17 March 2023

General Manager, Policy
Australian Prudential Regulation Authority
Email: superannuation.policy@apra.gov.au

Dear Sir/Madam

Discussion Paper: Financial resources for risk events in superannuation

The Actuaries Institute ("Institute") welcomes the opportunity to provide our feedback on the issues raised in APRA's discussion paper – financial resources for risk events in superannuation – dated November 2022 ("Discussion Paper"). The Institute is the peak professional body for actuaries in Australia. Our members have had significant involvement in the development and management of superannuation within Australia.

The Discussion Paper outlines APRA's intention to replace the existing Prudential Standard SPS 114 Operational Risk Financial Requirement ("SPS 114") with materially reshaped requirements. The Institute agrees there is a need for superannuation funds to strengthen financial contingency planning and resilience so as to support secure member outcomes, and is supportive of material changes to SPS 114.

The Discussion Paper suggests SPS 114 is reshaped to widen the permitted use of the Operational Risk Financial Requirement ("ORFR"), adopt a more sophisticated risk-based approach to the level of financial resources, and reduce barriers to its efficient use. The Institute fully supports these ambitions.

The Discussion Paper proposes that the existing SPS 114 approach is replaced by a new Baseline+ model that has two components: the baseline component and the operational risk component. The baseline component seeks to ensure ready access to financial resources to fund recovery or exit activity, whilst the operational risk component makes funds available to address the impact of operational risk events. The Institute supports key elements of the APRA proposals, and in particular:

- Clearer and broader scope for use of ORFR
- A more risk-based approach to calculation of the ORFR
- The introduction of a baseline component, and
- Recognition that the baseline and operational risk components can be held as either reserves or as trustee capital.

However, the Institute has concerns that the APRA proposals may lead to reserves that are higher and more conservatively invested than is necessary, to the detriment of overall member outcomes. In particular:

- There should be sufficient flexibility permitted when calculating the baseline component.

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- Requiring the baseline component to be held in Common Equity Tier 1 Capital is overly conservative.
- The Baseline+ reserving methodology suggested does not consider the impact of alternative reserving and capital management approaches, or contingent funding structures such as insurance.

In addition, given the merits of maintaining an industry reference for RSE licensees, the Institute recommends that APRA publishes details of the range of the ORFRs and the median ORFR adopted by RSE licensees.

We set out our more detailed commentary in the Attachment to this submission.

The Institute looks forward to APRA's release of the draft standard replacing SPS 114 and guidance for consultation in mid-2023. In the meantime, we would be pleased to discuss this submission. If you would like to do so, please contact [redacted], Chief Executive Officer of the Actuaries Institute, on [redacted] or [redacted]

Yours sincerely,

[redacted]

[redacted]
President

Attachment: Financial resources for risk events in superannuation

Strengthening Financial Contingency Planning and Resilience

The Institute agrees there is a need for superannuation funds to strengthen financial contingency planning and resilience. Such strengthening would support secure member outcomes. Therefore, the Institute supports material changes to SPS 114 to achieve this result.

The Discussion Paper suggests SPS 114 is reshaped to widen the permitted use of the ORFR, adopt a more sophisticated risk-based approach to the level of financial resources, and reduce barriers to its efficient use. The Institute fully supports these ambitions, and these initiatives align with our April 2022 Research Paper *Uplifting Superannuation Risk-Based Capital Management* *(RBCM)*, which promotes using a RBCM framework. A RBCM framework entails setting aside and managing capital and reserves dependent on a trustee's and its superannuation fund's risk profile and risk appetite.

To implement an integrated RBCM structure within superannuation, relevant high-level principles are outlined in the Institute Research Paper:

- **Single framework** – Consolidate related policies and regulatory frameworks to an overarching RBCM framework
- **Business plan integration** – Integration of the RBCM strategy into the annual strategic and business plan review
- **Scenario and data-driven** – Apply scenario testing
- **Transparent and holistic reporting** – Regular board reporting at a holistic level, including any mismatches between risk and capital.

Benefits of such a RCBM implementation include:

- A more systematic approach to funding and preparation for loss events
- Strengthening the link between risk and capital management, and
- Helping to maximise long-term member outcomes.

The Institute Research Paper also discusses regulatory support as a driving factor of success, mainly through alterations to SPS 114. SPS 114 currently provides a limited capital incentive to use scale and superior RBCM capabilities to deliver capital-efficient outcomes. This inefficiency is partly driven by the 0.25% of FUM minimum guidance, where the Institute encourages APRA to instead consider a more flexible approach.

Overall reflections on the APRA Proposal

The Institute agrees with the Discussion Paper that SPS 114 has helped introduce rigour as the industry established operational risk reserves. In doing so, the approach historically met needs and expectations.

Further, the Institute agrees with the Discussion Paper on the key ORFR issues, including:

- Concerns and confusion over the appropriate use of reserves
- Reluctance to draw upon financial resources of the ORFR where they are entitled to do so, and
- Lack of trustee sophistication in setting reserves.

