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## PRACTICE GUIDELINE 499.05

# FINANCIAL CONDITION REPORTING FOR SUPERANNUATION FUNDS

June 2012

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## **1. INTRODUCTION**

### **1.1 Application**

- 1.1.1 This Practice Guideline applies to a Member preparing information, analysis or advice regarding the financial condition of a Fund ("financial condition reporting", as discussed in section 1.3 below).
- 1.1.2 This Practice Guideline applies to both defined benefit and accumulation funds (including pension divisions).
- 1.1.3 This Practice Guideline does not apply to the particular requirements for an actuarial investigation of a defined benefit superannuation fund required under SIS Regulation 9.5 (which are covered by Professional Standard 400 (Investigations of the Financial Condition of Defined Benefit Superannuation Funds)) or any other legislative or regulatory requirements covered by other Professional Standards or Practice Guidelines.

### **1.2 Classification**

- 1.2.1 This Practice Guideline has been prepared in accordance with Council's Policy for Drafting and Developing Practice Guidelines. It must be applied in the context of the Code.
- 1.2.2 This Practice Guideline is not mandatory.
- 1.2.3 Nevertheless, if the Professional Services provided by a Member are covered to any extent by this Practice Guideline, a Member should consider explaining any significant departure from this Practice Guideline to the Principal, and document such explanation.

### **1.3 Background**

- 1.3.1 The financial condition of a Fund is an holistic assessment of that Fund's capacity to meet its current and future obligations to the users of its services and other stakeholders. In a superannuation context, this means the assessment is focused on the capacity of a Fund to fulfil its obligations to the current and future members of that Fund.
- 1.3.2 An assessment of the financial condition of a Fund reflects a number of distinct aspects and their interactions. It depends fundamentally on the relationship between the Fund's assets (the nature and term) and the corresponding liabilities. In a monetary sense, the financial strength – current and future – of the Fund reflects its resilience to future potential adverse circumstances and the quality and nature of its risk management and governance.

- 1.3.3 Such assessments need to be made on a recurring basis to reflect experience and changes in future expected conditions.
- 1.3.4 It is possible to report on single aspects of the financial condition of a Fund, however the omission of the consideration of interactions with other aspects of the Fund's overall financial condition should be explicitly stated (discussed further in section 4.2 of this Practice Guideline).
- 1.3.5 As the obligations to Fund members vary, so do the key aspects of a Fund's financial condition and the assessment of the financial condition of that Fund needs to reflect its particular characteristics. In particular, defined benefit, defined contribution accumulation and defined contribution decumulation structures have differing characteristics and, as such, differing drivers of their ongoing financial condition.
- 1.3.6 The ultimate responsibility for maintaining the financial condition of a superannuation Fund rests with the Board of the Fund. Members may be asked by a Fund's Board (or representative) to prepare reports on some or all aspects of the financial condition of a Fund to assist the Board assess and manage the financial condition of their Fund.
- 1.3.7 Financial condition reporting or financial condition report ("FCR") can provide the Board with valuable insight in their assessment of these risks and consideration of the level of operational risk reserves (or capital) to be held. More broadly, effective financial condition reporting provides the Board with qualitative and quantitative insight into the inherent and residual risks faced by their Fund and the Fund's capacity to withstand adverse conditions.
- 1.3.8 The term 'financial condition reporting' is used in all cases and the term 'FCR' is used when all aspects of the financial condition and their interactions are addressed. Financial condition reporting, as judged appropriate by the Member, should reflect and reference other reporting already undertaken, either by Members or other relevant professional service providers.
- 1.3.9 FCRs are required by legislation (supported by prudential standards issued by APRA and the Private Health Insurance Administration Council) to be prepared for life insurance companies and friendly societies, general insurance companies and private health insurance companies. There are no current legislative or supervisory requirements for financial condition reporting in relation to superannuation funds (except to the extent it is a life insurance product offered by a life insurance company). While not required by legislation, a Member may be asked to prepare an FCR (or one of its components) in order to assist the Board meet their obligations under legislation or APRA prudential standards (for example, Board attestation in relation to scale, operational risk reserves, risk appetite or stress testing).

#### **1.4 Purpose**

The purpose of this Practice Guideline is to guide Members in undertaking financial condition reporting, including preparing FCRs, for Boards of superannuation funds.

#### **1.5 Previous versions**

There are no previous versions of this Practice Guideline.

#### **1.6 Legislation / regulatory requirements**

While there is presently no legislative or supervisory requirement to undertake financial condition reporting or prepare an FCR for superannuation funds, Members should be familiar with current legislative and industry best practice requirements in respect of solvency, risk management and reserves. The Appendix to this Practice Guideline provides a suggested list of items to consider.

### **2. COMMENCEMENT DATE**

This Practice Guideline commences on 1 July 2012.

