

Superannuation (prudential standard) determination No. 6 of 2024

EXPLANATORY STATEMENT

Prepared by the Australian Prudential Regulation Authority (APRA)

Superannuation Industry (Supervision) Act 1993, section 34C(1) and (6)

Under subsection 34C(1) of the *Superannuation Industry (Supervision) Act 1993* (the Act), APRA has the power to determine standards (prudential standards), in writing, in relation to prudential matters to be complied with by all RSE licensees of registrable superannuation entities (RSEs). Under subsection 34C(6) of the Act, APRA may, in writing, vary or revoke a prudential standard.

On 11 October 2024, APRA made Superannuation (prudential standard) determination No. 6 of 2024 (the instrument), which revokes *Prudential Standard SPS 114 Operational Risk Financial Requirement* made under Superannuation (prudential standard) determination No. 1 of 2012 and determines a new *Prudential Standard SPS 114 Operational Risk Financial Requirement* (SPS 114).

The instrument commences on 1 July 2025.

1. Background

APRA's mandate is to ensure the safety and soundness of prudentially regulated financial institutions so that they can meet their financial promises to depositors, policyholders and fund members within a stable, efficient and competitive financial system.

APRA carries out this mandate through a multi-layered prudential framework that encompasses licensing and supervision of institutions. APRA is empowered under the Act to issue legally binding prudential standards that set out specific prudential requirements with which APRA-regulated institutions in the superannuation industry must comply. These standards are supported by prudential practice guides which clarify APRA's expectations in respect of the prudential requirements.

SPS 114 sets out requirements for RSE licensees to maintain and manage financial resources to protect beneficiaries and to address incurred or potential losses arising from operational risks that may affect RSEs within its business operations. The operational risk financial requirement (ORFR) is the amount of financial resources maintained by the RSE licensee to respond to these operational risks.

Amendments to the prudential requirements are aimed at ensuring that RSE licensees maintain an appropriate level of funding to address operational risks, that they are better positioned to use the financial resources to meet the ORFR when needed, and that they can manage the impact of disruption and smooth operational risk related losses fairly over time and across different cohorts of beneficiaries.

2. Purpose and operation of the instrument

The purpose of this instrument is to revoke the previous version of the standard and to replace it with a new version.

The key requirements of SPS 114 are set out below, including the amendments required to meet the updated obligations in SPS 114:

1. Operational risk financial requirement (ORFR)

Paragraph 9 sets out an overarching requirement for an RSE licensee to maintain, manage and utilise financial resources to protect beneficiaries from losses due to operational risks that relate to the RSEs within its business operations.

This new provision has been introduced to streamline and clearly set out this key requirement for RSE licensees.

2. ORFR strategy

Paragraphs 10 to 11 outline requirements for an RSE licensee to formulate and give effect to an ORFR strategy and to set out how it will be implemented. Minimum requirements for the ORFR strategy include setting the ORFR target amount and tolerance limit, setting out how the ORFR financial resources can be used and how they will be held, setting the investment strategy for operational risk reserves, the process for implementing a replenishment plan, the review process and the process for managing the financial resources in the event of a wind-up. The Board is required to approve the ORFR strategy and is accountable for ensuring its implementation.

Minor changes have been made so that the ORFR strategy is expressed more broadly, rather than being primarily focussed on the ORFR target amount. Objectives for the ORFR strategy are no longer required to be identified as they are inherently included in the requirements for SPS 114.

3. ORFR target amount and tolerance limit

Paragraphs 12 to 13 outline requirements for an RSE licensee to determine a target amount of financial resources (ORFR target amount) and a tolerance limit (below the ORFR target amount) that reflects the level below which the RSE licensee must take action to replenish the financial resources held to meet the ORFR.

Minor changes have been made to the factors to be considered when determining these amounts, including the addition of the RSE licensee's operational risk profile and risk assessments.

Paragraph 14 outlines that, if APRA considers that the ORFR target amount and/or tolerance limit does not adequately reflect the requirements of SPS 114, APRA may require an RSE licensee to meet an ORFR target amount or tolerance limit determined by APRA.

