



# ENFORCEMENT STRATEGY REVIEW

## Final Report

29 March 2019

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# Contents

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Foreword	4
Executive Summary	6
Chapter 1: APRA's approach to enforcement	11
Chapter 2: Enforcement under the twin peaks	20
Chapter 3: A new enforcement appetite for APRA	24
Chapter 4: Supervisory-led enforcement	35
Chapter 5: Enforcement governance	43
Chapter 6: Enforcement support	46
Chapter 7: Legislative reforms	48
Appendix 1: Terms of Reference	54
Appendix 2: Panel membership	56
Appendix 3: Activities undertaken by the Review	57
Appendix 4: APRA's supervisory toolkit	59
Appendix 5: Recommendations dependent on Government action	61
Appendix 6: Glossary	63

# Foreword

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On 12 November 2018, the Australian Prudential Regulation Authority (APRA) announced a comprehensive, forward-looking review of its enforcement strategy (the Review) and released accompanying Terms of Reference (see Appendix 1).

The Review was prompted by the Government introducing the Banking Executive Accountability Regime (BEAR), which gave APRA new and stronger powers with respect to banks and their directors and senior executives (accountable persons). Further impetus came from two other directions: the 2018 Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Royal Commission); and initiatives within APRA's Corporate Plan 2018-2022 (corporate plan), including increased transparency and broadening supervision and its intensity.

The Review was led by APRA Deputy Chair, John Lonsdale, with support from a secretariat (the Secretariat) comprised of APRA staff and a secondee from the United Kingdom Prudential Regulation Authority (PRA). An independent advisory panel (the Panel) was also appointed to provide an expert perspective on matters arising from the Review. The Panel comprised: Dr Robert Austin, Former Judge, Supreme Court of New South Wales; Commissioner Sarah Court, Australian Competition and Consumer Commission (ACCC); and Professor Dimity Kingsford Smith, Minter Ellison Research Professor of Risk and Regulation, and Deputy Director (Research) of the Centre for Law, Markets and Regulation at the University of New South Wales (see Appendix 2 for biographies).

The Review's purpose was to examine and make recommendations about APRA's approach to using enforcement to achieve its prudential objectives. The Review's recommendations have been informed by internal and external stakeholder engagement and empirical evidence, including an internal scan of APRA's approach to enforcement and a review of practices of peer regulators (see Appendix 3). The evidence shows that, while enforcement is essential to enable effective prudential regulation, APRA will always have to balance certain factors, such as the need for efficient outcomes and the benefits of transparency versus risks to financial stability, in considering how to meet its mandate in a manner that best protects the Australian community.

APRA's appetite for taking enforcement action is closely linked to a number of other components of its supervisory approach. As such, the Review has referenced elements of APRA's wider operations. However, it was not the Review's role to address these matters in depth. In particular:

- As part of its corporate plan, APRA is undertaking a broader refresh of its supervisory approach. The Review has considered this work only to the extent it relates to enforcement.
- APRA has separately announced its response to the Royal Commission's recommendations and will continue working with the Government to implement them. This includes reviewing APRA's supervisory framework in relation to governance, culture and remuneration, as well as working on reforms to the superannuation prudential framework. It also includes work underway to review APRA's broader relationship with

the Australian Securities and Investments Commission (ASIC). In addition, the Government has appointed an independent panel to conduct a capability review of APRA.

- Although the specific case studies referred to in the Final Report of the Royal Commission are important context for the Review, the Review was not intended to respond to these matters, which are being considered through APRA's internal processes.

APRA thanks the Panel members for their involvement in the Review. APRA also acknowledges the assistance of Associate Professor Andrew Godwin from Melbourne Law School, University of Melbourne, in drafting this report.

# Executive Summary

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APRA's mandate is to 'protect the Australian community by establishing and enforcing prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by the institutions we supervise are met within a stable, efficient and competitive financial system'.<sup>1</sup> In this way, APRA aims to assure:

- **bank depositors** that their money is safe;
- **insurance policyholders** that insurers have the resources to pay valid claims;
- **superannuation fund members** that their savings will be appropriately managed; and
- **the Australian community** that the financial system is stable.

With its focus on financial safety and stability, APRA fits into a subset of regulators that promote safety.<sup>2</sup> Similar to other safety regulators, APRA seeks to identify risks proactively and take action to prevent harm before it occurs. Consequently, much of APRA's effort involves lifting industry standards, intervening early and working with regulated entities behind the scenes to address issues.

As the International Monetary Fund (IMF) observed in its 2018 Financial Sector Assessment Program report, the strength and resilience of Australia's financial system has continued to grow in recent years. Australia was assessed as having a robust regulatory framework, with prudential supervision that shows generally high conformity to international best practices and at times goes beyond agreed minimums.<sup>3</sup> The benefits of this were evident during the global financial crisis (GFC) when Australian entities remained relatively stable, in part due to APRA's conservative capital requirements and risk monitoring in the preceding years.<sup>4</sup>

However, although Australia's financial system is fundamentally sound and resilient to economic stress, the Royal Commission has revealed significant issues. It concluded that

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<sup>1</sup> APRA's purpose and objectives are formally set out in s. 8 of the *Australian Prudential Regulation Authority Act 1998*, and are reflected in the mandate set out in the *APRA Corporate Plan 2018-2022*, <<http://www.apra.gov.au/corporate-plan>>.

<sup>2</sup> Safety regulation is a stronger form of regulation that governments typically apply where there are risks to physical safety, such as in relation to food standards and air travel. Financial safety is grouped together with these because of the severity of potential harm to individuals, the financial system and the real economy if it is not maintained. This explanation is set out in the *Financial System Inquiry Final Report*, March 1997, <<http://fsi.treasury.gov.au/content/publications.asp>>.

<sup>3</sup> International Monetary Fund, *Australia: Financial System Stability Assessment*, IMF Country Report No. 19/54, February 2019, <<https://www.imf.org/en/Publications/CR/Issues/2019/02/13/Australia-Financial-System-Stability-Assessment-46611>>.

<sup>4</sup> Financial Stability Board, *Peer Review of Australia*, 21 September 2011, <[http://www.fsb.org/2011/09/r\\_110926b/](http://www.fsb.org/2011/09/r_110926b/)>.

'the law has not been obeyed, and has not been enforced effectively'.<sup>5</sup> The Final Report of the Royal Commission reiterates what many in the community would see as obvious: that entities must obey the law and regulators must enforce the law. The message is clear: to fulfil its mandate, APRA must both effectively enforce and be seen to be effectively enforcing the law.

For APRA, as a safety regulator focused on preventing harm, enforcement<sup>6</sup> is not limited to taking court-based action. Rather, it means being prepared to use the full range of its formal powers – such as powers to direct entities or impose licence conditions – to achieve prudential outcomes and deter unacceptable practices.

This Review has concluded that APRA's appetite to use enforcement 'primarily ... as a last resort and mainly where financial promises or stability are at risk' has been too low.<sup>7</sup> In particular, APRA should in future:

- take stronger action earlier where entities and individuals are not open and cooperative;
- be more forceful in holding entities and individuals to account for actions that could have an adverse impact on financial soundness and stability, or lead to other inappropriate prudential outcomes;
- more actively consider the deterrence benefits of enforcement action;
- be more innovative in the use of its powers or combinations of powers; and
- as part of increasing its focus on enforcement, coordinate more effectively with ASIC where the two agencies have enforcement matters of common interest.

Changes to enable these shifts must be driven by APRA's leaders, and staff need to be empowered to implement them effectively.

In most circumstances, non-formal supervision approaches,<sup>8</sup> which form the basis of much of APRA's work, are highly effective. They can be a timely and resource-efficient way of achieving prudential outcomes without using formal powers. In contrast, the use of certain formal powers, such as court-based action, can involve significant time, cost and supervisory resources. They also carry the risk the intended prudential outcome may not be achieved.

However, formal powers are an important part of the supervisory toolkit and using them appropriately can bring benefits. It can make non-formal supervision approaches more

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<sup>5</sup> *Royal Commission into Misconduct in the Banking Superannuation and Financial Services Industry: Final Report*, Vol. 1, 1 February 2019, p 12, <<https://financialservices.royalcommission.gov.au/Pages/reports.aspx>>.

<sup>6</sup> Enforcement (also referred to as 'formal enforcement' or 'enforcement action') refers to the use of APRA's legal powers to compel the remediation of prudential risks, to hold institutions and individuals to account for their actions, and to achieve deterrence.

<sup>7</sup> APRA, *Written submissions of the Australian Prudential Regulation Authority in response to the Interim Report*, October 2018 at paragraph 45, <<https://www.apra.gov.au/submissions>>.

<sup>8</sup> Non-formal approaches include supervisory methods and tools such as prudential and thematic reviews, financial analysis, and heightened engagement and reporting requirements. See *Figure 1: The supervisory toolkit* for additional examples.

effective by reinforcing the credible threat that APRA will take stronger action where entities and individuals do not cooperate. It can resolve matters that might otherwise remain unaddressed in a timelier manner. Where actions are made public it can send a strong message on deterrence to a broad audience.

APRA's low enforcement appetite has, in some instances, resulted in risks not being addressed in a timely manner. A lack of stronger action earlier has, at times, drawn supervisory resources into protracted engagement around remediation of issues in place of preventative supervision. General deterrence benefits have been limited given much of APRA's activity occurs in private. For regulated parties who do cooperate, a lack of consequences for those who flout the rules risks undermining the value and benefits of compliance.

APRA's stated enforcement appetite appears out of step with its international peers. For example, the UK PRA expresses its approach as 'we will not hesitate to use formal powers where we consider them to be an appropriate means of achieving our desired supervisory outcomes. This means that, in certain cases, we will choose to deploy formal powers at an early stage and not merely as a last resort'.<sup>9</sup> The US Office of the Comptroller of the Currency (OCC) likewise states its policy 'is to identify deficient practices and violations in a timely manner and initiate bank enforcement actions to require corrective action well before deficiencies affect a bank's financial condition or viability'.<sup>10</sup> In its recent assessment, the IMF noted APRA should 'enhance [its] approach to corrective actions by being more proactive in escalating the severity of the corrective action in a quicker and more active way if the bank is not effectively cooperating'.<sup>11</sup>

APRA's enforcement appetite has evolved over a number of years, with various internal and external factors shifting the enforcement pendulum back and forth. Following the failure of HIH Insurance in 2001, APRA moved to a more risk-based approach with a sharper focus on early intervention. But then, several unsuccessful proceedings and overturned decisions,<sup>12</sup> as well as a change in the statutory provisions for actions against individuals, later curtailed APRA's enforcement appetite.

The GFC meant APRA had to focus strongly on maintaining financial safety and system stability. This reinforced the importance of effective working relationships with entities, particularly in times of stress. However, as the turmoil calmed and regulators globally

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<sup>9</sup> UK Prudential Regulation Authority, *The Prudential Regulation Authority's approach to banking supervision*, October 2018, <<https://www.bankofengland.co.uk/prudential-regulation/publication/2018/pru-approach-documents-2018>>.

<sup>10</sup> Office of the Comptroller of the Currency, *Policies and Procedures Manual: Bank Enforcement Actions and Related Matters PPM 5310-3*, 13 November 2018, pp 3-4, <<https://occ.treas.gov/news-issuances/bulletins/2018/bulletin-2018-41.html>>.

<sup>11</sup> IMF, *Australia – Financial Sector Assessment Program: Detailed Assessment of Observance – Basel Core Principles for Effective Banking Supervision*, IMF Country Report No. 19/53, February 2019, p276, <<https://www.imf.org/en/Publications/CR/Issues/2019/02/13/Australia-Financial-Sector-Assessment-Program-Detailed-Assessment-of-Observance-Basel-Core-46610>>.

<sup>12</sup> For example, a number of disqualifications of former directors of HIH and trustees of the AXA Staff Superannuation Fund were overturned.



turned to the question of the GFC's underlying causes, it was evident that culture was a significant driver.<sup>13</sup> Regulators recognised that a greater focus on behavioural risks (i.e. actions of an entity or individual that do not foster prudent risk management) was needed. Behavioural risks could easily convert to financial consequences. Indeed, they could ultimately lead to entities failing.

These lessons have increased APRA's focus on behavioural standards, including in relation to governance, culture, remuneration and risk management. Behavioural standards have presented a particular challenge for prudential regulators globally, including APRA, as approaches to assessing, supervising and enforcing against such standards are still maturing. Their qualitative nature requires significantly more regulatory judgment to determine: if a breach has occurred; whether and when it might trigger a risk of beneficiary losses; and an appropriate timeframe for remediation of the issue. As a result, APRA has been hesitant to use enforcement to compel remediation of behavioural risks, or to hold entities and individuals to account and achieve deterrence in respect of these issues.

The 2018 Prudential Inquiry into the Commonwealth Bank of Australia and APRA's subsequent response demonstrated an increased focus and willingness to act on behavioural risks. The introduction of the BEAR continued this focus, by giving APRA powers to impose consequences on ADIs and their accountable persons for a material failure to meet new accountability obligations. APRA has had to consider closely how it will use the new statutory powers under the BEAR, particularly as it gives APRA the administrative power to disqualify individuals.

More recently, the Royal Commission has emphasised the need to improve the effectiveness and efficiency of the 'twin peaks' model, calling for APRA and ASIC to co-regulate aspects of superannuation regulation and an extended BEAR regime. These proposed changes reinforce the need for APRA and ASIC to share more information and coordinate more closely on enforcement matters to fulfil their respective mandates.

Together, these factors have already started to give APRA renewed focus on enforcement.

To further strengthen APRA's enforcement approach and ensure it remains sustainable and effective into the future, the Review recommends:

1. Strengthening APRA-ASIC coordination on enforcement by developing clear principles for sharing information and taking coordinated action on matters of mutual interest.
2. Increasing APRA's enforcement appetite from a 'last resort' to a 'constructively tough' approach and setting this out in a Board-endorsed, publicly available enforcement strategy.
3. Strengthening APRA's supervisory-led approach by assigning clear responsibility to supervisory divisions for applying the new enforcement appetite.

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<sup>13</sup> For example, refer to a speech given by Andrew Bailey, then CEO of UK PRA, *Culture in financial services – a regulator's perspective*, City Week 2016 Conference, 9 May 2016, <<https://www.bankofengland.co.uk/speech/2016/culture-in-financial-services-a-regulators-perspective>>.

4. Building a more forceful supervisory culture and approach, emboldened by the tone from the top and management support, to better empower and support supervisors to hold entities and individuals to account, including through use of enforcement action.
5. Establishing an APRA Member-led committee to drive enforcement decision-making and strengthen oversight.
6. Giving APRA's supervisors more enforcement support by creating a combined team of investigation and legal experts, and ensuring adequate funding for APRA's enforcement actions.
7. Bolstering APRA's statutory powers including: revising and creating additional penalties; enhancing APRA's enforcement powers in superannuation and private health insurance; removing barriers to joint investigations with ASIC; and extending the BEAR to other regulated industries.

If these recommendations are implemented, it can be expected APRA will continue to be a supervisory-led organisation that undertakes the majority of its work through non-formal approaches. Enforcement should not become its first option but will be used, where appropriate.

The Review believes these recommendations will sharpen APRA's ability to protect beneficiaries and fulfil its mandate. They will ensure APRA is more willing to use its formal powers in a timely manner and more innovative in using the full extent of its toolkit to deliver prudential outcomes. APRA will be more determined in holding entities and individuals to account and strategic in selecting cases for deterrence. It will be more transparent in its approach, although not all actions will be publicly visible.

For industry – and particularly for those entities and individuals failing to meet prudential obligations under legislation and standards – these recommendations mean APRA will:

- **act more quickly** – by being less patient about the time taken to remediate issues;
- **be more forceful** – by being firmer in clearly setting and following up on expectations, and more ready to hold to account; and
- **be willing to set public examples** – by being more transparent and sending strong public messages through enforcement action.

History has shown APRA to have been successful at evolving its approach to continue to deliver effectively on its mandate. In this regard, APRA already has a number of initiatives underway, many of which align with and support this Review's recommendations. To implement the recommendations, APRA should in the immediate term focus on increasing its enforcement appetite, driven by its leaders including through the Member-led Enforcement Committee. A number of other recommendations, such as changes to the supervisory approach, will by their nature take longer to implement and embed fully.

To ensure its effectiveness, ongoing monitoring of progress will be required and APRA should, in three years, conduct a comprehensive review of the implementation of the recommendations in this report.

# Chapter 1: APRA's approach to enforcement

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This chapter consists of three sections. The first briefly explains the Australian financial regulatory context. The second sets out the Review's assessment of APRA's enforcement appetite and explains why it should be increased. The third identifies factors that will need to be addressed to facilitate an increase in its enforcement appetite.

