



FINANCIAL  
SERVICES  
COUNCIL

# Strengthening operational risk management

FSC Submission

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## **1. About the Financial Services Council**

The FSC is a peak body which sets mandatory Standards and develops policy for more than 100 member companies in one of Australia's largest industry sectors, financial services.

Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, life insurers and financial advice licensees. Our Supporting Members represent the professional services firms such as ICT, consulting, accounting, legal, recruitment, actuarial and research houses.

The financial services industry is responsible for investing more than \$3 trillion on behalf of over 15.6 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange, and is one of the largest pools of managed funds in the world.

## 2. Executive Summary

The FSC and its members support this important initiative by APRA to review, strengthen and streamline regulatory requirements concerning operational risk management and welcome the opportunity to provide our feedback on the framework's design and its implementation. Operational resilience and strong operational risk management is critical for ensuring financial institutions can continue to operate soundly to meet the promises they provide to individuals that rely on the financial system to support their financial wellbeing – whether they be depositors, policyholders, beneficiaries, or their customers more broadly.

APRA's proposals represent a sizable uplift in industry practices for operational risk management. In doing so, APRA's proposals also have the potential to impose significant compliance costs on industry. Whilst we agree with APRA's intention to strengthen operational risk management requirements in a proportionate manner, we are concerned that the proposed granularity of requirements may have the unintended net effect of impeding industry efficiency.

Based on our reading, it would seem that APRA's requirements would commence for all material service provider agreements from 1 January 2024, and would apply to all existing material service provider arrangements. We oppose this proposal as revisiting all existing material service provider arrangements in this way prior to the implementation date of the standard would be an unworkable and artificial impost for both APRA-regulated entities as well as common service providers used across the financial services industry.

We observe the approach adopted by the UK Regulators where operational resilience requirements were finalised in March 2021 following formal consultation which commenced in December 2019. The transitional requirements for implementation have been set in two stages, with a 1-year transitional period for initial requirements for 31 March 2022 implementation, followed by a three-year transitional period for full implementation by 31 March 2025. We strongly recommend APRA to adopt a similar approach to implementation for APRA-regulated entities.

CPS 230 would also require entities to undertake a tender and selection process when entering into, renewing or materially revising an arrangement with a material service provider. We disagree with this proposal as a tender and selection process is only one option, and often the most rigorous and costly, for an entity to undertake. We suggest entities should also be permitted to undertake benchmarking as another option.

In addition, we note APRA's decision to implement these requirements through a cross-prudential standard as part of its broader modernising prudential architecture project. The FSC observes therefore that clear, timely and detailed prudential guidance is particularly important for effective industry implementation given the need to ensure the new cross-sector standard caters well when applied to different sectors of APRA's regulated populations that are subject to distinct legal frameworks. Towards this objective, Section 4.2 of this submission highlights the key areas where we would appreciate clarity from APRA in its upcoming guidance.

### 3. FSC Recommendations

1. Provide further guidance on the definition of critical operation to help entities move away from the existing 'critical business operations' and 'critical business activities' concepts when determining its critical operations.
2. Clarify the specific reference to 'data loss' used in the tolerance level definition in the broader context of operational risk management.
3. Comment on the rationale and the circumstances under which APRA would compel APRA regulated entities to review and change its tolerance levels for a critical operation, or where APRA may itself set tolerance levels where it identified a heightened risk or material risk.
4. Amend the definition of 'material service provider' so that it does not capture service providers that are, in fact, not material to a critical operation of an APRA-regulated entity.
5. Clarify that software providers, one-off, short-term and contractor arrangements would generally be excluded from the definition of material service provider.
6. Clarify that service providers that partially provide a specified material service are not automatically deemed a material service provider provided they are not considered material by the entity.
7. Move the prescribed list of operational risks in Draft CPS 230 to the accompanying guidance and provide guidance on the principles of operational risk categorisation to CPS 220 and SPS 220.
8. Consider providing entities discretion to delegate elements of the operational risk management framework, which are more operational in nature, such as oversight of material service provider arrangements and approval of BCP tolerance levels.
9. Provide further guidance on the requirement for an entity's comprehensive service provider management policy to include its approach to managing the risks associated with any fourth parties that material service providers rely on.
10. Amend the requirement for APRA-regulated entities from 'undertake' to 'consider whether to undertake' a tender and selection process before entering into, renewing or materially modifying an arrangement with a material service provider.
11. Consider the merit of streamlining the CPS 230 requirement for APRA-regulated entities to submit its register of material service providers to APRA on an annual basis by integrating it into APRA's regular data collection framework.
12. Where a disruption resulting from an operational risk and/or information security incident meets the criteria for notifying APRA that it has activated its BCP, the BCP notification should be taken as a notification for an operational risk and/or information security incident.

