



**AUSCRIPT AUSTRALASIA PTY LIMITED**

ACN 110 028 825

**T:** 1800 AUSCRIPT (1800 287 274)

**E:** [clientservices@auscript.com.au](mailto:clientservices@auscript.com.au)

**W:** [www.auscript.com.au](http://www.auscript.com.au)

**TRANSCRIPT OF PROCEEDINGS**

---

O/N H-959656

**THE HONOURABLE K. HAYNE AC QC, Commissioner**

**IN THE MATTER OF A ROYAL COMMISSION  
INTO MISCONDUCT IN THE BANKING, SUPERANNUATION  
AND FINANCIAL SERVICES INDUSTRY**

**MELBOURNE**

**9.45 AM, FRIDAY, 30 NOVEMBER 2018**

**Continued from 29.11.18**

**DAY 69**

**MS R. ORR QC and MR M. HODGE QC appear with MR M. COSTELLO, MS E. DIAS, MR A. DINELLI, MR T. FARHALL, MR M. HOSKING and MS S. ZELEZNIKOW as Counsel Assisting**  
**MR R. DICK SC appears with MR J. WATSON and MS E. BEECHEY for APRA**

<CROSS-EXAMINATION BY MR HODGE

5

THE COMMISSIONER: Yes, Mr Hodge.

10 MR HODGE: Thank you, Commissioner. Commissioner, just before I continue with Mr Byres, yesterday I referred to a document which was a June 2018 board – or executive board paper in relation to the CBA inquiry which was APRA.0054.0001.2430. I tender that document.

15 THE COMMISSIONER: And that document will become exhibit 7.151.

**EXHIBIT #7.151 EXECUTIVE BOARD PAPER IN RELATION TO CBA INQUIRY, JUNE 2018 (APRA.0054.0001.2430)**

20

MR HODGE: Thank you, Commissioner.

25 Mr Byres, yesterday we were discussing remuneration. What I wanted to turn to now was to talk about what APRA has done in terms of developing its approach to culture?---Yes.

30 One of the things that APRA is concerned about for an entity is its risk culture, and that's because, as you explain in your statement, as a result of undesirable behaviours and attitudes towards risk taking and risk management, the viability of an APRA-regulated financial institution itself might be threatened?---Yes.

35 And you say in your statement that APRA has chosen to focus specifically on the prudential aspects of risk culture rather than the broader concepts of risk culture or organisational culture as a whole?---Certainly that was our – our starting point, yes.

40 And does it follow, when you say “that was our starting point” that there's now a change that's underway in terms of how APRA is going to approach risk culture?---Well, I think it's reflective of some of the discussion we had yesterday, that the initial focus was very much on risk culture as it related to financial soundness, in the same way that the initial focus of remuneration was on financial soundness. As a result of – as I – or we've seen in recent years, there's a need to think and apply that concept of risk culture more broadly. It goes to the same issues, though, of, you know, prudential versus conduct regulator and raises some of the same issues about blurring of responsibility. As I said yesterday, I think APRA and  
45 ASIC can manage that well, but it's an issue that we have to think carefully about.

And that development of APRA's thoughts about risk culture, that has also happened against a background of changes at an international level, in terms of how international bodies think about risk culture?---Yes.

5 And we spoke yesterday about the Financial Stability Board's work on remuneration practices?---Yes.

The Financial Stability Board has also been doing work on risk culture?---Yes.

10 And one of the recommendations that the FSB made in, I think, 2012 was for supervisors like APRA to explore ways to formally assess the risk culture of financial institutions?---I think that's right, yes. Around that time.

15 And then in 2014 the FSB published guidance for supervisors like APRA in relation to assessing the risk culture of financial institutions?---I can't remember the specific document and date, but, yes, there was some material produced through that period by the FSB on – on risk culture.

20 Perhaps, just to help you, if we bring up RCD.0014.0090.0102. So this is the FSB's guidance that was published on 7 April 2014. Is that what you're thinking of?---Yes.

And by this time, some supervisory authorities in other jurisdictions had begun taking a more active role in assessing the culture of financial institutions?---Yes.

25 One regulator that had begun taking a more active role was the Prudential Regulation Authority in the UK?---Yes. I think that's right.

And another one the DNB in the Netherlands?---The Dutch central bank, yes.

30 And the DNB was probably the most advanced in this area?---Certainly, yes, they went furthest fastest, that's true, yes.

35 And can you just explain to the Commissioner, what was the nature of the work that they were doing?---Reflecting the fact that their financial system had essentially imploded, their large banks ABN AMRO, ING, etcetera, all had to be rescued, effectively, by their governments – they had had a serious financial crisis – so they were thinking very hard about how do we avoid getting into this situation again. the prudential regulatory supervisor, prudential regulatory arrangements are in the central bank in the Netherlands. So the DNB was tasked with thinking about a range of measures, reforms that would prevent these sorts of things happening again. And they went quite assertively into the area of culture and risk culture. And they created a team within the DNB, within the supervisory area of organisational psychologists and like – alike, with which to make assessments of culture within financial institutions.

45 Now, APRA's own focus on risk culture effectively began in about 2014?---Yes. So there was – in – in 2013/14 there was thinking about this issue. There was, I think, in

the SPS 220 the risk management standard in superannuation, there's a sort of brief reference to people's behaviour and understanding in relation to risk management. But the word "risk culture" really appeared for the first time in a very prominent way when CPS 220 that we talked about yesterday was produced, and there was a lot of  
5 debate about what was the role of the board and others in formulating and giving effect to risk culture within organisations.

I think what we spoke about yesterday was the draft of CPS 220 was released in 2014?---Yes.  
10

And then the final standard was published in 2015?---I – I think the final standard was published - - -

I'm sorry?--- - - - at the end of 2014.  
15

To come into effect?---It was effective from '15, Yes.

I'm sorry, you're quite right?---But that time period.

20 And CPS 220 in final form requires the board of an APRA-regulated institution to form a view of the risk culture in the institution?---Yes.

And the extent to which that culture supports the ability of the institution to operate consistently within its risk appetite?---Yes.  
25

And also to identify any desirable changes to risk culture and ensure the institution takes steps to address those changes?---Yes.

30 Because I think I've used the word "ensure" and "ensure" is a - - -?---It's a touchy subject amongst the director community but it means do all – make all reasonable steps that you might expect from a director – this is a paraphrasing – to do those things.

35 And, in particular, what was touchy and what I'm interested in understanding some of your views about is that the original proposal for CPS 220 was that it would require the board to ensure that a sound risk management culture is established and maintained throughout the institution?---I think that was correct. Yes. I wasn't around in APRA when that drafting work was done, but I think that's broadly correct, yes.  
40

And you say in your statement that this original proposal met with considerable opposition, particularly from company directors?---Yes.

45 And what was it about this proposal that directors objected to?---So I – I arrived back in the middle of this debate. So having been away from APRA and coming back in the middle of '14, I arrived back to the middle of this debate. There was a view – it wasn't specific – specific to this clause. It was a bit broader about some aspects of

5 CPS 220, but the – the essence of the concern was that the formulation of the words was requiring directors to do the jobs of managers. And that there were limitations to what non-executive directors could ensure. So there was – there was a concern about the nature of the word “ensure”, and then there was a – another concern about the extent to which they could set and establish and other things, a risk culture.

10 And ultimately, that concern led to the change in language that - - -?---Yes. I mean, essentially we said, okay, we accept that as part-time non-executive directors, it will be management ultimately that sets the tone from the top, manages the business day-  
to-day, sets and has the most influence on the culture. But a board can’t absolve  
itself from responsibility of at least forming a view as to what the risk culture is in  
the organisation. The board sets the risk appetite. The board should have regard to  
what they sense the risk culture to be and if they see there’s an inconsistency  
between those two things, they should task management with action to address that.  
15 And that’s the essence of where we landed.

20 And how does APRA’s supervision go about trying to make sure that boards form a view of the risk culture within the organisation?---So we – we have been developing, as with remuneration, trying to learn ourselves in this area because it’s not an area  
where we had the – the natural great wealth of knowledge. We – and so it was part  
of the creation of the GCR team that we talked a lot about yesterday. And the initial  
work was some work done by that team that led to a paper that was produced in ’16,  
October ’16, I think. But where they conducted an exercise where they went across  
the industry and looked at how were boards forming these views, how were boards  
25 going about what information were they getting, how – how possible was it for them  
to form a good view. Part of that work, I have to say, was instigated by the directors  
who said, “Well, you want us to do this job. It would be good if you told us, you  
know, some ways in which we might be able to go about it.”

30 I see. Is it fair to say this approach differs markedly from the approach in, say, the Netherlands, where the regulator is itself forming a view about the risk culture within the organisation?---Yes. I would say the Dutch, if I look internationally, I would say the Dutch are something of an outlier, or certainly furthest along on the spectrum.  
And, you know, we’re developing a process that I think is more what I would call  
35 more normal amongst our peers. But different people – no one’s exactly the same.

40 I see. We might come back to that in a moment when we talk a little further about the GCR. I just wanted to ask you some questions about something else that was published in 2015. You’re familiar with the Group of Thirty?---Yes.

45 And that’s another international body that does, amongst other things, work on culture in financial institutions?---It does a range of things. I mean, it’s not an official body in the same way the FSB or any of the other standard-setters are. It’s a private sector, in a sense, independent group. But, yes, they have done some work on culture.

THE COMMISSIONER: Well, a private sector group with a few heavy hitters in it, should we say, Mr Byres?---Sorry, I didn't mean in any way to diminish them but it's just that within the official structure, if you like, they're not endorsed by a government.

5

Yes.

MR HODGE: In July of 2015 the Group of Thirty published a paper called Banking Conduct And Culture: A Call For Sustained And Comprehensive Reform?---Yes.

10

And you're familiar with that paper?---Yes.

And presumably, APRA was aware of it at the time?---I was interviewed for it, so yes.

15

And would have considered the views that were expressed in the paper?---Yes.

I just wanted to ask you about a couple of aspects of that. Can we bring up the paper which is RCD.0014.0090.0018. Now, the report said quite a bit about what financial institutions should do to improve their culture?---Yes.

20

But it also addressed the role of supervisors like APRA in relation to the culture of financial institutions?---Yes.

25

And if we go to page .0083. We see here it sets out what is described as the supervisor roadmap for assessing conduct and culture?---Yes.

And what I'm just interested in understanding is some views you might have about the approach that's put forward here. If you look at the first section, which is Overall Approach, you see what's explained is:

30

*Since culture, conduct and values are about behaviours, the authorities should be committed to an approach of using supervision rather than rules and regulation to deal with conduct and value issues.*

35

?---Yes.

And presumably, that is consistent with the view that you would have about the approach that should be taken by a prudential supervisor?---Yes. I would say that's what we're trying to work towards, yes.

40

And then you see the next sentence says:

*Supervisors should look on cultural questions as root cause analysis and intervene when they see demonstrably serious problems as opposed to making culture a generalised additional supervisory add-on.*

45

?---Yes.

And I will come back to that idea in a moment. If we take that down and then bring up the section which is called Supervision. And you see it says:

5

*It is essential that there be enough supervision resources, and with the right skill sets/seniority and expert support if needed, to engage constructively with banks on these issues. The main objective should be early problem identification and bank-led corrective action.*

10

?---Yes.

Continuing:

15

*Conduct and values should be part of mainstream supervisory processes as opposed to a separate add-on.*

?---Yes.

20

And what that seems to suggest is that the assessment of cultural questions should form part of the ordinary supervisory work of a prudential regulator like APRA rather than being an add-on?---Yes.

25

And what it also seems to suggest is that the process of supervising culture would necessarily involve the regulator forming its own view about the risk culture and problems within the organisation in relation to culture as distinct from simply trying to monitor whether the board is forming a view about culture?---So I think you want to do both, if that's the – if that's your proposition. I agree with that.

30

I see. And so in terms of doing both, that means that for a prudential regulator like APRA, APRA would need to form its own view about risk culture within the organisation?---I think so. If – if – if I think about how a supervisor might look at it, you are going to quite often be looking at information which is bank information, or insurance company, or whatever financial institution it is. You would be looking at what is going up to boards, what are they seeing. You will be testing it against the word we used yesterday, a gut feel, and testing whether there's an alignment there or whether you think, in fact, that the information is painting a picture that's different to what the supervisor may him or herself experience.

35

40

I just want to make sure I've understood that. That seems to be very focused on what is the quality of the information coming up to the board for the board to form its view about risk culture. That seems to be slightly distinct from the idea of the supervisor forming their own view about risk culture and then trying to intervene to proactively prevent problems?---Maybe I'm not quite understanding the question, but the – if you went to any supervisor in APRA now and said, "Tell me about the culture of the institution" that they are responsible for supervising, they would all give you an opinion. They could all give you an opinion. But there's a strong element of my

45

experience, my gut feel, my intuition. You want to supplement that, if you can, with data points and more objective measures, and then try and synthesise those things into an APRA view. And the data might well reinforce your gut feel. It might actually say, “Actually, my intuition is not quite right and I’ve got to modify it.” But  
5 somehow, I think if I’m getting to your point, yes, APRA would have to form a view.

And then having formed a view, a way in which you would seek to proactively prevent problems is to engage with the board or the senior management about those problems?---Yes. So if you – if you want to test CPS 220, the board has an  
10 obligation to form a view, you might well start with the proposition of asking them what is their view. To be able to challenge that, you’ve got to have your own view, and it needs to be – but for that challenge to get too far, it has got to be a well-founded view. So - - -

15 To challenge the board’s view of risk culture?---Yes. So I think if you want to test and challenge, which I think is going to the heart of your question, we have to have a view, and we will see if it’s – it’s aligned with – with the board’s view.

Perhaps if we then look at that in the context of the GCR?---Mmm.

20 That was the team that APRA created in 2015?---Yes, because – sorry, yes, it was.

And the aim of that team was to provide support to supervisors on issues relating to governance, culture and remuneration?---That’s right.

25 And did APRA have to also make changes to the size of its supervisory teams to enable them to undertake the type of culture assessments that seems to be envisaged by the FSB and the Group of Thirty?---Well, the initial – the initial team was a very small complement. So we didn’t – we were still finding our way in this area.

30 I’m sorry, just if we break it up. The GCR is supporting the supervisory teams?---Yes.

35 The supervisory teams still themselves need to form a view about risk culture if they’re going to do that?---Well, yes, but they may do it by asking the GCR team to, in a sense, do the work.

