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Dear Neil,

Supervision of conglomerate groups – 2. Risk management and capital adequacy Harmonising cross-industry risk management requirements

The Australian Bankers' Association (ABA) welcomes the opportunity to respond to APRA's consultation papers, *Supervision of conglomerate groups – 2. Risk management and capital adequacy* and *Harmonising cross-industry risk management requirements*. The ABA provides the attached comments for APRA's consideration.

Yours sincerely,

Tony Burke

Australian Bankers' Association Inc. ARBN 117 262 978
(Incorporated in New South Wales). Liability of members is limited.

Submission

Supervision of conglomerate groups - 2. Risk management and capital adequacy

Harmonising cross-industry risk management requirements

July 2013

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The Australian Bankers' Association (ABA) welcomes the opportunity to respond to APRA's consultation papers, *Supervision of conglomerate groups - 2. Risk management and capital adequacy* and *Harmonising cross-industry risk management requirements*. The ABA provides the following comments for APRA's consideration.

1. Timing

As the ABA indicated in its submission on the governance and risk exposures consultation package, the proposed 1 January 2014 implementation date for the Level 3 reforms poses significant issues for Level 3 groups. In particular, the ABA is concerned that there is insufficient time for Level 3 groups to undertake the necessary Board and senior management engagement and education processes on the Level 3 reforms; complete governance processes involved in making the necessary changes to risk management and capital policies; undertake any necessary restructuring of external funding of subsidiaries to comply with the Level 3 capital standards; and, ensure that Level 3 regulations are adopted on a consistent basis with the Level 2 Basel III capital reforms applying to ADIs.

The table below provides an indicative high-level implementation timeframe that would be needed for these steps.

ACTION	DURATION
Designate resourcing (will require Board/senior management approval) and interpret final package (Standards and Guides)	1 to 2 months
Conglomerate-wide gap analysis, including offshore businesses	2 months
Establish new policies, revise and update existing policies, risk management strategies and systems	3 months
Final Board engagement, including education and approval	2 to 3 months (will depend on meeting scheduling and agenda load)
Conglomerate-wide education and roll-out, including offshore businesses	2 to 3 months

Given the uncertainties that remain, full resourcing cannot be committed nor can implementation work begin until after the entire Level 3 package is complete, including the Standards and Guides. In addition, there are already a number of domestic and international regulatory reforms currently reshaping financial services, in particular the wealth management industry. All these reforms draw on the resources of ADIs and ultimately their capacity to hastily implement the Level 3 reforms this year.

Unlike the Basel III reforms, the Level 3 and risk management consolidation reforms are not being driven by tight international timeframes. The ABA believes it is more important to ensure a proper and orderly implementation of the reforms in an appropriate timeframe rather than a rushed implementation to meet

an artificial implementation deadline. Also, it is important that ADI Level 3 groups are not given conflicting signals and timeframes for adopting the Basel III reforms (i.e. 3PS 110 Paragraph 57(c) and 57(d) effectively impose the Basel III capital conservation requirements on the ADI Level 3 group in January 2014 whereas APS 110 Paragraph 24 imposes it on the ADI from January 2016).

Given the short timelines and the already full agendas for Board meetings for the remainder of the current calendar year, it would not be possible for the risk management strategy, risk appetite statement, risk culture evidence, and internal audit review to be in place and approved by the Board by 1 January 2014. As a result the ABA firmly believes it is appropriate to delay the implementation of the Level 3 reforms by 12 months to provide additional time for Level 3 groups to ensure the reforms are adopted in a proper and consistent manner across all Level 3 groups; and to permit consideration of the implications of the yet to be released Basel IIII reforms, e.g. Domestic Systemically Important Bank requirements, on Level 3 requirements. The ABA asks that any change be conveyed as soon as possible in order to ensure market certainty and confidence.

It is the ABA's understanding that ADIs need to comply with the requirements in CPS 220 from 1 January 2014 as well as continuing to comply with the existing requirements relating to the Risk Management Systems in APS 310. Even though the declaration process in CPS 220 is an annual process, because the Standard has a compliance date of 1 January 2014, ADIs would need to comply with all other parts of the Standard as well (and therefore it makes sense to include the declaration as well). This means there is some duplication of processes with different attestation/declaration requirements in APS 310 and CPS 220. Industry is also conscious that ADIs will need to comply with the new "3PS 310" by 1 January 2014. A preferable approach would be for APRA to incorporate the APS 310 requirements relating to the Risk Management Systems into CPS 220 and delay the implementation of CPS 220 until the Standards have been streamlined.

Additionally, is APRA able to clarify the expected timing for release of the draft PPG? To aid APRA in drafting the PPG(s) and final standards, the ABA would welcome the opportunity to provide suggestions as to how the requested changes (below) can best be incorporated.

2. Capital adequacy

2.1. Diversification

While recognising that diversification benefits may arise from group membership, APRA has clearly stated that the minimum capital requirement in the Level 3 framework should be the sum of the minimum requirements from each of the building blocks. In support of this position, APRA notes that "...contagion risks increase during periods of extreme stress as correlations become stronger...". The ABA believes that diversification should be able to be taken into consideration when setting the target Level 3 surplus i.e. the Level 3 target surplus should not simply be the sum of the target surplus or capital buffers maintained in each of the Level 3 building blocks. Diversification is a guiding principle behind the internal economic capital theory in the industry and should be applied consistently, across the industry and internally between blocks. One of the most significant benefits derived from a conglomerate structure is the diversification benefits that arise due to the often uncorrelated nature of the businesses and the offsetting impacts of economic factors on different parts of the conglomerate. In APRA's Level 3 industry workshop on 25 June, APRA confirmed that there is no prohibition on recognising diversification in setting capital targets, subject to the Level 3 group maintaining an appropriate level of minimum capital. The ABA requests that APRA confirm this, in either the final prudential standard or a PPG.