## Australian financial regulatory context

APRA's mandate and role is shaped by Australia's 'twin peaks' model of financial regulation, which originated from the Wallis Inquiry.<sup>14</sup> Under this model, the functions for financial regulation are split between two agencies: ASIC, which is responsible for regulating companies, market conduct and consumer protection; and APRA, which is responsible for prudential regulation.

### Box 1: APRA's mandate

To protect the Australian community by establishing and enforcing prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by the institutions we supervise are met within a stable, efficient and competitive financial system.<sup>15</sup>

The Financial System Inquiry<sup>16</sup> and the Royal Commission<sup>17</sup> both re-examined this model and supported its retention.

The nature of the financial promises APRA aims to protect differs across the APRA-regulated industries. For ADIs and insurers, both essentially promise to pay defined amounts in the future according to contractual terms. APRA's focus is therefore to ensure they have adequate financial resources in the future to meet the promises they make to their depositors and policyholders today. In contrast, with the notable but declining exception of defined benefit funds, Registrable Superannuation Entities (RSEs) have no fixed obligation to pay future amounts in superannuation. Instead, the promise relates to managing members' savings solely for their best interests. APRA's focus is therefore on how the RSE Licensee

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<sup>14</sup> Refer to note 2.

<sup>15</sup> Refer to note 1.

<sup>16</sup> *Financial System Inquiry: Final Report*, November 2014, <<http://fsi.gov.au/publications/final-report/>>.

<sup>17</sup> Refer to note 5.

manages and carries out its business operations fairly, efficiently and effectively to achieve appropriate member outcomes.<sup>18</sup>

These differences result in some variance in the way APRA regulates and supervises those industries. The emphasis and focus differ, and the methods used reflect the different statutory powers and tools available for each industry. However, APRA seeks to adopt a harmonised approach, where possible.

## APRA's enforcement appetite

### APRA's supervisory toolkit

As the prudential regulator of the twin peaks model, APRA focuses on financial safety and stability. APRA uses a supervisory cycle of risk identification, risk assessment, risk response and escalation (see Chapter 4 and Box 4: APRA's supervisory approach, for further detail). APRA seeks to identify and assess risks and intervene early to prevent harm before it occurs. Much of this involves working cooperatively with entities to identify and rectify problems before they threaten the ability of an entity to meet its financial promises. This approach is most effective where APRA has an open and cooperative relationship with entities. However, where entities are not willing or able to remediate issues or prudential risks are sufficiently serious, APRA must use increasingly forceful approaches.

Prudential supervision encompasses all the activities of the supervisory cycle through which APRA seeks to ensure that entities are meeting their prudential obligations. To achieve this, APRA has wide-ranging methods and tools at its disposal, as detailed in Figure 1 below. For the purpose of this report, these methods and tools are categorised as:

- **Formal enforcement** (also referred to as 'enforcement' or 'enforcement action') – the use of APRA's legal powers to compel the remediation of prudential risks, to hold entities and individuals to account for their actions, and to achieve deterrence.
- **Non-formal approaches** – the other supervisory methods and tools APRA uses to achieve prudential outcomes.

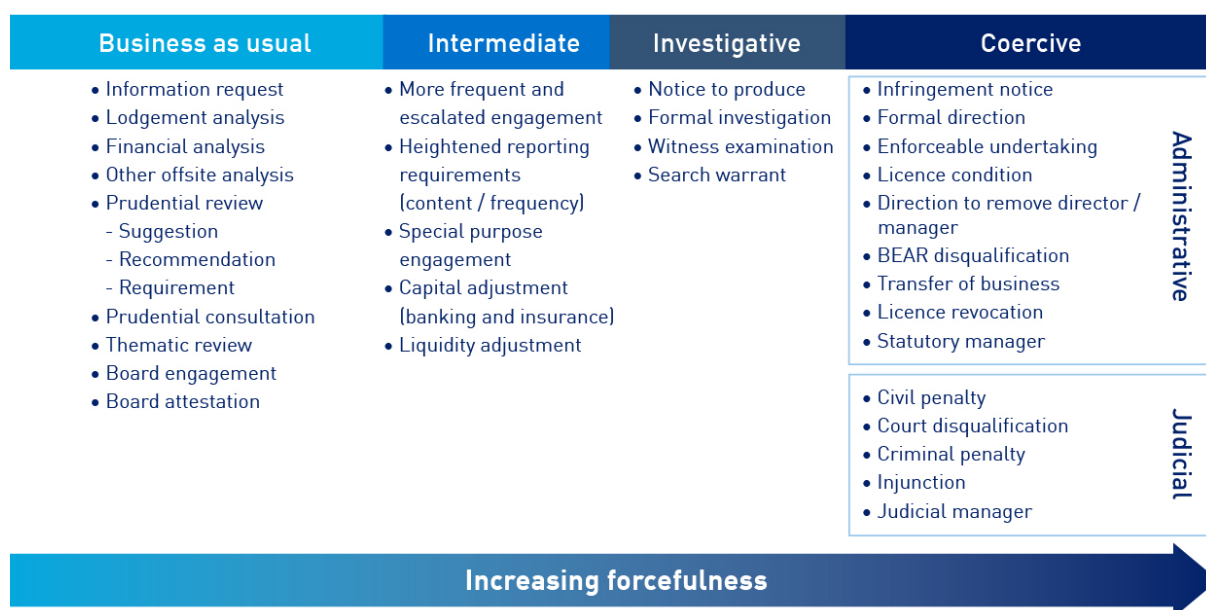
As Figure 1 shows, APRA's supervisory toolkit runs on a spectrum from the non-formal tools used in day-to-day supervision through to the most forceful tools at the formal end. Supervisors may select tools for use from anywhere along the spectrum to suit the circumstances with which they are dealing.<sup>19</sup> Importantly, some of the intermediate tools APRA has available, such as capital adjustments for ADIs and insurers, can be powerful and highly effective in influencing the behaviour of entities and individuals.

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<sup>18</sup> Witness statement of Wayne Byres on behalf of the Australian Prudential Regulation Authority, EXHIBIT 7.145 - WIT.0001.0178.0001, Public Hearing, 28 November 2018, pp 8-9 at 36-37, <<https://financialservices.royalcommission.gov.au/public-hearings/Documents/transcripts-2018/transcript-30-november-2018.docx>>.

<sup>19</sup> However, those at the more forceful end generally have threshold conditions that must be met before they can be deployed.

Figure 1: The supervisory toolkit<sup>20</sup>



Formal enforcement is an integral part of the supervisory toolkit. Prudential supervision can only be effective if regulated parties believe the regulator will take increasingly forceful actions, including using its formal powers, where prudential issues are not being properly addressed.<sup>21</sup>

For a prudential regulator, enforcement actions should largely be aimed at preventing and remediating prudential risks. Where appropriate, enforcement action should also be used to hold entities and individuals to account for their actions which, within the broader context of achieving deterrence,<sup>22</sup> has pre-emptive effects in line with prudential aims.

## APRA's last resort enforcement appetite

The *APRA Supervision Blueprint* defines enforcement as 'a special category of supervisory activity, in which specific intervention and remedial actions are pursued, usually because APRA does not believe that a regulated entity has the ability or willingness to rectify *serious identified weaknesses that threaten financial viability or safety* [emphasis added]'.<sup>23</sup> In practice, APRA appears to have interpreted this narrowly, as relating to *imminent* threats to financial viability or safety. As a result, APRA has taken quick and effective enforcement action in relation to imminent threats to viability. On behavioural risks, APRA has either not taken

<sup>20</sup> For definitions and descriptions of how the tools are used, refer to *Appendix 6: Glossary* and also *Box 4: APRA's supervisory approach*.

<sup>21</sup> Ayres, I. and Braithwaite, J., *Responsive Regulation: Transcending the Deregulation Debate*, Oxford University Press, 1992.

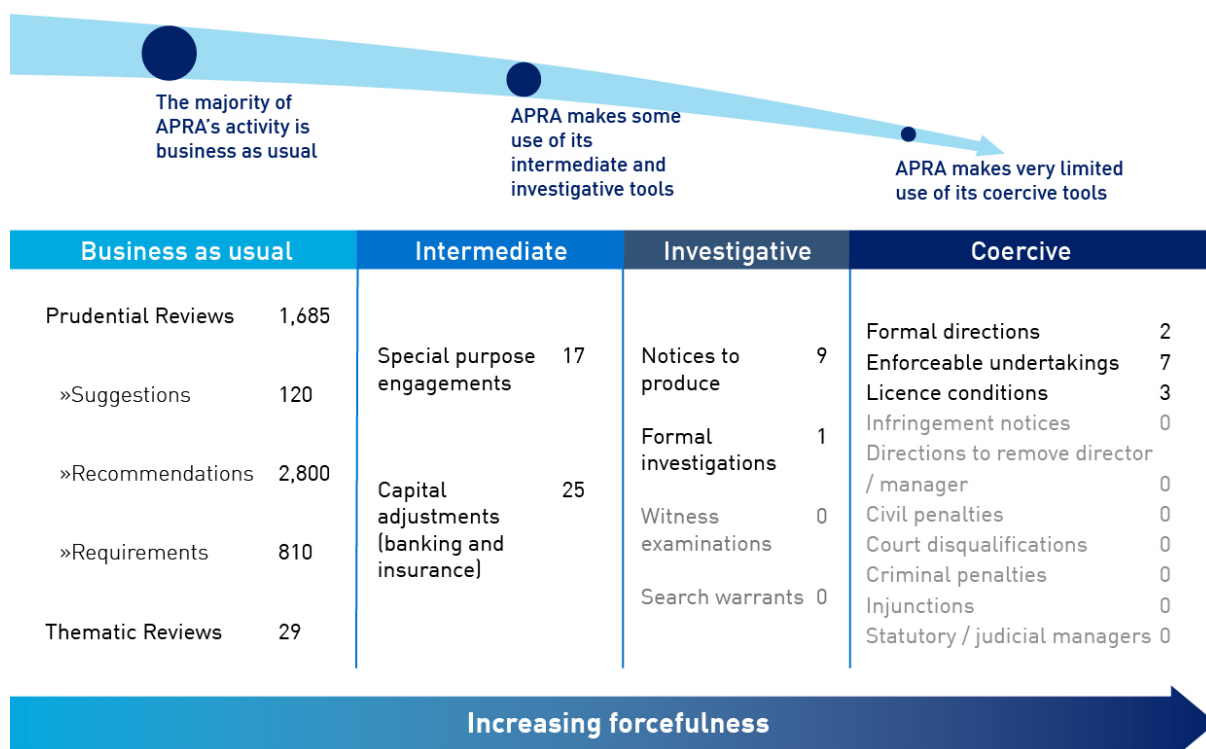
<sup>22</sup> Deterrence can be both specific and general. Specific deterrence is the use of enforcement action to discourage the particular entity or individual that committed the breach from doing so again. General deterrence is intended to discourage other regulated entities or individuals from committing similar or other breaches.

<sup>23</sup> APRA, *The APRA Supervision Blueprint*, May 2015, p 14, <<http://www.apra.gov.au/apra-supervision-blueprint>>.

enforcement action or has been slow to act. In addition, APRA's focus on addressing issues with individual entities has limited its consideration of wider deterrence benefits.

APRA's appetite, and its supervisory emphasis, can be gauged from how frequently it uses formal and non-formal tools. Figure 2 shows usage rates for APRA's formal tools and selected non-formal tools.

**Figure 2: APRA's indicative use of various supervisory tools from 2013-2018<sup>24</sup>**



Value indicates the number of times each method/tool has been used from 2013-2018 across APRA's regulated industries.  
Source: APRA Q Supervisory System and databases maintained by APRA's Legal and Enforcement teams.

Clearly, the vast majority of activity is at the non-formal end of the spectrum. For entities that are willing and able to address issues, non-formal approaches are an appropriate and highly efficient way of achieving prudential outcomes. Strikingly, over the last five years APRA has made very limited use of its formal powers.

Despite the low enforcement appetite this generally portrays, the Review notes that APRA's appetite is increasing. Recent actions such as APRA's response to the findings of the Prudential Inquiry into the Commonwealth Bank of Australia in April 2018 show it using enforcement to address behavioural risks and giving greater weight to both specific and general deterrence.

<sup>24</sup> See Appendix 4: APRA's supervisory toolkit for the methodology underlying the data shown in Figure 2: APRA's indicative use of various supervisory tools from 2013-2018.

## Reasons for APRA's enforcement appetite

APRA's history and operating environment (as set out previously) have shaped its approach to enforcement, as has the recognition of the trade-offs that enforcement action can involve. This section discusses these trade-offs.

### *Openness and cooperation of entities*

Given the openness and cooperation of entities are important factors in successful prudential supervision, APRA has been concerned about the impact of enforcement on these factors. The internal engagement undertaken by the Review revealed that around half of APRA supervisors thought increased enforcement activity would adversely impact their ability to access information and elicit cooperation from entities. However, despite this internal perception, the Review believes an increased enforcement appetite would not necessarily jeopardise the effectiveness of supervisory interactions.

APRA often appears to have viewed this trade-off as a simple one, in which increasing levels of forcefulness result in decreasing levels of openness and cooperation. The Review's discussions with other domestic and international regulators indicated a more nuanced view of this trade-off. These agencies were of the view that, where a regulator is considered to be reasonable and fair in its actions, previous enforcement action or the credible threat of further enforcement action actually optimises the effectiveness of the interactions. A number of regulators also indicated that sophisticated entities are generally able to separate the handling of enforcement matters from day-to-day supervision, especially where different personnel are involved.

### *Efficiency of outcomes*

Using formal powers can involve significant time, cost and supervisory resources, with no certainty of achieving the intended prudential outcome. In most circumstances, non-formal approaches are effective in achieving prudential outcomes in a resource-efficient and timely manner. Indeed, this is how the vast majority of APRA's supervision occurs. The internal engagement revealed that most supervisors thought entities were generally cooperative in meeting APRA's expectations.

However, APRA has at times overlooked the inefficiency of persisting with non-formal approaches where an entity is not cooperating. In these instances, using stronger action is likely to have proved a more efficient method.

### *Behind the scenes approach*

With a few exceptions, APRA has primarily taken action in private. This is a result of the very real risk that public awareness of prudential concerns will exacerbate an issue by damaging confidence in an entity or the financial system. This could complicate or undermine remediation, resulting in poorer prudential outcomes. However, comparisons to peer regulators suggest APRA has scope to be more transparent in its actions and achieve greater benefits from general deterrence without jeopardising its financial safety objectives.

## Consequences of a low appetite

The Review believes the collective effect of APRA's choices in relation to the trade-offs discussed above has been to diminish the credible threat of consequences for failing to meet

APRA's requirements. This risks diminishing the effectiveness of APRA's non-formal supervision approaches. Regulatory theory suggests non-formal, suasion-based approaches are effective largely because they are buttressed by the threat of more severe actions if requirements are not met. More formal actions signal the authoritative nature of the regulator and the gravity of its public purpose. Clearly, APRA needs to demonstrate its appetite for enforcement. In the words of Ayres and Braithwaite, 'regulators will be more able to speak softly when they carry big sticks'.<sup>25</sup>

The Review's analysis shows that an overly low enforcement appetite can lead either directly or indirectly to less than optimal prudential outcomes, as outlined below.

### *Protracted exposure to known risks*

Effectively identifying issues is a crucial first step in supervision. However, extended periods of remediation significantly diminish the value of having identified the issue in the first place. In instances where the primary prudential concerns relate to behavioural risks, APRA has tended to tolerate lengthy periods of time for entities to remediate issues. This is because, as previously noted, the qualitative nature of behavioural standards means significantly more judgment is involved and it often takes entities longer to deliver and demonstrate measurable progress.

However, the longer the delay, the higher the probability a risk will crystallise or a small issue become a larger one. In addition, long lag times increase the risk of the issue never being satisfactorily remediated. For example, lengthy delays could mean the issue becomes lost or misunderstood as a result of staff changes at both APRA and/or the entity.

### *Diversion from forward-looking supervision*

Tolerating delays in remediation and persisting with non-formal approaches rather than circumventing protracted cycles with stronger strategies can in some instances lead to an inefficient use of APRA's resources. This can divert supervisory attention from forward-looking preventative activities.

Although using stronger strategies can also be resource intensive, using enforcement where needed reinforces the message APRA is willing to act. For entities that are not cooperating, restoring that cooperation may ultimately depend on APRA demonstrating this willingness. This in turn has the potential to help avert future, drawn-out remediation processes, allowing APRA to focus on preventative activities.

