INTERNATIONAL ORGANISATION OF PENSION SUPERVISORS

Toolkit for Risk-based pensions supervision

Case Study

Australia

Risk-based Pensions Supervision provides a structured approach focusing on identifying potential risks faced by pension funds and assessing the financial and operational factors in place to mitigate those risks. This process then allows the supervisory authority to direct its resources towards the issues and institutions which pose the greatest threat.

The IOPS Toolkit for Risk-based Pensions Supervisors provides a 5-module framework for pensions supervisors looking to apply a system of risk-based supervision. A web-based format allows: a flexible approach to providing updates and additions; users to download each module separately as required; and a portal offering users more detailed resources, case studies and guidance. The website is accessible at www.iopsweb.org/rbstoolkit.

This document contains the **Australia Case Study.**

AUSTRALIA[1]

I. Background

A. Pension system

1. Pension system in Australia

Private retirement saving funds, known as 'superannuation' in Australia, form a major part of the Australian government's retirement income policy. Superannuation accounts are predominantly funded by compulsory contributions paid by employers on behalf of their employees, and are largely defined contribution (DC) schemes.

Historically, Australia's pension system originated in the trust-based defined benefit (DB) model similar to many other countries. By the 1980s employers were already starting to make trust- based DC arrangements available, which later evolved into multi-employer or industry-level funds.

Compulsory superannuation contributions was extended to the vast majority of employees with the introduction of the Superannuation Guarantee in 1992. Prior to this superannuation coverage was limited to a small percentage of employees. Since 1992 compulsory contribution levels at which employers are required to contribute have risen from three per cent of salary to nine and a half per cent. Contribution rates are set to increase to 12 per cent of salary by 2025.

Since 2005, most employers have had to offer their employees a choice of funds, and funds must allow transfer of accounts to any other superannuation provider, or to a self-managed superannuation fund (SMSF). Superannuation funds are now nearly all DC, with only a few legacy DB plans remaining.

The superannuation industry has experienced significant change over the last decade. With the introduction of compulsory superannuation licensing for trustees and fund registration, the industry has gone through a major consolidation process resulting in a smaller number of trustees and larger, more complex superannuation funds.

The superannuation industry comprises a number of different types of superannuation fund, and common classifications are outlined below.

[1] This case study was prepared by Australian Prudential Regulatory Authority ('APRA').

Table 1: Types of Superannuation Funds in Australia

Type of Superannuation Fund	Description
Corporate	A regulated superannuation fund established for the benefit of employees of a particular entity or a group of related entities, with joint member and employer control.
Industry	A regulated superannuation fund for employees of employers in the same industry, which may be run on a not-for-profit basis by trustees with joint member and employer control. Many funds are multi-industry and many are also open to the public beyond the targeted industry.
Public Sector	A regulated superannuation fund or scheme providing benefits for Government employees, or a scheme or fund established by a Commonwealth, State or Territory law. A sub-group of public sector funds are exempt public sector schemes which are not regulated by APRA but operate in a similar way to regulated funds.
Retail	A regulated superannuation fund which may offer superannuation products to the public, commonly offered by banks and other large financial corporations. Master trusts (defined as an umbrella trust or fund which uses a single trustee and a single common trust deed to operate the superannuation arrangements for unconnected individuals and/or companies) are classified as retail funds. Other types include: **Eligible rollover Funds (ERFs)** funds which accept inactive small accounts and lost member account rollovers from other superannuation funds, are also retail funds **Pooled Superannuation Trusts (PSTs)** funds which only accept investments from trustees of other superannuation funds **Approved Deposit Funds (ADFs)** funds which only accept eligible termination payouts from members until age 65 and also includes single member ADFs regulated by APRA.
Small APRA Funds (SAFs)	Superannuation funds with fewer than five members, which are required to have a professional licensed trustee and are regulated by APRA.
Self-Managed Superannuation Funds (SMSFs)	Superannuation funds with fewer than five members where all members must be trustees and which are regulated by the Australian Taxation Office (ATO).

Superannuation accounts can be offered by 'public offer' funds which are either employer or industry-based (including trade union-sponsored) funds operated on a non-profit basis that have decided to expand their membership base, or retail funds offered under a master trust by commercial providers, typically bank-owned or other financial conglomerates. Most trustees are corporate trustees although the legal structure allows for non-corporate entities (groups of individuals) to form a trustee.

