

# AFTERSHOCKS!

THE SUPERANNUATION COMMITTEE OF THE LEGAL PRACTICE SECTION OF THE LAW COUNCIL OF AUSTRALIA



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## Trustee Resilience

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# The 'R' word: Resilience

the capacity to recover quickly from difficulties; toughness.

the quality of a person exposed to high risk factors that often lead to delinquent behaviour, but they do not do so.

the ability of a substance or object to spring back into shape; elasticity.

*"the often remarkable resilience of so many British institutions"*

# The other 'R' word: Risk and Superannuation

*Operational risk –  
ORFR Reserve SPS114  
and Trustee ORFR  
Strategy*

*Defined Benefits  
(market risk,  
assumption risk) -  
SPS160 and  
DB Funding Policy*

*Insurance risk -  
SPS250, SPS160 and  
Trustee's Insurance  
Management  
Framework*

*Change (IT, regulatory)  
risk – General  
Reserving Policy*

*Working capital –  
Trustee Working Capital  
/ Dividend Policy*

*Liquidity risk - Liquidity  
Management Policy*

# 'Strengthening Financial Resilience in Superannuation'

## APRA's 2021 Discussion Paper

### Focused on trustee financial resilience

- Emphasises role of 'prudent RSE licensee' and context of 'increasing complexity of its business operations'
- Does not discuss regulators, and their role
- Does not explore reasons for that complexity

### A little late to the party?

- DP published 19 November 2021, responses due 11 March 2022
- But SIS Act Amendments due to commence 1 January 2022

### Could have been clearer

- Blurs fund assets and RSE licensee's assets and resources
- Fee setting discussion assumes only ever a fee *power* not a *right*
- Appears to assume applicability of RSE licensee's statutory obligations eg s 52(2)(c) SIS Act to activities undertaken by that trustee in its personal capacity

# Capital: What and Why?

## Treasury Secretary Tim Geithner, House Financial Services Committee (2009)

“Capital sets the amount of risk you can take overall. Capital assures you have big enough cushions to absorb extreme shocks. You want capital requirements to be designed so that, given how uncertain we are about the future of the world, given how much ignorance we fundamentally have about some elements of risk, that there is a much greater cushion to absorb loss and to save us from the consequences of mistakes in judgment and uncertainty in the world.”

## APRA’s ADI requirements: APS110 - Capital Adequacy (2016), [8]

“Capital is the cornerstone of an ADI’s financial strength. It supports an ADI’s operations by providing a buffer to absorb unanticipated losses from its activities and, in the event of problems, enables the ADI to continue to operate in a sound and viable manner while the problems are addressed or resolved.”

# Capital: How Much? This much (and not less)

Pablo Hernandez de Cos, Chairman, Basel Committee

Why mandate a capital buffer? “First, it gives bank’s flexibility to absorb buffers in times of stress, thus enhancing their resilience. Second, it mitigates negative macroprudential externalities (eg fire sales or deleveraging). And third, it prevents imprudent depletion of capital resources, by setting constraints on the amount of capital distributions.”

APRA’s ADI requirements: APS110 - Capital Adequacy (2016)

If a bank’s CET1 capital ratio falls below its buffer requirements, there is an expectation that it will only be for a limited period and it will put in place capital management actions to increase its capital ratios to ensure that it is ‘unquestionably strong’.

A breach of a bank’s minimum capital requirements would be considered by APRA to be a significant prudential concern and signal deficiencies in a bank’s financial management.

# RSE licensees: 'structure'



Unacknowledged, but implicit to APRA's Discussion Paper:



