

CORPORATE SUPER ASSOCIATION

SUBMISSION

ON:

**THE APPLICATION TO SUPERANNUATION FUNDS OF THE PRINCIPLES SET OUT
IN THE DRAFT PRUDENTIAL STANDARD ON OUTSOURCING FOR ADIs, ISSUED
BY AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY ON 7 NOVEMBER
2001**

TO:

AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY

ATTENTION:

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CORPORATE SUPER ASSOCIATION

Abbreviations used in this submission

The Issues Paper	Issues Paper, <i>Options for Improving the Safety of Superannuation</i> , issued by Joe Hockey, then Minister for Financial Services and Regulation, on 2 October 2001.
The Association	The Corporate Super Association
APRA	Australian Prudential Regulation Authority
ADI	Authorised Deposit-Taking Institution
SIS Act, SIS legislation	Superannuation Industry (Supervision) Act 1993, and related legislation

1. Background

1.1 The Corporate Super Association

The Corporate Super Association is Australia's dedicated representative body for major Not For Profit corporate superannuation funds and their corporate sponsors.

The assets of Association members amount to approximately \$60 billion, representing about 75% of total corporate superannuation sector assets in Australia and some 750,000 individual employee fund members. The dominant position of the Association in the corporate Not For Profit superannuation sector is indicated by the fact that Association member funds total only 2% by number of the total number of funds in the sector, but hold 75% of the assets.

1.2 The special nature and function of superannuation

Recent public documents, notably the Issues Paper, start from the mistaken premise that "superannuation is essentially a managed investment with special characteristics....." (opening of Section 1.2). The special characteristics identified are listed as compulsion, restrictions on access to capital by members, and members' lack of access to information sufficient to assess or manage "financial risks associated with their superannuation investment".

The assumption that superannuation shares the characteristics of bank deposits and managed investments is at the root of some highly inappropriate suggestions for the "reform" of the superannuation system, as well as attempts to apply to superannuation identical regulatory templates to those which are suitable to long term managed investments and short term deposits undertaken at individuals' discretion.

Superannuation funds fulfil a very different role from that of discretionary investments entered into by individuals. Provision of superannuation benefits on retirement is an occupational or employment issue, involving a long-term commitment to continue to provide income at a time when the flow of employment income has ceased. Where the superannuation obligation is linked to employment, the employer should retain an interest in and commitment to the security and performance of the funds supporting the obligation. Assets are held in trust, and their safekeeping and performance are the responsibility of the trustees. Delivery to the individual does not occur until a trigger event, such as retirement, occurs. In the particular case of defined benefits, it is simply not possible to quantify an amount accumulating for the benefit of any particular member, until the event which causes the benefit to be defined, occurs.

Certainly there have been developments in the area of superannuation which have increased the apparent similarities between superannuation and discretionary managed investments and deposits. There is an increased focus on superannuation as an entitlement (arising from the compulsory nature of the Superannuation Guarantee minimum support and other contractual aspects), giving rise to a stronger feeling of member ownership during the accumulation phase. Further, the increase in popularity of accumulation schemes (as opposed to defined benefits)

CORPORATE SUPER ASSOCIATION

has given rise to increased interest on the part of members in the performance of the fund. Consequently, investment choice has been almost invariably introduced by the large corporate superannuation funds.

The distinguishing features of superannuation remain:

- superannuation is a collective investment undertaken on a fiduciary basis;
- in certain cases, notably in defined benefit schemes, individual interests are not separately identified, because they cannot be quantified until particular circumstances occur;
- responsibility for the security of the funds is the collective responsibility of the trustees, representing the interests of all members as a group, and not that of each member on his or her own account. In the special case of a defined benefit scheme, the trustees must also take into account the role of the employer, because the capacity to pay benefits is linked to the employer's continuing viability; and
- the long-term nature of the funding process requires specialist investment expertise, in order to ensure that liabilities are appropriately matched by assets in terms of risk and in terms of relative liquidity.

These characteristics set superannuation apart from discretionary individual savings plans, where the interests of individuals are clearly defined, the source of the money is their own funds, the time of withdrawal is their own affair, and there is no other party with employment or fiduciary obligations standing between them and their investments.

It is crucial that the distinction be borne in mind when changes to regulatory legislation and regulatory instruments are being contemplated.

1.3 The role of Not For Profit Superannuation Funds

In this submission reference is made to:

- *Not For Profit employer sponsored superannuation funds.* In Not For Profit funds, the trustee body does not obtain profit, nor is there a dividend payable to shareholders of the trustee bodies. The main reason for the existence of the funds is a concern on the part of the employer sponsor to provide for the welfare of employees and their dependants through appropriate incentive and benefit structures. There is no profit motive or commercial interest in bringing funds under management. The governing trustee bodies represent the interests of members and sponsoring employers. Consumer protection in these entities is, to a major extent "built in" through the extensive cooperative involvement of employers and members in the governance of the funds.

Any addition to costs borne by Not For Profit superannuation funds directly reduces the assets available to fund retirement benefits for the members.

- *For Profit entities.* These may be:
 - superannuation funds, master trusts, pooled superannuation trusts or unit trusts;
 - fund administrators, investment managers, or professional trustees;
 - any combination of the above.

