



Uplifting Superannuation Risk-Based Capital Management

RESEARCH PAPER

APRIL 2022



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This paper has been prepared by an actuarial Working Group established by the Actuaries Institute's Superannuation and Investments Practice Committee.

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Acknowledgement

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1. Synopsis

This Research Paper aims to assist superannuation trustees uplift their approach to risk-based capital management (**RBCM**) as they review their approach to maintain the financial strength needed to operate their businesses effectively, and protect superannuation fund members' best financial interests.

Capital and reserve management within the superannuation industry is currently largely driven by the Superannuation Industry (Supervision) Act 1993 (**SIS Act**) and Australian Prudential Regulation Authority (**APRA**) prudential standards. Whilst capital and reserve management within superannuation has traditionally been less sophisticated than in other APRA regulated entities, approaches taken have historically largely met needs and expectations.

Release of this Research Paper coincides with increased regulator attention on financial resilience of superannuation trustees, and the superannuation funds which they manage. APRA issued its Discussion Paper *Strengthening Financial Resilience in Superannuation* in November 2021, and has included superannuation entities within its proposed cross-industry prudential standard *Financial Contingency Planning*, issued in December 2021 which covers all APRA regulated entities.

The Working Group postulate the time is right to implement a more integrated RBCM structure within superannuation since:

- superannuation funds are becoming larger and more sophisticated with industry consolidation, and continued flow of mandated superannuation contributions;
- legislative changes now prohibit a trustee being indemnified out of fund assets for penalties, fines and infringement notices;
- a trustee must now comply with a best financial interest duty;
- there is emerging regulatory and commercial need for APRA regulated funds to strengthen financial contingency planning; and
- there is an ever-increasing focus on member outcomes, and more generally strengthening financial resilience, within APRA regulated funds.

The Working Group believes the opportunity exists for the superannuation industry to apply components of the Internal Capital Adequacy Assessment Process (**ICAAP**) used within the insurance and banking industries to build on the existing, albeit fragmented, superannuation industry policies and processes. This would improve connectivity of risk and capital management within superannuation, leading to enhanced member outcomes.

The Working Group invites participants in the superannuation industry to continue the conversation on how to enhance RBCM within superannuation and looks forward to any feedback on this Research Paper.



2. Introduction

Capital and reserve management within the superannuation industry is currently largely driven by the SIS Act and APRA prudential standards. In particular, Superannuation Prudential Standard 114: *Operational Risk Financial Requirement (SPS 114)* which considers Operational Risk Reserves (**ORR**) and Superannuation Prudential Standard 160: *Defined Benefit Matters (SPS 160)* which considers Defined Benefit and self-insurance reserves.

The introduction of SPS 114 uplifted RBCM across the superannuation industry, which met the needs and expectations of the industry at the time. However, despite the uplift, RBCM in superannuation continues to be less sophisticated to that for other APRA regulated entities such as insurers and banks.

APRA has turned its attention to enhancing the financial resilience of superannuation trustees and funds. APRA released its Discussion Paper *Strengthening Financial Resilience in Superannuation* in November 2021, and has included superannuation entities within its proposed cross-industry prudential standard *Financial Contingency Planning*, issued in December 2021 which covers all APRA regulated entities.

Part of the brief to the Working Group was to consider the extent to which RBCM frameworks applied to other APRA regulated entities can usefully be applied by a superannuation fund trustee when enhancing financial resilience within superannuation. The Working Group also sought to provide practical examples of how a trustee might go about making a 'next step' towards uplifting its RBCM within the construct of the current superannuation regulatory framework.



3. Background

3.1 Superannuation Fund Reserves

Superannuation fund trustees have historically established reserves within the superannuation fund for which they are trustee to help them address contingent events and potential equity issues between different member cohorts. These reserves not only include operational risk reserves, defined benefit reserves and self-insurance reserves, but in some instances also general reserves, administration reserves and investment reserves (where a smoothed crediting rate rather than unit pricing is applied).

Section 52 (2) (i) of the SIS Act requires a trustee, where a superannuation fund entity has reserves, to *“formulate, review regularly and give effect to a strategy for the prudential management, consistent with the entity’s investment strategies and its capacity to discharge its liabilities (whether actual or contingent) as and when they fall due”*. However, with the exception of more recent APRA guidance in Prudential Practice Guide SPG 515: Strategic and Business Planning (**SPG 515**), it has largely been left up to the fund trustee to determine the types and levels of fund reserves outside the requirements of SPS 114 and SPS 160.

SPG 515 states that the use of reserves ultimately affects member outcomes, and so reserves must be established with a clear purpose and then managed in a consistent and equitable manner. Under SPG 515, APRA expects that a trustee will develop policies and processes to determine the need for reserves, as well as their size and management. The policies and processes should articulate the rationale for reserve establishment, and ongoing objectives and measures to manage the reserves.

3.2 Trustee Capital

Historically, many superannuation trustees, particularly trustees of profit-for-members funds, have been ‘\$2 companies’ and have effectively had no trustee-entity capital or access to contingent capital. This was possible because trustees could be indemnified out of superannuation fund assets, except in some more extreme eventualities (e.g. breach of trust) where legislation prohibits trustees from being indemnified in this manner.

Some trustees have held capital to manage risks at the trustee entity level rather than (or as well as) reserves within the superannuation fund or have secured access to contingent capital should the need arise. Many trustees have taken out trustee indemnity insurance or Directors & Officers insurance to protect against contingent events where these can be insured.

Recent changes to section 56 and 57 of the SIS Act have extended the circumstances prohibiting indemnity out of fund assets, and any penalties, fines and infringement notices can no longer be indemnified out of fund assets. All superannuation fund trustees are therefore considering whether, and if so how, they will establish trustee entity capital, and instances in which the established capital could be utilised.

We discuss in this paper the importance of SPS 114 in promoting effective operational RBCM by trustees, and comment on the extent of its success to this end. We note that whilst the typical approach to superannuation RBCM complies with regulatory requirements, it is generally fragmented without a structured framework that links together the various capital and reserving elements.

We also discuss in this paper the impact of the section 56 and 57 changes to the SIS Act, as well as the new trustee best financial interest duty. Both these changes are likely to lead to a more integrated approach to capital and reserve management so as to improve the financial sustainability of the trustee entity and promote good financial member outcomes.

