Prudential practice guide

Draft SPG 114 Operational Risk Financial Requirement

Integrated version

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AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY | APRA.GOV.AU

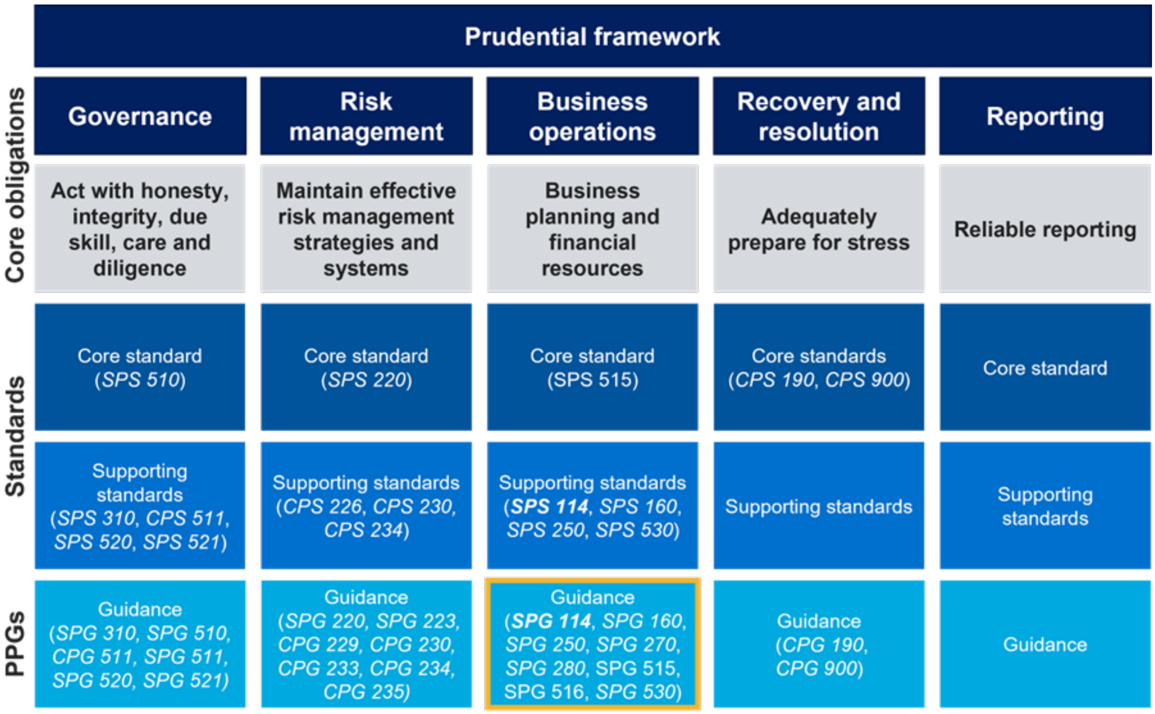
Contents

About this guide

Prudential practice guides (PPGs) provide guidance on APRA's view of sound practice in particular areas. PPGs frequently discuss legal requirements from legislation, regulations or APRA's prudential standards, but do not themselves create enforceable requirements.

The *Superannuation Industry (Supervision) Act 1993* (SIS Act) requires an RSE licensee to maintain and manage, in accordance with the prudential standards, financial resources to cover the operational risk that relates to each RSE[1]. *Prudential Standard SPS 114 Financial Resources for Operational Risk* (SPS 114) establishes requirements relating to these financial resources.

The graphic below summarises APRA's prudential framework, showing the location of SPG 114 in the ***business operations pillar***.



This PPG is also to be read in conjunction with *Prudential Practice Guide CPG 230 Operational Risk Management*, which provides guidance on APRA's expectations with respect to an RSE licensee's management of operational risks.

Subject to the requirements of RSE licensee law[2], an RSE licensee has the flexibility to structure its business operations in the way most suited to achieving its strategic objectives. Not all practices outlined in this PPG will be relevant for every RSE licensee and some aspects may vary depending upon the size, business mix and complexity of the RSE licensee's business operations.

