NATIONAL SUPERANNUATION FUND

RESERVING MANAGEMENT POLICY

and

INVESTMENT OF RESERVES POLICY

DOCUMENT CONTROL

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Name	Position
Dominic Beange	Investment Consultant
David Brown	Chief Investment Officer

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1. PURPOSE OF THE CREDITING RATE POLICY

1.1 The purpose of this policy is to provide a framework for the Trustee Board when determining the approach to reserves (if any), and investment of any reserves.

2. LEGISLATIVE REQUIREMENTS

2.1 The primary legislative document governing the superannuation industry is the Superannuation Act 2000 (as amended). Section 71A of the Act refers to Reserves. (See Attachment 1).

2.2 The Trustee Board is also required to adhere to various Prudential Standards and in relation to reserving management and the investment of any funds held in reserve. *Superannuation Prudential Standard 1/2014* Authorised Superannuation Fund Investments (PS 1/2014) refers. Paragraphs 14 and 15 refer in detail to Reserving Policy, and investment of any reserves (if applicable). (See Attachment 2).

3. WHAT ARE RESERVES, AND WHY WOULD NASFUND HOLD RESERVES?

3.1 Superannuation funds generally seek to pay out all, or virtually all, earnings for a period to the members in the Fund at that time. This is generally seen as fair to all members, whether they be current, exiting or prospective members, as those members current at any time receive current earnings (which can be negative as well as positive).

3.2 Reserves are part of the earnings of a given period, which are not paid out in that period, and are kept “in reserve” for a future period.

3.3 Not all unallocated monies constitute reserves. Unallocated monies that are not reserves include accounting constructs such as suspense accounts, and accounts for accrued expenses and provisions for administration expenses, taxation or building maintenance.

3.4 Superannuation funds may want to keep a level of reserves from one period to be spent or allocated to member accounts in a future period.

3.5 A common type of reserve is one used to smooth Crediting Rates over time, in this paper referred to as an Investment Fluctuation Reserve (IFR). Some members of Superannuation Funds feel more secure if Crediting Rates were smoother, rather than having volatile returns from year to year. Other members, particularly those close to retirement, may feel disadvantaged if earnings are not distributed in full. The Australian Prudential Regulation Authority (APRA) notes that portability of benefits between funds has "caused trustees to reconsider the appropriateness of IFR's and, as a result, many [IFR's] have been dispensed with". (Source: APRA Prudential Practice Guide SPG 235).

3.6 Other common reserves include funds held to pay for multi-year expenses such as system upgrades (Administration Reserves), funds held instead of paying insurance premiums (Self Insurance Reserves), or funds held in case of a future expense arising from unexpected human or system failure (Operational Risk Reserves).

3.7 The Trustee Board of NASFUND is mindful of the competing interests of separate groups of members, especially the possibility that some members may pay towards a reserve and leave the Fund without receiving a corresponding benefit. For reasons of member fairness therefore, NASFUND Trustee Board expects Crediting Rates to reflect Fund earnings in the relevant period (which may be positive or negative).

3.8 Where reserves are maintained, the Trustee Board will establish a comprehensive management strategy which will contain appropriate objectives for which the reserves are established as well as measures to manage the reserves.

3.9 Before establishing a reserve, the Trustee Board will clearly describe why the reserve is to be established, and its ongoing purpose. If reserves are to be established, the Trustee Board may establish a separate reserve for each identified purpose or may cover more than one purpose through a single reserve account.

3.10 If more than one purpose is to be covered through one reserve, the Trustee Board would only do so if the identified purposes are fundamentally similar in nature, and if the management of one reserve is adequate to prudently manage the separate purposes over time.

3.11 Other types of reserves that might be maintained by Superannuation Funds include Contributions Reserves, Self-insurance Reserves, Compliance Reserves, Administration Reserves and Liquidity Reserves. The Trustee Board does not intend to open reserves to manage these risks at this time.

3.12 The Trustee Board has decided to limit the possible reserves to manage just three specific categories: Administration, Investment Fluctuation and Operational Risk.

3.13 If reserves are maintained these are not expected to be “large” (Section 71A of the Superannuation Act suggests reserves in aggregate should not exceed 2% of the Fund’s assets), and not be allowed to have a negative value.

