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Bank Custodians and Systemic Risk in the Australian Superannuation System

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Bank Custodians and Systemic Risk in the Australian Superannuation System

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Abstract

Custodians play an integral role in the administration of Australia's superannuation system. This paper considers the way in which the small number of custodians, and the increasingly diverse set of services they provide to superannuation funds, gives rise to systemic risk within the superannuation system. It also considers the way in which the current regulatory scheme addresses this risk. It finds a regulatory scheme in which the potential for systemic risk is increasingly recognised but in which little is currently done to manage this risk as a result of institutional, jurisdictional and political factors.

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INTRODUCTION

Australia's superannuation system exists to facilitate the accumulation of financial assets by individuals over their working-age lives that can be applied towards meeting some portion of their expenditure in retirement. The trustees of the superannuation funds in which these accumulations are administered typically retain a variety of specialist service providers to assist them in the discharge of their duties. Key amongst these service providers are the custodian banks that provide asset custody and other ancillary services to the funds.

The role of the custodian is important. The superannuation system currently contains over A$1.84 trillion.[1] Prudent stewardship of those assets is primarily the responsibility of the trustee of each fund, but the custodian is integrally involved in both the safekeeping of the assets and the production of information flows, for instance related to securities trade confirmations and asset valuations, necessary for the trustee to discharge its duties to members and to government bodies such as the Australian Prudential Regulation Authority ('APRA') and the Australian Tax Office. Custodians are also increasingly providing (directly or through agents) ancillary services such as securities lending, deposit-taking, foreign currency dealing and proxy voting.

The regulatory scheme applied to the superannuation system focuses primarily on the key decision nodes within the system: the trustees. Much of the regulation of the custody industry (at least in so far as the superannuation aspects of the industry are concerned) in Australia is therefore imposed indirectly through regulation of the trustees responsible for appointing custodians. As we shall see, this introduces certain challenges and gives rise to certain risks at both a local and a systemic level. To these challenges must be added the complexity introduced when (master) custodial arrangements are outsourced to sub-custodians and the lack of saliency of custodial activities within bank regulation. This article starts to excavate some of those issues and in so doing contributes to the broader research agenda concerned with the implications of network interconnections for the presence and regulation of systemic risk in global financial markets.[2]

The article proceeds as follows: the article commences by outlining the role played by the custodian in a modern superannuation fund. It then describes the structure of the custodial industry in Australia as it pertains to the superannuation system. The next section identifies and describes the operational and other risks arising from custody activities at a local, fund-by-fund, level and assesses their implications for risk at a systemic level. The article goes on to evaluate the regulatory issues arising from the presence of those risks. The concluding comments sum up and offer some suggestions for future research and analysis.

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1 Australian Prudential Regulation Authority, *Quarterly Superannuation Performance* (March 2014), p 6.

2 See for instance Besar D, Booth P, Chan KK, Milne AKL and Pickles J, "Systemic Risk in Financial Services" (2011) 16(2) *British Actuarial Journal* 195.

THE ROLE OF THE CUSTODIAN IN A SUPERANNUATION FUND

The administration of the superannuation system in Australia is highly de-centralised. Around one third of the assets of the system are administered in Self-managed Superannuation Funds ('SMSFs').[3] SMSFs have 4 or fewer members each of whom is jointly responsible for administration of the trust.[4] Almost all of the remaining two thirds is administered by trustees acting on behalf of registrable superannuation entities ('RSEs').[5] There are approximately 300 of these.[6] It is this latter, intermediated type of superannuation fund with which we are primarily concerned here.

The modern intermediated superannuation fund is an archetypal 'virtual' institution.[7] The institution centres on the trustee, in which resides responsibility for administering the trust. The trustee is subject to the terms of the instrument establishing the trust, to relevant statutory and regulatory regimes and to such general law obligations as are not eclipsed by either statute or the instrument. However it can, and most commonly does, appoint a variety of agents to assist in the discharge of its duties.[8] The decision of which tasks to 'outsource' to agents is a key question for the trustee of each superannuation fund, to be taken having regard for the peculiar circumstances of the trust for which it is responsible.[9] There is therefore no strict legal requirement for trustees of superannuation funds to appoint a custodian. However, as the analysis presented below demonstrates, in practice the overwhelming majority of trustees do appoint custodians. The appointment of a reputable custodian has been endorsed by APRA as 'best practice'.[10]

There is no comprehensive and universally applicable definition of the custodian role in a superannuation fund. Section 10 of the *SIS Act* defines a 'custodian' in the context of a superannuation fund as:

> 'a person (other than a trustee of the entity) who, under a contract with a trustee or an investment manager of the entity, performs custodial functions in relation to any of the assets of the entity'

The *SIS Act* does not however define the term 'custodial functions'.

'Custody' is however defined in the *Corporations Act 2001* (Cth). Section 766E of that Act provides:

> 'a person (the provider) provides a custodial or depository service to another person (the client) if, under an arrangement between the provider and the client, or between the

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3 APRA, n 1 6.

4 *Superannuation Industry (Supervision) Act 1993* (Cth) s 17A . In practice the trustees of many SMSFs are incorporated. This is permitted so long as all members serve as directors of the trustee company.

5 APRA, n 1.

6 APRA, n 1 8.

7 Donald S, Arnold B, Bateman H, Buckley R and Liu K, "The implications of complexity for systemic risk in the superannuation system" CLMR Working Paper 2013-3 (July 2013), http://www.clmr.unsw.edu.au/resource/compliance/prudential-regulation/clmr-working-paper13-3-implications-complexity-systemic-risk-superannuation-system.

