

Australian Prudential Regulation Authority

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APRA

Helen Rowell
MEMBER

2 January 2014

Mr Jason McNamara
Executive Director
Office of Best Practice Regulation
Department of Finance and Deregulation
John Gorton Building
King Edward Terrace
PARKES ACT 2600

Email: helpdesk@obpr.gov.au

Dear Mr McNamara

**REGULATION IMPACT STATEMENT
HARMONISING CROSS-INDUSTRY RISK MANAGEMENT REQUIREMENTS**

I am writing in relation to the attached draft Regulation Impact Statement (RIS) prepared by the Australian Prudential Regulation Authority for its proposal to harmonise cross-industry risk management requirements.

I am satisfied that the draft RIS meets the Government's best practice regulation requirements, in particular that:

- the problem being addressed and the objectives of government action are well articulated;
- all feasible options are considered;
- the analysis of the likely impacts of each option is adequate and presented in a balanced way; and
- the conclusion is supported by the analysis in the RIS.

I submit the RIS to the Office of Best Practice Regulation for formal assessment.

Yours sincerely,

Appendix: APRA's responses to items raised by the OBPR on the 1st pass RIS

Overall Comments

OBPR issue

1. The RIS as currently drafted lacks internal consistency. In particular, the RIS claims that:
 - (a) The proposed enhancements to risk management requirements are in response to material problems and will therefore deliver appreciable benefits; and
 - (b) The majority of institutions already have staff/functions that include the role of the CRO/BRC and therefore compliance costs will be negligible.
2. However, to our reading it appears there are two possibilities: Firstly, that unacceptable risks are present in the current system, and risk management practices amongst some entities should improve, which may result in appreciable costs and benefits: OR risk management practices are already largely appropriate, and this proposal represents a codification of existing requirements (in which case compliance costs, as well as benefits, will likely be low).

APRA response

APRA has updated the RIS to clarify that the proposed enhancements are in response to a minority of institutions that are materially lagging industry better practice. If a problem arises in one of these lagging institutions, the opaqueness of risk management practices can lead to stakeholders believing that all institutions have weak risk practices. This can create material problems by undermining the confidence in, and stability of, the Australian financial system. Accordingly, the material problems of one institution can create material problems for all institutions, and therefore the benefits for all significantly outweigh the costs for the few.

The OBPR's two suggested possibilities are not mutually exclusive. As noted above, a minority of institutions who lag their peers pose an unacceptable risk to the financial system. At the same time, other institutions currently demonstrate better practice risk management. The cost burden is largely on those lagging institutions; however, both those institutions and their peers benefit from the reduced likelihood of weak risk management practices undermining confidence in the industry. The codification of industry better practice means that although the costs are material for particular institutions, the relative cost to industry is negligible. However, the asymmetric impact that the failure of a small institution has on confidence in the financial system means that the benefits for industry remain significant.

Problem

OBPR issue

3. To address this apparent inconsistency it is very important that the RIS more clearly explains the status quo: Are entities already largely following the requirements outlined in the proposal? How many entities are understood to be fully or partially complying?

APRA's response

APRA has updated the 'Problem' section of the RIS to clarify the status quo. The RIS identified approximately 58 medium-sized institutions are materially non-complying with the proposals under both 'Option 3 - implementation through prudential standards' and 'Attachment A: Business Cost Calculator report (variable ongoing cost by size of business)'. This means that approximately 298 are currently near or fully complying with the proposals, and will face negligible (if any) incremental compliance costs.

OBPR issue

4. If entities are mostly following the requirements the RIS should clearly state this and provide a more balanced assessment of the expected benefits and conclusion. This may require a more precise discussion of the standards of risk management among different-sized entities. For example:
 - (a) What are the incremental benefits where entities are already largely following the requirements?
 - (b) Are there common characteristics of those entities that are not following the requirements? Are they mostly smaller entities? How significant are those entities in the context of the overall market? Could a failure of one of these entities result in broader economic problems? How likely is this?
 - (c) What is the likely impact of proposal of changes to risk management processes where entities are largely already following the requirements?

We note that it may be difficult to sustain a claim of high benefits and low costs under this scenario.

