# Draft Prudential Practice Guide

## CPG 220 – Risk Management

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Australian Prudential Regulation Authority

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# About this guide

Prudential practice guides (PPGs) provide guidance on APRA's view of sound practice in particular areas. PPGs frequently discuss legal requirements from legislation, regulations or APRA's prudential standards, but do not themselves create enforceable requirements.

This PPG aims to assist APRA-regulated institutions in complying with *Prudential Standard CPS 220 Risk Management* (CPS 220) and, more generally, to outline prudent practices in relation to risk management. CPS 220 sets out requirements in relation to the risk management framework of an APRA-regulated institution, and Level 2 and Level 3 groups. These requirements include the need for an institution and group to have a risk management framework that is consistent and integrated with the risk profile and capital strength of the organisation, supported by a risk management function and subject to comprehensive review.

In this PPG, the term 'APRA-regulated institution' refers to an authorised deposit-taking institution, a general insurer, a life company or an authorised non-operating holding company (NOHC) and, where applicable, Level 2 and Level 3 groups.

This PPG is designed to be read together with CPS 220 and does not address all prudential requirements in relation to risk management.

Subject to meeting CPS 220, an APRA-regulated institution has the flexibility to configure its approach to risk management in a manner best suited to achieving its business objectives. Not all of the practices outlined in this PPG will be relevant for every institution and some aspects may vary depending upon the size, business mix and complexity of the institution.

# Contents

## Introduction

1. The information in this guide supports compliance with *Prudential Standard CPS 220 Risk Management* (CPS 220).

## Risk governance

2. Risk governance refers to the formal structure used to support risk-based decision-making and oversight across all operations of an APRA-regulated institution. This typically consists of board committees and management committees, delegations, management structures, and related reporting.
3. The risk governance structure will be dependent on the size, business mix and complexity of the APRA-regulated institution. The concepts of risk ownership, functionally independent review and challenge, and independent assurance provide a sound basis for ensuring risks are appropriately identified, assessed and managed.
4. An effective risk governance model contains checks and balances to support appropriate consideration of risk management throughout the APRA-regulated institution. APRA considers the three lines-of-defence risk management and assurance model[1] to be one that facilitates an effective risk governance model for risk management. This model provides assurance that there are clearly defined risk ownership responsibilities with functionally independent levels of oversight and independent assurance.
5. The first line-of-defence comprises the business management who assume ownership of risks. Accordingly, business management are responsible for day-to-day risk management decision-making involving risk identification, assessment, mitigation, monitoring and management. APRA expects the roles and responsibilities of risk owners to be clearly defined and, where appropriate, incorporated into performance reviews.
6. The second line-of-defence comprises the specialist risk management function(s) and responsible Board Risk Committee(s) that are functionally independent from the first line-of-defence. The second line-of-defence supports the Board of directors (the Board)[2] in three key areas, by:
   (a) developing risk management policies, systems and processes to facilitate a consistent approach to the identification, assessment and management of risks;
   (b) providing specialist advice and training to the Board and first line-of-defence on risk related matters;
   (c) objective review and challenge of:
      (i) the consistent and effective implementation of the risk management framework throughout the APRA-regulated institution; and
      (ii) the data and information captured as part of the risk management framework which are used in the decision-making processes within the business, in particular the completeness and appropriateness of the risk identification and analysis, ongoing effectiveness of risk controls, and prioritisation and management of action plans; and
   (d) oversight of the risk profile and its reporting and escalation to the Board.
7. The third line-of-defence comprises the independent assurance function and Board Audit Committee, each of whom provides independent assurance to the Board that:
   (a) the risk management framework is appropriate for the APRA-regulated institution, consistently implemented and operating effectively. This includes an assessment of the overall framework and the effectiveness of risk management practices, including its influence on decision-making; and
   (b) the policies, procedures and systems are appropriately designed and consistently implemented to operate effectively.

1 For further details refer to Appendix A - Three lines-of-defence risk governance model.

2 For the purposes of this PPG, a reference to the Board, in the case of a foreign ADI, Category C insurer or an Eligible Foreign Life Insurance Company, is a reference to the Senior Officer Outside of Australia or Compliance Committee (as applicable) as referred to in *Prudential Standard CPS 510 Governance* (CPS 510).

## Role of the Board

8. The Board is ultimately responsible for the risk management framework of the APRA-regulated institution. CPS 220 requires a Board to ensure that an institution has, at all times, a risk management framework that governs the way the institution manages risks arising in the institution.
9. The Board may delegate responsibilities to its committees and senior management but this will not absolve the Board from ensuring its responsibilities are fulfilled. APRA expects that any delegation of responsibilities will be accompanied by clearly documented roles and reporting structures to ensure Board oversight is maintained.
10. The Board is directly responsible for the broader strategy of the APRA-regulated institution and, in particular, approving the risk appetite statement, business plan, and risk management strategy. Effective design of these documents and related processes will facilitate their integration, with each process appropriately supporting the other.
11. The Board of the APRA-regulated institution is responsible for the risk management framework, whether or not risk management and business operations are outsourced to a third party or are performed by another part of a group.
12. In determining whether the Board has met its responsibilities, APRA will assess the steps taken by the Board to ensure, to the best of its knowledge and having made appropriate enquiries, it meets its responsibilities. For example, APRA expects a Board would determine when risk issues should be escalated to it. Where risk issues have failed to be appropriately escalated, APRA expects the Board to remedy the failure. APRA takes a pragmatic approach to assessing whether a Board is fulfilling its responsibilities in practice, and will assess steps taken by the Board to support an appropriate risk management framework.