8 Liu K and Arnold B, "Australian Superannuation Outsourcing" (2010) 4 *Jassa* 6

9 APRA, *Superannuation Prudential Standard, Outsourcing; SPS 231* (November 2012).

10 APRA Superannuation Fraud Checklist for Trustees http://www.apra.gov.au/Super/Documents/Superannuation-Fraud-Checklist-for-Trustees-1.pdf and APRA How to Reduce the Risk of Fraud: A best practice guide http://www.apra.gov.au/Super/Documents/How-to-reduce-the-risk-of-fraud-A-Best-Practice-Guide-for-Trustees-1.pdf.

provider and another person with whom the client has an arrangement, …, a financial product, or a beneficial interest in a financial product, is held by the provider in trust for, or on behalf of, the client or another person nominated by the client.'

The holding of assets on behalf of the trustee is therefore clearly at the core of any 'custodial' relationship. However observation of the arrangements actually entered into between trustees and custodian banks identifies two further distinct types of services, some combination of which may be provided by the custodian to the trustee: a set of informational services and a variegated set of 'value added' services.

Focussing first on the core custodial role, it is now widely accepted that in an age of electronic registers and trading the custodian ordinarily holds the assets of the fund on bare trust for the trustee.[11] In that role it is also responsible for tasks such as account opening, securities registration, collection of investment income (dividends, interest, rent and the like), derivatives clearing and settlement of transactions that are ancillary to the custodian holding legal title.[12] The custodian *qua* trustee cannot lawfully mix the assets of the fund with its own,[13] and, in the event of insolvency of the custodian, the assets are not available for distribution to the creditors of the custodian.[14]

The custodian will also typically be responsible for a variety of what might best be characterised as informational services. These necessarily include portfolio valuation and periodic reporting to the trustee but may also include reporting on corporate events relevant to the assets, performance reporting, tax reporting, the provision of reports suitable for provision to a regulator and the calculation of unit prices at a fund or sub-fund level. In the event of a mistake or delay in the provision of this information the custodian will typically be liable purely on a contractual basis to compensate the fund for any losses incurred, subject to any limitations or other conditions contained in the custodial agreement.[15]

Finally, there are a range of 'value added' services that custodians often provide to trustees. These include taking deposits, undertaking foreign exchange transactions, facilitating securities lending and borrowing, and arranging proxy voting. The nature of the relationship between the custodian and the trustee in these circumstances will depend on the precise nature of the service. In the case of accepting deposits, *prima facie* the custodian bank becomes an unsecured debtor to the trustee of the fund to the extent of the deposit.[16] However this is situation is muddied where cash is received

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11 See for instance Yates M and Montagu G, *The Law of Global Custody* (4th Ed, Bloomsbury Professional, London, 2013), [3.12]; ASIC, *Custodial and depository services in Australia*, Report 291 (July 2012) at 19. The traditional characterisation of custody as being a form of bailment has been substantially undermined by the difficulty of establishing in an electronic environment the requirement that the custodian have physical possession of the asset.

12 See ACSA, *Custodians in Australia: How custodians support Australia's wholesale superannuation and investment sectors*, (2012) Australian Custodial Services Association and APRA, "Custodian operations in the superannuation industry", (2011) 1 *APRA Insight* 12.

13 See for instance *In the matter of Lehman Brothers International (Europe) (In Administration) and in the matter of the Insolvency Act 1986* [2012] UKSC 6, in which it was held that the fact that client monies were paid into a house account (that is, not mixed) did not negative the existence of a trust.

14 From the principle in *Barclays Bank Ltd v Quistclose Investments Ltd* [1970] AC 567.

15 The extent to which a custodian can limit its liability is restricted to sub-custodian and contractor action by ASIC Class Order CO 13/1410 and ASIC Regulatory Guide RG133.

16 *Carr v Carr* (1811) 1 Mer 541n. More recently see *Space Investments Ltd v Canadian Imperial Bank of Commerce Trust Co (Bahamas) Ltd* [1986] 3 All ER 75.

by the custodian bank as settlement for the sale of assets held on trust, which cash would under ordinary trust principles still be impressed with the trust. The complexity increases when the superannuation fund engages in securities lending. Then, depending on the precise form of the securities lending agreement, the collateral provided by the counterparty may be in the form of cash placed with the custodian as deposit taker, in which case the trustee will be an unsecured creditor of the custodian in respect of that cash collateral, or in some other form (specie for instance) in which case the relationship is more likely to be one of bare trust. Finally, there are also within this category a range of circumstances in which the custodian is plainly acting as counterparty to the fund. An example of this would be when the custodian is providing foreign exchange hedging services to the trustee.

In practice custodians will provide a bespoke combination of these informational and value added services under their contract with the funds' trustees. The relationship between the trustee and its custodian is thus potentially quite variegated, containing elements of trust, agency, debt and contract. As this article shows, this variegation is crucially important in understanding the different ways in which local failures in respect of custody services can propagate and hence assume systemic implications.

