SUBMISSION

Submission to APRA – Discussion Paper: Financial resources for risk events in superannuation

17 March 2023

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Australian Prudential Regulation Authority
General Manager, Policy

via email: superannuation.policy@apra.gov.au

17 March 2023

Dear Sir / Madam,

Discussion Paper: Financial resources for risk events in superannuation

The Association of Superannuation Funds of Australia (ASFA) is pleased to provide this feedback in response to your consultation on the Discussion Paper *Discussion Paper: Financial resources for risk events in superannuation* (Discussion Paper).

ABOUT ASFA

ASFA is a nonprofit, non-partisan national organisation whose mission is to continuously improve the superannuation system, so all Australians can enjoy a comfortable and dignified retirement. We focus on the issues that affect the entire Australian superannuation system and its $3.3 trillion in retirement savings. Our membership is across all parts of the industry, including corporate, public sector, industry and retail superannuation funds, and associated service providers, representing over 90 per cent of the 17 million Australians with superannuation.

GENERAL COMMENTS

ASFA member organisations support the general intent of the Discussion Paper to promote more ongoing use of the Operational Risk Component (ORC) of the Operational Risk Financial Requirement (ORFR), including expanding the allowable uses to include investigations, remediations and mitigation-related activities to address operational risk within a fund/product.

Member organisation noted that the existing prescriptive capital framework under SPS 114 does not take into consideration the specific risk characteristics of each fund and, as such, tends to lead to increased holdings in the ORFR that generally exceed a fund's risk profile, to the detriment of fund members. Each year trustees assess and quantify their operational risk exposure, and the amount calculated as a result of this generally is significantly less than they currently are required to hold in reserves.

Members are supportive of the proposals to provide more flexibility and generally expect that this would result in them holding less Operational Risk Capital and welcome the more flexible and efficient approach to requiring trustees to hold financial resources to respond to operational risks.

1. Appropriate amount of capital

Members have indicated that a fixed amount of capital is not appropriate and does not reflect the risk characteristics or scale of the fund – capital reserves need to be determined with flexibility and reflect each fund's risk profile, operating model and size.

The capital held should reflect the likelihood and impact of a risk event were it to occur, taking into consideration past experience. Adopting a Funds Under Management (FUM) based model does not take into consideration the adequacy of the risk management framework in operation in each fund.

Members have suggested that APRA guidance should be with respect to principles to be applied to determine the quantum, as opposed to prescribing a specific rate of 25 basis points of FUM, that trustees would apply to calculate the amount of capital to hold over time. The principles could be aligned with those applied by other prudentially supervised entities in financial services, and would provide more latitude provided to trustees to determine the appropriate level of financial resources to be held, as well as how and when to replenish.

In particular, members have observed that the new framework should ensure that members are not penalised twice for the expense of managing operational risk within a superannuation fund - where a fund has uplifted its risk management framework and capabilities but the method for determining the capital reserve is a set amount, that does not take into consideration the uplift in risk management.

2. Risk systems and processes

Member organisations have suggested that, in addition to the two-tiered model proposed, there should be consideration of an approach whereby APRA takes into consideration the extent to which the trustee has invested in adequate risk and governance processes the extent to which trustees have invested in specific governance, risk and compliance systems, information security systems and procurement systems when determining the amount of risk capital to be held..

3. Limits on allowable use

There are mixed views among our member organisations with respect to the proposed changes on allowable use:

- some members are pleased that APRA is proposing enhancements to the current limits on the allowable uses of the ORFR and support the ability for capital to be applied more broadly to improve controls and systems to reduce the risk of operational risk events occurring
- other members do not support allowing the ORFR to be used on operational risk prevention activities, as they view prospective risk prevention activities to be part of trustee’s Business As Usual (BAU) activities.

4. Need for further guidance

Member organisations have indicated that the proposed changes leave elements open to interpretation that, if not addressed, could lead to the revised standard not achieving its objectives.

Accordingly, they have suggested that further guidance from APRA will be helpful in supporting appropriate implementation of the new standards.

SPECIFIC COMMENTS

ASFA member organisations have provided the following specific feedback with respect to the proposed changes to SPS 114 outlined in the Discussion Paper.

1. Use of operational risk component for strategic initiatives

There are mixed views among our member organisations with respect to the proposed changes on allowable use.

Some member organisations have agreed that the operational risk component should be permitted to be used for strategic initiatives that are expected to reduce the fund's operational risks, such as system, process and controls enhancements and improvements.

