



Australian Prudential
Regulation Authority
CAPABILITY REVIEW

JUNE 2019

Australian Prudential
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CAPABILITY REVIEW

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LETTER OF TRANSMITTAL

28 June 2019

Hon Josh Frydenberg MP
Treasurer
Parliament House
Canberra ACT 2600

Dear Treasurer

Capability Review of the Australian Prudential Regulation Authority

In accordance with the Terms of Reference, we are pleased to present our Capability Review of the Australian Prudential Regulation Authority (APRA) Report.


The Report makes 24 forward-looking recommendations which seek to ensure that APRA is best placed to deal with its future environment and the challenges which lie ahead.

Nineteen recommendations are made to APRA and five recommendations reside with the Government. All recommendations complement each other.

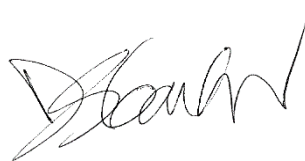
While the views and recommendations in this Report were arrived at independently, they followed extensive and insightful consultations. This involved meeting with over 30 stakeholders, hosting of five roundtables with key industry experts and international prudential regulators, receipt of 19 written submissions, a quantitative and qualitative staff survey, focus groups, a review of over 1,000 APRA documents and analysis of information from seven international peer regulators. In addition, the Panel met with and received presentations from APRA's senior leaders on over 30 occasions.

We commend the Report to you.

Yours sincerely



Graeme Samuel
Chair



Diane Smith-Gander
Member



Grant Spencer
Member

PANEL BIOGRAPHIES

Graeme Samuel



Professor **Graeme Samuel** AC is a Professorial Fellow in Monash University's Business School and School of Public Health and Preventative Medicine. He is also President of Dementia Australia, Chair of the National Health and Medical Research Council National Institute for Dementia Research, Chair of Lorica Health (a CMCRC company), Director of Digital Health CRC, Chair of South East Melbourne Primary Health Network and Chair of Airlines for Australia and New Zealand.

Graeme Samuel's former roles include Chair of the Australian Competition and Consumer Commission, Associate Member of the Australian Communications and Media Authority and President of the National Competition Council. Graeme Samuel was a member of the Panel which conducted the Prudential Inquiry into the Commonwealth Bank of Australia. He was Chair of the Australian Government's Panel of the Review of Australia's Independent Medical Research Institutes and advisor to the Department of Health in its review of private health insurance.

In 2010 he was made a Companion of the Order of Australia for eminent service to public administration through contributions in economic reform and competition law, and to the community through leadership roles with sporting and cultural organisations.

Diane Smith-Gander



Ms **Diane Smith-Gander** AO is a non-executive director of AGL Energy Limited and Wesfarmers Limited, Chair of Safe Work Australia, Chair of the Asbestos Safety and Eradication Council and a board member of Keystart Loans Group.

Diane Smith-Gander's former roles include Chair of Broadspectrum Limited, Deputy Chair of NBN Co, non-executive director of the CBH Group, Commissioner of Tourism WA, board member of the Committee for Perth, group executive at Westpac and partner at McKinsey & Company.

Diane Smith-Gander is an Adjunct Professor in corporate governance at the University of Western Australia and a member of its Business School advisory board. Diane Smith-Gander is also a trustee and member of the Board of CEDA — Committee for Economic Development of Australia and was the former President of Chief Executive Women. Diane Smith-Gander has also established her own advisory company, DSG Advisory Pty Ltd.

Grant Spencer



Mr **Grant Spencer** is a former Deputy Governor and Head of Financial Stability and former Acting Governor at the Reserve Bank of New Zealand. He is currently an Adjunct Professor at Victoria University Wellington.

Grant Spencer has previously held senior roles at the International Monetary Fund (IMF) and ANZ Bank (NZ).

Grant Spencer chaired the OECD Committee on Financial Markets from 2015 to 2018, and the Financial Markets Working Group of EMEAP, an association of eleven East Asian and Pacific Central Banks. Grant Spencer was a member of the New Zealand Capital Markets Development Taskforce in 2010 and has served as non-executive director of the New Zealand Institute of Economic Research, council member of the New Zealand Corporate Treasurers Association and member of the University of Canterbury Business School Advisory Board.

ACKNOWLEDGEMENTS

The Panel would like to thank APRA staff and the APRA Members for their assistance and engagement in the Review.

The Panel would also like to thank everyone who generously gave their time and insights during the consultation process.

Finally, the Panel wishes to acknowledge the support provided by members of the Treasury Secretariat: Warren Tease, Merrick Peisley, Emily Hodges, James Douglas, Lauren Hogan, Cate Le Mesurier, Kevin Zhang, Rumesh Stoner, Lalarukh Javaid, Faith Cooper and Callie Voulgaris.

TERMS OF REFERENCE

Under the APRA Act, APRA's statutory mandate is, in performing and exercising its functions and powers, to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, to promote financial system stability in Australia.

APRA also has industry-specific statutory responsibilities under the relevant industry acts, to protect the interests of bank depositors, insurance policyholders and superannuation fund members, and to administer the Financial Claims Scheme. This includes under the Superannuation Industry (Supervision) Act APRA's responsibility for ensuring RSE licensees prudently manage their business operations consistent with their member best interest obligations and the delivery of quality member outcomes.

The objectives of the APRA Capability Review are to:

1. Assess APRA's capability to deliver upon its statutory mandate under the APRA Act and relevant industry acts.
2. Undertake a forward-looking assessment of APRA's ability to respond to an environment of growing complexity and emerging risks for APRA's regulated sectors.
3. Identify recommendations to enhance APRA's future capability, having regard to the changing operating environment and any relevant organisational initiatives which are already underway.

As part of its work the Panel should evaluate the extent to which the following factors support APRA to deliver its statutory mandate:

- well-considered and clear strategy that takes into account the future operating environment, effectively cascaded throughout the organisation;
- decision-making that balances financial safety and financial stability, and considerations of efficiency, competition, contestability and competitive neutrality;
- culture that supports supervisory and enforcement actions in support of strategic objectives;
- robust internal governance arrangements, supported by fit-for-purpose internal reporting, performance monitoring and audit and assurance activities;
- appropriate resource allocation, responsive to emerging issues, and efficient utilisation;
- staff with necessary expertise (for example, industry, technical and data analytics) supported by appropriate tools;
- sound process and outcomes realised across APRA's core supervision, policy and resolution functions (including appropriate utilisation of enforcement tools);
- appropriate engagement with Australian financial sector regulators, including suitable information sharing arrangements; and
- fit-for-purpose statutory powers.

In each case, the Panel should focus on those areas considered to be of greatest relevance to the Review objectives. The Panel should to the extent relevant take into account practices of, and benchmark APRA against, comparable international prudential regulators. The Panel should also take into account as a starting point relevant recent reviews and reports as they relate to APRA, including the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry Interim and Final Reports, the Productivity Commission's final report Superannuation: Assessing Efficiency and Competitiveness, the Productivity Commission's final report Competition in the Australian Financial System, the IMF's Financial System Stability Assessment of Australia (scheduled for release in early 2019) and APRA's own internal Enforcement Review (scheduled for completion in March 2019).

In undertaking its assessment, the Panel should take as given APRA's legislative framework, except as outlined above in relation to APRA's statutory powers.

The Review is to commence in March 2019 and is to report to Government by 30 June 2019.

LIST OF RECOMMENDATIONS

Chapter 2 — Empowering APRA for new challenges

Recommendations

2.1	Building upon APRA’s strategic initiative to enhance ‘leadership, people and culture’, APRA Members should address variation in leadership capability for all management levels. This should include a priority focus on leading change, effective execution and accountability. In addition, APRA should develop a cultural change program that fosters internal debate and contestability.
2.2	APRA should set transparent standards to hold staff and itself accountable for the timeliness of approvals and other commercially-important decisions for regulated institutions. APRA should publicly disclose adherence rates to these performance standards in its external accountability assessment (see recommendation 6.4).
2.3	<p>APRA should revise its organisational structure to reinforce the impact of the leadership and cultural changes recommended by the Review and APRA’s own strategic plans. APRA should:</p> <ul style="list-style-type: none"> a. restructure supervision divisions along industry lines — banking, insurance and superannuation; b. revise management structures and levels, with a view to widening spans of control and enhancing efficiency, speed of decision-making and empowerment; c. shift internal configuration to better support industry-focussed strategic activities and more agile ways of working; and d. create distinct people-leader and technical-specialist career pathways.
2.4	APRA’s Chair should relinquish his ADI-specific oversight role and adopt a broader organisation-wide role. The remaining Members should split their roles to include a mix of industry, policy and functional responsibilities.
2.5	To help facilitate a number of recommendations in the Review, the Government should remove APRA from the application of the APS Workplace Bargaining Policy. APRA should engage with the Government to consider ways to enable greater variation in remuneration levels.

Chapter 3 — Maintaining financial stability in an ever changing world

Recommendations

3.1	While lifting organisational capability across the areas identified in this Review is important and necessary, APRA should retain its long-standing and core capability of fostering financial safety and financial stability.
3.2	APRA should build credit risk capacity to simultaneously maintain high supervisory intensity in both non-retail and retail credit risk.
3.3	Reflecting its role as an independent prudential regulator, APRA should take a more transparent and assertive role in articulating the objectives of its macro-prudential policies, the design of the instruments chosen and assessment of its impacts, including on the broader areas of its mandate. APRA should continue to develop its public communication around the extent of systemic risks, conditions required for macro-prudential actions and assessments of any actions taken.
3.4	APRA should advise the Government of the current state of its resolution capability and crisis preparedness as a basis for assessing whether additional resources are required to advance this work more quickly. This should be completed by the end of 2019.
3.5	APRA should seek to build strong allegiances with public and private sector experts, other regulators and financial firms to augment its internal capacity and to collaborate on ways to strengthen the cyber resilience of APRA's regulated sectors.
3.6	To better prepare for and respond to the consequences of digital innovation and disruption, APRA should increase its IT risk capacity and capability, including through increased collaboration and partnerships. In doing so, APRA should consider the implications of new business models, management and transformation of legacy IT landscapes, greater reliance on third-party providers (for example, cloud providers), and technology-enabled competition.
3.7	To support its consideration of competition, APRA should: <ul style="list-style-type: none"> a. create a competition champion within APRA, preferably at Member level. Their role should be to ensure that issues of competition are embedded effectively across all areas of APRA; b. ensure that there is sufficient tension in the internal debate and analysis of competition. It should test how policies are developed and applied by supervisors. This could be done in the Quality Assurance function and reported to the competition champion; and c. report regularly on competition developments in its external accountability assessment (see recommendation 6.4).

Chapter 4 — Governance, culture and accountability: Broadening APRA’s approach to supervision

Recommendations

4.1	<p>As part of its work to revise and enhance its supervisory and policy frameworks, APRA should:</p> <ul style="list-style-type: none"> a. ensure the policy framework is focussed on assessing appropriate outcomes around GCA risk in regulated entities, not just appropriate processes; b. further develop its toolkit for assessing GCA risks, including board and senior management performance, and ensure that it has an escalating suite of options for engaging with entities; c. embed the recent entity self-assessment process into its more intense supervision of GCA risks by making it a biennial requirement. The self-assessments should be more prescriptive than APRA’s recent program, including coverage of questions set out in Appendix 2. The self-assessments, APRA’s assessment of each of them, APRA’s thematic reviews, and any rectification requirements imposed by APRA in response to a self-assessment should be published; d. establish an external panel of experts to assist it in undertaking more in-depth assessments of individual entities; and e. explore ways to collaborate with regtech specialists and other experts to develop more efficient and effective tools to identify GCA risks.
4.2	<p>APRA should build on the CBA Prudential Inquiry and entity self-assessments by embedding CBA-style prudential inquiries as an ongoing part of its supervisory toolkit. The Panel would expect to see several prudential inquiries in the first few years to reinforce the need for rigorous self-assessments (see recommendation 4.1). In time, the inquiries should involve retail and industry superannuation, insurance and ADI entities.</p>
4.3	<p>The Government should consider providing APRA with a non-objections power to veto the appointment or reappointment of directors and senior executives of regulated entities. This would bring it into line with international regulators and strengthen its capacity to pre-emptively regulate GCA risks. The power should be available to APRA only where the risks associated with the entity, including but not limited to member outcomes for superannuation funds, warrant it.</p>

Chapter 5 — Regulating the Superannuation System for members

Recommendations

5.1	APRA should create a new Superannuation Division, headed by an Executive General Manager. A key focus of the Division should be the overall performance of the superannuation system for members.
5.2	<p>APRA should embed and reinforce its increasing focus on member outcomes, and continue to ensure that trustees prudently manage member funds.</p> <p>Consistent with this change of approach, APRA should:</p> <ul style="list-style-type: none"> a. publish objective benchmarks on product performance and publicly take action to demonstrate its expectations for member outcomes; b. develop a superannuation performance tool that replaces PAIRS by the end of 2019. The tool should be focussed on member outcomes; c. update its superannuation reporting standards and collect product level data that facilitates accurate assessments of outcomes and comparability across funds; and d. increase the resourcing dedicated to the superannuation industry.
5.3	In accordance with recommendation 23 of the Productivity Commission’s Superannuation Inquiry, the Government should legislate to make APRA’s member outcomes mandate more explicit. The Government should clearly outline its expectations for APRA on superannuation in its next Statement of Expectations.

Chapter 6 — APRA in the System

Recommendations

6.1	<p>The Panel supports the direction of the APRA Enforcement Strategy Review. To effectively embed the Enforcement Approach, APRA should change its existing internal norms that create a low appetite for transparent supervisory challenge and enforcement by:</p> <ul style="list-style-type: none"> a. departing from its behind closed doors approach with regulated entities; b. adopting a stronger approach towards recalcitrant institutions; c. building organisational confidence and improving management support; and d. increasing its risk appetite and use of the escalation toolkit.
6.2	<p>While APRA’s regulatory tools are generally fit-for-purpose, the Government should consider:</p> <ul style="list-style-type: none"> a. reviewing the adequacy of penalties across APRA's legislative framework; b. providing APRA with the power to appoint a skilled person to undertake a review of a regulated entity; and c. enhancing its private health insurance licensing powers.
6.3	<p>APRA should reinvigorate its approach to collaboration and information sharing with regulators and its international peers including clear protocols for staff.</p>
6.4	<p>APRA should use its existing external accountability framework more effectively, including a more assertive use of the Statement of Intent and it should publish a regular external accountability assessment.</p>
6.5	<p>The Government should consider streamlining and improving the effectiveness of existing accountability arrangements when establishing the financial regulator oversight authority.</p>
6.6	<p>APRA should take a more strategic, active and forceful approach in its public communications. As an independent regulator, it should use public communications to shape community and government expectations of it. In relation to specific areas, APRA should:</p> <ul style="list-style-type: none"> a. publish an interpretation of its mandate; b. clearly articulate its role and approach to macro-prudential policy (see recommendation 3.3); c. advise the Government of the current state of its resolution capability and crisis preparedness (see recommendation 3.4). Taking account of the impact on the market, part of this advice could be published; and d. be more transparent in relation to superannuation, including by publishing objective benchmarks for superannuation performance on member outcomes and a strategy to promote long-term industry performance.

EXECUTIVE SUMMARY

A strong track record but a need to embed change

Australia has not experienced a recession for close to 30 years. A resilient and profitable financial system has been one of the foundations of that success. Since APRA's inception in 1998 there have been very few failures of significant financial institutions and no systemic financial crisis in Australia. Such a track record is rare internationally. APRA is highly respected by its global and Australian peers and by the entities that it regulates. This respect is well deserved.

APRA's successful track record has been supported by a strong regulatory architecture, sound economic policies and benign economic conditions in Australia. The financial sector has benefited from strong tailwinds which have underpinned growth and profitability in the sector. APRA's external environment will not always be as conducive.

This Review was conducted during a period of organisational change at APRA in response to its 2018-22 Corporate Plan and external events including the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Hayne Royal Commission), CBA Prudential Inquiry and the introduction of the Banking Executive Accountability Regime (BEAR). Extensive turnover at senior staff levels over the past few years has been part of that change. There has been investment in strengthening information technology (IT), risk and data analytics, enterprise planning, supervisory and policy capabilities. Also, in response to the Hayne Royal Commission, APRA has reviewed its approach to enforcement.

Many elements of APRA's Corporate Plan are consistent with the conclusions of this Review. The Panel notes an awareness on the part of top management of the necessity to embed meaningful change throughout the organisation. Change is necessary and the Panel hopes that this Review will give it further impetus. However, this Review identifies issues around culture, variability in leadership capability and capacity to implement change which could act as constraints and need to be addressed in their own right.

The Hayne Royal Commission and community expectations

This Review was recommended by the Hayne Royal Commission. The damaging revelations revealed during the Commission's inquiry have had a profound impact on the community. Boards, management and trustees of prominent and financially successful firms and superannuation funds face questions about their competence, integrity and commitment to customers and members. Questions of legality are yet to be determined in many cases. Questions about the inability of regulators to anticipate and deal forcefully with the misconduct revealed by the Hayne Royal Commission have also been raised. Trust in the financial system and its regulators has diminished. Community expectations about the role of regulators have been heightened.

It is important that these problems of misconduct are rectified and that industry behaviour and customer outcomes become better aligned to community expectations. Where laws have been broken there is rightly an expectation that those responsible will be held to account. But for a prudential regulator a 'litigation-first' or a litigation-focussed enforcement strategy will not help it achieve its ex-ante mandate, although APRA should not resile from legal remedies when they are needed.

APRA's response to the community's heightened concerns should be in a manner consistent with its mandate. It should retain its focus on maintaining financial safety and stability but focus more intensely on governance, culture and accountability (GCA) in the financial sector.¹ It should accept that GCA risks have a major bearing on financial risk. This Review is careful not to make the distinction between financial and non-financial risks common in discussions of GCA. Weaknesses in GCA frameworks feed directly into financial safety and stability. For a prudential regulator there is no binary choice between supervising financial or GCA risks. Failures of GCA have often been at the heart of financial failures and systemic instability. The Global Financial Crisis (GFC) clearly demonstrated this. They are as much a part of a prudential regulator's remit as capital and liquidity ratios. The Panel notes APRA's attempts to build capability in this area but questions whether its importance for a prudential regulator has been recognised in the past.

While APRA can supervise these risks more effectively, it cannot guarantee that all customers will have a good experience with their bank, insurance company or superannuation fund. Individual misconduct regulation resides with the Australian Securities and Investments Commission (ASIC). Closer collaboration between APRA and ASIC will be crucial, to agree their respective roles and to deliver the desired outcomes.

Variability in leadership, a conformist culture and aversion to transparency are constraining APRA

The main conclusion of this Review is that APRA's internal culture and regulatory approach need to change. There is also variability in its leadership capability. There is no doubt that in matters of traditional financial risk APRA is an impressive and forceful regulator. But the Panel observes that APRA's tolerance for operating beyond quantifiable financial risks has been low. APRA appears to have developed a culture that is unwilling to challenge itself, slow to respond and tentative in addressing issues that do not entail traditional financial risks. In combination with APRA's organisational structure, these factors limit its ability to deliver on the breadth of its mandate and adapt to new challenges.

The Panel does not want APRA to build capability elsewhere by diminishing its core capability and acknowledges that this will be a challenging task. APRA can do better in other areas without undermining its excellence in regulating financial risk. Changes in capability, focus and structure should occur in line with culture. Equally, changes in APRA's external governance arrangements and more flexibility in its funding and compensation frameworks should be considered.

APRA has a strong preference to do things behind the scenes with regulated entities. The Panel believes that this limits its impact and authority. There are good reasons for a prudential regulator to be discreet, particularly in cases of acute financial stress. However, APRA needs to shift the dial towards a more strategic and forceful use of communication to ensure that it maximises its impact with regulated entities. Its Enforcement Approach should move it in this direction.

Some things need to be kept confidential. But APRA should consider what is appropriate to be communicated to the public. Its expectations of entities should be made public as should any failure by entities to meet those expectations, including responses by APRA to those failures.

The Panel met a wide range of senior representatives of APRA-regulated entities during the Review. Almost universally, they praised the openness and integrity of APRA's senior staff and the

1 For brevity, the Review will denote governance, culture and accountability issues as GCA. It acknowledges that this collapses distinct issues into an acronym and embeds issues such as remuneration under accountability.

effectiveness of APRA's discreet approach. They note that this approach benefits both APRA and their firms.

A common observation made in these discussions was that their entities were more willing to cooperate with and provide information to APRA when it worked behind the scenes with them. It was noted that more transparency on APRA's part would threaten that relationship. The Panel is not persuaded by that argument or the implication that APRA would be less informed if it operated more openly. While cooperation is always to be preferred to compulsion, regulated entities must provide APRA with the information it needs. An approach involving protracted behind the scenes negotiations of prudential issues is out of step with public expectations of regulators following the Hayne Royal Commission. As the Bank of England has noted in a different context, reliance on the lift of 'Governors' eyebrows and fireside chats are no match for a clearly communicated framework' in today's financial system.²

APRA should use strategic communication to better define its authority and shape its own destiny. It is investing in capacity in this area. More effective communication of its priorities and mandate will provide a clear signal to the market as to what the regulator wants, making it more transparent and more effective in its supervision of the financial sector. APRA is independent of the government and has strong and wide-ranging standard-setting powers. It has the foundations of a powerful institution but needs to build on these foundations by better communicating its objectives and achievements.

APRA's current external governance arrangements are not effective in holding it to account against its mandate. These should be reviewed in line with the creation of a financial regulator oversight authority. Even within these constraints APRA could be more effective. As a starting point, a public statement of its interpretation of its mandate and how APRA implements it would benefit APRA and make it easier for others to hold it to account. A useful historical analogue is the Reserve Bank of Australia's (RBA's) public definition and ownership of its inflation target in the early 1990s. APRA should also use its Statement of Intent (Sol) more assertively. It is appropriate that APRA take into account the government's broad objectives when pursuing its mandate. However, APRA should highlight areas where the government's objectives are outside its Corporate Plan and areas in which APRA has more pressing resourcing priorities. This is entirely appropriate for an independent regulator.

The same mandate, a sharper focus, new risks and new ways of doing things

APRA has a broad mandate that has not changed since its inception. The Hayne Royal Commission and CBA Prudential Inquiry have brought GCA risks into sharper focus. They have also led to questions about whether they fit in APRA or ASIC's mandate. The Panel believes that they fit in both but in different ways and with different objectives. APRA's prudential mandate requires it to look forward, to assess how an entity's GCA frameworks may impact on its financial safety. ASIC, as a conduct regulator, will look at conduct that has already happened and may be a breach of the law.

APRA's capability to regulate and supervise GCA risks is at an early stage. This is the case for many regulators but APRA may be behind its international peers. Staff departures stalled its earlier investment in GCA risk capability. APRA has received additional funding to strengthen these areas, so external constraints on its capability are now less acute and, of late, there is more focus on GCA risks within APRA. However, the Panel is concerned about some scepticism in APRA of the need to change

2 Shafik, M, 2015, *Goodbye ambiguity, hello clarity: the Bank of England's relationship with financial markets*, February 2015.

and to allocate resources to areas that are not perceived to have large prudential risks. GCA risks are core to prudential supervision and, for an ex-ante regulator like APRA, should already have more prominence in its work. Embedding new resources and developing a culture that supervises GCA risks as rigorously as traditional financial risks should be one of APRA's priorities.

All regulators are finding this a challenging issue. There are few quantitative metrics to build into standards. Arrangements also vary across institutions and business models. Ultimate responsibility for the quality and execution of GCA frameworks rests with boards, trustees and senior management. This has been a problem for APRA in recent years, as boards, trustees and senior executives in the financial sector have been found lacking.

APRA does not have the skills or resources to successfully supervise GCA risks alone. The recommendations in this Review attempt to harness external resources for APRA and at the same time make boards, trustees and senior management more publicly accountable to ensure that their GCA frameworks support high standards of conduct and financial integrity. Noting the impact of the CBA Prudential Inquiry on APRA's approach to GCA risks and its broader impact on regulated entities, the Panel recommends that APRA be ready to implement several similar inquiries over the next two years. These should involve superannuation (retail and industry), insurance and authorised deposit-taking institution (ADI) entities. This form of inquiry should become one of the ongoing tools used by APRA to implement necessary improvements in the maintenance of required standards in GCA by regulated entities. They should draw on external experts. The choice of entities to be reviewed should be informed by entity self-assessments or issues identified in APRA's supervision. APRA should also embed a regular, more prescriptive and public self-assessment program for a range of entities in its work.

Dealing with cyber risks is another area in which APRA's capability does not match the significance of the risk. This is common to many regulators. Cyber is an immediate and significant risk, not an emerging one. The Panel assesses that APRA will always struggle to have the skills and resources to deal with this unilaterally. Greater and more innovative collaboration will be necessary. Raising the prominence of these risks at the Council of Financial Regulators (CFR) is a good step. Others are needed. Thought needs to be given to whether there are sufficient expert resources in Australia to support the current fragmented approach to managing cyber risk in the financial sector. A collaborative approach is required with both APRA and government playing coordinating roles.

Financial risks are not static, they change over the cycle and can become correlated across firms so that individual weaknesses scale up to become systemic problems. Following the GFC, policy makers have considered ways of managing systemic financial risks in a dynamic way, under the heading of macro-prudential policies. Knowledge of the theory and practice of these policies is still developing. Some of APRA's recent interventions in the residential mortgage market, notably industry-wide restrictions on investor and interest-only lending, can be classified as macro-prudential policies, although APRA has not embraced this term. Despite some concerns about their impact on competition, these policies have had the desired effect of reducing risk that had been building up in residential mortgage books. APRA's intervention was effective. As in other areas, APRA needs to be more transparent about its ownership and approach to these policies, including the important supporting role of the CFR.

Superannuation needs more priority and concrete action

APRA's approach to superannuation has followed the premise, as set out in the Wallis Inquiry, that the management of superannuation funds implied a 'less intense promise' to members than the repayment of bank deposits or payouts under insurance contracts. This is true in the narrow sense

that the outcome of an investment in a superannuation fund is generally uncertain. However, members should expect an intense promise from trustees that their funds are managed with due care, skill and diligence and in their best interests.

APRA has placed more emphasis on member outcomes in the past few years. But the Panel notes that it has been slow to broaden its perspective on superannuation. APRA needs to lift its effort on superannuation and shift its thinking and focus by developing its policy and supervision framework and by building its skills and resources dedicated to the sector. This would be assisted by changes to APRA's existing structure. To facilitate this change of approach, APRA should create a new Superannuation Division under an Executive General Manager (EGM). A key focus should be on member outcomes. The analytical work of the division should give more emphasis to horizontal cross-industry comparisons of fund performance. APRA should publish its forward strategy on assessing whether funds are acting in members' best interests and on how it will deal with persistently underperforming funds.

Crisis management and resolution are critical capabilities

APRA's efforts to build capital requirements, strengthen balance sheets and tighten lending standards in the residential mortgage market in the past few years have made the financial system more resilient. But this is no guarantee against a financial failure or crisis. The Panel notes the assessment of the IMF that APRA needs to strengthen its crisis management and resolution capabilities. The Panel also observes that in the event of a crisis APRA would need to redeploy resources quickly within a tight resourcing constraint. APRA is very aware of this challenge but has delayed plans to strengthen its crisis management and resolution capability because of competing external demands on its resources and delays in legislation. Given the importance of being prepared for a crisis, APRA should advise the Government of its current state and objectives as a basis for assessing whether additional resources are required in this important area.

Technological change, competition and APRA's productivity

Technology is changing the face of the financial services industry. New technology-focussed businesses are entering the industry and open banking is likely to broaden the scope for non-ADI provision of bank-like services. This is likely to benefit consumers but raises a number of questions for APRA. How does it balance the need to focus on financial activities rather than financial institutions? How does it balance financial safety and stability against supporting innovation and competition when new entrants bring risks that are not well understood?

APRA has attempted to assist new entrants establish themselves through its revised licensing arrangements. Yet feedback from industry experts and other regulators suggests that APRA is slow to embrace new entrants. They suggest that it is risk-averse, preferring technologies it knows and trusts and business models that are aligned with its supervisory powers and mandate. This could hamper firms' ability to innovate and adopt technologies that could enhance their competitive position. APRA is seen by the industry as slow in providing guidance on new technologies and not sufficiently cognisant of commercial perspectives.

These observations point to the broader question of how APRA embeds competition, competitive neutrality and efficiency in its mandate. This is a difficult task and requires nuanced judgment. APRA could be said to have a 'do no harm' approach to competition: support competition when it can, but not at the expense of any perceived risk to financial stability. This may seem a reasonable proposition given the necessity of financial stability. However, there should be greater recognition of the nature

of any trade-off and the strategic importance of facilitating competition for the incumbent institutions. APRA can do more, including publishing a clearer interpretation of its mandate, establishing a strategic position on competition and being held to account. It should create a competition champion in the organisation and embed a regular assessment of competition into its quality assurance process.

APRA should build on its Project Athena and embrace technological changes that will boost its productivity. The Capability Review Staff Survey revealed that APRA staff feel that its IT and data capabilities need improvement. Its supervision may benefit from new forms of data analysis, including text-based analysis for monitoring GCA risks. If APRA can raise productivity levels in supervision and more broadly across the organisation then it will be better placed to meet its new challenges.

A new structure to reinforce a new culture

The changes recommended in the Review require APRA to address variability in its leadership capability and develop a more open-minded culture, adaptable to change and supportive of more assertive engagement of staff with its regulated entities. There needs to be more clarity in communication and lines of accountability. These changes may be achieved within APRA's existing organisational structure. However, in the Panel's view, that structure is not conducive to them having their full effect. A change in organisational structure is more likely to reinforce the required behavioural changes.

APRA should replace its Diversified and Specialised Institutions Divisions with separate banking, insurance and superannuation divisions. This will increase senior management's focus and accountability for dealing with industry-specific issues. It will also strengthen the development of industry skills. A restructure will give APRA the opportunity to achieve greater efficiencies, review management structures, increase empowerment at the frontline and address some of the leadership variability identified in this Review. An objective of the restructure should be to devolve authority more effectively through the organisation. APRA staff note that decision-making is slow, with issues being taken through various committees and sometimes 'parked' for long periods, before decisions are made. A new, flatter structure with clear accountability would facilitate this.

The creation of three industry supervision Divisions provides an opportunity to reconsider the role of Members. The Chair should relinquish his oversight of ADIs and adopt a broader organisation-wide role. The remaining Members should then each have roles that combine a mix of industry, policy and functional responsibilities.

The way ahead

There are no simple solutions to raising APRA's capabilities. It operates in a complex, uncertain and dynamic environment. It requires highly skilled staff with good judgment and courage. They need to be supported by strong leadership and technology. APRA also needs to use its independence, powers and authority to greater effect to shape its future.

The areas of improvement identified in the Review are mostly for APRA to respond. Cultural change is necessary. A culture that has facilitated success in regulating traditional financial risks can be a constraint on innovation and capability development. There needs to be more internal challenge of management to ensure that the organisation adapts with developments in the financial system and addresses the breadth of its mandate. APRA needs to be more transparently assertive in its

communication. This is particularly the case with regulated entities but also applies to communication with the Parliament and the public so that APRA can better define its authority and shape its own future. These changes need to come from the top and be embraced throughout the organisation.

Some constraints are beyond APRA's control. Challenging the culture and reprioritising existing resources are necessary but not always sufficient to build capability. APRA has been resource constrained in recent years. The Government has responded by providing additional funding in the last Mid-Year Economic and Fiscal Outlook (MYEFO) and Budget. APRA needs to deploy those funds effectively to build its capability in targeted areas. Once that is done it should review its capacity against its broader remit and more complex operating environment. Industry benefits a great deal from a world class regulator and consumers need a regulator that can ensure the system is safe, robust and accountable. APRA is part of an insurance policy against a costly major financial crisis in Australia. Adding additional resources if needed could complement and facilitate the changes recommended by this Review.



CHAPTER ONE: APRA'S BACKGROUND AND OPERATING ENVIRONMENT

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CHAPTER 1: APRA'S BACKGROUND AND OPERATING ENVIRONMENT

APRA's mandate

APRA is the prudential regulator of the financial services industry.

APRA regulates the industry under five 'industry' Acts and administers the Financial Claims Scheme (FCS) for depositors and insurance policyholders.³ The industry Acts provide for licensing and regulatory oversight of:

- ADIs — including banks, credit unions and building societies;
- General insurers (including reinsurers);
- Life insurers and friendly societies;
- Private health insurers (PHI); and
- Superannuation funds (excluding self-managed funds).

SECTION 8 OF THE AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY ACT (APRA ACT) — PURPOSE FOR ESTABLISHING APRA

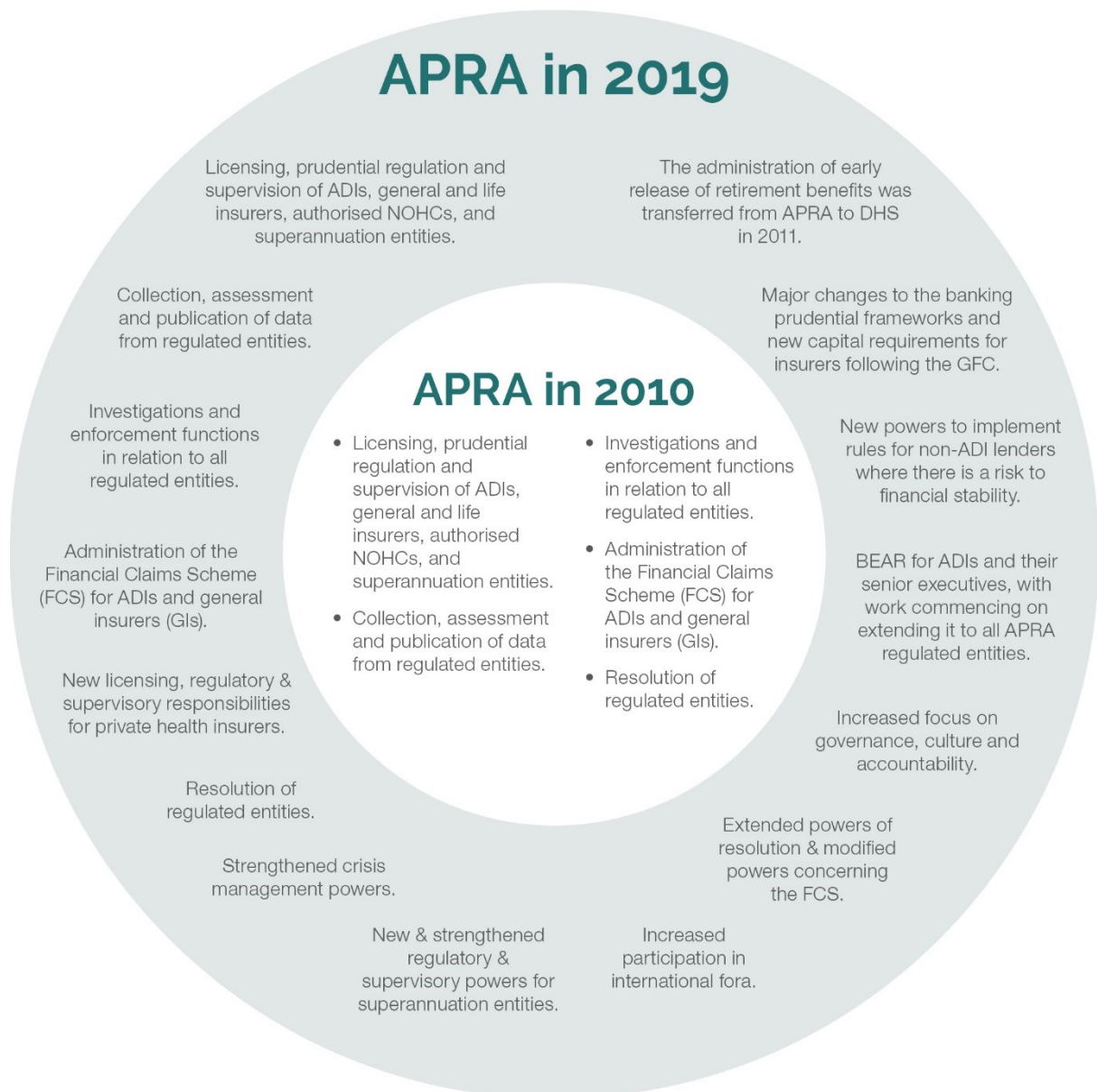
1. The main purposes for which APRA exists are as follows:
 - a. regulating bodies in the financial sector in accordance with other laws of the Commonwealth that provide for prudential regulation or for retirement income standards;
 - b. administering the financial claims schemes provided for in the *Banking Act 1959* and the *Insurance Act 1973*; and
 - c. developing the administrative practices and procedures to be applied in performing that regulatory role and administration.
2. In performing and exercising its functions and powers, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, is to promote financial system stability in Australia.

A number of reviews such as the 2014 Financial System Inquiry (the Murray Inquiry), the Hayne Royal Commission and the Productivity Commission (PC) reviews into competition in the financial system and into superannuation have not recommended a fundamental change to APRA's mandate.

³ The FCS operates to protect Australian depositors and general insurance policyholders where an ADI or general insurer fails.

Currently APRA regulates around 510 entities. Its regulated population consists of approximately 150 ADIs with \$4.4 trillion in assets; 190 superannuation entities with \$1.7 trillion funds under management; and over 170 insurers with just under \$400 billion in assets.

Figure 1.1: APRA's expanded remit 2010-2019



APRA's remit has expanded over recent years (Figure 1.1). Most notably, it was given oversight of the FCS for ADIs and general insurers in 2008 and 2010. In addition, legislative changes in 2012 provided it with a major increase in supervision powers for superannuation entities. It assumed supervisory responsibilities for PHIs in 2015. APRA's work has been further expanded by major post-crisis reforms and more recent events such as the heightened focus on governance, culture and accountability (GCA).

APRA's strategy and vision

APRA publishes a four-year rolling Corporate Plan every year to set out its functions, capabilities and its strategic initiatives. In 2018, APRA updated its plan for the 2018-2022 period, stating that its primary focus is on the need for APRA to be fit-for-purpose into the future. APRA's current strategy identifies six strategic priorities for organisational change and capability improvement:

- Broadening risk-based supervision;
- Improved data-enabled decision-making;
- Building resolution capabilities;
- Strengthening external engagement and collaboration;
- Enhancing leadership, people and culture; and
- Lifting organisational capability.

APRA's current vision is 'to deliver a sound and resilient financial system, founded on excellence in prudential supervision'.

APRA's operating model

Core functions

Licensing and supervision

Supervision of regulated entities is APRA's core business. This starts with licensing entities under the relevant industry Acts. In 2017, APRA established a separate licensing team to provide more consistent and efficient engagement with entities seeking to be authorised by APRA, including those with innovative or non-traditional models. In 2018, APRA finalised a phased licensing framework for ADIs. This aims to provide a pathway to assist entities navigate the licensing process, including the introduction of restricted banking licences. These allow new entrants to conduct some banking business while they build resources and capabilities.

Once licensed, entities are subject to supervision, which is APRA's core activity and capability. Every supervised entity is assigned a responsible supervisor. For larger entities, this may be a team of supervisors. For smaller entities, a responsible supervisor may cover a number of entities.

APRA's supervision is underpinned by the prudential framework, which is the set of requirements and expectations applicable to regulated entities as articulated through legislation, prudential standards, reporting standards and guidance.

A PRUDENTIAL LENS

APRA applies a risk-based prudential focus to supervision. Prudential supervision focusses on the financial safety of financial institutions. It seeks to ensure that risks taken by financial institutions are within reasonable bounds and effectively managed so that the financial system is protected and institutions are well placed to meet the financial commitments made to their customers. For example, a bank accepts deposits and promises to repay them on demand and an insurer accepts premiums on the promise of meeting claims when a specified event occurs.

A prudential lens is forward-looking and emphasises preventative measures (ex-ante focus) by supervising institutions against outcomes, rather than ex-post punitive action designed to punish and deter misconduct. The conduct of an institution is assessed with regard to how it may impact on the stability of the institution or sector rather than through a consumer lens.

APRA has stated that its aim is to identify the likely failure of an APRA-regulated institution early enough so there is timely corrective action or an orderly exit. APRA and successive governments note that it does not pursue a 'zero failure' regime. Instead, it seeks to maintain a low incidence of failure of APRA-regulated institutions while not impeding continued improvement in efficiency or hindering competition in the financial system.

The nature of the promise by superannuation trustees is different to that of APRA's other regulated entities — rather than having a fixed obligation to pay future amounts, the promise relates to managing members' savings in their best interests solely for their retirement. Because of this, superannuation trustees are not subject to the broader capital requirements that apply to ADIs and insurers. Consequently, APRA's supervision of superannuation is focussed on how the trustee manages and carries out its business operations fairly, efficiently and effectively to achieve appropriate member outcomes.