There is one more layer of complexity that needs to be highlighted before we conclude this description: the use of sub-custodians. The contracting custodian (often termed the 'master custodian') may itself appoint sub-custodian agents to act for it in jurisdictions and markets in which it either cannot or does not act. The role of the master custodian is thus to coordinate this network of sub-custodians alongside its own custody activities on behalf of the trustee. It is true that the trustee of a superannuation fund typically appoints the master custodian with knowledge of their sub-custody network at the time of appointment and with the knowledge that there are Australian regulatory restrictions on the extent to which sub-custodian liability can be limited.[17] However the trustee of the Australian superannuation fund will not itself have any direct relationship with the sub-custodians which hold title to the securities subject to the sub-custodial agreement, nor can it directly influence the terms of those sub-custodial agreements.

CUSTODIANS IN THE AUSTRALIAN SUPERANNUATION SYSTEM

Most of the entities acting as custodians to Australian superannuation funds today are members of banking groups. This is in part because the operational aspects of custody give rise to substantial economies of scale and synergies with certain banking and other financial services but also because the capital requirements imposed on custodians operate as a constraint on market entry by smaller potential entrants.

In Australia, a number of providers of custodial services, including the largest providers by assets under custody, are members of an industry association called the Australian Custodial Services Association (ACSA). ACSA provides data on the activities of its members including both Australia and global assets held in custody. This data for June 2013 is set out in Figure 1.

[17] ASIC Class Order CO 13/1410 and ASIC Regulatory Guide RG133, n 15

Figure 1: Australian and global assets held by ACSA members June 2013

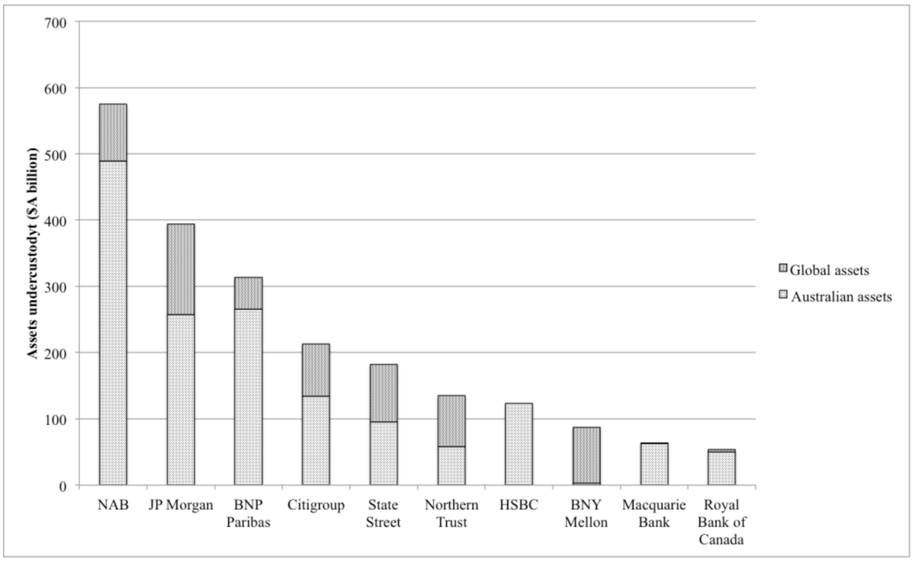
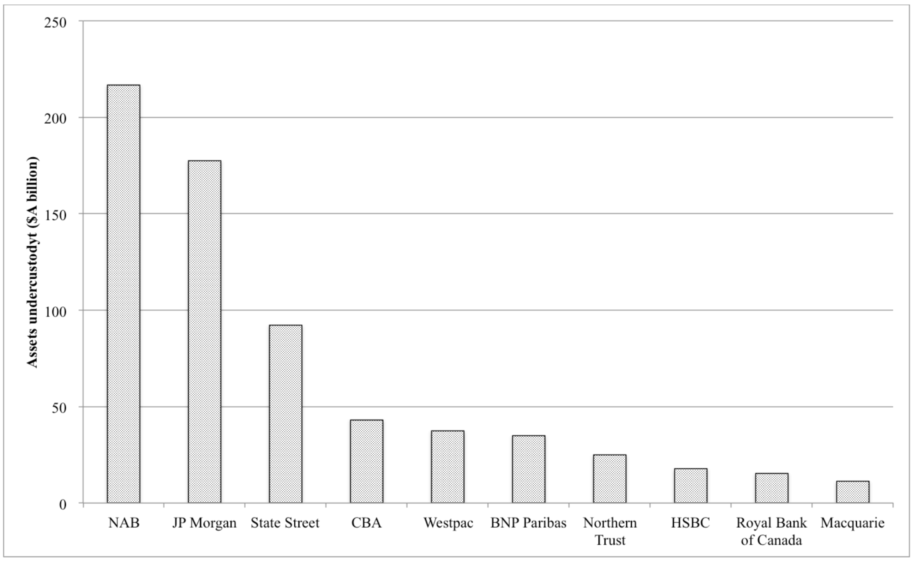


Figure 1 shows that there are two Australian headquartered entities in the ten leading providers of custodial services in Australia. The market leader is National Australia Bank ('NAB') with more than half a trillion dollars of assets under custody. Macquarie Bank (through its subsidiary, Bond Street) is responsible for the custody of more than $60 billion.

The market share position in respect of superannuation is significantly different. Figure 2 presents analysis derived from the 2012 annual reports of the leading 150 superannuation funds in Australia, representing some $685 billion of assets under custody.

Figure 2: Custodians in the superannuation sector 2012



One issue that becomes apparent from Figure 2 is that the top five providers of custodial services include three of the four major retail banks in Australia. That is, the provision of custody in the superannuation sector is markedly different from the provision of custodial services to Australian clients as a whole. To some extent this is a matter of vertical integration. NAB acts as custodian of funds within the NAB group but also offers custody services in competition with other custodians. In contrast, Westpac provides custody only to its subsidiary BT Funds Management and Commonwealth Bank of Australia (CBA) provides custodial services to Colonial First State Investments, its consolidated asset management division.