2.2. Capital shortfall assessment and transferability of capital

APRA's draft prudential standard 3PS 110 outlines a proposed requirement, as part of the Level 3 ICAAP, for the Level 3 Head to complete a two-step capital shortfall assessment of each non-APRA-regulated institution. This two-step process is outlined in draft 3PS 110, paragraph 56 and involves:

- identifying non-APRA-regulated institutions in the Level 3 group that have insufficient Level 3 eligible capital to cover their contribution to the Level 3 PCR; and
- determining whether other Level 3 institutions in the Level 3 group have sufficient unrestricted surplus capital to cover any shortfall identified in the first step.

Draft 3PS 110 states that these assessments must be performed on a legal entity basis unless otherwise agreed with APRA.

In relation to the first step, the ABA believes the standard only requires the capital shortfall assessment to be conducted in relation to those non-APRA-regulated institutions that generate material risks to APRA beneficiaries and, as a result, contribute to the Level 3 PCR.

However, in APRA's Level 3 industry workshop on 25 June, APRA indicated that institutions not posing material risks to beneficiaries (i.e., no contribution to Level 3 PCR) might still be required to undergo the assessment if their EC is negative (e.g., if levered). The ABA disagrees with this position.

- APRA have clearly stated a number of times in the Response to Submissions that "the Level 3 framework sets APRA's requirements for the Board of the Level 3 Head to provide oversight of the *material risks* faced by the Level 3 group" (emphasis added) and that it has "refined its proposal from requiring all material non-APRA-regulated institutions to meet APRA's risk management requirements, to now require the risk management framework to capture the *material risks* that non-APRA-regulated institutions pose to the Level 3 group" (emphasis added). Therefore, the requirement to conduct the capital shortfall assessment in relation to non-APRA-regulated institutions that do not generate material risks appears contrary to the intention of the Level 3 framework;
- The cost of conducting the capital shortfall assessment will definitely outweigh the (immaterial) risks being assessed. In the case of some Level 3 groups, all of their entities which generate material risks are adequately capitalised and therefore, in the absence of this interpretation, they would not have been required to conduct a capital shortfall assessment at all; and
- In relation to leveraged companies, the top down approach to measuring Eligible Capital already ensures that any leverage within holding companies is excluded from Eligible Capital and is not being used to cover the Level 3 PCR.

The ABA has a number of other questions and comments in relation to the capital shortfall assessment which were addressed during the workshop on 25 June, but for which the ABA would appreciate formal confirmation in the final prudential standard or a PPG:

- Can APRA confirm that non-APRA-regulated institutions that form part of an APRA-regulated Level 2 group are not required to be assessed individually as part of the capital shortfall assessment? For example, an offshore banking subsidiary that forms part of the Level 2 ADI should not be assessed individually;

- Draft 3PS 110 requires the calculation of the funds management block and other activities block Required Capital on a standalone basis. Industry is concerned that this approach is inconsistent with current internal economic capital framework which is based on business or product lines (not legal entity blocks).

- The ABA believes it is important that APRA adopts a flexible approach to recognising grouping of like entities for conducting the capital shortfall assessment. The contribution of the Funds Management block and Other Activities block entities to the Level 3 PCR should be based on existing internal capital allocations. This will leverage existing capabilities and avoid any risk of duplication. Given internal capital allocations are typically conducted on a business line basis, the ABA firmly believes that APRA should adopt a flexible approach and allow the capital shortfall assessment to be aligned with the Level 3 group's approach to internal capital allocation; and
- Can APRA confirm that the second step in the two-step capital shortfall assessment process is not required to be completed if no non-APRA-regulated institutions are identified as having insufficient Level 3 eligible capital to cover their contribution to the Level 3 PCR? The ABA does not believe it should be necessary to conduct an analysis of unrestricted surplus capital (transferable capital) if there are no capital shortfalls in any of the non-APRA-regulated institutions.

Draft 3PS 110 outlines capital that is considered to be restricted capital and therefore not transferable to cover a capital shortfall in a non-APRA-regulated institution. The ABA has comments on some of the criteria.

- For an ADI that is to provide the 'transferable capital', the ABA does not believe that this assessment of transferable capital can be conducted at a stand-alone ADI entity level, as there are no capital restrictions that apply to the stand-alone ADI entity. The assessment can only be completed for either the Level 1 ELE or the Level 2 banking group, as these are the levels at which APRA capital requirements apply.
- Paragraph 57(c) requires an ADI to apply the Basel III capital conservation buffer to Level 3 from January 2014. However, APRA's banking regulations i.e. APS 110 Paragraph 24, apply the capital conservation buffer from January 2016. ABA requests that the Level 3 regulations be amended to ensure a consistent adoption date of the Basel III regulations across Level 2 and Level 3 groupings.
- Paragraph 57 (d) states that any capital required to meet the lowest capital trigger above a Level 1 or Level 2 entity's PCR is considered restricted. The Discussion Paper (page 18) goes on to specify that "the lowest ICAAP trigger is effectively the point at which APRA would expect the institution to take steps to restore its capital position". This guidance does not seem to recognise the fact that an ICAAP can have a series of triggers which initiate responses ranging from issuing new shares under Dividend Reinvestment Plans up to dividend cuts and large equity raisings. The ABA seeks clarification that where an APRA-regulated entity has multiple trigger levels above its PCR, with varying levels of potential or required remedial actions for each trigger level, it is only the lowest or last trigger level that determines the amount of restricted capital for the entity. While APRA confirmed this at the 25 June workshop, the ABA would appreciate APRA formally clarifying this when the final standards are released.
- Paragraph 57 states that any additional costs that the Level 3 group has to bear as a result of transferring capital, such as taxation or currency exchange costs, must be deducted from the amount available to absorb losses. The ABA seeks clarification as to whether a likelihood or materiality threshold can be applied. In addition, the ABA seeks confirmation that, if the entity which may realise a taxable gain is part of the tax consolidated group whose losses in respect of the entity with the capital shortfall are likely to absorb the gain, then no tax expense needs be recognised.