3.3 Impact of SPS 114 on Superannuation Industry Capital Management

SPS 114 has applied since 2013 and establishes requirements for a superannuation fund trustee to maintain adequate resources inside or outside the superannuation fund for which they are trustee to address operational risk events that may affect its business operations.

SPS 114 was issued alongside other APRA prudential standards and prudential practice guides relevant to application of RBCM by a trustee entity. These include:

- **Prudential Practice Guide 114: Operational Risk Financial Requirement (SPG 114);**
- **Superannuation Prudential Standard 220: Risk Management (SPS 220);** and
- **Prudential Practice Guide 220: Risk Management (SPG 220).**

SPG 114 provides guidance to a trustee as it applies SPS 114.

SPS 220 sets out the requirements for a trustee's risk management framework, including measures in place to control, monitor and, where appropriate, reduce these risks. SPG 220 includes examples of operational risks that may lead to operational risk events.

SPS 114 has fundamentally shaped how trustees reserve for operational risks. In particular, SPS 114 requires a trustee to have an ORR either within the superannuation fund or as trustee capital held by the trustee entity itself. The ORR must be set at a level equal to an Operational Risk Financial Requirement (**ORFR**) target amount chosen by the trustee. APRA provides guidance rather than mandates the approach for determining the ORFR target amount.

APRA's guidance in SPG 114 includes:

- an expectation that most trustees use a straightforward approach to determine their ORFR target amount;
- a view that the ORFR target amount be based, at a minimum, on the impact of operational risk events that may have a material impact on the trustee's business operations but excluding extreme events that may have a catastrophic impact; and
- an expectation that the ORFR target amount is equivalent to at least 0.25% of funds under management (**FUM**), unless the superannuation fund invests in another entity that is subject to operational risk financial requirements (e.g. a pooled superannuation trust or a life investment policy invested by an APRA-regulated life insurance company).

3.4 Observations on Effectiveness of SPS 114

Almost ten years after the initial application of SPS 114, we make the following observations.

Concerns and confusion over appropriate use and management of reserves

The case studies and findings of the 2018 Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry suggested concerns and confusion around appropriate use of superannuation related capital and reserves with conduct and compliance risks associated with getting these decisions wrong.

More specifically in relation to ORR management, there appears to be uncertainty on appropriate uses of the ORR, as evidenced by the IOOF case study highlighted at the Royal Commission, and the subsequent unsuccessful legal action taken against IOOF by APRA. This case study highlighted that it is not always clear what is, and is not, an appropriate use of the ORR.

More recently in its November 2021 Discussion Paper *Strengthening Financial Resilience in Superannuation*, APRA suggested industry practices in relation to both the setting of target reserve amounts and review of reserves and reserving policies across the industry could be improved. It also commented in this Discussion Paper that in relation to ORR management "it is evident that RSE licensees are reluctant to call on these financial resources, even where they would be entitled to do so" further indicating trustee hesitancy or lack of clarity around appropriate reserve usage.

Little evidence of capital and reserve management policy integration

Whilst difficult to confirm, the Working Group was not aware of many examples of the superannuation industry integrating trustee entity and superannuation fund capital and reserve management into a single framework. Instead, the more usual approach is for the ORFR Strategy, reserve management policy (over and above ORFR), and trustee capital policy (potentially with an associated dividend management policy) to be developed as discrete policies that are not linked through some overarching framework. This lack of cohesion is often exacerbated by different business owners for the different policies, leading to fragmented application and oversight.

A preference to select the expected minimum 0.25% ORFR target amount with limited RBCM

The approach followed by many superannuation fund trustees under SPS 114 has been to set the ORFR target amount at the minimum guidance level of 0.25% of FUM. This target is then subject to periodic review that the ORFR target percentage remains sufficient to protect fund members.

Whilst this is a less sophisticated approach to setting a risk-based target than that taken by other APRA regulated entities such as insurers and banks, it promotes management of the link between the exposure of members to operational risks and the availability of capital to cover this risk.

The Working Group notes that while a compliance approach to select the minimum guidance level 0.25% ORFR target amount provides some financial protection to superannuation fund members against operational losses, it provides limited capital incentive to use scale and superior RBCM capabilities to deliver capital efficient outcomes to members below 0.25% of FUM. Further, for some superannuation fund trustees, there may be instances where it is appropriate to hold capital above the minimum of 0.25% of FUM.

Limited reserving standards

APRA provide guidance and outlines its expectations to assist trustees with reserve management within a superannuation fund as per paragraphs 58 to 64 of SPG 515 (issued in August 2019). Beyond SPG 515, SPS 114 which covers operational risks and SPS 160 for defined benefit matters, there are no other reserving standards to assist a trustee with reserve management for the superannuation fund for which they are trustee.

APRA recognised the opportunity for uplift commenting in 2019¹, “consideration could be given to developing a broader reserving standard and guide, reflecting expected practices around reserves, which could cover all reserves including those established for operational risk events”.

3.5 Impact of Section 56 and 57 of SIS Act

Section 56 of the SIS Act prevents superannuation trustees and section 57 their directors from using trust assets to pay a liability for breach of trust if they failed to act honestly in a matter concerning the entity, or intentionally or recklessly failed to exercise, in relation to a matter affecting the entity, the required degree of care and diligence.

Trustee Directors will usually acquire Directors & Officers professional indemnity policies to cover them for these risks to the extent permitted by law. In addition, it is common for superannuation trustees to effect superannuation trustee liability insurance to protect them for actions seen to be in breach of fiduciary responsibilities and reimburse the trust assets where they have been called on to meet legal costs.

Following recommendations from the Royal Commission, section 56 and 57 of the SIS Act have been amended. It has been extended to include a prohibition on indemnifying a superannuation trustee and its directors from trust assets to pay:

- criminal, civil or administrative penalties incurred in relation to a contravention of any Commonwealth law;
- amounts payable under infringement notices given under Commonwealth law; and
- costs of undertaking a course of education in compliance with an education direction from the regulator.