## Risk management culture

13. APRA's view is that a sound risk management culture (risk culture) is a core element of an effective risk management framework. Risk culture is the combined set of individual and corporate values, attitudes, competencies and behaviours that determine an APRA-regulated institution's commitment to, and style of, risk management.
14. CPS 220 requires a Board to ensure that a sound risk culture is established and maintained throughout the APRA-regulated institution. An institution's risk culture is strongly influenced by the 'tone at the top'. APRA expects the Board and senior management to demonstrate their commitment to risk management and foster a sound risk management environment, in which staff would be actively engaged with risk management processes and outcomes, and a risk management function that is influential and respected.
15. The Board influences and communicates its desired risk culture through the APRA-regulated institution's business strategy, risk appetite, and understanding of key risks and capabilities, as well as how risk management behaviours are encouraged and rewarded. In fostering an effective risk culture, it is important that there is consideration of the culture across the whole organisation.
16. A sound risk culture:
    (a) supports transparency and openness of risks, the internal control environment, events and issues, and ensures there are well-designed processes and effective risk reporting;
    (b) encourages awareness of risks and responsibility for managing those risks;
    (c) ensures that appropriate actions are taken in a timely manner for issues and risks identified that are outside of set thresholds and tolerances/limits. For example, risk indicators that remain 'red' for extended periods of time could indicate complacency or a lack of funding in the overall management of risk; and

(d) rewards staff for appropriate risk management behaviours. Typically, this would be achieved through incorporating risk management as a core responsibility within individual roles and responsibilities.

17. APRA considers that the development of the desired risk culture would be assisted by a Code of Conduct, ongoing risk education and awareness training programs, processes to ensure behaviour is monitored and managed within risk appetite, and robust and prudent risk management policies.

18. Remuneration policies will positively influence the desired risk culture if they are designed to encourage and provide incentives to employees to act responsibly and with integrity, in a manner consistent and integrated with the APRA-regulated institution's risk management framework.[3]

## Group risk management

19. CPS 220 allows an APRA-regulated institution that is part of a group to meet the requirements of the standard on a group basis, provided that the Board of the institution is satisfied that the requirements are met in respect to that institution.

20. APRA expects that the appropriateness of using a group risk management framework would be assessed by that APRA-regulated institution according to the size, business mix and complexity of that institution's business operations. The purpose of this assessment is to ensure that the group's framework is 'fit for purpose' for the institution.

21. APRA expects this assessment by the APRA-regulated institution to be conducted prior to using the group's framework and after any changes to the group or the institution that may materially impact on the risk management framework. The institution needs to have a clear understanding of the reliance on, and interaction with, the group's risk management framework, and understand the consequences of these arrangements for the risk profile of the institution.

22. If the APRA-regulated institution is part of an Australian or international corporate group, APRA expects the institution to assess the appropriateness of links with the group's risk management framework and be able to provide a summary of this assessment.

23. If an APRA-regulated institution is part of an international insurance or banking group where the head office or ultimate holding company is outside Australia, and the institution uses the group's risk management framework, APRA expects the institution to have a documented summary of how the group framework meets APRA's requirements for that institution.

## Risk management framework

24. A risk management framework enables an APRA-regulated institution to identify, analyse and manage the current and emerging material risks within its business. Effective approaches to risk management provide meaningful information that appropriately supports decision-making and oversight at each level within the institution. The risk management framework will ideally support an institution in:

    (a) identifying, analysing and understanding each of the material risks at all levels of the institution;

    (b) ensuring that appropriate strategies, policies, effective operating controls and other mitigants are in place and operating effectively;

    (c) providing reliable and meaningful risk information (reporting) to decision-makers;

    (d) ensuring that there is adequate oversight of the risk profile and management framework; and

    (e) facilitating a proactive risk culture.

3 Refer to CPS 510 and *Prudential Practice Guide PPG 511 Remuneration* on the design of remuneration policies.

25. This is achieved, in part, through a clearly articulated risk appetite statement that outlines the APRA-regulated institution's risk appetite and risk tolerances within its risk capacity.[4]

26. APRA expects that the primary focus of an APRA-regulated institution's risk management framework would be the management of risks in a way that is consistent with both the best interests of depositors and/or policyholders and the maintenance of the sound financial position of the institution.

27. APRA expects the Board and senior management to know and understand the APRA-regulated institution's operational structure and associated risks. Risk can arise from structures that impede transparency, such as special-purpose or related structures. APRA expects the Board and senior management to consider the implications of the institution's structure in facilitating effective risk management.