I see?---And then provide the expert advice. So, as I said, every supervisor will have a view, if they’ve had sufficient engagement with the regulated institution, they can  
40 all – they will all have an opinion. I assure you they all have an opinion. But if they want some extra support, extra advice, they may get assistance from GCR team or they could, in fact, ask the team to do an exercise. And the way we did the initial pilot work that led to the October paper – October ’16 paper that I referred to before, we really did that just with the GCR team doing it itself.

45 I see. And the GCR team initially, I think, was three people?---That was the – the very initial stage, yes.

And then ultimately, how big did the team become?---So, it's – it has fluctuated because we've had ins and outs, but it's – the current budget head count is 10 people.

5 I see. In terms of where things are at – let's just trace that through – there was a – an information gathering exercise that the GCR team did in late 2015 and early 2016?---Yes.

10 And that was for the GCR team to try to understand how the APRA-regulated institutions were complying with the requirement to form a view or for the board to form a view of risk culture?---Yes, how they were going about that exercise, recognising that no one had a very good idea as to what good practice might look like.

15 And in October 2016, APRA published the information paper that was - - -?---Yes. - - - the product of that assessment?---Yes.

And in the paper, I think the point is made:

20 *To date APRA's work has largely been exploratory and heavily focused on assessing institutions' approaches to implementing the risk culture requirements of CPS 220.*

25 ?---I think that's what it says, yes.

And perhaps if we bring up part of the report just so we can look at it. It's RCD.0021.0035.0059. And go to page .0081. And we just need to go over the page, I think, to 0082. Thank you. And you will see at the bottom of the page there's a heading A More Anticipatory Supervisory Approach to Risk Culture?---Yes.

30 And what's explained there – so this is as at October 2016 – is what APRA is contemplating as its future approach to risk culture?---Yes.

35 And it said:

*Although APRA already considers risk culture as part of its ongoing supervisory activities, APRA intends to refine and sharpen its approach to assessing risk culture. Conducting pilot risk culture reviews will form a key component of this work.*

40 ?---Yes.

45 And this is then – you can see in the next paragraph – something that's anticipated to be a more intensive review?---Yes.

And what that seems to indicate is by late 2016, APRA had decided that it would shift to more active supervision of the risk culture of APRA-regulated

institutions?---Well, I think that – that was, in essence, at the heart of the creation of the team the year before. But certainly, we were flagging here – what we were trying to flag here was that quite often supervisors would go and do a review maybe of credit risk, maybe of market risk, maybe of operational risk – some sort of review.

5 And as part of that exercise, but not as the primary purpose of the exercise, they would obviously make some observations about culture. And what we were flagging here was that instead of that being a part-time or adjunct or add-on to some other primary activity, that we would actually try and do some reviews where the primary purpose was to assess culture or risk culture.

10 And what was it that had prompted that shift in thinking?---I think all of the documents you referred to, the international thinking, the sorts of issues we talked about yesterday. It was just part of that evolution.

15 And by June 2017, APRA had formulated a pilot program for risk culture review?---Yes.

And one of the things that was going to be involved in that program was APRA making an independent assessment of each institution’s risk culture?---That was –

20 that was the proposal, yes.

And it would involve a planning phase, including reviews of available information from the institution?---Yes.

25 And a field work phase - - -?---Yes.

- - - would include surveys, interviews, focus groups and in situ observations?---Yes.

And an analysis phase where APRA would then analyse the results of the information it had collected?---Yes.

30 And then a feedback phase where APRA would share the results of its analysis with management and make suggestions to improve the risk culture of the organisation?---Yes. And I would say that – that’s the process we go through for any sort of review, but, yes, they were the basic steps involved.

35 And then finally, a monitoring phase where you would monitor the implementation of those things?---You see what actions – yes.

40 Now, the first of the pilot risk culture reviews began in July of 2017?---Around that time, yes.

And we understand the results of the first review were provided to the relevant institution in November 2017?---That sounds about right.

45 And there had then been planned to be a second pilot review in October of 2017?---That sounds right.

But that was suspended because the resources were redirected to the prudential inquiry?---Yes. We had a – obviously, a couple of key resources who were our core expertise in this area, and they were redirected to do similar sort of work in relation to risk culture for the CBA inquiry because that was seen as a priority.

5

And then in late 2017 and early 2018, a number of the senior members of the GCR team resigned?---Yes.

10 And APRA then decided not to proceed with the risk culture pilot reviews in their original form?---Yes.

Decided to re-scope those reviews?---Yes, we did.

15 And if we bring up APRA.0040.0001.0003. This is a presentation that's explaining how it is that the risk culture pilot reviews are to be refocused?---Yes.

20 And if we go to page .0009. This is an attempt to explain what the refocus is going to be. And it appears as if the refocus is going to be on, rather than assessing – rather than APRA making its own assessment about – of the risk culture, understanding how the entity assesses its risk culture?---That was the broad reshaping, yes.

25 And instead of holding a workshop to provide detailed feedback to management about APRAs assessment of the entity's risk culture, APRA will instead provide feedback in writing but that will, of course, be based on its consideration of the entity's own assessment of its risk culture?---Yes. Although, I think as a practical matter, we always, whenever we do a review, we always have some kind of closing meeting at the end where, as just a matter of professional courtesy, we talk about the sorts of issues that we've identified, and particularly before we commit things to writing and any sort of formal response, if the entity concerned perhaps feels we haven't viewed – we've missed some documents, we haven't seen something, it's a last opportunity to put evidence before us. But the formal response would be a written report afterwards, yes.

35 But – and I don't think we're disagreeing about this – a written report that is about APRAs consideration of the entity's own - - -?---Yes.

- - - way of assessing risk culture, as distinct from a workshop where it's giving feedback based on APRAs assessment of the risk culture?---Yes.

40 That is the critical difference in – the critical change that APRA has made?---Yes. I think it's – it's nuanced in the sense that part of – part of any assessment of whether a process or a framework within an institution is adequate would be whether it's producing outcomes that intuitively seem right to you. So it's not to say that we would just be looking at a process document and saying it's very good. It would still need to have some sort of sense checking against it. But we were not, if – we were not seeking to be the definitive culture consultant. It's ultimately for boards to do that work for themselves.

45

In particular, what you were doing was shifting back to a less resource intensive way of approaching risk culture?---I think that's true. We had – when the pilot program was first presented, the original proposal was they would do five pilots and report back, and – and we asked them to come back after two. You know, we didn't get the  
5 second one done because of the CBA, although that in itself acted as something of a pilot. The concern that I think we always had was is this going to be – it was pretty – the pilots were a very intensive process. Very reliant on key people. And there was always a question mark as to how scalable it was going to be across the APRA population. And this trade-off between depth and coverage was an issue that we  
10 were always grappling with, and the conclusion that we reached through this review, having done the first two exercises, the one that was the genuine pilot and the one – and the work we did on CBA was if we tried to do that into the future, we just didn't have the resources to get anywhere near the coverage that we would need.

15 I see. And I think, just to take or pull out some of the points you're making, your view is the initial pilot review and the risk culture component of the CBA prudential inquiry were both very valuable, in the sense - - -?---They were.

20 - - - they provided very valuable insights into the culture of the two organisations?---Absolutely. They were fabulous pieces of work.

And – I think we looked at this document yesterday, but in an assessment following the prudential inquiry, APRA had considered that in its ordinary supervisory work before the inquiry, it had been less effective at driving cultural change at  
25 CBA?---Yes. We were – we were battling hard, yes.

So the work is – the work that was done was valuable?---Absolutely.

30 And the ordinary supervisory activity had not been effective or as effective at driving cultural change?---It hadn't been fully effective, that's right. But we had had some successes but we were continuing to battle hard there.

But the problem is from APRA's perspective, one of resources, to be able to roll that out across other financial institutions?---Yes. So the way I think about it is – is  
35 almost as a – perhaps a – escalation pyramid or perhaps triage sort of exercise. So we have – we can have multiple levels of intervention. The day-to-day supervisors will be forming views but they're not necessarily experts on culture and it will be sort of intuition and gut feel and experience. We can have these sort of reviews that you're referring to that will be supported – strongly supported by the GCR team, that  
40 will go to an extra level of depth and bring – through the GCR team bring an important element of cross-industry perspective, because a supervisor may be able to compare their current entity with one they supervised before or another one that they're currently supervising but they don't have the full industry breadth that the specialist team would have. So we can do the first level, which is the supervisor  
45 only, we can engage GCR and do this sort of work. It doesn't preclude us, if we felt we had a real problem, or this work that we had done had come to the conclusion that there was something very poor about the risk culture of the entity, from going and

doing – doing one of those deeper exercises. It would probably require us to perhaps utilise external resources to support us doing that work. But we have sufficient powers that if we thought we wanted to go and do one of those really deep sort of exercises like in the CBA review, we could do that. It would just – as I said, it would probably require us to hire some external resources to help us do that exercise.

5 THE COMMISSIONER: Well, is the premise for that that there is not now observed to be a deep problem?---No. I wouldn't say that, Commissioner. I think  
- - -

10 Well, it seemed to me that that was the premise implicit in what you were saying?---No, I think - - -

I just want to - - -?---Sorry.

15 - - - pull that out and see whether that is the premise?---No, that's not the premise. But I think we – we would say that boards are now highly attuned to this issue, so are devoting time and attention to this issue. They recognise that there is a – there is work to be done just about in every organisation, and so it's not that the issues aren't getting attention and that there isn't work to do. But for us to be able to do that  
20 CBA-style review or the initial pilot review, given all the other things we have to do, there is a resourcing constraint. And we have to think about how do we most efficiently use our resources. And the – the proposition I was trying to put was that not every organisation needs the CBA-style review, or the – the other organisation  
25 that we did the pilot on. So we need to balance and efficiently target our resources where they're most needed.

Yes.

30 MR HODGE: Thank you, Commissioner.

One of the things that you've said in your statement is that APRA is reconsidering whether its work on culture should have an exclusively prudential focus?---Yes.

35 And that would seem to carry with it the idea that APRA is at least considering whether it would broaden its focus to look to identify cultural drivers of misconduct as part of its supervisory work?---Yes, in the same way that we talked about yesterday, we're thinking about how you factor that into the work we're doing on remuneration. I mean, these things, as we talked about, are intertwined. There  
40 would be no point going a bit further on remuneration if you weren't correspondingly aligned when you're looking at culture.

45 And how is it that APRA would do that, that is, how is it that it would look to identify cultural drivers of misconduct as part of its supervisory work if it's retreating from the original conception of the pilot reviews to something that is more concerned with how the entity assesses its risk culture?---So I think we would still be – the fact that we have had a – a slight step back in the way that we – we are working here

doesn't preclude us from identifying issues that might go to conduct. Many of the drivers, I think, will be related to issues of incentives that we've already talked a lot about. So I see these things as being quite intertwined.

5 THE COMMISSIONER: Mr Hodge, can you give me the reference in the statement to – that you've just made.

MR HODGE: Paragraph 381 of Mr Byres' statement.

10 THE COMMISSIONER: Thank you.

MR HODGE: At page .0096.

THE COMMISSIONER: Thank you.

15

MR HODGE: Perhaps if we just finish off risk culture then by considering this: do you think – or you've said there's been an improvement in the way boards consider risk culture, they're much more focused now on issues of risk?---There has certainly been a lift in the time and attention given to the issue.

20

And do you think that the boards of APRA-regulated institutions have now become quite comfortable with the requirement that they form a view of the risk culture of their institution?---No.

25 You don't think they're even comfortable with that?---Well, I – I think they've come to accept they've got an obligation but it's a very hard task, particularly in large complex organisations, because in any – if you looked at any of the major banks, there actually isn't some monolithic culture. There are – there is some sense of organisational culture but then there will be divisional cultures and depending on what line of business you're in, and there could be differences in geography. So the challenge I think they all feel is they recognise the task, they accept the task. I – I think they accept and acknowledge the importance of the task and that it is something they should do. But it's actually a very hard task.

30

35 Do you think there's a call to further strengthen the requirement to go back to what APRA had originally proposed in 2014, that the board must ensure that a sound risk management culture is established and maintained through the institution?---I'm not sure that that's – so do I have a view as to whether that should change. No, I don't have a view. I'm not sure that that's right. And this is part of a broader piece of work that we've had to think about, because of this concern that was triggered by CPS 220, that where is the right role between what is a true responsibility of a non-executive director versus what is the role of management. If you asked me, I think our standards are probably – so they're very good at describing what's the role of the board. They actually don't put a huge emphasis on actually what is the role of the chief executive and management in these particular spaces. And so the answer may not be to more strongly mandate the role of the board; it may be to, perhaps, part of

40

45

BEAR, etcetera, to more strongly articulate the obligations of management to fill in the – the total picture.

I see?---So I don't – I'm not sure of that one.

5

THE COMMISSIONER: Well, is that more than – I don't want to dismiss it, but is that more than a drafting problem? What I mean by that is this: first, directors trip on the word “ensure”?---Mmm.

10 I understand that. Second, we've all got to trip on the need to distinguish between the role of the board and the role of management. That's a necessary trip wire that we've got to - - -?---Yes.

15 - - - identify and observe. But does it not come down to management, if you like, ensuring - - -?---Yes.

- - - if you prefer, taking all reasonable steps towards identified result under the overall supervision of or subject to - - -?---Yes.

20 - - - the overall supervision of the board?---Yes. And I think that - - -

So I?---I agree.

25 That's a question of drafting it. It's not a question of the – the substance of what you're trying to achieve, is it?---So, yes, I agree there's clarity of drafting there and what we have at present is tried to produce that concept that you have just talked about. But what's not clear, I would say, in the – in the current standard, there is nothing that explicitly articulates that role of management. So it has got a role for board in overseeing something, but the “something” is not clear. It's sort of taken for granted. And maybe, if you want to start more firmly enforcing an obligation,  
30 you've got to be clear about what the obligation is.

35 Well, certainly that. If you – if you're going to be enforcing the obligation, there has got to be no doubt about what the obligation is. That's - - -?---Yes.

- - - evident. But to the extent to which prudential standards are properly seen as identifying aims, objectives, rather than specification of particular norms of behaviour, the aim or objective that has to be identified may be thought to be one about risk, broader than financial risk, broader than existential consequences and  
40 maybe focused on the fact that, yes, there are differing role for management and for board, but the roles each have to be performed and each have to be performed in a complementary fashion?---Yes.

45 Now, are we at a point where APRA could, should, needs to, must – let's not hook ourselves up on the particular verb – do something about prudential standards concerning risk beyond existential financial risk?---The short answer is yes. Exactly what - - -

Long question, short answer. Thank you, Mr Byres.

MR HODGE: Thank you, Commissioner.

