

Royal Commission on Misconduct in the Banking, Superannuation and Financial Services Industry and the Financial Sector Assessment Program assessment of Australia

External oversight and accountability of APRA and ASIC

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Objective

The objective of this paper is to analyse and compare the findings and policy recommendations of the Royal Commission ² (RC) and the International Monetary Fund's (IMF) Financial Sector Assessment Program (FSAP) assessment of Australia. In this context, it focusses on internal and external oversight of financial regulators, where the FSAP and the RC take divergent views. It highlights the key issues arising and makes recommendations to address them.

Introduction

The RC and the FSAP are both independent reviews of aspects of the Australian financial sector, yet they take very different perspectives. The daily hearings of the RC were great spectacles with apparent conflict of interests and significant incidents of poor market conduct. The publication of the Australian FSAP, only three weeks after the RC's report, on the other hand, attracted relatively little news media attention or market commentary.

The FSAP³ is a comprehensive and in-depth analysis of the stability of a country's financial system and compliance with international standards on financial sector regulation. FSAPs are designed to help countries identify key sources of systemic risk in the financial sector and implement policies to enhance their resilience to shocks and contagion. The most comprehensive and relevant output of the Australian FSAP for this paper are the Technical Note on insurance supervision and the Basel Core Principles (BCP) assessment of banking supervision arrangements. The latter is the international minimum standard for sound prudential regulation and supervision of banks and banking systems.⁴ The superannuation sector was an important part of the RC's work, but the FSAP's attention to super was negligible, probably reflecting the lower risk of contagion arising from defined contribution schemes. In this context, the main differences between the FSAP and the RC are outlined in Annex I.

¹ This paper's findings, interpretations, and conclusions are entirely those of the author and do not purport to represent the views of the World Bank, its Executive Directors, or the countries they represent.

² The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry

³ FSAPs are a joint responsibility of the IMF and the World Bank in developing economies and emerging markets and of the IMF alone in advanced economies, such as Australia.

⁴ The BCP assessment addresses only APRA's role and performance but has some references to ASIC, mainly in the area of regulatory cooperation. In general, however, the BCP findings in the area of external oversight are applicable to both APRA and ASIC, as their external oversight arrangements are similar.

The RC and the FSAP: benchmark and findings

1. *Benchmark*

The FSAP's benchmarks are comprehensive, detailed and granular international minimum standards, supplemented by documented guidance and good practices. The RC's benchmarks, on the other hand, are vaguely defined "community standards and expectations". The RC identified six high-level norms of good behaviour, but these were not designed to measure the effectiveness and ability of regulators, so it selectively resorted to alternative benchmarks, such as international standards, peer regulators' practices and occasionally the *Banking Act 1959* (Banking Act).

The only area however where the RC explicitly refers to international standards⁵ is the chapter on culture, governance and remuneration. The RC finds that APRA's supervision has been focused too much on financial soundness and stability. It cites from multiple Financial Stability Board (FSB) papers to underscore this message.

The way these international standards are used by the RC, however, is conceptually flawed. One cannot use an FSB standard, much less a G30⁶ report, as a benchmark to assess if the regulator's lens has been too narrow. Ultimately, it is the law, the APRA Act and ASIC Act in this case, as well as the respective Statements of Expectations and Statements of Intent that set the regulatory perimeter for each regulatory authority. Unfortunately, the language in these documents does not provide sufficient guidance. It remains unclear why the RC did not recommend these to be clarified.

FSB standards or guidance papers are not binding, but as a member jurisdiction, Australia is inevitably under a degree of peer pressure to broadly adhere to standards or guidance issued by the FSB. Even though regulation in Australia has been closely aligned with international standards, there have been sound reasons to deviate from them in some cases⁷.

2. *Findings*

Broadly speaking, the findings of the FSAP and the RC are aligned in four overlapping areas: culture, remuneration and governance in the banking sector; regulatory cooperation; enforcement; and accountability, governance and external oversight of regulators (see Annex II for a detailed assessment), except for the internal and external oversight of regulators where they take a divergent view. The remainder of this paper will focus on this topic of accountability, governance and external oversight of regulators.

⁵ Transcript, Byres, page starting from pg. 7936 for FSB and pg. 7432 for G30 and multiple references in the Report

⁶ The G30 is a grouping of private and public sector persons, not endorsed by a Government. They are not even a standard setter.

⁷ Such as with the modified application of Liquidity Coverage Ratio (LCR) requirements for banks by allowing banks' capacity to access RBA liquidity via repo facilities to count towards their liquidity buffers

a. Internal and external oversight of regulators

Like any institution, regulators need internal governance processes and arrangements that enable timely decisions to be made at the appropriate level. The RC refers to this as “accountability”⁸ but I will use the term “internal oversight”.