### *Lack of deterrence*

A few recent examples aside, APRA has generally not taken action against entities or individuals once an immediate prudential issue has been addressed. APRA has historically paid less attention to the need to deter unacceptable practices from recurring through enforcement action, despite its preventative benefits.

By not placing greater focus on deterrence, APRA has missed out on the benefits of sending a strong message – to a specific entity or individual or, in the case of public action, to a broad

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<sup>25</sup> Refer to note 21, p 17.



audience – to reinforce the credible threat of action for poor behaviour or not meeting requirements. As the UK Treasury noted in its review of enforcement decision-making, ‘Effective, proportionate and robust enforcement action delivers credible deterrence, so that wrongdoers believe they will be held to account and that meaningful sanctions will follow. This helps to protect consumers, enhance the integrity of UK markets, and increase the stability of our financial system’.<sup>26</sup> The Review notes that APRA’s approach to taking public action has started to shift recently, in line with its broader focus on increasing transparency.

## Increasing APRA’s enforcement appetite

The following chapters set out recommendations to increase APRA’s enforcement appetite. Two areas necessary for success will be evolving APRA’s supervisory culture to support the increased appetite and strengthening the way APRA works with ASIC on enforcement. The sections below provide further background on these issues.

### Supervisory culture

Enforcement forms part of APRA’s supervisory approach. Formal enforcement is at the sharp end of the supervisory toolkit and its use, when appropriate, can provide an effective means of achieving optimal prudential outcomes. In addition, when dealing with uncooperative and unconstructive entities and individuals, taking a more forceful approach to supervision is critical for helping to identify where enforcement action may be needed and ensuring that a strong trail of evidence is in place to support APRA taking action.

Given this link, APRA’s supervisory culture has been consistent with its last resort enforcement appetite. The supervisory culture, some recent shifts aside, has tended to be risk averse with little appetite for taking enforcement action given the uncertainty of outcomes, high cost and resource commitment involved. This is reflected in the following comments on the institutional appetite gathered during the Review:

*‘There appears to be reluctance to consider enforcement options which results in an overly cautious approach where enforcement actions are not a credible deterrent for entities.’*

*‘Impediments to taking enforcement action very much include the mindset of decision makers ... which arguably on balance have been generally too risk averse.’*

*‘The view appeared to be that we should only use coercive powers if it was guaranteed that the entity would either accept them, or that, if it went to court we were guaranteed of victory.’*

*‘... consideration is given to a variety of matters – time, cost, effort, likelihood of success ... the bar for pursuing enforcement action is set high.’*

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<sup>26</sup> UK Treasury, *Review of enforcement decision-making at the financial services regulators: Final Report*, December 2014, p 3 at [1.6], <<https://www.gov.uk/government/consultations/review-of-enforcement-decision-making-at-the-financial-services-regulators-call-for-evidence>>.

This cautious tone is also reflected in the introduction to APRA's internal enforcement manual, which states that 'where enforcement action is taken ... APRA must ensure that all opportunities for challenge are minimised; enforcement outcomes are not compromised; and there is minimal risk of consequential damage to APRA's reputation as a credible regulator'.

APRA's supervisory culture must be one that considers the full range of actions, including those of increasing forcefulness, in determining the appropriate responses to risks or issues of increasing prudential concern. It is imperative that the tone from the top of the organisation drives this change in the culture. Without explicit support from APRA's leaders, supervisors may be less likely to consider enforcement action, may self-censor and avoid recommending such action, or may face opposition in recommending such action.

In addition, APRA must be prepared to respond firmly and with greater confidence to challenge. When faced with opposition from uncooperative and unconstructive entities and individuals, APRA must be assertive in backing its judgment and formally investigating an issue. APRA must also be more assertive in holding entities and individuals to account for delivery of risk remediation activities and by imposing consequences for behaviour that gives rise to prudential concern. It should be more innovative in how it uses the full supervisory toolkit, including through one or a combination of formal tools, where appropriate.

The Review found positive signs of a recent shift in tone from the top, with increased support for supervisory forcefulness and the use of enforcement. Staff are attuned to this shift, as reflected in the following comment made during the Review's internal engagement:

*'There has been a noticeable and positive shift in the last 12 months to actively considering more intrusive action to respond to serious risks.'*

However, such a shift has yet to be embedded across the whole organisation. APRA's leaders need to ensure the change in supervisory culture and empowerment to use enforcement, where appropriate, is fully driven through the organisation. This aligns with broader reforms to the organisation's supervisory approach and supporting infrastructure, which is currently undergoing a wider refresh, as set out in APRA's corporate plan.

## APRA-ASIC coordination

For the twin peaks model to work effectively, information sharing and coordination between APRA and ASIC are vitally important, particularly on enforcement matters. Coordination and cooperation between APRA and ASIC already occur. Officials from both regulators meet regularly on a range of issues, including enforcement matters of mutual interest. However, more needs to be done. As the Royal Commission notes: '[f]ailures to share information, co-ordinate approaches and act with a consistent purpose will result in duplication of effort or, worse, regulatory failings.'<sup>27</sup> The Royal Commission has called for increased co-regulation of aspects of superannuation regulation and the BEAR, recommending giving ASIC the powers to enforce in these areas while also explicitly stating that APRA should retain its powers to

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<sup>27</sup> Refer to note 5, p 458.

take enforcement action. This recognises that APRA needs these powers to carry out its own mandate.

Over time, APRA and ASIC's separate responsibilities have grown closer around conduct concerns. Globally, regulators including APRA acknowledge that conduct and other behavioural risks are relevant to prudential regulation.<sup>28</sup> Revelations of the cultural drivers of the GFC provided a pointed lesson. However, as the Final Report of the Royal Commission recognises, the lenses through which APRA and ASIC consider conduct issues differ:

'Conduct often has both prudential and non-prudential connotations. In its prudential sense, conduct is most directly concerned with the institution in question being administered with appropriate integrity, prudence and professional skill and with action by the institution that, alone or in aggregate, could present a threat to the survival of the institution or the stability of the market. In each case, the focus is on the health of the institution and its ability to meet the promises it has made, and the health of the broader market. In its more common, non-prudential sense, 'conduct' is concerned with consumer protection and market conduct rules. Its essential focus is on the rights and interests of consumers in the context of their participation in the financial services industry.'<sup>29</sup>

In short, the same conduct concerns could be of interest to both APRA and ASIC for different reasons, reinforcing the need for them to share information, cooperate and coordinate closely on enforcement matters. A robust working relationship should encourage an environment of constructive mutual challenge between APRA and ASIC on these matters.

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<sup>28</sup> For example, refer to Basel Committee on Banking Supervision, *Corporate Governance Principles for Banks – Guidelines*, July 2015, <<https://www.bis.org/bcbs/publ/d328.htm>>.

<sup>29</sup> Refer to note 5, p 450.

## Chapter 2: Enforcement under the twin peaks

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This chapter sets out the Review's first recommendation, which should be incorporated into work already underway to review the broader APRA-ASIC working relationship.

APRA is currently working with ASIC to review cooperation and coordination arrangements between the two agencies.<sup>30</sup> This initiative was underway as part of APRA's corporate plan and was given increased priority as part of APRA's response to the Royal Commission's recommendations.<sup>31</sup> In the Government's response to the Royal Commission, it noted:

'The Government agrees to remove barriers to information sharing between the regulators and require APRA and ASIC to cooperate, share information and notify each other of relevant breaches or suspected breaches, as appropriate. Improvements to informal and formal communication, cooperation and collaboration between the two regulators are critical. This should include efficiently sharing information and intelligence and working together on enforcement and investigation activities. The Government supports ASIC and APRA continuing to work together to update their existing memorandum of understanding to ensure that it clearly sets out how they will comply with their statutory obligation to cooperate.'<sup>32</sup>

### Strengthen APRA-ASIC coordination on enforcement

#### Recommendation 1

APRA and ASIC should agree clear principles under which they will:

- share information in a timely fashion on breaches and potential breaches relevant to their counterpart's mandate;
- consult with each other when considering enforcement action against entities regulated by both agencies; and
- coordinate enforcement action,

recognising that each agency's primary objective must be to take any action needed to meet its own mandate.

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<sup>30</sup> APRA and ASIC are reviewing the cooperation and coordination arrangements between the two agencies, including revising the existing Memorandum of Understanding. The review will be completed in 2019.

<sup>31</sup> Refer to note 5, p 458.

<sup>32</sup> *Australian Government response to the Royal Commission*, Recommendations 6.9 and 6.10, p 33-34, <<https://treasury.gov.au/publication/p2019-fsrc-response/>>.

## APRA-ASIC coordination on enforcement

The Royal Commission's recommendations will require closer coordination between APRA and ASIC given the Government's endorsement of ASIC's expanded role as the primary conduct regulator for superannuation, and joint administration of the BEAR legislation across entities regulated by both agencies. Determining how APRA and ASIC should improve cooperation and coordination on enforcement actions will be a key enabling step for APRA in moving to a higher enforcement appetite. The section below proposes the principles that should guide a higher level of coordination.

The Review also identified legal barriers to APRA and ASIC effectively coordinating on joint investigations (see Chapter 7 and Appendix 5 for recommendations to address these issues).

### Guiding principles

The Review, in consultation with ASIC, proposes a set of guiding principles for how APRA and ASIC should coordinate and cooperate on enforcement actions relevant to both agencies. Three guiding principles are proposed.

#### Box 2: Guiding principles for enforcement coordination

**Share:** APRA and ASIC should always share relevant information in a timely way, to the full extent permitted by law, where either is aware of breaches or potential breaches relevant to their counterpart's mandate.

**Consult:** APRA and ASIC should consult with each other when considering enforcement action against entities regulated by both agencies. This will allow both agencies to assess the potential impacts for their mandates.

**Coordinate:** If APRA or ASIC are considering enforcement action in relation to issues relevant to both regulators' mandates, enforcement action should be coordinated to the greatest extent possible. Each situation should be assessed on its merits and the outcome may be action by one regulator, or action by both (separately or jointly, as appropriate). In all cases, open communication between regulators should be maintained to ensure each agency is fully informed and able to discharge its regulatory responsibilities.

### International benchmarking

In forming these guiding principles, the Review considered the existing coordination practices between APRA and ASIC, and looked at the approaches taken in other jurisdictions. A number of jurisdictions have regulatory models with separate responsibility for conduct and prudential regulation. The Review considered approaches taken in the Netherlands, New Zealand, South Africa and the UK. Many of the arrangements in place in these jurisdictions are similar to the approach taken in Australia. However, internationally there is a tendency towards an 'if not, why not?' approach to sharing information, whereas Australia's arrangement has historically been more conditional. The UK approach is particularly relevant to consider given the close similarity of its twin peaks model to Australia.

## *The UK twin peaks*

In 2013, the UK adopted a twin peaks model of financial regulation. The Financial Services Authority, which was responsible for both conduct and prudential regulation, saw its responsibilities split between two new regulatory authorities: the PRA and the Financial Conduct Authority (FCA).

The FCA and PRA consult and coordinate in relation to all enforcement actions taken against entities they both regulate. In particular:

- **Joint investigations.** Each agency will assess whether or not it is appropriate to undertake an investigation. If one agency is taking action, it may not be necessary for the other to do so. Where both decide to investigate, they will assess whether any investigation should be joint. The PRA and FCA can appoint joint investigation teams made up of employees from both agencies.
- **Shared information.** Statutory arrangements in the UK allow the FCA and PRA to have full access to the information obtained by the other during any investigation (joint or not).
- **Consultation and coordination.** The FCA and the PRA decision-making processes remain separate and independent, but they closely coordinate their actions following joint investigations, and they have achieved a number of coordinated enforcement outcomes in settled cases. They coordinate financial penalties to ensure the totality of the penalties are proportionate. Public announcements about outcomes in these enforcement cases are jointly issued or very closely coordinated.

### **Box 3: Coordinated enforcement actions undertaken by the PRA and FCA**

#### **Millburn Insurance Company Ltd**

On 1 February 2016, the PRA and FCA announced that, following a joint investigation, they had each fined Millburn Insurance for failing to run its business with due skill, care and diligence. The CEO was also banned and fined for failing to take reasonable steps to establish appropriate systems and controls to monitor underwriting, technical provisions, capital, reinsurance and financial reporting.

The case included both prudential and consumer detriment issues. Millburn allowed agents and subagents to write business on its behalf. It also held a limited amount of capital, relying on 100 per cent reinsurance arrangements. Millburn did not monitor these arrangements properly and, when one of the reinsurers failed, Millburn was unable to pay the claims of policyholders.

A joint PRA and FCA investigation was initiated, with members of the FCA investigation team also appointed as PRA investigators. An FCA case manager led the investigation, with appropriate oversight and strategic input from the PRA. The cost of the investigation was funded jointly by the FCA and PRA. All decisions regarding PRA enforcement actions were made by the PRA based on evidence obtained by the FCA-staffed investigation team. The PRA and FCA retained their separate decision-making functions, while closely coordinating the timing of their respective actions and the accompanying publication.

The settled enforcement actions following the investigation were closely coordinated, albeit with separate and independent decision-making. The financial penalties imposed by each regulator were coordinated. For Millburn, the PRA's fine was £2,863,066 and the FCA's fine was £1,137,500 – reflecting the fact that the matter was largely prudential in nature. The CEO was fined and banned

### Box 3: Coordinated enforcement actions undertaken by the PRA and FCA

by both regulators: £25,173 from the PRA and a larger fine of £51,600 from the FCA, which also covered misconduct by the CEO in relation to a separate FCA solo-regulated firm.

If the matter had been contested rather than settled, it does not automatically follow that the two regulators would have attempted to issue joint proceedings. To date, the PRA and FCA have not concluded joint enforcement action in a contested matter.

#### **James Edward Staley (Chief Executive Officer of Barclays Group)**

On 11 May 2018, the PRA and FCA announced that they had jointly fined Mr James Staley, CEO of Barclays Group, a total of £642,430. This matter involved a dual-regulated banking business. It concerned the behaviour of Mr Staley and his attempts to identify the author of an anonymous letter, which was being dealt with under Barclays' whistleblowing procedures. The letter related to management behaviour in relation to hiring practices – not exclusively prudential or customer specific, but a governance matter relevant to both the PRA and FCA.

Given the importance of good governance to both regulators, the role that whistleblowers play in exposing poor practice and the fact that a CEO should set an example in relation to the firm's culture, values and behaviours, both regulators decided to start formal investigations. They formed a joint investigation team made up of FCA and PRA staff. Coordinated document requirement notices were issued, avoiding duplication, and representatives of both sides were present for, and participated in, compelled interviews.

This was a case that settled and the financial penalties imposed by each regulator were coordinated.

# Chapter 3: A new enforcement appetite for APRA

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This chapter explains the Review's second recommendation, outlining a more effective enforcement appetite for APRA, underpinned by a clear objective, criteria and guiding principles.

## Increase APRA's enforcement appetite

### Recommendation 2

Increase APRA's enforcement appetite from 'last resort' to 'constructively tough'. This means APRA should take enforcement action to hold entities and individuals to account to prevent and address serious prudential risks:

- earlier than it currently does, well before an imminent threat to financial viability;
- in broader circumstances than it currently does, including in relation to behavioural risks; and
- to achieve deterrence, including by making enforcement actions public where appropriate, to send strong messages that entities and individuals must comply with their prudential obligations.

APRA should articulate the increased appetite in a Board-endorsed enforcement strategy. The enforcement strategy should be published.

The proposed new enforcement appetite, constructively tough, can be broken down into three components that the Review believes should form the basis of APRA's published enforcement strategy (see Figure 3):

1. **Enforcement objective:** outlining what APRA seeks to achieve through enforcement.
2. **Enforcement criteria:** setting out the issues that will lead APRA to consider enforcement action.
3. **Guiding principles:** steering APRA's strategic decisions on when and how to take enforcement action.



