Prudential Practice Guide

SPG 114 – Operational Risk Financial Requirement

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About this guide

Prudential practice guides (PPGs) provide guidance on APRA's view of sound practice in particular areas. PPGs frequently discuss legal requirements from legislation, regulations or APRA's prudential standards, but do not themselves create enforceable requirements.

The *Superannuation Industry (Supervision) Act 1993* (SIS Act) requires an RSE licensee to maintain and manage, in accordance with the prudential standards, financial resources to cover the operational risk that relates to each RSE within its business operations.[1] *Prudential Standard SPS 114 Operational Risk Financial Requirement* (SPS 114) establishes requirements relating to these financial resources.

This PPG aims to assist an RSE licensee in complying with those requirements and, more generally, to outline prudent practices in relation to the operational risk financial requirement (ORFR).

This PPG is to be read with other PPGs related to risk management, including *Prudential Practice Guide SPG 220 Risk Management* (SPG 220), *Prudential Practice Guide SPG 231 Outsourcing* and *Prudential Practice Guide SPG 232 Business Continuity Management.*

For the purposes of this guide, and consistent with the application of SPS 114, 'RSE licensee' and registrable superannuation entity (RSE) have the meaning given in the SIS Act.

Subject to the requirements of SPS 114, an RSE licensee has the flexibility to structure its business operations in the way most suited to achieving its business objectives. Not all practices outlined in this PPG will be relevant for every RSE licensee and some aspects may vary depending upon the size, business mix and complexity of the RSE licensee's business operations.

1 Refer to s. 52(8)(b) of the SIS Act.

Operational risk financial requirement

1. SPS 114 establishes requirements for an RSE licensee to maintain adequate financial resources to address operational risk events that may affect its business operations. SPG 220 provides examples of operational risks that may lead to operational risk events.[2]

2. APRA envisages that an RSE licensee's definition and application of operational risk would be clearly understood and consistently applied throughout the RSE licensee's business operations in order for the effective identification and management of this risk.

3. An effective risk management framework will enable an RSE licensee to develop a thorough understanding of the operational risks facing its business operations, its appetite for operational risk and the measures it has in place to control, monitor and, when appropriate, reduce these risks.[3] It is APRA's view that, in time, this will facilitate the implementation of rigorous and more evidence-based methods in relation to an RSE licensee's operational risk financial requirement strategy.

ORFR strategy

4. The ORFR strategy is a key document that enables an RSE licensee to provide clear direction and guidance to senior management to facilitate consistent and effective maintenance of adequate financial resources to address operational risks.

5. Sections 52(2)(e) and (f) of the SIS Act impose a duty on an RSE licensee to act fairly in dealing with classes of beneficiaries within each RSE and with beneficiaries within a class. APRA expects an RSE licensee would give primacy to the consideration of this duty in all aspects of its ORFR strategy.

2 Refer to SPS 114 for definitions of 'operational risk' and 'operational risk event'.

3 Refer to *Prudential Standard SPS 220 Risk Management* and SPG 220.

Determining the ORFR target amount

6. SPS 114 requires an RSE licensee to consider the operational risks that may impact on its business operations when determining its ORFR target amount. APRA expects an RSE licensee's assessment of operational risks to focus in particular on those risk events that it believes may have a material impact on the beneficiaries of its business operations.

7. APRA does not endorse any particular approach for determining the ORFR target amount. APRA expects that the majority of RSE licensees would determine their ORFR target amount based on a fairly straightforward approach.

8. There is scope for broad interpretation of the range of impacts that the ORFR target amount aims to cover. It is APRA's view that the ORFR target amount would be based, at a minimum, on the predicted impact of operational risk events that may have a material impact on the RSE licensee's business operations. This minimum expectation excludes extreme events that may have a catastrophic impact.