Regulators are agents of the government and ultimately the public. They must be able to resist political and industry interference and pursue their statutory mandates with objectivity. International standards set specific criteria to determine operational and financial independence of regulators⁹. Typically, these refer to transparent processes for appointment and dismissal of senior staff, stable sources of agency funding and adequate legal protection for staff. Without proper safeguards for independence, political and industry interference in prudential and market conduct regulation and supervision is a potentially significant risk. It can occur by reducing funding to decrease a government deficit, by de-regulating or weakening credit underwriting standards to boost growth or by appointing a political ally as head of the agency. This results in short-term political successes at the expense of long-term financial stability.

To put checks and balances on their independence, regulators must be accountable, or in terms of the RC, subject to external oversight. This means they are able to ‘explain and justify’ to external stakeholders, such as the government, the parliament and the public how their actions have contributed to accomplishing their mandate. External oversight and transparency are thus the flipside of independence; the more independent an authority, the stronger the external oversight requirements should be. Still, when it comes to external oversight, more is not necessarily better and, as explained below, trade-offs between independence, expertise and efficiency need to be made.

b. Internal oversight

FSAP findings

The Australian FSAP finds strong internal governance to support timely decision-making at APRA.¹⁰ It does not make any recommendations to strengthen internal oversight.

RC findings and recommendations

The starting point of the RC to identify the need to strengthen the internal oversight of the regulators is the Bank Executive Accountability Regime (BEAR)¹¹. The RC’s reasoning goes as

⁸ The RC uses the terms ‘accountability’ and ‘external oversight’ in a different way than the international standards. When the RC uses the term ‘accountability’ it refers to matters of internal oversight and sound governance. When the RC uses the term ‘external oversight’, it refers to the concept of (external) accountability in international standards. To avoid confusion, I will use the terms internal and external oversight in this paper.

⁹ Core Principles for Effective Banking Supervision, Principle 2 “Independence, accountability, resources and legal protection for supervisors.”

¹⁰ BCP, page 57, paragraph 3. No detailed assessment for ASIC internal oversight is available.

¹¹ The Banking Executive Accountability Regime (BEAR) as set out in Part IIAA of the Banking Act 1959 establishes accountability obligations for authorised deposit taking institutions (ADIs) and their senior executives and directors. The regime also establishes, among other things, deferred remuneration, key personnel and notification obligations for ADIs.

follows: the concept of risk culture applies to a statutory authority just as much as it does to a financial services entity. This statement is then illustrated by the adoption of the Senior Managers Regime¹² by the two UK twin peak regulators - the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA). In this respect, mention is made of “hypocritical risk” or the regulator expecting “something” of the regulated community, but not holding itself to that standard. This then results in the recommendation to apply “the core tenets of the BEAR” to APRA’s and ASIC’s management and internal arrangements.

Discussion

There are some important observations to be made in regard to the RC’s thinking as laid out above. First, the drafting of accountability maps and statements is presented as a noble initiative of the FCA and PRA; an illustration of how regulators should aspire to hold themselves to the same standard as the entities they regulate. In reality, this was imposed on the FCA and PRA after an official enquiry into a serious incident as described in Annex III. No incident of this nature and impact has occurred with APRA or ASIC, and the FSAP found that APRA’s internal processes are adequate.

Second, there is simply no such concept of “hypocritical risk” or the requirement for regulators to hold themselves to the same standard as their regulated industry enshrined in international standards or practice. Upholding this principle would not only create an outright conflict of interest¹³, as the regulator would be setting its own regulations and standards, but also an ongoing incentive for lax regulation and a risk of continuous challenge by the industry on the interpretation of regulatory principles by benchmarking itself against the regulator. In fact, the RC was not guided by this concept in the other sections of the Report. A consistent application of the notion of “hypocritical risk”, for example, should have resulted in an unambiguous recommendation of requiring independent non-executive directors appointed to APRA’s and ASIC boards.¹⁴

Given the material differences between the operations and risks of banks and other financial institutions, on the one hand, and the business of regulators, on the other, financial sector legislation and standards, like the BEAR, are not “fit for purpose” for regulators. Still, regulators should “practice as they preach” and the drafting of clear accountability statements and maps is good governance, increases transparency and can prevent incidents such as those that took place in the UK. Yet, there are much better suited international standards, principles and good practices, such as the IMF Code of Good Practices on Transparency in Monetary and Financial Policies and the work done by the Central Bank Governance forum at the Bank for International Settlements (BIS) to draw from, rather than applying the nebulous concept of the “core tenets of the BEAR” to APRA and ASIC.

¹² The Senior Managers Regime is a part of UK financial regulation aimed at increasing personal accountability of senior executives in the financial services industry. It came into effect in March 2016.

¹³ In case the supervisor has regulatory powers.

¹⁴ Final Report, page 467 and page 468, where the RC argues against including independent directors to APRA’s and ASIC boards.

c. External oversight

FSAP findings and recommendations

The Australian FSAP states that APRA is “subject to a strong accountability framework to parliament, the government and the general public”¹⁵. There are no specific shortcomings noted when assessing APRA against international standards for accountability or external oversight¹⁶.

