Strengthening Financial Resilience in Superannuation Discussion Paper

KPMG Submission

KPMG Australia

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We have an experienced team of lawyers and consultants, many of whom are leaders in their fields, who are experienced in trustee governance, risk and compliance and regularly advise on trustee resilience together with our consulting colleagues. We are a safe pair of hands, and have earned the respect of clients and regulators and can provide trustee boards and management with the confidence they need in their decision-making. As part of KPMG, we bring together all the skills and experience that our clients need to provide holistic end-to-end solutions every time.

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Introduction and Approach

KPMG welcomes APRA's discussion paper on trustee resilience. The financial stability of superannuation trustees is critical to providing strong and stable outcomes for members, as well as being critical from a macroeconomic perspective given the scale of collective assets under management in the superannuation industry.

How trustees think about capital management needs to evolve past Operational Risk Financial Requirement (ORFR) (SPS 114) & Strategic Planning & Member outcomes (SPS 515) requirements, as outlined in the discussion paper on '*Strengthening Financial Resilience in Superannuation*'.

Purpose of Capital Management

Good capital management begins with a sound understanding of the different purposes for which capital is required. For a superannuation fund this includes:

Stability and withstanding adverse events/outcomes

- This first purpose focuses on fund stability and withstanding adverse events and outcomes.
- For a fiduciary such as a superannuation trustee, considerations include having sufficient capital to meet member expectations of a very low risk of the fund (and therefore prospective and vested member benefits) being impacted by risks (other than risks they expect to be exposed to such as investment risk resulting from market performance).
- Besides large unanticipated loss events, funding short term operational shortfalls (due to performance or a short period where expenses are anticipated to exceed revenue) may also be included within this category, or alternatively be allowed for separately from large unlikely loss events.
- This broad category also includes potential penalty liability of a trustee entity, or other liability, that cannot be indemnified by the superannuation fund.

Funding initiatives

- This second purpose focuses on the ability to fund initiatives. Specifically, this is capital to fund initiatives that provide benefits to members which exceed the cost of the benefit (and for which no better or more cost-effective alternative approach to achieving those benefits exists). These initiatives should also be linked to the fund's strategy and business plan.
- At a more detailed level "initiative funding" can be divided into a number of sub-categories. For example:
  - Initiatives to invest in technology to improve efficiency/reduce cost, investment performance, improve member service, introduce a valuable product offering, to increase growth to reduce unit costs, etc.
  - Initiatives related to mergers or successor fund transfers.
  - Some funds may also consider within this overall "funding initiatives" category the funding of expenditure to meet new regulatory / compliance requirements. A superannuation fund, for example, cannot operate without investing to meet these requirements to continue to hold its license. Some may consider funding costs of regulatory change to be a separate standalone category from "funding initiatives". Regardless of how it is categorised it is a valid reason to hold/deploy capital.

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This purposive approach to identifying capital needs is broadly consistent with the capital management philosophy of other large and sophisticated organisations in fiduciary type industries/products, such as organisations that manage funds and make commitments to pay benefits to customers (e.g., banks, insurers, non-superannuation funds managers, etc.).

Approach and Principles

KPMG supports an approach of trustees adopting a holistic and dynamic capital management framework, based on risk profile and risk appetite of the fund, which is subject to regular and frequent review having regard to the risks and initiatives that trustees are facing. Inherent in this approach is also the management and investment of the capital held having regard to the need for access and appropriate levels of liquidity.

We define good holistic capital management of capital for superannuation as having regard to these anticipated future needs while applying the following principles:

- Funds should hold sufficient capital to meet member expectations of a very low risk of the fund (and therefore prospective and vested member benefits) being impacted by risks (other than risks they expect to be exposed to (such as investment risk relating to market performance)). This fundamentally requires an understanding of the risk profile of the fund.
- It is reasonable for entities to maintain reserves to fund potential initiatives where the benefits to the membership overall are greater than the cost.
- In deploying and in raising capital, funds should consider intergenerational fairness and fairness/outcomes between cohorts within a generation.
- In deploying and in raising capital, funds should clearly understand the demarcation between fund purposes and corporate purposes and capital held in those different capacities.
- Generally, reserves that are clearly surplus to fund the potential anticipated spending needs based on the principles above should be returned to members.