Guideline ORFR target amount

9. APRA expects a soundly run RSE licensee that has implemented an effective risk management framework to have an ORFR target amount that is equivalent to at least 0.25 per cent of funds under management (FUM). For the purposes of calculating the ORFR target amount, APRA views FUM as the total of asset balances of each RSE within the RSE licensee's business operations.

10. APRA expects that an RSE licensee will consider circumstances when more than this guideline amount may be appropriate and envisages it is unlikely that there will be many circumstances where less than this guideline amount would be appropriate.

11. An equivalent method of expressing the guideline amount in relation to a defined benefit fund may be 0.25 per cent of liabilities in respect of vested benefits.

12. Paragraphs 17 to 26 discuss an alternative guideline amount that may be applied when an RSE invests in another entity that is subject to SPS 114 or another APRA financial requirement relating to operational risk.

Tolerance limit

13. The ORFR tolerance limit is intended to enable an RSE licensee to manage immaterial fluctuations below the ORFR target amount without the need for a replenishment plan.
14. APRA envisages that immaterial fluctuations may arise from a small payment or payments out of the financial resources held to meet the ORFR target amount, or an insignificant underperformance of the financial resources held to meet the ORFR target amount against an RSE licensee's investment objectives for the financial resources.

Impact of compensation arrangements on the ORFR target amount

15. An RSE licensee may enter into arrangements that could provide it with a compensation payment to address the cost of an operational risk event. Such arrangements may include insurance policies, access to financial resources under an enforceable agreement or undertaking, or guarantees.
16. APRA's view is that compensation arrangements may play an important role in replenishing the financial resources held to meet the ORFR target amount after it has been used. However, such arrangements do not reduce the probability of operational risk events and there is likely to be a level of uncertainty as to the timing, coverage and availability of compensation payments. Accordingly, APRA's view is that compensation arrangements do not influence the ORFR target amount but can reduce the prospect that members bear the cost of replenishing the financial resources held to meet the ORFR target amount.

Impact of another APRA financial requirement on the ORFR target amount

17. The assets of an RSE ('an investing RSE') may be invested in another entity that is subject to SPS 114 or another APRA financial requirement relating to operational risk. This other entity may be another entity within the RSE licensee's business operations (e.g. a pooled superannuation trust (PST)) or another entity outside the RSE licensee's business operations.
18. An RSE licensee may determine that an investing RSE's investment in another entity reduces the RSE licensee's ORFR target amount. This may occur where the RSE licensee establishes that the other APRA financial requirement will directly address certain operational risks that would otherwise be addressed by the RSE licensee's ORFR target amount in respect of an investing RSE. In order for an RSE licensee to decide such a reduction is appropriate, APRA would expect an RSE licensee to be able to demonstrate that it has:
    (a) undertaken appropriate analysis of the coverage and availability of the other entity's APRA financial requirement for the purpose of any operational risks that would otherwise be covered by the RSE licensee's ORFR target amount in respect of an investing RSE;
    (b) a thorough understanding of the other entity's risk management framework such that it is satisfied that the framework appropriately addresses the operational risks that would otherwise be addressed by the RSE licensee's ORFR target amount in respect of an investing RSE; and
    (c) determined, via assessment, that the other entity adequately manages its operational risks.

    APRA considers that an RSE licensee would typically only be able to demonstrate the above when the other entity is within an RSE licensee's business operations, or is closely related to the RSE licensee.

19. Where another APRA financial requirement has a substantial impact on an RSE licensee's ORFR target amount in respect of an investing RSE, an RSE licensee would describe this in its ORFR strategy. In addition, the RSE licensee would ordinarily ensure that amongst other things:
    (a) both entities have aligned risk management frameworks for the management of operational risk;
    (b) the RSE licensee has the ability to influence the other entity's approach to the management of operational risk; and
    (c) the other entity maintains an appropriate amount of unrestricted financial resources for operational risks that would otherwise be addressed by the RSE licensee's ORFR target amount in respect of the investing RSE.