- Paragraph 58 states that capital is considered restricted if it cannot be transferred to the relevant non-APRA-regulated institution within five business days from the decision to move the capital being made. The ABA seeks clarification on what is meant by "the decision to move the capital being made". The ABA assumes that the decision to move the capital is made once all necessary Board approvals have been obtained. APRA confirmed this at the 25 June workshop; however, the ABA would appreciate APRA formally clarifying this in the final standard.
- Paragraph 60 is unclear. Can APRA please provide an example of the situation envisaged in this paragraph?

2.3. Minority Interest

The ABA notes APRA's comment in the Response Paper that it has considered extending the recognition of minority interests at Level 3 to other entities or industries (i.e. beyond ADIs and their overseas equivalents), but has concluded after an initial review that the additional complexity would outweigh the benefits of a more accurate assessment of loss-absorbing capital. APRA notes that it is willing, however, to review its position on this issue and requests feedback in particular on how to appropriately determine the loss-absorbing portion of minority interests in a Level 3 cross-industry context.

Given that Level 3 groups typically involve subsidiaries that are not fully owned, and in light of APRA's willingness to review its position, the industry provides a proposal for the appropriate treatment of minority interests at Level 3, which industry believes is consistent with the Level 2 treatment of minority interests in ADIs and would not add complexity to the capital framework. An additional advantage of the proposal below is that it would reduce the risk of unnecessary and unintended cost implications (from the current proposal) in the future.

The current Level 3 proposals for minority interests can lead to anomalous and potentially mathematically inconsistent outcomes. For example, it is possible that the Level 3 capital requirement will exceed, or be out of proportion to, the actual investment in the entity, given that the capital requirement is based on 100% ownership of the assets. The proposals also imply that selling down a portion of the investment in an entity does not reduce risk, which is not logical.

To rectify such anomalies, it is recommended that minority interests in consolidated subsidiaries at Level 3 (i.e. in the OA and FM Blocks) be recognised in Eligible Capital using the same principles that apply at Level 2, i.e. Eligible Capital includes minority interests that qualify as loss absorbing Common Equity Tier 1 capital (CET1) as per APS 111 Attachment B, less the amount of minority interest that is surplus to the minority investors' share of the PCR requirement at Level 3. This can be achieved by adapting APS 111 Attachment C to the Level 3 context (simply by replacing "Level 2" with "Level 3", and "ADI" with "Level 3 group" and removing the references to capital conservation buffer).

To demonstrate by way of example, assume a consolidated Level 3 entity is capitalised with $60 of CET1 from the Level 3 group and $40 of CET1 by minority interests and has a PCR of $80 (for 100% of the assets). In this case, the Eligible Capital for the Level 3 group (Level 3 EC) would be calculated using the same formula as in APS 111 Attachment C paragraph 5:

Level 3 EC	= CET1 (L3 group) + CET1 (minority interest) / (Total CET1) x (PCR)
	= $60 + $40 / $100 x $80
	= $92
Level 3 PCR	= $80

In other words, the minority interests' surplus capital of $8 (i.e. its CET1 in excess of its share of the PCR) cannot be counted as part of the Level 3 group's Eligible Capital. This is consistent with the approach at Level 2 under APS 111 Attachment C paragraph 5 and is therefore a simple method of extending the recognition of minority interests at Level 3 to other entities or industries (i.e. beyond ADIs and their overseas equivalents).

2.4. Structural separation

The ABA notes APRA's proposal to recognise the benefits of the operational separation of non-APRA-regulated institutions to reduce contagion risk to APRA beneficiaries, which could potentially reduce the appropriate Level 3 Prudential Capital Requirement (PCR) for individual Conglomerate Groups. If it is held that structural separation, such as Non-Operating Holding Company (NOHC) structures, is a key tenet in reducing contagion risk in Conglomerate Groups, then it would follow that Conglomerate Groups that achieve structural separation should receive a benefit, through lower capital requirements, for this reduction in risk to APRA beneficiaries.

It could be argued that there are a number of benefits for APRA-regulated Conglomerate Groups to move to structures that recognise structural separation between regulated and non-regulated businesses, such as:

- Allows a business that is considered by the relevant entity to be 'non-core' or in runoff be structured accordingly without impacting the 'core' business – which could be particularly useful in times of financial distress. It would also allow a credible determination within the NOHC whether to make further investment, arrange a sale or remove the risk from the Conglomerate Group;
- Facilitating increased and improved governance across the holding company and related entities;
- Development of individual company risk appetites in line with the overall principles outlined by the holding company, which should encourage wider consideration of the unique risks within particular entities and business units;
- Increased capability to control capital flows between entities and increased separability of entities; and
- Improved capital transferability between major operating entities – with decisions on flows of capital to be routed through the holding company.

