Risk Management for Super Funds:

Is it time to focus on operational risk?

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Some new features for the funds

- The post budget environment
  - Time pressure to get ready
  - System issues
  - Communication to members
  - New products
  - New competition
- The post licensing environment
  - Larger funds

Post retirement products

- New challenges
  - Competition
  - Long term or short term horizon?
  - Transaction frequency – the new banks?
  - Access to transactions
  - Costs and structures
  - New risks

Op risk in banking - Laker

- “Operational risk is one of the largest risks now confronting banks. … There is much that can go wrong.”
- “Determining the appropriate level of capital to cover such operational losses is a challenge.”
- “It is difficult to assess the likelihood of particular events occurring and the size of losses that might result.”

Operational risk

- “The risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events”
- Operational risk can be categorised in many ways. Here is one approach
  - Governance
  - Process
  - People
  - Systems
  - External

In super – so what?

- An operational risk “event” in a super fund could lead to the loss of
  - $$$
  - FUM and/or members
  - records
  - staff
  - a third party provider
  - reputation/brand
  - their licence
- Such potential losses are increasingly important in our competitive environment

Examples of governance risks

- Conflict of interest at trustee level
- Failure in the provider selection process
- Inadequate monitoring of providers
- Missing market opportunities
- Lack of succession planning
- Inadequate staff resources
- Inadequate insurance
- Failure to meet licence requirements

Examples of process risks

- Poor performance or failure of providers
- Regulatory or compliance breaches
- Loss of, or damage to, records
- Software or program errors e.g. calculations
- Process errors in operations e.g. unit pricing
- Internal failure to apply policies
  - Note: APRA’s focus on RMPs
- Failure of modelling exercises
  - E.g. new products, strategy development
- Fraud

Examples of people risks

- Professional negligence, misconduct or unethical behaviour
  - client, provider, or in-house
- Poor training
- Human error
- Deliberate in-house "terrorism"
- Employment practices
- Turnover/loss of key people

Example of system risks

- Failure of in-house/third party systems
- Failure of clearing house
- Breakdown of service/information from external sources
- Legacy systems
- Inability to update in time
  - e.g. the new post-budget environment
  - reporting requirements

Example of external risks

- Government decisions
  - Often requires a quick response
- Decisions or attitudes by regulators or courts
- Loss of physical assets e.g. storm, fire, flood
- Pandemic
- Unexpected litigation
- Adverse publicity – direct or collateral

Possible consequences for the fund

- Incorrect contributions; benefit payments; asset allocation; and/or investment returns
- Loss of $$ and members (current & new)
- Higher costs of operations
- Poor service
  - – Delayed benefits, lack of information

➢ Affects the future “life” of the fund

How can funds reduce these risks?

- Identify risk awareness/appetite at Board level
- A clear governance structure
- Known controls and reporting lines
- Known and operating policies and procedures
- Ongoing training and awareness
- A culture of reporting “near misses”
- Introduce Key Risk Indicators
  – people, processes, systems

How does it affect what funds do?

- Use the risk management strategy and policy
- Regular risk management report
  - Reviewed by Board or RMC
- Annual risk report to trustees
  - Review of strategy
- Operational audits
  - Internal and external audits
- Culture
- Relevant insurance e.g. Trustee Liability Insurance

A comment on Trustee Liability Insurance

- Provides protection to the trustees
- Needs to ensure that there is reimbursement to the fund
- Does it cover everything?
  - Excludes fraud by fund staff
  - Excludes poor processes
  - Not a back up "insurance" policy
- Excludes the actions of service providers

What do members expect?

- No loss!
- In a DC environment, “my funds are protected”
- Can we deliver?
  - Not with 100% certainty
- But are there preferred options?

How do we fund op risk "events"?

- There are 3 broad options
  - Capital – like APRA requirements for banks
  - Reserve – available but it needs to be built up?
  - Do nothing – cop the consequences

An op risk reserve for DC funds

- Protects the fund from the uncertainties of unpredictable op risk events
- Protects members' benefits (not 100%)
- Protects the fund's operations and brand
- Provides confidence to members
- Improves equity between members across years but is it fair within a single year?
- Needs disclosure to members

How a reserve can be established

- Build it up gradually over 5 years
  - Note: Reserves already exist in many DC funds
- The reserve can be used when there is a major op risk “loss” to the fund
- It is NOT capital – it can be used!
- How big?

An example

- The objective: say 0.7% of DC liabilities
- Gradually built up with, say a 0.1% reduction each year from investment return over 5 years
- Built up from admin & insurance results
- As the fund doubles in size in 5 years, the reserve could reduce to 0.6% of DC liabilities

Risk Management in Aussie super in 2007

- Super funds are becoming more like other FS institutions
- Risks cannot be eliminated but must be managed
- It requires the involvement of all parties
- The consequences of an "event" needs to be managed
- Member balances need protection from most "events"
- Funds need to consider their position
  - From both members' perspective and the fund's strategy