Trustees of all superannuation funds with five or more members are required to be licensed by the supervisor, the Australian Prudential Regulation Authority (APRA). Licensing, which was introduced in 2006, has been accompanied by a substantial reduction in the number of trustee entities that APRA supervises.

The superannuation industry supervised by APRA has continued to consolidate. The number of registrable superannuation entity (RSE) licensees (trustees) and registrable superannuation entities (funds) has continued to fall; there has been an increase in fund mergers and acquisitions within the corporate, industry and public sector fund sectors; and integrations within wealth management divisions of financial service conglomerates have taken place. As at September 2019 there are approximately 110 trustees supervised by APRA. SMSF sector, which is not supervised by APRA, has continued to grow in terms of assets as a share of the total sector.

2. Regulatory framework for superannuation

The private pension system in Australia is subject to regulation and supervision by three main authorities, the Australian Prudential Regulation Authority (APRA), the Australian Securities and Investments Commission (ASIC), and the Australian Taxation Office (ATO).

The Superannuation industry is predominantly governed by the following key pieces of legislation and regulation:

- *Superannuation Industry (Supervision) Act 1993 and Regulations*
  (administered by APRA, ASIC and the ATO)

- *Retirement Savings Act 1997 and Regulations*
  (administered by APRA)

- *Chapter 7 of the Corporations Act 2001 and Regulations*
  (administered by ASIC concerning disclosure, Australian financial services licensing (AFSL), consumer protection including dispute resolution and conduct issues)

- *Superannuation Guarantee (Administration) Act and Regulations*
  (administered by the ATO and includes the Choice of Fund legislation)

- *Superannuation Prudential Standards*
  (effective 1 July 2013 - promulgated and administered by APRA)

In 2009, the Government commissioned the Super System Review (Cooper Review) to comprehensively examine and analyse the governance, efficiency, structure and operation of Australia's superannuation system. The Review's objectives were also to improve regulation of the superannuation system while also reducing business costs within the system. The Review's final report was provided to the Government in June 2010.[2]

The Government's response to the recommendations of the Cooper Review was known as the Stronger Super reforms. The Government concluded it was appropriate to enhance the requirements and responsibilities for superannuation trustees and provide APRA and other regulators with improved tools and powers. As part of Stronger Super, APRA was given authority under the SIS Act to issue prudential standards which are binding on RSE licensees, for superannuation entities. APRA also revised its regulatory data collection from superannuation funds.

<u>MySuper</u>

A key element of Stronger Super was the introduction of 'MySuper' — a low-cost, simple superannuation option. MySuper is a superannuation product for 'default' contributions, that is, superannuation contributions by members that have not made a proactive selection of a superannuation fund. The legislated characteristics of a MySuper product include:

- a single diversified investment strategy for the product;
- all product members to have access to the same options, benefits and facilities;
- investment returns to be allocated proportionately to product members;
- any employer fee subsidisation to not favour some product members over others;
- no limitations on the kind or source of contributions; and
- no pension may be paid from assets held within the MySuper product.

Between 1 January 2013 and 31 December 2013, APRA authorised 115 MySuper products.

MySuper products represent a significant proportion of superannuation fund assets. As at 30 June 2019, total assets of superannuation entities with more than 4 members regulated by APRA was $1,913.6 billion of which $755.9 billion was MySuper assets.

<u>Strengthening member outcomes</u>

Reforms are currently underway aimed at strengthening prudential and legislative requirements to support an increased focus on the delivery of outcomes to members. These reforms include a legislated 'member outcomes assessment' as well as amendments to APRA's prudential framework to require trustees to approve strategic objectives supporting the achievement of outcomes for members, annually reviewing the trustee's performance in achieving these objectives, monitoring expenditure decisions against expected outcomes and requirements to support the legislated outcomes assessment. The legislation and amendments to APRA's prudential framework were finalised in 2019 and trustees are working towards the implementation of the requirements in 2020.