28. Stress testing, including both scenario analysis and sensitivity analysis, is used to assess a range of potential impacts on different material risks. Stress testing is important in considering potential changes that could occur in the external operating environment, and provides a more forward-looking view of an APRA-regulated institution's risk profile. APRA expects that stress testing would be based on a combination of robust modelling and informed expert judgement, with effective senior management engagement and Board oversight.

## Integration of risk management framework and Internal Capital Adequacy Assessment Process

29. The risk management framework supports the Board and senior management in obtaining an appropriate view of the APRA-regulated institution's overall risk profile. Reporting facilitates decision-making and oversight, taking into consideration the overall structure and nature of business and different approaches to managing different material risks. In understanding the overall risk profile of the institution, specific consideration would be given to:

    (a) identifying risks throughout the institution that, in combination, may have a material impact on the institution;

    (b) understanding the interaction of material risks throughout the institution. For example, a failure in processes or systems (operational risk) may result in excess claims being paid (underwriting risk); and

    (c) risks of contagion arising from issues identified with related parties (including any non-APRA-regulated activities).

30. APRA requires an APRA-regulated institution, excluding foreign ADIs, to have an Internal Capital Adequacy Assessment Process (ICAAP).[5] An ICAAP involves an integrated approach to capital adequacy and risk management, aimed at ensuring that the capital held is adequate in the context of the risk profile and risk appetite of that institution. An institution's risk management framework and ICAAP are required to be integrated and consistent.

4 Refer to CPS 220 for the definitions of risk appetite and risk tolerance. Risk capacity is the maximum risk an institution can bear.

5 Refer to P*rudential Standard APS 110 Capital Adequacy, Prudential Standard GPS 110 Capital Adequacy, Prudential Standard LPS 110 Capital Adequacy*, *Prudential Standard 3PS 110 Capital Adequacy,* and *Prudential Practice Guide CPG 110 Internal Capital Adequacy Assessment Process and Supervisory Review.*

31. An APRA-regulated institution is not required to duplicate content between its ICAAP summary statement or ICAAP report and its risk management strategy. However, APRA expects that the risk management strategy would contain sufficient detail to provide a holistic view of the institution's strategy for managing risk without having to source other documents. Where other documentation contains additional detail, APRA expects that cross-references will be clear and up-to-date to facilitate consistency and integration between the documents.

## Material risks

32. CPS 220 identifies categories of risk that the risk management framework must, at a minimum, cover. APRA's view is that the emphasis on each risk category is likely to differ according to the size, business mix and complexity of the APRA-regulated institution. APRA expects that an institution would be able to demonstrate how it determines 'materiality' of risk categories and to identify the key risk drivers within each category. Communicating what the institution views as material is important to ensure that its approach is understood by its staff and is consistently applied across its business operations.

## Strategic and business planning

33. CPS 220 requires an APRA-regulated institution to maintain a business plan that sets out its approach for the implementation of its strategic objectives. The business plan is an important management and control tool that enables an institution to identify how it will achieve its strategic objectives.

34. Fundamental to an effective risk management framework is a sound business plan that is consistent and integrated with the risk management strategy and risk appetite statement. APRA expects that the APRA-regulated institution's risk management framework will provide relevant information to senior management and the Board to facilitate the strategy and business planning process (e.g. areas of increased risk, changes in the environment, prioritisation and allocation of resources). APRA also expects that the relevant components of the risk management framework would be reviewed in the context of the institution's strategic and business planning processes.

35. CPS 220 requires a rolling business plan of at least three years' duration that is reviewed at least annually. A rolling plan supports a medium to long-term view of business objectives, while the annual review ensures it is dynamic and updated to reflect current goals.

36. APRA expects the APRA-regulated institution's business plan review process would consider the impact on the risk profile of the institution's business operations and identify the potential changes to the material risks. This might include formal consideration of issues arising from planned material changes to the institution's business operations and risks.

## Risk appetite statement

37. The risk appetite statement is used to communicate the Board's expectations of how much risk on the APRA-regulated institution it is willing to accept. APRA's view is that a reasonable and easily understood risk appetite statement that aligns to the approaches used to identify, assess and manage material risk is fundamental to risk management.

38. The articulation of risk appetite and risk tolerances is central to a risk appetite statement. Risk appetite is the degree of risk an APRA-regulated institution is prepared to accept in pursuit of its strategic objectives and business plan. Risk tolerances translate risk appetite into operational limits for the day-to-day management of material risks, where possible.

39. The development and review of an APRA-regulated institution's risk appetite statement will generally be performed as part of the strategic and business planning process. The risk appetite statement would provide relevant information on the Board's expectations regarding the risk appetite, and would in turn be updated to reflect any changes as a result of the strategic and business planning process.

40. APRA expects that the Board would be actively engaged in developing and reviewing the risk appetite statement, and would be able to demonstrate ownership of the statement. APRA considers that this might be achieved, in part, through reporting and communication processes and structures that enable the Board and Board Risk Committee to:

    (a) identify the APRA-regulated institution's overall current risk profile and how this compares to its risk appetite and capital strength;

    (b) understand how senior management interprets and applies risk tolerances;

    (c) be satisfied that senior management's interpretation and application of the risk appetite is appropriate;

    (d) appropriately align risk appetite to the approach adopted in the risk management framework for assessing, monitoring and managing the different material risks; and

    (e) take factors (a), (b), (c) and (d) into account when reviewing the risk appetite statement.