13. Consider the merit of removing the additional requirement to notify APRA in relation to offshoring arrangements.
14. Provide an appropriate transition period for arrangements with existing service providers, given the complexities associated with arrangements already in place and the large number of arrangements affected. We suggest a staggered multi-year transition period would be appropriate.
15. Provide a notice period where APRA has used its powers to designate a provider as a material service provider and, by extension, require changes to an entity's service provider arrangements.

## 4. Overall design

### 4.1. Single cross-industry standard

APRA's decision to implement strengthened operational risk management requirements through a single cross-industry standard is part of APRA's strategic initiative to modernise the prudential architecture of the financial services system. We support the principle of streamlining prudential requirements towards the objective of ensuring that prudential rules are easy to understand, find and navigate.

As part of APRA's strategic initiative, APRA has moved towards a more principles-based and outcomes focused approach for setting prudential requirements. This will ultimately mean that the regulatory framework and its regulated population is better positioned to adapt to changes in the industry and in technology more generally.

However, this is not to overlook the challenges that come with adopting an approach that, by its very nature, is more generalised. A single cross-industry standard can be challenging for APRA-regulated entities operating in specific sectors to interpret, implement and embed. In contrast, an industry specific prudential standard can specifically tailor for interactions with sometimes overlapping, yet clearly distinct legal frameworks underpinning each sector.

We observe that in recent times, the wealth management industry has become more disintermediated with many conglomerate financial services organisations choosing to divest from vertical integrated business models. The costs for implementation and the impact on industry efficiency therefore should not be underestimated.

### 4.2. Areas for further guidance

As a general comment, APRA's adoption of a principles-based and outcomes focused approach when seeking to implement new cross-prudential standards means the role of timely and detailed prudential guidance increases from important to critical in ensuring APRA-regulated entities have sufficient clarity to efficiently implement new requirements.

Towards this objective, we would welcome clear and specific guidance on the following areas:

- Examples of what APRA considers critical operations. The definition of critical operation could be interpreted in different ways resulting in a broad interpretation of what should be captured as a material service provider
- Examples or case studies on what APRA would consider material weaknesses in an APRA-regulated entity's operational risk management framework, and how these would be assessed by APRA and the actions required to be taken by the APRA-regulated entity to address the issue.
- Identifying a material service provider, including relevant factors that assist an APRA-regulated entity in its materiality assessment

- The treatment of material service provider that is a related party or a connected entity, noting that CPS 231 prescribed a streamlined set of requirements for related body arrangements
- An entity's approach to managing the risks associated with any fourth parties that material service providers rely on
- Assessment of whether a service provider is "systematically important in Australia" and what would be considered a "concentration of service provider" in due diligence, and whether APRA or another Government Authority might be better placed to make this assessment
- What would be considered a "heightened prudential concern" in a service provider arrangement, noting that there might be practical challenges, including financial and human resources, with APRA requiring an entity to make changes to an existing commercial arrangement
- Current expectations in relation to cloud computing, which were previously set out in APRA's 2018 information paper
- Interaction of notification requirements with breach reporting requirements. For example, we would expect 'becoming aware' would follow a consistent interpretation as the breach reporting guidance
- Interaction of the proposed APRA powers for entities to hold additional capital in the event of a material weakness (paragraph 18 of draft CPS 230) with existing Operational Risk Financial Requirements imposed on Trustees under SPS 114. There should not be any duplication of requirements or powers, nor any inconsistency in the two standards
- Interaction of implementation and documentation requirements with SPS 220 in practice
- Expectations on the extent of the 'comprehensive risk assessment' prior to providing a material service to another party (paragraph 27 of draft CPS 230)
- Expectations on 'regular monitoring, reviewing and testing controls' (paragraph 29 of draft CPS 230)
- Clarity in respect of how the operational risk profile is to be articulated in practice (paragraph 30 of draft CPS 230)
- The level of assurance required for issue closure post remediation, for example the definition of assurance and who by (we expect this would be 2<sup>nd</sup> line level)
- The definition of operational risk incidents and near misses (if APRA had a view)

### **4.3. Proportionality**

The FSC strongly supports APRA's approach to strengthen operational risk management requirements in a proportionate manner. This is particularly important given the need to ensure that the cross-sector reach of the new standard caters well when applied to different sectors of APRA's regulated populations, which as noted earlier are subject to distinct legal frameworks.