[1] Refer to section 52(8)(b) of the SIS Act.

[2] Refer to subsection 10(1) of the SIS Act for the definition of 'RSE licensee law'.

For the purposes of this guide and consistent with the application of SPS 114, RSE licensee and registrable superannuation entity (RSE) has the same meaning given in subsection 10(1) of the SIS Act.

For the purposes of this guide and consistent with SPS 114, where an RSE licensee is required to 'demonstrate' a matter, that term requires the RSE licensee to prove or show the matter both in written form and in practice. This emphasises that APRA expects matters to not only be appropriately documented but importantly to be demonstrably put into practice.

> This integrated version of SPG 114 maps APRA's guidance to the relevant paragraphs in SPS 114. Paragraphs from SPS 114, which are enforceable requirements, have been set out in blue boxes like this; the accompanying guidance follows below, outside the blue boxes.

Glossary

APRA	Australian Prudential Regulation Authority
Hybrid fund	For the purposes of this PPG, a hybrid fund is an RSE that provides both defined benefits and accumulation benefits
ORFR	Operational risk financial requirement
PPG	Prudential practice guide
RSE	Registrable superannuation entity as defined in s. 10(1) of the *Superannuation Industry (Supervision) Act 1993*
RSE licensee	As defined in s.10(1) of the *Superannuation Industry (Supervision) Act 1993*
Significant Financial Institution	Significant Financial Institution as defined for RSE licensees in paragraph 20(u) of *Prudential Standard CPS 511 Remuneration*
SIS Act	*Superannuation Industry (Supervision) Act 1993*

Guidance

Operational risk financial requirement (ORFR)

8. An RSE licensee must maintain, manage and utilise, in accordance with this prudential standard, financial resources to protect beneficiaries from losses due to operational risk that relate to the RSEs within its business operations.[3]

1. Operational risk incidents expose members to the risk of financial loss and disruption that may also deprive them of a financial gain. The ORFR is intended to provide members with confidence that there is a low risk that the RSE licensee will have insufficient available financial resources to:

   a) spread the cost of operational risk incidents fairly over time and across different cohorts of members; and

   b) maintain critical operations within tolerance for severe disruption where this exposes members to a material risk of loss.

Determining the ORFR target amount and tolerance limit

11. For the purposes of paragraph 8, an RSE licensee must determine:
    (a) a target amount of financial resources (ORFR target amount); and
    (b) a tolerance limit below the ORFR target amount (tolerance limit) that reflects the level below which the RSE licensee must take action to replenish financial resources held to meet the ORFR.

12. An RSE licensee's ORFR target amount and tolerance limit must be determined on a prudent basis that suitably reflects:
    (a) the ORFR strategy objectives:
    (b) the uses of the ORFR financial resources permitted under paragraphs 14 and 15; and
    (c) the size, business mix and complexity of the RSE licensee's business operations.

ORFR target amount and APRA's guideline amount

2. APRA expects a soundly run RSE licensee, that has implemented an effective risk management framework, to have an ORFR target amount that is equivalent to at least 0.25 per cent of funds under management (FUM). For the purposes of calculating the ORFR target amount, APRA views FUM as the total of asset balances of each RSE within the RSE licensee's business operations. An equivalent method of expressing

[3] For the purposes of this Prudential Standard, an RSE licensee's business operations includes all activities as an RSE licensee (including the activities of each RSE of which it is the licensee), and all other activities of the RSE licensee to the extent that they are relevant to, or may impact on its activities as an RSE licensee.

the guideline amount in relation to a defined benefit fund may be 0.25 per cent of liabilities in respect of vested benefits.

3. Where an RSE invests in a Pooled Superannuation Trust within the same RSE licensee's business operations, APRA expects that when considered as a whole, the ORFR target amount covering the aggregate assets associated with both entities would be at least 0.175 per cent of aggregate FUM.