The amendments apply in relation to liabilities imposed on or after 1 January 2022. Following the change, costs need to

¹ Information Paper - Review of APRA's 2013 superannuation prudential framework, 30 April 2019 s5.1.2

be met out of the trustees' or Directors' personal assets or insurance. This presents a significant RBCM challenge to any trustee entity that does not have actual capital or contingent funding (e.g. insurance) to cover such an unexpected event, which is more prevalent across not-for-profit superannuation trustee entities.

As a consequence of this change, not-for-profit trustees are currently reviewing their capital management strategy at the trustee entity level.

3.6 Impact of Best Financial Interest Duty

One of the aims of the best financial interest reform to the SIS Act, as introduced as part of the Your Future, Your Super reforms, is to remove the ambiguity of how a trustee spends members' money. Under the reform, a trustee must be able to point to evidence that it has properly discharged its best financial interest duty.

The superannuation industry is expecting APRA to continue to focus on this overarching SIS Act requirement. Again, we expect this increasing focus by APRA on appropriate use of capital and reserves will provide a catalyst for a trustee to review the way that capital and reserves are managed across the trustee entity and superannuation fund for which it is trustee.

Those trustees that can successfully integrate trustee entity and superannuation fund capital and reserve management into a single framework are well positioned to demonstrate they are both meeting best financial interest duty and holding an appropriate level of capital and reserves aligned to optimising long-term member outcomes (coverage for risk whilst also avoiding excessive long-term capital and reserve costs).

3.7 Linking Risk and Capital Management

A deep understanding of a trustee's superannuation related risks is central to development of its RBCM framework. This includes an understanding of the trustee entity's risk profile, particularly in relation to more severe unexpected losses to which that entity might be exposed.

A trustee will typically define its key risks (including material risks) within its risk management strategy and risk appetite statement. In Appendix A we include a list of the typical risks covered by a trustee's overarching risk management framework. We also include in this list where that risk is specifically required to be considered under the SIS Act and APRA prudential standard requirements.

The trustee's risk assessment will then consider the potential loss as a result of risk to both fund members and the trustee entity. A key part of its risk assessment is formulation of its risk appetite settings, indicating the level of loss that would fall inside or outside its risk tolerance.

Ultimately RBCM will link this trustee risk assessment with the financial capital or contingent sources of funding that will be required to cover these risks to a level that is satisfactory to the trustee Board.



4. Capital, Reserve and Contingent Funding Structures

The governance of trustee entities is heavily regulated not only by APRA, but also by the Australian Securities & Investments Commission (ASIC), which regulates the licencing of financial services entities holding an Australian Financial Services Licence (AFSL). ASIC has issued Regulatory Guide 166 Licensing: Financial Requirements (RG 166) which sets out minimum working capital requirements of a trustee entity.

4.1 Capital and Reserve Structures

Table 1 below describes some of the more common capital and reserve structures within a superannuation business. In this context the superannuation fund is referred to as the Registrable Superannuation Entity (RSE) and the trustee as the Registrable Superannuation Entity Licensee (RSEL).

Table 1 – Examples of Capital and Reserve Structures as a Source of Pre-Funded Financial Resources

Structure	Description
General or Administration Reserves (refer SIS s52(2)(i) and SPG 515)	Reserves held within the RSE that are general in nature and able to be deployed in the best interest of members to cover unexpected events. These reserves might also be used to meet certain RSE payments (e.g. APRA levies), as a structure where unallocated member money can be kept (e.g. tax credits) in advance of deployment to members, or to assist with day-to-day cash flow management.
Defined Benefit Reserve (refer SPS 160)	Reserves held within the RSE specific to the management of defined benefit liabilities, including amounts to cover future contingent liabilities that might arise from time to time.
Insurance Reserve (refer SPS 160 and SPG 515)	Reserves held within the RSE specific to the management of any self-insurance of member insurance liabilities, including an amount to cover unexpected liabilities that might arise from time to time. Insurance reserves may also be established to manage profit share returned through premium adjustment mechanisms.
Operational Risk Reserve (in RSE) (refer SPS 114)	Reserves held within the RSE to cover the impact to member balances from operational loss events as defined under SPS 114. The ORR cannot be used to cover other operational risk related losses over and above the restoration of member balances without consultation with APRA.
Operational Risk Reserve (in RSEL) (refer SPS 114)	Capital held within the RSEL to cover the impact to member balances from operational loss events as defined under SPS 114. This structure cannot be used to cover other operational risk related losses over and above restoration of member balances.
Strategic Reserve	Reserves held within the RSE to fund strategic project expenditure aligned to the trustee business plan, intended to enhance member outcomes.
Strategic Capital	General or specific capital held within the RSEL to fund future general or specific strategic initiatives aligned to the trustee business plan.
Working Capital (refer RG 166)	Capital held within the RSEL to meet the day-to-day working capital requirements of the business (e.g. direct or third-party fund administration costs). Where such costs are met directly out of the RSE, this reserve can transition into the RSE.
Unexpected Loss Capital	Capital held within the RSEL that is either general or specific (e.g. regulatory fines reserve) in nature to cover unexpected losses or any other contingency expenditure items.
Free Capital	Excess capital held by the RSEL over and above the RSEL's target requirements.

4.2 Contingent Funding Structures

Table 2 below outlines a variety of common contingent funding structures that can be used in the event that capital and funding need to be sourced, to either top up existing reserve and capital structures or provide direct funding to cover an event that has occurred.

Table 2 – Examples of Contingent Structures as a Source of Financial Resources When Required

Structure	Description
Shareholder Capital Injection[^]	As required, ability of RSEL to request a shareholder inject fresh capital into the RSEL.
Claim Against a Third-Party Supplier	As specified within third party contracts, ability of RSEL to make a claim against a third party for losses resulting from failure to properly deliver their service to the trustee.
Third-Party Insurance Policy on Members	As specified within insurance contracts, ability of RSEL to make a group insurance claim to provide capital for payment of insurance claims made by fund members.
Third-Party Group insurance policy on RSEL and Director risks	As specified within trustee and Director insurance contracts, ability of the RSEL to make an insurance claim for an event resulting in losses to the RSEL and/or directors.
Indemnities	Ability of the trustee to make a claim against a previously agreed indemnity offered by a third party.
Retained Earnings (including dividends withheld)	Contingent repurposing of capital held within an RSEL earmarked as a dividend payment to a shareholder (for profit RSEL), or for return to members (not-for-profit RSEL).
Deducting from Member Balances or RSE Reserves	As specified within the RSE trust deed and/or PDS, the ability of the RSEL to make deductions from the RSE to cover its costs. This might also include the levy of a fee to members to provide funding against a particular event.

