17/03/2023

Gideon Holland
General Manager, Policy
Australian Prudential Regulatory Authority
Level 12, 1 Martin Place
Sydney NSW 2000

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

Dear Gideon,

AustralianSuper submission to financial resources for risk events in superannuation consultation

AustralianSuper welcomes the opportunity to provide a submission to APRA's Discussion Paper on Financial resources for risk events in superannuation.

AustralianSuper is Australia's leading superannuation fund and is run only to benefit members. Over 3 million Australians are members of AustralianSuper and we invest over $275 billion of their retirement savings on their behalf. Our purpose is to help members achieve their best financial position in retirement.

AustralianSuper supports APRA's proposal for a more flexible and efficient approach to requiring RSE licensees to hold financial resources to respond to operational risks. In principle, AustralianSuper supports the two-tiered approach outlined in the Discussion Paper, subject to our responses to the questions in the Discussion Paper and additional comments in the Attachment.

We would be pleased to provide additional information or to discuss this submission in further detail. If that would be of assistance, please do not hesitate to contact me or Nick Coates (**ncoates@australiansuper.com**).

Regards

Matt Harrington
Chief Financial Officer

Attachment: Responses to Questions and Additional Comments

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Attachment: Responses to Questions and Additional Comments

General comments

A principles-based approach is more desirable than a prescriptive approach

A principles-based approach to setting the Operational Risk Financial Requirement (ORFR), aligned to an RSE's operational risk profile and risk appetite statement, is in members' best financial interests. While a two-tiered approach, as outlined in the Discussion Paper, can also achieve the same outcome, and would be broadly acceptable, we have concerns about potential unintended consequences based on specific details of the proposal.

Prescriptive prudential frameworks increase compliance and operational costs. This is relevant to the ORFR, where reserving can directly detract from member returns. Holdings in the ORFR that are not commensurate to RSEs' operational risk profile are to the detriment of returns for members. An excessive ORFR balance is not in members' best financial interests, as it reduces the income earned in members' accounts, thereby impacting retirement outcomes. Member equity when ORFR balances grow materially in line with funds under management and are not utilised, is a further issue with today's approach.

As set out in our previous submission of 17 March 2022 to APRA's consultation on Strengthening Financial Resilience in Superannuation, the current capital framework for superannuation under SPS 114 *Operational Risk Financial Requirement* ignores the specific risk characteristics of each RSE, which may relate to size but also may relate each RSE's degree of established risk frameworks. In requiring a target of 0.25% of funds under management (FUM) to be held to address operational risk events which may affect business operations it inherently assumes no difference in operational risk across RSE licensees within the industry and a proportional increase in operational risk with growth in the FUM (see below).

Overall, we believe that a holistic view of total capital would best achieve the aims of the proposed prudential changes. In other words, taking a view of an RSE's total capital position across all reserves in the context of the maturity of the RSE's risk management practices, investment in risk management systems and processes, ongoing continuous improvement of risk management practices and governance processes, and an RSE's level of self-sufficiency.

New SPS and SPG should reflect scale benefits

As noted by the Discussion Paper, SPG 114 has the effect that the money held to meet the ORFR increases linearly with FUM rather than in line with risk. The new prudential standard and guidance should be clear in allowing ORFR targets to reflect scale benefits. This is important for the following reasons:

- Internal modelling conducted by AustralianSuper since the beginning of the ORFR requirements has shown that the potential loss that the Fund is exposed to has not risen at the same rate that members' assets have grown; and
- A flat bps target does not reflect the ongoing investment which AustralianSuper is making in its Risk Management Framework, risk governance and operational risk oversight, all of which contribute to reduce the likelihood and severity of an operational risk incident.

APRA should allow early adoption of the new approach

APRA should allow RSE licensees to elect to adopt the new requirements in the discussion paper from a date earlier than 1 January 2025 particularly from a members' best financial interest perspective.

This would facilitate earlier adoption of the new approach of better supporting financial resilience in superannuation, where entities have capability to do this. Additionally, this would also allow entities to align adoption of the new ORFR approach with connected reforms being progressed by APRA, which have earlier start dates.

Finally, adoption of the new approach will likely create additional demand for risk-based capital modelling expertise in the Australian market, which is limited. If RSE licensees were permitted to elect earlier start dates for adoption, this would ease demand for this expertise by spreading it over a longer time period.

