Strengthening Financial Resilience in Superannuation

SuperRatings' Submission

May 2024

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1. Executive Summary

SuperRatings would like to thank APRA for providing us with the opportunity to deliver this submission in response to the consultation on “Financial resources for risk events in superannuation: Operational risk financial requirement”, which seeks feedback and comments on APRA’s proposed amendments to SPS 114 and the guidance supporting it, Prudential Practice Guide SPG 114 Operational Risk Financial Requirement (SPG 114), to:

- clarify the purpose of the ORFR;
- introduce a clear and direct relationship with CPS 230;
- widen the range of uses for the ORFR; and
- amend the notification requirements to facilitate use of the ORFR.

SuperRatings is a research and ratings firm, which has been assessing and rating superannuation funds for more than 20 years. Given SuperRatings’ background in superannuation, we are well placed to provide input on the amendments posed by the consultation.

Due to the importance of sound management of members monies across the industry whilst also protecting members in the event of a large scale operational risk event in a fair equitable way, we have also engaged with peers during this process as we feel it is imperative that there is a reserving mechanism that is well-aligned to enhancing long term member financial outcomes, supports innovation within appropriate guardrails and builds upon the benefits realised from the existing framework.

Whilst we welcome the proposed changes which are expected to better position super funds to use the ORFR to manage the impact of disruption and smooth operational risk related losses fairly across different cohorts of beneficiaries, we don’t believe that the current mechanism of funding ORFR is optimised when viewed through a lens of equity or members best financial interest. This is best exemplified by those members who are exercising choice and moving between funds. In this scenario, these members will have left their ORFR contribution behind for others to potentially benefit from – perhaps even having to contribute again on arrival into their new fund.

Our primary concern with the current ORFR framework is the embedded lack of equity and portability. The ORFR reserve provides members with no direct financial benefit and the member gets no share of the reserve on transition to pension or if they change/leave funds. Another concern with the current framework is the complications that can arise during the fund merger process, where the go forward fund may need to top up its ORFR reserve levels and this serves as a point of friction in the merger process.

SuperRatings does not have a particular view on whether APRA’s maintenance of the existing guideline target amount of 25 bps of FUM is the right amount, although we note this is approximately 9 months of operating expenses for the median fund we track. This should also be considered in conjunction with other reserves being held by funds. Whilst we believe that superannuation funds undertake some analysis of their positions on whether the target amount of 25 bps is appropriate, we note that most funds retain 25 bps as their target. As the industry continues to grow, ORFR reserves have grown from an estimated $2.1 billion at the time of introduction of ORFR requirements to over $6 billion, held outside of members accounts, and of which the majority has been member funded. During this period, only a small portion of this amount has been released from ORFR reserves to meet operational losses.

As the industry matures and we see robust competition across the market, we believe that reserves, their size and their permitted uses would benefit from greater clarity. Additionally, while the ability to access these reserves must be maintained, a competitive and dynamic system would benefit from the ability to staple reserves to the member as they move between funds. Currently, there is an implicit disincentive to exercising choice as members may lose their contributions to reserves when they leave the fund, which could be remedied to provide a transparent and direct financial benefit to members.

SuperRatings has undertaken significant research and engagement with the industry and APRA about the need to promote member equity and portability of ORFR reserves. Through our work, we believe there is a viable path to allow portability and deliver a more direct and explicit benefit to members. It is our view that super funds should be encouraged to optimise the benefits of ORFR in members best interest, and that any processes to facilitate this should be encouraged. SuperRatings would encourage APRA to promote the portability of ORFR reserves to remove any disincentive for members to change funds.

Recognising the need for the superannuation industry to constantly innovate, SuperRatings has worked to develop a solution, ORTC Protect, to address these key limitations of the current framework. This means there is a clear and present opportunity to unlock this benefit for members and facilitate the sustainability of the superannuation industry by reducing friction points in the merger process. SuperRatings has done this as a proud member of the Lonsec Group, ensuring that the solution is robust and institutional grade.

