APRA’S SUPERVISORY ACTIVITIES AND PRIORITIES

- APRA’S SUPERVISORY APPROACH AND PROCESS
- KEY SUPERVISORY THEMES
- AUTHORISED DEPOSIT-TAKING INSTITUTIONS
- GENERAL INSURANCE
- LIFE INSURANCE AND FRIENDLY SOCIETIES
- SUPERANNUATION
- ENFORCEMENT ACTIVITIES
APRA’S SUPERVISORY APPROACH AND PROCESS

APRA has long emphasised strong and proactive supervision as a core means of fulfilling its mandate. This approach, which maintains supervisory intensity even in good times, was an important contributor to the resilience of the Australian financial system in the face of the global financial crisis. A focus on supervision also provides greater ability to tailor requirements to suit individual circumstances: in other words, supervision has greater capacity to be both risk-based and outcomes-focussed. This, in turn, is likely to maximise both the efficiency and effectiveness of the prudential framework.

At the heart of APRA’s supervisory approach are its Probability and Impact Rating System (PAIRS), the Supervisory Oversight and Response System (SOARS) and Supervisory Action Plans (SAPs). PAIRS risk ratings provide a structured means to consistently assess the risk profile of APRA-regulated institutions. These institutional ratings, along with a measure of impact should the institution fail, are combined in the SOARS framework to determine the appropriate supervisory intensity: higher risk and/or impact will, all else being equal, lead to greater supervisory intensity. Supervision plans are then developed to specify the activities that APRA supervisors need to undertake, taking into account both institutional issues as well as risks identified from an industry-wide perspective. This alignment of risk and supervisory intensity is the foundation of APRA’s risk-based approach.

To better support the activities of its frontline supervisors, APRA continued to enhance the effectiveness and efficiency of its supervision processes and systems during 2013/14. To this end, improvements were made to supervision processes to ensure APRA’s regulatory activities remain directed at key issues associated with individual APRA-regulated institutions, and to information technology (IT) systems and tools such that supervisors have more ready access to up-to-date and reliable information about institutions’ risk profiles.

During 2013/14, APRA completed the rollout of a new IT platform that better supports its core supervisory functions and will bring long-term benefits to supervisory performance. The rollout of this upgrade was the first leg of a larger program to enhance supervision infrastructure that promises a range of benefits, including:

- the ability to obtain a portfolio view of key risks and issues identified with APRA-regulated institutions across all industries, and supervisory actions planned to address these;
- the ability to conduct extensive analysis of PAIRS risk ratings to better inform the identification of institutional and systemic risks;
- greater visibility on resources allocated to supervisory activities across APRA to ensure frontline supervisors and risk specialists are conducting work targeted at addressing identified risks; and
- productivity and efficiency gains.

Planning for the next systems release as part of the program is in progress. This will include the delivery of fast and reliable ways for APRA staff to work together within a secure information management environment that is integrated with the core supervision platform. Full benefits of the new IT platform are expected to flow once all aspects of the larger program have been implemented.
KEY SUPERVISORY THEMES

While APRA’s approach is tailored to the individual risk profile of each regulated institution, three important industry-wide themes were also pursued during 2013/14.

Governance and the role of boards

APRA’s supervisory philosophy recognises it is the board and senior management of each regulated institution that are primarily responsible for its financial and operational soundness.

APRA’s focus on governance means that it places significant emphasis on the role of the boards of APRA-regulated institutions. This has involved increased emphasis within supervisory activities on governance structures and processes, including board stewardship, remuneration, culture, risk appetite and risk management frameworks. During the year, APRA continued its program of regular meetings with boards, and has begun to supplement these in a number of cases with additional meetings with the chairs of boards and board committees. In addition, the new prudential standards for superannuation, and particularly the new standard on governance, have meant APRA has been engaging in more intensive discussions with both trustee boards and senior management across the superannuation industry on these issues.

Over recent years, APRA has received feedback that some aspects of the prudential framework are perceived to require board involvement in matters that are more appropriately reserved for management. That has not been APRA’s intent. There are sound reasons why APRA imposes additional obligations on boards of APRA-regulated institutions as part of its prudential framework for protecting the interests of depositors, policyholders and fund members. In doing so, APRA’s goal is to promote strong governance practices and robust oversight of the operations of each institution; but APRA does not expect boards to take on day-to-day management responsibilities. As a result, APRA commenced a stocktake of its requirements of boards during 2013/14, with a view to improving how these requirements are conveyed. APRA also developed an Aid for Directors of ADIs and insurers, designed to provide an overview, in general terms, of the purpose of prudential regulation, the legal framework through which it is implemented, and the additional obligations applying to directors of APRA-regulated institutions. The purpose of this Aid, which was published in October 2014, is educational; it does not take the place of any APRA prudential standard or guidance, or establish any formal requirements beyond those already set in the prudential standards.
Capital management

Beyond the necessary task of meeting minimum capital adequacy requirements, APRA places a great deal of attention on the way in which regulated institutions manage their own financial strength. In 2013/14, APRA continued to devote a considerable amount of time and effort to assessing the Internal Capital Adequacy Assessment Processes (ICAAPs) of ADIs, general insurers and life insurers (including friendly societies).

Although the requirements for ICAAPs have been in place for some years for ADIs, they were only introduced in the insurance sectors in 2013. An important component of the new prudential requirements is the obligation for institutions in these industries to prepare an ICAAP Summary Statement as well as an annual ICAAP Report. During 2013/14, APRA undertook a comprehensive review of ICAAP Reports. This review focused on issues such as internal governance, modelling and data reliability, scenario development and the use of stress testing. The review included peer comparisons with a view to identifying better practice and potential areas for improvement. In December 2013, APRA wrote to all insurers summarising the results of the benchmarking process and identifying examples of better practice.

Crisis preparedness

Both regulated institutions and APRA supervisors need to be prepared to deal with a range of adverse events that may threaten the financial soundness, and even viability, of an institution’s business. A range of supervisory activities were pursued during 2013/14 that were designed to enhance the understanding of, and preparedness for, adverse events.

