



16 April 2019

APRA Capability Review Secretariat  
Markets Group  
The Treasury  
Langton Crescent  
Parkes ACT 2600

By email: [APRACapabilityReview@treasury.gov.au](mailto:APRACapabilityReview@treasury.gov.au)

Dear Sir/Madam

### **APRA Capability Review**

AFMA welcomes the opportunity to provide comment to the APRA Capability Review. AFMA's membership includes many domestic and foreign ADIs and our comments reflect our experience in dealing with related APRA matters.

AFMA supports capability reviews as a valuable periodic process to externally validate the abilities of authorities, agencies and commissions and we have been pleased to provide feedback to such reviews previously.

We note that the timing of the Review is relatively compressed but given that APRA is a well-functioning authority that has been subject to recent independent scrutiny through the IMF's Financial System Stability Assessment we believe it should be sufficient.

Our comments separately address matters concerning the terms of reference for the Review.

We trust this submission is of assistance.

Please feel free to contact me for more information at [djeffree@afma.com.au](mailto:djeffree@afma.com.au) or on 02 9776 7993.

Yours sincerely

Damian Jeffree

**Director of Policy and Professionalism**

## 1. Comments on terms of reference

The objectives of the APRA Capability Review, as stated in the Terms of Reference, are entirely appropriate and consistent with the proper role of a review of this type.

### *Factors to be considered*

The terms of reference, as drafted, include a range of factors to be considered by the Panel, which are generally appropriate for the task to hand. However, we do have a concern about the formulation of the following factor:

“decision-making that balances financial safety and financial stability, and considerations of efficiency, competition, contestability and competitive neutrality;”

This factor reflects some but not all of the wording of the Australian Prudential Regulatory Authority Act 1998 (the APRA Act) Section 8 *Purpose for establishing APRA*:

### **8 Purpose for establishing APRA**

(1) The main purposes for which APRA exists are as follows:

- a) regulating bodies in the financial sector in accordance with other laws of the Commonwealth that provide for prudential regulation or for retirement income standards;
- b) administering the financial claims schemes provided for in the Banking Act 1959 and the Insurance Act 1973;
- c) developing the administrative practices and procedures to be applied in performing that regulatory role and administration.

(2) In performing and exercising its functions and powers, APRA is to **balance** the objectives of **financial safety and efficiency, competition, contestability and competitive neutrality** and, in balancing these objectives, is to promote **financial system stability** in Australia.

I have bolded the section that appears to have been reworked to form the factor.

It is evident that a critical purpose of APRA as set out in the Act is lost in the extract used to construct the factor.

In particular, the factor is set independently of what the Act, in Section 8 (1), describes as “The main purposes for which APRA exists”; these being in broad terms prudential regulation, administration of the financial claims scheme and developing related administrative practices.

“Decision making” by APRA, as with any exercise of its functions and powers, should be informed by these primary purposes and, most notably in our context, the prudential regulation objective. Other factors are secondary matters intended to guide APRA’s response to satisfy the primary objectives, so it appropriately balanced and effective. The Terms of Reference should be interpreted in a manner that provides due accord to this priority.

The factor also leaves off the final phrase of this part of the Act “and, in balancing these objectives, [APRA] is to promote financial system stability in Australia”. This phrase from the *Purpose for establishing APRA* section of the Act is an important and critical distinction and one that we believe should have been maintained in the Terms of Reference.

Without this phrasing financial (system) stability is listed in the factor as just one of many balancing criteria to be considered by APRA, on equal footing with “financial safety” and “considerations of efficiency, competition, contestability and competitive neutrality.” This should not be, and based on the Act itself is not, the case for the prudential regulator.

With the phrasing in the Act in place “financial system stability” quite properly becomes the over-arching aim when considering the balancing criteria. The primacy that the Act gives to financial system stability as a balancing factor when APRA considers prudential matters is entirely appropriate given the risks to the economy and the public of a failure in this regard.

To ensure the Review assesses APRA against an appropriate set of factors, it is essential that these factors accurately reflect the requirements and objectives expressed in the APRA Act. Therefore, we would support this factor being interpreted in a manner that more accurately reflects the phrasing used in the Act.