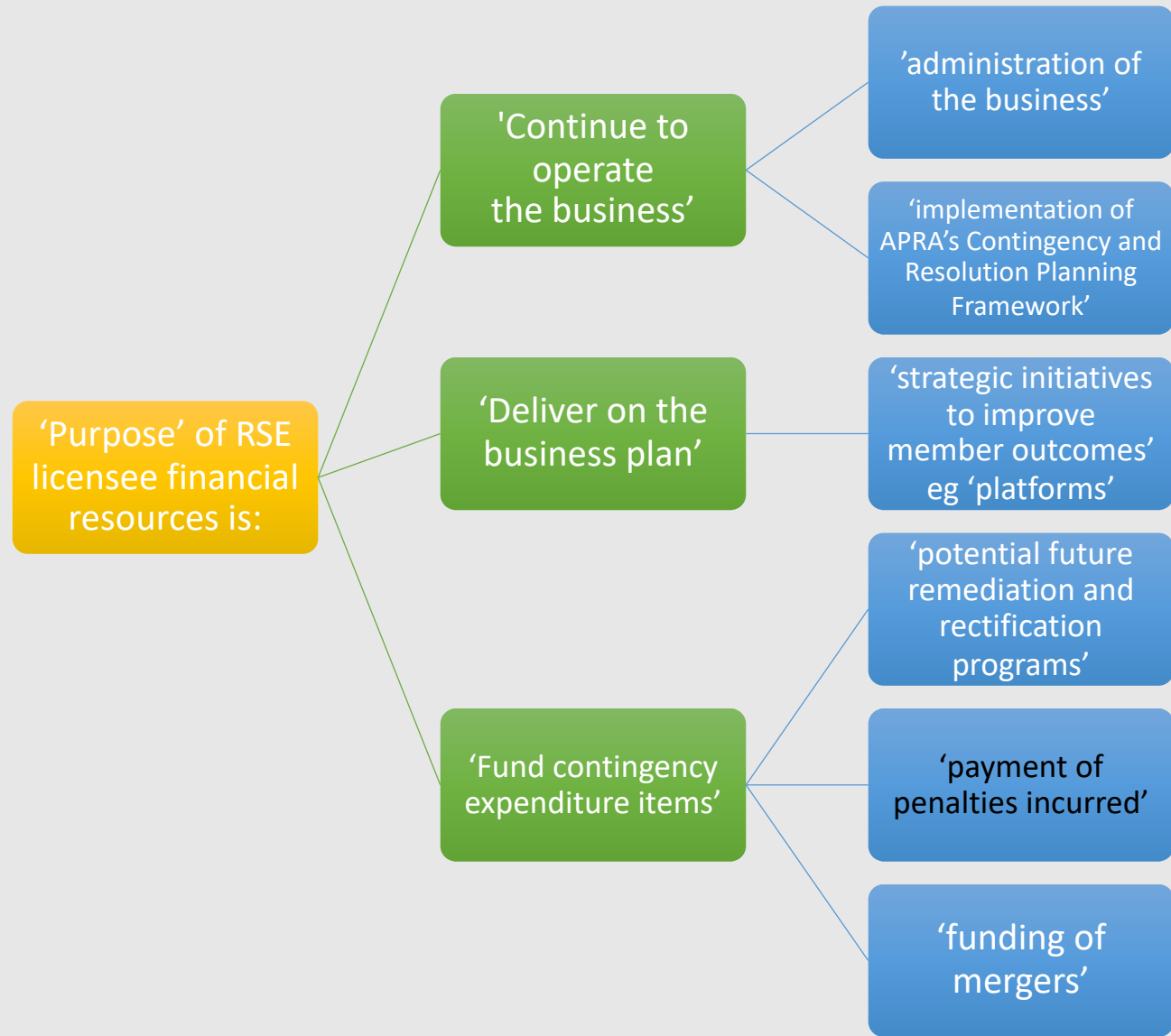
Advantages leading to the pervasive use of trustee model

- Insolvency protection
- Exclusion of liability
- Right of indemnity (exoneration and reimbursement)
- Doctrine of subrogation for trust creditors




Advantages of incorporated entities as trustees

- Limited liability
- Perpetual succession
- Simplified asset ownership and third party contracting
- Structured decision-making







## APRA & financial resources: 'sources'

DP canvasses some sources of financial resources:

- 'Fee revenue from members'
- 'Capital injections from shareholders and other parties'
- 'Bank guarantees or other avenues of contingent support'
- 'Indemnification from related parties'
- 'Income derived from reserves and trustee company assets'
- 'Insurance'

Would be useful to include an in-depth discussion of:

- Trustee's right of indemnity
- The need to protect fund members from the *'disorderly failure of an otherwise sound and sustainable RSE licensee'*.

