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Financial resources for risk events in superannuation

Deloitte response to consultation

17 March 2023

Deloitte.

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General Manager, Policy
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via email: PolicyDevelopment@apra.gov.au

17 March 2023

Dear [redacted]

Deloitte response to consultation on *Financial resources for risk events in superannuation*

Please find enclosed the Deloitte submission on APRA's industry consultation on the "Financial resources for risk events in superannuation" discussion paper (the Discussion Paper). The Discussion Paper outlines proposed enhancements to the current Prudential Standard SPS 114 Operational Risk Financial Requirements (SPS 114).

Yours sincerely,

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Context

The Australian superannuation system has grown rapidly over the last three decades. During that time, there have been numerous changes to legislation and to the market's response. The industry has consolidated largely through fund mergers, and we now have a much smaller number of funds, many of which are large even in global terms.

The Australian superannuation system has built up a widely respected track record of delivering strong long-term investment returns to most members, with low levels of losses to fraud and other operational risks. However, this has not been without difficulties, and some funds and service providers have incurred significant remediation liabilities.

Despite the many improvements that have been made, the industry still faces many risks which need to be mitigated. In November 2021, APRA released a Discussion Paper, Strengthening Financial Resilience in Superannuation. It called for submissions from RSE licensees and other industry participants. Deloitte responded with a response describing many of the issues faced by superannuation funds in identifying their risks and making appropriate provision for them. We welcome APRA's consideration of how to develop this area further.

We note that the Australian superannuation and retirement system has a few characteristics which make it unique in global terms:

- The bulk of superannuation members and assets in Australia are defined contribution (DC) rather than defined benefit. This means (for DC funds) that employers provide no guarantees to members other than meeting their legal requirement to pay the prescribed SG contribution rate.
- Most of the membership and assets are held in funds which are not backed by employers and/ or financial institutions with substantial capital bases.
- Almost all members can choose a superannuation fund (rather than accepting the default fund selected by their employer). While a default MySuper product will usually have a strong investment strategy suitable over long periods of membership, members can also choose a more conservative or more growth-oriented investment strategy and can vary their investment strategy over time. They can also set up their own fund (a Self-Managed Superannuation Fund, or SMSF). More than 1.1 million Australians have SMSF accounts (sometimes in parallel with accounts in APRA-regulated funds).
- The majority of retirement income accounts are managed by members without any structured annuitisation or default investment strategies. Most members take on many risks when they retire including all investment risk, longevity risk, and agency risks (high fees or poor performance). The new Retirement Income Covenant should lead to better retirement products in time.
- The structure of a MySuper product requires that it offers a minimum level of death and total and permanent disability insurance benefit to all qualifying members, by default.
- The government Age Pension is means-tested. It ensures that all (eligible) retirees have retirement funding for at least a basic (modest) retirement, but larger superannuation accounts are necessary to provide a comfortable retirement, particularly for those who are single and/ or do not own their own home.

Internationally, capital requirements for operational risk vary considerably both between markets and within markets. The combination of this situation and the different characteristics of the Australian system means that the Australian superannuation system needs to develop its own risk management framework.

1 Response to Consultation

Our responses to the consultation questions are derived from our experience working with clients to understand and effectively implement regulatory change. In addition, through our experience, we have observed historical and persistent challenges in relation to operational risk management that regulated entities have faced.

1.1 Baseline + model

<table>
<tr><th>Question</th><th>Deloitte Response</th></tr>
<tr><td>1.1.1 What changes, if any, would enhance the proposed scope of permitted use for the baseline component and for the operational risk component?</td><td>We note that the proposed permitted uses of the different components are:

Baseline component - Narrow scope: Recovery activity or transfer of members, service providers or change of RSE licensee.
Operational risk component - Broad scope: Respond to the impact of operational risk, including investigation and remediation. May be used to act before an event occurs if consistent with the purpose.