AFMA supports the proposal to use comparable international prudential regulators as benchmarks as appropriate.

#### *Relevant recent reviews and reports*

In relation to the relevant recent review and reports the Terms of Reference requires the Panel to take into account, we agree that it is sensible to consider:

- the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry Interim and Final Reports*;
- the IMF’s *Australia: Financial System Stability Assessment*; and
- APRA’s own internal *Enforcement Review*.

These are appropriate starting points for a Capability Review.

As AFMA does not represent the industry on superannuation we make no comment on the use or non-use, of the Productivity Commission’s final report *Superannuation: Assessing Efficiency and Competitiveness*.

However, the utility of the Productivity Commission’s final report *Competition in the Australian Financial System* for the purpose of this Review is doubtful given its narrow focus on competition in selected (albeit important) areas of the financial system. More significantly, the Government has yet to respond to the Productivity Commission’s report but it has indicated that it is not favourably disposed towards all of its recommendations.

Further, the Report’s conclusions regarding some aspects of the industry’s regulation are not shared by the official sector, as evident from submissions made to the Inquiry. As such it may not yet form an appropriate tool for analysis, and at a minimum any use of its recommendations should be appropriately cautious.

## 2. Comments on APRA's Capability

The Terms of Reference state that the objectives of the APRA Capability Review are to:

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

### 2.1. Overall Findings

Taking the first of these objectives, as outlined in the preceding section, APRA's primary objective is the regulation of entities in the financial sector in relation to laws that provide for prudential regulation.

This is also aligned with the Terms of Reference requirement to consider whether APRA has "sound process and outcomes realised across APRA's core supervision, policy and resolution functions (including appropriate utilisation of enforcement tools)".

In our view, this is the key outcome and, given the history of the Australian financial system to date, it has been clearly demonstrated that APRA has delivered upon its statutory mandate in this primary and most important regard.

This is evidenced by the low level of prudential failures in local institutions during a period of global turbulence. This is a substantial and important achievement for Australia as a whole and the industry recognises this as a direct benefit to the financial sector and the broader economy.<sup>1</sup>

While there are many factors that influence the likelihood of prudential failures including the health of the economy and system stability, it is unlikely that this result over such an extended period is due solely to chance, and more likely that sound prudential management has necessarily been present.

More generally AFMA's view is that APRA is a sound and effective regulator and, while we will in this submission recommend some fine tuning of its approaches in various areas, there is not a case for wholesale change.

Appropriately for a prudential regulator APRA has set a stable steady course that has created net benefit for the Australian economy. APRA is a strong, disciplined regulator

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<sup>1</sup> In the US failures of banks are commonplace and there have been only three years since the FDIC was founded in 1933 that there have been no bank failures. Between 2008 and 2018 there were 528 bank failures in the US which held a total of \$711 billion in assets.

<https://www.fdic.gov/bank/historical/bank/> see also

<https://www.dandodiary.com/2019/01/articles/failed-banks/heres-good-news-no-bank-failures/>

with high expectations of the industry, but one that exercises objective common sense to work with industry to find the most cost-effective solutions to its objectives.

APRA's general approach to its regulatory task results in good outcomes for Australia as a financial centre. Its regulatory responses are generally appropriately calibrated and pitched, are squarely aimed at improved regulatory outcomes and are appropriately motivated.

Generally, APRA avoids regulatory responses that damage the business environment and perceptions thereof, and seeks a balance that contributes to Australia's reputation as an attractive place to do business. Negative regulatory impacts to the business environment or perceptions around it can be economically costly both to the finance industry and the wider economy.

AFMA observes that the Twin Peaks model, and in particular the feature of the model of having separation between the conduct regulator and the prudential regulator as contributing to clarity of purpose for both regulators. In practice, it is very difficult for a single body to balance the often opposed demands of prudential (and systemic) stability with conduct regulation as has been demonstrated by experience in other jurisdictions.

These clear purposes can pursued independently by the separate regulators then be balanced through an external process in the Council of Financial Regulators.