**Margaret Cole,**  
Executive Board Member of APRA,  
House of Representatives, Standing  
Committee, Economics (Australia's  
four major banks and other financial  
institutions: superannuation sector)  
10 February 2022

"The disorderly failure of an otherwise sound and sustainable RSE licensee would likely to be severely detrimental to members as it would likely impose material costs and create significant operational risks. In the case of insolvency, APRA would be required to appoint an acting trustee to prevent adverse impacts on members and ensure stability of the governance of the fund until a new long-term trustee could be identified and be ready to take over. The route to Acting Trustee is complex, requires a specific license, and certain triggers to be satisfied. Distinct from an Acting Trustee, to install a long-term future trustee to run the fund as a viable going concern takes considerable time. Given legal requirements, including ensuring its existing members are not disadvantaged, such a trustee will need to engage in due diligence. It will also need to be ready to harmonise operations, technology and platforms used for administration. It is not a quick or easy fix."

*Sempre: AustralianSuper* [2021] SASC 147, [65]-[71]; *HESTA* [2021] VSC 809, [35]-[36]; *QSuper* [2021] QSC 276, [40(n)]; *Spirit Super* [2021] NSWSC 1672, [39]; *Cbus* [2021] NSWSC 1679, [38]; *NGS* [2021] NSWSC 1694, [43].



# Insurance: 'mind the gap'

“[N]ot a complete prophylaxis”: *Hesta*, [2021] VSC 809, [64]

- Breadth of conduct to be insured post *Financial Sector Reform (Hayne Royal Commission Response) Act 2020* (Cth) (intro of ‘superannuation trustee service’ under AFSL, restrictions on indemnity s 56 SIS Act)
- Timing of payouts on claims
- Increasing premium/coverage costs
- Reduced limits of indemnity
- Chancing the deductible
- Basis of cover (losses occurring, or claims made?)
- Impact of exclusions
  - Deliberate, wilful, intentional fraudulent, dishonest or malicious acts excluded
  - Prior claims and known circumstances excluded
- Impact of market pressures
  - Royal Commission (*insurers are nervous*)
  - World events (*reinsurers are anxious*)
  - Rising claims incidence (class actions/regulatory enforcement) (*trustees are terrified*)

Alternative  
‘resources’ to the  
right of indemnity  
carry risks for  
trustee resilience

## CAPITAL INJECTIONS

Trustees do not control their shareholders

- Absence of right to compel shareholder capital injections
- Why inject more anyway? Dividends could undermine trustee resilience

And trustee structures do not only involve shareholders

- Government (eg *Re QSuper Board* [2021] QSC 276)
- Company limited by guarantee (eg *Hesta* [2021] VSC 809)
- Directors holding shares of trustee on trust for fund (eg *Motor Trades Association of Australia Superannuation Fund P/L* [2021] NSWSC 1672)

APRA also points to ‘Other parties’: who are they?

- Nominating / sponsoring organisations?
  - Will this blur or undermine the obligation of trustee directors to comply with their s 52A covenants?
- State/local governments? Should taxpayers / ratepayers contribute?
  - Is trustee resilience a ‘public good’?

Another alternative  
'resource' to the  
right of indemnity  
carries risks for  
trustee resilience

### 'INDEMNIFICATION FROM *RELATED* PARTIES'

Focus on *related* parties

- Impact of the *Financial Accountability Regime Bill 2021*?

What of the rise of the 'virtual' institution?

- With focus on *related* parties, risks overlooking prevalence of outsourcing in superannuation industry
- Ability to (re)negotiate better indemnities for penalties?

Systemic risks to trustee resilience

- What of risk contagion from inadequate regulation and supervision of key (outsourced) service providers?

# Bridging the gap: the 'Section 56' Cases

*Re QSuper Board*  
[2021] QSC 276

*Re Hest Australia Ltd*  
[2021] VSC 809

*Re Care Super Pty Ltd*  
*(No 2)* [2021] VSC 854

*Application by LGSS Pty*  
*Ltd atf Local Government*  
*Super* [2021] NSWSC 1613

*Application by Maritime*  
*Super Pty Ltd atf Maritime*  
*Super* [2021] NSWSC 1614

*Application by Motor*  
*Trades Association of*  
*Australia Superannuation*  
*Fund Pty Ltd atf Spirit*  
*Super* [2021] NSWSC 1672

*Application by United*  
*Super Pty Ltd atf*  
*Construction and Building*  
*Unions Superannuation*  
*Fund* [2021] NSWSC 1679

*Application by NGS Super*  
*Pty Ltd atf NGS Super*  
[2021] NSWSC 1694

*AustralianSuper Pty Ltd v*  
*McMillan* [2021] SASC 147

*HostPlus*  
*(orders made,*  
*no reasons yet)*

*EISS Super*  
NSWSC 2022/51827  
[TBD]

*Australian Catholic Super*  
NSWSC 2022/67811  
[TBD]

Where to from here?

