Law Council
OF AUSTRALIA

Legal Practice Section

Discussion Paper: Strengthening Operational Risk Management

The Australian Prudential Regulation Authority

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- Queensland Law Society
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About the Section

The Legal Practice Section of the Law Council of Australia was established in March 1980, initially as the 'Legal Practice Management Section', with a focus principally on legal practice management issues. In September 1986 the Section's name was changed to the 'General Practice Section', and its focus broadened to include areas of specialist practices including Superannuation, Property Law, and Consumer Law.

On 7 December 2002 the Section's name was again changed, to 'Legal Practice Section', to reflect the Section's focus on a broad range of areas of specialist legal practices, as well as practice management.

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- contribute to the development of the legal profession;
- maintain high standards in the legal profession;
- offer assistance in the development of legal and management expertise in its members through training, conferences, publications, meetings, and other activities; and
- provide policy advice to the Law Council, and prepare submissions on behalf of the Law Council, in the areas relating to its specialist committees.

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Introduction

1. The Legal Practice Section of the Law Council of Australia's Superannuation Committee (**the Committee**) is pleased to provide this submission to the Australian Prudential Regulation Authority (**APRA**) in response to:

    - the issues raised in the Strengthening Operational Risk Management Discussion Paper (**Discussion Paper**); and
    - the draft Prudential Standard CPS 230: Operational Risk Management (**draft CPS 230**).

APRA Discussion Paper

2. The Committee provides the following responses to APRA's questions in its Discussion Paper. Where a question is not addressed, the Committee has no comment to provide.

Overall design

Question 1: Is a single cross-industry standard for operational risk management supported?

3. The Committee considers that there should be a separate standard for registrable superannuation entity (**RSE**) licensees with a focus on regulated superannuation entities and the requirements unique to superannuation funds under the law, including, for example, the establishment and management of a designated operational risk reserve.

4. The proposed cross-industry standard necessarily dilutes those operational risk management *parameters* that are specific to the legal regime governing superannuation funds, and fails to have sufficient regard to the duties and constraints imposed upon RSE licensees in comparison to other APRA-regulated entities, such as insurers and banks.[1]

5. In the Committee's view, a cross-industry standard will create uncertainty and compromise the suitability and effectiveness of the new standard as it applies to RSE licensees.

Question 2: Are there specific topics or areas on which guidance would be particularly useful to assist in implementation?

General

6. If APRA disagrees with the Committee's submission that it is inappropriate for RSE licensees to be governed by a cross-industry standard for operational risk management, then the proposed standard should at least make provision for sector-specific guidance.

[1] The Committee notes that the draft CPS 230 only includes passing reference to super-specific requirements, for example, sub-paragraph 53(g) on termination rights and reference to the best financial interest duty.

7. Sector-specific guidance on APRA's intended implementation of the standard, including the transition, ought also to be addressed.

8. The Committee considers that the APRA response on measures to improve financial resilience of regulated entities may also have implications for the draft CPS 230, particularly in relation to the operation of, and possible drawing upon, operational financial risk reserves for RSE licensees.

9. APRA may therefore consider waiting for the completion of its review on 'Strengthening Financial Resilience in Superannuation' before finalising the draft CPS 230. In that regard, the Committee notes that consultation on the respective discussion paper closed more than seven months ago, in March 2022.

Avoiding ambiguity when referring to different industries

10. The Committee considers that, as the draft CPS 230 is intended to apply to regulated entities across distinct regulatory sectors, it is important to be clear whether some paragraphs are intended to apply to only some types of entities and not others. For instance, see paragraphs 44 to 46 below, relating to proposed paragraph 49 of draft CPS 230.

Need for clarity about standard of performance and relevance of 'tolerance levels'

11. In the Committee's view, there are some aspects where the standard of performance required is either unclear or appears to be unduly onerous. As regulated entities would be legally obliged to comply with the CPS 230, it is critical that there is sufficient clarity regarding the standard of performance that is intended to be imposed on an entity.