The prudential framework and prudential standards are 'principles-based'. APRA's stated approach is to set out expectations and allow regulated entities to adopt a suitable approach pursuant to their complexity, business model and size. There are important exceptions, such as in relation to minimum capital requirements.

Day-to-day supervision is the responsibility of teams in APRA's frontline divisions, supported by risk specialists who: provide in-depth risk assessments at an entity and industry level; identify emerging risks; and offer horizontal risk insights across industries. Further intelligence is gathered through statistical and industry analysis. Supervisors are also supported by technical advice, legal and resolution specialists.

All regulated entities are supervised according to a common supervision methodology.

Two fundamental elements of this methodology are the Probability and Impact Rating System (PAIRS) and Supervisory Oversight and Response System (SOARS) both introduced by APRA in 2002.

- The purpose of PAIRS is to determine an entity's overall risk rating. This is calculated with reference to the assessment of inherent risk and / or management and control for key risk classes or risk areas.

- The purpose of SOARS is to determine APRA's supervision stance for each regulated entity. There are four stances: Normal, Oversight, Mandated Improvement, and Restructure. The SOARS stance is a function of the output of the PAIRS assessment and the impact rating were the entity to fail.

For each regulated entity, the major supervision activities planned for the year are captured in the Supervisory Action Plan. The SAP is developed by incorporating top-down industry risks and themes captured in APRA's industry risk registers and bottom-up assessment of the responsible supervisor or team.

APRA is currently reviewing its supervision model to take into account recommendations and insights of the Hayne Royal Commission, the IMF's 2019 Financial Sector Assessment Program (FSAP) and the CBA Prudential Inquiry.

Policy

APRA's policy function is responsible for establishing and maintaining a fit-for-purpose prudential framework that reflects all elements of APRA's mandate. APRA's prudential framework aims to protect beneficiary interests by requiring prudent practice from institutions and enabling prompt, effective and proportionate supervisory responses to significant risks. APRA aims to set requirements that are clear and well understood by institutions and supervisors. Where appropriate, requirements are principles-based and allow a range of prudent practices to achieve an outcome.

Resolution

APRA aims for institutions to be appropriately prepared to recover from severe adversity, supported by credible plans for effective resolution at a point of failure. This involves working with institutions to ensure that they are prepared for the effective implementation of resolution plans and, working with domestic and international counterparts, to ensure readiness for international cooperation if needed.

The operational capability to resolve failures and near-failures in an orderly manner, and the ability to identify any potential threats to the viability of institutions early enough so that corrective action can be initiated or orderly exit achieved, is key. It is also important to have sound operational processes for communications, enforcement activity, maintaining or applying resolution strategies and readiness to administer the FCS.

APRA is continuing a large body of work to develop its resolution capabilities following the passage of major legislative reform in 2018.

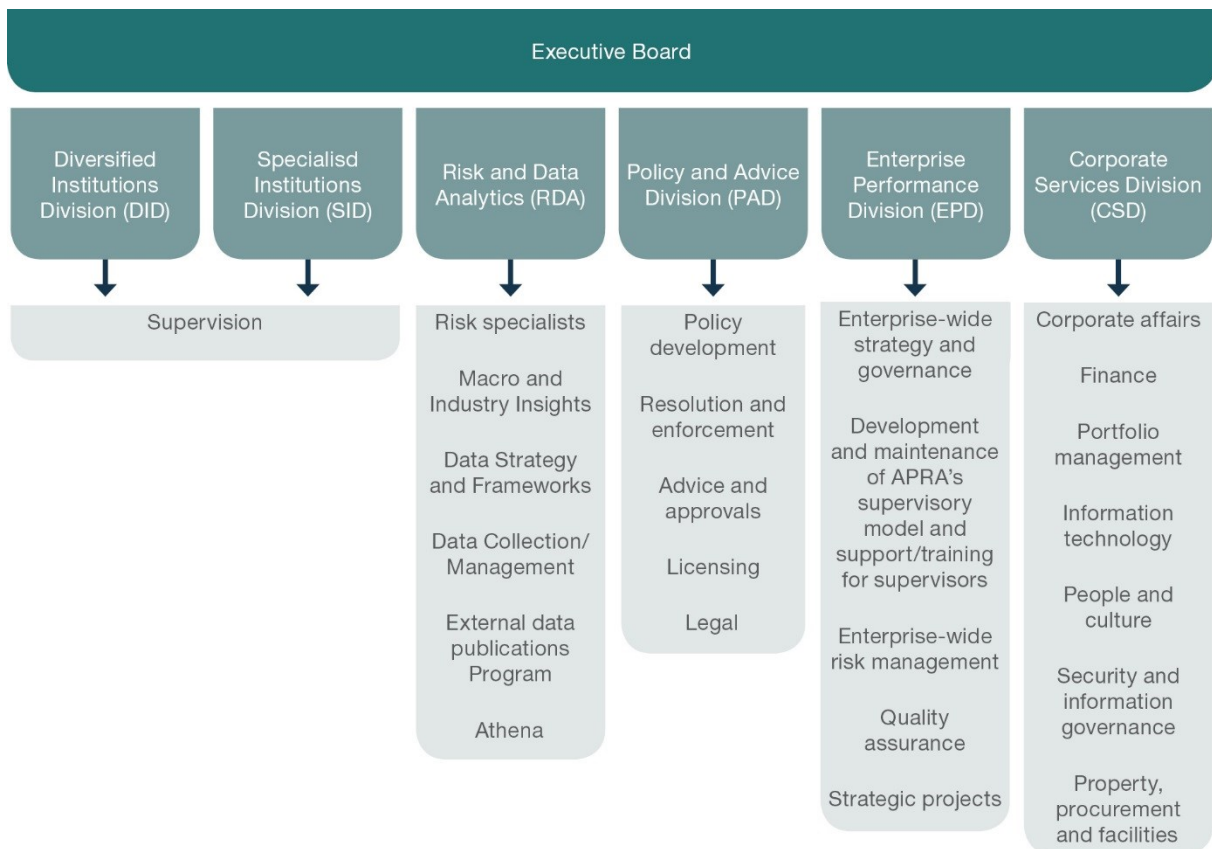
APRA's organisational structure

APRA's current organisational structure comprises six divisions, each headed by an EGM (Figure 1.2):

- Two 'frontline supervision' divisions: Diversified Institutions Division (DID) and Specialised Institutions Division (SID):
 - DID supervises the approximately 122 functionally diversified financial institutions. These include large financial conglomerates, banks, insurance companies and superannuation funds. They account for around 70 per cent of total assets in the APRA-regulated industries.
 - SID supervises over 340 smaller entities, including regional banks, credit unions, building societies, friendly societies, insurers and superannuation funds. Superannuation is by far the largest industry in SID, both in terms of assets and in number of entities.

- **Policy and Advice Division (PAD):** PAD works closely with Treasury on legislative issues and develops prudential standards and industry guidance material. This division provides technical advice, interpretations and approvals. It includes APRA's crisis management and investigations specialists, APRA's licensing team and the legal team that provides legal advice across all APRA activities.
- **Risk and Data Analytics (RDA):** RDA provides specialist expertise across credit, investment, liquidity, market, governance, culture, remuneration, operational and insurance risks. It includes data analytics teams that perform industry analysis. These teams also manage APRA's data collection and publications. RDA has responsibility for Project Athena, a major program of work to transform APRA's data analytical capabilities by modernising the way APRA collects, stores and provides access to data.
- **Enterprise Performance Division (EPD):** EPD supports the development and maintenance of APRA's enterprise-wide strategy, internal governance structure and organisational performance reporting. It is responsible for the development of APRA's supervisory approach and framework, guidance materials, supervisory training and supervisory IT systems. EPD includes the risk management and compliance function, the quality assurance function and manages organisation wide strategic projects.
- **Corporate Services Division (CSD):** CSD provides corporate support services, including handling internal and external communications, web services and development, project and change management. It includes the finance, people and culture, information technology, security and information governance, portfolio and project management, property, procurement and facilities management functions.

Figure 1.2: APRA's organisational chart



APRA's funding

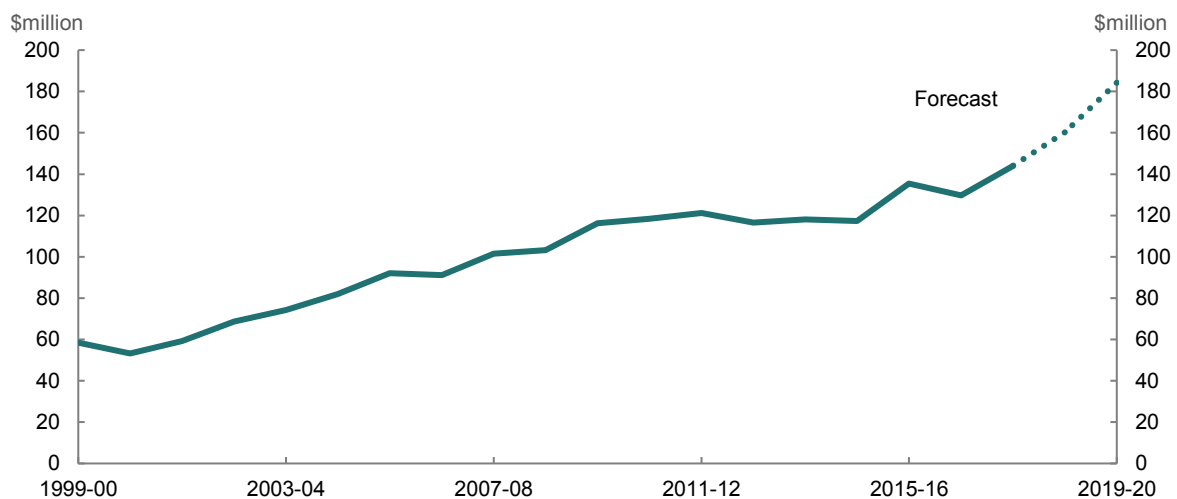
APRA is part of the Treasury portfolio of agencies. APRA's annual budget is subject to the usual government agency review and approval processes. APRA is in turn funded primarily from appropriations, for which the Commonwealth is substantially reimbursed through levies collected from regulated financial institutions. In addition to levies, APRA directly charges certain institutions fees for services. There is a small appropriation in lieu of interest on funds held within the APRA Special Account.

Changes to APRA's operating budget are met with a corresponding change to the levies recovered from industry. Therefore, the majority of funding for APRA does not have an impact on the Australian Government's budget 'bottom line'. Levy-recovered appropriations account for approximately 95 per cent of APRA's total funding with the other five per cent recovered from various fees for services.

Over the last decade, APRA's average annual expenses were \$122 million.⁴

4 Over the period 2008-09 to 2017-18, in nominal terms.

Figure 1.3: APRA's expenses 2000-2018 (nominal terms)



As part of the 2019-20 Budget, the Government announced it would increase APRA's four-year funding by a total of \$150 million (a 25 per cent increase in its annual funding compared to 2017-18). This extra funding was to strengthen APRA's supervisory and enforcement activities and address key areas of concern identified by the Hayne Royal Commission. Specifically, the funding will be used by APRA to:

- Extend the BEAR to all APRA-regulated entities;
- Boost supervision intensity across APRA-regulated entities, including focussing on underperforming superannuation funds and member outcomes; and
- Enhance the supervisory framework for governance, culture and remuneration applying to all APRA-regulated entities, including through building and accessing technical expertise.

This funding is in addition to the \$58.7 million provided to APRA (and recovered from industry) over three years as part of the 2018-19 Mid-Year Economic and Fiscal Outlook (MYEFO). This funding was given so that APRA could:

- Enhance its supervision by increasing the number of frontline supervisors for the largest and most complex financial institutions;
- Enhance its ability to identify and address new and emerging risk areas such as cyber, fintech and culture, by building internal expertise and increasing access to technical specialists outside APRA;
- Improve its data collection capabilities in order to leverage the benefits of inter-agency intelligence sharing; and
- Provide for a review of its enforcement strategy and its use of formal enforcement powers across the industries it supervises, including superannuation.

The Government has indicated that it will exclude APRA from the most recently announced efficiency dividend.

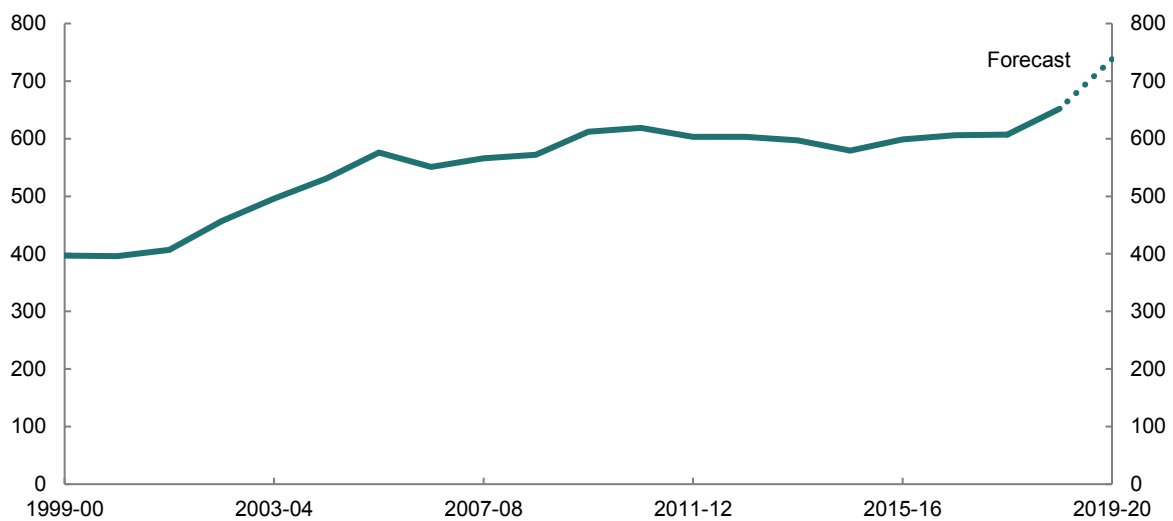
APRA's staffing

APRA's mandate requires it to maintain a workforce with a diverse set of skills and a broad range of educational backgrounds including actuarial, financial, legal and economics. While APRA is not a public service agency, it is subject to the Australian Public Service (APS) Workplace Bargaining Policy.⁵

At the time of the HIH Insurance collapse in 2001, APRA's staff numbers were just below 400. Post-HIH there was a significant increase in staffing between 2003 and 2005. Since that time APRA has operated with staffing levels at around 600.

At the end of February 2019 there were 656 full-time equivalents across six offices (Sydney (two offices), Melbourne, Brisbane, Adelaide and Canberra) and across six divisions. This number is forecast to increase to 738 in 2019-20 as part of APRA's increased funding (Figure 1.4).

Figure 1.4: Average APRA staffing



Since 1999 APRA has targeted remuneration at the 25th percentile of the financial services sector with the aim of recruiting and retaining good quality staff. An independent benchmarking report in 2015 found that APRA was operating well below the 25th percentile of the sector. In the 2018-19 MYEFO, APRA was provided with funding to support it to return to the 25th percentile of the sector.

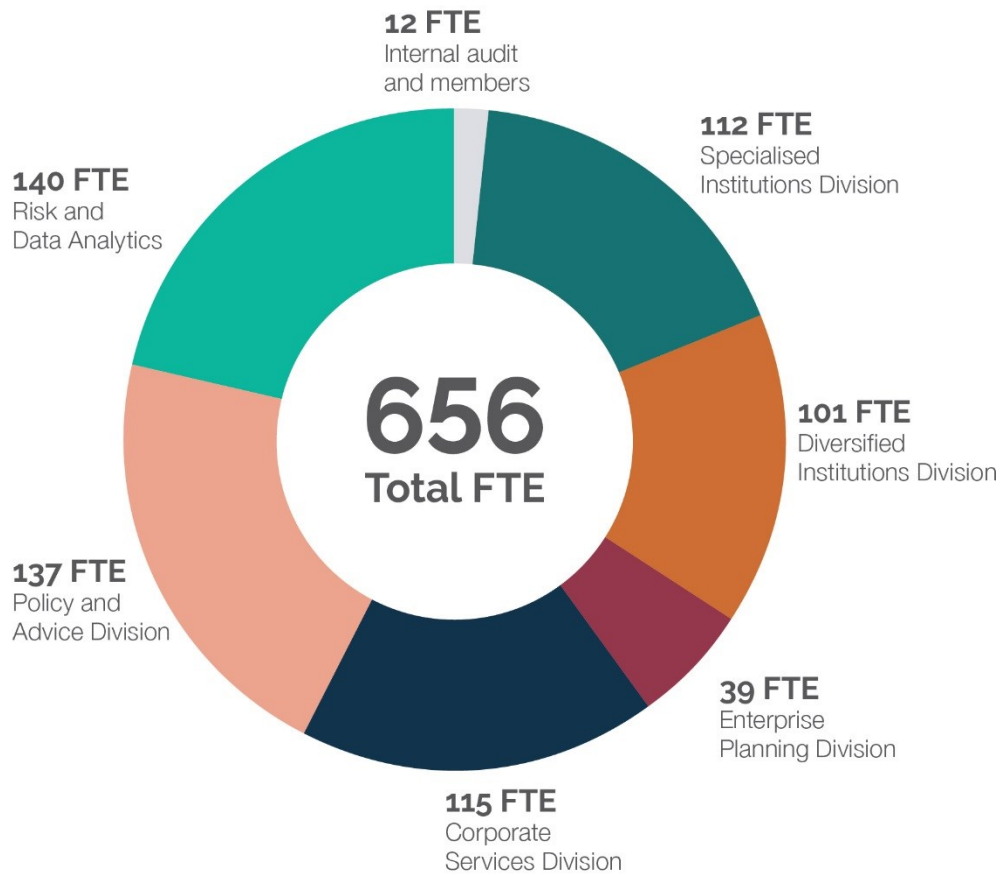
Distribution of staff

As a risk-based supervisor, APRA deploys resources to areas of greatest risk. This means that for a given level of risk, larger institutions receive more supervisory attention than smaller institutions, reflecting the fact that larger institutions carry a greater systemic risk; and for a given size, institutions with a higher risk profile will receive more intensive supervision than those with a lower risk profile.

Figure 1.5 provides an overview of staffing across APRA's six divisions and executive.

5 Statement of expectations 2018.

Figure 1.5: APRA's staffing composition per division⁶



Over time APRA's core supervisory resources have been reduced (both in absolute and relative terms), and central teams have been increased.

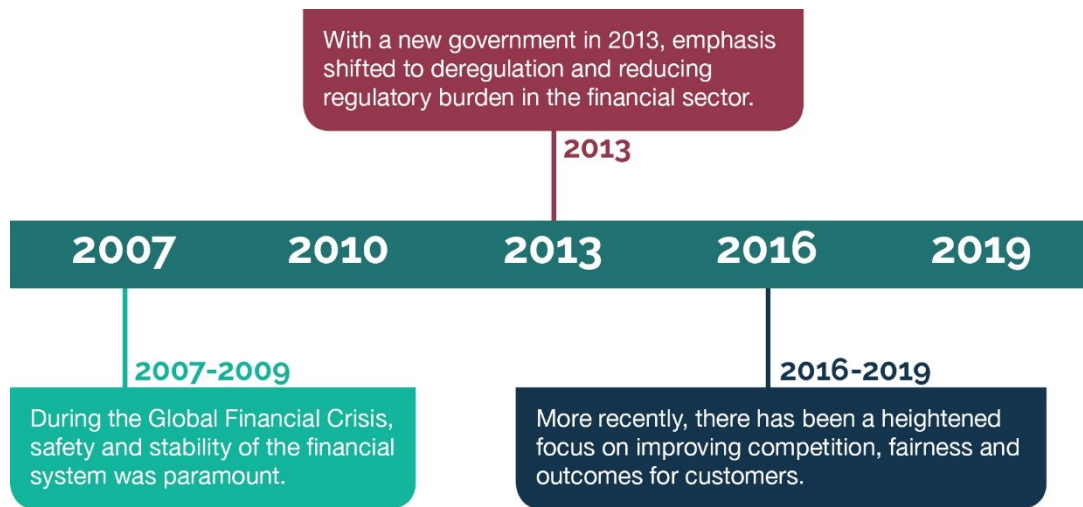
External accountability

As an independent statutory body, a number of accountability mechanisms are imposed on APRA to allow the public, the Parliament and the government to assess APRA's priorities, its performance and whether it is using its delegated powers appropriately. One mechanism is the government's Statement of Expectations (SoE) for it and APRA's Statement of Intent (SoI).

Figure 1.6 illustrates how expectations of APRA have evolved in recent years.

6 As at February 2019.

Figure 1.6: Changing expectations of APRA



The current external accountability framework is focussed on governance and financial accountability. There is no existing process requiring regular and systemic review of how well APRA discharges its statutory functions or exercises its statutory powers. As a result, the Hayne Royal Commission recommended the establishment of a financial regulator oversight authority for both APRA and ASIC, and quadrennial capability reviews.

APRA's beginning — 1997 Financial System Inquiry (the Wallis Inquiry)

APRA was established by the APRA Act, following the 1997 Financial System Inquiry (the Wallis Inquiry) which proposed a new regulatory framework for Australia's financial system.

In the two decades prior to the Wallis Inquiry, Australia's financial system had experienced significant change as a result of deregulation, the rapid growth in the number of financial products, industry consolidation, technology advancements, the introduction of the Superannuation Guarantee charge and increased interconnectedness with global markets. The then-Government commissioned the Wallis Inquiry to examine the adequacy of the regulatory framework governing the financial services sector.

The Wallis Inquiry recommended:

- That the disparate sector-based agencies be replaced by standalone agencies operating on functional lines. It recommended a single, national prudential regulator (which became APRA) and another entity responsible for market conduct and consumer protection (which became ASIC). APRA consequently replaced the former Insurance and Superannuation Commission, the prudential supervision function of the Reserve Bank of Australia (RBA) as well as nine other state and Commonwealth regulatory bodies;
- That the new regulators operate with autonomy from executive government to provide public confidence in their impartiality in exercising discretion and applying the law; and
- That the new prudential regulator supervise segments of the financial sector where the financial promises made by entities were deemed to be the most intense.

The implementation of separate prudential and conduct regulators has become known as the 'twin peaks model' for the regulation of the financial system.

Significant events that have shaped APRA

The collapse of HIH Insurance

The collapse of HIH Insurance had a profound impact on APRA's framework, organisational structure, culture and supervisory approach. At the time of its collapse in 2001, HIH Insurance was the second largest insurance company supervised by APRA. It was the largest corporate collapse in Australia at the time, with losses estimated at up to \$5.3b.

The collapse of HIH Insurance, and APRA's subsequent response, highlighted the importance of active supervision and a willingness to intervene where appropriate. APRA's efforts to build a more forceful supervisory culture following the HIH Insurance collapse is often cited as a contributing factor to Australia's strong economic performance during and after the GFC. Key APRA changes following the HIH Insurance episode include:

- Replacing the previous governance structure of a CEO and non-executive board. Since 1 July 2003, APRA has been governed by full-time members;
- Increasing the focus on specialist supervisory expertise; and
- Introducing PAIRS and SOARS to underpin APRA's risk-based supervisory approach.

Almost two decades after the collapse of HIH Insurance, efforts to further improve APRA's supervision — to identify risks early and respond promptly — remain at the forefront of APRA's latest Corporate Plan. The need to further strengthen a 'questioning, sceptical and, where necessary, aggressive approach' was also highlighted in APRA's Enforcement Strategy Review.

Overturing of APRA's AXA director disqualifications

In 2005, APRA attempted to disqualify seven directors of AXA under allegations they were not fit and proper.⁷ These individuals appealed APRA's decision to the Administrative Appeals Tribunal (AAT), which overturned the decision.

Following the AAT decision, the then-Government replaced APRA's administrative disqualification process with a court-ordered disqualification process. APRA's power has recently been reinstated for Accountable Persons in ADI groups under the BEAR (explained below).⁸

Strengthening of superannuation oversight

In the 25 years since the introduction of the Superannuation Guarantee,⁹ Australia's superannuation framework has significantly evolved as a result of the sector's rapid growth and its increasing importance for individuals and society at large.

Under the *Superannuation Industry (Supervision) Act 1993* (SIS Act), APRA is responsible for most of the general administration of the Act, including the oversight of licensing, trustee duties, default

7 AAT decision in *Re VBN and Ors and Australian Prudential Regulation Authority* (2008).

8 Section 37J of the *Banking Act 1959*.

9 In 1992, the then-Government introduced a national compulsory system of superannuation through the *Superannuation Guarantee (Administration) Act 1992*. Under this system, employers are required to make contributions on behalf of eligible employees to a superannuation fund.

MySuper requirements and operating standards. Broadly, ASIC is responsible for disclosure regulation and financial services licensing and associated obligations.

There have been a number of significant legislative developments which have expanded APRA's remit in superannuation. In 2004, new APRA licensing requirements for trustees of registerable superannuation entities (RSEs) came into effect, requiring trustees to obtain a licence and to register all entities under their trusteeship. Today, RSEs are subject to APRA prudential standards which set out certain minimum governance and risk management requirements.

In response to the 2010 Super System Review (the Cooper Review), in 2012 APRA was given the power to make prudential standards for superannuation trustees. Clearer duties to improve the governance and integrity of the system were placed on directors of superannuation trustee boards. APRA was also charged with the role of authorising and oversight of default MySuper products.

In 2014, the Murray Inquiry re-examined the superannuation system and concluded that while it has considerable strengths, further changes were necessary to modernise it. In response, APRA was granted stronger supervision powers, including a broad directions power in 2019.

In 2019, the Productivity Commission's Inquiry into the Efficiency and Competitiveness of the Superannuation System (PC Superannuation Inquiry) was released. The report made a number of wide-ranging recommendations to ensure that the system is fit-for-purpose in the future, including recommendations to assist in rationalising the tail of underperforming superannuation funds and a capability review of APRA — especially its capability to fulfil its member outcomes mandate.

Regulatory response to the GFC

APRA's most meaningful contribution to the resilience of the financial system during the GFC came from its efforts to strengthen entities' financial health prior to the crisis. In the years preceding the crisis, APRA implemented more conservative ADI capital requirements than most of its international peers and maintained a strong focus on credit underwriting standards. APRA's effectiveness was also supported by the constructive working relationships it had developed with regulated entities prior to the crisis. This enabled it to quickly increase the intensity of its supervision, request more information and give clear direction to institutions when needed.

Strengthening financial safety and stability

These lessons helped to shape APRA's post-GFC response. In the years following the crisis, APRA focussed on further strengthening financial safety and system stability. This includes through Life and General Insurance Capital (LAGIC) requirements implemented in 2013. These sought to enhance the existing capital requirements to strengthen the resilience of the insurance industries. For ADIs, minimum capital and liquidity requirements were significantly strengthened.

Regulator toolkit: crisis management powers

Following the GFC, it was recognised that APRA should be equipped with powerful, flexible and timely powers to manage the potential failure of a regulated financial entity. In 2018, APRA's crisis management powers were enhanced by providing clear powers to enable it to set requirements on resolution planning and ensure banks and insurers are better prepared for a crisis and an expanded set of crisis resolution powers that enable APRA to act decisively to facilitate the orderly resolution of a distressed bank or insurer.

Focus on macro-prudential policy

The GFC also brought about an increased focus on macro-prudential policy as regulators explored ways to respond to emerging financial risks in a more dynamic way. From 2014 to 2018, APRA steadily strengthened system-wide mortgage lending standards, reversing an earlier erosion in policies and practices that had flowed from strong competitive pressures. These measures have strengthened the resilience of individual ADIs and promoted the stability of the financial system overall.

Macro-prudential regulation is still in its infancy. There is considerable variation in views internationally on how these policies should be applied and governed and no consensus on a preferred framework has emerged to date.

Greater recognition of the role of GCA structures

The GFC was a reminder that non-financial risks arising from poor GCA structures can have significant financial impacts. This led to greater international focus on developing ways to strengthen regulators' capacity to supervise these risks to complement the strengthening of regulation of capital and liquidity requirements.

In 2018, the Government introduced the BEAR. This established clear and heightened expectations of accountability for ADIs, their directors and senior executives. It ensures that there are clear consequences in the event of a material failure to meet those expectations. The BEAR complements existing APRA prudential standards covering governance, risk management and the fitness and propriety of responsible persons of an APRA-regulated entity. The regime commenced on 1 July 2018 for large ADIs and is due to commence on 1 July 2019 for medium and small ADIs. The Hayne Royal Commission recommended extending the BEAR to all APRA-regulated entities.¹⁰ The Government has agreed to this recommendation.

PRUDENTIAL INQUIRY INTO THE COMMONWEALTH BANK OF AUSTRALIA

In 2017, APRA established a prudential inquiry into the Commonwealth Bank of Australia (CBA Prudential Inquiry), following a number of issues which raised concerns about the frameworks and practices in relation to the governance and accountability within the CBA group.

The review made 35 recommendations and resulted in CBA entering into an enforceable undertaking with APRA. The enforceable undertaking established a framework by which the bank will demonstrate that it is addressing the Prudential Inquiry panel's recommendations. APRA also imposed an additional \$1 billion capital requirement on CBA.

Restoring trust and social licence

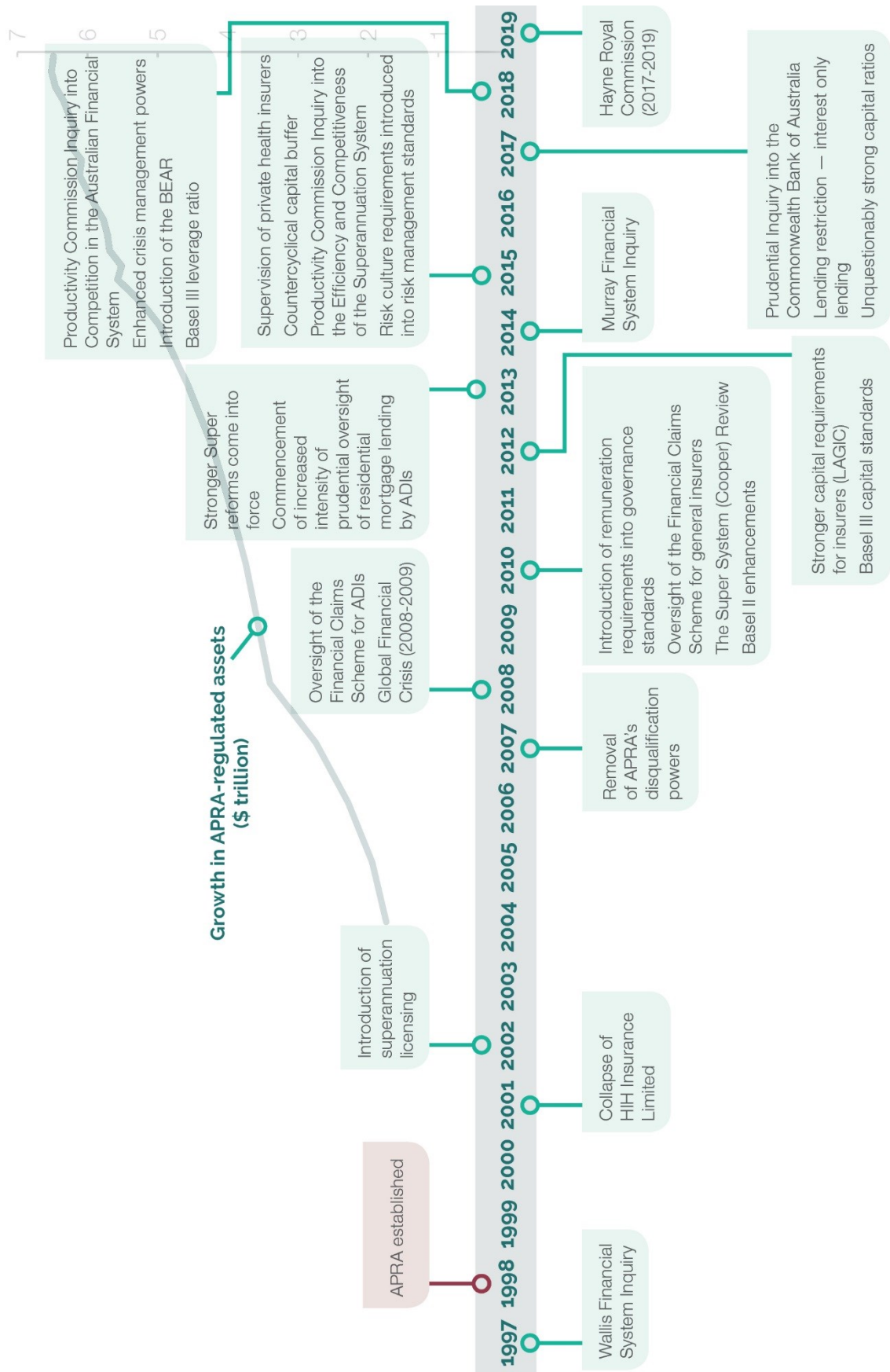
Globally, to restore trust and confidence in the financial services industry following the GFC, there are heightened expectations that financial service providers should be responsive to changing community concerns and expectations and make a positive contribution to society. This is often referred to as institutions maintaining a 'social licence' to operate. Similarly, the community expects executives within these entities to act with a high degree of care and diligence.

10 Recommendation 6.8.

These heightened expectations will frame any public or Parliamentary assessment of APRA's success in the supervision of its regulated entities and its approach to its oversight of its GCA responsibilities.

Figure 1.7 highlights key events that have impacted APRA's mandate and operations. In recent years, the amount of change has significantly increased.

Figure 1.7: Timeline and overview of key APRA events



Events that will continue to shape APRA in the future

The Hayne Royal Commission

The Hayne Royal Commission concluded in February 2019. Along with the recommendation that APRA be subject to a capability review as soon as possible — forming the impetus of this Review — a number of key themes and recommendations are pertinent to APRA:

- That the primary responsibility for misconduct in the industry rests with the entities concerned, their boards and senior managers. It recommended that the BEAR be extended to all APRA-regulated institutions¹¹ and that APRA update its prudential standards regarding remuneration and incorporate the supervision of culture and governance into its prudential standards review.¹² It also recommended that APRA should internally formulate and apply to its own management accountability principles of the kind established by the BEAR;¹³
- The twin peaks established by the Wallis Inquiry should be reinforced in superannuation. APRA's remit in respect of the SIS Act should be shared with ASIC in a way that aligns with their traditional roles and strengths;¹⁴
- The law should require APRA and ASIC to cooperate, share information to the maximum extent practicable and notify the other whenever it forms the belief that a breach in respect of which the other has enforcement responsibility may have occurred;¹⁵ and
- A new financial regulator oversight body for APRA and ASIC should be created to assess the effectiveness of each regulator in discharging its functions and meeting its statutory obligations. Capability reviews of the regulators should occur on a four-yearly basis.

11 Recommendation 6.8.

12 Recommendation 5.7.

13 Recommendation 6.12.

14 Recommendation 6.3. Consistent with the recommendation in the Productivity Commission Superannuation Inquiry Report, recommendations 23 and 24.

15 Recommendation 6.9.

APRA Enforcement Strategy Review

APRA completed its Enforcement Strategy Review in April 2019. The review was in response to a range of developments, including the creation of the BEAR, the CBA Prudential Inquiry, evidence presented to the Hayne Royal Commission and proposals to give APRA expanded enforcement powers, particularly in superannuation.

APRA's enforcement appetite has evolved over a number of years, with various internal and external factors shifting the enforcement pendulum back and forth. Following the failure of HIH Insurance in 2001, APRA moved to a more risk-based approach with a sharper focus on early intervention. However, several unsuccessful proceedings and overturned decisions, such as APRA's attempted disqualifications of several AXA directors in 2006, curtailed APRA's enforcement appetite.

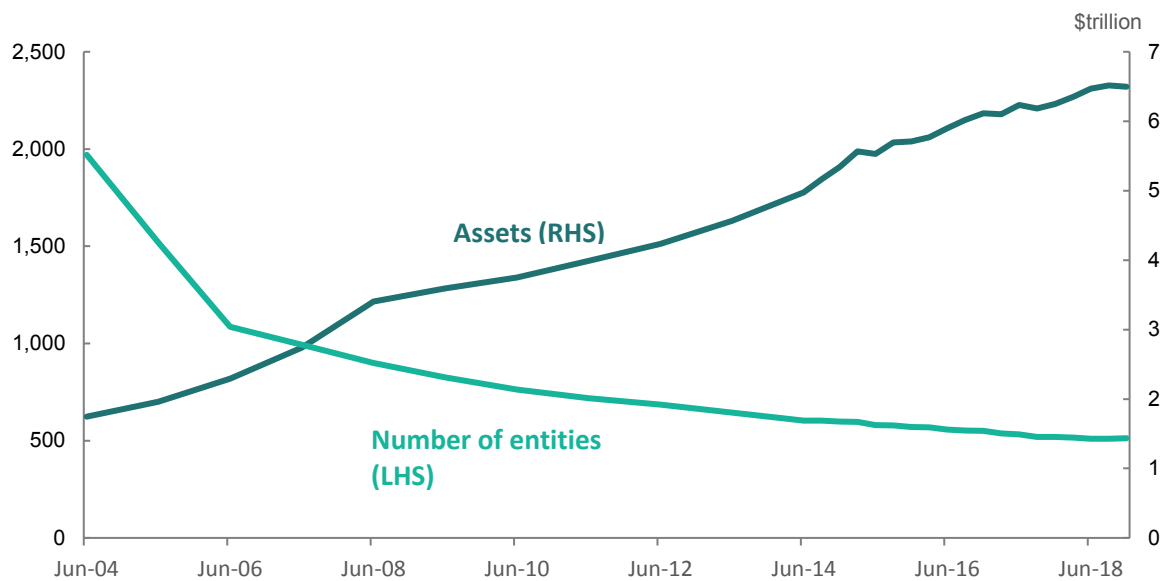
APRA is in the process of shifting to a 'constructively tough' enforcement approach. Under this approach, APRA has committed to using the full range of its powers more actively, such as direction powers and licence conditions, to achieve prudential outcomes and deter unacceptable practices.

An ever-evolving financial sector

Over the last 20 years there has been substantial consolidation across the financial services industry as a result of mergers, acquisitions of foreign-owned subsidiaries by local institutions, foreign entities acquiring life insurers and the exit of other foreign financial institutions. This activity has largely been driven by the pursuit of greater scale efficiencies and has resulted in greater market concentration.

Largely as a result of industry consolidation and due to a significant change in approach to licensing of the superannuation industry, the number of institutions supervised by APRA has fallen by more than two-thirds since 2001. While this means that APRA's supervisory population has declined, large conglomerates and blurring between financial sectors (as predicted by the Wallis Inquiry) has increased supervisory complexity at an entity level.

More recent trends include industry fragmentation and the general shift away from the 'bancassurance' model, growth from non-bank lenders and greater use of personal data for customer-level risk-based pricing.

Figure 1.8: APRA-regulated entities against growth in assets over time¹⁶

Competition in the financial sector

As at June 2018, the top five APRA-regulated groups account for 78 per cent of assets in the ADI industry, 64 per cent in general insurance (based on gross written premiums), 81 per cent in life insurance (including friendly societies) and 28 per cent of assets in the superannuation industry.¹⁷

The Murray Inquiry brought the issue of competition in the system to the fore. Although it considered that competition was generally adequate, high concentration and increasing vertical integration in some parts of the system led it to recommend that competition should be proactively monitored over time. As part of the Government's response to the Murray Inquiry, in 2017 it tasked the Productivity Commission to review competition in Australia's financial system.

The PC's Inquiry into Competition in the Australian Financial System (PC Competition Inquiry) found that there was limited competition in the financial sector and that the larger financial institutions had the ability to exercise market power over their competitors and consumers. It found that:

- APRA was not well placed to consider competition effects and that the Australian Competition and Consumer Commission (ACCC) should act as a competition champion for the financial sector; and
- APRA should conduct and publish evaluations of its 'material interventions'¹⁸ including the effects on competition.

¹⁶ Asset figures have been revised slightly from APRA Annual Reports in line with the audited returns received during the year. The number of total superannuation entities comprises public offer funds, non-public offer funds and eligible rollover funds. It does not include small APRA funds and approved deposit funds.

¹⁷ As at 30 June 2018. APRA, 2018, *2017-2018 Annual Report*.

¹⁸ For example, how changes in APRA's 2017 *Prudential Standard APS 120: Securitisation* have affected the costs of funds and competitiveness of non-authorized (smaller) lenders. Recommendation 8.1.

Broad-based digital disruption

In 2014, the Murray Financial System Inquiry observed that 'Australia is in the midst of one of the most ubiquitous, generally applicable technology changes the world has seen...'¹⁹ Five years later, this remains the case. While digital disruption reflects healthy competition, and ultimately is of significant benefit to consumers, it carries certain inherent risks for existing APRA-regulated entities as part of the transition process.