Other members do not support allowing the ORFR to be used on operational risk prevention activities, as they view prospective risk prevention activities to be part of trustee's BAU activities. In their view, using funds from the ORFR for prospective risk prevention activities:

- introduces additional complexity to the calculation of the operational risk component
- may result in a reduction of funds available in the ORFR to fund an operational risk events; and
- dilutes the primary purpose of funds within the ORFR, that is to ensure members are equitably protected from the effects of an operational risk event.

Given this, they propose that risk prevention activities and risk mitigation related activities should be excluded from the definition of an 'operational risk event'.

2. Unintended consequences

Members have identified some unintended consequences of the model including:

- inconsistent approach and methodology being adopted by trustees across the industry - for trustees who adopt a more conservative approach this could lead to a competitive disadvantage
- the application of the baseline component may be detrimental to smaller sized funds, especially if a minimum fixed amount is applied.

3. Levels of baseline and operational risk components likely to diverge across the industry

While member organisations welcome the flexibility to be able to calculate their capital requirements, trustees applying different calculations methodologies based on varied assumptions is likely to lead to divergence across the industry.

Member organisations have suggested that, to ensure a level of consistency in the approach taken across the industry, additional guidance should be provided with respect to the underlying assumptions for the calculation of the ORC, including:

- confidence level, e.g. capital to be held for a 1-in-X year event
- extent of consideration of material risk events / stress
- range of operational risk events / scenarios to be considered
- whether should consider a top-up for unknown risks / model risk reserve
- extent to which trustees should consider potential recoveries through insurance, legal action, or third-party indemnification
- if based on expected losses – expectation around the time that should be covered.

4. Practical barriers may continue to exist

Member organisations have identified that barriers to the efficient use of resources may continue to exist in practice, including:

- Limitations re data – not having access to sufficient and/or reliable operational risk event data, especially with respect to rare and/or extreme events, may affect trustees when determining an appropriate amount for the fund's operational risk component
- Compliance costs – there may be an increase in costs associated with governance, monitoring, legal and compliance
- Funding – more regular replenishment of the reserve will necessitate increased consideration being given to funding implementation and the effect this would have on members, especially as the reserve target level will be recalculated and may fluctuate year on year
- Investment returns – to enable ongoing use the ORC predominantly will need to be held in cash. This will come at an opportunity cost as the reserve monies will not be able to be invested in higher yielding assets.

5. Time to implement

Member organisations have identified that, to the extent internal models are required to identify appropriate capital requirements, funds will require time to build appropriate models and collate data.

Whether a commencement date of 1 January 2025 is achievable will depend on when the final standards and guidance are available to enable the industry to implement them. Given this, some members have suggested that an appropriate transition period will be needed for funds to comply with the new requirements once the standards and guidance have been finalised.

Some members have indicated that an option to adopt an earlier start date could be provided, that would allow trustees to align their implementation with related APRA standards and enable the objectives of the new standard to be realised sooner.

6. APRA Connected Reform

Members have indicated that it is important for all 'APRA Connected Reform' dependencies to be fully considered when the standard is being finalised, and for APRA to ensure that the final Prudential Standard and Guidance is aligned and consistent.

7. Further clarity is needed on 'core risk resources', 'target resources' and 'tolerance limit'

The concept of a tolerance limit likely will necessitate some latitude with respect to the time to replenish in order to promote equitable outcomes across cohorts of members.

Members have observed that trustees' may not have an appetite to operate close to the Tolerance Limit and that its continued use, in conjunction with the requirement to replenish, may continue to act as a barrier to the efficient use of the ORC.

Accordingly, members have suggested that further clarity be provided with respect to the concepts of Core Risk Resources, Target Resources and Tolerance Limit, together with guidance on the changed role of the Tolerance Limit, including the consequences of dropping below the limit and the accepted timeframe for replenishment.

8. Baseline component

Member organisations are supportive of APRA's principles-based approach, and the RSE licensee-led method for the baseline component.

Members have indicated that, until there is further clarity as to the requirements and APRA's expectations, they are yet to establish a methodology for determining the baseline component.

They have noted that use of the baseline component will only be relevant for a small number of trustees and that an unintended consequence will be that a substantial amount of capital across the industry will yield low investment returns.

Member organisations have recommended an alternative approach to the 'basic calculation option', that trustees could choose to adopt if they do not want to use the RSE-licensee-led method.

