



Superannuation (prudential standard) determination No. 1 of 2012

Prudential Standard SPS 114 Operational Risk Financial Requirement

Superannuation Industry (Supervision) Act 1993

I, Ross Jones, delegate of APRA, under subsection 34C(1) of the *Superannuation Industry (Supervision) Act 1993* (the Act), DETERMINE *Prudential Standard SPS 114 Operational Risk Financial Requirement* in the form set out in the Schedule, which applies to all RSE licensees.

This instrument commences on 1 July 2013.

Dated: 15 November 2012

[signed]

Ross Jones
Deputy Chair

Interpretation

In this instrument:

APRA means the Australian Prudential Regulation Authority.

RSE licensee has the meaning given in section 10(1) of the Act.

Note 1 It is a condition imposed on all RSE licences that the RSE licensee and, if the RSE licensee is a group of individuals, each of the members of the group, must comply with the RSE licensee law [section 29E(1)(a)]. RSE licensee law includes the prudential standards [section 10(1)]. APRA may direct an RSE licensee to comply with a specified condition of its RSE licence by a specified time if APRA has reasonable grounds to believe that the RSE licensee has breached the condition [section 29EB]. A failure to comply with a direction may lead to cancellation of the RSE licence [section 29G] and may be an offence attracting a penalty of 60 penalty units [section 29JB].

Schedule

Prudential Standard SPS 114 Operational Risk Financial Requirement comprises the 8 pages commencing on the following page.



Prudential Standard SPS 114

Operational Risk Financial Requirement

Objectives and key requirements of this Prudential Standard

This Prudential Standard establishes requirements for an RSE licensee to maintain adequate financial resources to address losses arising from operational risks that may affect registrable superannuation entities within its business operations.

The Board of an RSE licensee is ultimately responsible for ensuring that it holds, and has unfettered access to, financial resources in the form of operational risk reserve(s), operational risk trustee capital or a combination thereof to meet the target amount of financial resources that the RSE licensee determines is necessary to respond to these losses (ORFR target amount).

The key requirements of this Prudential Standard are that an RSE licensee must:

- have a documented strategy that sets out the RSE licensee's approach to determining, implementing, managing and maintaining the ORFR target amount;
- have suitable policies and procedures to manage the financial resources held to meet the ORFR target amount;
- determine a tolerance limit below the ORFR target amount that, if financial resources held to meet the ORFR target amount were to breach this limit, would require the RSE licensee to notify APRA and implement a replenishment plan; and
- ensure that the financial resources held to meet the ORFR target amount are only used to address an operational risk event or to ensure that the ORFR target amount remains at an appropriate level.

Authority

1. This Prudential Standard is made under section 34C of the *Superannuation Industry (Supervision) Act 1993* (SIS Act).

Application

2. This Prudential Standard applies to all registrable superannuation entity (RSE) licensees (RSE licensees) under the SIS Act.¹
3. All RSE licensees must comply with this Prudential Standard in its entirety, unless otherwise expressly indicated.
4. The requirements of this Prudential Standard apply for the purposes of section 52(8)(b) of the SIS Act.
5. This Prudential Standard commences on 1 July 2013 (effective date).

Operational risk financial requirement

6. For the purposes of this Prudential Standard, an ‘operational risk’ is the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. This definition includes legal risk but excludes strategic and reputational risk.
7. For the purposes of this Prudential Standard, an ‘operational risk event’ is an operational risk that has:
 - (a) materialised; and
 - (b) caused one or more beneficiaries in an RSE to sustain a loss, or to be deprived of a gain to which they otherwise would have been entitled, in relation to their benefits in that RSE.
8. An RSE licensee must determine a target amount of financial resources to address the operational risks of the RSE licensee’s business operations.² This target amount must reflect the size, business mix and complexity of the RSE licensee’s business operations and, at a minimum, include:
 - (a) an amount that the RSE licensee determines is necessary to address operational risks that it has identified in its risk management framework having taken into account the RSE licensee’s risk appetite and appropriate

¹ For the purposes of this Prudential Standard, ‘RSE licensee’ has the meaning given in section 10(1) of the SIS Act.

² For the purposes of this Prudential Standard, an ‘RSE licensee’s business operations’ includes all activities as an RSE licensee (including the activities of each RSE of which it is the licensee), and all other activities of the RSE licensee to the extent that they are relevant to, or may impact on, its activities as an RSE licensee.

risk mitigations and controls.³ This amount must reflect any uncertainty in the scale of losses; and

- (b) an additional amount that the RSE licensee determines is required for operational risks that have not been specifically identified in its risk management framework.

For the purposes of this Prudential Standard, the target amount determined in this paragraph is referred to as the operational risk financial requirement (ORFR) target amount (ORFR target amount) of the RSE licensee.