5 I will move then to the last topic in relation to governance, culture and remuneration, Mr Byres.

10 THE COMMISSIONER: Before we do that can we clean up what you are tendering and what you're not tendering, Mr Hodge. We've got - - -

MR HODGE: I tender only the document that I just brought up on the screen, Commissioner, which is an APRA document.

15 THE COMMISSIONER: So the G30 piece we have already?

MR HODGE: It's – those are all public documents.

THE COMMISSIONER: Public documents.

20 MR HODGE: I will tender them if you want, Commissioner, but - - -

THE COMMISSIONER: No, I've got enough.

25 MR HODGE: It's APRA.0040.0001.0003. That's the risk - - -

THE COMMISSIONER: Refocusing risk culture pilot reviews, April 2018, exhibit 7.152.

30 **EXHIBIT #7.152 REFOCUSING RISK CULTURE PILOT REVIEWS, APRIL 2018 (APRA.0040.0001.0003)**

35 MR HODGE: Thank you, Commissioner.

Mr Byres, I want to move then to talk about BEAR?--Mmm.

40 THE COMMISSIONER: Sorry, forgive me then, Mr Hodge, if I can just intrude one further step about culture. We've spoken about G30, Mr Byres. I assume you saw that this morning the G30 most recent paper came out of embargo. And that paper says, particularly, that, amongst other things at page 6, I think it is:

*With the ongoing Royal Commission investigation and pending recommendations –*

45 I interpolate in this country –

*as well as continued revelations of retrospective misconduct among Australia's financial institutions, we anticipate that the Australian banking industry is only beginning its long journey to repair its conduct and culture.*

5 What do you say about that proposition? Because the next question will be what's  
APRAs part in it?---Yes. Thank you for warning me. Look, I think that is a fair  
statement, that there is a – a long journey to go. So, therefore, to your question,  
what's our part in it. I would probably highlight a few things. I could probably  
highlight a number of things but I would put it under a couple of broad themes, if I  
10 could. So the first is thinking harder about the issue – all of these things within the  
prudential framework – thinking harder about the issue of accountability. BEAR is a  
example, but BEAR only applies to one – one industry sector. But the general  
concept of clarity of accountability, or, more to the point, the problem of diffused  
responsibility and no clarity of accountability has been the heart of many problems  
15 that have happened. No one had responsibility. No one has actually taken  
responsibility for issues. Boards have not known how to apply consequences  
because it's not clear who was responsible for things. So a strengthening of  
accountability. Secondly, if I look at the issues that – the multitude of issues that  
were produced through your January requests for people to bring out and confess  
20 their sins, and, I mean, there's so much there, it – my reflection on – and I certainly  
haven't read it all, but as you just look at it all, you can't help but think that  
compliance and audit functions are not strong enough in organisations. So these  
issues persist too long before they are detected. And it's evident also in ASICs  
breach work, that issues can go for such a long period of time in organisations  
25 without being identified. It's probably fair to say that the prudential framework, if  
you look for references to compliance and internal audit, they're fairly cursory and  
short and we will need to think about how we give them more prominence in our  
assessment of risk management because it has traditionally been, as you've said, the  
sort of financial soundness perspective. But audit and compliance have to be at the  
30 very forefront. Because regulators can't find all this stuff. We can't be the first line  
of defence. So accountability, stronger control mechanisms to detect issues early, get  
them rectified while they're small, and the third thing is we've talked all about  
yesterday is incentives and the flipside of incentives, consequences. So that would  
be my quick answer – relatively quick answer to your question, Commissioner.

35 Yes.

MR HODGE: Thank you, Commissioner.

40 We will deal with BEAR relatively briefly, Mr Byres. It came into force for the big  
four banks on 1 July this year?---Yes.

And it will come into force for other ADIs on 1 July next year?---Yes.

45 Now, BEAR in its current form imposes a number of different types of obligations  
on banks and on accountable persons within those banks?---Yes.

The obligations or the – include what are referred to as accountability obligations?---Yes.

5 And each accountable person has three accountability obligations?---Yes.

He or she must conduct the responsibilities of his or her position as an accountable person by acting with honesty and integrity and with due skill, care and diligence?---That's one, yes.

10 Must also do so by dealing with APRA in an open, constructive and cooperative way?---Yes.

15 And must also do so by taking reasonable steps in conducting those responsibilities to prevent matters from arising that would adversely affect the prudential standing or prudential reputation of the bank?---Yes.

And the bank itself has similar accountability obligations?---Yes.

20 And if the bank breaches its accountability obligations and the breach relates to prudential matters, then the bank may be liable to – for a civil penalty?---Yes.

25 And if APRA is satisfied that an accountable person has breached his or her accountability obligations, APRA may disqualify that person from being an accountable person?---Yes.

In October of this year APRA released an information paper about its approach to implementing the BEAR?---Yes.

30 But that information paper does not explain how APRA will approach breaches of the BEAR?---No.

You're still working on that?---Yes.

35 And why is it, apart from the fact that you're still working on it, that you haven't yet published or explained how you will approach breaches?---Because it has been caught up in a broader thinking about enforcement strategy.

40 I see. All right. So the – just so I'm clear, the reason that APRA has not to date explained how it will approach enforcement of BEAR is because that has been caught up as part of the broader review of enforcement strategy?---Yes, there was – there was some work done. We've certainly developed what we think is a – a framework internally if we had to do something tomorrow. But given that we've – we're undertaking a broader review of approach to enforcement, it didn't make sense to put out something on BEAR if then subsequently we were going to change that in  
45 some way.

Would it not have made sense to put out something before 1 July 2018 about your approach to enforcement of BEAR, that is, before it actually came into effect for the big four?---It would have been. I – it would have been nice to do, I suppose, yes.

5 And do you have a view as to why that didn't happen?---That was just resourcing. I mean, BEAR has been an extremely demanding process for us to get up and running on day one. The timetable was relatively short, and we wanted to make sure that we had a credible implementation on day one, recognising that inevitably we would adapt and evolve as need be. But resources were applied to the primary task of  
10 getting the accountability statements, the accountability maps, the registration all in order so that at least the system was operational on 1 July 2018.

I see. You've said publicly that APRA will need to be satisfied that a contravention is material before it brings proceedings?---Yes. Well, you don't – I mean, obviously  
15 you don't disqualify people lightly and you don't start civil penalty proceedings lightly. So it would be by definition material.

Can you give an example of what would be a material contravention?---For a bank or for – for an individual?

20 For a bank?---Well, I think the two examples that I often talk about because they're in the public domain, I think the – the issues that were identified by the CBA inquiry report would have asked you to at least think about – would have asked us to think about was there a case to be made for some penalty. The other one which is a very  
25 public case, but some time ago, was the – the NAB FX options episode where it was clear that there were significant failings in governance and oversight in that organisation. And – and questions about – or that could have gone to prudential standing. So they would be two cases that I think are ones that you would be looking, at least asking the question about, whether a penalty was warranted.

30 In the case of the CBA prudential inquiry, what are the particular matters that would be causing you to, had BEAR been in place, to ask the question is a civil penalty - - -?---Well, I don't think it's a particular matter, I think it's the collective of it.

35 I see?---That would say, you know, clearly something – it's not necessarily any of the individual issues in and of themselves, or by themselves, but the collective picture is clearly, you know, was clearly of concern, and I'm not saying that we would have. I'm saying but it would be the sort of case where you would reasonably say, well, does this meet the test of jeopardising the prudential standing and  
40 prudential reputation of the bank.

And what about for the – for individuals involved. If BEAR had been in place earlier, do you think that any of the matters revealed by the CBA prudential inquiry would have at least given rise to the question of whether APRA should seek to  
45 disqualify somebody from being an accountable person?---That is – that's a tricky question, because one of the things that I think is at the heart of many of the issues, not just at CBA, elsewhere, has been the lack of clarity about who was actually

5 accountable for things. That was – that was a fundamental part of the problem. No one – no one seemed to have ownership of the issues. So what the BEAR does is makes very clear the accountabilities for individuals. They accept those accountabilities, and then makes very clear that there is a serious consequence if you fail them in a material way.

10 I understand. The point you’re making being without the benefit of accountability statements, it’s difficult to say in the case of the CBA prudential inquiry who it is that ought to have been held accountable for any of the failings?---That’s right, because you end up with people saying, “Well, it wasn’t me, it was him or her.”

15 In APRA’s submissions in response to the interim report, it has said that there will be benefits to adopting a similar accountability regime across other sectors of the financial system?---Yes.

And that would include insurers?---Yes.

20 And superannuation companies or trustees?---Yes. It – it might need to be tweaked to the sort of unique circumstances of superannuation but in concept, yes.

25 Meaning tweaked in order to, perhaps, disentangle the idea of prudential issues?---It just – some of the things that – in super, for many super organisations, the vast bulk of things are actually outsourced. And so you – you might have to think about how you clarified some of the responsibilities because you’re not actually – you don’t have your own executives, necessarily, running things day-to-day.

30 And what about extending it to other financial services companies?---Look, beyond the APRA-regulated sector, you’re probably aware the UK regime is – is the one in which the BEAR regime was modelled, but it’s different to the BEAR regime in three dimensions: (1) it covers a wider range of institutions and goes beyond what we would call the APRA-regulated flock; (2) it goes - - -

35 THE COMMISSIONER: Capturing what sort of other institutions, Mr Byres?---Other investment firms, investment banks, stockbrokers – other sorts of financial intermediaries.

40 Yes?---So, sorry, it goes for a wider range of institutions, it goes to a wider range of conduct, and in that regard it’s important that – to note that, therefore, it’s a dual-administered regime by both the UK PRA and the UK FCA. And then the third dimension is that it has some – it has a broader set of sanctions within it, some what I might call intermediate sanctions. So the BEAR, as currently crafted, has two primary sanctions, a disqualification, which is obviously an extreme sanction for an individual, or a significant fine, which the explanatory memorandum for the Act said should be used in – only for significant cases. I forgot – material or significant,  
45 something of that nature. The UK regime has some lower order, for want of a better term, penalty provisions that can be used for, perhaps, issues that don’t hit that threshold.

MR HODGE: Can I just focus on one idea there, which is that the UK regime is jointly administered by both the FCA and the PRA?---Yes.

5 Under – or in the way that you would see a model where BEAR might be extended to apply to other financial services entities and to a wider range of misconduct, do you think that would necessarily require a joint administration of the regime by APRA and ASIC?---Sorry, could you repeat the question, sorry?

10 Yes. What I – I just want you to think about the point you’re making about the breadth of the UK regime, which - - -?---Yes.

- - - applies to a wider range of financial services companies and a wider range of misconduct and it’s jointly administered by the PRA and the FCA?---Yes.

15 So if Australia was to also adopt an expansion of the BEAR that came – or became more like the UK model where it applied to a wider range of companies, embraced a wider range of misconduct or embraced misconduct, would be one way of putting it - - -?---Mmm.

20 - - - do you think that would also necessitate joint administration between ASIC and APRA?---Well, I think – so I don’t particularly – I’m not particularly putting in a bid to expand the flock of institutions that we supervise. So if it went to a wider set of organisations beyond our current prudentially regulated industries, then I would say, yes, you would leave that to ASIC to deal with. If it went to other ranges of conduct, 25 then, again, I – if you think of the – I’m not very good on the Corporations Act, I’m sorry, but 912 – whatever the honestly, efficiently, one is that I’m sure you’ve heard many times – we don’t administer that. So if you wanted to use the BEAR as a means of saying, “Well, that has been breached and we want to use the BEAR as consequences”, I think you have to say that’s an ASIC capacity. So my short answer is yes, I think you do need dual administration if you broaden it. 30

And how would that work, do you think, dual administration?---I – look, I haven’t really thought about the specific design features, and I’m not a lawyer so I’m not quite sure how you would piece it together, but it seems to me there’s a template in 35 the UK which, from what I can tell, talking to my counterparts in the UK, seems to work very neatly and fairly seamlessly and they seem to think it works quite well and the two agencies don’t seem to have difficulty dealing with issues. So I – I can’t offer you anything other than to suggest there is a template and that would be my starting point. 40

I see. I want to then – unless you have any - - -

45 THE COMMISSIONER: Just one minor exploration, perhaps not minor exploration of that template. Is an informing idea that the prudential supervisor or supervisory authority may encounter events, conduct, etcetera, of a kind that the supervisory authority might think, “There may or may not be an issue of conduct there. We will

refer the case to the conduct regulator for its consideration.”?---Absolutely. Yes.  
Because - - -

5 Do you anticipate that being a general form of arrangement that is manageable and workable between you and ASIC?---The general answer is yes.

10 Do you think it requires a deal of refinement, or is it enough to leave it at that high level?---No, the only thing that we would want to make sure of is the way – there are some – and, again, I’m not the lawyer so I apologise, Commissioner – there are some - - -

15 Not many people apologise for that fact, Mr Byres. Go on?---There are – there are reasonably good provisions by which information can flow between APRA and ASIC and back again. Most of the time, because we have the supervisors, we’re more likely to spot something and hand it over there than perhaps the other way because they would not be in and around the institutions unless there’s already a problem, although they’re moving more towards our way of operating. There are issues about the way in which information that we gather using our powers can be used by ASIC under their powers and some issues around the way the secrecy provisions on information collected by APRA translate once handed to ASIC. I would imagine, though, that it’s not beyond the wit of the Parliamentary draftsman to find a way to make all of this work, to make the – the intent of the regime function as smoothly as possible.

25 Yes. Yes, Mr Hodge.

MR HODGE: Thank you, Commissioner.

30 Mr Byres, what I want to turn to now is to consider an issue or to consider enforcement from the perspective of APRA. One of the points that you make in your witness statement is that there is a difference between the nature of the promises made by, on the one hand, ADIs and insurance entities, and the nature of the promises made by superannuation entities?---Yes.

35 And the difference seems to come down to this, that the nature of the promise that is made by an ADI to depositors and by insurance entities to policyholders is fundamentally a promise with a prudential character. It is a promise that at a point in time in the future, the entity will have the financial capacity to pay a defined amount to either the depositor or the policyholder?---Correct.

40 Whereas in the case of superannuation, say, where we’re talking about defined benefit schemes which for the most part - - -?---There are - - -

45 - - - are on their way out?--- - - - less and less, yes.

Or exist less and less, it is a different promise. It is not a promise to pay a fixed amount of money at a point of time in the future, it is a promise to receive money and to manage it and deal with it in a particular way?---Correct.

5 And, in particular, to deal with it for the sole purpose or in accordance with the sole purpose test and also to deal with it in accordance with the covenants set out in section 52 of the SIS Act to act in the best interest of the members, to prioritise the interests of the members?---Yes.