The Institute is encouraged by APRA's consultation process to address these issues.

The Discussion Paper proposes that the existing SPS 114 approach is replaced by a new Baseline+ model that has two components: the baseline component and the operational risk component. The baseline component seeks to ensure ready access to financial resources to fund recovery or exit activity, whilst the operational risk component makes resources available to address the impact of operational risk events.

The Institute supports key elements of the APRA proposal. These elements include:

- Clearer and broader scope of the ORFR to allow funds to adopt a better decision-making framework and governance to assess and confirm the compliance of decisions to use capital and reserves for appropriate purposes.
- A more risk-based approach to calculating the ORFR that forces RSE licensees to think deeply about the risks of their funds compared with their risk appetite. The Baseline+ model has sought to promote this through RSE licensees now having to calculate appropriate reserves and capital commensurate to the fund's risk profile in both the baseline and operational risk components. This deeper thinking ultimately creates a stronger link between risk and reserving.
- Introducing a baseline component promotes greater integration with APRA standards, including CPS 230, 190 and 900, and SPS 515.
- Recognition that the baseline and operational risk components can be held as either reserves or as trustee capital.

Feedback on the specific APRA Proposals

The Institute has concerns that the APRA proposals may in some instances lead to reserves that are higher than necessary to the detriment of overall member outcomes. In particular:

Baseline Component Calculations

Addressing question "*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?*"

The Institute is concerned that a potentially overly restrictive calculation on the baseline component would be applied. As such, the Institute would like to highlight the basic calculation method as misaligned for the Australian superannuation landscape and a need for an RSE licensee led method requiring flexibility.

Basic Calculation Misalignment

The Discussion Paper proposes a baseline component with an optional basic calculation. This basic calculation has not been detailed, though it provides the United Kingdom and the Republic of Ireland calculations as precedence. Both models utilise a dollar-per-member calculation for risk reserving. The Institute has discussed these structures with industry participants from the UK and Ireland. Through these discussions, the Institute notes the UK and Ireland are currently in a transition towards Master Trusts - an environment that differs from Australia, which has already seen significant consolidation. Trustees in the UK have generally not implemented the basic calculation because, other than for smaller Master Trusts, they have concluded that establishing such large reserves would not be in the best interests of members.

As such, the magnitude of the dollar-per-member amount would need to be carefully considered if applied in the Australian environment.

The Institute believes that implementing a basic calculation would discourage trustees from thinking about the fund's risk profile in a sophisticated manner and considering the most appropriate mitigants including appropriate models for reserving.

Flexibility for the RSE licensee led method

The Institute proposes the calculations of RSE licensee-led method within the baseline component should allow the RSE licensee significant flexibility to ensure RSE licensees consider and hold reserves and capital commensurate to their fund's risk exposure and risk appetite. If APRA were to follow the UK's relatively prescriptive approach, the baseline component would be calculated in a restrictive fashion and would potentially tie up more reserves or capital. Such detrimental member outcomes could be avoided if Trustees were permitted a risk overlay.

Capital Requirements of Reserves

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

Holding the baseline component in Tier 1 Capital may lead to returns lower than the fund as a whole over time, to the detriment of fund members. As was evidenced by the ability of superannuation funds to pay COVID access payments on short notice, funds did not need Tier 1 Capital to provide liquidity. Many Trustees may conclude that Tier 1 Capital is also not required to meet obligations of the ORFR, whether held as reserves in the fund or as trustee capital.

The Institute would like further clarification on what assets and restrictions will be applied to the reserves and capital held under SPS 114.

Holistic Risk-based Reserving

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

A holistic risk-based reserving and capital management approach would consider all the reserves, capital and insurance held by a trustee and its superannuation fund, and allow adjustment to the Baseline+ model approach where other sources of capital could be used to support operational risk and recovery or exit activity. However, the Baseline+ reserving methodology suggested in the Discussion Paper does not consider the impact of these alternative funding structures. Contingent funding structures should make up part of the consideration of the overall recovery, reserving and capital assessment, as they could be potential sources of funding following an operational risk event.

Removal of 0.25% of FUM Minimum Guideline ORFR Target Amount

Addressing question "*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)?*"

APRA has proposed the removal of its ORFR minimum guideline target amount of 0.25% of FUM as presently included, in SPG 114 in conjunction with other proposed enhancements. The Institute notes that:

- There are benefits to maintain an industry reference to support each fund's own assessment of the ORFR.
- Investment-linked superannuation policies in life insurance companies are subject to an Operational Risk Charge (LPS118) at 0.25% of FUM.
- The insurance and pension prudential capital regulations overseas often require a regulatory review and approval for an entity's adoption of an internally assessed capital requirement less than a standard requirement.

Given the merits of maintaining an industry reference for RSE licensees, the Institute recommends that APRA instead publishes details of the range of the ORFRs and the median ORFR adopted by RSE licensees.