Whilst unchanged, this paragraph enables APRA to act where it is considered that an RSE licensee is not maintaining adequate financial resources to protect beneficiaries or to address potential losses arising from operational risk events.

4. *Use of ORFR financial resources*

Paragraph 15 sets out the purposes for which the ORFR financial resources may be used. These include addressing operational risks that could reasonably be considered to have caused, or could cause beneficiaries to sustain a loss or be deprived of a gain, to which they otherwise would have been entitled. In addition, the ORFR financial resources may be used to meet the requirements of *Prudential Standard CPS 230 Operational Risk Management (CPS 230)* and to reduce a surplus where they are materially larger than the ORFR target amount.

Changes have been made to permit the broader use of the ORFR financial resources to prevent operational risk, in addition to the existing permitted uses for events that have materialised. In addition, the use of the financial resources now includes a direct link to operational risks as set out in CPS 230.

5. *Access to ORFR financial resources*

Paragraphs 16 to 17 set out how the ORFR financial resources must be held. An operational risk reserve must comprise financial resources that are separately identifiable, unrestricted and readily available to address operational risks. Trustee capital must be held in a form that is equivalent to Common Equity Tier 1 Capital.

Minor refinements to add clarity have been made to the wording of these paragraphs.

6. *Shortfall management*

Paragraphs 18 to 20 outline requirements that apply where the ORFR financial resources fall below the tolerance limit. In this circumstance, an RSE licensee is required to implement a replenishment plan to replenish the ORFR financial resources. APRA may require an RSE licensee to revise its replenishment plan.

7. *Review and audit*

Paragraphs 21 to 23 outline requirements for an RSE licensee to review the appropriateness of its ORFR target amount and tolerance limit at least annually, and following a material operational risk incident or material change to the RSE licensee's business operations. An RSE licensee is also required to implement satisfactory internal audit procedures and external audit arrangements to ensure compliance with, and the adequacy and effectiveness of, the ORFR strategy. APRA may require the appointment of an external expert to provide an assessment of, and report on, the RSE licensee's approach to meeting the requirements of SPS 114.

8. *Notification requirement*

Paragraph 24 sets out a requirement for an RSE licensee to notify APRA prior to making a material change to the ORFR target amount.

Changes have been made to simplify the notification requirements to APRA. An RSE licensee is no longer required to notify APRA where the financial resources have fallen below the tolerance limit or where a need is identified for the use of a material amount of the ORFR financial resources. A key purpose for reducing the notification requirements is to reduce regulatory burden and encourage the use of the ORFR for its intended purposes.

Exercise of discretion by APRA

The prudential standards provide for APRA to exercise various discretions. Decisions made by APRA in exercising those discretions are not subject to merits review. This is because these decisions are preliminary decisions that may facilitate or lead to substantive decisions which are subject to merits review.

Under the Act, it is a condition on all RSE licences that the RSE licensee must comply with the RSE licensee law, which includes prudential standards. However, there are no penalties prescribed for a breach of the prudential standards under the Act. Instead, an RSE licensee's breach of an RSE licence condition is grounds for APRA to make further, substantive decisions under the Act in relation to the RSE licensee. Those decisions include, as the case may be:

- (a) to cancel a licence to operate an APRA-regulated superannuation fund (section 29G of the Act); and
- (b) to issue a direction to the RSE licensee, including a direction to comply with the whole or part of a prudential standard (section 131D of the Act).

It is only at this stage that an RSE licensee is exposed to a penalty: loss of licence or 100 penalty units each day if it breaches the direction (section 131DD of the Act).¹ The subsequent substantive decisions of APRA to impose a direction are subject to merits review.

Adjust and exclude discretion

SPS 114 gives APRA the discretion to adjust or exclude a provision of the prudential standard (paragraph 6). The power to create such a discretion is provided for under subsection 34C(5) of the Act. APRA discretion must be exercised in writing.