APRA's response

APRA has made amendments throughout the RIS to provide a clearer assessment of the expected benefits of the proposals. In particular, APRA has added a paragraph to the 'Enhancement' section and have significantly expanded the cost/benefit analysis under each option discussed in the 'Option impact analysis' section. As noted above, there exists an asymmetry in costs and benefits given that the costs to industry as a whole are significantly lower than the benefits from a reduction in the risk of a medium-size institution undermining confidence in the financial system.

OBPR issue

5. If most entities are *not* following the requirements then the RIS will need to provide significantly greater depth to the discussion of the problem. For example:
 - (a) What are the identified deficiencies in risk management for insurers and ADIs, as stated in page 5?

- (b) What are the current regulations driving executive board risk management practices, and where is the regulatory gap?
- (c) What are the existing private incentives for boards/executive to manage corporate risks effectively, and why are these incentives thought to be incomplete?
- (d) Are there any similarities between the risk factors referred to in the US and risk management practices in Australia? What are the extreme problems referenced on page 2 and how are they relevant to Australia? Have any of the identified risk factors or precursors of institutional failures materialised in Australia? If not, the RIS should clearly state that these risk factors have not been observed.
- (e) What is the current standard of risk management practices in Australia? If risk management practices are largely sound, this should be stated clearly.
- (f) What is the nature of the risk - is it of a single institutional failure, systemic failure, or some combination of these?

APRA's response

Most institutions are near or fully complying with the proposals, taking into account APRA's repeated indication that it will take a pragmatic approach to applying the requirements based on the size, business mix and complexity of institutions. APRA has expanded several paragraphs in the 'Enhancement' section of the RIS to clarify the scope and scale of the problem.

OBPR issue

6. Given the preferred option the RIS should include a more detailed analysis of the particular organisational, structural or behavioural issues that may currently reduce the effectiveness of a board in managing corporate risk. To address this issues the RIS could consider the following:
 - (a) What are the particular conflicts of interest that apply to board members that prevent them from effectively identifying risks and promoting mitigation strategies to management?
 - (b) What are particular issues with board structures that reduce their effectiveness in engaging in risk search, promoting dissenting views, identifying mitigation strategies or considering alternative course of action?
 - (c) What are the issues that prevent CEOs from facilitating frank discussions of risk issues at the board level?
 - (d) To what extent have these been addressed by creating direct (and personal) incentives through director's duties?

APRA's response

APRA has significantly expanded the 'Option 3 - implementation through prudential standards' section to provide a more detailed analysis of the proposal and the behavioural issues each proposal addresses.

Options and impact analysis

OBPR issue

7. Once the RIS has discussed the particular behavioural issues driving risk management practices at the board level, the RIS should discuss how having a dedicated CRO and BRC would address these issues. In this discussion the RIS may wish to consider the following issues:
 - (a) What evidence is available to suggest that this function will change entity decision-making?
 - (b) Is there a risk that the CRO/BRC will be separated from management/firm more generally and not have access to the relevant information (compared with risk being integrated into board practices)?

APRA's response

As noted above, the 'Option 3 - implementation through prudential standards' section has been significantly expanded to provide a more detailed analysis of the proposal and the behavioural issues each proposal addresses.

OBPR issue

8. Consistent with our comments on the problem section, the reference to 'deficiencies in risk management for ADIs and insurers' (on page 5) should be clarified - are these deficiencies in current risk management practices or merely perceived deficiencies in the current framework?

APRA's response

As noted above, APRA has expanded the 'Enhancement' section to address the current actual deficiencies in risk management practices by laggard institutions. These deficiencies are not present in the majority of institutions given current practice or their size, business mix and complexity.

OBPR issue

9. Page six refers to Board flexibility in determining its risk management arrangements. The analysis of both Options 1 and 2 should examine in further detail the benefits of flexibility in risk management in terms of: cost, ensuring executive governance and oversight is closely integrated with key management functions, and promoting innovation in risk management practices.

- (a) This discussion should also examine whether there are any particular differences in the risks faced by insurers and ADIs: whether there are justifiable divergences in risk management frameworks, and whether the scope for prudentially regulated institutions to tailor their frameworks to their business may be affected by prescriptive regulation on the structure of these frameworks.
- (b) Similarly, the discussion of costs of Options 1 and 2 may need further substantiation or, failing this, qualification. For example, the RIS claims (at page 6) that ‘...ADIs and insurers that chose not to adopt these practices may have a greater probability of losses given a lower quality of risk-based decision-making’. This claim should be examined in light of the problem statement (as revised): together with any risks associated with carving out risk-management into a separate executive sub-committee with a separate chair. Put another way, more substantiation should be provided as to why the proposed arrangements are likely to be superior to a more integrated board-level risk analysis framework.

