17 March 2023

[redacted]
Head of Superannuation Policy
Australian Prudential Regulation Authority
GPO Box 9836
SYDNEY NSW 2001

Via email: superannuation.policy@apra.gov.au

Dear [redacted],

RE: APRA Consultation on Financial Resources for Risk Events in Superannuation

The FSC welcomes the opportunity to consult on proposed changes to Prudential Standard 114 (**SPS114**) relating to financial resources for risk events in superannuation.

The FSC does not support the principle that members of superannuation funds should fund the operational risk reserve. The ability for funds to be able to fund operational risk events from sources other than the Operational Risk Financial Requirement (**ORFR**) should be maintained so that funds can continue to ensure they are always making decisions that meet their legislative duty to act in the best financial interests of members.

In practice in many retail funds the cost of an operational risk event is funded through shareholder capital not through the operational risk reserve. This approach is in the best financial interests of members of the fund, as shareholder risk capital is a more appropriate funding source. However, the approach taken by APRA will mean that industry funds, which utilise members money to fund operational risk events, will unwittingly take on the position of capital provider to the fund and all the risks associated with this, which is not in their best financial interests. We cannot see a clear justification for why the financial backers of these funds cannot provide their own risk capital.

Alternatively, if APRA is of the position that it is, in fact, in the best financial interests of members of industry funds to use member funds to fund operational risks, APRA should make clear that it is therefore in the best financial interests of members of retail funds to fund these risks as well.

Further, the FSC is calling on APRA to be clearer about the scope of permitted use for quarantined funds. This includes making it clear that no portion of the funds can be used to indemnify directors against penalties for misconduct as per Section 56 of the *Superannuation Industry (Supervision) Act 1993 (Cth)* (**the SIS Act**).

The FSC does not support APRA's proposed Baseline+ approach. APRA has no basis for justifying the current proposal of setting a minimum amount for either the baseline or operational risk component of the funds. Specifically, we believe the calculation should instead be an entirely risk-based calculation. A risk-based calculation will avoid quarantining large amounts of sums for events that only have a small chance of occurring.

Financial Services Council Ltd
Level 5, 16 Spring Street
Sydney NSW 2000

E. info@fsc.org.au
W. fsc.org.au
ABN 82 080 744 163

Answers to the specific consultation questions are outlined below.

Summary of Recommendations

1. APRA should make clear that no component of the financial risk reserve can be used to indemnify directors of superannuation funds against penalties for misconduct.
2. APRA should provide guidance on the extent of allowable use of the Operational Risk Component for investigations and mitigation before events occur.
3. APRA make clear that if it is in the best financial interests of industry fund members to fund operational risks from member capital, it is also in the best financial interests of retail fund members to do the same.
4. APRA make clear that fund discretion is still available when making decisions about whether to use shareholder capital or the quarantined pooled funds to manage operational risks.
5. Relative risk of transfer or fund failure should be a key consideration in the calculation of the baseline component to account for the fact that not all funds bear the same risk of a transfer event occurring. APRA should provide a standardised risk adjusted factor for funds to apply.
6. Consideration should be given to how to make the resource requirement more efficient for funds that form part of a Group.
7. APRA provide clear guidance as to the calculation of both the baseline and the operational risk component of the Baseline+ model so that funds can make appropriate decisions about capital levels in house, without the need for expensive third party consultants.
8. The Baseline component should be reviewed every three years, in line with other APRA prudential standards.
9. There should be no minimum amount required for either the baseline nor operational risk component. APRA should instead provide clear guidance as to the expected requirements of each component including how relative risk of a transfer or operational event occurring impacts the required funding.
10. APRA should provide clear guidance to funds about what is expected to be included in the calculation of each component of the updated ORFR requirement so that industry decisions are consistent and appropriate.

The Baseline+ Model

<u>Question 1 – Enhancements to the Proposed Scope of Permitted Use</u>

The operational risk component is a reshaped requirement distinct from the previous ORFR requirement. As such, this will require superannuation funds to reassess the pool of funds required to be held for this component. While FSC members welcome the expanded scope of allowed uses for the operational risk component, there are still some questions as to acceptable use cases.