Baseline+ model

1. **What changes, if any, would enhance the proposed scope of permitted use for the baseline component and for the operational risk component?**

    a. The discussion paper (page 15) proposes that the baseline amount include funding the activation of a plan that involves the transfer *or receipt* of members under proposed enhancements to SPS 515. If the intent here is that this includes supporting the receipt of members from another RSE, we question whether this would be an appropriate use of an ORFR designed to protect current members of the receiving RSE from operational risk events. We, therefore, propose removing the ability to use the ORFR to fund the receipt of members from another RSE.

    b. Also, see response (c) to Question 3 where we propose excluding risk mitigation related activities and risk prevention activities from the definition of 'operational risk event'.

2. **What legal or practical restrictions may impede RSE licensees from implementing or complying with the proposed Baseline+ model?**

    In line with response (a) to Question 1, we envisage some challenges in calculating the Baseline component amount required for the "…activation of a plan that involves the transfer *or receipt* of members under proposed enhancements to SPS 515", particularly if no such plans are expected by some RSEs in the short to medium term.

    In line with response (b) to Question 1 and response (c) to Question 3, we envisage some challenges in calculating the Operational risk component amount required for risk mitigation related activities and risk prevention activities, which in our view are important operational expenditure activities rather than activities to be met from the ORFR.

    Whilst relevant expertise exists within the Fund, implementing and complying with the proposed Baseline+ model will require additional resources and would likely create additional demand for risk-based capital modelling expertise in the Australian market. As noted above, allowing for RSEs to elect to adopt the proposed changes from an earlier date would ease this pressure by spreading the demand for this expertise over a longer time period.

3. **Are there any likely unintended consequences of the model or individual proposed requirements?**

    We believe there are a number of unintended consequences of the Baseline+ model, as currently framed.

    a. The calculation of the Baseline component should explicitly include probability analysis. The proposed model for calculating the Baseline component suggests that a sufficient amount of financial resources are readily available for recovery or exit activity regardless of the probability of a recovery or exit occurring, which is different to how the operational risk component would be calculated. Currently, recovery activity forms part of the multiple scenarios used in our statistical/actuarial modelling of the operational risk component.

    b. The narrow scope of the permitted use of funds allocated to the Baseline component would lead to an inefficient use of members' funds. These funds would need to be held in cash or high-quality liquid assets for a recovery or exit event. We suggest that the liquidity requirement for funds held as part of the Baseline requirement is amended to align with paragraph 32 of the current SPG 114 (i.e. "…an RSE licensee would ensure that the assets in the reserve have an appropriate risk profile and are sufficiently liquid to achieve this objective.")

    c. Amending the definition of 'operational risk event' to include prospective risk mitigation related activities and risk prevention activities will result in unintended consequences. The discussion paper (page 20) proposes that the new definition of 'operational risk event' is intended to expand the allowable uses to include investigations, remediations and *mitigation* related activities to address operational risk within the RSE, as well as to *encourage operational risk prevention activities to reduce the likelihood of reoccurrence of operational risk events* under the proposed amendments to SPS 515.

        We consider that operational risk mitigation or prevention activities and continued focus on operational risk mitigation should be part of the ongoing focus of RSE licensees and should be funded through ongoing member fees and operational budgets. This should not be dependent on funds within operational risk reserves or reduce the level of such reserves that are maintained to make good any losses to members caused by operational risk events that may materialise. Whilst we support the encouragement of such operational risk mitigation and prevention activities, using funds from the ORFR for prospective risk prevention activities that are currently part of RSE licensees' BAU activities:

- Introduces additional complexity to the calculation of the operational risk component;
- May result in a reduction of funds available in the ORFR to fund actual operational risk events; and
- Inadvertently may link investments in risk mitigation activities with funds within the ORFR whose primary purpose is to ensure members are equitably protected from the impacts of operational risk events.

We therefore propose excluding risk mitigation related activities and risk prevention activities from the definition of 'operational risk event'.

Also, see response to Question 8.

Baseline component

4. Will RSE licensees likely have sufficient capability to calculate the proposed Baseline component, and what methodology would be used?

Whilst relevant expertise exists within the Fund, implementing and complying with the proposed Baseline component requirements will add cost by requiring additional resources and would likely create additional demand for risk-based capital modelling expertise in the Australian market more generally. As noted above, allowing for RSEs to elect to adopt the proposed changes from an earlier date would ease this pressure by spreading the demand for this expertise over a longer time period.