4. APRA's guideline target amount is a standard industry benchmark. In exceptional cases, an RSE licensee may adopt a lower target amount. In such cases SPS 114 requires an RSE licensee to engage with APRA prior to adopting a lower amount, and would:

a) typically be a significant financial institution;

b) provide a clear and compelling rationale that sets out why its target amount is appropriate for its risk profile, size and complexity, based on quantified evidence;

c) provide a robust methodology for establishing its target amount, with appropriate governance and controls, for ensuring the ongoing appropriateness of the ORFR target amount; and

d) clearly demonstrate that it meets *Prudential Standard CPS 230 Operational Risk Management* and is operating better practice in line with relevant prudential practice guides including *Prudential Practice Guide CPG 230 Operational Risk Management* and *Prudential Practice Guide SPG 515 Strategic and Transfer Planning* (Business planning and financial resource management).

5. The availability of alternative sources of funding may be one influencing factor for RSE licensees when deciding whether to determine a bespoke ORFR target amount to reflect their own circumstances, and if so the amount. An RSE licensee may have access to alternate sources of funding to address operational risk incidents such as other regulatory financial requirements, insurance arrangements or financial commitments from a party external to the RSE licensee's business operations.

6. If an alternate source of funding is to be taken into account in the ORFR target amount, APRA expects that an RSE licensee would be able to provide robust evidence that demonstrates how it has determined this is appropriate. APRA expects the assessment would consider matters including, but not limited to, the availability of funds, any liquidity limitations and risks associated with accessing the funds when needed, and a contingency plan should the alternate source of funding not be available when needed.

7. APRA expects it will be difficult for an RSE licensee to be able to demonstrate that it can confidently rely upon a material service provider to directly address the cost of all operational risk incidents. In such circumstances, a prudent RSE licensee would also consider matters such as the coverage of the service provider agreement and the financial capability of the service provider in varying scenarios.[4]

Attribution of the ORFR target amount

8. An RSE licensee may attribute its ORFR target amount, and the ORFR financial resources, to enable it to meet the requirements in a way that reflects its operating model. This may be necessary to provide clarity on monies held for different RSEs, sub-funds, critical operations and components that are required to be covered. Attribution may facilitate efficient and equitable funding, management, usage and replenishment of the total ORFR target amount over time and across different cohorts of members.

[4] Refer to *Prudential Standard CPS 230 Operational Risk Management.*

9. APRA expects that an RSE licensee of a hybrid fund would have particular regard to member equity in relation to its method to fund the ORFR target amount (and use of these financial resources) across accumulation and defined benefit member divisions.[5]

Tolerance limit

10. The ORFR tolerance limit is intended to enable an RSE licensee to manage immaterial fluctuations below the ORFR target amount without the need for a replenishment plan.

11. APRA envisages that the circumstances leading to immaterial fluctuations could include a small payment or payments out of the financial resources held to meet the ORFR target amount, or an insignificant underperformance of the ORFR financial resources amount against an RSE licensee's investment objectives for the financial resources.[6]

Use of ORFR financial resources

14. An RSE licensee may only use ORFR financial resources to address the operational risks that could cause one or more beneficiaries in an RSE within the RSE licensee's business operations to sustain a loss, or to be deprived of a gain to which they otherwise would have been entitled, in relation to their benefits in that RSE.

15. ORFR financial resources may be used:
    (a) subject to paragraph 14, to meet the requirements of *Prudential Standard CPS 230 Operational Risk Management* (CPS 230) for the effective management and prevention of operational risk incidents, including the remediation of material weaknesses and maintenance of critical operations within tolerance levels through severe disruption; and
    (b) to reduce a surplus where ORFR financial resources are materially larger than the ORFR target amount.