We observe that Draft CPS 230 uses the language "comprehensive" for a number of requirements, see for example Paragraph 26 which would require an APRA-regulated entity



to maintain a comprehensive assessment of its operational risk profile. Proportionality can be enhanced in these circumstances to make clear that what is considered “comprehensive”, and the level of associated documentation required, would vary as appropriate to the entity’s size, business mix and complexity.

While the principle of proportionality might also seem implicit in relation to the business continuity plan requirements, we would consider it useful to integrate explicit language around proportionality of requirements when finalising the standard, for example in relation to setting risk tolerance levels.

#### **4.4. Implementation burden**

We note APRA expects the impact of its proposals, as set out in the APRA Discussion Paper, to have no material impact on the efficiency of APRA-regulated entities.

In our view however, APRA’s proposed approach has the potential to impose significant compliance costs on industry. While we cannot readily estimate the quantum of costs for FSC members at this point, we are primarily concerned that the proposed granularity of requirements may have the unintended net effect of impeding industry efficiency.

Areas of particular concern include:

- The level of granularity that might be expected of all entities when defining operational risk, the framework for control design and operating effectiveness testing, and the mechanisms for identifying and rectifying material weaknesses and control gaps.
- The expansion of business continuity plans and testing to include maximum extent of data loss the entity would accept, and tailoring the plans to cover the material risks of the APRA regulated entity and the contingency arrangements associated with material service providers.
- The practicality of the requirement for an entity to set out its approach to managing the risks associated with any fourth parties that material service providers rely on.
- The requirement to identify and maintain a register of its material service providers and manage the material risks associated with using these providers, which under the proposed drafting would appear to capture a great number of service providers
- The retrospective nature of the APRA’s proposals and the lack of a transition period for service provider agreements already in place.

We welcome APRA’s acknowledgment that it intends to implement the new standard in a proportionate manner. Guidance on the “comprehensiveness” of documentation required would help to address the concern that APRA’s proposals would not disproportionately impact entities that are simpler in size, complexity and nature.

## 5. Specific requirements

### 5.1. Definitions

#### Critical operations

APRA defines a critical operation in Paragraph 34 of draft CPS 230 and under Paragraph 35, would require that certain operations be classified as a critical operation. The Discussion Paper states that critical operations are processes that would be important for a particular entity to ensure it could continue to deliver through a disruption.

Draft CPS 230 would also require the entity to define, identify and maintain a register of its operations that would also meet the definition of a critical operation. As noted by APRA in its Discussion Paper, the concept of critical operations in draft CPS 230 is similar to the existing concept of 'critical business operations' in the current CPS 232, but with a definition now more focused on outcomes and the key stakeholders of the entity rather than the entity itself. It is also similar to the existing concept of 'critical business activities' in the current SPS 232.

Currently, these lists of critical business operations and critical business activities are often documented at quite a granular level. If these lists were adopted to implement CPS 230, the flow-on implications would result in APRA regulated entities capturing a long list of material service providers, which could be overly onerous for APRA regulated entities to maintain.

#### **Recommendation**

1. Provide further guidance on the definition of critical operation to help entities move away from the existing 'critical business operations' and 'critical business activities' concepts when determining its critical operations.

#### Tolerance Levels

Tolerance levels have been defined to specifically reference 'data loss'. 'Data loss' would appear to be a new term and so it would be useful to define this in the broader context of operational risk management as this seems more applicable to CPS 234. For example, it would be helpful to confirm the "the maximum period of time the entity would tolerate a disruption to the operation" would be practically the same as 'recovery time' as set out in CPS 232 and SPS 232.

