KPMG

Financial Resources for Risk Events in Superannuation

KPMG submission

KPMG Australia, March 2023

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Executive summary

As a leading professional services firm, KPMG Australia (KPMG) is committed to meeting the requirements of all our stakeholders – not only the organisations we audit and advise, but also employees, governments, regulators and the wider community. We strive to contribute to the debate that is shaping the Australian economy and welcome the opportunity to make further comment on Strengthening Financial Resilience in Superannuation in response to APRA's Discussion Paper on Financial Resources for Risk Events in Superannuation.

The landscape of superannuation continues to shift with a new stream of mergers, unprecedented levels of remediation, enforcement and class action litigation, added to continued regulatory reform and cyber risk.

Superannuation funds are becoming some of the largest and most complex financial institutions in Australia, and this is reflected in their evolving risk profile. The landscape of superannuation continues to shift with a new stream of mergers, unprecedented levels of remediation, enforcement and class action litigation, added to continued regulatory reform and cyber risk. It is therefore not surprising that there is a renewed focus on the financial stability of superannuation trustees. The financial strength of superannuation funds is critical both in terms of providing strong and stable outcomes for members, and from a macroeconomic perspective, given the scale of collective assets under management in the industry.

KPMG supports an approach of superannuation trustees going beyond the Operational Risk Financial Requirement (ORFR) (SPS 114) to embracing a holistic and dynamic capital management framework approach that is founded on an understanding of the purpose of capital management, strong capital management principles, and is tailored to the risk profile and risk appetite of the relevant superannuation fund. The framework should anticipate the investment of the capital held having regard to the need and timing of access and associated levels of liquidity. The framework should also be subject to regular review having regard to the risks the trustee is facing, the funding of initiatives and the potential for material unexpected events.

Our approach to this submission is to set out what we view as the role of the trustee, purposes of capital and foundation principles in section 1, further KPMG insights in section 2, and responding to the specific questions in the discussion paper in section 3.

Thank you for the opportunity to participate in the consultation process and we look forward to working with APRA on this important matter

Yours sincerely,

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Background

About KPMG

KPMG is a global network of professional firms providing a full range of services to organisations across a wide range of industries, governments and not-for-profit sectors. We operate in 144 countries and territories and have more than 236,000 people working in member firms around the world. In Australia, KPMG has a long tradition of professionalism and integrity combined with our dynamic approach to advising clients in the digital-driven world. We have over 12,000 people, including more than 650 partners, with offices around the country.

Actuarial Advisory Team

KPMG Australia's Life Actuarial team has over 65 professionals, based in Sydney and Melbourne. These professionals operate in life and superannuation as well as finance, funds management and banking. Our clients include the leading insurers and financial services companies operating in Australia, New Zealand and the Asia Pacific region. We help insurers, superannuation funds, banks and government manage financial risks by evaluating the likelihood of future event happening and designing ways to reduce the likelihood and impact of undesirable ones.

Superannuation Advisory

KPMG's Superannuation Advisory Team is dedicated to assisting our clients address their business/fund needs and assist in delivering holistic advice that enables them to achieve their strategic, governance and tactical imperatives including delivering better member outcomes.

KPMG Law

We have an experienced team of lawyers and consultants, many of whom are leaders in their fields, who are experienced in trustee governance, risk and compliance and regularly advise on trustee resilience together with our consulting colleagues. We are a safe pair of hands, and have earned the respect of clients and regulators and can provide trustee boards and management with the confidence they need in their decision-making. As part of KPMG, we bring together all the skills and experience that our clients need to provide holistic end-to-end solutions every time.

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Section 1: Approach and principles

Good capital management begins with a sound understanding of the role of the trustee and the different purposes for which capital is required.

Role of the Trustee

The fundamental role of the trustee is to hold and manage the superannuation assets on behalf of members and beneficiaries. Because of the level of trust imparted, and inherent inequality in the trustee beneficiary relationship, the law imposes strong personal obligations on the trustee. These obligations are to a large extent engrained in the trustee covenants in the Superannuation Industry (Supervision) Act (SIS Act). A trustee owes fiduciary obligations and must act in the best financial interests of the beneficiaries (in exercising its duties and powers). Fundamental to the role of trustee is a duty to invest, but this in turn is subject to a duty of care. A trustee cannot take undue risk or adopt an entrepreneurial spirit. Instead, the trustee's role must be performed with the care, skill and diligence of a prudent superannuation trustee. A trustee must understand the risks inherent in proposed actions, and in undertaking to act the trustee must be aware of the responsibility of looking after the money (or superannuation) of others. Added to this role is a protective feature, that the trustee must act in a manner to preserve trust property and safeguard trust property against loss.