10 And APRA under the SIS Act, although it shares responsibility for superannuation with ASIC, it's APRA that has responsibility for those sole purpose promises and also for the promises in – I think it's part 6 which is the section 52 promises?---Yes. Section 52, section 62, yes.

15 Yes. And because of the difference in the promises, when somebody breaches or fails to adhere to a superannuation promise, it looks much more like a conduct issue rather than a prudential issue. Do you agree?---It can.

20 And – in fact, what it looks particularly like is it's much more akin to the types of promises made by a responsible entity of a managed investment scheme in relation to the investors in that type of scheme?---Yes. I mean, I think there's two basic issues. There's a – what I might call the traditional prudential, is my money safe, is it appropriately accounted for, is there a custodian looking after the assets, is it safe. And then is it being managed in accordance with the covenants. Those are the two  
25 promises.

And that seems to create, particularly in relation to superannuation, a potential conundrum for APRA, which is that its prudential instincts and approach are not necessarily easily reconcilable with the approach that needs to be adopted for a  
30 conduct breach?---So you are right that it's not the clear-cut prudential issue, and that was recognised all the way back in Wallace, that, you know, there was a debate on the one hand. On the other it ended up saying largely because of the mandatory nature of superannuation, that a degree of prudential supervision was warranted, yes.

35 And the same issue – or the same type of conundrum seems to arise in relation to BEAR, where if you were to take action, particularly to take civil penalty action, against a bank, that's not easily reconcilable with the type of prudential approach that you might ordinarily be taking?---No, I think that's fair to say, and I think I say in my statement there can be tensions between the objectives.  
40

And where that seems to lead to is a question about whether if there are tensions between, on the one hand, being a good prudential regulator and on the other hand being a good conduct regulator, it would be better to make some shift so that you only need to be one or the other rather than being in that position of tension?---It's –  
45 that's a difficult one. We – in the issue – I – I – in I think our response to the interim report, or perhaps also in relation to round 5, we did acknowledge – and I think it's obvious – that the current regulatory framework in superannuation doesn't align

neatly with the twin peaks concept of the architecture in the broader regulatory system. If you like, ASIC has been carved out of some things which might normally be its natural territory. And APRA is tasked with doing some of those things. I'm just – I'm thinking about your question. I mean, we – and this maybe goes to the heart of your issue – we don't see ourselves as sometimes a prudential regulator and sometimes a conduct regulator. Our Act, our mandate, our name, the statement of expectations – everything that we have says we are a prudential regulator, but we do have these other things that take us into the conduct territory. But if we're going to be judged as to what we are, we're a prudential regulator.

I think you're right to say that takes us into the heart of the issue. But the issue is you are a prudential regulator that has then had some conduct regulation tacked on to what it is that you do?---Yes, but I think it's because these – as we talked about yesterday, it's not as simple as saying we can put prudential matters in this box and conduct issues in this box and say one box belongs to APRA and one box belongs to ASIC. There will inevitably be issues that have both prudential and conduct dimensions to them. And in the superannuation space, it has been said, well, APRA should take carriage of those.

Or it is the case that APRA is obliged to take carriage of those because of the way the legislation - - -?---Yes.

- - - is at the moment?---Yes.

But the question of whether APRA should be tasked with taking carriage of those is, obviously enough, a live question - - -?---Yes.

- - - given the things that we've looked at. And I take your point – or one of your points to be you can't actually draw or readily necessarily draw a bright line between here's the prudential bit of the SIS Act and here's the conduct bit of the SIS Act. That's right?---Yes.

And, therefore, trying to just say we will just shift these bits away from APRA over to ASIC may be problematic because they will include some prudential elements to them which APRA is best placed to dealing with?---Yes. I – I think that sort of simple saying, “Well, I will redirect this clause to somewhere else” – I think there are ways that you can re – if you wanted to rebalance, and that's the “if”, there are potentially ways that you could rebalance. Assuming you still took the view that was Wallace and the Cooper review and Murray which all included there needed to be some degree of prudential supervision of superannuation, then there are ways in which you could reassign the roles. But I think you have to sort of think through pretty carefully to make sure that it didn't jeopardise the core prudential task that APRA would still presumably be left with.

For example, one thing that might be done – and I'm interested to hear your view about – is that civil penalty consequences would be introduced for a breach of the covenants in section 52?---Yes, I think that proposal is currently - - -

That's right?--- - - - under consideration.

And the entity which would have responsibility for those civil penalty consequences or for bringing a civil penalty proceeding would be ASIC rather than  
5 APRA?---Sorry, you're proposing that - - -

I'm asking your view about that possibility?---I – I guess it's a possibility. It then becomes, I suspect, problematic for the industry who are saying, "Well, we are – unless" – you're saying you're going to carve the whole of section 62 and say ASIC  
10 is now responsible for that piece of the Act?

You don't necessarily need to do that, do you. You can have – it continue to be the case that you have responsibility and ASIC has responsibility for enforcing those provisions?---Yes. So you could say one option would be to say, well, APRA, you  
15 supervise to section 52, and if you find an infringement of some sort or another, in a mechanism I talked about with the Commissioner before, we find a way to hand that to ASIC as to prosecute.

And do you think that would fit more comfortably with your role as the prudential regulator and ASICs role as the conduct regulator?---At face value, it – it would be more attuned to the twin peaks model. My only reservation, as I think about it, is that one of the ways that the average prudential supervisor – sorry, none of our prudential supervisors are average, they're all very good – but one of the ways that the prudential supervisor gets action is by always having the ability to threaten that  
25 there could be a stronger sanction. So most of the time it's not needed. Most of the time it's not used. But a supervisor that's talking to, in this case a superannuation fund, is able to agitate and achieve change because there are some sanctions in the background. Now, if there was, by virtue of the fact that the supervisor was diminished in their ability to at least threaten sanction, that may actually diminish  
30 APRA's ability to achieve change without resorting to those sorts of things. I'm only posing it as a possible risk. I'm not saying it's the end of the world if that was the case.

It's unlikely to be a risk in relation to section 52 and civil penalties because at the moment there are no civil penalties available for a contravention of section  
35 52?---Yes. But I think all I – perhaps to put – to put the hypothetical scenario in a different case, so once the penalty is there, if a case could be put to ASIC in your scenario – so the supervisor may find something, they find has been done that's inappropriate, a breach – deemed to be a breach, we form a view that it is a breach,  
40 and it warrants sanction, at least in the current regime we have some resources to pursue that if we choose to pursue it. If we handed it to ASIC, there is a risk, of course, that they've got a myriad of other priorities and we might see it as a priority but they might not. All of this, though, I'm just talking hypotheticals here.

I understand. It also assumes – or the ability of a supervisor to rely upon the threat of bringing some proceeding assumes that it's a credible threat for a superannuation  
45 entity?---Yes.

And at least at the moment and without wanting to be too unkind about it, it's difficult to believe that any superannuation entity thinks there's a credible threat that APRA would ever launch any proceeding against them, don't you think?---Well, I think you – you know, I can see the changes that are made all the time by  
5 supervisors. So if they're not relying on that, then their charm and persuasion is very good.

Well, that – that might be right. Whatever it is that they're doing, they're very good at. They just don't need to be able to rely upon the threat of bringing some sort of  
10 enforcement proceeding to achieve what they're trying to achieve?---No. And most of the time that's not happening. Most of the time supervisors don't resort to those threats. But nonetheless, it's handy to have in the – in the background.

In terms of APRA's approach to enforcement, it appears that there was a realisation  
15 following round 5 of the Royal Commission that it was necessary to start – for APRA to start thinking about what its enforcement strategy was?---No. I would say we – I – in my – certainly for me, I've been thinking about this ever since the BEAR emerged, because it seemed to me that we were going to have – we had some  
20 significant new powers being handed to us and we had to think about whether we were equipped to utilise those powers. There's no doubt after the range of issues emerged in round 5 that that gave impetus to pushing that work along, and it was also – it also coincided with the arrival of Mr Lonsdale at APRA, who started in October and was tasked with taking charge of, amongst other things, BEAR and enforcement.

Well, just in terms of the proposition that you've been thinking about it since you  
25 took over BEAR. Between then December of 2017 and July of 2018, what was the work that was being done about enforcement?---Well, I think the work that was being done was devoted to are we getting a process – do we have a process that would allow us, if we needed to make decisions about BEAR, do we have a decision  
30 process in place. Are we clear about how we would escalate an issue in the organisation, who would make decisions under BEAR. So that was where the time and attention was devoted. But from my perspective, I've, for my sins, been around APRA for a long time, and I can remember when we had the disqualification power that BEAR reintroduced to APRA. And we tried to undertake a number of  
35 disqualifications, and – and for various reasons they were overturned at the AAT. And so it seemed to me – and then the – the power was changed shortly after that. So it seemed to me that it was going to be important that as we thought about how we use the power again in the future that we didn't fall into just saying, well, we used to do it this way and we will do it that way again because actually that way didn't  
40 seem to work that well.

I will just make sure we've understood the points you're making. The power that  
45 you used to have for a relatively brief period of time, I think, perhaps two or three years was to be able to administratively disqualify a person. Is that right?---I think we had it longer than that.

For longer than that?---I think we had it essentially for – it was there – I’m happy to be corrected but my recollection is we had it for a longer period of time than that. But around 2007 – ’06, ’07 it was changed so that we couldn’t do it administratively

5

---  
You had to go to court?--- - - - and that we would have to apply to the Federal Court.

And then you stopped doing it, that is, you didn’t apply to the court?---I’m not sure I – I don’t think we’ve applied, no.

10

And the issue when you had been administratively disqualifying some people was that then they would apply for a review of your decision to the AAT and the AAT would set aside your decision?---Yes. Not – there were a number of those decisions that were set aside, including directors of HIH Insurance, which were set aside, yes.

15

And your point, I think if I’m understanding it, is a relatively narrow one, which is to say when it used to be the case that we could administratively disqualify somebody we obviously didn’t do it quite as well as we might have because we had - - -?---No, it was – we were – we were – we were subject to some criticism about the way we had run a number of those cases.

20

Yes?---And – and I – you know, in my mind I have no doubt that’s why the law was changed to change the way it works because we were deemed not to have exercised that authority - - -

25

Properly?--- - - - properly. And so 10 years on, as it was given back to us, it was going to be really careful – really important that we were careful not to eventually end up, when we utilised it, in the same spot again.

30

So that was what you were looking at in the first half of this year?---Yes. So the – the key – the thing that I tasked the BEAR team and the enforcement people was just to say, “Look, if on 2 July something emerges and we need to respond to it, what will our process be? How are we going to make the decisions? Who is going to make them? What will be the process by which we do that?” So that was where the prioritisation was, to try and just make sure we had, for want of a better term, an interim framework, but it – it’s the framework as it currently stands till it’s changed. We had a framework in place that meant if we had a case emerge that said an accountable person has breached their obligations, that we would know how we would manage that in APRA. But that is, as it currently is, sort of standalone to what our normal enforcement process might be. And at some point you want to put all of this together into a more complete package, or a complete framework for the organisation.

35

40

45

And so isn’t what happened that round 5 of the Royal Commission occurred and then after that there was a discussion of the executive committee about what needed to be done about enforcement strategy?---So what we said – so there are a few things after round 5. We had, obviously, to make submissions. So we had to be clear about what

we were going to say in those submissions. And, as I said, the key trigger point for – so it had been in my mind that we would have to do this. We currently had a sort of a – we were sitting with a BEAR process and another enforcement process within APRA. We were getting a new member in who was going to have oversight for all of these things, and a fresh set of eyes to look at what the future strategy should be. And what I would say is round 5 triggered a discussion that I had with Mr Lonsdale to say, “This has to be your day one priority.”

I see. Well, what – maybe if I show you a note of the ExCo discussion. Can we bring up APRA.0037.0001.0004. So this is a document that was produced to us. The metadata says that the date of this is 28 August 2018. So after round 5 and presumably when you were preparing some submissions, but also, more generally, considering what your response was going to be to round 5?---Yes. I wrote that document.

You wrote the document?---I wrote it.

So then you see there’s a heading at the top which is:

*Feedback to Royal Commission After Round 5: need some top down direction on some issues.*

?---Yes.

And what did that mean?---So we had a team of people who were tasked with putting together the submissions in response to round 5. Both the individual case studies and the – the policy questions that came out of round 5. And what we were trying to do was give some top down direction to that team. Okay, here are the key issues – and this was, you know, my list of issues that I just sort of stream of consciousness sat down and wrote them all out – and these are the issues that we – you know, as the ExCo, are we all clear because there’s no point having a team just go away and start doing some drafting and then I have a view, Mr Summerhayes has a view, Mrs Rowell has a different view. We needed to give the team A clear direction upfront on a range of these issues.

Then we see on Enforcement, the issues that you had identified. The first one was:

*What is enforcement strategy and why is it appropriate?*

?---Yes.

And did APRA have an enforcement strategy at that time?---I don’t know that we’ve got a document that says, “This is a strategy document.” There’s an enforcement documentation that talks about how we do things, yes.

And then the second question that you posed was:

*Could/should/will enforcement strategy be reviewed?*

?---Yes.

5 So at that stage you hadn't made the decision to review your enforcement strategy?---I think that was more – no, I think we had, because we – I had, well before this, spoken to Mr Lonsdale about this would be one of his tasks on starting at APRA.

10 Would be reviewing the enforcement strategy?---Yes. Looking at it in the context of we have these new responsibilities under BEAR. We're going to have to think about how we apply them. That will have implications, I think, for supervision and enforcement more generally and so, yes.

15 Why do you think you would have tried to get the other members of the board on – to agree that one of the issues you would need to consider is could/should/will enforcement strategy be reviewed if, in fact, you had already decided to review the enforcement strategy?---So this, just to be clear, the – the reference to ExCo is the board and the six executive general managers. So it's the group of the top 10. Sorry,  
20 what was your question again?

Why would you have been getting ExCo to all agree that one of the issues you needed to consider was could/should/will enforcement strategy be reviewed if you had already decided to review the enforcement strategy?---Well, I think it was just –  
25 as I said, it was a stream of consciousness of issues that we needed to think about and what were we going to say in the submissions.

The issue you needed to consider was could/should/will enforcement strategy be reviewed?---Yes.

30

But you had already decided to review the enforcement strategy?---Yes. So it probably could have just said how will, but that's - - -

I see. I tender that document, Commissioner.

35

THE COMMISSIONER: Note of ExCo discussion by Mr Byres, 28.8.18 APRA.0037.0001.0004, exhibit 7.153.