It also raises significant strategic issues for APRA. New technology and new ways of delivering financial services offer the potential for a more competitive and innovative financial system. They may also increase the risks to financial stability in ways that are yet to be well understood. APRA has a key role in transparently presenting the issues to the public.

There are three key ways that digital disruption is affecting APRA and APRA-regulated entities:

- The ongoing transformation of existing regulated entities' IT landscape, including investment in online and mobile services, increased outsourcing (especially use of cloud services), greater interoperability (for example, through Application Programming Interfaces (APIs) and open banking), artificial intelligence-enabled decision-making, and ongoing digitisation of back-office functions. Established market participants face a major forward pipeline of major systems migrations and management of legacy systems;
- The emergence of new technology-enabled business models. In the decade to 2017, APRA authorised 93 new entrants (including 26 ADIs but only one new locally incorporated ADI). Since 2017, (and coinciding with the introduction of the new restricted licensing regime), APRA has observed a sharp increase the number of new license applicants;
- The increased competition from niche and scale technology competitors, including from participants whose activities remain outside the APRA regulatory perimeter.²⁰ As an example, during the review period Apple announced its intention to launch a credit card product.

There is the potential for change to follow an exponential path: limited change apparent at first, with some false starts, only for the tempo of change to snowball as multiple technology and business model innovations reach maturity.

Ongoing and increasingly sophisticated cyber risk threats

Cyber security threats to private and public sector organisations continue to grow in frequency and sophistication. A major cyber attack represents a top-tier operational risk for financial services companies both in Australia and globally. In contrast to other risks to which APRA-regulated entities are exposed (for example, credit, insurance, liquidity and funding risk), a cyber attack involves a hostile actor.

While APRA will never be able to prevent cyber attacks occurring or having an impact on regulated entities — nor should there be an expectation that APRA can do so — APRA will need to play a leadership role in fostering resilience amongst its regulated industries.

19 Murray Financial System Inquiry, p. xiv.

20 For example, a lender whose business model does not involve taking deposits would not conduct 'banking business' for the purposes of the Banking Act, and would not be licenced or supervised by APRA but their activities could still influence competitive dynamics for APRA-regulated entities.

The future economic climate

When assessing the capability required of a prudential regulator, it is useful to set aside the most likely 'central case' scenario and focus on the capability required in the event of potential 'downside' scenarios in the financial sector and economy.

Australia has experienced 28 years of annual economic growth, including through the Asian Financial Crisis and GFC. The last few decades since APRA's inception have provided a favourable external environment for Australian financial institutions and in turn a comparatively benign external environment for APRA.

A less favourable economic environment in the future would increase the pressure on APRA, including its organisational capacity, crisis management and resolution functions and credit risk capability.



CHAPTER TWO: EMPOWERING APRA FOR NEW CHALLENGES

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CHAPTER 2: EMPOWERING APRA FOR NEW CHALLENGES

APRA is a solid prudential regulator, however it is an immature organisation in the sense that it has not focussed on the 'business' of what it does (strategic priorities, strategy implementation, and operational support to achieve the core supervision / policy / resolution outcomes)...APRA does not have a continuous improvement mindset and is change resistant.

— APRA staff

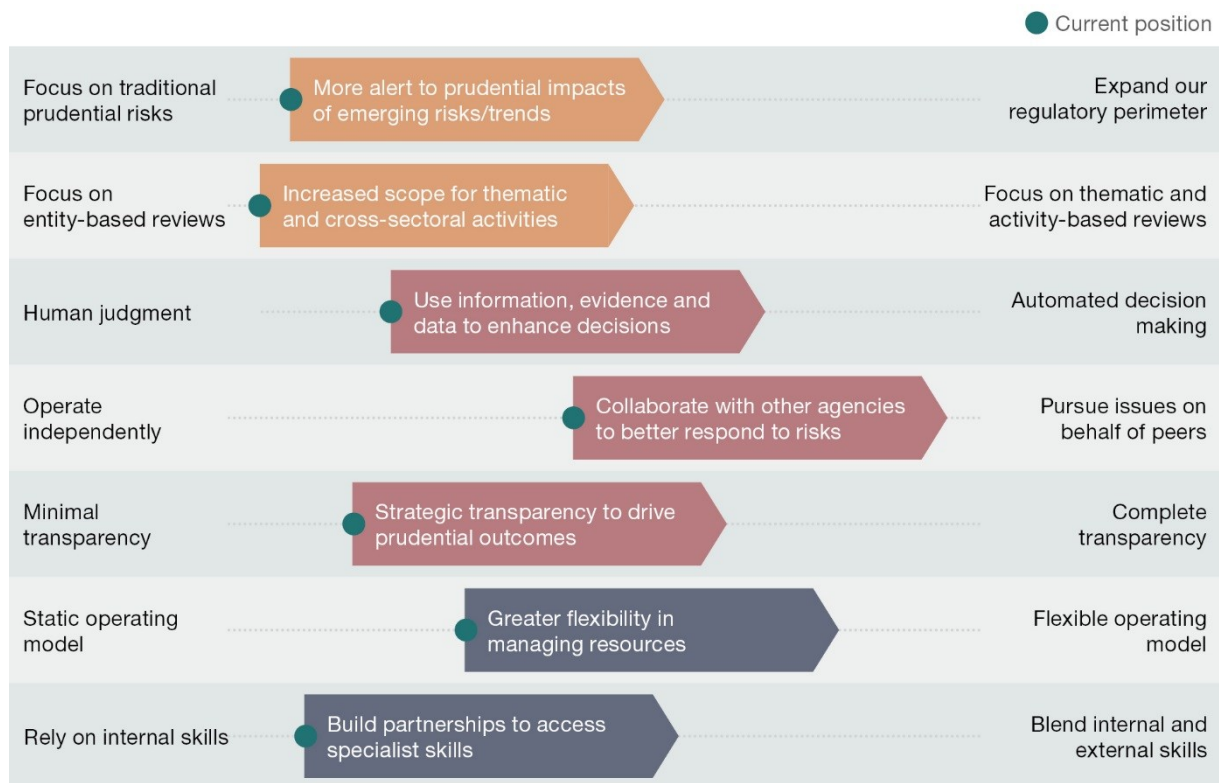
APRA has an ambitious and much-needed Corporate Plan in place. Many elements of the plan will move it in the direction intended by this Review. Implementing the plan will be challenging. APRA is not a nimble organisation. With its unwavering focus on 'traditional' financial risks it has been slow to build capability in other areas. In particular, while it has embarked on significant organisational change in the past few years it has been slower to forcefully embed matters beyond a narrow interpretation of its mandate. APRA will find it difficult to respond to new developments, including in the areas of cyber and IT risk, resolution and crisis management, macro-prudential supervision, GCA and superannuation, without a change in its internal capability, culture and structure. These developments require APRA to develop capability beyond traditional financial risk assessments and to regulate more complex issues.

There is no doubt that external factors have shaped APRA's workload over the past few years, straining its resources. This has impeded its progress on systemically-important issues such as preparing for cyber threats, crisis management and the resolution of failed institutions.

The Panel observes that APRA's tolerance for operating beyond quantifiable financial risks is low. APRA appears to have developed a culture that is reluctant to challenge itself, slow to respond and tentative in addressing issues that do not entail traditional financial risks. It has a culture of conformity. To position for the coming changes in its external environment it will need to build capability to increase the adaptability of the organisation. This will require further strengthening of its leadership capability and a more open and questioning culture. The pace of the organisation in terms of delivering on strategic priorities and decision-making will need to be increased. The Panel believes that these changes will be more effectively embedded in APRA if its internal structure and governance arrangements are changed.

APRA is aware of the need for change. APRA advised that following its strategy development process it would be changing the way it operates to shift further away from: having a focus on traditional prudential risks and entity-based reviews; an inclination towards minimal transparency; and being predominantly reliant on internal skills (Figure 2.1). The Panel agrees with this direction. The remainder of this Chapter will consider a number of characteristics within APRA that may contribute to these outcomes. Later chapters take up this discussion and apply it to particular aspects of APRA's role. The themes in this Chapter echo through the Review.

Figure 2.1: APRA’s positioning on key strategic choices²¹



The Panel’s conclusions in this Chapter are drawn from: extensive meetings with APRA’s managers across different levels, quantitative staff survey results, aggregated insights from focus groups and qualitative survey comments and specialist advice that compared APRA to other regulation agencies. The Panel also discussed workforce practices with international prudential regulators. Further detail on methodology, including selection of staff quotes, is contained in Appendix A.

Leadership and culture

Strong staff commitment

APRA staff are strongly committed to its mission. They believe that APRA undertakes important work and they are proud to contribute to this:

A terrific organisation, challenging and dynamic, full of purpose and one that cares for its staff. Leaders in APRA are generally able to embrace change but they could take more risks in this space and adopt more creative ways of generating change within their teams (as most tend to be quite conservative in their approach). Overall proud to be part of APRA and what it does for the community.

— APRA staff

21 Recreated from material provided by APRA to the Panel.

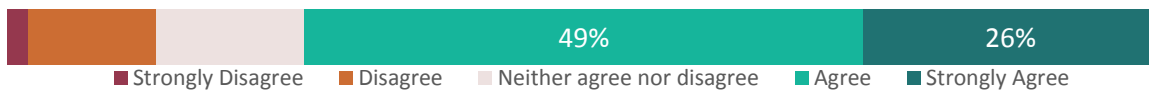
APRA staff also have a very strong sense of its values and strategic objectives. They believe that APRA's senior leadership acts in a way that supports these values and cares about the wellbeing of staff. These traits are positive for APRA and provide a very sound foundation for it.

Capability Review Staff Survey — Values, leadership and strategy

Proposition: I have a clear understanding of APRA's values.



Proposition: APRA's senior leadership acts in a way that is consistent with APRA's values.



Proposition: APRA's senior leadership is concerned about the wellbeing of staff.



Proposition: I have a clear sense of APRA's strategic objectives.



Variation in leadership and cultural norms

One of APRA's six strategic priorities is to enhance leadership, people and culture. APRA advised that 'a significant programme of work to improve talent practices...has been underway for the last 18 months'.²² Key objectives are to build strong and inclusive leadership, foster the desired culture and improve the employee experience. The initial focus is on fostering authentic, courageous and accountable leaders at APRA.

Part of this process has been reflected in the departure of long-term staff, with additions through external hires. APRA is also investing in building internal leadership capability. It advised that in late 2017 it made changes to recruitment and promotion processes to place a greater emphasis on leadership, especially for Senior Manager (SM) and above level positions. Over the same period it has taken a firmer stance around performance-related matters.

In the last 12 months, APRA introduced a new leadership and behavioural capability framework designed to provide clear guidance regarding the capabilities required to be successful at any given

²² APRA has between four and five management levels (counting the Members). These are Members, EGMs, General Managers (GMs), 'Level 5' SMs, and in some parts 'Level 4' Managers. Most Level 4 staff and lower level staff comprise advisors, analysts and support staff of differing levels of seniority. Members are statutory appointees and responsible for APRA performing its statutory mandate. EGMs are responsible for divisions, GMs are generally responsible for branches or projects within divisions, SMs are responsible for teams (and / or Level 4 Managers) and Level 4 Managers are responsible for teams.

level. In May 2019, APRA's Executive Committee (ExCo) endorsed an enhanced capability framework defining leadership and people capabilities in detail at different maturity levels.

The Panel believes that this strategic focus on leadership is necessary. There is a degree of variability in leadership capability across APRA.

APRA has made great gains improving its leadership cadre over the last couple of years. The bar has certainly been lifted! The problem is that too many underperforming managers...remain in my division...

— APRA staff

APRA managers are generally perceived by staff and their regulated entities to have strong technical skills. However, the Panel noted that there are gaps in other areas of managerial expertise. Key areas which need to be addressed are adaptability and openness to change, culture and contestability and accountability and trust.

Adaptability and openness to change

The Panel is concerned about APRA's capacity to execute change at pace. While it has embarked on organisational change in recent years, more generally APRA is slow in changing attitudes, changing the way it works and developing organisational capability beyond traditional financial risk.

APRA is currently undergoing and planning significant organisational change. Some is internally-led but external events such as the Royal Commission, CBA Prudential Inquiry and the Parliament's introduction of BEAR have also been important catalysts.

Adaptability and openness to change is a recurring theme throughout this Review:

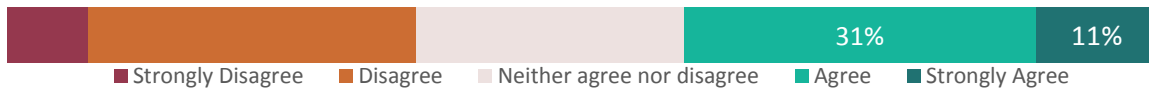
- The issues discussed in this report relating to decision-making, resource allocation, and execution of strategic initiatives are indicative of low organisational capability to change;
- APRA has been slow to develop capability in areas central to its role, including resolution (see Chapter 3) and GCA (see Chapter 4);
- APRA has been slow to shift its focus on member outcomes in relation to superannuation and change in this area has been motivated by the PC Superannuation Inquiry and the Hayne Royal Commission (see Chapter 5); and
- APRA has been slow and inconsistent in pursuing firm-specific issues (see Chapter 6).

In the Panel's assessment, capability around leading and executing change is variable. While some mid-level managers presented as strategic and aware of the changing context, others seemed unable to articulate APRA's current operating context, future direction and the capabilities required.

In terms of staff perceptions, only 42 per cent of staff agreed that APRA quickly redeploys its resources in response to new priorities. This partly reflects the view that APRA does not have the appropriate resources within the institution to manage organisational change effectively. Only 48 per cent felt that APRA staff are open to new ways of doing things, and only 28 per cent believe that decisions are made in a timely manner.

Capability Review Staff Survey — Prioritisation, innovation and decision-making

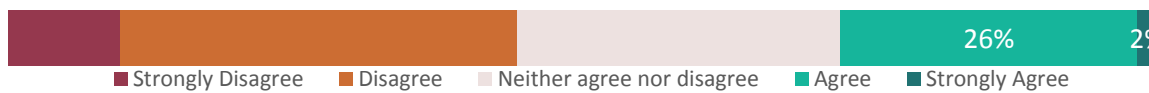
Proposition: APRA quickly redeploys its resources in response to new priorities.



Proposition: Staff at APRA are open to new ways of doing things.



Proposition: Decisions are made in a timely manner at APRA.



A staff comment reflective of these results is as follows:

APRA needs to build a culture that accepts and indeed, embraces organisational change. It works in an environment where the industries it regulates, the political environment and community expectations are constantly evolving and the organisation needs to be able to adjust accordingly. A large part of this involves hiring for mindset and seeking individuals who are willing and interested in working in a dynamic environment rather than those waiting for change to stop...APRA needs to better hold leaders to account. In too many circumstances, leaders who are ineffective in bringing together their teams and driving outcomes are allowed to continue in their roles with no consequence...

— APRA staff

Culture and contestability

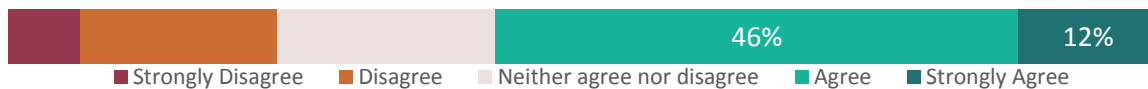
APRA's values of collaboration and accountability explicitly seek to foster robust debate and encourage discussion of diverse points of view. Nonetheless, in parts of the organisation there appears to be a culture that is challenged by robust debate and internal contestability. There is greater scope to raise and discuss external matters (for example, industry issues) compared to internal matters.

Challenge is often perceived in terms of personal critique instead of professional collaboration. As a result, conflict in the form of expressing divergent perspectives is sometimes avoided. Career progression is perceived by many as being best served by close alignment with some managers' views — a patronage model of advancement. Staff perceive that challenging their manager's views or speaking out in internal forums are risky and potentially career-limiting activities.

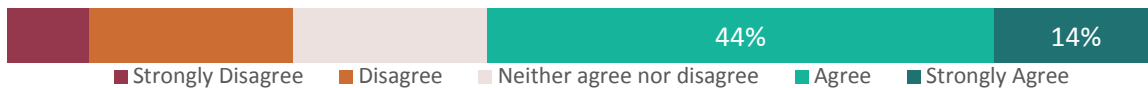
The Capability Review Staff Survey responses to questions around internal debate and challenge showed that 58 per cent of staff agreed that management encourages a range of views, and 58 per cent of staff agreed that they felt they could challenge ideas put forward by management. In addition, 53 per cent of staff agreed that diverse perspectives on complex issues are robustly debated within APRA. Only 49 per cent of staff felt that if they were to raise issues or concerns internally they would be confident that there would be no adverse consequences for them.

Capability Review Staff Survey — Internal contestability

Proposition: Management encourages a range of views, including those different to their own.



Proposition: I feel like I can challenge ideas put forward by management.



Proposition: Diverse perspectives on complex issues are robustly debated within APRA.



Proposition: If I were to raise issues or concerns internally I am confident there wouldn't be adverse consequences for me.



These results were supported by interviews and focus group discussions. Some representative staff comments:

...Sometimes it feels like there is too little constructive conflict of ideas! I feel like there is a less robust culture of debate, disagreement and challenge than what might be considered 'optimal'.

...Internally, differing views are often taken as 'attacks on the person' rather than the sort of healthy debate which ought to be encouraged...APRA is not mono-cultural (though there are institutionally consistent cultural features like conservatism, risk aversion, sensitivity and the propensity to form cliques)...

— APRA staff

The net effect is a 'tendency towards conformity' in APRA. This is concerning in a prudential regulator. Robust internal debate and internal contestability is an important enabler of flexibility in an organisation and in the identification and management of emerging risks to the financial system.

Accountability and trust

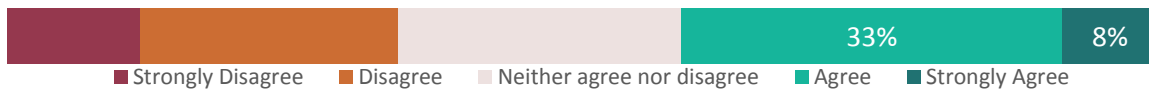
The Panel notes a broad-based perception that APRA does not consistently set expectations and hold management to account on these. Only 41 per cent of staff agreed that APRA sets clear expectations regarding leadership behaviour and holds APRA's leaders to account.²³ A high level of 'disagree'

²³ APRA's 2019 Pulse Survey asked an adjacent question, namely, 'All employees are held to the same standards of ethical behaviour'. This received a more favourable response rate of 66 per cent, being an improvement since 2016.

responses is also observed. Amongst GMs and EGMs the agreement rate is higher at 68 per cent, perhaps due to greater visibility but also divergent perspectives.

Capability Review Staff Survey — Leadership behaviour expectations

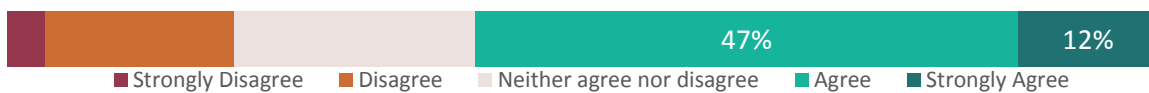
Proposition: APRA sets clear expectations regarding leadership behaviour and holds APRA leaders accountable.



There is somewhat greater clarity around accountability for engagement with regulated entities, with 59 per cent of staff agreeing that APRA sets expectations for its staff about how to supervise regulated entities, and holds people and teams accountable for that. In interviews and focus groups, staff noted inconsistency in terms of provision of feedback regarding decisions made.

Capability Review Staff Survey — Supervision expectations

Proposition: APRA sets clear expectations for APRA staff about how to supervise regulated entities, and holds people and teams accountable.



APRA needs to better hold leaders to account...Leaders who manage other leaders need to have the courage to hold ineffective leaders to account and either seek to improve their performance as leaders (and be seen to be doing so) or move them out of leadership positions...

— APRA staff

The level of staff trust in managers is variable. In some pockets of APRA, staff do not have a high degree of trust that their managers would 'back them', that it would be safe to make a mistake, or that career-related outcomes are fair. As noted above, only 49 per cent of staff believe that there would be no adverse consequences for them if they raised issues or concerns.

These issues around trust and accountability of leaders are a concern. For more junior staff to effectively engage with regulated entities they need clear guidance from managers and confidence in their support.

RECOMMENDATION 2.1

Building upon APRA's strategic initiative to enhance 'leadership, people and culture', APRA Members should address variation in leadership capability for all management levels. This should include a priority focus on leading change, effective execution and accountability. In addition, APRA should develop a cultural change program that fosters internal debate and contestability.

Strategic planning — sound framework, slow execution

APRA has an ambitious Corporate Plan for 2018-22 (see Chapter 1). Its strategic planning program has been iteratively enhanced in recent years. In 2018, APRA undertook a major review of its strategic planning process, including the incorporation of external advice.

APRA's strategic planning process is considered through four main lenses which are organisational, industry, policy and divisional. APRA's Strategy outlines its organisation-wide strategy on a four-year rolling basis. Industry strategies are developed for APRA's regulated industries: banking; life insurance, general insurance and PHI; and superannuation. These strategies outline strategy and priorities against APRA's core functions over one and four year horizons. The policy prioritisation process reviews and confirms APRA's medium-term policy priorities. Divisional planning captures activities to be delivered by divisions over a one-to-two year horizon.

The strategic planning framework involves a 12-month rolling refresh cycle, with key activities sequenced through the year to manage interdependencies across different activities. The APRA organisational strategy, industry strategies and policy prioritisation are jointly considered in the first quarter of the calendar year, then translated into divisional plans and entity-specific strategies and subsequently workforce development and planning activities. Internal communication is supported by Member-led town hall meetings and other activities.

A key output of APRA's most recent strategic planning process was a draft four year roadmap for APRA's six strategic initiatives (Figure 2.2).

Figure 2.2: APRA’s Strategic initiatives: four-year roadmap

Roadmap	Calendar year	2018				2019				2020				2021			
		Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	
1. Lift organisational capability	Initiatives	1.1 Improve our ability to manage change			Uplift program mgmt												
		1.2 Improve risk and performance measurement and reporting			Uplift change mgmt												
		1.3 Create flexible / collaborative workforce			Design & implement risk / perf. reporting												
		1.4 Develop innovation strategy			Update RAS												
2. Enhance our leadership, people and culture	Initiatives	2.1 Build strong and inclusive leadership			Design												
		2.2 Articulate and foster our desired culture			Plan execution												
		2.3 Improve our employee experience			Implement												
3. Broaden risk-based supervision	Initiatives	3.1 Enhance our ability to identify and respond to emerging risks			Design approach												
		3.2 Modernise our supervision framework			Plan execution												
		3.3 Optimise use of internal and external skills			Implement												
4. Improve data-enabled decision-making	Initiatives	4.1 Articulate a strategy on the use of data			Embed frameworks and measures												
		4.2 Deliver Program Athena			Deliver on culture roadmap												
5. Build resolution capability	Initiatives	5.1 Build a strong prudential framework for managing failure			Plan new ways of working												
		5.2 Ensure our internal readiness to respond to a crisis			Continue employee experience uplift												
		5.3 Promote industry preparedness for a crisis			Develop playbook												
6. Uplift external engagement and collaboration	Initiatives	6.1 Expand communication activity (prudential outcomes)			Map current state												
		6.2 Expand communication activity (accountability)			Design future state												
		6.3 Adopt 'whole of system' mindset			Finalise & integrate quality management												

APRA's framework for strategic planning is robust. It has been strengthened with additional resources and a more outward focus. While APRA is yet to complete a full-year cycle under the recently enhanced framework, its messages appear to be cascading through the organisation. APRA staff reported a strong understanding of its strategic objectives, a sound understanding of how these influenced divisional priorities and a fair understanding of how these influence team-level planning and activities.

While APRA's strategy formulation is robust it struggles with execution. As at December 2018, six months after endorsement of the deliverables underpinning the strategic initiatives in its Corporate Plan, it was progressing well on some of the deliverables but had 'not mobilised well' on others.²⁴ Specifically, 21 of 41 deliverables underpinning APRA's six strategic initiatives required a reset in terms of timeline, budget or resources. The second half of 2018 was a challenging period for APRA, with external demands including the Hayne Royal Commission and IMF FSAP. Nonetheless, delays in timely execution of strategic initiatives is not unique to this period. A representative staff comment:

APRA has undergone — and is undergoing — a huge amount of change. This is despite the fact that historically APRA has a very poor track record at change management. It's certainly very far from being a core skill of APRA...

— APRA staff

Delivery — decision-making and productivity

Decision-making

APRA makes a broad range of decisions. They vary in terms of complexity, impact, scope of application and frequency. A key top-level distinction is between policy and supervisory decisions:

- Policy decisions to amend APRA's prudential and reporting framework are coordinated through APRA's Prudential Policy Committee (PPC) and Executive Board (EB). These decisions are typically among the most complex and most important that APRA makes. They are also relatively infrequent. Policy decisions follow a formal consultation process. It is appropriate that these decisions are subject to very robust internal scrutiny.
- Supervisory decisions range considerably in terms of complexity, impact and frequency. While less common, these decisions can also include some of the most complex and important decisions that APRA makes, such as the decision to grant a licence, grant internal-ratings based (IRB) accreditation or take enforcement action. As a generalisation, supervision decisions are delegated to responsible supervisors (or, for higher impact decisions, the relevant GM or EGM), but with highest complexity and highest impact decisions subject to committee oversight and / or input from relevant groups.

APRA has in place a formal decision-making protocol (DMP) which specifies the level at which formal decisions may be made. The DMP captures formal powers and accordingly does not cover many internal APRA decisions or 'day-to-day' supervision decisions.

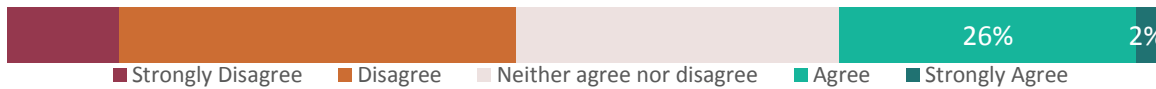
APRA's staff have a clear view about its decision-making capacity. Only 28 per cent believe that decisions are made in a timely manner.²⁵ This was the lowest level of agreement with any question in the Capability Review Staff Survey. Yet 63 per cent of staff feel that decisions are subject to appropriate levels of approval and 68 per cent feel empowered to make decisions within their formal delegation.

24 ExCo Meeting, Strategic and Performance — Strategy and Planning Stocktake, 26 February 2019.

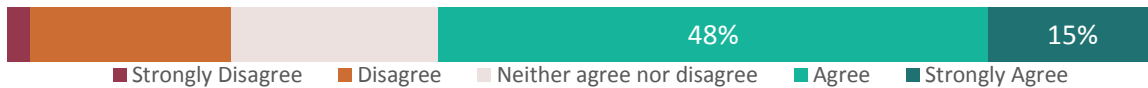
25 APRA's 2019 Pulse Survey asked a similar question 'in my opinion, decisions are made in a timely manner at APRA'. This received a comparatively favourable response rate of 42 per cent.

Capability Review Staff Survey — Decision-making

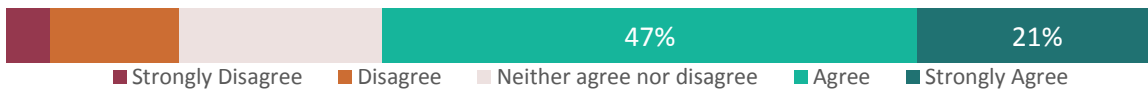
Proposition: Decisions are made in a timely manner at APRA.



Proposition: Decisions at APRA are subject to appropriate layers of approval.



Proposition: I feel empowered to make decisions within my formal delegation.



The fact that a majority of staff feel empowered to make decisions is consistent with APRA's philosophy to let key supervisory decisions rest with individual supervisory teams and their managers.

While APRA has a sound formal decision-making framework for formal powers, a significant proportion of staff perceive that decisions are not made in a timely manner. Qualitative staff comments indicate that informal processes operating in conjunction with the formal framework may be problematic for a range of reasons to varying degrees in parts of the organisation. Some adverse decision-making dynamics referred to by staff include:

- **Timeliness** — as noted, only 28 per cent of staff agree that decisions are made in a timely manner. It is also observed that sometimes matters of little importance are subject to comparable levels of process and consultation as critical decisions. Staff also observed instances where an impasse was reached, where key stakeholders had conflicting views, and where there was no effective resolution mechanism.
- **Clarity of process** — there is sometimes ambiguity in terms of the process required to land an internal or supervisory decision (especially for decisions not captured by the DMP).
- **Scope for debate** — there is sometimes a tendency for staff to elicit the preferences of key internal stakeholders and then work towards that outcome.
- **Risk of decision reversal** — even where the formal process is clear, staff commonly seek formal or informal endorsement from potentially interested parties. In a similar way, staff referenced decisions being made at supervision team level that were sometimes reversed upon the regulated entity escalating the matter to more senior levels.

Some illustrative comments from staff include:

Its speed of decision-making. Some decisions need to be carefully thought about and discussed but many times the decisions go through many rounds of papers and discussion and then someone at the top makes a decision...At the other end of the

spectrum some straight forward decisions could be delegated and acted on quicker. There seems to be a nervousness or conservatism about making a mistake...

...in my time at APRA (over 10 years) I have never felt empowered to make decisions without management and committee approvals at multiple levels

...When institutions are consistently able to get a different result by appealing to GM levels and above, line supervisors become demoralised and institutions become emboldened to push the limits...it is important to note that there are significant parts of APRA to which these suggestions do not apply. APRA also appears to be moving in the right direction on these matters

— APRA staff

In relation to specific decisions, in this case the timing of APRA's publication of its response to self-assessments, a staff member noted:

APRA likes a process, which can be slow...need a cultural change

— APRA staff

It is likely that some of the leadership issues noted above are contributing to the slow pace of decision-making at APRA. Recommendations 2.1 and 2.3 set out in this Chapter are designed in part to assist with organisational pace, speed of decision-making and empowerment.

Decision-making in response to entity-specific applications

Feedback on one aspect of APRA's decision-making, its decisions in response to applications from regulated entities, is mostly positive. The Panel notes:

- In the 2019 APRA Stakeholder Survey, responses regarding APRA's handling of the process for decisions were reasonably good. APRA's approach was characterised as 'very well' or 'well' by 75 per cent of respondents, 'neutral' by 22 per cent of respondents and 'poorly' by 2 per cent of respondents.²⁶
- In the course of the Review, some individual stakeholders perceived 'extensive' and 'unacceptable' delays in receiving responses to inquiries and regulatory approvals. One regulated entity referenced a protracted and extremely costly process, which they characterised as involving 'moving of the goal posts' and 'working in the dark'. Capital issuance transactions and IRB accreditation applications²⁷ were specifically referenced as decisions which could be outstanding for months or years, and require multiple back and forth iterations with APRA.
- Based on a random sample of 21 DMP decisions made during 2018 (classified by APRA as moderate complexity) the average resolution time was 73 days. Based on a small sample of seven capital issuance decisions made during 2018, the average resolution time was 86 days, but with a large range from 10 days through to 221 days. For the transaction resolved after 221 days,

26 Results from the 2019 APRA Stakeholder Survey have not yet been published.

27 IRB accreditation is a critical decision of APRA with material implications for an ADI's capital level. The application process is not a straightforward approval or rejection, rather APRA's practice is to iteratively work with applicants on models and governance to support them to meet APRA's expectations. The length of the process depends on the quality of the bank's data, model application, among many other factors. In line with the Murray Inquiry, APRA made changes in December 2015 to make it easier for applicants to obtain IRB accreditation for part of their credit portfolio. Capital issuance transactions are complex but relatively routine decisions. Capital issuance transactions are critical decisions in the sense that the regulated entity's capital underpins their financial resilience.

60 per cent of the resolution time was due to time taken by the regulated entity responding to matters raised by APRA.

APRA has taken steps in recent years towards streamlining and improving the timeliness of decisions (for example, establishment of a central licensing team and change initiatives within its Advice and Approvals area responsible for capital instruments).

At an aggregate level, APRA's handling of decisions affecting regulated entities is fair, with improvement in recent years. However, there have been some instances where the process and timeliness have been poorly managed.

RECOMMENDATION 2.2

APRA should set transparent standards to hold staff and itself accountable for the timeliness of approvals and other commercially-important decisions for regulated institutions. APRA should publicly disclose adherence rates to these performance standards in its external accountability assessment (see recommendation 6.4).

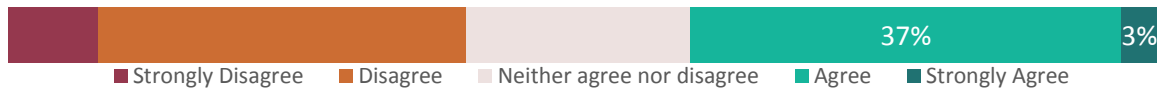
Standards set by APRA should mostly be based on prudential considerations but there should also be a degree of commerciality. The Panel notes that introduction of timeliness standards is likely to result in APRA rejecting a greater proportion of decisions at an earlier stage but providing clear reasons for doing so. It may be helpful for APRA to publish any decision-making criteria routinely used internally where this is not already publicly available.

Productivity — data capability and IT tools

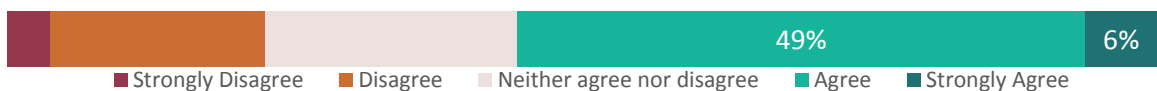
APRA's data and IT tools are constraining productivity. A key strategic initiative in APRA's Corporate Plan is to improve data-enabled decision-making. The Capability Review Staff Survey results relating to IT and supervisory tools, data access and efficient data utilisation are low. Only 40 per cent of staff agree they have the IT and other supervisory tools required to perform their role. Only 55 per cent and 52 per cent of staff respectively feel they are able to effectively access routinely collected data and efficiently utilise data and information to perform their role.

Capability Review Staff Survey — Data capability and IT

Proposition: My team has the Information Technology and other supervisory tools required to undertake its role.



Proposition: My team has sufficient access to routinely collected information and other data to effectively perform its role.



Proposition: My team is able to efficiently utilise data and information to effectively perform its role.



Some illustrative staff comments include:

Supervisory tools and ability to utilise relevant data efficiently are improving following the strong focus (for example, Athena) in recent year or two but needs to be bedded down and improved as it is put into practice.

...Invest in uplifting the technology solutions (systems, tools) to allow more efficient access to information, including entity data, information, KPI tracking, reporting and monitoring tools...

— APRA staff

One of APRA’s strategic initiatives is to improve data-enabled decision-making. APRA is four years into a data modernisation project (‘Project Athena’) scheduled for completion in 2020. The project vision is to ‘build the platform to improve data-enabled decision-making by delivering new technology and capability’. The key components of the project are to replace the existing data collection solution, establish an enterprise data warehouse, deliver analytical capabilities to enable easy access to data, and set up an innovation centre to build data science capability.

APRA faces a number of data-related challenges despite the improvement in its capability over the past few years: reporting standards are not consistently fit-for-purpose in terms of coverage and granularity; there are highly manual processes and many tools for accessing and analysing data across the organisation; and there is a high reliance on entity-specific requests which are not scalable. These issues are intended to be addressed by Project Athena, or at least will be easier to address following completion of that project.

Project Athena is also intending to develop capacity in innovative data analysis by establishing an Innovation Lab in RDA to undertake natural language processing and other similar techniques to analyse the large amounts of qualitative data APRA receives. Like APRA, other domestic regulators and international prudential regulators are in the early stages of experimenting with regtech. This

work has the potential to improve the efficiency of frontline teams' analysis of GCA risks and enable greater insights for thematic reviews.

The IMF FSAP concluded:

Additional investment in data and analytical tools would strengthen financial supervision and systemic risk oversight. Relative to international experience, the assessment identified shortfalls in the granularity and consistency of data to support the analysis of supervisory and systemic risks and the formulation of policy. The CFR agencies are recommended to conduct a major review of potential data needs and implement improvements, publishing the resulting data where feasible.²⁸

CFR agencies are in the process of establishing a Multi-Agency Data Collection Committee to implement the IMF FSAP recommendation.

Internationally, some prudential regulators exhibit comparable data maturity to APRA and like APRA are in the process of multi-year projects to uplift data capability. When effectively delivered, Project Athena will boost APRA's data capability and enhance risk sensing and productivity.

Workforce capability

APRA's formal learning and development (L&D) framework provides a core industry training curriculum structured around the themes of industry knowledge, legislation and regulation, supervision methodology and tools and risk areas. The framework has three tiers, starting with core knowledge and concepts and building to extension courses.

In the Panel's assessment, APRA's L&D program is in need of a rebuild as it only provides partial coverage and is out-of-date. In reaching this perspective, the Panel notes:

- Results of the Capability Review Staff Survey, in which only 49 per cent of staff agree that staff development is well supported by formal L&D activities;
- A review of data provided by APRA on actual L&D activities conducted in 2018 indicated training provided only partial coverage. For example, APRA's formal credit training in 2018 comprised an online consumer lending course, and around 15 other external courses each completed by between one and three staff; and
- Representative staff comments, including:

...there are many moving parts to the industries that we regulate and numerous emerging issues that we need time to upskill for, to ensure that we can effectively regulate the entities of the future. This is not possible when resourcing is such that time for training becomes a luxury.

— APRA staff

APRA's technical L&D program seems less mature than international peers. It is important to note that sophistication of L&D programs across international prudential regulators is closely correlated with scale. Large prudential regulators have comprehensive and established L&D programs. Nonetheless, prudential regulators most comparable to APRA appear to be more sophisticated than APRA in terms of development and delivery of technical L&D programs.

28 IMF, 2019, *Australia: Financial Sector Stability Assessment*, p. 8.

APRA has partly acknowledged its L&D program is 'in need of an upgrade' and has attributed this to 'competing priorities...over an extended period'. APRA's Supervision Fitness program includes a plan to develop stronger training in the 'art' of supervision, with the aim of building supervisory mindset, skills and capability.

The Panel encourages APRA to focus on establishing a fit-for-purpose L&D program, to support the refreshed supervision model and support APRA's strategic priorities. It may be beneficial for overall ownership for relevant aspects of APRA's L&D program to shift to the team responsible for APRA's Supervision Fitness program.

Organisational design and governance

APRA's current divisional structure around supervision has been in place for almost two decades, yet the Australian financial system has changed significantly. The banking sector is more concentrated. This intensifies the systemic risks arising from the major banks having very similar business models. The superannuation sector is much larger. The number of entities has declined significantly and, for the most part, their sophistication has increased. The insurance industry has also changed with an increase in the role of international insurance companies in the Australian market, particularly for life insurance. The trend towards banks embedding wealth management businesses in their structures is quickly reversing. Beyond these sectoral shifts, the complexity of the system has increased both in terms of the use of technologies and the interdependencies within it.

The Owen Inquiry following the collapse of HIH Insurance noted the pros and cons of the DID and SID structure. It recommended APRA 'urgently instigates a review of APRA's organisational structure, balancing its cross-sectoral responsibilities with accountability and knowledge of financial services'. APRA ultimately retained the DID and SID structure but did make other changes such as introduction of cross-entity capabilities now contained in RDA and to a lesser extent PAD.

Organisational structure

The changes recommended throughout the Review require APRA to address the variability in its leadership capability and develop a more open-minded culture, adaptable to change and supportive of more assertive engagement of staff with its regulated entities. There needs to be more clarity in communication and lines of accountability. These changes may be achieved within APRA's existing organisational structure. However, in the Panel's view, that structure is not conducive to them having their full effect. A change in organisational structure is more likely to reinforce the required behavioural changes. The Panel notes that different organisational structures always have costs and benefits, as discussed below. On balance, the Panel believes that the net benefits of a change in supervisory structure to be positive and would warrant incurring the transition costs.

Industry-aligned supervision divisions and internal configuration

APRA's supervision function is predominantly undertaken by DID, SID and RDA. DID and SID are industry-aligned at a branch level. Currently, DID comprises two ADI branches, one combined life insurance and superannuation branch and one general insurance branch, with approximately 45, 30 and 30 staff respectively. SID comprises one banking branch, one insurance branch and one superannuation branch, with approximately 45, 25 and 40 staff respectively. The introduction of industry-aligned branches within DID and SID is relatively recent, having been introduced in DID in 2017 and SID in 2018.

APRA's current structure has some advantages. The split between DID and SID structurally supports the proportional application of prudential standards and supervisory approach to entities of different sizes and complexity. The current structure also supports conglomerate (that is, group-wide) supervision. However, this is less relevant now as many entities divest non-core businesses.