Directors' obligations under the Corporations Act to take reasonable care and diligence and to prevent insolvent trading should also not be ignored in this matrix of obligations.

The prudent and protective nature of a trustee's role necessarily leads to rationale of why a trustee should consider the appropriate capital to hold in its responsibility as trustee, and this is fundamentally aligned to the purpose of capital that follows.

Purposes of Capital

For a superannuation fund the purposes of capital include stability and withstanding adverse events/outcomes and funding initiatives. For further detail on these purposes please refer to our March 2022 submission on Strengthening Financial Resilience in Superannuation[1] (KPMG March 2022 submission).

This purposive approach to identifying capital needs is broadly consistent with the capital management philosophy of other large and sophisticated organisations in fiduciary type industries or products, such as organisations that manage funds and make commitments to pay benefits to customers (for example, banks, insurers, responsible entities of managed funds).

As outlined in the KPMG March 2022 submission we define strong holistic management of capital for superannuation as having regard to anticipated future needs while applying the following principles:

- Funds should hold sufficient capital to meet member expectations of a very low risk of the fund (and therefore prospective and vested member benefits) being impacted by risks (other than risks they expect to be exposed to (such as investment risk relating to market performance)). This fundamentally requires an understanding of the risk profile of the fund.
- It is reasonable for entities to maintain reserves to fund potential initiatives where the benefits to the membership overall are greater than the cost.
- In deploying and in raising capital, funds should consider intergenerational fairness and fairness/outcomes between cohorts within a generation.
- In deploying and in raising capital, funds should clearly understand the demarcation between fund purposes and corporate purposes and capital held in those different capacities.
- Generally, reserves that are clearly surplus to fund the potential anticipated spending needs (based on the principles above) should be returned to members.

[1] https://www.apra.gov.au/sites/default/files/2022-11/Submission - KPMG Australia.pdf

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- Capital management should be dynamic, subject to regular review and alive to triggers for material change.

At a more detailed level, these principles should be taken into account when developing capital management frameworks, policies, processes and procedures.

Determining capital based on the above purposes and principles is complex and involves judgement (including in relation to the likelihood of future events which are, by nature, uncertain). This means that there is no single “right” number for the value of capital held.

Importantly, the capital management approach and targets are not static and, based on the above, should be expected to vary based on changes in the fund’s internal and external environment.

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Section 2: KPMG insights

Leading capital management practices are holistic

From a principles perspective, KPMG is of the view that the capital management approach (and prudential capital regulation) should be holistic. It should also be integrated with the fund's risk appetite, strategy and business planning. This would be then consistent across the other APRA regulated industries.

The current consultation paper seems highly focussed on operational risk and strategic defensive purposes – i.e. it has less on overall capital/overall requirement for good fund-wide holistic capital management. In focusing on capital requirements for strategic defensive purposes the proposed baseline amount considers only funds who are merging due to exit / contingency plans. It does not seem to recognise that there are funds that commence merger scans ahead of contingency planning, or funds who look to merge for strategic reasons rather than exit purposes. In considering capital that is required for strategic assertive purposes a trustee needs to link back to their business plan and consider funding sources.

KPMG appreciates that this would be a big jump to make given where super funds are at – nonetheless there can be a good way of beginning this journey and making sure that the amount and purpose for reserves including "the money over there" (reserves other than baseline and operational risk) is not implied or assumed.

Purpose / objective of capital

The purpose of capital in other industries is that "there should be a very low risk of members having their benefits immediately reduced because of a risk they did not reasonably expect to be exposed to". This purpose is similar to, but not quite the same, as APRA's purpose as per the discussion paper - for members to be "equitably protected from the impact of operational risk events".

As described above, part of a superannuation trustee's role is to preserve trust property. In doing so, a trustee acting prudently does its best to protect the account balances of members, including from any reduction in their account balance due to an operational risk event they did not expect to be exposed to.