**Figure 3: Constructively tough objective, criteria and guiding principles**

1. Objective	To prevent and address serious prudential risks and hold entities and individuals to account			
<p>2. Criteria</p> <p><i>The issues that will lead APRA to consider enforcement action</i></p>	<p>Where an entity or individual has not:</p> <ul style="list-style-type: none"> <li>adequately prevented or addressed prudential risks; or</li> <li>conducted business with honesty and integrity, or with due skill, care and diligence; or</li> <li>dealt with APRA in an open, cooperative and constructive way;</li> </ul>	and in such cases:	<ul style="list-style-type: none"> <li>there has been an adverse impact on financial soundness, stability or, in the case of superannuation, the interests of members; or</li> <li>the risk or behaviour could have, or could have had, an adverse impact on financial soundness, stability or, in the case of superannuation, the interests of members. For example, actions that do not promote prudent risk management; or</li> <li>APRA's ability to make an accurate and timely assessment of an entity's prudential risk profile has been, could be or could have been impeded.</li> </ul>	
<p>3. Principles</p> <p><i>Guiding APRA's strategic decisions on when and how to take enforcement action</i></p>	<p><b>Risk-based</b></p> <p>APRA's appetite for enforcement should prioritise the issues and entities that pose the most serious prudential risks.</p>	<p><b>Forward-looking</b></p> <p>APRA should use enforcement to prevent serious prudential risks from having a realised impact.</p>	<p><b>Outcomes-based</b></p> <p>APRA should use enforcement when appropriate to achieve desired prudential outcomes.</p>	<p><b>Deterrence</b></p> <p>APRA should actively consider the need to deter similar practices from occurring in the future, including by making its enforcement actions public, where appropriate.</p>

## Enforcement objective

The Review proposes that the objective of APRA's enforcement appetite should be to use enforcement where appropriate to hold entities and individuals to account to **prevent and address serious prudential risks**, including behavioural risks, well before they present an imminent threat to financial viability. APRA should also consider the need to deter unacceptable practices from occurring in the future where appropriate. Through these objectives, APRA will use enforcement to achieve its mandate of protecting the interests of depositors, policyholders and superannuation fund members.

## Enforcement criteria

APRA should use the enforcement criteria in Figure 3 to identify serious prudential risks that should be escalated for potential enforcement action. These criteria are designed to ensure that APRA considers the use of enforcement earlier and for broader risks than it has previously. The criteria should be communicated publicly in APRA's enforcement strategy to make it clear to industry the circumstances in which APRA will consider enforcement action. This should include outlining the common factors that APRA will take into account when

assessing the seriousness of an issue. The criteria should also form the basis of more detailed guidance for supervisors, as discussed in Chapter 4.

The proposed enforcement criteria in Figure 3 are common across all APRA-regulated industries, providing consistency and transparency in APRA's enforcement approach. However, the criteria are not intended to be an exhaustive list. APRA should consider enforcement whenever it might be appropriate for achieving its mandate.

## Guiding principles

Meeting the enforcement criteria in Figure 3 should not automatically lead to APRA taking enforcement action. APRA should use its enforcement powers strategically to achieve its prudential objectives, taking into account the facts, matters and circumstances of the particular case under consideration.

To inform APRA's decisions on when and how to take enforcement action, the Review proposes a set of principles to guide decision-makers and help ensure consistency in how APRA applies its new enforcement appetite. The first three principles (risk-based; forward-looking; outcomes-based) are consistent with APRA's overall supervisory approach. The fourth principle (deterrence), which has been less of a focus for APRA, will require additional guidance based on the points outlined below.

**Risk-based.** APRA should assess the seriousness, nature and circumstances of the matter and prioritise the issues and entities that pose the most serious prudential risks. APRA's use of enforcement should not be limited to a focus on financial risks. Where there is a behavioural risk that could have a material prudential impact, APRA should not hesitate to use enforcement. APRA should take into account the actions and behaviour of the entity or individual before, during and after a breach or other incident. APRA's regulatory priorities should also inform its enforcement responses where relevant.

**Forward-looking.** APRA's appetite for enforcement should support its supervisory focus on preventing harm, mitigating risks and achieving ex ante remedial actions. APRA should use enforcement to prevent serious prudential risks from having a realised impact. Deterrence should also be an important forward-looking component of APRA's use of enforcement (see below).

**Outcomes-based.** APRA's appetite for enforcement should be driven by the prudential outcomes APRA is trying to achieve. In some circumstances, non-formal supervisory approaches may be a more appropriate response to a serious prudential risk. This includes, for example, where non-formal approaches can result in timelier and more comprehensive remediation of risks. APRA has significant flexibility in how it uses its non-formal supervisory approaches, allowing for a significant increase in supervisory intensity, as discussed in Chapter 4.

**Deterrence.** In determining when and how to take enforcement action, APRA should actively consider the need to deter a recurrence of serious prudential risks. Taking enforcement action to hold entities and individuals to account when they do not meet their prudential obligations can have significant deterrent impacts, through demonstrating clear consequences for poor prudential outcomes. This includes both in respect of the specific entity or individual concerned and, where the action is public, by the message it sends to

other industry participants. However, in deciding whether to undertake public enforcement action or otherwise publicise its action, APRA will need to balance financial stability risks, as discussed below.

### *Transparency and financial stability risks*

Demonstrating APRA's intent and willingness to use its full range of enforcement powers will be fundamental to building the credibility of APRA's new enforcement appetite. Through making more of its enforcement actions public, APRA can influence industry behaviours far beyond the immediate targets of the action.

However, in some cases financial stability could be harmed by making APRA's enforcement actions public. As a prudential regulator, APRA must always balance the benefits of transparency against any immediate risks to financial stability. This should not preclude APRA from holding entities and individuals to account, where it is appropriate to do so. However, financial stability risks will influence how and when APRA makes its enforcement actions public.

APRA should develop an enhanced communication strategy to maximise the general deterrence impact from its enforcement actions – both public and private. For enforcement actions that APRA makes public, it should clearly explain how these actions achieve its prudential objectives. For other enforcement actions, APRA should design its publication strategy to ensure that it gets the maximum benefit from the resources it deploys. Greater transparency can be achieved in a variety of ways, including publishing anonymised case studies and aggregated data on the use of, and reasons for, more forceful supervisory intervention and enforcement action. APRA has recently begun to provide greater transparency on its 'supervision in action', including how it uses various tools to address specific prudential risks.<sup>33</sup> APRA should continue to build on this approach.

## **Effectiveness**

This section compares the effectiveness of the proposed constructively tough enforcement appetite with the last resort appetite in meeting APRA's prudential objectives. It considers prudential trade-offs, peer benchmarking and hypothetical scenario analysis.

### *Prudential trade-offs*

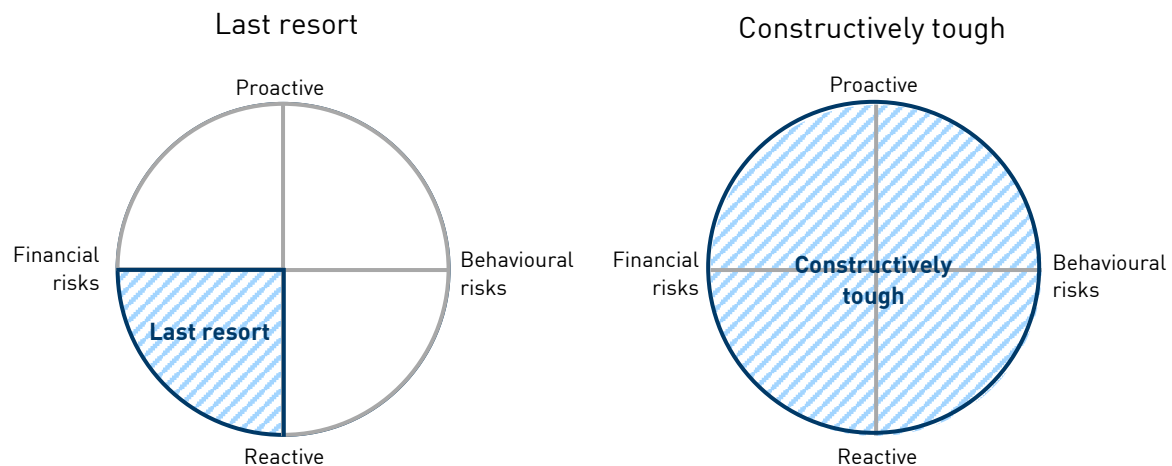
The Review believes a constructively tough enforcement appetite would strengthen APRA's ability to meet its prudential objectives without giving rise to unacceptable trade-offs.

Figure 4 compares the objectives of a last resort approach with a constructively tough enforcement appetite, illustrating the shift in appetite.

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<sup>33</sup> APRA, *APRA Annual Report 2017-18*, pp 31-39, <<https://www.apra.gov.au/annual-reports>>.

**Figure 4: Enforcement appetite**



As demonstrated on the left-hand side, APRA has previously used enforcement as a last resort and largely in relation to financial risks (the bottom left quadrant). In contrast, under a constructively tough approach, APRA would be prepared to use enforcement, where appropriate, in all four quadrants. This includes for more proactive and preventative purposes, seeking to address both behavioural and financial risks well before they present an imminent threat to viability. Making certain enforcement actions public for general deterrence effects would further strengthen this forward-looking focus.

Table 1 below compares the key guiding principles of a constructively tough enforcement appetite to a last resort approach. It also summarises the key potential trade-offs.

**Table 1: Comparing a last resort and constructively tough enforcement appetite**

	Last resort	Constructively tough
<b>PART A: Guiding principles</b>		
Risk-based	<ul style="list-style-type: none"> <li>Financial risk.</li> </ul>	<ul style="list-style-type: none"> <li>Financial risk.</li> <li>Behavioural risk.</li> </ul>
Forward-looking	<ul style="list-style-type: none"> <li>Largely where financial viability concerns have emerged.</li> </ul>	<ul style="list-style-type: none"> <li>Before financial viability concerns emerge.</li> </ul>
Outcomes-focused	<ul style="list-style-type: none"> <li>To address risks when they present an imminent threat to viability.</li> </ul>	<ul style="list-style-type: none"> <li>To hold entities and individuals to account to prevent and address serious prudential risks.</li> </ul>
Deterrence	<ul style="list-style-type: none"> <li>Deterrence not an active consideration.</li> </ul>	<ul style="list-style-type: none"> <li>Deterrence an active consideration.</li> </ul>
<b>PART B: Prudential trade-offs</b>		
Openness	<ul style="list-style-type: none"> <li>Entities are generally open in dealings with APRA.</li> </ul>	<ul style="list-style-type: none"> <li>Openness should be maintained and strengthened by being a key enforcement criterion and accountability obligation.</li> </ul>
Cooperation	<ul style="list-style-type: none"> <li>Entities may not cooperate in adequately remediating prudential risks.</li> </ul>	<ul style="list-style-type: none"> <li>Cooperation should be maintained and strengthened by being a key enforcement criterion and accountability obligation.</li> </ul>
Transparency	<ul style="list-style-type: none"> <li>Transparency on enforcement actions is not prioritised.</li> </ul>	<ul style="list-style-type: none"> <li>Broader range of enforcement actions communicated publicly, subject to financial stability concerns.</li> </ul>
Efficiency	<ul style="list-style-type: none"> <li>Non-formal approaches generally result in timely resolution of issues, where entities are cooperative.</li> <li>However, remediation processes can become protracted where entities are uncooperative.</li> <li>Lack of efficiencies that could be achieved by greater use of general deterrence.</li> </ul>	<ul style="list-style-type: none"> <li>Some enforcement action can involve significant time, cost and resources compared to non-formal approaches.</li> <li>However, earlier use of enforcement could prevent protracted remediation processes in some instances.</li> <li>Significant efficiencies may be achieved through greater use of general deterrence.</li> </ul>

<b>Key:</b>	Strong	Moderate	Weak
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The Review considers that an increased willingness and intent to take more forceful action earlier, and to address a broader range of risks, should strengthen APRA's ability to meet its

prudential objectives. As demonstrated in Part A of Table 1, this reflects the use of enforcement to hold entities and individuals to account through a broader risk-based approach, a more forward-looking outcomes focus and a stronger emphasis on deterrence.

The potential trade-offs from a higher enforcement appetite are summarised in Part B of Table 1. A particular concern raised during the Review's internal engagement was the potential adverse impact of greater enforcement action on the openness and cooperation of entities and individuals. The Review considers that a constructively tough enforcement appetite, underpinned by transparent criteria, will balance this potential trade-off.

The Review believes a constructively tough appetite would not negatively impact open and cooperative relationships with industry and could, in fact, strengthen them. A number of peer prudential regulators support this view. In the Review's discussions with other regulators, a common theme was that clear and transparent enforcement action can underpin more cooperative and open relationships, not only at the entity where enforcement action has been taken but across the industry more broadly. Entities with strong compliance and risk management frameworks should expect appropriate enforcement actions to be taken against other entities that have not made this effort and investment.

The Review recommends that APRA publicly communicate its enforcement objectives, criteria and guiding principles, to ensure that entities and individuals are fully aware of when and how APRA would consider enforcement action. In particular, entities and individuals should be aware that APRA will consider enforcement action if they are not open and cooperative.

The impact of a constructively tough enforcement appetite on the use of supervisory resources and timeliness of outcomes is less clear. To a large extent, it will depend on the type of enforcement action being taken. For example, some enforcement action (such as court-based action) can involve significant time and financial resources compared to non-formal approaches, and the outcome can be uncertain. Other types of enforcement, such as the use of APRA's powers to impose licence conditions or issue formal directions, may be less resource intensive.

There can also be broader positive impacts, beyond the immediate targets of enforcement action. A greater willingness to use enforcement to compel remediation of serious prudential risks could help make non-formal supervisory approaches more effective, through demonstrating the consequences of not cooperating. Efficiencies may also be gained from the general deterrence impacts of making enforcement actions public, where appropriate, as action against one entity or individual can lead to an improvement in broader industry practices.

### *Peer benchmarking*

The Review believes that a constructively tough enforcement appetite would bring APRA more in line with its peers. The Review held discussions with a broad range of regulators, including those with prudential mandates, conduct mandates and safety mandates for non-financial industries. Table 2 below contains public statements from these regulators indicating their appetite for using enforcement. Consistent with a constructively tough enforcement appetite, prudential and other safety regulators typically emphasise their appetite for using powers early, before serious threats to their mandates emerge.

Moving to a constructively tough enforcement appetite is also consistent with the IMF's recommendations in its recent assessment of APRA. The IMF recommended that APRA should 'enhance [its] approach to corrective actions by being more proactive in escalating the severity of the corrective action in a quicker and more active way if the bank is not effectively cooperating. This includes ... using formal corrective actions, such as directions, in a more active way'.<sup>34</sup>

**Table 2: Peer regulators' enforcement appetite – public statements**

Statement of appetite	
<b>Prudential regulators<sup>35</sup></b>	
De Nederlandsche Bank	'in the event of non-compliance, the institution is called to account. If this is to no avail, it is a severe violation and/or the institution is not willing to comply, in principle measures to enforce remediation are taken. Moreover, depending on the circumstances of the case, DNB may impose a fine or report the offence to the judicial authorities'
Office of the Comptroller of the Currency	'initiate bank enforcement actions to require corrective action well before deficiencies affect a bank's financial condition or viability'
Office of the Superintendent of Financial Institutions	'supervision involves assessing the safety and soundness of institutions, providing feedback as appropriate, and using powers for timely intervention where necessary'
Prudential Regulation Authority	'the PRA will choose to deploy formal powers at an early stage and not merely as a last resort ... We can and will take supervisory or enforcement action if our red lines are crossed'
<b>Other financial regulators<sup>36</sup></b>	
Australian Competition and Consumer Commission	'our enforcement actions seek to maximise impact across the industry sectors'
Australian Securities and Investments Commission	'we use our enforcement powers to detect and deal with unlawful conduct, to recover money in appropriate circumstances and sometimes to prevent unlawful conduct before it happens'
Australian Transaction Reports and Analysis Centre	'AUSTRAC may take enforcement action against a reporting entity for serious and/or systemic breaches of the AML/CTF Act' 'Well targeted and proportionate enforcement action benefits reporting entities and the wider community'
Financial Conduct Authority	'as a supervisory authority, we do more than simply set principles and rules and act when things go wrong' 'where we suspect serious misconduct, we will start an enforcement investigation'

<sup>34</sup> Refer to note 11.

<sup>35</sup> Some of these regulators have mandates that are broader than prudential regulation. However, there are generally separate agencies responsible for conduct regulation in these jurisdictions.

<sup>36</sup> The FCA also has certain prudential regulatory responsibilities. The MAS is responsible for conduct and prudential regulation.

Statement of appetite	
Monetary Authority of Singapore	'MAS is committed to administering an enforcement regime that fosters high standards of professional conduct and delivers fair and robust enforcement outcomes to deter misconduct and preserve investor confidence'
Other safety regulators	
Australian Radiation Protection and Nuclear Safety Agency	'ARPANSA adopts a graded and risk-based approach to compliance and enforcement. The minimum response necessary should be used to achieve the desired result which in most cases will be a return to compliance'
Civil Aviation Safety Authority	'enforcement action will not be used to punish aviation participants for actions, omissions, or decisions that are commensurate with their experience and training but that result in a non-compliance or otherwise actionable safety deficiency. However, CASA will not tolerate gross negligence, recklessness, wilful violations and destructive acts'

## Hypothetical scenarios

To assess how a constructively tough enforcement appetite could work in practice, Table 3 shows several stylised hypothetical scenarios. The scenarios provide a simple representation of the proposed shift in APRA's enforcement appetite, demonstrating how APRA could apply its new enforcement criteria and guiding principles to achieve its prudential objectives.

