



# Regulation Impact Statement

## Superannuation prudential standards

(OBPR ID: 14155)

### Introduction

APRA regulates 208 RSE licensees of 493<sup>1</sup> registrable superannuation entities (RSEs) with total assets of \$918.2 billion as at 30 June 2012.<sup>2</sup> APRA's mandate is to establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by APRA-regulated entities are met within a stable, efficient and competitive financial system.

The Government has passed amendments to the *Superannuation Industry (Supervision) Act 1993* (SIS Act) that provide APRA with prudential standards making power for superannuation.

APRA has had the power to issue prudential standards for authorised deposit-taking institutions (ADIs) since 2000, the general insurance industry since 2002 and the life insurance industry since 2005. Prudential standards work effectively in these industries as a flexible tool for APRA to make and adjust requirements relating to the management of risk. Prudential standards are made in consultation with the regulated industries and other stakeholders to facilitate the consideration of the costs and benefits to all parties affected by the requirements.

APRA's proposed prudential standards for RSE licensees not only implement key elements of the Government's Stronger Super reforms, but also support APRA's mission to ensure that RSE licensees act in a manner that is consistent with the best interests of superannuation beneficiaries.<sup>3</sup>

The Stronger Super reforms respond to recommendations contained in the final report of the *Review into the Governance, Efficiency, Structure and Operation of Australia's Superannuation System* (Super System Review) dated 30 June 2010. These recommendations included strengthening the governance, integrity and regulatory settings of the superannuation system for APRA-regulated superannuation funds and creating a new simple, low cost default superannuation product called 'MySuper'. The Stronger Super reforms are expected to deliver significant fee savings for members, estimated at \$1.55 billion per year in the short term, rising to \$2.7 billion per year over

<sup>1</sup> This number does not include the estimated 3201 Small APRA Funds as at 30 June 2012.

<sup>2</sup> Data sourced from APRA's *Quarterly Superannuation Performance Statistics for June 2012*.

<sup>3</sup> Refer to the Stronger Super website for further details on the reforms:  
<http://strongersuper.treasury.gov.au/content/Content.aspx?doc=home.htm>

the longer term.

Note that this Regulation Impact Statement (RIS) should be read in the context of the broader changes to the superannuation industry being implemented by the Government. The Prime Minister granted an exemption from the RIS requirements for parts of the Stronger Super legislative reforms and the Treasury prepared a RIS on the Stronger Super implementation which was assessed as adequate by the Office of Best Practice Regulation in September 2011. The RIS prepared by the Treasury covered the introduction of MySuper as well as the proposed governance changes for the superannuation industry. The proposed governance changes outlined in the Treasury RIS contemplate the creation of a distinct new office of trustee director or heightened duties for directors to attempt to address the governance problems identified by the Super System Review.

This RIS addresses only the introduction of the proposed suite of prudential standards for superannuation.

## **Problem**

### **Breadth of APRA's prudential standards for superannuation**

An effective and flexible prudential framework is core to APRA achieving its statutory responsibility to prudentially regulate RSE licensees for the benefit of members. A lack of appropriate requirements and standards can undermine APRA's ability to require adequate standards of behaviour from RSE licensees and consequently its ability to carry out its statutory responsibility.

Currently, the requirements of the SIS Act and *Superannuation Industry (Supervision) Regulations 1994* (SIS Regulations) form the basis of APRA's powers to prudentially regulate RSE licensees. APRA also issues various forms of non-binding guidance material to RSE licensees to clarify APRA's expectations on prudential matters where appropriate.

The Government has given APRA prudential standards making power for the superannuation industry and has specifically referred to APRA the making of prudential standards on four topics.

Specific provisions in the *Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Act 2012* amended the SIS Act to introduce new legislative covenants for RSE licensees. These include covenants relating to risk management and conflicts of interest, which contain specific reference to APRA's prudential standards as a means to supplement the legislative obligations. Further, the Government has repealed the former section 29H and section 29P of the SIS Act, which include core risk management requirements, on the basis that APRA will determine new prudential standards relating to risk management to house these requirements. The existing capital requirements have also been repealed from the SIS Act.

The Government has also specifically referred to APRA the making of a prudential standard to require all defined benefit funds and sub-funds be funded to vested benefit level.

These actions by the Government mean that APRA must determine at least four prudential standards (covering risk management, the operational risk financial requirement, conflicts of interest and defined benefit matters) to give effect to its mandate.

The Stronger Super reforms recognise that, for many Australians, their superannuation savings will form a significant part of their retirement income. Therefore, it is vital for members of the community to have confidence that the framework surrounding superannuation is sufficiently robust and that superannuation funds are managed prudently and deliver a comfortable and secure retirement for members.

### **Evolution in superannuation fund governance**

Compulsory superannuation was introduced in 1992, with the most recent estimates showing that

94 per cent of employees are covered by superannuation.<sup>4</sup> The introduction of RSE licensing for all superannuation funds regulated by APRA, which was successfully implemented by 2006, included substantial additional requirements for RSE licensees, including specific licence conditions relating to the governance and risk management of the RSE licensee's business operations. This strengthening of the prudential framework for RSE licensees resulted in a significant improvement of governance and risk management standards within the superannuation industry compared to the rather disparate practices that characterised the industry prior to licensing. APRA's supervision of this prudential framework has encountered continual improvement in RSE licensee governance and risk management practices between 2006 and the present day and significant inroads had been made when the Super System Review commenced in 2009.

The movement towards stronger trustee governance flowing from RSE licensing gained further momentum on the release of the final Super System Review report, which highlighted a range of governance inadequacies that persisted in the superannuation industry. As part of its supervision of superannuation funds, APRA has observed a number of RSE licensees choosing to voluntarily respond to some of the criticisms levelled at the superannuation industry by improving the governance and risk management processes.

The requirements contained in the suite of 11 prudential standards developed by APRA in response to the Super System Review report are set at a level that reflect this evolution of practices by RSE licensees. For this reason, APRA considers that many of the requirements proposed within the prudential standards are already current practice for many RSE licensees. This view was supported by a number of the submissions received during the consultation about the proposed prudential standards, which indicated that many RSE licensees already considered that they met the intent of the prudential requirements in their current process and procedures.

The prudential standards are, therefore, focused on fostering greater consistency in the standard of industry practices by setting the minimum expectations for those RSE licensees who do not already meet these standards.

### **Public policy considerations**

The introduction of prudential standards for superannuation is designed to both consolidate RSE licensees' continuing enhancement of governance standards and support regulation of the superannuation industry. The prudential standards support the achievement of the Government's public policy goals, recognising the importance of the superannuation industry to the Australian economy more broadly.

The superannuation industry has changed dramatically since the current regulatory framework was established.