<u>Prudential standards</u>

[2] Super System Review Final Report: https://treasury.gov.au/publication/super-system-review-final-report

APRA's prudential standards for superannuation, commenced in 2013 and support and expand on the legislative obligations with requirements for, among other things, frameworks, policies and documented processes that superannuation funds need to have in place. The prudential standards are legally enforceable, and are also supported by non-enforceable guidance (prudential practice guides).

APRA has issued cross-industry prudential standards relating to governance, fitness and propriety, outsourcing, business continuity management, margining and risk mitigation for non-centrally cleared derivatives and information security. These cross-industry prudential standards apply to banks and other deposit-taking institutions, general insurers and life insurers. Where appropriate, APRA harmonised the requirements for superannuation with these cross-industry standards. There are also a number of prudential standards that are specific to superannuation.

The Prudential Standards covering matters common to other APRA regulated industries, are:

1. Prudential Standard SPS 220 Risk Management, which sets out requirements for an RSE licensee's risk management framework;

2. Prudential Standard CPS 226 Margining and Risk Mitigation for Non-centrally Cleared Derivatives, which sets out requirements for most APRA-regulated entities including RSE licensees to have appropriate margining practices in relation to non-centrally cleared derivatives;

3. Prudential Standard SPS 231 Outsourcing, which requires outsourcing arrangements involving material business activities entered into by an RSE licensee to be subject to appropriate due diligence;

4. Prudential Standard SPS 232 Business Continuity Management, which requires an RSE licensee to have a whole-of-business approach to business continuity management;

5. Prudential Standard CPS 234 Information Security, which sets out requirements for most APRA-regulated entities including RSE licensees to take measures to be resilient against information security incidents;

6. Prudential Standard SPS 310 Audit and Related Matters, which sets out audit requirements;

7. Prudential Standard SPS 510 Governance, which seeks to ensure that an RSE licensee's business operations are managed soundly and prudently by a competent Board; and

8. Prudential Standard SPS 520 Fit and Proper, which seeks to ensure that an RSE licensee prudently manages the risks that may be posed to its business operations should persons acting in responsible positions not be fit and proper.

The Prudential Standards covering matters that are specific to superannuation are:

1. Prudential Standard SPS 114 Operational Risk Financial Requirement, which seeks to

ensure that RSE licensees maintain adequate financial resources to address potential losses arising from operational risks that may affect RSEs within its business operations;

2. Prudential Standard SPS 160 Defined Benefit Matters, which seeks ; to ensure that RSE licensees of defined benefit funds are able to meet the liabilities of those funds, through the assets of the fund, as they become due;

3. Prudential Standard SPS 250 Insurance in Superannuation, which seeks to ensure that RSE licensees have a sound insurance management framework with respect to making insured benefits available to beneficiaries;

4. Prudential Standard SPS 515 Strategic Planning and Member Outcomes, which seeks to ensure that RSE licensees manage their business operations in a sound and prudent manner in order to achieve its strategic objectives;

5. Prudential Standard SPS 521 Conflicts of Interest, which seeks to ensure that RSE licensees identify, avoid and manage potential and actual conflicts of duty and interest and sets minimum requirements that must be adopted in a conflict management policy; and

6. Prudential Standard SPS 530 Investment Governance, which seeks to ensure that RSE licensees have a sound investment governance framework and manage investments in a manner consistent with the best interests of beneficiaries.

Table 2: Prudential standards for superannuation and behavioural prudential standards that apply to other APRA-regulated industries

	Superannuation	**Authorised deposit-taking institutions**	**General insurers**	**Life companies**
Behavioural standards				
Governance	SPS 510	CPS 510	CPS 510	CPS 510
Fit and Proper	SPS 520	CPS 520	CPS 520	CPS 520
Margining and risk mitigation for Non-centrally Cleared Derivatives	CPS 226	CPS 226	CPS 226	CPS 226
Outsourcing	SPS 231	CPS 231	CPS 231	CPS 231
Business Continuity Management	SPS 232	CPS 232	CPS 232	CPS 232
Information Security	CPS 234	CPS 234	CPS 234	CPS 234
Risk Management	SPS 220	CPS 220	CPS 220,	CPS 220
Audit and Related Matters (actuarial, where relevant)	SPS 310	APS 310	GPS 310, 311	LPS 310, 320
Standards specific to superannuation				