Table 3 does not provide a comprehensive representation of APRA's response in these scenarios, including how APRA would assess the nature, seriousness and circumstances of each matter prior to taking enforcement action. It also does not include how APRA would use its non-formal supervisory approaches to complement any enforcement action taken or how it would cooperate with other regulators, such as ASIC, on the relevant matters.

Consistent with Recommendation 2, the hypothetical scenarios demonstrate that a constructively tough enforcement appetite would involve APRA using enforcement:

- earlier than it has previously;
- for broader risks than it has previously; and
- to achieve general deterrence impacts, where appropriate.



Table 3: Hypothetical scenarios

Scenario	Constructively tough				Last resort
	Criteria	Principles	Appetite for enforcement	Appetite for actions to be public	Appetite for enforcement
Senior executive at a larger ADI was aware of material data errors in prudential capital reporting but did not promptly inform APRA.	<ul style="list-style-type: none"> <li>Not dealing with APRA in an open way; and</li> <li>APRA not able to make an accurate and timely assessment of the entity's risk profile.</li> </ul>	<ul style="list-style-type: none"> <li>Larger entity with high potential systemic impact.</li> <li>Action aimed at strengthening future behaviours and data accuracy.</li> <li>General deterrence benefits – provided no stability concerns.</li> </ul>	✓	✓	✗
Inadequate remediation of the root cause of material credit losses at a larger ADI, including a lack of consequences for those responsible.	<ul style="list-style-type: none"> <li>Not adequately addressing financial risk; and</li> <li>There has been an adverse impact on financial soundness.</li> </ul>	<ul style="list-style-type: none"> <li>Larger entity with high potential systemic impact.</li> <li>Action aimed at ensuring appropriate and timely remediation of risk.</li> <li>General deterrence benefits – provided no stability concerns.</li> </ul>	✓	✓	✗
Entity has been uncooperative in remediating weaknesses in its risk management framework within agreed timeframes.	<ul style="list-style-type: none"> <li>Not adequately addressing risk, not cooperating with APRA; and</li> <li>There could be an adverse impact on financial soundness.</li> </ul>	<ul style="list-style-type: none"> <li>Action aimed at ensuring appropriate and timely remediation of risk, and increasing future cooperation.</li> <li>General deterrence benefits – provided no stability concerns.</li> </ul>	✓	✓	✗
During a loan file review, APRA identifies signs that certain staff may have mis-sold loan protection insurance. ASIC aware.	<ul style="list-style-type: none"> <li>Does not appear to meet criteria. Risk is unlikely to have an adverse impact on financial soundness.</li> </ul>	N/A	N/A	N/A	✗

Scenario	Constructively tough				Last resort
	Criteria	Principles	Appetite for enforcement	Appetite for actions to be public	Appetite for enforcement
During a prudential review, APRA identifies that an entity has moderate weaknesses in its outsourcing arrangements and requires the entity to remediate within a specified timeframe. Entity is cooperative.	<ul style="list-style-type: none"> <li>Does not appear to meet criteria. Entity is being cooperative in remediating and risk is unlikely to have an adverse impact on financial soundness.</li> </ul>	N/A	N/A	N/A	✗
APRA becomes aware that a larger RSE Licensee was not acting in the best interests of members, although the entity has now taken steps to prevent it from happening again.	<ul style="list-style-type: none"> <li>Not adequately addressing behavioural risk; and</li> <li>There has been an adverse impact on beneficiaries.</li> </ul>	<ul style="list-style-type: none"> <li>Issue has affected a significant number of beneficiaries.</li> <li>Action aimed at compensation.</li> <li>General deterrence benefits – provided no stability concerns.</li> </ul>	✓	✓	✗
Entity has ongoing governance deficiencies, resulting in continued breaches of a number of behavioural standards.	<ul style="list-style-type: none"> <li>Not adequately addressing behavioural risk; and</li> <li>There could be an adverse impact on financial soundness.</li> </ul>	<ul style="list-style-type: none"> <li>Action aimed at ensuring appropriate and timely remediation of risk.</li> <li>General deterrence benefits – provided no stability concerns.</li> </ul>	✓	✓	✗
During a severe economic downturn, a smaller ADI incurs significant losses, with a heightened risk that it could breach capital requirements.	<ul style="list-style-type: none"> <li>Not adequately addressing financial risk; and</li> <li>There has been an adverse impact on financial soundness.</li> </ul>	<ul style="list-style-type: none"> <li>Heightened risk of losses to beneficiaries.</li> <li>Action aimed at preventing non-viability.</li> <li>Making actions public in near-term could weaken stability.</li> </ul>	✓	✗	✓

# Chapter 4: Supervisory-led enforcement

This chapter explains the Review's third and fourth recommendations, reinforcing a supervisory-led approach to enforcement, and proposing changes to APRA's supervisory culture and approach<sup>37</sup> to help deliver a constructively tough enforcement appetite. The first section explains why the Review is recommending that the move to a constructively tough enforcement appetite should be led by APRA's supervisory divisions, rather than by shifting to a more enforcement-led model. The second section discusses the Review's recommendation for building a more forceful supervisory culture for APRA and refreshing its supervisory approach to align with the new enforcement appetite.

## Reinforce a supervisory-led approach to enforcement

### Recommendation 3

Assign clear responsibility to the supervisory divisions for applying the enforcement appetite. This means supervisors and their management should understand enforcement options, maintain supervisory watch lists of potential enforcement cases, escalate matters that meet the criteria set out in the enforcement appetite, and make recommendations to the new Enforcement Committee.<sup>38</sup>

## Build a more forceful supervisory culture and approach

### Recommendation 4

Build a more confident and forceful supervisory culture, emboldened by tone from the top of the organisation and management support, and refresh the supervisory approach, including the underlying infrastructure,<sup>39</sup> to:

- better empower and support supervisors to undertake forceful supervision, including by holding entities and individuals to account through the use of enforcement; and
- appropriately tailor the approach to industry-specific factors, to take account of issues of relevance to each sector and actively facilitate the use of enforcement.

Direct a relevant portion of the increase in APRA's resources, as recently announced by the Government,<sup>40</sup> to its supervisory divisions as appropriate to reflect the additional work required to implement an increased enforcement appetite.

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<sup>37</sup> For a description of the current supervisory approach, refer to *Box 4: APRA's supervisory approach*.

<sup>38</sup> For further details on the Enforcement Committee refer to *Chapter 5: Enforcement governance*.

<sup>39</sup> Infrastructure includes risk rating and response tools, guidance, training, and performance and reporting measures.

<sup>40</sup> Treasurer, The Hon Josh Frydenberg MP, *Record funding and resources for ASIC and APRA to help restore trust in Australia's financial sector*, 23 March 2019, <<http://jaf.ministers.treasury.gov.au/media-release/047-2019/>>.

## Reinforce the supervisory-led enforcement approach

The Review recommends that APRA should reaffirm its supervisory-led enforcement approach, where enforcement is seen as an integral part of prudential supervision, rather than a separate function only deployed when supervision has failed. The Review does not consider it appropriate for APRA to move to an alternative model where a standalone enforcement function, separated from APRA's supervisory divisions, takes responsibility for applying the new enforcement appetite.

The proposed roles and responsibilities under the recommended model are illustrated at Figure 5. The role of the supervisory divisions is described in further detail in this chapter. The roles of the decision-making committees and the investigation and legal specialists are described in further detail in the following chapters.

**Figure 5: APRA responsibilities for enforcement**

Supervisory divisions	Investigation and legal specialists
<p>Responsibility for:</p> <ul style="list-style-type: none"><li>• considering full range of supervisory tools including enforcement options;</li><li>• identifying cases that appear to meet the enforcement appetite criteria;</li><li>• maintaining watch lists and escalating matters in line with guidance and protocols;</li><li>• seeking advice and support from investigation and legal specialists;</li><li>• developing supervisory strategies and making recommendations on enforcement to the Enforcement Committee; and</li><li>• managing supervisory relationships and strategies during the implementation of enforcement actions.</li></ul>	<p>Responsibility for:</p> <ul style="list-style-type: none"><li>• providing advice to supervisors on enforcement options;</li><li>• providing support to supervisors on managing interactions with entities during enforcement action; and</li><li>• implementing formal enforcement actions, including conducting investigations, preparing cases for judicial or administrative proceedings, and running matters in court where necessary.</li></ul>
Enforcement Committee (Member-led decision-making body)	APRA BEAR Disqualifications Panel
<p>Responsibility for:</p> <ul style="list-style-type: none"><li>• overseeing watch lists of prospective cases;</li><li>• reviewing and challenging the supervisory strategy on escalated matters;</li><li>• deciding whether or not to take enforcement action on escalated matters;</li><li>• referring relevant cases to the APRA BEAR Disqualifications Panel for decision; and</li><li>• reviewing APRA's enforcement strategy on an ongoing basis to assess its suitability.</li></ul>	<p>Responsibility for:</p> <ul style="list-style-type: none"><li>• deciding whether or not to disqualify individuals under the BEAR.</li></ul>

## Supervisory-led approach

Under this approach, as detailed in Figure 5, APRA's supervisory divisions have responsibility for applying the constructively tough enforcement appetite. Supervisors would be supported throughout this process by investigation and legal specialists who would advise on potential enforcement options and, in the event of a decision to use enforcement, implement the formal powers under which the relevant action is taken. During this implementation, supervisory divisions would maintain responsibility for ongoing supervision, including managing the supervisory relationship and strategy.

This model largely aligns with APRA's current approach, which the Review recommends be retained but reinforced. Given that enforcement action is at the sharp end of the supervisory toolkit, it is appropriate for supervisors to have access to, and understanding of, these tools to help achieve desired prudential outcomes. With their in-depth understanding of entities, supervisors are best placed to:

- assess whether an issue presents a serious prudential risk that may warrant enforcement action;
- set clear expectations with entities and follow up on their delivery, which is critical for both identifying those cases where expectations have not been met and ensuring that a strong trail of evidence is in place to support APRA taking action; and
- manage any implications for the overall supervisory strategy for the entity.

Reinforcing this approach will clarify that APRA's supervisory divisions have responsibility for considering the use of enforcement action, empowering supervisors to follow-up on remediation more forcefully throughout the different stages of supervision. Clarifying supervisory ownership of the enforcement appetite should also help to minimise any perception that escalating a matter for enforcement action might represent a supervisory failing.

Although the responsibility for recommending whether to take enforcement action would rest with supervisors, investigation and legal specialists should be involved from an early stage. Supervisors should be encouraged to seek support and advice from these specialists as serious prudential risks start to emerge. Specialists should advise on issues such as: potential enforcement options; the approach to evidence-gathering; and how to manage ongoing supervision without compromising the prospect of successful enforcement action.

This supervisory-led approach does carry the risk that the escalation of issues for enforcement action could be inconsistent, delayed or avoided, including because of potential supervisory capture. However, the Review considers appropriate oversight and challenge processes should mitigate this risk (see Chapter 5).

## Enforcement-led approach

An alternative to a supervisory-led approach would be for APRA to build a separate enforcement function with responsibility for considering and recommending whether to take enforcement action, based on information provided by supervisors (or other sources) and its own evidence-gathering.

Such a standalone function would need to have the resourcing and institutional influence to undertake its own evidence-gathering, assess whether an issue presents a serious prudential risk, and recommend whether or not enforcement action should be taken. Although supervisors might retain responsibility for ongoing supervision, this model is likely to involve a more formal 'handover' of the enforcement matter to the separate enforcement function.

While this approach could have certain advantages, in particular by ensuring those considering enforcement action are not responsible for the broader supervisory relationship with an entity or individual, the Review does not consider it an appropriate way for APRA to implement its increased enforcement appetite. Taking an enforcement-led approach would likely give rise to a number of issues, including disempowering supervisors from utilising the full range of the supervisory toolkit and creating other inconsistencies between APRA's supervisory approach and the use of enforcement.

In addition, an enforcement-led approach would require significant and expensive structural changes to elevate the status and resourcing of a standalone enforcement function. Building a full-scale function would not be the most efficient use of resources given APRA is expected to continue to achieve its mandate largely through non-formal supervisory approaches, with enforcement action used to prevent and address serious prudential risks.

## **Peer benchmarking**

The Review's benchmarking of approaches taken by peer prudential regulators, including the PRA, OCC and DNB, confirmed that supervisors typically have responsibility for considering enforcement options and applying their organisation's enforcement appetite through the course of their supervisory work. These regulators encourage supervisory staff to engage their investigative or legal teams in dialogue at an early stage when issues first start to emerge. This is considered a prerequisite for successful regulatory action, particularly when identifying emerging problems and selecting the most appropriate response.

## **Build a more forceful supervisory culture and approach**

The Review considers APRA's supervisory culture and approach will need to adjust to deliver a constructively tough enforcement appetite. In particular, the culture set by APRA's leaders must empower and support supervisors to undertake forceful supervision when dealing with uncooperative or unconstructive entities.

## **Assertive and forceful supervision**

Assertive supervision is critical to identifying those matters where more forceful action, including potential enforcement action, may be needed. Supervisors should feel supported in being assertive with entities and individuals, providing clear messages regarding APRA's expectations and following up to ensure these expectations are met.

Where supervisors are concerned that there could be a serious prudential risk, they should be supported to undertake a more forceful approach. This will help to establish a trail of evidence for subsequent action and should include:

- escalating emerging issues on watch lists under the oversight of the Enforcement Committee, with a recommended supervisory strategy to address a matter, including the potential use of one or a combination of formal enforcement actions;
- communicating key elements of this strategy to the entity or individual, particularly in relation to APRA's next steps and the likely consequences if expectations are not met within a specified timeframe; and
- making a recommendation on enforcement action to the Enforcement Committee in accordance with the appetite, to ensure appropriate consequences where expectations are not met.

## Supervisory culture

The Review considers it critical that the tone from the top of APRA backs the delivery of a constructively tough enforcement appetite. APRA's leaders must 'walk their talk' by actively promoting and supporting the new appetite, and demonstrating a willingness to use the full supervisory toolkit, including enforcement action, where appropriate. They should empower supervisors to undertake forceful supervision and actively consider the use of enforcement action. This will be crucial in helping supervisors to keep the option of enforcement front of mind and support them to recommend enforcement action in circumstances consistent with a constructively tough appetite. It will also have important public signalling benefits, given that projecting regulatory intent is essential to achieving effective deterrence.

To increase its enforcement appetite, APRA must be prepared to respond firmly and confidently to challenge. For example, where an entity refuses to accept that a serious prudential risk exists, it should be expected the issue will be resolved through a formal investigation, rather than through protracted negotiation and delayed risk remediation. If the investigation concludes the particular risk was not as material as APRA originally thought, this should be considered a positive outcome. If the risk is found to be material, APRA should hold entities and individuals to account, including by imposing appropriate consequences for inadequate risk remediation or for behaviour that gives rise to serious prudential concerns. There is also room for APRA to be more innovative in the use of the full supervisory toolkit, including one or a combination of formal enforcement actions, to respond to a risk or issue where appropriate.

Under the new enforcement appetite, APRA will also need to have some tolerance for taking enforcement action that proves unsuccessful, either because the decision is overturned or because it loses in court. It should be recognised that such a result is not necessarily a failure or mistake. Indeed, it can lead to some positive outcomes, including signalling APRA's view of particular risks and helping to establish legal precedent and potentially a case for legislative change.

Cultural change takes time and requires strong organisational willingness. Encouragingly, the Review found signs of a shift already taking place within APRA, with internal engagement showing significant support for increasing APRA's use of enforcement action.

## Supervisory approach

As part of its corporate plan, APRA had already identified the need to broaden its risk-based supervision and increase its supervisory intensity. This work is underway, involving a wholesale refresh of APRA's supervisory approach. The current supervisory approach is described in Box 4 below.

APRA's work to refresh its supervisory approach will be important in facilitating forceful supervision and enabling a constructively tough enforcement appetite. In particular, it should seek to better empower and support supervisors to be assertive and give greater consideration to the use of enforcement. Achieving this will require greater focus on escalation as part of the supervisory cycle.

### Box 4: APRA's supervisory approach

APRA's supervisory approach involves an ongoing cycle where supervisors identify prudential risks, assess their potential impact and determine an appropriate risk response, including escalating risks where necessary.

