ORFR and member equity
Some practical considerations

The Stronger Super changes introduced a number of Prudential Standards for the superannuation industry. One of those superannuation prudential standards (SPS 114) introduced an Operational Risk Financial Requirement (ORFR) for super funds to be established over a three year period from 1 July 2013. The ORFR is intended to be a reserve to meet the cost of potential future operational losses such as administration errors, fraud events or legal claims against the fund due to inadequate process.

Although each fund is different, APRA has taken the view (at least initially) that the ORFR will be set at 25 bps for the majority of funds. Excluding the SMSF sector (who are not regulated by APRA), 25bps on the remainder of the superannuation industry assets of approximately $1.1 trillion is $2.75 billion set aside for potential operational risk events. This is a lot of money held in reserves and largely will be established by deductions from members' accounts over the next 3 years.

The superannuation industry is coming to terms with scale of the changes required by Stronger Super quite rapidly and ORFR is just one area that is new and evolving.

This article is not about the various techniques used for the modelling or quantification of the ORFR. Rather, we set out below some practical considerations particularly in the area of equity for members that we believe the industry will face over the next few years based on our work helping clients to establish their risk frameworks and ORFR reserves.

Firstly, some high level comments on ORFR and member equity:

- We expect these issues will be more acute over the next three years whilst funds are building up their ORFRs (at varying speeds)
- These issues will apply to all funds but will be particularly relevant to multi-employer funds (MEFs) such as industry funds and retail master trusts
- As consolidation in the industry continues, and as funds continue to move into (or between) MEFs, the movement of ORFR (or lack thereof) between the existing and receiving funds will create some interesting questions
- Where possible the industry should work together to agree consistent treatment of ORFR movements.

We would note that member equity issues in superannuation and reserving are not new and not unique to ORFR. Some of these issues are similar to those faced by funds historically in the use of insurance or investment fluctuation reserves.

In some ways, commercial terms between receiving funds trying to win new business will reduce some of the initial equity related issues with ORFR on transfer. As funds move between MEFs any differences in levels of ORFR or the way that the ORFR is funded may be allowed for in the overall pricing approach as MEFs compete to win new business. Clearly, the larger funds and/or those that are part of conglomerate groups will be at an advantage in terms of being able to absorb these 'costs'.

In addition to these member equity issues on transition to a new plan, there are still many issues in terms of the ongoing practical management of the ORFR which will impact on member equity. We discuss below three practical considerations regarding the ORFR in more detail:

1. How should the ORFR be invested?

Note: There is certainly a level correlation between the ORFR and assets (for things such as unit pricing errors for example). So if assets rise it does make sense for the ORFR to increase with assets. However, the correlation is not 100% and to top up the ORFR purely in line with changes in assets does not necessarily reflect the change in risk.

We understand that APRA prefers the ORFR to be expressed as a percentage of assets (not a dollar amount) and invested in cash or a very low risk investment strategy. In many ways it makes sense to invest the ORFR predominantly in cash or a low risk investment strategy. It would seem rather perverse for a reserve established to protect against losses to be eroded by equity market falls if it is invested in shares. However, if the ORFR is invested in a different strategy to the fund assets then this immediately creates a disconnect. In particular, if the ORFR is invested in cash and the bulk of the fund assets are invested in, say, a balanced 70/30 strategy and earn strong returns based on equity market gains, then the ORFR reduces as a percentage of overall assets. Should the ORFR fall below the 'tolerance limit', the trustee must put in place processes to replenish the ORFR (often requiring a deduction from member accounts). However, if equity markets fall again at a later time, the ORFR may rise above the required target amount after having asked the members for additional replenishment. This raises interesting member equity questions as members are continually joining and exiting the fund and may therefore be asked to replenish ORFRs for investment impacts when they were not even a member of the fund, or vice versa.

A similar impact can occur purely based on the fund's cash flow. If the fund has positive net cash flow, the ORFR will gradually be diluted as a percentage of fund assets over time (assuming the ORFR and fund assets earn the same investment return). Conversely, the ORFR for a fund with negative cash flow, will increase over time (as a percentage of fund assets).