- Stress testing. Since 2012, APRA has increased resources for stress testing as part of an internal strategy aimed at improving both APRA’s and the industry’s own stress-testing capabilities. APRA’s focus on stress testing was further sharpened during 2013/14 with two main streams of work. In the first, APRA conducted an ADI stress test involving the largest ADIs based on common adverse scenarios. These scenarios are centred on risks that could emerge in a housing market downturn, and seek to test the resilience of ADIs to both a sharp economic recession and a higher interest rate environment (given the nature of the scenarios, the stress test was also applied to providers of Lenders’ Mortgage Insurance (LMIs)). Alongside APRA’s own stress tests, APRA has also examined the internal stress-testing programs of individual institutions as part of the ICAAP reviews (see above).
Recovery and resolution planning. In recent years, APRA initiated work with a number of the largest ADIs on recovery planning: that is, plans that institutions would put into action to stabilise their operations during a period of severe financial stress. The plans, useful for institutions and for supervisory purposes, are also a starting point for further work to develop credible resolution planning, i.e. planning by the authorities in the event that an institution does not have the capacity to rectify its own problems. Along with members of the Council of Financial Regulators, APRA has continued its work on general resolution planning, with a focus on measures that would enable cost-effective resolution of a regulated institution in the event recovery is not feasible. This work has primarily involved exploring resolution options for a distressed ADI, and funding issues related to the Financial Claims Scheme (FCS), including options for prefunding, and refinement of ADI crisis resolution coordination.

During 2013/14, APRA also conducted an internal crisis simulation exercise involving a fictional life insurer. The simulation was observed by senior APRA staff, and a post-simulation report identified a number of enhancements that have been subsequently reflected in updates to APRA’s crisis management plans.

Financial Claims Scheme (FCS). In mid-2013, APRA released an amended Prudential Standard APS 910 Financial Claims Scheme. APS 910 requires that ADIs are operationally ready to meet payment, reporting and communication requirements should the FCS be activated. All ADIs were required to be compliant with the amended APS 910 by 1 July 2014, unless otherwise granted a specific extension by APRA. A number of such extensions were granted, reflecting the individual circumstances of some institutions. All ADIs without extended transition under APS 910 have successfully tested the format of payment instruction files with APRA’s paying agent, the Reserve Bank of Australia (RBA), to ensure that FCS payments could be made if required.
AUTHORISED DEPOSIT-TAKING INSTITUTIONS

There was little change in the ADI population or its composition in 2013/14. One credit union and one building society converted their status to that of a mutually-owned bank, continuing a consistent recent trend. Since 2011, nine credit unions and two building societies, accounting for around 30 per cent of total credit union and building society assets, have rebranded as mutual banks.

The overall financial position of the ADI sector strengthened over 2013/14, supported by relatively stable economic conditions and improved funding markets. Industry profitability remained strong, with steady net interest margins, continuing declines in bad debts and cost savings from productivity initiatives. Capital ratios increased, with the weighted average Common Equity Tier 1 (CET1) ratio rising from 8.7 to 9.1 per cent. Funding and liquidity positions were significantly more resilient than prior to the financial crisis, and ADIs enjoyed ready access to term funding markets over the year.

Steady economic growth, moderate unemployment and historically low interest rates underpinned further improvements in ADIs’ asset quality over 2013/14. Low interest rates not only reduced the debt burden for existing borrowers but also increased demand, particularly amongst the household sector, for new debt commitments. Credit growth strengthened moderately as a consequence.

Credit quality

During 2013/14, APRA’s highest supervisory priority for the ADI sector has been lending for housing. Residential mortgage lending has traditionally been a low risk and profitable business for ADIs. However, residential mortgage lending now accounts for about 60 per cent of the banking system’s domestic loan portfolio, which is high by both historical and international standards. Just by virtue of its size, housing lending would justify additional supervisory scrutiny. In the current environment of historically low interest rates, high household debt, high and rising house prices and strong competitive pressures, APRA has been intensifying its monitoring of housing lending standards even further. Recent mortgage reviews of ADIs have, for example, paid particular attention to policies in relation to lending at high loan-to-value ratios and/or low serviceability ratios, including the robustness of controls ADIs have in place to ensure borrowers can still meet mortgage repayments should interest rates rise in the future.

In June 2011, APRA wrote to the chairs of a number of ADIs to remind boards of the need to be alert to any deterioration in credit standards in residential mortgage lending. At that time, APRA sought assurances that boards were actively monitoring their residential mortgage lending portfolios and were comfortable with their credit standards. Each of the boards concerned provided those assurances.
Since then, interest rates have fallen to record lows and pricing pressures have been building up in some housing markets. The potential risks about which APRA expressed concerns in 2011 have only risen further, particularly in the context of very active competition between lenders. Credit standards in residential mortgage lending have again come under pressure and, in some cases, have returned to pre-crisis settings.

In these circumstances, lending practices that may appear prudent at the individual institution level may, in aggregate, fuel systemic risks. Lending focussed on particular higher-risk segments may encourage speculative borrower behaviour that could have adverse consequences should interest rates rise strongly or economic conditions deteriorate. Even if individual institutions are well capitalised for the risks they are assuming, the cumulative effect of such lending may undermine the stability of the overall banking system. These concerns have led some countries that have had low interest rates and stable economic conditions to introduce ‘macroprudential’ measures recently to restrain residential mortgage lending.

During the course of 2013/14, APRA has gradually ‘turned up the dial’ to ensure ADIs are wary of the potential for further reductions in lending standards. This has included:

- additional data collections which have allowed APRA to more readily identify, and provide feedback to, those ADIs pursuing more aggressive lending policies;
- the issuance of Prudential Practice Guide 223 Residential Mortgage Lending, which outlines prudent practice in addressing housing credit risk within an ADI’s risk management framework, in applying sound loan origination criteria and appropriate security valuation methods, in the management of hardship loans and in establishing a robust stress-testing framework; and
- seeking renewed assurances from the boards of the largest housing lenders that they and senior management are actively monitoring their institution’s residential mortgage risk profile, including the impact of any changes to credit standards.