APRA also proposes to empower itself to compel APRA regulated entities to review and change its tolerance levels for a critical operation, or may itself set tolerance levels where it identified a heightened risk or material risk. It would be helpful for APRA to comment further on the rationale for these powers and to provide additional information on when such measures would be enacted.

### Recommendation

2. Clarify the specific reference to 'data loss' used in the tolerance level definition in the broader context of operational risk management.
3. Comment on the rationale and the circumstances under which APRA would compel APRA regulated entities to review and change its tolerance levels for a critical operation, or where APRA may itself set tolerance levels where it identified a heightened risk or material risk.

### Material Service Providers

Under Paragraph 48 of Draft CPS 230, APRA defines material service providers as those on which the entity relies to undertake a critical operation or that expose it to material operational risk. A material service provider may be a third party, related party or connected entity. A service provider may be identified as a result of an individual arrangement or multiple arrangements with an APRA-regulated entity. As expressed in the Discussion Paper, Draft CPS 230 emphasises a broader definition of material service providers beyond purely outsourcing arrangements.

We observe that this proposed definition might appear to capture *any and all* service providers on which the entity relies to undertake a critical operation. In our view, the definition of a 'material service provider' should allow for materiality and only capture those service providers that are relied on, in substance, for a critical operation. This change would align with the regulatory intent expressed in the APRA Discussion Paper for entities and for APRA to focus on those service providers deemed to be material. It would also not unduly penalise those APRA-regulated entities that choose to rely on a larger number of service providers for the diversification benefit that comes from not overly relying on a small number of providers.

The proposed definition of material service provider could also be interpreted to include the following type of arrangement but which we do not believe would be the intent:

- Software providers – software licensing arrangements are generally not currently considered an outsourced material business activity. While the software might be performing an activity, it remains under the control of the APRA-regulated entity.
- One-off, short-term and contractor services – where the cost of switching between providers is low and switching is relatively easy. This includes contractor relationships such as mail, telephony, legal, printing, travel and transportation services etc. These types of arrangements were previously carved out in CPS 231 and SPS 231 via associated guidance.

#### **Recommendation**

4. Amend the definition of 'material service provider' so that it does not capture service providers that are, in fact, not material to a critical operation of an APRA-regulated entity.
5. Clarify that software providers, one-off, short-term and contractor arrangements would generally be excluded from the definition of material service provider.

### **5.2. Specified critical operations and material service providers**

Under Draft CPS 230, APRA has specified certain operations that must be included. APRA's Discussion Paper notes that this will ensure critical operations are consistently captured across the industry. APRA has similarly specified a list of services considered material.

Similar to the definition of material service providers, it is not clear whether APRA's drafting of Paragraph 49 captures *any and all* service providers that provide a material service or only those service providers that are considered material. In our view, the drafting should be clarified to make clear it is the latter. This would have the effect of not automatically including service providers that provide a partial component of the material service and are not considered material by the entity. Again, this change would align with the regulatory intent expressed in the APRA Discussion Paper to focus on those service providers deemed to be material.

The current drafting would be particularly problematic for arrangements with promoters and financial planners automatically deemed as material. This would suggest that all of these arrangements would need to be considered as a material service provider. These arrangements have only recently been reviewed and updated by entities to comply with the Product Design and Distribution obligations and following the ceasing of grandfathered remunerations, which was an exhaustive exercise.

#### **Recommendation**

6. Clarify that service providers that partially provide a specified material service are not automatically deemed a material service provider provided they are not considered material by the entity.

### **5.3. Operational risk granularity**

We observe Paragraph 23 of Draft CPS 230 states that the full range of operational risks include but are not limited to:

- Legal risk
- Regulatory risk
- Compliance risk
- Conduct risk
- Technology risk
- Data risk
- Reputational risk

- Change management risk

Different entities, depending on their size, business mix and complexity, will likely prefer differing approaches to operational risk taxonomy. For example:

- Legal risk and regulatory risk as they relate to operational risk could be categorised within compliance risk
- Reputational risk can be considered an impact as opposed to a category of operational risk.

The granularity of categorisation may result in a flow on impact, for example to the requirement to maintain a comprehensive assessment of an entity's operational risk profile (Paragraph 26 of Draft CPS 230). Another example is the requirement to identify and maintain a register of an entity's material service providers and manage the material risks associated with using these providers under (Paragraph 48 of draft CPS 230).

