

10 April 2019

APRA Capability Review Secretariat
The Treasury
Langton Crescent
PARKES ACT 2600

Via email: apracapabilityreview@treasury.gov.au

Dear APRA Capability Review Secretariat

2019 APRA Capability Review

Thank you for the opportunity to provide feedback to the APRA Capability Review.

The Australian Institute of Company Directors (**AICD**) has a membership of more than 43,000 including directors and senior leaders from business, government and the not-for-profit sectors. The mission of the AICD is to be the independent and trusted voice of governance, building the capability of a community of leaders for the benefit of society.

1. Executive summary

Overall, the AICD considers that APRA is a highly effective prudential regulator that successfully promotes financial system stability in Australia. A key component of APRA's effectiveness is the constructive and open relationship it maintains with regulated entities.

However, we recognise that the Royal Commission into the Banking, Superannuation and Financial Services Industry (**Royal Commission**), in bringing to light instances of systemic and widespread misconduct, has made it clear that shifts need to occur within our financial sector regulators (including, potentially, internal governance arrangements) to more effectively address issues as they arise, in a more timely manner. Certainly, as Commissioner Hayne recognised in his final report, primary responsibility for misconduct in the financial services industry lies with the entities concerned, and their boards and senior management. However, the regulators play an important role in deterring misconduct and ensuring appropriate accountability.

In particular, the AICD agrees that there needs to be greater focus on governance, culture, remuneration, as well as oversight of non-financial risk, through a prudential lens. However, as a general rule, we strongly believe that a principles-based rather than prescriptive approach to these issues remains appropriate.

Our comments in this submission have been confined to broader regulatory and governance issues raised by the Terms of Reference.

2. APRA's mandate

We note that section 8(2) of the Australian Prudential Regulation Authority Act 1998 (APRA Act) provides that "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, to promote financial system stability in Australia”.

In AICD’s responses to the Royal Commission, we acknowledged that APRA’s prudential focus, and its core objective of promoting financial system stability, means that its regulatory scope is necessarily limited.

Overall, the AICD considers that APRA is a highly effective prudential regulator that successfully fulfils its core objective. This was most recently reflected in the IMF’s Financial Sector Assessment Program report on Australia published in February 2019, which concluded that the Australian financial system has been further strengthened since their last assessment in 2012.

However, it would be beneficial as part of the current review to reflect on the way in which the various considerations that APRA is required to balance under the APRA Act are taken into account in decision-making, and whether an appropriate balance is being struck. In particular, concerns have been raised by some AICD members that due consideration is not being given to issues of competition and competitive neutrality – that is, the impact which regulatory action or standards may have upon different market segments within an industry (for example, the impact of regulation and compliance on competition in the retail banking sector given implications for smaller banks, and the implications of credit growth restrictions). Greater transparency regarding how APRA balances issues of competition in setting and enforcing standards may assist.

3. APRA’s approach to enforcement, and relationships with regulated entities

One of APRA’s strengths – which contributes to its effectiveness as a prudential regulator - is the open and constructive relationship it maintains with regulated entities. This facilitates honest and timely discussions about important matters. It also supports APRA’s approach to supervision, and reliance on suasion to influence outcomes.

In terms of enforcement more generally, we acknowledge that there are significant limitations with court-based enforcement work in the context of prudential regulation, which requires efforts to be front-end focused to avoid issues crystallising. We note, however, that APRA has a range of tools in its toolkit that sit between suasion and litigation, and should be willing and resourced to use them when needed (for example, imposing license conditions or directions). We also suggest that APRA should more readily escalate matters, including to the boards of organisations, when dealing with uncooperative entities. The AICD acknowledges that, in some circumstances, litigation may be necessary in order to achieve both general and specific deterrence. We expect that these matters will be addressed through APRA’s recently completed internal enforcement review.

4. Governance, culture and remuneration

The AICD recognises that governance, culture and remuneration, as well as management and oversight of non-financial risk, have a prudential dimension, and agrees that there needs to be a greater focus on these issues going forward, especially in light of the Royal Commission’s findings. We note that APRA’S recently released policy priorities for 2019 confirm that strengthening the prudential framework to lift the bar for industry in terms of governance, remuneration practices and the management of non-financial risks will be an ongoing focus. Of course, these matters are primarily for entities themselves to address, and the AICD is also focusing on ways in which we can support members through additional resources and guidance.

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We strongly recommend that APRA engage closely with relevant stakeholders when considering its approach to these issues – not just when revising relevant prudential standards but more broadly – to ensure that different perspectives, including those of various industry participants, is appropriately understood and considered.

It will also be important to ensure that internal teams are sufficiently resourced. Accordingly, it was pleasing to note the additional funding allocated to APRA in the 2019 Federal Budget which will support recruitment of additional employees with deep skills and experience in the relevant areas, including from within industry. It is essential that appropriate resourcing continues.

In terms of APRA's prudential standards, the AICD believes that ordinarily it is not appropriate to prescribe governance practices, although we note the approach taken in Prudential Standard CPS 510 Governance to set out minimum foundations for good governance of an APRA-regulated institution. We have consistently expressed the view that it is almost always preferable to adopt an approach which is flexible and principles-based, similar to the ASX Corporate Governance Council Principles and Recommendations, so that boards can adapt governance practices to suit their organisation's circumstances and operating systems rather than adopting a "tick the box" approach. As noted by APRA in its aid for directors of ADIs and insurers, "APRA's approach to supervision is built on the premise that the board and management of an APRA-regulated entity are primarily responsible for the entity's financial soundness and prudent risk management".