These steps have lessened some of the more aggressive lending that APRA had been observing. Nevertheless, competitive forces remain strong, and credit standards remain under pressure. In addition, the Council of Financial Regulators has been discussing the systemic risks that arise from emerging imbalances in the housing finance market, particularly in relation to housing investment. APRA, with advice from Council members, is considering what further steps might be appropriate to temper potential threats to the health of individual ADIs, or financial stability more generally, from these developments.
Credit growth in Australian business lending was much more subdued, and there was a further pronounced decline in the share of impaired exposures over the past year as ADIs worked through legacy problem loans. However, as the profile of existing exposures improves, APRA’s credit risk reviews over the past year have indicated some of the same competitive pressures on lending standards are emerging in the wholesale (large value) business loan segment, reflected in lower loan margins, lengthened maturities and, in some cases, an easing of loan covenants. There are also early signs of some ADIs increasing their appetite for commercial property exposures, a segment that has on occasion led to large losses for some lenders. As with housing standards, this is an area that will also be subject to heightened scrutiny by APRA in the year ahead.

**Capital**

In its supervision of capital management, APRA’s focus is on ensuring that ADIs do more than simply meet minimum regulatory requirements. ADIs must demonstrate to APRA that they have built and can maintain buffers that reflect their specific risk profile and give them the capacity to absorb significant losses during any periods of stress. The setting of these capital buffers is a crucial part of an ADI’s internal capital management and planning, as defined in the ICAAP. ADIs have substantially strengthened their capital positions since the global financial crisis. The aggregate CET1 capital ratio stood at 9.1 per cent at end-June 2014, around 40 basis points higher than a year earlier. This is not only well in excess of the 4.5 per cent minimum requirement that presently applies, but has the ADI sector well in excess of the new capital conservation buffer – which will see the effective minimum CET1 ratio increase to seven per cent – when it comes into effect from 1 January 2016.

In December 2013, APRA announced a framework for dealing with domestic systemically important banks (D-SIBs). From 2016, the four major banks will be required to meet a higher capital conservation buffer, with an additional CET1 capital requirement equivalent to one per cent of risk-weighted assets. The capital plans of the four major banks indicate they are well placed to deal with any adjustments to their capital positions in response to this additional requirement. The current economic outlook should allow for adequate retention of earnings even with the existing high dividend payout rates. To shore up common equity, some of the major banks have again started to retain capital from dividend reinvestment plans (DRPs), following a period when they were either partially or fully offsetting the boost to common equity from DRPs by buying back shares in the market.
Liquidity

ADIs’ resilience to funding-market shocks has significantly improved in recent years, with further strengthening evident in 2013/14.

Wholesale funding conditions have significantly eased, with spreads between Commonwealth Government Securities and the major banks’ unsecured bonds at their lowest level since the onset of the financial crisis. This reduced risk aversion among global investors meant larger ADIs have had ready access to international wholesale markets for unsecured debt. As a result, the issuance of covered bonds in 2013/14 was minimal, with ADIs preferring to conserve their covered bond capacity well below legislative limits as a contingency against future disruptions to wholesale funding.

The more favourable conditions in wholesale markets have impacted pricing for domestic deposits, with competition easing in the latter part of the financial year. Activity in the residential mortgage-backed securities (RMBS) market also picked up, with spreads at their lowest level since late 2007. This market has in the past provided a significant source of funding for ADIs, and several have recently taken advantage of the more favourable conditions by increasing their issuance.

As a result of these developments, ADIs have continued to add to their holdings of high quality liquid assets and increase their share of funding from more stable sources.

This strengthening has occurred against the backdrop of, and been partly driven by, the implementation of the new Liquidity Coverage Ratio (LCR) requirements, which come into force in Australia in 2015. Besides finalising the regulatory framework for the LCR in late 2013, its implementation has been a major area of supervisory focus for APRA for the past year. The LCR is designed to improve ADIs’ resilience to liquidity shocks by requiring them to hold a stock of high quality liquid assets to cover the expected net cash outflows during a 30-day period of stress. Given the absence of sufficient high quality liquid assets in Australia due to the Australian Government’s low levels of outstanding debt relative to the liquidity needs of the banking system, APRA and the RBA have implemented an arrangement to allow ADIs to access a standby liquidity facility at the RBA. This facility – the Committed Liquidity Facility (CLF) – allows ADIs access to secured funding from the RBA in the event of liquidity stress, in return for the payment of a commitment fee. ADIs may use the CLF to meet part of their requirement to hold high quality liquid assets, but to ensure it is used to the minimum extent needed, ADIs applying for such a facility must first demonstrate they have taken ‘all reasonable steps’ to meet the LCR requirement through their own balance sheet management.

To prepare for the introduction of the LCR, APRA conducted a trial exercise in 2013 in which supervisors evaluated pro forma requests from ADIs to access the CLF. It included scrutiny of three-year funding plans, reviewing the robustness of ADI liquidity transfer pricing, and evaluating remuneration incentives for executives responsible for funding and liquidity management. The process highlighted a number of areas with scope for improvement, and APRA supervisors continue to work with institutions on these issues ahead of the formal implementation of the LCR in 2015, including the determination of initial CLF amounts in late 2014.
GENERAL INSURANCE

There was a small decrease in the number of authorised general insurers and reinsurers during the year as some insurance groups rationalised licences inherited in previous acquisitions. The number of authorised insurers fell from 121 to 115 over the year. Insurance Australia Group’s acquisition of Wesfarmers’ insurance business also took effect on 30 June 2014, strengthening the market share held by large insurance groups in the personal and commercial lines markets. Despite the increasing concentration in both markets, healthy competition is evident among the large domestic insurance groups, APRA-authorised subsidiaries of foreign insurers and other local insurers.

The general insurance industry is strongly capitalised, with an industry capital coverage ratio of 1.9 times the regulatory minimum (before supervisory adjustments) at 30 June 2014. Capital levels have been bolstered by healthy industry profitability, in particular among personal line insurers that have benefited from premium increases and relatively benign weather conditions. In contrast, the financial performance of commercial insurers was subdued during the year as competitive pressures constrained premium growth. The low interest rate environment also had a negative impact on insurers’ investment income.