9. The ORFR target amount must be approved by the Board of the RSE licensee (the Board).⁴
10. An RSE licensee must determine a tolerance limit below the ORFR target amount (tolerance limit) that reflects the level below which the RSE licensee must take action to replenish financial resources held to meet the ORFR target amount. The tolerance limit must have regard to the size, business mix and complexity of the RSE licensee's business operations and be approved by the Board.
11. APRA may require an RSE licensee to⁵:
 - (a) meet an ORFR target amount determined by APRA, within a specified time; or
 - (b) adopt a tolerance limit determined by APRA

if APRA considers that the ORFR target amount or tolerance limit set by the RSE licensee, as relevant, does not appropriately reflect the operational risks of the RSE licensee's business operations.

12. The Board is ultimately responsible for ensuring that the RSE licensee holds, and has unfettered access to, financial resources to meet the ORFR target amount.

RSE licensees that are part of a group⁶

13. Where an RSE licensee is part of a corporate group, and the RSE licensee utilises group policies or functions, the Board must approve the use of group

³ Refer to *Prudential Standard SPS 220 Risk Management* for requirements relating to the risk management framework.

⁴ For the purposes of this Prudential Standard, a reference to 'the Board' is a reference to the Board of directors or group of individual trustees of an RSE licensee and 'group of individual trustees' has the meaning given in section 10(1) of the SIS Act.

⁵ Where this Prudential Standard provides for APRA to require an RSE licensee to meet a specific ORFR target amount or tolerance limit, or otherwise exercise a power or discretion, the power or discretion is to be exercised in writing.

⁶ For the purposes of this Prudential Standard, a reference to 'a group' is a reference to a group comprising the RSE licensee and all connected entities and all related bodies corporate of the RSE licensee, 'connected entity' has the meaning given in section 10(1) of the SIS Act and 'related body corporate' has the meaning given in section 50 of the *Corporations Act 2001*.

policies and functions and must ensure that these policies and functions give appropriate regard to the RSE licensee's business operations.

Financial resources to meet the ORFR target amount

14. The financial resources held to meet the ORFR target amount must be held either as:
 - (a) an operational risk reserve held within an RSE;
 - (b) operational risk trustee capital held by the RSE licensee; or
 - (c) a combination of both an operational risk reserve held within an RSE and operational risk trustee capital held by the RSE licensee.
15. To be eligible to meet the ORFR target amount, an operational risk reserve held within an RSE must:
 - (a) be separately identifiable from member accounts and reserves held in the RSE for other purposes; and
 - (b) provide an unrestricted commitment of financial resources to address losses arising from operational risks in a timely manner.
16. To be eligible to be used to meet the ORFR target amount, operational risk trustee capital must be held in a form that is equivalent to Common Equity Tier 1 capital.⁷

Use of financial resources held to meet the ORFR target amount

17. An RSE licensee may only use the financial resources held to meet the ORFR target amount to make a payment to address an operational risk event or to enable it to meet the requirements in paragraphs 19(h) and (i) inclusive.

ORFR strategy

18. An RSE licensee must have a strategy, approved by the Board, for meeting the ORFR target amount (ORFR strategy).⁸ The Board is ultimately responsible for ensuring the implementation of an RSE licensee's ORFR strategy.
19. At a minimum, an RSE licensee's ORFR strategy must describe:

⁷ Common Equity Tier 1 comprises the highest quality capital elements that fully satisfy all of the following essential characteristics: it provides a permanent and unrestricted commitment of funds; is freely available to absorb losses; does not impose any unavoidable servicing charges against earnings and ranks behind the claims of depositors and other creditors in the event of winding-up.

⁸ Under section 52(2)(i) of the SIS Act, an RSE licensee that holds reserves is required to have a strategy for their prudential management. The requirement to have an ORFR strategy is in addition to the requirement for an RSE licensee to have a general reserving strategy (where reserves in addition to those used to meet the ORFR target amount are held within the RSE).

- (a) the factors that influence the size of the ORFR target amount and the tolerance limit, including amounts that the RSE licensee determines are required for each of the components in paragraph 8;
- (b) whether the RSE licensee will use the method described in paragraph 14(a), (b) or (c) to meet the ORFR target amount and the steps that it takes to ensure that it complies with paragraph 12;
- (c) the processes the RSE licensee will apply to ensure that the requirements in paragraphs 15 and 16 (as applicable) are met on an ongoing basis;
- (d) how the RSE licensee has regard to the requirements of section 52(8)(b) of the SIS Act in relation to each RSE;
- (e) the investment strategy for maintaining any operational risk reserves held to meet the ORFR target amount;
- (f) the process for determining when and how the financial resources held to meet the ORFR target amount can be called upon;
- (g) the process for implementing a replenishment plan in accordance with paragraph 20 (replenishment plan);
- (h) the processes for monitoring and reviewing the adequacy of the ORFR target amount, including the steps to be taken to ensure the ORFR target amount remains at an appropriate level in the event of changes such as:
 - (i) a significant change in the size, business mix and complexity of an RSE within the RSE licensee's business operations; or
 - (ii) the wind-up of an RSE; and
- (i) the process for managing the financial resources held to meet the ORFR target amount in the event that the RSE licensee is wound up.

