Strengthening crisis preparedness

Australian Prudential Regulation Authority

KPMG Australia

April 2022

–

KPMG.com.au

Contents

Executive summary

KPMG background

Section 1: Recommendations

Section 2: KPMG insights

Key authors

Executive summary

As a leading professional services firm, KPMG Australia (KPMG) is committed to meeting the requirements of all our stakeholders – not only the organisations we audit and advise, but also employees, governments, regulators and the wider community.

Strengthening the financial resilience of the Australian financial system is a key component of the Australian Prudential Regulation Authority's (APRA's) remit. As such, KPMG welcomes the opportunity to provide input into APRA's proposed approaches for addressing potential future financial crises. CPS 190 and CPS 900 provide the building blocks for a comprehensive framework to deal with Financial Contingency and Resolution. This is a complex area and there are opportunities to learn from other G20 jurisdictions that have started on this journey across the banking and insurance industries. However, as there are few international precedents for the superannuation industry, KPMG considers that more detailed assessments will need to be undertaken to ensure a practical approach is developed to financial resilience.

KPMG has worked with clients globally and domestically on this topic. Whilst programs to develop and implement plans can be complex and burdensome, we believe there are effective and efficient approaches that APRA can take to reduce the disruption to organisations in an already crowded regulatory change environment.

In the below submission, KPMG has provided responses to APRA's specific queries as well as additional insights and recommendations based on our experiences and learnings in this space.

We would welcome a meeting with APRA at a future date to discuss our submission and look forward to continuing the debate on this vitally important issue with APRA and the broader industry.

Yours sincerely,

Craig Davis
Partner
Regulatory & Risk Advisory
KPMG Australia

Robert Warren
Partner
Regulatory & Risk Advisory
KPMG Australia

Anthony Donohoe
Partner
Regulatory & Risk Advisory
KPMG Australia

Background

KPMG is a global network of professional firms providing a full range of services to organisations across a wide range of industries, governments, and not-for-profit sectors. We operate in 147 countries and territories and have more than 219,000 people working in member firms around the world. In Australia, KPMG has a long tradition of professionalism and integrity combined with our dynamic approach to advising clients in the digital-driven world.

Risk Consulting

KPMG provides a holistic approach to risk to help our clients' risk framework align to their business agenda, especially as people prepare to drive sustainable growth into their business in an environment where trust and credibility are critical to success.

We work to protect and enhance business value by helping our clients manage risk in an agile and effective way, cut costs and improve business performance. We believe risk and compliance is more than a box-ticking exercise – it is a critical investment that can underpin an organisation's long-term growth, value and sustainability.

Our team of risk professionals comprises specialist individuals and teams dedicated to providing timely and practical advice, drawing on KPMG's advisory services that include a range of both holistic and specialist risk services

Banking and Capital Markets

KPMG's Banking & Capital Markets group is one of the leaders in the market. Combining a strong local presence and deep capability, with access to a global network of banking professionals, KPMG's Banking & Capital Markets team in Australia is ideally placed to help our clients successfully navigate through these disruptive times and provide strategic advice to capitalise on future opportunities.

Superannuation, Asset and Wealth Management

Drawing on our deep and extensive local and global expertise and insights, KPMG can provide advice and guidance in relation to investment management, superannuation, product design and distribution, investor support services. Our clients include superannuation funds, managed funds across all asset classes, the wealth businesses of banks and life insurers, custodians and administrators (both internal and external).

Actuarial Advisory Team

KPMG Australia's Actuarial team has over 100 professionals, based in Sydney, Canberra and Melbourne. These professionals operate in life, general insurance, and superannuation as well as finance, funds management and banking. Our clients include the leading insurers and financial services companies operating in Australia, New Zealand and the Asia Pacific region. We help insurers, superannuation funds, banks and government manage financial risks by evaluating the likelihood of future event happening and designing ways to reduce the likelihood and impact of undesirable ones.