Gross claims costs to insurers from natural catastrophe events during the year were at relatively low levels, with Cyclone Ita and bushfires in NSW and Perth having the most impact. However, a significant amount of claims on insurers (and reinsurers) from the series of natural catastrophes in 2011, including the Christchurch earthquakes, are still outstanding. Where the recoverable reinsurance amounts associated with these claims are owing from non-APRA authorised reinsurers, higher capital charges apply because of the length of time they have now been outstanding, which in turn increases the affected insurers’ capital requirements. APRA supervisors continue to monitor the impact of developments in this area.

Affordability of natural perils insurance remains a source of reputational risk for the industry, particularly for properties at high risk of damage from cyclone activity and riverine flooding. Where the cover for such perils is a compulsory part of insurers’ policy offering, home and contents insurance may become unaffordable for some policyholders. In instances where riverine flood cover is available on an opt-out basis to owners of properties at high flood risk, policyholders may well exercise the opt-out provision because of the high cost of this cover, reducing their ability to withstand a flood event. Insurance affordability has received most attention in north Queensland, with the Australian Government considering options to address the issue.

APRA substantially revised the capital requirements for general insurers in 2012/13. The final component of these new requirements – the introduction of the insurance concentration risk charge (ICRC) for a series of significant natural peril events – came into effect on 1 January 2014. APRA supervisors engaged closely with insurers as they prepared for this change, which resulted in a higher ICRC for some insurers.
Catastrophe risk management

Recent natural catastrophes in Australia and New Zealand highlighted the need for general insurers to have robust reinsurance programs in place. A rigorous approach properly recognises the importance of strong governance and risk management processes in determining catastrophe reinsurance needs, and in the use of catastrophe models. APRA expects insurers’ senior management to understand and challenge catastrophe model inputs, assumptions, process and outputs, and boards must provide strong oversight of catastrophe risk management frameworks.

A thematic review by APRA of governance and risk management processes as it relates to catastrophe modelling by general insurers highlighted a number of concerns in this area. These included the excessive reliance by some insurers on catastrophe model output in reinsurance purchasing decisions and the setting of capital targets, and the absence of formal processes to challenge this output.

As part of APRA’s drive to encourage better industry practice in this area, a letter was sent to industry in late 2013 setting out the conclusions from the thematic review and highlighting issues APRA expected insurers to address. Supervisors have been engaging with insurers during 2014 on their responses to the issues raised.

Low interest rate environment

The low interest rate environment poses challenges to the general insurance industry, and the risks arising from these conditions for a sample of insurers were examined by APRA during 2013/14, with a focus on governance practices, pricing, investment strategies and operational risk.

All insurers in the sample had appropriate management and controls in place. In their feedback, insurers acknowledged the continuing competition in some long-tail classes was constraining their ability to achieve adequate price increases to offset the negative impact of lower investment yields. Insurers also indicated they were not looking to significantly change their conservative investment strategies to seek higher yielding investments, including those strategies relating to their investments backing policy liabilities.

APRA supervisors will be continuing to review the effectiveness of insurers’ risk management frameworks to ensure that insurers appropriately recognise and respond to changes in their risk profiles as investment market conditions alter.
Reserving risk

General insurers and reinsurers face the perennial risk of inadequate reserving for insurance liabilities – particularly those liabilities with a long tail – which leaves them exposed to significant losses if the claims outlook deteriorates in later years. This is a heightened risk in the present environment given a range of challenges to insurers’ profitability, which can create pressure to release reserves to support short-term results. These challenges include pressure on underwriting results arising from competitive pressures in a number of lines as well as the low interest rate environment dampening investment income. As a result, APRA is closely monitoring industry practice in this area.

Other supervisory matters

The low interest rate environment is one of the drivers of increased demand from global capital market investors for insurance-linked investments, due to the higher yields on offer from these products. These products, which are substitutes for traditional reinsurance, are largely concentrated in the US property catastrophe and retrocession market and have led to direct pressure on the pricing and profit margins of traditional reinsurers operating in that market. The growth in these products offshore has also contributed to an excess of traditional property reinsurance on offer in peak areas such as Australia, resulting in downward pressure on pricing.

A review by APRA during the year found that there is little appetite at present among Australian insurers for these alternative reinsurance products. Insurers surveyed had a preference for traditional reinsurance because it is readily available on favourable terms and conditions. Some insurers also cited the value of maintaining longstanding relationships with their traditional reinsurers, and the cost effectiveness and certainty of traditional arrangements. APRA will continue to monitor developments in this area and, where needed, review alternative reinsurance arrangements entered into by Australian insurers to ensure they adequately address APRA’s reinsurance and collateral requirements.

Underwriting and pricing processes remain key areas of focus for APRA given that any deficiencies in these processes can lead to declining profitability and, eventually, declines in insurers’ capital coverage ratios. Pricing risk in the commercial lines segment has been the subject of an APRA review throughout 2014, as an oversupply of capacity has fed heightened price competition, with insurers at risk of mispricing risks to the detriment of future profitability and capital levels. APRA has sought to identify changes to market share among commercial line insurers that can be attributed to aggressive pricing strategies, and examine the adequacy of premiums for business classes in this segment. This review will assist APRA supervisors in their ongoing engagement with insurers around pricing strategies and processes.
LIFE INSURANCE AND FRIENDLY SOCIETIES

As at 30 June 2014, there were 28 registered life insurers and 12 registered friendly societies. The number of registered friendly societies fell from 13 to 12 during the 12 months to 30 June 2014 as a result of the merger of Lifeplan Australia Friendly Society Limited with Australian Unity Investment Bonds Limited, which had acquired Lifeplan some years prior.

Strength in equity markets contributed to the 10 per cent growth in industry assets, and encouraged growth in superannuation-based premium inflows. Over 90 per cent of life insurer assets support superannuation business. Growth in the friendly society industry has been more limited, with benefit fund assets increasing by just under five per cent over the year. The sector remains reliant on savings products, which has become a highly competitive market.

Risk insurance premium revenue growth was strong during 2013/14, at 12 per cent and 19 per cent for individual and group business respectively. For individual business, this growth was largely driven by automatic age- and inflation-related increases, while for group business higher premiums reflected insurers’ responses to recent poor disability claims performance.