This approach would take into account the potential benefit from recovering integration costs over a longer period of time, such as the 6 to 24-month transition phase used in some overseas jurisdictions. APRA could provide guidance with respect to setting a minimum required level, that would assist the industry in avoiding the additional, unnecessary cost with respect to the development and implementation of more complex financial modelling.

Furthermore, members have identified that, for a group with multiple RSE licensees, the holding of a pool of funds in each entity is not an efficient use of reserves. Accordingly, consideration should be given to the possibility of alternative arrangements, such as a pooled amount held at group level, that may be called on by any RSE licensee in the group.

9. Applying a more sophisticated risk-based approach to baseline and operational risk components

A number of, generally larger, member organisations apply a relatively sophisticated risk-based approach to the calculation of their ORFR, often based on scenario analysis and Monte Carlo simulations. They have expressed concern that the application of a similar approach across the industry may be constrained by the (lack of) availability of data and expertise, especially with respect to smaller funds that may need to rely on expensive consultancy support.

Member organisations have recommended that APRA consider the adoption of a standardised approach that could still provide a level of diversification between industry participants and allow more risk mature organisations potentially to reduce the level of capital held. This approach would reduce the cost of implementation and provide a greater level of consistency and confidence in the outcomes.

If the approach proposed in the Discussion Paper is adopted it may need to be accompanied with controls to safeguard robustness in modelling across the industry, such as a requirement for an independent model validation. Further, the collection and sharing of industry risk event loss data could facilitate greater awareness and alignment across the industry of potential risk events that may need to be considered in the scenario modelling to determine the ORC.

10. If the ORC is shareholder funded there are additional barriers

Member organisations have identified that there are differences where a reserve is funded by shareholders or from the fund.

A superannuation fund's corporate structure will determine the extent to which an ORC can be utilised.

For many retail superannuation funds, the application of the ORC will be unique to their organisation's structure – as such, implementing a 'one-size-fits all' approach will not be workable and will lead to some of these funds being required to hold capital that will never be able to be utilised. By way of example, one member organisation's preliminary assessment is that its structure most likely will not allow it to utilise the ORC for improvements to systems etc.

Trustees for whom the ORC is shareholder funded have advised that, unless the benefits of using the ORC are apparent, they may be reluctant to amend their operating model. For such trustees the funding of operational risk events, remediations and mitigation takes place through alternative funding mechanisms and, as such, factors such as the equitable treatment of cohorts of members through more regular injections into the ORC are not a consideration.

Furthermore, holding an ORC at the trustee level, if used, has contribution tax implications that act as an additional barrier to the efficient use of the ORC.

Members consider that reserves need to have clear boundaries regarding the purposes of usage. Given this, they have suggested that APRA guidance could provide examples as to APRA's expectations with respect to how the use of the ORC may work in practice, including the extent to which use of the ORC for investigations and for mitigation before events occur is permitted, and confirm whether a shareholder-funded ORC remains supported by the proposed changes to the standard.

11. Reviews

Member organisations have indicated that whether the requirements have been appropriately applied and adequate capital is held across the industry could be assessed as part of the comprehensive review of the risk management framework that takes place every three years. Should any issues arise, consideration could be given to whether independent assurance may be required.

RESPONSES TO SPECIFIC CONSULTATION QUESTIONS

Member organisations have provided the following responses to specific consultation questions.

Baseline+ model

1. *What changes, if any, would enhance the proposed scope of permitted use for the baseline component and for the operational risk component?*

Member organisations have questioned whether use of the baseline amount with respect to the activation of a plan that involves the receipt of members may give rise to issues regarding whether this would be an appropriate use of an ORFR, designed to protect current members from operational risk events, especially where the merger is happening for a reason other than in response to an operational risk event.

2. *What legal or practical restrictions may impede RSE licensees from implementing or complying with the proposed Baseline+ model?*

Members have identified that estimating the amount required for the 'activation of a plan that involves the transfer or receipt of members under proposed enhancements to SPS 515' may prove difficult, especially if the fund does not expect such a plan in the short to medium-term.

3. *Are there any likely unintended consequences of the model or individual proposed requirements?*

The Discussion Paper encourages operational risk prevention activities to reduce the likelihood of the reoccurrence of operational risk events. Some member organisations have identified that they have concerns about the amendment of the definition of 'operational risk event' to include prospective risk prevention activities that should already form a part of BAU activities.

Baseline component

4. *Will RSE licensees likely have sufficient capability to calculate the proposed baseline component, and what methodology would be used?*

Member organisations have indicated that trustees are likely to have sufficient capability to calculate the proposed baseline component.