[^] Whilst debt funding to the RSEL is not considered to be a source of contingent capital, it could be a strategy to provide RSEL liquidity from time to time in advance of restoring other capital reserves.

5. Uplifting Superannuation RBCM

5.1 Establishing Guiding Principles

To implement a more integrated trustee entity RBCM structure within superannuation, the starting point is to establish a set of RBCM principles relevant to superannuation. In addition to the overarching principle of delivering long-term member outcome targets, the Working Group has defined the following four high level guiding principles to support an uplift in superannuation RBCM:

- **Single Framework** – Consolidate RBCM related policies and regulatory frameworks to a single overarching RBCM framework. The framework should have a summary statement that provides the Board and APRA with a holistic view of the trustee's RBCM processes.
- **Business Plan Integration** – Create a RBCM strategy that is integrated into the annual strategic and business plan review.
- **Scenario and Data Driven** – Apply scenario testing on a broader set of capital management challenges, to enhance any gaps or limitations in RBCM related data capture.
- **Transparent and Holistic Reporting** – Regular RBCM Board reporting at a holistic level, including reporting of mismatches between risks and capital.

To help inform the development of these principles, the Working Group also undertook a high-level review of the Internal Capital Adequacy Assessment Process (ICAAP), which is a RBCM requirement on APRA regulated insurance and banking entities, including gap analysis back to the current approach to capital management in superannuation. Appendix B documents this analysis including possible opportunities to uplift the RBCM process in superannuation across key ICAAP components.

5.2 Building on Current Superannuation Industry Requirements

RBCM is developed on a foundation of a sound understanding of the trustee's risk profile, financial capital and reserves and contingent funding structures. Whilst this paper does not go so far as to suggest an ICAAP regulatory requirement be put in place for the superannuation industry, our analysis in Appendix B illustrates how the various components of the ICAAP framework can be utilised to improve superannuation trustee capital management by bringing together current and emerging (e.g. Draft CPS 190 and 900) regulatory RBCM elements in a more cohesive way, and ultimately strengthening the connection between risk and capital/reserves.

5.3 Benefits and Evidence of Successful Superannuation RBCM

A RBCM framework provides three key benefits:

- **It provides a more systematic approach to funding and preparation for loss events** – it provides the trustee with a systematic and disciplined approach to prioritising sources of capital to fund financial losses that emerge as and when risks are realised. It also helps in the development of appropriate contingency and resolution planning that can be applied if a material risk crystallises.
- **It strengthens the link between risk and capital management** – it provides a comprehensive process of understanding risk and translating this into appropriate financial capital and contingent protection, bringing together the fragmented set of policies and procedures that constitute trustee entity risk and capital management in many trustee entities today.

- **It helps maximise long-term member outcomes** – it maximises long-term member outcomes by ensuring member balances are only diluted to the extent needed to appropriately cover fund risks, and that any changes in risk profile over time are appropriately reflected in an appropriate structural form and level of trustee capital (at RSEL level) and reserve (within the RSE) structures.

Some examples of evidence of a successful uplift in a trustee's RBCM framework include:

- SPS 114 (ORFR) compliance with ORFR Strategy processes that form part of a broader trustee RBCM framework;
- easier compliance with both current and emerging regulatory requirements (e.g. Draft CPS 190 and 900) and any potential future decision by APRA to introduce regulatory requirements linked to “a broader reserving standard”;
- resolution of any section 56 SIS Act compliance risk associated with receiving a material regulatory fine;
- trustee and member confidence funding is in place to deliver on the trustee business plan to improve member outcomes;
- trustee and member confidence both funding and plans are in place to cover and respond to material contingency events, including the need or opportunity to undertake a fund merger;
- improved operational risk event data capture and submission over time;
- risk and capital disclosure that gives confidence to fund members and other internal and external stakeholders;
- improved basis for trustee assessment of the capital and reserving implications of superannuation fund consolidation;
- clearer decision-making framework and governance to assess and confirm the compliance of decisions to use capital and reserves for different purposes; and
- improved quantification of incentives (internal risk-based capital release) for initiatives that will contribute to the effective management of risk.

5.4 Superannuation RBCM Critical Success Factors

There are several pre-conditions relevant to the successful implementation of a fit for purpose trustee RBCM framework:

- **Fund scale** – for smaller funds, the resources may not be available to develop and implement a RBCM uplift.
- **RMF design and operational effectiveness** – an overarching RBCM framework will only be effective if the underlying trustee Risk Management Framework (**RMF**) is operating effectively.
- **Risk and event data quality** – the quality and quantity of risk and event data capture is critical to support a RBCM system that enables a dynamic linkage between risk and capital management. The Working Group recognises it will take time to build the maturity of each trustee's event data capture system and notes the value of regulatory involvement in assisting the industry in this process, including facilitating the industry wide aggregation of operational event data and insights in a way that meets privacy and confidentiality requirements.
- **Trustee intent and capabilities** – the trustee will need to be committed to using RBCM as a tool to improve member outcomes and have Directors that bring some level of capability and experience in optimising risk and capital outcomes.
- **Regulatory support** – the SPS 114 framework provides limited capital incentive to use scale and superior RBCM capabilities to deliver capital efficient outcomes to members below the APRA guidance minimum 0.25% of FUM. For APRA to consider a more flexible regulatory regime, it will be helpful for the industry to demonstrate it has in place an appropriately fit for purpose RBCM regime to support such a framework. In its April 2019 Information Paper, APRA suggested it is more open to more future flexibility in ORFR target setting.



6. Practical Examples

We set out below two practical examples of application of more structured RBCM within superannuation funds and trustee entities.

Example 1 sees trustees build on the current SPS 114 requirement to conduct an annual review of the ORFR target and tolerance, and also set an appropriate internal capital target in relation to non-ORFR related structures. The combination of superannuation fund reserves and the internal capital target would allow the trustee entity to be confident it is holding appropriate capital to cover its risks, meet regulatory requirements and ensure that in the longer term they are not holding excessive capital leading to unnecessary costs to members.