The recent poor experience in group risk has resulted in a considerable easing of competitive pricing pressures for this line of business, and some quite large rate increases have been implemented as a result. Competition remains strong in the individual risk market, though some price increases have been evident in this area as well. Despite this, life insurance industry profitability was down 12 per cent for the year, mainly due to poor claims experience for both group and individual lines and higher lapse rates for individual business. Low interest rates, leading to subdued investment income, also presented a challenge to life insurers.

Lapse rates for individual risk business have continued to rise and are now significantly higher than several years ago. This change in lapse experience is attributed to a number of factors including a declining need for risk insurance by ageing ‘baby boomers’, stronger competition in the market, pressure on some households’ budgets leading to some pruning of discretionary expenditure, and the longer-term impact of premium rates that automatically increase each year with age.

It is also possible that consumers recognising the life insurance cover they hold no longer meets their changing needs, and that product ‘churn’ by financial advisers in light of the attraction of very high up-front commission rates for new business, has contributed to lapse rates.

Working in conjunction with the Australian Securities and Investments Commission (ASIC) as it undertook a program to review industry practices, APRA has highlighted to insurers the significant reputational risk attached to inadequate oversight of sales practices.
The industry’s capital position remained robust in 2013/14. As at 30 June 2014, the aggregate capital held for life insurers was 1.9 times the regulatory minimum (before supervisory adjustments), while for friendly societies the multiple was 2.6. While this ratio varies considerably across individual life insurers and friendly societies, in overall terms the industry is well capitalised and capable of withstanding significant headwinds.

As with general insurers, a well-structured and rigorous stress testing program is an essential component of a life insurer’s capital management strategy, and the adequacy of stress testing is one area of improvement identified by life insurers in their ICAAPs. Following its ADI stress test in 2014, APRA is planning a standardised stress test to be applied to a representative sample of life insurers in 2014/15.

Group risk insurance

The group risk insurance claims experience was the main contributor to lower overall industry profitability in 2013/14.

The second half of 2013 saw a number of insurers and reinsurers report poor profit results – including significant losses in some cases – from group risk contracts, mostly for industry superannuation fund schemes. While this has been mainly attributed to rising total and permanent disablement (TPD) lump-sum benefit claims, the claims experience for disability income benefits was also poor.

In response to this poor experience, by the end of 2013 three major reinsurers had ceased quoting on new TPD business, and quotation on TPD renewal business was generally conditional on minimal changes to contract terms. Given that group risk business is typically a ‘bundled’ package of TPD and death cover, this effectively meant a significant reduction in reinsurer capacity available to group risk insurers. While there appears to be some interest from additional foreign reinsurers in writing business in Australia, the recent reduction in capacity has posed challenges for group risk insurers seeking reinsurance, resulting in significant premium increases for many group policies.

Factors contributing to this situation include:

- record amounts of default cover being made available without underwriting;
- a weakening of underwriting controls for optional levels of cover, and automatic acceptance of incremental increases in cover without the need for medical tests;
- the growth in complexity of TPD benefit definitions, resulting in some types of claims being admitted that arguably may not have been intended to be covered by the policy wording;
- changing community attitudes to mental health, leading to a higher prevalence of claims for stress-related illness;
- more claims now being subject to the involvement of lawyers on behalf of claimants;
• superannuation fund member awareness of life insurance cover available through superannuation, leading to a higher propensity to claim; and

• failure to match the greater complexity of the claims environment with development of an adequate pool of experienced claims staff.

Despite a number of warnings from APRA, group risk insurers have been slow to accept that significant price reductions combined with softer underwriting practices and enhancements to benefits would ultimately affect profitability. Nor was the emergence of other underlying headwinds recognised in a sufficiently timely fashion or allowed for in pricing assumptions.

The immediate response of affected life insurers has been to lift premiums sharply to redress losses. Not only has this led to adverse outcomes for superannuation fund members, it does not address the structural problems that caused the situation. APRA supervisors are therefore coordinating closely across the life insurance and superannuation sectors to ensure that life insurers, reinsurers and superannuation fund trustees are working together to identify and resolve the underlying causes of the strains in the group risk insurance market. Throughout, APRA’s message to life insurers and reinsurers has been that boards must ensure they understand adequately the risks they incur in group insurance business, and that risk management processes are adequate for the uncertainties in this line of business.

Many life insurers and reinsurers have subsequently undertaken extensive reviews of their group-risk pricing methodology, product design and claims management. Foreign-owned reinsurers in particular have drawn on their global experience and expertise to seek better insights into the Australian market so as to improve performance.

On 1 July 2013, APRA’s new prudential standards for superannuation came into effect – including Prudential Standard SPS 250 Insurance in Superannuation. Two critical new responsibilities of trustees under SPS 250 are (a) for an insurance management framework that reflects the risks associated with making insured benefits available, and (b) the need to maintain records of sufficient detail that a prospective insurer can properly assess the insured benefits made available.

APRA supervisors are reviewing the adequacy of trustees’ implementation of the new prudential standards. As noted below, the availability of sufficiently detailed, accurate and timely insurance-related data appears to be lacking across the industry and APRA has informed life insurers and superannuation fund trustees of the need for improvement in this area. APRA has issued guidance for superannuation fund trustees to assist them in meeting the requirements of SPS 250 and is currently preparing relevant guidance for life insurers.
Other supervisory matters

Given the industry trends and issues outlined, it is not surprising that APRA’s supervisory intensity has lifted significantly in the past 12 to 18 months. APRA supervisors have closely monitored developments and taken steps to highlight to boards and management the poor risk management practices that have contributed to the current situation. Life insurers have also been urged to analyse claims trends so as to identify and respond to the causes of adverse claims experience. APRA strongly supports the use of industry wide claims studies to this end. It is evident that the quality of data held by life insurers is mixed, and that a lack of sufficiently detailed, accurate and timely data impedes appropriate analysis in many cases.

Some forms of life insurance business remain exposed to investment market risks. Investment markets have been generally positive in the last financial year, the Australian equities market rose 12 per cent over 2013/14 and, while longer term interest rates rose slightly over the same period, the official cash rate remains historically low. Low interest rates across the yield curve have reduced investment income, presenting a long-term challenge to those parts of the industry that are also facing a worsening claims experience and sharpened competitive pressure. APRA continues to monitor industry’s exposure to asset market risks.