Once again, SuperRatings would like to thank APRA for the opportunity to prepare a submission to this consultation. Feel free to contact any of the following should you have any questions or require further information:

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2. About SuperRatings

SuperRatings, a member of the Lonsec Group, is an independently owned superannuation research company providing data analysis, analytics and insights services and product benchmarking to the superannuation industry. SuperRatings prides itself on providing impartial services to our clients and their members, therefore our ratings methodology includes all superannuation funds, and we limit the ratings percentile bands of funds to ensure our assessment remains independent. We actively promote engagement, education and ownership of superannuation through the provision of:

- Research Analysis;
- Ratings;
- Insights Services;
- Product Reviews;
- Benchmarking; and
- Opinion.

Since its inception, SuperRatings has comprehensively reviewed hundreds of Australia's largest superannuation funds and service providers. SuperRatings currently maintains detailed information in respect of 400 superannuation products, incorporating MySuper, Choice and Pension products.

We believe we offer the most extensive industry coverage accounting for over $1.35 trillion in funds under management and 22 million member accounts. This allows us to understand the various costs, fees, products, services and performance of superannuation funds and benchmark these against the broader market.

3. Response to submissions

3.1. Baseline+ model

APRA's earlier proposal to introduce a Baseline+ model with two components: the baseline component and the operational risk component received mixed feedback during initial round of submissions.

SuperRatings supports APRA's latest approach for addressing concerns raised on the concept of the Baseline+ model which sought to adopt a more sophisticated risk-based approach to the management of operational risk financial resources, informed by an RSE licensee's risk profile and risk appetite.

We believe the operational risk component of the Baseline+ model has been addressed through the expansion of allowable uses of the ORFR as well as affording funds a mechanism to put a case forward for holding a reduced amount of ORFR reserves, without placing additional time and cost burdens on funds to undertake a detailed risk assessment to determine an appropriate amount of ORFR reserves.

3.2. Allowable uses

Since 2013 APRA, through SPS114, has required all regulated funds to have at least one reserve, the operational risk financial requirement (ORFR). More recently we have observed a significant number of funds establish trustee capital reserves in response to amendments made to Section 56 of the Superannuation Industry Supervision (1993) act. However, funds also have significant flexibility to create and manage reserves for a range of purposes as there are few clearly defined guidelines for when and how it is appropriate to create a reserve.

As the risks faced by funds continue to evolve, we are observing an increasing number of reserves being created as funds seek to address a range of risk and regulatory concerns. We believe it is important to have clarity on the purpose, appropriateness and size of reserves held by funds such that we have been tracking a range of common reserves held by funds.

Types of Reserves

- General Reserve 58%
- Insurance Reserve 37%
- Trustee Capital Reserve 17%
- Investment Reserve 15%
- Administration Reserve 14%
- Other 26%

In addition to the ORFR over half of funds maintain a general reserve, while 37% of funds have a reserve related to insurance. A smaller but still significant 17% of funds have established a trustee capital reserve, while 15% have an investment related reserve and 14% have an administration related reserve. Over a quarter of funds have a reserve designated for another purpose.

To better understand the impact on member balances of funds holding these reserves, we have analysed the value of some of the most common reserves of most funds across the industry, with the results summarised in the table below as at 30 June 2023:

Reserve Values (SuperRatings data)

Reserve	Median $ Value	Median % of Assets	Total $ Reserves
Operational Risk Financial Requirement	$41M	0.25%	$5,864M
General Reserve	$29M	0.16%	$4,424M
Insurance Reserve	$5M	0.02%	$572M
Trustee Capital Reserve	$10M	0.03%	$119M

We estimate there is approximately $11 billion held by funds in reserves across the industry as at 30 June 2023. Slightly over half of this amount is from the required ORFR, while general reserves are estimated to be worth just over $4.4 billion.

With the size and complexity of reserves growing, funds need to be reviewing the appropriateness of each of the reserves they hold, with consideration given to why they were created, how they are being used and their alignment with members' best financial interest. Where funds lack conviction that current reserve values and strategies are optimal, we encourage them to actively manage the size of and strategy for the reserve to ensure the significant level of assets held in reserves are being used in a way that maximises member outcomes in an equitable way.

Consistent with our earlier comments related to the relatively few instances that ORFR reserves have been called upon since inception of the framework, SuperRatings supports APRA's proposed expansion to the allowable uses of the ORFR to a wider range of circumstances related to managing the financial impact of operational risks that relate to an RSE, provided any replenishment of reserves is undertaken in a fair and equitable way that promotes all members best financial interests.