40 **EXHIBIT #7.153 NOTE OF EXCO DISCUSSION BY MR BYRES DATED 28/8/2018 (APRA.0037.0001.0004)**

45 MR HODGE: Was reviewing the enforcement strategy part of – or is it part of the enforcement review?---It's the same thing.

I see. So, again, perhaps just thinking about this, what you said in your statement was:

5 *In the period immediately after the round 5 hearings the members discussed during their regular engagement the need to prioritise an enforcement review.*

?---Yes.

10 And it was agreed that Mr Lonsdale should make this his priority on his commencement?---Yes.

15 Again, it seems as if you decided to do this after the round 5 hearings?---What I'm trying to convey there is we decided that instead of it just being one of many things that John would start on as he arrived, it had to be his priority. And - - -

I see?--- - - - as I said, I have had a subsequent discussion with him and we had a discussion on his first day at APRA to say this – “of all the things that we've given you to look at, this is your number one priority.” So we were increasing the, if you like, urgency given to the task.

20 I see. And then I will bring up another document which is APRA.0037.0001.0025. So this is a document titled What Is APRAs Enforcement Strategy and Why Is It Appropriate?---Yes.

25 Have you seen this document before?---I think I saw it for the first time last night.

I see. The metadata that we have from APRA for this document says it's dated 18 October 2018. Does that sound right to you?---I have – I have to say, as I said, I have never seen the document until last night. And I'm not sure on the basis on which it was prepared.

35 I see. You don't know whether this is actually APRAs enforcement strategy or not?---Look, as I read through it last night, I thought it was a reasonable articulation, but it's not a, for want of a better term, it's not a board-approved document or a board-approved articulation of strategy. But - - -

40 Does it seem problematic to you that APRA, given its conduct role in relation to superannuation, would not have a board-approved enforcement strategy?---As I said, I think the – the general approach to enforcement is probably articulated within the enforcement manual in various ways. But having – I can take your point. Having a single page that articulates strategy would probably be useful.

45 You've – you were asked some questions in your statement about NULIS, the NAB trustee, and the potential breach of section 52(2)(c) - - -?---Yes.

- - - of the SIS Act?---Yes.

And I'm interested – and we will return to this in a moment – but do you have a view as to whether deducting fees from members' accounts where it's not authorised and no service has been provided is dishonest conduct?---I guess it depends on how that came about, but in the layman sense of the word, potentially it could be, yes.

5

Is this – when you say “how it came about”, there's an issue about it – I think you suggest it was an IT issue?---So if – if it was, you know, deliberately done with intent, then yes, I would say that's dishonest. If it was a processing error that occurred despite all efforts to the contrary to prevent those sorts of things happening, then I'm – I probably wouldn't use the word “dishonest”.

10

I see. I tender that document, Commissioner.

THE COMMISSIONER: What do I describe it as, Mr Hodge?

15

MR HODGE: Well, a document titled – APRA document titled What is APRA's Enforcement Strategy and Why Is It Appropriate. I just wanted to check the basis on which it was produced to us.

20 THE COMMISSIONER: I had thought of draft enforcement strategy, but - - -

MR HODGE: I wouldn't cavil with that, Commissioner.

25 THE COMMISSIONER: I was looking across more at Mr Byres rather than you?---Look, that's fine. I'm thinking if it was produced in late October, you said?

MR HODGE: Yes, it's – the metadata says it was from mid-October?---It was probably a document that was being produced in the context of the enforcement review that Mr Lonsdale initiated. So - - -

30

THE COMMISSIONER: APRA draft enforcement strategy APRA.0037.0001.0025, exhibit 7.154.

35 **EXHIBIT #7.154 APRA DRAFT ENFORCEMENT STRATEGY  
(APRA.0037.0001.0025)**

40 MR HODGE: Now, Mr Lonsdale assumed his position in October of this year?---Yes. I think it was the 8<sup>th</sup>.

And you said one of his areas of responsibility was to be – to consider enforcement by APRA?---Yes.

45 Mr Lonsdale was appointed for his policy expertise, having worked as a deputy secretary at Treasury?---I think John has a broad range of skills and experience. So I

don't know the specific reason, but, yes, that would be one of the reasons, his policy expertise.

5 And in conducting the enforcement review, he's going to be supported by a secretariat?---Yes.

And there's also going to be an external advisory panel?---Yes.

10 And the panel is to be – the external panel is to be comprised by the former New South Wales Supreme Court Judge Robert Austin?---Yes.

The ACCC Commissioner Sarah Court?---Yes.

15 And Professor Dimity Kingsford Smith?---Yes.

Now, undoubtedly, they all have – they are all preeminent Australians with leading expertise in relation to this. Is there a reason, though, why you wouldn't have an external panel conducting the review rather than it being done internally?---No. Nothing other than we thought this was the most efficient and effective way to do it.  
20 And we needed to – we need to make sure that whatever comes out of this fits with and meshes with our supervision approach. The two things have to be – there has to be a continuous spectrum, if you like, and – so we wanted to bring together within the group that is working on it a mix of lawyers, there are some supervisors, people from our enforcement area, litigation. So a group of people designed to think about  
25 enforcement within APRA. And we thought that was best done by our internal team with lots of disciplines within the group, and some external people to provide some, you know, outside perspectives. Obviously, Bob Austin, who – prominent in the legal profession, Sarah Court from the ACCC, who is – heads up their enforcement function in the ACCC, so a regulatory enforcer. And Professor Kingsford Smith who  
30 has done a lot of thinking about regulation and – and how things work.

There's – and I don't suggest in any way that these people are not extremely well qualified and at the top of what they do. But they're not the ones who are doing the review?---No, they're not the ones doing the review, but in – they will, in a sense, be  
35 challenging what's coming out of the – the team and the process. So the whole point of them is to give us feedback.

Their positions are unpaid positions?---Other than, perhaps, some incidental expenses but, yes, they are doing it voluntarily.  
40

The commitment that they've been asked to make is up to – to attend up to three meetings?---Yes.

45 In Sydney?---Yes.

The substantive work for the review is to be undertaken by the secretariat?---Yes.

The – under the project plan for the review, the external panel won't receive a copy of the draft report?---I'm sure they would.

5 Well, I will bring that up. If we bring up APRA.0071.0001.0003. So this is the project plan for the - - -?---Yes.

- - - conduct of the review. And you see the key milestones?---Yes.

10 So there's to be the initial meeting of the external panel in week 4?---Yes.

And then the first iteration of the draft report is to go to Mr Lonsdale in week 6?---Sorry, week 6, yes.

15 And then there's to be two more meetings of the external panel?---Yes.

And the second iteration of the draft report is to go to Mr Lonsdale in week 15?---Yes.

20 And the draft report and recommendations is to go to the members, which is you - - -?---Yes.

- - - and Mr Summerhayes?---Mrs Rowell and Mr Lonsdale himself, yes.

25 Yes. And then the final report is to go to you?---To the four of us, yes, again.

Yes?---Yes.

30 And then there's – if we scroll down the page we can see there's a process timeline?---Yes.

And on its face, there's not provision for the external panel to be provided with and review the draft report, but you're saying that's not intentional?---Well, I think if you – sorry, could you go back to the top of the page - - -

35 Yes?--- - - - please. I mean, I think the – the reason the panel – external panel members' meetings are scheduled as they are in week 11 and week 16 is so that they would be having the opportunity to shape the draft reports before – the draft recommendations and there would be discussion about the proposals at those meetings, particularly the second and third one, before the draft recommendations are  
40 – are finished at the end of February.

45 I see. That's your intention for what will happen with the report?---So just – just to be clear, that's the way I read that plan. And I – I think that's – I'm absolutely sure Mr Lonsdale would be wanting their input on the recommendations as things are developing. And I'm sure, actually, those three individuals would be wanting to know what's happening. They've lent their names to this exercise. They would want to be informed of how it's shaping up.

Will their response to the report be published?---I don't think it's envisaged that they would produce a response to the report. I think they're an advisory panel. My understanding, without going through and looking through all the working papers in detail, is they're not actually producing a report. They're providing advice, they're  
5 looking at the draft material, they're providing feedback and comment. They're a sounding board. But ultimately, you know, we have to own this.

The challenge with that seems to be that, ultimately, it's a report being done internally, albeit with the – at least the ability to meet three times with an external  
10 panel, to review your approach to enforcement?---Yes.

As distinct from getting an external view, a truly external view and report on your enforcement approach?---Yes. So that – that is true.

15 And, for example, with the ASIC capability review, that was done by three external people?---Yes.

And with the APRA prudential inquiry, that was led by three external people then supported by APRA team?---Yes.

20 Why not, when you have three potentially available to you – they may not be able to make the time commitment necessary for them to do the review – but if you potentially have three of the leading experts on areas fundamental to how you go about conducting enforcement available to you, why not have them review  
25 you?---Well, those three experts, I – I think the first – the first issue is they are not available to us full-time. Obviously, Sarah is a Commissioner of another agency. She has a full-time job. We've been very lucky that Mr Sims, as chair, has allowed her to participate in this exercise. Dimity Kingsford Smith has teaching and other obligations she has to fulfil. Professor Austin has his obligations. So why not those  
30 three. Well, shortly – simply because they're not available. We want this job done – I mean, it's a big task. We want to take it very seriously. Dare I say it, the proof in the pudding will be that we have committed to publish the results. So we're not trying to do something in-house and then say to everyone else, "Don't worry, we're – we've – we've done a review and we will do something different in future." We've  
35 said we've published the terms of reference. Very clear of what they are, what we're looking at, the questions we're asking, and we've committed, even though we don't know what the answer is going to be yet, we've committed to publish the results at the end. So people will judge us then on the basis of what's the product.

40 Do you have any inherent objection to opening APRA up to external scrutiny, to have an external capability and enforcement review done?---No. We've said many – we've been asked this many times, do we have a fundamental objection to a capability review. The answer is no. The government, after the FSI inquiry, the government decided it would do a capability review of ASIC first. It did that. The  
45 only thing we have said is that because in the last 18 months we've been subject to a number of reviews, including, in particular, a recently completed review that was very extensive by the IMF, that there was simply an organisational capacity that we

didn't want multiple reviews all happening at the same time. That's the only thing we asked for, not to have multiple reviews happening on top of one another.

5 Now, you have both your IMF review and your own enforcement review - - -?---The IMF review is done. It's finished.

10 So now there's no obstacle to having external reviews?---No, and we've said publicly – I've been asked this question when I've made Parliamentary appearances and I've said we have no objection - - -

Don't tell us about that?---I've said publicly. We have no objections.

Is that a convenient time, Commissioner.

15 THE COMMISSIONER: Yes. If I come back at, what, sort of quarter to midday, Mr Hodge?

MR HODGE: Yes, thank you, Commissioner.

20 THE COMMISSIONER: We will just take a break, Mr Byres.

**ADJOURNED**

**[11.40 am]**

25

**RESUMED**

**[11.46 am]**

30 THE COMMISSIONER: Yes, Mr Hodge.

MR HODGE: Thank you, Commissioner.

35 Mr Byres, what I want to turn to now, then, is superannuation, and to consider superannuation and the way in which APRA has dealt with some problems in relation to superannuation. In 2016, the Australian National Audit Office completed its independent performance audit in relation to APRA and superannuation entities?---Yes.

40 And you're familiar with that report?---Yes.

Could we bring that up. That's RCD.0014.0063.0512. And if we go to page .0518. We see the objective of the audit was to assess the effectiveness of APRAs processes for the prudential regulation of superannuation entities?---Yes.

45 And the audit identified quite a number of problems with APRAs processes for the supervision of superannuation entities?---I think it had four recommendations and a few suggestions, yes.

Well, if we go over to page .0519, we see the last two sentences of paragraph 5:

5 *In recent years, similar superannuation entities have received varying levels of supervision and higher risk entities have not consistently been subject to more intense supervision.*

And then it goes on to say:

10 *Further, many of the activities reviewed by the ANAO were late and not recorded in the issues and document management systems and APRA has limited external reporting of its supervision of the superannuation industry.*

?---Yes.

15 And then if we go over the page to page .0521. Paragraph 15 we see:

20 *APRA does not have a quality assurance framework. It does not undertake independent reviews of supervisors' work such as financial and qualitative analysis of interactions with entities.*

?---Yes.

And in 16:

25 *There is limited oversight by APRAs executive of the implementation of supervision activities and APRA can better specify its key performance indicators to measure the timeliness, quality and implementation of superannuation activities.*

30 ?---Yes.

And then there were four recommendations that were made - - -?---Yes.

- - - which we see that APRA agreed with all of them?---Yes.

35

And then if we go over the page to page .0542. This is about APRAs review of the appropriateness of prudential standards, reporting standards and prudential practice guides, in relation to super is what the ANAO was concerned with?---Yes. Yes.

40 And we see in the grey box at the top, the second sentence:

45 *However, APRA has not yet established a review program or scheduled a point-in-time review of the effectiveness and appropriateness of its suite of standards and prudential practice guides since their implementation in 2013.*

?---Yes.

Continuing :

5           *The timeframe for undertaking such a review is approaching given that APRA specified that they would be reviewed three to four years after their implementation.*

?---Yes.

10           And has that review now occurred?---It's currently underway.

I see. And then if we go over the page to page .0557. This is explaining or dealing with how APRA goes about identifying and dealing with industry-wide superannuation risks?---Yes.

15           And if we look at paragraph 4.11, we see:

20           *The ANAOs analysis found that risks were listed on the register for periods between three and 15 months before scoping papers were provided to the Superannuation Industry Group for approval. In three of the four papers, activities had been initiated in response to the risk prior to the approval of the scoping paper. None of the papers identified delivery dates and responsible officers for all activities. Without clear strategies and plans for managing heightened industry risks that identify outcomes, delivery dates and responsible officers, it is possible that relevant actions are not undertaken to address risks and that APRA is unable to assess its progress in managing risks.*

25

?---Yes.

30           And has this issue of how APRA will go about dealing with scoping studies for industry-wide risks been addressed now?---Yes.

35           And how has it been addressed?---So – so we have a general process by which – what we call heightened industry risks are identified and managed through the – the industry groups. We also – probably the previous financial year, so maybe 18 months ago – developed for each of the industries that we supervise, what we termed an industry strategy, and designed to identify what would be the priorities for the industry over a 12 month and a four-year time horizon, designed to give more structure to this very issue.

40           I see. One of the other issues that the Audit Office identified was the failing to record actions in AIMS?---Yes. Yes.

45           And AIMS is the centralised record keeping system that APRA was using?---It was – it was a – AIMS stands for activities and issues management system. Yes.

And APRA is still using that system?---No.

What's the system that it has switched to now?---It's now called Q. Just the letter Q.