### **3. DEFINITIONS**

#### **3.1 In this Practice Guideline:**

**'APRA'** means the Australian Prudential Regulation Authority (or its successors from time to time).

**'Board'** means the trustee board of a Fund or its equivalent.

**'Code'** means the Institute's Code of Professional Conduct.

**'Fund'** has the same meaning as the definition of "Superannuation Fund" in section 10 of the SIS Act.

**'Material'** means important or essential in the opinion of the Member.

**'RSE'** means a "Registrable Superannuation Entity" as defined in section 10 of the SIS Act.

**'SIS Act'** means the Superannuation Industry (Supervision) Act 1993 (Cth).

**'SIS Regulations'** means the Superannuation Industry (Supervision) Regulations 1994 (Cth).

**'Specialist Professional'** means any person who is qualified by education, training or experience to provide advice in the relevant area.

- 3.2 A word that is derived from a defined word has a corresponding meaning.
- 3.3 Other capitalised terms used in this Practice Guideline have the same meaning as set out in the Code.

## **4. SCOPE OF AN FCR / FINANCIAL CONDITION REPORTING**

### **4.1 Objective / scope of an FCR**

4.1.1 The objectives of a comprehensive FCR for a Fund are to provide:

- (a) an objective assessment of the financial condition of a Fund, now and in the future;
- (b) an assessment of Material risks facing the Fund, now and in the future; and
- (c) an objective assessment of the adequacy of the Fund's reserves including any operational risk reserve and the processes for utilising and replenishing those reserves.

4.1.2 The scope of an FCR will include the following:

- (a) financial strength assessment (financial condition at the date of review);
- (b) Fund sustainability (expected financial condition in the future);
- (c) actuarial risk review (adequacy and suitability of the risk management framework); and
- (d) stress testing (adverse experience, for example liquidity, unit pricing, other).

The FCR will provide an overall holistic assessment of a Fund's financial condition (including a summary of recommendations and key results) based on consideration of each of the above components.

4.1.3 The components of an FCR are illustrated below:

Holistic Assessment (overview, interactions, recommendations)	
Financial Strength Assessment (financial condition today)	Fund Sustainability (financial condition in the future)
Actuarial Risk Review	Stress Testing

## **4.2 Financial condition reporting – comprehensive vs component versions and reporting over time**

- 4.2.1 Financial condition reporting refers to information, analysis or advice regarding particular items that may affect the financial condition of a Fund. The scope of any financial condition reporting should be set out clearly in the report, along with any limitations on the scope of application of the report.
- 4.2.2 There is currently no requirement for a comprehensive FCR to be conducted containing all of the components mentioned in section 4.1 of this Practice Guideline. Members may be asked to perform one or more components of an FCR in isolation and this Practice Guideline may be used to assist in those circumstances.
- 4.2.3 As mentioned in section 1.3.4 of this Practice Guideline, while it is possible to focus on one component of FCR analysis, it is consideration of the interactions between the different aspects of the Fund that enable a proper holistic assessment of its financial condition. Therefore when undertaking only a single component of the analysis, the analysis should not be referred to (or named) as an FCR but by the name of that component (for example, fund sustainability analysis) together with a comment that this can form part of an FCR when combined with other components.
- 4.2.4 Alternatively, the FCR may be performed as part of a systematic program to examine different components over a period of time (for example, performing different types of stress tests in subsequent years). In these circumstances, the report may be referred to as an FCR.
- 4.2.5 Currently there is no legislated or regulatory requirement for an FCR for a Fund, so there is no minimum timeframe for a Board to commission a new report. However, it is suggested that good practice would be to have a comprehensive FCR prepared at least once every three years (or a three year program to complete the various components).
- 4.2.6 A change in Fund circumstances (for example, a merger), whether proposed or actual, may necessitate a change in the assessment of financial condition and this should be stated in any report.

## **4.3 Defined benefits**

- 4.3.1 An FCR will generally report on the financial condition of the whole Fund including any defined benefits sub plans.
- 4.3.2 While the particular requirements for actuarial investigation of a defined benefit superannuation fund required under SIS Regulation 9.5 are covered by Professional Standard 400 (Investigations of the Financial Condition of Defined Benefit Superannuation Funds) and usually the subject of a separate report, the results of

that investigation would normally be referred to within the FCR and, where possible, incorporated into the FCR.