At a more detailed level, capital and risk frameworks, policies, processes and procedures should be developed taking into account these principles.

It is also noted that determining capital based on the above purposes and principles is complex, involves judgement (including in relation to the likelihood of future events which are uncertain) and therefore there is no single “right” number.

Importantly, the capital management approach and targets are not static and based on the above should be expected to vary based on changes in the fund’s internal and external environment.

Importance of Risk Profile and Appetite

Where capital is held for the purpose of “Stability and withstanding adverse events/outcomes” (as described above), it is critical to understand the risk profile of the fund. This can equally be the case whether the capital is held within the fund or outside of the fund (in the corporate account of the trustee). In either case, the activities of the fund and the fund’s risk profile are critical. Quantitative modelling and inputs can help determine capital requirements to support this purpose, however, other qualitative factors are also important to understand the risk profile for a particular fund. Many funds have invested significantly in first line processes, controls and risk management – as well as in second line and the risk management framework overall. Where a fund already has existing high quality risk assessments and analysis this is useful input for understanding the risk profile.

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Risk appetite and risk profile in turn inform the level of capital required. Further consideration should then be given to how that amount of capital is managed, and what triggers and levers are available where an event requiring capital occurs (or is at risk of occurring), or where the circumstances of the trustee and or the fund change.

The categories of capital that trustees should be maintaining will differ according to the purpose, with the risk assessment, quantum to be upheld and funding mechanisms being determined differently across the categories. The purpose of a holistic framework is to have a complete view across an entity, and to consider not only the different categories of capital but also the interrelationship between those categories at a holistic level having regard to the purpose of financial stability.

Summary of Approach

A holistic framework based on the purposes and principles set out above provides a sound basis for trustee decisions in relation to the holding, deployment and raising of capital.

In summary, our view is that trustees should adopt a holistic dynamic capital management framework and practices that have regard to the capital that a trustee entity may hold in different capacities (both as a fund trustee and in its personal capacity) and for different purposes.

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Section 1: Sources of financial resources

In relation to sources of financial resources we make comment on

- Sources of funding and support used by Registrable Superannuation Entity Licensees (RSELs)
- Use and determination of level of trustee fee
- Access to external financial resources

Sources of funding

Sources of funding and support vary significantly across the different sectors, depending on the capital the RSE licensee has access to. Retail funds have historically been able to rely on capital support from parent entities (as well as retained earnings from fees charged), whereas industry funds rely on trustee reserves (that are sourced from trustee fees).

Recently we have seen retail funds consider developing more contemporary capital management practices (to fund operating expenses, deliver their business plans and fund contingency expenses) in a way that does not presume a heavy reliance on capital support from a parent entity, with a greater focus on the need for reserves (usually held in a corporate capacity). This is largely due to two factors:

- an understanding that capital needs (including for remediation, the payment of penalties, the payment of damages or settlement costs) cannot be guaranteed by a parent, but will need to be considered by the parent at the relevant time, and the appropriate accounting for any provisions is at the trustee entity level; and
- the divestment (or intended divestment) of retail funds by the banks, where the funds now need to operate on a more standalone basis. New shareholders may not have the traditional mechanisms for the fund to request additional capital as banks did and may not have the same appetite to invest.

We do note that where a sale or divestment has occurred, there is likely access to an indemnity deed from the divesting parent in favour of the new parent (or the trustee itself) for the purpose of funding remediation or pre-sale conduct issues that result in liabilities post sale.