That said, the FSAP assessors observe significant weaknesses in APRA’s independence and conclude that APRA is “materially non-compliant” with international standards. There are four reasons for this downgrade. First, the right of Parliament to disallow APRA’s prudential standards; second, the right of the Minister to give written directions to APRA, third, a budgeting process that does not offer a reasonable level of flexibility and autonomy for APRA to set objectives and implement them in a reliable way; and finally, the limitations resulting from the Australian Public Service (APS) Workplace Bargaining Policy which may result in difficulties recruiting and retaining high quality staff with highly specialized skills¹⁷.

On the observed weaknesses of APRA’s independence, the government responded that these are fundamental aspects of Australia’s parliamentary system predicated on ‘checks and balances’, whereby government agencies are accountable to the executive and the parliament, which is ultimately responsible to the public. It states that these mechanisms are required to promote confidence in the financial system.¹⁸ That may well be true, but prudential supervisors in Canada (IMF, 2014), the Euro Zone (IMF, 2018), Germany (IMF, 2016), Japan (IMF, 2017) and the UK (IMF, 2015) as well as the US (IMF, 2015) are also accountable to their executive and parliament. Unlike APRA, every single one of them complies, or largely complies, with the international minimum standard on independence and accountability. Accordingly, there is substance to the IMF’s conclusions in respect of a lack of independence for APRA, and similar points can be made in respect of ASIC.

RC findings and recommendations

The RC recommends establishing a new oversight authority¹⁹ to assess the effectiveness of APRA and ASIC in discharging their functions and meeting their statutory objectives. It justifies

¹⁵ IMF, Page 57, paragraph 3 of BCP assessment

¹⁶ This assessment is in the BCP assessment and thus only applies to APRA. A more comprehensive assessment against the IMF Code of Good Practices on Transparency in Monetary and Financial Policies: Declaration of Principles was not part of the FSAP. This could be applied to APRA, ASIC, AUSTRAC and the RBA.

¹⁷ On 17 July 2019, the Government released the APRA capability review. It recommended that the Government should remove APRA from the application of the APS Workplace Bargaining Policy and for APRA to engage with the Government to consider ways to enable greater variation in remuneration levels (Recommendation 2.5)

¹⁸ BCP, page 280, paragraph 82

¹⁹ The Murray Inquiry already recommended that a Financial Regulator Assessment Board (FRAB) be established to undertake “annual ex post reviews of overall regulator performance against their mandate”. The recommendation was not accepted by the Government at the time. The powers of FRAB however were significantly more limited than the RC

this by stating that “the current accountability framework is heavily focused on governance and financial accountability but lacks a regular and systematic review of how well either regulator discharges its statutory functions and exercises its statutory powers.” Suitably, this oversight body’s role will be analogous to that of APRA under the current BEAR regime. Accountability maps for APRA and ASIC executives should thus be lodged with the oversight body and the authority should superintend compliance with the BEAR regime. The RC further recommends that the oversight body be constituted by three part-time members, supported by permanent staff capable of advancing the work of the authority on a day-to-day basis. Additionally, the legislation should empower the new authority to conduct inspections of ASIC or APRA at times and in ways of its choosing, to issue a notice to either regulator requiring it to produce documents or provide information in any form, and to issue directions to either regulator in connection with the adoption and implementation of the BEAR principles. Finally, the RC recommends that quadrennial capability reviews will need to be performed by the oversight authority.

Discussion

The RC found a low enforcement appetite with ASIC²⁰ and a narrow focus on financial risk by APRA. In responding to this finding, the RC again uses language of the BEAR by (correctly) stating that “the concept of risk culture is as applicable to a statutory authority as it is to a financial services entity”.²¹ Yet, the RC does not follow through on this statement. Nowhere does it recommend an assessment of the regulators’ culture or behaviour, or a means to find the root causes. Instead, the RC addresses the symptoms rather than the root causes when concluding that a “bigger stick”, or an external oversight body, is required.

The BEAR has deferred remuneration provisions because behaviour in financial institutions is driven by variable performance-based remuneration. Applying these provisions to regulators is neither feasible nor relevant, but there are of course other incentives driving regulators’ behaviour. Low enforcement appetite can have many, often complex and deep-seated causes, including: industry capture; lack of resources; inappropriate resources or limited legal powers; and poor outcomes from experience, to name only a few. Regulatory behaviour is largely driven by statutory mandate (appropriately) and (much less appropriately) the desire to protect careers and promotions. There is literature and ample country evidence of industry, political and self-capture by regulators resulting in opportunistic behaviour like lax regulation, poor enforcement and forbearance (Schueler, 2003 and Dijkstra ,2010).