Over the period from June 2002 to June 2012, total superannuation assets regulated by APRA grew from \$328.8 billion to \$918.2 billion, approximately equal to two-thirds of Australia's gross domestic product.<sup>5</sup> In June 2011, superannuation assets held by funds were almost half the size of the level of assets held by Australia's banks and other authorised deposit-taking institutions. The compulsory nature of superannuation means that by 2035, Australians are projected to have increased their collective super savings to \$6.1 trillion.<sup>6</sup>

Superannuation forms a key component of the Government's retirement incomes policy. Australia also faces the demographic challenge, like many OECD countries, of an aging population which has the potential to place significant pressure on fiscal policy settings in the future. The compulsory nature of superannuation means that the failure of the market to deliver optimal outcomes for

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<sup>4</sup> Australian Bureau of Statistics Publication 102.0 - Australian Social Trends, March 2009.

<sup>5</sup> APRA *Quarterly Superannuation Performance June 2012* and APRA *Annual Superannuation Bulletin 2011*.

<sup>6</sup> Treasury estimate.

superannuation impacts negatively on almost all superannuation fund members. In a system of mandatory retirement savings where members must be part of the system, RSE licensees and superannuation regulators have an even greater obligation to ensure that confidence in the system is maintained.

An RSE licensee accepts contributions from and on behalf of members and invests those assets in the best interests of members for the goal of providing retirement benefits to members. For superannuation members, particularly those with defined contribution benefits, there is no definitive financial end goal; members rely on RSE licensees to act in their best interests and maximise their retirement benefits. Given the long term nature of superannuation and the myriad of complex decisions RSE licensees are required to make, there are a number of risks that if not appropriately managed, can lead to the erosion of ultimate benefits paid to members. Risks relating to inappropriate investment of assets are an example of this, as is inappropriate management of operational risk or conflicts of interest.

Standards of governance within superannuation entities regulated by APRA have been continually improving over recent years. Despite this, the market alone cannot be relied upon to ensure that appropriate levels of risk management and governance continue to occur within all RSE licensees.

### **Harmonisation of prudential frameworks**

Prudentially regulated financial institutions commonly operate as part of a wider corporate group across more than one industry regulated by APRA. Such groups account for a significant proportion of the superannuation industry regulated by APRA. Non-alignment of regulatory requirements across industries can increase the cost of compliance for these groups. This has the potential to undermine the member/depositor/policyholder entitlements.

There are also examples of regulatory arbitrage where risks are not aligned across industries. This is an issue for cross-industry groups which have the ability to adjust legal structures and have access to licences across multiple industries. For example, there are currently no requirements relating to remuneration practices in the superannuation industry. APRA proposes to extend the remuneration requirements which apply to other APRA-regulated industries to the superannuation industry. The existing non-alignment of remuneration requirements provides an opportunity for regulated entities to structure remuneration arrangements in such a way as to comply with more stringent requirements in other industries but avoid compliance with the intent of the remuneration requirements across the group as a whole.

In summary, APRA's view is that, given the attention paid by RSE licensees to current guidance and recommendations made by APRA in its supervisory practice, there is an increasing standard of governance across the industry. A large number of RSE licensees already have in place processes and controls which align with the intent of the new requirements in the proposed prudential standards. The aim of the proposed prudential standards is to ensure that all RSE licensees, especially those that do not operate at the same level of governance as the majority of the industry, adopt and maintain minimum standards of governance.

## Objectives of prudential standards

APRA's stated supervisory approach is to be 'forward looking, primarily risk based, consultative, consistent and in line with international best practice'.<sup>7</sup>

In introducing prudential standards for superannuation, APRA's objectives are to:

- apply standards to all RSE licensees that are aligned appropriately with existing good standards of governance in the superannuation industry regulated by APRA, to support the implementation of the Government's Stronger Super reforms; and
- improve the alignment of requirements across the industries APRA regulates.

Prudential standards are designed to improve the clarity and certainty of prudential regulation by providing additional detail on prudential matters set out in the enabling legislation. Prudential standards are legislative instruments within the meaning of the *Legislative Instruments Act 2003*, and are therefore disallowable in the Senate, subject to scrutiny by the Standing Committee on Regulations and Ordinances and require extensive industry consultation as part of their development and ongoing revision.

The proposed prudential standards for superannuation will involve relocation of many of the operating standards for superannuation which are currently contained in the SIS Regulations.

Although APRA has developed draft prudential standards for superannuation with a view to alignment with the banking and insurance industries wherever possible, APRA has carefully considered the structure of the superannuation industry in doing so. For example, APRA is not aligning the requirements for independent directors that apply to ADIs and insurers. This is because the legal framework for superannuation set out in the SIS Act requires certain RSE licensee boards to be structured with 'equal representation' of member and employer representatives. This does not allow APRA to make the same requirements for RSE licensees as for other industries.

APRA is cognisant of developments in pensions' regulation internationally, including International Organisation of Pension Supervisors guidelines and principles of private pension supervision.<sup>8</sup> APRA has taken into account the range of requirements of pension funds worldwide and included consideration of these requirements where appropriate.

## Options

APRA must determine at least four prudential standards (covering risk management, the operational risk financial requirement, conflicts of interest and defined benefit matters) to give effect to the mandate given to it by the Government and to ensure that there are no inadvertent gaps in the regulatory framework.

The mandates provided to APRA with respect to individual prudential standards are<sup>9</sup>:

- the *Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Act 2012* sets out the requirements for RSE licensees to maintain and manage financial resources in accordance with a prudential standard to cover operational risk. APRA must, therefore, make a prudential standard relating to operational risk financial resources to ensure the Government's reforms are appropriately implemented;

<sup>7</sup> <http://www.apra.gov.au/AboutAPRA/Pages/Default.aspx>

<sup>8</sup> IOPS Principles of private pension supervision <http://www.oecd.org/site/iops/documents/40329249.pdf>

<sup>9</sup> [http://strongersuper.treasury.gov.au/content/Content.aspx?doc=publications/government\\_response/default.htm](http://strongersuper.treasury.gov.au/content/Content.aspx?doc=publications/government_response/default.htm)

- the *Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Act 2012* includes new covenants applying to RSE licensees and individual directors of RSE licensees which require priority to be given to the interest of beneficiaries in the event of a conflict. These covenants make specific reference to compliance with the prudential standards in relation to conflicts;
- the Government, in its response to recommendation 6.10 of the Super System Review, referred to APRA the need to develop a prudential standard that focuses on funding to protect vested benefits, including specifying a time period within which an RSE which is in an unsatisfactory financial position must be restored to a satisfactory financial position; and
- Stronger Super made numerous references to improving the risk management requirements for RSE licensees, including removing the requirement for RSE licensees to prepare separate Risk Management Strategies and Risk Management Plans as well as requiring that risk management plans explicitly include a liquidity management component. The Government also consulted on the proposed format for risk management changes, foreshadowing that APRA would be expected to develop a risk management prudential standard.<sup>10</sup> The previous risk management requirements located in the SIS Act were repealed on 8 September 2012.

The options covered in this RIS, therefore, are proposed on this basis.

### **Option one – Determine four prudential standards required to support the Stronger Super reforms**

Option one would involve APRA determining only the four prudential standards required for the Stronger Super reforms, rather than implementing a broad suite of prudential standards covering a wide range of prudential matters.