Even fee revenue carries risks for trustee resilience

### FEE REVENUE FROM FUND MEMBERS

#### Inadequacy of fee revenue to fund trustee capital

- Lack of 'claims' experience in context of new penalty regimes and heightened enforcement posture of regulators to estimate future losses (fines/penalties/insurance gap)
- Lack of industry data to benchmark fees (due to limited or delayed disclosures; Court confidentiality/suppression orders)

#### Uncertainty as to how to hold and spend fee revenue

- On the balance sheet or within a fund reserve?
- Constitutional 'protections' to preserve the trustee reserve (dividend restrictions, trustee cessation events eg *NGS* [2021] NSWSC 1694, [16])
- Other restrictions on & alternative uses for trustee ['risk' / 'resilience'] reserves?

#### Commercial imperatives and generating (excess) revenue

- As a reason not to overcharge: *QSuper* [2021] QSC 276, [45]
- APRA's stated goal to detect a 'canary in the coal mine' via its Heatmaps & YFYS Performance Test - will adverse outcomes from 'failing' the test incentivise fee reductions to 'pass' the test? Consequences for resilience?

Penalty liability risk is currently major driver of trustee capital needs

### 2019

- *Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No.1) Act 2019 (Cth)*
  - new civil and criminal penalties for contravening covenants (see ss 52 and 52A, 54B and 54C, 193 SIS Act)

### 2019

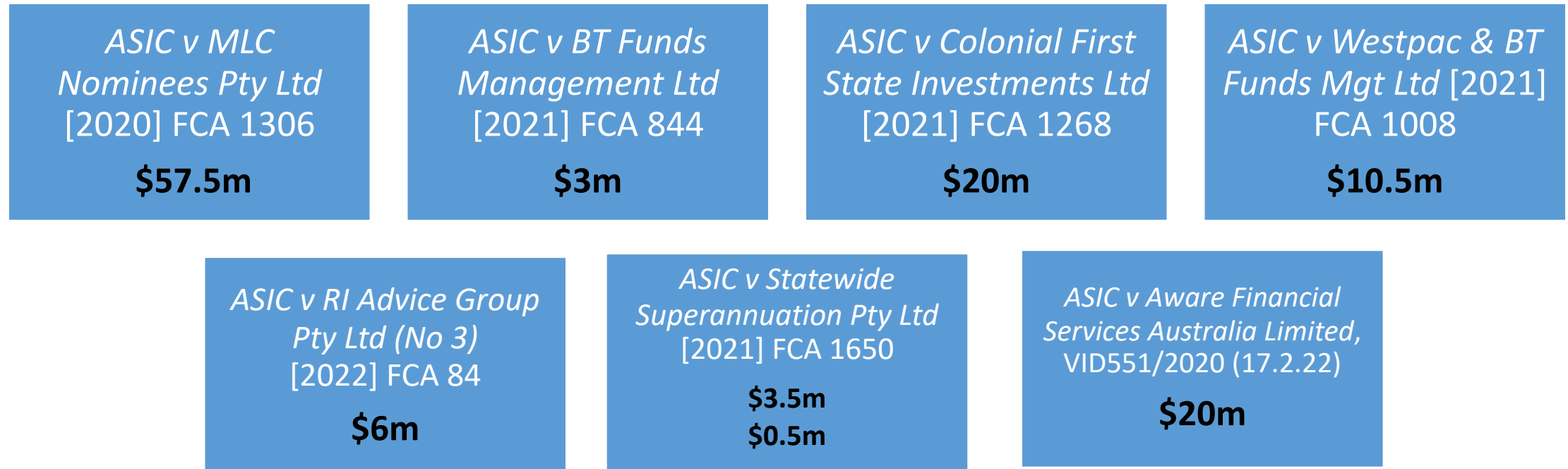
- *Treasury Laws Amendment (Strengthening Corporate and Financial Sector Penalties) Act 2019 (Cth)*
  - significantly increased civil penalties
  - increased penalties for certain criminal offences under Corporations Act and ASIC Act
  - created new ordinary criminal offences to sit alongside existing strict and absolute liability offences
  - new civil penalty regimes eg s 912A(1)(a) Corporations Act
  - expanded infringement notice regime