Investment Governance (SPS 530), Conflicts of Interest (SPS 521), Defined Benefit Matters (SPS 160), Operational Risk Financial Requirement (SPS 114), Insurance in Superannuation (SPS 250), Strategic Planning and Member Outcomes (SPS 515)

B. Risk-based Supervisory Approach

3. APRA's Risk-based Supervisory Approach

APRA's mandate is to protect the Australian community by establishing and enforcing prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by institutions are met within a stable, efficient and competitive financial system. In carrying out its mandate, APRA takes a risk-based approach to supervision in order to allocate its scarce resources to the areas of greatest risks. It applies the same broad risk-based supervisory model to superannuation funds as to banks and insurance companies, with some adaptations for the unique nature of superannuation and APRA's somewhat broader mandate under the SIS Act.

APRA's supervisory approach is based on the fundamental premise that the primary responsibility for financial soundness and prudent risk management within a supervised financial institution rest with its board of directors and senior management. APRA's role is to enforce minimum standards and promote prudent behaviour by financial institutions through a framework consisting of legislation, prudential standards and prudential guidance, which aims to ensure that risk-taking is conducted within reasonable bounds and that risks are clearly identified and well managed. In the case of superannuation, this also extends to oversight of whether superannuation entities are meeting their particular duties under the relevant legislation, as well as the 'reasonable expectations' of their members.

Resources

APRA's internal resources for supervising superannuation draw on a number of divisions and specialist areas. The Specialised Institutions Division supervises stand-alone financial entities, including the majority of superannuation funds. The Diversified Institutions Division supervises financial conglomerates, including many large retail funds housed within broader financial services groups. Supervision teams in both of these divisions are referred to as APRA's 'frontline' resources and are supported by specialists in particular types of risk, and data analytics, legal and technical advice groups. APRA has a policy team dedicated to superannuation prudential standards and legislation.

Frontline supervisory staff are allocated a portfolio of institutions (depending on the size of entities), usually along industry lines. Analysis of superannuation fund data is undertaken by the same team that undertakes on-site supervision of the fund. The data submitted by superannuation funds is also collated by risk and data analytics specialists to provide broader industry and peer group insights.

Entity-level supervision

A minimum or 'baseline' level of supervisory activity must be undertaken for each superannuation entity. This baseline level of activity seeks to give APRA sufficient information to adequately identify and assess the key risks affecting each of the regulated entities. It provides an objective basis from which to determine APRA's risk-based priorities, which attract the majority of time and effort from supervisors.

The baseline supervision activity supports the identification of risk and determination of risk ratings through the PAIRS tool. During 2019 and beyond APRA is undertaking a review its supervision tools including PAIRS with the aim of developing a strengthened, contemporary supervision model and tools.

If supervisors find key areas of risk or weaknesses in risk management processes when performing these activities, risk ratings are adjusted to reflect this, and supervisory responses become more targeted and timely focusing on the areas in need of attention.

For the superannuation sector, supervision activities primarily include:

- Prudential consultations and meetings involving a high level discussion with the board and senior management on strategy and key risks and issues;
- Prudential reviews (mostly undertaken as on-site visits) to review governance, risk management, operational risk, market and investment risk and other factors;
- Meetings with management to discuss specific issues or concerns;
- Analysis of financial data and other information including audit reports submitted to APRA;
- Analysis of internal exception reports designed to flag outlier institutions from the financial data received;
- Review of actuarial reports for defined benefit/ hybrid pension funds; and
- Analysis of other regulatory and market information; and
- Escalation to formal enforcement action, where significant concerns are identified and enforcement action is determined to be the most effective course of action for APRA.

For superannuation trustees, the assessment of inherent risk assesses the board and management of the entity and its overall approach to risk governance, as well as considering:

- *market and investment risk*: risk of losses due to adverse movements in the level or volatility of market rates or prices
- *insurance risk:* risk of insured benefits and expected terms and conditions offered to members being adversely impacted by a superannuation trustee's insurance arrangements or insurance management framework.
- *operational risk*: the risk of losses resulting from inadequate or failed processes, people and systems, whether internal or occurring within a service provider– or from an external event
- *liquidity risk:* the risk that an institution will not be able to meet its payment obligation as they fall due without significant unexpected costs

- *strategy and planning risk:* risk associated with an entity's business model and how it wants to position itself strategically.