In essence, industry believes that contagion risk is reduced to some extent by structural separation and should be favoured compared to a structure where the conglomerate group head is an operating entity with the majority of APRA beneficiaries.

While industry believes that the conditions outlined by APRA to determine the appropriateness of the degree of structural separation makes sense, the ABA believes that, for all entities, any benefits of structural separation should be recognised and determined on a case by case basis. This conflicts with APRA's view on Domestic Systemically Important Banks (D-SIBs), where APRA states that it believes that there is a risk that there could impact on the viability of an ADI if there is a loss in market confidence in any of the conglomerate entities. In many cases this will not reflect the reality and may actually be more likely to enhance the viability of the regulated entities assuming an appropriate communications and recovery plan is in place. This should be considered alongside the improved financial strength of ADI's through required compliance with APRA's Basel III liquidity and capital standards. Furthermore, by excluding Level 3 groups containing a D-SIB from potential structural separation relief creates an arbitrary distortion in the regulatory and competitive framework to that applied to large insurance company led Level 3 groups and small Level 3 groups which will also rely upon financial markets for funding of their operations and hence are subject to the same risk of loss of market confidence.

On page 29 of the discussion paper, it is stated that "APRA considers that the ICA to be used in the Level 3 group's capital adequacy could differ from the outcome of the economic capital model (ECM) that the group uses for internal capital management purposes". Can APRA expand on its thinking with regard to the way that the ICA used in business performance measurement might be adjusted to generate a contribution of the non-APRA-regulated BB to the Level 3 PCR?

The ABA understands APRA's reason for FI deductions at Level 3 to be the systemic issue of cross-holdings of capital across the FI industry. While this reason may be justified for ADIs (i.e. per Basel, where an ADI invests in the capital of another ADI or other FIs), it is not clear that systemic issues arise where investments in FIs are held by the OA block, particularly where operational separation exists. A 100% capital deduction implies that all FI activities are liable to become worthless in a crisis, and that there is perfect correlation between them all – to industry, this appears unrealistic. An alternative approach could be for equity investments in non-consolidated FIs held by the OA block to be determined using the internal capital allocation, which uses a portfolio model to assign higher capital requirements to highly correlated exposures and lower requirements to less correlated exposures, thus achieving the aims of the Basel reforms in holding additional capital behind correlated FI exposures.

2.4.1 Other

Can APRA please advise the operations of the following paragraphs:

- 3PS 111, Paragraph 11 permits the application of fair value to financial instruments. As Level 3 capital is only CET1, which is ordinary shares that may not be marked-to-market under Australian Accounting Standards, can APRA advise what 'capital securities' this section is applied to as under APS 111 it deals with MtM AT1 and T2 securities in the capital base calculation; and
- 3PS 111, Paragraph 23 deals with intra-group transactions that do not present a genuine contribution to financial strength. As Level 3 capital is determined on a 'top-down' approach all Intra-Group transactions are eliminated. Can APRA advise to what scenarios and capital instruments they are referring to, in and under what application of the capital standards?

Further, can APRA expand on its thinking in regards to what appears to be a disconnect between the eligible capital, which is determined on a top down basis, and the capital requirements, which are determined on a bottom up basis? This can lead to inconsistencies where, for example, an asset is held at a different value at Level 1 versus Level 3. The PCA may be set based on the value recognised at Level 1, but it is being compared against the value recognised at Level 3.

Can APRA also provide its thinking in relation to the potential for excluding covered bonds from aggregation of large exposures?

3. Risk management

As a general comment the ABA supports the harmonisation, consolidation and enhancement of the risk management requirements set out in existing prudential standards. The ABA is aware of the need to consider appropriate policy responses to the risks and complexities of conglomerates and understands the challenges faced by APRA in finalising its policy on conglomerates in an environment of international debate in this area.

The ABA's submission in March to APRA consultation *Supervision of conglomerate groups - 1. Group governance and risk exposures* raised a number of concerns. In the ABA's opinion many of those overarching concerns apply equally to the Risk Management Discussion Paper and the ABA would ask APRA to revisit those comments. In particular, those regarding the issues of a level playing field for entities that are part of a conglomerate group and those that are not, and the issues of timing.

Detailed feedback on CPS 220 *Risk Management* and CPS 510 *Governance* is contained in the tables attached (Appendix A and Appendix B). However, the key areas of concern, where the ABA is of the opinion that changes are required to the standards as currently drafted, are summarised in the following sections.

It may be advantageous for APRA to initially work with other prudential regulators in comparable jurisdictions with a view to providing mutual recognition where the requirements are equivalent. To remove duplication, the ABA believes this should be clarified on an industry-wide basis rather than deferring to individual entities to work with their supervisor.

3.1. Role of the Board

Industry is concerned that the use of the word "ensure" in paragraph 12 infers a level of managerial ownership by the Board of the issues set out in items (a)-(h) that is beyond "gaining comfort" over these items, as was verbally referred to by APRA as being the intent of this section. Industry requests that an alternative wording is adopted that more accurately conveys the intent of this section and suggests that APRA consider making item (a) the one item that the Board must "ensure" and refer to being "reasonably satisfied" over the other items (b)-(h).