The legislative requirements which support the development of these four prudential standards are discussed further in the Explanatory Memorandum which accompanies *Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Act 2012*.

#### ***Operational risk financial requirement***

The Stronger Super reforms include legislative requirements relating to operational risk and the requirement for RSE licensees to hold financial resources to meet operational risk losses.

Operational risk is the risk that a superannuation fund may suffer loss due to inadequate or failed internal processes, people and systems or from external events and are a fundamental risk faced by superannuation fund members. The purpose of the operational risk financial requirement (ORFR) is to mitigate operational risks faced by fund members by requiring all RSE licensees to hold a minimum level of financial resources which can only be used to respond to losses arising from operational risks. APRA's prudential standard sets principles-based requirements for the policies and processes that an RSE licensee needs to have in order to prudently manage, monitor and review their operational risk financial resources.

Previously, public offer RSE licensees were required to hold net tangible assets of at least \$5 million, either directly, in combination with an approved guarantee or through a custodian. This requirement has been repealed from the SIS Act on the basis that it will be replaced by the operational risk financial requirement.

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<sup>10</sup> Governance Working Group - Issues Paper on Risk Management  
[http://strongersuper.treasury.gov.au/content/Content.aspx?doc=consultations/working\\_groups/governance/default.htm](http://strongersuper.treasury.gov.au/content/Content.aspx?doc=consultations/working_groups/governance/default.htm)

## ***Conflicts of interest***

The management of conflicts has been given prominence within the Stronger Super legislative reforms. The *Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Act 2012* sets out amendments to the SIS Act that require RSE licensees to comply with prudential standards developed by APRA in relation to conflicts.<sup>11</sup> The intention of APRA's prudential standard for conflicts of interest is to supplement the requirements of the legislation by requiring RSE licensees to comply with principles-based requirements set by APRA.

## ***Vested benefits***

There is a gap in the current requirements relating to the funding of defined benefit funds. Current requirements contained in the SIS Act are primarily concerned with funding to minimum requisite benefits and provides RSE licensees five years to return the fund to a position of technical solvency.<sup>12</sup> Minimum requisite benefits are the benefits provided in a defined benefit fund to meet the requirements of the *Superannuation Guarantee (Administration) Act 1992*. This amount is generally lower than the vested benefits of a member which is the liability calculated by an actuary pursuant to a formula based wholly or partly on the member's salary. Failing to fund a defined benefit fund to the level of vested benefits is referred to as an unsatisfactory financial position.<sup>13</sup> The Government has proposed that APRA issue a prudential standard that focuses on funding to protect vested benefits and specifies the time period within which a defined benefit fund that is in an unsatisfactory financial position must be restored to a satisfactory financial position, in much the same way that the SIS Regulations presently addresses insolvency of funds and minimum requisite benefits.

## ***Risk management***

The SIS Act previously required RSE licensees to develop and implement a Risk Management Strategy (RMS) and Risk Management Plan (RMP). The purpose of the RMS is to identify, manage and monitor risks in relation to all of an RSE licensee's activities. The RMP performs a similar function in relation to each individual RSE.

Legislative amendments to the SIS Act which require RSE licensees to prepare a RMP have been repealed. This simplifies compliance for RSE licensees by reducing the number of documents they are required to produce. Despite this, there are some risks which were required to be addressed in the RMP which need to be determined within the risk management prudential standard to avoid a regulatory gap in APRA's supervision of risk management.

## **Option two – Determine a suite of eleven prudential standards**

Under this option, APRA would determine 11 prudential standards applying to RSE licensees. These prudential standards can be broadly categorised as relating to: governance, risk management, investment governance and other prudential standards. Further detail about the proposed requirements in each of the prudential standards is provided in Attachment A. Note that existing operating standards in the SIS Regulations relating to fitness and propriety, outsourcing and investment governance will be repealed by the Government on determination of the prudential standards.

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<sup>11</sup> Schedule 1, item 12, subparagraph 52(2)(d)(iv).

<sup>12</sup> Refer to SIS Regulation 9.17.

<sup>13</sup> Refer to SIS Regulation 9.04.

### ***Governance-related prudential standards***<sup>14</sup>

APRA's proposals focus on minimum requirements for the processes and policies that RSE licensees should have in place as robust governance arrangements. These include a board renewal policy, a board performance assessment process, a conflicts management framework, a 'fit and proper' policy and an internal audit function.

### ***Risk management-related prudential standards***<sup>15</sup>

Effective risk management is a cornerstone of APRA's prudential requirements across all APRA-regulated industries. APRA's prudential standards include requirements relating to risk management, outsourcing, the operational risk financial requirement and business continuity management.

### ***Investment governance prudential standard***<sup>16</sup>

Managing the investments of an RSE is a core responsibility of RSE licensees. APRA's proposed prudential requirements for investment governance will require RSE licensees to document clear investment objectives for all investment options, the processes and criteria used when formulating an investment strategy, including the selection of investment managers, and the processes for monitoring investments in each investment option.

### ***Other prudential standards***<sup>17</sup>

Although the majority of superannuation funds offer accumulation benefits, some RSE licensees operate defined benefit funds. APRA therefore proposes a specific prudential standard on defined benefit funding, including requirements to raise the required funding level to the vested benefits level and introduce requirements for self-insurers and defined benefit funds in an unsatisfactory financial position.

APRA also proposes a specific prudential standard relating to insurance in superannuation, to supplement new legislative obligations relating to the provision of insurance benefits to superannuation fund members.

## **Impact analysis**

### **Assessment of costs and benefits associated with both options**

#### ***Benefits***

The benefits for RSE licensees from the introduction of prudential standards include that:

- prudential standards provide greater clarity of how the requirements of the SIS Act and SIS Regulations can be met; and

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<sup>14</sup> The governance-related prudential standards are: *Prudential Standard SPS 510 Governance (SPS 510)*, *Prudential Standard SPS 521 Conflicts of Interest (SPS 521)*, *Prudential Standard SPS 520 Fit and Proper (SPS 520)* and *Prudential Standard SPS 310 Audit and Related Matters (SPS 310)*.

<sup>15</sup> The risk management-related prudential standards are: *Prudential Standard SPS 220 Risk Management (SPS 220)*, *Prudential Standard SPS 231 Outsourcing (SPS 231)*, *Prudential Standard SPS 114 Operational Risk Financial Requirement (SPS 114)* and *Prudential Standard SPS 232 Business Continuity Management (SPS 232)*.

<sup>16</sup> Refer to *Prudential Standard SPS 530 Investment Governance (SPS 530)*.

<sup>17</sup> Refer to *Prudential Standard SPS 160 Defined Benefit Matters (SPS 160)* and *Prudential Standard SPS 250 Insurance in Superannuation (SPS 250)*.



- requirements in prudential standards can be set in a way that is flexible and principles-based which provides freedom for RSE licensees to interpret the requirements in line with the size and complexity of their business operations.

A clear, flexible and principles based framework for legislative requirements ultimately benefit superannuation fund members, as they are offered greater protection in a clear and efficient regulatory structure.