It will also be crucial that any new or revised prudential standards on governance, culture or remuneration do not blur the important distinction between the board and management. As Commissioner Hayne recognised in his final report, "the task of the board is overall superintendence of the company, not its day-to-day management".

We hold a similar same view with respect to remuneration frameworks and structures. The AICD strongly supports a principles-based approach to remuneration guidance rather than a prescriptive approach. In the same way as there is no "one-size fits all" approach to governance arrangements, so too must remuneration structures be tailored to each organisation and sector (with corporate strategy being a key consideration). However, given the Royal Commission final report highlighted the dynamic relationship between governance, culture and remuneration, clearly there is a need for more guidance to industry in order to minimise the risk of poor regulatory and customer outcomes, to better align with community expectations. The challenge will be for APRA to strike an appropriate balance between detailed guidance and a principles-based approach.

For completeness, we note that we have stated that we see merit in a more prescriptive approach to some aspects of superannuation governance, given the unique nature of the superannuation sector¹. More generally, more robust oversight of RSE licensees will be beneficial going forward. We note that APRA's policy priorities for 2019 indicate that APRA will have a strong focus on heightened expectations for fund and trustee performance.

We also note that, given its close engagement with a wide cross-section of entities, APRA is in a unique position to observe and reflect on what constitutes "good practice" in terms of governance, and can assist the regulated population by publicly sharing these insights.

¹ AICD Submission to the Royal Commission on Round 5 Closing Submissions, 21 September 2018. We also note the comment in Wayne Byres' speech to the Australian Financial Review Banking and Wealth Summit in relation to the self-assessment undertaken by certain APRA regulated entities against the key findings of the CBA Inquiry that 'superannuation trustees tended to utilise a 'lighter touch' process, often justified on the basis that the problems in CBA couldn't apply to them. Given one of the core CBA findings that success 'dulls the sense'...I'd urge some caution against that conclusion': <https://www.apra.gov.au/media-centre/speeches/building-resilience-three-dimensions>.

These insights are valuable to the industry and can assist to lift standards across sectors. This should be achieved without unduly prescribing governance practices or structures. For example, the Inquiry into CBA was a valuable exercise, and the publicly available report provided many learnings for companies both within and outside the financial services industry. Similarly, we support the public release of a thematic report on the self-assessments completed by certain financial services industries, and encourage ongoing transparency in relation to important governance insights.

All that said, if guidance or standards are to become increasingly prescriptive, an important consideration is whether the relevant requirement/s are more appropriately dealt with in legislation through the parliamentary process.

5. Co-ordination between ASIC and APRA

Clearly, there will need to be a greater level of co-ordination and information sharing between ASIC and APRA going forward (particularly in the context of co-administration of the Banking Executive Accountability Regime) and to the extent that there are any legislative barriers to information sharing, these should be resolved by the government.

It is important that the parameters of the relationship between the regulators – including any agreements in terms of approach to information sharing – are transparent and well understood. While the AICD recognises and supports the need for greater co-ordination between the regulators, the importance of maintaining APRA's constructive relationships with regulated entities should be taken into account when formulating arrangements.

More broadly, it is essential that ASIC and APRA co-ordinate effectively in relation to supervisory work and initiatives. Given the heightened scrutiny of regulated entities by both regulators, and the new supervisory initiatives being undertaken by ASIC (being the ASIC Corporate Governance Taskforce and the Close and Continuous Monitoring program), there is a risk of duplication and unnecessary drain on both company and regulator resources unless there is effective communication and co-ordination between ASIC and APRA. In practice, this would extend to, for example, alignment in terms of engagement planning (including with boards) and the scope of documents and data-sets requested in order to avoid unnecessary overlap and distraction.

6. Governance of APRA

We note that Commissioner Hayne suggested in his final report that the appointment of non-executive directors may be an issue for consideration in a capability review. The AICD believes that having a board with a majority of non-executive directors would strengthen oversight, objectivity and independent thinking, and bring external perspectives to APRA – all objectives that APRA itself considers to be important, including in its prudential standards.

From an international perspective, there are a number of examples of regulators with board structures in place, including the Financial Conduct Authority and the Financial Reporting Council in the UK and the Financial Markets Authority in New Zealand. A recent report on oversight of regulators, "Who Guards the Guards" prepared by The New Zealand Initiative in 2018, points to evidence that suggests that the model creates better internal checks and balances on regulatory decision-making than alternative governance models².

² Roger Partridge and Amy Thomasson, "Who Guards the Guards?: Regulatory Governance in New Zealand", The New Zealand Initiative, 2018.

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The challenge will be finding individuals with the requisite knowledge and experience to provide effective oversight, at the same time as avoiding any material conflicts of interest arising from other board positions.

At a political level, the AICD believes it is important that APRA's role is well understood, and government's expectations clearly articulated. We note that the Statement of Expectations (SOE) issued in respect of APRA has been infrequently updated (the government has recently released an amended SOE in relation to APRA in 2018. Prior to this, the SOE was revised in 2014 and 2007 – despite the Uhrig Review contemplating a review on an annual basis, or more regularly where appropriate)³. A more frequent review of the relevant SOE, and consequently the Statement of Intent issued by APRA in response, could assist in ensuring that the role and mandate of the regulator are clear, and in addressing any issues as they arise.

7. Next steps

We hope our comments will be of assistance. If you would like to discuss any aspect of this letter, please contact Christian Gergis, Head of Policy at cgergis@aicd.com.au or Sally Linwood, Senior Policy Adviser at slinwood@aicd.com.au.

Yours sincerely



LOUISE PETSCHLER
General Manager, Advocacy

³ John Uhrig, Review of the Corporate Governance of Statutory Authorities and Office Holders (Commonwealth of Australia), 2003.