This picture of the distribution of custodial assets across custodians has the potential to be misleading. In particular, the assets so reported may in fact be subject to sub-custodial arrangements entered into by the custodian as master custodian.[18] So for instance both Westpac and CBA use a sub-custody network in overseas markets, relying on services provided by one or more of the other major custody providers. In the case of assets administered on behalf of Australian superannuation funds this is almost universal in respect of securities listed in smaller overseas markets, such as those in Latin America, Africa, Eastern Europe and Asia. It is often the case that only one or two major custodial groups operate in these markets, whether for reasons of licensing and access or simply economies of scale, and that so it is expedient and more cost-effective for master custodians to rely on their services, notwithstanding that the parent of the local custodial operation may be a direct competitor in other markets. The picture derived from a simple observation of the assets under custody may therefore not provide an accurate description of who is in fact is responsible for the custody of the assets of Australian superannuation funds.

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18 See, for example, Agnes, P "Embeddedness in custodial banking", (2002) 93 (3) *Tijdschrift voor economische en sociale geografie* 254. Du Chenne, J "Sub-custody risk and AIFMD", (Summer 2012) *Global Custodian*. Hainsworth, A (2007) "The Shareholder Rights Directive and the challenge of re-enfranchising beneficial shareholders", 1 (11) *Law and Financial Markets Review* 10. Smethurst, J and Benjamin J. "Restatement of the law relating to client securities", (2009) 4 (3) *Capital Markets Law Journal* 311.

CUSTODIANS AND SYSTEMIC RISK IN THE SUPERANNUATION SYSTEM

Australia's superannuation system exists to facilitate the accumulation of financial assets by individuals over their working-age lives that can be applied towards meeting some portion of their expenditure in retirement. Put simply, it collects, invests and then returns monies.

The monies are exposed to a variety of risks along the way. These include investment risk, risk of fraud and, most pertinently in the context under consideration here, operational risk.[19] Many of these risks have a purely local character in the sense that they will affect only the interests of those involved in a particular fund, or perhaps even just a sub-fund or investment option. However other risks may possess a systemic dimension from the outset (such as a stock market crash or a change to the taxation of particular types of earnings[20]) or else possess a nature capable of propagating in such a way as to transform a local risk into one with systemic implications. Custodians, it turns out, are a source of both types of risk.

The way in which operational risks of a local tenor arise and are dealt with by custodians has been subject to detailed analysis by regulatory bodies, including ASIC[21] and the Bank of International Settlements ('BIS'). [22] BIS for instance defines custody risk as:

> 'The risk of loss on assets held in custody in the event of a custodian's (or sub-custodian's) insolvency, negligence, fraud, poor administration, or inadequate recordkeeping.'[23]

Academic and other commentators have also conducted extensive analysis of the risks in custody generally,[24] and in relation to specific activities undertaken by custodians on behalf of their clients.[25]

This article aims to take that analysis in a slightly different direction. The notion that custodians may be a source of systemic risk in the superannuation system is far less developed. The European Central Bank ('ECB') identifies specifically systemic risk in its typology of custody risks, alongside 'custodian risk' and 'custodian client risk'.[26] It does not however analyse the conditions under which

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19 Australian Government Treasury (2001) "Options for Improving the Safety of Superannuation - Background Paper", http://archive.treasury.gov.au/documents/188/PDF/SuperBI.pdf .

20 Perhaps the most notable of these was the 1988 decision to impose a tax (15%) on the investment earnings of superannuation funds.

21 ASIC, n 11 28-35.

22 CPSS-IOSCO (2012) "Principles for financial market infrastructures", 19. http://www.bis.org/publ/cpss101a.pdf.

23 CPSS-IOSCO, n 22 19.

24 See, for example, Greenwood, P and Miles R "In the Matter of Lehman Brothers International (Europe) (In Administration)", (2013) 19 (7) *Trusts & Trustees* 787. Loader, D *Clearing, Settlement and Custody*. (Elsevier, Amsterdam, 2013). McGill, R and Patel, n *Global Custody and Clearing Services* (Palgrave Macmillan, Basingstoke, 2008).

25 See, for example, Klees, EH "How safe are institutional assets in a custodial bank's insolvency?" (2012) 68 (1) *Business Lawyer* 103. Ong KTW and Yeung EYC "Repos & securities lending: the accounting arbitrage and their role in the global financial crisis", (2011) 6 (1) *Capital Markets Law Journal* 92. Pizzo, M "Related party transactions under a contingency perspective",(2013) 17 (2) *Journal of Management & Governance* 309.

26 Diana Chan et al. (2007) "The Securities Custody Industry". Occasional Paper Series No 68, European Central Bank.

risks identified (which are essentially local risks) become systematic, nor the mechanisms or dynamics that are responsible for transforming a local failure into one with systemic implications.[27]

There are two distinct ways from a conceptual perspective in which 'local' failures can assume systemic implications. The first stems from the fact that most custodians serve multiple superannuation funds. The second stems from the fact that many funds are linked through common usage of other service providers or through co-investment in investment vehicles.