Life insurers also report challenges attracting and retaining claims staff, which is putting pressure on remuneration of experienced staff in this field. Most life insurers have commenced projects to address the cost of managing claims and improve their handling. In particular, early intervention in major injury claims is acknowledged widely as a key factor in reducing claims costs and supporting claimants. However, managing such claims effectively requires a specialist expertise that has been in short supply for some time. This suggests the need to better develop and invest in the pool of capable and experienced claims staff, which presents another longer-term challenge for the industry.

Finally, APRA supervisors consulted closely with insurers through 2013/14 as life insurers and friendly societies continued to bed down new internal processes associated with meeting the new capital adequacy standards that took effect on 1 January 2013. The integration of life insurance with broader wealth offerings in many institutions meant that the adjustment to other regulatory changes, including the Future of Financial Advice (FOFA) and Stronger Super reforms, were also key areas of focus during the year.
**SUPERANNUATION**

The long-term trend of superannuation industry consolidation continued in 2013/14, albeit at a slower pace than was evident several years ago. Over the year the number of trustees with Registerable Superannuation Entity (RSE) licences declined by 25 to 168, and the number of funds under their trusteeship fell by 239 to 3,127.

The superannuation industry experienced a year of sound growth supported by good investment performance. Continuing strength in global and domestic equity markets resulted in the fifth consecutive year of positive investment returns, and the second consecutive year of double-digit returns. The total value of superannuation assets at end-June 2014 was $1.9 trillion, equivalent to 11.7 per cent of Australia’s GDP. While net contributions to the industry were stable from quarter-to-quarter, the level of total benefit payments continued to rise as the system matures and a larger proportion of members move into retirement.

A significant focus for the industry during the year was complying with new prudential standards that came into effect on 1 July 2014. Despite the considerable work by many funds to meet the new standards, it was evident during the year that some needed to make further changes to policies, procedures and processes to fully embed the new requirements. This applied across a number of areas covered by the prudential framework, including risk appetite and risk management, investments, insurance, and stress testing. Funds also have been building up financial resources necessary to meet the new operational risk financial requirement that came into effect on 1 July 2013.

In applying the new standards, APRA takes into consideration the size, complexity and business operations of individual institutions. APRA’s approach throughout the year was that if funds were making a substantial effort to comply, it would work with trustees rather than take supervisory action in the near term. More than one year on from the effective date of the new standards, however, this period of forbearance has come to an end and APRA expects that all funds now fully comply with the new standards.

To assess the level of progress in implementing the key new prudential requirements, APRA has commenced a series of thematic reviews examining a cross-section of the industry. These provide the opportunity to engage with RSE licensees on current industry practice, share views, outline expectations, and identify any areas for improvement or requiring further industry guidance. The two reviews currently underway are examining insurance risk management and conflicts-of-interest management, both areas in which APRA believes there is room for considerable improvement in industry practices.

Engagement with industry has been a key aspect of implementation, particularly around collection and publication of statistical data. To this end, a number of roundtable discussions were held involving industry associations and selected superannuation funds with a particular focus on the confidentiality of data, terminology to describe the segmentation of the industry and issues related to revised quarterly reporting.
**MySuper authorisation**

The implementation of MySuper saw an increased level of supervisory involvement from APRA, particularly during the authorisation process. Complying with the requirements for MySuper was a significant undertaking for RSE licensees that sought to offer such products, needing to address the express legislative requirement that they promote the financial interests of MySuper members, meet the enhanced trustee obligations for MySuper products, and meet the relevant superannuation prudential standards introduced with effect from 1 July 2013.

The licensing process began in early 2013 and continued throughout the year, with MySuper products offered by some funds from 1 July 2013. From 1 January 2014, all default superannuation contributions had to be paid into MySuper products.

APRA authorised 115 MySuper products before the end of 2013, two more in January 2014 and another one in June 2014. The number of MySuper products authorised by APRA is fewer than originally envisaged. This reflected in large part a reduction in the number of applications for tailored MySuper products for large employers following amendments to the Superannuation Industry (Supervision) Act 1993 (SIS Act) to allow greater flexibility in product offerings, especially in relation to insurance.

Throughout the authorisation process, APRA provided feedback to industry on draft applications and policies to help ensure favourable outcomes when final applications were received. APRA also conducted detailed reviews of the applications and engaged closely with RSE licensees during the authorisation process. As many of the issues discussed were shared across a number of RSE licensees, answers to the common questions emerging were published on APRA’s website to assist applicants. While the assessment of applications was undertaken primarily by APRA supervisors, a centralised internal review process ensured consistency in the approach and outcomes.

The focus of APRA’s assessment was whether the RSE licensee in question was likely to comply with the rules and obligations for offering a MySuper product and, in particular, the enhanced trustee obligations set out in the SIS Act. The assessment process included consideration of responses to the information requested in the application or sought in addition by APRA, and the materiality of any perceived deficiencies in policies, procedures and strategies provided by the applicant in relation to the MySuper requirements. APRA also took into account the applicant’s history under its supervision.
Areas where APRA provided the most feedback during the application process included the enhanced trustee obligations contained in the new covenants in the SIS Act and the requirements in APRA’s prudential standards for governance, conflicts of interest (in particular the Register of Relevant Duties and Interests), the reasonableness of the proposed conditions for exclusion from opt-out insurance coverage, and the appropriate amount and tolerance limits for the Operational Risk Financial Requirement (ORFR). In relation to MySuper investments, discussions were around the structure and operation of lifecycle investment strategies, including the operational complexities around such strategies and funds’ approach to stress testing.

As a result of this iterative process of feedback, no final applications for authorisation of a MySuper product have been rejected by APRA to date.

APRA will be engaged in the ongoing assessment of various aspects of MySuper, including the identification and transition of Accrued Default Amounts. Other areas APRA will be examining when reviewing implementation of MySuper products include the performance of products against their investment return targets, the extent to which fee levels and structures are consistent with the legislative requirements, and compliance with the insurance requirements for MySuper products.

