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The Hon Dr Jim Chalmers MP
Treasurer
Parliament House
CANBERRA ACT 2600

By Email – [redacted]

Dear Treasurer

USE OF DERIVATIVES BY SUPERANNUATION FUNDS

The Council of Financial Regulators (CFR) was asked by the previous Treasurer on 11 November 2021 whether it had concerns regarding the use of derivatives by superannuation funds in Australia. The CFR was asked to reply by 30 June this year.

The CFR's assessment is that derivatives usage by superannuation funds is predominantly for risk management purposes and is supported by appropriate financial and operational risk management regulatory standards and frameworks. It raises no particular concerns at this point in time.

Operational capability of funds to properly manage large volumes of derivative transactions

Derivatives exposures of trustees are currently concentrated amongst a handful of funds. Derivatives usage is, however, likely to become more widespread in coming years as the sector continues to mature and consolidate. The CFR will continue to monitor this growth, including the implications for liquidity.

APRA currently has no material concerns regarding the capability of trustees to manage the operational risks arising from derivatives exposures. Based on APRA's analysis, trustees generally have access to adequately skilled and resourced internal investment personnel, specialist external advice and adequate risk management and trading systems. Like all trustee assets, derivatives are required to be held by external custodians and valued independently or through an audited process.

Prudential implications for the operation of individual funds and the outcomes for members of those funds

Our assessment is that the legislative and regulatory framework governing trustees' use of derivatives is sound and comprehensive. One important element of this framework is that trustees are not permitted to use derivatives for gearing purposes (SIS Act). The main effect of this constraint is that use of derivatives is limited to risk management and derivatives may not be used to gain leveraged exposure to market risks.

APRA's assessment is that the existing use of derivatives by superannuation funds is consistent with trustees' obligations to act in their members' best financial interests. Currently, the main use of derivatives is for hedging foreign exchange exposures. This enables superannuation funds to offer products with lower exposure to foreign exchange rate volatility. Derivatives are also used by some trustees to manage asset allocations and liquidity in a way that is lower cost to members than transacting in physical assets. The most common derivatives used by trustees are simple and widely traded over-the-counter derivatives. Counterparty risks are managed through various measures such as counterparty limits and the use of collateral.

Super funds derivatives - as at 30 June 2021

Exposure type	% of total
Foreign exchange	77.0%
Interest rate	8.9%
Equity	8.5%
Other	5.1%
Credit risk	0.4%
Commodity	0.1%
	100.0%

As a consequence of the limitation on gearing, derivatives exposures are unlikely to become a large share of any trustee's total assets. The derivatives exposures of the most active users amount to less than two per cent of their total assets.

Trustees' use of derivatives is subject to APRA regulatory standards covering financial and operational risk management. Key aspects of these standards include counterparty risk management, collateral management, monitoring and breach reporting, service provider oversight and liquidity management. These standards have recently been updated to include more stringent liquidity risk management requirements.

Trustees and any other firms with larger derivatives exposures are also required to meet stricter financial risk management standards introduced following the global financial crisis. The effect of these standards is to reduce counterparty and systemic risks associated with derivatives. It also provides an incentive for trustees to make greater use of derivatives cleared through central counterparties.

Superannuation funds are required to report data to CFR agencies and also provide public disclosures on their use of derivatives. These data provide indicators of potential risks that may arise from derivatives. The data collections will be enhanced in coming years to increase the coverage, frequency of reporting and disclosure requirements.

Broader implications in terms of financial system stability

The CFR's view is that there is currently limited scope for financial instability to result from the use of derivatives by superannuation funds. Superannuation funds managed the liquidity issues associated with pandemic-related withdrawals reasonably well, increasing their holdings of liquid assets. This episode highlights the importance of both strong liquidity risk management regulatory standards and trustees maintaining a strong focus on their liquidity positions.

The CFR would be pleased to provide further information and discuss our assessment.

Yours sincerely

cc: Wayne Byres – Chair, APRA
Steven Kennedy PSM – Secretary to the Treasury
Joseph Longo – Chair, ASIC