AIST

10 May 2022

General Manager, Policy
Policy and Advice Division
Australian Prudential Regulation Authority

**Email**: PolicyDevelopment@apra.gov.au

Dear Sir/Madam

## Strengthening crisis preparedness

## Brief

AIST notes that the application of the proposed crisis preparedness standards within the superannuation sector is limited to the trustees / RSE licensees of funds and not the funds themselves. This distinction means that profit-to-member super funds are by-and-large already compliant with the new requirements proposed. Guidance supporting the standards will need to address the specifics of how the standards will operate in sectors with distinctive business models, not just take a blanket approach to the financial services industry more broadly.

**About AIST**

*Australian Institute of Superannuation Trustees is a national not-for-profit organisation whose membership consists of the trustee directors and staff of industry, corporate and public sector superannuation funds.*

*As the principal advocate and peak representative body for the $1.6 trillion profit-to-members superannuation sector, AIST plays a key role in policy development and is a leading provider of research.*

*AIST advocates for financial wellbeing in retirement for all Australians regardless of gender, culture, education, or socio-economic background. Through leadership and excellence, AIST supports profit-to-member funds to achieve member-first outcomes and fairness across the retirement system.*

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## Submission

AIST thanks APRA for the opportunity to provide input to this consultation.

AIST acknowledges the challenges in developing industry-wide rulesets for a broad set of participants and that elements of such rulesets will apply differently in each sector. Capturing banking and insurance in the same net as superannuation, and the different business models within superannuation as a stand-alone sector, means the balance of risks and credible recovery options for each entity covered by the standards will vary.

Overall, AIST sees merit in financial firms anticipating and planning for contingencies arising out of potential future crises. Industry will benefit from clear and specific guidance from APRA, tailored to the unique circumstances of different sectors.

As a representative body for the profit-to-member superannuation sector, AIST's submission limits our comments to the impacts and application of the proposed framework to our member funds.

### The P2M fund model

The profit-to-member (P2M) superannuation fund model is unique in that the trustee of the superannuation fund, while legally a distinct entity separate from the fund, exists solely as the operator of the fund and conducts no other business.

The "shareholders" of the Trustee are the representative bodies who nominate directors to the Board. The equal governance model means that P2M Boards are made up of an equal number of representatives appointed by one or more unions who represent workers, and by extension the members of the fund, and employer groups who represent the interests of the employers contributing to the scheme. While not mandated by law, many P2M Boards also appoint independent directors, appointed jointly by the other directors but with no specific connection to either group. While the directors earn director fees for their work on the Board, the appointing bodies do not receive any dividends or shareholder benefits for their participation in operating the fund.

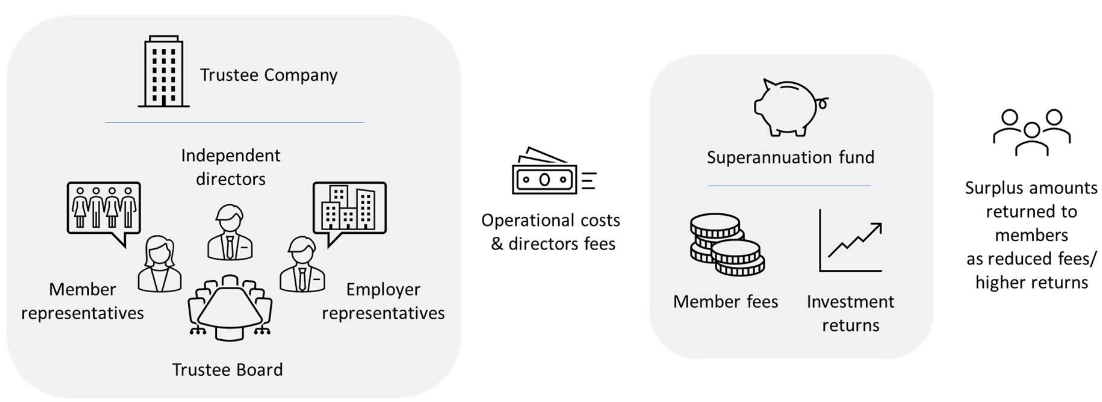
This model of governance removes any conflict between the fiduciary duty of trustees to always act in the best interests of members, and the motivation to draw a profit for the benefit of shareholders with a financial stake, as the latter does not exist. This ensures that any collection and use of revenue is done with the guiding principle that the money first and foremost belongs to members, and any use of that money must be to their benefit.

As fund trustee companies exist solely to manage the interests of their funds, the legal distinction between the trustee and the trust has historically been of minor importance. All expenses incurred in the operation of the fund have been met by the fund and expenses incurred in the operation of the trustee have been funded by the fund on a cost-recovery basis. The absence of profit motive or a need to accrue capital outside of the trust allowed fund assets to benefit from the beneficial tax treatment of superannuation within the fund without incurring higher income tax treatment outside of the fund.