#### Risk identification

APRA uses a range of non-formal tools to identify prudential risks, focusing on both current risks and those that could plausibly arise in the future. This work includes analysing financial data to identify early warning indicators, and stress test results to identify potential vulnerabilities in an entity's business model. Entities' policies and procedures, such as capital plans and strategy documents, are also reviewed (Lodgement Analysis). APRA also undertakes onsite analysis, visiting entities and meeting with relevant staff to understand how risks are being managed (Prudential Review).

#### Risk assessment

As supervisors form judgments, they update their risk assessment in APRA's risk rating tool (PAIRS). This informs the degree of supervisory intensity (SOARS stance).

#### Risk response

APRA sets a supervisory action plan for each regulated entity at least annually. The plan includes a baseline level of supervisory activity to ensure supervisors maintain an up-to-date assessment of an entity's risk profile. Higher risk and more systemic entities are subject to more intensive plans.

Supervisors can respond to potential prudential risks by undertaking in-depth reviews together with APRA's specialist risk teams, where appropriate (Prudential Review). Where APRA identifies weaknesses, it requires or recommends an entity improve their practices, depending on the seriousness of the issue.

APRA also meets with executives and Board members to communicate its risk assessment and expectations, and seeks commitment to addressing any identified issues (Prudential Consultation).

APRA regularly updates its risk assessments as entities progress their risk responses. APRA generally lowers the risk rating if an entity is effective in addressing risks.

For key industry risks, APRA pursues coordinated, thematic actions across multiple entities (Thematic Review). This includes, for example, APRA's work to strengthen ADI residential mortgage lending standards in recent years.



#### Box 4: APRA's supervisory approach

##### Escalation

Where entities are not cooperative or constructive, or there are other serious prudential risks, APRA increases its supervisory intensity. This involves requiring remediation action, revising the supervisory strategy, and escalating engagement with entities and individuals.

### *Resources and infrastructure*

APRA's supervisory divisions will require more resources if APRA is to retain its strong focus on risk identification, assessment and response, while also increasing the supervisory focus on the escalation of issues and embedding a constructively tough enforcement appetite. APRA has received additional funding from the Government to implement the recommendations of the Royal Commission. This should be used, as appropriate, to support the supervisory divisions in carrying out the extra work required to implement the increased enforcement appetite.

In addition, APRA's supervisory infrastructure, including its risk rating tools, guidance and training, and performance and reporting measures, must empower and support the supervisory focus on escalation of issues and enforcement. In particular, the Review believes the work to refresh the supervisory approach should include the reforms below.

#### **Risk rating and response tools**

Refreshing the supervisory infrastructure will include reviewing APRA's PAIRS and SOARS frameworks. These are the tools supervisors use to assess an entity's probability and impact of failure, and the appropriate level of supervisory intensity. Changes to these tools should include ensuring supervisors are supported in identifying matters that may require more forceful supervision and the potential use of enforcement action.

#### **Guidance and training**

The Review considers APRA's supervisory guidance and training should be enhanced to support supervisors in backing their judgment, undertaking forceful supervision and recommending the use of enforcement action where appropriate. Although there is an internal enforcement manual, APRA should reconsider its content, focusing on material that would be of most use to supervisors.

In particular, APRA should provide enhanced supervisory training and guidance on:

- the range of enforcement tools available to APRA;
- the constructively tough enforcement appetite, in particular building on the criteria set out in Chapter 3 to develop clear protocols for escalating matters to the Enforcement Committee for potential enforcement action;
- behavioural standards, including to reflect ongoing developments in the prudential framework;

- the process for responding to breach notifications and whistleblower reports, to ensure that enforcement action is properly considered if the circumstances meet the enforcement appetite;
- the approach to ongoing supervision in cases where enforcement action is under consideration or in progress, having regard to the formalities of evidence-gathering and procedure;
- the principles for sharing enforcement-related information with ASIC, as noted in Chapter 2; and
- the skills that are called on when undertaking more forceful supervision, including handling difficult interactions, dealing with challenge and resetting or re-establishing effective relationships following enforcement action.

### **Performance and reporting measures**

Effective performance and reporting measures will be critical to ensuring that issues are escalated for enforcement action where necessary. These measures should include minimum requirements and key performance indicators for oversight by executive committees on matters such as:

- assessing and responding to an entity's proposed risk remediation activity within a set timeframe, including agreeing a timeframe for closing the activity;
- closing an entity's risk remediation activity within the timeframe agreed with the entity and, if not, demonstrating that escalation actions have been taken, including agreeing a supervisory strategy and communicating next steps to the entity; and
- recommending to the Enforcement Committee whether to take formal enforcement action where an issue or matter appears to meet the enforcement appetite.

### **Tailored supervisory approach**

In implementing these changes, APRA should consider sector-specific issues, particularly for superannuation. As the nature of the financial promise differs across the APRA-regulated industries, APRA's approach to supervision already varies across industries. The Review considers the supervisory approach should be further tailored to take account of these sector-specific issues to actively facilitate the use of enforcement action where appropriate. For superannuation, issues relevant to the best interests of members may arise separately from issues relevant to the probability of failure, as reflected in the criteria for the constructively tough enforcement appetite set out in Chapter 3. Some material differences also exist in the nature of the tools available for superannuation (see Chapter 7).

# Chapter 5: Enforcement governance

This chapter explains the Report's fifth recommendation, outlining a more robust governance structure for enforcement matters, to provide oversight and challenge on how serious prudential risks are being managed, with clearer roles and accountabilities for escalation and decision-making.

## Strengthen APRA's decision-making and oversight processes for enforcement

### Recommendation 5

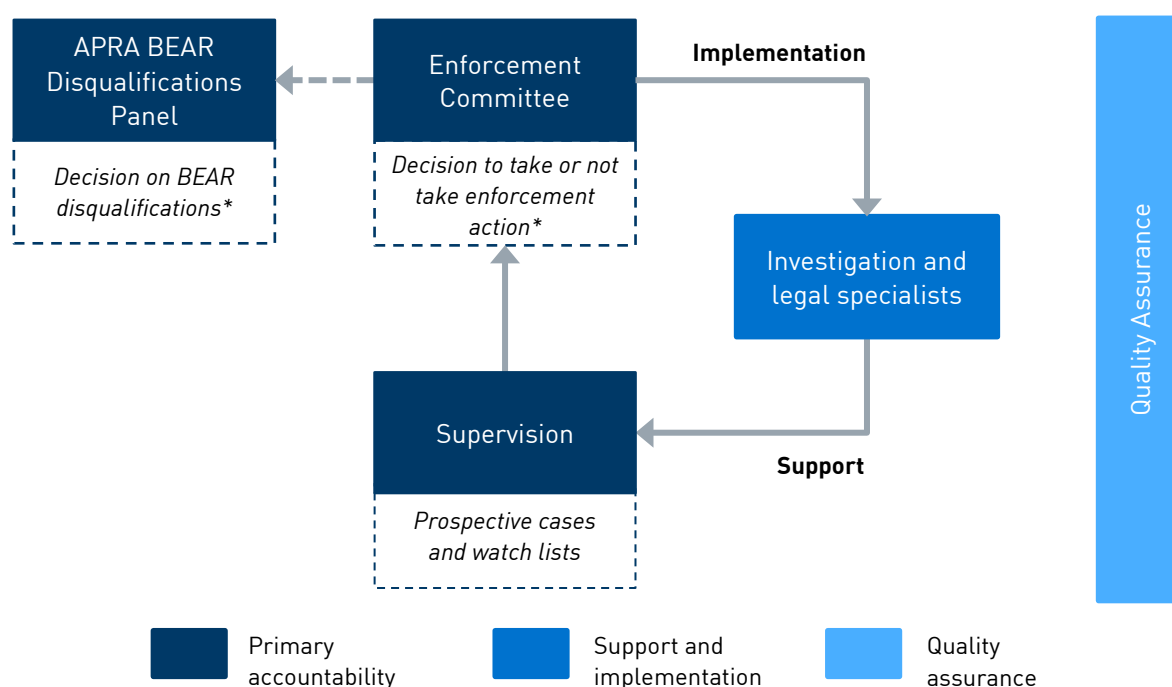
Establish an APRA Member-led Enforcement Committee for enforcement decision-making to give APRA executives greater visibility of potential enforcement matters and ensure the constructively tough enforcement appetite is applied appropriately.

Establish an APRA BEAR Disqualifications Panel comprised of independent persons to make disqualification decisions under the BEAR.

Ensure appropriate oversight and challenge in relation to enforcement matters, including through the Member-led Enforcement Committee and through APRA's Quality Assurance (QA) function.

Figure 6 illustrates the proposed new accountabilities and processes.

Figure 6: APRA decision-making map for enforcement



\* Some decisions are subject to a statutory right to request that APRA reconsider the decision. Where an entity or individual requests a reconsideration, the decision would be made afresh by a newly constituted committee or panel.

## Decision-making on enforcement

APRA's decisions to take formal enforcement action will have a high impact on those entities or individuals involved. For APRA, the implications can also be significant, including reputational risk, legal risk, cost, resourcing, time and opportunity cost. Decisions *not* to take enforcement action could be equally significant. APRA must therefore have appropriate decision-making processes, reflecting the high impact of these decisions, to ensure its enforcement appetite is applied in a consistent manner over time and across the industries it regulates.

For normal, day-to-day supervisory operations, the relevant decision-making powers should continue to be delegated to individual APRA staff. This approach, particularly for business as usual matters, is timely and efficient, with minimal bureaucracy and clear accountability.

However, for high impact matters such as enforcement action, the Review believes APRA should not rely on the decision of one individual. The process through which APRA makes these decisions needs to be consistent and transparent, taking into account APRA's broader strategic objectives.

### Peer benchmarking

In assessing the enforcement decision-making models of Australian and overseas peer regulators (see Appendix 3 for a full list), the Review found all but one operate committee-based decision-making models for most of their significant enforcement matters. Despite idiosyncratic examples of powers still exercised by individual executives, collaborative decision-making by enforcement committee appears to be the norm. In some enforcement models, such as the ACCC's, only the most senior executives or commissioners sit on the enforcement decision-making committee. In other examples, such as the UK PRA, a tiered committee system is used for different levels of enforcement decision-making, aligning the seniority of the committee membership with the impact of the decision.

### APRA Member-led Enforcement Committee

The Review recommends APRA move to a Member-led, committee-based decision-making model for enforcement matters. The model should be designed to ensure senior executives, including APRA Members, have a direct role in applying the constructively tough enforcement appetite. The committee should also provide a means of ensuring that APRA's strategic objectives are fully considered when making enforcement decisions, in accordance with the principles set out in the appetite.

Having enforcement decisions taken by a committee will help ensure that APRA makes decisions consistent with its increased appetite, notwithstanding changes in personnel that happen over time. By having a Member-led committee model, APRA's leadership will be seen to have collective responsibility for decisions to take, or not take, enforcement action. Open discussion of the matters presented to the committee will make these cases more visible across the organisation, demonstrating to staff how the increased enforcement appetite applies in practice.

## APRA BEAR Disqualifications Panel

For BEAR disqualification matters, APRA will not only escalate and investigate the matter, but will also be the substantive ‘merits’ decision-maker. This means APRA will decide whether the matters alleged have been proved, whether disqualification is appropriate and, if so, its duration and scope.

In these cases, APRA needs to give heightened consideration to the risk of bias and ensure procedural fairness by separating those involved in the matter at previous stages from those exercising judgement on the substantive ‘merits’ decisions. For civil and criminal matters, the court provides this separation and independence. For BEAR disqualifications, APRA needs to ensure the ultimate decision-maker approaches the matter with an open mind and can reach a decision that is, and is seen to be, impartial. If APRA fails to implement a sufficiently robust process, this could result in administrative decisions being challenged on the basis that the decision-makers were tainted with previous exposure to the matter.

Given the high impact of BEAR disqualification decisions, APRA was already considering options to address this issue; for example, bringing in external persons to support independent decision-making. The Review recommends APRA formalises these plans by creating an APRA BEAR Disqualifications Panel employing experts drawn from outside APRA to bring an additional element of independence to decisions on BEAR disqualification matters.<sup>41</sup>

## Oversight and challenge

As noted in Chapter 4, one risk of a supervisory-led approach to increasing APRA’s enforcement appetite is the potential for inconsistencies in the way individual supervisors or supervisory areas apply the enforcement appetite and escalate matters.

The Review believes APRA should put in place measures to help improve consistency, including providing supervisors with clear guidance and training on when to consider enforcement action and escalate matters. The Member-led Enforcement Committee should also play an important oversight role on prospective enforcement matters, in particular by reviewing and challenging supervisory strategies in relation to issues on watch lists.

APRA’s QA function should also assess how the appetite is being applied in practice. APRA’s QA function is currently being strengthened through a review of existing practices, methodology and tools. The Review recommends APRA ensures this function can provide robust oversight of escalation processes. It should be used to help assure the Enforcement Committee has adequate visibility of prospective enforcement matters, including proactive identification of matters where enforcement should be considered. This will be particularly important in the early stages of implementation as APRA is adjusting to a new enforcement appetite.

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<sup>41</sup> This would be similar to the Bank of England’s Enforcement Decision Making Committee (EDMC). The purpose of the EDMC is to create a functional separation between the investigative function of the PRA and the decision-makers in contested enforcement cases. This is particularly important given the PRA is able to impose penalties without court proceedings.

# Chapter 6: Enforcement support

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This chapter explains the Review's sixth recommendation, outlining how APRA's enforcement support infrastructure needs to be developed in line with a constructively tough appetite. The new appetite will also require increased access to external support for investigations and enforcement actions, which could present a problem where funding for this comes at the expense of APRA's other critical operational priorities. To mitigate this trade-off, APRA should have access to a source of hypothecated funding for enforcement.

## Build APRA's enforcement support in line with its new appetite

### Recommendation 6

Build an enforcement support infrastructure shaped around the new appetite, with the ability to take on an increased number of investigations and enforcement actions.

Seek the Government's consideration to establish a new hypothecated enforcement fund for APRA.

## Enforcement skillsets and infrastructure

The size of APRA's support function and enforcement infrastructure reflects the last resort enforcement appetite. APRA's investigation and litigation specialists represent about three per cent of total staff at current levels. APRA also utilises external support on an ad hoc basis, where required.

### Consolidated, strengthened investigation and legal specialists team

The supervisory divisions will require an increased level of specialist support in applying the new enforcement appetite. The Review recommends combining APRA's current investigation and litigation specialists into one team within the Legal group, under APRA's General Counsel. This will strengthen the institutional influence and independence of the team.

The capability and confidence of the specialist support team in implementing the use of formal powers will be an important enabler of the new appetite. The newly combined support team will be responsible for giving supervisors confidence to integrate formal powers into their supervisory strategies by:

- providing fearless, independent advice to supervisors on options for pursuing enforcement; and
- having the capacity to implement formal enforcement actions, including conducting investigations, preparing cases for judicial or administrative proceedings, and running matters in court where necessary.

The support team will not be responsible for setting the supervisory strategy for a particular matter. Although supervisors will be expected to give due weight to the advice provided by specialists, ultimate responsibility for the strategy and whether or not to recommend a

particular action would rest with supervisors. Challenge of the strategy should come from the Member-led Enforcement Committee and APRA's other oversight mechanisms.

Given APRA has not prioritised its enforcement support function as a result of the last resort appetite, some additional specialist personnel, with requisite experience and industry know-how, will be required. APRA has received additional funding from the Government to facilitate implementation of Royal Commission recommendations, and a relevant part of these additional resources should be directed to bolstering the support team.

## **Enhanced infrastructure**

APRA's ability to implement effective enforcement actions also depends on it having the appropriate supporting systems to produce evidence of sufficient quantity and quality to support the issues asserted. APRA's current evidence management systems are built around the last resort appetite. Work is needed to improve APRA's ability to keep records in a manner that enables later production in court. These changes should be reflected in APRA's supervisory approach, as noted in Chapter 4, and assisted where necessary by IT specialists and external providers. APRA will also need to invest more in other forms of enforcement infrastructure, such as improved precedent and knowledge databases.

## **Establish a new hypothecated enforcement fund for APRA**

One of the key trade-offs for APRA on whether to take enforcement action is its cost. The Review was informed of instances where formal investigations or other enforcement actions were considered but were not pursued because the cost was not thought to be an efficient use of APRA's resources relative to other priorities.

APRA has a longstanding Contingency Enforcement Fund (CEF) in place.<sup>42</sup> However, the CEF has never been used, as it is designed as a last resort contingency reserve, requiring ministerial approval. The CEF is only accessed where the resources needed for enforcement action are unable to be met from APRA's ongoing resources and a number of other conditions are met.<sup>43</sup>

To enable the new enforcement appetite, the Review considers that APRA needs a hypothecated enforcement fund, separate from its operating budget, sufficient to cover the cost of the mid- to large-sized investigations and other enforcement actions expected under its new enforcement appetite. This will enable APRA decision-makers to more readily pursue enforcement action, as the expense of these actions will not compete for resources with APRA's other critical functions.