20. APRA's view is that transactions between the two entities will inevitably give rise to additional operational risks. This is regardless of the strength of the relationship between the two entities, the level of oversight that the RSE licensee has over the other entity and the level of assurance provided by the other entity. Further, not all of the operational risks of an investing RSE are likely to be able to be addressed by the APRA financial requirement of another entity.

21. Where an investing RSE is invested in another entity outside of the RSE licensee's business operations that is subject to SPS 114 or another APRA financial requirement relating to operational risk, and the RSE licensee considers that a reduction in the ORFR target amount is appropriate, APRA expects the ORFR target amount would be at least 0.10 per cent of FUM for the investing RSE.

22. APRA expects that if an RSE licensee seeks to rely, in part, on the APRA financial requirement of an entity that is outside of the RSE licensee's business operations, the RSE licensee would formalise this arrangement through a clear and enforceable contractual agreement. The RSE licensee would also establish information-sharing protocols and notification requirements to enable it to monitor the continuing appropriateness of its reliance on the other APRA financial requirement.

23. Where an investing RSE invests in another entity within an RSE licensee's business operations that is also subject to the requirements of SPS 114, such as a PST, the RSE licensee may allocate the reduction in the ORFR target amount to:
    (a) the investing RSE;
    (b) the investee entity; or
    (c) both entities.

24. APRA expects that:
    (a) the ORFR target amount for the investing RSE would be at least 0.10 per cent of the investing RSE's FUM;
    (b) the ORFR target amount for the investee entity would be at least 0.10 per cent of the investee entity's FUM; and
    (c) considered as a whole, the ORFR target amount covering the aggregate assets associated with both entities would be at least 0.175 per cent of aggregate FUM.

25. For example, where an RSE licensee with an RSE with assets of $100 million wholly invests those assets in a PST within the RSE licensee's business operations, the ORFR target amount would be calculated based on $200 million of FUM. This would result in:
    (a) the guideline ORFR target amount under paragraph 9 would be at least $500,000;
    (b) the ORFR target amount for the investing RSE would be at least $100,000;
    (c) the ORFR target amount for the PST would be at least $100,000;

(d) the ORFR target amount covering the aggregate FUM would be no less than $350,000.

26. APRA expects an RSE licensee would have documented decision making processes and outcomes to explain how any reduction in the ORFR target amount has been allocated. This would ordinarily have regard to, at a minimum:

    (a) the operational risk exposures in each entity; and

    (b) the source from which compensation for a loss relating to an operational risk event would be most appropriately paid.

ORFR target amounts for different operating models

27. Outsourcing an activity, such as fund administration, generally results in changes to the operational risk profile of the RSE licensee. APRA considers that the transfer of risks to a service provider may lead to new risks due to the changes in operations and the level of direct oversight and control as a result of the service provider relationship.

28. APRA expects it will be difficult for an RSE licensee to be able to demonstrate that it can confidently rely upon a service provider to directly address the cost of all operational risk events. In addition to the guidance on when an RSE licensee relies in part on another APRA financial requirement, a prudent RSE licensee would also consider matters such as the coverage of the outsourcing agreement and the financial capability of the service provider in different scenarios.[4]

Attribution of the ORFR target amount

29. An RSE licensee may attribute its ORFR target amount, and the financial resources held to meet its ORFR target amount, to different parts of its business operations. An RSE licensee may choose to do this because of matters such as different risk profiles, funding approaches or benefit provisions across different RSEs, sub-funds, products, investment options or MySuper products. Attribution may facilitate equitable funding, management, usage and replenishment of the total ORFR target amount across members.

30. For hybrid funds, APRA expects that an RSE licensee would have particular regard to member equity in relation to its method to fund the ORFR target amount (and use these financial resources) across accumulation and defined benefit member divisions.