### 2021

- Treasury Laws Amendment (Your Future, Your Super) Act 2021 (Cth)*
- 'best financial interests' duty (ss 52(2)(c), 52A(2)(c) SIS Act) (but: *what does it all mean?*)
  - evidential burden of proof for BFID reversed in civil penalty proceedings (s220A SIS Act) (so: *what must a trustee do?*)



# A growing trail of pecuniary penalties



## Penalty liability risk – more to come?

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- *ASIC v RM Capital & The SMSF Club*, NSD906/2019 (conflicted rem)
- *ASIC v State Super Financial Services Ltd*, VID551/2020 (fees for no service)
- *ASIC v Retail Employees Superannuation Pty Ltd*, VID94/2021 (rollovers)
- *ASIC v AMP Financial Planning Pty Ltd*, VID420/2021 (fees for no service)
- *ASIC v Diversa Trustees Ltd*, VID573/2021 (outsourced service providers)
- *ASIC v One Path Custodians Pty Ltd*, NSD1306/2021 (fees for no service)
- *ASIC v BT Funds Mgt*, VID705/2021 (insurance in super, conflicted rem)

Penalty liability risk: is the 'superannuation context' relevant, and if so, how?

- *ASIC v MLC Nominees Pty Ltd* [2020] FCA 1306; 147 ACSR 266, at [199] (Yates J)
- *ASIC v Westpac Securities Administration Limited* [2021] FCA 1008, at [39] (O'Bryan J)
- *ASIC v AGM Markets Pty Ltd (in liquidation) (No 4)* [2020] FCA 1499, at [34]-[35] (Beach J)
- *ASIC v BT Funds Management Limited* [2021] FCA 884 (Wheelahan J)
- Explanatory Memorandum to *Financial Sector Reform (Hayne Royal Commission Response) Bill 2020* at [9.171]; see too [9.169]-[9.173], and [9.185]:  
*"nature and structure of superannuation entities means there is a risk that penalties incurred by a superannuation trustee could impact beneficiaries. The requirement to consider the impact on beneficiaries mitigates this risk."*

Where to from  
here?

Section 56 Cases  
unfinished business

## CAPTIVE INSURANCE

‘Potential availability beyond the immediate future’:  
*AussieSuper*, [26] (so come back next year)

### Potential advantages of captive insurance

- *Financial benefits* - cash flow, costs of capital reduction, speed of claims payment/settlement, stabilizing risk financing cost cost over time, portfolio effect
- *Risk management benefits* - direct access to reinsurance market, improved insurer purchasing power, cycle management and independence, funding of non-insurable risks, control over claims settlement, setting of claims reserve
- *Organisational benefits* - formal mechanism of risk retention, appropriate funding of risk retention, corporate governance considerations, creation of additional revenue stream

## Potential downsides of captive insurance

- Structuring issues (pure, group, sponsored, onshore/offshore?)
- Capital adequacy commitment (depending on domicile); ASIC RG 126.58
- Risk of adverse results eroding captive's capital
- Operating costs
- Management commitment/resourcing
- Compliance with trustee covenants?

## What about alternative risk transfer arrangements?

- Group solutions: self-insurance pool; risk retention group; risk purchasing group; large deductible plan
- Innovative financial products
  - Bonds or insurance linked securities
  - Derivatives
  - Sidecars
  - Collateralized reinsurance

## APRA's toolkit to ensure trustee resilience

Should APRA detect deficiencies in trustee resilience, APRA has a ready toolkit to *ensure* trustee resilience. APRA is already beginning to 'push forward' with its agenda, it clearly has 'more risk appetite' post Royal Commission.