In the RC’s work, some obvious root causes could at least have been explored. Some readily observable candidates are: the use, and the increasing occurrences of non-extension, of term appointments for senior regulatory executives, which potentially increases the risk of industry capture; and capped salaries, that could potentially make supervisors particularly keen for

recommendations (no permanent staff, no directions power, no assessments of individual transactions, enforcement actions and individual complaints, no financial system regulation policy matters)

²⁰ The RC did make some observations on APRA’s enforcement appetite in the Interim Report, but no recommendations were included in the Final Report. Following the publication of the Final Report, APRA published its Enforcement Strategy Review. The FSAP rated Principle 11 of ‘Corrective and sanctioning powers of supervisors’ as ‘compliant’ but made good practice recommendations for quicker escalation and more active use of formal enforcement powers.

²¹ RC Final report, page 469

good relations with the industry and to actively seek promotions. Hence, they might be more inclined to supplement their work-portfolio with more visible project work. There is a risk this happens at the expense of ongoing supervision activities, thus leading to slow and weak enforcement. Furthermore, the regular published stakeholder satisfaction surveys as part of the current accountability arrangements do not particularly encourage regulators to take firm supervisory and enforcement stances. This list is far from complete and by no way a deep analysis, but it's an illustration of what a root cause analysis might start to look like.

It goes without saying that regulators should be subject to external oversight. A large corpus of international standards and good international practices, as well as a long list of academic literature, are available on the topic.²² The RC's recommendation, for example, of capability reviews of regulators, is good practice and, in the case of APRA (and other regulators), long overdue²³.

Remarkably, the RC chose not to refer to these international standards and practices, or even any other benchmark or international peer practice, in this section of the report. Instead, it recommended the creation of a new oversight body with powers to give directions and do inspections at times and in ways of its choosing. There are significant risks and observations that come with the proposed arrangements which the RC did not reflect on.

First, the power to give directions and to undertake inspections at will opens the door to reverse regulatory and supervisory decisions, to remove regulators from office, and to impose sanctions like the BEAR. Regulators are chosen because of their expertise, sound judgement and political and industry independence. It is a slippery slope to then give power to a body and to persons who do not necessarily have the same degree of expertise and political independence to override those decisions or decide on the career of key regulatory decision makers. It undermines the very expertise and the independence regulators were selected for (Bird, 2011). Prudential supervision is not an exact science; supervisory intensity is risk-based, regulation is principles-based and there are resource constraints which constantly require priorities to be juggled. The risk of an external body second-guessing decisions with the benefit of hindsight can affect the resolve and weaken the authority of the regulator towards the industry. Applying this to regulators that already lag their international peers on independence and resources only further increases the risks.

Second, Australian financial regulators' accountability requirements are complex and have evolved in a piecemeal way. A range of bodies carries out narrow rather than overall performance assessments²⁴. Adding an additional accountability mechanism to an already long list of existing, including some non-effective²⁵, mechanisms, comes with efficiency losses. Dealing with an oversight body, particularly with permanent staff, requires time and attention of senior decision makers, which cannot be dedicated to the core task of supervision.

²² For example, Basel Committee (2012), Basel Committee (2015), Quintyn, Ramirez & Taylor (2007), Bird (2011), D'Hulster & Unsal (2019)

²³ A capability review of ASIC was performed in December 2015.

²⁴ A list of the accountability requirements is listed in Annex III.

²⁵ See Byres Witness Statement, page 27, paragraph 116. Questions on the Annual Report, the Corporate Plan and the assessment against the Regulator Performance Framework are rare.

Third, it raises the fundamental question of to whom, and how, the oversight body will be accountable, 'justify and explain' its actions and how it will be funded.

Fourth, a potential conflict of interest could arise in an oversight body that is empowered to require particular changes in a regulator's governance and behaviour, as well as to undertake performance assessments (where the latter would entail subsequent assessments of matters that had been implemented by the oversight body's directions).

Finally, while clearly outside of the mandate of the RC, the recommendations on external oversight of regulators call on the government to further reflect on the ambit of this new arrangement. There do not appear to be many sound arguments why only ASIC and APRA are to be singled out by the legislator and placed under an oversight body. The RBA's Payments System Board as well as AUSTRAC, an agency that has a significant impact on the financial sector but is outside of the Treasury portfolio, should also be included.

Conclusions

The legal approach of a RC has proven well suited for identifying violations of laws, regulations and norms *ex post*. It is less well suited for making policy recommendations in an area as complex, globally-benchmarked and continuously evolving as the financial sector. The RC's vague benchmark for assessing the effectiveness of regulators has resulted in a "pick and choose an international standard" approach and the application of ill-suited laws, such as the BEAR, to regulators. Add considerable time pressure, as well as a restricted mandate to this mix, and it becomes a recipe for rushed policy making by the government in response to the RC's recommendations.

The RC's findings and recommendations in relation to the external oversight arrangements for financial sector regulators warrant careful consideration to ensure that they are actioned in a responsible manner, and that conflicts of interest and impediments to regulatory independence are avoided. In this respect, there are four important conclusions and recommendations that can be made:

First, a rigorous assessment, including international benchmarking of the Australian financial sector regulators (APRA, ASIC, AUSTRAC and the RBA) in respect of their internal and external oversight and independence should be performed. The objective should be the establishment of a consistent set of requirements and standards for all financial sector regulators and to bring them at least on par with their international peers in the area of independence.