Financial resources to meet the ORFR target amount

31. An RSE licensee may hold the financial resources to meet its ORFR target amount as operational risk trustee capital and/or an operational risk reserve within one or more RSEs within its business operations. A prudent RSE licensee would decide on an approach that is fair to beneficiaries and appropriate given its own circumstances.

Operational risk reserves

32. SPS 114 requires that the ORFR strategy include an investment strategy for maintaining any operational risk reserve. The primary purpose of an operational risk reserve is to provide an unrestricted commitment of financial resources to address losses arising from operational risk events in a timely manner.[5] When formulating, implementing and reviewing an investment strategy for an operational risk reserve, APRA expects an RSE licensee would ensure that the assets in the reserve have an appropriate risk profile and are sufficiently liquid to achieve this objective.

33. An RSE licensee may decide to implement an investment strategy for its operational risk reserves that mirrors the investment strategy of the RSE. This approach may assist it to maintain the level of ORFR financial resources at an appropriate level over time, provided that the RSE's investment strategy is liquid and the risk profile appropriate for the purposes of the ORFR.

34. The requirements of SPS 114 do not prevent an RSE licensee from holding reserves for other purposes that it deems appropriate. Whilst an RSE licensee may use financial resources of another

4 Refer to *Prudential Standard SPS 231 Outsourcing*.

5 Refer to SPS 114.

reserve to fund or replenish an operational risk reserve, it may only make a transfer out of an operational risk reserve in accordance with the provisions on the use of the financial resources held to meet the ORFR target amount in SPS 114.

Operational risk trustee capital

35. If an RSE licensee holds some or all of the financial resources to meet the ORFR target amount as operational risk trustee capital, it is APRA's view that these resources would ordinarily be held as assets of the RSE licensee itself.

36. APRA expects an RSE licensee would be able to demonstrate it has appropriate processes and controls in place to:

    (a) quarantine the capital for the sole purpose of meeting the ORFR target amount; or

    (b) monitor the value of its capital against both the portion of the ORFR target amount that the RSE licensee has determined should be held as trustee capital, and other liabilities of the RSE licensee.

Building the financial resources to meet the ORFR

37. APRA recognises that an RSE licensee's transition plan to build the financial resources to meet the ORFR target amount may include the transfer of assets from existing reserves or capital held to meet public offer licence conditions. APRA expects any such methods to be clearly articulated in the transition plan.

38. After an operational risk event where the financial resources have been used and the tolerance limit breached, SPS 114 requires that an RSE licensee implements a replenishment plan to rebuild the financial resources to meet the ORFR target amount.

39. If circumstances change during a transition or replenishment period such that the proposed funding method, or the ORFR target amount itself, is adjusted, APRA expects that a replacement transition or replenishment plan would be produced. A replenishment plan may take into account an anticipated payment from a compensation arrangement on which an RSE licensee believes it can reasonably rely.

Use of the financial resources held to meet the ORFR

40. An RSE licensee may call upon the financial resources held to meet the ORFR target amount to address an operational risk event. This definition is based on losses sustained by, or gains deprived from, beneficiaries and not costs to correct the cause of the event.

41. SPS 114 requires that the ORFR strategy must describe the process for calling on the financial resources held to meet the ORFR target amount. APRA expects this would be a clearly articulated process with suitable controls to ensure that any payments are consistent with the requirements of SPS 114 and the RSE licensee's ORFR strategy.

42. APRA envisages that a payment to address an operational risk event may include a transaction or other process-related cost(s) when an RSE licensee is able to justify that the cost has only materialised as a result of the operational risk event and payment of the cost in a timely manner is essential to ensure that the loss is properly addressed and members do not incur large one off expenses.

43. Examples of uses that APRA would regard as inconsistent with SPS 114 may include, but are not limited to, paying a premium for an insurance policy that may provide cover for certain operational risks, payment of any levies, costs of upgrading IT systems or payments addressing losses relating to investment underperformance.