It is not clear whether APRA expects APRA-regulated entities to decompose operational risk to this level of granularity or that this prescribed list is merely intended to require entities to approach managing operational risk in a way that is nuanced, comprehensive and holistic. We believe it should be the latter and this would be more consistent with APRA's stance for a principles-based and outcomes-focused approach.

#### **Recommendation**

7. Move the prescribed list of operational risks in Draft CPS 230 to the accompanying guidance and provide guidance on the principles of operational risk categorisation to CPS 220 and SPS 220.

### **5.4. Role of the Board**

While we strongly support the Board having accountability of the overall framework, we believe APRA should provide APRA-regulated entities discretion to delegate elements of the operational risk management framework, to management, which are more operational in nature, such as oversight of the BCP tolerance levels, the results of BCP testing and execution of findings, and risk and performance reporting on material service provider arrangements.

Under APRA's proposals, the Boards of APRA-regulated entities would be required to operate at a very granular level, which may hinder their overall role of governance and oversight.

#### **Recommendation**

8. Consider providing entities discretion to delegate elements of the operational risk management framework, which are more operational in nature, such as oversight of material service provider arrangements and approval of BCP tolerance levels.

## 5.5. Material service provider arrangements

### Fourth-party risk management

We note the new requirement for APRA-regulated entities to manage the risks associated with any fourth (and further) parties of material service providers. While we understand this direction and rationale, we would require further guidance around APRA's expectations on how far this requirement is to be practically implemented, for example, taking into consideration the resources required and the commercial nature of agreements such as confidentiality clauses around disclosing fourth parties. In some cases, when considering the materiality, criticality and risk associated with the third party and its reliance on fourth parties, attestation from the third party or indemnity clauses in agreements could be considered sufficient.

For example, a third-party service provider may rely upon multiple (potentially tens) of service providers. If the third party is not an APRA regulated entity themselves then they may not have conducted and have available to demonstrate adequate governance on these arrangements that would support compliance with CPS 230 or provide a similar level of assurance. Therefore, the ability to obtain comfort that the use of a fourth party is appropriate could be very difficult and time-consuming for APRA regulated entities.

Additionally, paragraph 52 states that an APRA regulated entity must take reasonable steps to assess whether the provider is systematically important in Australia. It would be challenging for an APRA regulated entity to undertake this assessment without knowledge of the provider's use more broadly within Australia. Even if it could be concluded that the service is systematically important then what would be the steps that APRA would expect an APRA regulated entity to take? For example, we expect that the use Microsoft 365, Azure and Sharepoint may be considered systemically important, but what is then expected of the APRA regulated entity.

#### **Recommendation**

9. Provide further guidance on the requirement for an entity's comprehensive service provider management policy to include its approach to managing the risks associated with any fourth parties that material service providers rely on.

### Service provider due diligence

Under APRA's proposals, an APRA-regulated entity would, among other things, need to undertake an appropriate tender and selection process before entering into, renewing or materially modifying an arrangement with a material service provider.

We would disagree with this proposal. It would be more appropriate for the APRA-regulated entity to consider whether to undertake a tender and selection process.

A tender and selection process is only one option, and often the most rigorous and costly, for an entity to undertake. This is recognised by APRA in its insight paper concerning a thematic review of the outsourcing arrangements of superannuation trustees:

*“...trustees often benchmark costs and services against an expert’s view of the market, using either an external consultant or an internal team. This is because, in some cases, obtaining quotes was impractical.”*

#### **Recommendation**

10. Amend the requirement for APRA-regulated entities from ‘undertake’ to ‘consider whether to undertake’ a tender and selection process before entering into, renewing or materially modifying an arrangement with a material service provider.

### **Annual submission of material service providers register**

We note the requirement for APRA-regulated entities to submit its register of material service providers to APRA on an annual basis as part of CPS 230 requirements.

This information provided on a regular basis might be better captured through the APRA Data Collection process, which allows for more improved detail and comparability of data submitted by different entities. For example, this information is already captured in some level of detail in the existing SRS 332.0 data collection. However, this might come at the cost of additional effort for entities as they would be required to manually re-enter details from an internally generated document into APRA connect.

