

2.2 Improving cyber resilience

APRA seeks to reduce the impact of cyber incidents on the financial system and Australian community. In the face of escalating risks, APRA expects regulated entities to significantly improve their cyber resilience practices and be able to withstand cyber-attacks.

Cyber resilience is an area of major strategic focus for APRA, underpinned by its 2020-2024 Cyber Security Strategy.⁶ The updated strategy seeks to influence the practices of regulated entities and involves acting in concert with peer regulators and other government agencies, while supporting the Australian Government's 2020 Cyber Security Strategy.

As part of its Cyber Security Strategy over the next 12-18 months, APRA will:

- initially as a pilot with a small group of select APRA-regulated entities, instruct entities to engage independent auditors to assess compliance with *Prudential Standard CPS 234 Information security* to identify and address weaknesses in cyber practices;
- continue to collect cyber resilience data which will be used to generate cross-industry insights on better practice examples. These insights will be shared with regulated entities to strengthen cyber practices;
- launch a pilot for a cyber information sharing community across APRA regulated entities to improve industry situational awareness and the sharing of technical information; and
- in concert with the CFR, test cyber resilience of Australia's financial services industry via a pilot Cyber Operational Resilience Intelligence-led Exercise.⁷

2.3 Transforming governance, risk culture, remuneration and accountability

APRA is continuing its work to transform GCRA across APRA-regulated entities' management of financial and non-financial risk. Over the next 12-18 months, APRA will:

- following the finalisation of *Prudential Standard CPS 511 Remuneration*, conduct an implementation review across a sample of regulated entities and share these insights in due course with all regulated entities;
- drive improvement in the governance and risk culture practices by continuing risk culture deep dives at a small number of large Australian financial entities, follow up and evaluation of entities' actions in response to risk governance self-assessments and regular prudential engagements. This will include working to close issues currently resulting in capital overlays or enforceable undertakings; and

⁶ APRA, Speech by Geoff Summerhayes '[Strengthening the chain](#)' (November 2020)

⁷ CFR, [CORIE framework launched to test cyber resilience of Australia's financial services industry](#) (December 2020)

- implementing a tool to benchmark and assess trends in risk culture across regulated entities, after undertaking a risk culture survey for a pilot group of regulated entities.

APRA will also be working with Government to extend the accountability regime to all APRA-regulated entities.

2.4 Improving recovery and resolution capability

COVID-19 emphasised the importance of APRA's strategic priority to enhance its recovery and resolution capability and that of the industry via effective contingency planning and regular testing of those plans. In 2020 APRA was focused on contingency planning for near-term risks to the financial system. Stabilisation in the external environment will enable APRA to refocus on its planned supervisory priorities over the next 12-18 months. APRA is proposing to release for consultation a draft cross-industry prudential standard on recovery and resolution planning as outlined in its Policy Priorities Paper. This will be reinforced by the following supervisory priorities:

- strengthening the credibility of recovery plans across all APRA-regulated industries to ensure that supervised entities have and maintain a credible recovery capability, with APRA's assessment of an entity's recoverability as a key input into the SRI Model assessment;
- ensuring that simple, credible resolution strategies are in place for more vulnerable entities across each industry. These are critical for situations where an entity is facing financial stress and private sector recovery is not possible; it means that the entity and APRA are prepared to implement an orderly exit or resolution that maintains financial stability and minimises any impact on public funds and beneficiaries (depositors, policyholders and members); and
- driving improvements in small ADIs' compliance with *Prudential Standard APS 910 Financial Claims Scheme* to ensure that entities are adequately prepared should the Financial Claims Scheme safety net be required.

Expanding recovery and resolution planning in the superannuation industry is also an important priority over the coming period and will help underpin the Government's implementation of the *Your Future Your Super* reforms.⁸

2.5 Climate-related financial risks

Climate change is a driver of financial risks, as well as business opportunities, for all APRA-regulated entities. While the financial nature of these risks is increasingly understood, there remains a need for regulated entities' to enhance their capacity to manage and respond to climate risks. APRA continues to increase its scrutiny of the manner in which ADIs, insurers and superannuation trustees are managing the impact of risks arising from climate change.

⁸ Australian Government Treasury, [Your Future, Your Super package](#) (November 2020)

In a letter to industry in 2020, APRA outlined areas of focus for its climate risk activities.⁹ Though some supervision initiatives were deferred due to COVID-19, APRA remains committed to ensuring that regulated entities take a strategic and risk-based approach to the management of climate-related financial risks. APRA intends to develop climate risk guidance in 2021 to assist with this, as highlighted in the Policy Priorities paper.