12. APRA expects an RSE licensee would document the specific circumstances for which it will consider the use of ORFR financial resources in its ORFR strategy. The circumstances must be consistent with SPS 114 and the RSE licensee's legal duties and obligations, including any limitations on accessing reserves. Situations that APRA considers would be appropriate for this purpose include, but are not limited to, using the ORFR financial resources for:

    a) remediation activities, including addressing an identified vulnerability or weakness that presents a material risk that may impact the maintenance of critical operations, or addressing the root cause of an event;

    b) costs associated with the prevention of losses and disruption in response to an identified material weakness. For example, where the RSE licensee has determined that if not addressed, there is a

[5] For the purposes of this PPG, a hybrid fund is an RSE that provides both defined benefits and accumulation benefits.

[6] For the purposes of this PPG, a reference to 'ORFR financial resources' is to be read as 'financial resources held to meet the ORFR target amount'.

material risk that could cause beneficiaries to sustain a loss or be deprived of a gain to which they otherwise might have been entitled; and

c) executing, or supporting the execution of, a business continuity plan or the orderly exit from a service provider agreement in response to an operational risk incident.

13. APRA considers that it would generally not be appropriate to use ORFR financial resources for expenses including, but not limited to:

a) business as usual costs, such as funding the development, maintenance and enhancement of the operational risk management framework, or investing in new systems, processes and technology where this is not in response to an operational risk incident or near miss;

b) paying a premium for an insurance policy that may provide cover for certain operational risks, payment of any levies, payments addressing losses relating to investment underperformance; and

c) the payment of financial penalties incurred by the RSE licensee or any other use that is inconsistent with restrictions that preclude a trustee from being indemnified out of the operational risk reserve held as an asset of the RSE.

Managing surplus ORFR financial resources

14. Activities such as a change in the risk profile of the RSE licensee's business operations, a reduction in membership or change in FUM, a successor fund transfer or wind-up or investment performance have the potential to create a surplus of financial resources where the RSE licensee may decide that the ORFR target amount is too high in the new circumstance and requires downward adjustment.

15. When members of an RSE are being transferred under a successor fund transfer it may be open to an RSE licensee to determine it appropriate to transfer an amount of the ORFR financial resources to a receiving RSE licensee or for those monies to be allocated to member accounts prior to transfer.

16. APRA expects an RSE licensee would seek appropriate independent advice and implement a fair and transparent response to a surplus situation that has regard to how the surplus of financial resources has arisen and its legal duties and obligations.

17. If an RSE licensee intends to make a material payment to reduce a surplus, APRA expects the RSE licensee would engage with APRA before the payment is made.

Access to ORFR financial resources

16. To be eligible to meet the ORFR target amount, any ORFR financial resources held as an operational risk reserve within an RSE must:

(a) be separately identifiable from member accounts and reserves held in the RSE for other purposes; and

(b) provide confidence that the ORFR financial resources will be available when needed to address operational risks in a timely manner.[7]

17. To be eligible to be used to meet the ORFR target amount, any ORFR financial resources held as trustee capital must be held in a form that is equivalent to Common Equity Tier 1 capital.[8]

Operational risk reserves

18. The primary purpose of an operational risk reserve is to provide an unrestricted commitment of financial resources to address losses arising from operational risk events in a timely manner. APRA expects an RSE licensee would ensure that the assets in the operational risk reserve have an appropriate risk profile and are sufficiently liquid to achieve this objective.

19. An RSE licensee may decide to implement an investment strategy for its operational risk reserves that mirrors the investment strategy of the RSE. This approach may assist it to maintain the ORFR financial resources at an appropriate level over time, provided that the RSE's investment strategy has sufficient regard to liquidity and that the risk profile is appropriate to meet the purpose of the ORFR.

20. APRA expects investment earnings from the investment of an ORFR risk reserve to be allocated to the ORFR risk reserve.

Operational risk trustee capital

21. Where an RSE licensee holds some or all of its ORFR financial resources as operational risk trustee capital, APRA expects an RSE licensee would be able to demonstrate it has appropriate processes and controls in place to:

(a) quarantine the capital for the sole purpose of meeting the ORFR target amount; and

(b) monitor the value of its capital against both the portion of the ORFR target amount that the RSE licensee has determined should be held as trustee capital, and other liabilities of the RSE licensee.