### *Costs*

The costs of the implementation by RSE licensees of the requirements contained in prudential standards will, in most cases, be ultimately borne by members of RSEs in the form of higher fees and/or lower investment returns. Overall, it is not clear how large this cost will be because the Stronger Super reforms are creating an environment with more transparency and comparability of fees and costs, and this competition may lower fees.

There are many drivers of costs in superannuation funds, including the size of the RSE, the type of investment structure chosen by the RSE licensee, the complexity of the RSE and the resultant need for additional resources, and advice such as legal, investment and compliance. Competition is also an important driver of fees charged to cover costs in the superannuation industry. With an increasing focus on comparable costs and fees with the introduction of MySuper, this is likely to place downward pressure on fees borne by members.

Costs for RSE licensees of complying with prudential standards arise from different sources. They can include:

- updating or setting new policies, processes or systems;
- training of directors, responsible persons or other staff members to comply with new requirements;
- costs of engaging external parties to meet the new requirements such as the additional scope of external audit and the additional actuarial valuations that may be required within the defined benefit prudential standard; and
- costs associated with retaining external parties to assist compliance, especially where the RSE licensee's business operations are small or wholly outsourced.

Principles-based requirements mean that costs incurred tend to align with the size and complexity of the RSE licensee; APRA's expectations of how RSE licensees will meet the requirements of the prudential standards will, therefore, vary. For this reason, the costs of implementing the prudential standards are not quantified in this RIS.

### **Assessment of costs and benefits associated with option one – Determine four prudential standards required to support the Stronger Super reforms**

#### *Benefits*

APRA considers that benefits would flow to the industry, superannuation fund members, APRA and the Government under option one.

The benefits of producing only the prudential standards strictly required by the SIS Act and SIS Regulations are that new obligations for RSE licensees are minimised. This means that the cost of complying would be less than if the proposed full suite of prudential standards were introduced.

The four prudential standards outlined in option one focus on several important risk areas – holistic risk management, the risk that members will suffer financial losses because of operational risk events, the risk that members of defined benefit funds will not be paid their full benefits on retirement and the risk that decisions made by an RSE licensee might be affected by interests that conflict with the interests of beneficiaries.

### **Costs**

The majority of the costs in both options can be classified as compliance related costs that are associated with RSE licensees assessing their operations against the requirements of the prudential standards and undertaking changes to comply where necessary. The costs related to the ORFR prudential standard differ from compliance costs in that it requires financial resources to be held by the RSE licensee.

APRA sought information from interested parties on the impact of the proposed changes and specifically any marginal compliance costs that APRA regulated entities are likely to face. This included requesting that respondents use the OBPR's Business Cost Calculator. Overall, whilst the respondents acknowledged that the introduction of prudential standards will have a cost impact, they did not attempt to specify what these costs might be, other than one entity which provided an estimate of costs in relation to two governance proposals, which APRA is no longer pursuing. Further, the feedback indicated that there remains general support for the prudential standards.<sup>18</sup>

The prudential standards contain a number of core characteristics that will result in specific compliance costs for RSE licensees. Any reform that results in costs for an RSE licensee is likely to see those costs passed onto members in the form of higher fees. The costs of implementing just the prudential standards outlined in option one are less than would arise if APRA implemented the whole suite of 11 prudential standards. It should be noted, however, that the increase in cost from option one to option two is not linear as there will be efficiencies gained by applying the risk management framework across the whole business operations and the conflicts framework would support broader governance frameworks. In addition, there would be further efficiencies in meeting the new requirements as RSE licensees would undertake the same types of review and gap analysis across all of the standards at the same time.

### *Prudential Standard SPS 114 Operational Risk Financial Requirement*

The requirements of SPS 114 for RSE licensees to establish and maintain a risk based amount of financial resources for operational risk are new requirements and additional costs as a consequence of these requirements are inevitable. Some funds will already have reserves in place for the purpose of mitigating operational risks faced by the RSE licensee and RSE however the requirements of SPS 114 will restrict the use of reserves to defined circumstances as well as require replenishment of any reserves used within a reasonable period of time. A clear benefit to members is that financial resources will be available to minimise the risk that members interests are reduced by an operational risk loss.

The costs of implementing the requirements of SPS 114 are variable as the regulatory settings allow RSE licensees flexibility as to how they will fund and ultimately hold this amount of financial

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<sup>18</sup> Refer to <http://www.apra.gov.au/Super/Pages/Submissions-Prudential-Standards-for-Superannuation-April-2012.aspx> for the non-confidential submissions on the draft prudential standards.

resources. Further, the costs associated with meeting the new requirement will depend on whether the RSE already retains reserves within the fund that might be apportioned for this purpose.

One scenario might be where an RSE licensee does not have existing reserves and chooses to fund the ORFR using a reduction in members' investment returns. APRA has indicated publicly that a prudent RSE licensee would maintain an ORFR target amount that represents 0.25 per cent of funds under management; SPS 114 requires the RSE licensee to have these financial resources in place within three years of the commencement of the provisions. This results in an indicative cost of implementing the ORFR for this fund would be approximately 0.083 per cent of FUM each year over the three years.

The range of business structures in the superannuation industry allows a number of ways to meet this cost:

- where an RSE licensee has access to capital (either held directly or via a parent company), capital may be allocated for the purposes of meeting the ORFR; and
- where an RSE licensee does not have access to capital, the resources will have to be drawn from the assets of the fund. This could take the form of an increased administration fee charged to members or a reduction in the net investment return to members.

#### *Prudential Standard SPS 220 Risk Management*

SPS 220 is unlikely to result in anything more than minor additional costs for RSE licensees because there are only minor changes from existing obligations. For the most part it is only the location of the requirements which has changed from the SIS Act to SPS 220.

There will be some increased cost as the requirement for RSE licensees to maintain a risk appetite statement and a risk management function are new requirements. Implementation of the risk appetite statement will involve the development of policies and governance of the newly developed policies. The requirement to have a risk management function has been developed with the diverse nature of the superannuation industry in mind and it is permissible for RSE licensees to draw on existing resources to meet this requirement, rather than necessarily hire additional resources.

Other areas that may involve minor increases in costs include the definition of material risks, requirements to submit an annual risk management declaration to APRA and the requirement to notify APRA of certain scenarios related to risk management. These are not completely new requirements but expand on requirements currently in the SIS Regulations, APRA's reporting framework and within breach reporting requirements contained in the SIS Act.

Further requirements contained in SPS 220 include requirements for risk management policies, procedures and controls as well as clearly defined roles and responsibilities, formal reporting structures for the management of material risks and strategic business planning requirements. Whilst these requirements are new, they are common practice within the industry and have been part of APRA's ongoing recommendations to RSE licensees as part of prudential reviews for some time.

