

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 capability[44]

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]

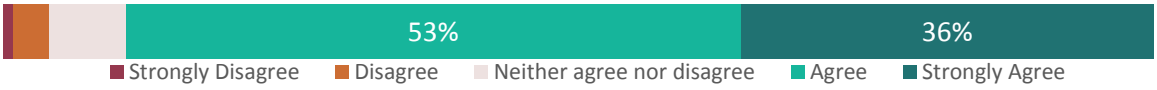
The IMF also assessed APRA's policy frameworks for banking, general and life insurance against international standards. APRA's policy frameworks were highly rated.

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.

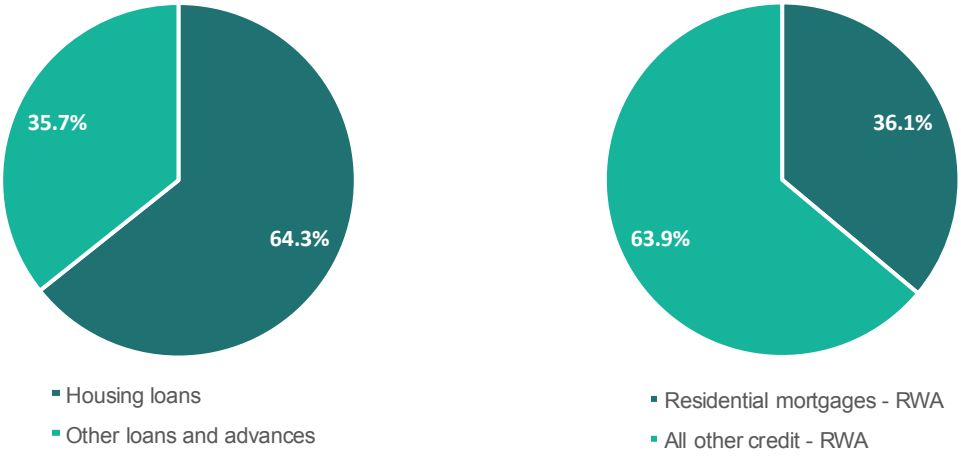
The remainder of this Chapter outlines on an exceptions basis areas where enhancement of APRA's capability to foster financial resilience and operational resilience would be desirable.

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 assets[48]



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 Committee[49] 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.

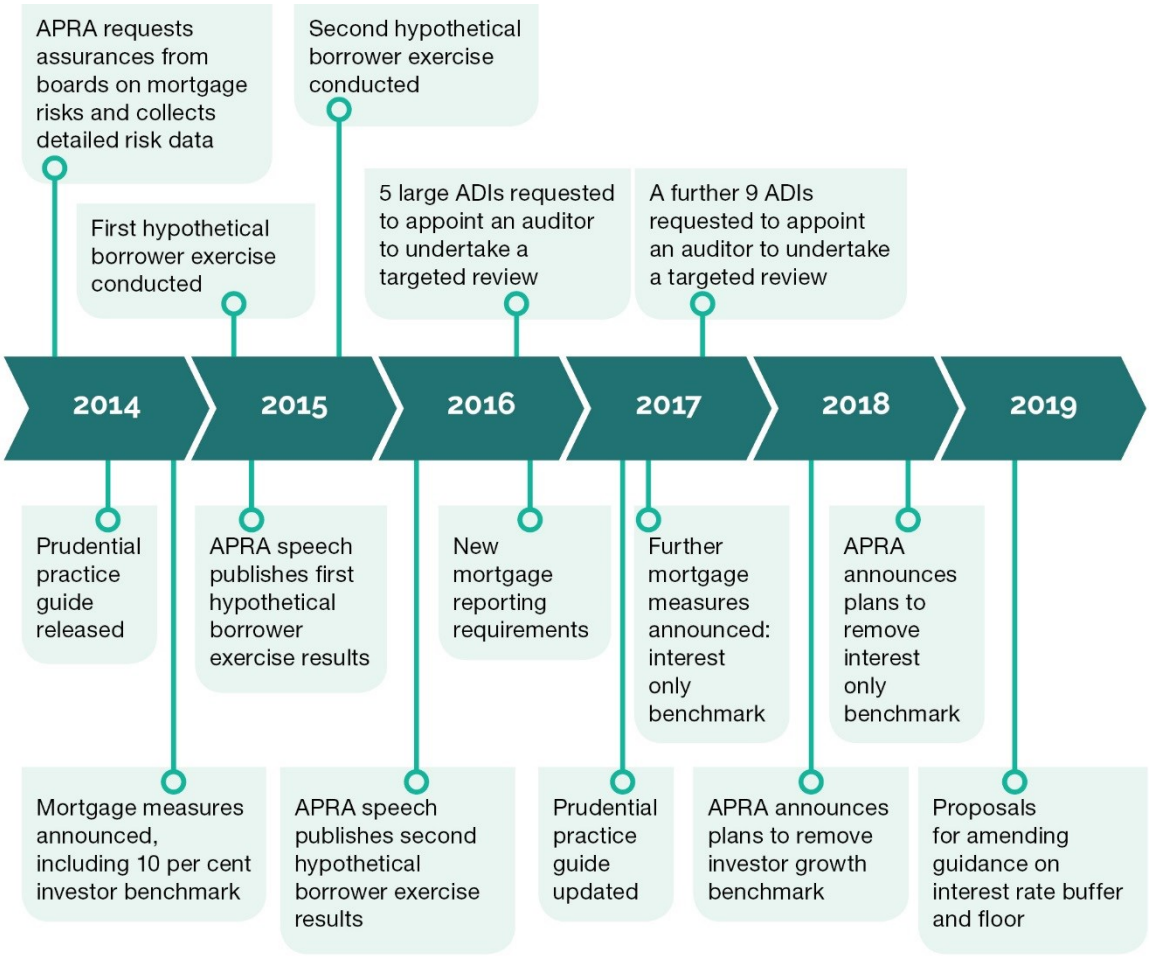
53 APRA's industry-wide and macro-prudential activities are not limited to housing. Other key lenses employed by APRA include industry-wide stress testing and the introduction of the countercyclical capital buffer framework (CCyB). The CCyB became effective in January 2016. The high-level purpose of 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 resolution[60]

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 untaken 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.