We have seen Not-for-Profit (NFP) funds adopt an array of reserving strategies unique to each Fund's operating model. They too seek to develop contemporary capital management practices that consider their unique operating models and arrangements. NFP funds have predominantly been better capitalised by way of reserves (beyond ORFR requirements, when compared to retail counterparts). Strategic/operational initiatives are commonly funded through general reserves.

As the industry continues to evolve at pace with both sales and mergers of superannuation funds, we expect that funding and support practices will change across all fund types in the near term. Alignment may occur between the sectors in relation to how capital is raised and managed, with retail banks potentially adopting more formal reserving strategies with reduced access to shareholder capital and NFP funds beginning to charge trustee fees.

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All outsourcing and servicing arrangements typically include indemnities for loss caused by breach of the outsourcing agreement. However, trustees do need to take care in reviewing those indemnities so that they do not inappropriately cap or inappropriately exclude liability or loss (which results from the provider's conduct). Another area for trustees to take care is where liability is shared, and how each "share" is determined. There may also potentially be delays in the third party provider agreeing to liability and the payment of amount. Until this is resolved, and depending on the exact circumstances, if the uncertainty is sufficiently great it may result in the superannuation fund needing to account to members in the interim. Finally, what is unclear is the extent to which trustees consider in their due diligence the appropriateness of service provider capitalisation, and the extent to which that might offset (or increase) a trustee's potential capital requirements.

Insurance is a typical external source of capital. While we do not comment on pitfalls or issues to be wary of when negotiating insurance, in terms of capital provision we note that trustees should be acutely aware of timing lags in the payment of insurance following a claim. There can be significant time spent in making and justifying a claim, and this potential for lag should be considered in the trustee's capital management strategy. Trustees should also be mindful of the capacity in which insurance is being sought (see below for further comments on this issue relating to capital reserves held in a trustee's corporate capacity outside of a fund).

Determining an Appropriate Trustee Fee

The starting point for determination of a trustee fee is always the rights or powers to charge that fee under the relevant trust deed, and any limitations or caps set out.

However, in terms of determining the amount within the scope of the trust deed, we are of the view that it is currently very difficult to discern a directly comparable benchmark for a trustee fee in the superannuation market, where the purpose of that fee is to remunerate for a trustee's professional services.

The rationale for this position is that the nature of what is included in a trustee fee is not consistent across the market.

Traditionally, the trustee fee NFP funds charge typically include the costs of the administration of the fund (both current and prospective (having regard to the costs of outsourcing and reserves)), without factoring any additional remuneration for the services of the corporate trustee. Retail funds, by comparison, while including a revenue and risk margin, also typically pay operating expenses from the corporate accounts of the trustee entity (rather than directly from the fund). As such, reliable data as to the comparative margin (and the profit element) is not easily discernible.

As a first step, an alternative to benchmarking is to consider the cost, expense and effort required in order to perform the relevant trustee services, and then add a profit and risk margin on top. The question is then what is an appropriate profit and risk margin. Comparison to the market can then provide a comparative view as to the competitiveness of the fee.

In recent cases where we were asked to consider a trustee fee in the context of a trustee looking to use that fee revenue for the purpose of building a capital reserve, we were asked to consider a fee that priced the "risks" that a trustee providing professional services needed to cover in their fee, but not a profit margin greater than the risk element.

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To cater for this, we developed a methodology that has regard to factors which, in our view, provided a suitable proxy for the risk related remuneration of a trustee in this context. The factors are:

- the target amount of trustee capital (having regard to the specific risk profile of the fund), as representing the risk that a trustee needs to cover as a professional provider of superannuation trustee services; and
- the competitiveness of the total fees and costs of the fund against the comparative market, which implicitly considers the ultimate member performance outcomes, and provides a lens of reasonableness.