Key feedback on the above proposed uses:

One of the uses of the baseline component outlined in the Discussion Paper is transferring or receiving members. With regard to assets, the Discussion Paper only refers to “transfer of MySuper assets”. We suggest that it would be useful to clarify whether APRA expects potential costs relating to the transfer of choice members and assets to be taken into account in calculating the baseline component. We would highlight that choice members include retirees, many of whom would be at least as reliant on the Trustee as MySuper members. Please refer to the below extract from our 10 March 2023 response to APRA’s consultation on Superannuation transfer planning: Proposed enhancements for our comments on potential challenges with any separate transfer of MySuper assets and choice assets:

“Impact on choice product holders – under the SIS Act, an RSE licensee has a general obligation to act in the best interests of the beneficiaries at all times. Therefore, the requirement of transferring the MySuper assets should also be considered in the context of choice assets to avoid any unintended consequences. For example:

Is the expectation that choice assets would transfer at the same time. If choice assets were not, then this would potentially lead to the RSE licensee disadvantaging choice product holders as a result of the transfer of MySuper assets (and the loss of economies of scale).
It is possible that efficiencies are lost by not transferring all members at the same time.
The MySuper and choice products are often comprised of the same underlying investments and therefore it could be difficult to practically split the groups of members and could also add significantly to the cost burden.
As a consequence of the above, there would be further consideration of how those costs are apportioned between transferring and remaining members.
The practical approach adopted where a member has both MySuper and choice assets.
These would need to be carefully considered from a member’s best financial interest perspective by funds.

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Question	Deloitte Response
	Transfer timelines when licence not cancelled *– there could be an expectation that this would become the benchmark and even in instances where the licence as not cancelled, a similar timeline would be expected.* ***Transferring versus receiving fund*** *– the ability to meet the 90-day timeline will rely on both the transferring and receiving fund being able to accommodate this. Therefore, the alignment in the ability for funds to action this is important.”* - Operational risk should be clearly defined and aligned with CPS 230 to ensure consistency in approach and make the breadth of risks that are to be managed using this reserve clear to stakeholders. - There may be undesirable consequences if the operational risk component is allowed to be “used to act before an event occurs if consistent with the purpose”. We would expect the cost of mitigating operational risk through appropriate people, systems and processes should be part of the normal cost of operating a fund and financed accordingly. Capital held against residual operational risks would not be able to fulfil its role if it were redirected to funding costs of operations. - Further guidance should be provided on the situations in which alternative means of funding should be investigated and how this interacts with insurance arrangements and conditions for being able to claim on insurance policies held by the fund and by its service providers. - The operational risk framework to reserve for costs relating to potentially receiving future transfers of members should not be encouraged. Receiving additional members is not an operational risk event and should be considered in the context of overall financing of the fund and members’ best financial interests. Our experience is that receiving large numbers of members through a Successor Fund Transfer would normally involve other reserves (e.g. general reserve or strategic reserve) being drawn down to fund up-front costs, and then replenished using some of the benefits of increased scale.

Question	Deloitte Response
1.1.2 What legal or practical restrictions may impede RSE licensees from implementing or complying with the proposed Baseline+ model?	Practical considerations associated with implementing or complying with the Baseline + model include: • **Initial funding requirements** - Depending on the approach for calculating the baseline level and the operational level, there may be an immediate requirement for the RSE licensee to set aside additional amounts to fund the levels to those defined. This could have a detrimental impact from a members' best financial interest perspective if the current population are expected to fund a disproportionate level of this reserve that they will ultimately not receive the (full) benefit of. In addition, the joint funding approach in this scenario between members and shareholders (if relevant) should also be considered. • **Performance test** – If a fund had to put aside substantial additional reserves in an aggressive time period, that would affect its results in the Your Future Your Super performance test, with impacts that would vary between funds and could be severe. • **Investment decision** – The RSE licensee would need to consider the investment of both the baseline reserves and the operational risk component. The overall size of the baseline reserve and operational risk component would therefore need to be considered in the context of the FUM and the expected combined risk/return profile of the invested capital. We expect that many RSEs would seek to invest reserves in a way that gives an element of matching to likely movements in account balances. • **Member understanding and communication –** Consideration would need to be given to appropriately communicate this approach to members. This could include updates to configurations for annual member statements to communicate to individual members the amounts deducted from their accounts. • **Defined uses** – As outlined under 1.1.1, there could be areas or uses of reserves that span different categories. Clear guidance would need to set out examples of use cases.
1.1.3 Are there any likely unintended consequences of the model or individual proposed requirements?	Depending on how reserving requirements are determined, there may be a risk of reserves being held at a higher level than would be optimal for the interests of members and for intergenerational equity. Refer also to our response to question 1.2.4.