- Determine prudential standards – 34C(1) SIS Act
- Suspension/removal & replacement of trustee – Pt 17 SIS Act
- Supervision Risk Intensity Model Assessments
- Additional licence conditions – s 29EA SIS Act
- Directions power – Pt 16 Div 2 SIS Act
- Direction to relinquish control – Pt 16 Div 2 SIS Act
- Change in control approval – 29HA SIS Act
- Cancellation of licence – s Pt 2A Div 7 SIS Act
- Amalgamation of funds – Pt 18 SIS Act
- Intervention in proceedings – s 320(1) SIS Act
- Commence enforcement proceedings (shared with ASIC)

(Not that it's so easy for APRA to suspend or remove a trustee pre-insolvency)

### Section 133 SIS Act

- only in the circumstances specified in s 133(1)(a)-(g), including "the RSE licensee breaches any of the conditions of its RSE licence": s 133(1)(e) (see s29E)
- discretionary ("may suspend or remove": s 133(1))
- must be by written notice given to the trustee, which notice must:
  - set out that decision (s 133(4)(c)) and
  - give the reasons for that decision (s 133(4)(b))
- reviewable decision (s 344, s 10(taa))

### Examples of trustee removal

- *Trio Capital Ltd* (2009)
- *APRA v Derstepanian* [2005] FCA 1121
- *Pruess and APRA* [2005] AATA 748

### Cost and timeliness of suspension/removal

Where to  
from here?

Self help: trustee  
resilience and  
potential avenue  
of judicial advice

- Trust deed amendment to introduce superannuation trustee fee-charging: eg *Re QSuper Board* [2021] QSC 276
- Ownership of fund assets: eg *CareSuper (No 1)* [2021] VSC 805
- Missing documents: eg *CareSuper (No 1)* [2021] VSC 805
- Exercise of a superannuation trustee fee-charging power: eg *CareSuper (No 2)* [2021] VSC 854
- Retirement as trustee if financial resilience in jeopardy?
- Mergers / SFTs (Is there a 'duty to merge'? What about operation of 'equivalent rights' tests?)
- Defence of proceedings (eg class action, regulatory proceeding)?
- Whether proposed use of Fund assets would comply with statutory covenants (eg s 52(2)(b), (c), s 62(1) SIS Act)
  - Insurance premiums?
  - Marketing and advertising?
  - Investments for ESG purposes?
  - Agreements re payment of pecuniary penalties?



# Where to from here: (more) legislative change?

## Modify s 56/ 57 SIS Act Amendments?

- Reverse the Courts' jurisprudence on indirect indemnification?
- Parliamentary Committee hearings signals: modify SIS Act so as to better vindicate parliament's apparent intention to hold trustees 'accountable' (and those that stand behind them)?

## Further mitigate risk to beneficiaries by extending impact on them as a relevant consideration on assessment?

- Currently, limited to:
  - Corporations Act*, ss 1311A(2) (fine) and 1317G(6)(e) (pecuniary penalty)
  - ASIC Act*, ss 93C (fine), s 12GBB(5)(e) (pecuniary penalty)
- But not: SIS Act, *Anti-Money Laundering and Counter-Terrorism Act 2006* (Cth), *Privacy Act 1988* (Cth), and Taxation legislation (assuming affected)

## Reinstate minimum trustee capital legislative requirement?

- Reverse 2012 SIS Act Amendments removing \$5m minimum? If so, what should be the new minimum?
- ORFR consequences?

To end: some questions about trustee capital reserves to support resilience for your further consideration

1. What is trustee capital and what role should it play?
2. What should count as trustee capital and why?
3. Why are there different definitions of capital? When is each appropriate?
4. Who should set the regulatory requirements for trustee capital?
5. What should be the regulatory requirements for trustee capital?
6. How should superannuation trustee standards compare to requirements for other financial institutions?
7. How much capital does a superannuation trustee need?
8. How much capital should superannuation trustees usually carry over the regulatory minimum? Why?
9. Should trustee capital requirements vary over the business cycle? Why not?
10. What happens if a superannuation trustee does not have enough capital? What principles should guide outcomes?
11. Will capital requirements always make superannuation trustees 'safer' (resilient)?
12. What are the negatives of superannuation trustee capital requirements?
13. Will superannuation trustees seek/find a way to evade tougher requirements? If so, what should be done?