APRA is currently completing a supervisory review of the regulated entities that participated in APRA's 2018 climate risk survey. The outcomes of these reviews are being used to inform the development of APRA's climate risk guidance and ongoing supervision activities.

As part of APRA's actions to both uplift the scenario analysis capability and strengthen the understanding and management of climate-related risks within the financial sector, APRA is leading work on a climate vulnerability assessment (CVA) together with the CFR. Beginning with large ADIs in 2021, the CVA will:

- explore the potential financial exposure and macroeconomic risks to large ADIs, the financial system and economy from both physical and transition climate risks; and
- assist APRA in understanding how the large ADIs might adjust their business models in response to different climate change scenarios.

APRA is currently designing the CVA and expects to engage with the ADIs participating in the assessment in 2021. The design of the CVA will reflect APRA's cooperation with international peer regulators. APRA also recognises that there have been significant investments by large ADIs in recent years to improve their climate risk assessment and response capabilities, and where possible the CVA will leverage this capability. The CVA also presents an opportunity for enhanced consistency across ADIs in their approach to assessing climate-related risks, improving the value of the climate risk analysis for both individual ADIs and the wider market.

⁹ APRA, [Understanding and Managing the Financial Risks of Climate Change](#) (Letter, 24 February 2020)

Chapter 3 - Banking

The banking industry entered COVID-19 well-capitalised and with sound liquidity and funding. COVID-19 presented unprecedented risks and the potential for significant adverse outcomes for customers and banks. Government, central bank and prudential support programs have been provided to mitigate this. These programs will be gradually unwound in the period ahead.

APRA is focused on maintaining the banking industry's resilience and enhancing its crisis readiness, supporting prudent outcomes through the pandemic and in the transition to the post-pandemic recovery. In response to COVID-19, APRA made a necessary shift from baseline supervision to a sharpened focus on financial resilience. In 2021, in addition to the cross-industry initiatives outlined in Chapter 2, APRA will focus on the three key areas outlined below. In doing so, APRA recognises that its supervisory approach must be tailored and proportionate to the various cohorts of the industry, recognising differing business models and challenges.

3.1 Credit Risk

While Government support measures, including APRA's temporary capital relief for loan repayment deferrals, have played an important role in assisting borrowers, credit risk increased significantly for banks as a result of COVID-19. Banks are expected to experience an increase in credit losses as government support is withdrawn and they will need to work through elevated volumes of problem loans.

Credit quality, problem loan management and provisioning will therefore be areas of focus in the period ahead. APRA will maintain a heightened level of supervisory engagement as it monitors credit risk, with a particular emphasis on the identification of problem loans and higher risk portfolios, including undertaking 'deep dives' to obtain assurance about effective portfolio management. Progress on reducing and ultimately clearing loan repayment deferral portfolios will continue to be monitored. To facilitate this, banks may be asked for portfolio specific data and other credit information.

The pending finalisation of *Reporting Standard ARF 220 Credit Exposures and Provisions*, which is the enhanced data collection for credit risk, will allow APRA to undertake improved analysis and monitoring. For banks accredited to use the internal ratings-based approach to credit risk, APRA will be assessing portfolio re-rating and model performance. Reflecting the importance of credit to the operation of the broader economy, APRA will also be monitoring the availability of credit to different types of borrowers.

3.2 Capital Management

APRA expects that at all times banks maintain capital adequacy, and during COVID-19 there has been a need to ensure that banks use buffers to absorb losses and continue to provide credit to support the economy if needed.

APRA has provided capital guidance to banks, including on dividend payouts and will continue to monitor ADIs to ensure ongoing prudent capital management. APRA will continue to assess banks' capital management, including their stress testing capabilities, the scenarios they consider and how recovery planning options have been integrated, in order to identify gaps and ensure that they deliver on their capital management plans.

3.3 Liquidity

Bank funding and liquidity positions have benefited from extraordinary central bank support provided during COVID-19. APRA will continue to focus on the stability of bank liquidity and funding in the face of uncertainty and will be examining how, when appropriate, ADIs will be able to transition away from the extraordinary support that has been provided in an orderly manner.

APRA has a program of supervisory work aimed at ensuring reliability and stability in funding and liquidity, including:

- addressing risk management deficiencies identified at peak times of COVID-19;
- facilitating a smooth reduction in Committed Liquidity Facility limits given the increasing availability of Commonwealth and State government securities to provide High Quality Liquid Assets; and
- supporting the transition of the banking industry to funding self-reliance as external support measures are phased out.

