Australian Prudential Regulation Authority

Protecting Australia's depositors, insurance policyholders and superannuation fund members

APRA's vision

is to be a world-class prudential regulator, with excellence of supervision as our foundation.

APRA's core mission

is to establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by institutions we supervise are met within a stable, efficient and competitive financial system.

We also act as a national statistical agency for the Australian financial sector.

APRA's values

underpin the critical role we play in protecting the financial well-being of the Australian community: as a result, high standards are required in everything we do. In our work and in our interactions with others, we value and seek to demonstrate:

- Integrity
- Collaboration
- Professionalism
- Foresight
- Accountability

APRA's supervisory approach

s forward-looking, primarily risk-based, consultative, consistent and in line with international best practice. This approach also recognises that management and boards of supervised institutions are primarily responsible for financial soundness.

Financial regulation in Australia

The Australian Prudential Regulation Authority (APRA) is one of four independent agencies that oversee the Australian financial system. The other three are the Reserve Bank of Australia (RBA), the Australian Securities and Investments Commission (ASIC) and the Australian Competition and Consumer Commission (ACCC).

APRA is responsible for prudential supervision of individual financial institutions and for promoting financial system stability in Australia. ASIC is responsible for financial market integrity, business conduct and disclosure, and consumer protection in the financial system. The RBA is responsible for monetary policy, stability of the financial system and the safety and efficiency of the payments system. The ACCC is responsible for competition policy.

APRA, ASIC and the RBA work together to ensure a coordinated approach to the resolution of issues relating to the stability of the financial system. Together with the Commonwealth Treasury, these agencies form the Council of Financial Regulators, which provides advice to the Australian Government on the adequacy of Australia's financial regulatory arrangements.

Established in 1998, APRA is a Commonwealth statutory authority established under the *Australian Prudential Regulation Authority Act 1998*. APRA's high-level powers for the prudential supervision of institutions derive from this Act and from specific industry legislation: the *Banking Act 1959*; the *Insurance Act 1973*; the *Life Insurance Act 1995*; and the *Superannuation Industry (Supervision) Act 1993*.

APRA is primarily funded by levies paid by the institutions it supervises. APRA's head office is located in Sydney, and it also has offices in Melbourne, Brisbane, Canberra, Adelaide and Perth.

What is APRA's role?

APRA supervises Australia's authorised deposit-taking institutions (banks, building societies and credit unions), life and general insurance and reinsurance companies, friendly societies and superannuation funds (excluding self-managed funds).

APRA promotes safety and soundness in business behaviour and risk management on the part of the institutions it supervises. It establishes and enforces prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by the institutions it supervises are met within a stable, efficient and competitive financial system.

APRA refers to depositors, insurance policyholders and superannuation fund members as 'beneficiaries'. The financial interests of these beneficiaries lie at the centre of APRA's mission.

APRA promotes financial stability by requiring institutions it supervises to manage risk prudently so as to minimise the likelihood of financial losses to beneficiaries.

However, APRA cannot eliminate completely the risk that a financial institution might fail and attempting to do so would constrict the financial system.

APRA collects data for its own purposes and acts as a national statistical agency for the financial sector, collecting data on behalf of the RBA and the Australian Bureau of Statistics.

APRA plays a role in preserving the integrity of Australia's retirement incomes policy. In addition, APRA administers the regulations under which people can, in limited circumstances, apply for the early release of their superannuation benefits on specified compassionate grounds.

APRA also has responsibility for administering the Financial Claims Scheme arrangements, which provide depositors in a failed deposit-taking institution with timely access to their deposit funds (up to a limit), and eligible policyholders and other claimants with access to funds to meet insurance claims in the event of the failure of a general insurer.

Promoting stability and confidence

A stable and efficient financial system is crucial to the effective functioning of the Australian economy. Without confidence and stability in the financial system, individuals and corporations would be less able and less willing to borrow, protect their assets and invest. Prudential supervision plays an important role in supporting this confidence and stability.

Financial transactions necessarily involve some form of promise to meet financial commitments. For example:

- » a deposit-taking institution accepts deposits from members of the public and promises to repay them on demand or at some future time;
- » an insurance company accepts premiums on the promise to meet insurance claims when a specified event occurs; and
- » a superannuation fund trustee receives contributions from members and is responsible for managing those funds to provide for a member's retirement.

Beneficiaries are not in a position to assess fully whether financial institutions are well managed and, consequently, whether they are able to meet their financial promises when called upon to do so. This is why APRA exists.