While there was merit in leveraging APRA's capabilities in the implementation of BEAR given this ensured a relatively smooth implementation and provided confidence to Government and industry, more generally from a long term perspective the Government should take care to ensure APRA's prudential mandate remains uncompromised by a parallel conduct mandate. Aside from the inherent inefficiencies competing internal aims risk degrading the clarity of purpose and commitment that is required in a prudential regulator.

## **2.2. Regular Reviews**

### **Hayne Recommendation 6.13 – Regular capability reviews**

APRA and ASIC should each be subject to at least quadrennial capability reviews. A capability review should be undertaken for APRA as soon as is reasonably practicable. [Vol 1, p 41]

AFMA supports quadrennial capability reviews as suggested by Hayne. Regular reviews of the regulator performance against their mandates provide a mechanism to consider whether there are areas for enhancement and improvement which will ultimately produce better outcomes for the regulated community and general public.

AFMA also supports reporting on actions taken in line with annual Statements of Intent being included in the Annual Report, noting that some actions may need to remain confidential for an extended period of time.

These quadrennial major reviews could be supplemented in the Annual Report with a standardised annual program for Australian regulators of independently conducted surveys based on feedback from regulated entities and other relevant stakeholders on relevant criteria over the course of the year.

Given the substantial reporting obligations on APRA we are also of the view that it may be appropriate to consider the totality of APRA's reporting burden.

APRA reports on its website that it currently has many reporting oversights. Together with proposals in train these include:

- An Annual Report tabled in Parliament;
- Multiple Senate and House of Representative Committees each year;
- The Australian Government's Regulator Performance Framework;
- An annual Corporate Plan that looks forward four years;
- *Ad hoc* Australian National Audit Office (ANAO) performance reviews;
- Periodic FSB, IAIS and IMF assessments such as the FSAP;
- Regular Capability Reviews going forward; and
- Potentially reporting to the new oversight body to be created.

This is a substantial and potentially burdensome reporting program and is in addition to the load assumed by responding to *ad hoc* reviews such as the Productivity Commission Review into Competition in the Australian Financial System and the Hayne Royal Commission. In total these overlapping reviews place a substantial burden on APRA's resources outside of its core activities.

During and following the Royal Commission APRA's resources have been stretched and in a way for which it would have been difficult to plan. The Royal Commission's findings are expected to continue to place strain on APRA's resources for the next few years.

AFMA supports ensuring APRA's reporting commitments are manageable, rational and avoid duplication.

### **2.3. Strategy**

The Terms of Reference require the Review to consider whether APRA has a "well-considered and clear strategy that takes into account the future operating environment, effectively cascaded throughout the organisation".

AFMA's view is that APRA has benefited from sound leadership. As a result APRA's strategy as it impacts wholesale banking and financial markets has raised few concerns.

APRA's 2019 Policy Priorities paper which form part of its 12 to 18 month strategy reflects a full and appropriate agenda for the regulator. This initiative is a good regulatory practice.

Key areas of focus will include:

- Remuneration and non-financial risk management;
- Extension of the BEAR regime to insurance and superannuation;
- Basel III, related capital implementation work, related party exposures;

- Insurance related work;
- Prudential requirements for superannuation trustees; and
- Other prudential standard review and other matters.

The full agenda contains a range of matters relating to prudential strengthening, efficiency and competition as well as policy areas driven by external factors such as Basel III requirements, accounting standard changes, the Royal Commission and other drivers.

In addition to these policy priorities APRA is undertaking a comprehensive data collection update program and a cross-government Economic and Financial Statistics program that it is coordinating.

APRA's 2018 to 2022 Corporate Plan sets out its priority areas over the coming period with focuses on:

- Broadening risk-based supervision;
- Improving data-enabled decision-making;
- Building resolution capability;
- Strengthen external engagement and collaboration;
- Enhance leadership, people and culture; and
- Lift organisational capability.

The Corporate Plan reflects a good level of self-awareness on the part of APRA and is sensibly aligned with the directions the organisation should be headed.

## **2.4. Decision Making**

The Terms of Reference require the Review to consider whether APRA has a "decision-making that balances financial safety and financial stability, and considerations of efficiency, competition, contestability and competitive neutrality".