4. ADMINISTRATION RESERVE AND ASSOCIATED INVESTMENT STRATEGY

4.1 The Trustee Board reserves the right to create/maintain an Administration Reserve.

4.2 An Administration Reserve would be maintained to hold funds ready for future administration expenses, to ensure the Trustee’s solvency and support its business operations. Such a reserve may have merit as the Trustee for National Superannuation Fund (NASFUND) is a not-for-profit trustee, and therefore does not have access to accrued earnings in the event of emergency. Such a reserve, therefore, may be seen as similar to minimum capital requirements for banks and insurance companies.

4.3 If the Trustee Board chooses to maintain an Administration Reserve, such a reserve is not expected to be more than 0.5% of the Net Assets of Fund, and to never be negative. At the time of writing, the Trustee Board *does not maintain an Administration Reserve*.

4.4 Associated investment strategy: Funds held in an Administration Reserve will be separately accounted for, apart from the general investment pool of member’s funds. Given that such a reserve is intended to be called on to cover unexpected administration costs, the Administration Reserve funds would be invested conservatively, and in low risk investments such as bank deposits or Treasury Bills (guaranteed by the State of Papua New Guinea). The Fund will account for such reserves separately, but the actual funds may be invested along with other Fund investments of a similar nature.

5. INVESTMENT FLUCTUATION RESERVE AND ASSOCIATED INVESTMENT STRATEGY

5.1 The Trustee Board reserves the right to create/maintain an Investment Fluctuation Reserve.

5.2 An Investment Fluctuation Reserve (IFR) would be maintained to hold funds for future years, in order to minimize the impact of market fluctuations on members' account balances and to smooth Crediting Rates over a number of years. For example, to increase the Crediting Rate in a year in which earnings are temporarily low, or to reduce the Crediting Rate in a year in which earnings are temporarily high.

5.3 If the Trustee Board chooses to maintain an IFR, such a reserve is not expected to be more than 2.0% of the Net Assets of Fund, and to never be negative. At the time of writing, the Trustee Board *maintains an Investment Fluctuation Reserve*.

5.4 Associated investment strategy: Funds held in an Investment Fluctuation Reserve will be separately accounted for, apart from the general investment pool of member's funds. Given that such a reserve is intended to be called on to smooth Crediting Rates in periods of temporary volatility, the IFR funds would be invested conservatively, and in low risk investments such as bank deposits or Treasury Bills (guaranteed by the State of Papua New Guinea). The Fund will account for such reserves separately, but the actual funds may be invested along with other Fund investments of a similar nature.

6. OPERATIONAL RISK RESERVE AND ASSOCIATED INVESTMENT STRATEGY

6.1 The Trustee Board reserves the right to create/maintain an Operational Risk Reserve.

6.2 An Operational Risk Reserve would be maintained to hold funds for future years, in order to have funds available in the event of an operational error such as system or human error.

6.3 The Fund seeks to reduce operational risks to a minimum through robust policies and procedures, and policing these procedures through regular internal and external audits. The Fund has a Risk Management Framework and holds insurance policies against losses due to operational error (including fraud), and the Trustee Board does not see an Operational Risk Reserve as a substitute for proper care and diligence.

6.4 APRA notes in SPG 235 that "it is becoming more common for trustees to maintain a contingency reserve to assist in mitigating operational risks {and} APRA considers this to be prudent practice". APRA states that maintaining certain reserves (for example, an Operational Risk Reserve that could be drawn on to rectify incorrect Crediting Rates) "may in fact be a more equitable way of meeting the cost of rectifying operational errors than charging the full cost to the persons who are members of the fund at the time the errors are detected or rectified". APRA notes "There is no inherent inequity in this approach to spreading costs over time or generations of members, given that all members potentially benefit from the intended smoothing effect, even if the contingencies do not eventuate during the membership of a particular cohort." (Source: APRA Prudential Practice Guide SPG 235).

6.5 The Trustee Board expects third party providers to make good their own errors, and insurance policies are maintained as well. However, claims against a service provider or insurance policy, even if lodged immediately, will often be paid with a delay, may be settled for less than the full amount or may not be accepted by the insurance company or service provider, resulting in litigation and associated costs. An appropriate Operational Risk Reserve would assist the Trustee to meet the costs of rectifying errors without having to await the outcome of recovery action against third parties, thus benefitting members through continuity of service.

6.6 Associated investment strategy: Funds held in an Operational Risk Reserve will be separately accounted for, apart from the general investment pool of member's funds. Given that such a reserve is intended to be called on to make good the costs of operational errors, the Operational Risk Reserve funds would be invested conservatively, and in low risk investments such as bank deposits or Treasury Bills (guaranteed by the State of Papua New Guinea). The Fund will account for such reserves separately, but the actual funds may be invested along with other Fund investments of a similar nature.