Superannuation Advisory

KPMG’s Superannuation Advisory Team is dedicated to assisting our clients address their business/fund needs and assist in delivering holistic advice that enables them to achieve their strategic, governance and tactical imperatives including delivering better member outcomes.

Insurance

KPMG’s insurance group provides services to help Australian insurers find sustainable pathways to growth. KPMG recognises that today's economic environment is forcing insurers to rethink the way they conduct business. Volatile markets, disruptive technologies, and a complex web of new regulations and compliance issues have brought financial services businesses to a crossroads.

Section 1: KPMG Recommendations

KPMG has extensive experience assisting clients globally and locally with their financial contingency and resolution planning. As such, in addition to the specific questions that APRA has posed we would like to provide some additional feedback and recommendations that we believe may be usefully considered in the development of these prudential standards.

Standard	Ref	Recommendation
CPS 190	1	Clarify whether financial contingency plans will incorporate a financial institution's capital contingency plan, liquidity contingency plan and recovery plan into one plan, and consider the efficiency benefits of this option (versus the alternative of maintaining separate plans).
	2	Provide further clarification on the concept of solvent exit in the case of well-established authorised deposit-taking institutions.
	3	Provide clarity on the timeframe for implementation of Financial Contingency Plans at Levels 2 and 3, in recognition of the potential complexity associated with this aspect of contingency planning.
	4	Provide further guidance on expectations with respect to financial contingency planning for financial conglomerates and in respect of cross-border aspects of such plans.
CPS 900	5	Consider having a separate prudential standard on resolution for each industry sector, in recognition of the fundamental differences in resolution requirements for banks, insurance and superannuation.
	6	Further assess the options for achieving satisfactory resolution outcomes at least cost for financial institutions.
	7	Clarify the expected sequencing and timeframe of resolvability assessments and resolution planning by category of financial institution, with a view to prioritising by systemic importance and minimising compliance burdens.
	8	Clarify the expected timeframe for development of resolution plans, recognising that it may be a multi-year program for some institutions.
	9	Clarify the respective responsibilities of APRA and regulated entities for resolvability assessments and resolution planning.
	10	Limit the accountability of financial institution Boards to those aspects of resolvability and resolution over which Boards have

Standard	Ref	Recommendation
		control, in recognition that some key elements of resolution are outside of the control of Boards
	11	Define 'non-viability' and the concept of point of entry into resolution.
	12	Provide a more comprehensive definition of 'critical function' and consider alignment to the terminology used in the Financial Stability Board (FSB) 'Key Attributes of Effective Resolution Regimes for Financial Institutions'.
	13	Provide further guidance on the framework to be applied in determining whether loss absorbing capacity (LAC) would be required and, in the event that LAC is required, the amount of LAC instruments that would need to be issued.

Section 2: KPMG insights

Introduction

The APRA discussion paper on 'Strengthening Crisis Preparedness' notes that the aim of the draft prudential standards for financial contingency (CPS 190) and resolution planning (CPS 900) is to ensure that regulated entities are better prepared for situations that may threaten their viability.

The draft standards aim to strengthen the financial system's ability to withstand stress and, in the unlikely event of entity failure, minimise the need for taxpayer funded support whilst maintaining the stability of the financial system and protecting depositors, policyholders and superannuation beneficiaries.

Framework design

The design of the high-level framework is consistent with international practice but there are nuances in relation to the role that the resolution authority, in this case APRA, plays in resolution planning, including resolvability assessments.

The role of APRA

Greater clarity could be provided on the distinction between resolution plans and pre-positioning plans, and on the respective responsibilities of APRA and regulated entities in relation to all elements of the resolution planning, resolvability assessment, and pre-positioning planning processes.

In most G20 jurisdictions, the resolution authority takes responsibility for conducting resolvability assessments and resolution planning based on information and assistance from the regulated entities.

CPS 900 contemplates that the regulated entity has responsibility for resolvability assessment and resolution pre-positioning, with APRA having responsibility for resolution planning.