4.3.3 There are some areas where it is not particularly relevant to consider the defined benefits sub plans (for example, impacts on unit pricing). However, it is important to consider the impact of defined benefits sub plans in the following areas:

- (a) financial strength assessment (discussed in section 5 of this Practice Guideline) – defined benefit surplus or deficits and also the strength of any employer covenant impact on financial condition. An FCR assessment might summarise the financial positions of the various sub plans (for example, if the Fund is a master trust with multiple defined benefit sub plans);
- (b) fund sustainability (discussed in section 6 of this Practice Guideline) – the projected defined benefit assets and cash flow should be incorporated where possible (possibly using the results of the triennial actuarial investigation);
- (c) actuarial risk review (discussed in section 7 of this Practice Guideline) – there are a number of unique financial and operational risks that need to be considered in such a review; and
- (d) stress tests (discussed in section 8 of this Practice Guideline) – these depend on the review undertaken, but defined benefits sub plan results may be important to incorporate (for example, liquidity assessment – particularly if the defined benefits sub plan has been closed for some time and that section is experiencing cash outflows).

#### **4.4 Equity between Fund members**

4.4.1 In each of the different components of financial condition reporting, issues of equity between different groups of Fund members are often present (for example, examining issues in relation to allocating fees between different groups in Fund sustainability analysis or evaluating the reasonableness of approaches to allocating investment return in unit pricing stress tests).

4.4.2 The Member should be prepared to comment on questions of Fund member equity as they arise in the financial condition reporting being performed. The Member should also be mindful of the unique characteristics of different Fund member groups and present separate analysis for different groups (if appropriate).

4.4.3 Different groupings of Fund members include (but are not limited to) defined benefit, accumulation, pensioners, active, inactive, public offer, Fund members who have not made a choice (default) and Fund members who have made a choice, age, gender and occupation.



#### **4.5 Valuation of Fund assets**

In order to complete a number of the components of an FCR, the Member will be required to determine a value of the Fund's assets. Members are reminded of their obligations under the Institute's Professional Standard 404 (Valuation of Superannuation Fund Assets) in relation to the valuation of superannuation fund assets.

### **5. FINANCIAL STRENGTH ASSESSMENT**

#### **5.1 Elements of a financial strength assessment**

5.1.1 Financial strength assessment is a 'point in time' assessment of a Fund's financial condition. This is distinct from the Fund sustainability assessment which considers financial condition into the future.

5.1.2 A financial strength assessment would typically include the following elements:

- (a) reserve (or capital) adequacy review;
- (b) reserve movement analysis (change in financial condition);
- (c) Board financial strength assessment;
- (d) service provider strength assessment;
- (e) recognition of Material risks;
- (f) impact of business strategy; and
- (g) impact of Fund member expectations / guarantees.

#### **5.2 Reserve (or capital) adequacy review**

5.2.1 Reserves (and capital) represent the availability of financial resources above the level of Fund members' benefits. The level of reserves is a measure of solvency and assessing their adequacy is an important element in assessing financial condition.

5.2.2 The review would identify all of the different types of reserves (or capital) held by the Fund and their magnitude.

5.2.3 The review would typically include:

- (a) identifying the Board's reserving policy document and providing comments on the reserving (or capital) policy;

- (b) commenting on the appropriateness of the Board's target level of reserves or capital (and, in particular, the amounts held in respect of any operational risk financial requirement and reserves in relation to insurance). Members may also comment on the appropriateness of any tolerance limits set by the Board;
  - (c) reviewing the Fund's current position against any target levels of reserves or capital (including any operational risk financial requirement) and also against any tolerance limits;
  - (d) if relevant, considering the adequacy of the Board's replenishment plan in respect of any shortfall in any operational risk financial requirement;
  - (e) considering the reserves and reserving policy against any APRA prudential standards on operational risk financial requirements;
  - (f) considering the reserves and reserving policy against any industry good practice guidance, any industry surveys on levels of reserves or capital (including any operational risk financial requirement) and level of financial resources held by similar entities in other industries (for example, life insurance companies and friendly societies); and
  - (g) commenting on the appropriateness of the investment of reserves (or capital) and the nature of their administration / segregation.
- 5.2.4 In considering the appropriateness of the target level of reserves or capital (including any operational risk financial requirement) and any associated tolerance limits, Members will typically consider the components of the financial condition reporting, in particular the actuarial risk review, other elements of the financial strength assessment and the results of any stress testing.
- 5.2.5 Modelling may be undertaken using appropriate risk modelling techniques to determine an appropriate level of reserves (or capital) considering the risk appetite of the Board. Models may be constructed using assumptions based on: the experience of the Fund; broader experience (the pooled experience of multiple Funds); or using judgment based on other relevant experience.
- 5.2.6 Where reserves are below the target level of reserves, the analysis would consider the means for replenishing those reserves and the time frame for doing so. Fund projections (in the Fund sustainability analysis) could be used for this purpose. These projections may be used to recommend a replenishment plan to the Board. Alternatively, this analysis may be used to comment on the adequacy of the Board's existing replenishment plan.