In the case of the new trustee fees being established for the purpose of the trustee using that remuneration to fund its capital amount for potential penalty liability, it is possible that current administration fees charged to members may not be sufficient to cover the operating costs of the trustee and the new trustee fee. In this scenario, the trustee will need to use all or part of the reserves to pay the new trustee fee. There may be disclosure implications to such use, which would need to be considered. In this scenario, the new trustee fee will have an impact on the competitiveness of the Fund but, based on our review of the Trustee fees proposed to be charged by NFP funds, it will generally only be marginal given the size of the new trustee fee (and capacity to pay from existing reserves).

The source of funding for a project or an initiative should also be considered. The principle noted in our overarching comments is that to be valid or worthwhile, spending on a capital initiative must generate benefits exceeding costs (and there is no other better or more cost-effective way of achieving those benefits).

However, where the fund does not already have existing reserves for funding such an initiative then additional considerations (i.e. conflicts with the other principles outlined above) must be taken into account to determine the source for the additional funding. For example, the intergenerational/cohort impacts if the funding is to be provided by increased fees (e.g. the benefits may not all flow exactly to the members whose account balance is impacted by the increased fees).

Making such a decision involves judgement. In this submission we simply recognise that for a fund that does not have existing reserves, this decision-making process exists and requires judgement, balancing competing principles.

Access to external financial resources

As previously noted, where a fund does not have ready access to capital and needs to raise additional fees to generate it, this can create a conflict with other capital management principles. Many superannuation funds are aware of this and are conscious that other solutions may be available such as joint ventures, more progressive funding approaches/licensing, outsourcing, etc. This is also consistent with our point that superannuation funds should seek the lowest cost approach to obtaining an available benefit.

We note that are not generally supportive of the approach of a trustee borrowing or indeed entering the business of lending as a way of generating revenue for capital purposes. In our view, this introduces unnecessary risk into the superannuation environment (although there may

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be group circumstances that mitigate that risk). We do recognise that there have been instances with the introduction of the ORFR where loan arrangements have been put in place to fund the ORFR, and this may well have been appropriate.

Successor fund transfers and other events

Successor fund transfers, or other significant events such as the replacement of a trustee or the winding up of a fund, raise particular capital related issues. In this context we comment on two issues.

(i) Obtaining Indemnities

On a successor fund transfer or the replacement of a trustee, the transferring trustee should, in additional to the usual indemnities, consider negotiating indemnities in its favour from the receiving or new trustee such as:

- an indemnity to cover liabilities that could be met out of fund assets but for the merger. This indemnity would be available to the transferring trustee if the merger had not occurred and would cover any liabilities that are permitted to be paid out of fund assets under the fund's trust deed, being those liabilities that are permitted to be paid out of fund assets under section 56 and 57 of the Superannuation Industry (Supervision) (SIS) Act; and
- an indemnity to cover liabilities that cannot be met out of fund assets because of sections 56 and 57.

The ability to secure such indemnities will of course be dependent on the receiving (or new) trustee appetite and the perception of the risk profile of the transferring trustee. Ultimately the receiving (or new) trustee will need to be able to form the view that such arrangements are in the best financial interests of members (which we acknowledge may be a difficult view to form in some circumstances).

(ii) Trustee entity capital reserves

Once a trustee builds up capital that the trustee holds in its personal capacity (e.g. by being remunerated from the fund assets for its trustee services), a relevant question for the trustee is the management of that trustee capital upon the occurrence of certain events.

Particularly significant events are a successor fund transfer, the appointment of a new trustee, or the winding up of the fund. In each situation the trustee will need to consider how to deal with any capital that it is holding in its personal capacity outside of the fund. While from a "principles" perspective there is attraction in the notion that the capital, given it was sourced from the fund, should follow the fund, this negates the personal character of the capital (in that it is not a fund asset). In this context a trustee entity will need to consider its constitution, its capital management policy, the impact of any negotiations regarding indemnities with a successor or new trustee, and ultimately its need to hold capital for a period of time in the event of indemnities arising that have not followed the fund (and may not have been otherwise indemnifiable in any event).