Second, a holistic review and streamlining of the regulators' existing external oversight mechanisms and the development of a range of more meaningful regulators' performance indicators and mechanisms is required. This task should cover APRA, ASIC, AUSTRAC as well as the financial regulatory functions of the RBA. This will allow regulatory effectiveness to be assessed in a more coherent and consistent way and lay the foundations for a better informed and more comprehensive performance assessment framework.

Third, an external oversight body or panel to oversee the four Australian financial sector regulators' performance has the potential to significantly strengthen regulators' accountability, provided that it is carefully designed and not overly intrusive. An oversight body with permanent staff and the power to give directions will only further undermine what is left of APRA's and ASIC independence, drive them deeper into 'materially non-compliant' territory and pose significant financial stability risks. Moreover, conferring a directions power

on the oversight body would create a potentially serious conflict of interest, impeding the ability of the oversight body undertaking thoroughly objective assessments of the regulators.

Finally, more work at an international level by the FSB is required in the area of external oversight and performance assessment of financial regulators. A well-designed and strong regime will put Australia at the forefront in the international regulatory community. This knowledge and experience should then be used to take on a leading role on the topic of regulatory oversight and performance by international standard-setters like the FSB and its affiliated organisations.

ADDENDUM

On 17 July 2019, the Government released the APRA Capability Review (the Review), in response to the RC and previous recommendation of the Productivity Commission. The Review made 24 recommendations, 19 directed to APRA and the remaining 5 directed to the Government. The Review recognized APRA as a high-quality prudential supervisor that has been successful in delivering its core mandate –safe and resilient of regulated entities and a sound and resilient financial system. That said, it identified important changes to ensure that APRA is well positioned to respond to an environment of growing complexity and emerging risks.

ANNEX I: COMPARISON OF THE FSAP AND THE RC

| | FSAP | RC |
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| Scope | <ul style="list-style-type: none"> • Public sector assessment with private sector engagement • Agreed with the authorities and the Government | <ul style="list-style-type: none"> • Public and private sector • Terms of Reference set by Government |
| Focus | Financial stability and compliance with international standards on financial sector regulation | Banking, financial advice, superannuation, insurance, activities and oversight of financial regulators |
| Outlook | More forward looking than backward looking | Backward-looking (case study approach) and forward-looking (policy recommendations) |
| Benchmark | <ul style="list-style-type: none"> • Assesses a country's financial system stability against a well-established, internationally agreed and regularly updated benchmark, or an international standard²⁶. The latter consist of a minimum standard, guidelines and sound practices²⁷. • Includes comprehensive stress tests of the financial system • Is an internationally consistent and comprehensive measure of the quality of a | <ul style="list-style-type: none"> • "Community standards and expectations". The Commission identified six norms of conduct, or criteria, which underpin community standards and expectations as set out in the Interim Report: <ul style="list-style-type: none"> - obey the law; - do not mislead or deceive; - act fairly; - provide services that are fit for purpose; - deliver services with reasonable care and skill; and - when acting for another, act in the best interest of that other²⁸. |

²⁶ The main international standards that can be considered in an FSAP are the Basel Core Principles for Effective Banking Supervision (BCP), the International Association of Insurance Supervisors (IAIS) Principles of Insurance Supervision the International Organisation of Securities Commission (IOSCO) Objectives of Securities Regulation, the Key Attributes for Effective Resolution Regimes for Financial Institutions, Core Principles for Effective Deposit Insurance Systems (IADI).

²⁷ Standards set the baseline or minimum requirements. These are complemented by guidelines which elaborate on the standards and sound practices which describe observed practices with a view to promoting common understanding and improving supervisory and banking practices.

²⁸ Hayne (2018), page 290

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| | <p>regulatory and supervisory framework across countries.</p> <ul style="list-style-type: none"> • In the case of banking supervision assessment, it relies on a granular common and well-established methodology. There are 29 Principles, 239 essential criteria and 15 additional criteria in a BCP assessment. | |
| Level of subjectivity | <ul style="list-style-type: none"> • Significant, as principles-based international standards need to be applied to the specifics of the Australian financial sector. • A peer review process is meant to ensure consistency across countries. | <ul style="list-style-type: none"> • Significant, except for the first criterion (“obey the law”). |
| Frequency | <ul style="list-style-type: none"> • Every 5 years in G20 countries; less frequently and regularly in other countries. | <ul style="list-style-type: none"> • One-off exercise |
| Quantification | <ul style="list-style-type: none"> • Each Principle is rated: <ul style="list-style-type: none"> - Compliant - Largely Compliant - Materially non-compliant - Non-compliant - Not applicable | <ul style="list-style-type: none"> • None, no ratings are given |
| Methodology | <ul style="list-style-type: none"> • Preparation of a self-assessment by the relevant authorities • Review of laws, regulations, policies and procedures • Testing of implementation by reviewing supporting documents and interviewing authorities and relevant stakeholders | <ul style="list-style-type: none"> • Background papers • Witness statements • Witness appearances • Written submissions |
| Findings and observations | <ul style="list-style-type: none"> • Non-binding recommendations • Non-adoption can have an impact on IMF bilateral surveillance under Article 4 of the Fund’s Articles of Agreement. • 15 key recommendations | <ul style="list-style-type: none"> • Interim report • Final report including recommendations to be adopted by the Government which would then become binding statutory or regulatory obligations on affected parties. • 76 recommendations |
| Overlapping themes | <ul style="list-style-type: none"> • Culture, remuneration and governance in the banking sector • Regulatory cooperation • Enforcement • Accountability, governance and oversight of regulators | |