As noted in Section 1, we have reservations about the change in meaning that accompanies the rephrasing of the APRA Act's requirements. As such we base our assessment of the whole of APRA Act Section 8.

In relation to Section 8 (1) (a):

"The main purposes for which APRA exists are as follows:

- a) regulating bodies in the financial sector in accordance with other laws of the Commonwealth that provide for prudential regulation or for retirement income standards;"

As stated in section 2.1, the evidence is that APRA has achieved this primary goal.

In relation to Section 8 (1) (b) "administering the financial claims schemes provided for in the Banking Act 1959 and the Insurance Act 1973" we offer no comment, as this lies outside AFMA's main areas of expertise and insight.

In relation to Section 8 (1) (c) "developing the administrative practices and procedures to be applied in performing that regulatory role and administration", we find that broadly

APRA has applied appropriate practices and procedures in performing its regulatory role and administration.

In relation to Section 8 (2) “In performing and exercising its functions and powers, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, is to promote financial system stability in Australia.”

AFMA’s view is that APRA has appropriately balanced the objectives of financial safety and efficiency, competition, contestability, and competitive neutrality with its primary objective (under section 1(a)) of the implementation of prudential regulation.

AFMA is also of the view that in balancing the objectives APRA has had an appropriate overall focus on promoting financial system stability in Australia.

AFMA views it as important that APRA’s decision making has been based on the long-term through-the-cycle positioning and principles. Every position and policy adopted by APRA must be ready to stand downturns in the economic cycle.

Prudential security should not be taken for granted as it is relatively easy for well-intentioned policy prioritisations that in the near term are seen as expeditious and pragmatic to decay commitments to longer terms objectives such as prudential security.

In this regard, we note it is important that uncertainty is not created in relation to the Government’s expectations in regard to primary outcomes such as prudential regulation and systemic stability. Appropriately weighting non-primary priorities needs to involve careful calibration such that uncertainty is clearly and consistently avoided.

### **Consultation processes**

APRA has a clear commitment to consultation and engagement with the industry and its efforts in delivering effective engagement in this regard are to be commended.

AFMA has extensive experience with APRA’s consultation processes over an extended period of time. The types of engagement APRA uses to refine its policies, processes and systems includes formal consultations, informal consultations, regular and episodic dialogues, workshops, presentation at AFMA conferences and meetings, and high level liaison meetings.

AFMA’s experience of APRA consultations has found them to be thoughtful, properly structured and for the most part to result in substantive change where appropriate.

### *Timings*

APRA’s ability to consult is sometimes constrained by the timelines of government commitments. While recognising this, AFMA is keen to stress the benefits of standardised timeframes and responsiveness.

For consultation 3 months should be the standard period. While many consultations are for this period, we would support increased consistency in this regard.



Our preference is to ordinarily have at least 12 month implementation periods. This period should start only after regulatory guides are developed. FAQs can form an ongoing source of implementation information as implementation progresses but it is appropriate that the 12 months time period commences only once the major questions have been addressed.

In relation to CPS 234, the guidance (CPG 234) has recently been issued in draft while full compliance is required by 1 July. This type of timing has an impact on the industry's preparedness and ability to implement.

AFMA members also find where there are different exposure measures across prudential standards this can lead to an increased regulatory burden as exposures have to be captured multiple times across different customer subsets.

Where possible industry would prefer greater consistency in the timing of responses to matters raised. Firms submission of documents for review should be more consistently turned around in a reasonable timeframe. Some delays in relation to turn around times may be linked to resourcing pressures.

AFMA supports greater consistency in the amount of feedback provided following consultations, through its response papers. Information on the reasoning for APRA's positioning is important to assist the industry to understand the context of regulations and guidance, particularly where APRA has diverged from a common industry view.

#### *Good regulation practices*

While APRA's consultation practices meet a good standard in the context of Australian regulators (and in some cases such as the D2A replacement project are excellent) and comply with the Office of Best Practice Regulation guidelines with respect to regulatory cost/benefit analysis and Regulation Impact Statements there remains the opportunity for improvement and greater consistency.

In this regard we note two lines of enquiry that may be worth investigating.