3.2. Risk Appetite

Paragraphs 28 and 29 of the draft standard discuss the topic of risk appetite but focus only on the risk appetite statement (RAS). Industry agrees with the objectives of paragraph 28 but is of the opinion that the prescribed content of the RAS in paragraph 29 is contrary to those objectives. Industry's view is that the RAS, whilst being the cornerstone of the articulation of the risk appetite, is only one component of that, the others being the limits contained in Group-level policies for particular risks and the processes contained in the wider risk management framework. The detailed content shown in sections (a) to (e) of paragraph 29 are all important elements of the risk management framework but are not necessary for inclusion in the RAS. Their inclusion is in fact unhelpful in concisely articulating the high-level limits on business outcomes and risk principles that should be contained in the RAS. Industry suggests one of two solutions to this:

1. Amend the wording of paragraph 29 to refer not to the "risk appetite statement" but the "risk appetite or wider risk management framework" (preferred); or
2. Amend the wording of paragraph 29 to refer not to the "risk appetite statement" but the "risk appetite" and include only (a) and (b); and move (c)-(e) to paragraph 24 (covering the content of the risk management framework)

3.3. Risk management function

CPS 220 sets out the requirements for a risk management function. Some ADIs and other entities to which this Standard applies may need to make some structural changes internally to comply with the requirements set out in paragraphs 37-42. This adds weight to the need to have appropriate transition to allow any organisational changes to be undertaken in a considered manner.

Industry does not believe the restriction on appointed Actuaries of life and general insurers also being the Chief Risk Officer (CRO) is necessary and suggest this is removed. This requirement is unnecessarily restrictive for bank-owned insurers and burdensome where the insurance operations are small.

Furthermore, industry would like to clarify the intention of the requirement for each APRA-regulated institution's risk management function to be headed by a CRO that must have a direct reporting line to the CEO. In the case of conglomerate groups, subsidiaries, including general insurers and life insurers, may be headed by divisional CROs that report into the Group CRO function and to the CEO of the

subsidiary, but do not directly report to the conglomerate group CEO. For clarification, industry is seeking an understanding of the intent of this requirement and whether the Group CRO function is sufficient for this purpose.

A similar clarification is sought for paragraph 42 which relates to the compliance function and the need for all APRA-regulated institutions to have a designated compliance function. Can APRA confirm whether a group compliance function is sufficient for meeting the requirements in paragraph 42 for APRA-regulated entities which are part of a group (i.e. insurers)?

3.4. Other

It would be helpful if APRA could clarify (perhaps in the PPG) its expectations as to how the Board would provide evidence that it has ensured an appropriate risk culture.

Can APRA expand on its views of the relationship between the risk management strategy etc. under APS 220 and the Description of Risk Management Systems under APS 310?

Can APRA provide guidance and examples on what constitutes materiality regarding notifying APRA of "significant breaches of the risk management framework", "material revisions to business plans" and "right to conduct business in a jurisdiction has been materially affected by law"?

Additionally, industry would like to highlight the added complexities associated with operating in overseas jurisdictions where, as APRA is aware, local regulators often stipulate that entities located in those jurisdictions should be operated independently from the conglomerate group. This is further complicated when foreign regulators have incommensurate approach to prudential oversight such as command and control in New Zealand, Indonesia, China and others. Industry would find it helpful to understand how APRA proposes to deal with such conflicting circumstances. Industry recommends the Level 3 framework should have regard to comparable requirements in other jurisdictions. Industry is comforted by APRA's stance that it will accept, where appropriate, compliance with an equally robust foreign jurisdiction regime in terms of governance and behavioural standards. Industry would welcome this position being clarified in the PPGs.

4. Governance

The ABA recognises that it may be appropriate to separate Board and Audit Risk Committees at a Level 3 Head level. However, this becomes problematic where there are multiple subsidiaries operating multiple Board audit and risk committees. In such cases, it is not uncommon to combine the Board audit and risk committee to reduce duplication, complexity and repetition. Separation of such committees would require extensive revisions of the risk management framework and policies and procedures and would result in duplication of committee administration.

The ABA submits that CPS 220 should be flexible enough to allow for separate, or combined, audit and risk committees to be used provided all committee responsibilities are clearly set out in the committee charter.

It is also the view of industry that there are benefits of allowing a CEO to be a member of a Risk Committee. Benefits include ensuring 'buy in' from executives and encouraging co-operation between the Risk Committees and CEOs. To allow this, the ABA requests that amendments are made to allow a CEO to be a member of the Risk Committee. Any prudential concern regarding independence should be adequately met by having a majority of independent Directors and an independent Chair, or alternatively by a specific exception from the requirement for membership to be comprised solely of independent Directors, to permit membership on the part of the CEO.

APPENDIX A - Feedback on specific provisions of draft CPS 220 *Risk Management*

The ABA has the following feedback on specific provisions in CPS 220*:*

CPS 220 Paragraph:	Issue	Comments
General	Application to super funds	The ABA notes CPS 220 will not apply to the superannuation industry and instead RSE licensees must comply with the superannuation specific risk management prudential standard (SPS 220). The ABA is concerned this will result in different practices for conglomerates with some entities adhering to CPS 220 while RSE licensees comply with SPS 220. To ensure simplicity and harmonisation RSE licensees within a Level 3 regulated entity should have the option of complying with SPS 220 or CPS 220.
Paragraphs 3 – 5	Application of provisions	Large conglomerate groups are comprised of a number of large, medium and small APRA and non-APRA-regulated entities. Could APRA please provide some guidance in the Standard as to whether the Level 3 group will be deemed non-compliant with CPS 220 if a subsidiary entity (either APRA-regulated or non-APRA-regulated) fails to comply wholly, or in part, with the requirements of the Standard?
Paragraph 12	Role of Board	The ABA supports active engagement by the Board and agrees that it is ultimately responsible for the institution's risk management framework. However, the ABA would like to highlight two issues: Firstly, it is unclear as to what extent the Board can delegate some responsibilities to the Board Risk Committee. To accurately reflect business practices and structures in a large conglomerate group, the Standard should clarify that the Board *can* delegate responsibilities to the Board Risk Committee. Secondly, it is unclear as to what is most appropriately a Board level responsibility and what is a senior management level responsibility? CPS 220 blurs the lines between responsibilities that would typically be considered managerial in nature and those that would be considered the remit of the Board. As per the comments in 3.1 'Role of the Board' it is the use of the word "ensures" that infers managerial ownership by the Board, despite APRA's assurance to industry that this is not the intention.

