



# **FINANCIAL SERVICES ROYAL COMMISSION FINAL REPORT**

**Part 5: A new regulatory frontier – APRA's  
approach to supervision and enforcement in  
a post-Royal Commission environment**

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**CLAYTON UTZ**

In the Final Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Commissioner Hayne made a number of recommendations concerning the role of APRA as the prudential regulator. These recommendations are set out at **Annexure A** and focus on APRA's approach in supervising and enforcing sound cultural, governance and remuneration practices in the financial services industry.

[We have analysed Commissioner Hayne's observations about – and the implications for – cultural, governance and remuneration practices](#). In this update, we explain what you can likely expect in your dealings with APRA in the post-Commission era and what you can do now to prepare for APRA's changed approach to supervision and enforcement, in anticipation of the Government and APRA implementing the recommendations. Mr Byres', APRA's Chairman, [Opening Statement to the Senate Economics Legislation Committee](#) of 21 February 2019 confirms these likely changes in approach to APRA's supervision and enforcement of the industry.

## 1 APRA'S ROLE

APRA is responsible for the prudent management of financial institutions so that they can meet their financial obligations under all circumstances (and prevent the failure of the financial system or the entities within the system). This is to be contrasted with ASIC's role as the conduct regulator, being responsible for promoting a fair, transparent and efficient financial system and consumer outcomes.

This distinction is important for the following reason: the remit of each regulator is aligned with their traditional roles and strengths. While enforcement is a fundamental aspect of ASIC's work, APRA's skills are geared towards prudential regulation and its capabilities in respect of enforcement are less developed. APRA has described the core element of its role as "proactive ex ante supervision, rather than ex post enforcement". Nevertheless, Commissioner Hayne has urged APRA to consider whether visible public denunciation and punishment of an entity should be utilised to deter misconduct.

A number of recent developments, including the introduction of the Banking Executive and Accountability Regime (**BEAR**), overseas benchmarking of APRA, the Productivity Commission's Inquiry into Competition in the Australian Financial System and, of course, the Commission, have created impetus for APRA to conduct an internal review of its enforcement strategy, the report of which is due to be completed by March 2019. More specifically, the APRA Enforcement Strategy Review will provide recommendations on how APRA may:

- increase the breadth of issues it seeks to address through public enforcement action;
- take more enforcement action to hold individuals to account, including under and the BEAR and other powers; and
- take more public enforcement action, including litigation, to achieve general deterrence effects in appropriate cases and publicly disclose enforcement priority areas.

## 2 RECOMMENDATIONS

The Commissioner has made recommendations directed at strengthening:

- ▶ cultural, governance and remuneration practices within the industry, and APRA's supervision and enforcement of those practices (see recommendations 5.1 to 5.3 and 5.7);
- ▶ APRA's oversight of Registrable Superannuation Entities (**RSE**) licensees (see recommendations 4.14 to 4.15 and 6.3 to 6.5);
- ▶ APRA's regulation of BEAR (see recommendations 6.6 to 6.7); and
- ▶ the co-operation between ASIC and APRA as co-regulators of the industry (see recommendations 6.9 and 6.10).

APRA has indicated that it will expeditiously implement those recommendations requiring APRA's direct attention, and the Government has announced that it will otherwise implement all of these recommendations.

## 3 WHAT TO EXPECT FROM APRA

Commissioner Hayne's recommendations and observations about the prudential regulator, together with the findings that may emerge from the APRA Enforcement Strategy Review, are likely to result in the following changes in your dealings with APRA:

### 3.1 Increased intensity of supervision and use of public forms of supervision

Mr Byres, APRA's Chairman, has acknowledged that the intensity of its supervision needs to increase and its focus broadened. APRA's supervisory actions to date have ranged from routine supervision activities (such as onsite visits, a supervisory risk assessment generally once a year and regular meetings with Boards, CEOs and other key personnel) to more intrusive and punitive actions (such as a prudential review or targeted review), that have the impact of specific deterrence. APRA has acknowledged that because these actions are not undertaken publicly, they will not have a strong general deterrent effect.

Bearing in mind the Commissioner's observation that "the deterrence of misconduct depends on visible public denunciation and punishment", APRA may be expected to utilise public forms of supervision. APRA may consider publicly drawing attention to failings in practices that it identifies in an entity from its supervision activities.

### 3.2 Greater use of public enforcement tools

APRA's enforcement approach to date has emphasised the use of tools such as issuing a direction to comply that, according to APRA, can be used flexibly to achieve a range of outcomes.

