Governance working group

Issues paper on operational risk requirements

March 2011

PROPOSED REFORM

On 16 December 2010, the Government announced the Stronger Super package of reforms in response to the recommendations of the Super System Review. As part of these reforms the Government announced that the current capital requirements for superannuation fund trustees should be replaced with a risk-based system applying to all funds regulated by the Australian Prudential Regulation Authority (APRA) for holding financial resources against operational risk.

The Government committed to consulting with relevant stakeholders on whether such a system should require resources to be held in the form of trustee capital or an operational risk reserve within the fund, as well as on a method for calculating such a requirement. In addition, the Government announced that any trustee capital or operational risk reserve requirement imposed under the *Superannuation Industry (Supervision) Act 1993* (SIS Act) should be in addition to any capital requirement arising from a trustee's non-superannuation business.

These proposed reforms are in response to recommendation 6.1 of the Super System Review, which, amongst other topics, examined how Australia's superannuation system currently deals with operational risk and identified a number of areas for improvement.

The issues raised by this paper relate to whether financial resources should be held in the form of trustee capital or an operational risk reserve, whether there should be minimum or maximum amounts and considerations in setting transitional arrangements.

Consistent with the process for other industries regulated by APRA, it is expected that APRA would develop a prudential standard in consultation with industry that details how the quantum of the financial resources will be calculated.

RATIONALE

Operational risk is the risk that a superannuation fund may suffer loss due to inadequate or failed internal processes, people and systems or from external events.

The management of operational risks is the trustee's responsibility. To mitigate operational risks, Australia's superannuation legislation requires trustees, among other things, to meet minimum standards of fitness and propriety and have adequate financial, human and technical resources, an adequate risk management framework and systems to manage any outsourced material business activities. Recommendations 6.4, 6.5, 6.6 and 6.9 of the review relate to trustees' risk management frameworks and are the subject of a separate paper.

In addition to these general requirements, trustees of public offer superannuation funds are required to meet a minimum capital requirement. Currently, trustees of public offer funds must hold net tangible assets of at least $5 million, either directly, in combination with an approved guarantee, or through a custodian.[1] In limited cases the capital requirement can be met when all fund assets are held in a prudentially regulated entity, such as a life insurance company. There are no capital requirements for the trustees of non-public offer superannuation funds.[2]

The review found that these existing trustee capital requirements are not sufficient to protect fund members adequately from the impact of operational risk. In particular, the review found that the trustee capital requirements are too low relative to the operational risks faced by many superannuation funds, are not calibrated to reflect these risks, and do not take into account the fact that some trustees may manage several funds and may also manage non-superannuation managed investment schemes. The review was also concerned that the capital requirements only apply to public offer superannuation funds.

The review also found drawbacks to the guarantee and custody alternatives by which trustees can satisfy the capital requirements. A guarantee is relatively inflexible as it can only be called on in the event of a default by the trustee to whom it is provided, while custodians are not responsible for operational failures that do not relate to the custody of a fund's assets. In addition, the market for custody services is highly concentrated, and a custodian is only required to hold $5 million in capital irrespective of the number of trustees for whom it acts as custodian.

Rather than seeking to augment the trustee capital requirements, the review sought to address these concerns through introducing a requirement for funds to maintain risk based operational risk reserves with some capacity for this requirement to be offset by trustee capital. The review also recommended that the reserve requirements imposed on superannuation funds should be additional to any capital requirements relating to trustees' management of non superannuation managed investment schemes.

POLICY ISSUES

The Government has committed to introducing a risk-based system applying to all APRA-regulated funds for holding financial resources against operational risk. It has not yet been decided whether these resources should be maintained by trustees, in the form of a minimum level of net tangible assets, or within superannuation funds themselves, in the form of an operational risk reserve. Another area that has not been settled is the extent to which any requirement will be able to be satisfied through alternative methods, such as reliance on guarantees or the capital of custodians. Issue 1 of this issues paper seeks feedback on which of trustee capital or an operational risk reserve is the best means of maintaining a buffer against operational risk losses.

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1 In instances where trustees of public offer funds employ a custodian to hold the $5 million in net tangible assets, a further amount of liquid assets must be held by the trustee. In most cases this amount will be $100,000, although up to $250,000 may be required in instances where there are increased risks, such as those arising from internal administration of the fund.

2 Trustees may also be required to hold an Australian Financial Services Licence issued by the Australian Securities and Investments Commission, which also imposes capital requirements, but need only comply with the capital requirements under superannuation legislation.

The new requirements will be risk-based. This means that the level of resources that must be maintained against operational risk will reflect the extent of the risks faced by the superannuation fund in question (if operational risk reserves are mandated) or the extent of the risks faced by the funds managed by a particular trustee (if the trustee capital approach is followed).

There are a number of factors which can influence the extent of these risks, including: the size of the fund; the level of the fund's operating costs; whether an external administrator is used or whether fund administration is conducted 'in-house'; the extent to which other external service providers are used and whether they are prudentially supervised; the quality of the fund's governance and risk management processes; the indemnities and insurances maintained by the fund; the complexity of the products offered by the fund, including the level of member investment choice; and whether (and how frequently) the fund conducts unit pricing.

The size of a fund's operational risk reserve or trustee capital requirement may be affected by the extent to which resources are available elsewhere. For example, should the Government introduce a system of mandatory operational risk reserves, the minimum required size of a fund's reserve may be able to be partly offset by capital voluntarily maintained by the fund's trustee.