This approach has the potential to place excessive compliance burdens on financial institutions and may not harness the efficiencies that can be derived from APRA itself undertaking responsibility for resolvability assessments.

KPMG suggests that consideration be given to clarifying APRA's responsibilities. In particular, APRA's responsibility for resolvability assessment and resolution planning based on data and qualitative information provided by financial institutions, and where financial institutions are responsible for defined actions in relation to resolution pre-positioning.

Further clarification would also be helpful on APRA's responsibilities regarding cross-border elements of resolution planning. Paragraph 16 of CPS 900 states that a regulated entity must support the cross-border elements of a resolution plan. The draft standard and consultation material are silent on APRA's responsibilities in cross-border resolution. Given that cooperation and coordination in cross-border resolution depends more on the resolution authorities than on the regulated entities, it would be helpful if APRA could clarify its own responsibilities in these areas. KPMG considers that the draft prudential standard could be reworded to make it clear that a regulated entity has responsibility only for cross-border matters that are within its control.

The role of the Board

Draft CPS 900 imposes responsibility on a regulated entity's Board for ensuring that the entity is resolvable. KPMG suggests that APRA give further consideration to this, given that a regulated entity Board can only be expected to have responsibility for matters under its control, and therefore cannot be held responsible for many of the resolution actions that lie outside of its control. These may include decisions by APRA and other government agencies (e.g. ASIC, RBA) to exercise (or not exercise) particular resolution powers. The obligation of the Board should be limited to those matters for which the Board has control.

Entry into resolution

In a speech[1] to the Risk Management Institute of Australasia Annual Conference 2022, APRA's Renée Roberts noted that "resolution action… is likely to occur prior to ordinary insolvency at what APRA describes as the 'point of non-viability' – the point at which APRA believes it is compelled to intervene to ensure resolution is orderly".

KPMG notes that there is no definition in draft CPS 900 of 'non-viability' and a lack of clarity on the concept of 'point of entry into resolution'. We consider that clarification is required on what constitutes the 'point of entry into resolution' and how it is anchored to the notion of 'non-viability'. A framework for assessing and determining non-viability should be specified by APRA.

We suggest that the legal process for entry into resolution should also be clarified. For example, at the appointment of a statutory manager or the invocation of mandatory business transfer powers.

Financial resources

Under CPS 900 "APRA-regulated entities must maintain the financial resources required to operationally execute resolution actions". KPMG considers that the implications of this need to be clarified, especially the expected level of financial resources and on the basis of what level of stress testing.

The proposal suggests that Significant Financial Institutions (SFIs) might be required to issue loss absorbing capacity (LAC) instruments. However, no guidance is provided on the framework to be applied in determining whether LAC would be required and, in the event that it is required, the amount of LAC instruments that would need to be issued. KPMG suggests that APRA provide the necessary guidance on this for further consultation with affected parties.

A cost/benefit analysis should also be undertaken, given that LAC is for tail-end risks of extremely low probability, but the capital costs are ongoing.

[1] *https://www.apra.gov.au/news-and-publications/executive-director-policy-and-advice-division-ren%C3%A9e-roberts-speech-to-risk*

1. Is the approach to proportionality well-balanced and appropriate?

Under the draft standards, larger or more complex entities would be subject to heightened contingency planning and resolution planning requirements, consistent with their greater risks to financial stability, and consistent with international practices. This may require SFIs, or those that provide critical functions, to take identified pre-positioning steps to remove potential barriers to execution and allow for orderly resolution. Smaller entities would be subject to fewer requirements.

KPMG broadly supports APRA's proposed proportional approach but would welcome further consideration and clarification on the themes below.

Definitions of SFIs and Critical Functions

KPMS considers that a number of terms and concepts could be better defined and further clarified.

KPMG suggests that APRA assess the asset thresholds for SFIs, potentially lifting the thresholds to higher levels that are more commensurate with the notion of systemically important financial institutions. This would help to lower the compliance burdens for financial institutions that are caught by the current thresholds but whose failure would be unlikely to have significant systemic impact. KPMG consider that the size threshold could be adjusted periodically so that it bears a broadly consistent relationship to the total assets of the financial system.