APRA may exercise this power when it is satisfied that the adjustment or exclusion of a specific requirement for one or more specified RSE licensees will better support APRA in meeting its objectives. For example, the adjustment or exclusion may be necessary to obtain a better prudential outcome than would be the case if the prudential requirement were applied unaltered to a particular RSE licensee. A tailored approach would give APRA comfort that the prudential requirements apply appropriately to protect the interests of beneficiaries. APRA will also take into account other considerations, such as efficiency, competition, contestability, competitive neutrality and regulatory burden, including comparisons with the entity's peer group.

¹ The exception is section 54B of the Act, which provides that breach of a covenant under sections 52 or 52A is a civil penalty provision.

The exercise of APRA's powers is governed by a robust decision-making framework which is documented in APRA's internal policies. This framework supports APRA in fulfilling its mandate by limiting decision making to those senior APRA officers with the appropriate experience and skill to exercise prudent judgement. The framework also requires decision makers to seek advice from internal technical experts.

Exemption from sunseting and disallowance

SPS 114 is exempt from disallowance in accordance with paragraph 44(2)(b) of the *Legislation Act 2003* (Legislation Act) and regulation 9 of the *Legislation (Exemptions and Other Matters) Regulations 2015* (Legislation Regulations) as SPS 114 is an 'instrument (other than a regulation) relating to superannuation'.²

SPS 114 is exempt from sunseting in accordance with paragraph 54(2)(b) of the Legislation Act and regulation 11 of the Legislation Regulations as SPS 114 is 'an instrument (other than a regulation) relating to superannuation'.³

As SPS 114 falls within the above-mentioned exemptions to disallowance and sunseting, APRA does not have discretion to subject SPS 114 to disallowance and sunseting. To mitigate against any adverse impact arising from the above-mentioned exemptions from disallowance and sunseting, APRA undertook consultation on SPS 114 (refer to section 3 below for further details) and will continue to conduct regular reviews of SPS 114.

Incorporation by reference

Under paragraph 14(1)(a) of the Legislation Act, where SPS 114 refers to provisions in primary legislation or a disallowable legislative instrument (e.g. the *Superannuation Industry (Supervision) Regulations 1994*), this is a reference to the primary legislation or disallowable legislative instrument as it exists *from time to time*.

Under paragraph 14(1)(b) of the Legislation Act, where SPS 114 incorporates by reference another superannuation prudential standard determined by APRA under section 34C of the Act, or reporting standard determined by APRA under paragraph 13(1)(a) of the *Financial Sector (Collection of Data) Act 2001*, the superannuation prudential standard and reporting standard referred to is the version that exists *at the time* SPS 114 was determined. A reference to a non-superannuation prudential standard in SPS 114 is a reference to the version that is in force and operation from time to time.

² For paragraph 44(2)(b) of the Legislation Act, section 42 of the Legislation Act (disallowance of legislative instruments) does not apply to a legislative instrument in a class of legislative instrument referred to in an item of the table contained in regulation 9 of the Legislation Regulations. Item 3 of the table contained in regulation 9 of the Legislation Regulations provides that 'an instrument (other than a regulation) relating to superannuation' is a class of legislative instrument not subject to disallowance.

³ For paragraph 54(2)(b) of the Legislation Act, Part 4 of Chapter 3 of the Legislation Act (sunseting of legislative instruments) does not apply to a legislative instrument in a class of legislative instruments referred to in an item of the table contained in regulation 11 of the Legislation Regulations. Item 6 of the table contained in regulation 11 of the Legislation Regulations provides that 'an instrument (other than a regulation) relating to superannuation' is a class of legislative instrument not subject to sunseting.

All documents incorporated by reference in SPS 114 are available on the Federal Register of Legislation.

3. Consultation

On 19 February 2024, APRA undertook a public consultation on proposed amendments to the prudential requirements and guidance for the operational risk financial requirement (ORFR) for RSE licensees. Amendments were proposed to SPS 114 and accompanying guidance in *Prudential Practice Guide SPG 114 Operational Risk Financial Requirement* (SPG 114). The proposals sought to strengthen the financial resilience of RSE licensees and ensure they have ready access to financial resources to respond to, and rectify, the impacts of operational risk.