Funds will need to have in place a clear process of how to handle fluctuations in the ORFR due to investment earnings or cash flow impacts ensuring members are not unintentionally advantaged or disadvantaged.

2. Tracking of the ORFR

Once the ORFR is set up, it will need to be continually tracked and also rebalanced from time to time. The ORFR will change due to two separate issues:

- Usage of the reserve in the event of claims
- General changes in the level of reserve due to the ongoing running of the fund.

This article focusses on the general changes in the level of reserve due to the ongoing running of the fund which may result in a non-trivial administrative task.

Usage of the reserve

Tracking the reserve as a result of events should be a natural outcome of good risk management process. Tracking the reserve should not be the focus but an outworking of good process. The key is for the fund to have in place clear processes for the monitoring and management of risk.

Funds will want to avoid having to charge members ORFR 'catch up' fees as a result of investment earnings or cash flow impacts (as per earlier point) or due to membership changes. Similarly, should the ORFR rise above 25bps, this raises the question of how the 'excess' should be used.

Take the example of a fund that is growing rapidly or running off. The pure change in the membership profile over time will result in the ORFR as a percentage of assets changing. If the membership halves over the next 5 years the ORFR as a percentage of assets will grow possibly to a level that is considered unnecessarily high. In theory, this could mean that exiting members of the fund have contributed unnecessarily high amounts to the ORFR which are left in the fund for the benefit of other members.

Another question that arises with MEFs is whether the ORFR is tracked at fund level or sub fund level. At a total level, the fund will be holding 25bps initially but over time even if the ORFR remains at 25bps at the total fund level, the individual sub plans are likely to be under or over 25 bps. This raises interesting questions of equity across sub funds and also if funds are to join or leave the MEF regarding how much of the reserve will they bring/take with them.

Funds will need to have in place detailed ORFR monitoring and ongoing management plans to specifically address how and when the rebalancing process will work.

3. Implications for Successor Fund Transfers (SFTs)

In terms of funds changing providers, our view is that it would seem sensible that any ORFR built up by deductions from member accounts will follow the fund if it were to leave its current fund. Conversely, if the ORFR (or part of the ORFR) is subsidised by the MEF provider then it would seem sensible that the ORFR will not follow the fund if it were to leave. In reality, this is a simplistic view of a complex area and we don't discuss it further in this brief article.

However, one aspect that requires some thought is for funds that move between MEFs and the ORFRs are not the same. This raises interesting questions for Trustees in terms of providing equivalent rights in the event of an SFT. If the ORFR charge (as a percentage of assets) is higher or lower in the receiving fund does this mean that members will be debited or credited the differential between the two ORFRs on transfer?

Either way the Trustee would need to be able to demonstrate the overall benefits of the new MEF are (at least) equivalent for members.

Note: We only consider here movement of ORFR between funds leaving or joining corporate divisions of MEFs. Many of the same issues apply to individuals transferring between personal divisions of funds.

Could an insurance model approach be used for ORFR?

Many of the equity issues raised in this article arise as sub funds within MEFs are treated as individual funds. However, rather than getting bogged down in tracking every dollar across each fund, an alternative approach could be to treat ORFR charges like an insurance premium and pool risks across funds. If you claim, you receive the benefit of the premium paid but if you don't claim you don't expect to receive anything in return on the basis that across the overall pool of risks the premiums are sufficient to cover expected claims as they arise.

With today's modern technology in multi-billion dollar MEFs, dealing with the management and tracking of ORFR at a sub plan level should not be an issue and trying to develop processes that are simpler and easier is not necessarily the way to go. However, APRA's ORFR is required at the Trustee level (not at sub plan level within a MEF) and a pooling approach would certainly streamline many of the processes for these large complex funds.

This brief paper raises just a few of the important practical considerations for trustees relating to the ongoing management of the ORFR. We believe it is important to consider these issues sooner rather than later and to have a plan to deal with all possible scenarios that may be faced. The more the industry can form a view on these issues and hopefully work together to achieve consistent treatment will make for a much smoother pathway through the many ORFR issues and Stronger Super more generally.

If you would like further information on this topic or would like to discuss some of the practical considerations regarding the ORFR for your fund, contact:

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