We also suggest that APRA give further consideration to the concept of 'significance' for systemic stability purposes, taking into account a financial institution's market share in particular market niches and key financial markets (e.g. share of inter-bank market, share of payment system transaction volumes, share of lending in particular market niches).

In relation to CPS 190 paragraph 5(b), the phrase 'determined as such by APRA, having regard to matters such as complexity in its operations or its membership of a group' can be elaborated further by listing the matters APRA will consider in this regard. For example, KPMG suggests that the standard can better articulate that the interdependency or contagion risks aspects of the institutions in a particular member group are of importance to APRA. These concepts would benefit from clarification to enable financial institutions to better understand whether they are likely to fall within the definition of a significant financial institution.

The definition of 'critical function' could usefully be clarified and more closely aligned to the terminology used in the Financial Stability Board (FSB) 'Key Attributes' in respect of critical functions and critical services. There should be a clear distinction between critical functions (which relate to a regulated entity's interaction with external parties) and critical services (which relate to internal services).

2. What are the estimated compliance costs to meet the new requirements?

APRA states that possible requirements entailed with pre-positioning planning may include:

- changes to organisational or legal structure, including the location of any shared support services within a Group;
- renegotiation of contracts, including with third-party service providers;
- development of wind-down or run-off plans for particular businesses or assets;
- measures to ensure the operational continuity of key functions and services during resolution; and
- any other actions required to remove barriers to the execution of resolution options or mitigate execution risks.

The costs associated with resolution planning are expected to be very high. Both in terms of the resources needed (internal and external) to undertake resolvability assessments and the cost of designing and implementing pre-positioning plans. Ongoing maintenance costs must also be considered such as operational capabilities, and data and systems required to execute a resolution plan.

KPMG recognises the importance of investing in pre-positioning planning to ensure resolution plans are viable. International experience demonstrates that pre-positioning actions can take several years to implement and may result in resolution strategies being abandoned. For example, the sale of a portfolio of RBS branches was a condition attached to the state-backed bail-out during the GFC with the objective of increasing competition. Separation of the IT infrastructure proved to be too complex after several years and c.2 billion GBP investment, and the sale was abandoned.

KPMG suggest that APRA recognise that the costs may outweigh the benefits in some situations. In that context, we propose APRA seeks to avoid excessive compliance burdens for the regulated institutions, taking into account the net present value of expected benefits of resolution planning relative to the potentially high cost of resolution pre-positioning.

In KPMG’s view, potential resolution options should be limited to a small number (one to two) of viable options that align to resolution objectives, thereby reducing the scope of resolvability assessments for regulated entities. This will help to lower the compliance burdens and associated costs.

Financial contingency planning (CPS 190)

3. Should APRA indicate preferred contingency options?

Financial institutions should have the latitude to devise their own contingency options to restore themselves to financial soundness, rather than these being specified by APRA. Contingency options will be based on a financial institution’s unique risk profile, legal entity structure and commercial arrangements with other financial institutions.

Given these arrangements will vary across the industry, the financial institution will be better positioned to understand the effectiveness of the contingency options available to restore capital and liquidity strength under a stress event.

Accordingly, at most, APRA might provide guidance to financial institutions on contingency options and a suggested framework to help financial institutions assess the feasibility of the options. We would advise against any form of prescription in this area.

4. Are the proposed contents of the financial contingency plan comprehensive?

APRA should provide clarity on whether financial contingency plans are recovery plans or whether they are an integration of recovery plans, capital contingency plans and liquidity contingency plans, such that institutions do not need to maintain separate contingency plans (and hence avoid the duplication that currently arises).

In order to support the integration of these three plans, the contingency plan should not be limited to how a regulated entity should respond to stress events that 'threatens its viability'. Trigger events should encompass early warning signs and governance around timely management and escalation of these signs. Trigger events and corresponding action plans should range from early warning signs, low, medium and severe trigger events.