Annex II: Recommendations of the Royal Commission and selected corresponding statements in the FSAP

| Royal Commission | FSAP - Findings and recommendations | Aligned |
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| <p align="center">1. Culture, governance and remuneration</p> | | |
| <p>Recommendation 5.1 - Supervision of remuneration - principles, standards and guidance</p> <p>In conducting prudential supervision of remuneration systems, and revising its prudential standards and guidance about remuneration, APRA should give effect to the principles, standards, and guidance set out in the Financial Stability publications concerning sound compensation principles and practice.</p> | <p>The supervision of remuneration arrangements in included in Principle 14 Corporate Governance - Essential Criterion 7 stating:</p> <p>“The supervisor determines that the bank’s Board actively oversees the design and operation of the bank’s and banking group’s compensation system, and that it has appropriate incentives, which are aligned with prudent risk taking. The compensation system, and related performance standards, are consistent with long-term objectives and financial soundness of the bank and is rectified if there are deficiencies. “</p> <p><u>Findings and observations:</u></p> | <p>Broadly aligned IMF is more descriptive</p> |
| <p>Recommendation 5.2 - Supervision of remuneration - aims</p> <p>In conducting prudential supervision of the design and implementation of remuneration systems, and revising its prudential standards and guidance about remuneration, APRA should have, as one of its aims, the sound management by APRA-regulated institutions of not only financial risk but also misconduct, compliance and other non-financial risks.</p> | <p>Supervisors assess remuneration arrangements including compliance with relevant prudential requirements through:</p> <ul style="list-style-type: none"> • targeted onsite prudential reviews to assess the effectiveness of the remuneration framework; • review of board papers from the Board Remuneration Committee; | |

- review of disclosures required under APS 330 including:
 - qualitative information relating to the bodies that oversee remuneration; the design and structure of remuneration process, description of the ways in which current and future risks are taken into account in the remuneration process, description of the ways in which the ADI seeks to link performance during a performance measurement period with levels of remuneration and description of the ways in which the ADI seeks to adjust remuneration to take account of longer-term performance including malus and clawbacks;
 - quantitative information including the number and amount of guaranteed bonuses awarded, termination payments, outstanding deferred remuneration split into cash, shares, or other forms, the amount of deferred remuneration paid out, breakdown of remuneration into fixed and variable, deferred and non-deferred, the amount of reductions due to ex post adjustments.

To increase its understanding of the practices across firms, APRA's GCR team undertook a review of current remuneration practices and executive remuneration outcomes at a sample of firms in 2017. The objective of

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| | <p>the review was to allow APRA to better gauge how remuneration related requirements and expectations are being interpreted and implemented in practice. The review primarily focused on whether performance-based components of an entity's remuneration framework have been designed to encourage behavior that supports the long-term financial soundness and risk management framework of the entity. Outcomes from the review have been conveyed to the relevant sample institutions and APRA has issued an information paper (BCP, page 147).</p> | |
| <p>Recommendation 5.3 – Revised prudential standards and guidance</p> <p>In revising its prudential standards and guidance about the design and implementation of remuneration systems, APRA should</p> <ul style="list-style-type: none"> - Require APRA regulated institutions to design their remuneration systems to encourage sound management of non-financial risks and to reduce the risk of misconduct - Require the Board of an APRA regulated institution to make regular assessments of the effectiveness of the remuneration system in encouraging sound management of non-financial risks, and to reduce the risk of misconduct. - Set limits on the use of financial metrics in connection with long term variable remuneration - Require APRA regulated institutions to provide for the entity, in appropriate circumstances, to claw back remuneration that has vested; and - Encourage APRA regulated institutions to improve the quality of information being provided to boards and | <p style="text-align: center;">None</p> | |

