

21 May 2023

Gideon Holland
General Manager, Policy
Australian Prudential Regulation Authority
GPO Box 9836
SYDNEY NSW 2001

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

Dear Mr Holland,

RE: Consultation on Draft SPS 114 Operational Risk Financial Requirement and associated guidance

The Financial Services Council (FSC) welcomes the opportunity to consult on proposed changes to *Superannuation Prudential Standard 114 Operational Risk Financial Requirement (SPS114)* *Prudential Practice Guide 114 Operational Risk Financial Requirement (SPG 114)* relating to financial resources for operational risk events in superannuation, and would like to thank APRA for the additional time provided to pull this submission together.

The FSC acknowledges and supports the Australian Prudential Regulation Authority's (APRA's) decision to move away from the previously proposed 'Baseline+' model, including to not use specified amounts as discussed in our previous submission. Additionally, we commend APRA for incorporating our recommendation to explicitly prohibit the use of Operational Risk Financial Requirement (ORFR) financial resources for covering penalties incurred by directors as stipulated under section 56 of the *Superannuation Industry (Supervision) Act 1993 (Cth)*, as outlined in the draft SPG 114.

While we recognise APRA's efforts to enhance the applicability and effectiveness of the ORFR, we must express our concern regarding the persisting requirement that sets the ORFR target at 0.25 per cent of funds under management (FUM). This requirement imposes a disproportionate burden on a substantial number of RSE licensees, particularly those managing large funds. Initially, such a directive was perhaps necessary to guide the industry through the early stages of implementing the prudential standard. However, the sector has matured, and RSE licensees now possess robust operational risk data, enabling them to model their target amounts based on solid evidence, rather than adhering to an arbitrary figure directly proportional to FUM. This overly conservative requirement can immobilise significant capital resources, which could otherwise be utilised to enhance operational efficiencies and reduce fees for members. We urge APRA to establish a clear framework that allows RSE licensees with the necessary capabilities to determine their own ORFR target amounts based on credible evidence.

The FSC also has several recommendations that would enhance SPS 114 and SPG 114 to help reduce any ambiguity or industry burden they would cause if drafted as they are as shown in the summary below.

About the Financial Services Council

The FSC is a peak body which sets mandatory Standards and develops policy for more than 100 member companies in one of Australia's largest industry sectors, financial services. Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, and financial advice licensees.

The financial services industry is responsible for investing more than \$3 trillion on behalf of over 15.6 million Australians. The pool of FUM is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange and is one of the largest pools of managed funds in the world.

Summary of Recommendations

1. Explicitly include and clarify the definition of 'operational risk' within SPS 114 to ensure all stakeholders fully understand and can comply with the operational risk requirements;
2. Remove the investment strategy requirement for RSE licensees that utilise trustee capital to meet their ORFR target amount, as this creates an unnecessary burden without enhancing risk management;
3. Provide an evidence base for the 0.25 per cent of FUM guidance as drafted in paragraph 2 of draft SPG 114. In the absence of this evidence, APRA to consider alternative appropriate guidance for RSE licensees setting a target amount;
4. Provide clearer guidelines on what evidence and methodology RSE licensees should present when proposing an ORFR target amount that deviates from the standard 0.25 per cent of FUM;
5. Continue to allow, or explicitly permit going forward, the current guidance in SPG 114 paragraph 21, which enables funds to reduce their ORFR target amount when investing in entities that are also subject to SPS 114;
6. Clarify that the requirements for managing a surplus of ORFR financial resources should only apply to RSE licensees who hold these resources within the RSE reserves, not those holding them as trustee capital;
7. Retain the current guidance amount of 10 basis points for Pooled Superannuation Trusts unless a clear, justified rationale for an increase is provided, given the significant cost implications;
8. Amend SPS 114 to explicitly state that ORFR financial resources can be utilised not only to prevent potential future operational risks but also to address and remediate existing operational incidents;
9. Elevate essential operational risk management details from SPG 114, paragraph 12, into SPS 114 to provide RSE licensees with a clear and direct reference for compliance;
10. Define a flexible replenishment period for ORFR resources of three to five years post-use, to provide certainty of APRA's replenishment expectations;
11. Remove the annual review requirement for ORFR target amounts for RSE licensees

adhering to the 0.25 per cent of FUM guidance. This could be replaced with a less frequent triennial review to reduce administrative burden; and

12. Remove the dual requirement for internal and external audits of the ORFR strategy to reduce costs and streamline compliance efforts, reflecting an efficient regulatory approach.

Definition of Operational Risk

The FSC notes that SPG 114 describes operational risk exposures in some detail and contains some further information about the allowable uses but raises concern that the draft SPS 114 does not define operational risk. The current version of SPS 114 clearly defines operational risk in paragraph 6 as shown:

'For the purposes of this Prudential Standard, an 'operational risk' is the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. This definition includes legal risk but excludes strategic and reputational risk.'