12. In addition, some paragraphs appear to substantially duplicate others, but with slightly different wording. This creates the potential for uncertainty as to whether one paragraph is intended to operate merely as an explanation or summary of another paragraph, or whether a different obligation is intended to apply. For example:

    - Sub-paragraph 11(b) states that an APRA-regulated entity '*must … maintain its critical operations within tolerance levels through severe disruptions* …' This appears to impose an absolute obligation that might not be reasonable to expect in practice.
    - However, paragraph 13 appears to cover essentially the same subject matter as sub-paragraph 11(b), but with a reasonable relaxation to the standard required: an entity '*must, **to the extent practicable** … continue to operate within tolerance levels in the event of a disruption* … (emphasis added).
    - Similarly, sub-paragraph 37(a) contemplates that there may be situations where critical operations are disrupted beyond 'tolerance levels' for some time periods.

13. As the standard imposed by sub-paragraph 11(b) appears to be inconsistent with those in paragraph 13 and sub-paragraph 37(a), the Committee recommends that paragraphs 11 and 13 be rationalised to eliminate duplication and inconsistency with respect to the standard that is required.

14. The Committee also notes that paragraph 23 appears to substantially replicate the content of paragraph 12, with some differences in wording.

15. In addition, paragraph 27 provides that an entity must conduct a '*comprehensive risk assessment before '**providing** a material service **to** another party*' (emphasis added).

The Committee queries whether 'providing' a material service 'to' another party is an error and whether this should instead be 'procuring' a material service 'from'. If this is not an error, then the Committee does not consider it to be clear what paragraph 27 is referring to in the context of an RSE licensee. Alternatively, if paragraph 27 is indeed intended to refer to procuring material services from another party, this paragraph seems redundant, given that paragraphs 46 to 59 of the draft CPS 230 address the management of service provider arrangements.

Specific requirements

Question 5: How could APRA improve the definitions of critical operations, tolerance levels and material service providers?

16. These matters arise from proposed paragraphs 34 to 38 of the draft CPS 230.

'Critical operations' and 'tolerance levels'

17. The Committee suggests that the definition of 'critical operations' be amended and that the meaning and purpose of 'tolerance levels' be clarified for the reasons set out below.

18. Firstly, the Committee submits that the definition of 'critical operations' at proposed paragraph 34 erroneously refers to the 'process' as having a material adverse impact, rather than the *disruption* to the process. This definition should be amended to reflect that the 'disruption' is what will have a material adverse impact (and not the 'process' that is being disrupted).

19. Next, paragraph 34 applies 'tolerance levels' by reference to 'critical operations'. This paragraph implies that a tolerance level is a degree of disruption to a process beyond which there will be a material adverse impact on depositors and other clients of an entity. The Committee notes that there is a degree of circularity within this paragraph: it requires one to firstly assume that the process in question is of a kind where a disruption *could* have a material adverse impact, and then to determine what level of disruption would have such impact.

20. The Committee notes that paragraph 37 appears to suggest a different concept of a 'tolerance level', by requiring an entity to establish tolerance levels for what it would 'tolerate' or 'accept. However, no explanation is provided as to what is meant by 'tolerate' or 'accept'. As a result, it is unclear whether a 'tolerance level' in paragraph 37 is the entity's assessment of what level of disruption would have a material adverse effect on clients (per paragraph 34) or whether it refers to some other qualitative judgement based on some other (unspecified) criteria.

21. It appears to the Committee that the intent of paragraph 37 is to require the entity and its board to determine what level of disruption would have a 'material adverse impact', and this is what is intended by the words 'tolerate' and 'accept'. If this is the intent, the paragraph should make this clearer.

22. To clarify these concepts, the Committee suggests:

    - replacing paragraph 34 with: 'A process undertaken by an APRA-regulated entity or its service provider is a **critical operation** if a disruption to that process could have a material adverse impact on its depositors, policyholders, beneficiaries or other customers, or its role in the financial system';

- inserting a definition of ‘tolerance level’ within paragraphs 34 to 38 such as: ‘A **tolerance level** is the degree of disruption to a critical process beyond which there would be a material adverse impact on an APRA-related entity’s depositors, policyholders, beneficiaries or other customers, or its role in the financial system’; and
- amending paragraph 37 by removing references to ‘tolerating’ and ‘accepting’ tolerance levels and inserting that the entity should ‘determine’ tolerance levels.

23. The Committee notes that ‘material adverse impact’ is not defined in the draft CPS 230, but it presumes this would be for each entity to determine.

Material change versus significant change

24. The Committee also suggests review of the references to ‘material change’ as compared to ‘significant change’ in the draft CPS 230.

