Financial Resources for Risk Events in Superannuation

KPMG Australia Submission

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KPMG

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1. Introduction

KPMG appreciates the opportunity to make further comment in response to APRA's consultation letter, including draft Prudential Standard SPS 114 Operational Risk Financial Requirement (SPS 114) and draft Prudential Practice Guide SPG 114 Operational Risk Financial Requirement (SPG 114). As the landscape of superannuation continues to shift with a continued stream of mergers, unprecedented levels of remediation, enforcement and class action litigation, continued regulatory reform and cyber risk rating as one of the strongest risks to business, it is not surprising that there is a renewed focus on the financial stability of superannuation trustees. It is uncontentious that the financial stability of superannuation funds is critical to providing strong and stable outcomes for members, as well as being critical 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 emerging risks arising in the future, the funding of initiatives and the potential for material unexpected events.

Our approach to this submission is to set out our recommended approach to capital management, which is founded on what we view as the foundational principles and purposes of capital, and in context of this discussion to make specific comments on the draft SPS 114 and draft SPG 114.

2. 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.

2.1 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 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.

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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.

2.2 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.

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 our 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.
- 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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3. 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 letter and draft SPS 114 and SPG 114 seem highly focussed on operational risk when discussing needs for financial resources for risk events – i.e. it has less on overall capital/overall requirement for good fund-wide holistic capital management. While we understand that APRA is focused on the accompanying trustee covenant (SIS Act s 52(8)(b) requiring an RSE Licence to maintain and manage (in accordance with the prudential standards) financial resources to cover the operational risk that relates to the entity, it could consider a broader based prudential standard that has a more holistic nature.

KPMG appreciates that this may be a big jump to make given the current industry practice – 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 operational risk) is not implied or assumed.

4. Purpose / Objective of ORFR

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". The purpose of ORFR is similar to, but not quite the same. As per the draft SPG 114, ORFR is intended to provide members with confidence that there is a low risk that the RSE licensee will have insufficient 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.

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.

5. 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 ORFR amount and reserves are not efficiently used and is almost wasteful. 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).

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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 to 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 years 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.

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.

6. Permission to Spend on Risk Management

The draft SPS and SPG 114 provide for applying ORFR reserve resources to fund improvements to reduce the risk of operational events in certain limited circumstances.

While acknowledging this access contains various restrictions/conditions[1], we question the appropriateness of allowing such permission within the framework even in the constrained way that appears to be envisaged.

For example, in thinking about a scenario where a trustee had 25bps in ORFR and then spends 24bps on improving its risk management system, this would then result in 1bp being left in the ORFR Reserve. 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 had identified investment requirements 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

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[1] For example the draft SPG 114 outlined scenarios for which APRA would consider inappropriate to use ORFR financial resources for expenses including, but not limited to:

a) 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 an operational risk incident or near miss;

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 the RSE licensee 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 the RSE.

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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 approach capital approach (which could align with a holistic regulatory approach as well) would make this consideration explicit and not result in potential gaps of coverage.

Specifically, the draft SPS 114 appears to contemplate that ORFR can be used for the remediation of material weaknesses and maintenance of critical operation in relation to CPS 230. What is not clear is whether it is intended that an operational risk event is required or whether general remediation in anticipation of potential member loss is sufficient. We suggest that APRA clarify the scope of this permitted use.

7. 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).

[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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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.

In its consultation letter, APRA recognises that some RSE licensees may seek to develop their own capability to calculate a bespoke ORFR target amount. In those cases, the draft SPG 114 requires engagement with APRA prior to any adjustments. Our view is that, to assess the appropriateness and adequacy of such bespoke ORFR target amount, the following practices need to be followed:

- APRA applies consistent approach in reviewing and assessing the bespoke ORFR target amount;
- There should be clarity around what that process will look like; and
- APRA and the RSE licensees need to have understanding of risk exposures across a wide range of diverse areas for sources of large operational risk, such as activities associated with financial advice, unit pricing, investment operations, administration, fraud, etc. This includes good forward-looking view of emerging risks in areas such as retirement income, financial advice and other increases in complexity and expansion/internalisation of operations how they might change, and other risk management activities.

8. 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.

9. Operational Risk Events Scaling with 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 size[3]. 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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