The primary purpose of this fund would be to enable access to the external expertise required to pursue formal investigations and other actions. For the fund to be effective, it should be readily accessible and therefore not subject to the current conditions of access for the CEF.

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<sup>42</sup> Established FY 07/08.

<sup>43</sup> For instance, the CEF can only be accessed for matters with total costs exceeding \$0.5 million.

# Chapter 7: Legislative reforms

This chapter explains the Report's seventh recommendation on enhancing APRA's legislative framework to ensure it supports APRA taking action under the constructively tough enforcement appetite (see Appendix 5 for detailed legislative proposals).

## Ensure APRA's legislative framework can facilitate the new enforcement appetite

### Recommendation 7

Seek the Government's consideration of legislative amendments that enhance APRA's enforcement powers and penalties by:

- addressing impediments that could hinder the new enforcement appetite, including remedying the adequacy of penalties, closing gaps in APRA's enforcement powers in superannuation and private health insurance, and removing barriers to conducting joint investigations with ASIC; and
- extending the BEAR across all APRA-regulated industries and, in so doing, considering the introduction of a civil penalty for a breach of accountability obligations by an accountable person.

## Key enhancements to APRA's powers

APRA's legal framework generally supports its mandate. However, the Review believes certain legislative enhancements could be made to address gaps in APRA's powers to support the increased enforcement appetite, such as:

- ensuring the adequacy of the penalties prescribed for breaches of the Industry Acts and the *Financial Sector (Collection of Data) Act 2001* (FSCODA);
- addressing shortcomings in APRA's enforcement powers in superannuation and private health insurance; and
- addressing barriers to joint investigations by APRA and ASIC.

Table 4 summarises gaps in APRA's enforcement powers.



**Table 4: Assessment of effectiveness of certain APRA enforcement powers**

	ADI	GI	LI	PHI	Super
<b>APRA's enforcement powers</b>					
Adequacy of penalties					
Issue directions					
Compulsory transfers					
Impose conditions on licence, registration or authorisation					
Injunctions					
Licence revocation					
Joint investigations with ASIC					
<b>Accountability</b>					
Application of the BEAR					
Apply to court to impose a civil penalty against an accountable person					
<b>APRA's investigations powers</b>					
Seek information					
Conduct investigations					
<b>Key:</b>	Strong	Moderate	Weak		

## Adequacy of penalties

The impact of criminal offence or civil penalty provisions in the Industry Acts and FSCODA will only be effective if credible penalties are ascribed to them. Many of the penalties prescribed by these Acts are 300 penalty units or less. This currently equates to \$63,000 (\$210 per penalty unit). These existing penalties should be strengthened to deter well-resourced entities and individuals from non-compliance.

The Review notes the work of the ASIC Enforcement Review Taskforce (ASIC Taskforce) and the subsequent passage of the *Treasury Laws Amendment (Strengthening Corporate and Financial Sector Penalties) Act 2019* to strengthen penalties for corporate and financial sector misconduct. The learnings from the ASIC Taskforce on the need for increased civil penalties, the additions of ordinary offence provisions alongside existing strict liability offences, and the additions of new civil penalty provisions to existing criminal penalties are equally relevant for APRA's legislative framework. Incorporating these changes would ensure APRA has appropriate enforcement options for breaches of the law, that wrongdoing is adequately punished and effective deterrence impacts achieved.

## Strengthening APRA's enforcement powers

### *Superannuation*

The lack of quantitative requirements in superannuation, such as capital, means a greater reliance on APRA's statutory powers may be needed to achieve effective prudential

outcomes. Certain gaps in APRA's superannuation enforcement powers will be addressed by the *Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No. 1) Bill 2019* (IAMOS Bill). In particular:

- APRA's directions power for superannuation is restricted to directing an RSE Licensee to comply with a licence condition when APRA has reasonable belief a breach of a condition has occurred. A strengthened and broader directions power, as proposed in Schedule 5 of the IAMOS Bill, would enable APRA to readily address prudential concerns at an earlier stage when it believes a breach is likely to occur. The proposed directions power aligns with APRA's powers in the banking and insurance industries.
- The Review also supports Schedule 3 of the IAMOS Bill, which will make directors and RSE Licensees subject to civil penalties for breaches of their covenants, implementing Recommendation 3.7 of the Royal Commission. The lack of a direct penalty means APRA has to consider resorting to its limited power to direct an RSE Licensee to comply with a licence condition and can only pursue a penalty if there is a subsequent breach of a direction. Introducing a civil penalty for breaching the RSE Licensee covenants or director covenants gives APRA a more direct and flexible power to penalise breaches and achieve deterrence.

In addition, the Review has identified other gaps in APRA's superannuation powers that the IAMOS Bill does not address:

- While APRA can impose an additional licence condition on an RSE Licensee, similar to its powers to impose conditions on an authorisation or registration of an ADI or general or life insurer, there is no direct consequence to an RSE Licensee breaching an additional licence condition. The Review recommends that an RSE Licensee be made liable to a penalty where it contravenes an additional licence condition. This would deter breaches, as the risk of liability to an RSE Licensee is more immediate and APRA can enforce the conditions more efficiently.
- There may be circumstances where a successor fund transfer would clearly be of benefit to fund members due to prudential concerns regarding an RSE Licensee. However, RSE Licensees have frequently resisted APRA's recommendations to merge, and APRA currently lacks the power to require an RSE Licensee to undertake a merger by way of a successor fund transfer. Were the IAMOS Bill to pass, APRA's broad directions power would likely allow it to direct a merger. However, the Review recommends introducing an explicit power to compel a merger to remove any risk of challenge and protect members' funds from further deterioration.

The Review notes that a key consideration when taking enforcement action against an RSE Licensee is the question of whether the action may be detrimental to members. The *Superannuation Industry (Supervision) Act 1993* (SIS Act) prohibits an RSE Licensee and its directors from indemnifying themselves from the members' funds under certain circumstances, including for liability for a monetary penalty under a civil penalty order. However, in other cases some of the costs that the RSE Licensee might incur in defending APRA's enforcement actions may be borne by members. The Review recommends further consideration be given to strengthening the legislative protections against members' funds being used to cover the costs of actions against RSE Licensees and directors, to ensure

APRA (and ASIC) can readily enforce the law without adversely impacting the interests of members.

### ***Private Health Insurance***

APRA's enforcement powers in private health insurance have significant shortcomings when compared with other APRA-regulated industries. For example, APRA can only impose a condition on the registration of a private health insurer at the time of registration. In the other industries, APRA can impose a licence condition at any time, which can be an effective enforcement tool. For example, APRA has successfully used licence conditions with general insurers experiencing viability concerns to put them into run-off. But APRA is unable to take similar action should concerns arise regarding a private health insurer. The Review recommends that APRA be empowered to impose a condition on the registration of a private health insurer at any time, as it does in the other APRA-regulated industries.

APRA also does not have discretion to cancel the registration of a private health insurer, as it does in other industries. Yet it may be appropriate in some circumstances for APRA to revoke a registration for a serious breach of the law. The Review recommends that APRA should have the power to cancel the registration of a private health insurer on the same grounds available to APRA in other APRA-regulated industries.

APRA does not have the power to effect a compulsory transfer from one private health insurer to another. For ADIs, general insurers and life insurers, the compulsory transfer powers in the *Financial Sector (Transfer and Restructure) Act 1999* (Transfer and Restructure Act) are an efficient tool for protecting depositors or policyholders where APRA has viability concerns about a regulated entity. Currently, APRA is unable to respond quickly to protect policyholders if it was to have concerns that a private health insurer is unable to meet its claims. The Review therefore recommends private health insurers be subject to the Transfer and Restructure Act, particularly Part 4 of the Act, which provides for compulsory transfers.

APRA may only apply to the Federal Court for an injunction against a private health insurer under the *Private Health Insurance (Prudential Supervision) Act 2015* (PHIPS Act) to enforce cases of unauthorised business. In instances where a private health insurer is engaging in conduct that may affect its viability, or other conduct of significant concern, APRA does not have the power to seek immediate intervention from a court. The Review recommends APRA should have the power to apply for an injunction on broad grounds, similar to the grounds for the injunction powers in the other Industry Acts, so it can respond quickly to immediate concerns.

The Review also notes the existence of broader inconsistencies between the PHIPS Act and other Industry Acts. The Review suggests consideration be given to aligning the PHIPS Act with the other Industry Acts to promote a stronger legal framework for APRA's prudential supervision of private health insurers.

### **Barriers to joint investigations with ASIC**

As discussed in Chapter 2, the Review recommends enhancing the coordination of enforcement matters between APRA and ASIC, particularly in the form of joint investigations. A number of legal impediments inhibit the joint exercise of investigation powers, including the sharing and use of information collected by one agency.

APRA and ASIC should have full and unrestricted use of information obtained under the investigation and examination powers of the other agency. At present, APRA and ASIC may only exercise their investigative powers for their own purposes and not for the purpose of another agency, unless legislation specifies otherwise. This acts as a barrier to the agencies using their powers in concert and simultaneously.

In cases of joint investigations, the Review recommends that information received by one agency using investigative powers is deemed to have been received by both. It should not be necessary to conduct a legal analysis on whether procedural fairness must be afforded in each instance where information sharing is proposed during a joint investigation. In addition:

- in the case of a joint examination, where an examinee's response to a question asked by one agency is relevant to the other, the other agency ought to be able to receive and use that information for its own purposes; and
- material obtained under ASIC's search warrant powers (as proposed to be strengthened under the recommendations of the ASIC Enforcement Review Taskforce Report) should be able to be shared with APRA and be admissible for APRA proceedings.

In addition, while the Review does not anticipate that APRA and ASIC will bring joint proceedings frequently, it is important to have the option available. APRA and ASIC legislation does not explicitly provide for the agencies to bring joint proceedings. While it is open to them to submit to the court to hear a matter jointly, this is without precedent. Without specific legislative direction there is uncertainty as to whether such a submission would be accepted. The Review therefore recommends that APRA and ASIC legislation explicitly provide for the agencies to bring joint proceedings.

## Accountability

The Review agrees that an accountability regime modelled on the BEAR should be extended across APRA-regulated entities in accordance with Recommendation 6.8 of the Royal Commission. The BEAR requires clear lines of accountability within entities and provides APRA with powers that will facilitate an increased enforcement appetite. This should apply to all APRA-regulated industries.

The Review notes that a breach of an accountability obligation by an accountable person is not enforceable by civil penalty under the current regime. The Review recommends consideration be given to introducing a civil penalty provision for contraventions of accountability obligations by accountable persons, when implementing the extension of the BEAR. This would widen the range of APRA's tools to enforce a contravention against accountable persons in circumstances where disqualification is an excessive outcome. It would also assist APRA in reinforcing individual accountability. The PRA, in comparison, has the power to impose penalties on individuals, which the Review understands has proved an effective enforcement tool.

## Other enhancements to APRA's investigation powers

Robust investigations and information-seeking powers are essential to gather the evidence needed to pursue enforcement actions. However, inconsistencies exist in APRA's investigation powers across the APRA-regulated industries. The Review supports the

proposals in Chapter 8.2 of the September 2012 Australian Treasury consultation paper, *Strengthening APRA's Crisis Management Powers* (the 2012 Consultation Paper), to address these gaps. The Review considers a further in-depth assessment of APRA's investigation powers, similar to that conducted by the ASIC Taskforce, could be beneficial given other potential gaps identified since the 2012 Consultation Paper was released.

# Appendix 1: Terms of Reference

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## Scope

1. The Review will conduct a forward-looking examination of APRA's approach to the use of enforcement to achieve its prudential objective of ensuring that financial promises made by its supervised institutions are met within a stable, efficient and competitive financial system (the Review).
2. The Review will examine APRA's current enforcement strategy and infrastructure, and in particular, how it interacts with APRA's core supervisory approach. It will assess any legal, practical or structural impediments to APRA taking enforcement action where such action is appropriate.
3. The Review will make recommendations on:
  - a) the breadth of issues APRA seeks to address through public and non-public enforcement action;
  - b) the considerations in determining when APRA should take enforcement action to hold entities and individuals to account, including under the Bank Executive Accountability Regime (BEAR) and other powers;
  - c) the considerations in determining whether and when it may be appropriate for APRA to take public enforcement action, including litigation, to achieve general deterrence effects in appropriate cases; and
  - d) APRA's internal governance, organisation, enforcement strategy, resourcing and any other factors relevant to APRA's enforcement function.

## Areas of focus

4. In examining the issues set out above, the Review will focus on:
  - a) the relationship between APRA's supervisory approach and enforcement action;
  - b) APRA's process for identifying candidate enforcement actions;
  - c) APRA's decision-making process on whether to take enforcement action;
  - d) APRA's approach to breach reporting and whistle-blowers;
  - e) the weight given to factors (including but not limited to cost, timeliness, remediation, precedential value) in determining whether to take enforcement action;
  - f) APRA's approach to publicly disclosing enforcement priority areas;

- g) whether internal organisational change would be required to achieve an appropriate level of enforcement action;
- h) whether the resources and skill sets currently within APRA are adequate to achieve an appropriate level of enforcement action;
- i) whether there is greater need for APRA to more closely cooperate with other regulatory agencies when dealing with enforcement-related matters;
- j) whether the current and proposed legislative framework is adequate to support the recommended approach; and
- k) any other relevant matters agreed by the APRA Members from time to time.

## Timing

- 5. Draft recommendations will be available to APRA Members by 28 February 2019 with the final Review to be presented to the APRA Members by 31 March 2019.

## Governance

- 6. The Review will be conducted by APRA Deputy Chair John Lonsdale and supported by APRA staff and external advisors as necessary. The APRA Members will be regularly informed on progress over the course of the Review.
- 7. An external advisory panel comprising Dr Robert Austin (Former NSW Supreme Court Judge), Commissioner Sarah Court (Australian Competition and Consumer Commission) and Professor Dimity Kingsford Smith (Director of the Centre for Law, Markets and Regulation, University of New South Wales) has been appointed to provide an expert perspective on matters arising from the Review.

## Appendix 2: Panel membership

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The Panel established to provide expert advice comprised:

### **Dr Robert Austin, *Former Judge, Supreme Court of New South Wales***

Dr Robert Austin was Judge of the Supreme Court of New South Wales from 1998 to 2010. After serving on the Supreme Court, Dr Austin returned to Minter Ellison (where he previously worked from 1990 to 1998 as Partner), taking a role as a senior lawyer in the firm's corporate division, working there from 2011 to 2015. Since 2015, Dr Austin has returned to the Bar and is currently at Level 22 Chambers.

Dr Austin has taught company law and equity at the University of Sydney since 1969 (full time until 1990 and subsequently part time). His legal practice extends to corporate law and governance, equity, managed investment schemes, superannuation and financial services.

### **Commissioner Sarah Court, *Australian Competition and Consumer Commission***

Commissioner Sarah Court is currently serving her third term as a Commissioner of the ACCC, a position she has held since 1998, and is also an Associate Commissioner of the New Zealand Commerce Commission. Prior to joining the ACCC, Commissioner Court was a Senior Executive Lawyer and Director Adelaide/Darwin at the Australian Government Solicitor.

Commissioner Court is responsible for enforcement and litigation at the ACCC. She chairs the ACCC's Enforcement Committee, Compliance Committee, Consumer Data Right Committee and Legal Committee. She also currently sits on the Merger Review Committee and Adjudication Committee.

### **Professor Dimity Kingsford Smith, *Minter Ellison Research Professor of Risk and Regulation and Deputy Director (Research) of the Centre for Law, Markets and Regulation at the University of New South Wales***

Professor Dimity Kingsford Smith holds the Minter Ellison Chair in Risk and Regulation at UNSW Law. She is Deputy Director (Research) of the Centre for Law, Markets and Regulation at the University of New South Wales (UNSW). Professor Kingsford Smith was Director of the Centre from 2016-2018. Prior to joining UNSW Law in January 2005, Professor Kingsford Smith was Director of the Centre for Law in the Digital Economy at Monash Law from 2001 to 2004.

Professor Kingsford Smith teaches in the areas of corporate law, regulation of securities and financial products and corporate governance. Her particular areas of research and publication are corporate and financial regulation, and regulatory theory and policy. She is a member of the ASIC External Advisory Committee and was a member of the Treasury Taskforce advising on the Enforcement Powers of ASIC (2016-2017).



# Appendix 3: Activities undertaken by the Review

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The Review adopted a three-phase approach, with each phase occurring concurrently.