Commissioner Hayne observed that there was a "lack of action" by APRA in response to conduct identified during the Commission's hearings, including that it had not taken any public step pointing to any deficiency in the governance and risk culture of any of the major banks or any other APRA-regulated institution, until the CBA Prudential Inquiry. APRA has never taken action against an institution for failing to comply with APRA's remuneration requirements.

APRA's armoury of enforcement tools also includes the ability to:

- ▶ apply to the Court for a mandatory injunction requiring the entity to comply with a requirement;
- ▶ impose a licence condition on the entity's registration or seek a penalty for breach of an existing licence condition;
- ▶ pursue a court enforceable undertaking with the entity to address concerns;
- ▶ impose additional capital requirements;

- ▶ engage a special purpose auditor (or actuary for insurers) under the prudential standard for the relevant industry; and
- ▶ remove or disqualify an individual from their position or from holding senior roles within the relevant industry.

APRA may consider using these more public enforcement tools in the future to achieve general deterrence.

### 3.3 Emphasis on reducing the risk of misconduct

Commissioner Hayne observed that APRA had not dealt with the risk of misconduct as being an end in itself, in particular, by way of remuneration practices and systems, unlike its international counterparts. The Commissioner has implored the industry to ask the following questions about its culture, governance and remuneration practices, and we can expect APRA, in its supervision of prudential matters, to also ask these questions of entities:

- ▶ Is there adequate oversight and challenge by the board and its gatekeeper committees of emerging non-financial risks?
- ▶ Is it clear who is accountable for risks and how they are to be held accountable?
- ▶ Are issues, incidents and risks identified quickly, referred up the management chain, and then managed and resolved urgently?
- ▶ Is enough attention being given to compliance? Is it working in practice? Or is it just "box-ticking"?
- ▶ Do compensation, incentive or remuneration practices recognise and penalise poor conduct? How does the remuneration framework apply when there are poor risk outcomes or there are poor customer outcomes? Do senior managers and above feel the sting?

[See our detailed analysis on Culture, Governance and Remuneration here.](#)

### 3.4 Enhanced regulation of remuneration practices

APRA has acknowledged that it must undertake, and has commenced, further work to enhance the Prudential Standards and guidance on remuneration practices. Commissioner Hayne observed that APRA's prudential standards and guidance about remuneration had a narrow focus, and has encouraged APRA to increase the intensity of its supervision of the way remuneration frameworks are implemented.

APRA is expected to make available revised Prudential Standards and Guidance on remuneration for consultation in 2019 that will, among other things, incorporate the following principles (based on either Commissioner Hayne's recommendations on remuneration or the Financial Stability Board's principles on remuneration):

- ▶ the board must actively oversee the remuneration system's design and operation;
- ▶ the board must monitor and review the remuneration system to ensure the system operates as intended;
- ▶ APRA-regulated institutions to improve the quality of information being provided to boards and their committees about risk management performance and remuneration decisions.
- ▶ staff engaged in financial and risk control must be independent, have appropriate authority, and be remunerated in a manner that is independent of the business areas they oversee and commensurate with their key role in the firm;
- ▶ remuneration must be adjusted for all types of risk, and outcomes must be symmetric with risk outcomes;
- ▶ APRA-regulated institutions should design their remuneration systems to encourage sound management of non-financial risks, and to reduce the risk of misconduct;

- ▶ remuneration payout schedules must be sensitive to the time horizon of risks;
- ▶ the mix of cash, equity and other forms of remuneration must be consistent with risk alignment;
- ▶ supervisory review of remuneration practices must be rigorous and sustained, and deficiencies must be addressed promptly with supervisory action;
- ▶ firms must disclose clear, comprehensive and timely information about their remuneration practices to facilitate constructive engagement by all stakeholders;
- ▶ limit the use of financial metrics in connection with long-term variable remuneration; and
- ▶ APRA-regulated institutions to provide for the entity, in appropriate circumstances, to claw back remuneration that has vested.

[You can learn more in our detailed analysis on Remuneration here.](#)

### 3.5 Increased supervision of culture

Although APRA (and ASIC) have taken a more active interest in culture in recent years; APRA's approach to culture has been to focus on failings in governance, culture and accountability that indicate a lax attitude to risk-taking, which might ultimately impact the soundness of the financial institution itself.

Commissioner Hayne recognises that culture cannot be prescribed or legislated. APRA is expected to assess each entity's self-assessment against the standards enunciated in Report of APRA's Inquiry into CBA.