Despite the historical motivations for DID and SID, the Panel believes that a shift to separate industry-aligned supervision divisions is now warranted. This would be a change consistent with the recent move to industry-aligned branches within the current divisions. APRA should collapse DID and SID into Banking, Insurance and Superannuation Divisions. The recommendation in Chapter 5 to create a standalone Superannuation Division is a natural catalyst for this change. Creating separate industry-aligned divisions will strengthen the development of industry skills and provide clearer career paths in the organisation. It will provide clearer responsibilities and accountabilities and facilitate a more streamlined management structure and increased empowerment within divisions. The Panel notes that international prudential regulators most comparable to APRA are structured along industry lines.

While individual staff are not necessarily best placed to consider the pros and cons of different organisational structures, some staff recommended a divisional restructure along industry lines. One representative comment:

Core structural changes to the organisation, the most impactful of which would be restructuring frontline divisions by industry specialisation. That is, rather than the current DID / SID / RDA structure, this should be changed to industry based divisions for ADI, superannuation and insurance. This should significantly enhance strategic industry focus, improve efficiency and break down inherent inadequacies in collaboration that currently exist...

— APRA staff

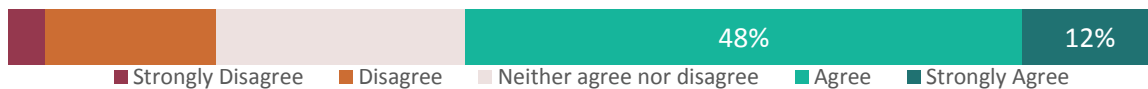
APRA's current internal configuration supports risk identification and prudential review activities at the entity level. It also supports some entity-based accountability as there is a clear 'responsible supervisor' for each regulated entity, although they may be overseen by several layers of management.

However, splitting entities within a given industry across SID and DID may lead to inconsistency in approaches to within-industry supervision across the divisions. Also, APRA's internal configuration means that industry-wide analysis is less readily accommodated. It is more challenging for APRA to pursue industry-wide thematic review activities, benchmarking activities and aggregation of entity-level insights across divisions.

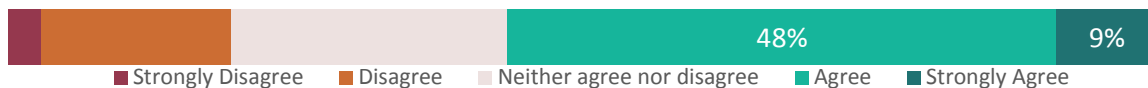
Views from APRA's staff on the effectiveness of collaboration across divisions are mixed. In the Capability Review Staff Survey 60 per cent of staff agree that frontline teams collaborate effectively with other divisions to achieve APRA's objectives, and 57 per cent of staff agree that teams across APRA collaborate effectively to address industry-wide issues.

Capability Review Staff Survey — Collaboration

Proposition: Frontline teams collaborate effectively with other Divisions to achieve APRA’s objectives.



Proposition: Teams across APRA collaborate effectively to address industry-wide issues.



In focus groups, RDA participants report that they often struggle to collaborate and get buy-in from frontline divisions. RDA and PAD participants further report that DID is hard to work with, more territorial and less receptive to cross-divisional collaboration. Conversely, frontline divisions report feeling over-loaded by the number of horizontal activities layered upon their existing workload. An example comment highlighting this tension:

...more collaboration required between frontline and specialist staff (often left to frontline to determine and set the rules, specialist opinions at times can be ignored or over ridden)...thematic reviews can take too long to complete, poorly organised, those in the working groups have too much other work at the same time...

— APRA staff

To be clear, APRA does many horizontal activities and does them well. APRA has conducted 29 thematic reviews in the last five years. However, such activities are less naturally accommodated by APRA’s current divisional structure which blends industries across two supervisory divisions. Consequently, such activities can proceed very slowly. As part of such a restructure, APRA should increase the share of staff allocated to horizontal activities and introduce formal mechanisms to enable dynamic reallocation of staff in response to changing priorities and emerging issues.

The creation of industry-based supervision divisions should be used to devolve industry responsibilities to the relevant EGMs who would become APRA’s leads on industry issues both internally and externally. This would provide greater ownership of industry issues within the relevant divisions. As discussed further in Chapter 5, APRA should also consider whether there is merit in embedding relevant staff from RDA, PAD and legal in the new divisions.

Management layers, spans of control and career pathways

APRA’s management structure is characterised by a high number of layers of management for an organisation of its size. Further, APRA’s managers have low spans of control (that is, a small number of direct reports). This is partly but not wholly justified by reference to the high level of judgment required to be exercised by staff.

APRA has between four and five management levels (counting the executive members).²⁹ At an aggregate level, the proportion of staff at APRA with some level of managerial responsibilities is

²⁹ Level 4 manager role exists in some but not all areas of APRA.

roughly 25 per cent.³⁰ The average spans of control, on a level-by-level basis, for the top five executive levels are outlined in Figure 2.3.³¹

Figure 2.3: Management layers and spans of control

Level	Number of Managers	Average Span of Control
Members ³²	4	2
EGMs	5	5.4
GMs	19	4.7
Level 5	67	4.0
Level 4	40	3.5

Both overly wide and overly narrow spans of control can be detrimental to organisational efficiency and performance. Narrow spans of control are typically associated with managers spending too much time performing the same type of work as their reporting staff, underinvestment in systems and automation and organisations where promotions are the primary way of recognising and retaining high performing staff.

In the Panel's assessment, APRA should revisit its management structures and levels, with a view to widening spans of control and enhancing efficiency, speed of decision-making and empowerment. As part of making this change, APRA should introduce distinct technical-specialist and people-leader career pathways, as utilised by some comparable prudential regulators internationally.

RECOMMENDATION 2.3

APRA should revise its organisational structure to reinforce the impact of the leadership and cultural changes recommended by the Review and APRA's own strategic plans. APRA should:

- a. restructure supervision divisions along industry lines — banking, insurance and superannuation;
- b. revise management structures and levels, with a view to widening spans of control and enhancing efficiency, speed of decision-making and empowerment;
- c. shift internal configuration to better support industry-focussed strategic activities and more agile ways of working; and
- d. create distinct people-leader and technical-specialist career pathways.

The Panel notes APRA considered revising its organisational structure in 2018 prior to commencement of the Review but no final decision was made while the Hayne Royal Commission was ongoing.

30 Calculation excludes APRA's CSD and administrative staff.

31 Span of control in this figure is defined as the ratio of staff at a given level to the number of staff that report to that level. Calculation excludes CSD and administrative staff.

32 Span of control is a less relevant concept at the Member level, given their different role.

The role of members

The EB is the most senior management forum and is made up of the four APRA Members. The EB is responsible and accountable for APRA's achievement of its functions and does this by setting the strategic direction and leadership of the organisation. The EB is a decision-making body and is supported by other senior management committees:

- ExCo, which provides oversight on APRA's organisational performance, progress on strategic priorities, risk profile, people and culture matters and general organisational effectiveness;
- PPC, which facilitates senior level discussion and coordination in relation to the development of prudential policy;
- Supervision Oversight Committee (SOC), which focusses on strategic oversight and review of APRA's core supervision function; and
- Resolution and Enforcement Committee (REC), which focusses on strategic oversight and review of APRA's enforcement strategy and resolution function, including all related strategic initiatives and risks.

Each of these Committees is chaired by an APRA Member and operates under a terms of reference agreed by the EB. Externally chaired Risk Management and Audit Committees also provide independent assurance on APRA's risk management, financial and performance reporting responsibilities, systems of internal control and compliance with applicable laws and regulations.

Each Member also has day-to-day responsibilities along industry lines. Currently, Wayne Byres oversees major banks, Helen Rowell oversees superannuation, John Lonsdale oversees other ADIs, resolution and enforcement, and APRA's work on culture and remuneration (including BEAR) and Geoff Summerhayes oversees insurance. The Members interact closely with the boards and senior management of entities within their industry focus.

The Panel believes that an internal restructure of APRA and the addition of a fourth Member, John Lonsdale, in October 2018 is an opportunity to reconsider the role of Members. The Chair should relinquish his industry focus and adopt a broader organisation-wide role. The remaining Members should split their roles to include a mix of industry, policy and functional responsibilities. In adjusting these governance arrangements, the Members should also devolve authority more effectively through the organisation to provide EGMs and their senior staff greater authority and responsibility in their industry divisions.

RECOMMENDATION 2.4

APRA's Chair should relinquish his ADI-specific oversight role and adopt a broader organisation-wide role. The remaining Members should split their roles to include a mix of industry, policy and functional responsibilities.

Non-executive directors

The Hayne Royal Commission raised the possibility that the APRA Capability Review could consider whether APRA would benefit from the appointment of one or two non-executive directors. Commissioner Hayne expressly did not indicate a view either way. A number of stakeholder

submissions supported this proposal, noting that it would strengthen oversight, objectivity and independent thinking and bring external perspectives to APRA.

Following consideration of this proposal, the Panel has concluded that APRA would not be well served by the appointment of additional non-executive directors. This judgment is informed by two key considerations. First, the Panel's recommendation about the Chair relinquishing industry responsibilities is designed to further strengthen the Chair's strategic oversight role. Second, the Panel considers the combination of both executive members and non-executive members would be a difficult and unwieldy governance structure in practice.

Resourcing and operational flexibility

APRA is a lean regulator compared to many of its international peers. Its supervisory resourcing is at the low end of the international scale. APRA has worked within this resource envelope for some time. However, it is confronting a broader and more complex range of issues. The past few years have also revealed that there is little flexibility in the organisation to respond to additional demands on its resources and deliver on its Corporate Plan. This has resulted in a delay of plans to strengthen its capacity to supervise cyber risks and new technological developments and in continuing to build on its ability to respond to a financial crisis or the failure of a large entity.

The Panel notes:

- APRA received a considerable uplift in resourcing in the 2019-20 Budget. These resources are yet to flow through to the organisation (in terms of staff recruitment and fulfilling other functions for which they were earmarked). This is in addition to funding provided in the 2018-19 MYEFO;
- In recent years APRA's remit has expanded, the GCA elements of its mandate have been forcefully clarified, the external environment has raised new prudential risks and the complexity, scope and intensity of APRA's activities has increased;
- While APRA aspires to be world leading in its approach to prudential regulation and supervision, its resourcing levels appear to be low on a 'top-down' and 'bottom-up' basis when compared to prudential regulators internationally (see further below and also Chapter 3). Moreover, APRA's mandate is broader than some prudential regulators internationally;
- APRA does not enjoy the same economies of scale, or the benefit of being able to leverage central bank back office systems and support, when compared with some other prudential regulators; and
- APRA often competes for resources with private sector financial institutions. In high demand areas (for example, cyber and IT risk) this is especially acute.

Staff perceive resourcing challenges to be acute throughout the organisation. Some illustrative staff comments, made prior to uplift in the 2019-20 Budget, are as follows:

...We have run on a shoe string budget as the world moved on and became far more complex leading to us dropping the ball because we didn't have the capacity to think about the emerging risks. We are addressing some of these issues but it will take time!

Enhancing organisational capability is driven to a large degree by APRA's capacity to recruit...we are finding it extremely difficult...when it comes to talent...We need to be able to pay our people at a competitive rate versus the industry otherwise it will never matter how much more resources we are given.

— APRA staff

APRA's funding model

The Wallis Inquiry recommended that APRA should be different from Australian Public Service (APS) regulators and should be able to establish its own staffing and remuneration structures 'in whatever form will be most conducive to their effectiveness and efficiency'.³³ It recommended that regulatory agencies should collect enough revenue from their regulated entities to fund themselves, but not more.³⁴

The Wallis Inquiry also considered that as a key part of this independent remit, APRA should operate off budget:

If they are funded through the Commonwealth Government budget, they should have their funding levels determined by reference to policies for financial system regulation rather than to targets for the overall budgetary balance.³⁵

APRA's budget is proposed by the APRA Members and put to the government for consideration and endorsement. Once endorsed, it is included in the annual Treasury Portfolio Budget Statements. If APRA is asked to undertake significant new activities, or considers that it is inadequately resourced to meet future demands, it can submit a New Policy Proposal. As part of the standard Budget process, any public comments or concerns about APRA's resourcing and activities can be raised in pre-Budget submissions.

Successive governments have supported APRA since its establishment. This has ensured that APRA's financial resources have been sufficient to enable it to discharge its supervisory and other responsibilities. Nonetheless, endorsement of the budget proposed by the APRA Members is not guaranteed and is subject to the usual and appropriate scrutiny applied to all government proposals for funding.

APRA is funded from annual levies collected from supervised institutions, with a smaller contribution from interest earnings, fees for services and miscellaneous cost recoveries. Levies are determined by the Government after consultation with industry and are raised according to the *Financial Institutions Supervisory Levies Collection Act 1998* and a suite of imposition Acts applying to the

33 Wallis Inquiry, p. 531.

34 Wallis Inquiry, p. 527.

35 Wallis Inquiry, p. 535.

regulated industries. In 2017-18, industry levies made up around 95 per cent of APRA's approved funding.³⁶

APRA has been subject to governments' general efficiency dividend requirements. Agencies are typically required to meet reductions in their base expenditure levels at a set percentage amount per year. Over the period 2014-15 to 2018-19, APRA's total expenditure has been reduced by around \$23 million from its originally approved budgets because of efficiency dividends. The Government proposes to exclude APRA from the efficiency dividend most recently announced.

In its 2012 and 2019 FSAP reports, the IMF noted that government approval of the budgets of APRA (and ASIC) leaves the agencies exposed to cutbacks for financial or other reasons. The 2019 IMF FSAP recommended:

Provide APRA with a higher level of autonomy and flexibility in determining its budget so that it can reasonably manage it to fulfill its financial stability mandate, and in a way that allows improved medium term visibility for resource planning purposes.

Remove the constraints imposed by the efficiency dividends on APRA's budget.

Remove the requirement to subject APRA's staff employment and remuneration to the APS Workplace Bargaining Policy, and conduct a periodic reassessment of APRA staff recruitment and remuneration policies and practices to ensure that APRA remains a competitive and efficient Workplace.³⁷

APRA's supervisory resourcing compared to international prudential regulators

APRA's supervisory resourcing seems low compared to international prudential regulators across a range of metrics. Some 'top-down' and 'bottom-up' measures of resourcing are considered below.

APRA's supervision function is undertaken by around 370 staff, including 230 frontline staff and 140 risk specialist and other staff.³⁸ Average APRA frontline resources for different categories of regulated entities are depicted in Figure 2.4.

Figure 2.4: Average APRA frontline FTEs for different classes of regulated entities

Class of regulated entity	Average frontline FTE
Major bank / complex ADIs	6.0 - 6.4
Other domestic banks, credit unions and building societies	0.1 - 2.3
General insurers, life insurers and PHIs	0.2 - 1.9
Superannuation entities	0.1 - 1.0

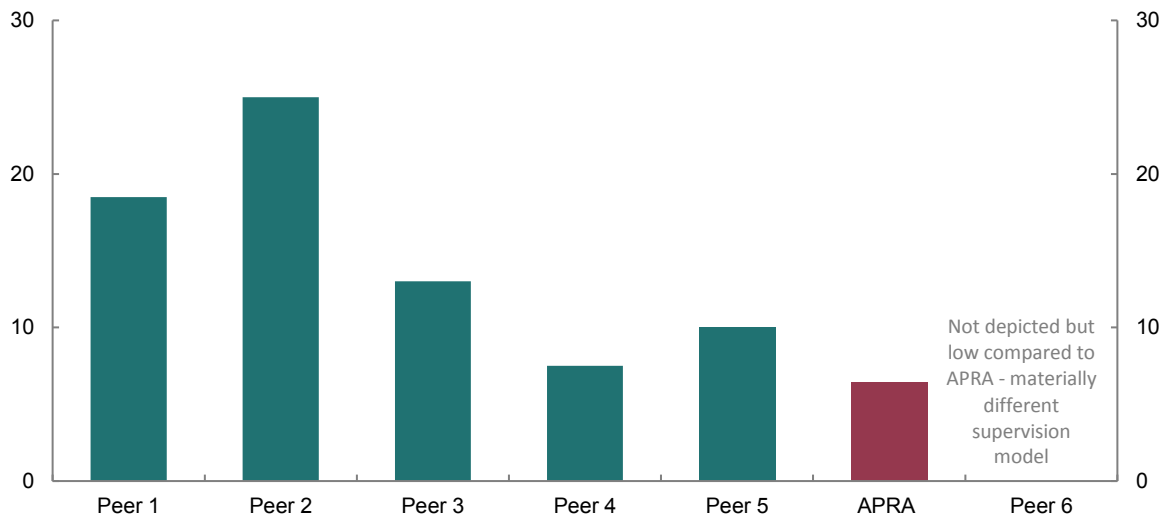
36 Australian Government 2017, *Proposed Financial Institutions Supervisory Levies for 2017-18*, p. 8.

37 IMF, 2019, *Australia: Financial System Stability Assessment*, p. 75.

38 As at 31 December 2018.

Using the major banks as an example, APRA’s frontline resourcing levels are low compared to prudential regulators internationally as shown in Figure 2.5.

Figure 2.5: Frontline FTEs per D-SIB equivalent — APRA compared to international prudential regulators³⁹

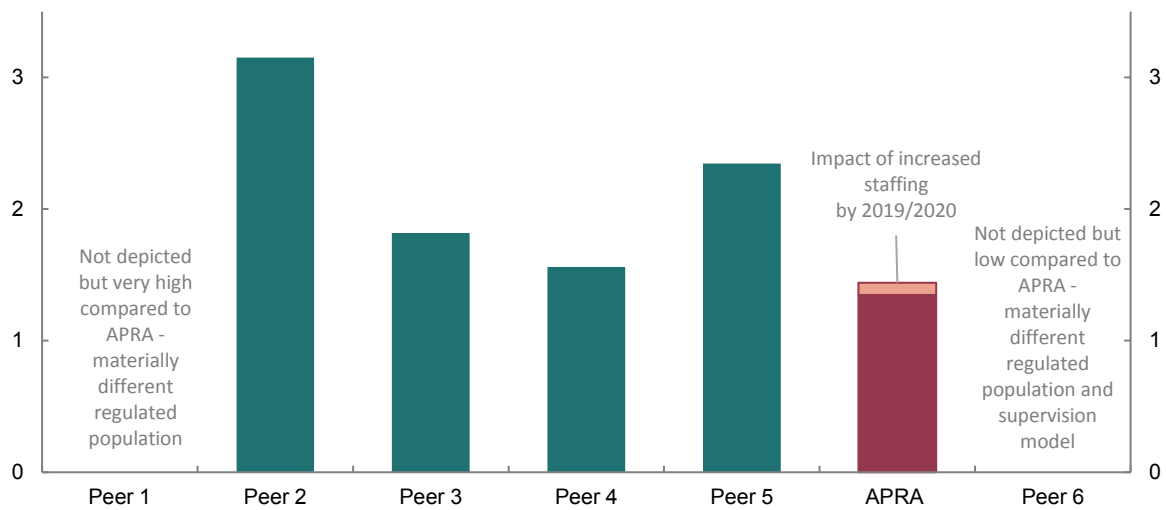


One top-down measure of resourcing levels is the total number of staff per regulated entity. APRA’s resourcing is on the low end compared to peers, as shown in Figure 2.6.⁴⁰ This will remain the case following the increase in staff levels by 2019-2020.

39 This figure compares resourcing levels for domestic systemically important bank (D-SIBs) (or closest equivalent) across jurisdictions. Banks most comparable to the Australian major banks are used where possible. Prudential regulators responsible for home supervision of global systemically important banks allocate significantly greater levels of staff. Note, De Nederlandsche Bank is not included in Figure 2.5 and Figure 2.6 given the joint role of the European Central Bank — Banking Supervision and national authorities supervising significant institutions.

40 Top-down comparison across jurisdictions has limitations. This is due to different mandates, regulated populations and organisational arrangements across jurisdictions. In any event, top-down comparison measures are consistent with bottom-up comparison measures. Data presented reflects best estimates.

Figure 2.6: APRA staff per regulated entity — APRA compared to international prudential regulators



The Government has provided increased funding to APRA in the 2019-20 Budget and it remains appropriate for APRA and the Government to monitor and discuss the adequacy of funding.

Remuneration policies

While APRA is not part of the APS, APRA is subject to the APS Workplace Bargaining Policy. The Panel notes APRA's difficulty in attracting and retaining highly-skilled staff, including in niche areas subject to high market demand and the constraints that the policy places on APRA defining management roles more flexibly. The Murray Inquiry noted that '[e]ffective regulators need to be able to offer competitive salaries'.⁴¹

To complement internal changes at APRA, particularly recommendation 2.3, the Panel recommends:

RECOMMENDATION 2.5

To help facilitate a number of recommendations in the Review, the Government should remove APRA from the application of the APS Workplace Bargaining Policy. APRA should engage with the Government to consider ways to enable greater variation in remuneration levels.

41 Murray Financial System Inquiry, p. 238.



CHAPTER THREE: MAINTAINING FINANCIAL STABILITY IN AN EVER CHANGING WORLD

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CHAPTER 3: MAINTAINING FINANCIAL STABILITY IN AN EVER CHANGING WORLD

APRA's vision is to deliver a sound and resilient financial system, founded on excellence in prudential supervision.⁴²

In large part APRA has delivered on this vision. Its relentless focus on regulating and supervising the financial risks in its regulated entities, has supported a sound and resilient financial system. APRA is highly respected by its peers and the entities it supervises. In this respect it is an impressive and successful prudential regulator of world standing.

The approach of pre-empting big financial risks, notably in housing for ADIs, and monitoring them intensively has been beneficial to the financial system. APRA's approach contributed to Australia getting through the GFC in much better shape than most developed economies. As one senior bank executive noted:

APRA and the RBA were impressive during the GFC.

— Senior bank executive

It is useful to distinguish between three aspects of APRA's role. APRA's Chair classified these as financial resilience, operational resilience, and organisational and cultural resilience.⁴³ This Chapter focusses on APRA's role in fostering financial and operational resilience and how APRA considers various parts of its mandate. In summary:

- APRA has a well-developed policy and supervision framework which underpins its success in regulating financial risks. It is building on these capabilities;
- APRA's management of the growing risks in residential mortgage lending over the past few years had the desired effect. However, it needs to better publicly articulate its approach to managing dynamic risks in a macro-prudential way and identify the bounds of its responsibilities. It should clarify which policies are subject to macro-prudential adjustment and which policies represent conventional through-the-cycle supervision;
- APRA needs to continue to enhance its preparedness for a crisis that extends across a range of financial entities and also its resolution of a failing medium or large-sized entity;
- APRA's capability to foster resilience against cyber threats across its regulated population is not commensurate with the risks in this area;
- APRA's IT risk capability is not matched to current and near-term industry trends;
- APRA has effectively managed risks around mortgage lending. APRA's capacity to supervise non-retail credit risk should be increased; and
- More needs to be done to embed considerations of competition in APRA's culture and approach.

42 APRA, 2018, *2018-22 Corporate Plan*, p. 2.

43 Byres, W, 2019, *Building resilience in three dimensions*, 27 March 2019.

Financial resilience — strong foundations, critical capability⁴⁴

The IMF’s FSAP was conducted over the course of 2018 and 2019. The headline conclusion was that:

The Australian authorities have taken welcome steps to further strengthen the financial system since the previous FSAP. Bank capital requirements have been raised and applied more conservatively than minimum Basel standards. Funding risks have been lowered. Financial supervision and systemic risk oversight have been enhanced. And the authorities have taken successful policy action to calm rapid growth in riskier segments of the mortgage market.⁴⁵

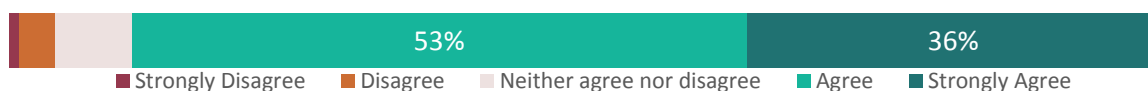
The IMF also assessed APRA’s policy frameworks for banking, general and life insurance against international standards. APRA’s policy frameworks were highly rated.

Public sector and expert commentators were consistent in their assessment that APRA had performed ‘very well’ in fostering financial resilience. It was noted that APRA was one of the few prudential regulators in the world that had ‘got the balance right’ between supervision, policy frameworks and its principles-based approach over reliance on prescriptive ‘black-letter’ law regulation.

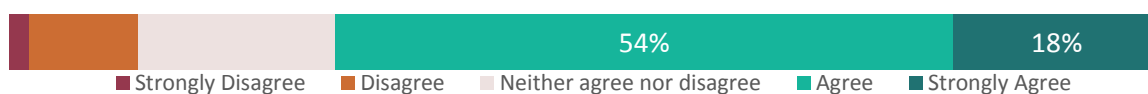
This broadly aligns with the perceptions of APRA staff, with the great majority of staff expressing confidence that APRA was well placed to identify material issues relating to financial resilience (and, to a slightly lesser extent, macro-prudential risks).

Capability Review Staff Survey — Identification of financial risks

Proposition: APRA is well placed to identify material issues with individual regulated entities’ financial resilience (for example, capital, liquidity, credit).



Proposition: APRA is well placed to identify and manage evolving risks to system-wide financial stability including risks of a macroprudential nature.



One of the difficulties of assessing the performance of a prudential regulator is that it is very hard to define success with quantitative metrics. APRA uses two quantitative metrics as an indicator of realised outcomes for its beneficiaries (for example, depositors and policyholders). These are the Performing Entity Ratio and the Money Protection Ratio, which have been 99.93 per cent and 99.97 per cent since APRA’s inception.⁴⁶ These positive results reflect a combination of sound

⁴⁴ A high level overview of APRA’s policy and supervision framework is contained in Chapter 1.

⁴⁵ IMF, 2019, *Australia: Financial Sector Stability Assessment*, p. 7.

⁴⁶ The Performing Entity Ratio is an indicator of the incidence of failure amongst regulated institutions. It is calculated as the as the number of regulated institutions that met their commitments to beneficiaries in a given year divided by the total number of regulated institutions. The Money Protection Ratio is an indicator of the incidence of loss in the financial sector. It is determined as the dollar value of liabilities to beneficiaries in Australia in a given year, less any losses due to prudential failures, divided by the total dollar value of liabilities to beneficiaries in Australia in APRA-regulated institutions.

prudential regulation by APRA, public sector and government policy and favourable economic conditions.

In the decade since the GFC, and especially in the last four years, there has been a step up in the scope, intensity and complexity of APRA's supervision function:

- Developments in the external environment (especially, cyber risk and IT risk generally);
- New and more complex policy frameworks (Basel III capital and liquidity reforms, committed liquidity facility requirements, life and general insurance capital requirements, Level 3 prudential standards);
- Expanded scope of APRA activities (for example, stress testing, recovery planning, supervisory colleges);
- Increased intensity of supervision (for example, residential mortgages, thematic review activities);
- Expansion of APRA's legislative mandate (for example, BEAR); and
- The forceful articulation and increased expectations in areas within APRA's long-standing mandate (per the Hayne Royal Commission, PC Superannuation Inquiry, CBA Prudential Inquiry and APRA Enforcement Strategy Review).

During the period of this Review, APRA was in the process of reviewing its supervision model and nature of its supervision activities under its 'Supervision Fitness Program'. The purpose of this program was to update APRA's supervision model to take into account developments in the external environment, and recommendations and insights of the Hayne Royal Commission, FSAP and CBA Prudential Inquiry. Some of the elements in scope include a refresh of supervision philosophy, revision of PAIRS and SOARS, greater top-down coordination of onsite supervision activities, training in the 'art of supervision' and a more systematic approach to horizontal analysis and activities.

The maintenance of strong financial entities and a stable financial system is crucial for the prosperity of Australia and the well-being of the community. It is important that APRA retains its strength in this area while responding to the recommendations of this Review and the increasing demands on it as a regulator. One commentator noted:

As the regulatory promise shifts you need someone to remind people of the benefits of stability.

— Senior academic

RECOMMENDATION 3.1

While lifting organisational capability across the areas identified in this Review is important and necessary, APRA should retain its long-standing and core capability of fostering financial safety and financial stability.

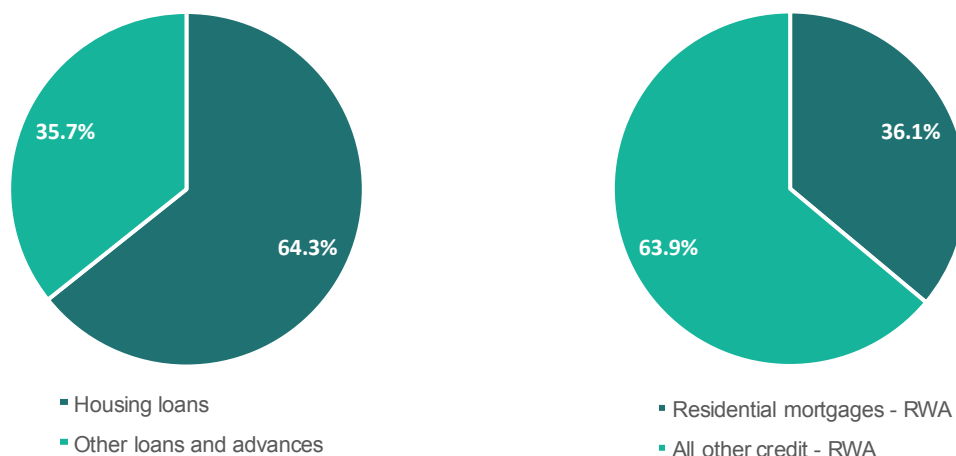
The remainder of this Chapter outlines on an exceptions basis areas where enhancement of APRA's capability to foster financial resilience and operational resilience would be desirable.

Non-retail credit risk capacity

APRA’s approach to traditional financial risks is rigorous and effective. In noting that, APRA has focussed much attention on risks emanating from exposures to housing. It has developed strong capabilities in this area. APRA mobilised significant resources in the past few years to address concerns about increasing risks in residential mortgage books. This was reflected in its macro-prudential responses between 2014 and 2017 and the implementation of extensive supervisory measures throughout this period.

This focus on housing risks is entirely appropriate. Housing represents 64 per cent of assets in the Australian banking system in dollar terms, and 36 per cent of the banking system when considered in risk-weighted asset terms (Figure 3.1).⁴⁷

Figure 3.1: Housing loans as a share of total loans and advances and as a share of credit risk weighted assets⁴⁸



In the Panel’s assessment, APRA’s focus on credit risks outside the housing market (‘non-retail’ credit) is comparatively less developed and intense. The exception is commercial real estate and New Zealand dairy exposures. The Panel noted:

- APRA’s internal reporting confirms its less intense focus on non-retail credit. Internal reporting in the ADI Quarterly Report, presented at the October 2018 Supervision and Resolution Committee⁴⁹ Meeting stated:

Business lending. The recent focus on mortgages and commercial property has meant that other credit portfolios have not had the same level of regulatory scrutiny. As a deep dive risk review into ADIs SME and corporate portfolios has not occurred for several years the lending practices in these portfolios is not known at an industry view and there is a risk that lending standards are not as tight as necessary. These portfolios are known to perform worse in times of stress.

47 Risk-weighting is a concept utilised in APRA’s capital framework. Risk-weighted assets (RWAs) is an approach that allows comparison of aggregate credit risk across different types of portfolios.

48 Data as at December 2018, on a consolidated group books basis for the Australian banking system excluding foreign branches.

49 The Supervision and Resolution Committee predates the current SOC and REC.

— APRA document

- Based on an examination of APRA’s supervision files, data reporting framework, prudential review activity, committee and industry group papers, the overall quality, coverage and level of activity is strong for residential mortgages, good for commercial real estate and in prior years New Zealand dairy, but lower for other categories of non-retail credit;⁵⁰
- In 2018, APRA pivoted to increase supervisory focus with respect to the major banks’ small and medium business lending exposures;
- Assessing risks in mortgage lending is comparatively straightforward as products are relatively homogenous. This is not the case for more complex non-retail loans. These require more intense focus and more specialist expertise; and
- APRA’s specialist credit risk resourcing appears to be low compared to international peers. APRA’s specialist credit risk team is made up of 17 staff, whereas the credit risk specialist team of a closely comparable prudential regulator is made up of 45 staff.⁵¹ In addition, one prudential regulator has established an external pool of credit risk experts to assist with onsite credit reviews, providing scale and specialisation which supplements internal credit risk capability.

While APRA has appropriately taken a risk-based approach in supervising credit risk, increased capacity in non-retail credit is warranted.

RECOMMENDATION 3.2

APRA should build credit risk capacity to simultaneously maintain high supervisory intensity in both non-retail and retail credit risk.

Macro-prudential policy needs clearer articulation

Following the GFC, prudential regulators and central banks sharpened their focus on systemic financial risks. Policies to manage those risks over the cycle come under the broad heading of ‘macro-prudential’. They have two key characteristics — their focus is systemic and they are dynamic. They complement traditional prudential regulation which is focussed on individual regulated entities and which applies ‘through-the-cycle’.

Both APRA and the RBA have responsibility for financial stability. They work collaboratively with other members of the CFR — ASIC and Treasury — on stability, including macro-prudential policies. In 2012, APRA and the RBA jointly published their roles in macro-prudential policy:⁵²

50 This observation does not apply to IRB model supervision.

51 These figures refer to credit risk resourcing in specialist divisions, and hence do not capture credit risk expertise among frontline staff. For both APRA and the other prudential regulator, figures cited include specialist staff responsible for oversight of IRB models.

52 RBA and APRA, 2012, *Macro-prudential Analysis and Policy in the Australian Financial Stability Framework*, September 2012.

- The main tools for macro-prudential supervision in Australia are only exercisable by APRA. APRA is the only agency which has the power to act to directly change the behaviour (and, if necessary, the balance sheets) of entities to achieve macro-prudential outcomes; and
- The RBA has had a longstanding responsibility for financial stability, confirmed in the context of the 1998 financial sector regulation reforms and the Statement on the Conduct of Monetary Policy. The primary instruments available to the RBA include the use of its role as liquidity provider and its regulatory powers over the payments system. The RBA's monetary policy considerations are also informed by financial stability developments.

APRA draws heavily on the RBA to assist it in forming views of system-wide developments in the financial system and their interplay with the broader economy.

APRA's intervention to restrict residential investor and interest-only mortgage lending between 2014 and 2017 can be described as macro-prudential policy.⁵³ APRA's actions drew on resources across the institution. Key activities included monitoring, risk identification, CFR engagement, response option generation and development, and implementation and monitoring. These activities were undertaken through collaboration across PAD's policy development function, RDA's macro and industry insights team and risks specialists, and DID's and SID's supervision teams. Macro-prudential and other measures taken by APRA to foster sound residential mortgage lending standards are depicted in Figure 3.2.

In January 2019, APRA published its review of the impact its policy and supervisory measures had on housing. This represented an increase in transparency compared to APRA's historical practice. The policies had the desired effect and lending standards improved.⁵⁴ Growth in market segments that may have embedded more risks in ADI and household balance sheets — investor loans and interest-only loans — has slowed substantially. The rise in ADI and household balance sheet vulnerabilities has been checked. The resilience of the financial system and economy has improved.⁵⁵

The Panel note that some industry participants consulted during the Review were unpersuaded by APRA's analysis and commentary around the competitive and distributional implications of its actions. The PC Competition Inquiry was critical of APRA's interventions because of their apparent detrimental impacts on competition.⁵⁶ However, those impacts need to be judged against the benefits of mitigating rapidly building risks in the financial system and the speed with which APRA responded. In submissions to the PC Inquiry, the RBA and Treasury both noted the PC's concerns but argued that the benefits of acting were more important and that APRA and the CFR had considered the possible costs and benefits of alternative policies beforehand. While acknowledging how quickly APRA was required to react in 2014 when introducing the 10 per cent investor benchmark and the fact that this was the first intervention of its type, this debate emphasises the need for APRA to be well prepared for possible future interventions and, to the extent possible, transparent about its possible tools.

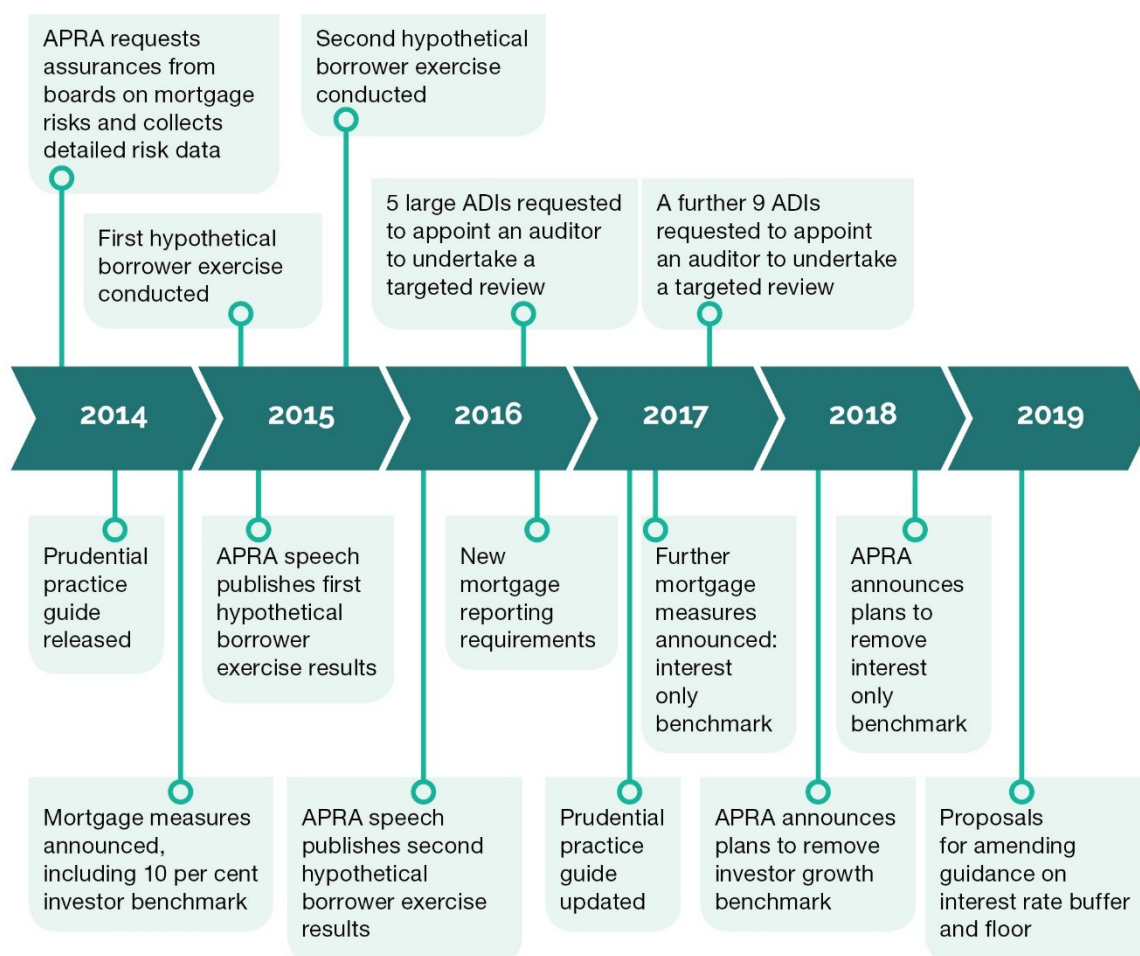
53 APRA's industry-wide and macro-prudential activities are not limited to housing. Other key lenses employed by APRA include industry-wide stress testing and the introduction of the countercyclical capital buffer framework (CCyB). The CCyB became effective in January 2016. The high-level purpose of the CCyB is to make bank capital requirements responsive to the macro-financial environment. APRA sets the CCyB based on an assessment of a set of core indicators of systemic risk, following engagement with the RBA and CFR. In practical terms, this means that banks can be required by APRA to hold an additional capital buffer, between zero and 2.5 per cent depending on APRA's assessment of systemic risks. Currently the CCyB is set as zero.

54 APRA, 2019, *Information Paper: Review of APRA's prudential measures for residential mortgage lending risks*.

55 RBA, 2018, *Financial Stability Review*, October 2018.

56 PC Competition Inquiry.

Figure 3.2: Timeline of measures to foster sound residential mortgage lending standards



The IMF identified a number of factors needed to support effective macro-prudential policy:⁵⁷

- Clearly defined goals and scope;
- Strong supervision and enforcement, complemented by appropriate monetary, fiscal and regulatory policies;
- The ability to assess systemic risk, assemble and deploy the toolkit, monitor and close regulatory gaps and close data and information gaps; and
- Strong institutional and governance frameworks with appropriate strength of powers and clear accountability.

These foundations are mostly in place at APRA or in the surrounding CFR architecture in Australia. But adjustments are required, particularly around APRA defining its authority, approach and accountability.