25. Paragraph 52 requires an entity to do certain things before ‘materially modifying’ a material service provider arrangement:

    - sub-paragraph 58(a) requires an entity to notify APRA after ‘materially changing’ certain agreements; however
    - paragraph 58(b) requires notice of a proposed ‘significant change’ to an offshoring agreement.

    The Committee queries whether there is intended to be a difference between a ‘material’ change and a ‘significant’ change, or whether the same term should be used in all cases?

Question 6: What additions or amendments should be made to the lists of specified critical operations and material service providers?

26. Under paragraph 49, arrangements with certain material service providers are listed, including ‘arrangements with promoters and financial planners’.

27. The Committee is of the view that the intended application of the specified providers in paragraph 49 is unclear and ought to be removed. This because arguably they will not, in all instances, provide services considered ‘material’, within the ordinary meaning of that expression, to the operations of a regulated super fund. Refer below to the Committee’s further comments on this specific paragraph of the draft CPS 230 (see paragraphs 44 to 46).

Question 8: What form of transition arrangements and timeframe would be needed to renegotiate contracts with existing service providers (if required)?

28. The Committee notes that typical material service provider contracts may have a timeframe of between one and three years, in which substantive changes may be negotiated. For major engagements, a change in provider (including in-sourcing) may have a lead time of 18 months to three years to achieve.

29. Some contracts will have an in-built mechanism to facilitate within-term adjustment of contractual terms to accommodate relevant changes in regulatory requirements impacting those arrangements. In that context, the Committee submits that a

three-year transition deadline with a requirement to diligently seek to incorporate the new requirements from the outset ought to be considered.

Draft CPS 230

30. The Committee provides the following comments on specific paragraphs in the draft CPS 230.

Paragraph 18—Extended APRA power where entity's operational risk management has material weakness

31. The Committee has significant reservations about paragraph 18 and submits that it should be carefully reviewed and revised—or, preferably, deleted altogether.

32. Paragraph 18 seems to be an odd mix of, on the one hand, descriptions of the pre-existing regulatory regime and, on the other hand, conferrals of far-reaching new powers on APRA.

33. For example, to say that APRA may impose conditions on an RSE licensee's licence (at sub-paragraph 18(d)) is merely to describe the existing position under section 29EA of the *Superannuation Industry (Supervision) Act 1993* (Cth) (**SIS Act**). That statement is uncontentious and, in the Committee's view, unnecessary.

34. On the other hand, to provide that APRA may require an RSE licensee to commission an independent review (at sub-paragraph 18(a)), or to develop a remediation program (sub-paragraph 18(b)), or to 'take other actions required [presumably, by APRA] in the supervision of this Prudential Standard' (paragraph 18(e)) seem to be attempts to confer extraordinary powers on APRA.

35. There is a detailed regime in Part 16A of the SIS Act under which APRA may give directions of virtually unlimited kinds to an RSE licensee.

36. In order for APRA to give a direction, it must satisfy at least one of the grounds in sub-section 131D(1) of the SIS Act. The Committee accepts that, in any given case, it may not be very difficult for APRA to enliven this power by demonstrating that it 'has reason to believe' that a ground exists.

37. Nevertheless, sub-section 131D(1) of the SIS Act provides a safeguard (of sorts) in respect of the use of the extraordinary power conferred under sub-section 131D(2), in particular under paragraph 131D(2)(n).

38. Further, if APRA gives a direction, then the RSE licensee has the benefit of the safeguards in the SIS Act, provided in:

- section 131FA (power to comply with a direction);
- section 131FB (general protection from liability);
- section 131FC (specific protection from liability); and
- section 131FD (protections from liability do not limit each other).

39. Finally, and in the Committee's view very significantly, an exercise of APRA's power to give a direction is susceptible to an application for reconsideration by APRA followed by an application for merits review by the Administrative Appeals Tribunal.[2]

[2] *Superannuation Industry (Supervision) Act 1993* (Cth) ('*SIS Act*) s 10(1) (definition of 'reviewable decision' paras (taaa) and (taac)); s 344.

40. The Committee notes that none of the above safeguards would apply to an exercise of power under sub-paragraphs 18(a), 18(b) or 18(e) of the draft CPS 230, if those paragraphs are, in fact, conferrals of new and independent powers.