### 5.3 Reserve (or capital) movement analysis

5.3.1 The reserve movement analysis would generally take the form of a “whole Fund reconciliation”. This reconciliation is useful to identify the key sources of reserves and also to identify any issues with administration and unit pricing processes. Further, the increase (or decrease) in reserves can be thought of as the profit and loss of the Fund’s operations (this analysis is important to consider whether the pricing basis was adequate).

5.3.2 Reserve movement analysis involves comparing the movements in net assets, vested benefits and the balancing item being the movement in reserves. A possible format is set out below:

	Vested Benefits	Reserves	Fund Net Assets
Opening balance			
Inflows			
Outflows			
Closing Balance			

5.3.3 The inflows and outflows would typically be split according to the different elements (for example: for inflows – contributions, investment return; and for outflows – benefit payments expenses).

5.3.4 Vested benefits may be split between those Fund members in-force at the end of the year and those who have left during the year. Judgment is often required in attributing fees and tax deducted as part of the unit pricing process. Other elements that are of interest include the cost of “member protection” and the investment return allocated to each investment option.

5.3.5 Information for this exercise is typically derived from the Fund’s financial statements (net assets), the Fund’s administration system (vested benefits) and the Fund’s custodians (including breakdown of tax, expenses and investment return).

5.3.6 The movement in reserves should be split into the different types of reserve held (for example, operational risk reserve and general operating reserve).

5.3.7 Members would typically comment on any Material changes during the year and on the variances of the actual movement in reserves for the year against any budget for those reserves.

### 5.4 Board financial strength assessment

In commenting on Board financial strength, the Member would typically consider:

- (a) the amounts of discretionary capital held outside the reserving / capital policy; and
- (b) the professional indemnity cover held (levels of sum insured, excesses, claims experience and adequacy considering any minimum requirements under an Australian Financial Services Licence).

### **5.5 Service provider financial strength assessment**

5.5.1 A key issue when considering the financial condition of a Fund is to review the arrangements with the service providers as both a source of risk and a source of financial strength.

5.5.2 In commenting on service provider financial strength, the Member would typically:

- (a) identify all of the Material service providers; and
- (b) for each such provider, consider (and to the extent possible report on):
  - (i) contractual limitations on liability;
  - (ii) levels of professional indemnity insurance held by the provider;
  - (iii) level of capital held (or market capitalisation); and
  - (iv) credit rating.

5.5.3 It is acknowledged that the assessment of a service provider's financial strength is a substantial and difficult task in its own right, and that necessarily the Member may need to rely on third party information or external experts. It is acceptable for a Member to simply present the facts considered and not present a conclusion or forecast about the service provider's financial viability (although the Member should also note the limitation of the assessment in the report).

### **5.6 Recognition of Material risks**

5.6.1 The key results of the actuarial risk review would normally be referred to in an assessment of financial strength.

5.6.2 Risks of a Material nature should be identified and the likelihood and size of any residual risks (after controls are applied) should be quantified and placed in the context of the Fund's financial resources (such as reserves).

## **5.7 Impact of Fund business strategy / business plan**

- 5.7.1 In commenting on the impact of Fund business strategy / business plan, the Member should consider the Board's stated strategy (strategic goals articulated as part of Board business planning / strategy sessions).
- 5.7.2 Business strategy may also impact on the future levels of reserves and, therefore, the results of the Fund sustainability assessment (if available) should be considered at future Board planning and strategy sessions.
- 5.7.3 If the Fund is a corporate superannuation fund, the Member should also consider the impact of the sponsoring employer's superannuation strategy.

## **5.8 Member expectations / guarantees**

- 5.8.1 In assessing the financial strength of a Fund, the Member should consider and comment on the strength of any representations made to Fund members about the Fund and its products including any promises of a financial nature and including (but not limited to):
- (a) any guarantees in relation to investment return; or
  - (b) any Material representations about target investment return or target levels of risk; or
  - (c) any representation about changes in future insurance premiums; or
  - (d) any representations about longevity risk or levels of retirement income.
- 5.8.2 In assessing the level of reserves in a Fund, the Member should consider whether or not the liability for Fund members' benefits has been valued appropriately and whether or not the reserves held are adequate considering the additional risks (including asset liability resilience reserves).

## **6. FUND SUSTAINABILITY ASSESSMENT**

### **6.1 Elements of Fund sustainability assessment**

- 6.1.1 A Fund sustainability assessment is important for assessing the expected future financial condition of a Fund (including the future adequacy of reserves), assessing a Fund's future liquidity requirements (and risks) and also assessing the risks to the Fund's financial condition as a result of any inadequacies in the Fund's fees structure.
- 6.1.2 Fund sustainability assessment can assist the Board to consider the question of whether the Fund (and its products) have sufficient scale.

6.1.3 A Fund sustainability assessment would typically include the following elements:

- (a) projection of the Fund's assets, cash-flow and membership;
- (b) fee sustainability analysis / Fund scale;
- (c) projection of reserves; and
- (d) an appropriate range of stress tests.