57 IMF, 2013, *Key Aspects of Macroprudential Policy*, IMF Policy Paper.

Compared to international peers, APRA and the RBA have taken a more nuanced view of macro-prudential policies. APRA and the RBA see them as being subsumed within the broader prudential and policy framework for promoting financial stability.⁵⁸

APRA has viewed them as traditional bank supervision:

...these efforts are often tagged macro-prudential, but...we see our role — in simple terms, seeking to make sure lenders continue to make sound loans to borrowers who can afford to pay them back — as really pretty basic bank supervision.⁵⁹

This nuance that macro-prudential policies are mostly business-as-usual for APRA may not be an issue in itself but it is consistent with a recurring theme in the Review that APRA lacks innovation and is tentative in expanding its capability and authority into areas that genuinely fit into its mandate but stretch the limits of traditional prudential supervision. Recommendation 3.3 provides APRA with more transparent ownership of the management and implementation of macro-prudential policy. But it creates some unease in the Panel as APRA will have to grow into this authority.

Knowledge of the theory and practice of macro-prudential policies is still developing. There are a range of governance arrangement and tools used internationally. APRA has the sole responsibility for macro-prudential policies but works closely with the CFR in considering those policies. The IMF FSAP noted that while this arrangement was effective in coordinating decisions on regulatory matters it was less formal than others employed internationally. The IMF suggested that a greater degree of transparency and accountability would be desirable.

The Panel supports APRA's ownership of macro-prudential policy and recommends that it adopt a more transparent and systematic approach to its implementation. APRA should define its approach to macro-prudential policies in terms of the relevant objectives, instruments and policy-making process, including the role of its CFR partners. Empirical assessments of past policy initiatives should be published, including for the 2014-17 intervention. In the Panel's view, a clearer articulation of macro-prudential policy, including differentiation from business as usual prudential policy, will enhance the prospects for its future success.

The foundations for the effective use of macro-prudential policy by APRA are mostly in place. As best practice is still developing greater transparency around the intent and expected impact of policies will allow APRA to justify ownership of this area and be held to account.

RECOMMENDATION 3.3

Reflecting its role as an independent prudential regulator, APRA should take a more transparent and assertive role in articulating the objectives of its macro-prudential policies, the design of the instruments chosen and assessment of its impacts, including on the broader areas of its mandate. APRA should continue to develop its public communication around the extent of systemic risks, conditions required for macro-prudential actions and assessments of any actions taken.

58 Ellis, L, 2012, *Macroprudential Policy: A Suite of Tools or a State of Mind?*, 11 October 2012.

59 Byres, W, 2018, 'Remarks for the Regulators' Panel', 9 February 2018.

Crisis management and resolution⁶⁰

APRA's efforts to build capital requirements, strengthen balance sheets and tighten lending standards in the residential mortgage market in the past few years have made the financial system more resilient. But this is no guarantee against a financial failure or crisis.

APRA needs to continue to enhance its preparedness for a market-wide crisis that affects multiple entities and its capacity to respond to a single distressed entity in collaboration with CFR members. APRA advised that:

Prior to the GFC, it is arguable that APRA under-invested in crisis management capabilities. Following that shock, a process of legislative reform was initiated to improve the statutory basis for resolution, although this was not completed until 2018 ... APRA now has a large multi-year work program to build resolution frameworks and capabilities, but has struggled to maintain momentum on this work as other priorities have arisen.

— APRA document

These delays are partly explained by the other issues to which APRA has had to respond. The process of providing strengthened crisis management legislative powers to APRA was also slow. Treasury and APRA drafted a consultation paper in 2011. This was publicly released in 2012 but put on hold pending the Murray Inquiry. Legislation was ultimately passed in March 2018.

APRA is very aware of the importance of strengthening its crisis preparedness and resolution capabilities. It faces the difficult choice of allocating resources to issues of contemporary focus such as the Hayne Royal Commission and its oversight of the superannuation sector and issues around crisis preparedness and resolution which are not front-of-mind in the broader community. There is no easy way to balance this choice. APRA should advise the Government of its current state and objectives as a basis for assessing whether additional resources are required in this important area.

Resolution is identified as one of APRA's three main functions. Building resolution capacity is currently one of six strategic initiatives within APRA's 2018-2022 Corporate Plan but has been an area identified for uplift for much longer. Key milestones in recent years include:

- The enhancement of the legislative framework relating to resolution in 2018 (as noted above);
- Recovery planning thematic reviews, which have materially improved recovery plans across banking and insurance industries; and
- APRA's release of its Total Loss-Absorbing Capacity proposal in November 2018.

Key aspects of APRA's resolution capability remain outstanding. These include: introducing a recovery and resolution prudential standard; developing detailed failure management procedures

60 In this section, the following terminology is used:

- 'Recovery planning' refers to preparatory work undertaken by regulated entities to develop frameworks and (private sector) options that could be deployed in the event of a crisis;
- 'Crisis management' refers to the range of options available to APRA to respond to or mitigate the impact of a crisis relating to an entity-specific or system-wide crisis; and
- 'Resolution', in the narrow sense, refers to steps taken by APRA to finally resolve a regulated entity once it has become non-viable (including but not limited to administration of the FCS). 'Resolution' can also be used as an umbrella term to also encompass recovery planning and crisis management.

and communication plans; further progress on recovery planning focussing on operational capability; increased FCS assurance; and development of resolution plans. One APRA staff member observed:

three years on and we are still in the foothills of [entity's] resolution planning...

— APRA staff

APRA's historical track record in this area is characterised by extended timeframes and delay. There have been multiple drivers of this. These include: the lack of bank failures in Australia; the historical combination of enforcement and resolution activities under a single GM; modest resourcing compared to offshore jurisdictions and the need to prioritise other work streams.

In the event of a crisis, APRA would need to closely coordinate with relevant domestic and potentially offshore agencies. While the CFR and the Trans-Tasman Council on Banking Supervision have in place crisis management procedures there is more work to be done to enhance and test ability to operationalise those procedures. The IMF noted:

Reinforcing financial crisis management arrangements is a priority. Encouraging progress has been made in strengthening APRA's resolution powers and expanding banks' recovery planning to cover additional institutions. ... It is also important to complete the resolution policy framework quickly, to ensure that banks expand their loss absorbency capacity to bear the costs of their own failure. Bank-specific resolution plans should be rolled out and validated swiftly.⁶¹

The Panel has observed that APRA's crisis preparedness work has been mostly focussed on ADIs. APRA is comparatively less well placed in terms of crisis preparedness for other industries.

The Panel also notes that international practice around crisis and resolution varies across countries. In most jurisdictions, deposit insurance and resolution functions are the responsibility of a separate, dedicated authority or department. The resources allocated to deposit insurance and resolution functions in some comparable jurisdictions are of a higher order of magnitude than in Australia.

The Panel is concerned about the risks of further delay in APRA's plans to strengthen its crisis management and resolution capabilities and note the IMF's observation that 'reinforcing financial crisis management is a priority.' This is an important issue that would benefit from open engagement with the Government.

RECOMMENDATION 3.4

APRA should advise the Government of the current state of its resolution capability and crisis preparedness as a basis for assessing whether additional resources are required to advance this work more quickly. This should be completed by the end of 2019.

61 IMF, 2019, *Australia: Financial System Stability Assessment*, p. 7.

Cyber — a collaborative solution

Everything is changing faster than enterprises and regulators can respond.

— Cyber security expert

The risk of cyber attack is a growing threat and major operational risk for private and public sector entities. APRA's capability in this area does not match the significance of the risk. The challenges in this area are by no means unique to APRA.

Collaboration on the issue between regulators in Australia and internationally is deepening and developing quickly. This is a good thing and will need to continue. Close collaboration with IT experts, peer regulators and the industry will be necessary. The nature of the threat in the financial services industry, and the interconnected nature of the industry, means that finding a solution has the characteristics of a public good. A coordinating role for government may be needed. To the extent that collaboration within the industry is needed, traditional issues around anti-competitive practices may need to be reviewed.

Cyber security threats continue to grow in frequency, sophistication and severity.⁶² They are distinguished from other operational risks in a number of ways: they are conducted with malicious intent; they are near-certain to happen; their duration is uncertain as malicious code may reside in IT systems for an extended time; and they are adaptable and increasingly easy to implement.⁶³ Growing interoperability, outsourcing and technology-centric business models all increase the complexity of responding to cyber-threats.

APRA's IT risk team was established in 2002. Currently, this is a generalist team of nine staff with responsibilities spanning the full spectrum of IT risk issues faced by regulated entities. Its responsibilities are demanding. The subject matter covered by this team is wide, and includes cyber-risk, information security, system migrations, new technology entrants, data management and quality and cloud computing. These are broad and quickly evolving areas. In addition to the breadth of subject matter, the team supports a range of APRA functions. These include supporting policy development, onsite prudential review activities, technical review of licensing applications, review of outsourcing applications and coordination with domestic and international bodies.

APRA has taken some steps in recent years to foster resilience to cyber-risks. In 2016 and 2017, it conducted cyber surveys and published the results. In 2018, APRA released an updated prudential standard aimed at ensuring that regulated entities take measures to be resilient against information security incidents (including cyber attacks).⁶⁴ In March 2019, APRA commenced consultation on an update to associated guidance.⁶⁵

APRA updated its Cyber Risk Strategy in 2018. The core elements of the strategy are to expand supervision capability, strengthen the prudential framework, build response capability and drive insights, over a four-year period and beyond. APRA does not currently have a formal cyber incident response plan or routine data collection.

Internationally, prudential regulators identify cyber-risk as a top-tier priority. It is recognised as a challenging and rapidly developing area. The prudential regulators leading in this area have taken steps, including coordinating penetration testing, facilitation of industry information sharing, setting minimum 'hygiene' standards for industry and developing incident response protocols.

62 Australian Cyber Security Centre, 2017, *2017 Threat Report*.

63 Nelson, L, 2018, *Stock-take of global security regulatory initiatives*.

64 APRA, 2018, *Prudential Standard CPS 234 Information Security*.

65 APRA, 2019, *Draft Prudential Practice Guide 234 Information Security (CPG 234)*.

One prudential regulator is considering minimum ‘impact tolerance’ standards, setting the maximum amount of disruption in the delivery of vital services to the economy. This prudential regulator is proposing to actively test whether firms are able to meet these standards and intends to pilot a cyber-stress test exercise. Another leading prudential regulator coordinates an industry Cyber Security Steering Group as a means to facilitate sharing of information and leading practices and also conducts business continuity exercises. Meanwhile, one prudential regulator has established a Cyber Security Advisory Panel, comprised of global experts, to assist it in this area.

The prudential regulators leading in this area tend to have two advantages:

- They are able to leverage well-established national-level cyber strategies and expertise; and
- They tend to have significant dedicated resources (for example, 10-30 cyber-specialists for comparable prudential regulators, in addition to general IT risk specialists).

APRA will never be able to prevent cyber attacks. There should not be an expectation that it can do so. APRA should have a leadership role supporting development of the financial sector’s cyber defences and supporting broader efforts at a national level. While APRA has made some contribution to date its capability in this area is behind leading peers, and as APRA progresses its current cyber strategy the cyber threat environment will have changed further.

APRA’s capability development in this area will need to continue, potentially supported by more flexibility in its salary arrangements. Given the dimensions of the problem there is also a question around whether there is sufficient capacity in Australia for entities to develop solutions. A coordinating role for governments may be necessary and more effective.

APRA’s scale and mandate mean that it will be very challenging if not impossible for it to develop cyber risk capability entirely internally. The Panel believe that a collaborative approach to this area is the best way forward.

RECOMMENDATION 3.5

APRA should seek to build strong allegiances with public and private sector experts, other regulators and financial firms to augment its internal capacity and to collaborate on ways to strengthen the cyber resilience of APRA’s regulated sectors.

Digital disruption

In addition to cyber risks, APRA will need to adapt to a range of other technological developments in the next few years. These include:

- New technology-enabled business models — many involving non-traditional actors;
- Increased reliance on third-party service providers (for example, cloud);
- Ongoing transformation of existing regulated entity’s IT landscapes (including management of complex legacy systems); and
- Increased competition from niche and scale technology competitors in core activities.

While more speculative, some industry experts envisage radical changes in the nature of financial services competition in coming years. Traditional banking's focus on lending and deposit markets could be supplemented by an equally important market for data, which would in turn drive partnerships between regulated entities and firms outside APRA's regulatory perimeter.

While likely to be positive for competition and consumers, the scale and pace of change involves possible transition risk for APRA's regulated sectors. APRA's capability and capacity in this area is already challenged by the volume, scope and pace of change. The demands upon APRA will only increase in coming years.

As part of the Review, APRA undertook a high-level self-assessment of its current IT risk capability and target state (Figure 3.3).

Figure 3.3: IT risk capability and target state

	Current state	Target state
Proactive supervision of the regulated population and new licence applications	<ul style="list-style-type: none"> Piecemeal and limited coverage onsite prudential review schedule, especially outside the major banks Onsite prudential review activity crowded out by reactive urgent work (10 per annum, down from 30 in 2011) Delays with outsourcing consultations relating to cloud and systems migrations 	<ul style="list-style-type: none"> Systematic, representative onsite review coverage of regulated population and key third-party providers Tailored supervisory approach (onsite reviews, third-party assessments, surveys, self-assessment) Engagement across all regulated entities Elevated testing and assurance around prudential standard compliance
Build and maintain specialist expertise and organisational capability	<ul style="list-style-type: none"> Variable confidence across Frontline teams engaging on IT risk; late escalation of material IT risk issues internally Limited scope for expert staff to invest in development of organisational capability Limited scope for in-depth forward-looking research Staff turn-over impacted by market demand 	<ul style="list-style-type: none"> Uplift in baseline skills and knowledge on IT risk across frontline teams Timely escalation of issues internally Uplift in data analysis capacity Proactive approach to emerging issues Remuneration closer to industry levels
Maintain prudential framework to reflect industry developments	<ul style="list-style-type: none"> Information security standard and guidance in place — but known industry compliance challenges Service provision standards does not adequately address current challenges, including service provision, cloud, complex ecosystems and supply chains Business Continuity Management standard does not reflect current industry practice No Data Management prudential standard 	<ul style="list-style-type: none"> Fit-for-purpose prudential standards and guidance
Collaboration with public sector and industry stakeholders	<ul style="list-style-type: none"> Limited capacity for industry communication, reactive engagement, piecemeal engagement with key stakeholders Constrained capacity to contribute to international and domestic forums 	<ul style="list-style-type: none"> Regular, timely systematic communication with industry and key stakeholders regarding areas of concern and better practices Proactive engagement with international and domestic forums

External perspectives of APRA’s capability were similar. They mainly focussed on issues of competition and innovation and did not address the complex issue of what these developments mean for financial stability.

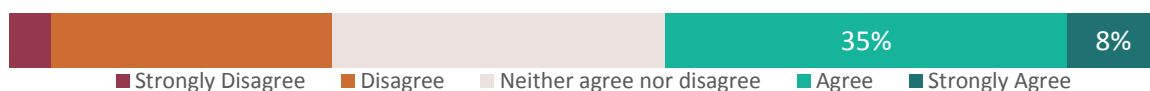
One industry stakeholder described APRA as ‘immature, conservative’ with a ‘limited outward focus’. It was suggested that APRA ‘must be prepared to contemplate dynamic industry change’. One regulated entity expressed frustration with delays, uncertainty and conflicting messages associated with an effort to use cloud technology on a pilot basis. The establishment of the central licensing team by APRA was favourably perceived. However, it was suggested that APRA had in practice encouraged technology solutions familiar to it, as opposed to innovative alternatives in use offshore. At the other end of the spectrum, one industry expert observed ‘the IT risk team at APRA is one of the better ones in the world... but it’s too small’.

The Panel heard that industry would like APRA to be more transparent about what it wants to achieve in the area and be more open to new technologies. APRA’s Corporate Plan envisages the development of an external innovation strategy.

In terms of staff perspectives, only 43 per cent of staff feel that APRA is well placed to identify material risks associated with operational resilience (which includes, but is not limited to IT risk and cyber).

Capability Review Staff Survey — Identification of operational risks

Proposition: APRA is well placed to identify material issues with regulated entities’ operational resilience (e.g. cyber).



APRA’s target state is descriptive of existing leading practices of prudential regulators internationally. These prudential regulators have built capability and capacity in recent years. Leading prudential regulators most comparable to APRA estimated they had between 30 and 49 dedicated IT risk (including cyber) specialist staff, compared to 9 for APRA. One APRA staff member observed ‘we’re stretched across all areas.’

The external technological landscape is changing quickly and APRA has limited resources to respond. Beyond the resourcing issue, technological change also raises difficult questions about how APRA balances its mandate. Some of the technological changes occurring could boost competition and make the financial sector more efficient. At the same time, they could introduce new risks into and across the system that are not well understood at the moment and not easily supervised.

These cyber and IT risks are another important issue facing APRA that warrants public scrutiny and discussion. It would be a useful addition to APRA’s external accountability framework (see Chapter 6). This could be used to frame the public analysis of emerging benefits and financial risks in new technologies and to assist and advise governments.

RECOMMENDATION 3.6

To better prepare for and respond to the consequences of digital innovation and disruption, APRA should increase its IT risk capacity and capability, including through increased collaboration and partnerships. In doing so, APRA should consider the implications of new business models, management and transformation of legacy IT landscapes, greater reliance on third-party providers (for example, cloud providers), and technology-enabled competition.

Competition — balancing a multifaceted mandate

APRA has a multifaceted mandate that requires it to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality. APRA does so in a way consistent with the intent of the Wallis Inquiry and APRA Act — it pursues financial safety and financial stability as its primary goals but not in a way that unduly hinders competition, competitive neutrality, contestability and efficiency of the system. This is a difficult task that requires nuanced judgment. APRA embeds some structure around this task when considering the impact of its behaviour on competition in the system.

Submissions to and consultations during the Review show a degree of unease about APRA’s impact on competition and its commerciality. This was not reflected in APRA’s stakeholder survey which was positive about its role.⁶⁶ Responses in APRA’s external stakeholder survey, concerning whether ‘APRA effectively pursues financial safety, balanced with considerations of efficiency, competition, contestability and competitive neutrality, and promotes financial stability’ were good. In relation to this proposition, 73 per cent of respondents ‘agreed’ or ‘strongly agreed’, while 10 per cent of respondents ‘disagreed’ or ‘strongly disagreed’.

In terms of internal staff perceptions, 52 per cent of staff agreed that efficiency, competition, contestability and competitive neutrality are an important consideration at APRA.

Capability Review Staff Survey: Competition

Proposition: Efficiency, competition, contestability and competitive neutrality are important considerations at APRA.



Consistent with the observations in the PC Competition Inquiry, the focus on “competition” within APRA’s statutory mandate is directed towards fostering choice and increased responsiveness to consumers.⁶⁷ It is not, as some regulated entities tend to advocate, about ‘levelling the playing field’ or attempting to achieve alignment with international regimes. APRA’s role is not to actively promote competition.

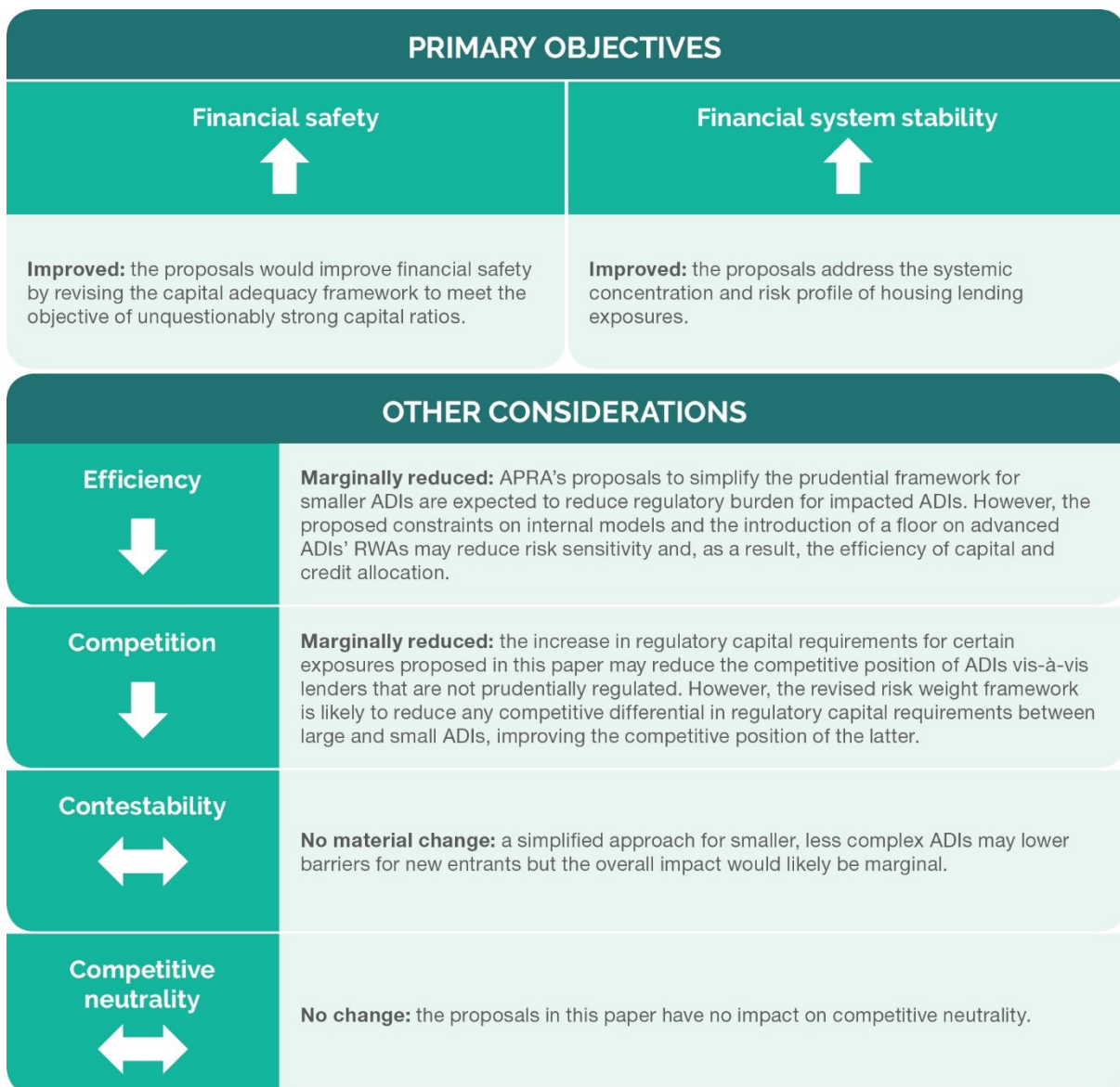
66 APRA’s External Stakeholder Survey has not yet been published.

67 PC Competition Inquiry, pp. 71-72

APRA mostly considers competition when reviewing policy changes and also in its licensing framework. Both of these functions are undertaken within PAD. The PPC is the primary committee in relation to decisions relating to competition.

APRA’s policy discussion papers include basic analysis of the directional impact of its proposed policy changes on various elements of its mandate. A representative example is recreated in Figure 3.4. This practice, introduced in recent years, is an improvement. However, the analysis underpinning it is modest: brief directional commentary is provided; the assessment is wholly qualitative; and multiple complex changes are considered in aggregate. As noted, efficiency, competition, contestability and competitive neutrality are presented as ‘second-tier’ considerations subordinate to financial safety and system stability considerations.

Figure 3.4: Competition analysis in an APRA discussion paper⁶⁸



68 Recreated from APRA, 2018, *Discussion Paper: Revisions to the capital framework for authorised deposit-taking institutions*, p. 17.

APRA announced the establishment of a central licensing unit in May 2017. This was supported in the 2017-18 Budget. The purpose of the unit is to better position APRA to engage with applicants with innovative or non-traditional business models. Subsequently, APRA introduced a restricted ADI licensing framework, as an alternative pathway to new entrants becoming a full ADI. These measures have reduced barriers to entry for new entrants. The establishment of the central licensing team has coincided with an increase in the number of licences granted has increased across all industries. The number of licence applications made to APRA has also significantly increased, although this may be a coincidence.

APRA does not consider competition issues as part of business-as-usual supervision activities. This is mostly appropriate, in the sense that key policy trade-offs and choices are reflected in the prudential framework, although there are areas where industry-wide micro-prudential activities can have competitive implications.

The Panel notes various critiques regarding APRA's impact on competition. For example, some regulated entities are of the view that:

- APRA's IRB-modelling framework creates an 'uneven playing field' by allowing IRB-accredited banks lower capital requirements and hence lower funding costs; and
- APRA's prudential framework and supervisory approach places a disproportionate and unnecessary burden on smaller regulated entities.

These and other competition issues are nuanced. There may be some truth to these contentions, in particular applications of APRA's 'proportionate' approach to prudential supervision. At the same time, there are areas where APRA has revised its approach in recent years.⁶⁹ There are also areas where, entirely appropriately and in line with its mandate, APRA has reviewed the range of relevant issues and determined that prudential safety and stability considerations must predominate.

APRA's philosophical approach and its application is reasonable. It could be described as a do-no-harm approach to competition: support competition when possible but not at any perceived risk to financial stability. Over time, a resilient financial system is likely to promote sustainable competition. Too intense competition that leads to poor risk-taking in financial firms would undermine stability.

The fact that APRA's approach to regulation is not prescriptive, is focussed on outcomes and is applied proportionally according to an entity's circumstances means that it provides a degree of flexibility to different business models.

One potential area of concern is that for a regulator with a financial stability focus, competition issues may not be a prominent focus. It is observed that competition was only mentioned in passing in APRA's 2018-2022 Corporate Plan and competition was not a frequently referenced concept within APRA's committees and industry groups (Figure 3.5).

69 Examples include calibration of 'unquestionably strong', increased weights for IRB residential mortgage portfolios, introduction of staged IRB accreditation, introduction of the restricted ADI framework, and proposed introduction of a tailored approach for small ADIs.

Figure 3.5: Word cloud based on concept frequency within APRA committee and industry group papers⁷⁰



Some of the feedback that the Review has obtained from medium, small and new entrants suggest that competition issues may not be a prominent focus. This feedback is consistent with the Review's observations around APRA's unwavering focus on financial stability and its risk-averse approach to pushing into areas of its mandate that go beyond traditional prudential regulation.

The Panel heard from a number of medium to smaller ADIs that a commonly used term by APRA is 'outlier'. If some entities have different risk metrics to their cohorts, APRA tends to scrutinise them more intensely and encourage uniformity, without taking account of differences in business models and skills. While APRA's position is that it has a vendor neutral stance, new entrants with technology-based business models perceived that APRA was very risk averse if they used different technologies or vendors to those known to APRA. With rapid advances in technology such an approach by APRA

70 Based on text analysis of 12 Executive Board meeting packs, 2 ExCo meeting packs and 3 meeting packs for APRA's other committees and industry groups. Most recent packs provided from 2018 and 2019 were utilised. Note, analysis of PPC meeting papers in isolation did not have a materially different result as regards competition.

would restrict competition and efficiency gains in the future. These are consistent with observations of a 'one-size-fits-all' approach by APRA. Entities noted that supervisors appeared to have no authority to flexibly adjust their advice to entities and in a way that better reflected their business models and risks.

In the Panel's assessment, APRA should take a more structured approach to competition and other balancing considerations, including in cooperation with the ACCC. In 2019, APRA was taking tentative steps towards doing this. For example, competition in the Australian banking market, and development of APRA's competition analysis framework, was considered by APRA's ADI Industry Group in March 2019.

RECOMMENDATION 3.7

To support its consideration of competition, APRA should:

- a. create a competition champion within APRA, preferably at Member level. Their role should be to ensure that issues of competition are embedded effectively across all areas of APRA;
- b. ensure that there is sufficient tension in the internal debate and analysis of competition. It should test how policies are developed and applied by supervisors. This could be done in the Quality Assurance function and reported to the competition champion; and
- c. report regularly on competition developments in its external accountability assessment (see recommendation 6.4).



CHAPTER FOUR: GOVERNANCE, CULTURE AND ACCOUNTABILITY — BROADENING APRA'S APPROACH TO SUPERVISION

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CHAPTER 4: GOVERNANCE, CULTURE AND ACCOUNTABILITY — BROADENING APRA'S APPROACH TO SUPERVISION

Assessing the rigour of a firm's GCA frameworks and outcomes is challenging for prudential regulators and entities themselves. APRA's ability to do so is at an early stage but developing. This is recognised by APRA and its regulated entities. This partly reflects the prioritisation of resources towards a range of other issues over the past few years. Staff departures have also stalled its earlier investment in this area. It also reflects the nature of the problem and APRA's culture and regulatory approach. Consultations with APRA during the Review and a Capability Review Staff Survey suggested a degree of scepticism in parts of the organisation about the importance of these risks for a prudential regulator and the need to give them as much prominence in its work as the supervision of traditional financial risk.

The Panel recognises the concern of APRA and others of a potential blurring of its prudential role with ASIC's conduct role. GCA matters are important to APRA where they undermine the financial safety of an entity or are sufficiently widespread to have a systemic impact. Experience shows that weak GCA arrangements are at the heart of many financial failures. This was evident in the GFC and the much earlier failure of HIH Insurance. The Panel considers that supervising GCA risks is a core job for a prudential regulator. Ensuring that firms have sufficient capital and liquidity buffers provides a foundation for a resilient financial system: it is a necessary condition for success for APRA, but it is not sufficient. APRA should also seek to minimise the likelihood that firms have to draw on these buffers, including by having strong GCA arrangements.

APRA's capability should be strengthened in this area. To do this, APRA needs to draw more on external resources and be more innovative to overcome the challenges it faces.

Current approach to governance, culture and accountability risks

International experience during the GFC highlighted that poor GCA arrangements in financial institutions can damage the safety and soundness of individual institutions and the broader financial system, resulting in significant macroeconomic costs. They are a fundamental prudential risk.

Even in those instances in which GCA failures manifest themselves mostly in misconduct, and more easily fit under the remit of a conduct regulator, they can result in significant financial losses for the entities involved. This can impede their capacity to effectively deliver on their financial commitments to clients and member outcomes. They also undermine trust in financial entities, the financial system and their regulators. Since the GFC, the global banking industry is estimated to have paid US\$350 billion to US\$450 billion in penalties for conduct-related matters.⁷¹ In Australia, the major

71 Group of Thirty, 2018, *Banking Conduct and Culture: A Permanent Mindset Change*, p. 3.

banks and AMP are expected to incur over \$1.5 billion in remediation costs in relation to misconduct in financial advice and consumer lending alone.⁷²

Prudential regulators have placed greater emphasis on GCA risks in recent years. This represents a sharpening of focus on an aspect of prudential regulators’ mandates, rather than an expansion of those mandates. However, these issues have presented challenges to the traditional model of prudential regulation focussed on assessing financial risks.

GCA cannot be regulated and supervised using traditional models employed by APRA and other regulators. They are harder to define, more difficult to detect ex-ante and require a greater degree of judgment to supervise. In fact there is a degree of resignation and uncertainty around a regulator’s capacity to intervene in these areas:

Regulation has a limited role to play given that culture cannot be mandated or defined by rules. Regulation can be an effective tool in outlining basic principles (especially related to good conduct), refocussing banks’ attention on areas of persistent failure, and providing insights and lessons learned from across industry. Supervision can play a role in monitoring and providing feedback to banks that aid the bank board and senior management in addressing culture and conduct.⁷³

The Panel also noted this uncertainty and resignation in its consultations:

It’s fanciful to think that the regulator can solve these big issues; they should not get distracted.

Boards are responsible for conduct, not APRA.

— Industry experts

Can you be as firm in setting a requirement in an area which is just a matter of opinion?

They [APRA] are astute [regarding] traditional risks, less so on operational risks and struggle with emerging risk and conduct risk.

— Senior bank executives

The Hayne Royal Commission was clear on the ownership of these risks:

There can be no doubt that the primary responsibility for misconduct in the financial services industry lies with the entities concerned and those who managed and controlled those entities: their boards and senior management.⁷⁴

Boards, trustees and management are the ultimate owners of GCA risks. Regulators need to work with them to ensure that their risk frameworks and outcomes are robust. It also means that boards and trustees must be up to the task.

72 The major banks and AMP have paid out or offered approximately \$350 million in compensation and provisioned a further over \$800 million in relation to fees-for-no-service (ASIC, 2019, *19-051MR ASIC provides update on further reviews into fees-for-no-service failures*, media release, 11 March 2019). The same entities have paid more than \$470 million in remediation in relation to consumer lending (Hayne Royal Commission Interim Report, 2018, p. 37).

73 Group of Thirty, 2018, *Banking Conduct and Culture: A Permanent Mindset Change*, p. xiii.

74 Hayne Royal Commission, p. 4.

A challenge for APRA has been the inability of boards and trustees of regulated entities to effectively embed these issues in their risk management frameworks:

Mr Comyn said that one of the key things that CBA had learned from the report of the Prudential Inquiry was that there was ‘[n]ot enough capability in the management of non-financial risk’...CBA had ‘an enormous amount of work to do to improve our management of non-financial risk’. Dr Henry also accepted that in NAB there was ‘insufficient attention given to the management of non-financial risk.’⁷⁵

Of more concern:

The evidence before the Commission showed that too often, boards did not get the right information about emerging non-financial risks; did not do enough to seek further or better information where what they had was clearly deficient; and did not do enough with the information they had to oversee and challenge management’s approach to these risks.⁷⁶

And:

But there is still a lack of clarity in many organisations on how the board will champion, oversee and monitor conduct and culture issues.⁷⁷

For APRA to become a more effective regulator of GCA risks it will be crucial for it to bring boards and senior executives along with it.

Prudential regulators internationally believe that GCA issues are central to effective prudential regulation, but also that there are boundaries around the nature of the prudential regulators’ role. One industry expert observed, ‘we fully believe the culture risk of the institution can manifest in financial risk’ and ‘we are not the conduct regulator but we do have responsibility when conduct issues present risks to the institution’. The Panel acknowledges that the increased focus on GCA risks has overlapped the boundaries between prudential and conduct regulation, particularly under Australia’s twin peaks model (see Chapter 6).

APRA’s policy and supervision of GCA risks

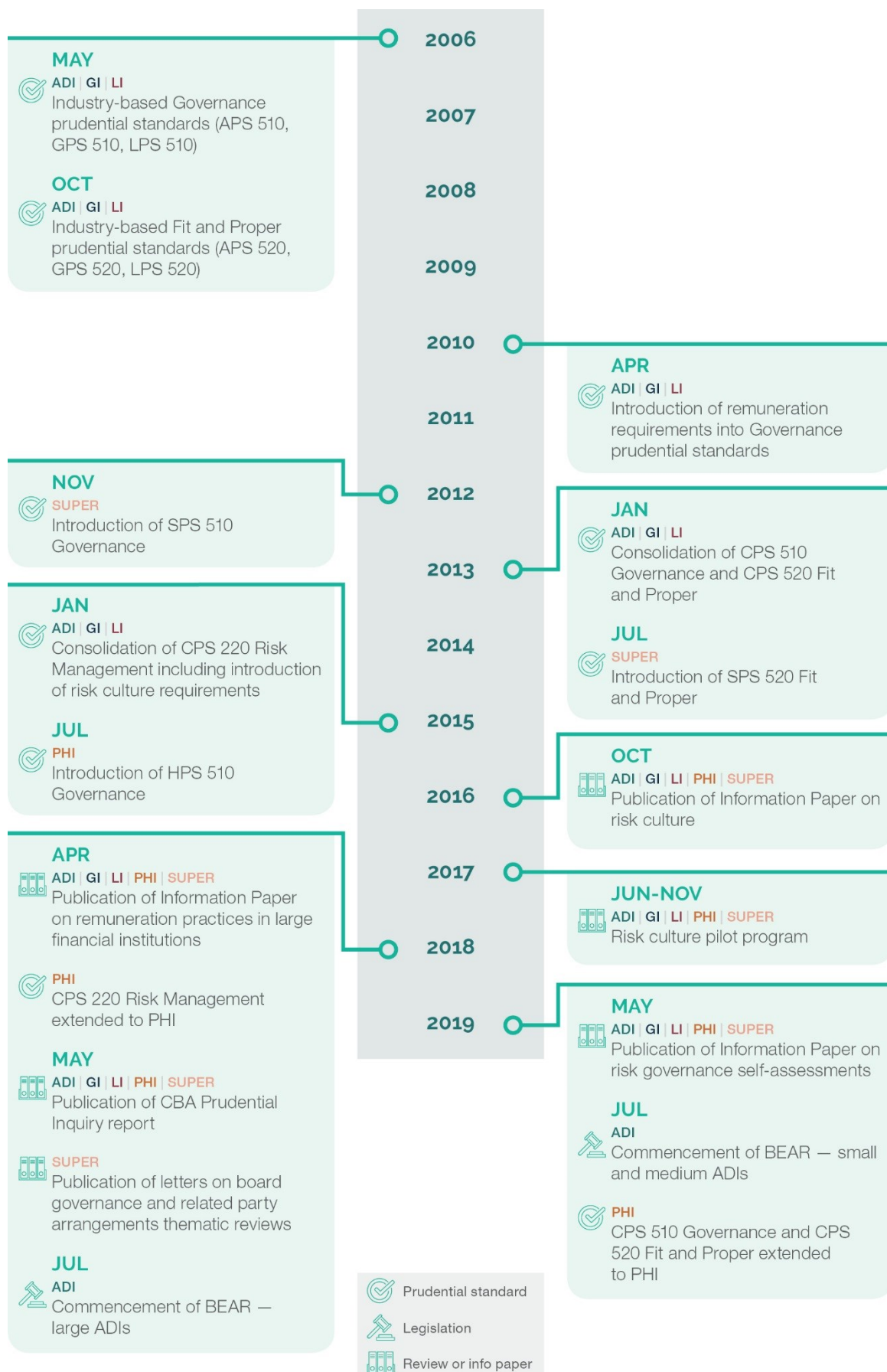
APRA has introduced a number of prudential standards and supervisory activities that address GCA risks (Figure 4.1). Some of the prudential standards have been in place since early in APRA’s existence, with the introduction of new standards and updates over time to accommodate emerging areas of focus, both domestically and among the international regulatory community.

75 Hayne Royal Commission, p. 404.

76 Hayne Royal Commission, p. 395.

77 Group of Thirty, 2018, *Banking Conduct and Culture: A Permanent Mindset Change*, p. xi.

Figure 4.1: Evolution of APRA’s framework for GCA risks



Policy — Legislation and Prudential Standards

APRA has three key prudential standards relating to GCA:⁷⁸

- APRA’s prudential standard on governance (CPS 510) provides that the board of a regulated entity is responsible for the oversight of the sound and prudent management of their institution. It imposes minimum standards in relation to board arrangements and mandates that entities have a board-approved remuneration policy;⁷⁹
- The standard on risk management (CPS 220) makes boards responsible for ensuring there is an appropriate risk management framework in place, including a board-approved risk appetite statement and management strategy. It requires boards to form a view on the risk culture of an institution and make an annual risk management declaration to APRA;⁸⁰ and
- The risk management standard also requires entities to establish a board-approved remuneration policy that aligns remuneration with risk management and provides for downwards adjustment of variable remuneration. Boards must establish a remuneration committee that conducts regular reviews of the policy and makes annual recommendations on the remuneration of individuals covered by the policy.⁸¹ The fit and proper standard (CPS 520) requires individuals identified as ‘responsible persons’ to have appropriate skills, experience and knowledge and to act with honesty and integrity. Boards are responsible for ensuring the fitness and propriety of responsible persons and for approving the entity’s fit and proper policy.⁸²

The Hayne Royal Commission made a number of recommendations to APRA on the supervision of GCA risks, including revised prudential standards and guidance on remuneration.⁸³

Under the BEAR introduced in 2018, ADIs and their directors and senior executives are subject to an enhanced accountability regime, including specific accountability obligations. ADIs must ensure that they have clearly defined accountability statements for each of these individuals and an accountability map covering its ADI group. Directors and senior executives must be registered with APRA prior to being appointed, and APRA must maintain a register of these individuals. Registration takes effect 14 days after APRA is notified or receives any additional requested information.⁸⁴ APRA does not have the power to formally object to an appointment, but during the notification period it may query or challenge the nomination of an individual to be an accountable person and their responsibilities.⁸⁵

78 This discussion covers the prudential standards as they will apply from 1 July 2019. The standards have been updated over time to reflect additional areas of focus. Key developments are outlined in Figure 4.1.

79 See APRA, 2019, *Prudential Standard CPS 510 Governance*, applying to ADIs, insurers and friendly societies. Similar arrangements tailored to superannuation apply under APRA, 2016, *Prudential Standard SPS 510 Governance*.

80 See APRA, 2019, *Prudential Standard CPS 220 Risk Management*, applying to ADIs, insurers and friendly societies. Similar arrangements tailored to superannuation apply under APRA, 2012, *Prudential Standard SPS 220 Risk Management*.

81 See APRA, 2019, *Prudential Standard CPS 220 Risk Management*, applying to ADIs, insurers and friendly societies. Similar arrangements tailored to superannuation apply under APRA, 2012, *Prudential Standard SPS 220 Risk Management*.