It is intended that, consistent with the process for other APRA-regulated industries, the detail of how the operational risk reserve or trustee capital requirements will be calculated will be contained in a prudential standard, developed by APRA in consultation with industry. This will include the size or method of calculating any minimum or maximum levels of the requirements. It has not yet been decided whether there should be minimum or maximum bounds to the requirement, and the Government is seeking feedback on this matter at Issue 2 of this paper.

The Government is seeking feedback on the most appropriate arrangements for implementing the new requirements, including the length of the transition period, at Issue 3 of this paper.

The Government is particularly interested in feedback on the practical implications of the alternatives canvassed in this issues paper.

Issue 1 – Trustee capital or an operational risk reserve

Currently, the capital requirements applying to trustees of public offer superannuation funds provide the members of those funds with some protection from losses due to operational risk. The Super System Review has, instead, recommended that all large APRA-regulated funds should be required to maintain operational risk reserves. The review also suggested that there should be some scope for these reserve requirements to be offset by trustee capital and that the trustees of small APRA-regulated funds (SAFs) should maintain capital in lieu of reserves held within their funds.

In the case of an operational risk reserve, fund members are contributing to a pool of resources within the fund which can be drawn upon to meet losses due to operational failures. The reserve, and the earnings on the reserve, ultimately belong to the members of the fund. However, when losses do occur, it is the fund members, through the reserve, who bear the cost.

In the case of trustee capital, the cost of operational failures is met from trustee resources (to the extent that these resources exist) and not by fund members.[3] The cost of servicing this capital is reflected in the management fees the trustee charges fund members. Trustee capital can either be built up through subscriptions from the trustee's shareholders or through the retained earnings of the trustee, derived from the management fees charged to fund members. Some types of trustees may have to rely entirely on retained earnings to raise capital.

[3] Trustees may, however, impose a special levy on members to fund the costs of operational failures.

In the case of SAFs, it is more efficient for the trustees to to hold capital rather than establish operational risk reserves.

A secondary issue is the extent to which reserving or trustee capital requirements may be satisfied through alternative arrangements. As discussed above, the Super System Review identified a number of drawbacks to the way that the current trustee capital requirements can be met through the use of guarantees or reliance on the resources of custodians. Some of the limitations of the custody alternative are also relevant to the method of satisfying the capital requirements by holding all the assets of the fund in a prudentially regulated entity.

In general, these options may not provide fund members with the same level of protection against operational risk losses as they would enjoy from financial resources held directly by their fund or its trustee. Holding resources directly can, however, come at a cost to fund members, either in the form of higher member fees (where resources are held as trustee capital) or, potentially, lower returns to members (in the case of operational risk reserves).

Question 1.1 In maintaining a financial buffer against operational risk losses, what are the advantages and disadvantages of holding resources in the form of trustee capital or an operational risk reserve?

Question 1.2 In what way, if any, should the rules relating to SAFs differ from those for other types of funds?

Question 1.3 To what extent should arrangements involving guarantees, custodians or holding assets in a prudentially regulated entity assist in meeting an operational risk resource requirement, and why?

Issue 2 – Minimum and maximum levels

The Super System Review recommended that there be a minimum dollar figure for the operational risk reserves of all large APRA-regulated funds. The principal argument for holding a minimum dollar level of financial resources against operational risk losses is that there are a range of operational risks that are largely fixed in nature, even in relatively small superannuation funds. Any new requirement to maintain minimum levels of operational risk reserves or trustee capital should provide members with at least as much protection as the current capital requirements for public-offer trustees.

The review also recommended that there should be a maximum level for the operational risk reserves of all large APRA-regulated funds, expressed as a percentage of the assets in the fund. If APRA's assessment of the risk in the fund resulted in the view that a fund's reserve should be higher than this maximum, the review recommended that APRA use other measures to cause the trustee to reduce the risk exposure of the fund.

Any ceiling on the operational risk reserve or trustee capital requirement should provide members with meaningful protection against reasonably expected operational risk losses while preserving sufficient incentive to prevent operational failures from occurring. The requirement should also not be so large as to detract unreasonably from member returns.

Question 2.1 What are the advantages and disadvantages of setting a minimum dollar figure for an operational risk reserve or trustee capital requirement?

Question 2.2 What are the advantages and disadvantages of setting a ceiling on any operational risk reserve or trustee capital requirement?

Issue 3 – Implementation arrangements

Implementing any new capital or operational risk reserve requirement will require a range of regulatory changes and appropriate transition arrangements. It is anticipated that amendments would be required to the SIS Act and Regulations and that APRA would issue a prudential standard containing detailed rules on the design of the new requirement. The rules governing non-superannuation managed investment schemes will need to be amended to require responsible entities that are also superannuation fund trustees to maintain separate capital requirements in respect of their non-superannuation business.

It is anticipated that any new operational risk reserve or trustee capital requirement will commence on 1 July 2013, along with other regulatory changes arising from recommendations of the Super System Review. Establishing a suitable framework for assessing operational risks and translating these into capital or reserving requirements would require substantial consultation by APRA with the superannuation industry prior to this date.

Following 1 July 2013 funds and their trustees will be given a reasonable transition period to accumulate sufficient reserves or capital to comply with the new requirements. In establishing the transition arrangements, the objective would be to gradually enhance member protection without placing an undue burden on current members or creating a competitive disadvantage for some funds.

Question 3.1 What issues would be involved in building up an operational risk reserve or trustee capital requirement?

Question 3.2 What transition period would be appropriate? Why?

Question 3.3 Are there any factors which the transition arrangements should address?