**Governance**

Across all of APRA’s regulated industries, there is a heightened emphasis on engagement with boards. This reflects APRA’s view that the actions and tone from the top – from directors and senior management – are critical to ensuring a robust approach to governance and risk management across the organisation.

This is particularly the case in superannuation given the heightened duties for trustee directors under the SIS Act legislation. In the past year, APRA’s supervisors have engaged with both boards and senior management of funds to obtain a more in-depth understanding of strategic risks and issues. Throughout these discussions APRA is expecting to see evidence that directors have a sound level of understanding of the prudential issues, and approach their role with an independent and challenging mind.

APRA expects board members in the superannuation industry generally to display strong skills and capabilities, and a level of professionalism commensurate with their role in what are increasingly large and complex financial services operations. Directors need to possess the requisite skills and expertise, both individually and collectively, to discharge their roles as fiduciaries effectively. They also should ensure that the information provided to them is at the right level and sufficient to support their decision making.

As part of its engagement APRA is also assessing the effectiveness of board renewal policies, processes for appraising board performance and whether there are robust and transparent appointment processes as required by Prudential Standard SPS 510 Governance.
Insurance in superannuation

As noted earlier in this Chapter, a range of issues have adversely affected the pricing and accessibility of group insurance for superannuation funds, including historical pricing practices, the approach taken to tenders in the group risk market and the management of insurance data.

Implementation of the prudential requirements under SPS 250 are progressing but is generally at an early stage. There is considerable room for improvement in the Insurance Management Frameworks and Insurance Strategies that have been implemented as a result of the new prudential requirements to address the risks associated with insurance arrangements and the business processes requirements for these offerings.

The sustainability and appropriateness of benefit design is attracting increasing attention from most trustees in light of the problems that have emerged in the group risk insurance market. With insurance costs rising steeply for some funds, APRA has also asked funds to consider whether the levels of insurance are appropriate for their membership or risk unreasonably eroding retirement benefits. Data quality poses an ongoing challenge and, as noted earlier in this Chapter, APRA has been stressing the need for RSE licensees to be proactive in developing data management protocols with administrators and insurers, putting in place processes to improve data quality and ensuring that there is a sufficient run of data to assess historical portfolio performance. APRA has also been encouraging funds to undertake more detailed assessments of their insurance portfolios.

Conflicts of interest

Detailed information about the range of conflicts-management practices was gathered as part of the MySuper authorisation process. APRA has been assessing how these practices, and others in place more broadly across funds, are being applied in a range of different circumstances.

APRA has observed that the conflicts registers vary in quality, and that there are widely differing approaches to what is considered a ‘relevant’ interest or duty. There are also evident in the superannuation sector a number of instances where directors have multiple roles and complex inter-relationships within the industry. Boards need to assess the extent to which these relationships involve, or may be perceived to involve, conflicts and determine how such relationships are managed and reported, with regard to members’ best interests.

Risk management

Discussions on risk management have formed a significant part of APRA supervisory work over the past year. The introduction of Prudential Standard SPS 220 Risk Management from 1 July 2013 imposed a requirement on boards to have a robust risk management framework in place, and for these to work effectively. Under the standard, trustee boards are expected to set and articulate their risk appetite and risk tolerances, and ensure they are embedded in fund operations.

In many instances APRA has asked funds to further develop and clarify Risk Appetite Statements, and it sees scope for improvements in this area. There is an expectation that boards have a clear view on the degree of risk that is acceptable within the business, that this view is clearly articulated, and that prompt action is taken when risk exceeds approved limits.
Data integrity

Data integrity continues to present as a significant issue for the superannuation industry. Poor data quality has the potential to threaten the delivery of SuperStream objectives and compromise APRA’s data collection. Poor quality data in the insurance area have resulted in upward pressure on prices and made the consideration of appropriate benefit design more difficult. Poor data may also impact fund members through incorrect benefit payments, inappropriate investment offerings and a general lack of confidence in the integrity of the system.

APRA has continued to stress to RSE licensees the importance of data integrity and robust data management in meeting their obligations to members, as there remains significant room for improvement in data management practices across the industry. While improvements are expected to flow from the data quality requirements embedded in SuperStream, it may be some time before these are evident. APRA expects that once they are fully implemented, the new data collection and reporting requirements will improve the insight into the quality of industry-wide data and lead to further improvements in data integrity.

When RSE licensees are tendering for services, particularly administration and insurance, APRA expects they will ensure that data needs are an integral part of the tendering process. Among other things, this means considering whether pricing of services provides sufficient resources for the adequate management of data, and provision for that data to have the quality and timeliness required to meet APRA’s prudential requirements.

Liquidity

Liquidity issues that emerged during the global financial crisis have slowly subsided as members’ funds in frozen investment options have gradually been released, and the level of frozen funds has been reduced.

However, a number of factors continue to impact the liquidity need of funds including portability requirements, transfers of ‘lost’ money to the Australian Taxation Office (ATO), outflows to self-managed super funds (SMSFs) and an increasing number of members approaching the withdrawal phase. A number of funds have also been increasing investment in less liquid asset classes such as infrastructure. This has not given rise to any particular concerns as these assets are consistent with superannuation as a long-term investment. Funds are nevertheless encouraged to consider the liquidity impact of these investments especially if they form a significant part of the investment portfolio. The new obligation on funds to process rollovers within three days has also focussed the attention of RSEs on liquidity.
Superannuation Prudential Standard SPS 530
Investment Governance imposes a higher standard of governance in relation to liquidity risk management. APRA requires RSE licensees to have a liquidity management plan that outlines procedures for measuring and monitoring liquidity on an ongoing basis. RSE licensees must consider how liquidity would be managed in a range of stress scenarios and the actions that would be taken in response to adverse liquidity events. The requirement to undertake stress testing is new for many superannuation funds and the industry has some way to go to fully embed this requirement. Liquidity management practices across the industry have continued to improve, although many trustees continue to lag in the areas of liquidity monitoring, contingency planning and liquidity stress testing. With improved understanding and risk management of liquidity needs, RSE licensees will be in a position to better assess whether their present liquidity requirements are appropriate for their current and future needs.