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Section 2: Implementation of SPS 515

In relation to the implementation of SPS 515 we make comment on

- The determination of the adequacy of financial resources
- Further enhancements to processes
- Scenario testing informing the financial projections in the business plan
- How scenario testing informs the determination and assessment of the adequacy of financial resources

We anticipate further enhancements to processes to determine the adequacy of financial resources as trustees begin to adopt holistic capital management practices that consider funds held in their various capacities.

Our introductory overarching comments set out a holistic capital management approach which at a high-level describes the basis, principles and considerations for best practice capital management to support trustee decision-making.

It is aligned to best practice management of capital in other fiduciary-type industries/organisations, albeit including additional considerations given the high-level of NFP ownership structures.

The level of understanding and implementation of capital management consistent with this approach varies across the industry. We expect the level of understanding and sophistication in supporting policy and practices to increase over time.

It is important to recognise that scenario testing can be used for both the capital purposes set out in our introductory comments, namely:

- stability and withstanding adverse events / outcomes; and
- funding initiatives.

Our approach to assisting funds establish ORFR reserves (falling within the "Stability and withstanding adverse events/outcomes" purpose) involves significant effort working with management and risk specialists to identify and parameterise unlikely but possible scenarios. The results of this scenario analysis are taken into account in finalising the ORFR target amount.

This is similar to the use of scenario testing in other sectors, which is based on the following approach:

(i) Devote significant thinking to identifying potential scenarios involving loss given the business operations and risks – do this across the whole of the operations. We also use our understanding and surveying of industry events as a starting point and to inform discussion/prompt thinking.

(ii) Parameterise the scenarios.

(iii) Calculate financial impacts.

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(iv) Use these to set reserves and/or if reserves appear low compared with scenario outcome(s), consider whether this may indicate reserves are too low and require increasing.

Section 3: ORFR

In relation to ORFR we make comment on

- Instances where funds have called upon ORFR financial resources
- Whether RSELs are likely to change their approach to the use and maintenance of the ORFR

Based on our experience, most funds have had events that met the criteria to call on the ORFR reserves. Most events are small and/or funded by third parties ultimately (e.g., the fund having some responsibility when a member breached contribution limits by a small amount). We think it is important to keep in mind that the distribution of operational risk events (in most industries not just superannuation) is that there are a large number of small events that have little impact and a relatively very small number of events with large impacts. The important feature of the ORFR as we understand it, is to reduce the impact on members when there is a large event (only a large event can get close to the APRA guided minimum of 0.25% of fund assets).

Therefore, consistent with the principles set out in our introductory comments, the important assessment criterion is the member expectations of a regulated financial and fiduciary organisation that the fund would only be impacted by risks to which they do not expect to be exposed (i.e. operational losses such as financial losses to a fund from fraud, unit pricing, insurance administration errors, having to compensate for poor advice, etc) in very rare circumstances and to a low extent.

As noted elsewhere, this underlying philosophy of low risk to not meeting commitments to members is common in other fiduciary and/or savings/insurance type organisations, that are prudentially regulated. It is based on what society expects in a modern well-functioning economy.

We have not given significant thought to the administrative aspects of small amounts and how book entries might be made across reserves, etc. Obviously, funds may and should think about different purposes of capital when managing capital and determining adequate amounts. Nonetheless, the overall total amount of capital held is relevant and when a small event occurs it is not significantly material (from a member protection perspective as described above) where it is funded from.

As noted above, the ORFR is important when a large event causing substantial financial damage occurs noting that such events should be very rare. By way of comparison, we note that for banking and insurance, the regulatory prudential minimum capital targets a 1 in 200-year frequency. We are aware that some of the discussion of the ORFR and its purpose does not seem to acknowledge this.

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One observation we think is relevant is that life insurance investment linked funds also have a minimum regulatory prudential capital amount of 0.25% of assets (more in certain circumstances) – as for superannuation funds, a life insurance investment linked fund is subject to unit pricing and fraud risks for example. However, a superannuation fund tends to have additional risks, such as insurance administration and advice, which a life insurance investment linked fund is not exposed to. Although we acknowledge that size, diversification, outsourcing, simplicity of operations, quality of risk management, etc. are also considerations and therefore it is not always the case that a superannuation fund has more operational risk than a life insurance investment linked fund.