82 See APRA, 2018, *Prudential Standard CPS 520 Fit and Proper*, applying to ADIs, insurers and friendly societies. Similar arrangements tailored to superannuation apply under APRA, 2013, *Prudential Standard SPS 520 Fit and Proper*.

83 Hayne Royal Commission, Chapter 6.

84 Part IIAA of the Banking Act.

85 APRA, 2018, *Information Paper: Implementing the Banking Executive Accountability Regime*, p. 13.

The Hayne Royal Commission recommended that the BEAR be extended to all APRA-regulated entities and that APRA and ASIC should jointly administer it.⁸⁶ The Government has agreed to this recommendation and further announced it intends to introduce a similar regime applying to non-prudentially regulated firms focussed on conduct.⁸⁷ The Hayne Royal Commission also recommended responsibility for product design, delivery, maintenance and remediation be added to the list of accountable persons under the BEAR, of which APRA has accepted and commenced implementation.⁸⁸

Supervision — Putting policy into practice

APRA’s supervisory approach takes the view that boards and trustees of regulated entities are ultimately responsible for the oversight of GCA issues.⁸⁹ APRA’s role is to set minimum standards, supervise and, if necessary, take enforcement action based on performance in respect of these standards and its mandate. These risks are judgmentally assessed in the PAIRS framework under the broad headings of board, management and risk governance. APRA applies single models for regulation and supervision of GCA risks across its regulated industries. While separate standards apply to the superannuation industry, there are significant similarities in the key elements of the standards between superannuation and the other industries.

Since 2016, APRA has also undertaken thematic reviews on board governance and related party arrangements within superannuation entities, risk culture, remuneration practices in large financial institutions and entity self-assessments of GCA. APRA launched a risk culture pilot program in mid-2017, completing one review before commencing the CBA Prudential Inquiry.

In 2017, APRA commissioned a prudential inquiry into CBA to examine GCA frameworks and practices following a number of incidents that damaged CBA’s reputation and public standing. The inquiry was conducted by an expert panel. In its final report, the CBA Panel identified a number of shortcomings in CBA’s GCA frameworks and made 35 recommendations to address them.⁹⁰

Within APRA, responsibility for supervision of GCA risks is shared between frontline supervisory teams and the GCA team within RDA. This team was established in 2015 and now has around 8.5 full-time equivalent staff. Policy development and enforcement support is provided by PAD.

Current APRA work program

APRA is taking steps to address the issues raised in recent reviews and build its capability. APRA built on the CBA Prudential Inquiry by making 36 of the largest APRA-regulated entities undertake formal self-assessments against the report’s key findings. APRA believes that this has been a useful exercise for itself and its regulated entities.⁹¹ During consultations, a number of institutions also noted that the self-assessment process was useful for them.

86 Hayne Royal Commission, recommendations 6.6, 6.7 and 6.8, pp. 457-458.

87 Australian Government, 2019, *Restoring Trust in Australia’s Financial System: The Government response to the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*, p. 33.

88 APRA, 2019, *Table with APRA’s Responses to Royal Commission Recommendations*, p. 1.

89 See for example, *Prudential Standard CPS 510 Governance and Prudential Standard CPS 220 Risk Management*.

90 CBA Prudential Inquiry, 2018.

91 Byres, W, 2019, *Building Resilience in Three Dimensions*, 27 March 2019.

As discussed further in Chapter 6, APRA has increasingly released information papers to reflect on the outcomes from its thematic reviews and place expectations on industry regarding areas for improvement. Most recently, APRA’s information paper on the outcomes of the GCA self-assessments identified a range of common weaknesses in GCA across institutions, variable quality in self-assessments across institutions and a lack of sufficient self-criticism by boards and senior management.⁹² The Panel believes that this paper was a useful addition to APRA’s communications strategy. However, the process would have been more transparent had APRA required entities to publish the self-assessments.

APRA has developed a work program to revise its prudential standards on remuneration, risk management, governance and fit and proper, and to sharpen its associated supervision to reflect the findings of the Hayne Royal Commission and CBA Prudential Inquiry.⁹³ This includes making them more outcomes-focussed rather than process and frameworks-focussed. Work to revise these prudential standards is forecast to continue through to 2020. APRA is also reviewing its supervisory framework and its approach to risk assessment. APRA has indicated that this will include consideration of how GCA risks are more effectively incorporated in PAIRS assessments.

The Enforcement Strategy Review and new Enforcement Approach present a stronger platform for APRA to address GCA risks, through recognition that in the past APRA has been too slow to act, particularly on non-financial risks and adoption of the ‘constructively tough’ enforcement appetite applying to a broader range of circumstances, including GCA risks.

The establishment of an Innovation Lab to improve data analytics capability in unstructured data and the recent funding announcements will also assist APRA in responding to its expanded responsibilities in relation to GCA risk.

Prioritisation of Basel III, Murray Inquiry and other reforms

Following the GFC, APRA and international regulators prioritised the implementation of strengthened capital and liquidity requirements for ADIs contained in the Basel III Accord. In fact, APRA has been a leader in this area, implementing the Basel III framework at the same time or ahead of international peers.⁹⁴ This work has continued as a priority with the international framework only being settled in 2017 and subsequent domestic implementation ongoing. These global developments were complemented by the Murray Inquiry’s recommendation of ‘unquestionably strong’ capital. APRA has also undertaken a program of strengthening the capital framework for general and life insurers via reforms to the LAGIC arrangements.⁹⁵ Strengthening the financial resilience of entities is consistent with APRA’s mandate to ensure financial safety and stability, and is to be welcomed. APRA’s work has strengthened the resilience of the Australian financial system.

92 APRA, 2019, *Information Paper: Self-assessments of governance, accountability and culture*, pp. 4-5.

93 APRA, 2019, *Information Paper: APRA’s Policy Priorities*.

94 Byres, W, 2018, *Witness Statement of Wayne Stephen Byres on behalf of the Australian Prudential Regulation Authority*, p. 33, paragraph 140.

95 The LAGIC framework consists of the capital adequacy and solvency prudential standards for life and general insurers and sets minimum requirements for financial resilience for these entities. Reforms introduced from 2013 made significant changes to the capital framework for general and life insurers, including to improve risk sensitivity and align approaches across general and life insurance. APRA is currently consulting on proposals to integrate PHI into the LAGIC framework (APRA, 2018, *Roadmap for APRA’s Review of the Private Health Insurance Capital Framework*).

Strengthening APRA’s capability

APRA is better positioned to build its capability to regulate GCA risks than it has been for some time. The drag on resources caused by the implementation of Basel III and Murray Inquiry reforms is fading. APRA has also been provided with additional funding to build this capability. But based on a review of internal papers, the APRA Capability Review Staff Survey, focus groups and interviews, the Panel believes that APRA still faces a number of challenges. APRA’s culture and regulatory approach needs a reset. It also needs to be innovative in building its capability — both greater internal capability and use of external resources to complement that.

It is difficult to compare the relative progress of different global regulators in dealing with GCA risks. All are making slow progress. Feedback from international peers suggests that APRA may be lagging others in its supervision of governance and middle-of-the-pack on culture and remuneration.

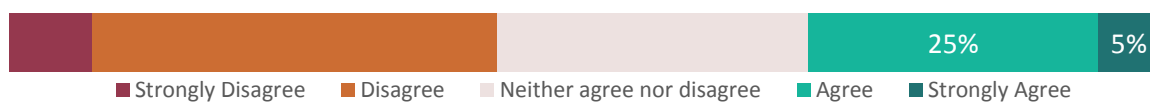
Starting point and change management skills are a concern

Mr Byres noted that the references to compliance and internal audit in the prudential standards were ‘fairly cursory and short’, and that APRA would ‘need to think about how we give them more prominence in our assessment of risk management because it has been traditionally been...[assessed from] a financial soundness perspective.’⁹⁶

From the Capability Review Staff Survey, only 30 per cent of APRA’s staff believe that it is well positioned to identify GCA risks, while 42 per cent believe APRA is not well placed to consider these risks.

Capability Review Staff Survey — Identification of GCA risks

Proposition: APRA is well placed to identify material issues with regulated entities’ governance, culture and remuneration arrangements



We are good with the old school stuff, but not good with challenges like culture and governance.

— APRA staff

The Panel partly agrees with this assessment but goes further. Supervising GCA risks should move from being seen as a challenging new area to recognition as a core role for a prudential regulator.

Building capability to supervise GCA risks has been slow and capabilities in this area remain an area for development, a point recognised by APRA’s staff:

Find an effective solution to monitoring and addressing non-financial risks (culture, governance, etc.). Financial risks are relatively well covered, but APRA struggles to identify and address non-financial risks (CBA, IOOF, amongst others).

96 Hayne Royal Commission, p. 406.

Upskill particularly in remuneration, governance and culture and other non-financial risks through current staff external training and recruitment from industry to upskill the current staff.

Ensure APRA has sufficient skills in governance and culture, both in terms of the specialist teams and in frontline.

— APRA staff

While APRA had previously undertaken some work in this area, the creation of a standalone team to work on GCA risks is a relatively recent development. It began in 2015 with three FTE, growing to seven in subsequent years before increasing to around 8.5 as at May 2019. Progress has been stop-start, with most of the team departing APRA in 2018. It is still below budgeted headcount despite recent new arrivals. Additional funding provided to APRA to implement BEAR for ADIs in 2017-18 and further funding in the 2019-20 Budget should provide the basis to re-establish and strengthen the team: \$30 million over four years was provided to extend the BEAR to all prudentially regulated institutions; and a further \$50 million over four years was provided to enhance the prudential framework for GCA risks.

APRA has noted that its challenge will be to find staff with the right expertise to fill these positions. These skills will be different to those APRA currently hires, encompassing skills and expertise in behaviour, organisational culture and incentives. While some expertise will be required in-house, it will be difficult for APRA to retain all the required expertise internally. A partnering model using outside experts is more likely to deliver sustainable capability for APRA into the future.

A partnering model may also assist in addressing inherent scalability constraints that arise in many of the methods for supervising and assessing GCA risks. This is particularly the case for deep dives such as the risk culture pilot and CBA Prudential Inquiry. Both of these projects were highly resource-intensive and difficult to run in parallel.⁹⁷ Indeed, subsequent planned risk culture pilots were delayed as a consequence of the CBA Prudential Inquiry. Even with additional resourcing provided in the 2019-20 Budget it may not be possible for APRA to expand the deep dive approach across other entities to any significant degree while relying only on internal resources.

Recent APRA activities in this area are instructive and point to a potential way forward. The Hayne Royal Commission noted that the CBA Prudential Inquiry was a significant development in both APRA’s approach to GCA risks and for regulated entities, providing ‘a very valuable, publicly available account’ of how GCA failures can drive misconduct and broader prudential risks and how to address these problems.⁹⁸ The Panel agrees, and considers that additional, targeted prudential inquiries would be a powerful tool for APRA and have an important demonstration effect in the financial system.

Ongoing self-assessments would supplement prudential inquiries and assist APRA to determine potential institutions for which an inquiry would be undertaken. Placing a greater ongoing responsibility on boards and trustees, with APRA reviewing and questioning results where warranted, will assist APRA in assessing a wider range of entities’ performance in addressing GCA risks more efficiently than if APRA were to undertake this work itself. It would also facilitate identification of thematic risks.

97 The first risk pilot took around 4 months, reviewing two divisions of an entity with less than 1 per cent of its market’s total assets. The CBA Prudential Inquiry at its peak had 12 APRA full-time staff, 10-15 external consultants and an expert panel, compared with a business as usual supervisory team of one senior manager and five analysts (Byres, W, 2018, *Witness Statement of Wayne Stephen Byres on behalf of the Australian Prudential Regulation Authority*, p. 122, paragraph 506).

98 Hayne Royal Commission, pp. 384-386.

APRA needs a cultural and regulatory reset

When a resource-constrained institution is confronted with a difficult challenge that it does not believe is a core threat to its mandate then that challenge is less likely to be taken up. The Panel believes that this is part of the problem with GCA in APRA.

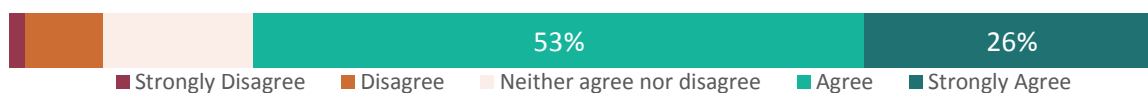
APRA may need to re-assess its principles-based approach to regulation in this area. As boards and trustees are also struggling to identify appropriate practices, a degree of prescription by APRA may be useful. This would make it more outcomes-focussed. Recommendation 4.1 is a step in this direction.

The Review has identified a range of mindsets that combine to slow progress and limit APRA’s capability in this area:

- APRA does not consistently give enough weight to the view that GCA risks are genuine drivers of financial risk for an institution that should be a core part of a prudential regulator’s work. While 79 per cent of APRA’s staff noted that GCA risks are an important focus this is not yet evident in implementation of APRA’s strategy and qualitative feedback or, as noted below, views of senior management. Nor, as noted earlier, is it embedded in practice. APRA’s approach to its work is to ensure that the last resort defence of capital and liquidity buffers are in place. It should place more weight on GCA risks to ensure that these are rarely drawn on.

Capability Review Staff Survey — Importance of GCA risks

Proposition: Governance, accountability, remuneration and culture considerations are an important focus of APRA



- Its risk-based approach to the allocation of resources and entity supervision is sensible but biases it away from issues that are not perceived to entail financial risks. This includes GCA. Comments from senior APRA executives in discussions about the allocation of resources to GCA hint at this:

How much time and effort do you want to spend on a stable organisation?...this is a risk-based decision.

Is the commitment of resources worth the effort?

...will not occupy staff with issues with minimal prudential implications.

— APRA senior staff

- A tentative approach to prosecuting concerns about GCA risks with boards and trustees and the escalation of problems towards stronger enforcement. APRA appears to place a very high hurdle on actively engaging with entities when it is concerned about their GCA arrangements:
 - This is highlighted in APRA’s Enforcement Strategy Review (see Chapter 6). It revealed a forceful response to ‘financial’ risks but not for ‘non-financial’ risks.
 - APRA senior executives note the need for ‘absolute clarity of evidence’ and that the ‘missing piece was not the identification [of GCA risks] but bringing enough evidence together’. Obtaining strong evidence is desirable but setting high hurdles for the quality of evidence will be a constraint in areas where significant judgment is required.

- A strong bias against transparency and the use of strategic communications for deterrence purposes (see Chapter 6).

These factors may have been reflected in the strength of APRA’s supervisory and enforcement approach to GCA. APRA’s current supervisory framework, approach and tools are not well suited to supervising GCA risks and require revision, an issue that APRA has recognised. APRA’s prudential standards on governance and risk management are focussed on management of financial risks rather than on other risks such as GCA.⁹⁹ APRA’s supervisory emphasis to date, consistent with the drafting of the prudential standards, has focussed on ensuring entities have appropriate frameworks, and has not placed sufficient emphasis on ensuring those frameworks deliver appropriate outcomes. This includes the PAIRS framework: while it includes categories that can incorporate GCA risks, the supporting guidance has relatively little focus on assessing effectiveness. A consequence has been relatively weak consideration of GCA risks in supervisory activities. APRA notes that these risks are now more closely scrutinised. The IMF made a related point in its recent FSAP, recommending APRA consider revising the PAIRS framework to appropriately capture risk governance and control weaknesses in board and senior management assessments.¹⁰⁰

APRA’s strategic priority of broadening risk-based supervision, and its forward work program for GCA to transition its supervisory approach from being framework-driven to more outcome-focussed, seek to address these issues. The Panel welcomes these initiatives but notes that they have yet to be finalised, implemented and embedded in APRA’s supervisory approach.

Leveraging External Resources

APRA needs to change how it works:

- Invest and explore the benefits of new technology and alternative ways of detecting GCA failures in regulated entities;
- Develop mechanisms to make boards and trustees more effective in their oversight role of their entities; and
- Continue to build its internal capability to supervise GCA risks at both an entity and industry level.

In the Panel’s view it is unlikely that APRA will be able to build a solely internal capability to pre-emptively identify and rectify emerging GCA risks. It will need to supplement its internal resources through more effective external engagement with boards and trustees and also by drawing on the advice of external experts on GCA arrangements. The Panel’s recommendations in this area draw on the lessons learnt in the CBA Prudential Inquiry, the Hayne Royal Commission, APRA’s Enforcement Strategy Review and observations of international regulators.

New technology for detecting GCA failures

Technological developments are creating opportunities to monitor GCA risks using innovative types of data analysis, loosely labelled regtech. It is early days yet but these technologies may assist APRA and its regulated entities. As noted in Chapter 2, APRA is developing some capacity in innovative data analytics.

99 The Hayne Royal Commission similarly noted that APRA appeared to have considered misconduct risks through the prism of an entity’s attitude to risk more generally, rather than a standalone risk, p. 345.

100 IMF, 2019, *Australia: Financial System Stability Assessment*, p. 78.

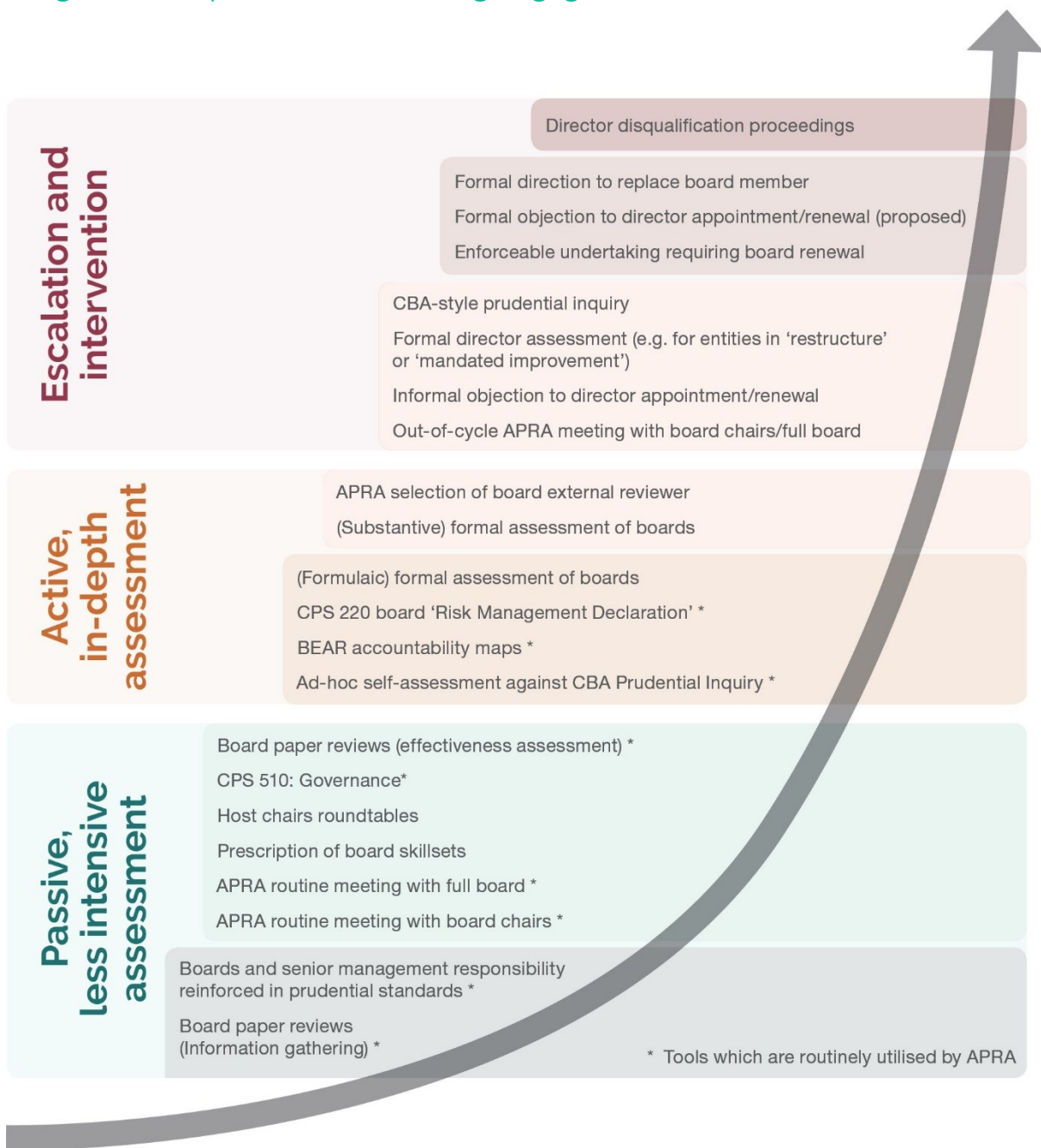
More innovative use of unstructured data has the potential to improve the efficiency of APRA’s analysis of GCA risks. Inevitably developments in technology and data science will outstrip APRA’s internal capability. Close collaboration with external regtech firms would also be desirable. The Panel is very supportive of this type of investment.

Engagement with boards and trustees

APRA should change the way it engages with boards and trustees to improve its ability to supervise GCA risks and to increase the effectiveness of boards and trustees themselves.

APRA’s legislative and supervisory framework sets out arrangements for engagement with boards, trustees and senior management of its regulated entities. These range from less intensive assessment through to more active engagement and direct intervention and enforcement (Figure 4.2).

Figure 4.2: Options for escalating engagement with boards and trustees



APRA generally focusses its engagement options at the less intense end of the spectrum and mostly works behind the scenes. APRA’s model appears to be relatively unusual compared to its international peers. APRA’s interactions with boards and senior management are highly reliant on Members and EGMs, particularly for large entities. Consequently, APRA’s interactions with boards and senior executives are relatively infrequent, with mostly annual meetings. Several of APRA’s international peers achieve more frequent — at least quarterly — engagement with boards and senior management by using senior frontline staff (for example, similar to GM level in APRA), in addition to periodic top-level meetings. One prudential regulator has established an external pool of senior advisers with deep industry experience to supplement in-house capability in this area.

APRA’s frontline teams do not regularly engage at the highest levels of regulated entities, meaning they are less likely to be able to deliver forceful messages to key individuals within institutions and to be taken seriously when they do so.

Compared to some of its international peers, APRA’s supervisory framework has less well established activities for setting expectations of, and assessing the effectiveness of, boards and senior management. Examples of supervision activities utilised by prudential regulators internationally to assess boards include full board effectiveness reviews (including use of case studies), succession planning reviews, cross-industry thematic reviews of board effectiveness, formal fit and proper assessments, and meeting observations.

A further area of difference with international peers is APRA’s capacity to vet potentially inappropriate board or trustee candidates. Several of APRA’s peer regulators have explicit powers in relation to board and senior management appointments. These range from a non-objections power through to formal approval of board members and senior executives. This provides greater oversight of the quality and appropriateness of board members at the time of appointment.

The Panel believes that providing APRA a non-objections power to consider the appointment or re-appoint of board members and trustees would be a light-touch way of pre-empting the risks of poor board appointments.

Recommendations

The Panel has concluded that limits on internal resourcing, limits on scalability of activities and the higher level of judgment inherent in supervising GCA risks mean that APRA is unlikely to have sufficient internal skills and resources to supervise these risks.

The recommendations below address a question posed by a senior APRA official:

How much do we do to solve the problem ourselves and how much can we use tools to force the institutions to do the work?

— APRA senior staff

The recommendations recognise that boards and trustees are the ultimate owners of GCA risks. They provide APRA with a range of tools to more effectively engage with boards and trustees. The recommendations provide more transparency around the management of GCA risks by boards and trustees and their supervision by APRA. In time, this should raise capability in APRA and the industry and provide clearer accountability to the public and Parliament. The recommendations will also allow APRA to draw on greater external assistance to complement its internal capabilities. The recommendations should be read alongside the recommendations of APRA’s Enforcement Strategy Review, the CBA Inquiry and Chapter 6 of the Hayne Royal Commission. APRA should also continue to develop its internal capabilities, and most importantly, challenge internal mindsets that do not give GCA risks appropriate weight in its policy and supervisory work.

RECOMMENDATION 4.1

As part of its work to revise and enhance its supervisory and policy frameworks, APRA should:

- a. ensure the policy framework is focussed on assessing appropriate outcomes around GCA risk in regulated entities, not just appropriate processes;
- b. further develop its toolkit for assessing GCA risks, including board and senior management performance, and ensure that it has an escalating suite of options for engaging with entities;
- c. embed the recent entity self-assessment process into its more intense supervision of GCA risks by making it a biennial requirement. The self-assessments should be more prescriptive than APRA’s recent program, including coverage of questions set out in Appendix 2. The self-assessments, APRA’s assessment of each of them, APRA’s thematic reviews, and any rectification requirements imposed by APRA in response to a self-assessment should be published;
- d. establish an external panel of experts to assist it in undertaking more in-depth assessments of individual entities; and
- e. explore ways to collaborate with regtech specialists and other experts to develop more efficient and effective tools to identify GCA risks.

As part of its work on GCA, APRA should require entities to undertake a self-assessment of their management of GCA risks every two years, with boards and trustees to prepare a progress assessment in the interim years. The entities required to undertake the self-assessment should be broadly consistent with the entities APRA required to undertake the first self-assessment in late 2018. The responsibility should lie with the full board, with each board member or trustee endorsing the self-assessment. Boards and trustees will be accountable for the quality of their assessments and whether the assessments failed to identify problems ex-ante.

APRA should design the self-assessment to be consistent with, complement and reinforce but not duplicate, existing obligations including directors’ duties, the revised GCA risk policy framework, and the BEAR (including its forthcoming extension to other prudentially regulated entities and ASIC-licensed entities). This may include, for example, an expectation from APRA that regulated entities will include directors’ and trustees’ obligations to undertake self-assessments in their BEAR accountability statements. Such an approach would make explicit that directors and trustees must meet the accountability standards set out in the BEAR when preparing their entity’s self-assessment, and that failure to do so would give APRA the option to pursue the consequences available under the BEAR.

APRA should require that entities publish their self-assessments, similar to NAB’s publication of its first self-assessment. APRA should also publish its assessment of each entity self-assessment and any rectification requirements or ‘penalties’ (such as capital overlays) imposed in response to a self-assessment. APRA should further publish a review of the industry’s self-assessments, highlighting common themes and individual weaknesses, similar to its recent information paper on the outcomes of the GCA self-assessments. Examples of poor and good quality self-assessments should be disclosed.

APRA should use these self-assessments to inform itself about the adequacy of the institution’s arrangements, board, trustee and management capability and the evolution and size of GCA risks over time.

There is a natural risk that boards’ assessments of themselves will be less than rigorous. Where APRA considers that self-assessments are lacking or fail to identify risks over time it should request that its independent expert panel, supported by APRA staff, review more rigorously the institutions’ arrangements and the board, trustee and management’s capability to oversee and manage them. These reviews should be published by APRA.

The expert panel should consist of experts in GCA risks, including or potentially using insights from new technologies for identifying GCA risks.

RECOMMENDATION 4.2

APRA should build on the CBA Prudential Inquiry and entity self-assessments by embedding CBA-style prudential inquiries as an ongoing part of its supervisory toolkit. The Panel would expect to see several prudential inquiries in the first few years to reinforce the need for rigorous self-assessments (see recommendation 4.1). In time, the inquiries should involve retail and industry superannuation, insurance and ADI entities.

The pool from which entities are chosen for these prudential inquiries should be broadly consistent with the entities that were required to undertake the recent self-assessments. APRA should use the entity self-assessments and issues identified in supervisory activities to determine which entities to review. Entities chosen for a prudential inquiry should not be required in the same year to undertake the self-assessment outlined in recommendation 4.1, but should be required to undertake subsequent self-assessments.

In conducting these prudential inquiries, APRA should draw on the independent expert panel outlined in recommendation 4.1. As with the CBA Prudential Inquiry and its requirements of entities undertaking self-assessments, APRA should publish each of these additional prudential inquiries.

RECOMMENDATION 4.3

The Government should consider providing APRA with a non-objections power to veto the appointment or reappointment of directors and senior executives of regulated entities. This would bring it into line with international regulators and strengthen its capacity to pre-emptively regulate GCA risks. The power should be available to APRA only where the risks associated with the entity, including but not limited to member outcomes for superannuation funds, warrant it.

Providing APRA with a non-objections power would build on and strengthen the registration arrangements provided for under the BEAR. It would also complement APRA’s existing removal and disqualification powers, which are available where an individual already occupies a board or certain senior executive roles.

The Panel recognises that such a power may be perceived to raise moral hazard risks for APRA, in that APRA may be seen to be responsible for the quality of board, trustee and senior appointments. The Panel agrees with APRA’s current stance that entities are ultimately responsible for the quality of individuals appointed to these positions. For this reason, the Panel recommends that the power be framed as a non-objections power, rather than a positive-vetting power. Furthermore, the power

should be available to APRA only where the risks associated with the entity, including but not limited to member outcomes for superannuation funds, warrant it. In the Panel’s view, it should always include the range of medium to large entities involved in its recent self-assessment program. It should also include entities whose SOARS stance is ‘mandated improvement’ or where APRA has otherwise taken formal enforcement action.¹⁰¹

101 Where an entity is in resolution, APRA already has the power to appoint a statutory manager to take control of, and give directions to, a regulated entity, including in relation to appointments.



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CHAPTER 5: REGULATING THE SUPERANNUATION SYSTEM FOR MEMBERS

APRA has regulated the superannuation system predominantly from a prudential perspective, focussing on the financial stability of funds and any limited systemic risks. Generally, APRA has taken an industry-neutral approach to supervision of superannuation: many of its policies and supervisory tools are broadly the same as those used for banking and insurance. APRA has not sufficiently acknowledged that differences in the superannuation industry require a different approach to supervision. APRA's prudential approach may have led it to under-resource its oversight of superannuation.

APRA needs to give more priority and tailor its approach to superannuation. It needs to refocus its attention to regulating trustees to deliver good retirement outcomes, while still ensuring that trustees carefully and diligently manage member funds. The Panel believes this is best achieved through a structural change to create a superannuation-specific division in APRA and more cross-industry analysis. While APRA has made some progress on member outcomes it needs to embed that focus into its broader superannuation regulatory framework.

Regulation of superannuation in Australia

The Wallis Inquiry recommended that superannuation be regulated by APRA rather than only ASIC, because 'the implications of compulsory contributions and tax assistance for superannuation...imply that government should provide greater regulatory assurance in relation to superannuation than would normally apply for market linked investments'.¹⁰²

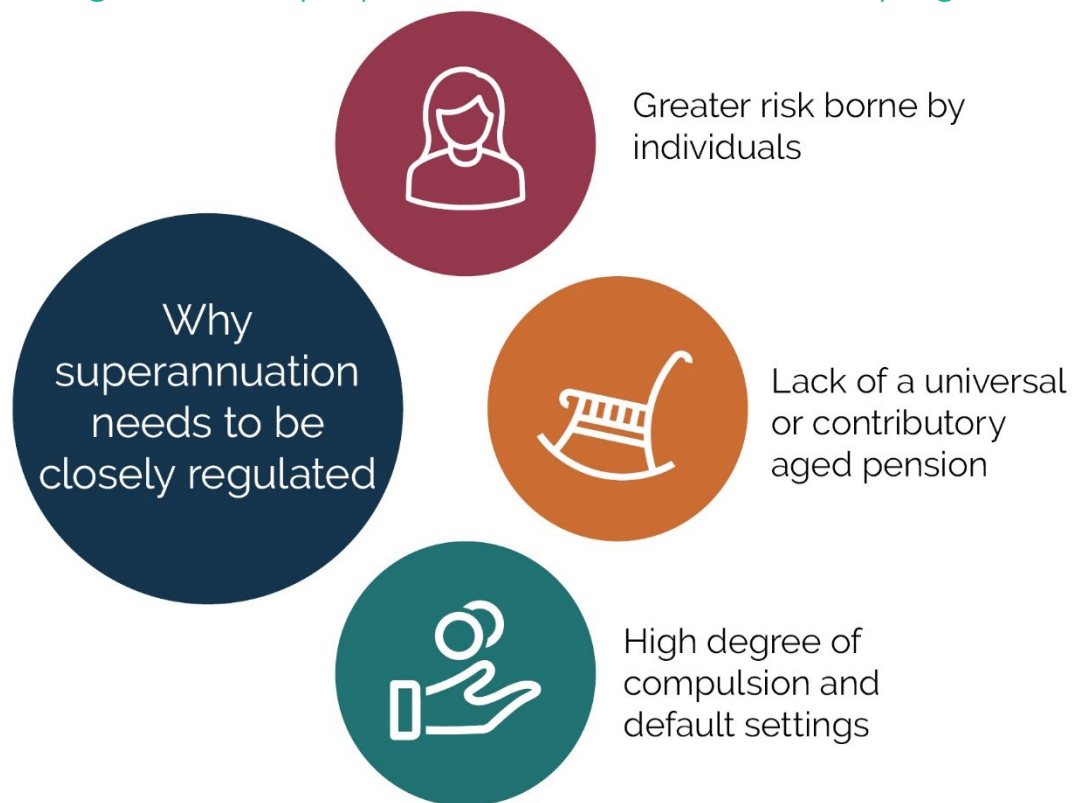
However, APRA's role in superannuation has also been different to its role in other industries: the Wallis Inquiry stated 'APRA's role is more than prudential regulation.' The Wallis Inquiry confirmed that APRA's role goes to retirement income policy: 'it is efficient to link prudential regulation of superannuation...with regulation to ensure compliance with government retirement income policies.'¹⁰³ The Hayne Royal Commission articulated this more clearly '[U]nlike other financial products ...the regulatory focus for superannuation must extend to the outcomes that will be delivered to members.'¹⁰⁴ Figure 5.1 demonstrates why superannuation needs to be closely regulated in Australia. While the 'member outcomes' language is recent, and linked to recently passed legislation, the role of superannuation has always been to support members' incomes in retirement and APRA has always been responsible for regulating this role.

102 Wallis Inquiry, p. 192.

103 Wallis Inquiry, pp. 332-333.

104 Hayne Royal Commission, p. 254.

Figure 5.1: Why superannuation needs to be closely regulated



The superannuation system is currently largely regulated by APRA, with 97 per cent of members (representing over 18 million individuals in the superannuation system) having an account in the APRA-regulated sector.¹⁰⁵ APRA regulates trustees of superannuation funds, who are required to act in the best interests of their members. APRA is also responsible for ensuring that trustees of default products comply with 'enhanced trustee obligations'.¹⁰⁶ ASIC is the regulator responsible for regulating disclosure and financial advice.¹⁰⁷ Following the Hayne Royal Commission, the Government intends to give ASIC greater responsibility for regulating the conduct of trustees,¹⁰⁸ with APRA remaining responsible for regulating system performance.

105 Based on 2016-17 Australian Taxation Office (ATO) data. About 2 percentage points of these people also have self-managed superannuation accounts. Source: Treasury

106 Section 6, SIS Act.

107 Section 6, SIS Act.

108 Australian Government, 2019, *Restoring Trust in Australia's Financial System: The Government response to the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*, p. 32.

BACKGROUND ON SUPERANNUATION

WHY IS SUPERANNUATION DIFFERENT TO BANKING AND INSURANCE?

- The nature of the promise is different to other industries
- A conceptual blurring of prudential and conduct regulation
- The trust structure
- A much lower risk of a run / failure
- No capital requirements
- High risk of conflicts of interest

WHAT ARE MEMBER OUTCOMES?

- Retirement outcomes for members ultimately depend on long-term net returns
- Returns, fees, costs and insurance all affect net returns
- Trustees are now required to compare their products' returns, fees, costs and insurance strategy
- Member outcomes do not include benefits unrelated to retirement outcomes

WHY IS REGULATING SUPERANNUATION SO IMPORTANT?

- Members are highly disengaged due to:
 - Behavioural biases
 - Product complexity
 - System settings
- System inefficiencies cause lower retirement incomes
 - The PC found poor performing products can lead to 13 years' lost income

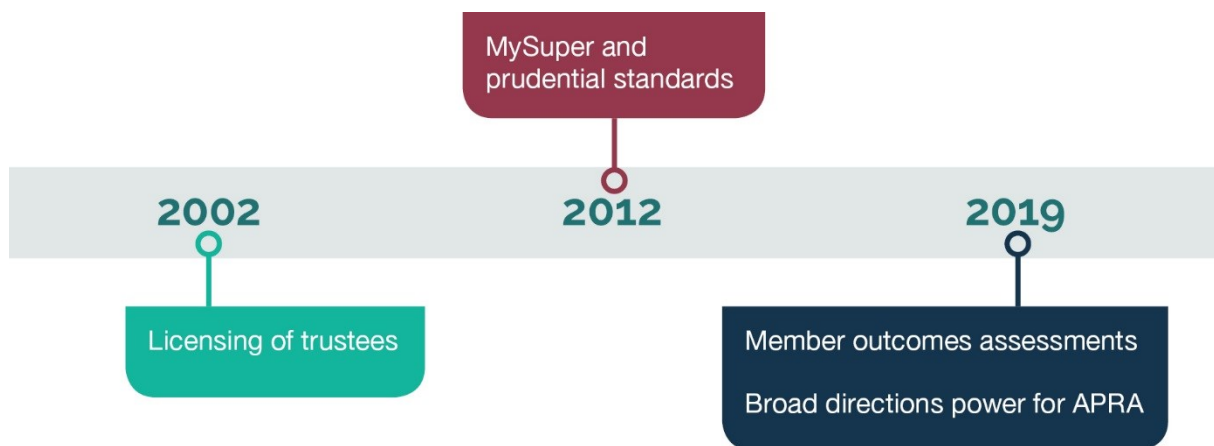
The regulatory environment for superannuation has strengthened over time. APRA has progressively gained more powers to regulate the sector (Figure 5.2):

- The Stronger Super reforms in 2013, coming out of the Cooper Review, were designed to tackle inefficiencies in the system, including product proliferation and rising fees. The reforms gave APRA the power to authorise default products¹⁰⁹ and make prudential standards. They also imposed limits on the charging of certain fees;
- The 2019 Member Outcomes legislation gave APRA comprehensive powers to direct trustees and greater control of the owners of superannuation trustees.¹¹⁰ This legislation will significantly strengthen APRA's leverage over trustees.

109 Products where members have not chosen their superannuation fund.

110 *Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No. 1) Act 2019.*

Figure 5.2: Timeline of superannuation regulation



Assessment of APRA’s regulation of superannuation

APRA was aware of the...drag on superannuation returns due to conflicts of interest — but never did anything about it.

— Industry expert

APRA’s role in superannuation is to ensure trustees prudently manage their business operations in a manner consistent with their member best interest obligations and the delivery of quality member outcomes.¹¹¹ Its performance should be assessed against this. Staff working on superannuation in APRA report that they are focussed on member outcomes but this does not seem to be broadly reflected in APRA’s approach or resourcing.

APRA fundamentally is a bank supervisor, in terms of culture...With a bank you really can’t afford to do in public what you need to do in private because you might inadvertently cause a run...but when you’re supervising superannuation and insurance companies you don’t have the same run-risk... APRA should be much more public...whether a given superfund is working in the members interests.

— Industry expert

The Panel believes that APRA has under-resourced superannuation and not approached it with an appropriate regulatory focus. This is due to its focus on financial system stability, with large ADIs and insurers being primary drivers of systemic risk. Member outcomes and superannuation have often taken a ‘back seat’ — as they rarely raise financial stability issues. As an example, APRA’s vision statement — ‘to deliver a sound and resilient financial system, founded on excellence in prudential supervision’ does not reference superannuation and the non-financial stability drivers of member outcomes.

APRA’s challenges in superannuation require further effort to embed the changes underway in APRA to strengthen the focus on member outcomes, including structural change in the organisation.

111 APRA and ASIC, 2018, *Regulation of superannuation entities by APRA and ASIC*.

Findings of recent reviews

The PC was highly critical of APRA's approach to superannuation, stating that APRA 'steadfastly regulates through a prudential lens' whereas superannuation 'is not a market characterised by prudential risk'. The PC Superannuation Inquiry found that APRA was focussed on superannuation funds and their interests, rather than the needs and interests of members, which are not always aligned. The PC Superannuation Inquiry also criticised APRA for focussing its data collection on fund-related data and not member-focussed data.¹¹²

The PC Superannuation Inquiry criticised APRA for focussing on adherence to process over outcomes. It recommended that ASIC take responsibility for regulating the conduct of trustees and appropriateness of products while APRA take responsibility for ensuring high standards of system and fund performance, including licensing and product authorisation. The Inquiry also noted that APRA should have a more explicit 'member outcomes' mandate to replace its misplaced prudential mandate. Questions about APRA's ability to promote member outcomes were a key factor behind the PC's call for a capability review — stating 'APRA will also need an exponential uptick in dedicated expertise and resources to deliver on what is expected of it.'¹¹³

The Hayne Royal Commission, which overlapped in timing with the PC Superannuation Inquiry, ultimately concluded that ASIC should take a greater role in superannuation, finding that APRA's traditional regulatory approach was not always appropriate for superannuation:

APRA is predisposed to methods of regulation that rely on 'supervisory suasion' conducted 'behind closed doors', rather than to public deterrence. The prudential regulator may wonder whether public denunciation of an entity might disturb the stability of an entity or the system. But, as I have said, deterrence of misconduct depends upon visible public denunciation and punishment. ASIC's core work is consistent with that objective. APRA's is not.¹¹⁴

112 PC Superannuation Inquiry, p. 28.

113 PC Superannuation Inquiry, p. 43.

114 Hayne Royal Commission, p. 452.

APRA’s approach to regulating superannuation

Figure 5.3: APRA’s approach to regulating superannuation



Resources are industry light, inconsistent in approach and constantly changing.

