



8 August 2016

To: All authorised deposit-taking institutions (ADIs), general insurers, life companies, Level 2 Heads and potential Level 3 Heads

Implementing the non-capital components of the framework for supervision of conglomerate groups

APRA is today releasing final requirements for the non-capital components of APRA's framework for the supervision of conglomerate groups (Level 3 framework). These requirements will take effect from 1 July 2017.

APRA has, since its establishment, been conscious of the need to understand and assess the financial and operational aspects of conglomerate groups, as well as the individual APRA-regulated institutions within them. Although membership of a conglomerate group may provide benefits to APRA-regulated institutions, it may also increase and change the risks they face. APRA's Level 3 framework aims to ensure that prudential supervision adequately captures the risks to which APRA-regulated institutions within a conglomerate group are exposed and which, because of the operations or structures of the group, are not adequately captured by the existing prudential framework.

In March 2016, APRA announced¹ that it would implement the non-capital components of the Level 3 framework, and released for consultation minor changes and clarifications to the prudential standards and practice guides previously published in August 2014.² APRA received four submissions in response, three of which were marked as confidential.

APRA has considered the feedback provided during consultation, and the attachment to this letter provides details on APRA's response to the submissions. As a result of the submissions, APRA has made amendments to two of the draft prudential standards published in March 2016. These changes are minor, and provide clarifications of APRA's policy intent.

The final prudential standards and prudential practice guides are available on the APRA website.³

Prudential standards applicable to ADIs, general insurers, life companies, Level 2 Heads and Level 3 Heads

- *Prudential Standard CPS 220 Risk Management (CPS 220)*
- *Prudential Standard CPS 231 Outsourcing (CPS 231)*
- *Prudential Standard CPS 232 Business Continuity Management (CPS 232)*

¹ <http://www.apra.gov.au/CrossIndustry/Pages/Supervision-of-conglomerate-groups-L3-March-2016.aspx>

² [http://www.apra.gov.au/CrossIndustry/Pages/Supervision-of-conglomerate-groups-\(Level-3\)---August-2014.aspx](http://www.apra.gov.au/CrossIndustry/Pages/Supervision-of-conglomerate-groups-(Level-3)---August-2014.aspx)

³ <http://www.apra.gov.au/CrossIndustry/Pages/Supervision-of-conglomerate-groups-L3-August-2016.aspx>

- *Prudential Standard CPS 510 Governance (CPS 510)*
- *Prudential Standard CPS 520 Fit and Proper (CPS 520)*

Prudential standards and prudential practice guides applicable to Level 3 Heads

- *Prudential Standard 3PS 001 Definitions (3PS 001)*
- *Prudential Standard 3PS 221 Aggregate Risk Exposures (3PS 221)*
- *Prudential Standard 3PS 222 Intra-group Transactions and Exposures (3PS 222)*
- *Prudential Standard 3PS 310 Audit and Related Matters (3PS 310)*
- *Prudential Practice Guide 3PG 221 Aggregate Risk Exposures (3PG 221)*
- *Prudential Practice Guide 3PG 222 Intra-group Transactions and Exposures (3PG 222)*

Next steps

APRA has previously announced its intention to apply the Level 3 framework to eight Level 3 groups.⁴ APRA will formally determine the Level 3 Head and members of each of the eight Level 3 group between now and 1 July 2017, with the determination coming into effect on 1 July 2017.

APRA announced in March 2016 that it was deferring the capital components of the Level 3 framework in order to allow the final form of these requirements to be determined following the finalisation of related domestic and international policy initiatives. APRA intends to consult again on capital requirements in the Level 3 framework. However, APRA does not anticipate that this consultation will commence earlier than mid-2017, with implementation of any new requirements no earlier than 2019.