Shortfall management

20. If the level of financial resources held to meet the ORFR target amount falls below the tolerance limit, an RSE licensee must implement a replenishment plan. The replenishment plan must seek to replenish the level of financial resources held to meet the ORFR target amount within a reasonable period in a manner that ensures that the RSE licensee acts fairly in dealing with beneficiaries.⁹ The replenishment plan must, at a minimum, explain:
- (a) how the shortfall has arisen;
 - (b) the amounts that apply in relation to each RSE;

⁹ For the purposes of this Prudential Standard, a reference to 'beneficiaries' is a reference to 'beneficiaries of an RSE within the RSE licensee's business operations'.

- (c) how the RSE licensee will replenish the financial resources held to meet the ORFR target amount, including the source of funding; and
 - (d) the expected date for the RSE licensee to again meet the ORFR target amount.
21. An RSE licensee's replenishment plan must be approved by the Board prior to implementation.
22. APRA may require an RSE licensee to revise its replenishment plan if APRA considers that the plan does not meet the requirements of this Prudential Standard.

Review and audit

23. An RSE licensee must review its ORFR target amount and tolerance limit annually to ensure that the ORFR target amount and tolerance limit are adequate based on the size, business mix and complexity of the RSE licensee's business operations, and that the ORFR target amount and tolerance limit suitably reflect the operational risks identified in the RSE licensee's risk management framework.
24. An RSE licensee must review the appropriateness of its ORFR target amount and tolerance limit following any material change to the operational risks identified in its risk management framework or the size, business mix and complexity of an RSE within its business operations.
25. An RSE licensee must implement satisfactory internal audit procedures and external audit arrangements to ensure compliance with, and the adequacy and effectiveness of, the ORFR strategy.¹⁰
26. APRA may require the appointment of an appropriate external expert to provide an assessment of, and report on, the adequacy and effectiveness of, the RSE licensee's ORFR strategy. The report must be paid for by the RSE licensee and must be made available to APRA within 10 business days after it has been provided to the RSE licensee.

Notification requirement

27. An RSE licensee must notify APRA, within 10 business days, if:
- (a) it determines the ORFR target amount must be adjusted to ensure ongoing compliance with this Prudential Standard;
 - (b) the financial resources have fallen below the tolerance limit;
 - (c) the RSE licensee becomes aware of an emerging operational risk event, or combination of emerging operational risk events, that would require the

¹⁰ Refer to *Prudential Standard SPS 310 Audit and Related Matters* and *Prudential Standard SPS 510 Governance* for requirements relating to external and internal audits respectively.

use of a material amount of the financial resources held to meet the ORFR target amount;

- (d) the RSE licensee becomes aware that an operational risk event has occurred that it determines may require the use of a material amount of the financial resources held to meet the ORFR target amount; or
- (e) any other RSE licensee-determined material trigger event has occurred that may require the use of financial resources held to meet the ORFR target amount.

Transitional arrangements

28. An RSE licensee must build the financial resources to meet the ORFR target amount within three years of the effective date in a manner that ensures that the RSE licensee acts fairly in dealing with beneficiaries.
29. An RSE licensee must develop a plan for implementing its ORFR strategy and building the financial resources to meet the ORFR target amount (transition plan). The transition plan must, at a minimum, set out:
 - (a) how the RSE licensee will build sufficient financial resources to meet the ORFR target amount; and
 - (b) the expected date for the RSE licensee to meet the ORFR target amount for the RSE licensee's business operations. If the expected date for an RSE within the RSE licensee's business operations meeting the ORFR target amount differs from the expected date for the business operations as a whole, the transition plan must also set out the expected date(s) for each RSE(s).
30. The transition plan must be approved by the Board before it is implemented and at any time it is materially revised. An RSE licensee must submit a copy of the transition plan to APRA within 10 business days of Board approval.
31. An RSE licensee that holds a class of licence that enables it to be trustee of a public offer entity must continue to comply with the obligations imposed by the previous section 29D(1)(g) and section 29DA of the SIS Act¹¹, as in force immediately prior to 1 July 2013, until it has met the ORFR target amount for the first time.
32. An RSE licensee must notify APRA, within 10 business days:
 - (a) when the ORFR target amount is met for the first time;

¹¹ In so complying, the RSE licensee must assume that regulation 3A.04 of *Superannuation Industry (Supervision) Regulations 1994*, and the forms of guarantee approved for the purposes of subsections 29DA(3) and (4) of the SIS Act, as in force immediately prior to 1 July 2013, continue in force. If, immediately prior to 1 July 2013, section 29DA(5) applied to the RSE licensee, the RSE licensee must assume that the written requirements relating to the custody of assets referred to in that subsection, and the RSE licensee's agreement in writing to comply with them, as applicable immediately prior to 1 July 2013, continue to apply.

- (b) if the RSE licensee has formed the view that it is unlikely to be able to meet the ORFR target amount within the original timeframe specified in the transition plan; or
- (c) if there has been a material change to, or deviation from, the transition plan, together with an explanation for the change or deviation.

Adjustments and exclusions

- 33. APRA may, by notice in writing to an RSE licensee, adjust or exclude a specific prudential requirement in this Prudential Standard in relation to that RSE licensee.¹²

¹² Refer to section 34C(5) of the SIS Act.