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| <p>their committees about risk management performance and remuneration decisions.</p> | | |
| <p>Recommendation 5.7 — Supervision of culture and governance</p> <p>In conducting its prudential supervision of APRA-regulated institutions and in revising its prudential standards and guidance, APRA should:</p> <ul style="list-style-type: none"> - build a supervisory program focused on building culture that will mitigate the risk of misconduct; - use a risk-based approach to its reviews; - assess the cultural drivers of misconduct in entities; and - encourage entities to give proper attention to sound management of conduct risk and improving entity governance. | <p>“A periodic more comprehensive assessment of banks’ risk management and governance framework will further enhance APRA’s supervisory approach. Such an assessment would ensure that APRA’s risk based supervisory processes remain focussed on the key gaps in banks’ management and risk culture. These processes will be strengthened even further if APRA’s supervisory assessment incorporates banks’ management of non-financial risk, based on a closer engagement with the relevant domestic agencies, mainly ASIC and AUSTRAC.” (BCP, page 8, para 3)</p> | <p>Broadly aligned. IMF also involves AUSTRAC</p> |
| <p>2. Regulatory cooperation</p> | | |
| <p>Recommendation 6.9 – Statutory obligation to cooperate</p> <p>The law should be amended to oblige each of ASIC or APRA to:</p> <ul style="list-style-type: none"> - Cooperate with the other - Share information to the maximum extent practical; - Notify the other whenever it forms the belief that a breach in respect of which the other has enforcement responsibility may have occurred. | <p>APRA and ASIC are encouraged to work jointly to analyze the risk arising from such investment products provided by insurers. APRA and ASIC have regular conversations on topics of mutual interest. At this stage, however, the cooperation on insurance mainly focuses on conduct issues related to insurance products, such as the claim data projects. Given the market development in investment linked products, there is merit in further exploiting potential synergies between APRA and ASIC to analyze the interlinkages, potential conflict of interests and potential systemic risk implications stemming from the interactions between insurers and asset management activities. Some of the findings support a case for potentially further strengthening of both prudential and conduct regulation and measures to address conflicts of interest, such as enhancement of disclosure, concentration/leverage limits for the investments and</p> | <p>Broadly aligned</p> <p>IMF narrower in focus.</p> <p>No mandatory cooperation by IMF</p> |

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| | <p>robust investment policies on the instruments issued by the group entities (Technical note – Insurance Sector: Regulation and Supervision – Page 25)</p> <p>A periodic more comprehensive assessment of banks’ risk management and governance framework will further enhance APRA’s supervisory approach. Such an assessment would ensure that APRA’s risk based supervisory processes remain focussed on the key gaps in banks’ management and risk culture. These processes will be strengthened even further if APRA’s supervisory assessment incorporates banks’ management of non-financial risk, based on a closer engagement with the relevant domestic agencies, mainly ASIC and AUSTRAC.” (BCP, page 8, para 3)</p> | |
| <p>Recommendation 6.10 – Cooperation memorandum</p> <p>ASIC and APRA should prepare and maintain a joint memorandum setting out how they intend to comply with their statutory obligation to cooperate</p> <p>The memorandum should be reviewed biennially and each of ASIC and APRA should report each year on the operation of and steps taken under it in its annual report.</p> | <p>Further strengthening of APRA-ASIC coordination would also help to raise the effectiveness of supervision of governance and conduct issues, by expanding enterprise risk management (ERM) to capture conduct risks, ideally by joint work between the agencies, such as joint rule making, reporting and onsite inspections (Technical note – Insurance Sector: Regulation and Supervision – page 6 para 4}b</p> | <p>Broadly aligned</p> |
| <p>3. Accountability of regulators</p> | | |
| <p>Recommendation 6.12 – Application of the BEAR to regulators</p> | <p>”</p> <p>APRA has a robust governance framework and internal decision-making processes that ensures its effective</p> | <p>Divergent</p> |

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| <p>In a manner agreed with the external oversight body (the establishment of which is the subject of Recommendation 6.14 below) each of APRA and ASIC should internally formulate and apply its own management accountability principles of the kind established by the BEAR.</p> | <p>ability to timely act in normal and emergency cases. {BCP, page 57}</p> | |
| <p>Recommendation 6.13 – Regular Capability review</p> <p>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 practical.</p> | | |
| <p>Recommendation 6.14 – A new oversight authority</p> <p>A new oversight authority for APRA and ASIC, independent of Government, should be established by legislation to assess the effectiveness of each regulator in discharging its functions and meeting its statutory objects.</p> <p>The authority should be comprised of three part-time members and staffed by a permanent secretariat.</p> <p>It should be required to report to the Minister in respect of each regulator at least biennially.</p> | <p>APRA is subject to a strong accountability framework to Parliament, the government and the general public. APRA publishes a four-year corporate plan, an annual performance statement, and an annual report. It also has to report to the Government regulator performance framework and is subject to financial and performance audits. In addition, it has a regular standing appearance before Senate Committees. This accountability framework provides by itself a robust and transparent set of checks and balances over APRA’s performance (BCP, page 57)</p> <p>Further improvements to the independence and funding capacity of the regulatory agencies would facilitate continued high quality supervision. While both APRA and ASIC have clear responsibilities, they are subject to powers of government direction that may impact their independence. APRA and ASIC are also subject to a number of constraints and uncertainty in their budget (particularly over the medium term), which may prevent them from attracting and retaining sufficient staff with requisite specialized skills. Areas of increasing risks, such</p> | <p>Divergent</p> |