Yours sincerely



Wayne Byres
Chairman

⁴ [http://www.apra.gov.au/CrossIndustry/Pages/Supervision-of-conglomerate-groups-\(Level-3\)-August-2014-media-release.aspx](http://www.apra.gov.au/CrossIndustry/Pages/Supervision-of-conglomerate-groups-(Level-3)-August-2014-media-release.aspx)

Attachment

Response to issues raised in consultation

In the March 2016 consultation on the non-capital components of the Level 3 framework, APRA invited comments on the prudential practice guides and on clarifications to the prudential standards. Comments received focussed on the prudential standards; no comments were received on the prudential practice guides.

Clarity, materiality and application of requirements throughout a group

The cross industry prudential standards apply to each individual regulated institution, Level 2 Head and Level 3 Head. As such, a number of key terms are defined in these standards to refer to these different types of institutions. A Head of a group must apply the requirements appropriately throughout the group.

Comment from submissions

Respondents sought clarity regarding the use of key terms in the standard and found the various key terms added complexity to the requirements. Some respondents requested further clarity on how to apply the cross-industry prudential standards throughout a group, including where the prudential framework requires assessments of materiality. Respondents also raised concerns that group-wide application may conflict with or overlap with local requirements for overseas jurisdictions.

APRA's response

APRA agrees that there can be complexity in expressing requirements that apply to an individual institution, a group, and a Head of a group. For the purposes of the Level 3 framework it is important to distinguish between the various types of institutions covered and this necessarily involves additional terminology. APRA reviewed this terminology but has not made any changes, as it is necessary to achieve appropriate differentiation between the various institutions to which different parts of APRA's prudential framework applies.

Where a Head of a group is required to ensure that a requirement is applied appropriately throughout the group, APRA expects that the Head of a group will form a view about how to apply the requirements to institutions within the group (including institutions that are not APRA-regulated) in a way that protects depositors, policyholders, and/or registerable superannuation entity (RSE) beneficiaries against the material risks arising from the activities of institutions in the group. Further, it is the responsibility of the Head of a group to make assessments of materiality, as this will differ across institutions and Level 3 groups.

As stated in APRA's [August 2014 Response to submissions: Supervision of conglomerate groups](#), where an institution in the group is meeting requirements in another jurisdiction, the Board of the Head of a group would have the option of demonstrating to APRA that the institution is meeting the higher of the APRA requirements or the other jurisdiction's requirements.⁵ Further:

'Where a Level 3 Head is unable to require a Level 3 institution to implement group-wide policies due to legal or local regulatory constraints, APRA expects the Level 3 Head would

⁵ Australian Prudential Regulation Authority, *Response to submissions: Supervision of conglomerate groups*, August 2014, page 15.

consider alternative controls to mitigate the risk of contagion from the operations of that institution.’⁶

Responsibilities of subsidiary and group boards for remuneration policy - performance-based remuneration

Paragraph 56 of CPS 510 requires an APRA-regulated institution’s Remuneration Policy give the Board of the APRA-regulated institution the power to adjust performance-based components of remuneration downwards, to zero if appropriate.

Comment from submissions

Respondents commented that, when applied on a group basis, paragraph 56 of CPS 510 requires that the group Remuneration Policy permits the Board of the Head of a group to adjust performance-based remuneration downwards for relevant persons in its subsidiaries. In that case, the remuneration adjustments by the Board of the Head of the group could conflict with and potentially override decisions of the Board of an individual subsidiary.

APRA’s response

APRA’s view is that the Boards of individual institutions within the group are integral to effective governance. However, APRA does not consider it appropriate to restrict the Board of the Head of a group from being able, where the Board deems it to be appropriate, to override the discretion accorded to the Boards of subsidiaries to adjust remuneration for relevant persons in those institutions. APRA has therefore maintained the existing wording in paragraph 56 of CPS 510.

