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Financial resources for risk events in superannuation: Operational Risk Financial Requirement

About the Super Members Council

We are a strong voice advocating for the interests of more than 11 million Australians who have over \$1.5 trillion in retirement savings managed by profit-to-member superannuation funds. Our purpose is to protect and advance the interests of super fund members throughout their lives, advocating on their behalf to ensure superannuation policy is stable, effective, and equitable. We produce rigorous research and analysis and work with Parliamentarians and policy makers across the full breadth of Parliament.

Executive Summary

SMC welcomes APRA's proposals to comprehensively redefine the Operational Risk Financial Requirement (ORFR). This includes supporting the expansion of its permissible uses to encompass a more extensive and granular assessment of risk management practices, extending beyond solely realised events that cause member detriment. However, while supportive overall, our submission identifies some areas for further improvement in the proposed guidance on bespoke ORFR arrangements. While acknowledging the desire for sector-wide consistency, SMC identifies the following areas for improvement:

- **Lack of Sector Neutrality:** The current approach treats smaller funds without a parent company differently to those that do, even if their risk profiles are similar.
- **Operational Risk Impact:** The reliance on alternative funding, particularly from parent companies, introduces the risk of a single material operational event affecting both entities. This could limit the parent entity's ability to provide support or require unplanned capital injections from the parent entity, potentially jeopardising the reserved capital for the bespoke arrangement. These factors suggest a lack of sector neutrality in the application of the standard - and warrant exploring options that better account for the diverse landscape of business models and risk profiles across the industry.

Recommendations

1. **The prudential standard and its associated guidance should be sector-neutral.**
2. **The availability of bespoke target amounts should be assessed on the basis of risk rather than status as a Significant Financial Institution.**

Introduction

We welcome APRA's proposals to materially reshape the role of the Operational Risk Financial Requirement (ORFR) and expand its allowable uses to include a broader and more nuanced consideration of risk management beyond solely materialised events occasioning loss to members.



While we agree that the current proposal is simpler than the baseline+ approach put forward in the prior consultation, that model had some flexibility for funds to calculate target amounts for both the baseline and buffer components which reflected the increasing sophistication in risk management by the industry.

While we appreciate the desire for consistency across the sector, the current 25 basis point guidance figure does not fully account for the diverse business models, risk profiles, and member demographics within seemingly similar funds. A set metric based solely on FUM, or number of member accounts may not be the most accurate reflection for all. Options that capture this wider range of factors are more appropriate.

It is also important for industry to gain an understanding of the rationale behind the recommended 25 basis points proposed by APRA, as it is unclear what the underlying thinking and modelling is behind this figure. An improved understanding of the factors that led to this figure would assist trustees when assessing an appropriate amount for a bespoke arrangement, should they wish to pursue such arrangements.

In addition, solely evaluating the Operational Risk Reserve (ORR) is likely to offer an incomplete picture of a trustee's operational risk mitigation capacity - because trustees use a broader toolkit to manage operational risks, with the ORR being simply one reserve amongst multiple reserves. Consequently, evaluating the ORR in isolation overlooks these additional resources and could result in excess capital being held within the ORR.

Bespoke arrangements

APRA has proposed a set of principles for funds who may seek to negotiate a bespoke target amount that is better suited to their risk profile and circumstances. However, this opportunity is not offered equally across the full range of funds and is independent of funds' risk profiles.

APRA expects that bespoke arrangements in "exceptional cases" would be limited to significant financial institutions (SFIs). SFI has an existing definition in the prudential framework in that it applies to RSEs with more than \$30 billion in combined total assets. As a result, any differences in prudential requirements dictated by status as an SFI apply differently according to the business model being operated.

In the profit-to-member sector, the most common structure is for a single trustee with a single fund, which means the \$30 billion figure is directly correlated to the assets of the fund. In the retail sector, a trustee may operate several funds of different sizes, and, in turn, a parent company may operate multiple trustees so the \$30 billion applies to the combined assets of the group.

As noted by APRA, bespoke reserving arrangements are likely to be attractive to many licensees, including many who do not currently qualify as an SFI. APRA acknowledged this in its previous discussion paper:

"APRA expects the majority of RSE licensees would seek to adopt the RSE licensee-led method, as it is more likely to result in an amount of money that more appropriately reflects the risk profile and risk appetite of the RSE licensee's business operations."

It's noteworthy that sub-funds under a group trustee can have varying risk profiles. While a small to medium sized fund in such a group structure could potentially negotiate a bespoke ORR due to the group meeting the SFI definition, a similarly sized fund operating in the profit-to-member sector would be automatically excluded. This lack of flexibility creates an uneven playing field across different sectors, regardless of their inherent risk profiles. It would be beneficial for an additional avenue to be created that allows all entities to seek bespoke arrangements, this would ensure that funds with similar risk profiles could be treated similarly.

In addition, the guidance does not currently make clear where there are alternate sources of funding, whether the entities providing this funding need to be an ARPA regulated entity, domiciled in Australia. As regulatory settings vary across jurisdictions, any expectation on to this should be made clear in the guidance.

The APRA guidance further suggests that the availability of alternative funding sources is a factor influencing the suitability of a bespoke arrangement. Since guidance often becomes the de facto interpretation of the standard, this could limit bespoke target amounts to entities with parent companies or substantial trustee capital reserves. The inclusion of this consideration in the guidance implies that the standard is not sector-neutral in its application.



The impact of material operational risk on the availability of alternative funding sources also needs further consideration. This applies particularly when relying on a parent company as a secondary source, a significant risk event could potentially affect both entities - flowing down from the parent and potentially limiting their support, or flowing up from the fund, requiring additional capital from the parent beyond the planned level. In either scenario, the reserved capital for the bespoke arrangement might be compromised.

Recommendation 1:

The prudential standard and its associated guidance should be sector-neutral

Linkage to risk

We welcome the clear linkage of bespoke arrangements to a compelling evidence-based rationale for why an alternative amount is appropriate to the risk profile, size and complexity of the licensee and a demonstration of compliance with other risk management standards. This shows that risk is clearly a vital element in the consideration of any target amount that may vary from the proposed 25 basis points. We recommend such controls be the yardstick of whether an alternative amount is appropriate, regardless of the size of the fund. It would be useful to include additional principles-based guidance in the upcoming SPG 114 on the appropriate 'trustee determined factors' that need to be satisfied for a target amount of lower than 25 basis points.

We further recommend that any approved bespoke arrangement may be varied in future as a fund's risk profile changes rather than become a fixed set-and-forget figure. This may encourage funds to take active steps to uplift systems and processes to de-risk the fund, while also providing assurance that resources are available to respond to a material operational risk event if needed.

Recommendation 2:

- **The availability of bespoke target amounts should be assessed on the basis of risk rather than status as a Significant Financial Institution.**