Chapter 4 - Insurance

Overall, the insurance industries that APRA regulates remain well-capitalised, and have flexed and adapted to the operational issues arising from COVID-19. Each industry is experiencing its own challenges, either as a result of underlying sustainability issues or due to the COVID-19 driven economic disruption.

4.1 General insurance

In 2020 general insurance industry profitability declined due to the catastrophic bushfire and storm events and the early impacts of COVID-19 on investment returns. Despite this, the industry's capital coverage has remained stable.

The pandemic has raised questions around the role of insurers in protecting the community against pandemic risks. These risks are extremely difficult to insure as they frequently manifest globally and are therefore highly correlated, meaning coverage is unlikely to be affordable. The most prominent example of this has been in business interruption (BI) insurance.

Recovery and resolution planning for insurers remains a priority in line with APRA's broader cross-industry work on crisis readiness and work has also continued on managing the risks associated with insurers' high reliance on overseas reinsurance.

4.1.1 Business interruption insurance

The economic and social disruption from COVID-19 has put the spotlight on insurers and the role of business interruption (BI) cover in assisting the business community with the recovery from COVID-19 impacts. APRA has been closely monitoring the industry's exposure to business interruption policies, given the uncertainty that has arisen over the effect of policy wordings. Some of these matters are currently being tested in the Courts, and early indicators are that insurers may be liable for exposures beyond their original intent because of insufficient attention to the precision of policy terms and conditions.

The ongoing uncertainty has caused challenges for insurers and policyholders and resolving that uncertainty as quickly as possible is critical, to allow all parties to move forward. APRA is working with peer regulators, industry and other stakeholders towards this objective.

APRA expects that insurers will reserve prudently for potential claims, and pay all legitimate claims in a timely fashion. APRA has undertaken intense monitoring of the potential impact BI could have on insurers and this will continue into 2021. Entities can expect APRA to maintain a close watch over the BI legal proceedings and seek regular updates on insurers' exposures, provisioning levels, stress testing and the extent of support from reinsurers, in an effort to assess the potential impact on capital levels. APRA is also assessing the readiness of insurers to deploy recovery options in the event of a severe adverse outcome and will be monitoring steps being taken by insurers to facilitate the availability and affordability of appropriate cover into the future.

More broadly, BI provides a case study in the efficacy of insurers' governance and risk management practices in relation to how products are developed, reviewed and updated. This will be a focus area for supervisors in the short to medium term including the robustness of pricing processes and the link between policy wordings and reinsurance to assess any potential misalignment in coverage.

4.1.2 Overseas reinsurance

The global reinsurance market is critical to the functioning of the Australian insurance industry and supports the availability of insurance to the Australian community. While reliance on reinsurance is a necessary feature of the insurance industry, it presents certain risks should that reinsurance not be available. To manage this risk, APRA will continue with supervisory activities aimed at understanding the parent group's capital management approach and capital support available to Australian reinsurers, both in times of business-as-usual and stress situations. During COVID-19, APRA increased its engagement with home regulators and parent groups of offshore reinsurers in order to identify and respond to broader institutional and systemic impacts of the pandemic, and this will continue in 2021.

4.2 Life insurance and friendly societies

While capital coverage in the life insurance industry has remained relatively stable, the industry continues to face significant product sustainability and profitability challenges. COVID-19 is expected to exacerbate these challenges. As a result, maintaining financial resilience and sustainability is an area of heightened supervisory focus.

Due to COVID-19, certain areas of focus prior to the pandemic, such as product sustainability and data quality, have been reinforced. Activities such as regular stress testing exercises using COVID-19 related scenarios, new data collections, and recovery planning are either underway or planned in the near future.

In response to the industry's challenges, APRA has increased its engagement at the industry level, reinforcing its message that accountability for improving the ongoing sustainability of the industry sits with a broad set of stakeholders in the life insurance and friendly society ecosystem. If the sustainability challenges are not appropriately addressed by the industry, then there is a risk that some types of life insurance may not be available to the Australian community in the future.

4.2.1 Sustainable products

The life insurance industry faces long-standing challenges, substantially in relation to legacy products with unsustainable features. Instances of poor product design and unsustainable product offerings are threatening affordability of retail products. Pricing and design of insurance offerings available through superannuation are also facing sustainability challenges.

APRA will maintain its heightened supervisory focus and willingness to intervene, reflecting concerns about the sustainability of certain products. Individual disability income insurance

(IDII) is a particular area of focus. APRA has already intervened in relation to IDII with a number of measures, including higher capital requirements, to incentivise the industry to change market practice.¹⁰

The higher capital requirements will remain in place until individual insurers can demonstrate they have taken adequate steps to address APRA's concerns. In instances where individual insurers fail to meet expectations, APRA may impose further capital requirements, or if appropriate, take more forceful action, such as issuing directions or imposing licence conditions.