We understand these allowable uses to include items such as; remediation activities, costs associated with operational risk prevention, managing disruption, executing business continuity plans and supporting an orderly exit from a service provider agreement in response to an operational risk incident.

Given this proposed increase in the allowable uses of ORFR reserves, we see an opportunity for funds to review other reserves being held to ensure that members money is not being held aside in reserves that could potentially be used for similar purposes.

In terms of the ORFR itself, we remain focussed on the benefits to members of every super fund that has contributed to the ORFR reserves and would encourage funds to demonstrate in all instances how these enhanced allowable uses of ORFR reserves are in the best financial interest of members, particularly those members who have already contributed to the ORFR reserve, but also future members who will likely be levied again to replenish the ORFR to maintain its level at 25 bps.

Within the guidance of allowable uses of ORFR, SuperRatings would propose the funds are encouraged to manage the ORFR reserves such that ORFR reserves provide a direct financial benefit to members or provide benefits to members in the form of reduced administration fees.

SuperRatings has engaged APRA in consultation on a solution for ORFR that provides a mechanism to deliver direct benefits to members and promotes portability. It is our view that superannuation funds should be encouraged to optimise the benefits of ORFR for members best interest, and that any notification or regulatory process to facilitate that be streamlined.

With the increase of Superannuation Guarantee to 12%, and the increase to the contribution cap, members will be levied further to maintain the ORFR reserves, either by way of member funded or indirectly through the cost of Trustee capital. We believe that we have devised a model, ORTC Protect, that can manage that burden on the member whilst maintaining alignment with the purpose of the ORFR reserve.

3.3. Determining the ORFR amount

Assessing the appropriateness of reserve levels is particularly complex, with funds often only providing details of reserve values as part of their annual financial reporting, making understanding movements into and out of reserves and the reasons for these movements difficult to determine. APRA will likely have a clearer view of this.

As part of maintaining the Baseline component of the Baseline+ model, we note that the ORFR target amount of 25 bps is likely to remain as is, at least for the time being. This target amount was first implemented in 2013 when total industry assets were ~$1.62 trillion. Fast-forward to 2024 and total industry assets are approx. ~$3.7 trillion and expected to grow to $10 trillion by 2050, and therefore the increased size of funds may render this target amount to be misaligned with the future needs of the industry (i.e. the highest probable cost of any operational error).

The solution we have devised has been designed with the future needs of ORFR requirements in mind such that it can accommodate increases or decreases in the ORFR target amount in an efficient and equitable manner. Additionally, we believe our solution removes impediments to future fund mergers in that it streamlines how the ORFR reserve levels are managed by the go forward entity.

Having decided not to pursue the risk-based component of the Baseline+ model at this time in favour of the baseline approach, we would welcome ongoing consideration being given by APRA to whether the target amount of 25 bps remains appropriate. Indeed, under the solution we have demonstrated, there is a pathway to enhance the flexibility of any changes to the level over time, as well as supporting orderly mergers in the industry, by turning these reserves into a model that has a direct financial benefit to the member and is portable.

Through our discussions with super funds on the topic of ORFR reserving, and particularly this consultation phase, it is the target amount of ORFR that seems to dominate conversations. Funds are acutely aware of the significant amounts of money being set aside for operational risk events, which is only expected to grow under the current target amount.

Whilst we recognise that having a consistent target amount across the industry levels the playing field as well as minimising the time and cost funds have to spend on assessing and determining a risk based ORFR target amount that is right for them, we share some of the concerns raised by funds and indeed in prior submissions that the current ORFR target amount of 25 bps of FUM is leading to excessive amounts of reserves being held – monies which could otherwise have been distributed to members.

We do note that there are provisions for funds to adopt a lower target amount in exceptional cases, but we expect this to be pursued by a small number of funds at this time. Indeed, it is perhaps unsurprising that the median fund currently holds 25 bps of fund assets in their ORFR in line with the stated target amount.

3.4. Notification requirements

We note that APRA proposes to remove the broad notification requirements, with only the specific requirement on the part of super funds to notify APRA where a fund seeks materially to amend its ORFR target amount to be retained.

We believe this removal of broad notification requirements is likely to promote increased use of the ORFR, and with that the potential for more frequent levies on members as funds will need to replenish their reserves to maintain the target amount of 25 bps. Funds will need to ensure that any replenishment strategy is carried out in a fair and equitable manner that is in the best financial interest of its members.