# 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.

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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.

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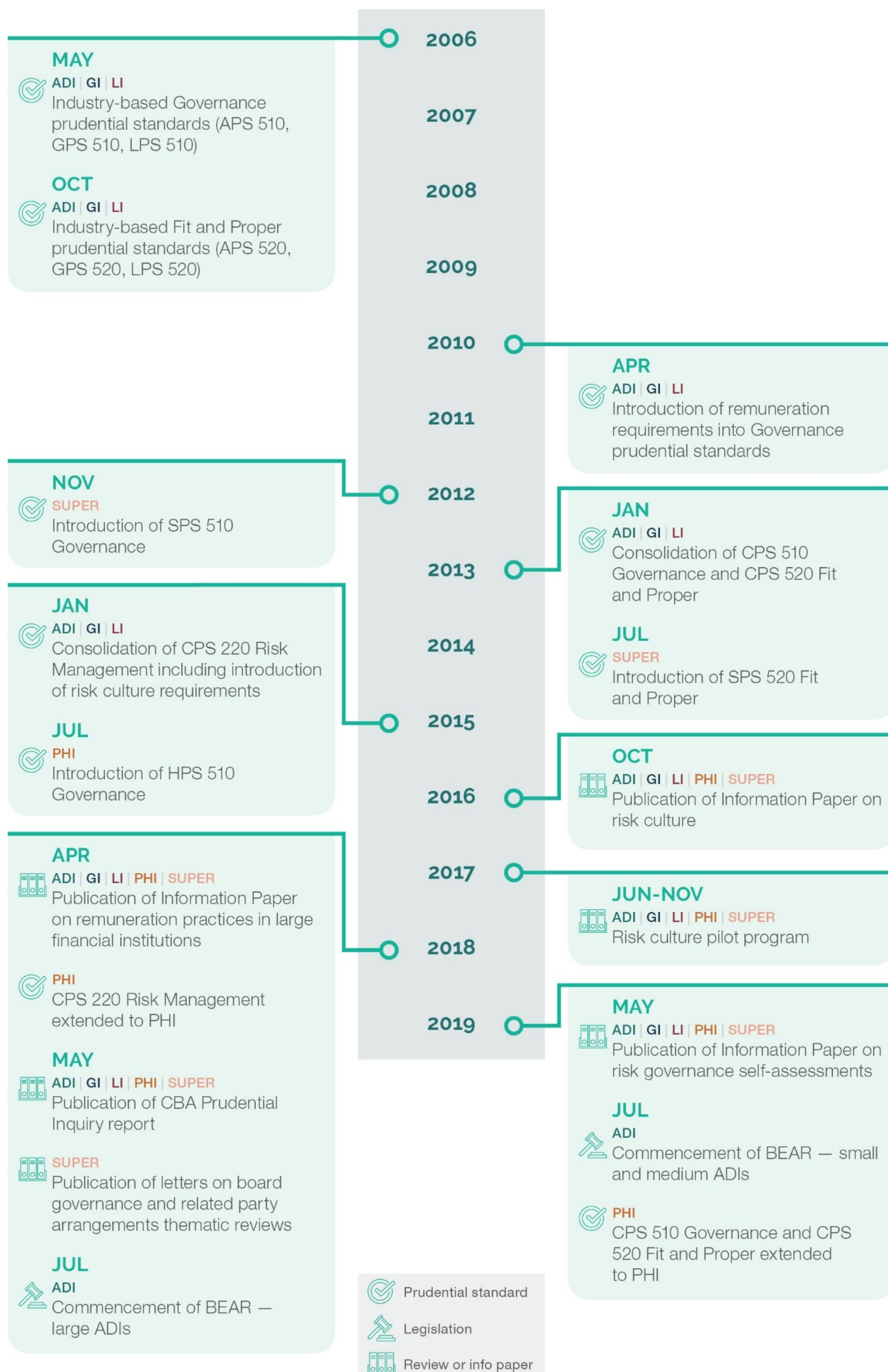
75 Hayne Royal Commission, p. 404.

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]

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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.

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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.

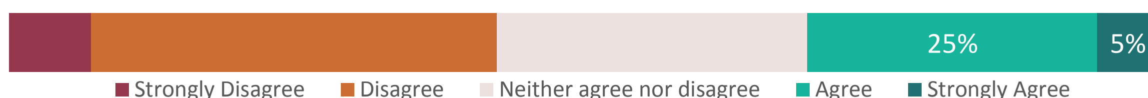
### Starting point and change management skills are a concern

> 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.

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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.