Example 2 sees trustees deploy understanding of capital, reserves and contingent funding structures to meet an unexpected loss. It sees trustees use scenario testing of a regulatory fine being issued to a trustee entity to inform an appropriate RBCM strategy that ensures that risk is covered within trustee risk appetite. This example can also be applied to the development of a contingency plan to respond to financial stress (Draft CPS 190), and identify available financial resources to execute actions to resolve a financial crisis (Draft CPS 900).

6.1 Example 1 – Building on Annual ORFR Target and Tolerance Review to Develop a Trustee Entity Internal Capital Target

This example shows how a more RBCM approach to trustee entity RBCM allows development of an internal capital target (equal to or above the regulatory capital requirement) by expanding the annual ORFR target and tolerance analysis to consider risks and capital needs more broadly.

Whilst sufficient capital must always be held to meet regulatory capital requirements, it may be in a trustee's interest to hold more capital than required by the legal minimum. The aim of an internal capital target is to ensure that capital is sufficient to cover the risk of unexpected losses to the trustee, whilst considering contingent funding structures. The analysis to develop the internal capital target helps in this regard. It can also be used to indicate the extent to which any free capital held within the trustee entity should be considered for return to either members or shareholders (e.g. via dividends) in order to ensure that long-term costs of capital to the trustee entity are not excessive.

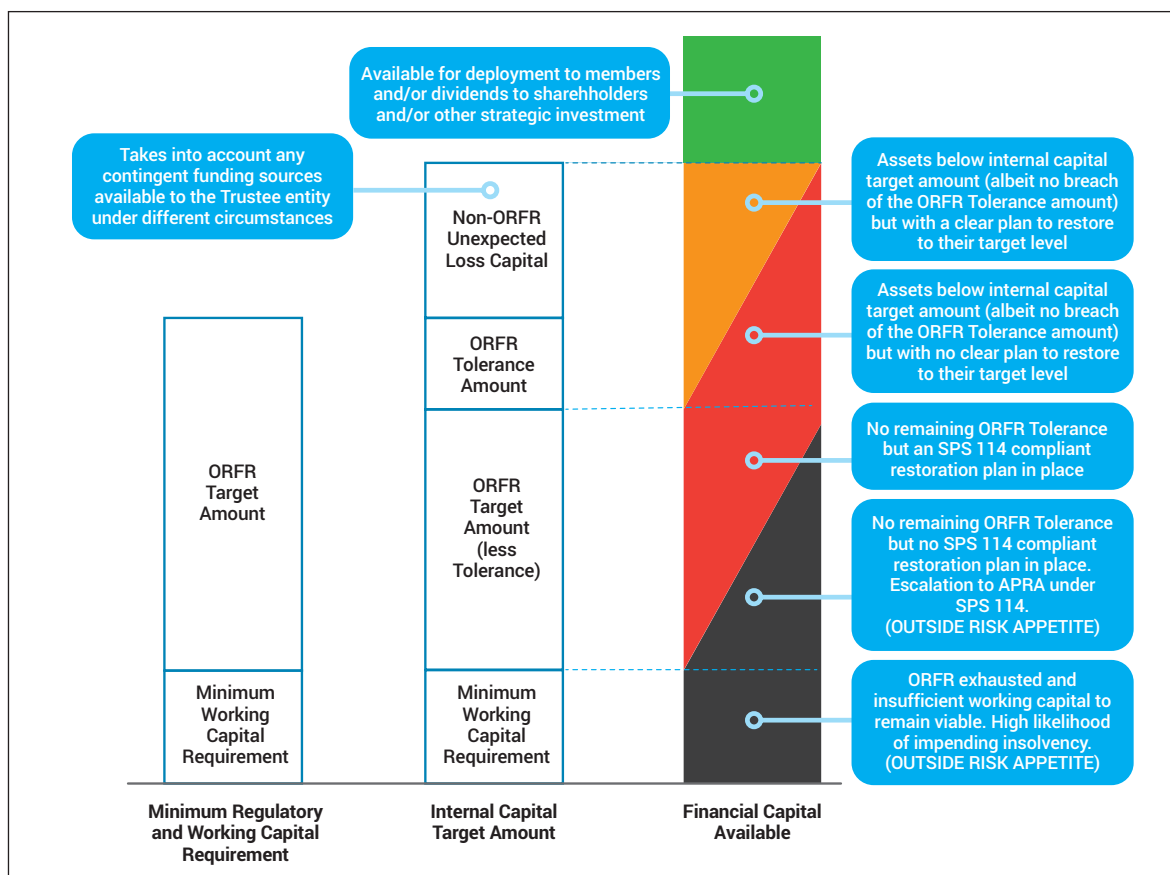
The following steps illustrate how a trustee might deepen its traditional ORFR target and tolerance review to derive and then monitor an internal capital target mapped back to trustee material risks:

1. **Update loss history** – to understand the extent to which trustee entity capital or contingent structures have been needed historically to cover risk-based or non-risk-based events.
2. **Develop scenarios** – engage the trustee and executive management to consider the likelihood and impact of potential severe risk events mapped back to trustee material risk classes.
3. **Assess capital and contingent funding structures** – update and reconfirm the level and nature of various superannuation fund reserves and trustee entity capital, and contingent funding available to the trustee. Consider the extent to which these contingent funding sources might be available to cover the various scenarios developed earlier and any limitations to their use under law or contracts that might be in place.
4. **Test ORFR target and tolerance amount** – use the previous RBCM analysis to statistically test² the appropriateness of the ORFR target and tolerance.
5. **Develop and/or test internal capital target** – again use the previous RBCM analysis to statistically test the appropriateness of an Internal Capital Target against which a trustee might manage an overall trustee entity level capital position to cover other non-ORFR related unexpected losses; this should be in addition to any working capital, strategic capital and ORR held at the trustee entity level.
6. **Prepare a RBCM report for the trustee** – for the annual approval of the ORFR Target and Tolerance (as managed through the ORFR Strategy) and Internal Trustee Entity Capital Target (as managed through the trustee's Capital and Dividend policy) that will apply for the next 12 months unless reviewed earlier by virtue of a review trigger.