#### **Recommendation**

11. Consider the merit of streamlining the CPS 230 requirement for APRA-regulated entities to submit its register of material service providers to APRA on an annual basis by integrating it into APRA’s regular data collection framework.

## **5.6. APRA Notification**

### **Operational risk incidents**

The operational risk incident notification requirement and timeframe set out in Paragraph 32 of Draft CPS 230 is reasonable. We also agree with APRA’s position that a notification of an information security incident under CPS 234 does not need to be separately reported under the operational risk incident notification requirement of Draft CPS 230.

### **Activation of a business continuity plan**

The activation of an entity’s BCP notification requirement and timeframe set out in Paragraph 41 of Draft CPS 230 is reasonable.

This requirement is consistent with its equivalent in CPS 232 and SPS 232. APRA has clarified in CPG 234 that where a disruption resulting from an information security incident meets the criteria for notifying APRA under CPS 232, an APRA-regulated entity must notify

APRA in accordance with the CPS 232 requirements. Under these circumstances, the notification under CPS 232 would be taken to also be a notification under CPS 234.

**Recommendation**

12. Where a disruption resulting from an operational risk and/or information security incident meets the criteria for notifying APRA that it has activated its BCP, the BCP notification should be taken as a notification for an operational risk and/or information security incident.

**Service provider agreements relied on for a critical operation**

The notification requirement and 20 business day timeframe following entry into or material change to an agreement for material service providers is reasonable.

Under Draft CPS 230, we observe there are no requirements for APRA-regulated entities to consult or to obtain APRA approval prior to entering into any offshoring agreements. However, there is an additional notification requirement to provide notification to APRA “prior to entering into any offshoring agreement with a material service provider, or when there is a significant change proposed to the agreement, including in circumstances where data or personnel relevant to the service being provided will be located offshore”.

This additional offshoring notification requirement would capture a wide number of overseas institutions given the broad definition of a material service provider.

To reduce ongoing compliance costs, this requirement could be consolidated with the general 20 business day notification requirement. We further note the due diligence requirements on APRA regulated entities under Paragraph 52 which place specific emphasis on risks associated with geographic location and concentration.

**Recommendation**

13. Consider the merit of removing the additional requirement to notify APRA in relation to offshoring arrangements.

**5.7. Transition for arrangements with existing service providers**

Based on our reading, it would seem that APRA’s proposals for requirements to commence for all material service provider agreements from 1 January 2024, and would apply to all existing material service provider arrangements.

It is unclear whether APRA expects that all existing arrangements to be compliant with the requirements by the implementation date of 1 January 2024.

Adequate transitional arrangements will allow the industry as a whole to better manage the implementation of the standard, especially in instances where service providers are utilised by multiple APRA regulated entities, noting resource-intensive nature of this activity.



We observe the approach adopted by the UK Regulators where operational resilience requirements were finalised in March 2021 following formal consultation which commenced in December 2019. The transitional requirements for implementation have been set in two stages, with a 1-year transitional period for initial requirements for 31 March 2022 implementation, followed by a three-year transitional period for full implementation by 31 March 2025. Our initial view is that it would seem natural for APRA to adopt a similar approach to implementation for APRA-regulated entities.

To revisit all existing material service provider arrangements prior to the implementation date of the standard would be a great impost on APRA-regulated entities and therefore we request that the existing arrangements are grandfathered until they are scheduled for renewal or receive a material modification. To alleviate concerns that some material arrangements would have long terms (such as seven or ten years), we consider it might be appropriate to set a maximum timeframe (say three years) that an arrangement can run before the entity would be required to review it under the requirements CPS 230.

We believe it would also be worthwhile setting out sufficient forward notice when APRA has decided to use its powers to designate a provider as a material service provider and, by extension, require changes to an entity's service provider arrangements (Paragraph 51 of draft CPS 230). These changes would naturally take some time to properly implement given the commercial considerations and the coordination required with the service provider who may themselves not be an APRA-regulated entity.

### **Recommendation**

14. Provide an appropriate transition period for arrangements with existing service providers, given the complexities associated with arrangements already in place and the large number of arrangements affected. We suggest a staggered multi-year transition period would be appropriate.

15. Provide a notice period where APRA has used its powers to designate a provider as a material service provider and, by extension, require changes to an entity's service provider arrangements.