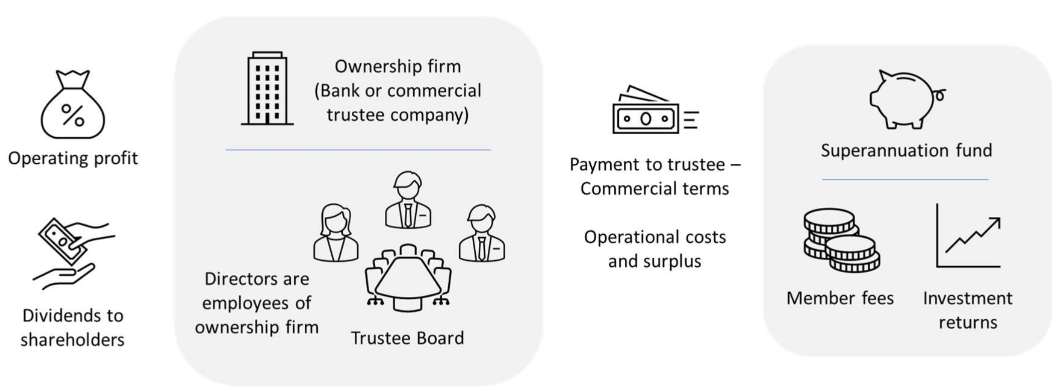


That P2M funds have performed strongly and weathered several significant financial market shocks and periods of market volatility without major financial detriment demonstrates that the model is sound, and funds are well placed to continue to operate well into the future.

**Profit-to-member super fund governance model**




**Retail super fund governance model**




Recent legislative changes in relation to the payment of penalties from trust assets ("the s56 amendment"[1]) have necessitated the establishment of a trustee capital reserve to be held

[1] An amendment to Section 56 of the Superannuation Industry (Supervision) Act 1993.

separately from the fund. It is this reserve that is ultimately the subject of this consultation as it relates specifically to the resiliency of the trustee, not the fund, in a financial crisis[2]. As such, the process taken by trustees to establish those reserves and the rationale considerations accepted by justices in the relevant matters are particularly instructive in the consideration of the two new proposed standards. P2M funds are well prepared to meet the requirements of the standard through the work already undertaken through that process.



## Risks to P2M trustees

The lack of capital within trustee companies prior to the s56 amendment indicates that no existential threat unique to the financial resilience of the trustee previously existed. The amendment moved the liability to pay for penalties and infringement notices from the fund to the trustee. This created the risk of trustee insolvency if a reserve was not held to meet such a liability.

Funds have done considerable contingency planning work in assessing the risk and potential quantum of such liabilities in establishing their trustee capital reserves. Management of the reserve, including its initial funding, target value and cap on amounts to be retained, applicable uses, replenishment after a claim on the holding and settlement of held amounts should the trustee wind up have all been addressed in significant detail in the development of capital reserve policies.

A consequence of trustees holding capital amounts is the risk of class actions that were rare under the prior legislation as fund assets are preserved. A pool of available capital in the trustee risks litigation funders chasing actions if their fees for service can be drawn from reserved amounts. Through discussions with representatives of the legal community within superannuation, AIST understands that litigators typically do not bother to pursue cases where payouts are likely to be below $30 million so the potential quantum of the threat to superfunds cannot be understated. However, our legal colleagues also understand that compensation orders that may be imposed by a Court on a trustee resulting from a class action for breach of any of the SIS Act statutory covenants (as opposed to penalties) could continue to be met from the assets of the fund so long as the provisions of section 56 of the SIS Act are not triggered.

The hypothetical example provided in the discussion paper about a fund becoming closed to new members due to underperformance, and this leading to financial stress at the trustee level, is not

[2] "The proposed CPS 190 would support the objectives of SPS 515; however, CPS 190 is narrowly targeted at scenarios where the RSE licensee itself is under financial stress. The proposed CPS 190 is not focused on rectifying identified poor member outcomes or underperformance, as required by the business planning and business performance review provisions in SPS 515." – Consultation discussion paper

fit for purpose as it assumes revenue collection from the fund as a standard process. Impaired revenue generation from a descaling fund is only likely to arise in the retail super fund sector where trustees operate on commercial terms with their funds. Group failure as addressed in the second example is also not relevant to the P2M business model.



## Recovery and exit options

As capital reserves are funded from trustee fees charged to the fund's members, the only credible recovery option for a P2M trustee in financial crisis is limited to refunding the reserve in accordance with the trustee's reserving policy.

Should the reserve amount be insufficiently provisioned to enable recovery, or the trustee determines that the consequences of a regulator or member action are so significant that it is no longer in members best interests to continue, the only credible action for a trustee is to discharge its responsibilities by transferring the fund to an alternate trustee and exiting the industry.