FSC members have the capability to set the target amount and under what circumstances they can use the reserve. It is critical for APRA to provide certainty regarding the definition of 'operational risk' within SPS 114. A precise and clear definition is fundamental to ensuring that all stakeholders have a consistent understanding and can appropriately manage their regulatory obligations. We urge APRA to either clarify this definition within SPS 114, or reaffirm the existing definition to avoid any ambiguity that could impede effective risk management.

RECOMMENDATION 1

Explicitly include and clarify the definition of 'operational risk' within SPS 114 to ensure all stakeholders fully understand and can comply with the operational risk requirements.

ORFR Strategy

The FSC notes that APRA writes prudential standards that need to be applied to various business models, predominantly being industry and retail funds. There are many features of each business model that flow through to how RSE licensees meet the requirements stipulated under SPS 114, the most critical being the difference in how an RSE licensee structures itself to meet the funding requirements of the ORFR.

Paragraph 9(e) of SPS 114 stipulates that an ORFR strategy should include an investment strategy for the operational risk reserves. This should apply solely to RSE licensees holding capital as a reserve within an RSE as opposed to held at trustee capital.

Many of FSC's members meet this requirement through holding capital and not reserves within the RSE itself, which is commonplace for an industry fund. It is up to the trustee to determine how that capital is held as long as it is readily available to be used in operational risk events. ORFR held as trustee capital are the assets of the RSE licensee that are segregated on the balance sheet to back its ORFR target amount. Imposing an investment

strategy requirement for assets held as trustee capital not only diverges from industry practices but also places an unnecessary and substantial administrative burden on RSE Licensees. This requirement could detract from their ability to effectively manage operational risks. We strongly recommend that APRA reconsiders this mandate to align with the operational realities and financial strategies of RSE licensees.

RECOMMENDATION 2

Remove the investment strategy requirement for RSE licensees that utilise trustee capital to meet their ORFR target amount, as this creates an unnecessary burden without enhancing risk management.

ORFR Target and Tolerance Amounts

The FSC notes that SPS 114 makes clear the prudent basis for determining the ORFR target amount and tolerance limit. The combination of paragraphs 2-4 in SPG 114 appear to create an additional requirement i.e. APRA will not consider an application from an RSE licensee for a lower amount unless they can comply with certain requirements listed in paragraph 4.

Comprehensive industry analysis robustly demonstrates that a blanket ORFR target of 25 basis points is not only excessive but also disproportionately impacts larger RSE licensees, potentially leading to inefficient capital utilisation. This one-size-fits-all approach does not account for the varied risk profiles across different RSE licensees. We recommend a more nuanced approach that allows RSE licensees to set targets reflective of their specific operational risks and financial structures.

RSE licensees conduct modelling to determine an appropriate and responsible target amount, as walked through in *Case study 1* below. This type of modelling represents a more appropriate and accurate approach than the proposition put forward in the guidance.

Case study 1

A large superannuation trustee runs a capital modelling exercise as part of determining the most efficient use of capital for their RSE. As part of this exercise, the RSE also has in place controls to quarantine the capital amount, and it monitors the use of its capital against the target amount and its other liabilities. It has controls in place to support compliance on CPS 230 and SPS 515.

The trustee has also documented the basis for its model based on its size and complexity, it's current and expected membership and FUM, it's risk profile and set of risk and has evidence to support these statements.

Management provides the information to the board with a recommendation to support a ORFR target amount of capital of

10bps. If the board agrees to a change in the requirement capital requirements, management implement the decisions made by the board and inform regulatory supervisors of the change.

It is further arguable that the FUM of an RSE licensee is not proportional to the operational risks they face and hence a percentage-based approach is also less appropriate than a dollar-based amount. A fixed amount would provide trustees with a more dynamic and realistic approach to setting the target amount relevant to their businesses.

RECOMMENDATION 3

Provide an evidence base for the 0.25 per cent of FUM guidance as drafted in paragraph 2 of draft SPG 114. In the absence of this evidence, APRA to consider alternative appropriate guidance for RSE licensees setting a target amount.

As the drafting currently stands, it is unclear whether the RSE licensee has discretion to set their own target amount or not in paragraph 4 in SPG 114. If APRA's position is that all RSE licensees must hold 25 basis points or meet the specific requirements for a lower amount. Please see the suggested alternate drafting for proposed SPG 114 paragraph 4 below along with explanations driving the suggested changes:

- Removal of 'exceptional cases' – if industry are able to meet the specified requirements and show a mature methodology for calculating a more appropriate ORFR target amount, this should not be exceptional. APRA should be encouraging industry to model and develop a more robust capital modelling framework, which in turn would allow industry to have a more tailored approach to developing their ORFR target amount;
- Paragraph 4(d) – suggested change clarifies that the ORFR amount itself does not have to meet the requirements of CPS 230; the connection to CPS 230 should be the description of the types of operational risks that APRA considers need to be covered by the target amount; and
- Paragraph 4(e) - proposed new paragraph to ensure there is clarification on prudential standard requirements and guidance; also suggested edits remove the words "better practice", which could cause confusion and could be interpreted broadly.