## **6.2 Data**

6.2.1 Generally, an analysis of Fund member data would include a Fund member reconciliation to establish the nature of membership flows within the Fund. This would include summarising flows to and from each of the states of Fund member activity (for example, active, inactive and pension) and to and from each of the product categories (for example, employer, personal, defined benefit and default division versus a choice division).

6.2.2 It is useful to clearly define an "inactive" Fund member (for example, a Fund member who has not received an employer contribution for over three months) and not simply to rely on the Fund member's administration record status.

## **6.3 Fund member behaviour analysis**

6.3.1 Fund member behaviour analysis is used to help determine appropriate assumptions and also to identify potential areas of emerging risk.

6.3.2 The analysis would typically include a Fund member profile summarising key characteristics of the Fund membership from a financial and demographic perspective (for example, member grouping and account size).

6.3.3 An analysis would typically include the following elements:

- (a) rates of Fund members leaving the Fund;
- (b) rates of Fund members joining the Fund;
- (c) rates of Fund members becoming inactive and rates of Fund members becoming active again;
- (d) information about contribution levels (for example, voluntary contributions and rollovers);
- (e) information about pensioner behaviour (rates of drawdown and take up rates); and

(f) investment switching behaviour.

6.3.4 Results may be segmented based on available criteria or, where there are significant differences in behaviour experienced, between different groups (gender, age, category and size of benefit).

6.3.5 An analysis of the concentration of Fund member balances can be useful in identifying risks associated with the departure of key groups in the Fund (and also potentially examining the behaviour of that key group).

6.3.6 An analysis of the death and disability experience and rates of changing of voluntary insurance cover may also be undertaken as part of this member behaviour analysis. If this analysis is not undertaken, assumptions for Fund projections may be drawn from general industry experience or derived from the Fund's own insurance premiums.

#### **6.4 Assumptions for projection**

6.4.1 Assumptions will usually be determined considering the recent experience of the Fund, the views of the Fund's executives and the Board, the experience of other Funds and applying judgment in relation to future circumstances.

6.4.2 Alternative assumptions are typically used to understand the potential impact of different scenarios to assist risk management.

6.4.3 Assumptions should reflect the current business strategy. The Member may consider the impact of possible changes in business strategy in the results.

#### **6.5 Projection analysis**

6.5.1 Results of a projection analysis would typically include:

(a) level of assets;

(b) cash flows (including contributions and benefit payments);

(c) Fund membership numbers (including number of new Fund members and exits);

(d) amount of fee revenue generated from Fund members; and

(e) level of reserves (operational risk and other).

6.5.2 When considering net cash flows, it is useful to separately identify cash flows coming from expected investment return (unrealised capital gains and other returns) and other cash flows to illustrate the Fund's likely liquidity position.

6.5.3 Projection of activity (movements) might be required, particularly if the fee structure (or underlying cost structure) has activity-based pricing.

6.5.4 Results from different scenarios would normally be shown to illustrate key drivers of the results and highlight potential areas of risk.

## **6.6 Fee sustainability analysis / Fund scale**

6.6.1 A fee sustainability analysis compares the Fund's projected fee revenue deducted from Fund members' accounts against the level of project costs actually incurred in the operation of the Fund.

6.6.2 The first step in a fee sustainability analysis is to conduct an expense analysis to determine cost assumptions. This expense analysis involves breaking up Fund costs into fixed and marginal costs. The marginal costs can then be related to particular Fund characteristics (size of assets, number of Fund members and particular Fund member activity such as benefit payments). The costs examined may be the past few years' actual experience or the forecast (budgeted) costs.

6.6.3 These cost assumptions are then applied to the forecast (budgeted) results (to produce a comparison of expected revenue on fee basis compared with expected expenses).

6.6.4 The Member may also comment on Fund member equity, namely whether fees are allocated on a fair and reasonable basis in accordance with SIS Regulation 5.02.

6.6.5 Members may also be asked to provide an opinion as to whether or not the Fund has sufficient scale. The fee sustainability analysis provides information about future size of the Fund (in terms of membership and assets) and also an indication of possible future fee levels which can be compared against current competitor fee levels and market forecasts to make an assessment as to expected relative competitiveness in the future.

## **6.7 Projection of reserves (or capital)**

6.7.1 The Fund's financial strength assessment (refer section 5 of this Practice Guideline) includes a review of the adequacy of reserves at the investigation date. The Fund sustainability assessment may contain a projection of future reserves (or capital) using the projection results so as to consider the size of future reserves and also for comparison to Board reserve (or capital) targets.

6.7.2 If the Board is currently holding less reserves than its target level, then alternative replenishment plans to develop the reserves can be considered using the Fund projections and alternative fee structures.