CPS 220 Paragraph:	Issue	Comments
		By way of example: • ensuring senior management monitor and manage all material risks; • ensuring that sufficient resources are dedicated to risk management; • ensuring that uncertainties attached to risk measurement are recognised; and • ensuring that staff understand and are educated on risk appetite, risk profile and capital strength. Typically, the Board would delegate responsibility for matters like those listed above to senior management. In the ABA's opinion, the Standard should make it clear that the Board can rely on senior management to implement the risk management framework and advise/inform the Board accordingly. This could potentially be achieved by rewording CPS 220, replacing 'ensuring' with a requirement that the Board 'is reasonably satisfied', which would align with the wording used in paragraph 13 of CPS 220. In particular 12(g), i.e. the Board must ensure *….'limitations and uncertainties relating to the output of any models used to measure components of risks are well understood'*, is something senior management should ensure the Board is aware of, not that the Board should be responsible for. It will be difficult to reconcile these increased requirements with Dr John Laker's speech on 'The Importance of Good Governance' where he noted the difficulty Boards had in digesting voluminous and detailed reports - creating "*A potentially fatal 'wood for the trees' problem".*[1] Dr Laker went on to explain that APRA intend to "*assess whether they* [i.e. APRA requirements on boards] *are consistent across industries and whether there are any that are unreasonable, cumbersome or unduly onerous*". The ABA welcomes Dr Laker's comments and believes this should remain a guiding principle for all prudential requirements. For these reasons, the ABA has suggested that the word "ensure" be amended to "is reasonably satisfied" to more accurately convey the intent of this section.
Paragraph 27(f)	Material risk	Can APRA provide clarification of what is meant by "risks arising from its strategic objectives and business plans"?

[1] http://www.apra.gov.au/Speeches/Pages/The-importance-of-good-governance.aspx

CPS 220 Paragraph:	Issue	Comments
Paragraphs 13 – 16	Group risk management	The wording in paragraph 13 is somewhat confusing. Paragraph 14 seems to be an attempt to clarify this but the requirements are not clear. To avoid ambiguity, paragraph 13 and 14 should be more clearly reworded. January 2014 will not provide sufficient time to thoroughly review (and update - if required) the risk management frameworks of APRA-regulated institutions to identify "*the linkages and significant differences between the institution's and the group's risk management framework*". For this reason, the ABA would ask APRA to consider a 12 month implementation period to January 2015.
Paragraphs 17 – 19 generally	Requirements of the Head of a group	Under paragraph 18, the Head of a group must "*develop and maintain a Board approved liquidity management policy for the group.*" Whilst the ABA agrees that a group-wide liquidity policy is appropriate, extending the current liquidity management policies to the entire group will be a complex and time consuming process. It will require careful consideration by senior management and board committees and may entail new liquidity management policies for excluded entities in addition to identifying and resolving conflicts across applicable prudential standards. It is unlikely this will be able to be completed by January 2014. The upcoming *APS 210 Liquidity,* focusing on Level 1 and Level 2 entities, becomes effective on 1 January 2014. It would be helpful if APRA could provide some guidance as to whether compliance with APS 210 can be used to meet compliance with CPS 220 where the Group can show that liquidity risks outside Level 1 and 2 entities are immaterial. A further consideration to support extending the implementation date is the new Basel III liquidity framework (and two new minimum global liquidity standards) which comes partially into effect on 1 January 2015. It seems sensible to us to align policy requirements under CPS 220 to the introduction of the Basel III quantitative requirements.
Paragraphs 20 – 26	Risk management framework	There appears to be circular references between the risk management framework and the Risk management strategy. For example, under paragraph 24 the Risk management framework must contain a 'risk management strategy'. Under paragraph 31 the risk management strategy must contain key elements of the risk management framework. The terminology used may require some refinement given that risk management strategy is used

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		both as a generic term (paragraph 24 - '*a risk management strategy*') and as a specific document (paragraph 31 – '*An RMS is a document that describes …*'). The key point with these proposals is that the risk management framework should be flexible enough to allow cross-reference to strategies, plans, policies and procedures documented elsewhere. The ABA seeks confirmation from APRA that CSP 220 will allow incorporation by reference, as advised at the 25 June workshop. On a drafting point, paragraph 23 provides that an APRA-regulated institution's risk management framework must provide 'reasonable assurance'. This term is more commonly used in the context of oversight principles of an audit function. The ABA suggests that paragraph 23 be reworded to the effect that an APRA-regulated institution's risk management framework must provide *a structure for identifying and managing* each material risk, having regard to the size, business mix and complexity of operations. Whilst the ABA agrees that aggregation of risk is generally appropriate, it would like to raise two issues: • Firstly, as APRA is aware, data quality is an ongoing issue for many financial institutions and there are gaps and discrepancies particularly with historical data. Collecting and improving data quality is not an issue that can be quickly or easily resolved. Rather, it is an ongoing exercise to improve data quality over time. The ABA would suggest that CPS 220 recognises that a robust data framework enabling aggregation is, in some cases, an aspirational state to be worked towards. • Secondly, there may be circumstances where aggregation is not appropriate, e.g. market risk where different metrics are used by different business units. The ABA suggests amending CPS 220 to clarify that aggregation should only be used where appropriate and meaningful.
Paragraphs 28, 29	Risk appetite	The ABA fully supports the overarching principle that a risk appetite statement (RAS) should be appropriate, clear and concise. This is a key document and should be readily understandable by all employees across the group. The difficulty with APRA's proposal is the requirement to include detailed limits information and processes in the RAS. This will result in duplication with information documented elsewhere and is difficult to reconcile with the requirement to keep the document clear and concise.