SPG 114

4. APRA's guideline target amount is a standard industry benchmark. ~~In exceptional cases,~~ ~~a~~An RSE licensee may adopt a lower target amount. In such cases SPS 114 requires an RSE licensee to engage with APRA prior to adopting a lower amount. **APRA expects an RSE licensee seeking to adopt a lower target amount would:**

a) typically be a significant financial institution;

- b) provide a clear and compelling rationale that sets out why its target amount is appropriate for its risk profile, size and complexity, based on quantified evidence;
- c) provide a robust methodology for establishing its target amount, with appropriate governance and controls, for ensuring the ongoing appropriateness of the ORFR target amount; ~~and~~
- d) clearly demonstrate that it meets *how it has met the above requirements in line with Prudential Standard CPS 230 Operational Risk Management; and is operating better practice in line with relevant prudential practice guides including*
- ~~e)~~e) show how it has taken into account the guidance in Prudential Practice Guide CPG 230 Operational Risk Management and Prudential Practice Guide SPG 515 Strategic and Transfer Planning (Business planning and financial resource management) *when determining the lower amount.*“

RECOMMENDATION 4

Provide clearer guidelines on what evidence and methodology RSE licensees should present when proposing an ORFR target amount that deviates from the standard 0.25 per cent of FUM.

The FSC would like to note APRA's removal of the current paragraph 21 of SPG 114 which provides the ability for a fund to reduce the target from 25 to 10 basis points where services are provided by an APRA regulated entity as shown below:

21. Where an investing RSE is invested in another entity outside of the RSE licensee's business operations that is subject to SPS 114 or another APRA financial requirement relating to operational risk, and the RSE licensee considers that a reduction in the ORFR target amount is appropriate, APRA expects the ORFR target amount would be at least 0.10 per cent of FUM for the investing RSE.

The FSC understands this is a niche situation but has provided useful guidance to prevent doubling up of reserves in these situations. The removal of this guidance signals a disallowance for this sort of arrangement and in turn would create significant industry burden and cost. FSC recommends continuing to include this guidance or for APRA to expressly permit this sort of arrangement on a go forward basis despite the removal of the guidance.

RECOMMENDATION 5

Continue to allow, or explicitly permit going forward, the current guidance in SPG 114 paragraph 21, which enables funds to reduce their ORFR target amount when investing in entities that are also subject to SPS 114.

Managing surplus ORFR financial resources

Paragraphs 14-17 of SPG 114 are written for circumstances where the ORFR is held in a reserve in an RSE and not where it is held as trustee capital. As such, the requirements set out in the paragraphs should not be applicable to RSE Licensees that meet its ORFR requirements via its own balance sheet. As such, we recommend amending the wording to clearly articulate that these paragraphs are only relevant to when the ORFR is held within a RSE.

RECOMMENDATION 6

Clarify that the requirements for managing a surplus of ORFR financial resources should only apply to RSE licensees who hold these resources within the RSE reserves, not those holding them as trustee capital.

Pooled Superannuation Trusts (PSTs)

The FSC notes that paragraph 3 of SPG 114, the guidance amount for a PST has increased from 10 basis points to 17.5 basis points. There has been no rationale or reasoning provided for this change, which would create significant burden and costs for industry. This change in guidance would mean an RSE licensee will effectively hold 42.5 basis points for investments held through a PST, which is a large reserving or capital impost for industry.

The FSC requests further information on whether there has been a material increase in the operational risks associated with operating a PST that needs to be considered. The FSC also requests that the rationale for the change be clearly communicated to assist RSE Licensees forming a view on the appropriate amount for their PSTs.

Recommendation 7

Retain the current guidance amount of 10 basis points for Pooled Superannuation Trusts unless a clear, justified rationale for an increase is provided, given the significant cost implications.

Uses of ORFR

Use of ORFR financial resources for operational risk events

Paragraph 14 of SPS 114 sets out the circumstances under which the RSE licensee may use the ORFR financial resources. These are described in terms of preventing potential future operational risk events - “address operational risks that could cause [...] beneficiaries [...] to sustain a loss”.

While it is preferable to address weaknesses in operational risk management before any incidents occur and while we welcome this addition to the standard, we believe that we should continue to explicitly consider the circumstance when an operational incident has

already occurred.

In this case, the financial resources will be needed to both rectify the incident and remediate the underlying weakness in risk management. Therefore, we request that the existing requirement, which makes clear that the ORFR is to be used to make a payment to address an operational risk event, be reinstated.

