APRA’s priorities in the development of the prudential supervision framework over 2003/04 were determined largely by the recommendations of the HIH Royal Commission and by the Government’s reforms to superannuation. In two other major areas – the new Basel Capital Accord and the introduction of International Financial Reporting Standards (IFRS) – the agenda is being set internationally. APRA also took steps to tighten the capital adequacy framework for housing lending by ADIs and for the provision of lenders mortgage insurance. It also began to release draft prudential standards on a cross-industry basis.
General insurance reform

The HIH Royal Commission made 21 recommendations directly relevant to APRA’s responsibilities and to the prudential framework for general insurance. The Government has responded to these recommendations and, in November 2003, APRA released a discussion paper, *Prudential Supervision of General Insurance – Stage 2 Reforms*, on a proposed second round of general insurance reforms. The new prudential framework has helped to strengthen the position of the general insurance industry but the HIH Royal Commission concluded that the framework could be strengthened.

The discussion paper outlined proposals to:

- revise the existing prudential standards and guidance notes for general insurers, covering corporate governance matters among others, in light of experience and market developments; and

- increase disclosure about the activities of general insurers, by insurers themselves and by APRA, in order to promote market discipline.

APRA received almost 80 submissions in response to the proposals and it has been meeting with respondents. In June 2004, it co-hosted a seminar with the Insurance Council of Australia which provided a further opportunity for APRA to set out its perspective on reform and for the industry to respond.

Over the coming year, APRA plans to continue the consultation process and will develop further discussion papers and draft prudential standards for public comment. Subject to this consultation process, APRA anticipates finalising most of the proposed changes to the prudential standards for general insurance during 2005. On disclosure issues, APRA will be monitoring developments in the adoption of IFRS before finalising its views.

In a further response to the HIH Royal Commission recommendations, APRA will be releasing a discussion paper, *Supervision of Corporate Groups Involving General Insurers*, setting out proposals in relation to group structuring, measurement of capital adequacy, management of risk concentrations and other risk management issues for corporate groups involving general insurers. Development of this framework will involve considerable input from industry, with finalisation planned for 2006.
Superannuation licensing

The Government’s superannuation safety reforms came into effect from 1 July 2004 through amendments to the Superannuation Industry (Supervision) Act 1993. Overall, the reforms will enhance APRA’s ability to identify and respond to potential threats to the interests of superannuation fund members.

The reforms establish a new superannuation licensing regime involving compulsory licensing for trustees of all APRA-regulated entities, registration of those entities and risk management requirements for trustees and entities. There are three classes of licence – a public offer class, a non-public offer class and an extended public offer class for those trustees licenced to operate both public and non-public offer superannuation services. Trustees will have to meet the requirements of these licences, as well as operating standards covering such matters as risk management, fitness and propriety, outsourcing and the adequacy of resources. These operating standards also came into effect from 1 July 2004 and are supported by guidance material produced by APRA; they apply to trustees who have been licensed by APRA.

In addition to the licensing requirements, the reforms strengthen APRA’s powers in respect of the funding and solvency of defined benefit funds, and augment the responsibilities of auditors and actuaries for reporting breaches of prudential requirements.

The reforms provide for a two-year transition period during which existing trustees who wish to continue their trustee operations must apply for a licence. Trustees that choose not to be licenced or that fail to meet the licence criteria must transfer any funds they operate to a licenced trustee by the end of the transition period. Currently, there are around 1,400 trustee entities responsible for over 10,000 superannuation funds.

APRA has established a dedicated team to coordinate the licensing task and it is now assessing applications. APRA is also holding a series of workshops in most Australian capital cities to assist trustees with the licensing and registration processes. Trustees should now be considering how their fund, its rules and its administration shape up against the licence criteria, rather than wait until towards the end of the transition period.
New Basel Capital Accord

In June 2004, the Basel Committee on Banking Supervision (the Basel Committee) released its updated capital adequacy framework, now known as the Basel II Framework. The Framework, which provides more risk sensitive capital requirements for deposit-taking institutions, is largely unchanged from the third consultative document released in April 2003.

The Basel II Framework has three key elements:

- new and considerably more sophisticated minimum capital requirements, including specific capital charges for operational risk (Pillar 1);
- institutions’ own assessment of their capital adequacy and enhanced supervision of capital management processes (Pillar 2); and
- materially increased disclosure requirements (Pillar 3).

APRA will require all ADIs to adopt the Basel II Framework, which will be implemented in Australia through APRA’s prudential standards. It is anticipated that draft standards will be released for public comment by early 2005.

The Basel Committee has made all but the most advanced Basel II approaches available for implementation from the end of 2006, with the most advanced approaches available a year later. APRA is currently consulting with ADIs on whether it should implement all approaches – the standardised, the foundation and advanced internal ratings-based approaches for credit risk and the advanced measurement approach for operational risk – on a common starting date from the end of 2007.

The Basel Committee has consistently maintained that the Basel II Framework should at least maintain the overall level of capital in the banking system. The new Framework, however, acknowledges that the current Basel capital accord generally overstates the risks associated with housing lending. APRA supports the Basel Committee’s views about the overall level of capital. Nonetheless, it accepts that some modest reductions in regulatory capital may be appropriate for ADIs in Australia because of the relatively heavy weighting of housing loans in their lending portfolios, though the new capital requirements for operational risks will be somewhat of an offset.