2 Gorst, T., Dang, V., Burgess, M., Hassan, T., Abbasi, B. (2020.) Using Operational Risk Scenarios to Calculate an Internal Risk Based Capital Position.

We illustrate how this might be applied in Figure 1 below.

Figure 1 – Illustrative Comparison of Trustee Minimum Capital Requirement Against Internal Capital Target to Inform Trustee Balance Sheet Risk



6.2 Example 2 – Ensuring Availability of Financial Capital and Contingent Funding Sources to Meet Most Regulatory Fines

The changes to sections 56 and 57 of the SIS Act now require regulatory fines to be met other than through superannuation fund assets.

A trustee must assess the level of financial capital (or contingent access to capital) to meet regulatory fines if/when they occur and prioritise how these sources of capital would be applied should fines be incurred.

A trustee's assessment will typically begin with analysis to understand the potential exposure to a regulatory fine. This should take into account the effectiveness of the incumbent control environment to mitigate the compliance breaches that might lead to a regulatory fine. Subject to data availability (which may need to be built up over time), this analysis can be used to deduce a potential loss distribution. This will show that there are some extreme loss situations (e.g. a very large AUSTRAC fine) which are very unlikely to occur, but which would have material consequences for the trustee, and possibly require a recovery plan.

The trustee can then consider its risk appetite as set out in its risk appetite statement when determining the magnitude of regulatory fines for which it wants sufficient financial or contingent capital in place to cover payment. This analysis would help not only plan for how capital or contingent sources would be prioritised to meet fines, but also test the strength of contingent sources of capital under different regulatory fine scenarios. Where sources are limited, the analysis might lead to the trustee sourcing trustee entity capital in advance of any regulatory fine by levying a trustee fee to members of the superannuation fund. Alternatively, where there is concern about the limited utility of particular sources, the trustee entity can take proactive steps to increase their utility. For example, proposing amendments to legal provisions making explicit the circumstances in which shareholder capital can be called upon, or a benchmark review of a third-party supplier.

There will likely be some extreme loss situations which the trustee entity cannot realistically cover by its capital requirements without impacting on long-term member outcomes. The potential consequence of an extremely large regulatory fine occurring would be the insolvency of the trustee entity, and its replacement by an alternate trustee to govern the superannuation fund.

Table 3 provides an example of how financial capital and contingent funding sources might be prioritised under a regulatory fine scenario where the trustee has been fined.

As an example, where a regulatory fine is issued as a result of a third-party supplier failure, a review of contractual arrangements would reveal the extent to which recourse might be available from that supplier to meet the cost of a regulatory fine.

Table 3 – Example of Prioritising Capital, Reserve and Contingent Structures to Meet a Regulatory Fine Issued to a Trustee Entity

Structure	Structure Available?	Priority
RSE Fund Reserves – General		
General or Administration Reserves	N – prohibited under s56 of SIS Act	–
RSE Fund Reserves – Specific		
DB Reserve	N – prohibited under s56 of SIS Act	–
Self-insurance Reserve	N – prohibited under s56 of SIS Act	–
ORFR Strategy (in RSE)	N – prohibited under SPS114	–
RSEL Trustee Entity Capital		
ORFR Strategy (in RSEL)	N – prohibited under SPS114	–
Working Capital	Y – but noting the potential impact to RSEL solvency	7
Retained earnings (dividends withheld)	Y	5
Unexpected Loss or Strategic Capital	Y	4
Free Capital	Y	3
Contingent Capital (to RSE or RSEL)		
Shareholder capital injection	Y	6
Claim against a third-party supplier	Y – if the third party has accepted responsibility	1
Third-party insurance policy on members	N/A	–
Third-party insurance policy on RSEL and Director risks	Y – if loss is covered	2
Deducting from member balances (fully disclosed) after the fine has been issued for the purpose of paying that fine	N – prohibited under s56 of SIS Act	–
Deducting from member balances (fully disclosed) before any fine has been issued for the purpose of raising a Trustee reserve to meet regulatory fines	Y	N/A

More broadly, there are other extreme loss situations outside of regulatory fines, where it is appropriate for a trustee to assess the level of financial capital (or contingent access to capital) and prioritise how these sources of capital would be applied. This exercise will assist trustees to develop a financial contingency plan under APRA's proposed new requirements in Draft CPS 190 and will help to identify available financial resources to execute actions to resolve a financial crisis under Draft CPS 900.



7. Conclusion

RBCM is developed on a foundation of a sound understanding of a trustee's risk profile, financial capital and reserves and contingent funding structures.

Whilst the superannuation industry has traditionally been less sophisticated than other APRA regulated industries in how it undertakes RBCM, particularly for smaller industry participants, incumbent frameworks have generally met the needs and expectations of the industry. The superannuation industry has been assisted through the focus on superannuation reserve management outlined in SPS 160 and SPS 114. Nevertheless, the opportunity exists for the superannuation industry to apply ICAAP components to build on the existing, albeit fragmented, superannuation industry policies and processes and improve how a trustee entity connects risk and capital management to improve member outcomes.

The Working Group invites participants in the superannuation industry to continue the conversation on how to enhance trustee entity RBCM within superannuation and looks forward to any feedback on this Research Paper.

Appendix A:

Table of Typical Superannuation Risks

Table A.1 below provides an illustrative list of typical risks to a superannuation trustee and the superannuation fund for which they are trustee, as developed by Working Group members. References to regulatory requirements are also included.