#### *Prudential Standard SPS 160 Defined Benefit Matters*

SPS 160 will result in additional funding costs for employers with defined benefit funds as it requires an RSE licensee to act earlier to fund shortfalls and to fund to a higher minimum level than in the past. There are many defined benefit funds which manage this risk actively by maintaining funding at vested benefit level or higher, and having in place early warning systems which mean the

RSE licensee responds quickly in the event solvency of the fund slips. The costs of funding defined benefits are primarily met by employers, therefore the costs to the industry and members are low as they are limited to the costs of implementing the requirements of SPS 160 such as developing policies, monitoring and review and seeking actuarial advice. SPS 160 introduces new requirements which will support the RSE licensee being able to pay defined benefits as they fall due.

The costs of SPS 160 will only be borne by defined benefit funds and therefore are not costs which will be incurred by all RSE licensees. Defined benefit assets make up approximately \$158 million, or 18% of the assets of RSE licensees with more than four members.<sup>19</sup>

The potentially significant costs of the requirements of SPS 160 are:

- requirements for regular and interim actuarial valuations (this requirement is new in part only);
- application of the requirements of SPS 160 to sub-funds as well as RSEs (noting that this generally already industry practice)
- potential costs of a formal restoration plan;
- potential costs of an actuarial investigation being required by APRA;
- cost of reporting to APRA;
- monitoring and review costs; and
- costs relating to monitoring self insurance arrangements.

#### *Prudential Standard SPS 521 Conflicts of interest*

It is currently common practice for RSE licensees to have conflicts frameworks in place to manage compliance with the duty to act in the best interest of members which is outlined in section 52(2)(d) of the SIS Act. However, new legislative obligations encourage greater robustness in these frameworks. The costs of preparing and disclosing the registers are new, but are unlikely to be significant because the RSE licensee can leverage off existing disclosure mechanisms e.g. the website or other existing means. It would generally be expected that the RSE licensee is best placed to prepare a conflicts register hence the costs of implementing this requirement is limited to the RSE licensee's time rather than the costs of external resources.

#### **Assessment of costs and benefits associated with option two – Determine a suite of eleven prudential standards**

Option two involves APRA producing a suite of prudential standards which both addresses the legislative changes that APRA is required to support as well as producing prudential standards that align with those already in place for the other industries regulated by APRA.

#### ***Benefits***

The Stronger Super reforms are intended to enhance the governance and efficiency of the superannuation system. The benefits of producing an additional seven prudential standards are that they will support APRA's ability to enforce appropriate standards for RSE licensees more broadly, which assists the implementation of the entire suite of Stronger Super reforms, including the focus on governance of RSE licensees.

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<sup>19</sup> APRA Annual Superannuation Bulletin June 2011.

The introduction of the seven additional prudential standards will support RSE licensees maintaining standards of governance and oversight that are more closely aligned with both APRA's views and better practice across the industry. The standards will also have the effect of requiring those RSE licensees with sub-optimal governance arrangements to improve their practices so as to meet the accepted practices of the superannuation industry.

APRA considers that each of the seven additional prudential standards will result in incremental improvements in practice across much of the superannuation industry. For example, SPS 520 includes new requirements for RSE licensees to identify its responsible persons for the purpose of assessing each of these persons against the fit and proper criteria. Whilst this has previously been strongly recommended by APRA in guidance material and generally adopted as good practice by many RSE licensees, making these steps mandatory in SPS 520 will ensure that *all* RSE licensees undertake this assessment. This will result in greater confidence that responsible persons in the superannuation industry are, and remain, fit and proper.

A further example of the incremental benefits flowing from requirements in the seven additional prudential standards comes from SPS 530, which requires RSE licensees to develop and implement a due diligence process for the selection of investments. Again, a large number of RSE licensees have adopted this practice as being reasonable business practice; making this a mandatory obligation in the prudential standard, however, will ensure that this practice is adopted by all RSE licensees.

Producing the seven additional prudential standards for RSE licensees aligns the prudential framework for superannuation with the frameworks of other APRA-regulated industries, wherever this is practicable. The alignment of requirements across industries regulated by APRA assists by simplifying the prudential framework thereby making compliance with the requirements for groups which operate more than one APRA regulated institution simpler to understand and less costly. Many of the governance frameworks which are already in place for other regulated entities within a group can be readily replicated by RSE licensees. In many cases entities that are already part of a group may already meet the requirements APRA is proposing within the seven additional prudential standards.

APRA's role includes the enforcement of compliance with much of the SIS Act and SIS Regulations. Making prudential standards on a broad range of matters as is included in the suite of 11 prudential standards provides APRA with a clear and legally enforceable tool to support high standards of governance and operations of RSE licensees in a flexible and principles based environment. This also assists entities to comply with the SIS Act and SIS Regulations within a framework that takes into account the diverse structure of the superannuation industry regulated by APRA.

The introduction of only some prudential standards would not align with APRA's approach in the other industries regulated by APRA. The introduction of the seven additional prudential standards which harmonise the requirements for RSE licensees with the other APRA-regulated industries reduces the chances of regulatory arbitrage within groups.

The alternative to the determination of prudential standards would be for the prudential requirements to be contained in the operating standards of the SIS Regulations. APRA considers that regulating using prudential standards has an inherent flexibility when compared with regulating by operating standards. RSE licensees operate in a dynamic environment where change in response to factors both within the RSE licensee and the external environment is an ongoing feature. Prudential standards are a more appropriate in such an environment as minimum standards in the face of new risks faced by RSE licensees can be readily implemented. This is because, in part, amendments to prudential standards, whilst subject to adequate Parliamentary oversight, can be

changed without having to rely on the machinery of Government. The amended provisions are also drafted by APRA, drawing on its proximity with the industry to ensure that requirements are expressed in a way that reflects industry norms and language.

Prudential standards can be drafted in a principles-based manner which makes allowances for the diversity of RSE licensees, rather than applying a one-size-fits-all approach. This is important because APRA regulates a diverse range of RSE licensees which vary widely in size and complexity.

### *Costs*

The analysis of the costs of option two are focussed on the incremental costs of this option compared to option one, as the costs of option one are unavoidable. Principles based requirements mean that costs incurred will be aligned with the size and complexity of the RSE licensee. This makes the costs of implementing the prudential standards very difficult to quantify as the RSE licensees APRA regulates are diverse and APRA takes a flexible approach to regulation. For example, SPS 510 has a requirement to have a dedicated internal audit function. This would be met by many large RSE licensees already, by internal staff or by outsourcing this function to an audit firm. However some small RSE licensees may not have this specific role at this stage, but the function could be absorbed by an existing resource of the RSE licensee at minimal cost.

All of the prudential standards expressly permit the use of group policies where RSE licensees are part of a corporate group, reducing the cost of implementing the prudential standards for these entities.

### *Moderate costs associated with introducing prudential standards*

Requirements considered to be ‘moderate costs’ are classified as such for one of several reasons. This is because requirements have not existed within the legislative framework in the past, APRA has not issued guidance on the matter or made the recommendations on the matter as part of the regular review process or they are not considered to be common practice within the superannuation industry.