Insufficient focus and understanding of large / rare events that make up the vast majority of operational risk losses

A theme across the submissions to APRA's first discussion paper consultation was that the current Operational Risk Financial Requirement (ORFR) amount and reserves are not efficiently used. We agree that to the extent a fund/trustee is setting up other reserves for operational risk outside of the ORFR that there is duplication, and this would be an inefficient allocation of capital.

KPMG's perspective is that this duplication issue should be addressed directly (and from a trustee decision making and regulatory prudential point of view there needs to be greater consideration of how reserves are set up and for what purpose).

In our view, this point is not strong support for other arguments and theories. For example, the ORFR is too high and this much is not needed, which is a separate point to duplication of capital. As well as other points sometimes used to argue for lower ORFR, such as "we have never had an event", "the industry hasn't had many events", "our risk management is better" if this is used as an argument without considering whether the risks might be getting bigger too – see below.

A key point that should be understood is that in a modern economy, large fiduciary institutions are expected to perform their obligations, particularly as they have undertaken to act on behalf of others, and meet the promises they have made to customers/members. From a policy perspective it should be very rare that someone would have their benefits reduced for a risk they didn't expect. Additionally, confidence and financial strength in the industry are important.

The regulatory capital position in other industries of 1 in 200 speaks to this (and when you add in additional buffers most companies in other industries have reserves well beyond this). We are of the view that an adequate total capital position of a trustee and fund gives confidence and financial strength to the industry, not just the proposed baseline amount.

In summary, by definition the large/rare events make up the vast majority of operational risk losses (consistent with other industries) – very frequent small amounts do not make up much of the overall losses. This thinking and understanding should be front and centre.

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Permission to spend on risk management

In thinking about a scenario where a trustee had 25bps in ORFR and then spends 24bps on risk management, this would then result in 1bp being left in the ORFR. What happens if a 10bp event then occurs? This would obviously be a hugely detrimental outcome - and based on the history of operational risk events, is not implausible.

We understand there can be a challenge if a fund wanted to invest to improve its risk management but did not have available reserves to support that investment.

However, enabling a situation where a fund may not have sufficient reserves to support a large but plausible event (i.e. that its reserves did not provide a high probability of meeting an event) does not in our view align with the regulatory intent for capital setting requirements. Good trustee decision making and regulatory prudential capital is about both risk management and appropriate capital. As outlined above, where some trustees may have additional operational risk reserves outside of their ORFR they may have access to capital to cover this scenario. And our concern is that not all funds have sufficient capital outside of their ORFR to cover such a scenario and their ongoing operational costs. Adopting a more holistic capital approach (which could align with a holistic regulatory approach) would make this consideration explicit and not result in potential gaps of coverage.

Use of internal model for ORFR – challenges of a self-assessment

In allowing an internal ORFR to be developed it is interesting to consider a commonly referenced study that “80% of drivers think that they are better than average”. This same risk applies in the reference to superannuation funds. That is, the management of some funds may potentially overestimate the effectiveness of their governance, risk and control environment and therefore understate the likelihood of a large operational risk event occurring. We wish to emphasise this is not a criticism of the superannuation industry – it is common across regulatory frameworks in other industries, that where elements of the capital setting process are subjective rather than prescriptive that the frameworks include aspects to address the potential bias[2].

While the superannuation industry is currently viewed as having an effective default prescriptive 25bps approach, our experience is that what is really in place is a hybrid. Consistent with SPS 114 trustees should consider their material risks (and some consistently do). Then the 25bps is an effective default floor where a trustee adopts a higher target amount to cover their unique risk profile.

Another salient point is that some trustees (perhaps due to a lack of relevant information) are not actively considering risks at an industry level and do not have line of sight of industry wide events.

From a best practice perspective, in our view, trustees should be regularly reviewing their target amount (actually regularly reviewing their overall target and actual levels of capital based on tailored risk assessment (and on a holistic capital management basis)), with appropriate regulatory oversight and industry expert input, having regard to their unique operating model, risk profile and appetite and industry risks as a whole.

Additionally, in setting and reviewing a target ORFR amount (as part of this approach), a best practice approach utilises both qualitative and quantitative methodologies such as stochastic modelling, scenario analysis, peer benchmarking and review of historical actual losses – and as noted above – that this includes consideration and awareness of large events that have occurred across the industry (not just those that have occurred in their particular fund).