The FSC is not supportive of the use of any component of the funds being used to indemnify directors of superannuation funds against penalties for misconduct. Under Section 56 of the SIS Act, provisions in the governing rules of an entity are void if it purports to preclude a trustee from being indemnified out of the assets of the entity. This includes where there is a liability for a breach of trust for failing to act honestly, failing to exercise the degree of care and diligence required, criminal, civil and administrative penalties, paying for education in compliance with an education direction.[1]

The FSC submits that clearer guidance is warranted as to what these funds can and should be used for, including making expressly clear where the funds cannot be used for specific purposes. This will assist funds in planning how much is required, as well as the tolerance level to be individually set.

Recommendation

1. APRA should make clear that no component of the financial risk reserve can be used to indemnify directors of superannuation funds against penalties for misconduct.

Recommendation

2. APRA should provide guidance on the extent of allowable use of the Operational Risk Component for investigations and mitigation before events occur.

Question 2 – Legal and Practical Restrictions

Shareholder vs. Member Capital

As noted in the Discussion Paper, there is a general hesitance to draw upon the financial resources currently held as part of the ORFR because of notification and replenishment requirements.[2] FSC members concur that historically, there is little incentive to use the ORFR for its intended purpose, choosing instead to use surplus assets to manage cashflow in relation to operational risks.

It is important to acknowledge that there may be a significant difference between how different funds finance operational risks including a difference in how some retail funds manage cashflow compared to industry funds. In some retail funds, the surplus assets that are being used to manage these operational risks can come from shareholder capital as opposed to industry funds where the funds come directly from members. That is, some funds maintain their required ORFR but utilise existing shareholder capital to fund any operational risk events, rather than dipping into the ORFR which may need to be replenished with member capital.

Where operational risks are currently funded by shareholder capital over member capital, there may be no incentive to change the operating model to now always using these quarantined funds for operational risks. Of particular note is the legal requirement to act in members best financial interests. It is hard to see how retail funds would be acting in the best financial interests of members if they switched from using shareholder funds to member funds. This once again calls into question the under capitalisation of industry funds, and the implicit shareholder status of members of these funds who are left footing the bill for industry funds, despite not electing to take equity or operational risk in the fund.

---

[1] Superannuation Industry (Supervision) Act 1993 (Cth) s. 56 (2)
[2] APRA. (2022). Discussion Paper: Financial resources for risk events in superannuation. p. 8

If APRA is of the opinion that it is in the best financial interests of members to fund operational risks with member capital, as would be done in industry funds, it should acknowledge too then that it would also be in the best financial interests of members of retail funds to do the same.

Recommendation

3. APRA make clear that if it is in the best financial interests of industry fund members to fund operational risks from member capital, it is also in the best financial interests of retail fund members to do the same.

Noting that the Discussion Paper seeks to avoid funds spending their own capital on operational risks and instead utilise the quarantined pooled funds, FSC members are concerned that under the proposed changes they will no longer be able to use their discretion as to whether to use shareholder capital or the designated pooled funds to fund operational risk events. As noted above, it is not always in members best interests to use their capital in this way and so discretion is an important consideration.

Recommendation

4. APRA make clear that fund discretion is still available when making decisions about whether to use shareholder capital or the quarantined pooled funds to manage operational risks.

Other Practical Barriers to Use of Funds

In addition to the issues outlined above, there may be other barriers to the efficient use of resources such as:

- **Higher compliance cost** - A reserve that is more frequently used with a broader scope will cost more through additional governance, monitoring, legal and compliance costs. These costs would be passed on to members through increased fees in order to maintain the sustainability of the fund.
- **Funding** – A reserve that is used more regularly will need replenishment more regularly. Consideration would need to be given to efficient implementation and the impact this would have on members, particularly as the target level of the reserve will be recalculated and could fluctuate year on year.
- **Investment Returns –** the operational risk component would probably need to be predominantly held in cash (or other highly liquid asset) to enable ongoing use. This requirement comes at a cost as the reserve monies cannot be invested in higher yielding assets which better match the risk profile/assets of the fund, consequently impacting members or the Trustee (depending on who funds the Operational Risk Component).

Impact on Members

Any additional compliance or funding costs would likely be passed on to members through higher fees in order to maintain the sustainability of the fund. This would then need to be balanced with the enhancements also proposed in APRA’s proposed changes to transfer planning, which is proposing funds create resource intensive plans to potentially enact a transfer.