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| | <p>as cyber, group, conduct, and cross-border warrant an expansion of resources in certain key functions at ASIC and APRA, such as in enforcement and the supervision of IT and operational risk, as well as to support strengthened monitoring of foreign activities and cooperation with international regulators)Technical note - Insurance Sector: Regulation and Supervision - page 6)</p> <p>Recommendation: In line with international best practice, the independence of APRA and ASIC to undertake their duties should be strengthened. The ability of Ministers to give directions to APRA and ASIC on matters of supervisory policy and priorities limits independence and accountability of the supervisory authorities should be removed. Independent decision making by the management (APRA members and ASIC commissioners) of APRA and ASIC in relation to their statutory duties should also be supported by the introduction of a requirement for disclosure, in case of dismissal of an APRA member or ASIC Commissioner. The possibility of the Minister to give ASIC a written direction should also be removed. (Technical Note - Insurance Sector - Regulation and Supervision - Page 19 Paragraph 36)</p> | |
| <p>4. Enforcement</p> | | |
| <p>No recommendations for APRA, but findings mainly in the interim report</p> | <p>APRA would be well advised to consider consistently supporting its partial reliance on firms self-identifying problems through the active and quick use of stronger and/or more formal actions when it discovers a firm has been reporting and attesting incorrectly to the effectiveness of its risk governance processes. Based on that, there seems to be scope for APRA to escalate the severity of the corrective actions in a quicker and more</p> | <p>Aligned</p> |

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| | <p>effective when the concerned bank is not effectively cooperating. This includes escalation from “recommendation” to “requirement” and also using formal corrective actions, such as directives in a more active way” (BCP page 24, paragraph 63)</p> | |
| <p>Recommendation 6.2</p> <p>ASIC should adopt an approach to enforcement that:</p> <ul style="list-style-type: none"> - Takes as a starting point, the question of whether a could should determine the consequences of a contravention; - Recognizes that infringement notices should principally be used in respect of administrative failings by entities, will rarely be appropriate for provisions that require an evaluative judgement and beyond purely administrative failings, will rarely be an appropriate enforcement tool where the infringing party is a large corporation; - Recognizes the relevance and importance of general and specific deterrence in deciding whether to accept an enforceable undertaking and the utility in obtaining admissions in enforceable undertakings; and - Separates, as much as possible, enforcement staff from non-enforcement related contact with regulated entities. | <p>Not applicable (not in the FSAP scope)</p> | |

Annex III: Why the FCA and PRA prepared accountability maps and statements

During the witness appearance of Mr Shipton, Chair of ASIC a recent publication of detailed accountability maps and statements by UK Financial Conduct Authority was presented as “best international practice” and an example for ASIC and APRA. The background to the drafting of these accountability maps and statements is more challenging than what was presented at the RC hearings.

The UK Treasury Select Committee recommended²⁹ the FCA and PRA draw up responsibility maps allocating key responsibilities to individuals in their respective organisations after an official inquiry into a serious incident at the FCA following a misleading news story which influenced share prices of several insurers. The Inquiry came after two newspapers gave a misleading impression of the scope of a life insurance review following a preliminary briefing by the FCA, before the FCA had made any official announcement of its own. When the markets opened the next day, the share prices of several leading life insurers began to fall heavily. Only when the FCA published a clarifying statement about the scope of the review—several hours later that day—did share prices begin to recover. The Chairman of the UK Treasury Select Committee, called for a “full and transparent explanation about how such an apparently serious mistake came to be made by the FCA—the body appointed by Parliament to enforce high standards of conduct”. The review found serious weaknesses, and accountability maps and statements were required by the Treasury Committee.

²⁹ Para 184, www.publications.parliament.uk/pa/cm201415/cmselect/cmtreasy/881/881.pdf

Annex IV: Accountability mechanisms are currently in place for APRA³⁰

- Publication of the corporate plan setting out information on key strategies and activities over a rolling four-year period and annual reporting on it in the Annual Performance Statement.
- Publication of an Annual Performance Statement which demonstrates performance against objectives in the annual report. The latter is tabled in Parliament
- Annual reporting against the Australian Government's Regulator Performance Framework (RPF), which assesses the Commonwealth regulator's performance when interacting with business, the community and individuals against a common set of performance indicators. APRA's self-assessment is externally validated by stakeholders and the results are incorporated in the final published version.
- Financial, performance audits and ad hoc reviews of APRAs' performance by the National Audit Office. These reports are tabled in Parliament and are publicly available.
- Compliance with the Office of Best Practice Regulation, including the preparation of cost benefit assessments of regulatory changes and Regulation Impact Statements.
- Regular appearance for, and answering questions from, Senate and House Representatives Standing Committees by APRA members and senior executives. They also appear before ad hoc Parliamentary Committees and Inquiries.
- The Basel Committee and the FSB each conduct periodic peer reviews of the implementation and effectiveness of financial sector standards and policies

³⁰ IMF, page 47 of BCP assessment

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