Table 1 shows the number of funds served and the value of assets under custody of the ten largest custodians in the superannuation sector in Australia, based on data reported by the superannuation funds themselves.[28]

Table 1: Ten largest superannuation custodians 2012

Custodian	Number of Funds	Assets under Management
NAB	44	$217.14
JP Morgan	24	$203.59
State Street	5	$92.28
BNP Paribas	14	$91.74
CBA	2	$43.55
Westpac	9	$38.40
Northern Trust	4	$24.95
HSBC	6	$17.82
Royal Bank of Canada	2	$15.47
Macquarie	5	$11.39

The result of this co-dependence is that certain types of failure in the custodian will simultaneously affect (or to use a biological metaphor, 'infect') multiple entities. This process is often likened to biological 'contagion.'[29]

The most obvious risk in this light is the commercial failure of a custodian, or the failure of a broader corporate group of which it was part. The failure of Barings and Lehman Brothers are examples of this. [30] In both cases title to the assets held on trust was uncontroversial, but only once those assets could be identified within the mixed funds into which they had been placed. Much more problematic were the other aspects of the relationships between those entities and their custody clients, especially those in which the clients stood as unsecured creditor. In many of those cases the client suffered not only delay but also actual financial loss.

27 Notably, in the local Australian context, ASIC has adopted the ECB's typology in respect of 'custodian' and 'custodian client' risks, but has replaced 'systemic' risk with risk from 'corporate activity' as its third type of risk. ASIC, n 11.

28 A full description of this data set can be found in Nicholls, R Liu K and Bateman H (2014) "Linkages in Australian Superannuation: transactions, information and homogeneity." Working Paper 14/6. Sydney: Centre for Law, Markets and Regulation at UNSW Law.

29 See for instance Allen F and Gale DM, "Financial Contagion" (2000) 108 *Journal of Political Economy* 1; Gai P, Haldane A and Kapadia S, "Complexity, concentration and contagion" (2011) 58 *Journal of Monetary Economics* 453.

30 Yates and Montagu, n 11 3.13.

There are other less high profile risks that in practice could also disrupt the smooth operation of the system. Examples include a breakdown in the IT infrastructure employed by the custodian or a mistake in the valuation of a particular security (which mistake may have its source outside the custodian, such as a data vendor). Such failures would affect all customers of the custodian in question simultaneously; an issue made more acute by the concentration in the custody industry identified in Figure 2. Prudent business practices together with regulatory requirements ensure that custodians have a variety of risk management strategies in place in respect of these types of risks, as well as capital reserved to remediate any financial losses caused by their occurrence. However, as will be discussed below, it is not necessarily the case that the disruption caused can be entirely remediated by the application of regulatory capital.

The second way that local risks resident in the custodian can become systemic is that certain types of local failure can propagate over time beyond their initial location as a consequence of serial dependence. This phenomenon is sometimes referred to as a 'cascade'.[31] A mistake in the calculation of a unit price in a sub-fund in which a number of superannuation funds invested may, to extend the fluvial metaphor, flow into the calculation of unit prices or crediting rates of those superannuation funds. Similarly the inability to strike a unit price in such a sub-fund may limit the ability of some or all of the superannuation funds invested in it to themselves strike a unit price. Freezes of this type have the potential to put superannuation funds under commercial pressure, which pressure may then be transmitted to the service providers with whom they have contracted, and on then to the other clients of those service providers. In this way a local failure can initiate a process that comes in time to assume systemic proportions.

Importantly, not every local failure will inspire such a process, nor is it likely that the process will be smooth and continuous. For instance, an informational seizure, such as an inability to declare a unit price in a sub-fund in which a number of superannuation funds invested, could replicate in some locations and not in others (perhaps due to the materiality of the holding), which in turn could freeze the actual flow of monies in some, but perhaps not all, of those locations in which it replicated. The contagion thus could be highly non-linear; conditioned and critically contingent on the precise circumstances prevailing locally throughout the system.

Before progressing to the regulatory implications of these observations, it should be noted that there is another way to characterise these types of risk. Some of the risks relate to the information that is passing through the administration process. These data errors will typically affect the relative rights of participants in the fund. The rights of some participants will be undervalued, and some party or parties (perhaps outside the superannuation system entirely) will enjoy a matching overvalue. Remediation can usually be achieved simply by recalculating those rights based on accurate data. It may also be necessary for the party responsible for the error to compensate the (usually small minority) of participants who have acted to their detriment in the interim. The calculation may be very complex and time consuming to compute but the basic principle is relatively straightforward.

Other risks relate to delays arising from local failures. The complexity of modern investment portfolios means that delays in valuation or settlement, especially, can create liquidity and other

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31 See for instance Allen and Gale, n 29, Haldane A and May R, "Systemic risk in banking ecosystems" (2011) 469 *Nature* 351.

problems elsewhere in the portfolio. Steps taken to address such problems, for instance, by drawing down further on cash holdings than was intended or by selling other, more liquid securities to meet a putative call on cash, are typically not reversible. It is also possible, for instance when an entire fund is frozen, that no such steps may be feasible.

Finally it is important to recognise that the risks under consideration here can transform as they propagate. For instance the time taken to implement the steps required to address informational risks may introduce operational delays which in turn have downstream effects.

REGULATORY IMPLICATIONS

The focus of this article up to this point has been on the existence of risks in modern custody arrangements and on the potential for them to move beyond a local significance and assume systemic implications for the superannuation system. It is not intended that this description, nor the analysis it has nourished, should suggest that the local risks identified are not managed by the organisations offering custodial services. The analysis does however provide a context within which certain aspects of the regulatory scheme applied to the custodians of the assets of superannuation funds can be assessed.