The prime characteristic is the offering and issuing of financial products in order primarily to realise profit for the issuer's shareholders. These service providers and their agents have a financial interest in drawing additional funds under management. They have no connection, other than commercial, with either the sponsor or the members.

It is essential that the very different nature of these two broad categories continue to be recognised in separate regulatory and supervisory requirements.

CORPORATE SUPER ASSOCIATION

2. Proposed standard on outsourcing

APRA on 7 November 2001 issued a draft prudential standard on outsourcing for ADIs. In view of the intention in due course to extend the standard to all regulated institutions, including superannuation funds, APRA has stated that it would welcome comments from all regulated industry sectors.

2.1 *Relevance to superannuation sector*

APRA has stated that it considers that outsourcing is a significant issue for the superannuation industry and the introduction of a standard on outsourcing will be a high priority when the relevant legislation is amended to allow it.

In Joe Hockey's Issues Paper, the main concern expressed in relation to outsourcing by superannuation funds is the absence of regulatory control over the entities to which trustees may delegate functions related to the administration and management of their superannuation funds. These concerns appear to be shared by APRA.

3. Comment on the proposal – in application to superannuation funds

3.1 *Areas of support*

Information or recommendations from the regulator are likely to be welcomed if such documents clearly summarise:

- legal requirements, and
- best practice,

in the management of outsourcing certain functions by superannuation fund trustees.

Current practice by the regulator in clarifying compliance requirements involves the issuing of circulars summarising SIS Act requirements and indicating the regulator's expectations in relation to compliance with the law. This process is generally considered to be helpful.

3.2 *Areas of concern*

The proposed standard raises serious concerns.

1. It is drafted in a manner which conforms with the regulatory regime applicable to ADIs. ADIs differ greatly from superannuation funds in their structure and function¹ and the regulatory regime which applies to them is consequently different.
2. The standard does not set out key definitions. In particular, the term "outsourcing" is not defined. In the ADI context, the meaning may be relatively clear, but in the superannuation fund context, where trustees delegate many functions, it is less clear where the line would be drawn. For example, it is unclear whether the involvement of an employer-sponsor's staff in management of the fund would constitute a form of outsourcing. Again, where professional services firms replace in-house services of an advisory, administrative, or accounting nature, are the advisers performing outsourced activities?
3. Further, the number and variety of delegated or outsourced functions in a superannuation fund is generally much greater, because it is often only the management and key functions which are actually operated "in-house". In banks and investment institutions, there is generally a substantial in-house resource structure, with use of external resources for key service contracts the exception rather than the rule. These contrasts reflect the very different nature of superannuation funds, where the trustees, particularly in the Not For Profit sector, deploy resources in a very different way from the management of depository institutions. The trustee role does not, in its essence, involve the running of a financial institution with the accompanying infrastructure.

¹ See 1.2 above

CORPORATE SUPER ASSOCIATION

4. ADIs are few in number. By contrast, after excluding self managed funds, and even if the expected rationalisation occurs of employer sponsored superannuation funds, such that the smaller, less effective players are removed, there will remain thousands of superannuation funds. The proposed techniques for managing outsourcing risk for ADIs include extensive scrutiny by APRA of every material proposed contract. This approach may be practical for a sector in which there are few players, but will fail for practical reasons in a sector in which there are many players, with, as indicated at (3) above, very many more contracts for external services.
5. The principal requirements set out in the proposed standard will impose significant additional costs and compliance complexity on superannuation funds, and would ultimately reduce benefits to members, without significantly improving the safety of members' benefits.
6. Aspects of the proposed standard which would see APRA privy to negotiations with potential service providers, and with authority to discuss proposed contracts with potential service providers, are inappropriate because of the potential interference with or usurpation of the trustee's role by APRA and because it is not the role of the regulator to become a participant in such discussions.

These issues are discussed further in the paragraphs which follow.

3.2.1 Lack of conformity with SIS Act regulatory regime

It is accepted that the proposed standard has a clear status within the regulatory regime and legislation which applies to ADIs. However, because the regulatory regime applicable to superannuation funds is different, such a standard would not have a place within the SIS Act regulatory regime, as it currently stands.

- In the press release which accompanied the release of the proposed standard, it is stated that the standard is seen as complementary to the specific provisions of the SIS Act in relation to the use of third parties, and the regulations imposed on Approved Trustees. However, the legislative status of the proposed standard is unclear. Will the standard form part of the SIS Act and its regulations, or will it have separate legal status?
- In contrast, under the current arrangements where APRA issues Superannuation Circulars indicating the regulator's expectations in relation to compliance with the law, it is clear that the legal requirements are to be found under the SIS Act and its regulations and that the Circulars are intended as explanatory material in relation to the SIS Act.
- To introduce a separate category of compliance requirement complementary to the regulatory legislation, without clear legislation stating the requirements in plain terms, would be highly confusing and would increase compliance costs.

If the extension of the proposed standard to superannuation interests represents part of a campaign to extend to superannuation funds an identical regulatory regime to that applicable to ADIs, this campaign is extremely misguided. As indicated in section 1.2 of this paper, there are major differences between superannuation and discretionary deposits and these distinctions must continue to be recognised in the applicable regulatory regimes.

