Mercer

welcome to brighter

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17 March 2023

Subject: **Strengthening Financial Resilience in Superannuation**

Dear [redacted],

Mercer welcomes the opportunity to comment on APRA's Discussion Paper issued in November 2022 entitled *Financial resources for risk events in superannuation*.

Mercer supports the general direction and most of the content within the Discussion Paper. In particular, we agree that:

- The current arrangements and requirements regarding ORFR have limited its usefulness and a more flexible and robust arrangement is needed.
- The current ORFR financial resources held by RSE licensees have largely followed the guidance set out in SPG114 (i.e. 0.25% of FUM) and this industry-wide practice has led to some licensees holding very large ORFR financial resources. In some cases, these set-aside resources are excessive and to the detriment of members' best financial interests.
- The proposed general approach has merit and would provide RSE licensees with flexibility as well as an incentive to improve their risk management framework and operations, which is missing from the current ORFR arrangements. However we are unclear of the value of the baseline component.
- The opportunity for RSE licensees to determine the amount held to satisfy the operational risk component is a step forward and a significant improvement. Many superannuation funds are now major financial institutions in their own right and a "one-size-fits-all" is no longer appropriate or helpful. It can also disadvantage members. RSE licensees must accept the responsibility to manage their organisation and accept the need for a strong and robust risk management framework, as well as the need for funds to be set aside for the consequences of unexpected events or circumstances.
- RSE licensees should continue to be allowed to implement their own investment strategies for the operational risk component. After all, if RSE licensees are able to determine the amount of this component, the calculation should take into account the investment strategy adopted. This approach should also be extended to the baseline component, if this component is retained.

We have responded to the particular questions raised in the Discussion Paper in the Attachment. However, we wish to make the following two comments and a recommendation that are relevant to several of the questions asked.

1 Superannuation is very different from the other industries regulated by APRA. That is, the vast majority of superannuation funds do not offer or imply any guarantees. That is, members bear the risks. This is not to imply that operational risk events will not occur. They will! In addition, as noted in the Discussion Paper we want to improve (the community's) confidence in the superannuation system. Hence setting aside appropriate financial resources is a good thing to do. However, it must be recognised that superannuation has very different characteristics and features from banking and insurance.
2 The current guidance set out in SPG114, and in particular the 0.25 per cent figure, has meant that there has been limited industry development of appropriate models for a superannuation fund in terms of an operational risk reserve. Our experience has suggested that for larger funds a realistic figure was well below 0.25 per cent. Hence, there was little value in developing a more sophisticated model which would have incurred additional costs to members. The point is that it will take time for appropriate operational risk models to be developed.

It is recommended that APRA introduce a transition period for the implementation of these new arrangements allowing RSE licenses to transition over a period of say, three years.

We would be pleased to discuss any of these matters with you and members of the APRA team. Please do not hesitate to contact me on [redacted].

Yours sincerely,

[redacted]

[redacted]
Senior Partner

Attachment: Response to Consultation questions in the Discussion Paper

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

The Discussion Paper notes that the baseline component would be used “to support members’ funds, and support recovery or transfer activity if needed”. However, the expected uses of the baseline component are not clearly defined. For example, what is the boundary between the baseline and operational risk components?

Given that many superannuation funds have successfully exited the industry in recent years without it, we wonder about the need for the baseline component. As noted in the Discussion Paper, it will have a narrow scope and, as such, may be an unnecessary complication.

Further, as recognised in the Discussion Paper, the operational risk component could be used for broader operational risk events. However it is important that that this broader use is also clearly defined as this will assist RSE licensees in determining the appropriate amount to hold in the operational risk component.

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

There are a variety of corporate structures within the superannuation industry and flexibility within the proposed arrangements is therefore needed.

The Discussion Paper notes that the financial resources held to meet the proposed requirements can be held within an RSE, or as trustee capital held by the RSE licensee or a combination of both.

However, the size of the financial resources required to be held under the proposed Baseline+ model, with the expanded definition of operational risk events, is likely to be larger than the current arrangements for some funds. We recommend that additional flexibility be provided so that the some or all of the operational risk component could be held in the form of a contingent funding structures, such as a guarantee from one or more of the RSE licensee’s shareholders. After all, these shareholders often provide significant capital to support and expand their superannuation business in Australia.

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

As noted in our covering letter, the development of appropriate models for both the baseline and operational risk components will evolve over time. The definitions (as mentioned above) will also be critical.

It is possible that one unintended consequence will be to limit competition in the superannuation marketplace. That is, global players may be reluctant to enter the Australian market if they are “required” to set side in their trustee capital an increasing level of financial resources as their presence in the local market grows.

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

As mentioned above, the definition of the baseline component is critical. It is expected that it will be narrower than the current ORFR requirements.

However most RSE licensees have not experienced the requirements of a recovery or exit activity. Therefore, it is inevitable that some estimates will be required.

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

This is very difficult to quantify across the industry and is likely to vary considerably between funds due to their different characteristics. For example, a superannuation fund with a DB category is likely to be more complex and costly to exit thereby leading to a higher baseline component.

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

In line with other prudential standards, we recommend a review of the overall reserving/capital requirements every three years, unless there has been a significant change to the characteristics (say, following a merger), risk appetite or risk profile of the fund.

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

A baseline calculation linked to the number of members inherently assumes that all funds have similar characteristics. This is simply not the case. There is considerable diversity within the industry and a calculation based on member numbers would not allow for this diversity.

There are many examples of this diversity, including but not limited to:

- Multiple employers or a single employer
- Complexity of the insurance arrangements
- Guarantees related to previous arrangements
- Complexity of retirement products
- Size of fund
- Other reserves or sources of capital

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

Mercer does not support a minimum amount for the baseline component. RSE licensees should be encouraged to improve the risk management framework and processes with the related intention to reduce the level of financial resources required to be set aside under the Baseline+ approach. Any minimum amount would discourage funds that, otherwise, would be below or near this amount from undertaking further improvements.

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

Many funds will not have the capability today to calculate the risk-based operational risk component. In fact, given the potentially much broader definition of the operational risk component, it is likely that the development of appropriate models for this component will take longer than for the baseline component.

The models are also likely to vary between funds depending on their characteristics, operations, outsourced arrangements, size, and corporate structure. In other words, a “one-size-fits-all” is not appropriate which is entirely consistent with the intended direction of the proposed arrangements.

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)?*

As noted above, the application and relevant models and calculations of these new arrangements will evolve over time. Hence, it is too early to consider any controls that may be necessary to address the risk that the target amount may be not efficient or prudent.

Clearly APRA supervisors will have ongoing discussions with each RSE licensee following the introduction of these new arrangements. This should provide APRA with a better understanding of the potential risks than is possible now.

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

The target amount is to be built up in a manner that is equitable to members and, in particular, “to spread the impact of operational risk fairly across different cohorts of members”.

Therefore a single or specific time frame is not be appropriate. It will be depend on the cause and size of the shortfall.

One way forward may be to expect replenishment over a three year period where the shortfall is below a specified threshold but to accept a longer replenishment may be needed where the shortfall is more significant.