## **7. ACTUARIAL RISK REVIEW**

### **7.1 Scope / relationship with accounting audit**

7.1.1 The actuarial risk review and an accounting audit of a risk management framework cover different things.

7.1.2 An annual audit of the risk management strategy and risk management plan is required under the SIS Act. These responsibilities are clarified in guidance from APRA and the Auditing and Assurance Standards Board (see the Appendix to this Practice Guideline for more details). The Fund's approved auditor is required to state that the Board has:

- (a) complied with each risk management plan for the Fund that applied during that year;
- (b) adequate systems in place to ensure future compliance with any risk management plan for the Fund;
- (c) complied with each risk management strategy that applied to the RSE licensee during that year in relation to risks arising from any activities, and proposed activities, as RSE licensee of the Fund, and all other activities, or proposed activities, relevant to those activities; and
- (d) adequate systems in place to ensure future compliance with the risk management strategy for the RSE licensee in relation to future risks arising from any proposed future activities as RSE licensee of the Fund, and all other proposed future activities relevant to those activities.

7.1.3 These accounting audit requirements essentially focus on compliance with the Fund's existing risk management plan / risk management strategy.

7.1.4 If the accounting audit is an objective test of compliance with the controls, then an actuarial risk review of the risk management framework is a subjective evaluation of the risk management process. In particular, the purpose of the actuarial risk review is to examine whether the risk management strategy / risk management plan is appropriate (that is, adequate and suitable) in terms of:

- (a) the risks identified (whether all risks have been identified);
- (b) the likelihood and consequences associated with those risks (whether the risk ratings are appropriate);

- (c) the Board's risk appetite statement (whether the risk appetite and risk tolerances are consistent with the Fund's business plan, strategy and the controls in place);
- (d) the controls in place (whether the right controls are in place, given the Board's risk appetite / tolerances); and
- (e) the documentation meeting industry standards.

## **7.2 Other guidance and expertise**

7.2.1 Members should be familiar with the Institute's Information Note "Actuarial Advice regarding Risk Management of a Life Insurer (LPS 220) or General Insurer (GPS 220)".

7.2.2 Members should also be familiar with:

- (a) RSE licence requirements as they relate to risk management (sections 29H and 29P of the SIS Act);
- (b) APRA's Prudential Practice Guide SPG 200 (Risk Management);
- (c) enterprise risk management standards as represented in the Australian Standard on Risk Management "AS/NZS ISO 31000:2009 Risk Management — Principles and guidelines" (and ISO 31000: 2009 (Risk Management – Principles and Guidelines)); and
- (d) current industry best practice (for example, the best practice paper Number 19 "Risk Management Frameworks for Superannuation Funds" issued by the Association of Superannuation Funds of Australia Limited ("ASFA")).

7.2.3 Some of the challenges faced by individual Members performing a review of a risk management framework include:

- (a) actuaries are unlikely to be experts in every category of risk; and
- (b) actuaries are unlikely to be intimately familiar with every aspect of the Fund's operations.

7.2.4 These problems are unavoidable and likely to be faced by any professional performing a review of a risk management framework (as it is highly unlikely that any one person can be an expert in all areas).

7.2.5 Actuaries by training and experience have skills that are useful to perform risk reviews. That being said, there may be instances where a Member performing a review may rely on the assistance of other professionals or experts to provide assistance in

reviewing those areas of risk or understanding of the Fund with which he or she may not have a deep level of experience or understanding.

7.2.6 Section 4.3 of the Code ("Professional Expertise") requires a Member to take reasonable steps to ensure they have appropriate knowledge and skills in the relevant area (taking into account the nature of the Professional Services provided). Where that is not the case, the Member should consider whether it is appropriate to obtain the advice of one or more Specialist Professionals. However, it may not be practical or may be too expensive to procure the assistance of experts in every area of the risk review. In such cases, considering the nature of this Professional Service, it is reasonable for the Member to perform the risk review forming an opinion as a prudent person (not necessarily as an expert). In such cases, the Member should make a disclosure as to any consequential limitations in the review (for example, areas or categories of risk where the Member does not have appropriate knowledge and skills, and has not sought the assistance of Specialist Professionals in the relevant area).

### **7.3 Principles in approaching the risk review**

7.3.1 Each element of the review (appropriateness of risks covered, likelihood, consequences and adequacy of controls) is a subjective exercise and therefore ultimately relies on the Member's judgment.

7.3.2 In forming a judgment, the Member should:

- (a) consider his or her own experience with the Fund;
- (b) draw on his or her experience with other funds;
- (c) be aware of, and refer to, common industry practice; and
- (d) consider the Materiality of any risk.

7.3.3 It will be beneficial to undertake relevant numerical analysis, such as:

- (a) analysis of summary data (breaches, complaints, errors and omissions, claims and so forth) to look for emerging patterns; and
- (b) stress testing (detailed assessment) of key risks. This is particularly the case in respect of the consideration of risk appetite and risk tolerances, where stress testing results are useful to assess the appropriateness of an articulated risk appetite for given controls and Fund strategy.