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		As per our comments in 3.2 'risk appetite', the RAS should focus on limits on business outcomes, as well as setting the principles for the group's risk taking activities. The risk frameworks and policies for each risk type should then articulate more detailed and specific limits that support the RAS limits. The proposal to include all of these limits into the RAS would make it unwieldy and complex for staff to understand. A further consideration is that every time a change is made to one of the components of the RAS, the Board would have to re-approve it. To resolve this, it is suggested that the RAS should accommodate incorporation by reference of information and limits documented elsewhere. In relation to paragraph 29 specifically, (b) requires that the maximum level of risk that the institution is willing to operate within should be expressed as a risk limit. The ABA seeks confirmation from APRA that it will clarify, in CPG 220, that the limit may be qualitative rather than quantitative. Additionally, paragraph 29(b) requires a limit for each "material risk": Does this imply an aggregate limit must exist (e.g. on credit risk) or can this be satisfied by limits at a more granular level?
Paragraphs 30, 31	Risk management strategy	The ABA agrees with the objectives of, and sees the value in, having a risk management strategy. The concern is having a Board approved document in place by January 2014. This document should be rightfully owned by the Board. Enabling active, engaged discussion between Board and senior management as to what a risk management strategy should look like and what it should contain is a process that should require multiple Board engagements over a period of months. The ABA suggests that if APRA are seeking a quality outcome with a well thought through considered strategy, the Board should be given sufficient time to do so. In relation to the actual content of the document, the ABA would echo earlier comments about facilitating incorporation by reference where requirements, policies and procedures are documented elsewhere rather than duplicating them in the risk management strategy.
Paragraphs 35, 36	Policies and procedures	The process of reviewing, validating and reappraising policies across the conglomerate group to ensure they contain the necessary inclusions listed in paragraph 35 will be a significant piece of work. The ABA suggests that such an exercise is best undertaken as part of the annual review of each framework/policy. As recommended above the ABA has suggested a 12 month implementation

CPS 220 Paragraph:	Issue	Comments
		period (i.e. January 2015).
Paragraphs 43- 46	Review of the risk management framework	Paragraph 43 provides that the risk management framework should be reviewed by internal/external audit at least annually. Paragraph 44 provides that a comprehensive review should be conducted by '*operationally independent, appropriately trained and competent persons (this may include external consultants) at least every three years'*. The ABA suggests that the wording be flexible enough to accommodate situations where, in a large conglomerate group, components of the risk management framework are assessed on a rotational basis, for example every two to three years. For groups with extensive risk management frameworks it would be extremely challenging to assess every aspect of every framework every year. Additionally, the three lines of defence model is an integral part of risk frameworks and the ABA suggests that the review of risk management frameworks every three years (paragraph 44) can be conducted by internal audit or other suitably qualified internal resources (e.g. internal consultancy group). Industry asks that APRA provide clarification in the standard (or guidance in the PPG) on who would and would not be considered appropriate to conduct the review required by paragraph 44, for example, can group-level risk personnel review a subsidiary's risk management framework?

CPS 220 Paragraph:	Issue	Comments
Paragraphs 47 – 49 and Appendix A	Risk management declaration	Industry would ask for confirmation by APRA of their verbally stated intent that the declaration required under current standard APS 310 will be dropped at the time that the requirement for the declaration under CPS 220 becomes effective. If APS 310 is intended to continue in force alongside CPS 220 this will impose an additional burden in terms of timing and signatories under both standards. The ABA's interpretation of the deadline under CPS 220 is that it imposes a significantly shorter timeline than that under APS 310 (i.e. within 3 months of the end of the financial year). That will pose significant difficulties given the management attestation requirements that would be needed to support the declaration and the availability of Board time in the twenty five days following the end of financial year. Whilst the ABA appreciates the nature and scope of the declarations under APS 310 and CPS 220 are different, the preference from a process efficiency perspective would be to align the submission deadlines. This would mean that one paper could go to the Risk Committee and Board seeking endorsement for both declarations.
Paragraphs 50-53	Notification Requirements	Paragraph 52 requires an institution to notify APRA as soon as practicable and no more than 10 business days after it becomes aware of any material or prospective material changes to the size, business mix and complexity of the institution. In a typical institution proposals for new business initiatives are routinely considered. A significant proportion of such proposals may have material implications to prospective changes in size over time. However, this would be highly variable and subject to future internal approvals and market conditions. Furthermore, it is unclear at what point in time the 10 day window would begin. The ABA requests that APRA amend this requirement to more narrowly and objectively define what would constitute a notification event. The ABA recommends three refinements: 1. A clearer definition of the events in question. For example, this may be upon approval of an acquisition or disposal of a particular business (noting that notifications to APRA specified in other standards will also apply); 2. A clearer definition of the materiality threshold. The ABA recommends that notification is only required for proposals that require full Board approval; and 3. A clearer definition of when the 10 day window would begin. The ABA recommends that

CPS 220 Paragraph:	Issue	Comments
		notification be required 10 days from full Board approval of the proposal. Paragraph 51 states additional notification requirements in the event an institution becomes aware of a material deviation from the risk management standard or that the risk management framework did not address a material risk. In line with the above, the ABA recommends that materiality is based on whether it would be reasonable to expect that the Board be notified of the issue in question.