For a financial institution, risk can arise from a wide variety of sources, such as:

- » adverse economic conditions might cause borrowers to default on their loans;
- » premiums charged by insurance companies might not adequately cover future claims; or
- » the value of assets held by a financial institution might decline as a result of adverse movements in market prices.

Potential risks can also emerge from many unpredictable sources, such as natural or human catastrophes. The complexity of modern financial markets means that financial institutions must approach their risk management with a high degree of professionalism.

For these reasons, most countries have established prudential supervisory agencies to ensure risks taken by financial institutions are within reasonable bounds so that institutions are well placed to meet their obligations.

In the rare event an APRA-supervised institution fails, APRA seeks to minimise losses to beneficiaries and to the financial system.

Because problems in one financial institution can be transmitted to others, prudential supervision helps to preserve stability across the financial system and the broader economy.

Our approach

APRA supervises financial institutions across the deposit-taking, insurance and superannuation sectors.

APRA's work falls into four main areas:

» establishing prudential standards to be observed by supervised financial institutions;

» assessing new licence applications;

» assessing the financial soundness of supervised institutions; and

» where necessary, carrying out remediation, crisis response and enforcement.

APRA's aim is to identify potential weaknesses in supervised institutions as early as possible. When we discover any weaknesses, we work with the institution to fix them.

The primary responsibility for financial safety and soundness within an institution rests with its board of directors and senior management. APRA's approach is to ensure that boards and managers understand these responsibilities.

APRA is legally prohibited from publicly revealing most details about the institutions it supervises. APRA's commitment to confidentiality ensures there is a high level of trust between APRA and supervised institutions.

The names of all the institutions APRA supervises are listed on APRA's website (www.apra.gov.au) under respective industry headings. Other institutions, such as Registered Financial Corporations (RFCs, including finance companies) and Discretionary Mutual Funds (DMFs), are required to provide statistics to APRA but they are not prudentially supervised by us.

The prudential framework

APRA operates under laws determined by the Australian Parliament. Among other things, these laws grant APRA the power to set prudential standards that underpin its supervisory approach towards supervised institutions.

APRA has developed a comprehensive framework of prudential standards and prudential practice guides to promote sound financial and risk management and good governance across all supervised institutions.

APRA's prudential standards set out minimum capital and risk management requirements, which are legally binding. Prudential practice guides provide guidance on how supervised institutions might best satisfy the prudential standards.

APRA follows a risk-based approach under which institutions facing greater risks receive closer supervision. This enables APRA to deploy its resources in a targeted and cost-effective manner.

The framework of prudential standards and prudential practice guides addresses the inherent risks faced by institutions, the controls adopted to manage and mitigate those risks, and the level of capital needed by each institution to withstand unexpected losses.

Among other things, APRA's prudential standards address:

- solvency and capital adequacy;
- corporate governance;
- fitness and propriety of responsible persons;
- asset quality and concentration;
- liability valuations;
- liquidity;
- credit risk;
- operational risk;
- market risk;
- insurance and reinsurance risks;
- contagion risk from related entities;
- outsourcing; and
- business continuity.

APRA also has prudential standards covering matters specific to superannuation, which include:

- defined benefit matters;
- insurance in superannuation;
- conflicts of interest; and
- investment governance.

APRA recognises the complexity and diversity which exists among institutions and avoids a 'one-size-fits-all' approach. APRA's supervision allows institutions to use a variety of approaches to comply with high-level principles, rather than APRA seeking to direct an institution through detailed prescription. Notwithstanding this principles-based focus, APRA by necessity prescribes some absolute requirements, such as minimum capital requirements.

The key elements of APRA's approach to prudential supervision are outlined in the APRA Supervision Blueprint, which is available on APRA's website (www.apra.gov.au). The Blueprint sets out the objectives, processes and procedures for APRA's supervision.

How we supervise

All deposit-taking institutions, life and general insurance and reinsurance companies and friendly societies must hold an APRA licence to operate in Australia. APRA also licenses trustees of prudentially regulated superannuation funds.

After an institution is licensed, it is subject to ongoing supervision. The main purposes of this supervision are to ensure that institutions are managing their risks prudently and are meeting their prudential requirements, and to identify those institutions that are unable or unwilling to do so.

The two main supervisory tools APRA uses are on-site and off-site analysis. These reviews are undertaken by prudential supervisors with in-depth knowledge of institutions in a particular sector, and supported by specialist risk experts.

Off-site analysis

APRA's off-site analysis involves assessing the financial strength of an institution and making qualitative judgments about the effectiveness of the institution's management, operations and risk management systems. The analysis is undertaken on a continuous basis and includes:

» regular financial analysis supported by APRA's statistical collections;

» analysing emerging risk across APRA-supervised industries;

» risk-rating assessments (see 'PAIRS' assessments page 9); and

» analysis and assessment of prudential issues as they arise.