7. ANNUAL REVIEW OF RESERVING MANAGEMENT POLICY

7.1 The Trustee Board will review the Reserving Management Policy on a regular basis and at least annually.

7.2 The triggers for more frequent review are:

7.2.1 Sudden and unexpected negative portfolio returns (5% or more in one month), leading to high prospect of negative Crediting Rate in the present period;

7.2.2 Sudden and unexpected positive portfolio returns (5% or more in one month), as these returns are unlikely to be repeatable and for reasons of member fairness some of the windfall profit might be reserved;

8. ATTACHMENT 1: SUPERANNUATION ACT, SECTION 71A

The following is a transcript from the Superannuation (General Provisions) Act, 2000.

71A. Reserving.

(1) The trustee of an ASF may maintain reserves of the ASF unless the governing rules of the ASF prohibit it.

(2) On and from the Change Date as defined in Part XVIII in respect of the ASF, the amount standing to the credit of the reserve at any time shall not be more than 2% of the total value of the assets of the ASF at that time.

(3) The Central Bank may, by written notice to the licensed trustee of an ASF, fix a higher percentage for the purposes of Subsection (2) for the ASF.

(4) The licensed trustee of an ASF shall ensure that if the amount standing to the credit of the reserve of the ASF at any time is more than 2% of the total value of the assets of the ASF at that time, the strategy for the purposes of the covenant in Section 71(2)(ga) has been approved in writing by the Central Bank.

(5) The Central Bank may not give approval under Subsection (4) unless it is satisfied that the ASF's strategy for the purposes of the covenant in Section 71(2)(ga) takes proper account of the higher percentage, and makes provision satisfactory to the Central Bank for reducing the percentage of reserves to 2%

9. ATTACHMENT 2: PRUDENTIAL STANDARD 1/2014, PARAGRAPHS 14 AND 15

The following is a transcript from the Prudential Standard 1/2014 *Authorized Superannuation Fund investments*.

Paragraph 14

Investment Objective and Investment Strategy for Reserves

a) The Trustee Board must:
   a. Consider and document the objective and purpose of each reserve which it maintains;
   b. Determine an investment objective and an investment strategy for each of the reserves it maintains, which must be appropriate for the objective and purpose of maintaining each reserve.
   c. Develop and document a comprehensive Reserving Management Policy, in consultation with the Licensed Investment Manager, for all reserves which it maintains.

b) The Reserving Management Policy must be part of the Investment Framework for the ASF and must be reviewed on a regular basis (at least annually).

c) The Reserving Management Policy must be published in the Annual Report to members including being published on the public section of the ASF's web site.

Commentary

1) Investment fluctuation reserves are generally held for the purpose of maintaining a reserve to enable the Trustee Board to minimize the likelihood of negative crediting rates. As such, the assets held as reserves should be invested in a manner consistent with that objective and not invested in line with the general pool of assets held by the ASF for members.

2) Section 71A of the Act currently limits reserves to a maximum of not more than 2% of the total value of the assets of the ASF at that time. Where an ASF wants to operate a reserve or reserves, which in aggregate, exceed 2% of the total value of the assets of the ASF at any time, the Trustee Board must request approval in writing from the Bank for the higher percentage and for the investment objectives and strategies for the reserves.
3) If such approval is granted, the Bank may require that the Trustee Board undertake a membership education program to enhance the understanding and acceptance by the members and the general public of investment fluctuations and investment volatility.

Paragraph 15

Application and Management of Reserves

a) The Trustee Board must ensure that each reserve which it maintains must only be used in accordance with the purpose for which each reserve is established.

Commentary

1) The reserves of an ASF are monies forming part of the new assets of the ASF and have been set aside for a clearly stated purpose. Not all unallocated monies constitute reserves and this includes such things as defined benefit fund surpluses and suspense accounts used to record contributions and rollovers pending allocation to their specific members' accounts. Main classes of reserves include:
    i) Administration reserve used to fund future administration and operational expenses of an ASF.
    ii) Investment fluctuation reserve used in conjunction with crediting rates in an ASF to smooth the impact of market fluctuations on members' account balances over a number of years.

iii) Operational risk reserve used to hold the financial resources to meet an ASF target amount.

2) Reserves are largely concerned with contingent events and, as such, it is expected that the Trustee Board must exercise judgement in determining the need for them, their scop, size and operation.