Risk Management in DC Superannuation

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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/management
  - Process
  - People
  - Systems
  - External

What could it mean?

- An operational risk “event” in a super fund could mean the loss of
  – $$ by fund and/or members
  – records
  – staff
  – a third party provider
  – reputation/brand
  – FUM and/or members
  – Licence
- Increasingly important in the changing environment

Examples of governance risks

- Conflict of interest at trustee level
- Failure of 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

- Failure of, or poor return from, providers
- Regulatory or compliance breaches
- Loss of, or damage to, records
- Long term systemic error in operations
  - E.g. unit pricing ; crediting rates
- Internal failure to apply policies
- Failure of modelling exercises
  - E.g. new products, strategy development
- Fraud

Examples of people risks

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

Examples 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

Examples of external risks

- Government decisions
- Decisions or findings by regulators and/or courts
- Loss of physical assets e.g. storm, fire
- Pandemic
- Unexpected litigation
- Adverse publicity – direct or collateral

Possible consequences for members

- Incorrect contributions; benefit payments; asset allocation; and/or investment returns
- Loss of $$
- Higher costs e.g. business continuity
- Inability to move between funds/investments
- Poor service
  - Delayed benefits, lack of information

➢ Consequences for the funds and trustees

How can funds reduce these risks?

- Identify risk awareness/appetite with trustees
- A clear governance structure
- Known controls and reporting lines
- Known policies and procedures
- Ongoing training and awareness
- A culture of reporting “near misses”
- Key Risk Indicators
  – People, processes, systems

What can funds do to reduce these risks?

- 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

Can we fund for operational risk?

- What are members' expectations?
  - No loss
- Can this be delivered?
  - Not with 100% certainty
- So …

Is holding a reserve an option?

- Protects a fund from uncertainty
- Protects members' benefits from op risks
- Improves equity between members

+ Specific reserves in funds are different
    - E.g. benefit guarantees

An argument for a Reserve

- In a DC fund, the major risk is operational
- Many of these risks are unpredictable
- The consequence is a “loss” in this year
  - This loss could be significant
  - Some losses are capped; others are proportional
- Is this fair for the members?
  - Yes - after all, they have fund choice
  - No - the big loss is a one-off; it may have serious consequences for the fund and all members

A suggestion: An op risk reserve

- Build it up gradually over 5 years
- It <u>can</u> be dipped into when there is a major op risk ‘event’ leading to a ‘loss’
- It is then restored over 3 years
- It is <u>not</u> the same as capital adequacy
- How big should it be?

Example

• DC fund's assets	$1 bill
• Expected return (7%)	$70 mill
• Unexpected "event"	$15 mill

- Net return - loss of 1.5%
- Is that fair to the members?
- What might be the consequences?

A way forward

- Over 5 years, build a reserve of 1% of assets
  - i.e. 0.2% pa
- In the year of the "event", the reserve can be used
- Loss in this example is then reduced by up to 67%
  - Impact is therefore reduced
- Reserve is re-established in future years

Risks for DC super funds

- They cannot be eliminated, but can be managed
- This needs the involvement of trustees, fund management and providers
- In the case of an “event”, members could run
- This could adversely affect the fund and the members, more than the industry
- Is the time ripe for an “Op Risk Reserve”?

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