The first is increased formalisation of good regulation principles internally at APRA. We note that some international regulators have clearly defined principles they adhere to in this regard and these principles are actively enforced internally by the regulator. Relevant to APRA in this regard might be the [ICSA Principles for Better Regulation](#) which are specific to financial regulation.

AFMA supports bringing in industry very early in the ideas stage before consultation or even concept papers are formed. Consultation processes that leave external engagement to consider a fully formed draft may have missed opportunities to avoid further regulation, or to approach the regulation in a different manner.

The second line of inquiry is to consider the work of Archon Fung in the influential 2006 article *Varieties of Participation in Complex Governance*<sup>2</sup>. Fung offers a taxonomy to assess the inclusiveness of consultation processes along three axes of a 'democracy cube'.

At present Australian regulatory processes tend to fall towards the left on Fung's axes.

Increasing the early, active and empowered participation in the regulatory process by the regulated community and broader public is likely to be associated with more democratic and supported, and likely to be of net benefit to the Australian economy.

#### *Surveys to support consistency*

There is not perfect consistency in the level of engagement by APRA in its consultations. From time to time some consultations are reported to fall short of APRA's high standards. To increase consistency the new oversight body should include processes that review the regulated community's view of both the quality of the consultation process and the regulatory outcome of those consultations (including aborted consultations). Such a process should be standardised across the different regulators.

To incentivise regulators appropriately and improve consultation processes it may be appropriate for the oversight body to publish reports on the outcomes of these surveys on a consultation basis.

#### **Local Adaptation of International Regulations**

Regulating for the local adoption of international standards is an important part of APRA's responsibilities. Australia is a responsible international player and understandably disposed towards full and prompt adoption of these standards.

It is important to note that there can be real competitive costs to be borne by the economies of jurisdictions that are too far out in front in adopting these standards. Australian firms, while they are keen for the local regulatory environment to meet or be comparable to international standards, should not be disadvantaged by the implementation of international standards.

Some of these international standards such as the Basel rules do allow national regulator discretion in their application. Better use of these discretions in relation to the tailoring of rules and timeframes to suit domestic conditions, risks and priorities could be of direct benefit to the local implementation.

APRA, working with the RBA, needs to ensure it has a wide perspective that takes in the entire financial system that includes the financial markets, when it considers local implementation of international measures. Measures aimed at bank prudential

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<sup>2</sup> Fung, Archon (2006), 'Varieties of participation in complex governance', *Public Administration Review*, 66 (S1), 66–75. <http://faculty.fiu.edu/~revellk/pad3003/Fung.pdf> Revisited in 2015 in Fung, Archon. "Putting the Public Back into Governance: The Challenges of Citizen Participation and Its Future." *Public Administration Review* 75.4 (July/August 2015): 513–522. <http://archonfung.net/docs/articles/2015/Fung.PAR2015.pdf>

requirements can have direct and negative impacts on financial markets. A careful consideration of the potential for these interactions could lead to mitigation or staging measures.

## **2.5. Culture**

The Terms of Reference require the Review to consider whether APRA has a “Culture that supports supervisory and enforcement actions in support of strategic objectives”.

AFMA has only an external view of APRA’s culture as expressed through APRA’s external interactions. This limitation noted, we find APRA externally expresses a positive constructive culture that is appropriately aligned with its strategic objectives.

We understand a number of regulators in countries with well-developed regulatory structures have undertaken their own internal risk culture assessments as part of the OECD Regulatory Review and G20 Governance and Culture initiatives<sup>3</sup>. Such culture reviews can be an aid to developing internal cultures and may be of assistance to APRA.

## **2.6. Internal Governance**

The Terms of Reference require the Review to consider whether APRA has “Robust internal governance arrangements, supported by fit-for-purpose internal reporting, performance monitoring and audit and assurance activities”.

AFMA has very limited visibility of APRA’s internal governance and so offers no comment.

## **2.7. Resourcing**

The Terms of Reference require the Review to consider whether APRA has “appropriate resource allocation, responsive to emerging issues, and has efficient utilisation staff with necessary expertise (e.g. industry, technical and data analytics) supported by appropriate tools”.