1.2 Baseline component

Question	Deloitte Response
1.2.1 Will RSE licensees likely have sufficient capability to calculate the proposed baseline component, and what methodology would be used?	We note that the baseline component has clearly defined uses and therefore the amount should be directly related only to the purpose (i.e. addressing contingency plans and the transfer of MySuper assets). The level of capability to calculate this amount would depend on the skillset of the RSE licensee, however, it is expected that external support in the calculation process would be available. Considering MySuper and choice members together would in our view simplify calculations overall, to avoid choice members having to be considered in a separate exercise that would add a further layer of complexity.

Question	Deloitte Response
1.2.2 What is the likely level of the baseline component?	We consider that the approach should be primarily principles-based, as baseline requirements will vary between funds and over time. We note that the Discussion Paper suggests two methods for calculation: • RSE licensee-led method - An amount that the RSE licensee can demonstrate as sufficient to allow it to undertake the actions covered by the baseline component while ensuring business operations are maintained. • Basic calculation method - An amount based on the number of members, with the potential to be subject to a minimum dollar amount determined by APRA. For the Basic calculation method, further information from the various service providers would need to be received and considered to estimate a prudent per member cost of transfer – e.g. administration transition, custodian transition, investment transition, legal and consulting costs. In order to calculate a robust assumption, consideration would need to be given to: • Both the fixed level of costs along with any variable costs that relate to members and/ or FUM. • Taking into account any insurances that can cover certain costs. • Taking into account current service agreements and what is expected to be covered by any fixed cost arrangements versus billed in addition. Service providers, especially the administration service provider, would be key in any transfer of members and assets. Similarly, these service providers may also be involved in the RSE licensee's contingency plans. As such, engagement of these parties would be key in determining *"An amount that the RSE licensee can demonstrate as sufficient to allow it to undertake the actions covered by the baseline component while ensuring business operations are maintained".* Other key factors that would need to be considered in the calculation process, especially for the RSE licensee-led method are: • Assumed severity of the situation and expected response based on risk appetite and risk mitigation approach. • Assumed allowance to account for unknown activities that may arise. • For the transfer of assets, assumed period of functioning business as usual whilst undergoing transfer of assets. • The level of risk associated with management of group insurance arrangements from the superannuation fund side, taking into account the history of costs from operational risk events relating to group insurance. • Insurances that the fund already holds and their uses. • The relationship between Fund reserves, Trustee reserves and shareholder capital. • Any historical or expected penalties or regulatory action. • Market practice. • The extent to which other reserves would be available, for example reserves for future strategic projects which would no longer be required if the members are transferred to another fund. • The sequencing of events (e.g. if the baseline is in place to address business continuity plan, financial contingency plan, resolution plan or to undertake a transfer of members, consideration would need to be given to the event that is being assumed for the calculation of the baseline component).