The primary legislation governing the operation of the superannuation system, the *Superannuation Industry (Supervision) Act 1993* (Cth) (‘*SIS Act’)*, regulates the relationship between a superannuation fund trustee and a custodian only lightly.[32] The custodian must be an incorporated entity and have the minimum level of net tangible assets prescribed in the *Superannuation Industry (Supervision) Regulations 1994* (Cth).[33]

The regulatory primarily responsible for overseeing compliance with the *SIS Act*, APRA, does not have formal, direct regulatory responsibility for custodians. However it does impose some supervision on entities offering custodial services that goes beyond the supervision to which most of those entities would be subject by virtue of their location within banking groups (over which APRA also has jurisdiction). It has for instance issued a standard set of requirements of custodians acting for APRA supervised entities that covers issues such as the segregation of assets, but also the processes of appointment and monitoring by the trustee and the content of any custodial agreement.[34] More often, APRA acts indirectly in respect of custodians. There are for instance a number of elements of the Superannuation Prudential Standards issued by APRA that regulate the relations between trustees and their custodians. It has, for instance issued a detailed Prudential Standard with respect to outsourcing[35] in which it sets out, amongst other things, the minimum requirements on the form of the contractual relationship. Other Prudential Standards recognise that the trustee may have to rely on external parties and seek to regulate the activities of those external

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32 As we shall see below, such regulation as exists occurs mostly at the level of regulatory instrument, such as the Prudential Standards issued by APRA and Regulatory Guides issued by the ASIC.

33 *Superannuation Industry (Supervision) Act 1993* (Cth), s 123.

34 http://www.apra.gov.au/MediaReleases/Documents/Custodian-Requirements-ASE.pdf.

35 APRA, Prudential Standard SPS 231*. Outsourcing*, (Nov 2012). http://www.apra.gov.au/Super/PrudentialFramework/Documents/Final-SPS-231-Outsourcing-November-2012.pdf.

parties in respect of the fund through the trustee. [36] APRA can also use its jurisdiction over the trustee to gain access to the premises and certain of the documents of the custodian that pertain to services provided for the trustee. This indirect form of regulation, in which the regulation is articulated through the entity (in this case the trustee) over whom APRA has express authority, is a recurrent regulatory tactic employed by APRA. It deliberately isolates and privileges the trustee of each superannuation fund as the focal point for APRA's supervisory activities. In theory this simplifies the accountabilities across the system (the trustees are very clearly in the 'hot seat')[37] but, more pragmatically, it enables APRA to focus its supervisory activities on a relatively small, and observable, set of entities.

Chapter 7 of the *Corporations Act 2001* (Cth) is also relevant to custodians. Section 766A of that *Act* confirms that a business offering custody services in Australia is operating a financial services business. As such, that business is required by section 911A of the *Corporations Act 2001* (Cth) to hold an Australian financial services licence (AFSL) covering the specific financial service (custody) being provided. This requires the custodian to satisfy a range of general and tailored requirements.[38] Importantly, however, notwithstanding ASIC's view that the definition of custody contained in section 766E of the *Corporations Act 2001* (Cth) includes providers of sub-custody and secondary custody,[39] the providers of sub-custody services to Australian super funds typically take care to ensure that their services are provided to the master custodian in a form that cannot be characterised as offering the service in Australia, thereby sidestepping the need for an AFSL.

There are two critical documents that articulate ASIC's expectations of custodians within its jurisdiction. RG 133 provides detailed direction to custodians on holding assets and RG 166 imposes a liquidity requirement. These guides have an associated class order as to implementation.[40] Both RG 133 and RG 166 were revised in 2013 following its 2012 report on custodial and depository services in Australia.[41] That report was produced in response to the Parliamentary Joint Committee's

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36 See for instance APRA, *Prudential Standard SPS 220. Risk Management*, (July 2013), especially [40]. http://www.apra.gov.au/Super/PrudentialFramework/Documents/Final-SPS-220-Risk-Management-July-2013 . Also APRA, *Prudential Standard SPS 510. Governance*, (Nov 2012). http://www.apra.gov.au/Super/PrudentialFramework/Documents/Final-SPS-510-Governance-November-2012.pdf.

37 As the Commonwealth Treasurer of the day noted, "prime responsibility for the viability and prudent operation of the superannuation industry rests with trustees"; Dawkins, *Strengthening Super Security* (1992), 3. See also Productivity Commission, *Review of the Superannuation Industry* (2001), 6.1.

38 For a more detailed description of these, see ASIC (2012), n 11 20-21.

39 See http://www.asic.gov.au/asic/asic.nsf/byheadline/Dealing+and+providing+a+custodial+or+depository+service+as+a+secondary+service?openDocument

40 ASIC Class Order CO 13/1410 http://www.comlaw.gov.au/Details/F2013L01988

41 See http://www.asic.gov.au/asic/pdflib.nsf/add907be1c708f42ca256aca0007f465/4f3b0147d2f013f9ca257a31007f4ea9/$FILE/rep291-published-5-July-2012.pdf. ASIC supported these changes with a Regulatory Impact Statement: http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg133-RIS-published-21-November-2013.pdf/$file/rg133-RIS-published-21-November-2013.pdf, There was also a regulatory impact statement associated only with RG 166: http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg133-RIS-published-21-November-2013.pdf/$file/rg133-RIS-published-21-November-2013.pdf

('PJC') report into the collapse of Trio Capital[42] in which the PJC attributed the success of the fraud, in part, to vulnerabilities in the superannuation system related to custody of the assets invested.