A number of other requirements of the prudential standards have been issued in the past as guidance to RSE licensees. This has taken the form of circulars, guidance notes or prudential practice guides and some of the content of this guidance has been incorporated into binding requirements of the prudential standards. In other cases the material contained in the prudential standards has been part of standard recommendations to RSE licensees issued as part of APRA’s supervision process and over time have become current practice within the superannuation industry. Although these requirements may be relatively costly to implement APRA considers that the majority of RSE licensees would already meet the requirements at least in part and therefore very little additional cost would likely be incurred by an RSE licensee.

In other cases, a requirement is new but is being introduced with a high degree of flexibility so that the resources required from the RSE licensee to meet the requirement are relatively low.

An overview of new requirements where the potential cost is considered to be moderate includes requirements:

- (a) to have in place a Board Audit Committee and Board Remuneration Committee including specifying that only directors of the RSE licensee may sit on such Boards and that they must have a minimum of three directors on the Committees (option two only);

- (b) to have a dedicated internal audit function within the governance prudential standard (option two only);
- (c) to have a business continuity management policy and a business continuity plan which is regularly reviewed and tested;
- (d) to conduct business impact analysis of critical business activities of the RSE licensee;
- (e) to put in place an insurance management framework which includes systems, structures, policies, processes and people to manage member insurance. This framework includes minimum features outlined in the prudential standard and at least some of these features would already exist for the majority of RSE licensees;
- (f) to develop and implement a selection process for appointing an insurer;
- (g) which extend the scope of the external audit of RSEs beyond what was previously contained in the audit report;
- (h) to set a remuneration policy within the governance prudential standard which aligns risk management and remuneration and incorporates performance based remuneration. The remuneration policy must allow for performance based remuneration to be adjusted downwards, to zero if appropriate, to protect the interests of beneficiaries;
- (i) when determining an appropriate level of diversification for an investment strategy, identify and analyse risk factors and sources of return with which risk factors are associated;
- (j) to undertake stress testing of investments covering a range of factors that can create extraordinary losses or make control of risk in the investment strategy difficult; and
- (k) to put in place a liquidity management plan that covers all of the RSE's investment strategies.

*Low costs associated with introducing prudential standards*

Requirements which are low cost are those which require minimal resources to implement and could readily be met by minor changes, checks or review by RSE licensees. Other low costs requirements are those which reflect standard practice by the vast majority of RSE licensees already. Other requirements which are considered low cost are requirements which are being transferred from the operating standards within the SIS Regulations to the prudential standards.

Many of the requirements of the prudential standards are not new but are based on requirements which were previously set out in the SIS Act and SIS Regulations such as most of the requirements of the SPS 231 and SPS 520.

An overview of new requirements where the potential cost is considered to be low includes requirements:

- (a) to develop an outsourcing policy and requirements which expand on the previous definition of material business activity;
- (b) to conduct a detailed assessment of outsourcing options including the reason for outsourcing, tender and selection processes and undertaking due diligence reviews;
- (c) which expand on previous requirements that outline the matters which must be addressed within outsourcing agreements;

- (d) to have in place a fit and proper policy including an expansion of the definition of responsible person to whom the fit and proper policy applies; and
- (e) which expand on previous fit and proper requirements to include the approved auditor and actuary.

## Consultation

APRA's implementation of the Stronger Super reforms referred to it by the Government commenced in early 2011, including the development of draft prudential standards. APRA has undertaken a wide range of consultative activities since the beginning of 2011 to ensure that relevant stakeholders are afforded a range of opportunities to provide feedback on APRA's proposals. The consultative activities that APRA has undertaken include:

- release of discussion paper 'Prudential standards for superannuation' in September 2011 for a 3-month consultation period – <http://www.apra.gov.au/Super/Pages/superannuation-prudential-standards-consultation.aspx>. This discussion paper outlined the main areas proposed to be addressed in each prudential standard. APRA received 41 submissions on this discussion paper;
- release of eleven draft prudential standards and a response to submissions paper in April 2012 for a 3-month consultation period – <http://www.apra.gov.au/Super/Pages/Prudential-Standards-for-Superannuation-April-2012.aspx>. The draft standards released at this time incorporated feedback received on the September 2011 paper. The response to submissions paper provided further information about the content of the prudential standards and responded to significant issues raised during the previous period of consultation. APRA received 38 submissions on the draft prudential standards and has published the non-confidential submissions on the APRA website – <http://www.apra.gov.au/Super/Pages/Submissions-Prudential-Standards-for-Superannuation-April-2012.aspx>;
- public seminars in major capital cities in October/November 2011 and May/June 2012 to present the proposed prudential requirements and to discuss the practical application of the reforms;
- attendance at a range of industry conferences to present on details of the prudential standards; and
- meetings with individual RSE licensees, industry representative bodies, other regulatory agencies and other interested stakeholders on an ongoing basis to discuss specific details of the reforms, including APRA's implementation expectations.

All submissions to both the September discussion paper and the April response to submissions paper were supportive of APRA being given prudential standards-making powers in the SIS Act. Overall, the submissions were supportive of APRA's principles-based approach as being flexible so that RSE licensees can meet the requirements in a way that is suitable to the size, business mix and complexity of their business operations.

The feedback received was supportive of the suite of 11 prudential standards proposed by APRA, and several submissions specifically indicated support for the appropriateness of introducing prudential standards on topics beyond the four required by the Government.

The content of the final prudential standards has been modified to respond to the feedback received through the above processes. Most of the modifications have been minor wording changes to assist with clarity. Substantive feedback was received on the defined benefit and insurance prudential standards and APRA has made significant changes to these prudential standards as a result of this



feedback. Feedback suggested there were technical issues with valuation and timing of actuarial reports in SPS 160 that needed to be taken into consideration. APRA has incorporated this feedback into the final prudential standard. Also, APRA has moved from a prescriptive approach in SPS 250, which did not allow general insurers to provide income protection insurance within superannuation, to a more principles-based approach that focuses on adequate due diligence when selecting an insurer and identification and monitoring of risks associated with insurers. Submissions to both consultations were received from a variety of organisations which will be impacted by the prudential standards including RSE licensees, industry bodies, professional bodies and service providers and consulting firms.

## **Conclusion and recommended option**

The Government has introduced amendments to the SIS Act that provide APRA with prudential standards making power for superannuation.

APRA proposes to implement a suite of 11 prudential standards for superannuation. The introduction of these prudential standards for superannuation will implement the Government's Stronger Super reforms that require four prudential standards, as well as align current requirements for RSE licensees with those that are in place for the banking, life insurance and general insurance industries regulated by APRA.

The introduction of prudential standards for superannuation is aimed at improving the governance standards of a relative minority of RSE licensees. The standards of governance and compliance demonstrated by RSE licensees have improved significantly over the past few years, but there is still some capacity to make incremental improvements within many RSE licensee business operations. There are also a small number of RSE licensees that do not currently have in place governance arrangements that APRA considers to be good practice.

APRA's view is that the requirements of the 11 prudential standards will allow APRA to establish and enforce standards within superannuation entities it regulates that will support the management of risks which are ultimately borne by superannuation fund members.