APPENDIX B - Feedback on specific provisions of draft CPS 510 *Governance*

In relation to the proposals in CPS 510 the ABA has the following comments.

CPS 510 Paragraph:	Issue	Comments
General comments	General comments	**Terminology:** Uncertainty has been introduced in CPS 510 by deleting the word 'regulated', notwithstanding the definition in clause 2 which states CPS 510 applies to *'all APRA-regulated institutions'*. It is not clear if the drafting intention is merely to avoid repetition of the word 'regulated' or if the removal of that word signifies that the requirements are intended to apply to non-APRA-regulated institutions which may form part of a conglomerate group. In some cases, the removal of the word actually causes a conflict between the requirements (for example, in paragraphs 28 and 41 - the word 'regulated' should be reinstated in paragraph 26 to remove the conflict). Moreover, interchanging between the terms 'regulated institution' and 'institution' is confusing. The ABA notes APRA's statements at the industry workshop to the effect this is merely a new drafting style adopted, with the intention of simplifying the drafting so that after the first use of the expression "APRA-regulated institution" subsequent drafting refers to 'the institution". It would be helpful if APRA confirms this in the introduction, to clarify when an APRA-regulated institution is being referred to and when a non-APRA-regulated institution is being referred to. **Definition of Level 3:** Different definitions are used in different Prudential Standards which can also be confusing, for example: • Paragraph 9 of revised CPS 510 defines a 'Level 3 group' to be a '*group of entities of which a Level 3 Head is the parent entity. APRA may, by notice in writing adjust the group to include or exclude entities'*. • Paragraph 11 of revised CPS 510 then defines a 'Level 3 Head' to be either an ADI, or authorised NOHC under the Banking Act, a general insurer or authorised NOHC under the Insurance Act, or a life company or registered NOHC under the Life Insurance Act, in respect of which APRA has made a determination under paragraph 2 of 3PS 110. • However, APS 001 defines "Level 3" to mean "*the conglomerate group at the widest level'* with 'conglomerate group' defined in Attachment A of APS 001 to mean "*a group of companies that are related to each other within the meaning of section 50 of the Corporations Act 2001 where the group includes one or more ADIs that have been incorporated in Australia"*. Paragraph 2 of Attachment A of APS 001 then relevantly goes on to require that a conglomerate group must be

CPS 510 Paragraph:	Issue	Comments
		headed by an ADI. The ABA suggests that APRA review the terminology throughout CPS 220 to ensure consistency. Industry has taken comfort in APRA's comments at the industry workshop that harmonisation of the definitions will occur.
General	Separation of risk and audit committees	The ABA agrees that the Board Audit Committee and the Board Risk Committee need to have clearly documented roles and responsibilities. However, it is not uncommon for APRA-regulated entities to have one Board Audit and Risk Committee. As per the comments in Section 4 'Governance', above, requiring separate Committees will require revision of risk management frameworks which will be difficult to achieve in the short timeframe allowed and result in unnecessary duplication, particularly where similar issues (such as review of the risk management framework) are being brought to both, as well as increased administration. For this reason, the ABA strongly suggests APRA incorporate some flexibility into CPS 220 to allow for the separate responsibilities of each Committee to be carried out by one Committee - provided all required responsibilities are provided for in the Charter.
Paragraphs 73-79	Board Audit Committee	Paragraph 78 requires the Board Audit Committee to have both a Charter and terms of reference – these are generally understood to be the same. The ABA seeks confirmation from APRA that, as advised at the 25 June workshop, 'terms of reference' and 'charter' are synonymous. (The same comments apply to paragraph 106 in respect of the Board Risk Committee.) Paragraph 78(e) and 79: The ABA agrees that the Board Audit Committee should oversee the appointment and removal of the Head of Internal Audit. However, it is not clear whether this will require the Board Audit Committee of one APRA-regulated entity within a group to give prior endorsement to the appointment or removal of the Head of Internal Audit of another APRA-regulated institution within the same group. Assuming, this interpretation is correct, the ABA would suggest replacing *"the APRA-regulated institution*" with "*that APRA-regulated institution*". The same comments apply to the functions of the Board Risk Committee in relation to the CRO. The ABA does not have any issues with the requirement in Paragraph 79 to notify APRA if the auditor or Head of Internal Audit is removed from their position, and the reasons for their removal.

CPS 510 Paragraph:	Issue	Comments
Paragraphs 101-109	Board Risk Committee	Please also refer to the comments in Section 4 'Governance', above, regarding separation of risk and audit committees. Paragraph 106: The ABA questions the practicality of requiring the Board Risk Committee to 'advise' the Board on 'future risk appetite' and 'risk management strategy' as the Committee is responsible for oversight based on advice from management. The ABA suggests this requirement be amended to read 'regularly inform the Board'. The requirement for all members of the Risk Committee to be non-executive directors will prevent the CEO from being a member of the Committee. The ABA queries whether this outcome is consistent with good governance principles and whether the objective of risk committee independence cannot equally be achieved by having a majority of non-executive directors or alternatively, by including a provision that permits the CEO to be a member.