APRA’s response

APRA has enhanced the analysis of Options 1 and 2 by including additional wording to reflect that there are recognised differences in the risks faced by ADIs and insurers as well as expanding the cost sections. APRA has also expanded the cost analysis under Option 3, and has substantiated these costs in Attachments A and B.

OBPR issue

10. The impacts analysis notes in various places that the costs of adopting the proposed risk management practices will be effectively zero, owing to existing good industry practice.
- (a) These claims should be substantiated with reference to stakeholder/consultation feedback.
 - (b) This analysis should then be incorporated into the problem statement to provide greater balance and depth to the analysis of the scale and scope of the problem.
 - (c) This analysis should also inform the claimed benefits. For example, if the regulatory impacts consist largely of re-titling existing employees and functions that are already being carried out, it is difficult to understand how this will deliver better risk governance and reduced risk of unexpected losses to shareholders and other stakeholders (per page 9).

APRA’s response

APRA received 44 submissions from consultation. Only one submission completed the Business Cost Calculator and only two other submissions gave high-level wage estimates for the appointment of a dedicated CRO. APRA has expanded Option 3 to include these costs, identify APRA’s cost assumptions, and explain where these assumption result in a variation in the cost estimate provided by these submissions.

OBPR issue

11. The impacts analysis of Option 3 appears to proceed on the basis that homogeneity in risk management practices across industry is an inherently good thing. The RIS should explore this aspect in more detail and provide further supporting argument.

APRA's response

APRA has expanded the first paragraph of the benefits of Option 3 to address why homogeneity of risk management practices has a positive outcome.

OBPR issue

12. The justification/claimed benefits for the appointment of a CRO includes an ability to speak with candour to senior management, to develop a sound risk management culture, and provide objective challenge to Board decision. The RIS should explore these objectives/claimed benefits in greater depth, including any risks. For example:

- (a) How will the personal characteristics required of the office of CRO be achieved through what appear to be largely structural requirements? How will these changes drive the desired cultural change within organisations?
- (b) How do these structural requirements deal with the risk that the CRO will become 'domesticated' through CEO dominance, remuneration practices or other group behavioural pathologies?
- (c) Is there a risk that by developing nominal responsibility to an arm's-length CRO, the Board will reduce or lose entirely its strategic focus on risk management? Is there a risk the CRO will not have sufficiently detailed involvement in day-to-day management of the entity's affairs or otherwise face reduced information flow?
- (d) If, as is claimed at page 10, the CEO will reduce the probability of losses, enhance strategic decision-making, and lead to increased profitability, why do firms lack complete incentives to do this already?

APRA's response

As noted above, APRA has significantly expanded the analysis of Option 3 to justify the benefits of the CRO proposals. APRA has removed references to reduced probability of losses as this statement could create an unnecessary distraction about the particulars of measuring probability of loss, rather than the overarching benefits provided by better practice. Further, APRA has identified that firms have incentives to enhance risk management practices, as seen in the majority of industry already adopting these practices.

Compliance with Best Practice Regulation Handbook

OBPR issue

13. This section should also clarify that a decision has not yet been taken on this matter.

APRA's response

APRA has included wording to this effect.

Conclusion

OBPR issue

14. It is very important that the conclusion is altered to reflect changes to the rest of the document. You could consider the following when re-drafting the conclusion:

- (a) Is the conclusion balanced given the explanation of the status quo?
- (b) Are the claims appropriately measured given the magnitude of the problem; expected costs and benefits; and available evidence?

APRA's response

APRA has updated the conclusion in the RIS to reflect why the status quo is insufficient and have identified that the institutions that are materially impacted are in the minority.

Implementation and review

OBPR issue

15. This section notes that submissions argued that more time was needed to prepare for the new requirements. It is unclear why this would be the case if industry is already largely compliant. This aspect should be explored in further detail and changes to the compliance cost estimates made as required.

APRA's response

APRA has updated this section to identify why institutions sought additional time for compliance.