Exception reporting tools are provided to supervisors, which flag superannuation entities that have breached or are close to breaching pre-determined quantitative trigger points using quarterly regulatory data. These may not be regulatory breaches, but rather measures or risk, efficiency or sustainability. Breaches of these triggers, as well as other outliers on a range of performance metrics, will be referred directly to supervisory teams to review and potentially raise issues with the regulated entity.

Controls or risk mitigants may include:

- quality of the governing board/trustees: covers their understanding of responsibilities, their experience, competence and integrity and the presence of conflicts of interest;
- the quality of senior management: its experience, competence and integrity;
- effectiveness of operational management: this is defined to include human resource policies (recruitment and training) and, where relevant, management of outsourced operations by trustees;
- a fund's information systems and financial controls: capacity to produce timely and reliable information for regulators and members;
- adequacy of risk management systems: quality of arrangements for determining risk appetite, identifying and measuring risk, setting limits, monitoring compliance with those, and reporting;
- a fund's compliance culture and procedures: relates to compliance with laws and regulations and involves assessment of the competence, integrity and independence of responsible staff, as well as a fund's information systems; and
- the adequacy of independent review: this relates to internal and external audit and actuarial review, and requires assessment of both competence and independence.

Since 2017, APRA has intensified its supervision of superannuation funds that are not consistently delivering sound member outcomes or that may be unlikely to deliver sound or sustainable outcomes in the future. APRA has to date focused attention on 'outlier' funds that are underperforming on a range of metrics.[3] A number of these funds have since been strongly encouraged to merge with other funds or restructure their operations or products. This work will be expanded over the coming year to include a broader range of performance indicators.

[3] Refer to APRA's letter to all RSE Licensees dated 31 August 2017 https://www.apra.gov.au/letters-notes-advice-superannuation-rse

Industry-level risk assessment

APRA regularly reviews each industry it supervises and the general state of the macroeconomic environment for emerging issues and threats. These reviews may lead to actions relating to a specific regulated entity or lead to a revision of APRA's prudential requirements. Industry and risk specialists within APRA provide supervisors with up-to-date information on industry developments and emerging risks or trends that may adversely impact regulated entities' risk profiles. Supervisors are responsible for developing an appropriate supervisory action plan to mitigate any risks or issues identified. Supervisory actions will vary by regulated entity and reflect APRA's risk-based approach.

APRA's internal industry-focused committees consider and identify key emerging risks and supervisory issues for each industry, together with key actions that will be taken at an industry level. This may result in thematic reviews, which are coordinated on-site or off-site reviews of a particular risk areas or topic across multiple institutions, discussed further below.

In addition to regular analysis of key industry risks and issues, ad hoc industry-based studies may also be conducted by other areas of APRA. APRA's Risk and Data Analytics Division comprises risk specialists, research and industry analysis teams that provide active support on industry-level risks through undertaking regular analysis of key industry data and other information. Peer group financial analysis and other analytical support tools are also used to identify key trends within an industry sector and outlier regulated entities. External experts are also invited to present to APRA supervisors on a range of topics.

A key tool that can be applied to identifying, assessing and responding to risk at a systemic level is a thematic review. A thematic review is a coordinated supervisory activity targeting multiple institutions to evaluate the practices of a representative sample of entities in a specific risk area.

Following the thematic review, APRA provides entity-specific feedback, which outlines practices assessed as requiring improvement for that entity. APRA also publishes the results of the thematic review, generally in the form of a letter to the industry, summarising overall industry outcomes, highlighting what APRA considers to be good practices and indicating areas for improvement. The learnings from a thematic review are also captured more broadly in the supervision of entities not were not subject to the thematic review.

In recent years, APRA has conducted thematic reviews of the superannuation industry on the topics of board governance practices and management of related party arrangements. Letters to industry summarising the findings of these reviews are available on APRA's public web site.[4]

[4] https://www.apra.gov.au/sites/default/files/BGTR_letter%2520to%2520industry_20180516.pdf; https://www.apra.gov.au/sites/default/files/rpatr_-_letter_to_rsels_-_29_may_2018.pdf

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