As noted in both this submission and the FSC's submission on the transfer planning proposal, the requirement to plan and quarantine funds for a transfer event that might never happen will have an effect on members in the form of higher fees and costs without necessarily providing a tangible benefit, and this will likely not be in the best interest of members.

Question 3 – Unintended Consequences

Pooled Funds Not Always Likely to Be Used

Under the baseline component, funds are required to quarantine a certain amount of funds so as to execute a recovery or exit strategy. Notwithstanding the problems noted below with procuring specialist services to determine an appropriate amount (see Question 4), the general amount of capital likely to be required to be quarantined may interfere with funds' legislated duty to act in the best financial interests of members.

The amount of capital required to affect a transfer can be in the order of hundreds of millions of dollars, making achieving an appropriate return on equity, while factoring in the best financial interests requirement, very difficult. This will be especially costly as these will be low probability events. The FSC submits that if funds can only use the baseline component for wind down or recovery activities, this amounts to "dead" capital, that may never need to be used.

There has been significant merger activity within the superannuation sector in the last few years. This can be seen to be as a result of natural market forces, such as the need to scale, as well as from the Your Future, Your Super performance test which has resulted in funds being required to merge to benefit members.

That said, the likelihood of failing and/or merger activity occurring varies from fund to fund. There is a risk that the unintended consequence of the quarantining of the required base component will result in funds holding onto money at very low rates of return for a scenario that may never likely eventuate. This will affect overall investment returns across industry and is not necessarily in the best interests of members.

Acknowledging APRA's policy position in having funds financially ready for potentially significant events, the FSC submits that the calculation as to the appropriate amount of baseline capital required should consider the relative risk of a recovery or transfer happening. This would then allow the fund more flexibility as to how much to fund the baseline component and make it easier to make decisions with respect to the best financial interests of members. The FSC submits that in the interest of industry consistency APRA should provide a standardised risk adjusted factor for funds to use in such an event.

Recommendation

5. Relative risk of transfer or fund failure should be a key consideration in the calculation of the baseline component to account for the fact that not all funds bear the same risk of a transfer event occurring. APRA should provide a standardised risk adjusted factor for funds to apply.

Group Funds

Where there are Groups with multiple RSE licenses, it is not efficient that each fund be required to maintain their own pool of resources. Instead, groups should be allowed to hold a suitable pooled amount on behalf of their individual RSEs.

Recommendation
6. Consideration should be given to how to make the resource requirement more efficient for funds that form part of a Group.

The Baseline Component

<u>Question 4 – Capability to Determine Baseline Component</u>

The Baseline+ model requires funds to make determinations as to:

a) The maximum cost of implementing a trustee contingency or member transfer plan; and

b) An appropriate amount of operation risk capital based on the funds individual risk profile.[3]

While some funds do have the expertise required in house to make assessments as to an appropriate amount of capital, many funds do not and therefore determining this would require a significant fiscal and time cost. Anecdotal evidence from members suggests that ‘Big Four’ consulting firms can take up to four months to complete smaller scale assessments, and so it is expected that this process would take even more time, costing hundreds of thousands of dollars per entity.

As noted above, in some instances the money to fund these assessments may come from stakeholder capital but sometimes, and always in the case of industry funds, this funding will come from member funds. The FSC submits that it is not in the best interests of members to spend hundreds of thousands of dollars determining what an appropriate amount of emergency capital would be. This is especially true when considering the relative risk that a transfer would ever even occur.

Even funds that do have the resources to make a decision in house have noted that much clearer guidance is required from APRA regarding what should go into making the assessment of capital.

Further guidance is required as to what exactly APRA’s intentions are in relation to the proposed baseline funds. For example, if the baseline funds are to enact the proposed required transfer plan as per the concurrent consultation on superannuation transfer planning, and if, therefore, members are supposed to have a transfer partner selected. As noted above and in the aforementioned concurrent consultation response, this process can be extremely costly and, in the case of selecting a transfer partner, comes with a competitive risk.

[3] Ibid. p. 13

The FSC therefore submits that APRA should provide clear guidance that will assist members in making capital decisions in house without the need to seek further input from expensive consultants.

> **Recommendation**
>
> 7. APRA provide clear guidance as to the calculation of both the baseline and the operational risk component of the Baseline+ model so that funds can make appropriate decisions about capital levels in house, without the need for expensive third-party consultants.

<u>Question 5 – Likely Level of Baseline Component</u>

The costs associated with exit and transfer planning are hard to hypothetically quantify. This will depend on if the transfer of members is to another trustee or if an administrator is being appointed.