41. APRA expects an APRA-regulated institution to communicate appropriate aspects of its risk appetite statement throughout its business operations to ensure that the risk appetite statement is understood and consistently implemented, as appropriate. An appropriate summary of the risk appetite statement would include relevant information for the intended audience.

42. Risk appetite is a key consideration in developing policies in relation to key decision-making processes. For example, when an APRA-regulated institution develops a business case or agrees to contractual and service level agreements for a material outsourced arrangement, APRA expects that the risk management framework would be used to identify and assess risks, and that the risk appetite is considered in the decision-making and implementation process.

43. An APRA-regulated institution would generally use a variety of approaches and processes to assess different material risks. An institution with the capability to use risk quantification techniques would generally use them in the setting and monitoring of its risk appetite statement. Risk quantification techniques may provide an institution with assurance that the risk does not exceed the institution's risk tolerance and/or risk capacity. These techniques may not be appropriate for all types of risk. APRA expects that the results of such analysis and testing would be reported to the Board and/or Board Risk Committee and be taken into account when establishing or reviewing the risk appetite statement. APRA expects the Board to understand the limitations and assumptions relating to any models used to measure components of risk that could materially affect its decision-making.

44. Where an international insurance or banking group operates a subsidiary and a branch in Australia, APRA requires each APRA-regulated institution to have a risk appetite statement that is tailored to its risk profile. Although risk appetite may be set by the overseas group on a divisional basis, APRA nevertheless expects the branch risk appetite statement to provide an overview of the aggregate risk profile of the Australian branch operation.

### Risk appetite

45. Risk appetite expresses the aggregate level and types of risk that an APRA-regulated institution is willing to assume to achieve its strategic objectives and business plan before breaching its obligations or constraints determined by regulatory capital and liquidity needs.

46. In APRA's experience, risk appetite can be expressed in a number of ways to ensure that it is commonly understood and consistently applied across an APRA-regulated institution's business operations. Generally, the risk appetite is expressed in the form of high-level qualitative statements that clearly capture the institution's attitude and level of acceptance of different risks. Where appropriate, the risk appetite statement may include quantitative measures.

### Risk tolerance

47. Risk tolerances are established for each material risk, taking into consideration the risk appetite. Risk tolerances are based on the maximum level of acceptable risk. To facilitate implementation and monitoring of the risk appetite in day-to-day business activities, an APRA-regulated institution may also decide to set risk limits for more granular risks within each material risk.

48. Risk tolerances can be expressed in a number of different forms depending on the nature of the risk being managed. They can act as triggers for considering whether action is necessary in relation to the risk. Where possible, risk tolerance would be expressed as a measurable limit to enable a clear and transparent monitoring process that ensures the APRA-regulated institution remains within the determined risk tolerance. An institution may also define key indicators with thresholds around the risk tolerance.

49. APRA recognises that, for some risks, a qualitative risk tolerance may be appropriate. In these circumstances, the APRA-regulated institution would be expected to ensure the tolerance is well-articulated to enable consistent implementation across the institution's business operations and to determine when the risk tolerance has been exceeded.

50. Where a risk exposure falls outside the APRA-regulated institution's risk tolerance, APRA expects that the institution would develop and implement a plan of action to review the risk and reduce it to a level that is within its acceptable tolerance.

## Risk management strategy

51. CPS 220 requires an APRA-regulated institution to formulate, maintain and give effect to a risk management strategy that provides an overview of how the risk management framework addresses each material risk for the institution, with reference to the relevant policies, standards and procedures.

52. APRA expects that a risk management strategy would contain sufficient information to communicate, in general terms, the APRA-regulated institution's approach to risk management. This includes how it identifies, measures, evaluates, monitors, reports, and controls or mitigates the material risks of its operations. CPS 220 requires that the risk management strategy list the policies and procedures dealing with risk management matters. Where these policies and procedures require Board approval under other prudential standards, approval of the strategy does not negate the Board's responsibility to approve those individual documents.

## Risk management function

53. A key role of an APRA-regulated institution's risk management function is to assist the Board and senior management by providing independent and objective review and challenge, oversight, monitoring and reporting in relation to risks to the institution's business operations. An additional responsibility is to provide technical support and assist the Board and senior management to develop, implement and maintain the risk management framework.

54. APRA expects that the risk management function would also assist the Board in building risk management capabilities throughout the APRA-regulated institution by providing specialist education, training and advice to directors, senior management and staff of the institution. It would also typically facilitate the development and implementation of the Board's desired risk culture throughout the institution's business operations.

55. APRA expects the roles and responsibilities of the risk management function would be clearly defined and documented as part of the risk management framework. These responsibilities include assisting with the development and maintenance of the risk management framework.