5 And one of the problems that the ANAO identified, if we go to page .0567, was that when they – and we can see this most clearly in table 5.2 – when they looked at the extent to which actions arising from prudential reviews of superannuation trustees in the period 1 July 2013 to 24 March 2016, had been recorded in AIMS - - -?---Yes.

- - - that had happened to an extraordinarily limited extent?---Yes.

10 And that was contrary to what was supposed to occur?---Yes and no. So AIMS was a system that had been developed back in 2003, I think. It was a very old clunky system that supervisors absolutely detested using because it was very unfriendly, it was unhelpful. They found they put a lot of information in and they found it very hard to get information out. And so formally it was still there and it was available to  
15 be used, and so when I said yes to your question, it was officially the system, we hadn't yet developed the replacement system. But the "no" bit was that management was tolerant of people using spreadsheet or other systems because AIMS was so unhelpful in being able to extract information.

20 I see. One of the things that the ANAO also did was to then conduct an electronic file review of 50 trustee files. I can bring that up on page 0568?---I believe you.

And that included, we see in paragraph 5.8, an examination of 117 prudential reviews that were recorded in Q for the period 1 July - - -?---Yes.

25

- - - 2013 to 24 March 2016?---Yes.

And we see then in paragraph 5.10:

30 *For 30 reviews there was no documentation on the relevant trustee files indicating that the reviews had not been completed or that the documentation had not been filed electronically.*

?---Yes, that's what it says, yes.

35

I think what then happened was APRA then after that went and interrogated its hardcopy files and found that they could find the reviews recorded somewhere?---We were – so in that point in time that review was conducted, we were in the process of, but had not yet rolled out a proper electronic document management system. So the  
40 official records of APRA were hardcopy records. But for a range of pragmatic reasons, the – it was agreed with the ANAO that they would conduct their review of the electronic files. The official records of APRA, though, were still hardcopy records. We've now developed, in response to the recommendation they gave us, we've now got a electronic document management system and moved from hardcopy  
45 to digital.

Then we see in paragraph 5.11 that the ANAO also reviewed 492 quarterly risk reviews with completed status. Do you see that?---Yes.

And identified that 46 had in fact not been completed?---Yes.

5

And 183 reviews had either been – and we see the first bullet point:

*Completed late and as part of a cluster.*

10 Or the second bullet point over the page:

*Copied from previously completed quarterly risk reviews with no change.*

?---Yes.

15

And over the page as well we see in paragraph 5.12:

*The worse instance of clustering was seven reviews being completed on the same day for an entity with an oversight SOARS stance indicating that this entity had not had quarterly risk reviews completed for almost two years.*

20

?---Yes.

Now, there were two other issues identified by the ANAO that I want to particularly draw your attention to. One, if we go to page .0572 is in paragraph 5.25, the issue we've already spoken about, which is:

25

*APRA does not have a quality assurance framework for its supervision activities.*

30

?---Yes.

And then if we go to page .0574, and we see in paragraph 5.36 there's an issue raised by the ANAO about APRAs external reporting. And in particular it says:

35

*APRAs performance results are reported at an aggregate level across all of the industries that APRA supervises and provide little insight into the effectiveness of APRAs supervision efforts within individual industries including superannuation.*

40

?---Yes.

When you think about those issues to which I've drawn your attention, are they issues that were solely or are they solely within the superannuation area, or do you think they were more general issues across APRA?---Sorry, that whole collection of issues - - -

45

Yes?--- - - - we've talked about? No, because our supervision process is broadly the same. So AIMS was a problem for all supervisors, regardless of entity. The performance reporting, the one that you have on the screen now – I mean, that was aggregate. It wasn't just that there wasn't broken into superannuation, it wasn't  
5 broken into any of the other industries. The quarterly performance – quarterly reporting process, that was an issue across a number of industries, and we've reworked that process because, quite often for many institutions, the actual quarterly reporting doesn't produce much that is news. So we've streamlined the way we do that, rather than expecting everyone to do everything each quarter. And on the  
10 quality assurance one, so, again, that's a general framework one. I think in our response to the report we said we don't quite agree with the finding. We don't think – we think there are a number of mechanisms in the supervision process designed to – as quality controls but we also acknowledged that – and we had already instituted before this report – to build a proper line 2 risk management and quality assurance  
15 function in APRA, in the same way that we would expect in an entity that we supervise.

Is that to build, in particular, a quality management framework?---Yes. So quality assurance. What we've tried to do, the language we're now using in APRA, quality  
20 control is done, for want of a better term, in line 1, in the business. And quality assurance is provided by line 2, and then ultimately audit assurance by line 3. So we're trying to model the so-called three lines of defence model that we see in the organisations that we're supervising.

The quality management framework was originally scheduled to be implemented by  
25 December of 2017?---A framework, yes. But I think we've continued to evolve it since then. So I would still call it a work in progress, because we – we implemented something. It worked – it did some good things. But on reflection, we want to continue to evolve it, yes.

30 Your internal audit function looked at your quality management framework and reported to the board I think in October of this year?---A couple of months ago, yes.

I'm sorry, I said the board. I think it was the supervision and resolution  
35 committee?---Yes, but ultimately all the audit reports are noted by the board - - -

Yes?--- - - - at least. So it would have come to the board at some point.

40 And the audit report noted that:

*The implementation of a quality management framework has not been adequately prioritised and has been impacted by a lack of clarity and direction and purpose.*

45 ?---I don't have it in front of me but I – that sounds broadly like the conclusion, yes.

I can bring that up. That's APRA.0032.0001.0646 at .0670. If you look about halfway down the page, the second bullet point you see:

5           *The implementation of a quality management framework and agreed action arising from an ANAO audit and a strategic initiative deliverable, has not been adequately prioritised and has been impacted by a lack of clarity in direction and purpose.*

?---Yes.

10

And do you have a view as to why it is that that happened, that there was an inadequate prioritisation of the quality management framework and a lack of clarity in direction – in direction and purpose?---So the – the prioritisation issue is simply a factor of competing priorities and resources. And the fact that we had some changes in leadership in that area during the period. And I think the issue around lack of clarity in direction and purpose is (1) we've struggled with a bit because what we've had in APRA – and we've tried to continue to adhere to is – I won't say it's the BEAR regime but we've tried to be very clear that accountability for supervisory outcomes is with the supervisor. And there has been this question of how does the challenge process work. So if the line 2 people challenge the line 1 people about a review or an assessment or a conclusion that's reached, ultimately, what's the process by which the outcome, either a change of view or not, is determined. Because ultimately, we still want the supervisor to own the conclusions, and we don't want to have a situation where a supervisor says, "Well, I'm responsible for supervising this entity but everyone else is telling me what to do and I don't agree with it." So we've – we've grappled with how to get those accountabilities right and an appropriate level of challenge, but then maintaining an ownership of the issue in line 1.

30

And that issue of how things get challenged and consistency of approach to supervision, those are issues that were also raised by the ANAO?---Yes. It's a constant challenge.

35

Did you find it helpful to have the ANAO go through and identify all of these issues in relation to your approach to supervision?---In some cases it brought clarity to the issue, but if I look at the areas where they made a recommendation, the one they talked about of recommendation 1 was about consistency. We looked at those. We didn't necessarily agree with all the conclusions. But we did sharpen up some of our documentation, so that was helpful. The issue around AIMS and electronic record-keeping, we had projects in train to build those systems, so it was easy to agree we should do something because we were doing it. We did – the quality assurance function. Again, we built – we had appointed a CRO and started on that work in 2015. So it supported work that we were doing, and the fourth one about reporting, yes, fair comment. And the challenge for a prudential regulator is what are actually the good metrics to publish on those issues. So it provided useful checks. It provided, for me as the chair, some interesting independent insights and analysis,

45

some of which I was aware of, some of which identified where we had more work to do.

I tender that document, Commissioner.

5

THE COMMISSIONER: The ANAO report as well or what?

MR HODGE: That's a public document, Commissioner. I - - -

10 THE COMMISSIONER: Right. Supervision and resolution committee, 2 October '18, Internal Audit: Supervision Quality Controls and Quality Assurance, APRA.0032.0001.0646 becomes exhibit 7.155.

15 **EXHIBIT #7.155 SUPERVISION AND RESOLUTION COMMITTEE, DATED 02/10/2018, INTERNAL AUDIT: SUPERVISION QUALITY CONTROLS AND QUALITY ASSURANCE (APRA.0032.0001.0646)**

20 MR HODGE: As you know, there were a number of issues that were raised during round 5 about superannuation and how it is that APRA had responded to some of those issues?---Mmm.

25 And you were asked some questions about some specific issues that had been – that came out of round 5 - - -?---Yes.

- - - to address in your witness statement?---Yes.

30 And I want to just ask you about some of those. The first one is concerned with NULIS and fees for no service?---Yes.

Now, we understand APRA has now received notice of fees for no service issues across more than 10 RSE licensees?---I don't know the answer to that but it wouldn't surprise me if that was right. Yes.

35

Do you have a view now as to whether fees for no service is a systemic issue within the RSE licensees that you regulate?---Well, I think the – the evidence that has already been produced through the ASIC reports indicate it's a – it's a widespread and significant problem, yes.

40

Do you have any view as to what the extent of the problem tells you about the adequacy of APRA's supervision of RSE licensees?---It – it says that there are limits to supervision, I think, and that we are not down looking at transactions. We don't audit accounts. To some extent, we are dependent on institutions bringing issues to our attention when we're talking about those sorts of matters of detail.

45

What do you think it says about the culture of an organisation – of a financial services entity that it would have significant instances of fees being charged for no service?---It's a – sorry, it was what – what does that imply about the culture? Was that your question, sorry?

5

Yes. Yes?---Clearly, an insufficient attention to detail, clearly insufficient attention to compliance.

You know that the remediation of fees for no service has taken a very long time for some entities?---Yes.

10

Do you have a view about what that tells you about the culture of those organisations?---Well, I think it tells you that they have, at the heart of it, been slow to identify the issues. Possibly not been sufficiently alert to the potential for small issues to become broader systemic issues. It – one of the reasons it's taking so long is because of a problem with basic record-keeping. So I think I'm coming back to these issues of inattention to – to detail, paying attention to compliance.

15

And - - -

20

THE COMMISSIONER: Can I just test that a moment, Mr Byres. The notion of inattention to detail. Money would come in to the entity as amounts that had been deducted for payment of fees?---Yes.

Money would go out in payment of fees?---Yes.

25

There would be a difference?---There would be, yes.

Not a small difference?---It has turned out to be a very large difference.

30

Well, it turned out to be, and it was a large difference at the time. Now, is it inattention to detail not to notice that money in, money out are different to the extent that we're talking about here?---I don't pretend to know the intricacies of the accounting system but there would be money coming in – sorry, money taken out of accounts going into some sort of holding account within the general ledger, money would go out. There would be a residual sitting in that general ledger. Periodically that would be cleared out.

35

Cleared out where?---Well, cleared out to an institution, yes.

40

General resources of the institution?---Yes.

Yes?---So the question is, really, at what point did that become a sufficiently material number that it should have alerted people, auditors, etcetera, that that number was – or that – actually, that balance shouldn't have been there in the first place.

45

Well, we're now talking of hundreds of millions in remediation?---Yes, if not more.

MR HODGE: Just for one entity.

THE COMMISSIONER: Per entity.

5 MR HODGE: Yes, that's right.

THE COMMISSIONER: Yes.

10 MR HODGE: Does it tell you – and when you think about it, does it tell you anything at all about the effectiveness of the job that APRA did?---Yes. We've – I mean, I've thought about this – and I think there's a broader lesson from fees for no service, from some of the issues that we didn't go deep enough on and subsequently had to be revealed by the panel on the Commonwealth Bank, in the work that we've done on mortgages, that we have – and this is simplifying, but in all those cases, I  
15 think there's a sense that we have looked at robustness of frameworks, we've looked at policy documents, we've looked at procedures, and we've relied on audit and compliance functions to do the detailed testing, both internal and external. And – and conceptually, that if you have a good set of frameworks and policies and you – your audit and compliance function are doing their job to make sure that exceptions  
20 to those are being picked up, then actually things should broadly work as intended. But – so my general lesson, which applies to fees for no service but I think also applies to some of those other issues I have talked about is we have to think more about how do we get deeper, potentially doing more transaction testing or other things, or asking other people to do it on our behalf that would help us more readily  
25 identify these issues earlier.

So can I offer you an example and see if this is the type of thing that you're talking about. One of the issues that was explored during round 5, and has been referred to earlier this week, are the AMP Super trustees. I don't know to what extent you're  
30 familiar with that example, but - - ?---Not with the specific example but with the general issues, yes.

And what had happened in relation to the AMP trustees was that they have a particular framework in place which they call the business monitoring model?---Yes,  
35 I've – I'm aware of that, yes.

And APRA undertook a review of the business monitoring model in early 2017?---Yes, I think so. Yes.

40 And APRA characterised the BMM as robust?---Yes.

And then if we jump forward to about October of this year after round 5 APRA was having discussions with the AMP trustees and discovered that the AMP Super board had not sought the reasoning for a proposed timetable for MySuper fee reductions,  
45 and there was a nine month gap. And APRA said to AMP Super that it expected that they would question the appropriateness of this gap and satisfy itself that this timeframe was in its members' best interests. And I wonder, is that the type of thing

you're getting at which is, on the one hand, last year you were looking at the processes and the documents and saying, "This is a robust framework." But then on the other hand, then it comes to this year and after round 5 and you're looking at an actual outcome of the application of those processes and identifying that the outcome is deficient?---That's -- that's an example of what I'm talking about. I mean, I think for a -- I would guess, for AMP Super we might have the equivalent of one FTE devoted to AMP Super. There's a limit to what that person -- or equivalent of one person can do. And -- and so the focus tends to be on are the framework's policies looking robust. And in this particular case I think what we saw in the evidence in round 5 and subsequent discussions as a result of that was that the application of the framework was not as one would expect it to be. And I think that -- sorry, that's the same issue, if I turn to CBA, there were lots of issues where the frameworks and policies looked good, but the audit and compliance functions weren't necessarily alerting or raising issues up. And in mortgages, there are many fine mortgage lending policies out there but they weren't necessarily all being followed when people were making lending decisions. So it's an example of that general issue that we will have to think harder about how to respond to.