Generally, we find APRA’s resourcing to be of high calibre and with skill-sets appropriate to their roles. These resources are appropriately allocated to emerging issues.

Where there are highly technical and specialised policy areas (e.g. IFRS / accounting standards, market risk derivatives, counterparty credit risk) capacity with the requisite expertise can be more limited. While existing teams are well qualified and experienced APRA may find benefit in increasing the resources it has with these skill sets to ensure the current high standards are maintained.

Where additional capacity is needed such as in the Government’s relatively rapid program for the Bank Executive Accountability Regime (BEAR) regime, this can take time for APRA

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<sup>3</sup> See for example the speech and presentation by Melanie De Waal, DNB, at the Culture & Governance in Financial services Conference 13-15 November 2018.

to acquire, although it is acknowledged that the resource market is not deep and there is competition for the same resources from industry.

APRA has recently undertaken high quality leading work on information security, while not a new area for APRA, the inclusion of information security within a new prudential standard is a significant step forward in the integration of it into the prudential framework. This area of increased focus, and others like it including conduct, remuneration, culture and governance, will likely require increased resourcing particularly in light of the need to ensure staffing levels in highly technical areas are appropriate.

AFMA recommends that where APRA requires deep technical knowledge in specialised areas and where APRA is expanding its development of areas such as information security measures are taken to ensure APRA has optimal resourcing.

## **2.8. Regulatory Coordination**

The Terms of Reference require the Review to consider whether APRA has “appropriate engagement with Australian financial sector regulators, including suitable information sharing arrangements.”

There may be room to further build the information sharing connections within APRA itself and between APRA and some other regulators.

As an example, closely following the release of the information security standard CPS 234 the ACCC announced it planned to release its own information security standard based on but slightly different to CPS 234. The financial sector should have a single regulatory requirement for information security and greater regulatory cooperation should drive this outcome. Greater leadership of other regulators by APRA and potentially the Council of Financial Regulators could help avoid duplicative and inconsistent outcomes, by other regulators.

We do note that in relation to the Economic and Financial Statistics (EFS) project APRA has provided leadership across the other agencies and this is allowing it to resolve issues increasingly rapidly as the project progressed. APRA’s engagement on EFS has been comprehensive and appreciated by the industry. Ultimately it has enabled the resolution of various issues in time for the transition.

In relation to Hayne Recommendation 6.6 – Joint administration of the BEAR

ASIC and APRA should jointly administer the BEAR. ASIC should be charged with overseeing those parts of Divisions 1, 2 and 3 of Part IIAA of the Banking Act that concern consumer protection and market conduct matters. APRA should be charged with overseeing the prudential aspects of Part IIAA [Vol 1, p 39].

AFMA supports this proposal as an appropriate division of responsibilities between the two regulators. Given the potential for overlap and coverage gaps careful division of responsibilities and further clarity on the division is appropriate.

## **2.9. Statutory powers**

The Terms of Reference require the Review to consider whether APRA has “fit-for-purpose statutory powers”.

AFMA’s view is that APRA’s statutory framework is appropriate and well-functioning. We see no evidence to suggest an improper balance of regulatory powers.

## **2.10. Future Challenges**

Government policy is driving a number of trends including an increase in the number of smaller banks. In addition, capital and other bank supervision reforms may lead to a greater amount of non-ADI financing, colloquially known as “shadow banking”, over time.

These are likely to present different challenges for APRA.

As non-ADI financing has been growing it will be increasingly important to ensure banks do not face undue regulatory burdens relative to non-ADI financing. AFMA views it as appropriate that APRA works to ensure competitive neutrality of regulatory measures for ADIs with non-ADI entities.

In relation to small banks, APRA has extensive experience dealing with smaller entities and their differences in operational scale and capacity, and is well-placed to pursue and keep as central its core mandate.

Information security is a growing challenge for the financial sector and for APRA. While APRA has progressed important initiatives recently to assist in the response to the challenges we would expect information security to continue to be a key challenge for APRA in the future.

## **3. Conclusion**

APRA appears to be a well-functioning regulator with a sound track record for appropriate regulatory responses. APRA has achieved its core objectives in part due to stable and effective leadership and an appropriate strategy to support its mandate.