Shortfall management

18. Where the level of ORFR financial resources falls below the tolerance limit, an RSE licensee must implement a replenishment plan and replenish the ORFR financial resources. Replenishment must occur within a period and in a manner the RSE licensee determines will ensure that the RSE licensee acts fairly in dealing with beneficiaries and minimises the risk of adverse outcomes for beneficiaries.[9] The replenishment plan must, at a minimum, explain:

[7] Refer also to *Prudential Standard SPS 515 Strategic Planning and Member Outcomes* for requirements relating to the prudent management of reserves.

[8] Common Equity Tier 1 comprises the highest quality capital elements that fully satisfy all of the following essential characteristics: it provides a permanent and unrestricted commitment of funds; is freely available to absorb losses; does not impose any unavoidable servicing charges against earnings and ranks behind the claims of depositors and other creditors in the event of winding-up.

[9] For the purposes of this Prudential Standard, a reference to 'beneficiaries' is a reference to 'beneficiaries of an RSE within the RSE licensee's business operations'.

(a) how the shortfall has arisen;

(b) the amounts that apply in relation to each RSE;

(c) how the RSE licensee will replenish the ORFR financial resources, including the source of funding; and

(d) the expected date for the RSE licensee to again meet the ORFR target amount.

19. An RSE licensee's replenishment plan must be approved by the Board prior to implementation.

20. APRA may require an RSE licensee to revise its replenishment plan if APRA considers that the plan does not comply with the RSE licensee's duties and obligations.

22. If circumstances change during the replenishment period such that the proposed funding method, or the ORFR target amount itself, is adjusted, APRA expects that the replenishment plan would be reviewed and updated as needed. A replenishment plan may take into account an anticipated payment from a compensation arrangement on which an RSE licensee believes it can reasonably rely.

Review and audit

21. An RSE licensee must review the appropriateness of its ORFR target amount and tolerance limit at least annually and following a material operational risk incident or material change to the RSE licensee's business operations. The findings of the review must be reported to the Board.

22. An RSE licensee must implement satisfactory internal audit procedures and external audit arrangements to ensure compliance with, and the adequacy and effectiveness of, the ORFR strategy.[10]

23. APRA may require the appointment of an external expert to provide an assessment of, and report on, the adequacy and effectiveness of, the RSE licensee's approach to meeting the requirements of this Prudential Standard. The report must be paid for by the RSE licensee and must be made available to APRA, together with the Board's preliminary response within 30 business days after it has been provided to the RSE licensee.

23. APRA expects the annual review of the ORFR target amount and tolerance limit would be conducted by individuals with suitable experience, qualifications, capacity and understanding of the objectives of the ORFR to perform a robust, objective, timely and forward-looking review. Personnel from the risk management function and other suitably qualified and appropriate expert advisers may play a role in the review process.

24. Following a review of the ORFR, an RSE licensee may determine that it is appropriate to adjust its ORFR target amount, tolerance limit or any other aspects of an RSE licensee's ORFR strategy, including how the ORFR financial resources are held and invested.

25. In addition to its approach to monitoring operational risks under CPS 230, a prudent RSE licensee would implement forward looking triggers and reporting processes that alert the Board to matters that may need pre-emptive action or response in relation to the ORFR. These may relate to the the funding, management,

[10] Refer to *Prudential Standard SPS 310 Audit and Related Matters and Prudential Standard SPS 510 Governance* for requirements relating to external and internal audits respectively.

investment and use of the ORFR financial resources and the appropriateness of the ORFR target amount itself.

26. APRA expects that an RSE licensee would maintain appropriately comprehensive records relating to the use or potential use of its ORFR financial resources. This may include records of where the RSE licensee has considered but has decided against using the ORFR financial resources. APRA's view is that, over time, such information, together with insights on material operational risk incidents and near misses, would assist an RSE licensee in the development, review and monitoring of its ORFR strategy by providing a comprehensive record of when the RSE licensee decided to use or not use the ORFR financial resources.