Adopting Commissioner Hayne's observations on institutional culture, APRA can be expected to approach its supervision of culture in the financial services industry by:

- ▶ assessing the entity's culture;
- ▶ identifying what is wrong with the culture;
- ▶ educating the entity about its own culture;
- ▶ agreeing what the entity will do to change its culture; and
- ▶ supervising the implementation of those steps.

### 3.6 Emphasis on accountability

APRA can be expected to focus on enforcing the accountability obligations under the BEAR as part of its ongoing supervision of prudential matters. Mr Byres' Opening Statement to the Senate Economics Legislation Committee of 21 February 2019 refers to the significant resources devoted to the roll-out of BEAR and the necessity to manage the development of good quality accountability statements.

In addition to recommending that the BEAR be extended to RSE licensees, Commissioner Hayne also recommended that an accountable obligation be created for the design, delivery and maintenance of all products offered to customers and any necessary remediation of customers in respect of any of those products.

### 3.7 Expectation of greater and transparent engagement with APRA

Authorised deposit-taking institutions (**ADIs**) and Accountable Persons under the BEAR will be obliged to deal with APRA (and ASIC) in an open, constructive and co-operative way.

APRA will no doubt expect any individual responsible for communicating or dealing with APRA to engage with the regulator in a transparent and proactive manner for all types of matters, including during supervision, prudential reviews and investigations.

## 4 PREPARATION

Organisations can commence work now on strengthening cultural, governance and remuneration practices, given the Government's intention to implement all of these recommendations and APRA's intention to expeditiously implement those recommendations that require APRA's direct attention.

Commissioner Hayne's guidance about cultural, governance and remuneration practices, while of particular importance to institutions regulated by APRA, should be considered carefully by all corporate organisations.

We would suggest that you consider taking the following steps now, either in anticipation of the enhanced supervision that can be expected from APRA, or in ensuring that your organisation complies with best practice:

- ▶ review your remuneration framework, policies and guidelines now to consider whether it addresses Commissioner Hayne's recommendations and observations, including the changes that APRA proposes to incorporate into its Prudential Standards and Guidance (such as clawback mechanisms);
- ▶ consider whether further improvements to risk culture and risk governance can be made in practice or to policies and guidelines in light of the recommendations in the Report;
- ▶ those entities (including superannuation trustees) not yet subject to the BEAR should consider understanding the BEAR obligations currently imposed on ADIs and how they can be incorporated into the entity's accountability framework;
- ▶ bear in mind that ASIC may share any documents provided to it with APRA to investigate any prudential-related matter; and
- ▶ ensure that internal practices strive for a culture of engaging or dealing with APRA in an open, transparent and co-operative way, and consider implementing an engagement model or set of engagement principles with APRA, reflecting those matters as the guiding principles.

## 5 ANNEXURE A – RELATED RECOMMENDATIONS FROM THE COMMISSION

### Culture, governance and remuneration

#### Recommendation 5.1 — Supervision of remuneration — principles, standards and guidance

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 Board’s publications concerning sound compensation principles and practices.

Recommendations 5.2 and 5.3 explain and amplify aspects of this Recommendation.

#### Recommendation 5.2 — Supervision of remuneration — aims

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.

#### Recommendation 5.3 — Revised prudential standards and guidance

In revising its prudential standards and guidance about the design and implementation of remuneration systems, APRA should:

- ▶ 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 (whether through its remuneration committee or otherwise) to make regular assessments of the effectiveness of the remuneration system in encouraging sound management of non-financial risks, and reducing 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 their committees about risk management performance and remuneration decisions.

#### Recommendation 5.7 — Supervision of culture and governance

In conducting its prudential supervision of APRA-regulated institutions and in revising its prudential standards and guidance, APRA should:

- ▶ 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.

## Regulation of RSE licensees

### Recommendation 4.14 — Additional scrutiny for related party engagements

APRA should amend Prudential Standard SPS 250 to require RSE licensees that engage a related party to provide group life insurance, or who enter into a contract, arrangement or understanding with a life insurer by which the insurer is given a priority or privilege in connection with the provision of life insurance, to obtain and provide to APRA within a fixed time, independent certification that the arrangements and policies entered into are in the best interests of members and otherwise satisfy legal and regulatory requirements.

### Recommendation 4.15 — Status attribution to be fair and reasonable

APRA should amend Prudential Standard SPS 250 to require RSE licensees to be satisfied that the rules by which a particular status is attributed to a member in connection with insurance are fair and reasonable.

