

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.