Prudential Practice Guide

SPG 222 – Management of Reserves

November 2013

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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) contains provisions relating to the maintenance and management of reserves within a registrable superannuation entity. This PPG aims to assist an RSE licensee in complying with these requirements and, more generally, to outline prudent practices in relation to the management of reserves.

This PPG is to be read with other PPGs related to risk management, including *Prudential Practice Guide SPG 220 Risk Management*, *Prudential Practice Guide SPG 114 Operational Risk Financial Requirement*, *Prudential Practice Guide SPG 221 Adequacy of Resources, Prudential Practice Guide SPG 231 Outsourcing* and *Prudential Practice Guide SPG 232 Business Continuity Management*.

For the purposes of this guide, and consistent with the application of *Prudential Standard SPS 220 Risk Management*, 'RSE licensee' and registrable superannuation entity (RSE) have the meaning given in the SIS Act.

Subject to the requirements of the SIS Act, an RSE licensee has the flexibility to structure its business operations in the way most suited to achieving its business 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.

Introduction

1. The reserves of an RSE are typically regarded as monies forming part of the net assets of the RSE that have been set aside for a clearly stated purpose. Reserves are largely concerned with contingent events and, as such, APRA expects that an RSE licensee would exercise judgement in determining the need for them, their scope, size and operation. A prudent RSE licensee would also have robust and transparent policies and processes for the management of any reserves within an RSE.

2. While reserves are monies that have not been allocated to members, not all unallocated monies constitute reserves. Unallocated monies that are not reserves include defined benefit fund surpluses and accounting constructs such as suspense accounts used to record contributions and rollovers pending their allocation to the accounts of specific members.

3. Accrued expenses and provisions for administration expenses, taxation and management or service provider fees are liabilities of an RSE arising from past events and are not reserves for the purposes of this guidance.

4. In deciding whether or not to maintain reserves within an RSE, and how to manage any reserves, a prudent RSE licensee would at all times be mindful of its obligations as set out in the covenants in s. 52 of the SIS Act, in particular, its duty to exercise its powers in the best interests of the beneficiaries and to keep the money or assets of the RSE separate from other assets of the RSE licensee, or of a standard employer-sponsor or associate.[1] A prudent RSE licensee would also have regard to its duty to act fairly in its dealings with different beneficiaries when determining any strategy relating to reserves.[2]

5. The purpose of some reserves may be to spread potential costs across different 'generations' of members. This may lead to circumstances where some members who contributed to the development or replenishment of a reserve leave the RSE before the occurrence of the contingent events for which the reserve has been established. In this scenario, an RSE licensee may form the view that all members benefit from being part of an RSE with appropriate and prudently managed reserves, even if the contingencies do not eventuate during the membership of a particular cohort.

6. Although an RSE licensee may establish reserves for a number of different purposes within an RSE, APRA has observed the following common types of reserves:

   (a) *Administration reserve*: this may be used to fund future administration and operational expenses of an RSE or sub-fund.

   (b) *Investment reserve*: this may be used in conjunction with crediting rates or unit pricing in an RSE or a sub-fund to smooth the impact of market fluctuations on members' account balances over a number of years.

   (c) *Operational risk reserve*: this may be used to hold the financial resources to meet an RSE licensee's Operational Risk Financial Requirement (ORFR) target amount. *Prudential Standard SPS 114 Operational Risk Financial Requirement* includes specific requirements in relation to the use of an operational risk reserve.

   (d) *Self-insurance reserve*: RSE licensees that are permitted to self-insure insured benefits are expected to maintain reserves, or have other arrangements approved by APRA, to fund current and future insurance claims and to allow for the inherent uncertainty regarding the size and timing of claims, and any other risks that may arise from the self-insurance or other arrangements.

1 Refer to s. 52(2)(c) and (g) of the SIS Act.
2 Refer to s. 52(2)(e) and (f) of the SIS Act.

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7. APRA's view is that before establishing a reserve, it is important for an RSE licensee to be clear as to why the reserve is to be established, and its ongoing purpose.

8. Where a reserve is established, APRA expects that an RSE licensee's strategy for the management of the reserve would be comprehensive and contain appropriate objectives for which the reserve is established, as well as measures to manage the reserve. An RSE licensee may seek appropriate independent advice to assist it in formulating its strategy and managing and reviewing the operation of reserves.[3]

9. Measures that APRA would regard as sound practice in a strategy for the management of a reserve may include, but are not limited to:

   (a) clear definition by the RSE licensee of the purpose, or purposes, of each reserve, even if the reserve has a range of potential purposes, such as a general reserve;

   (b) balancing the number and nature of reserve accounts against risks identified by the RSE licensee and establishing whether, and under what conditions, amounts may be transferred from one reserve account to another, to beneficiaries or any other appropriate party;

   (c) determination by the RSE licensee of an appropriate target amount or range of each reserve, including how and over what period the reserves are to be initially funded or built-up and replenished after a transfer from the reserve;

   (d) determination by the RSE licensee of how it would respond in circumstances where a reserve has been exhausted or is insufficient to meet the cost of a contingent event, including whether, and over what period, other net assets of the RSE could be relied upon;

   (e) where a reserve is specific to a particular sub-fund of an RSE, or a particular type of interest within an RSE or sub-fund, effective mechanisms to ensure the reserve is quarantined to that sub-fund or type of interest;

   (f) periodic review to ascertain that each reserve remains appropriate to the RSE's circumstances, and that controls and procedures implemented by the RSE licensee ensure that reserves are used only for the intended purpose or purposes;

   (g) a process by which an RSE licensee would determine a reserve is excess to requirements or no longer required in accordance with paragraph 11; and

   (h) proper identification of the reserves in the accounts of the RSE to enable reporting to the RSE licensee, and to APRA as required by reporting standards made under the *Financial Sector (Collection of Data) Act 2001*.

10. Where an RSE is the subject of a successor fund transfer, it would be sound practice for any undistributed reserves to be transferred to a reserve that has been specifically created for the purpose in the successor fund and properly quarantined from, or equitably merged with, the rest of the successor fund.

11. When reserves are determined to be excess to requirements or no longer required, e.g. due to an RSE wind-up or a change in the operations of the RSE, APRA envisages that the RSE licensee would distribute, utilise and/or transfer the balance equitably.

3 Refer to *Prudential Standard SPS 160 Defined Benefit Matters* for actuarial requirements relating to the oversight of self-insurance arrangements, which may include self-insurance reserves.

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APRA_PPG_SPG221_102013