The challenge with other methodologies is that they may not adequately align to the capital’s purpose or objectives. KPMG’s suggested methodology is developed to be a realistic representation of actual risk linked back to the capital purpose.

Based on the above observations one conclusion is that in order for an internal based model approach to work an increase in regulatory supervision would be required.

[2] The approaches to minimising capital understatements where the capital formula/assumptions include subjective aspects are various and include; imposing prescriptive minimums over the subjective assumption/formula, requiring certain analysis or frameworks to be considered in making the subjective judgements, heightening the supervisory approach over the subjective elements – e.g. increased scrutiny, approval, requiring additional reviews, etc. It also includes, in some cases generally minimising the number of subjective elements to those where the value of including them exceeds the potential risks associated with them.

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Risk management improvements and risk trends

A common misconception across the industry is that risk management has improved with the consequence that risks are also reducing. We are concerned that even if risk management has improved, risks in the industry and for funds are also increasing due to the nature and scale of the potential risks. For example, the industry has seen an increase in class actions, obligations, complexity of operations and activities (including financial advice, types of investments, retirement income, etc.) Recent cyber security incidents in related industries are also of note. Superannuation funds are becoming some of the largest and most complex financial institutions in Australia, and in becoming so it would be remiss to assume that the risks they face are reducing.

Operational risk events scaling with funds under management (FUM)

There has been a view expressed by some that operational risk falls as a percentage of size when size grows. This may not always be the case as some risks are fund wide and grow proportionately with fund size3. Therefore it is important to ensure that any potential losses that are proportionate to FUM are appropriately accounted for when determined a target ORFR amount.

[3] Some other risks may be more likely to manifest as fixed dollar amounts (or otherwise generally reducing significantly as the size of the fund increases) – in summary some risks will tend to scale with size and some don't. Therefore overall we think it is incorrect to think that all risks reduce with size.

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Section 3: Consultation questions

Where we have made comments in the body of our submission that address APRA's consultation questions, we have indicated the section in which they are discussed below. Otherwise, our discrete responses to the questions in which we wish to answer are below.

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?

We recommend an approach that is based on the purpose of capital, with one essential purpose being having a low probability of members having their benefit reduced for risks they did not expect.

To meet this purpose, funds should have sufficient capital to execute a defensive strategic step (exit) as well as to have sufficient reserves to address operational risk events and a scenario of overall adverse operating environment (the target capital should also include sufficient capital for other necessary or desired uses as well) – with only a low probability of members having their benefit reduced for risks they did not expect (as noted above).

Nonetheless, it is noted that while the overall target level of capital should include calculations and consideration for each of these elements (as well as allowing for many others which are not discussed here) maintaining separate actual capital reserves for each of a large number of different uses (which are unnecessarily ring-fenced from each other) hinders good regulation and good (and efficient) capital management.

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

From a practical perspective we draw out two potential impediments.

(i) Quantum

One example APRA referred to in the consultation was the per account requirements in the UK. Translated to the average account size in Australia (i.e. re-expressing the per account amount as a percentage of fund assets) would result in a Baseline+ reserve amount of around 10bps of fund assets.

The operational risk requirement would be added to this (plus capital for other amounts as well which funds should hold even if they are not included in the actual regulation).

Some funds might find this difficult to meet (noting that, potentially in some circumstances or for some funds, the requirements may be higher than the measure of 10bps referenced above). However (as noted above), we consider the expectations of members and the community is that superannuation institutions should be strong. Therefore, the inability and difficulties to meet such a requirement should not override the fundamental importance of setting an appropriate target (both from a regulatory and internal capital management perspective).

(ii) Duplication and Ring-fencing

As we note in question 1, undue hard ring-fencing of capital/reserves for particular purposes is unnecessary and will unnecessarily harm and impede the practical implementation and compliance with a Baseline+ component – just as it has done in the past for the ORFR.

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

Please refer "Permission to spend on Risk Management" section above.

Baseline component

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

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

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

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?

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

Under this response, we have set out our responses to all the **Questions 4-8**.

The answer to this set of questions is a function of the circumstances of the particular fund.