56. APRA expects a risk management function to be appropriately structured to fulfil its roles and responsibilities. This may include placing risk management personnel within business line divisions or functions. For example, personnel who focus on market risk may be located within a specialist market risk team that is aligned to the relevant trading/investment functions. Where risk management personnel are located across the APRA-regulated institution, these personnel would still form part of the overall risk management function's reporting structure. It is important that the roles and responsibilities are clearly understood with clear reporting and escalation lines to the designated head of the risk management function, referred to as the Chief Risk Officer (CRO), and responsible committees.

### Chief Risk Officer

57. APRA expects the risk management function to have sufficient stature, authority and resourcing to support sound risk-based decision-making. This is reflected in the requirement in CPS 220 that the CRO, must have authority to provide effective challenge to activities and decisions that may materially affect the institution's risk profile.

58. This can be further evidenced by a CRO who is appropriately skilled, unencumbered by conflicts of interest with their risk management role, and can speak with candour to the Chief Executive Officer (CEO), the Board and relevant committees. Under a three lines-of-defence model, the role and responsibilities of the CRO are clearly within the second line.

59. The stature and authority of the CRO would be supported by their being a senior executive, having an ability to influence material decisions and remuneration appropriate to their responsibilities. APRA expects that the CRO's authority and participation in decision-making would support risk-based considerations that are consistent with the institution's risk appetite statement, risk management strategy and business plan. It is important that the CRO provides effective challenge as part of their participation in the decision-making process, ensuring that material decisions are risk-based.

60. CPS 220 requires an APRA-regulated institution to have a process for identifying, monitoring and managing perceived, potential and actual conflicts of interest. APRA's requirement for a 'designated' rather than 'dedicated' CRO provides scope for the person to have other roles and responsibilities, so long as there is no conflict of interest.

61. CPS 220 sets out requirements for the independence of the CRO and specifies roles that cannot also be performed by the CRO. CPS 220 recognises that an APRA-regulated institution may seek approval for alternative arrangements to those required. This may be where the institution is materially constrained in appointing a CRO who is free from conflicts of interest, or for reasons particular to that institution. APRA expects these instances to be limited to smaller and less complex institutions. Where an institution seeks an alternative arrangement under CPS 220, the Board is expected to demonstrate to APRA that it has undertaken a process to identify conflicts, has established structural oversight and controls to mitigate the additional risk, and is satisfied that the risk management framework will ensure these mitigants are adhered to. APRA will assess the appropriateness of alternative arrangements on a case-by-case basis. APRA expects that the Board would take into account the following controls and other mitigating factors that manage conflicts of interests including, but not limited to:

    (a) alternative sources of risk-based challenge to business lines;

    (b) the resources allocated to risk management;

    (c) executive level engagement in risk issues;

    (d) the strength of compliance and audit mechanisms;

    (e) oversight from the Board and its committees;

    (f) the experience and capabilities of the other risk management function personnel; and

    (g) the robustness of the regulated institution's and, where appropriate, the group's risk management framework.

62. CPS 220 requires that the risk management function, via a CRO, has direct and unfettered access to the CEO, Board, Board Risk Committee and senior management. CPS 220 also requires the reporting line for the risk management function to be independent from business lines, which requires the CRO to directly report to the CEO. Where an APRA-regulated institution is part of a group, including a Level 2 and/or Level 3 group, the CRO of that institution may report to the group CRO as long as the group CRO reports directly to the group CEO. Further, the Board of the Level 1 institution is expected to demonstrate that the group CRO is fulfilling his or her responsibilities to that institution on a Level 1 basis.

63. CPS 220 recognises that an Australian branch operation may seek an alternative arrangement for the requirement that the CRO report to the CEO. A number of Australian branch operations use a regional or global CRO who assumes the risk responsibilities for the branch. Due to their regional or global reporting lines, it may be impractical to require the CRO to report to the Australian branch's CEO. Where this is the case, APRA expects that the designated CRO has sufficient oversight of, and involvement with, the management of risk in the branch. APRA expects the branch would be able to demonstrate that the CRO can fulfil his or her roles and responsibilities to the Australian institution, evidenced by regular and unfettered access to the Australian branch Senior Officer Outside of Australia or Compliance Committee.

64. For the avoidance of doubt, CPS 220 does not require the designated head of the risk management function to be called a CRO.

## Compliance function

65. CPS 220 requires a designated compliance function to have a reporting line independent from business lines to support clear and timely reporting of compliance risks. APRA envisages that the CRO would be able to provide this independent reporting line and that they may have responsibility for the compliance function. Where a CRO is also the head of the compliance function, he or she is expected to effectively fulfil the responsibilities for each function.

66. Where an APRA-regulated institution combines its risk and compliance functions, APRA expects that the institution would allocate sufficient resourcing to fulfil the roles and responsibilities of each function.

## Outsourcing

67. APRA does not expect that outsourcing the risk management and/or compliance functions would be a common practice. Where an APRA-regulated institution considers there is adequate justification, this is considered to be a material business activity for the purposes of *Prudential Standard CPS 231 Outsourcing* (CPS 231).

## Monitoring and reporting

### Oversight and escalation processes

68. APRA expects an APRA-regulated institution's risk management framework to ensure that the Board and senior management receive regular, concise and meaningful assessment of actual risks relative to the institution's risk appetite, and the operation and effectiveness of controls.