APRA has observed worsening claims experience and a decline in profitability of insurance offered through superannuation funds, as well as instances of premium volatility and material changes in product design. In December 2020 APRA highlighted these warning signs at a roundtable of senior participants in both the life insurance and superannuation industries. APRA will shortly be communicating with industry on observed threats to the sustainability of insurance in superannuation and APRA's expectations of respective industry participants to act decisively to address them. APRA will actively monitor the industry's response and will intensify its actions if needed.

4.2.2 Friendly societies

APRA has established a three-year supervision roadmap, tailored to enhance the financial resilience of friendly societies. The roadmap was communicated to the industry in December 2020. In 2021, APRA will be reviewing the impact of the prolonged low interest rate environment on business model sustainability; board composition; and recovery planning. Planning work for other components of the roadmap (risk management, minimum capital requirement, and stress testing) will begin in the second half of 2021.

4.3 Private health insurance

While PHIs are generally financially sound, the effect of COVID-19 on investment returns, deferred claims liabilities, and the industry's response through the provision of financial hardship assistance and deferred premium increases underpinned a continued decline in profitability over the past 12 months. While investment incomes have stabilised, insurance margins remain under pressure as health (and hence claim) costs continue to rise faster than premiums.

The industry continues to face sustainability challenges due to rising premiums that are causing affordability issues and resulting in declining membership, particularly among the younger population. APRA expects that the economic impacts from COVID-19 will exacerbate sustainability challenges, as unemployment has increased amongst the younger population and wage growth remains subdued. In June 2019, APRA outlined its expectations that PHIs would develop robust, actionable strategies to address sustainability risks, as well as

¹⁰ APRA, [Sustainability measures for individual disability income](#) (Letter, December 2019)

recovery plans that outline how they will respond if their strategy is not successful or other material risks threaten their solvency.

Continuing the work commenced in 2020, in 2021 APRA will remain focused on building industry resilience and preparedness through recovery planning. APRA supervisors will also be assessing PHIs' progress in addressing affordability and sustainability risks. PHIs that take a passive approach to these risks can expect more intense supervision. More broadly, APRA will continue to drive an uplift in the practices of PHIs to ensure that they are well positioned to address new challenges in a rapidly changing operating environment. This will include working towards improving the industry's governance and controls around IT and outsourcing services, recognising that PHIs are using a growing range of material service providers.

Chapter 5 - Superannuation

The superannuation industry withstood significant and unexpected headwinds in 2020, including a weakened economic environment, shrinking superannuation inflows (driven by increasing unemployment) and an entrenched low interest rate environment. The temporary expansion of the Early Release Scheme (ERS) for COVID-19 led to a sharp increase in member outflows. Operational resilience was also tested on a number of fronts.

Despite the challenges 2020 posed, the industry performed reasonably well, ending the year in a sound position. However, there remains a need for the industry to maintain its focus on enhancing member outcomes and tackling areas of underperformance. This was a continued area of focus for APRA throughout 2020. As APRA's first full refresh of its MySuper Product Heatmap showed in December, a number of funds continue to display entrenched underperformance, and will face heightened scrutiny and possible enforcement action as APRA further steps up its efforts to lift member outcomes in 2021.

5.1 Sharpening APRA's supervisory approach

Improving outcomes for superannuation members continues to be one of APRA's key community outcomes. APRA is focused on embedding a superannuation trustee culture that is continuously improving the quality of outcomes delivered to members and ensuring areas of underperformance are addressed. APRA's overall strategy for improving outcomes for superannuation members is centred around four key areas:

- strengthening the prudential framework;
- sharpening APRA's supervisory approach;
- enhancing superannuation data and insights; and
- improving industry transparency.

APRA's initiatives for strengthening the prudential framework are outlined in APRA's policy priorities paper.

In addition to supervision of individual entity risks, APRA will conduct a number of thematic supervisory activities in the next 12 – 18 months as follows:

- Complete its review into unlisted asset valuation practices that commenced in 2020 after observing some trustee valuation practices during COVID-19. APRA will engage with poorer performing entities to ensure their practices are enhanced.
- Review trustees' implementation of requirements under *Prudential Standard SPS 515 Strategic Planning and Member Outcomes* (SPS 515) by examining:
 - the Business Performance Reviews for a range of trustees. One of APRA's focus areas will be on how trustees demonstrate they are responding to the impact of COVID-19 on their business operations; and