Depending on the approach adopted the initial effort to calculate the baseline component may be time consuming, although ongoing refresh and review should be more straightforward.

The methodology chosen will very much depend on what the basic calculation method will look like and whether it is appropriate for the trustee - if it is appropriate and does not lead to unintended consequences it is more likely that the basic calculation method will be used.

5. *What is the likely level of the baseline component?*

Most members have indicated that, at this stage, this is unknown.

One member has indicated that it is likely to use the RSE licensee-led method for calculating the baseline component and that they do not expect this component to increase in a linear manner with the growth of members or members' assets, as operational risk does not increase proportionally with the number of members, but acknowledges that this may not be the case for all funds. The fund expects the level of the baseline component to be significantly less than the amount would be were a basic calculation method to be used.

6. *How often should the baseline amount be reviewed and why?*

Member organisations have indicated that generally they are still giving consideration to this point.

One member has suggested that a review should occur annually, unless significant changes in the business risk environment trigger an earlier review.

7. *What are your views on providing a basic calculation option, with the amount held linked to member numbers? Are there any other methods that would be more efficient or better targeted?*

Member organisations generally have indicated that the basic calculation option is reasonable to include for instances where a trustee does not have the capability to calculate the baseline amount using the RSE licensee-led method.

Members have suggested, however, that for RSE licensees using the RSE licensee-led method the basic calculation method should not be used as an expectation for the level of the baseline component.

One member organisation has indicated that this is not a preferred approach as it can lead to unintentional detrimental impact on some licensees with large member numbers but relatively low account balances, putting them in a position of competitive disadvantage. It has suggested that member numbers should only be one component of the calculation, with other factors also being captured in the calculation, such as risk rating, the complexity of the organisation (number of administration systems, number of recent mergers etc), and quality/complexity of recovery and/or exit strategies.

It has been observed that for 'all-profit-to-member' licensees the ORFR ultimately is funded by the members - if a trustee is unlikely to require recovery / exit in the near future, funding for the full amount can be detrimental to members, especially if the amount involved is substantial.

As funds face different levels of risk, one option may be to adopt a risk-based approach - either applying the base component only for funds assessed as being 'at risk' or using a risk-weighted approach e.g. low, medium, high. By way of example, funds assessed as having a 'high' risk of requiring a recovery / exit will have to reserve for the full amount, while funds assessed as 'medium' or 'low' risk will only need to reserve for a prescribed / fixed proportion of the full amount.

Should the risk level increases in future, lower risk funds would have time to build up to the required baseline amount but would not be required to hold the full amount from the outset, that would be to the detriment of members.

The risk assessment will need to be clearly defined and applied consistently across the industry. In principle the reserve held should, to the extent possible, reflect the risks faced by the fund.

8. *Should APRA set a minimum amount for the baseline component or would this lead to unintended consequences?*

Members have indicated that, depending on the quantum, this could be detrimental to smaller funds, putting them in a position of competitive disadvantage.

Further, setting a minimum amount would ignore the specific risk characteristics of each fund and inherently assumes no difference in operational risk in funds across the industry, that would derogate from the principles-based approach.

Operational risk component

9. Would RSE licensees have the capability to determine an appropriate target amount for the operational risk component?

Member organisations have indicated that licensees would have the capability to determine an appropriate target amount for the operational risk component, and generally have an existing operational risk calculation that is performed at least annually.

Members have indicated that this will require industry data on rare and extreme operational risk events, that currently is not publicly available.

10. What controls may be necessary to address the risk that the target amount is not efficient or not prudent (too high or too low)?

Members have indicated that annual review and sign off by an independent party with relevant expertise and qualifications in quantifications of risks e.g. internal or external actuaries may be advisable.

11. How should a maximum timeframe for the replenishment of the operational risk component to its target amount be set?

Member organisations have indicated that any maximum timeframe should be around three years, as generally this is equitable and minimises the risk of adverse member outcomes.

Members have indicated that the maximum timeframe should not be less than 3 years, to minimise disruption to members, to allow for short term volatility and to reduce the effect on member equity, as the cost is spread over a longer term with a larger base of membership and therefore the effect on an individual member is lower.

Should a trustee need to develop a replenishment plan that exceeded the maximum time frame, there should be a mechanism whereby it is able to approach APRA for approval.

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Should you have any queries with respect to this, please contact me on [redacted] or via [redacted].

Yours sincerely

[redacted]

[redacted]
Director, Policy