

# CORPORATE SUPER ASSOCIATION

7 October 2007

Mr Jens Tinga  
Financial Affairs Division  
Organisation for Economic Co-Operation  
and Development

by e-mail [jens.tinga@oecd.org](mailto:jens.tinga@oecd.org)

## **Submission on draft OECD-IOPS Guidelines on the licensing of pension entities**

Dear Mr Tinga

I refer to the draft Guidelines on the Licensing of Pension Entities issued on 27 July 2007 by the OECD and the International Organisation of Pension Supervisors (IOPS). The opportunity to provide comments is appreciated, and I am writing to present the views of the Corporate Superannuation Association.

### **1 Background: the Corporate Superannuation Association**

Our Association represents the major Australian superannuation (pension) funds sponsored by single corporate employer sponsors. The Association represents 30 funds, most of the largest funds in the corporate fund sector. The assets of Association members amount to approximately \$56 billion, representing about 58% of total corporate superannuation sector assets in Australia.

Our funds typically are established as trusts with a single employer or employer group as sponsor. There is no shareholding in the governing body, and no profit derived from the operations of our funds. This also means that any cost of compliance increase has a direct impact on members' benefits. The funds are run as mutual entities, where the decisions are the responsibility of a trustee board. The board provides equal representation for employer and employee interests.

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## 2 Support for the draft guidelines

Our Association supports the approach of the OECD and the IOPS in seeking to establish international best practice guidelines on pension licensing regulations and licensing powers of pension supervisory authorities.

Our Association is generally in accord with your draft Guidelines.

However, we have a specific area of concern relating to capital requirements (Item 6 of part III in the draft Guidelines).

## 3 Concerns relating to capital requirements

### 3.1 Trustee structure

We have approached the issues raised in item 6 of the draft guidelines from the point of view of not for profit employer sponsored superannuation, operating under a trust structure. That model demonstrates a high standard of governance as a result of the equal representation of employers and members, the full support and involvement by employer sponsors, the observance of the trust principles on which superannuation in Australia has been built, and the absence of a profit motive in those involved in running the fund.

Before considering the appropriateness of a capital requirement for trustees, it is important to reflect on the distinction between the trustee and the trust structure within which the superannuation benefits are held. The reason that trustees do not currently hold capital (in general, setting aside regulatory requirements) is that their role is to administer a trust fund. In the past, there has been no perceived need for capital for the trustee as a separate entity, as the trustee has had no other function and has not, in the basic model, existed as an operating entity in itself. This remains the case in the simple employer sponsored not for profit structure generally adopted by stand alone corporate funds. In this context, we note that the traditional approach has been to use a combination of right of indemnity from trust assets (in respect of liabilities where the trustee has acted within its powers and without fault) and trustee liability insurance (to cover other situations).

### 3.2 Comparative data

We note that in the OECD and IOPS Comparative Report *The Licensing of Pension Entities in Private Pension Systems*, July 2007, paragraph 30 observes that capital requirements are a regular licensing requirement for pension fund managing companies, but that they are not generally applied to pension funds set up in trust form. An exception is noted for corporate trustees of public offer (retail) funds in Australia.

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We would emphasise that the reason for the exception for Australian retail funds is that, although nominally operating under a trust structure, they generally differ from other superannuation trusts. The retail funds are operated by an external commercial concern. Their trustee is not a body established to represent the interests of the employer and the members. It is a body that operates for the profit of shareholders who are completely distinct from the members of the fund. In addition the trustee is operating the fund on behalf of a number of different groups of interests and the direct link between the trustee and the interested parties is lost for this reason also. Hence, there is a governance need for the integrity of the trustee to be supported by a capital backing.

### **3.3 *Trustee concerns***

In the context of the current structure of stand-alone corporate superannuation funds, to establish trustee capital would pose some significant problems. Access to members' assets, to provide buffer capital, could give rise to breaches of the trusts under which the funds typically are established, and certainly gives rise to equity concerns between members and over time. Use of employer-sponsors' capital is likely to cause business strain and may well lead to closure of funds.

### **3.4 *Protection against failure or error***

We understand that the principal purpose of any proposed universal capital requirement would be to provide protection in the event of major systems failure or trustee error.

We acknowledge that these are potentially damaging events for trustees, but we question whether the quarantining of a prescribed capital amount is a necessary or sufficient remedy. We acknowledge that the responsibility for systems stability and backup lies in the hands of the trustee, and that the trustee is also ultimately responsible for striving to avoid major error.

However, we believe that the robustness of systems and trustee review, the outsourcing to reputable suppliers, and the prevalence of insurance against major failure and error events are more effective as safeguards than the existence of a capital balance for use as a buffer. In fact, the existence of a capital sum and the ability to call on this could discourage or reduce rigorous attention to:

- systems integrity,
- care with outsourcing agreements, and
- outsourcing of risk by way of appropriate insurance cover.

These issues are discussed further below.

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## 3.4.1 Robust systems

Systems and safeguards against loss of data are acknowledged to be crucial and are documented as part of the Australian Prudential Regulatory Authority (APRA) licensing process. We would expect that trustees would have full documentation of the systems used, comprehensive data backups in separate locations and full disaster recovery plans. We note that the high level of audit to which trustees are subject adds to the degree of internal control. Many funds will have an internal audit function of some sort. All are subject to an external financial and prudential audit, the licence conditions are audited together with the Risk Management Plan for each fund and the Risk Management Strategy of the Trustee, the latter being a prospective focus on management of key risks.

In the absence of such safeguards the existence of buffer capital would be inadequate, as not only would there be potential costs of reinstatement of systems, there would be potential for loss of information about the ownership of assets and the level and attribution of liabilities. This would lead to loss of capital through failure to identify assets and inability to confirm or contest entitlements claimed by members.

