The Supervison of Defined Contributions Funds: Australia's risk based approach

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The Regulatory Challenge DB & DC

- DB schemes rely on the employer sponsor so the supervisor focuses on ensuring that as best as possible, the employer meets its obligations/promises to the fund. Focus is on scheme funding, actuarial projections.

- DC funds place all risk on members. All investment earnings and losses ultimately fall on the members. There is no investment promise and no guaranteed return.

Supervisory challenge for DC

- Supervisors can take a compliance based approach or a risk based approach at the extremes. Most agencies use an approach which contains elements of both.

- Focus in Australia is on the trustee of the fund and its decision making processes, particularly risk management and governance.

Trustee Model

- Most Australian pension funds, whether DC or DB are operated through a trust structure. Trustees hold the pension fund assets in trust on behalf of members.
- Trustees owe a fiduciary duty to members and have a duty to act in the best interest of members while managing the pension savings in their care.

Brief History of Australian Pensions

- From early 20th century until 1980s Australia had a two tier model.
- First tier was government safety net pension introduced in 1909, funded by tax revenue on pay-as-you-go basis and currently set at 25% male average weekly earnings.
- Second tier a mix of public and private sector arrangements. Public sector employees were in unfunded DBs while private schemes were employer funded DB usually available only to male white collar workers.

Pension Reform

- In the 1980s the government introduced compulsory employer paid occupational pension contribution schemes based on individual accounts.
- It is currently set at 9% of the ordinary salary or wage and is paid by the employer into a fund chosen by the employee. If the employee makes no choice, the employer can choose.
- Rapid growth in pension funds with around $US750b funds under management, equal to more than 100% of Australia's GDP.

Risk based DC supervision

- A compliance or rules based approach will focus on compliance with a standard set of rules, and generally these rules do not differentiate according to the likelihood or potential magnitude of the potential consequences of non compliance.

- Risk based involves: understanding funds by undertaking a range of supervision activities, forming a risk assessment of these institutions and setting and implementing supervision strategies based on the risk assessment.

What does the process involve?

- Pension funds now have to be licensed so they have the same regulatory and supervisory status as banks and insurance companies.

- To obtain and maintain a license trustees must be in compliance with pension law and related operating standards. Main standards cover corporate governance, outsourcing, adequacy of resources and risk management.

Risk management strategy

- Strategy must explain how the trustees deal with material risks.
- As a minimum, it must cover decision making, governance, outsourcing, changes to legislation, theft and fraud.
- Assessment of material risk is done first on an unmitigated basis then there is an explanation and assessment of controls to mitigate identified risk followed by assessment of net risks after controls.

Features of risk management strategies

- Need to be kept up to date, especially in volatile markets.
- Reviewed when needed but no less than annually.
- Must be subject to external audit at least annually.
- Trustee must record and report significant breaches.

Corporate governance: fit and proper

- Fitness relates to having appropriate skills and attributes.
- Corporate governance framework that covers the skills needed to perform effectively, recruitment, induction, training needs, performance assessment.
- Propriety requires trustees to determine that each relevant person has the integrity, honesty and diligence to look after other people’s money.

Outsourcing

- Identification of material business activities that are outsourced.
- Selection of provider and monitoring provider performance.
- Arrangements must be on a commercial basis and at arms length.
- All outsourced activities must have formal written contracts which give APRA access to the service provider.

Resource adequacy

- Mirror image to outsourcing. If the activities are done in-house, trustees must provide appropriate human, financial and technological resources and an appropriate business plan.

APRA’s risk based framework

- Probability and Impact Rating System (PAIRS) looks at the likelihood and consequences of material risks, the effectiveness of the controls over those risk, and estimates and quantifies the net risk.

- Supervisory Oversight and Response System (SOARS) determines the supervisory oversight driven by the PAIRS rating.

Moving to a risk based framework

- Supervisors need sufficient confidence to be able to rank the various types of risk not treat all equally.
- Specialist training needed to move away from ‘tick the box’ compliance.
- Specialist unit takes responsibility for examining consistency of risk assessment across firms.

Dealing with industry

- Different funds receive different levels of supervision. They need to understand why.
- Risk rating not public.
- Need to build relationship of trust.
- Publishing prudential practice guides.

What has APRA learned?

- Many small and medium sized funds were unable or unwilling to implement the appropriate risk management regime required to obtain a license.

- Mergers as a consequence have led to fewer, larger funds with average size around US$1.5b.

- Funds putting more attention on corporate governance.

Where are the problems?

- Need for regular updating of risk management plans rather than ‘set and forget’.
- Funds need to better specify their risk management tolerance and the mitigating actions to be implemented.
- Need for compliance officers and specialist risk managers.

How has APRA benefited from the change to risk based DC supervision?

- More effective allocation of supervisory resources.
- Increased focus on identification and treatment of risk.
- Easier to enforce fund's adherence to risk management when there is a formal and approved process.

Investment Regulation

- Australian law does not set numerical or percentage limits on domestic or foreign equities nor any other types of investments.
- Many Australian pension funds have significant investment in infrastructure which are not very liquid so funds need to be aware of liquidity risks attached to various investment options.
- APRA does not vet or 'approve' in advance the investments made by pension funds.

Enforcement

- Sometimes it is necessary to take enforcement action against pension funds or trustees.

- Containment is highest priority: that is limiting losses to members.

- Containment action might include: suspending or replacing trustees, freezing assets and redemptions or closing the fund to non members.

- Deterrence via publicising enforcement action is secondary.