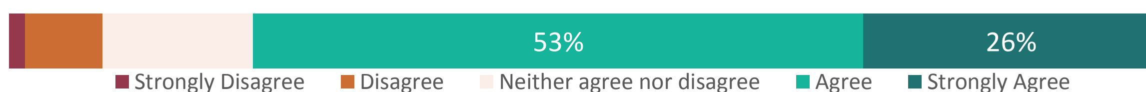
APRA may need to re-assess its principles-based approach to regulation in this area. As boards and trustees are also struggling to identify appropriate practices, a degree of prescription by APRA may be useful. This would make it more outcomes-focussed. Recommendation 4.1 is a step in this direction.

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.

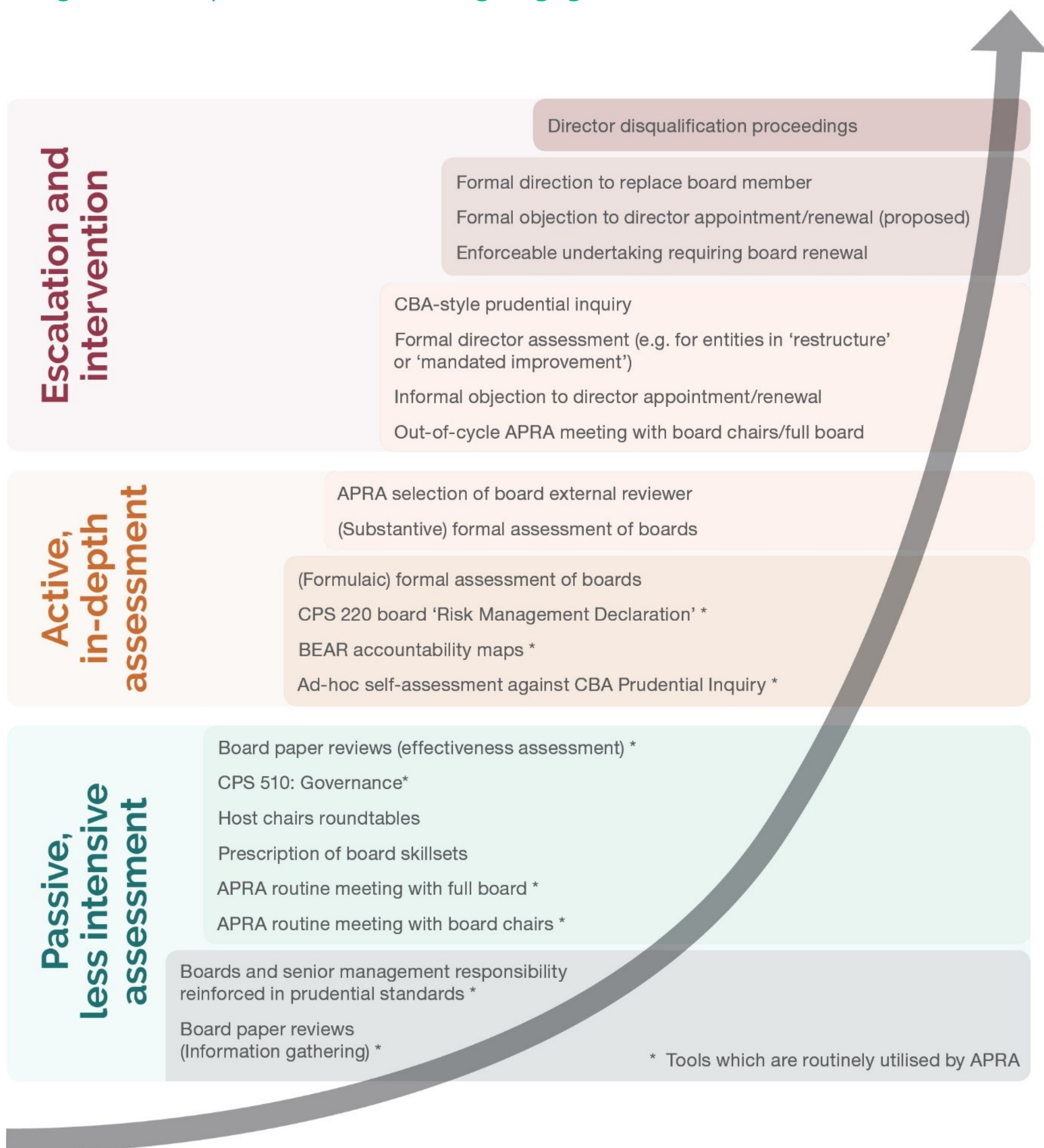
More innovative use of unstructured data has the potential to improve the efficiency of APRA's analysis of GCA risks. Inevitably developments in technology and data science will outstrip APRA's internal capability. Close collaboration with external regtech firms would also be desirable. The Panel is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