Prior to the February 2024 consultation, APRA had released two discussion papers, seeking early views from industry on financial resilience in superannuation and proposals for changes to the prudential framework. These discussion papers were released in November 2021 and November 2022.⁴

Eleven submissions were received for the February 2024 consultation (with two of these provided on a confidential basis). Ten non-confidential submissions were received for the November 2021 discussion paper and nine non-confidential submissions were received for the November 2022 discussion paper.

Respondents to the February 2024 consultation were generally supportive of the proposed changes to the draft amended SPS 114 and SPG 114. However, submissions identified some areas for further consideration for APRA, and other areas where greater clarity and additional guidance was requested. Key matters raised in the submissions included:

- The amended SPS 114 and SPG 114 not facilitating a holistic view of capital and reserving frameworks and practices for superannuation entities;
- The APRA guidance on the ORFR target amount being too conservative and, as a result, leading to excessive reserving by RSE licensees, particularly for larger funds, to the detriment of member interests; and
- Ambiguity with the nature of the regulatory engagement required where RSE licensees intended to adopt a bespoke ORFR target amount (below the APRA guidance amount), and the extent of data and analysis required to support an RSE licensee's conclusions.

APRA has taken account of these areas of feedback. In particular, APRA has made appropriate adjustments in relation to the guidance for the ORFR target amount so that the guidance outlines minimum target amount based on an entity's size. In doing so, promoting proportionality.

As a result, APRA has removed the guidance that referred to a need for regulatory engagement and an implication that data and analysis may be required to support an

⁴ The February 2024 consultation, the discussion papers and industry submissions are available here: <https://www.apra.gov.au/strengthening-financial-resilience-superannuation>

RSE licensee's conclusions. The final guidance outlines a clear and simple expectation that applies across the industry, based on entity size (based on funds under management).

APRA has responded to submissions that sought for SPS 114 requirements to be included in a holistic view of capital and reserving frameworks. APRA will not at this time consider SPS 114 requirements within this context, but remains open to considering these views at a later stage.

4. Impact Analysis

The Office of Impact Analysis (OIA) has confirmed that it considers the proposal is unlikely to have a more than minor impact, as APRA expects the proposed changes to have a very modest impact on regulated entities.

RSE licensees will need to review and update their ORFR strategy. As such the OIA advised that the preparation of an Impact Analysis is not required. The most recent changes to the prudential framework are aimed at simplifying the requirements and guidance further and are expected to result in a lower burden on RSE licensees than previously proposed.

5. Statement of compatibility prepared in accordance with Part 3 of the Human Rights (Parliamentary Scrutiny) Act 2011

A Statement of compatibility prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011* is provided at Attachment A to this Explanatory Statement.

ATTACHMENT A

Statement of Compatibility with Human Rights

Prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*

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This Legislative Instrument is compatible with the human rights and freedoms recognised or declared in the international instrument listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011* (HRPS Act).

Overview of the Legislative Instrument

The purpose of this Legislative Instrument is to revoke *Prudential Standard SPS 114 Operational Risk Financial Requirement* made under Superannuation (prudential standard) determination No. 1 of 2012 and replace it with a new version of the prudential standard.

SPS 114 sets out requirements for an RSE licensee to maintain and manage financial resources to protect beneficiaries and to address incurred or potential losses arising from operational risks that may affect RSEs within its business operations. SPS 114 outlines the key requirements for RSE licensees to have ready access to financial resources to respond to, and rectify, the impacts of operational risks.

Human rights implications

APRA has assessed the Legislative Instrument and is of the view that it does not engage any of the applicable rights or freedoms recognised or declared in the international instruments listed in section 3 of the HRPS Act. Accordingly, in APRA's assessment, the Instrument is compatible with human rights.

Conclusion

This Legislative Instrument is compatible with human rights as it does not raise any human rights issues.