RECOMMENDATION 8

Amend SPS 114 to explicitly state that ORFR financial resources can be utilised not only to prevent potential future operational risks but also to address and remediate existing operational incidents.

ORFR and Successor Fund Transfer (SFT)

One of the critical operational risks that an RSE licensee faces is the risk of a disorderly transfer of members. The drafting of paragraph 14 of SPS 114 (together with other references throughout both SPS 114 and SPG 114) suggest that it would be open to an RSE licensee to choose to use their ORFR to ensure an SFT is undertaken in a risk managed way because a decision to SFT can often be an option to respond to a material risk that could cause losses for members or deprive them of a gain.

We suggest that the ORFR be able to be used to fund an SFT where a decision to undertake an SFT is the result of the transfer plan required under SPS 515 being deployed, in the case where the entire RSE licensee is being wound up, addressing any concerns of member equity that would occur with a partial transfer.

RECOMMENDATION 9

Update SPS 114 to include provisions for using ORFR funds for an SFT as a result of a SPS 115 transfer plan in the cases where the entire RSE licensee is being wound up.

Replenishment Timeframes

The FSC welcomes the increased allowable uses of financial resources held to meet the ORFR as well as the clarity of the guidance provided for them. We also welcome the removal of the notification requirements. These remove commonly understood barriers to appropriate use of ORFR financial resources and together will support RSE Licensees deciding to make greater use of this source of funding.

We note, however, that paragraph 18 of draft SPS 114 now requires the RSE licensee to replenish in a manner and timeline that “minimises the risk of adverse outcomes for beneficiaries”.

This requires an RSE licensees to attempt to balance the heightened risk of having inadequate resources to protect beneficiaries from operational risks until replenishment is complete with the need to ensure that members are not unreasonably and negatively

affected by a swift (within 12 month) replenishment.

Without positive statements about what a reasonable period for replenishment could be, there is a risk that trustees will not be able to satisfy themselves that using the ORFR resources is in the best financial interests of members. This is because they will be unable to balance the opposing risks of inadequate resources over a period of time and the immediate financial impact on members (as noted above).

For example, if APRA's view is that replenishment must occur in a 12-month period, this is likely to discourage the use of the ORFR. We believe that a reasonable replenishment period would be 3 to 5 years, consistent with the permitted time period for the initial creation of the ORFR reserves in 2013. Providing a range will also provide some flexibility for an RSE licensee to ensure replenishment is tailored to factors of the usage (ie. How big the payment was, whether it was a one-off or reoccurring, etc.).

Replenishment over a reasonable longer period will also help preserve equity between different cohorts of members. For those trustees that hold some/all of their ORFR financial resources as trustee capital, a longer replenishment period will support an RSE licensee demonstrating ongoing financial resilience (as opposed to a situation where a large amount of capital is needed to be allocated to the ORFR immediately). This slower replenishment is, in our view, consistent with the intent of SPS 515.

RECOMMENDATION 10

Define a flexible replenishment period for ORFR resources of three to five years post-use, to provide certainty of APRA's replenishment expectations.

Review and audit

The FSC also notes that even with the inclusion of broader guidance around a ORFR target amount, the requirement to review the amount annually remains. It is a significant exercise to review the target amount requirement on an annual basis. This provides no benefit when strong guidance is issued for an RSE licensee to set their ORFR target amount to 25 basis points. We would expect that APRA has information to assess whether 25 basis points has been sufficient to address operational risk events. The FSC agrees that a review should be conducted following a 'material operational risk incident or a material change to the RSE licensee's business operation' to ensure the adequacy of the RSE Licensee's ORFR strategy. Removing the annual review requirement for RSE licensees who have followed the 25 basis points guidance would significantly reduce industry burden while not leading to any increase in risk for RSE licensees.

RECOMMENDATION 11

Remove the annual review requirement for ORFR target amounts for RSE licensees adhering to the 0.25 per cent of FUM guidance. This could be replaced with a less frequent triennial review to reduce administrative burden.

Paragraph 22 of SPS 114 requires an RSE Licensee to implement internal and external audit arrangements to ensure compliance with, and the adequacy and effectiveness of, the ORFR Strategy. Requiring both an internal audit and external audit review adds additional cost to the RSE Licensee (or the RSE) and creates an undue burden when requiring the audit of one of internal or external audit would be sufficient.

As trustees continue to focus on business efficiency in the interests of delivering value for money for members it is important that the regulatory approach also reflects this. A more efficient approach would be consistent with the expectations parliament requires as set out in the *Australian Prudential Regulation Authority Act (1998)*.

RECOMMENDATION 12

Remove the dual requirement for internal and external audits of the ORFR strategy to reduce costs and streamline compliance efforts, reflecting an efficient regulatory approach.

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

Yours sincerely,



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