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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	• 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	• 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	• 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	• 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	• 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	• Fit-for-purpose prudential standards and guidance
Collaboration with public sector and industry stakeholders	• Limited capacity for industry communication, reactive engagement, piecemeal engagement with key stakeholders • Constrained capacity to contribute to international and domestic forums	• 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.

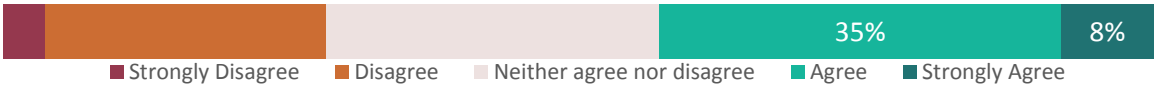
One industry stakeholder described APRA as 'immature, conservative' with a 'limited outward focus'. It was suggested that APRA 'must be prepared to contemplate dynamic industry change'. One regulated entity expressed frustration with delays, uncertainty and conflicting messages associated with an effort 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 though 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.

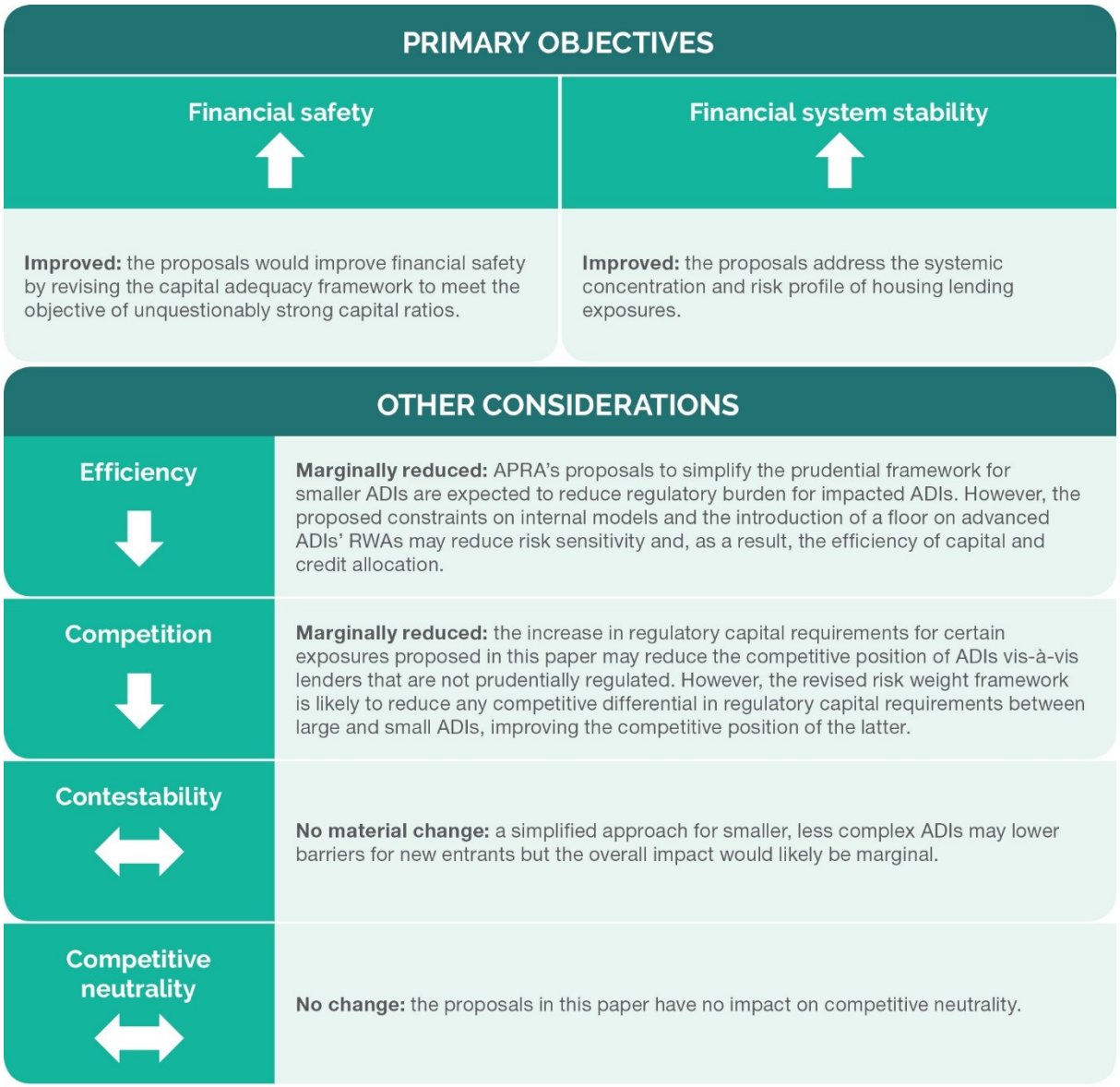
66 APRA's External Stakeholder Survey has not yet been published.

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 paper[68]



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 papers[70]



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).