41. The Committee is firmly of the view that APRA should not exercise its prudential-standards-making power in a way that has the effect of allowing it to bypass important safeguards that have been established by the Parliament. The Committee notes that imposing a condition on an RSE licence and making a prudential standard that is specific to an RSE licensee (and/or its connected entities) are other exercises that are also susceptible to reconsideration and merits review.[3] This reinforces the point that Parliament has intentionally established important safeguards in respect of the exercise of significant powers by APRA.

42. The Committee suggests that sub-paragraphs 18(c) and (d) of the draft CPS 230 are unnecessary and that sub-paragraphs 18(a), (b) and (e) are, with respect, objectionable. The Committee therefore suggests that consideration be given to removing paragraph 18 altogether.

43. As a final point in relation to proposed paragraph 18, the Committee is not sure that the words 'in the supervision of this Prudential Standard' in sub-paragraph 18(e) are apt. If sub-paragraph 18(e) is retained (despite the Committee's suggestion that it be removed), the Committee suggests the language ought to be amended to read 'in APRA's supervision of the entity under this Prudential Standard'.

Paragraph 49—Material service providers

44. Paragraph 49 of the draft CPS 230 specifies services that will always be 'material'. However, some of the services specified may only be relevant to some APRA-regulated entities and not to others. For example:

    - credit assessment would only be necessarily material to banks; and
    - underwriting, insurance brokerage and reinsurance would only be material to insurance companies.

    APRA's Discussion Paper appears to confirm this view.[4]

45. The Committee suggests paragraph 49 should specify which entity types APRA says each specified service would always be material to. Otherwise, there is the risk of confusion regarding how paragraph 49 applies. For example, if an RSE licensee uses an insurance broker to find directors and officers insurance cover for the licensee's officers, paragraph 49 might incorrectly suggest that such services are necessarily 'material' to the RSE licensee.

46. In addition, the list of prescribed 'material service providers' also includes 'arrangements with promoters and financial planners'. The Committee notes that 'promoter' is not defined at law and has no standard meaning, and in practice there may well be both material and immaterial fund promotion and financial planner arrangements. As such, the Committee suggests that 'arrangements with promoters and financial planners' should not automatically qualify as material service providers.

[3] Ibid s 10(1) (definition of 'reviewable decision' paras (df) and (doc)); s 344.
[4] Australian Prudential Regulation Authority ('APRA'), Strengthening operational risk management (Discussion Paper, July 2022) 25 [Table 6].

Paragraph 52—Service provider agreements

Sub-paragraph (a)—Mandated tender and selection process

47. Sub-paragraph 52(a) of the draft CPS 230 would create a mandatory obligation to conduct a tender for any material service provider appointment, renewal, or material modification.

48. It is unclear whether this significant change in approach to that currently applying to material outsourcing arrangements under CPS 231 (outsourcing standard) is deliberate and intended. Current CPS 231 refers to an obligation in the context of material outsourcing arrangements for the regulated entity to have 'undertaken a tender or other selection process for selecting the service provider'. As such, the current position is that there is no absolute requirement for RSE licensees to undertake a tender process before entering or renewing any material service provider arrangement.

49. The Committee is of the view that if a change in policy approach is intended in this way, then, at a minimum, the meaning of 'tender' should be clarified. A 'tender' does not necessarily involve more than one 'vendor' offering to provide goods or services. A 'tender' could involve only two parties, being the person requesting the tender for services and a single potential service provider responding to that request.

50. If APRA intends for 'tender' to mean a competitive process requiring an RSE licensee to invite responses from more than one potential service provider, then this should be made clear in draft CPS 230.

51. The Committee considers that scope could also be given to other kinds of service procurement, including requests for proposal and the installation of panel service providers who might have to meet certain minimum criteria (ongoing and reviewed periodically).

Sub-paragraph (c)—Assess if provider is 'systemically important in Australia'

52. The Committee notes there is a proposed requirement for APRA-regulated entities to ascertain whether the provider is 'systemically important in Australia' prior to entering into, renewing, or amending a material service provider arrangement.

53. The Committee considers that the intended meaning and purpose of this requirement is unclear, particularly for RSE licensees.

Paragraph 53—Minimum requirements for material service provider agreements

Sub-paragraph (a)—Services and service levels

54. The Committee notes that not all services will have appropriate service levels. Accordingly, the reference to the required specification of 'associated service levels' should be removed from sub-paragraph 53(a).

