AIST

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General Manager, Policy
Policy and Advice Division
Australian Prudential Regulation Authority

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Dear Sir/Madam

Financial resources for risk events in superannuation

Brief

AIST welcomes and supports APRA's proposal to amend *Prudential Standard SPS 114 Operational Risk Financial Requirement* to widen the scope of permitted use of the reserve, adopt a more sophisticated risk-based approach to the level of financial resources and reduce barriers to efficient use.

About AIST

Australian Institute of Superannuation Trustees is a national not-for-profit organisation whose membership consists of the trustee directors and staff of industry, corporate and public sector superannuation funds. As the principal advocate and peak representative body for the $1.7 trillion profit-to-members superannuation sector, AIST plays a key role in policy development and is a leading provider of research. AIST advocates for financial wellbeing in retirement for all Australians regardless of gender, culture, education, or socio-economic background. Through leadership and excellence, AIST supports profit-to-member funds to achieve member-first outcomes and fairness across the retirement system.

Submission

AIST thanks APRA for the opportunity to provide input to this consultation.

AIST strongly welcomes APRA's proposals to materially reshape the role and funding of the Operational Risk Financial Reserve (ORFR). AIST has previously requested that the purpose and allowable uses of reserves be reviewed, most recently in our feedback to the 2022 *Strengthening Financial Resilience in Superannuation* consultation, and we are very pleased to see APRA's consideration of those issues in the current discussion paper. The proposed principles-based approach is a vast improvement on the current prescriptive model and will allow for much greater flexibility in aligning reserved capital amounts with a fund's specific risk characteristics and permit the use of reserves for mitigation and prevention activities in addition to the remediation of risk events.

We agree that funds have, to date, followed existing guidance that applies a flat % rate and reflects only changes in members assets. This ignores scale benefits and has no correlation to the risk management frameworks, strategies and resources deployed in a superannuation fund. New standards and guidelines will need to be clear that ORFR targets should reflect the application of principles rather than a blunt statutory rate. This will give funds the flexibility to adapt their capital amounts over time as their circumstances evolve, without explicitly or inadvertently being confined to a restrictive dollar or percentage-based target.

The proposed Baseline+ approach

AIST is supportive of the proposal to introduce a tiered approach with underpinning principles determining target amounts which better reflect each fund's risk profile and the size and scale of their business.

The Baseline component will require funds to have resources available to support the implementation of recovery and exit actions. This has similar characteristics to the existing ORFR as a true reserve that is only drawn upon in extreme circumstances. By contrast, the Operational Risk component is much more flexible in its allowable uses and can be adjusted over time to reflect uplifts in risk management frameworks and capabilities.

In addition to considerations of the two-tiered model, there should be a total capital perspective when assessing whether a trustee is sufficiently capitalised. This should be inclusive of ongoing operating expenses (e.g. having good operational risk and governance processes), capital expenses (investments in systems e.g. risk management, procurement, information security) and reserving position and reserves. An entity that has invested in good systems and processes shouldn't be penalised by having to also hold a higher capital amount.

Recognising that funds have different approaches to risk management, and this must be balanced with member outcomes and best financial interests, it has been suggested that an upper limit on reserves be introduced, such as the 0.25% of assets that is currently held in the ORFR. This would permit funds to adjust the existing ORFR into the proposed model with negligible impact on members and provide the flexibility to draw down to their new risk-adjusted targets. Likewise, permitting funds to elect to adopt the new model from the point at which APRA finalises the new standard will allow funds the flexibility to coordinate the implementation of the new requirements with other projects, including related APRA reforms, ahead of the proposed hard 1 January 2025 start date.

Baseline component

Allowable use – CPS 190/900

The proposed allowable uses of the baseline component include funding the activation of a financial contingency plan under draft CPS 190 to resolve financial crises specific to the trustee rather than the fund itself. Per our comments to the *Strengthening Crisis Preparedness* consultation, the only credible threat to trustees in the profit-to-member sector is litigation and penalty risk arising from changes to Section 56 of the SIS Act. This led many funds in the sector to establish separate trustee capital reserves quarantined from the assets of the fund. Holding separate reserves in the trustee and fund to meet different liability risks is an inefficient use of members' funds so it is logical that a single risk reserve with flexible allowable use be established to meet a range of contingency scenarios.

Legal decisions supporting trustee capital reserving made distinctions between trust assets and trustee assets. It follows that for a profit-to-member fund to mitigate a CPS 190 event with the Baseline component, the reserve would need to be held within the trustee so as to not trigger a breach of Section 56. Alternately, the Baseline component could be used to fund the capital reserve and in turn be used to meet those liabilities.

APRA will need to provide specific guidance about the interaction of risks and reserves with this area of the law as it is unique to superannuation whereas CPS 190/900 have a broader application.