69. An APRA-regulated institution's formal escalation procedures would ordinarily cover reporting of exceptions to risk appetite, risk tolerances and more granular risk limits. This reporting would include sufficient commentary to facilitate management review and understanding of the report content, where necessary.

### Information systems for business reporting

70. APRA expects that an APRA-regulated institution would, as part of its risk management framework, establish, maintain and document effective Management Information Systems (MIS) commensurate with the size, business mix and complexity of its business operations.

71. Effective MIS provide appropriate information at each level of management and decision-making within the APRA-regulated institution. Such information systems assist in the management, communication and reporting of risk issues and outcomes and assist the management of the institution to appropriately monitor and manage different material risks. The MIS would be sufficiently flexible to support decision-making during periods of stress, when the institution's risk profile may significantly change.

72. APRA envisages that an APRA-regulated institution would implement controls for ensuring data in information and reporting systems is current, accurate and complete. Internal information and reporting systems would be secure and supported by adequate business continuity and disaster recovery arrangements.[6]

73. A well-functioning information and reporting system would typically:

    (a) produce appropriate risk and compliance data and reports;

    (b) incorporate information that is relevant to decision-making;

    (c) report accurate, reliable and timely information;

    (d) allow the institution to identify, assess and monitor business activities, existing and emerging risks, financial position and performance;

    (e) allow the institution to monitor the effectiveness of, and compliance with, its internal control systems and report any exceptions that arise; and

    (f) be reviewed regularly to assess the timeliness and relevance of information generated and the adequacy, quality and accuracy of the system's performance over time.

## Review of the risk management framework

74. CPS 220 requires an APRA-regulated institution to have two types of reviews of its risk management framework:

    (a) an annual review that covers compliance with, and effectiveness of, the risk management framework by internal and/or external audit; and

    (b) a three-year comprehensive review on the appropriateness, effectiveness and adequacy of the framework by independent experts.

### Annual review

75. APRA will accept annual reviews that explore particular elements of the risk management framework in depth and on a rotational basis. For example, if an institution's risk management framework has six material elements, it may choose to review two of these every year. The annual review signoff would include those reviews conducted during the previous year. However, APRA expects that all elements of the risk management framework would be subject to this annual review at least every three years. For insurers, the annual review required by CPS 220 is separate from the assessment of the suitability and adequacy of the risk management framework conducted by the Appointed Actuary.[7] This review must be reported to the Board Audit Committee or, in the case of a Category C insurer, foreign ADI, or Eligible Foreign Life Insurance Company to the Senior Officer Outside of Australia or the Compliance Committee.

76. APRA envisages that some branch operations would be subject to group internal audits of compliance with, and effectiveness of, its risk management framework. APRA may approve alternative timing

6 Refer to *Prudential Practice Guide CPG 235 Managing Data Risk* for further guidance.

7 Refer to *Prudential Standard GPS 320 Actuarial and Related Matters* (GPS 320) and *Prudential Standard LPS 320 Actuarial and Related Matters* (LPS 320).

to this annual review, such as on a biennial basis, if satisfied that those arrangements will, in APRA's view, achieve the objectives of this requirement. APRA will assess the appropriateness of alternative arrangements on a case-by-case basis with considerations including, but not limited to, the:

(a) size, business mix and complexity of the branch operations;

(b) process the Senior Officer Outside of Australia or Compliance Committee has undertaken to satisfy themselves that an alternate timing of review is appropriate;

(c) additional controls in place to mitigate the risk of non-compliance in interim years; and

(d) robustness of the branch operations and, where appropriate, the robustness of the group's risk management framework.

**Comprehensive review**

77. CPS 220 requires the comprehensive review to be conducted by operationally independent, appropriately trained and competent persons at least every three years. This review must be reported to the Board Risk Committee or, in the case of a Category C insurer, foreign ADI, or Eligible Foreign Life Insurance Company to the Senior Officer Outside of Australia or the Compliance Committee.

78. APRA expects the comprehensive review to include a comparison of the institution's current practice against better practice. Where any gaps are identified, APRA expects the review to outline steps to address these differences or identify why changing current practice is not considered appropriate. The review may draw upon the APRA-regulated institution's internal resources, such as internal audit reports, to the extent that the independence of the review is not undermined. For insurers, the Financial Condition Report assessment of the risk management framework[8] would be taken into account, but not solely relied upon, for the purposes of the comprehensive review. This forward-looking review is intended to assist the Board Risk Committee to oversee the implementation and appropriateness of the institution's risk management framework, while any compliance issues identified would be reported to the Board Audit Committee.

79. APRA expects these reviews would include an assessment as to whether the framework remains appropriate for the institution and the risks it faces, whether the framework has been consistently implemented, whether there are appropriate procedures in place to ensure that the framework addresses any new risks or changes to existing risks, including lessons learnt from risk incidents and near misses, and consideration as to whether the framework is effective in providing appropriate, effective and timely information to inform decision-makers.

80. An APRA-regulated institution may coordinate the comprehensive review with the review of its ICAAP. Capital management is an essential part of an APRA-regulated institution's risk management framework. APRA expects the comprehensive review would not simply be a review of the ICAAP, but would assess how the ICAAP is integrated with other elements of the risk management framework that are beyond capital management.