7.3.4 Of course, not every risk is foreseeable and therefore it is not possible to specify controls for every risk. Reserving is therefore important to mitigate "unknown

unknowns" (risks not specifically addressed in the Fund's risk management framework).

7.3.5 One of the key risks in a Fund is investment risk. When considering this risk as part of the actuarial risk review of a risk management strategy / risk management plan, particular attention should be paid to who is bearing that risk, their expectations and the mechanism by which the investment risk is passed through to those parties.

#### **7.4 Material to consider**

7.4.1 In preparing for an actuarial risk review, the following material should be considered in addition to the risk management framework (and underlying risk register):

- (a) documents relating to business strategy / business plans;
- (b) reports from recent APRA reviews (including the Fund's Supervisory Oversight and Response System (SOARS) and Probability and Impact Rating System (PAIRS) ratings);
- (c) internal audit reports;
- (d) external audit reports (especially relating to risk management);
- (e) minutes of meetings of the Audit, Risk and Finance or Compliance committees of the Board;
- (f) compliance incidence and breach reports / registers (significant and other);
- (g) complaints reports / registers;
- (h) errors and omissions reports / registers;
- (i) claims on professional indemnity insurance (and any potential claims notified); and
- (j) rectification costs paid by the Fund in recent years.

It is important to speak to key people involved in risk management of the Fund: Chief Risk Officer, other Fund executives (Chief Executive Officer, Chief Financial Controller, Chief Information Officer) and compliance committee members.

## **8. STRESS TESTS**

### **8.1 General principles**

8.1.1 Stress testing – or detailed assessment of key specified risks – may be performed as part of the actuarial risk review, as a stand alone analysis or as part of a broader FCR.

8.1.2 There are a number of different risks that might be stress tested, including liquidity risks or unit pricing risks.

8.1.3 It is likely to be prohibitively expensive to stress test every risk at once. Therefore the Member may suggest a program of stress testing key risks over a period of time. Determining which risks to stress test and the priority order in which to test them is a matter of judgment.

8.1.4 The approach taken to stress testing different risks will depend on the nature of the risks, however the following general approach might be considered:

- (a) consider the appropriateness of the Board's documented policies and procedures against the Member's own experience, legislation, regulator guidance and industry best practice;
- (b) examine the assumptions used and their appropriateness;
- (c) review any models used (review formulas, review results at intermediate stages and internal consistency);
- (d) check the underlying data being used is correct and is being used appropriately;
- (e) conduct reasonableness testing (consider actual results against what was expected via short hand methods and compare results to those that might be expected from other benchmarks);
- (f) prepare some adverse scenarios and examine the outcomes on the area being examined. The degree of adversity is a matter of judgment. For risks with a measureable distribution (for example, investment-related risks such as liquidity) an outcome of the lower one percentile (1%) or below might be appropriate;
- (g) consider the impact of both adverse short term "shock" scenarios and also medium to longer term cumulative decline scenarios (for example, the impact of ongoing investment returns that are below expectation);

- (h) consider the alignment of the stress testing with the Board's risk management framework and the Board's risk appetite statement (and risk tolerances) when setting parameters for the stress testing;
- (i) conduct some "reverse" stress testing which involves establishing a failure threshold (for example, based on the Board's risk appetite and risk tolerances) and identifying the extent to which experience must be adverse for the failure threshold to be reached;
- (j) examine actual risk events that have occurred (and subsequent rectification);
- (k) review any previous stress testing done for that particular risk; and
- (l) consider and comment on the appropriateness of any valuations (or valuation methodology) used.

8.1.5 The Member should consider the context of the stress testing and tailor the analysis accordingly. For example, if the analysis is to be used by the Board to meet its obligations under a prudential standard requiring a comprehensive program of stress testing, the Member should be familiar with the requirements of that prudential standard.

## **8.2 Liquidity stress tests**

8.2.1 In performing liquidity stress testing, the Member should consider the latest legislation, prudential guidance and best practice materials. Examples of these are set out in the Appendix to this Practice Guideline.

8.2.2 Possible elements of a liquidity stress test include:

- (a) review of the Fund's liquidity policy against industry / regulator guidance;
- (b) identification of which assets are currently considered illiquid;
- (c) consideration of the Fund's liquidity position at balance date (in the context of the Fund's policy);
- (d) for short term stress tests performed at the investment option level, consideration of changes in the following having regard to the Fund's liquidity position:
  - (i) market movements (individual asset sectors, combined portfolio movements, liquid asset sectors becoming illiquid, changes in currency and impact of hedging instruments);

- (ii) changes in Fund member behaviour (Fund members switching to cash, Fund members leaving the Fund and reduction in contributions);
  - (iii) changes in the level of capital commitments required on direct investments; and
  - (iv) the impact of debt refinancing on large direct investments; and
- (e) for medium term stress tests:
- (i) time to redemption analysis; and
  - (ii) the use of results from Fund sustainability analysis to look at cash flow requirements and the impact on the asset allocation and the level of illiquid assets.