Anecdotal evidence from FSC members suggest that the cost to transfer to another trustee is low, being made up primarily of legal costs. However, a transfer to an administrator may require hundreds of millions of dollars.

<u>Question 6 – Baseline Component Review Schedule</u>

The FSC suggests that the Baseline component should be reviewed every three years unless there is a material change in the risk profile or risk appetite of the fund. This would bring the review into line with other APRA Prudential Standards such as CPS 220.

> **Recommendation**
>
> 8. The Baseline component should be reviewed every three years, in line with other APRA prudential standards.

<u>Question 7 – The Basic Calculation Option</u>

The FSC supports full fund autonomy in calculating the required funds for both the baseline and the operational risk components of the funds. While a basic calculation option may make it easier for some funds, there is potential for the basic calculation to yield much more than is reasonably needed for a transfer. The calculation should include a risk probability weighting component, to reflect the low probability of the baseline component being used.

<u>Question 8 – Minimum Amounts</u>

APRA's intent with the removal of the guidance target amount of 25 bps of funds under management is to require funds to adopt a more sophisticated risk-based approach. The FSC submits that the quantification of operational risk across APRA regulated industries has historically been seen as cumbersome and subjective. For example, in banking, regulation has moved back to a standardised approach after more than a decade of attempting to calculate appropriate levels of operational risk capital. And this is despite internal and external operational risk data and quantitative expertise being more readily available in the banking industry.

The FSC is not supportive of APRA setting a minimum amount for either the baseline or operational risk component of the funds. As noted above, the baseline funds will represent a significant stockpile of cash that provides minimal returns and may never be used.

Therefore, each fund should make their own independent assessment of their baseline component. That said, this approach can lead to significant divergence across the industry as to the amount of funds deemed appropriate for the baseline component required.

As noted above, the FSC advocates for clear guidance on how the baseline model should be calculated to give industry the best possible tools to manage this process in house where possible. This may include independent model examples and validation, and shared, de-identified, industry risk event loss data.

Recommendation

9. There should be no minimum amount required for either the baseline nor operational risk component. APRA should instead provide clear guidance as to the expected requirements of each component including how relative risk of a transfer or operational event occurring impacts the required funding.

Operational Risk Component

Question 9 – Capability to Determine Risk Component

As noted above, not all funds have the required resources to adequately determine the quantum of appropriate funds. More guidance is required from APRA in relation to what assumptions should be used when setting the amount for this operational risk component so that all funds are equally equipped and making suitable assessments.

The discussion paper suggests that the operational risk component should be more akin to an expected loss amount.[4] It should be noted that current SPG114 guidance is non-committal on calculation approach or assumptions. To ensure there is a level of consistency in approach across the industry, additional guidance should be provided with regards to the underlying assumptions for the calculation of the operational risk component.

Helpful guidance would include:

- Confidence level, e.g., capital to be held for a 1-in-x year event
- Extent of consideration of material risk events/stress
- Range of operational risk events/scenarios to be considered
- Whether a top-up for unknown risks/model risk reserve should be considered
- Extent to which recoveries through insurance, legal action, or third-party indemnification should be considered; and/or
- If based on expected losses – expectation around the time (in number of years) the operational risk component should cater for.

Recommendation

10. APRA should provide clear guidance to funds about what is expected to be included in the calculation of each component of the updated ORFR requirement so that industry decisions are consistent and appropriate.

[4] Ibid p. 21

Question 10 – Necessary Controls

The FSC is supportive of fund discretion in relation to determining the quantum of funds appropriate to the relative risk of an operational risk event or transfer occurring. As noted above, the FSC submits that appropriate guidance from APRA will assist in ensuring these funds are appropriate.

Question 11 – Maximum Timeframes

The FSC submits that an appropriate maximum timeframe for the replenishment of the operational risk component will depend on the driver of why the operational risk component has fallen below the threshold. If it has fallen below the threshold due to funds under management growth, then that should be easily rectified in the short-term. If, however, it has fallen below the threshold because of a large customer remediation exercise, then longer timeframes are required so the current cohort of members do not bear the risk.

If you would like to discuss anything contained in this submission, please do not hesitate to contact me.

Yours sincerely,

[redacted]
Policy Manager, Superannuation and Innovation