Responsibilities of subsidiary and group boards for remuneration policy - adopting group governance arrangements

Paragraphs 12(a) and 13(a) of CPS 510, respectively, require a Head of a group to maintain a documented group Remuneration Policy, as well as have a group Board Remuneration Committee. In doing so, an APRA-regulated institution and a Head of a group are permitted by CPS 510 to adopt the group Remuneration Policy of a related body corporate. Similarly, a locally incorporated APRA-regulated institution and a Head of a group may use a group Board Remuneration Committee of their Level 2 group, Level 3 group, or other corporate group.

Comment from submissions

Respondents commented that paragraphs 62 and 70 of CPS 510 would allow a Head of a group to adopt a group Remuneration Policy and to use a group Board Remuneration Committee maintained by a subsidiary in the group. The concern raised was that a Head of a group would never in practice adopt these arrangements from a subsidiary.

APRA’s response

While adopting arrangements from a subsidiary is not common practice, paragraphs 62 and 70 of CPS 510 do not specifically prohibit a Head of a group from adopting the Remuneration Policy or using the Board Remuneration Committee of a subsidiary if it can nevertheless be shown that the arrangements in place comply fully with the relevant requirements in CPS 510.

⁶ Ibid.

APRA considers that the existing requirements in CPS 510 adequately protect against inappropriate group governance arrangements. For example, the use of a group Remuneration Policy must be approved by the Board of the Head of a group, and the Board of the Head of a group has ultimate responsibility for oversight of the group Board Remuneration Committee. Further, APRA requires that any group Remuneration Policy or group Board Remuneration Committee must comply with the relevant requirements in CPS 510. On that basis, APRA sees no need to amend its requirements in relation to this matter.

Review of the risk management framework

In December 2012, APRA amended CPS 510 to require APRA-regulated institutions to have a Board Risk Committee. Those changes require the Board Risk Committee to have responsibility for oversight of the implementation and operation of the risk management framework, and the Board Audit Committee to have responsibility for reviewing the risk management framework. The March 2016 consultation clarified that these requirements apply on a group basis, i.e. that the group risk management framework must be reviewed by the group Board Audit Committee and the group Board Risk Committee must have oversight of the group risk management framework.

Comment from submissions

Respondents sought further clarification regarding the roles of the Board Audit Committee and the Board Risk Committee regarding the risk management framework.

APRA's response

APRA has not changed its existing policy position in this regard. APRA's May 2013 discussion paper on ['Harmonising cross-industry risk management requirements'](#) stated that:

'The [Board Risk] Committee would be responsible for advising the Board on the appropriateness of the risk management framework, for providing the Board with objective non-executive oversight of the implementation of the framework, and for ensuring that senior management are appropriately implementing the Board's strategy for managing risk.'⁷

Whereas, the Board Audit Committee 'will continue to have responsibility for providing the Board, *inter alia*, with an objective review of the effectiveness of the institution's risk management framework.'⁸

APRA also requires the Head of a group to meet these requirements with respect to the group risk management framework.

Director independence

CPS 510 requires that a majority of the directors of an APRA-regulated institution (subject to specific exemptions) must be independent of the institution. Attachment A of CPS 510 sets specific conditions where a director will not be considered independent for the purposes of board representation.

⁷ Australian Prudential Regulation Authority, *Harmonising cross-industry risk management requirements*, May 2013, page 12.

⁸ Ibid.

The criteria in Attachment A are drawn from the second edition of the ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations* (ASX Principles).

Comment from submissions

Respondents suggested that Attachment A should be updated to reflect the most recent edition of the ASX Principles.

APRA's response

The third edition of the ASX Principles incorporates two new criteria for director independence; the length of director tenure, and close family ties to persons who are not independent. Given these issues apply more broadly than the Level 3 framework that was the subject of consultation, APRA believes it would not be appropriate to make these changes without further consultation. APRA will therefore consider incorporating these two factors into Attachment A at a later stage. APRA expects that, as good practice, a prudent institution would take these additional matters into consideration when forming a view about the independence of its directors, even though they are not part of APRA's requirements.