Allowable use – SPS 515

The paper states that this component can be used to fund the "activation of a plan that involves the transfer or receipt of members under proposed enhancements to SPS 515" suggesting that it could be drawn upon in any merger scenario. This will require some clarification as use of a reserve designed to protect current members from operational risk may not be necessarily appropriate for a transfer that involves the receipt of members.

Per our comments to the transfer planning consultation, mergers are not always a result of risk events and funds may have no short- to medium-term plans to accept inbound transfers that would feed into the estimation of costs required. Use of the reserve to support merger costs also limits the pool of capital in the transferred reserve, necessitating the realignment of reserves to reflect the new combined risk profile.

Calculation

Initial feedback from funds is that they would be more inclined to use an RSE licensee-led method for calculating the baseline amount, unless the methodology chosen for the basic calculation method is appropriate for the RSE and does not lead to unintended consequences.

Linking this calculation to member numbers or assets holds many of the same pitfalls of the current flat 25bp ORFR calculation:

- It provides for linear growth that is not proportional to risk and will impact funds differently depending on their membership characteristics.
- Funds with large numbers of low balance members would be differently provisioned than those with predominantly high balance members.
- There is no reflection in the calculation on the systems and complexity of the fund.
- It would require larger and lower risk funds to reserve significantly more than would actually be required to support a major (and potentially unlikely) remediation or exit scenario, creating a pool of non-productive capital that cannot contribute to the returns that are attributed to members.

- It would require smaller funds to hold the same relative amount as larger funds without the scale benefits, limiting the pool of working capital available to meet operational costs.

A principles-based approach with ongoing review and refresh as needed to reflect changes in the business risk environment is more appropriate for funds with more mature approaches to managing risk.

Should APRA opt to set a minimum baseline amount, it could use a risk-weighted approach as funds face different levels of risk. For example, funds assessed as having a 'high' risk of requiring a recovery or exit will have to reserve for the full amount while funds assessed as 'low' risk will only need to reserve for a prescribed or fixed proportion of the full amount. Low risk funds will have more time to build up to the full required baseline amount should the risk level increase in future and therefore should not be required to hold the full amount to the detriment of members. The risk assessment needs to be clearly defined and consistently applied across the industry. In principle, the reserve held should, as much as possible, reflect the risk faced by the funds.

Operational risk component

Allowable use

According to the paper "APRA expects that an RSE licensee would use the operational risk component as the **primary source of financial resources** to manage the impact of operational risk, supported by appropriate controls." This raises questions about whether this component is truly a reserve.

This framing suggests that any/all risk management costs should be attributed to this pool of capital, including ongoing projects, interventions, training, mitigation, and other activities in addition to specific distinct purposes, necessitating constant replenishment from general reserves which are currently used to fund these activities. Increasing requirements around risk management (e.g. business continuity planning, changes to the outsourcing standards, Financial Accountability Regime, cybersecurity, etc) will challenge the ability to anticipate the future costs that may need to be met from this pool of capital.

Should it be intended as ring-fenced capital for specific purposes or held as a 'rainy day fund' should it ever need to be drawn upon, this will need to be clarified.

Reference in the paper to using this component to "encourage operational risk prevention activities to reduce the likelihood of reoccurrence of operational risk events" could for instance be taken to mean that the reserve could be drawn upon for uses that require a significant discrete investment such as for the initial uplift of systems and processes required to meet new risk management standards, but the ongoing day-to-day activities following the implementation stage would be met from standard operational expenditure. A prudent fund should be undertaking risk mitigation and prevention activities in the normal course of business so ongoing BAU costs should be funded from ordinary operational expenditure, not a specific reserve designed to make good on materialised events.

It is also unclear whether there is any duplication or overlap with other requirements, such as the inclusion of costs associated with Business Continuity Planning (CPS 230) or exclusion of insured scenarios.

Industry would benefit from clear guidance on APRA's expectations, in particular setting the framework within trustees can exercise flexibility and discretion.

Calculation

The proposal to hold a baseline amount to address the expected impact of operational risks occurring in the normal course of business, whilst leaving a buffer that facilitates longer-term replenishment approaches is supported.

Funds undertake their own internal operational risk calculations on at least an annual basis, however, access to broader industry data on rare and extreme operational risk events would be beneficial for funds inclined to take more conservative approaches to risk.

In our view, the duration of a replenishment plan for the Operational Risk Component should align with that of the Baseline component, i.e. 3 years. This will spread risk equitably across the membership over the longer term and provide certainty for trustees.

For further information regarding our submission, please contact [redacted], Senior Manager, Advocacy & Research via email at [redacted].

Yours sincerely,

[redacted]

[redacted]

Chief Executive Officer