Hence, for a P2M fund, a contingency plan will contain its reserving policies and a plan for a merger with or successor fund transfer to another trustee. Such a plan would include the seeking of an alternative trustee partner, establishing timeframes for exit, the resources needed and sources of those resources, communication with members, regulators and other third parties, and so on.

It should be noted that the limited options open to trustees and challenges inherent in replacing a trustee for funds of significant size were recognised by Justice Blue in the rationale for AustralianSuper to amend its Trust Deed in response to the s56 amendment:

> *65 If AusSuper were to become insolvent, it would be unable to continue as trustee of the Fund. Section 120(2) of the Supervision Act defines a "disqualified person" amongst others as a company in respect of which a receiver, manager, administrator or provisional liquidator has been appointed or which is being wound up. Section 126K prohibits a disqualified person from acting as a trustee of a superannuation entity. Sections 133 and 134 empower APRA to remove a disqualified person as trustee of a superannuation entity and appoint a replacement trustee to act as trustee until the vacancy is filled.*
>
> *66 At first sight, it might be thought that it would be relatively easy for AusSuper to be replaced with an alternative trustee of the Fund. However, the evidence establishes that this is not the case and that there would be a very substantial cost and detriment to the Fund and therefore to the members of the Fund in that event.*
>
> *67 If AusSuper were unable to continue as trustee of the Fund, theoretically there would be three alternatives. First, the appointment of a replacement trustee to take over as the long term trustee of the Fund. Secondly, a winding up of the fund under the control of a short*

*term replacement trustee. Thirdly, a merger of the fund with another superannuation fund under the control of a short term replacement trustee.*

*68 Any replacement trustee (whether long term or short term) would be required to hold an AFS licence from ASIC and an RSE licence from APRA. APRA indicated in submissions that it would be unlikely to appoint or license a replacement trustee that had the same directors as a trustee that had become a disqualified person. It appears that there are three companies that hold an RSE licence that could be appointed by APRA as an acting trustee. However, that power has never been exercised in respect of a large superannuation fund of the order of the Fund. Any trustee appointed by APRA would only be an acting trustee in the short term and it would still be necessary to procure a long term replacement trustee if the first alternative could be pursued. Any acting trustee appointed by APRA would charge substantial fees.*



*69 Although trustees of existing superannuation funds do not necessarily have significant capital or financial support from their shareholders, it appears likely that a replacement trustee would be required to have substantial capital or financial guarantees in order to obtain a RSE licence. This would have to be provided in some form by the Fund, either by directly providing the capital or by paying fees of the type proposed by AusSuper to create such capital. Even if a replacement trustee could be procured without substantial capital, that trustee would run the same risk of insolvency as would have been run by (and hypothetically materialised for) AusSuper. On the evidence adduced before me, it appears unlikely that a long term replacement trustee could be procured in respect of a superannuation fund of the size of the Fund.*

*70 Mr Silk and Mr Schroder gave evidence that, even if a long term replacement trustee could be procured to take over as trustee of the Fund, there would be very substantial costs and losses incurred by the Fund. This would include very significant direct costs, being internal and professional costs, involved in replacing the trustee; cash flow and liquidity issues caused by members potentially seeking to withdraw their benefits from the Fund and employers ceasing to nominate the Fund as the default fund; and significant business disruption adversely impacting on fund governance, management and investments. Mr Silk and Mr Schroder estimated that the direct costs incurred by the Fund in this scenario would be in excess of $100 million. Mr Schroder gave evidence that, in addition to these costs, there would be a potential loss of value of the assets of the fund, which would potentially be billions of dollars.*

*71 Mr Silk and Mr Schroder gave evidence that, in the second and third scenarios, both the costs and losses to the Fund would be much greater than in the first scenario.*

## Overlap and interaction with other prudential standards

The contingency plan must include a trigger framework for the early identification and monitoring of stress and governance arrangements for the monitoring of triggers and timely activation of the contingency plan or specific actions within it.

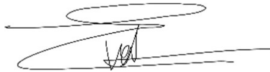
The nature of the risks to P2M trustees that would constitute a financial crisis are such that a soundly and prudently run trustee would have ample advance warning of an impending trigger event.



The lack of an operational delineation between Trustee and fund prior to the s56 amendment meant that all risk management and business continuity activities of a trustee were captured within the monitoring, review and notification obligations of the fund as mandated by the relevant prudential standards. Viability threats assessment, operational incident management, scenario analysis and stress testing are all carried out as part of the sound and prudent management of a fund's business operations and protection of beneficiaries' best interests. APRA sees CPS 190 as a natural extension to those existing obligations. AIST does not consider that the new standard's monitoring and trigger framework constitutes a new business activity for P2M funds. Therefore, AIST anticipates that existing frameworks are likely to form the basis of contingency planning.

For further information regarding our submission, please contact Kate Brown, Senior Manager Advocacy & Research on kbrown@aist.asn.au.

Yours sincerely,



Eva Scheerlinck

**Chief Executive Officer**