In the current consolidation environment, a merger partner may require a fund to have a certain level of capital attached. Each fund is unique and their attractiveness as a merger partner can depend on a number of factors outside of membership numbers. Funds with complex and customised product offerings, asset structures and insurance arrangements may need higher levels of surplus capital in order for a successor trustee to be willing to take on the additional risk and complexity of the transferring fund.

A fund with minimum surplus capital would likely need to have straightforward product offerings, consistent fee arrangements and a basic asset structure to be an attractive merger partner. Therefore a basic calculation method is not appropriate in all circumstances as it fails to recognise that the costs (both transition and ongoing) of most funds is not necessarily linked to membership numbers but each fund’s unique structure and circumstances.

What the method and resulting target amount (target amount of overall capital) should achieve/do is result in a low probability of members having their benefit reduced for risks they did not expect – including, and in particular, in the circumstance that the fund determines that it should exit (either by transferring members to another fund or by wind-up).

The following further observations are made on the methodology and resulting amount (this related to **Question 7** and **Question 8**). In relation to meeting the overall objective we noted above, there are advantages and disadvantages of “basic calculation/per member” vs more alternatives such as a more sophisticated/complex calculation, or having a minimum level set by APRA, or a more subjective basis. These advantages and disadvantages include:

- Simple/prescribed methods have the potential disadvantage that they may not take into account differences between fund/benefit/member characteristics and operational expense profile which impact the capital required to execute an exit without reducing member benefits. This would result in the requirement being higher or lower than a calculation which more accurately took into account these allowances.
- Measures that are more based on judgement or that are more subjective have the potential disadvantage that judgement is misapplied (as noted in relation to ORFR setting in question 1).
- Between a simple/prescribed method and a subjective method is a method which is prescribed but is more complex and takes into account more factors than simply the number of members (e.g. complexity of benefits, lack of scale and other factors that impact the attractiveness to potential transfer in funds, costs, etc).

We have not attempted to weigh all these elements in detail and balance which is overall preferred. We also consider it likely that the most appropriate approach is likely to change over time as further analysis, studies and experience emerges.

Nonetheless, and consistent with the key points we have made throughout this submission – whatever approach is adopted, in our view, the financial strength and importance of protecting member benefits is primary and should be given adequate weight against arguments for simplicity or other approaches which have a significant risk of potentially leading to inadequate amounts being held. Additionally, the specific circumstances of the fund should be considered and the target appropriately tailored, but also having regard to relevant external and industry risks.

We also note (as was noted for question 1) the supervisory approach actually influences the answer – for example, allowing more subjectivity from funds should only be considered where it will be coupled with higher supervisory oversight (and even potentially approval) of the calculated target amount.

The above notes the amount should take into account fund/benefit/member characteristics and operational expense profile. These impact attractiveness (and therefore capital levels required of the fund) to execute a transfer to potential transferring in funds. They also impact the costs of a wind-up (without transfer). It is further noted that the attitude/appetite of potential transferring in funds may change over

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time and may not always be as positive as they are currently. Consistent with other regulatory regimes – the target should adequately take into account that an exit may occur when the appetite for a transfer in is lower (the fund may need to have more capital than would otherwise be the case to facilitate a merger in without a reduction to its members benefits).

In relation to **Question 4**, i.e., whether funds have sufficient capital – this should not be the primary concern – see response to question 2 and the purpose as noted.

In relation to **Question 6**, again as noted elsewhere in this report the overall capital management should be reviewed regularly. The target calculation should be continuously updated (e.g. monthly or quarterly) for changes in size and member profile. The parameters that are inputs for the target calculation should also be reviewed reasonably regularly (both regulatory and, where the fund performs sets parameters internally). The frequency of review will depend on the complexity of the method selected but probably more importantly also is likely to become clearer over time as further analysis, studies and experience emerges.

In relation to **Question 5**, the observations made elsewhere in this question are relevant to considering the appropriate amount. In addition to these points, we would note that previous studies (and then making allowance for the appetite and costs to be more adverse than in the past) also provides useful information to consider within likely appropriate target amounts for the future.

Operational risk component

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

Please refer ”Use of Internal Model for ORFR – Challenges of a Self-Assessment” section.

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)?

Please refer ”Use of Internal Model for ORFR – Challenges of a Self-Assessment” section.

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

KPMG does not have a specific comment in relation to this question.

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