44. The financial resources held to meet the ORFR target amount may be used if the RSE licensee determines that it is appropriate to reduce the ORFR target amount. An example where an ORFR target amount may be reduced is where an RSE licensee transfers some members in a successor fund transfer. In this scenario, a transferring RSE licensee may re-determine its ORFR target amount. It may also decide in some circumstances that it is appropriate for an amount of the financial resources held to meet its ORFR target amount to be transferred to the receiving RSE licensee.

Review and monitoring of the ORFR target amount and tolerance limit

45. SPS 114 requires review of the ORFR target amount and tolerance limit on an annual basis, and following a material change to the operational risks identified in an RSE licensee's risk management framework or the size, business mix and complexity of an RSE within its business operations.

46. APRA expects the reviews would be conducted by individuals with suitable experience, qualifications, capacity and clarity of objectives to perform a robust, objective, timely and forward-looking review. Resources from the risk management function and other suitably qualified and appropriate expert advisers may play a role in the review process.

47. APRA expects that the review would be appropriate to the size, business mix and complexity of an RSE licensee's business operations.

48. Following a review of the ORFR under SPS 114, an RSE licensee may determine that it is appropriate to adjust its ORFR target amount, tolerance limit or any other aspects of an RSE licensee's ORFR strategy, including how the financial resources to meet the ORFR target amount are held and invested.

49. A prudent RSE licensee would also implement monitoring processes to identify and escalate issues relating to the ORFR strategy. This would ordinarily include an incident management process, assurance process and reporting processes. Some monitoring approaches may also be facilitated by material trigger events determined by the RSE licensee.

50. APRA expects that an RSE licensee would maintain records of operational risk events as part of its risk management framework. This may include records of near miss incidents i.e. events that did not result in financial loss, but had the potential to do so. APRA's view is that, over time, such information would assist an RSE licensee in the development, review and monitoring of its ORFR strategy by providing a comprehensive record of when the RSE licensee decided to use or not use the financial resources held to meet the ORFR target amount. Refer to SPG 220 for guidance on key information that may facilitate analysis of incidents.

RSE licensee-determined material trigger events

51. As part of its incident management process, an RSE licensee may determine a series of material trigger events that act as a risk management control by providing early warning and a means of escalation for matters that may require a decision by the RSE licensee and notification to APRA.

52. APRA expects that such triggers may relate to material events regarding the funding, management, investment and use of the financial resources held to meet the ORFR target amount, and the appropriateness of the ORFR target amount itself.

53. APRA expects an RSE licensee's material event triggers would ordinarily include a trigger relating to a significant excess of financial resources held to meet the ORFR target amount. This may alert the Board of the RSE licensee to consider whether any action is appropriate in relation to the surplus. An RSE licensee may also consider forward-looking triggers that may relate to the identification of a surplus or shortfall based on planned activities.

Managing surplus ORFR financial resources

54. SPS 114 requires an RSE licensee to determine an ORFR target amount that is appropriate to the operational risks to which it is exposed. Activities such as a change in the risk profile of the RSE licensee's business operations, a reduction in the membership, a transfer, merger or wind up or investment performance have the potential to create a surplus of financial resources where the

RSE licensee may decide that the ORFR target amount is too high in the new circumstances and requires downward adjustment.

55. APRA expects an RSE licensee would implement a response to a surplus situation based on a fair and transparent method that has regard for how the surplus of financial resources has arisen. If an RSE licensee intends to make a payment to reduce a surplus, APRA would expect to receive early notification of the matter before the payment is made.

56. When an RSE closes to new entrants or membership declines significantly, APRA expects an RSE licensee would actively manage the risk that any unfairness may arise in the ultimate distribution of the financial resources held to meet the ORFR target amount.

57. Where the RSE is being wound up, APRA expects an RSE licensee would ordinarily carefully consider the distribution of any surplus financial resources held to meet the ORFR target amount. APRA would generally expect an RSE licensee to seek appropriate independent advice in such circumstances and ensure a fair outcome.

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