55. Alternatively, the Committee suggests inserting the words 'where appropriate' before 'associated service levels'.

Sub-paragraph (g)—Termination rights

56. The draft CPS 230 proposes that material provider agreements must include termination provisions that permit an RSE licensee to terminate the arrangement,

where to continue the arrangement 'would be inconsistent with the RSE's licensee's duty to act in the best financial interest of beneficiaries'.

57. The Committee considers that, in practice, the application of such a requirement is likely to provide a fertile ground for advice, dispute, and conjecture without providing any obvious substantive improvement in the financial position of members under the current law.

58. The Committee suggests that there are other existing obligations on RSE licensees that would operate to provoke a termination of a service provider, if appropriate, and RSE licensees should be given flexibility to negotiate contracts having regard to their existing duties (particularly via the statutory covenants). Early termination of a service provider may itself give rise to increased costs ultimately borne by members. RSE licensees ought to be able to take into account all relevant circumstances before making such a decision and such a broad ground for termination in sub-paragraph 53(g) increases the risk for service providers and may result in increased charges.

59. If super-specific provisions are to be retained in the standard on this point, the Committee submits they ought to reference the trustee's statutory covenants as a whole (which apply to any service provider contracting arrangement) and not only one of the more prominent covenants—exercise of any trustee powers in the best financial interest (which is potentially oddly cast for this context).

60. In the Committee's view, an express 'best financial interests' termination right will create substantial uncertainty in application, especially in respect of when it *can* be exercised and when it *must* be exercised. This view is based on members' lengthy experience with the previous paragraph 52(2)(c) of the SIS Act (the 'best interests' duty) as well as its successor (the 'best financial interests' duty).

61. In the Committee's experience, there have been differences of opinion between lawyers, regulators, and other stakeholders in the superannuation industry about what the 'best interests' and 'best financial interests' obligations require an RSE licensee to positively do in any particular situation—including under review and termination provisions for major service provider contracts. For example, if an RSE licensee enters into a material service agreement on attractive commercial terms and at a competitive cost but, soon afterwards, another service provider offers the same services and terms but at a slightly lower fee, the following questions arise:

    - can (and should) the licensee terminate?; and
    - is the licensee obliged to terminate?

    It seems likely that if a contract contained such a right, a licensee could be under regulatory (and other) pressure to exercise the right if grounds for exercising it arguably exist.

62. Given the existing uncertainties regarding the practical requirements of the 'best financial interests' duty, the Committee considers it likely that the existence of such a termination right would lead to licensees frequently second-guessing their contracting decisions and repeatedly obtaining legal advice on the same contract about whether they can, or must, exercise the termination right. The Committee acknowledges that in many cases, there may be no clear answer to that question and the consequences are likely to be quite uncertain. If an RSE licensee purportedly exercised the right, the contract counterparty might challenge it, leading to a legal dispute.

63. In considering the minimum duration of a contract and any renewal and termination rights, an RSE licensee will already be obliged to negotiate with a service provider in accordance with the licensee's duties as a whole—including best financial interests and conflicts management duties and applying the prudent superannuation trustee standard of care. RSE licensees also have obligations to monitor and review service provider performance and at least periodically review their contracts with service providers.

Paragraph 56—APRA can require changes to a service provider arrangement

64. Paragraph 56 of the draft CPS 230 provides that APRA may require an entity to review and make changes to a service provider arrangement where APRA identifies heightened prudential concerns.

65. The Committee makes the drafting observation that, as worded, paragraph 56 does not expressly impose any obligation, or potential obligation, on an APRA-regulated entity. Instead, the paragraph seems to contemplate that APRA might request that an entity voluntarily make a change or that APRA might exercise some (other) power it has under legislation (for example Part 16A of the SIS Act) or another paragraph of a prudential standard to require the entity to make the change. This may be what APRA intends.

66. Whatever is intended, the Committee notes that a licensee's ability to comply with any APRA 'requirement' might be subject to the contractual rights of the relevant service provider and may have adverse financial implications for the RSE and members, if exercised.

67. The Committee notes that several other proposed paragraphs of the draft CPS 230 also use the expression that 'APRA may require' an entity to do something, without expressly imposing an obligation on the entity to comply: see paragraphs 18, 36, 38, 43, and 51. These provisions create uncertainty.