Prudential practice guide

SPG 114 Operational Risk Financial Requirement

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Contents

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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) requires an RSE licensee to maintain and manage, in accordance with the prudential standards, financial resources to cover the operational risks that relate to each RSE.[1] *Prudential Standard SPS 114 Operational Risk Financial Requirement* (SPS 114) establishes requirements relating to these financial resources.

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

Where this guidance says an RSE licensee must 'demonstrate' a matter, APRA expects this to be done in practice and to be documented.

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; the accompanying guidance follows.

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

Glossary

APRA	Australian Prudential Regulation Authority
CPS 230	*Prudential Standard CPS 230 Operational Risk Management*
FUM	For the purposes of this PPG, APRA views funds under management (FUM) as the total of asset balances of each RSE within the RSE licensee’s business operations
Hybrid fund	For the purposes of this PPG, a hybrid fund is an RSE that provides both defined benefit interests and accumulation interests in the fund
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	RSE licensee as defined in s.10(1) of the *Superannuation Industry (Supervision) Act 1993*
SIS Act	*Superannuation Industry (Supervision) Act 1993*

Guidance

Operational risk financial requirement (ORFR)

9. An RSE licensee must maintain, manage and utilise, in accordance with this Prudential Standard, financial resources to protect beneficiaries from losses due to operational risks that relate to the RSEs within its business operations.

1. Operational risk incidents expose members to the risk of financial loss and disruption that may also deprive them of a financial gain. For the purposes of this guidance, a reference to members may include both current and former members.
2. The primary purpose of the ORFR financial resources is to provide an unrestricted commitment of financial resources to address losses, and potential losses, arising from operational risks in a timely manner.
3. The ORFR is intended to ensure RSE licensees will have sufficient 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.

ORFR strategy

10. An RSE licensee must formulate and give effect to an ORFR strategy that sets out how it will meet the ORFR. At a minimum, the ORFR strategy must include the RSE licensee's:
    (a) ORFR target amount and tolerance limit, including how and why it has determined these amounts to be appropriate;
    (b) processes and parameters for determining when and how the ORFR financial resources can be used;
    (c) approach to holding the ORFR financial resources, including how the RSE licensee will ensure that the requirements in paragraphs 16 and 17 (as applicable) are met on an ongoing basis;
    (d) investment strategy for operational risk reserves held to meet the ORFR target amount;
    (e) process for implementing a replenishment plan in accordance with paragraph 18 (replenishment plan);
    (f) review process for the ORFR target amount, tolerance limit and ORFR strategy; and
    (g) process for managing the financial resources held to meet the ORFR target amount in the event that the RSE licensee or RSE is wound up.
11. The Board must approve the ORFR strategy and is ultimately accountable for ensuring the implementation of the RSE licensee's ORFR strategy.

ORFR target amount and tolerance limit

12. For the purposes of paragraph 9, 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). Where ORFR financial resources fall below the tolerance limit, the RSE licensee must take action to replenish financial resources to meet the ORFR.

13. An RSE licensee's ORFR target amount and tolerance limit must be determined on a prudent basis that suitably reflects:

    (a) the RSE licensee's operational risk profile and risk assessments;

    (b) the uses of the ORFR financial resources permitted under paragraph 15; and

    (c) the size, business mix and complexity of the RSE licensee's business operations.

14. If APRA considers that the ORFR target amount and/or tolerance limit set by the RSE licensee does not adequately reflect the requirements of this Prudential Standard, APRA may require an RSE licensee to:

    (a) meet an ORFR target amount determined by APRA, within a specified time; and/or

    (b) adopt a tolerance limit determined by APRA.

ORFR target amount and APRA guidance on minimum ORFR target amount

4. APRA expects a soundly run RSE licensee, that has implemented an effective risk management framework, to have an ORFR target amount no less than specified in the table below:

Funds Under Management	APRA guidance on minimum ORFR target amount
Greater than $165 billion	0.175% of FUM
Between $30 billion and $165 billion (inclusive)	0.20% of FUM
Less than $30 billion (inclusive)	0.25% of FUM

For the purposes of calculating the ORFR target amount, APRA views funds under management (FUM) as the total of asset balances of each RSE within the RSE licensee's business operations. An equivalent method of expressing the guideline amount in relation to a defined benefit fund may be the relevant percentage of liabilities in respect of vested benefits.