There will be some costs involved in implementing the new requirements within the prudential standards, focused primarily on those associated with reviewing existing policies, undertaking gap analyses of existing processes against the new requirements and allocating the necessary financial resources to fund the ORFR.

Given that APRA has a well-established approach to supervising the superannuation industry, as well as the demonstrated governance improvements by many RSE licensees since RSE licensing, the benefits to members flowing from the seven additional prudential standards are likely to be incremental in nature. Other expected benefits for regulated entities and for APRA's supervisory approach include a reduction of regulatory arbitrage in conglomerate groups arising from the alignment of prudential requirements applying to all APRA-regulated industries.

APRA has consulted extensively on the proposed prudential standards, taken feedback on the draft prudential standards seriously and implemented some significant changes as a result of feedback as well as a large number of minor amendments.

## **Implementation and review**

APRA intends to release the final prudential standards in November 2012, well in advance of the effective date of 1 July 2013 to assist the superannuation industry in meeting the new requirements. The final prudential standards will be supported by non-binding prudential practice guides. APRA proposes to release draft prudential practice guides in two tranches. The first tranche will be released in December 2012 for consultation, and will take effect on publication (expected to be June 2013). The second tranche of prudential practice guides will be released for consultation in early

2013.

If RSE licensees are unable to implement changes to their current business operations or existing arrangements to successfully implement the requirements of the prudential standards by 1 July 2013, APRA will consider transitional arrangements on a case-by-case basis. In addition, APRA has the ability to modify particular provisions in the prudential standards if they result in inappropriate outcomes for a particular RSE licensee's business operations.

The prudential standards will be reviewed after their implementation and on an ongoing basis to ensure they continue to reflect good practice and remain relevant and effective, for both APRA's prudential supervision purposes and for regulated institutions. APRA anticipates:

- that an internal working group during the implementation phase will consider issues raised in the practical application of the prudential standards at the time they become effective, as well as during any relevant transition periods for the prudential standards;
- involvement of specialist areas of APRA including risk teams specialising in particular areas as relevant to the prudential standards, legal services and industry technical services. This will involve examining and interpreting specific issues as they arise over time; and
- a point in time review of the effectiveness and appropriateness of the entire suite of prudential standards 3-4 years after they commence. This will be supported by evidence flowing from the associated data collection which APRA proposes to implement in 2013.

## **Attachment A: Proposed prudential standards – detailed requirements**

### **Prudential Standard SPS 114 Operational Risk Financial Requirement**

RSE licensees and their RSEs are exposed to a number of operational risks. Whilst a robust risk management framework enables an RSE licensee to identify, mitigate and monitor risks, it cannot entirely eliminate operational risk.

The core requirement in SPS 114 is that an RSE licensee must meet an operational risk financial requirement (ORFR), which is the target amount of financial resources that the RSE licensee determines to be necessary to address potential operational risk losses in its business operations.

SPS 114 requires an RSE licensee to:

- hold the financial resources required to meet the ORFR as an operational risk reserve(s) in the fund and/or operational risk trustee capital;
- develop and implement a strategy that sets out its approach to implementing, managing and maintaining the ORFR, and suitable policies and procedures to manage the financial resources held to meet the ORFR;
- determine a tolerance limit below the ORFR that, if financial resources held to meet the ORFR were to breach this limit, would require the RSE licensee to notify APRA and implement a replenishment plan; and
- ensure that the financial resources held to meet the ORFR are only used for operational risk events.

### **Prudential Standard SPS 160 Defined Benefit Matters**

Employer-sponsors of defined benefit funds generally bear the investment risk of beneficiaries. Nevertheless, prudential oversight of defined benefit funds is important because the RSE licensee must pay the benefits prescribed in the trust deed.

SPS 160 applies to both defined benefit funds and defined benefit sub-funds and requires RSE licensees to:

- arrange for the conduct and reporting of actuarial investigations into the accrued benefits and financial position of a fund or sub-fund;
- devise and institute a program to restore a fund or sub-fund to a satisfactory financial position where the fund or sub-fund is in an unsatisfactory financial position, and submit the program, and report, to APRA; and
- if the fund or sub-fund self-insures insurance benefits, comply with specific assessment and attestation requirements and hold a reserve to fund self-insurance liabilities.

### **Prudential Standard SPS 220 Risk Management**

Robust risk management is a key element of APRA's prudential requirements. An effective risk management framework allows RSE licensees to have sound oversight of the entirety of their business operations.

It is essential that an RSE licensee has robust systems for identifying, assessing, managing, mitigating and monitoring all material risks that may affect its ability to meet the reasonable expectations of beneficiaries and to maintain a sound financial position. These systems, together with the structures, policies, processes and people supporting them, comprise a risk management framework.

SPS 220 requires an RSE licensee to create and maintain:

- a risk management framework that is appropriate to the size, business mix and complexity of the RSE licensee's business operations and enables it to implement risk management approaches that appropriately manage different types of risk;
- a board-approved risk appetite statement and a designated risk management function (or role) that has responsibility for assisting the development of the risk management framework; and
- a board-approved risk management strategy that describes the key elements of the risk management framework.

Under SPS 220, the risk management framework will be subject to a regular, effective and comprehensive review and compliance audit. An RSE licensee will also be required to submit an annual risk management declaration to APRA and must notify APRA of material breaches or deviations from the risk management framework.

### **Prudential Standard SPS 231 Outsourcing**

The superannuation industry relies heavily on outsourcing. Many core functions are often outsourced, including administration, custody, investment management and other support functions (such as secretariat and information technology). Although outsourcing is appropriate in superannuation, it is critical that governance over these arrangements is sound. All outsourcing arrangements involving material business activities must be subject to appropriate due diligence, approval and ongoing monitoring.

Effective outsourcing requirements support RSE licensees to give sound consideration to the entirety of their outsourcing arrangements, including that there is a business case for outsourcing and that the arrangements are supported by legally binding agreements. Even where an RSE licensee outsources some or all of its material business activities, an RSE licensee remains responsible at all times for all of its functions.

SPS 231 requires an RSE licensee to:

- develop and maintain a policy, approved by the board, relating to the outsourcing of material business activities;
- have sufficient monitoring processes in place to manage the outsourcing of material business activities;
- have legally binding agreements in place for all outsourcing of material business activities;
- consult with APRA prior to entering into agreements to outsource material business activities to service providers that conduct their activities outside Australia; and
- notify APRA after entering into agreements to outsource material business activities.

## **Prudential Standard SPS 232 Business Continuity Management**

Business continuity management is an important component of a risk management framework and is essential to support an RSE licensee in meeting its obligations to its beneficiaries and other stakeholders.

A robust approach to business continuity management increases resilience to business disruption arising from internal and external events. Business continuity management may also reduce the material consequences of a business disruption on an RSE licensee's business operations, and ultimately the interests of beneficiaries of RSEs in those operations. SPS 232 is designed to support an RSE licensee implementing a whole-of business approach for the maintenance or recovery of critical business activities.