## 3.4.2 Outsourcing to reputable suppliers

A greater or lesser degree of outsourcing of functions is inevitable, as all but the largest funds gain efficiencies from utilising specialist suppliers of services. Where substantial functions are outsourced, we accept that the trustee remains liable for ensuring the integrity of the services provided. However, outsourcing a function should bring a degree of outsourcing of risk through sharing of responsibilities. As the Australian Prudential Regulation Authority has recognised in its Superannuation Guidance Note SGN 130.1 *Outsourcing*, the key to the appropriate management of risk in an outsourcing arrangement lies in the contracts between the suppliers of services and the trustees. An appropriate agreement can minimise trustee risk, whilst an inadequate agreement can increase it. Again this is an important area reviewed under the licensing process and subject to ongoing scrutiny.

The use of custodians also minimises risk and is an alternative to financial capital.

## 3.4.3 Trustee insurance policies

The purpose of insurance is the spreading of risk over time and over entities, and in terms of equity to members we see this feature as being important. The occurrence of an uninsured catastrophic event places immediate heavy burdens on the members of the fund at the time of the occurrence, regardless that there may be a cash sum available to meet immediate expense. In contrast, if an event is insured, a small expense (insurance premiums) is incurred on a regular basis, the impact is felt on member accounts in a small measure over a long period, and thus greater equity between fund members is achieved over time.

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We note that those of our funds that self-administer typically carry cover against systems failure, business interruption, and costs of disaster recovery. Those that outsource will as a matter of good practice review the adequacy of protection against such events in the service provider.

## **3.5 *Relative operational risk in single corporate employer sponsored funds***

We note that the degree of operational risk for trustees is significantly higher in the multi-employer environment than for the stand-alone employer fund. This is largely due to the nature of the relationships. The trustee of a stand alone corporate fund is familiar with the employer, the employer's business and the employees, and generally has excellent access and communication with the employer. This is reinforced by the trustee structure with a balance of employer and employee representatives. This leads to significant reduction of conflict and risk. This feature of stand alone funds has been appropriately recognised in Australia where the trustee is not required to have the capital backing required for approved trustees, and where there are separate classes of APRA licences and separate risk evaluation processes for trustees of single employer and multi employer funds.

## **3.6 *Other potential reasons for minimum capital requirements***

We understand that it is the operational risk aspect discussed above which has driven discussion of universal capital backing for trustees. For the sake of completeness, we have reviewed the other reasons for requiring capital which were put forward in Australia some years ago.

### **3.6.1 *Barrier to entry for trustee entities***

We note that, when the Australian Government promulgated the Safety of Superannuation Issues Paper late in 2001<sup>1</sup>, the imposition of uniform capital requirements was canvassed as posing a potential effective barrier to entry for trustee entities, where there was at that time very little in the way of effective barriers to would-be trustees. In our view, the barrier has well and truly been raised through the universal licensing regime. The trustee licensing and fund registration requirements currently in force in Australia were determined under a program of consultation, under which the proposal to impose capital requirements was rejected as doing little to increase integrity. Rather, it was determined that such a requirement would exclude certain viable trustee entities on grounds of absence of financial backing, rather than on appropriate grounds of integrity. Hence, mandatory minimum capital was determined to be inappropriate as such a barrier.

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<sup>1</sup> Issues Paper, *Options for Improving the Safety of Superannuation*, issued by Joe Hockey, then Minister for Financial Services and Regulation, on 2 October 2001.

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## **3.6.2 Confusion with banks and other deposit taking institutions**

We are concerned that the matter of capital backing for trustees may also have been raised in part because of confusion between the function and structure of superannuation funds (which in Australia generally operate under a trust structure for the benefit of members, with specific prudential controls applicable to that structure) and that of deposit taking institutions (which generally operate as companies, for the profit of shareholders, with depositors as customers).

## **3.7 *Potential effect of universal capital requirement***

There is potential detriment to fund members in imposing a capital requirement on the trustee.

(a) A trustee with capital is required to service that capital. Accordingly it seeks a fee in excess of the costs of running a fund. In some cases, this is reflected in a discrete fee paid to the trustee for its services. In other cases, the arrangement is not at all transparent and whilst the trustee may be said to be acting for no fee, it in fact engages related body corporates to provide services to the trustee for a fee which more adequately covers the cost of servicing the capital of the trustee. The capital requirement almost inevitably results in the building of additional structures, additional costs and encourages outsourcing of the trustee function to external profit driven shareholders.

(b) If the uniform capital requirement were introduced, the not-profit trustee could not survive. This would have a significant impact on competition and will, in the short term, lead to significantly higher costs being borne by superannuation fund members.

(c) Given the consolidation in the industry and the size of the funds being managed, any meaningful capital requirement would have to be significant indeed. At the present level of \$5 million is, in many cases, dwarfed by the funds managed by trustees in most cases. If a uniform capital requirement were to be introduced, to have any purpose other than to drive the not-for profit providers out of the market, the capital requirement would have to be on a level significantly higher than \$5 million. If that were the case, it would be expected that only the major financial institutions would be able to support such a requirement.

It is submitted that the costs to superannuation fund members of introducing a uniform capital requirement will be significant indeed and is not justified by the risks which are perceived to exist in the present arrangements.

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## 4 Conclusion

We submit that:

- the proposed capital requirement is not suitable for single employer sponsored funds operating within a trust structure
- the comparative study does not indicate that such a requirement is best practice or otherwise called for
- alternatives are in use, e.g. insurance, attention to systems and other risk protection measures, that are viable methods of protecting members' interests against operational failure.

Please contact my office on +61 3 9620 5155 or by e-mail to [corsuper@netspace.net.au](mailto:corsuper@netspace.net.au) if you would like to discuss the above.

Yours sincerely



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