KPMG suggests that further clarity be provided on the timeframe for implementation of financial contingency plans at levels two and three, in recognition of the potential complexity associated with this aspect of contingency planning. Further guidance will be needed on expectations with respect to financial contingency planning for financial conglomerates and in respect of cross-border aspects of such plans.

A prudential practice guide would be useful to provide pragmatic guidance to support contingency planning. We suggest guidance be developed to address expectations on key elements of the contingency planning framework. This may include:

- Guidance on potential triggers for invoking recovery options, instigating solvent exit and ultimately, resolution;
- Scenarios that provide an indication of the magnitude of impairment to capital and liquidity that institutions should consider;
- Expected timeframes for restoration to defined levels of financial soundness;
- Expectations on preparatory measures;
- Expectations on integration with the RAS, RMF, BCP, ICAAP and ILAAP; and
- A clear definition on what constitutes critical functions and critical services.

Further clarification is needed on APRA's proposed 'solvent exit' requirement. This may be a useful concept for newly licensed entities in their early years of operation. It also has application to insurers, with the long-established option of solvent run-off. However, it is not clear that 'solvent exit' is feasible for a long-established authorised deposit-taking institution (ADI), other than merger or takeover by another institution. KPMG suggests that further consideration by APRA is warranted for ADIs before imposing additional compliance burdens.

5. Are the frequency and type of reviews appropriate?

KPMG recommends a review of contingency plans every three years with triggers embedded for an out of cycle review when there are material changes in legal or organisational structure, business mix, strategy or risk profile. More frequent reviews for certain SFI's could be mandated at APRA's discretion.

KPMG considers that clarification on the expected compliance date for all aspects of CPS 190 would be helpful, in particular for SFIs. The first three-year review should be required three years post-implementation to allow sufficient time for processes to be embedded into the organisation.

Resolution planning (CPS 900)

6. Is the scope of entities subject to CPS 900 appropriate?

Refer to Question 1 for further information on scope.

Sequencing

KPMG considers that the sequencing of resolvability assessments and resolution planning by category of regulated institution should be clarified. As currently proposed, CPS 900 comes into force on 1 January 2024. Our understanding is that APRA will engage with significant financial institutions at an undefined point after the commencement date, but no information has been provided on the intended sequencing – such as whether all of the relevant institutions will be required to undergo resolvability assessments at the same time or whether the process will be advanced by reference to particular categories of institution. KPMG considers that it would be prudent to implement resolvability assessments and resolution planning in stages, possibly starting with ADIs and subsequently moving to insurance, then to superannuation, and by focusing on the most systemically important institutions first.

KPMG considers that the timeframe for the development of resolution plans should be clarified. In recognition that undertaking a resolvability assessment and development of resolution pre-positioning plans are inherently complicated and resource-intensive, there will need to be allowance for a reasonable (multi-year) timeframe for the completion of these tasks.

Cross-sector applicability

While KPMG appreciates APRA's desire to have a generalised framework across industry sectors for many prudential standards, we believe that separate resolution standards for ADIs and ADI non-operating holding companies (NOHCs), insurers and insurer NOHCs, and superannuation Registrable superannuation entities (RSEs) respectively, would increase the efficacy for resolution planning. We suggest a staggered approach to resolution planning across industries, as has occurred in most G20 jurisdictions, such that resolution plans are first completed for significant ADIs, and then extended to significant insurers, and only after that to significant superannuation

RSEs. This will enable the lessons from ADI resolution planning to be drawn on to inform resolution planning for insurers and superannuation.

It is likely that RSEs will only require a winddown plan or a merger/transfer of undertaking a plan, with some scope for separation of critical from non-critical functions and services. As such, superannuation RSEs should prioritise completion of financial contingency plans before undertaking resolution plans. CPS 190 currently applies to RSE licensees on 1 January 2025, yet CPS 900 mandates RSE licensees to have a resolution plan by 1 January 2024. We presume RSEs will not be approached until well after this date but clarification for planning purposes would be beneficial.