And what I'm interested then in understanding is APRA often refers to its approach as being risk-based and outcomes focused. And outcomes focused can sound like it's concerned with what is the ultimate actual outcome within the entity in the decisions that it makes. But I think what you are saying is it has traditionally meant something different. It has meant outcomes in terms of what are the processes that the entities have in place. Do they accord with the standards?---Yes. And that the -- the process, framework, policy, whatever it is, looks robust and -- when we think about outcomes focused, it's -- maybe the way I would describe it is trying to describe the way -- or the good attributes of running the business without telling the organisation exactly how to run its business. And so you should have a robust governance framework, you should have a robust risk management framework, you should have a strong audit function. But without prescribing for any individual organisation what the way to achieve those things are.

I think, though, you're agreeing that - - -?---I am agreeing I think.

- - - what's necessary then to do is to then step beyond saying we won't prescribe what the particular system is that you have, but we will now start trying to test what the outcomes of that system have been?---Yes. And that -- as I said, that has been a lesson for us across a range of dimensions, not just the issues that have appeared at this Commission. The challenge is always doing it with -- you know, with -- as every regulator has, finite resources. You can't be everywhere. You can't look at everything. You've got to try and identify with any organisation what are the highest areas of risks and the ones you're going to target, but potentially, thinking about how to go deeper into some of those issues.

If we go back to fees for no service, and we bring up your witness statement and go to paragraph 89 -- I'm sorry, page 89 paragraph 353. You express the view that:

*The initial breach report in December 2014 identified what appeared to be an operational/administrative error involving poor IT system functionality.*

5 Have you – just out of curiosity, have you actually reviewed the breach notice yourself and formed that view or is that based on something you’ve been told?---So I had – I had looked at the breach notice but then I went and spoke to one of the supervisors who was in that team at the time, just to talk about reflections and reactions that they had when they received that, so - - -

10 If we just bring up the breach notice which is NAB.005.070.0055. This is the notice that’s given by MLC Nominees to APRA in respect of the Universal Super scheme. And then if we go over to page 2 – I’m sorry, page 3. And we see here, it is set out the nature and impact of the breach. And it’s explained that:

15 *It appears that since 2007 MLC has been charging adviser service fees across a range of products when it should not have been.*

And then there’s various circumstances that are identified?---Yes.

20 And then if we go over the page, we see there’s an explanation of how it was discovered and the cause. So it was discovered in August 2014 when the administrator was reviewing an internal office holding account and discovered there are a significant number of accrued client adviser service fees that had been directed into the account. And the cause was said to firstly be a system functionality thing  
25 which is a client had to be attached to an adviser. And then second, that the process to remove an adviser from a member account occurred across three internal processing teams and it transpires that there were no continuous controls from a risk perspective over the end to end process. I am interested in whether you would expect that APRA, on being notified of an issue that had been going on for seven  
30 years, and where it was said that there were no continuous controls from a risk perspective over the end-to-end process, whether that would be something that now would trigger APRA to investigate further?---Unfortunately, these are all too common in financial institutions. So I think the supervisor – I mean, would certainly follow up with the – with the institution concerned to find out more details about the  
35 issue. But I’m just – I’m just wary of your word “investigate”, in the sense of formal investigations under the Act are one thing. Making inquiries are another thing. We would make further inquiries, yes.

40 And what did you do in this case?---Sorry, what did APRA do in this case?

Yes?---Yes. So I think they would have discussed the issue with the organisation with MLC. Satisfied themselves that the issue was going to be remedied and focused on what’s the process of rectification.

45 And when you say you think they would have, is there some record that you’ve seen within APRA of that having happened?---No, that’s – that’s derived from my discussion with the individuals.

If you think about the timeline, which is in April 2015 ASIC announced that it was investigating multiple instances of licensees charging clients for financial advice where the advice wasn't provided. You're aware of that?---Yes.

5 And then in June of 2015 NULIS lodged a second breach notification with APRA?---Yes.

And then in late 2015, NULIS and MLC nominees lodged a third breach notification with APRA?---Yes.

10 And by that point in time then, by the end of 2015, do you think, on reflection, that it was appropriate that APRA had not begun to itself bear down on the fees for no service issue, even just at NULIS?---Not necessarily, because I think – I suspect the subsequent breaches were being triggered by ASICs work that was announced earlier  
15 in the year and ASICs investigation or – across a range of entities. So – so I think – and there would – would have been by – certainly by the end of '15 APRA/ASIC engagement on the breadth and scale of their – I think it's called their wealth management project that was looking at this issue, how they were going about it. So  
20 I think we were very much leaving it to ASIC to pursue these issues and not seek to duplicate.

And that's consistent with what you say in your statement, which is that by the time the 2015 events were reported by the NAB entities, ASIC had announced that it was investigating fees for no service, and you say aside from not wanting to duplicate the  
25 work of another regulator APRA would have had no reason to doubt that ASICs work was going to produce an appropriate response, particularly in relation to outcomes for members?---Yes.

30 And I assume you know the Commission issued a notice to produce to APRA trying to obtain any documents where that decision or consideration was recorded, that is, where you thought about should we duplicate the work?---I - - -

35 Is this a duplication of the work?---I – I accept that. I'm not across all the notices but I'm happy to accept that.

And we didn't – there were no documents that were produced in response to that category. Does that surprise you?---Sorry, that someone had written down we should not do anything because?

40 Yes?---No, it doesn't surprise me.

Does it surprise you that there wouldn't be some sort of internal written – a record of some sort of internal consideration as to whether you should take this issue  
45 up?---Maybe there should. I think at that time, as I talked to the supervisors about it, they were getting these breaches. They were talking with NULIS MLC. They were very conscious that ASIC was investigating the issues. There were other issues they

were grappling with at the time. So the idea of diverting resources and replicating the ASIC work didn't seem to be a particularly sensible thing to do.

5 APRA knows and presumably knew that ASIC had no mandate in respect of any breaches of the trustees duties under the SIS Act?---So you're talking 52 and 62, yes.

So APRA, presumably, couldn't have thought that ASIC would be taking up those issues?---No.

10 And those were matters that, as we have seen, were reported to APRA or breaches of those obligations were reported to APRA by the entities?---Yes.

15 And I just want to test then or see whether on reflection you think it makes sense to say, well, we can leave it to ASIC because ASIC is investigating fees for no service?---Sorry, could you repeat your proposition?

20 Yes. I just want you to reflect, given that ASIC has no mandate in respect of breaches of the relevant duties under the SIS Act, and that the breaches had been reported to APRA, that APRA would simply say, "Well, this is something that we can leave to ASIC"?---No. I think what we would say is we've got another regulator that is looking at, essentially, the same facts, the same documents, the same actions, overlap of people. It's actually inefficient and sometimes unhelpful to have two regulators investigating the same thing at the same time. I can recall back when – when the Trio Capital matter happened and both APRA and ASIC were trying to investigate things at the same time. And it was clumsy and it was – it slowed both agencies down. And it was not an efficient use of resources. And so for a matter like this, I think my starting philosophy would actually be to say let one agency take the lead and then see what they get to and then the other agency can see what else needs to be pursued.

30 One of the other things that you say in your statement at paragraph 119 is that – I'm sorry, what used to be paragraph 119 of your draft statement is that the issues did not appear to be – or the breach did not appear to be systemic in nature?---Sorry, initially?

35 Yes?---That was the – certainly the view of the – of the supervision team at the time.

40 And, again, the Commission sought documents recording any consideration by APRA or reasoning or decision or conclusion that the breach did not appear to be systemic in nature, and no documents were produced. Does that surprise you?---I would have assumed that there would be some assessment of the issue somewhere. Whether it actually used the words "this is not systemic", I don't know.

45 In paragraph 354 of your statement you say:

*It subsequently became evident that the extent and breadth of the issues associated with what has now generally become known as fees for no service at*

*NULIS MLC and the industry more generally have been deeper and broader than originally anticipated.*

?---Yes.

5

When is it that that became apparent to you?---Well, I think through the course of 2015 after ASIC – I mean, ASIC was on to this issue earlier than APRA was, given its involvement in FOFA, financial advice fees. So if you're asking me for a precise date, I mean, that's a general observation, but I would say by the time ASIC started its investigation, it had identified – in 2015 it had identified that this was not – this was not a minor issue.

10

I see. And then a little further over the page – and I think we've – the page numbers have changed between the drafts, but you say in paragraph 363:

15

*In addition, given that in many cases the fees for no service issue was in large part a product of poor IT infrastructure, APRA could perhaps have taken a stronger stance in insisting that the NULIS MLC trustees tackle legacy system issues with their associated administrator.*

20

?---Yes. I think that was in response to a question of – of are we satisfied with our response. That was a reflection of mine.

And how did you form the view that the fees for no service issues were largely the product of poor IT infrastructure or legacy system issues?---Through talking to people at APRA.

25

Again, the Commission issued a notice and sought copies of any documents excluding emails recording APRA's consideration, reasoning, decision or conclusion that the fees for no service issue was in large part a product of poor IT infrastructure or was otherwise a product of legacy system issues and no documents were produced. Does it surprise you that there would be no document recording consideration by APRA of what – by – even by now they've agreed is a systemic issue, but no document recording what the underlying cause of that was what you've proffered which is poor IT structure and legacy system issues?---Not really. I mean, those words, just to be very clear, I wrote those words. They are my words. They're not a take from an APRA document. So asking where was the document that those words came from, I wrote them based on my discussion with a range of people who were involved in superannuation supervision around APRA, and a view that at the heart of all of these issues, or most of these issues is a problem that infrastructure has not kept up with the nature of products and the changing regulatory and legislative landscape.

30

35

40

Has it occurred to you that a cause of the problems might be conflicts of interest within these institutions?---That could be part of it, yes.

45

Has it occurred to you that a cause of the problems might be an inadequate set of controls over risk?---Well, that's, I think, a derivative or, in essence, how do you get poor IT infrastructure because you haven't paid attention to the risk. So I think the answer is yes to that.

5

Has it occurred to you that a problem might be the culture within the entities more generally in relation to conduct and compliance issues?---Yes. That – that, no doubt, has played a role in allowing that situation to develop.

10 Has it occurred to you that a cause of the problem might, to some extent, be either, on one view, dishonesty, or on another view a lack of the ethical strength necessary to understand that you can't charge fees for a service you don't provide?---Has it occurred to me of a lack of ethics. Is that your question?

15 Yes?---So I – my understanding – and I don't pretend to have the depth of the understanding that many people at APRA have is that – so we've looked at cases, it has been inattention rather than any other cause, but I wouldn't rule out other options.

20 Has it occurred to you that at least, for one or more of these entities there might be a financial risk posed by the extent of remediation that they will need to make for fees for no service?---The parent entities, you mean?

25 Yes?---Well, there certainly is going to be an extensive cost associated with remediation, yes.

30 Sufficient to at least factor into APRAs consideration of the financial risk to that company?---As this issue unfolds, yes, the amounts are material, but just so that I'm not misinterpreted, they're not going to threaten the financial soundness of the entities.

35 Have you considered, then, whether when you reflect on the way that APRA has stepped back from fees for no service, whether that is a failing to actually analyse and properly evaluate this industry-wide problem?---No. I don't think that's the case, because I think, actually, what we've been trying to do, while ASIC is pursuing this specific issue, is continue to focus on strengthening governance, strengthening risk management, pushing trustees to give more attention to what are the learnings from these exercises, and how do we avoid any sort of repeat into the future.

40 And can you give us an example of how you've been doing that with a trustee, say with the AMP trustees?---I can't – I'm not familiar enough with the AMP case. I think I'm talking more generally that - - -

45 Is there a particular - - -?--- supervisors - - -

- - - entity that you have in mind?---No. I think what I'm drawing attention to is the work that we've done in trying to push harder through the thematic reviews, through

the member outcomes work, through a raft of things that are occurring to – which are not going to fees for no service specifically, but are about trying to strengthen the role that trustees – strengthen the ability of trustees to perform their role effectively.

5 You've, I assume, read the Productivity Commission's draft report on superannuation?---I can't say I've read every page but I have – I have skimmed through it, yes.

10 You know the Productivity Commission had expressed the view that there was some confusion around the two regulators' respective roles given both have long held powers to police bad behaviour by trustee boards?---Yes, this is – this is some of the commentary about the blurring of responsibilities that we talked about.

And what the Productivity Commission also said was:

15 *It has become increasingly unclear which regulator has primary responsibility for trustee conduct with the risk of misconduct falling between the cracks and a lack of clear regulator accountability. Strategic conduct regulation appears at times to be missing in action. Ideally this would involve a regulator proactively*  
20 *identifying actual or potential instances of material member harm, investigating the underlying conduct and taking enforcement action in a way that provides a valuable public deterrent to future poor conduct.*

Are those observations that APRA agrees with?---Not entirely, no.

25 Is it the case - - -?---So we don't think the blurring is quite as suggested. And we think our – as I said on a number of other occasions, I think our supervisors are out – day-in day-out pushing for change and improvement. The final piece of that phrase that you read around public enforcement action is – is not what our normal modus  
30 operandi is. So I have to accept that – that last bit but not sure I agree with all of the earlier bits.

Well, ultimately, of course, the lack of public enforcement action is part of the criticism by the Productivity Commission that strategic conduct regulation is not  
35 occurring in relation to superannuation entities?---That's – that's the view they've expressed, yes.

And I just want to understand, do you think it is problematic that there is not public enforcement action that is taken against superannuation entities where, for example,  
40 they appear to have breached section 52?---Now, we're going to get into a discussion about sanctions and the limited sanctions that are available. So I think what we do is use our prudential processes and our prudential activities to try and prevent problems occurring. And as I said before, no regulator can prevent everything. But, you  
45 know, supervisors are there day-in day-out trying to enforce compliance and more than just compliance with the prudential standards.

I'm not sure that really quite answers my question. If we just step back from it, none of that is public enforcement action. Do you agree?---Correct.

5 Now, an issue is there are no civil penalties presently available for a contravention of section 52 of the SIS Act?---Correct.

10 And so an explanation that APRA might offer as to why it has never sought to seek, for example, a declaration that particular conduct has contravened section 52 is that it can't obtain a civil penalty to accompany that declaration. Is that an explanation you're offering?---It's one factor, yes.

15 But even if civil penalties were available for a contravention of section 52, isn't the difficulty that taking that type of enforcement action just doesn't fit very readily with APRAs approach?---To some extent, yes. There are obvious tensions there. And if we were – if we were taking lots and lots of enforcement action, I would probably have to conclude we were a poor prudential supervisor because ideally we should be trying to head these things off.

20 I want to move to another topic, but also related to super. You've – you were asked in your statement to address some issues arising from a speech that Mrs Rowell gave in 2015 in relation to MySuper investment strategies?---Yes.