It would be irresponsible to suggest that the integrity of the Australian superannuation system as a whole is imminently threatened by deficiencies in the regulatory supervision of custodial arrangements as currently practiced. However in financial markets, as in other domains, the most devastating risks are often those that are unrecognized or ignored. Listed below are four recommendations which if accepted would increase better equip APRA in particular to respond to the risks identified in this article of a local failure assuming systemic implications.

REGULATORS MUST COMPLEMENT THEIR CURRENT LOCAL FOCUS WITH A SENSITIVITY TO SYSTEMIC ISSUES

ASIC's approach to the risks posed by putative failures in the custody industry remains firmly local. Its 2012 Report expressly recognises the concentration of the industry[43] as well as a number of other emerging trends[44] but goes no further.

Similarly, most of APRA's supervisory focus in the superannuation sector historically has been on local risk.[45] So for instance *Probability and Impact Rating System* (PAIRS)[46] and *Supervisory Oversight and Response System* (SOARS)[47] that inform and guide its supervisory priorities both treat entities as distinct and do not regard systemic criticality (as distinct from size) as a criterion for intervention or escalation of supervisory activity.

This impression is further reinforced by APRA's internal structure. The supervisory teams in the Diversified Institutions Division responsible for superannuation entities are organised in groups focussed on specific institutions or collections of institutions, rather than on functional or thematic lines. The frontline supervisors in these teams are supported by a small 'Industry analysis' team and by a 'Statistics' team but a dedicated 'Research' team within the Policy and Statistics team was disbanded in 2013.

This is not to suggest that APRA is insensible to the potential for systemic risk in the superannuation system. Indeed its Supervision Blueprint notes that:

> 'A key part of APRA's supervisory assessments are supervisory action plans for supervised institutions. While these focus on addressing the key risk areas for an institution, in some cases broader industry or process issues may be identified which also require action.'[48]

Two industry-wide initiatives are reportedly currently in train: conflicts of interest and insurance in superannuation. Notably, however, neither is a systemic issue *per se*. Indeed examination of APRA's

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42 http://www.aph.gov.au/Parliamentary_Business/Committees/Joint/Corporations_and_Financial_Services/Completed_inquiries/2010-13/trio/report/index.

43 ASIC n11 13-14.

44 ASIC, n 11 17.

45 Black J "Managing Regulatory Risks and Defining the Parameters of Blame: A Focus on the Australian Prudential Regulation Authority"(2006) 28 *Law & Policy* 1.

46 See http://www.apra.gov.au/CrossIndustry/Documents/PAIRS-062012-External-version.pdf.

47 See http://www.apra.gov.au/CrossIndustry/Documents/SOARS-062012-External-version.pdf.

48 APRA, *Supervision Blueprint* (January 2010). http://www.apra.gov.au/AboutAPRA/Publications/Pages/Supervision-Blueprint.aspx.

website suggests that its various interactions with trustees over 2008-9 in relation to the holding, valuation and management of illiquid investments in the aftermath of the GFC were the last time such thematic enquiries had a systemic character.

This focus on local risk is understandable but is not strictly required. Section 8 of the *Australian Prudential Regulation Authority Act 1998* (Cth) empowers APRA to regulate:

> 'bodies in the financial sector in accordance with other laws of the Commonwealth that provide for prudential regulation or for retirement income standards'

There is nothing in that provision which would preclude attention to the systemic implications of identified local risks. Indeed APRA already considers systemic risk in the banking sector as part of its international obligations to the Basel Committee on Banking Supervision.[49] A change of mindset, then, not a change of mandate is required for APRA in respect of the superannuation system.

New regulatory tools are required to address systemic issues

The regulatory tools and strategies employed by APRA and ASIC to reduce the incidence and severity of local risks clearly reduce the potential for systemic risks of the types described in this article. There are however two aspects of a locally-focussed regime that render it less effective at addressing emergent systemic risks.

The first of these arises from the challenge of calibrating the regulatory settings appropriate for the systemic risks inherent in an entity and its processes based purely on a local assessment. Systemic risks of the type considered in this article are almost by definition contextual. Scale is not necessarily an indicator of systemic criticality and often it is the coincidence of a variety of characteristics that transforms a local failure into one with systemic implications. Indeed its criticality to the system may be the result of technical innovation or commercial acuity from which it expects to extract commensurate commercial reward. The entity requiring constraint may not have done anything wrong'. Unlike competition regulators, financial regulators on the whole have not historically been required to constrain commercial activity where there is no discretely identifiable wrong-doing. New analytical processes, perhaps drawn from competition regulation and other domains, will be required.

The second, though related, change required is to move beyond the current suite of regulatory tools. Clearly regulatory capital is not always going to be an adequate response, if only because of the escalating potential of a cascading risk. Financial sanctions are also problematic in that environment, given the challenge of justifying a quantum of remediation out of all proportion from the original failure. Similarly, the threat of licence deprivation or curtailment merely encourages multi-stage gamesmanship on the part of the regulated party. Other more nuanced regulatory processes, almost certainly implemented *ex ante*, are required.

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49 APRA, *Information Paper. Domestic systemically important banks in Australia*, (December 2013); http://www.apra.gov.au/adi/Publications/Documents/Information-Paper-Domestic-systemically-important-banks-in-Australia-December-2013.pdf. Ironically, the authors' attempts to have the custodial role played by entities within the banking groups considered in this analysis were summarily rebuffed.