3.2.2 Effectiveness, costs and impact on members' benefits

To extend to superannuation funds a similar standard to the proposed standard on outsourcing for ADIs would be inadvisable for reasons which include the following.

- There are many more superannuation funds than there are ADIs and the number of contracts to be scrutinised would be extremely large. This would result in significant additional costs and logistical problems for the regulator.
- The proposed standard would require notification to the regulator of every significant proposed contract by the trustee. The notification process would involve the provision of a substantial array of information about risk assessment and management by the trustees. This process would increase costs for the superannuation fund.

CORPORATE SUPER ASSOCIATION

- Such a process would also delay finalisation of contracts.
- For the regulator to perform a useful and timely review of each such contract for every superannuation fund, significant additional resources would be needed. In turn, increased regulatory costs would result in increased regulatory levies –increasing costs for the employer or members and reducing benefits to the consumer.
- It is not clear from the proposed standard and the guidance notes, what action the regulator would propose to take after review of proposed contracts.
- If the processes adopted and choices made by the trustee are overturned by the regulator, there would be serious implications for the trustee system and the powers of the trustee under the SIS Act. It is unlikely that the community would gain, and costs would increase.
- Proposals requiring access to the service provider and the provision of detailed information by the service provider are likely to result in increased costs levied by the service provider on the fund.

3.2.3 Proposed role of APRA in reviewing contracts with potential service providers

The proposed standard, at paragraph 6, would require notification of APRA before the ADI (or institution) entered into any agreement to outsource a major business activity. APRA would then assess the outsourcing arrangement and would be authorised to seek further information from the service provider.

The implied proposals that APRA should be privy to negotiations with potential service providers, with authority to discuss the proposed contracts with the potential service providers, are inappropriate. The proposals imply a level of involvement by APRA in the process of selection of service providers which potentially oversteps the role of regulator. The assessment of risk and other aspects of potential service arrangements is the responsibility of the trustees and where the trustees require assistance with such assessment, it is their responsibility to arrange for formal delegation of the task to experts in such matters. It is not the role of APRA to offer comment on risk and other aspects of potential contracts, or to communicate with potential service providers during negotiations. Negotiations can be sensitive, for commercial and other reasons, and are best not confused by potentially irrelevant requests for information by parties who are strangers to the proposed transactions.

The role of APRA should remain prudential. Review of contracts should involve assessment whether or not funds have exercised diligence in appointments: this has been an accepted part of a fund review. APRA should not be entitled automatically to receive details of service providers and contracts other than where relevant to their normal review. Automatic rights to access documentation (as recommended at paragraph 11) should not be required, and on-site visits to service providers should be avoided except where information cannot be obtained by any other means (such as a request directed through the fund's trustee).

Paragraph 18 of the proposed Standard would require notification to APRA of any problems with the service providers, and any proposal or discussions regarding terminating a relationship. This proposal is undesirable. It should be recognised that it is the role of the fund's trustees to conduct and manage service provider relationships. It is undesirable for the trustees to be required to discuss with APRA any problems or plans to terminate a service relationship, because such oversight by APRA could delay and inhibit proper action by the trustees.

APRA should have no regulatory discretions or rights to ask the fund auditor to report directly to it (paragraph 19 of the proposed Standard). It is important that the role and responsibilities of the auditor be as clearly defined as possible, including lines of reporting and accountability. The APRA return for the fund provides scope for any necessary comments on fiduciary or prudential controls, and the SIS Act provides scope for notification to the regulator where serious issues arise.

CORPORATE SUPER ASSOCIATION

4. Recommendations

4.1 Monitoring standards in external service providers

If APRA is concerned about standards in external service providers, the approach proposed in the proposed standard appears inefficient, involving the superannuation fund in significant expense, as well as duplication of effort. This duplication would result from separate scrutiny by APRA of contracts affecting each separate fund.

A more economical and efficient approach would be (subject to legal and constitutional constraints) for APRA to perform bulk vetting/risk management reviews of the service providers themselves, with the costs of performing such reviews being met by those service providers. As well as increasing efficiency, this approach would enable the service providers to provide to their existing and potential clients assurances of a clean bill of health from the regulator.

4.2 Clarification of legal status of any proposed standard and its interaction with the SIS legislation

It is essential that the status of any proposed standard, as applied to superannuation funds, should be clarified. The format of the current draft is consistent with the regulatory regime applicable to ADIs, but before any attempt is made to apply such a standard to the superannuation sector, it would be vital to clarify the role of the standard in relation to the SIS Act.

The SIS Act assigns powers to the regulator to make regulations under the Act setting standards in relation to certain specified matters. It is strongly recommended that this avenue continue to be used in order to retain legislative clarity and thereby minimise compliance costs.

4.3 Preferred format for advisory information or best practice statements from the regulator

A circular from the regulator indicating best practice in the area of outsourcing would be welcomed and in line with current practice. Current practice involves the backing of SIS Act requirements by circulars indicating the regulator's expectations in relation to compliance with the law.

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