25 And Mrs Rowell raised an issue which was that – I can bring this up. If we bring up RCD.0014.0090.0001. So this is the speech that she gave. And if we go over the page to .0013. I'm sorry, .0013. What Mrs Rowell begins talking about at the bottom of the page and what you've dealt with is something that is described as:

30 *An interesting if somewhat surprising picture. For each MySuper product with a single investment strategy it shows the allocation to growth assets and the return target that has been set. It also indicates the risk label based on the standard risk measure. What is surprising is that we see medium, medium high and high risk products with similar levels of growth assets and return targets. The products are more clustered than we expected, rather than showing a stronger trend from lower to higher risk levels. We will be looking into this*  
35 *further as part of our supervision activities seeking to understand why, for example, a medium risk product has a return target and level of growth assets that seem more consistent with a high risk product.*

40 ?---Yes.

And more recently, this year, there have been, I'm sure you are aware, some public discussion about what exactly constitutes a growth asset as compared with a defensive asset?---Yes.

45 And a criticism or complaint made that some superannuation trustees were describing as defensive assets what were actually in some people's view growth

assets?---Yes. They're very broad terms and there's a degree of fuzziness to growth, defensive, etcetera.

Yes. There's a view that - - -?---It's in the eye of the beholder, in many cases.

5

Well, they're not terms that have any technical meaning, at least in this context, that is, they don't – they're not defined - - -?---Correct.

- - - to be something. And particularly in relation to defensive assets, the criticism is that unlisted infrastructure is, in some – some types of unlisted infrastructure is counted as a defensive asset and some people would prefer that defensive assets be limited effectively to bonds and returns on cash?---Cash. Correct.

10

What I'm interested in understanding is where this issue went after Mrs Rowell said in 2015, "We're going to be looking into it"?---So I think we – so there was material that was produced internally, provided to supervisors to look at as they went about their work. There was, I – from memory, a paper that went to the – sorry, superannuation industry group that we talked about earlier that was looked at and then farmed out to supervisors. It highlighted some, what might at first glance seem to be outliers when you looked at a number of these dimensions. And then we also had our investment risk team which is one of our specialist teams – a sort of equivalent team to the GCR team that we focused a lot of the discussion on thus far but obviously looking at investment issues – also trawling through the data and trying to understand this issue a bit better. The end conclusion from it all was that it's a product – the lack of correlation that we might have expected to see was a product of a set of very broad imprecise labels.

20

25

And when you say that was the end conclusion, this is something we were trying to understand where that end conclusion is recorded. Do you know?---Well, I took it – I think I've made reference in my statement to an internal industry review report in March '16. So I have in paragraph 520 made reference to a report and a quote from that report which essentially concluded the range of outcomes highlighted the unsophisticated nature of the measures. That was at the heart of the issue.

30

35 And then said:

*It is apparent that caution needs to be exercised when comparing MySuper products with similar objectives and asset allocations and the underlying differences need to be understood.*

40

?---Yes. And the investment risk team had done some work at a more granular level rather than just looking at growth/defensive, but looking at more detail around asset classes.

45

And the supervisors were asked to consider this issue. Is that right?---If it was relevant to them, they were given information. So it's the sort of thing that would equip them to ask some questions. If they were doing a review. And my recollection

of the paper – but it has been some time since I looked at it – was it may have called out some that looked at the more extreme ends of being an outlier.

5 If you step back for a moment from the specific data analysis of what the relationship is between risk labels and returns and supposed asset allocations, and just think about the interests of the members and keeping the members informed, does this not suggest that there is a problem with the information available to members when they are told what the risk label is for a product and what the return target is for a product?---Yes. There's two problems. The risk label and the risk measure is too  
10 simplistic, or is simplistic, because the risk measure simply tells you something about how many times in a given period you might expect a return to go below zero. But it doesn't tell you anything about how far. It doesn't tell you anything about what the upside might be. It just tells you how many times in a given period might it go below zero. It's a very simple measure.

15 What I just want you to try and think about – and this is - - -?---Yes.

- - - what I want you to focus on is, is there a problem that APRA has identified with the information that is being provided or the quality of the information that is being  
20 provided to members about risk and target returns?---So this was where I was going to get to the second part of my question, because those that understand investment risk would tell you it's a bad measure, that it should be a standard deviation or it should be some other measure. Those that don't understand investment risk – and I – I've thought about this case in relation to my mother. My mother would understand that risk metric. She is concerned about how many times it might go negative. So  
25 it's a risk metric that appeals to the less – I don't wish to insult my mother here but the less financially literate, because it is a concept how many times might I get a negative return. She understands that concept very well. If I asked her or gave her a figure that said something about standard deviation of returns or it might be an  
30 expected return plus or minus something with a degree of confidence, which is what you really want to understand if you want to understand the risk, many people would not understand that. So we are – I think I'm agreeing with you that there is a – it's a very simple measure. It has limited information content. It's better than nothing. And it's not clear what the superior measure would be.

35 And you don't see a role that APRA might need to play in trying to figure out how to better inform members of superannuation funds about returns and the risks involved in their returns?---We could certainly try to do that when it comes to most disclosure-related issues, ASIC is – is lead there. We would be happy, I'm sure, to contribute to  
40 that. That standard risk measure, though, was produced after a long and fairly tortuous process with industry and APRA, and I think ASIC, trying to define what was a balanced fund, which is another very general concept that's often used in superannuation, and that failed to reach a landing, and the product that was produced was this standard risk measure. So we would be happy, but I'm conscious that it's  
45 not for want of trying already that that measure emerged.

And, again, then, this is something where it would require coordination between APRA and ASIC to move issues in relation to disclosure?---Yes.

I don't have any further questions for this witness, Mr Commissioner.

5

THE COMMISSIONER: Thank you, Mr Hodge. Mr Dick.

MR DICK: No questions, Mr Commissioner.

10 THE COMMISSIONER: No. Thank you very much, Mr Byres?---Thank you, Commissioner.

MR .....: Commissioner Hayne, what about the complaint system?

15 THE COMMISSIONER: Mr Byres - - -

MR .....: Why has that not being reviewed? This is just as corrupt as many other areas in this industry.

20 THE COMMISSIONER: Would you please sit down, sir.

MR .....: It has not been reviewed.

THE COMMISSIONER: Would you please sit down, sir.

25

MR .....: It has been passed over. Is this a function or result of this government  
- - -

30 THE COMMISSIONER: I think you are interrupting the work of the Commission, sir.

MR .....: under-funding and under-resourcing this Commission by a corrupt Prime Minister - - -

35 THE COMMISSIONER: Please sit down.

MR .....: - - - who did not want this process to happen. Just corrupt.

40 THE COMMISSIONER: You are interrupting the work of the Commission. Please stop.

MR .....: Rotten. Absolutely rotten. And you unfortunately – the good work you people have done will not be recognised. I'm telling you. It's rotten.

45 THE COMMISSIONER: I think rather than come back after a lengthy adjournment, if we take a break for five minutes and resume at about five past one.

<THE WITNESS WITHDREW

[1.00 pm]

ADJOURNED

[1.01 pm]

5

RESUMED

[1.05 pm]

10 THE COMMISSIONER: Yes, Ms Orr.

MS ORR: Commissioner, we have now concluded the evidence in this seventh and final round of public hearings for this Royal Commission. Over the course of the past two weeks, we've heard evidence from the CEOs of six of the largest financial service entities in Australia, CBA, Westpac, Macquarie, NAB, ANZ and AMP. We've heard evidence from the chairs of the boards of three financial services entities, CBA, NAB, and Bendigo and Adelaide Bank. And we've heard evidence from the chairs of the two regulators, ASIC and APRA.

20 As I said in our opening address last week, this round of hearings was different to the first six rounds. Our focus was not on identifying further instances of misconduct, but on understanding why misconduct occurred and what can be done to prevent it in future. For that reason, unlike in previous rounds of hearings, Counsel Assisting will not identify any particular findings as being open on the evidence. Nor will there be a process for the entities involved in this round of hearings to make further submissions to the Commission. Instead, we anticipate that the matters raised over the past two weeks will play a role in informing the recommendations that you make in your final report.

30 As this is the final round of our public hearings, it's appropriate that I say something more broadly about the work of the Commission throughout the public hearings. Since February, the Commission has conducted public hearings over the course of 68 hearing days. Over the course of those 68 days, many of which were long days, we have heard evidence from 134 witnesses, some of whom gave evidence more than once. We have tendered almost 400 witness statements and we have tendered more than 6500 exhibits, including the exhibits to those witness statements.

The witnesses who gave evidence during our public hearings have included representatives of financial services entities, banks, mortgage brokers, financial advice licensees, superannuation trustees, and insurance companies. They have included representatives of the regulators, ASIC, APRA, and the ACCC, and external dispute resolution bodies like FOS. They have included representatives of consumer groups, financial counselling services and industry bodies, and they have included consumers who gave evidence about their interactions with financial services entities, consumers who we chose because their experience were representative of experiences within the community.

I would particularly like to thank this last group of witnesses, the consumers who agreed to come and give evidence in the Commission's public hearings. Many of them travelled long distances and gave evidence about their private financial affairs in a very public forum. I know that they did not always find that easy, but their  
5 willingness to give evidence about their experiences has greatly assisted the work of the Commission, and I am grateful to them.

It is appropriate that I express my gratitude to others as well. The work involved in presenting seven rounds of public hearings, addressing the matters covered by this  
10 Commission's terms of reference, within the timeframe set by those terms of reference, has been enormous. It is important that I publicly record my sincere appreciation to every member of the team of counsel who have assisted you throughout these hearings. Those counsel comprise not only the other four barristers formally appointed to assist you, Michael Hodge QC, Albert Dinelli, Eloise Dias and  
15 Mark Costello but four further barristers who have worked with us throughout the year and whose contribution has been invaluable. They are Claire Schneider, Mark Hosking, Sarah Zeleznikow and Tim Farhall.

I am deeply grateful for the immense amount of work that our team of counsel has  
20 undertaken, for the quality of that work and the way they have each conducted themselves in undertaking that work. I also wish to record my thanks to the team of solicitors from the Australian Government Solicitor who have assisted us throughout the year. The dedication and tireless effort of our team of solicitors, which at 20  
25 people is no doubt smaller than many would think, has been critical to the presentation of these hearings, as has the assistance of our four administrative support staff.

Finally, these hearings could also not have taken place without a great deal of  
30 assistance from the staff of the office of the Royal Commission, would have provided invaluable support and expertise with the logistics and practicalities of conducting our hearings. Thank you, Commissioner. That concludes our final closing address.

THE COMMISSIONER: Thank you, Ms Orr. I, of course, have a further and more  
35 formal opportunity in my final report to acknowledge and thank those who have worked so hard to bring us to this point in the work of the Commission, but it's right that I should say something publicly and say it now. I am, of course, especially grateful to you, Ms Orr and all of the Counsel Assisting, Mr Hodge, Mr Dinelli, Ms  
40 Dias, Mr Costello, Ms Schneider, Mr Hosking, Ms Zeleznikow, Mr Farhall. Your work has been and dare I say will continue to be of immense help.

I am also especially grateful for the work that has been done by the Australian  
45 Government Solicitor's team led so admirably as it has been by Mr Simon Daley and Mr Simon Sherwood. None of what has happened, whether in the hearing room or in the work of the Commission outside hearings, could have occurred without the immense amount of work that AGS has done and done so skilfully.

5 In that connection, I should say publicly that I recognise the intensity of work that has been required of those acting for the entities whose conduct has been the subject of examination. And I should also say publicly that I recognise that, much more often than not, those acting for the entities and agencies concerned have sought to cooperate with the Commission and with solicitors assisting in seeking to deal with the requirements that the Commission has made.

10 The work of the office of the Royal Commission has been handled masterfully by Ms Toni Pirani and Ms Liz Brayshaw and to them and their staff we owe much. I should also say how grateful I am to Mr Justice Alstergren, the Chief Justice Designate of the Family Court and the judges of the Family Court of Australia that the Commission has been permitted to use this courtroom. The staff of Commonwealth Law Courts Melbourne and of the Family and Federal Courts have been of very great assistance in that regard.

15 Inevitably there are some phrases that have entered the vocabulary over the course of the Commission. Of those phrases, one of them, six words long – can I show you a document – would not have been possible without the work of our document system providers, Law In Order. They have managed not only the electronic hearing facilities but also the immense database that has been assembled over this last year. I am very grateful to them for their work.

25 And then there's the transcript of proceedings supplied by Auscript. We've been fortunate, indeed, to have the services of Ms Helen Lubke as our stenographer. Her skill remains for me a cause of continuing wonder, her calm attention to her tasks is a continuing cause of admiration, but I rather suspect that this passage of the transcript will read inaudible on tape.

30 Last, may I say something to those who ordinarily sit in the back row of the hearing room, and to those in the media room. This has been a public inquiry. The proceedings have been open to the public and they've been streamed. They've been the subject of reports and comment in all forms of the media. And so they should have been. The Commission has sought to do what it can to assist the media in performance of their job but we've done that by making information available generally to the public. The Commission has not sought to influence how the media has reported. We've not backgrounded, we've not provided the media or anyone with any information about what witnesses are to be called or subjects covered except by posting what we have on the website. We've not commented on what has occurred in the course of evidence.

40 It has been for the media and for the media alone to decide what will be the subjects of their reports, and what, if any, comments they may choose to make about what the Commission has done. And that, again, is as it should be. But it is also right that I recognise the role that the media has played in this being a public inquiry by reporting on the work of the Commission.

45 We will adjourn.

**MATTER ADJOURNED at 1.16 pm INDEFINITELY**

### **Index of Witness Events**

WAYNE STEPHEN BYRES, ON FORMER OATH	P-7428
CROSS-EXAMINATION BY MR HODGE	P-7428
THE WITNESS WITHDREW	P-7482

### **Index of Exhibits and MFIs**

EXHIBIT #7.151 EXECUTIVE BOARD PAPER IN RELATION TO CBA INQUIRY, JUNE 2018 (APRA.0054.0001.2430)	P-7428
EXHIBIT #7.152 REFOCUSING RISK CULTURE PILOT REVIEWS, APRIL 2018 (APRA.0040.0001.0003)	P-7442
EXHIBIT #7.153 NOTE OF EXCO DISCUSSION BY MR BYRES DATED 28/8/2018 (APRA.0037.0001.0004)	P-7455
EXHIBIT #7.154 APRA DRAFT ENFORCEMENT STRATEGY (APRA.0037.0001.0025)	P-7457
EXHIBIT #7.155 SUPERVISION AND RESOLUTION COMMITTEE, DATED 02/10/2018, INTERNAL AUDIT: SUPERVISION QUALITY CONTROLS AND QUALITY ASSURANCE (APRA.0032.0001.0646)	P-7468