[APRA] significantly underinvested in the wealth teams in the big institutions.

Superannuation is the poor cousin of APRA.

— Industry experts

APRA regulates superannuation entities similarly to its other regulated entities (Figure 5.3). Supervision is predominantly conducted on an entity basis. Risk assessments are conducted using APRA’s PAIRS framework which is based on traditional prudential concepts taken from ADIs. This vertical orientation is supported by thematic prudential and industry reviews that look across the industry. Policies in the form of prudential standards are developed to support these processes. Supervision staff working on superannuation are spread between supervision divisions (SID and DID), with support from relevant policy, risk, data and legal teams in PAD and RDA.

The Panel acknowledges that some aspects of the traditional prudential lens should be applied to the regulation of superannuation, including an ex-ante approach and a focus on outcomes over a focus on compliance. The focus on governance, fitness and propriety, and risk management is also appropriate. However, the risks in superannuation are not like-for-like with other APRA-regulated entities. Governance issues in superannuation can manifest in different ways to issues in banking and insurance. Also, the nature of risks are different. For example, banking and insurance capital and liquidity risks are central concepts, but these are not central to regulating superannuation. Prudential regulation of banking and insurance has a different focus on the end user. The Panel’s view is that APRA’s approach of harmonising across its regulated industries, and departing from this approach when it considers it ‘appropriate’, does not sufficiently take into account of differences in the superannuation industry.

Supervision documents prepared by APRA supervisors and provided to the Review mostly focus on risk management and compliance with prudential standards. Some sampled internal supervision documents showed little focus on member outcomes and whether trustees had complied with legal requirements designed to protect members’ savings, including the sole purpose test, MySuper obligations or fee requirements under the SIS Act. Additionally, sampled documents showed that while APRA looked at potential conflicts of interest between individual directors and the trustee, the

supervisors paid little attention to the risk of conflict of interests between trustees and related parties in their broader group structures and the members of the fund.

The shift to member outcomes

Despite an increasing focus on member outcomes, APRA's progress has been insufficient, especially in relation to system efficiency, fees and transparency. As a senior APRA staff member noted:

Investing in member outcomes is a work in progress.

— APRA senior staff

The Panel believes that APRA is headed in the right direction in beginning to tackle underperformance and improve member outcomes. APRA demonstrated its commitment to member outcomes when releasing its draft prudential standard *SPS 515 Strategic Planning and Member Outcomes* in December 2018 and through its advocacy for the Members Outcomes Act.

Internal documents show that consideration of member outcomes is now more prominent in APRA's work. APRA has set up an internal subgroup dedicated to member outcomes. Underperformance is the key risk identified in its Superannuation Risk Register, with causes clearly identified (inefficient operations and conflicts of interests leading to non-arm's length arrangements). APRA plans to create a centralised team to support supervisors and plans to improve assessment methodology, identify data gaps and explore obtaining data from other sources, improve transparency of performance and collaborate more closely with ASIC. The creation of a member outcomes dashboard will also assist supervisors to focus on outcomes. Helen Rowell has also clearly communicated a focus on member outcomes in a recent speech to industry:

Our superannuation analysts will harness data-driven insights to identify underperforming funds, products and options, and that 'outlier' list will be regularly reviewed and updated. The trustees of these funds will be targeted with intensified supervision, with APRA seeking prompt action to address areas of weakness or concern. If trustees are unable or unwilling to respond appropriately, we will be urging them to seriously consider whether restructuring or exiting the industry is in their members' best interests.¹¹⁵

Furthermore, 81 per cent of APRA staff working on superannuation agreed member outcomes were front of mind.

Capability Review Staff Survey — Member outcomes

Proposition: For those involved in superannuation matters, superannuation member outcomes are 'front of mind'.



While APRA is taking action on member outcomes, the Panel questions whether APRA has yet sufficiently embedded this focus into its frameworks. Stakeholders questioned whether APRA's rhetoric would be reflected in action to address underperformance. Supervisory documents also show that in practice, the focus on member outcomes is inconsistent. Supervisors appear to focus on

115 Rowell, H, 2019, *Opening the door to greater transparency in superannuation*, 13 March 2019.

factors contributing to outcomes for fund health rather than the outcomes themselves. This was evidence in some internal APRA documents reviewed:

- One supervisory document only showed concern for whether the trustee was ready to comply with the Member Outcomes Act assessment process and not whether the trustee was delivering on outcomes for members;
- Another example was work done by a supervisor in relation to a small fund with an aging membership and heavy net outflows. The work focussed on metrics around fund retention and inflows rather than addressing whether the fund was a viable vehicle to produce appropriate outcomes for its members; and
- In a letter to a fund in 2017 on member outcomes, APRA encouraged trustees to look at metrics such as brand loyalty and member identity, as well as member services provided, rather than focussing on issues pertinent to member outcomes in retirement — the key purpose of superannuation.

Structure of superannuation within APRA

Create a superannuation division that includes frontline, SAS, Policy and legal to support, integrate and strengthen depth of expertise.

— APRA staff

APRA needs to shift its focus, develop its policy and supervision framework and build its skills and resources to improve its work on superannuation. This will be more difficult to achieve in APRA's existing structure (Figure 5.4). The creation of industry-aligned branches within DID and SID is a recent enhancement of APRA's structure. However, the current structure, with superannuation spread across multiple divisions, may not have created a strong enough voice for superannuation in APRA. It may constrain APRA from building and maintaining its superannuation expertise. The Panel acknowledges that APRA has a dedicated member for superannuation and welcomes the addition of a new General Manager for superannuation.

The Panel believes that there may be differences in understanding around the importance of promoting retirement outcomes between staff working on superannuation and the broader organisation. APRA should create a new Superannuation Division under a dedicated EGM. Its primary focus should be on member outcomes. There should be more focus on regulating at an industry level rather than on an entity-by-entity basis.

This will complement APRA's recent heightened attention on member outcomes. The effectiveness of that work may be constrained with superannuation resources spread across many other functions. Embedding APRA's changes on member outcomes across all relevant divisions may diffuse the impact of those changes. Staff already note that this sharing of resources between divisions has created inconsistencies in approach.

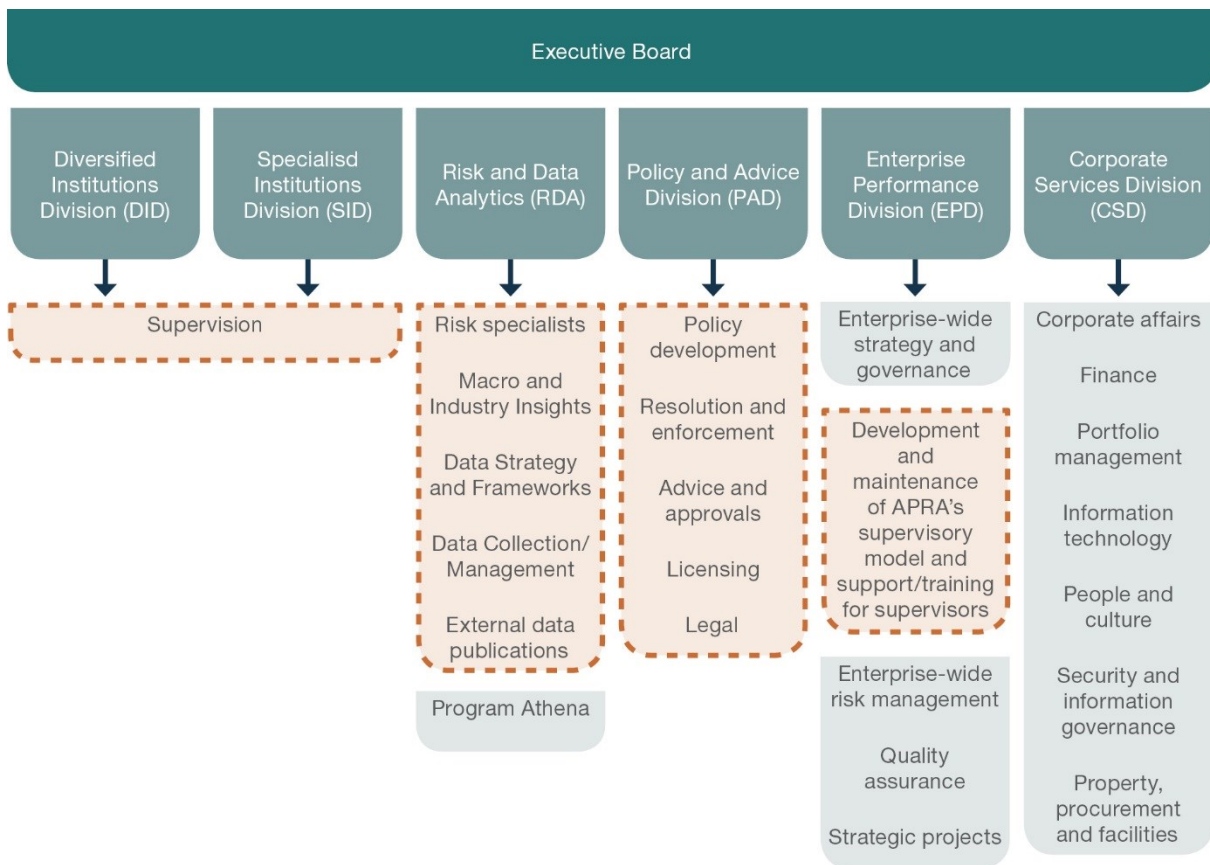
The Panel believes that such a restructuring of APRA will promote the development of a critical mass of expertise in superannuation, support APRA to develop a career path for those working in superannuation and encourage better supervision of superannuation. It is also of the view that the creation of a superannuation division would encourage greater consideration of superannuation in APRA's internal decision-making, including the prioritisation of APRA's resources. Following the Hayne Royal Commission, APRA and ASIC are working more closely on superannuation issues. It is likely that the creation of a dedicated superannuation division in APRA, with clear lines of industry expertise and accountability, would make that collaboration more effective. In addition, creating a separate superannuation division inside APRA would achieve some of the benefits discussed in the

Hayne Royal Commission of creating a standalone superannuation regulator without many of the costs.

This structural change should be accompanied by a shift in APRA’s supervisory philosophy in two ways. The first is that APRA’s analysis should focus more on industry trends and the benchmarking of funds’ delivery for members. This will sharpen APRA’s ability to identify funds that persistently underperform and the characteristics of those funds. It may also assist in anticipating and responding to emerging industry trends. Staff noted that a restructure along industry lines would ‘significantly enhance strategic industry focus, improve efficiency and break down inherent inadequacies in collaboration that currently exist’. The second, is that APRA should discontinue its use of PAIRS as a supervisory tool for superannuation (see below).

As part of this restructure, APRA should consider whether there is merit in embedding relevant staff from RDA, PAD and legal in the new division. This could enable it to develop a specific superannuation approach in its policy design, supervision and enforcement functions but could also reduce economies through fragmentation.

Figure 5.4: Location of superannuation in APRA’s current structure



The Panel acknowledges that there are some benefits to APRA’s existing approach and organisational structure. Many stakeholders appreciated that the entity-based approach allowed them to develop an ongoing relationship with supervisors and educate individual supervisors about their business along the way. However, submissions also noted that the entity-based approach to supervision (with some teams supervising as few as two funds) meant that staff did not understand the superannuation system as a whole.

While APRA does conduct thematic reviews, and does have support for cross-industry issues through RDA, submissions and stakeholders noted that APRA’s research capability had diminished over time,

resulting in less capacity to identify emerging trends. APRA has begun more thematic reviews in superannuation and has developed dedicated teams to conduct those reviews.

Prioritisation and resourcing of superannuation

APRA’s prioritisation of superannuation has had a variety of consequences:

- Reduced ability of APRA to attract, retain and develop staff with superannuation expertise;
- The long-term application of ADI-focussed supervisory tools to superannuation; and
- Insufficient focus on member interests.

Superannuation is secondary to banking.

APRA can feel very ADI focussed.

— APRA staff

APRA devotes more resources to regulating the banking and insurance sectors than the superannuation sector (Figure 5.5). While Figure 5.5 aggregates the three insurance industries, on entity per supervisor basis, superannuation has fewer resources dedicated to each entity. In recent years, APRA’s staffing numbers have increased, but not for superannuation.¹¹⁶ In an internal APRA document, APRA notes the ‘lower promissory intensity and the lower potential for financial sector contagion’ as a reason for the lower resourcing.

Figure 5.5: APRA staff by industry



Staff noted that ‘some frontline superannuation analysts are responsible for portfolios 2-3 times larger than a typical banking analyst.’ The Panel noted the high turnover of staff with superannuation experience, with the loss of 14 out of 77 superannuation-related staff in 2018. The Panel also noted staff observations in the Capability Review Staff Survey that a lack of resources supporting superannuation was a reason for these departures.

Consultation with industry representatives and participants revealed a concern about lack of expertise or experience on superannuation. A few knowledgeable supervisors were the notable

116 APRA internal data.

exceptions. One stakeholder noted that only one member of APRA’s supervision team had been there for 18 months. Submissions received by the Review observed that where supervision staff had little expertise in superannuation they paid little attention to outcomes for members.¹¹⁷

The Panel considers that issues around attracting and replacing staff, the high turnover rate and lack of superannuation expertise are, at least in part, symptomatic of APRA’s treatment of superannuation relative to other industries.

RECOMMENDATION 5.1

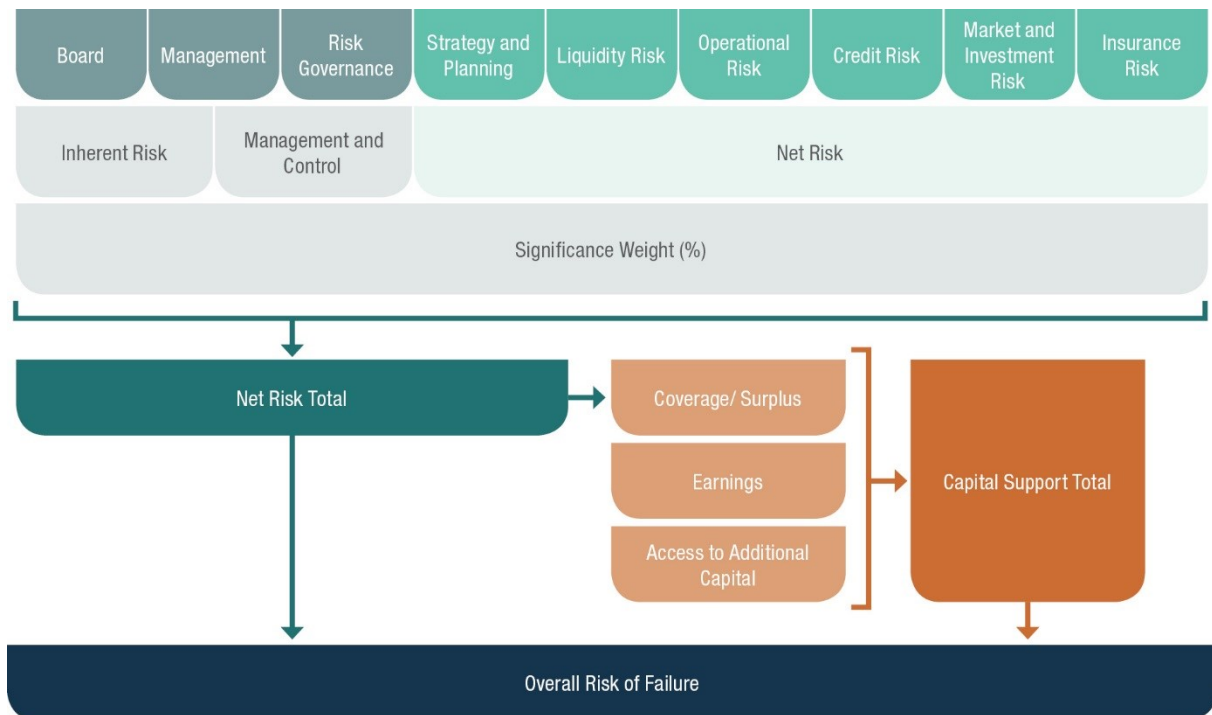
APRA should create a new Superannuation Division, headed by an Executive General Manager. A key focus of the Division should be the overall performance of the superannuation system for members.

Superannuation supervision tools

Tools available for superannuation are limited as is the data that we collect.

— APRA staff

Figure 5.6: Stylised image of the current PAIRS framework



The Panel believes that APRA’s use of the supervisory tool PAIRS is inappropriate for superannuation due to three main reasons:¹¹⁸

117 Australian Institute of Superannuation Trustees, 2019, *AIST Submission to the APRA Capability Review*, p. 11.

118 Note, PAIRS categories have different ‘significance weights’. The default significance weight for ‘credit risk’ for superannuation entities is nil.

- PAIRS is fundamentally directed towards estimating the probability of an entity failing (Figure 5.6). However, a (defined contribution) superannuation fund cannot fail in the way that a bank or insurer can fail. More importantly, members could experience poor outcomes long before their superannuation fund is at risk of failure;
- PAIRS calculates the overall risk of failure by considering the capital support (including coverage surplus, earnings and access to additional capital) available to entities. While superannuation funds maintain reserves, there is no robust framework or reference for these concepts because there is no capital framework for superannuation. Earnings and access to capital do not translate to superannuation entities; and
- PAIRS directs attention to superannuation trustees, as opposed to the outcomes for members. PAIRS does not explicitly assess member outcomes or related issues such as: conflict of interest risks between the trustee and members; related party transactions; or net returns. This has encouraged some supervisors to incorporate concepts relating to member outcomes into the tool. However this piecemeal approach to tailor the PAIRS framework can lead to different treatment of the industry within APRA.

The Panel welcomes APRA's decision to review the PAIRS framework. However, the PAIRS framework should not be used as a starting point for a new supervisory tool for superannuation. APRA requires a new superannuation-specific tool which has a primary focus on member outcomes, on a trustee-level and product-level basis. This tool could incorporate some elements of the current PAIRS tool, such as board and risk governance.

Policy approach

APRA's recent review of its prudential standards for superannuation concluded that the standards largely met their objectives but need further enhancements. APRA found that the standards may not always be achieving their policy intent.¹¹⁹

Stakeholders commented that APRA should have published more detailed guidance on benchmarking to accompany its draft prudential standard on member outcomes to enable consistent reporting of returns across the industry. The Panel believes that APRA could improve the outcomes focus of its prudential standards and should develop a methodology for public benchmarks to enable APRA to tackle underperformance and promote member outcomes.

APRA's approach to superannuation data

APRA is the principal financial sector data collection agency in Australia and has broad powers to make reporting standards to collect data and collects data on behalf of other agencies. APRA has a number of reporting standards relating to superannuation trustees.

The Panel notes two concerns about APRA's collection of superannuation data: the type of data APRA collects; and the fact that APRA does not ensure that it is provided with accurate data (i.e. data quality).

On the first issue, in relation to choice products (which represent around half of all accounts, and a substantial portion of underperformance),¹²⁰ APRA collects information on the prudential health of superannuation funds and does not collect product-level data. For example, APRA collects data on

119 APRA, 2019, *Information paper: Review of APRA's 2013 superannuation prudential framework*.

120 PC Superannuation Inquiry.

net earnings, administration fees, investment fees, flows of members and investment expenses. However, this data is only aggregated at the fund level. APRA only collects product-level data on default or MySuper products. This means members in choice products cannot always compare the returns and costs of their product with benchmarks or with other products.

There are issues around the quality of data that APRA collects and publishes. The PC Superannuation Inquiry noted that ‘non-reporting has been apparent in APRA data at least since 2004...the regulator appears to have enabled this non-reporting.’¹²¹ In the Capability Review Staff Survey, staff observed that the current data gaps and data errors impeded their ability to supervise. APRA has not issued an infringement notice or begun court proceedings for breaching reporting standards since at least 2013.¹²²

APRA is in the process of developing a new data strategy and is part way through its Project Athena data project (see Chapter 2) which will make data collection processes easier to change in future. APRA has publicly stated that it will use ‘data-driven insights to identify underperforming funds.’ Internal documents show that APRA plans to update its reporting standards to ensure that fit-for-purpose data is available in four years’ time. This would include choice and platform-level data that would enable benchmarking of product performance, and facilitate the informed decisions by superannuation members. The Panel questions whether this timeframe is acceptable, given that the need for action to address underperforming funds in order to safeguard members’ retirement savings has been recognised for some time.

RECOMMENDATION 5.2

APRA should embed and reinforce its increasing focus on member outcomes, and continue to ensure that trustees prudently manage member funds.

Consistent with this change of approach, APRA should:

- a. publish objective benchmarks on product performance and publicly take action to demonstrate its expectations for member outcomes;
- b. develop a superannuation performance tool that replaces PAIRS by the end of 2019. The tool should be focussed on member outcomes;
- c. update its superannuation reporting standards and collect product level data that facilitates accurate assessments of outcomes and comparability across funds; and
- d. increase the resourcing dedicated to the superannuation industry.

RECOMMENDATION 5.3

In accordance with recommendation 23 of the Productivity Commission’s Superannuation Inquiry, the Government should legislate to make APRA’s member outcomes mandate more explicit. The Government should consider clearly outlining its expectations for APRA on superannuation in its next Statement of Expectations.

121 PC Superannuation Inquiry, p. 182.

122 APRA Enforcement Strategy Review, p. 14.



CHAPTER SIX: APRA IN THE SYSTEM

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CHAPTER 6: APRA IN THE SYSTEM

Building on the examination of APRA's internal resources and structures in earlier Chapters, this Chapter assesses APRA's effectiveness in its external engagement with industry, other regulators and the Parliament. The Panel's main conclusion is that APRA needs to reconsider its approach to transparency, strategic communications and its assertiveness to varying degrees across its stakeholders. Its regulated entities are a critical part of its audience. But it should also consider the wider community and the Parliament. Public communication of what APRA expects of entities, and any failure to meet those expectations, will enable the public and Parliament to hold APRA and its regulated entities more effectively to account.

Noting some additions to powers are desirable, APRA should also reconsider its conservative and limiting assessment of its powers.

A more forceful supervision and enforcement approach is needed

APRA's approach towards regulated entities is changing. The Hayne Royal Commission, the introduction of the BEAR and APRA's current Corporate Plan have prompted a review by APRA. In its Enforcement Strategy Review, APRA acknowledges that to remain effective it should recognise the need to take stronger action earlier when it is appropriate — 'a constructively tough approach'. It also recognises that APRA should actively consider the deterrence benefits of enforcement action on more occasions, more effectively use its existing powers and coordinate more effectively with ASIC.

The Panel supports the direction of the Enforcement Strategy Review but notes that APRA should ensure that the new Enforcement Approach is embedded in its supervisory approach and culture. In line with the Enforcement Approach, the Panel believes that APRA needs to respond more quickly and effectively and increase its appetite to prosecute concerns in areas such as operational risk and GCA risks. While senior leadership appetite will be a key factor in the successful implementation of the Enforcement Approach, changes to APRA's internal culture will also be necessary and are considered in this Chapter.

The Panel has identified a number of cultural barriers to successful implementation of the Enforcement Approach:

- A strong bias against transparency in relation to entity-matters, linked to a desire to maintain open dialogue and cooperation with regulated entities;
- Lengthy timeframes in resolving cases with entities;
- Behaviours that limit the confidence of staff and their clarity around APRA's intent; and
- A conservative interpretation of its powers and supervisory toolkit.

The Enforcement Approach was only launched in April 2019. These observations, and the analysis that follows, are intended to be consistent with APRA's plan to roll out its new Enforcement Approach.

Moving from minimal transparency

APRA seeks to foster a cooperative, problem-solving relationship with regulated entities to achieve conformity with regulatory requirements. Much of APRA’s effort involves working with regulated entities behind the scenes to address issues.¹²³ For the most part this is a successful strategy.

There are several reasons APRA gives to support this approach:

- It maintains an open dialogue between APRA and entities;
- It encourages entities to self-identify problems and work with APRA to rectify them; and
- A concern that publicly identifying financial issues in an entity may be destabilising for it.

While these are valid considerations, APRA has placed too much emphasis on discretion and cooperation. The Panel believes that APRA’s strong preference to do things ‘behind the scenes’ with regulated entities is limiting its effectiveness. As noted in Figure 2.1, APRA is much closer to preferring minimal transparency than being fully transparent. Shifting the dial towards more transparency is part of its new Enforcement Approach.

There are some diverging views within APRA about the possible consequences of being more transparent. Senior management in the organisation most strongly and almost uniformly advocate for the behind the scenes approach and are concerned about the possible detrimental effects of being more transparent about its engagement with entities. This uniformity of view is not apparent in the Capability Review Staff Survey: 53 per cent of respondents agree that APRA is more effective in its supervision role when operating behind the scenes; and 55 per cent agreed that greater public transparency on APRA’s dealings with an individual entity would adversely impact openness and cooperation from that regulated entity.

Capability Review Staff Survey — Transparency and regulated entities

Proposition: APRA is more effective in its supervision role when operating ‘behind the scenes’.



Proposition: Greater public transparency on APRA’s dealings with an individual regulated entity would adversely impact my team’s ability to access information and elicit cooperation from that regulated entity.

Note: This is a negatively framed proposition.



123 APRA, 2019, *Enforcement Strategy Review*.

Other staff support APRA taking a tougher approach on institutions:

APRA could achieve greater efficiency and effectiveness through taking a more forceful approach (particularly where entities are being uncooperative on issues), by the earlier and more tactical use of the full suite of its powers and by making its actions transparent more often.

[APRA should] be proactive and take brave decisions on financial institutions.

— APRA staff

The Panel believes that APRA's preference to engage with regulated entities behind the scenes limits its scope to deter poor outcomes. Prudential supervision is only effective if regulated entities believe that APRA will take increasingly forceful actions when prudential issues are not being properly addressed.¹²⁴ One of these actions is the public disclosure of APRA's concerns or penalties imposed on entities. APRA's reliance on behind the scenes cooperation with recalcitrant entities neutralises the deterrence element of a responsive regulation model,¹²⁵ because it offsets the credible promise of escalated action. The Panel acknowledges that in the case of severe financial distress, discretion will be preferable.

As noted, for the most part APRA's cooperative, behind the scenes engagement with entities is effective. But the Panel encourages APRA to bear in mind that the very nature of its role as a financial sector regulator has an inherently adversarial element designed to help it achieve prudential outcomes that benefit not only regulated entities, but Australia's financial system more broadly. Discretion and cooperation have their limits as revealed in the Hayne Royal Commission and the CBA Prudential Inquiry.

The Panel is not persuaded by the view expressed to it by board and senior finance industry executives that more transparency on the part of APRA would limit their cooperation and openness with it. While cooperation is preferred to compulsion, regulated entities must provide APRA with information. Protracted behind the scenes disputes or resolution of problems is out of step with public expectations following the Hayne Royal Commission. APRA should ensure that its strengthened enforcement appetite prevents these occurrences happening in the future.

APRA is on the right path with its more open Enforcement Approach. But it still needs to challenge its mindset against transparency. Its failure to publish self-assessments of the GCA arrangements of 34 regulated entities was a missed opportunity and a reminder of the need for more cultural change. APRA chose not to release any granular information from this exercise but published a broad assessment of them.

A new approach needed for recalcitrant institutions

APRA has been effective in addressing *industry-wide* financial resilience matters through top-down policy and supervisory measures:

- In banking, this includes implementing the Basel core principles and Murray Financial System Inquiry recommendations around capital, liquidity and funding and the recent interventions in residential mortgages; and

124 APRA, 2019, *Enforcement Strategy Review*.

125 Ayres, I and Braithwaite J, 1992, *Responsive Regulation: Transcending the Deregulation Debate*, Oxford University Press.

- In insurance, this includes implementing the LAGIC reforms.

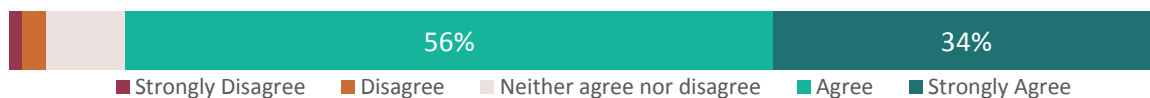
But APRA can be slow and inconsistent in pursuing firm-specific issues in cases where entities are recalcitrant and do not respond to its actions. Recent revelations about CBA and IOOF are cases in point. In both cases, APRA’s reputation was damaged when the problems, the time taken and inability to resolve them behind the scenes were revealed. After the Hayne Royal Commission and shift in community expectations, such outcomes will now be more detrimental to APRA and further reduce public confidence in regulators and the financial system.

There appears to be limited consequences for entities that strongly contest APRA’s positions on firm-specific matters. A number of factors inform this assessment:

- Based on APRA data collected as part of this Review concerning prudential review ‘requirements’¹²⁶ and ‘recommendations’¹²⁷ issued between July 2017 and June 2018, 34 (24 per cent of) requirements and 121 (24 per cent of) recommendations remained open, as at April 2019. While some matters will take an extended period to remediate, the number outstanding suggests that timely resolution may not be treated sufficiently seriously by APRA and hence its regulated entities;¹²⁸
- While 90 per cent of staff agree that APRA has a strong supervisory focus on identifying material risks and remedial actions, fewer (68 per cent) agree that APRA has a strong supervisory focus on ensuring identified material risks are addressed satisfactorily in a reasonable timeframe; and
- An in-depth review of APRA’s supervision files conducted as part of this Review generally reflected well on APRA. However, there are a small number of instances of a reluctance to take strong action.

Capability Review Staff Survey — Supervision approach

Proposition: APRA has a strong supervisory focus on identifying material risks and remedial actions.



126 A ‘requirement’ is an action APRA issues to an entity following a prudential review. Entities must take specific action to address the issue. Requirements typically relate to an entity’s failure to comply with legislation or prudential standards, or a fundamental deficiency in the entity’s risk management and / or governance practices.

127 A ‘recommendation’ is an action APRA issues to an entity following a prudential review. Entities are expected to formally consider implementing the recommendation. Matters resulting in a ‘recommendation’ typically relate to areas of risk management and / or governance that are not fundamentally deficient but could be improved. Timeframes for completion may not be required.

128 Outstanding review findings are captured in internal management reports, and can inform inclusion of entities on internal ‘watch lists’.

Proposition: APRA has a strong supervisory focus on ensuring identified material risks are addressed satisfactorily in a reasonable timeframe.



Many regulators agree that there is a tension between maintaining open and frank engagement and balancing the role of the regulator taking enforcement action. However, they note this could be resolved by distinguishing between areas where there has been an isolated mistake which has been addressed and cases where there are repeat issues, extended delays or a lack of transparent, fulsome disclosure.

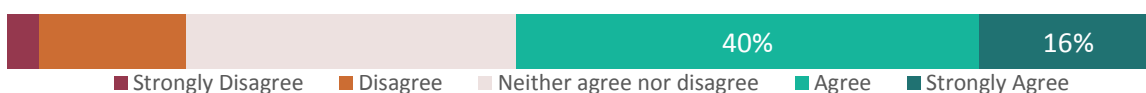
Improving management support and certainty of outcome

Varying confidence in management support and uncertainty about APRA's strategy in specific matters also play a role in APRA's low enforcement appetite. This will need to be addressed in order for a constructively tough approach to be successfully embedded. There are a number of contributing elements to this internal culture:

- The Capability Review Staff Survey reflects a strong theme of slow decision-making;
- While staff, and for that matter, the Panel, recognise the very nature of decision-making may require subjective judgment, there seems to be a degree of staff disenchantment about the consistency and approach to decision-making and a concern that these are difficult to navigate.¹²⁹ This leads to a sense of uncertainty amongst staff (see Chapter 2);
- The 'tone from the top' greatly influences organisational confidence. Some staff note that while rhetoric had shifted in favour of 'constructively tough', there is still a perception that this phrase is ambiguous and undefined. Staff indicate that 'sometimes support wanes as you go up the decision-making tree' and that some supervisors are 'significantly less tough on institutions than they should be'. The Capability Review Staff Survey reveals that 56 per cent of staff agree that APRA's senior leadership take effective action when regulated institutions 'push back'; and
- The acceptance of APRA's new constructively tough approach also seems to vary across the organisation. APRA's Enforcement Strategy Review and the Capability Review Staff Survey reveal divergences across divisions in the organisation.

Capability Review Staff Survey — Supervision leadership

Proposition: APRA's senior leadership take effective action when regulated institutions 'push back'.



[APRA needs to] clearly outline how the 'constructively tough' supervision regime will work in practice and embed this across all functions in a consistent manner.

— APRA staff

¹²⁹ Fifty-five per cent of staff agreed that the outcome of decisions at APRA depends on which person makes the decision.

The above internal factors may undermine the confidence and clarity of approach for staff, risking a successful implementation of the Enforcement Approach.

The Enforcement Strategy Review acknowledges that management has had little appetite for enforcement action where APRA may not be successful in court.¹³⁰ In line with the Enforcement Strategy Review, the Panel agrees that APRA should increase its tolerance to challenge from regulated entities. This will not only require the use of formal processes (explored below) but importantly a shift in the beliefs on perceived reputational risks for APRA.

Departing from a conservative approach to its powers

The Panel and a range of industry specialists consulted during this Review observe that APRA takes an overly conservative approach to the interpretation of its powers.

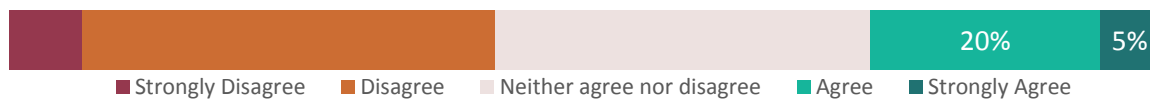
When surveyed, 78 per cent of staff feel that they have a good understanding of APRA’s formal powers. However, only 25 per cent think that APRA effectively uses the full suite of tools and powers with regulated entities.

Capability Review Staff Survey — Use of APRA powers

Proposition: I have a good understanding of APRA’s formal powers under relevant legislation and prudential standards.



Proposition: APRA effectively uses the full suite of its tools and powers with regulated entities.



Litigation should be a more significant focus.

— APRA staff

130 APRA Enforcement Strategy Review, p. 18.

CASE STUDY INACTION IN SUPERANNUATION

Up until the Hayne Royal Commission, APRA had:

- Only applied to disqualify one person since 2008 (this resulted in an enforceable undertaking);
- Only entered into enforceable undertakings with respect to one matter — the collapse of Trio Capital; and
- Not commenced any court proceedings relating to superannuation in the last 10 years.

This track record is particularly striking, given capital levers are not applicable to superannuation entities.

Since the commencement of the Hayne Royal Commission, APRA has launched a number of actions against IOOF entities, directors and executives for failing to act in the best interests of superannuation members.

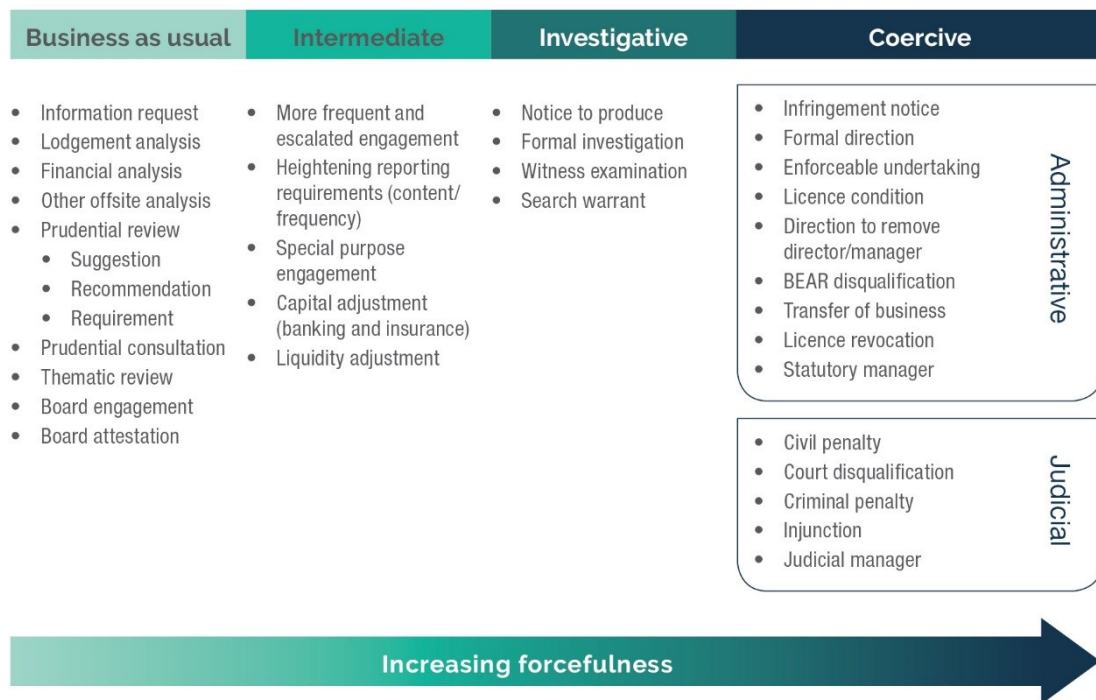
In June 2019, APRA imposed directions and conditions on AMP Super citing issues identified through ongoing prudential supervision and issues emerging from the Hayne Royal Commission.

Helen Rowell, APRA's superannuation member, stated that 'APRA plans to usher in a new era of superannuation transparency; providing better information on trustee and product performance, and increased visibility of APRA's actions to address underperformance.'¹³¹

APRA's existing set of powers provide a range of options (Figure 6.1). APRA's conservative approach may overstate the risks of an escalating and public use of its powers. To be clear, the Panel is not advocating a litigation-first approach for APRA. This would be detrimental. Rather, APRA should explore the full spectrum of its powers more effectively.

131 Rowell, H, 2019, *Opening the door to greater transparency in superannuation*, 13 March 2019.

Figure 6.1: APRA’s supervisory toolkit



Greater use of APRA’s toolkit has a number of benefits in addition to punishment and deterrence. Formal enforcement action can lead to jurisprudence and clarity around legal obligations imposed on entities.

RECOMMENDATION 6.1

The Panel supports the direction of the APRA Enforcement Strategy Review. To effectively embed the Enforcement Approach, APRA should change its existing internal norms that create a low appetite for transparent supervisory challenge and enforcement by:

- a. departing from its behind closed doors approach with regulated entities;
- b. adopting a stronger approach towards recalcitrant institutions;
- c. building organisational confidence and improving management support; and
- d. increasing its risk appetite and use of the escalation toolkit.

Some additions to APRA’s statutory powers are desirable

Recommendations of the Hayne Royal Commission, which were adopted by the Government, will enhance APRA’s regulatory toolkit. This includes enabling joint information sharing and investigations with ASIC and the extension of BEAR across other prudentially regulated industries. The Parliament has also recently passed legislation that significantly enhances APRA’s regulatory toolkit in superannuation.¹³²

132 Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No. 1) Act 2019.

APRA has a generally sound and fit-for-purpose set of statutory powers to deliver its mandate. The Panel notes three areas that warrant further consideration by the Government:

- The adequacy of the current penalty regime;
- The inability of APRA to appoint a skilled person to review a regulated entity; and
- Gaps in the PHI licensing regime.

This is in addition to new non-objections powers over the appointment of directors and trustees (see recommendation 4.3).

An opportunity to review penalties

It is timely to review the current penalties in APRA's industry acts and the *Financial Sector (Collection of Data) Act 2001* (FSCOD Act) to ensure their appropriateness.

In 2018, the Parliament strengthened penalties for ASIC-regulated corporate and financial sector misconduct.¹³³ In contrast, many of the penalties prescribed in APRA's Industry Acts and FSCOD Act have not been reviewed or updated in some time. Some provisions only have strict liability offences with no corresponding ordinary offence provisions. Existing criminal penalty provisions may also benefit from new parallel civil penalty provisions to give APRA greater flexibility when enforcing the law. It is important to ensure that penalties are effective deterrents and in step with community expectations.