Some of the key requirements of SPS 232 will require an RSE licensee to:

- identify, assess, manage, mitigate and report on potential business continuity risks such that the RSE licensee continues to meet its obligations to beneficiaries and other stakeholders;
- develop and implement a board-approved business continuity management policy, develop a business continuity plan that documents procedures and information to manage business disruptions and ensure that these are reviewed on an annual basis; and
- notify APRA in the event of certain business disruptions.

## **Prudential Standard SPS 250 Insurance in Superannuation**

The Government's reforms have placed a new emphasis on the role that insurance plays in the retirement outcomes of beneficiaries. APRA's proposals about the management of insurance in superannuation are designed primarily to support the new legislative requirements to offer insured benefits to, or acquire insurance for the benefit of, beneficiaries.

SPS 250 sets out requirements to inform how RSE licensees might structure their frameworks and processes to manage insurance acquired for the benefit of beneficiaries. Such offerings must be carefully considered and reviewed by RSE licensees and deemed to be an appropriate offering for the beneficiaries of the RSE.

SPS 250 will require an RSE licensee to, at a minimum:

- develop and implement an insurance management framework that reflects the risks associated with offering insured benefits, and acquiring insurance, and is appropriate to the size, business mix and complexity of its business operations;
- develop and implement a board-approved insurance strategy for offering insured benefits to, or acquiring insurance for the benefit of, beneficiaries;
- undertake appropriate selection processes for insurers, due diligence of selected insurers and ongoing monitoring of these insurers; and
- only enter into insurance policies that adequately address the minimum requirements for such policies.

## **Prudential Standard SPS 310 Audit and Related Matters**

The external audit of an RSE provides support for effective governance of the entirety of an RSE licensee's business operations and can contribute to a reduction in the risk that the reasonable expectations of beneficiaries might not be met.

SPS 310 is designed to govern the arrangements an RSE licensee must have in place to ensure that the board and senior management are provided with independent audit advice in relation to the operations, financial position and risk controls of the RSE licensee and all RSEs within its business operations. This advice assists the board and senior management in carrying out their responsibility for the sound and prudent management of the RSE licensee and all RSEs.

SPS 310 will require an RSE licensee to make arrangements to enable its approved auditor to fulfil its role and responsibilities, including facilitating the auditor's report and assessments for the appointment and fitness and propriety of the auditor. SPS 310 also outlines the role and responsibilities of the approved auditor pertaining to the scope of the audit, reporting obligations and special purpose engagements.

## **Prudential Standard SPS 510 Governance**

A culture that promotes good governance benefits all stakeholders of an RSE licensee and helps to maintain public confidence in the entity. It is therefore essential that an RSE licensee has a sound governance framework and conducts its affairs with a high degree of integrity. Effective governance arrangements also assist RSE licensees and their individual directors or trustees to satisfy their legal obligations in a manner that meets the reasonable expectations of beneficiaries.

An RSE licensee is ultimately responsible for the sound management of each RSE within its business operations and for discharging its duties to act in the best interests of beneficiaries. The focus of APRA's governance requirements is how RSE licensees govern themselves to ensure that they conduct their affairs with a high degree of integrity and in a way that reflects the size, business mix and complexity of the entirety of their business operations. A framework that promotes good governance serves to protect the interests of beneficiaries and helps to maintain public confidence in a transparent and accountable superannuation industry.

Some of the key requirements of SPS 510 require an RSE licensee to:

- ensure that the chairperson of each board committee that has responsibility for activities related to prudential matters is a director of the RSE licensee;
- develop and implement a policy on board renewal and procedures for regular assessment of board performance;
- have a remuneration policy that aligns remuneration and risk management and that covers all responsible persons of the RSE licensee excluding approved auditors and actuaries;
- have a Board Remuneration Committee and a Board Audit Committee each of which is comprised of only non-executive directors; and
- have an internal audit function that can either be operated in-house or provided by an outsourced service provider.

## **Prudential Standard SPS 520 Fit and Proper**

Persons who are responsible for the management and oversight of an RSE licensee's business operations need to have appropriate skills, experience and knowledge, and act with honesty and integrity. To this end, RSE licensees need to prudently manage the risk that persons in positions of responsibility might be incompetent or dishonest.

An RSE licensee must ensure that its board or individual trustees, as well as responsible persons throughout the RSE licensee, are fit and proper both on appointment and on an ongoing basis. The requirements in SPS 520 oblige the RSE licensee to develop a robust framework to ensure its responsible persons are fit and proper.

SPS 520 requires an RSE licensee to have and implement:

- a fit and proper policy with certain minimum features;
- a process for assessing the fitness and propriety of each responsible person of the RSE licensee; and
- a process for dealing with any responsible persons who are found to be not fit and proper.

SPS 520 also outlines criteria for determining whether a person is fit and proper for the purposes of both the standard and the SIS Act, with additional criteria identified for auditors and actuaries. Finally, it proposes reporting obligations of the RSE licensee and provisions for the protection of whistleblowers.

## **Prudential Standard SPS 521 Conflicts of Interest**

Managing conflicts of interests and duties is a key element in RSE licensees complying with their overarching legislative obligation to act in the best interests of beneficiaries.

SPS 521 focuses on how an RSE licensee should develop appropriate processes to identify and manage conflicts of interests and duties that may interfere with the RSE licensee's decision-making and activities.

A key legislative reform of Stronger Super is the introduction of new requirements applying to all RSE licensees and all directors of RSE licensees. These prioritise beneficiaries' interests where conflicts exist. A robust conflicts management framework should be appropriate to the size, business mix and complexity of an RSE licensee's operations. The minimum requirements for a framework are set out in SPS 521, which supplements the new and amended covenants in Part 6 of the SIS Act. An RSE licensee will be required to develop and implement a board-approved conflicts management framework covering the RSE licensee's business operations

Some of the other key requirements of SPS 521 require an RSE licensee to:

- develop and implement a conflicts management policy that is approved by the board; and
- develop and maintain up-to-date registers of relevant interests and relevant duties.

## **Prudential Standard SPS 530 Investment Governance**

Strong governance of investments is critical for an RSE licensee to be able to meet the reasonable expectations of beneficiaries of their RSEs in relation to retirement outcomes

The focus of the investment governance proposals in the September discussion paper was on the arrangements that RSE licensees have in place to support the appropriate selection, management and ongoing monitoring of their investments. Central to SPS 530 is a requirement to set investment objectives for each investment option offered by RSE licensees.

SPS 530 requires an RSE licensee to:

- develop and implement an investment governance framework for the management of investments to meet the reasonable expectations of beneficiaries;
- formulate specific and measurable risk and return objectives for each investment option;
- demonstrate how it is complying with the specific requirements relating to investments in the SIS Act, including to formulate and give effect to an investment strategy for each investment option. An RSE licensee will also be required to monitor and review these strategies on an ongoing basis;
- formulate a liquidity management plan;
- determine an appropriate level of diversification for each investment strategy to demonstrate compliance with the SIS Act requirements relating to diversification; and
- develop and implement an effective due diligence process for the selection of investments.