Effective date for conglomerate groups

CPS 900 suggests application of requirements to a 'Head of group' and all entities in the group. This would require the resolution plan to be prepared on a Level 1, 2 and 3 basis.

KPMG recommends that further consideration be given to the proposed commencement date of 1 January 2024 for resolution planning for financial conglomerates on a Level 3 basis, given the potentially complex issues involved. The commencement date of 1 January 2024 is ambitious if there is an expectation that regulated entities must undertake resolvability assessments and resolution pre-positioning with effect from that date. A longer period might be appropriate for such entities, particularly given the current depth and breadth of regulatory compliance activity already underway. We suggest that consideration be given to a staggered approach, whereby the resolution planning-related obligations relate to Levels 1 and 2 initially, and are only extended to Level 3 after these resolution plans have been completed.

7. Is the frequency and type of review appropriate?

Frequency of review

KPMG believes that the review frequency of the resolvability assessment of at least every three years appears to be reasonable.

Setting an independent review frequency of less than three years may fail to provide the commensurate value to SFIs in the context of a rare resolution event risk materialising. Whilst the consequence of a resolution event could lead to significant economic disruption, the likelihood of a resolution event occurring, or series of resolution events occurring are historically rare, and typically only occur in exceptional circumstances.

APRA requires a rolling business plan to be of at least three years duration. The updated business plan is highly relevant to the completion and review of the resolvability assessment, as it provides reference inputs such as the business overview, operations, management responsibilities and additional funding projections.

In addition, the Risk Management Prudential Standards require SFIs to undertake an independent comprehensive review of their risk management framework every three years. As such, KPMG suggests that further consideration should be given to the timing of the resolvability assessment reviews and the timing of the Risk Management comprehensive reviews, and the potential capacity constraints for SFIs to facilitate both reviews should they occur around the same time.

Type of review

APRA intends for the resolvability assessment review to be performed by operationally independent, appropriately experienced and competent persons. The operational independence consideration must ensure that potential self-review conflicts are mitigated. Those involved in the preparation of the resolvability assessment, pre-positioning plan and resolution plan must not also be involved in the subsequent review of these artefacts.

Given the scope of the review, KPMG considers that it is essential that the review is performed by a highly skilled cross-functional team which brings together a wide range of disciplines and capabilities across the Risk Management Function, Governance, Legal, Finance, Operations and Human Resources.

In particular, the team's expertise must include a selection of professionals experienced in communicating and liaising with regulators (such as APRA), a deep understanding of executing resolution options whilst applying professional judgement to make observations and provide pragmatic recommendations to meet APRA's requirements under the new Prudential Standard. KPMG suggest that APRA consider the experience and qualifications listed in ASIC's Regulatory Guide 258 to register as a liquidator, which includes reference to the requirements to fulfill membership of a professional Legal or Accounting body.

Key contacts:

Linda Elkins – National Sector Leader, Asset & Wealth Management

Steve Jackson - National Sector Leader, Banking & Capital Markets

David Kells – National Sector Leader, Insurance

Craig Davis – Partner, Regulatory and Risk Advisory

Robert Warren – Partner, Regulatory and Risk Advisory

Anthony Donohoe – Partner, Regulatory and Risk Advisory

Peter Komocki – Associate Director, Government & Regulatory Affairs

Olivia Spurio – Senior Consultant, Government and Regulatory Affairs

Co-authors:

Craig Davis – Partner, Regulatory and Risk Advisory

Robert Warren – Partner, Regulatory and Risk Advisory

Geof Mortlock – Special Advisor, Regulatory and Risk Advisory

Fiona Jarmson – Director, Regulatory and Risk Advisory

Suzanna Antoniou – Director, Regulatory and Risk Advisory

Alison Low – Associate Director, Regulatory and Risk Advisory

Andrew Attard – Associate Director, Regulatory and Risk Advisory

Sanya Chopra – Associate Director, Regulatory and Risk Advisory

KPMG.com.au