Based on our review of the Discussion Paper and discussions with peers and others with experience calculating such regulatory reserves in other jurisdictions, we expect the methodology to calculate the base requirement to include the following steps:

Step	Description
Step 1	Estimate the amount of funds required to carry out an orderly recovery or exit activity in line with the RSE's recovery and exit plan.
Step 2	*Deduct* any other resources available to the RSE that can be used for a recovery or exit plan (e.g. amounts in the Administration Reserve, and potentially the Insurance Reserve and Trustee Risk Reserve depending on the recovery or exit scenario).
Step 3	*Deduct* estimated net inflow of funds to be received or *Add* estimated net outflow of funds to be paid during the period reasonably expected to take to complete the recovery or exit activity. This would include: a. Inflow: Future administration fees b. Outflow: Future administration costs, less discretionary and other non-essential spend for an RSE that is undertaking a recovery or exit (e.g. marketing spend) c. Outflow: Additional legal, compliance and other costs related to the recovery or exit activity expected to be incurred during the period that were not captured in previous steps.

We believe that Steps 2 and 3 are required to arrive at an appropriate level for the Baseline component so that the amounts in the reserve are commensurate with an RSE's operational risk profile and does not unnecessarily impact the returns for members.

We also expect the Baseline component to be refined over time as CPS 190 practices are developed, implemented and refined through testing.

5. What is the likely level of the Baseline component?

AustralianSuper is likely to use the RSE licensee-led method for calculating the baseline component and we do not expect this component to increase in a linear manner with the growth of members or members' assets. We expect the level of the baseline component to be significantly less than the amount if a basic calculation method was used (based on either the £75 per member or €70 per member basic calculation amounts in the UK and Republic of Ireland, respectively, that are referenced in the Discussion Paper).

Potential reasons for this may include:

- The self-sustaining nature of most Australian superannuation funds, which do not rely on the support of a single employer or corporate sponsor (a key difference to many Master Trusts in the Republic of Ireland);
- The existence of the Administration Reserve (and potentially the Insurance Reserve and Trustee Risk Reserve depending on the recovery or exit scenario), and the ability to continue to receive administration fees in excess of administration expenses during a period required to exit, noting that the amount and type of expenses during an orderly exit period will be different to regular operations; and
- Funds required for recovery or exit activities do increase proportionally with the number of members and there will be benefits of scale – Master Trusts in the UK and Ireland are significantly smaller than superannuation funds in Australia.

6. How often should the Baseline amount be reviewed and why?

We suggest the Baseline component should be reviewed at least annually or following a material change in the RSE licensee's business continuity plan, financial contingency plan or resolution plan (under the draft CPS 230, CPS 190 and CPS 900, respectively).

7. What are your views on providing a basic calculation option, with the amount held linked to member numbers? Are there any other methods that would be more efficient or better targeted?

We consider that it is reasonable to offer a basic calculation option for instances where an RSE licensee elects not to calculate the baseline amount using the RSE licensee-led method. However, this method should not be used as an expectation for the level of the baseline component for RSE licensees using the RSE licensee-led method.

8. Should APRA set a minimum amount for the Baseline component or would this lead to unintended consequences?

We consider that a principles-based approach is appropriate. A mandated minimum ORFR target for all superannuation funds, regardless of size or risk profile would not reflect the maturity of the industry. Setting a minimum amount would ignore the specific risk characteristics of each RSE and inherently assumes no difference in operational risk across RSE licensees in the industry, as is the case with today's model, which is not in members' best financial interests.

As noted in our March 2022 submission, AustralianSuper's internally modelled operational risk calculation concluded that a lower level of reserves could be held to reflect both the organisation's inherent risk characteristics, and significant investment to uplift our risk management framework.

Operational risk component

9. Would RSE licensees have the capability to determine an appropriate target amount for the operational risk component?

Yes, AustralianSuper has an existing internally modelled operational risk calculation that is performed at least annually using a multiple scenario statistical model. Based on the Discussion Paper, exit or recovery scenarios will be excluded from this calculation as they will be included in the Baseline component.

10. What controls may be necessary to address the risk that the target amount is not efficient or not prudent (too high or too low)?

In addition to a Fund-wide Enterprise Risk Management Framework and a 'Three Lines of Accountability' approach, AustralianSuper has a comprehensive suite of controls in place to comply with the current SPS 114, which includes calculation, review and monitoring controls expected for a complex financial estimate like the ORFR target reserve amount. We expect that the existing control environment will need to be enhanced to include the additional calculation of the Baseline component and any other additional requirements within the new SPS 114. This includes annual peer and governance review of actuarial calculations, annual external audit review, independent review of the overall process and controls, and completeness of scenarios (including triggers for amendment) used in the calculations at least every three years.

11. How should a maximum timeframe for the replenishment of the operational risk component to its target amount be set?

Similar to the Baseline component, we expect that all replenishment plans for the operational risk component should be within three years, whilst being equitable and minimising the risk of adverse member outcomes. Any replenishment plans over three years should be approved by APRA.