Our overall observation is that we would caution suggesting that the ORFR can be reduced or not held without considering how the member expectations noted earlier in our response will be supported (i.e. very low risk of impact to the fund).

Section 4: Reserves

In relation to reserves we make comment on

- The maturity of frameworks adopted across the industry
- Whether licensees are likely to change their approach to the type and purpose of reserves held

Outside of the mandatory requirements in relation to ORFR, we have seen some funds express an interest in adopting formal capital management frameworks that holistically consider capital requirements beyond reserves. A holistic capital management framework considers all capital and reserve arrangements across the various capacities and purposes, including ORFR, net tangible assets (Australian Financial Services Licence requirement for responsible entities), penalty and other liability provisions, other capital buffers (e.g. internal capital buffers considering liquidity risk / cash admin buffer such as the short term shortfalls in operating performance noted in our overarching introductory comments) and potential known and unknown future initiatives that require capital funding and where the benefits to members exceed the cost.

To our knowledge, the type of holistic framework in relation to reserving policies / capital management described here and in our introductory comments is not yet adopted widely across the industry. We think all funds could benefit from adopting such a comprehensive reserving strategy.

Nonetheless, we think that funds will and are on a journey to becoming more sophisticated in their thinking of the holistic capital management principles we have discussed.

They will also improve the underlying policies, processes, tools and procedures which provide information on which to make decisions consistent with this holistic capital management framework.

It will likely become more akin to other fiduciary/savings/insurance type organisations with leading capital management approaches – albeit as we noted there are some additional considerations including where there are initiatives that are worth funding but limited reserves and considering intergenerational/cohort impacts.

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Section 4: Insurance

In relation to insurance, we make comment on statutory penalties and insurance premiums (noting some general comments above in respect of insurance time lags)

Statutory penalties and insurance premiums

In our view, there is an issue to be resolved as to whether the proceeds of a trustee's insurance policy can be used to meet statutory penalties, and indeed whether the premium supporting that policy can be paid from fund assets.

We acknowledge that there are different legal views in the industry on these two issues and that the issues are still being explored.

Our concern is that if an insurance premium to support payment of statutory penalties can be paid out of fund assets, there may be an argument that any resulting insurance proceeds may form part of fund assets. If this is the case, the insurance proceeds cannot be used to pay any statutory penalties consistent with sections 56 and 57 of the SIS Act. The answer will of course depend on the facts and the nature of the arrangements in place.

From the perspective of the principles set out in the introduction to this submission, in our view it is better if a trustee can clearly demarcate corporate (or personal) purposes and fund purposes. On this basis, if the premium referable to the exposure to statutory penalties is paid out of trustee capital (as opposed to fund assets), then it would be clear that the policy proceeds paid in response to a statutory penalty can be used to pay that penalty. Accordingly, to provide a degree of certainty, our preferred view is that it is important (at a minimum) to apportion the premium representing the amount referable to the exposure to statutory penalties and pay this out of trustee capital so that any policy proceeds that are paid in response to a statutory penalty can be used to pay that penalty. This approach may of course require a review of existing insurance arrangements.

Section 5: Contingency expenditure

In relation to contingency expenditure, we make comment on

- Sourcing funds for the payment of civil or administrative penalties
- Alternate avenues being considered to source the funding
- Estimating the quantum of funds to be held at the trustee company level for the purpose of paying penalties

We are aware of many trustees actively considering alternative avenues of source funding for the payment of civil or administrative penalties. We have been involved with this consideration for some funds and are aware of others through their submissions to the Courts to have trust deeds amended in order to introduce a trustee remuneration clause.