81. In considering whether a person is operationally independent, an APRA-regulated institution would take into account any role that the person may have in connection with the development or implementation of the framework, or the activities under review, that may impact on their ability to perform an objective review. Where an institution is using the group risk management framework, APRA expects that a person would not be operationally independent if they have been involved in the development or implementation of that framework.

8 Refer to GPS 320 and LPS 320.

### Difference between the annual and comprehensive review

82. The difference between the annual and comprehensive review is the depth and scope of the assessment. The annual review is focused on particular elements of the risk management framework. Given the depth of the review, APRA expects internal and/or external audit would cover all aspects of the risk management framework according to a rolling audit plan.

83. In contrast, the three-year review provides a holistic, institution-wide view of the risk management framework, including the interaction between its constituent elements. While the annual review is focused on the current state of the risk management framework, the comprehensive review is to provide an assessment and recommendations on the appropriateness of the framework going forward. APRA expects that the comprehensive review would draw upon the annual review reports when assessing how the particular elements of the risk management framework interact.

## Risk management declaration

84. CPS 220 requires the Board to provide APRA with a risk management declaration on an annual basis. While this declaration does not have to be audited, APRA expects that the two directors of the APRA-regulated institution who sign the declaration would have obtained reasonable assurance and, if necessary, considered independent advice on the matters upon which they have made a declaration.

85. CPS 220 allows an APRA-regulated institution's risk management declaration to be encompassed in the risk management declaration documentation of a Level 2 and/or Level 3 group, where applicable. Where a Level 1 institution's declaration is encompassed within the group declaration, the Level 1 institution's Board remains responsible for any qualifications in the declaration that relate to that institution. Where a risk management declaration is made on a Level 2 and/or Level 3 group basis, CPS 220 requires any qualification to identify whether it related to the Level 1 institution or the group's risk management framework. A qualification for the institution may not mean that a group-wide qualification needs to be made, and vice-versa. However, where a group's Board has taken the decision that a qualification at the institution level does not result in a group declaration qualification, the reason for this decision would be articulated.

86. CPS 220 requires the risk management declaration to be submitted to APRA in accordance with reporting standards made under the *Financial Sector (Collection of Data) Act 2001*, which include:

    (a) for a general insurer - on, or before, the day the yearly statutory accounts or group's annual accounts (as appropriate) are required to be submitted to APRA;

    (b) for a life insurer - on, or before, the day the annual regulatory financial statements are required to be submitted to APRA; and

    (c) for an authorised deposit-taking institution - within three months of the annual balance date or group's annual accounts (as appropriate) are required to be submitted to APRA.

## APRA notification requirements

87. CPS 220 requires an APRA-regulated institution to notify APRA of material changes to the size, business mix and complexity of the institution's business operations. APRA expects that this would include, but not be limited to, the following material changes:

    (a) events such as proposals relating to major modifications to, or the re-organisation of, the functions of the institution;

    (b) proposed acquisitions;

    (c) changes to business lines and products;

    (d) changes in organisational structure; and

    (e) deviations from the risk management strategy.

88. CPS 220 requires an APRA-regulated institution that conducts business outside of Australia to notify APRA when it becomes aware that its right to conduct business in any other jurisdiction has been materially affected. A restriction on the ability of an institution to conduct business overseas could impact on its Australian operations, and may have resulted from weaknesses in risk management. APRA expects to be informed, at a minimum, when the institution's right to conduct business has:

    (a) ceased in a jurisdiction;

    (b) been limited by a law of any jurisdiction in which business is being conducted;

    (c) been otherwise materially affected under a law of any jurisdiction in which business is being conducted;

    (d) otherwise been withdrawn; or

    (e) where applicable, changes to the ability of a group member to conduct business that materially impacts on the Australian operation's risk profile.

89. APRA expects that an APRA-regulated institution would be in regular dialogue with its supervisors about potential material changes to the institution. APRA expects that, at the latest, notification in accordance with the requirements in CPS 220 would be made within 10 business days of the Board becoming aware of a current or proposed material change to the institution's risk profile or business operations.

# Appendix A – Three lines-of-defence risk governance model

## First line-of-defence

1. Business management typically includes all levels of management responsible for the business decision making. The first line-of-defence also includes management committees and forums.
2. A key tenet of the three lines-of-defence model is that business management cannot abrogate its responsibility for risk management. The first line-of-defence is responsible for:
   (a) effective implementation of the risk management framework, including reporting and escalation of the relevant information to the Board, board committees and responsible senior management, as appropriate; and
   (b) managing risk in a way that is consistent and integrated with the risk management framework.
3. Executive and senior business management would ensure risk ownership is clearly defined and that the risk management framework is effectively implemented and supports decision-making. This would usually include reporting, escalation and monitoring procedures that are appropriate for the management of different risk categories.
4. The first line-of-defence would have clearly defined and documented roles and responsibilities, including the risks that individuals are accountable for. These roles and responsibilities would be tailored to reflect the risk owner's ability to control the risk to which they are accountable.