REGULATORY RISK TOLERANCE MUST BE ARTICULATED AND CALIBRATED MORE PRECISELY

There is widespread recognition of the need for regulatory activity to accommodate commercial risk taking. To this end, APRAs Supervisory Blueprint talks of APRA aiming to achieve a 'low incidence of failure of supervised institutions' rather than a zero risk of failure.[50] This reflects the Government's Statement of Expectations of APRA at the time the Blueprint was published. In that document, the Government noted that

> 'It is recognized that prudential regulation cannot and should not seek to guarantee a zero failure rate of prudentially regulated institutions or provide absolute protection for market participants (including consumers). A regulatory approach of this intensity would remove the natural spectrum of risk that is fundamental to well-functioning markets, and ultimately reduce the efficiency and growth of the Australian economy.'[51]

The current Government's Statement of Expectations, issued without fanfare in April 2014, is to similar effect. It notes that 'it is not possible or efficient to eliminate all risks and that trade-offs in risk reductions are necessary.'[52] This phrasing expressly recognises that some low frequency of local failures may be acceptable in the pursuit of the overall objectives of 'financial stability and efficiency, competition, contestability and competitive neutrality'.

What neither of these statements does is make clear that one important consideration in determining the form and intensity of a regulatory initiative is whether the risk poses a threat to the system as a whole. Risks carrying that potential warrant greater priority and justify more invasive regulation, but, as was noted above, can be harder to defend in the face of industry resistance because they are often imposed on parties who have done nothing 'wrong.' Express government recognition of this need to address threats to the system would buttress APRA's resolve in such circumstances. However such innovation seems unlikely given the priority currently accorded to the government's de-regulatory agenda.[53]

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50 APRA Blueprint, n 48 5.

51 http://www.apra.gov.au/AboutAPRA/Documents/Statement-of-Expectations-from-Treasurer-20-Feb-07.pdf.

52 http://www.apra.gov.au/AboutAPRA/Documents/140417-SOE-APRA-Statement-of-Expectations.pdf,.

53 Indeed reference to this agenda is the first item specifically raised in the government's 2014 Statement of Expectations of APRA; APRA, n 52.

THE LIMITS OF APRA'S JURISDICTION NEEDS TO BE REVIEWED

There are a variety of processes and activities required to administer a modern superannuation fund. There are two models by which this occurs today. There are a relatively small number of vertically integrated financial services organisations, mostly clustered around banking organisations, who subsume within their corporate structures many of the operational linkages required to administer the superannuation funds for which they are responsible. Alternatively, the majority of funds (by number if not by assets) employ an outsourcing model in which the trustee must rely on an ongoing basis on the coordinated efforts of a range of external parties to give effect to the trust. Different issues arise in respect of each.

APRA's jurisdiction over banking and insurance entities would seem, on its face, to address any concerns about its capacity to regulate superannuation entities pursuing the first, vertically-integrated business model. Any issues are therefore more practical than formally jurisdictional. The most important of these is the risk that the light capital requirements to provide services to the superannuation industry compared with those required to accept banking deposits or issue insurance contracts renders the parts of the group that provide trustee, custodial, advisory and other services less salient from a traditional regulatory perspective than those providing banking and insurance products.

APRA's jurisdiction in respect of the outsourced model is more problematic. Only some of the entities involved in the administration of a superannuation fund are formally within APRA's jurisdiction. Key components relevant to APRA's prudential regulatory mandate are not. That list includes member benefit administrators, investment managers and actuaries, albeit that the latter group is arguably 'enrolled' in a co-regulatory role on the basis of its recognised professional standards. As noted above, APRA addresses this limitation by focusing its regulatory attention on the trustee of each superannuation fund and by regulating the ways in which trustees can engage with the various external service providers it requires in order to administer the fund. This indirect supervision seems inconsistent with the crucial role played by the custodian (and perhaps also the member benefit administrator) in the administration of the funds.

The other jurisdictional problem is the use of sub-custodians operating in jurisdictions outside Australia. There are obvious problems with Australian regulators attempting to impose extra-territorial constraints on overseas entities but ASIC's current expectation that superannuation fund trustees

> 'specifically consider in their risk management arrangements the additional risks that may arise because of exposure to jurisdictions, sub-custodians and service providers that do not provide appropriate protections for and regulation of product types .'[54]

seems dangerously toothless. The Australian superannuation system is sufficiently large in global terms, and sufficiently important (on so many dimensions) in local terms, that more assertive regulation seems in order.

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[54] ASIC, n 11 35.

CONCLUDING COMMENTS

Custodians play a key role in the administration of the Australian superannuation system. Failures related to the custody of the assets in a superannuation fund can obviously have a significant impact on the funds involved, and on their members. The structure of the overall system however adds a further dimension to that risk. The widespread use of external service providers, including custodians, creates an interconnected environment in which local risks can affect a large number of funds either directly or through a process of propagation, a situation that is exacerbated by industry concentration in a number of sectors. The nature of any process of infection would not be straightforward. It would depend crucially on the precise nature of different aspects of the relationship between the trustees and their custodians. The length and complexity of the Lehman administration, in particular, highlights the risks to funds when the relationship comprises multiple characters beyond the simple custodian-client relationship. Not surprisingly ASIC and APRA are increasingly aware of the potential for local risks to have systemic implications, but for a variety of institutional, jurisdictional and political reasons they appear to be ill-equipped currently to address the threat.