A review of the existing penalty regime is also appropriate in light of the Panel's other recommendations which seek to enhance APRA's enforcement toolkit, for instance providing APRA with a non-objections power to veto the appointment or reappointment of directors and senior executives of regulated entities (see recommendation 4.3).

However, the Panel notes that the case for changing the penalties in APRA-administered acts is not as clear-cut as the case for ASIC legislation. APRA is not the regulator of misconduct and has the powerful ability to adjust capital requirements where it is concerned about the impact of misbehaviour for all industries other than superannuation. Any review will also need to consider the impact of penalties in the SIS Act on superannuation members.

Skilled person review

APRA should be given the ability to appoint a skilled person to report to it in relation to the affairs of a regulated entity, or to require a regulated entity to appoint such a person to do so. This power should be general in nature, limited only by reference to APRA's statutory mandate. Such a review could be used for diagnostic, monitoring, preventative or remedial purposes. APRA currently has a number of powers to appoint third parties. But these are focussed on auditors and actuaries, and are not comprehensive.

The Panel notes that this power would enhance APRA's escalation toolkit as it would provide an additional option to supplement business as usual supervision activities in circumstances where escalation to enforcement activities is not yet warranted. Skilled person reviews would support observations that APRA should judiciously leverage external expertise to a greater extent and be in step with tools available to international regulators, such as the United Kingdom's Prudential Regulation Authority.

133 *Treasury Laws Amendment (Strengthening Corporate and Financial Sector Penalties) Act 2019.*

Additional powers for PHI

APRA's PHI licensing powers could be strengthened. Currently, APRA can only impose a licence condition upon the initial registration of a PHI. APRA's powers should be extended to enable it to impose licence conditions where it has prudential concerns. Furthermore, APRA should be given broader powers to revoke insurer licences. For APRA's supervision of the PHI industry, see discussion below.

RECOMMENDATION 6.2

While APRA's regulatory tools are generally fit-for-purpose, the Government should consider:

- a. reviewing the adequacy of penalties across APRA's legislative framework;
- b. providing APRA with the power to appoint a skilled person to undertake a review of a regulated entity; and
- c. enhancing its private health insurance licensing powers.

Working effectively with other regulators

To execute its mandate, APRA should collaborate with a wide range of domestic and international regulators. While APRA collaborates well with the CFR, APRA's relationships with other regulators are not uniformly fit-for-purpose. APRA's 2018-22 Corporate Plan includes a strategic initiative to enhance engagement and collaboration with peer agencies.

In the immediate future, APRA will need to work more closely with ASIC. This is partly because they have been given joint, but different, roles for a range of matters. Also, the more intense focus on GCA risks has the potential to blur the boundaries between the 'two peaks'. APRA and ASIC should work closely together to define these boundaries. APRA will also need to continue to work closely with other regulators to lift it and the system's preparedness for a financial crisis.

The Panel observes that APRA's collaboration could be stronger in areas that are in need of a capability uplift (for instance GCA and superannuation) or where it requires intelligence from non-traditional sources. For instance, the IMF FSAP found that 'APRA's supervisory assessment of governance should also incorporate banks' management of non-financial risks, based on a closer engagement with the relevant domestic agencies, mainly ASIC and the Australian Transaction Reports and Analysis Centre (AUSTRAC).'¹³⁴

The increasing importance of APRA's relationship with ASIC

Cooperation and coordination with ASIC will be increasingly important over the next few years as ASIC takes on a growing role in relation to superannuation and the BEAR.¹³⁵ The Hayne Royal Commission found that APRA and ASIC failed to coordinate to take action regarding the payment of

¹³⁴ IMF, 2019, *Australia: Financial System Stability Assessment*, p. 28.

¹³⁵ As recommended by the Hayne Royal Commission and Productivity Commission Superannuation Inquiry.

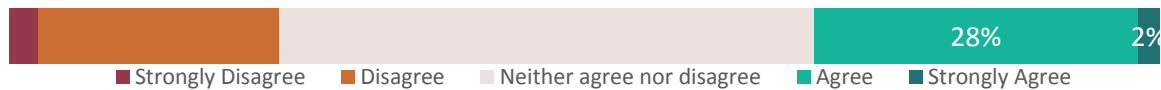
trailing commissions by trustees to related party financial advisers, and the charging of fees for no service.¹³⁶ It is vital that Wallis' two peaks of financial system regulation effectively engage.

APRA has indicated that it will work with ASIC to update their 2010 Memorandum of Understanding (MoU), agree clear principles for information sharing, consultation and coordination on enforcement action,¹³⁷ as well as removing impediments such as barriers to conducting joint investigations with ASIC.¹³⁸ This is consistent with the Hayne Royal Commission recommendation.¹³⁹

Senior representatives from both organisations told the Panel that the relationship is close and strengthening. This view is not echoed by APRA staff. The Capability Review Staff Survey identified that 30 per cent of staff agreed that APRA and ASIC work well together. In addition, 27 per cent of staff indicate that there are significant impediments to working closely with ASIC.

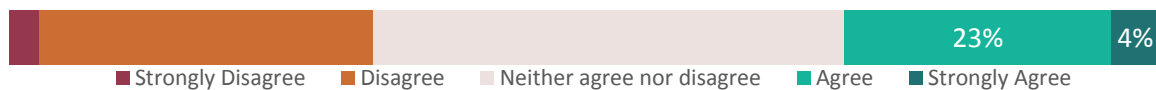
Capability Review Staff Survey — Relationship with ASIC

Proposition: APRA and ASIC work well together.



Proposition: There are significant impediments with working closely with ASIC.

Note: This is a negatively framed proposition.



One of the best things that could be done to enhance APRA's organisational capability would be to clarify the responsibilities between APRA and ASIC and that this would provide supervisors with more confidence in their actions and regulatory remit.

— APRA staff

The Panel's engagement with international peer regulators reveals that, in general, prudential regulators internationally are relatively less concerned than APRA about a potentially negative trade-off associated with sharing information with the conduct regulator.

APRA's leaders should improve their communication with staff members about the developing relationship with ASIC and seek ways to strengthen bilateral relationships throughout the organisation. The Panel notes APRA's internal protocols for sharing information are currently stricter than the legislative requirements, as the legislation allows APRA to share information with ASIC so that ASIC can perform its functions and powers. The Government's decision to impose a positive obligation on APRA and ASIC to co-operate and share information in response to a Hayne Royal Commission Recommendation will assist in improving this relationship.

136 Hayne Royal Commission Final Report Vol. 1.

137 APRA Enforcement Strategy Review, recommendation 1, p. 21.

138 APRA Enforcement Strategy Review, recommendation 7, p. 54. This is consistent with an IMF FSAP recommendation — APRA should deepen the regular cooperation with ASIC, and explore the possibility of undertaking joint activities, where feasible and appropriate. (IMF, 2019, *Australia: Financial System Stability Assessment*, p. 29)

139 Hayne Royal Commission Recommendation 6.10.

Other domestic relationships

The CFR is the highest level forum for managing financial system risk and is comprised of APRA, the RBA, ASIC and Treasury. The CFR provides a forum for identifying material risks, discussing appropriate actions and providing advice. Importantly, all delegated powers rest with the individual member agencies. The 2018 IMF FSAP and the Murray Inquiry found that the CFR was robust and comparable to international best practice. The Panel does not dispute that conclusion.

AUSTRAC is Australia's anti-money laundering and counter terrorism financing regulator. The 2019 IMF FSAP report recommended that APRA and AUSTRAC should significantly step up the frequency and the level of their cooperation by creating operational level working groups that meet on a frequent basis to discuss Anti-Money Laundering / Counter-Terrorism Financing issues in specific entities to better integrate associated risks into APRA's assessment of banks' risks as well as to support AUSTRAC's work.¹⁴⁰ APRA and AUSTRAC should implement the IMF's FSAP recommendation.

The Panel heard from stakeholders that the relationship between APRA and the RBA is cooperative and informal, particularly highlighting greater levels of collaboration when compared to international peers. The IMF's FSAP has also commented on this cooperative relationship with respect to financial stability and systemic risk issues.¹⁴¹ Similarly, the Panel heard positive feedback on APRA's relationship with Treasury, especially on policy matters.

The Panel would be supportive of APRA establishing a forum to ensure a coordinated, whole of government approach to financial sector misconduct issues. Such a forum could involve APRA, ASIC, ACCC, AUSTRAC and the ATO.

140 IMF, 2019, *Australia: Financial System Stability Assessment*, p.29

141 IMF, 2019, *FSAP: Detailed assessment of observance — Basel core principles for effective banking supervision*, p. 23.

APRA'S SUPERVISION OF PHI AND RELATIONSHIP WITH THE DEPARTMENT OF HEALTH

The PHI industry has several features that create different challenges for APRA in carrying out its prudential supervisory role compared to its other regulated industries.

PHI is a part of Australia's health financing system. As such, the PHI industry is subject to a high degree of government regulation. Key external factors relevant to APRA's prudential mandate include:

- Government regulation of pricing and product features, including annual ministerial approval of premium increases, community rating and risk equalisation;
- Government incentives to encourage greater participation in PHI, particularly by younger people and those on higher incomes, including Lifetime Health Cover, the PHI rebate and the Medicare Levy Surcharge; and
- Government regulation or control over the price of some inputs, including the cost of medical prostheses.

These factors produce risks that are largely unique to the PHI industry. The affordability of PHI is declining as premium increases outpace wages growth in order to keep pace with rising healthcare costs and utilisation. This risks impacting participation rates at the same time as the average age of policyholders is increasing, placing further pressure on premiums and affordability.

Since taking over responsibility for prudential regulation of PHI in 2015, APRA has worked to substantially improve entity resilience in terms of capital, risk management and governance to address these viability risks. APRA has also focussed on recovery planning. The Panel agrees this is appropriate, noting the work on recovery planning faces similar capability issues as discussed in Chapter 3.

The extent of government regulation of, and policy influence over, the PHI industry requires APRA to have an effective relationship with the DoH. APRA provides advice to the Department on the prudential sustainability of proposed premium changes. The direct link between premium changes and insurer viability means that APRA has an important role to play in this process. APRA should also have a sophisticated understanding of how PHI fits into the broader health system.

The Panel observes that APRA has a good working level relationship with the Department, with regular engagement on business as usual matters and an increasing appetite to engage on strategic issues. The relationship however is weak at more senior levels. For example, APRA does not have regular liaison meetings at senior levels with the Department, unlike its other key agency relationships. This is a risk for APRA in terms of its visibility of forthcoming political risks and its capability to work with the government to address urgent issues such as a failing entity. As part of its wider peer agency refresh, APRA should strengthen its engagement and relationship with the DoH at all levels of seniority.

International engagement

APRA is also part of the global regulatory community. APRA's international activities include bilateral and multilateral relationships with other regulators, facilitating information exchange, contributing to the policy development of global standard setting bodies and providing technical assistance to other regulators. APRA has information sharing arrangements with 32 overseas regulatory agencies through MoUs and letters of exchange. In 2018, APRA staff undertook 111 international visits — roughly two-thirds of these visits concerned core business (supervision, policy and resolution).¹⁴²

Refresh Memoranda of Understanding

While the frequency with which formal MoUs are signed is not always indicative of the strength and day to day effectiveness of regulator engagement, refreshing them is good housekeeping. Many of APRA's MoUs with other domestic and international agencies were signed when no current APRA Members were in office and do not reflect today's challenges (ACCC — 1999, ASIC — 2010, RBA — 1998, OSFI — 2007).

Industry representatives submitted to the Panel that it was important that the parameters of the relationship between the regulators, including any agreements for information sharing are transparent and well understood.¹⁴³

APRA should update their MoUs as part of its 2018-22 strategic initiative to enhance collaboration and engagement with peer agencies, ensuring that they reflect the current and emerging operating environment. As part of this refresh, APRA should consider its approach to information sharing and internally, inform staff of the appropriate information-sharing parameters.

RECOMMENDATION 6.3

APRA should reinvigorate its approach to collaboration and information sharing with regulators and its international peers including clear protocols for staff.

142 Sixty-six per cent core business (supervision, policy resolution), 23 per cent information exchange and 11 per cent technical assistance. APRA Insight Issue 4 2018.

143 Australian Institute of Company Directors, 2019, *Submission to the APRA Capability Review*.

Parliament and public — an opportunity to refresh external accountability

APRA's external accountability framework

APRA has a broad range of external accountability mechanisms to which it needs to respond (Figure 6.2).

The principal accountability mechanism for APRA is Parliamentary and ministerial oversight. APRA appears before Senate Estimates and the Standing Committee on Economics, which reviews APRA's annual report. In addition, APRA's prudential standards are subject to disallowance by the Parliament.

APRA's Parliamentary and ministerial oversight is a feature of Australia's democratic system. Independent agencies such as APRA are accountable to the Executive and the Parliament, which in turn are ultimately responsible to the public. It is important that these frameworks allow the Parliament and the public to assess how well APRA performs.

Ministerial responsibility centers on issuing a SoE to APRA. This aims to provide greater clarity about government policies and objectives. It includes the policies and priorities the government expects APRA to consider in conducting its operations. APRA is then given an opportunity to respond through its Sol. APRA is also subject to direction by the Minister,¹⁴⁴ although this power has never been utilised.

From time to time, APRA may be subject to ad hoc reviews, such as the recent PC Superannuation Inquiries as well as international reviews, and the five-yearly IMF FSAP, which focusses on compliance with international standards.

Outside these, there are a number of other reporting obligations including the whole-of-government regulator performance framework, annual reports of APRA's performance against the *Public Governance, Performance and Accountability Act 2013* (PGPA Act) and engagement with the Australian National Audit Office on its financial accounts.

It is important that accountability mechanisms in place allow the Parliament and the public to assess how well APRA performs. The Hayne Royal Commission examined APRA's external accountability framework and found that the existing oversight framework is heavily focussed on governance and financial stability. In addition, none of the existing processes involved a regular and systematic review of how well APRA discharges its statutory functions or exercises its statutory powers. As a result, the Hayne Royal Commission recommended the establishment of an independently chaired oversight body to report on the performance of APRA and ASIC.¹⁴⁵

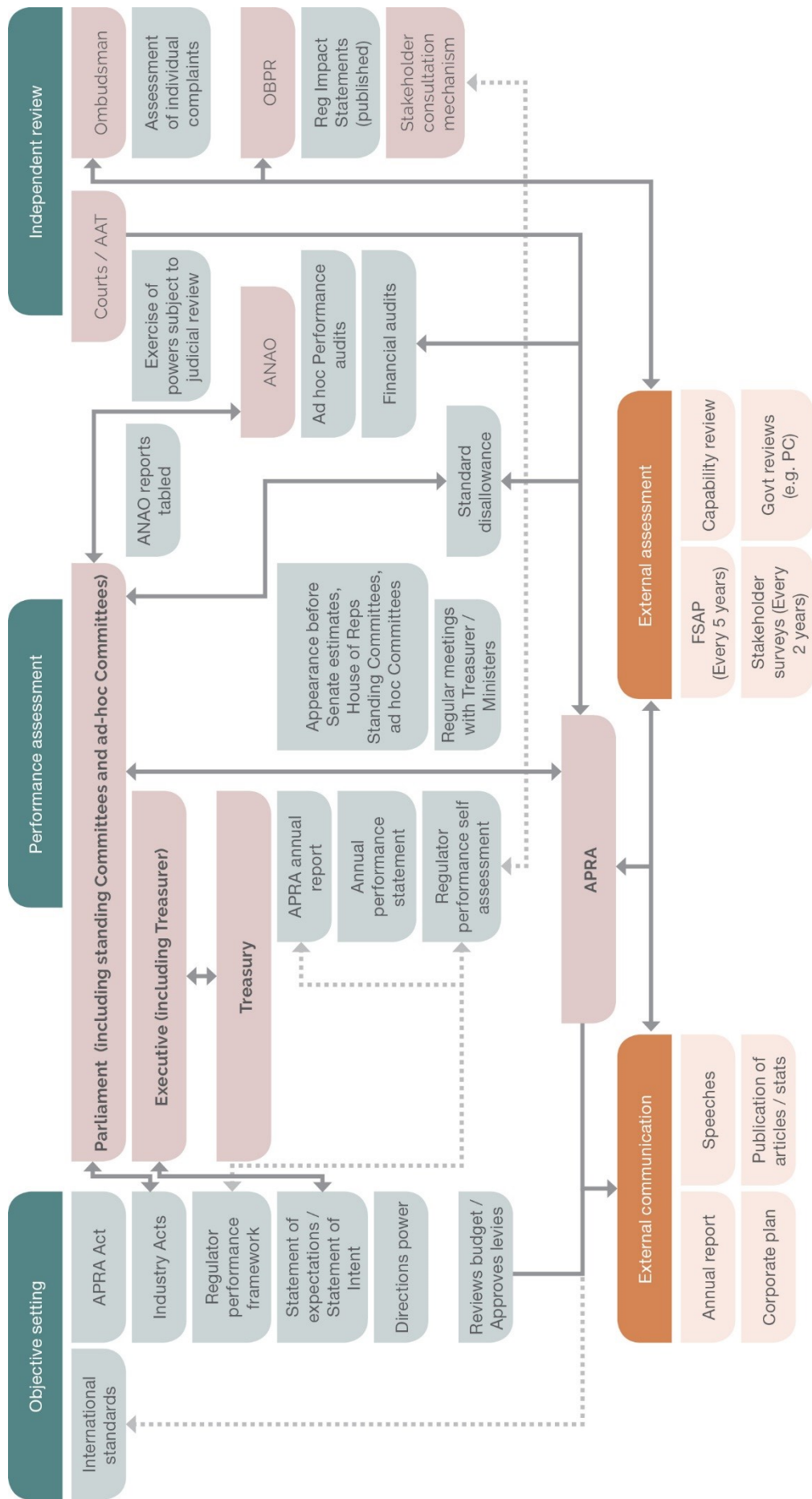
In addition, APRA has agreed to implement the recommendation of the Hayne Royal Commission to internally formulate and apply to its own management accountability principles of the kind established by the BEAR.¹⁴⁶

144 Section 12, APRA Act.

145 Hayne Royal Commission, recommendation 6.4.

146 APRA, 2019, *Table with APRA's Responses to Royal Commission Recommendations*.

Figure 6.2: Complexity of existing external accountability arrangements



Accountability post-Hayne — regulator oversight authority

The Hayne Royal Commission recommendation to establish a new oversight authority for both APRA and ASIC provides a good opportunity to reconsider the current external accountability regime.

Current oversight arrangements are made up of a range of reporting obligations, some that apply broadly across public service agencies and regulators and others which are more specific to APRA. The resulting framework is not purpose-designed and contains substantial duplication. It entails a considerable and ongoing resource drain on APRA, but does not efficiently hold APRA to account for the delivery of its mandate.

In meetings with the Panel, APRA's view was that aspects of the current external accountability framework are inefficient as they are duplicative and not adequately focussed on agreed performance criteria.

The Panel agrees with the observations made by Commissioner Hayne that none of the existing frameworks involve a regular and systematic review of how APRA discharges its statutory functions or exercises its statutory powers. It is not held to account against its mandate. The ASIC Capability Review made similar observations about ASIC's external accountability framework. It noted that Parliamentary oversight had become issues driven and reactive, at the expense of a more strategic long-term function.¹⁴⁷

The Panel will not pre-empt how the financial regulator oversight authority may design its arrangements, and is mindful that such arrangements will apply to both APRA and ASIC. Below, one approach is outlined that would assist APRA and be a more effective way for it to be held to its mandate.

APRA's external accountability framework could be adapted to more closely resemble the framework applied to the RBA. This would involve two Parliamentary testimonies per year. APRA could prepare a public document which would include an assessment, informed by any benchmarks or metrics developed by the oversight authority of how it is meeting its mandate. This could include issues of concern in the financial system or in particular sub-sectors and a forward-looking account of policy or strategic issues that it is considering. This would provide Parliament with a regular and systematic review of how APRA discharges its powers, tested against independently developed standards. Over time, APRA could be held to account against its public testimony. Unnecessary and overlapping existing parts of the framework could be removed under this arrangement.

More assertiveness with Statement of Intent

The ASIC Capability Review considered at length the role of governments' SoEs and ASIC's Sols. It observed that 'SoEs and Sols were not being fully leveraged to ensure broad public understanding of what is expected of ASIC, and what the limitations of its mandate are'.¹⁴⁸ Similar issues have been identified in this Review and raised in consultation.

It is important that regulators are informed about the governments' expectations of it and it is for governments to set those expectations. When applied to independent institutions they are high level statements, taking into account the institution's mandate and other idiosyncrasies.

147 Australian Government, 2015, *Fit for the future: A capability review of the Australian Investments Commission*, p. 48.

148 Australian Government, 2015, *Fit for the future: A capability review of the Australian Investments Commission*, p. 7.

APRA notes that, at times, past SoEs have forced it to reprioritise resources and delay the implementation of important strategic plans. This led to underinvestment in areas that have since led to problems emerging in its capability. The Panel accepts this. In the future APRA should use its Sols more effectively. It should clearly inform government of the extent to which its expectations fall within APRA's Corporate Plan. It should also identify the organisational impact of embedding the government's expectations and assess whether this is consistent with the effective execution of APRA's mandate.

APRA should also reconsider its broader communication strategy to better inform the public and the Parliament of its priorities and concerns. This will make it a more effective regulator and advocate for itself. This is explored further below.

RECOMMENDATION 6.4

APRA should use its existing external accountability framework more effectively, including a more assertive use of the Statement of Intent and it should publish a regular external accountability assessment.

RECOMMENDATION 6.5

The Government should consider streamlining and improving the effectiveness of existing accountability arrangements when establishing the financial regulator oversight authority.









Improving strategic communications

Public communications provide opportunities for regulators to achieve outcomes and demonstrate accountability. There are three broad categories of information that APRA publicly discloses: information about APRA, information about an industry or a group and information about an individual entity. This section focusses on the first two categories; APRA's communication approach regarding individual entities is discussed earlier in this Chapter.

APRA uses a number of channels of public communication (Figure 6.3). Members and senior leaders give public speeches. APRA also publishes information on its website — such as policy papers and FAQs. APRA also releases Prudential Practice Guides and statistical publications. In 2017, APRA expanded and rebranded its centralised communications team.

Every two years APRA conducts an independent survey of its key stakeholders on APRA's performance. Results from its 2019 stakeholder survey are largely positive.¹⁴⁹ On the whole, stakeholders consider that APRA's communications are useful, clear and effective. Results on APRA's statistical publications were more mixed (see Chapter 5 for a discussion of superannuation data).

Figure 6.3: Number of visits to APRA communications channels per month
May 2017—April 2019 (6 month moving average)

	Oct 2017	Apr 2018	Oct 2018	Apr 2019
 Twitter followers	3,617	3,883	4,177	4,429
 Media enquiries	30	20	30	27
 APRA phone inquiries	508	454	490	497
 People visits to APRA website	104,300	106,158	113,332	114,922
 Page views of APRA website	330,500	302,763	364,450	330,551
 Number of news articles (print, radio, TV, online)	1,265	1,625	4,959	4,855
 Media Releases	5	5	5	7
 Speeches delivered	7	5	7	4

The Wallis Inquiry noted that the operations of the regulator should be publicly disclosed to the maximum extent practicable.¹⁵⁰ In addition, the Palmer Report recommended that APRA promote further transparency for markets to assess the risks posed by financial institutions' activities.¹⁵¹ Increased public transparency through strategic industry level communications can provide the

149 Results from the 2019 APRA Stakeholder Survey have not yet been published.

150 Wallis Inquiry, p. 335-336.

151 Review of the Role Played by the Australian Prudential Regulation Authority and the Insurance and Superannuation Commission in the Collapse of the HIH Group of Companies (Palmer Report).

deterrence element that is necessary for effective regulation. In the Panel's view, APRA has not sufficiently embedded these observations into its communication strategy.

APRA should communicate the terms upon which it should be judged

As an independent regulator, APRA should use communications to set the framework against which it wishes to be judged and manage community and government expectations of it. This communication should go well beyond what is provided for in publications such as its annual report — a rudimentary requirement under the PGPA Act. The publishing of APRA's Enforcement Strategy Review, assessments of its interventions in the residential mortgage market and entity GCA self-assessments this year are steps in the right direction.

As Chapter 3 outlines, the Panel believes that APRA needs to more clearly articulate its interpretation and approach to its mandate and its role and views about macro-prudential policy.

A more communicative, transparent and assertive APRA will allow it to set the terms upon which it should be judged — by industry, media, Parliamentarians and the community. This communication style would reinforce APRA's new 'constructively tough' enforcement approach and the Panel's recommended proactive, transparent direction for APRA.

Painting a vision for regulated industries

APRA has developed industry strategies for its regulated population. While APRA uses speeches and quarterly *Insights* articles to convey its key messages, emerging issues and industry visions could be conveyed more clearly, forcefully and frequently.

Many international prudential regulators are more transparent and granular about industry issues and areas of supervisory focus than APRA. For example:

- The Office of the Comptroller of the Currency's Semi-annual Risk Perspective outlines its perspective on the operating environment, bank performance, key and emerging risks, and credit underwriting standards. It also provides aggregate details of banks' ratings, outstanding levels of 'matters requiring attention' and outstanding levels of formal and informal enforcement actions; and
- De Nederlandsche Bank publishes a strategy document highlighting strategic themes for the next five years.

Responses to the Capability Review Staff Survey indicated that many staff do not believe that greater public transparency on APRA's assessment of industry-level issues would adversely impact their team's ability to access information and elicit cooperation from regulated entities (the appropriateness of which is discussed earlier in this Chapter).

Capability Review Staff Survey: Transparency of industry issues

Proposition: Greater public transparency on APRA’s assessment of industry-level issues would adversely impact my team’s ability to access information and elicit cooperation from regulated entities.

Note: This is a negatively framed proposition.



APRA should publish periodic reports on its vision and assessment of the state of its regulated industries. This more strategic approach to communication will help reset APRA’s leadership role with its regulated industries.

APRA has recently indicated that external communication that promotes better prudential outcomes and demonstrate ability will be a priority in the near term.¹⁵² More recently, there has been an increase in the number of information papers communicating outcomes from thematic reviews and papers on its expectations of industry. There has also been an increase in the number of media releases relating to supervision.¹⁵³ The Panel welcomes these developments.

RECOMMENDATION 6.6

APRA should take a more strategic, active and forceful approach in its public communications. As an independent regulator, it should use public communications to shape community and government expectations of it. In relation to specific areas, APRA should:

- a. publish an interpretation of its mandate;
- b. clearly articulate its role and approach to macro-prudential policy (see recommendation 3.3);
- c. advise the Government of the current state of its resolution capability and crisis preparedness (see recommendation 3.4). Taking account of the impact on the market, part of this advice could be published; and
- d. be more transparent in relation to superannuation, including by publishing objective benchmarks for superannuation performance on member outcomes and a strategy to promote long-term industry performance.

¹⁵² APRA, 2018, *2018-22 Corporate Plan*.

¹⁵³ Over the last 18 months. APRA data.



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APPENDIX 1: CAPABILITY FRAMEWORK AND REVIEW METHODOLOGY

The capability framework

The Panel used a tailored approach to assess APRA’s capability to deliver upon its mandate and respond to an environment of growing complexity (Figure A2.1). This approach informs the findings and recommendations to enhance APRA’s future capability.

The Panel recognises the lessons compiled by the IMF based on observations from the GFC and findings from assessments of countries’ compliance with financial standards. It considers these lessons important in aligning APRA with its international peers. The IMF’s framework is as follows:¹⁵⁴

THE MAKING OF GOOD SUPERVISION

Good supervisors are expected to be intrusive, sceptical, proactive, comprehensive, adaptive and conclusive. To achieve these elements, the ‘ability’ to supervise must be complemented by the ‘will’ to act.

The **ability to supervise** requires:

- **Legal Authority** — an enabling legal framework that provides for adequate powers to allow a range of swift regulatory responses to ongoing and emerging situations.
- **Adequate resources** — sufficient funds and stable funding sources to enable a regulator to carry out their mandate.
- **Clear strategy** — a conscious and strategic approach to supervision that is communicated internally and to regulated entities.
- **Robust internal organisation** — decision-making processes that are well defined and with clear accountability.
- **Effective working relationships with other agencies** — effective coordination and cooperation mechanisms with other domestic agencies, national authorities and international organisations.

The **will to act** requires supervisors have:

- **A clear and unambiguous mandate** — realistic objectives in relation to financial stability and systemic soundness with potential conflicts effectively managed.
- **Operational independence** — freedom from political and industry interference reflected in appointments, funding and legal protections.
- **Accountability** — transparency in the use of resources, key decisions and supervision effectiveness.
- **Skilled staff** — confidence to respond to changes in industry practices.
- **A healthy relationship with industry** — dialogue with regulated entity while deterring regulatory capture.
- **Effective partnership with boards** — confidence to leverage existing mechanisms to prevent excessive risk-taking.

154 Vinals, J and Fietcher, J, 2010, *The Making of Good Supervision: Learning to Say “No”*.

Drawing from a number of existing frameworks, including the Australian Public Service Commission’s capability framework and the IMF’s work on assessing the key elements of good supervision, the Panel has identified the capability needs for a prudential regulator which include:

Figure A2.1: The capability framework



Authority

A clear mandate and legal framework define the operating parameters for a regulator to achieve its prudential outcomes. APRA’s ex-ante approach to supervision is designed to ensure that risks taken by its regulated entities are effectively managed so that the financial system is protected. The Panel’s assessment of the effectiveness of APRA’s execution of its mandate and the adequacy of its legal powers can be found in Chapters 2,3,4,5 and 6.

Strategy

A deliberate strategy and vision will set the direction, focus energy and resources, and articulate to its wide network the goals and objectives of the regulator. For APRA, perceptions of its remit have been shaped through a number of events and reviews — these are covered in Chapter 1.

The Panel has identified the following areas that will help reset APRA's leadership role in the regulation of the financial sector:

- As part of its mandate to maintain financial stability and safety, APRA also has to respond to changes in the operating environment and emerging risks. This is covered in Chapter 3.
- Lessons from the GFC demonstrated that regulators around the world did not capture adequately the risks that financial institutions were exposed to. The international regulatory community is placing greater emphasis on assessing and non-financial risks. The Panel's assessment of APRA's capability to supervise governance, culture and accountability is covered in Chapter 4.
- Considering the importance of superannuation for Australians' well-being in retirement, it is crucial for APRA to continue to build on its closer scrutiny of member outcomes. This is addressed in Chapter 5.

The Panel notes that some of these strategic areas are of contemporary importance and subsequent capability reviews may choose to focus on other areas.

Leadership and Culture

The culture of an organisation — the sum of its values, traditions, beliefs, interactions, behaviours and attitudes — is inherently linked to its leadership. An assessment of leadership capability assesses how APRA's senior leaders shape strategic thinking and results, cultivate productive working relationships along with personal drive and integrity and communicate with influence. The Panel's detailed analysis is in Chapter 2.

Operational flexibility

The robustness of an organisation can be measured through its internal governance, resourcing and enabling tools and technology. An agile organisation's internal governance defines a clear organisational structure with lines of responsibility and enables effective risk management and controls. Effective resourcing is important to align the needs and priorities with those of its workforce to ensure it can meet legislative, regulatory and strategic objectives. Acquiring and retaining skilled staff is a key issue for an organisation like APRA that is dependent on highly-skilled staff. To enable an organisation to deliver, it must also have the right tools, data and technology.

APRA's existing operating framework identifies People and Culture, Risk Intelligence and Frameworks, Organisational Effectiveness and Infrastructure as its key capabilities. These are exercised through its core functions of supervision, policy and resolution to achieve its mandate (see Chapter 1). The Panel's assessment of APRA's operational capabilities can be found in Chapter 2.

Accountability

Accountability and independence are required to give the financial system confidence in its regulatory oversight. Stable sources of funding and adequate legislative powers are key to maintaining the independence of a regulator. A regulator must also communicate clearly to a wide audience, to keep its stakeholders informed and to maximise its effectiveness. As part of that, formal mechanisms need to be in place for regulatory agencies to disclose to the public how resources are being used, key decisions, and to the extent possible, their effectiveness in relation to their objectives. Following the Hayne Royal Commission recommendation for the establishment of a new financial regulator oversight authority there is an opportunity to reconsider APRA's external governance. These issues are discussed in Chapter 6.

The Review methodology

The Panel's conclusions in this Review are based on a wide range of information (Figure A2.2). APRA has been directly or indirectly subject to a number of external reviews in the past few years, notably: Hayne Royal Commission, IMF FSAP, PC Superannuation Inquiry, PC Inquiry into Competition in the Financial System. Additionally, the Panel benefited from a number of other sources, including: presentations and meetings with APRA; a wide range of stakeholder meetings, a staff survey, staff focus groups, observations from international peer regulators and a review of APRA documents.

This enabled the Panel to draw on multiple sources of evidence to reach its conclusions.

The focus groups, some meetings with managers and survey analysis were conducted with the assistance of KPMG. This provided an additional level of internal challenge to the Panel's conclusions; a cross-agency perspective; and specialist input from a qualified psychologist.

Information sources

A range of information informed the Panel's assessment and conclusions:

- The Panel and secretariat met with over 30 stakeholders (including industry representatives and experts, regulated entities and academics);
- The Panel also hosted five roundtables with key industry experts and international prudential regulators, spanning across the various key themes of this Review;
- On over 30 occasions, the Panel and secretariat met with and received presentations from APRA's senior leaders;
- 469 APRA staff completed a survey on APRA's organisational capability, including quantitative and qualitative responses;
- Over 1,000 public and internal APRA documents were reviewed;
- Ten focus groups with Level 3 and Level 4 analyst / advisor level staff were conducted;
- Information from seven international peer regulators was sought regarding their practices and resourcing; and
- The Panel received 19 written submissions from stakeholders (including three confidential).

Figure A2.2: Overview of Review evidence



Staff Survey technical note

The quantitative staff survey results exclude respondents that indicated the question was not applicable for their role. In addition, responses from APRA's Corporate Services Division were included for values, leadership and strategy questions only. This Review cites aggregate 'strongly agree' and 'agree' figures from survey respondents but values for 'neither agree nor disagree', 'disagree' and 'strongly disagree' are also shown for completeness. For brevity, the Report refers simply to responses from 'staff'.

Use of staff quotes

Staff comments that appear in the Review are drawn from meetings with APRA senior leaders and managers, staff survey qualitative comments and focus group discussions.

Key considerations in selecting quotes were to select representative quotes and those that aligned with other evidence types. Overly specific quotes have been excluded, and quotes showing trajectory have been slightly preferred. In general, the number of quotes has been limited to one to two per concept discussed.

Submissions

The Panel conducted a public consultation on APRA's capabilities from 13 March to 10 April 2019 and invited interested stakeholders to make submissions.

Nineteen submissions were received, including 3 confidential submissions (Figure A2.3). The non-confidential submissions are published on the Treasury website.

Figure A2.3: Written submissions to the Capability Review

No.	Stakeholder
1.	Association of Superannuation Funds of Australia
2.	Australian Banking Association
3.	Australian Financial Markets Association
4.	Australian Institute of Company Directors
5.	Australian Institute of Superannuation Trustees
6.	Australian Small Business and Family Enterprise Ombudsman
7.	CHOICE
8.	<i>Confidential</i>
9.	<i>Confidential</i>
10.	<i>Confidential</i>
11.	Customer Owned Banking Association
12.	Dr Angus Young
13.	Dr Wilson Sy
14.	Financial Services Council
15.	Governance Risk and Compliance Institute
16.	Insurance Council of Australia
17.	Maurice Blackburn Lawyers
18.	Mr Peter Beck
19.	Private Healthcare Australia

APPENDIX 2: MATTERS FOR INCLUSION IN GCA SELF-ASSESSMENTS

These matters should be included in the self-assessment of GCA risks, drawing on the outcomes of the CBA Prudential Inquiry. A modified version of these matters should be considered for superannuation funds.

Desired outcome

In designing its self-assessment, the board must consider the outcomes that APRA would like to achieve from this process:

- APRA is clearly informed about the GCA frameworks in the institution;
- APRA can assess from the information and data provided that: these arrangements are robust; the board has the capability to oversee them; senior management have invested appropriately in them; and senior management has the capability to implement them;
- The self-assessments complement and reinforce the requirements of the BEAR regime, APRA's prudential standards on governance, risk management and fit and proper, and APRA's more intense supervisory focus on these issues;
- The self-assessments strengthen APRA's capability to identify on an ex-ante basis potential risks to the financial safety of your institution stemming from your oversight of its GCA frameworks.

Required content

Quality of board oversight

- A description of the GCA frameworks in the institution, including the role of the board, CEO and senior management in setting 'the tone from the top';
- An assessment of whether the board has requested and received adequate and timely information on GCA risks to enable it to set risk appetite and hold management to account, including any action taken by the board for the provision of inadequate information by management;
 - evidence that key quality assurance roles — including the CRO, internal and external auditors and actuaries as relevant — have regular, confidential access to the board, including an assessment of material provided by them to the board; and
 - case studies of key areas of GCA risk, including investigations of breaches and consequences where relevant.
- The actions taken by the board to hold executives to account for good and poor performance against the institution's GCA framework, including:

- The board’s guidance to management on its expectations in determining appropriate consequences for good and poor GCA risk behaviours and outcomes, including, but not limited to, adjustments to remuneration ; and
- Any action taken by the board to adjust the remuneration of the CEO and senior management or impose other consequences for breaches of GCA arrangements by them or their staff.
- An assessment of whether the board has requested and received comprehensive analysis of the links between achieving GCA guidelines and remuneration outcomes.

Senior leadership performance

- Whether the CEO and senior management accepts and embeds these frameworks in the institution, including:
 - Taking action to reduce these risks and mitigate their impact;
 - Promoting the voice of audit, risk and compliance functions as an effective counterbalance to the business units; and
 - Engaging in constructive challenge and debate.
- How the CEO and senior management embed the GCA framework in the institution, including committee structures around GCA risks and the cascading of information through the firm;
- An assessment of the quality of analytics and reporting used by the CEO and senior management to identify and monitor GCA risks:
 - This could include breach reporting, systemic client complaints, incidents reported by staff and counterparties.
- Information on investments undertaken by the CEO and senior management to ensure that GCA risks can be effectively monitored and dealt with promptly in the institution and that staff have the appropriate skills and resources;
 - This should include information of the use of new technological approaches — ‘regtech’ — to monitor and pre-empt GCA risks.
- The timeliness and effectiveness of any response to problems resulting from poor GCA frameworks;
- An assessment of the CEO and senior management’s engagement with regulators, including the nature and speed of response to regulatory requests.

APPENDIX 3: ABBREVIATIONS

Term	Definition
AAT	Administrative Appeals Tribunal
ACCC	Australian Competition and Consumer Commission
ADI	Authorised deposit-taking institution
APRA	Australian Prudential Regulation Authority
APS	Australian Public Service
ASIC	Australian Securities and Investments Commission
ATO	Australian Taxation Office
AUSTRAC	Australian Transaction Reports and Analysis Centre
BEAR	Banking Executive Accountability Regime
CCyB	Countercyclical capital buffer
CFR	Council of Financial Regulators
Cooper Review	Super System Review
CSD	Corporate Services Division
DID	Diversified Institutions Division
DoH	Department of Health
D-SIB	Domestic systemically important bank
DMP	Decision-making protocol
EB	Executive Board
EGM	Executive General Manager
EPD	Enterprise Performance Division
ExCo	Executive Committee
FCS	Financial Claims Scheme
FSAP	IMF's 2019 Financial Sector Assessment Program
FSCOD Act	<i>Financial Sector (Collection of Data) Act 2001</i>
FTE	Full-time equivalent
GCA	Governance, culture and accountability
GFC	Global Financial Crisis
GM	General Manager
Hayne Royal Commission	Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry
IMF	International Monetary Fund
IRB	Internal-ratings based
IT	Information technology

Appendix 3: Abbreviations

L&D	Learning and development
LAGIC	Life and General Insurance Capital Standards
MoU	Memorandum of Understanding
Murray Inquiry	2014 Financial System Inquiry
MYEFO	Mid-Year Economic and Fiscal Outlook
PAD	Policy and Advice Division
PAIRS	Probability and Impact Rating System
PC	Productivity Commission
PC Competition Inquiry	Productivity Commission's Inquiry into Competition in the Australian Financial System
PC Superannuation Inquiry	Productivity Commission's Inquiry into the Efficiency and Competitiveness of the Superannuation System
PCC	People and Culture Committee
PHI	Private Health Insurance
PPC	Prudential Policy Committee
RBA	Reserve Bank of Australia
RDA	Risk and Data Analytics
RSE	Registerable superannuation entities
SID	Specialised Institutions Division
SIS Act	<i>Superannuation Industry (Supervision) Act 1993</i>
SM	Senior Manager
SOARS	Supervisory Oversight and Response System
SOC	Supervision Oversight Committee
SoE	Statement of Expectations
SoI	Statement of Intent
Wallis Inquiry	1997 Financial System Inquiry