Other supervisory matters
SPS 530 requires an RSE licensee to have in place an investment governance framework for the selection, management and monitoring of investments, including monitoring and management of investment risk, that is in the best interests of beneficiaries. All trustees are expected to have put in place a process for deciding what options are offered to members and an overarching philosophy on which products they feel are suitable for the fund to offer. For platform providers, this means that trustees must have in place suitable arrangements such that the larger number of investment options offered under this model are adequately monitored to assess performance, whether they are meeting the trustees criteria and are ‘true to label’.

APRA has also been working closely with the ATO to ensure the smooth and effective implementation of the various elements of SuperStream. During the year the focus moved from rollover transactions, for which the industry progressively commenced operating under new requirements, to contributions processing. The latter covers a wider range of stakeholders including employers, payroll providers, clearing houses and gateway operators. Although it is expected that many funds will be receiving contributions in a compliant form by the end of 2014, RSE licensees that notified the ATO by 30 September 2014 of a later date have until 1 July 2015 to be fully compliant.

In May 2014, APRA and the ATO jointly wrote to all RSE licensees to clarify timeframes and key responsibilities in relation to contributions data and processing, including the expectation that breach reporting is not necessary in the period to 30 June 2015. To assist industry during this implementation period, APRA also announced that the collection of data to be used by Treasury and the ATO to measure SuperStream outcomes will not commence until 1 July 2015.
ENFORCEMENT ACTIVITIES

APRA’s supervisory approach is aimed at identifying and evaluating potential risks in regulated institutions at an early stage, and ensuring that these are appropriately mitigated before they could pose any threat to the viability of the institution. In other words, APRA seeks where possible to act preemptively to prevent problems, rather than deal with the consequences after they have occurred. APRA therefore initially seeks a collaborative approach to resolving prudential issues with boards and management of APRA-regulated institutions. This is often the least costly and most effective means of addressing supervisory issues that APRA identifies.

APRA is also empowered by legislation to take enforcement action when necessary. As a prudential regulator, APRA uses its formal enforcement powers less than traditional law enforcement agencies, preferring instead to focus on risk management practice and prevention measures. However, should an institution be unwilling or unable to take necessary corrective action, APRA will use its enforcement powers to protect the interests of depositors, policyholders and superannuation fund members. As a result, APRA does take enforcement action from time to time when unsound practices are being followed, when an institution finds itself in financial stress, or when the behavior of an institution or some of its officers is putting the institution’s ongoing viability at risk.

During 2013/14, APRA undertook 181 enforcement and related actions, down from the 250 actions reported the previous year. The reduction is largely a result of a number of formal investigations being finalised during the year. This has allowed APRA to reallocate some of its enforcement resources to assist frontline supervision teams in the early identification of risks in institutions, with a view to reducing the need for formal intervention at a later stage.

APRA’s investigation in relation to Trio Capital Limited was completed during 2013. Prior to its removal as a trustee in December 2009, Trio was trustee to four APRA-regulated superannuation funds and two pooled superannuation trusts. In mid-2013, APRA’s investigation resulted in six former directors of Trio entering into enforceable undertakings with APRA, thereby removing them from the superannuation industry for varying periods. APRA commenced legal proceedings against another director of Trio in 2013/14, although the matter was discontinued when the director chose to also enter into an enforceable undertaking. The total number of former Trio directors who have entered into enforceable undertakings with APRA following the Trio investigation is 13.
APRA aims to ensure that regulated institutions and the responsible persons associated with these entities operate in a prudent and professional manner. When APRA detects inappropriate behaviour by directors of any regulated institution, it will take action to deal with these individuals. During the year APRA’s enforcement area was closely involved with APRA supervisors on two matters involving directors of superannuation fund trustees. In one case, APRA’s enquiries into expense claims at a trustee led to the dismissal or resignation of the Chief Executive Officer and two directors of the trustee. During this period APRA closely monitored the trustee’s funds under management, which were subsequently transferred to a successor fund.

In the general insurance industry, APRA continued its administration of the FCS (the Policyholder Compensation Facility). This had been triggered in 2009/10 in relation to Australian Family Assurance Limited, a small general insurer to which a judicial manager (now liquidator) has been appointed. APRA and the liquidator finalised two claims in 2013/14. Only one claim remains open and APRA continues to work with the liquidator to explore options to allow this claim to be transferred to another insurer, which will allow the company to be wound up. The Committee of Creditors approved the payment of a partial dividend representing the bulk of the assets held by the liquidator in April 2014, which saw funds returned to the Federal Government in partial compensation for its funding of the FCS operation.

APRA has also continued to work closely with the judicial manager (now liquidator) to finalise the wind-up of another small general insurer, formerly known as Rural and General Insurance Limited. The liquidator expects to be able to wind up the insurer over the coming months pending the resolution of one insurance claim and one reinsurance recovery.

In the banking industry, APRA considered 109 matters during 2013/14 relating to the use of restricted words ‘bank’, ‘banker’, ‘banking’, ‘credit union’ or like names under section 66 of the Banking Act 1959. This is an increase on the 94 such matters considered the previous year.

APRA continues to develop its network of information sharing with other regulators and law enforcement agencies to ensure that its supervisors have access to, and can assess the impact of, any relevant information on their regulated institutions. APRA can now access the Australian Transaction Reports and Analysis Centre’s (AUSTrAC) Transaction Reports Analysis and Query database, which will be used to bolster its prudential supervision and enforcement activities. APRA has also been involved in a project coordinated by the Australian Crime Commission, which includes the Australian Federal Police, ATO and ASIC, that is developing a picture of the risks posed by crime entities deemed to have the highest impact on Australian investment and superannuation markets.

Finally, as noted further in Chapter 4, APRA entered into a Memorandum of Understanding (MoU) with the Australian Federal Police.
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¹ Includes institutions not regulated by APRA suspected of conducting unauthorised activity.

² The total of 22 actions for 2013/14 includes 16 actions relating to the use of restricted words.

³ Includes monitoring of foreign bank representative offices. The total of 101 actions for 2013/14 includes 93 actions relating to the use of restricted words.