### **8.3 Unit pricing and crediting rate stress tests**

#### 8.3.1 Possible elements of a unit pricing and crediting rate stress test include:

- (a) unit pricing policy:
  - (i) review of the Board's policy against good practice guides issued by APRA and the Australian Securities and Investments Commission ("ASIC"); and
  - (ii) consideration of the results of external audit, including any APRA / ASIC review;
- (b) assumptions / discretions:
  - (i) review of the tax assumptions inherent in the unit pricing calculation; and
  - (ii) review of the level of deferred tax assets;
- (c) reasonableness testing – for each investment option, comparing the returns over the year on the unit prices:
  - (i) against the investment manager returns;
  - (ii) against market survey returns and passive returns for similar asset allocations;
  - (iii) between the different divisions of the Fund (for example, accumulation and pension) and assessing if tax impacts are reasonable; and

- (iv) against the returns reported to Fund members (including communication material);
- (d) review of unit pricing errors and rectification in recent periods;
- (e) random formula audit of any spreadsheets used in process;
- (f) consideration of the appropriateness of the valuation methodology used; and
- (g) data checking, specifically that:
  - (i) asset values used by the custodian match those in the investment manager statements;
  - (ii) information given by the administrator to the custodian about cash flows and number of units is correct; and
  - (iii) the administrator has correctly applied the unit prices provided to it.

## **9. REPORTING REQUIREMENTS**

- 9.1 The report (or the relevant section in an FCR) should:
- (a) make clear to whom the report is addressed (usually the Board or its risk management committee and not usually the Fund's executive);
  - (b) make clear the report is not to be a document made available to Fund members and that the report is not to be used by ratings agencies;
  - (c) comment on any limitations;
  - (d) identify matters out of scope; and
  - (e) provide details of the Member preparing the report.
- 9.2 The report should include a section summarising the main recommendations arising from the work performed and where possible these recommendations should be prioritised.



## Appendix – Legislation / regulatory materials to consider

The legislative and regulatory materials the Member should consider include, but are not limited to, the following list (it is noted that the list is current at the time of drafting, but will change from time to time):

- (a) RSE licence requirements as they relate to risk management (sections 29H and 29P of the SIS Act);
- (b) relevant SIS Act requirements in relation to:
  - (i) unsatisfactory financial position and technical insolvency for both defined benefit and accumulation funds (for example, Part 9 of the SIS Regulations);
  - (ii) allocation of fees (for example, SIS Regulation 5.02);
  - (iii) the proposed “scale test” (at the time of drafting this Practice Guideline, this test was being proposed in a new section 29VN of the SIS Act (refer the Exposure Draft of the Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012);
  - (iv) for liquidity stress testing:
    - (1) section 52(2)(f) of the SIS Act and SIS Regulation 4.09 (re formulation of investment strategy);
    - (2) SIS Regulations 6.34(5) and 6.37 (in relation to payment of benefits);
- (c) relevant prudential standards and guidance issued by APRA, including (but not limited to):
  - (i) Prudential Practice Guide SPG 200 (Risk Management);
  - (ii) prudential standards issued in relation to minimum levels of reserves, including Prudential Practice Guide Draft SPG 235 (Use of Reserves in Superannuation Funds) issued 29 April 2009;
  - (iii) Superannuation Circular No II.D.1 “Managing Investments and Investment Choice” issued March 2006 (in relation to liquidity stress testing);
  - (iv) Circular IV.A.6 (responsibilities of the auditor);
  - (v) APRA’s paper “Liquidity, Licensing and Super Funds: What’s on APRA’s Agenda” (17 March 2008); and

- (d) Guidance Statement GS 002 (Special Considerations in the Audit of Risk Management Requirements for Registrable Superannuation Entities and Licensees) last issued in September 2010 by the Auditing and Assurance Standards Board;
- (e) enterprise risk management standards, such as AS/NZS ISO 31000:2009 (Risk Management – Principles and Guidelines) and ISO 31000: 2009 (Risk Management – Principles and Guidelines); and
- (f) current industry best practice, including but not limited to:
  - (i) relevant best practice papers issued by ASFA, such as paper Number 19 “Risk Management Frameworks for Superannuation Funds” and Best Practice Paper 35 “Managing Superannuation Fund Liquidity Risk” issued in October 2009; and
  - (ii) relevant guidance notes issued by the Financial Services Council.

## **END OF PRACTICE GUIDELINE 499.05**