APRA's off-site work addresses the material risks to which the assessed institution is exposed, and typically includes reviews of:

- capital adequacy;
- earnings and financial performance;
- key risk areas (including asset quality, management, market risk, insurance risk, liquidity risk and operational risk); and
- changes to business mix, organisational structure and governance arrangements.

APRA supervisors meet regularly with the management of each supervised institution to review their assessment of its prudential condition. Supervisors and APRA management also meet with the boards of supervised institutions on an as-needed basis.

On-site analysis

APRA supervisors regularly visit the premises of supervised institutions. During these visits, supervisors speak with staff and, where appropriate, examine records and files. These reviews typically target a particular risk area. They assess the effectiveness of an institution's risk management framework, including its internal governance processes. The frequency and length of these on-site reviews are determined on a case-by-case basis. APRA increases the frequency and intensity of its on-site reviews where supervisors identify an institution facing a greater than average risk.

Risk assessment

The centrepiece of APRA's supervisory risk assessment is the Probability and Impact Rating System (PAIRS). PAIRS helps supervisors make judgements about a supervised institution's risk position. The main objectives of PAIRS assessments are to:

- determine the probability that the institution may not meet its financial promises; and
- assess the potential consequences of not meeting those promises.

Supervisory outcomes and action

It is not enough for an APRA supervisor just to identify risk. APRA must also respond appropriately to identified risks. APRA's supervisory responses are driven by its Supervisory Oversight and Response System (SOARS). Supervisory responses can range from a normal cycle of review to a heightened supervisory stance that requires extra supervisory oversight, to mandating improvements or to restructuring a supervised entity.

Licensing and authorisation

In order to obtain an APRA licence to operate in Australia, applicants are required to present a submission addressing APRA's licensing criteria.

These licensing criteria will vary depending upon whether the applicant is applying for a licence to operate in the deposit-taking, life insurance, general insurance or superannuation industry. Applicants must be able to demonstrate their strategic and financial viability, an effective risk management framework and a capacity to meet all of APRA's prudential requirements.

In addition to addressing financial soundness and risk management, APRA's assessment covers the adequacy of operational resources, the quality of management and the reputation of the applicant. Subject to meeting the minimum requirements, APRA treats all applications equally, whether from institutions in Australia or overseas.

Remediation, crisis response and enforcement

From time to time, an institution may be unable or unwilling to meet its prudential requirements. APRA engages with these institutions to rectify the outstanding issues through a range of remedial actions.

APRA has substantial legal powers that enable it to intervene where there is a threat that an institution may not be able to meet its obligations to its beneficiaries. APRA will also intervene where there is a threat to the stability of the financial system. In these contexts, APRA has the power to conduct investigations of supervised institutions and, in some cases, to give them directions of a wide-ranging nature.

Where APRA concludes that the conduct of an individual in a supervised institution is inappropriate, APRA can apply to the Federal Court to have that person disqualified from working in their relevant industry.

If the Court finds the case proven, the individual is disqualified and their name added to the Disqualification Register on APRA's website.

In extreme situations, APRA can appoint a statutory manager with wide-ranging powers to assume control of a deposit-taking institution. In the case of general and life insurers, APRA can recommend to a Court that a judicial manager be appointed to take control of the institution. In the superannuation industry, APRA may replace a trustee where that trustee is unable to meet its prudential obligations.

Elements that underpin APRA's prudential supervision

- The board and management of a supervised institution are primarily responsible for its financial soundness and prudent risk management.
- APRA's prudential supervision is designed to encourage healthy risk management cultures within the institutions it supervises.
- APRA aims to *minimise* the risk of an institution failing; but survival and failure are ultimately in the hands of the institution itself.
- APRA's prudential supervision is risk-based, focussing attention and resources on areas and institutions of greatest potential risk to beneficiaries.
- As far as possible, APRA seeks to intervene early to address potential problems before they emerge. APRA's risk assessments anticipate future events and an institution's preparedness to handle them.
- APRA's prudential standards and guidance material are generally principles-based, recognising that sound prudential outcomes can be achieved by different institutions in differing ways.
- APRA's prudential supervision strives to be flexible. APRA responds to emerging risks and adapts to changing circumstances of supervised industries and institutions.
- In order to maintain high standards, APRA benchmarks itself against best international and market practices.
- In conducting supervision, APRA strives to be consistent, realistic and effective.

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