## Phase 1. 'Current state' analysis

The first phase focused on information-gathering to assess APRA's current approach to enforcement. This included:

- conducting an internal scan of APRA's approach to enforcement, involving a staff survey, interviews with APRA senior management and focus groups.
- reviewing relevant internal data (such as process maps and supervisory guidance documents).

## Phase 2. 'Future state' analysis

The second phase involved investigation and analysis with a view to recommending a proposed future approach to enforcement at APRA. A key component of this work was benchmarking against peer regulators. This involved engaging with representatives from the following domestic and international peers, including some responsible for regulating industries outside the financial sector:

### Prudential regulators

- De Nederlandsche Bank, Netherlands
- Office of the Comptroller of the Currency, US
- Office of the Superintendent of Financial Institutions, Canada
- Prudential Regulation Authority, UK

### Other financial regulators

- Australian Competition and Consumer Commission
- Australian Securities and Investments Commission
- Australian Transaction Reports and Analysis Centre
- Financial Conduct Authority, UK
- Monetary Authority of Singapore, Singapore

### Other safety regulators

- Australian Radiation Protection and Nuclear Safety Agency
- Civil Aviation Safety Authority

### Phase 3. Recommendations

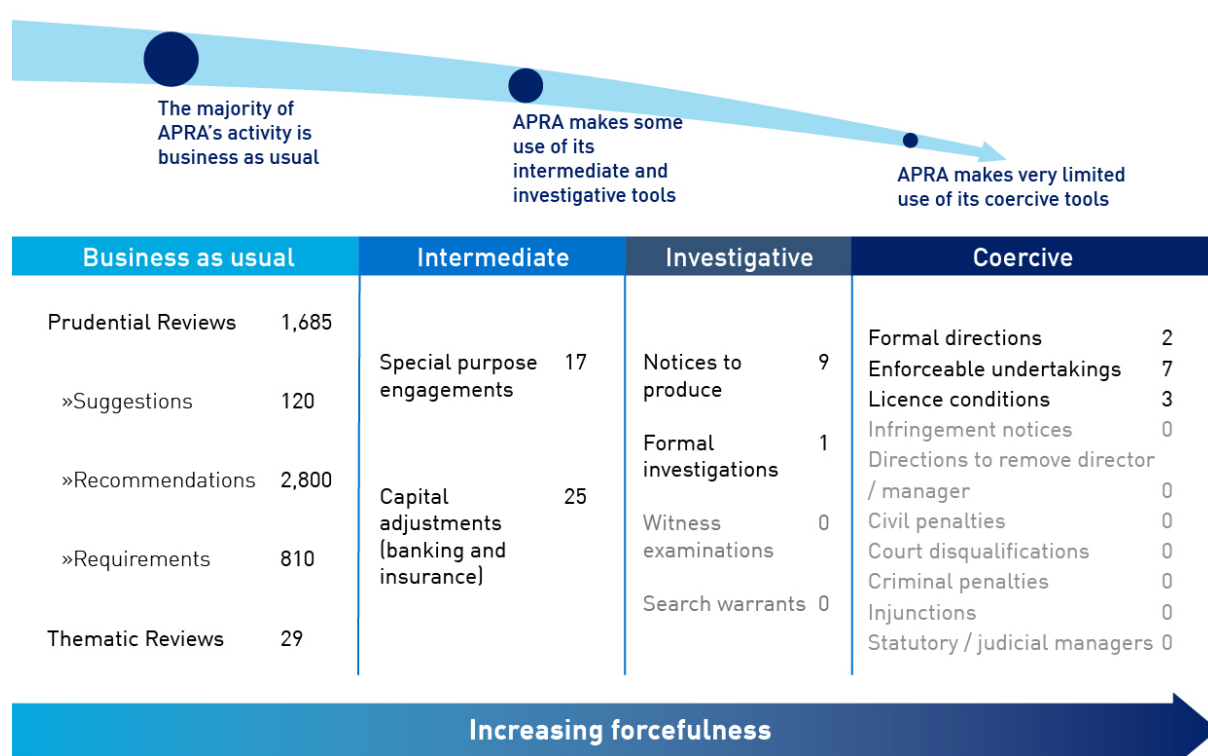
In developing the Review's recommendations, John Lonsdale and the Secretariat met with the Panel three times: in November 2018, January and February 2019. The Panel reviewed drafts of the report in February and March 2019, providing their guidance and feedback to the Secretariat. In line with the Terms of Reference, the APRA Members received the draft recommendations at the end of February 2019. The Final Report of the Review was presented to the APRA Members on 29 March 2019.

## Appendix 4: APRA's supervisory toolkit

Figure 2 below is an indicative representation of APRA's use of supervisory tools over the period 1 July 2013 to 30 June 2018. A comprehensive representation of APRA's use of investigative and coercive powers is provided. However, as there are a large number of business as usual and intermediate supervisory activities, only a subset is shown below. The subset is illustrative of the significant volume of activity undertaken at that end of the spectrum.

A more comprehensive list of APRA's supervisory tools is shown in Figure 1 of this report.

Figure 2: APRA's indicative use of various supervisory tools from 2013-2018



Value indicates the number of times each method/tool has been used from 2013-2018 across APRA's regulated industries.  
Source: APRA Q Supervisory System and databases maintained by APRA's Legal and Enforcement teams.

### Explanation of the data in Figure 2

- **Prudential reviews** – the number of prudential reviews conducted at individual entities. The data shown for the number of suggestions, recommendations and requirements (outcomes from prudential reviews) is based on annualised data from the period 2017-2018.
- **Thematic reviews** – the number of thematic reviews conducted across groups of entities. Data does not capture the number of entities covered in each thematic review. Recent examples of APRA's thematic reviews include its work on residential mortgage lending standards and disability income insurance.

- **Special purpose engagements** – the number of special purpose engagements conducted on matters relating to an entity. This data relates to engagements that have been formally required by APRA using its powers under its prudential standards.
- **Capital adjustments** – the number of times APRA has adjusted the Prudential Capital Requirement (PCR) for individual entities during the period.
- **Notices to produce** – the number of times APRA has issued a notice to produce information to an entity.
- **Formal investigations** – the number of formal investigations conducted into matters relating to an entity.
- **Formal directions** – the number of times APRA has issued a formal direction to an entity.
- **Enforceable undertakings** – the number of times APRA has accepted a court-enforceable undertaking from an individual or entity. APRA maintains an enforceable undertakings register on its public website.
- **Licence conditions** – the number of times APRA has imposed a condition on the authorisation, registration or licence of a regulated entity.

# Appendix 5: Recommendations dependent on Government action

This Appendix sets out the Review's recommendations that are dependent on Government action to enable full implementation.

**Table 5: Recommendations dependent on Government action**

RESOURCE PROPOSALS	SOURCE	BENEFITS
Establish a hypothecated fund for enforcement actions	Enforcement Strategy Review	Allows APRA to more readily pursue enforcement action.
LEGISLATIVE PROPOSALS	SOURCE	BENEFITS
Penalties		
Reform penalties prescribed by APRA’s Industry Acts and FSCODA	Enforcement Strategy Review (informed by ASIC Enforcement Review Taskforce Report, Chapter 7)	Credibly deters entities and individuals from non-compliance with the law and adequately penalises non-compliance.
Superannuation		
Strengthen directions power in superannuation	IAMOS Bill, Schedule 5	Enables APRA to efficiently address prudential concerns.
RSE Licensees and directors being subject to civil penalties for breaches of their covenants	Royal Commission, Recommendation 3.7; IAMOS Bill, Schedule 3	Deters RSE Licensees and directors from breaching their covenants.
Introduce a penalty for breach of an additional licence condition	Enforcement Strategy Review	Deters RSE Licensees from breaching additional licence conditions.
Introduce explicit power to compel an RSE Licensee to undergo a Successor Fund Transfer		Ensures APRA can take targeted action against severely underperforming superannuation funds.
Private Health Insurance		
Strengthen APRA’s power to impose conditions on the registration of a private health insurer	Enforcement Strategy Review	Widens APRA’s options in taking action against a private health insurer. Aligns APRA’s options with those available in other APRA-regulated industries.
Strengthen APRA’s power to cancel the registration of a private health insurer		
Introduce compulsory transfers power for private health insurers		
Strengthen APRA’s power to apply for an injunction against a private health insurer		

Joint Investigations with ASIC					
Empower APRA and ASIC to jointly exercise compulsory investigative powers	Enforcement Strategy Review	Enables APRA to conduct joint investigations with ASIC efficiently and effectively.			
Allow APRA and ASIC to have full and unrestricted use of information obtained under the compulsory powers of the other agency					
In joint investigations, make receipt of information by one agency using compulsory powers deemed to have been received by both agencies					
Enable APRA to receive and use material obtained by ASIC under an ASIC Act search warrant (where the search warrant is executed under ASIC’s strengthened search warrant powers proposed by the ASIC Taskforce)					
Empower APRA and ASIC to bring joint court proceedings against individuals or entities					
Accountability					
Extend an accountability regime modelled on the BEAR across all APRA-regulated industries	Royal Commission, Recommendation 6.8	Promotes accountability and transparency across all APRA-regulated industries.			
Consider introducing a civil penalty against accountable persons for breach of accountability obligations	Enforcement Strategy Review	Deters non-compliance by accountable persons and ensures appropriate punishment for non-compliance.			
Investigations					
Implement the recommendations in Chapter 8.2 of the 2012 Consultation Paper	Strengthening APRA’s Crisis Management Powers – Treasury consultation paper	Ensures APRA’s investigations are efficient, accurate and comprehensive, and informed by complete information.			
Extend the recommendations of Chapter 8.2 of the 2012 Consultation Paper to private health insurance	Enforcement Strategy Review				
Further assess and address deficiencies in investigation powers	Enforcement Strategy Review				
<table><tr><td>Key:</td><td>Underway</td><td>New proposal</td></tr></table>			Key:	Underway	New proposal
Key:	Underway	New proposal			

## Appendix 6: Glossary

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<b>ACCC</b>	Australian Competition and Consumer Commission
<b>ADI</b>	Authorised Deposit-taking Institution
<b>APRA</b>	Australian Prudential Regulation Authority
<b>APRA Act</b>	<i>Australian Prudential Regulation Authority Act 1998</i>
<b>APRA Member</b>	Also referred to as a 'Member', an individual who is appointed by the Governor-General to the position of an APRA Member under the APRA Act. The APRA Members are collectively responsible and accountable for APRA's operation and performance.
<b>ARPANSA</b>	Australian Radiation Protection and Nuclear Safety Agency
<b>ASIC</b>	Australian Securities and Investments Commission
<b>ASIC Act</b>	<i>Australian Securities and Investments Commission Act 2001</i>
<b>ASIC Taskforce</b>	ASIC Enforcement Review Taskforce. A taskforce, announced by the Government in October 2016, to review ASIC's enforcement regime. The ASIC Enforcement Review Taskforce Report was provided to the Government in December 2017.
<b>AUSTRAC</b>	Australian Transaction Reports and Analysis Centre
<b>BEAR</b>	The Banking Executive Accountability Regime, introduced in the <i>Banking Act 1959</i> by the <i>Treasury Laws Amendment (Banking Executive Accountability and Related Measures) Act 2018</i> .
<b>BEAR disqualification</b>	APRA's disqualification of a person, under the BEAR, from being or acting as an accountable person for failing to comply with his or her accountability obligations.
<b>Behavioural risks</b>	Actions of an entity or individual that do not foster prudent risk management.
<b>Behavioural standards</b>	APRA prudential standards relating to governance, culture, remuneration and risk management.
<b>Beneficiaries</b>	Depositors of ADIs, policyholders of general insurers, life insurers and private health insurers, and members of superannuation funds managed by RSE Licensees.

<b>Capital adjustment</b>	An APRA supervisory adjustment to an entity's Prudential Capital Requirement (PCR) to reflect risks not adequately captured in the minimum capital requirement.
<b>CASA</b>	Civil Aviation Safety Authority
<b>Civil penalty</b>	A monetary penalty, administered by the court, for non-criminal contraventions of the law.
<b>Court disqualification</b>	On application by APRA, the Federal Court of Australia's order to disqualify a person from being or acting as a director, senior manager or auditor, if the person is considered to not be fit and proper to be, or act as, such a person.
<b>DNB</b>	De Nederlandsche Bank. The independent central bank, supervisory authority and resolution authority of the Netherlands.
<b>Enforceable undertaking</b>	An undertaking given by an entity or individual that is accepted by APRA and enforceable in court.
<b>FCA</b>	Financial Conduct Authority. The conduct regulator for financial markets and financial services firms in the United Kingdom, and the prudential regulator for some of those firms.
<b>Formal direction</b>	A direction given by APRA to an entity under the relevant provisions of the Industry Acts.
<b>FSCODA</b>	<i>Financial Sector (Collection of Data) Act 2001</i>
<b>GFC</b>	Global Financial Crisis
<b>IAMOS Bill</b>	<i>Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No. 1) Bill 2019</i>
<b>IMF</b>	International Monetary Fund
<b>Industry acts</b>	Refers collectively to the <i>Banking Act 1959</i> , <i>Insurance Act 1973</i> , <i>Life Insurance Act 1995</i> , <i>Superannuation Industry (Supervision) Act 1993</i> and <i>Private Health Insurance (Prudential Supervision) Act 2015</i> .
<b>Infringement notice</b>	A notice issued by an authority setting out the particulars of an alleged contravention of an offence or civil penalty provision. An infringement notice gives the person to whom the notice is issued the option to pay the fine specified in the notice, or elect to have the offence heard by a court.
<b>Injunction</b>	A court order that compels an entity or individual to carry out, or refrain from carrying out, specified acts.



<b>Judicial Manager</b>	A Judicial Manager is a court-appointed manager of an entity that is vested with powers of control over the entity. The board of directors of the entity ceases to exercise powers over the entity on appointment of a Judicial Manager.
<b>Legal group</b>	APRA's in-house legal function, which is part of the Policy & Advice division.
<b>Licence condition</b>	A condition imposed by APRA on an entity's authority, licence or registration to conduct authorised business. The condition must relate to prudential matters.
<b>Liquidity adjustment</b>	An APRA supervisory adjustment to an entity's liquidity coverage ratio, minimum liquidity holdings or net stable funding ratio, as applicable, to reflect concerns about the entity's liquidity risk profile or the quality of its liquidity risk management.
<b>MAS</b>	Monetary Authority of Singapore. MAS is the central bank of Singapore and has responsibilities for prudential and conduct regulation.
<b>Notice to produce</b>	A court-enforceable notice served by APRA on another party requiring production of specified documents or information
<b>OCC</b>	Office of the Comptroller of the Currency. The regulator and supervisor of national banks, federal savings associations, federal branches and agencies of foreign banks in the United States of America.
<b>OSFI</b>	Office of the Superintendent of Financial Institutions. The prudential regulator and supervisor of financial institutions and pension plans in Canada.
<b>PRA</b>	Prudential Regulation Authority. The prudential regulator and supervisor of banks, building societies, credit unions, insurers and major investment firms in the United Kingdom.
<b>Prudential obligations</b>	The obligations imposed on regulated entities and individuals by the legislation and standards administered by APRA.
<b>QA</b>	APRA's Quality Assurance function.
<b>Recommendation (post-prudential review)</b>	An action APRA issues to an entity following a prudential review, with the entity expected to formally consider implementing the recommendation. Matters resulting in a 'recommendation' typically relate to areas of risk management and/or governance that are not fundamentally deficient but could be improved.

<b>Requirement (post-prudential review)</b>	An action APRA issues to an entity following a prudential review, as a result of which the entity must take specific action to address the associated matter. Matters resulting in a 'requirement' typically relate to an entity's failure to comply with legislation or prudential standards, or a fundamental deficiency in the entity's risk management and/or governance practices.
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<b>Royal Commission</b>	Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry
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<b>RSE</b>	Registrable Superannuation Entity. An APRA-regulated superannuation fund.
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<b>RSE Licensee</b>	The trustee of an RSE.
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<b>Special purpose engagement</b>	APRA's requirement of an entity to appoint an auditor to provide a report on a particular aspect of the entity's operations, prudential reporting, risk management systems or financial position.
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<b>Statutory Manager</b>	An APRA-appointed manager of an entity vested with powers of control over the entity. When a Statutory Manager is appointed, the board of directors of the entity ceases to exercise powers over the entity.
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<b>Suggestion (post-prudential review)</b>	An action APRA issues to an entity following a prudential review, highlighting an opportunity to move towards better practice.
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<b>Thematic review</b>	A supervisory activity coordinated across multiple entities to address a risk or area of concern present in one or more industries.
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<b>Transfer and Restructure Act</b>	<i>Financial Sector (Transfer and Restructure) Act 1999</i>
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