- expenditure management of certain advertising, promotion, sponsorship and payments to parent organisations by a select group of trustees.
- Continue heightened supervision of MySuper products identified as underperforming on APRA's MySuper heatmap, and extending to underperforming choice products based on the expansion of APRA's heatmap to choice products in 2021. APRA will take enforcement action where appropriate to require trustees to improve performance or transfer members to another product.
- Complete an in-depth review of selected large trustees' management of outsourcing providers, focusing on related party arrangements and managing conflicts of interest.
- Build on APRA's cross-industry GCRA initiatives, and set clear expectations that trustees address actual and perceived barriers that hinder boards from achieving the optimal mix of skills and experience required to fulfil trustee obligations. A broad thematic review and analysis will be undertaken over 2021 which will include review of the adequacy of skills and experience on boards, effectiveness of board appointment and renewal processes, and the quality of board and director performance reviews.

APRA will make industry-level findings from thematic work public, outlining good practice and areas where trustees are expected to strengthen practices.

5.2 Enhancing superannuation data and insights

APRA is significantly enhancing its superannuation data collection in order to support supervision and enhance insights in areas such as performance, fund expenditures and insurance. The Superannuation Data Transformation (SDT) program will expand, deepen and refine the data collected from the superannuation industry.¹¹ APRA has completed consultation on phase one of the SDT program and will release a response package in early 2021. Trustees will be required to report under the new reporting standards in the second half of 2021. APRA intends to continue to work with industry throughout the year via its industry working groups to support trustees during the preparations for the new reporting requirements and the introduction of APRA Connect.

5.3 Improving industry transparency

Strengthening transparency will assist stakeholders to hold trustees accountable for the outcomes delivered, particularly where underperformance is identified. The release of MySuper product Heatmaps is a major element in this process, providing credible, clear and comparable information for all MySuper products.

APRA will expand this work by releasing a Choice Heatmap in the second half of 2021 that will cover multi-asset class choice options and will highlight areas of underperformance in those products. APRA will also publish the results from the Government's performance test under the *Your Future Your Super* reforms. The insights from the heatmaps and Government

¹¹ APRA, [Consultation on APRA's Superannuation Data Transformation](#) (August 2020)

performance test will enable more intense supervisory action against trustees who continue to underperform. As the SDT program progresses, APRA plans to further enhance transparency by publishing additional information on trustee operations and the outcomes they deliver.

Attachment A: Timelines

Key supervisory activities and timelines are summarised in the table below.

Strategic focus area	Supervisory activity	Entities included	Expected commencement
Maintaining financial system resilience			
Cross-industry	Assessment of financial services industry service providers	Selected ADIs and trustees	Underway
	Assessment of operational risk and compliance transformation programs	Large ADIs and selected insurers and trustees	Underway
	Strengthening recovery planning	All ADIs and insurers, selected trustees	Underway
	Resolution strategy development	Selected ADIs, General Insurers and Life Insurers (LIs)	Underway
	Climate change supervisory review	38 large entities	Underway
Banking	Climate change vulnerability assessment	Large ADIs	2021 1H
	ADI stress test	Large ADIs	2021 2H
	FCS review	Selected small ADIs	2021 1H
	Credit portfolio reviews	Selected ADIs	Underway
Insurance	Overseas reinsurance – review of group capital management and support	Foreign general insurance reinsurers	Underway
	IDII intervention	All LIs	Underway
	Resilience planning	All PHIs	Underway
Improving cyber resilience			
Cross-industry	Assessment of CPS 234 implementation	Initially as a selection of APRA-regulated entities	Underway
	Development of a cyber information sharing community	Selection of APRA-regulated entities	Underway
	Cyber resilience data collection	Selection of APRA-regulated entities	Underway

Strategic focus area	Supervisory activity	Entities included	Expected commencement
Transforming governance, risk culture, remuneration and accountability			
Cross-industry	Evaluation of entities' risk governance self-assessment actions	36 large entities	Underway
	Deep dive risk culture reviews	3 entities per year	Underway
	Risk culture industry survey	Large and medium entities	Underway
	Assessment of CPS 511 implementation plans	To be determined	2021 2H
Improving outcomes for superannuation members			
Superannuation	Review of SPS 515 implementation – Business Performance review	Selection of trustees	2021 1H
	Fund expenditure review	Selection of trustees	Underway
	Outsourcing review	Selection of large trustees	Underway
	Trustee capabilities review	Selection of trustees	2021 1H
	Unlisted asset valuation review	Selection of trustees	Underway
	Superannuation Data Transformation project	All trustees	Underway
	Improving Transparency – Choice heatmap	All trustees	2021 2H
	Addressing areas of underperformance	Selection of trustees	Ongoing



APRA