5. Where an RSE invests in a Pooled Superannuation Trust (PST) within the same RSE licensee's business operations, or another entity outside of the RSE licensee's business operations which is subject to SPS 114 or another financial requirement relating to operational risk (other entity), APRA expects that the ORFR target amount would be at least 0.10% of FUM of the PST or the other entity.

6. An RSE licensee of a newly registered RSE or an RSE with very low FUM (e.g. an RSE in the process of winding down or transferring some or all beneficiaries and assets to another fund) is expected to determine an appropriate target amount, above the guidance on minimum target amount.

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 related to that service. 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.[2]

Attribution of the ORFR target amount

8. An RSE licensee may attribute its ORFR target amount, and the ORFR financial resources, to different parts of its business operations, 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.

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.[3]

Tolerance Limit

10. APRA expects that an RSE licensee's tolerance limit below its target amount of financial resources would be appropriate and readily measurable.

11. The tolerance limit is intended to enable an RSE licensee to utilise the ORFR for less significant amounts and to manage immaterial fluctuations below the ORFR target amount without the need for a replenishment plan. 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.[4]

Use of ORFR financial resources

15. An RSE licensee must only use ORFR financial resources for one or more of the following:

(a) to address operational risks that could reasonably be considered to have caused or 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;

(b) to meet the requirements of *Prudential Standard CPS 230 Operational Risk Management* for the effective management and prevention of operational risk incidents, including the remediation of identified material weaknesses and maintenance of critical operations within tolerance levels through severe disruption; and

[2] Refer to *Prudential Standard CPS 230 Operational Risk Management.*
[3] For the purposes of this PPG, a hybrid fund is an RSE that provides both defined benefits and accumulation benefits.
[4] 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'.

(c) 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 types of circumstances where it would use ORFR financial resources under its ORFR strategy. APRA considers that it would be appropriate to use ORFR financial resources in, but not limited to, the following circumstances:

(a) remediation activities to address losses sustained or deprived gains because of an operational risk incident;

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

(c) costs associated with the prevention of losses and disruption from operational risk incidents in response to an identified material operational weakness. For example, where the RSE licensee has determined that, if not addressed, there is a material risk of an operational risk event occurring that could cause members to sustain a loss or be deprived of a gain to which they otherwise might have been entitled; and

(d) executing, or supporting the execution of, a business continuity plan, or a recovery and exit plan, or the orderly exit from a service provider agreement which is 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) routine and 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, or to prevent, an operational risk incident (or near miss) or an identified material weakness;

(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 an RSE licensee, RSE licensee directors 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 an RSE.

Managing surplus ORFR financial resources

14. 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 positive investment performance have the potential to create a surplus of financial resources. In these circumstances, an RSE licensee may decide that the ORFR target amount is too high in the new circumstance and requires downward adjustment.

15. 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 the RSE licensee’s legal duties and obligations.

16. When members of an RSE are being transferred under a successor fund transfer, an RSE licensee may 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.

17. If an RSE licensee intends to materially reduce a surplus in financial resources, APRA expects the RSE licensee would engage with APRA before a decision 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) be unrestricted and readily available to address operational risks in a timely manner.

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.

Operational risk reserves

18. APRA expects an RSE licensee would ensure that the assets in an operational risk reserve have an appropriate risk profile and are sufficiently liquid to achieve this objective. ORFR financial resources, held either in an operational risk reserve within the RSE or as trustee capital, must be unrestricted and readily available to be used in a timely manner, including in a time of entity stress.

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 investments 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. The replenishment plan must, at a minimum, explain:

    (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.

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 *Prudential Standard CPS 230 Operational Risk Management* (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 funding, management, 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.

Notification requirement

24. An RSE licensee must notify APRA prior to making a material change to the ORFR target amount.