Aggregate risk exposures - specific funding sources

3PS 221 sets requirements for a Level 3 Head's aggregate risk exposure limits that form part of the aggregate risk exposures policy. Draft 3PS 221 required that the policy must, where appropriate, include group limits for on- and off-balance sheet exposures to the matters listed under paragraph 14(a), including 'specific funding sources'.

Comment from submissions

Respondents sought clarity on the policy intent of this requirement, in particular, whether APRA expects a Level 3 Head to monitor the owners of its publicly traded securities.

APRA's response

APRA's intention is that a Level 3 Head sets limits for on- and off-balance sheet exposures to types of funding used across the group, as well as circumstances where groups rely on concentrated sources of funding, e.g. a single market, product, or counterparty.

It is not APRA's expectation that a Level 3 Head sets limits on, and extend their monitoring and control frameworks to third party holders of the publicly traded securities of the group.

Joint ventures

APRA determines the institutions that form part of a Level 3 group using the definition provided in 3PS 001.

Comment from submissions

Respondents sought guidance on whether non-consolidated joint ventures would be included in Level 3 groups, and how a Level 3 Head should apply the Level 3 framework to non-consolidated joint ventures (e.g. the monitoring and control framework required under 3PS 221).

APRA's response

APRA's view is that the determination of whether joint ventures are part of the Level 3 group should be based on APRA's assessment of the ability of that joint venture to adversely impact the ability of the APRA-regulated institutions in the Level 3 group to meet their obligations to depositors, policyholders or RSE beneficiaries. Where APRA assesses that the joint venture is part of the Level 3 group, but the Level 3 Head is unable to implement the relevant controls on the joint venture, APRA expects that the Level 3 Head will implement other group controls to limit the financial and operational contagion risks from the joint venture.

Changes to CPS 231 and CPS 232

Comment from submissions

One submission sought clarity on the policy intent of some of the existing paragraphs in CPS 231 and CPS 232.

APRA's response

As these issues are not directly related to the Level 3 framework, APRA will address these issues in a broader review of these prudential standards.

Whistleblowing

The Level 3 framework published in December 2012 included an update to the whistleblowing provisions in CPS 520. This included an updated requirement that institutions must 'explain' the whistleblower policy to directors and employees, where the existing requirement requires that the policy be 'communicated'. These amendments were included in the August 2014 version of CPS 520 and adopted in the March 2016 consultation package.

Comment from submissions

Respondents sought clarification of APRA's expectation of the difference between 'communicating' and 'explaining' the whistleblower policy.

APRA's response

APRA expects that APRA-regulated institutions take reasonable steps to inform directors and employees of the content of the institution's whistleblower policy. It is not sufficient that the institution only makes the policy available to directors and employees, or only communicates that the policy exists.

Fit and proper notifications

CPS 520 requires APRA-regulated institutions to provide information to APRA about their responsible persons. This includes information about the appointment of new responsible persons, and if existing responsible persons cease to hold positions of responsibility.

The Level 3 framework published in August 2014 included a new requirement that institutions must notify APRA of the 'title of the responsible person position'. The March 2016 consultation package included this update in subparagraph 57(a) of CPS 520.

Comment from submissions

Respondents commented that the information required to be notified under paragraph 57 of CPS 520 does not align with *Reporting Form RF 520.0 Responsible Persons* (RF 520.0).

APRA's response

APRA will update RF 520.0 in due course to align the reporting form with the requirements in CPS 520.

Group liquidity management policy

CPS 220, paragraph 17 requires a Head of a group to submit to APRA the group liquidity management policy in accordance with the process outlined in CPS 220, paragraph 52. The March 2016 consultation package removed the reference to the group liquidity management policy from paragraph 52, creating an issue with paragraph 17.

Comment from submissions

Clarification was sought on the amendment to paragraph 52.

APRA response

APRA has updated paragraph 17 to clarify that a Head of a group must submit to APRA the group liquidity management policy 'as soon as practicable, and no longer than 10 business days, after Board approval'. This resolves the issue created by removing the reference from paragraph 52.