Question	Deloitte Response
1.2.3 How often should the baseline amount be reviewed and why?	A balance will be required between the cost of carrying out a review process on a regular basis, versus ensuring that a sufficient baseline level is reserved, accounting for both the current activities of the fund and also the activities within the wider superannuation market. Key trigger points should be defined and linked to both the setting of Strategic Objectives under SPS 515, and the proposed enhancement regarding the pre-planning requirements for a transfer of assets. We suggest that the method for determining the baseline amount should generally be reviewed triennially, subject to reviews being brought forward in response to specific triggers. Trigger events should be defined which could include threshold relating to: • The ability to run a sustainable operating structure and the projected build up or depletion of reserves. • Operational resilience and the ability to continue to deliver critical operations. • The Annual Superannuation Performance Test for MySuper products. • APRA sustainability metrics – considering rate of member growth and net cashflows. • The Trustee determination of whether the best financial interest of members is being promoted in the member outcomes assessment – as defined by SPS 515, considering the key metrics and peer relative performance. • Loss of key personnel.
1.2.4 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?	To provide clarity and make a lower-cost method available, it may be helpful for APRA to define a default formula for the basic calculation. However, this should be subject to avoiding undesirable consequences such as weakening incentives to mitigate operational risks. We therefore consider it important that the default formula: • Does not become a de facto minimum requirement, i.e. funds should be able to set reserving requirements at lower levels than the defaults if justified by their track records and investment in systems, processes and capabilities. • Is not automatically accepted as adequate. There should be clearly defined situations where a higher requirement should be considered, including factors such as data on actual losses from operational risk events and any material uncertainty of costs of remediation exercises in progress. We expect that when responding to any operational related risks there will be a fixed cost element to the overall costs incurred. However, the costs of some operational risk events could be broadly proportionate to assets – for example, investment trading errors and unit pricing errors. On the basis that an alternative option for calculation is being put forward for RSE licensees to adopt then the expectation would be that a relatively prudent basis should be utilised to calculate the basic calculation or the implementation of a minimum amount. Another key consideration is related to the likelihood of a trigger event occurring and the effects of that trigger event if it occurs. For example, a fund could be losing members to competitors as a result of various factors (e.g. moving to an alternative fund with lower fees, better investment performance, or more attractive insurance arrangements). If a core per member cost were to be utilised, with no margin for prudence or minimum level, then the amount which a struggling fund is required to retain to address a transfer event would reduce along with member numbers, at the exact point where the likelihood of the event occurring is potentially increasing.

Question	Deloitte Response
1.2.5 Should APRA set a minimum amount for the baseline component or would this lead to unintended consequences?	As per our response to question 1.2.4, funds with a reducing number of members would have a reducing baseline requirement, which may not be commensurate with the likelihood of a trigger event taking place.

1.3 Operational risk component

Question	Deloitte Response
1.3.1 Would RSE licensees have the capability to determine an appropriate target amount for the operational risk component?	This will vary between RSEs and external assistance would be available. Having a default formula available would help ensure availability of a method which RSE licensees should be able to apply at relatively modest cost. However, the role of this default formula should be subject to safeguards along similar lines to our comments on 1.2.4. Its use should be subject to conditions such that the formula: • Does not become a de facto minimum requirement, i.e. funds should be able to set reserving requirements where merited. • Is not automatically accepted as adequate. There should be clearly defined situations where a higher requirement should be considered, including factors such as any material uncertainty of costs of remediation exercises in progress.
1.3.2 What controls may be necessary to address the risk that the target amount is not efficient or not prudent (too high or too low)?	Some funds carry higher risks and arguably should hold a higher ORFR. Such circumstances would include: • Self-administration, which normally carries a higher risk than outsourcing to a specialist administration provider. • Funds with complex investment structures or where there is a higher degree of internal asset management. • Funds with a history of errors (such as mistakes with unit-pricing or the operation of group insurance). • Legacy products requiring complex administration.
1.3.3 How should a maximum timeframe for the replenishment of the operational risk component to its target amount be set?	We consider that the timeframe should have an element of flexibility. For example, rapid replenishment could be needed if there is an elevated risk of further adverse events in the near future or could be spread over time if there are reasonable grounds to expect recoveries from insurers. RSE's should be able to define tolerance limits which do not require specific replenishment plans, in order to be able deal cost effectively with relatively small drawdowns on the operational risk component. We suggest requirements for specific consideration by Trustees of appropriateness of any period exceeding one year and approval by APRA for any time period exceeding three years.

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