### Recommendation 6.3 — General principles for co-regulation

The roles of APRA and ASIC in relation to superannuation should be adjusted to accord with the general principles that:

- ▶ APRA, as the prudential regulator for superannuation, is responsible for establishing and enforcing Prudential Standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by superannuation entities APRA supervises are met within a stable, efficient and competitive financial system; and
- ▶ as the conduct and disclosure regulator, ASIC's role in superannuation primarily concerns the relationship between RSE licensees and individual consumers.

Effect should be given to these principles by taking the steps described in Recommendations 6.4 and 6.5.

### Recommendation 6.4 — ASIC as conduct regulator

Without limiting any powers APRA currently has under the SIS Act, ASIC should be given the power to enforce all provisions in the SIS Act that are, or will become, civil penalty provisions or otherwise give rise to a cause of action against an RSE licensee or director for conduct that may harm a consumer. There should be co-regulation by APRA and ASIC of these provisions.

### Recommendation 6.5 — APRA to retain functions

APRA should retain its current functions, including responsibility for the licensing and supervision of RSE licensees and the powers and functions that come with it, including any power to issue directions that APRA presently has or is to be given.

## Regulation of the BEAR

### 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.

### **Recommendation 6.8 — Extending the BEAR**

Over time, provisions modelled on the BEAR should be extended to all APRA-regulated financial services institutions. APRA and ASIC should jointly administer those new provisions.

### **Recommendation 1.17 — BEAR product responsibility**

After appropriate consultation, APRA should determine for the purposes of section 37BA(2)(b) of the Banking Act, a responsibility, within each ADI subject to the BEAR, for all steps in the design, delivery and maintenance of all products offered to customers by the ADI and any necessary remediation of customers in respect of any of those products.

### **Recommendation 6.7 — Statutory amendments**

The obligations in sections 37C and 37CA of the Banking Act should be amended to make clear that an ADI and accountable person must deal with APRA and ASIC (as the case may be) in an open, constructive and co-operative way. Practical amendments should be made to provisions such as sections 37K and 37G(1) so as to facilitate joint administration.

## **Information-sharing between APRA and ASIC**

### **Recommendation 6.9 — Statutory obligation to co-operate**

The law should be amended to oblige each of APRA and ASIC to:

- ▶ co-operate with the other;
- ▶ share information to the maximum extent practicable; and
- ▶ notify the other whenever it forms the belief that a breach in respect of which the other has enforcement responsibility may have occurred.

### **Recommendation 6.10 — Co-operation memorandum**

ASIC and APRA should prepare and maintain a joint memorandum setting out how they intend to comply with their statutory obligation to co-operate.

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.

## **Oversight**

### **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.

### **Recommendation 6.12 — Application of the BEAR to regulators**

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 to its own management accountability principles of the kind established by the BEAR.

### **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.

### **Recommendation 6.14 — A new oversight authority**

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.

The authority should be comprised of three part-time members and staffed by a permanent secretariat.

It should be required to report to the Minister in respect of each regulator at least biennially.

## **Other**

### **Recommendation 1.12 — Valuations of land**

APRA should amend Prudential Standard APS 220 to:

- ▶ require that internal appraisals of the value of land taken or to be taken as security should be independent of loan origination, loan processing and loan decision processes; and
- ▶ provide for valuation of agricultural land in a manner that will recognise, to the extent possible:
  - » the likelihood of external events affecting its realisable value; and
  - » the time that may be taken to realise the land at a reasonable price affecting its realisable value.

## GET IN TOUCH

We welcome conversations on Commissioner Hayne's report. If you wish to have your own conversation with us on the report and how it may affect you and your business, please contact us:

[FinancialServicesRC@ClaytonUtz.com](mailto:FinancialServicesRC@ClaytonUtz.com)

You can also keep up with our rolling coverage at our dedicated Financial Services Royal Commission hub <https://www.claytonutz.com/financial-services-royal-commission/hub>.

**Sydney**

Level 15

1 Bligh Street

Sydney NSW 2000

+61 2 9353 4000

**Melbourne**

Level 18

333 Collins Street

Melbourne VIC 3000

+61 3 9286 6000

**Brisbane**

Level 28

Riparian Plaza

71 Eagle Street

Brisbane QLD 4000

+61 7 3292 7000

**Perth**

Level 27

QV.1 Building

250 St Georges Terrace

Perth WA 6000

+61 8 9426 8000

**Canberra**

Level 10

NewActon Nishi

2 Phillip Law Street

Canberra ACT 2601

+61 2 6279 4000

**Darwin**

17–19 Lindsay Street

Darwin NT 0800

+61 8 8943 2555

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