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Amending the trust deed – legal considerations

An important consideration when amending a trust deed to introduce a trustee remuneration clause is whether the trustee's statutory and general law duties will be enlivened. That is, the trustee will need to consider whether, in making the amendments, it will be subject to duties including the duty to act in the best financial interests of beneficiaries and the duty to avoid conflicts.

In our view, where a clause is expressed as a power of the trustee (e.g. where the trustee has discretion to set the level of trustee fee), the trustee will be subject to the statutory and general law duties when it exercises its powers under the trust deed. That is, the trustee will need to take the interests of the beneficiaries into account in paying itself remuneration out of the assets of the fund.

In addition, if the trust deed does not confer an express right on the trustee to be paid remuneration and the trustee is seeking to amend the trust deed to introduce a remuneration clause into the trust deed, then there will be a clear conflict between the interests of the beneficiaries and the interests of the trustee.

Where the clause is expressed as a right of the trustee to be remunerated out of the assets of the fund, then the interests of the beneficiaries are subject to (and net of) that right of remuneration. Accordingly, in paying its remuneration out of the assets of the trust under an express right to do so, the trustee does not have to consider the interests of the beneficiaries. With an express right to remuneration, the only grounds of review by the Court are to ensure that the trustee has strictly adhered to the terms of the remuneration clause.

In addition, if the trustee takes remuneration in accordance with the express terms of the trust deed, there is no conflict with the interests of the beneficiaries. The trustee will be paid an authorised profit.

Alternate avenues to source funding

While it may be attractive to consider that there are viable alternative avenues to source capital funding, it seems axiomatic that the first port of call is the fund itself, and then the trustee's corporate reserves. Like many other financial services sectors, and indeed other sectors that rely on professional trustee services, it is also not unusual that a trustee (or the entity accountable for managing pools of funds) is remunerated for those services and that that remuneration in turn funds corporate reserves through retained earnings. Where dividends are paid to a shareholder, then from a member expectation perspective, it is likely logical that those shareholders that have had the benefit of the remuneration would like contribute capital when needed.

Target amount of trustee corporate capital

In our view, the preferred approach to determine the target amount of trustee corporate capital to be set aside as a reserve (to be invested) to provide for the risk of a penalty liability that is not indemnifiable, is a tailored qualitative and quantitative assessment.

To this end, we have performed qualitative assessments that involve a consideration of:

- the penalties applied to superannuation funds and other wealth management businesses in recent years and their basis;

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- the nature, size, scale and complexity of the trustee's operations and organisational, ownership and governance structure; and
- the effectiveness of a Fund's governance, risk and control environment.

In this assessment we also support the general principle that while the reserves should be adequate in most scenarios, it is not economic or practical to have reserves to fund every single extreme and remote scenario (as with reserving and insurance practices in any industry/economy).

We have particularly considered the merits and constraints of a tailored model which combines qualitative and quantitative assessment of the individual fund versus a more "one-size-fits-all" quantitative model.

Developing a complicated quantitative model with similar parameters to be adopted for each superannuation fund, and that assigns a probability to each category of penalty and assigns a distribution function to separately model the size of the penalty, suggests a level of understanding of both probability and severity/size at an individual penalty level that may not, in our view, exist. This modelling could convey a level of accuracy and precision in the proposed target amount that is quite uncertain. Accordingly, an undue focus on developing such a model and its parameters can also lead to recommending a target amount of trustee capital which is not appropriate.

One aspect to our approach is that we have considered historical penalties. In particular, we have considered penalties in the retail superannuation funds and broader financial services industry (broader than superannuation funds). The reason for doing this is that the volume of historical events with large penalties in superannuation events is sparse.

Using this approach, we are able to consider available data points with regards to historical penalties in relation to operating models, activities and risk management frameworks that applied to the organisations that have had these large penalties imposed.

Combining this with the understanding of a fund's operating model, risk appetite and quality of the risk management framework, allows an approach that is tailored to the relevant fund at hand.

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