Table A.1 – Illustrative Superannuation Related Risks

Risk	Description	Reference
Financial Risk ^		
Liquidity Risk ^	The risk of insufficient funds to meet financial commitments to members in a timely manner. Investment liquidity risk may manifest at the individual security level (i.e. an illiquid security), at the overall RSE level (i.e. an illiquid or partially liquid RSE), or within the trustee entity. This risk can be impacted by regulatory events, such as a failure in the YFYS annual performance test.	SPS 530
Insurance Risk ^	The risk that claim payments promised to a member are not paid on time or in full, or that uncompetitive insurance premium rates were secured (leading to erosion of member's fund balances).	SPS 250
Investment Governance Risk ^	The risk of inadequate governance resulting in inappropriate or negligent management of investments by the business.	SPS 530, SPS 114
Market Risk	The risk that the change in market rates and prices will have an adverse impact on investment returns.	SPS 530
Concentration Risk	The risk associated with losses to members arising due to an undiversified portfolio with excessive exposure to certain assets.	
Counterparty Risk	The risk that the other party in a financial product transaction will fail to fulfil their commitments.	
Balance Sheet Risk (RSEL Only)	The risk that there is insufficient capital on the balance sheet resulting in an inability to meet day-to day (working capital) requirements, and/or triggering a reportable breach of capital requirements to a regulator (e.g. in relation to ASIC RG166 requirements).	SPS 114 (RSEL held ORFR), ASIC AFSL requirement
Scale Risk	The risk of reduced economies of scale resulting in significant fixed costs spread across a reduced membership base. As an example, scale risk increases for any RSE that fails the YFYS annual performance test. As such, it is a key strategic risk that a trustee will seek to address through its annual strategy and business plan.	SPS 515
Operational Risk ^		
Non-Investment Governance Risk ^	The risk of inadequate governance resulting in an inappropriate decision not in the best interest of members.	SPS 510, SPS 114
Third-Party Supplier Risk ^	The risk arising when service providers and suppliers of material supplier arrangements fail to adequately perform the services as required or arising due to a disproportionate exposure to a supplier.	SPS 231, SPS 114
Business Continuity Risk ^	The risk of material impact to members or business operations arising as a result of not being able to maintain or recover critical business activities in a timely fashion, in the event of a disruption.	SPS 232, SPS 114
Indemnity Claim Risk	The risk that the trustee is subject to a liability created by a claim made against a previously agreed indemnity offered to a third party (e.g. as part of a SFT arrangement with a successor trustee).	
Technology Risk	The risk of damage to IT assets due to inappropriate or unauthorised physical access, inadequate environmental conditions or equipment, inadequate maintenance or failure to update of IT applications.	SPS 114

^ SPS 220 requires that the trustee's Risk Management Framework considers this risk.

Risk	Description	Reference
Operational Risk ^ (continued)		
Cyber Security Risk	The risk of disruption to technology services availability and/or data resulting from security incidents by malicious insider or external attacks. Includes loss or disclosure of confidential data held internally or at a supplier due to malicious insider or external attacks.	SPS 114
Data Loss Risk	The risk of data loss, misuse and disclosure affecting business operations.	SPS 114
Privacy Risk	The risk of members' personal information being inappropriately collected, misused, inappropriately shared, unsafely stored, and inappropriately accessed affecting member privacy obligations.	SPS 114
Fraud Risk	The risk of financial, identity or privacy loss to members or the business as a result of fraudulent activity originating either internally or externally.	SPS 114
Execution Error Risk	The risk of a material impact to members or business operations as a result of operational transaction errors or failed manual controls. Could include a unit pricing error or a tax provisioning error where member balances are allocated based on unitised values.	SPS 114
Model and Data Quality Risk	The risk of a material impact to members or business operations as a result of decisions based on incorrect models or data that is inaccurate, incomplete, inconsistent or misaligned to intent.	SPS 114
People Risk		
Employment Practice Risk	The risk of loss as a result in a failure of employment practices; e.g. costs arising from an unfair dismissal	
OH&S Risk	The risk of loss as a result of an occupational health and safety (OH&S) incident; e.g. costs arising from a sexual harassment issue.	
People, Talent Capability & Engagement Risk	The risk of loss as a result a workforce that fails to meet the required capabilities to run a super fund and deliver long-term outcomes for members. This risk would include the risk of loss of staff members with critical knowledge and skills required to run the fund.	
Social / Compliance Risk		
Conduct (Member Fiduciary) Risk	The risk that poor behaviour by the trustee (including suppliers such as administrators) results in a failure to deliver a promise to members, or a dilution in ultimate member outcomes. This risk is a subset of compliance risk but is managed separately given its importance.	SPS 114
Compliance Breach Risk	The risk that the trustee fails to comply with the law or their own policy requirements, resulting in regulatory action and potential member losses as a result of, and/or from remedying, the compliance failure.	SPS 114
Regulatory Fine Risk	The risk that the trustee is fined as a result of a failure to comply with the law. This risk is also a subset of compliance risk.	SPS 114
Litigation Risk	The risk that the trustee must pay damages to a third party as a result of a loss proven to be incurred by that stakeholder. This includes payments that might be required under a contract due to breach of that contract.	
Strategic Risk ^		
Strategic Positioning Risk	The risk that the trustee fails to develop strategies appropriate to sustainably deliver long-term member outcomes. This includes environmental risks whereby the trustee fails to develop strategies that will help mitigate the effect of climate change on long-term member outcomes.	SPS 515
Strategic Execution / Project and Change Risk	The risk to business operations due to a failure to identify, understand, sequence, appropriately fund or implement change to business operations in an optimal manner. Project and change risk may manifest within individual projects or the collective portfolio of projects affecting business operations.	SPS 515

^ SPS 220 requires that the trustee's Risk Management Framework considers this risk.

Appendix B:

ICAAP and Superannuation RBCM Gap Analysis

ICAAP and Non-Superannuation APRA Regulated Entity RBCM

An Internal Capital Adequacy Assessment Process (ICAAP) is a RBCM requirement on APRA regulated insurance and banking entities. It requires a Board to undertake appropriate analysis to ensure capital resources are commensurate with its risk profile. The ICAAP assesses the risks and capital and outlines a strategy for maintaining adequate capital over time; this includes setting a capital target consistent with the risk profile, risk appetite and regulatory capital requirement. An ICAAP is reported, and subject to ongoing monitoring, by the relevant Board. ICAAP is now a well-developed process within the insurance and banking space in Australia and similar concepts are applied globally.³

The analysis of capital adequacy within ICAAP typically explores possible capital responses (including contingent funding) to risks facing the entity. This is usually performed through business planning and the use of scenario testing.

ICAAP is synonymous with an enhanced level of capital management related disclosure. For example, Australian banks include a summary of ICAAP features and key capital metrics in their Pillar 3 (Risk-based capital) public reporting. For insurance companies ICAAP disclosure to the public is more limited and usually composed of just the capital position (e.g. capital base, and capital requirement and coverage ratio). Often an insurance company or banking entity will use an external credit rating to demonstrate its capital strength to the public.

