefit reductions, the process to reduce benefits may not be able to occur quickly enough because in UniSuper the process under Clause 34 takes at least 4 years;
- A significant surplus above VBI would need to be targeted as a buffer and this could not be distributed to members. To try to achieve this may require benefit reductions that would otherwise not be required; and
• A shift to a defensive investment strategy, which would result in a lower long term average return for the DBD fund and require further benefit reductions that would not otherwise not be necessary.

Maintaining a VBI above 100% would be an unnecessarily onerous measure for UniSuper, in particular, because:

• Over 120 employers contribute to UniSuper’s DB fund and the majority are substantially funded by the Commonwealth Government;
• It is unlikely that all resignation or retirement benefits (i.e. vested benefits) would need to be paid at the same time, given the spread of employers and underlying nature of the University sector; and
• The Accrued Benefit Index (ABI) is a more reflective measure of the adequacy of assets to pay benefits.

In light of this, we would like the following considerations to be made when determining the time frame of restoration plans:

• The time horizon required to restore funding to a satisfactory position will generally be longer for UniSuper, as there is no ability to increase employer contributions; and
• Remediation options, such as reducing future service benefits, generally take a number of years to have an effect.

Because of these features, where the time frame required for the restoration of funding is too short, more drastic actions than would otherwise be required might be the outcome. As a minimum, if a rectification period is prescribed, any Prudential Standard should retain the flexibility for APRA to grant longer rectification periods in specific cases.

Also, the Prudential Standard should consider the situation of adverse experience occurring during the rectification period. If the VBI of a particular fund was increasing towards 100% in accordance with a funding plan and then further adverse experience significantly worsened the position, it may be unreasonable to continue to expect full funding of vested benefits within the original time frame. It would often be appropriate to begin a new funding plan with an extended funding period in this circumstance.

We believe that restoration plans could be assisted by Trustees having the power to decide to pay partial withdrawal or resignation benefits when the fund is in an unsatisfactory financial position. This is because members who exit a defined benefit fund when the fund is in an unsatisfactory financial position and subsequently receive full benefits, place pressure on the fund’s assets. This is an unequitable outcome for remaining members, who may face future benefit reductions. Giving Trustees the power to only make partial payments to withdrawing members (if considered in members’ best interests) in this situation improves equity between members and also the efficacy of restoration plans.

Importantly, members who receive a partial payment could potentially be paid the remainder if the financial position of the fund recovers without the need to reduce benefits for all members, i.e. arrangements could operate as a deferred payment of full entitlements.
10.4.4 Technical Insolvency and wind-up priorities

The discussion under 10.4.1 above, describes the unique characteristics of UniSuper. In particular the fixed contribution nature of the defined benefit component of the fund means that flexibility is required both in provisions related to funding to a VBI of 100% as well as in Technical Insolvency. For similar reasons to those set out above for funding to a VBI of 100%, it is desirable that:

- APRA has discretion in circumstances of Technical Insolvency and time frames to restore solvency;
- The Trustee can make partial payments; and
- On wind-up priority is not given to one particular group of DB members over another.

Chapter 13: Insurance in superannuation

Stronger Super specifies a number of reforms relating to insurance offered to members. We understand that it is the intention of the Government to follow of a policy of phasing out self-insurance except for DB funds that are currently permitted to self insure.

An important feature of UniSuper’s Defined Benefit and Accumulation 2 membership is the in-built Death and Disablement benefits. These benefits are important to the way the fund has been designed so that members’ incomes are insured over their working lives and into retirement. These benefits are not “opt out”. Benefits are payable for temporary incapacity, disablement, terminal medical condition and death. The in-built benefits of the DBD and Accumulation 2 plans are provided (self-insured) by the Fund, not by an external provider.

UniSuper receives independent advice from actuaries on the financial management of the self-insurance arrangements along with actuarial oversight on the maintenance of adequate insurance reserves—consistent with the Actuarial Standards governing self insurance arrangements.

In Accumulation 2, members are charged an actuarially-calculated premium to cover the cost of this insurance; the fund also receives actuarial advice on the adequacy of the self-insurance reserve.

If we were required to restrict access to self-insured benefits to members only in our DB fund, existing members in Accumulation 2 will not be able to have access to self-insured in-built benefit.

Therefore, we seek further guidance on how to transition existing self insurance arrangements to an external insurer and the period of time over which this would be required. This will be especially important where existing self-insurance arrangements include conditions which an external insurer might not provide or may require additional negotiation. If an RSE licensee were required to match the current terms and conditions offered to members it may be extremely difficult - or impossible - to move the arrangements to an external insurer without detriment to members. Any transition requirements should also allow the trustee to have indemnity where certain benefits and conditions that are unable to be externally insured on a reasonable basis are ceased to be offered.

Further consultation in 2012

We understand that this Discussion Paper outlines the broad approach APRA will follow when issuing prudential standards and that further consultation will take place in early 2012. Therefore, we ask that you give consideration to the issues we have addressed in our submission when drafting
the prudential standards. We look forward to participating further with APRA’s consultation process when the Prudential Standards are drafted in 2012. In the meantime, we would be happy to elaborate on the points addressed our submission. Please do not hesitate to contact me if you require further information.

Yours sincerely,

Terry C. McCradden  
Chief Executive Officer