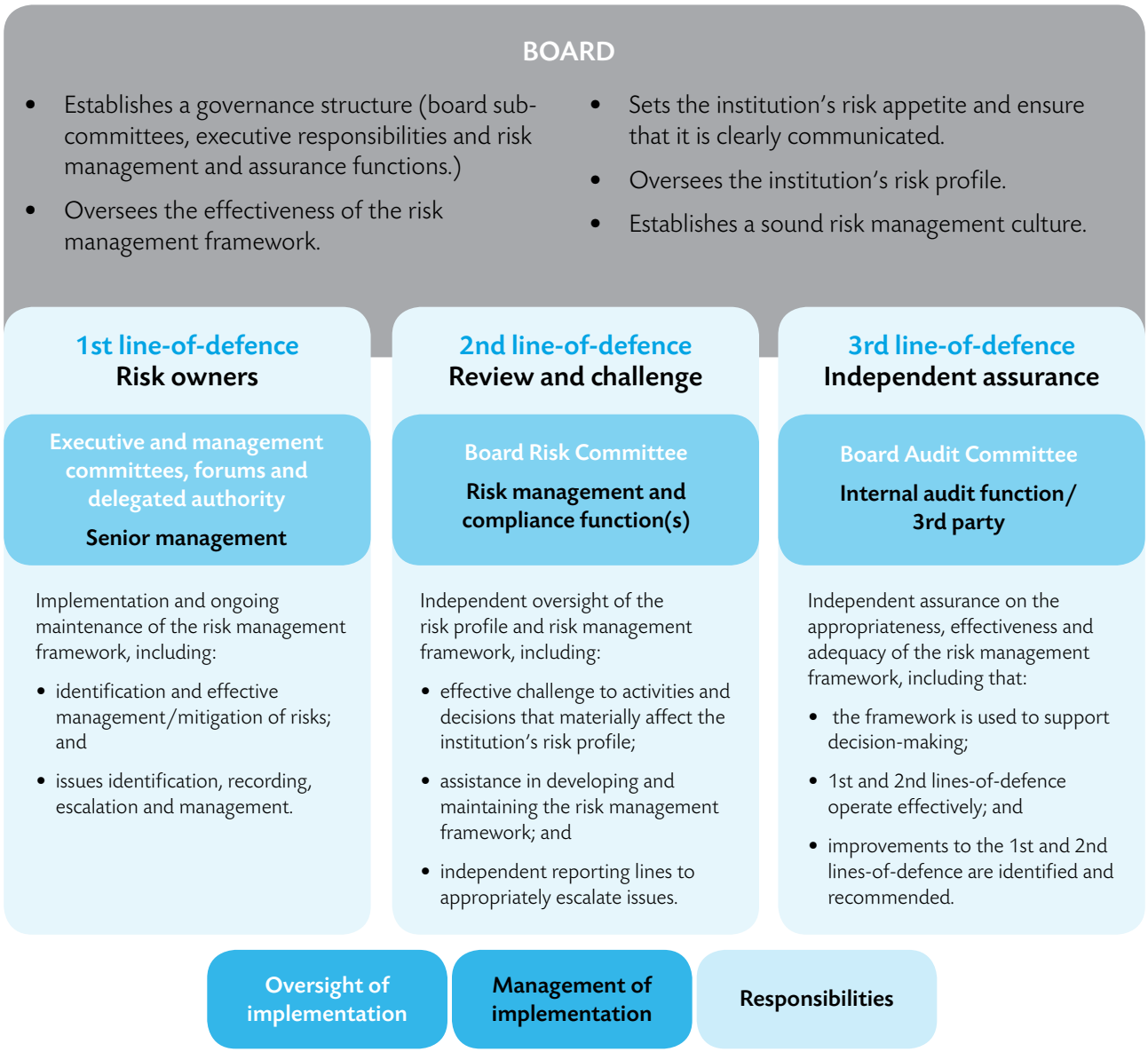
## Second line-of-defence

5. In order to be effective, the Board would ensure that risk management functions have:
   (a) adequately experienced staff with relevant technical knowledge and experience to facilitate the development, ongoing review and validation of the risk management framework; and
   (b) appropriate seniority and authority, with independent reporting lines to the responsible board committees.
6. Smaller and less complex APRA-regulated institutions often combine risk management roles with other roles or functions. Where such dual roles exist, APRA expects that appropriate care would be taken to ensure that the independence of the risk management function is maintained.

## Third line-of-defence

7. The application of the third line-of-defence would vary depending on the size, business mix and complexity of an APRA-regulated institution. The independent assurance function could, for example, include internal audit, a third-party assurance provider or a combination of the two. A key consideration would be ensuring appropriate independence, technical knowledge and experience.
8. While findings raised by the third line-of-defence would typically be utilised by management to increase business efficiency and inform decision-making these benefits are secondary to the primary assurance objective.
9. CPS 510 requires the separation of the Board Risk Committee and Board Audit Committee. The separation of these committees aligns with the distinct responsibilities for audit's role in the third line-of-defence and risk management's role in the second line-of-defence for independent assurance and risk management, respectively.

10. Below is a graphical representation of a three lines-of-defence risk governance model:



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