In addition to ICAAP, insurers and banks are required to prepare a recovery plan which documents potential ways to restore an entity's capital position following a severe stress (i.e. a trigger). Road-testing is usually performed to ensure each recovery option identified can be implemented under stresses and scenarios considered and what are the general applications and limitations of each identified option. A recovery planning exercise can also be considered as part of the RBCM for a Trustee entity.

Assessing Relevance of ICAAP to a Superannuation Trustee Entity

ICAAP is not an APRA requirement for the superannuation industry. Furthermore despite some common risk exposures (e.g. namely operational related), the key risks for licensed entities of banks and insurers (notably credit and insurance risks to which the licensee is primarily exposed) are different to the key risk faced by a superannuation licensee (namely investment related market risk to which members are generally exposed). Despite these differences we concluded that if ICAAP were applied within a superannuation context, it could potentially lead to an uplifted RBCM process to improve clarity on how the risk exposures faced by the fund and trustee can be met by different capital resources (at both the superannuation fund and trustee entity level). This uplift could be used to comfort superannuation fund members on the capital strength of their fund and trustee.

Table B.1 below describes at a high level the intent of the key components of an ICAAP framework, and how this may be of relevance to a typical superannuation trustee. This indicates how the components of ICAAP could potentially be extended to superannuation to help uplift superannuation RBCM. In suggesting this, we acknowledge that the superannuation industry is challenged by a general lack of data which can limit the ability to develop fit for purpose RBCM approaches.

3 Referred to as the Own Risk and Solvency Assessment (ORSA) process in Europe (EIOPA), and the United States (NAIC).

Table B.1 - Key ICAAP Components and Gap Analysis for Superannuation RBCM

ICAAP Component	Intent of Process	Gap Analysis - Superannuation RBCM Uplift Opportunity
RBCM framework overview	Describe the various policies, procedures, systems, controls and personnel that work together in an integrated RBCM framework. Demonstrate how the framework has been developed proportional to the size and complexity of the organisation and covering the key risks the entity is exposed to. Focus on forward looking capital management.	There are currently various superannuation RBCM related policy and regulatory components including the RMF (RAS, RMS), SPS 160 DB Funding Policy, SPS 530 Liquidity Policy, ORFR Strategy, Management of Reserves Policy and RSEL Capital and Dividend Policy. It would be useful for the Board to show how all these components tie together into a single overarching RBCM framework.
Developing RBCM Strategy for ensuring adequate capital over the planning horizon	Articulate RBCM related performance measures, action plans, objectives, strategic goals and ultimate target outcomes to assist the Board in proactively managing delivery of intended RBCM outcomes (over a five-year planning horizon).	Key components of the trustee policy framework could be summarised into an overarching RBCM strategy (designed to protect and enhance member outcomes) that is monitored and managed by the trustee and integrated into the annual strategic and business plan and member outcomes assessment.
Monitoring capital requirements and targets / triggers	Ensure a process is in place to monitor the adequacy of capital relative to targets and triggers in a way that ensures the Board can proactively respond to RBCM challenges.	Trustees already have a need to regularly monitor a variety of capital and reserve targets. The Working Group has noted the opportunity to better integrate RBCM monitoring across the various superannuation related capital and reserve structures.
Stress testing, scenario analysis and recovery planning	Ensure stress testing and scenarios are used to test the robustness of the RBCM strategy, including the appropriateness of any recovery or contingency plans to address potential high impact events.	Stress/scenario testing is already an important technique for testing the sufficiency of the ORR and DB Reserves. These approaches could be extended to assess other capital management challenges (e.g. regulatory fines) and the appropriateness of contingency plans in place.
Reporting on the ICAAP and outcomes	Ensures periodic reporting to the Board on progress in delivering the overall RBCM Strategy, extent to which capital settings remain within Board risk appetite and Board actions required.	A superannuation trustee Board currently receives regular reporting across key capital and reserves, albeit often in a somewhat disparate way.
Capital impacts of material risks not covered by the Prudential Capital Requirement (PCR)	Ensure analysis on those risks identified that are not adequately covered by capital, to enable a Board to determine if they are comfortable (within risk appetite) and if not what actions the Board needs to take to move back to within risk appetite.	The forthcoming section 56 changes are an example of where a risk may not be covered by incumbent capital, reserves or contingent structures. A process to ensure such 'mismatches' between capital and reserves can be proactively considered and addressed by a superannuation Board as and when they are identified is important.
ICAAP Summary Statement	A point-in-time summary description of the capital assessment and management processes of the regulated institution. It serves as a roadmap to the ICAAP that allows the Board and APRA to understand the capital assessment and management processes of the institution and help ensure both the Board and APRA can understand the capital management process of the institution.	There is a need for the trustee and APRA to have a holistic view of all the RBCM related processes (RMF, ORFR strategy, etc.) set in place to meet various risk and capital management requirements impacting a regulated RSE and trustee entity. A summary statement or a RBCM framework document can provide a snapshot of this.

Glossary – Key Terms

AFSL	Australian Financial Services Licence
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities & Investments Commission
AUSTRAC	Australian Transaction Reports and Analysis Centre
Draft CPS 190	APRA Prudential Standard 190: Financial Contingency Planning
Draft CPS 900	APRA Prudential Standard 900: Resolution Planning
ICAAP	Internal Capital Adequacy Assessment Process
ORFR	Operational Risk Financial Requirement
ORR	Operational Risk Reserve
RBCM	Risk-based capital management
RG 166	ASIC Regulatory Guide 166 Licensing: Financial Requirements
RMF	Risk Management Framework
RSE	Registrable Superannuation Entity
RSEL	Registrable Superannuation Entity Licensee
SIS Act	Superannuation Industry (Supervision) Act 1993
SPG 114	APRA Prudential Practice Guide 114: Operational Risk Financial Requirements
SPG 220	APRA Superannuation Prudential Guide 220: Risk Management
SPG 515	APRA Prudential Practice Guide 515: Strategic and Business Planning
SPS 114	APRA Superannuation Prudential Standard 114: Operational Risk Financial Requirement
SPS 160	APRA Superannuation Prudential Standard 160: Defined Benefit Matters
SPS 220	APRA Superannuation Prudential Standard 220: Risk Management



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