APRA also supports the principle underlying the Basel II Framework that capital requirements for deposit-taking institutions should acknowledge investments in better risk management systems. For some years, a number of internationally active banks have been seeking to improve their risk management systems by developing sophisticated approaches to credit risk management and by introducing economic capital models, which estimate a capital buffer against potential losses inherent in the risks in a business. The larger Australian banks have been at the forefront of that work and APRA acknowledges that such models can be valuable tools in managing risk and creating incentives to reduce risk. However, APRA concurs with the views of the Basel Committee that the models are not yet sufficiently robust, nor are the outcomes sufficiently comparable, to be used to calculate regulatory capital. As a consequence, the new Basel II Framework has been created as a ‘half-way house’ between the current Basel capital accord and the full use of economic capital models.
Against that background, APRA will adopt a cautious approach to agreeing to reductions in regulatory capital associated with the advanced approaches while it becomes comfortable with the quantitative estimates and methodologies used by the institutions concerned. This caution is based in part on the fact that, because of the long period of sustained economic growth in Australia, back-testing data covers only a limited range of mostly good economic experience. In addition, the larger Australian banks are still reviewing and, in some cases, revamping the models and methodologies they will be using and, at least in some product segments, will have limited opportunities to demonstrate that they meet the requisite use and experience tests. Nonetheless, ADIs implementing the more advanced approaches, other things being equal, can expect a meaningful reduction in minimum regulatory capital requirements.

International Financial Reporting Standards (IFRS)

Australia has committed to adopting IFRS from 1 January 2005. This will be a significant exercise for APRA-regulated institutions which will demand considerable board and management attention. During the year, APRA surveyed the ADI, life and general insurance industries to raise the level of awareness about IFRS and to assess preparedness for IFRS adoption. APRA’s expectation is that the great majority of APRA-regulated institutions will make a successful transition to IFRS but the transition for some institutions could increase operational risks.

The adoption of IFRS will require APRA to revise its prudential standards and statistical reporting requirements, although the impact is not uniform across APRA-regulated industries. APRA has made clear its intention to avoid undue disruption and will not be rushing its normal consultation processes. Over the course of 2004/05, APRA will be releasing a series of discussion papers on the main implications of IFRS for the prudential framework in Australia, but no changes to current prudential treatments will be made before July 2005 at the earliest. In the case of the ADI sector, the changes will, where relevant, be made in conjunction with the introduction of the Basel II Framework.

APRA has been liaising with the Financial Reporting Council, the Australian Accounting Standards Board, the Australian Auditing and Assurance Standards Board and professional accounting bodies on a range of accounting and auditing-related matters to do with IFRS. APRA has also augmented its accounting and actuarial skills to better position it for the transition to IFRS.

Capitalised expenses

In December 2003, after public consultation, APRA revised the capital adequacy standard for ADIs by requiring them to treat certain types of capitalised expenses – such as loan origination fees and commissions paid to mortgage originators and brokers – as intangible assets for prudential purposes, and to deduct them from capital. An earlier survey by APRA had identified inconsistencies in the treatment of these items in prudential reporting. The revised standard, which came into effect from 1 July 2004, strengthens the capital adequacy framework for ADIs by enhancing confidence that assets are available to protect depositors should an ADI come under stress.
Home loan risk–weighting

In February 2004, APRA released a discussion paper proposing the introduction of more detailed criteria for ADIs to qualify for the concessional risk-weighting of residential mortgage lending for capital adequacy purposes. APRA’s proposal followed its earlier survey of the experience of ADIs with ‘low doc’ loans, which are written with considerably less documentation and verification of income and serviceability than conventional mortgage lending, and which ADIs themselves consider carry a higher risk of loss. APRA also noted that, in some cases, ADIs are offering loans originated via mortgage brokers and other third party channels, without independently verifying relevant information about the borrowers.

For some time, APRA has allowed a 50 per cent risk-weighting for residential mortgage lending for capital adequacy purposes. This concession reflects the very low loss rates historically associated with mortgage lending in Australia. It also reflects the fact that conventional mortgage lending by ADIs has involved them undertaking a thorough assessment of the ability of the borrower to service the loan, verifying all material information related to the borrower and confirming the valuation and marketability of the property. APRA’s concern is that applying the concessional risk-weight to loans where these procedures are not followed may not adequately reflect the likelihood of increased risk.

Under the revisions proposed by APRA, loans where ADIs do not verify the borrower’s servicing ability would require a higher equity contribution by the borrower, or would need to be fully mortgage insured with an acceptable lenders mortgage insurer (LMI), before such loans qualify for the concessional risk-weight. APRA has consulted extensively with industry on these proposals and the revised prudential standards come into effect from 1 October 2004.

Lenders mortgage insurance

APRA’s housing loan stress test confirmed that a significant proportion of ADI counterparty default risk for housing loans is transferred to LMIs. In late 2003, APRA extended the stress test to LMIs and conducted a broader review of the LMI industry including reinsurance arrangements, parental support, reporting requirements and relationships with ADIs. This review highlighted inadequacies in capital requirements and reporting to APRA, inconsistencies in prudential supervision of LMIs and ADIs and possibly ineffective risk transfer arrangements.

In response to this review, APRA released a discussion paper in August 2004 proposing an improved capital framework for LMIs. The core elements of the framework are a new, more risk-sensitive regulatory capital model and a significant increase in minimum regulatory capital requirements. APRA has also proposed a tightening of the prudential rules governing the 50 per cent risk-weighting available to ADIs on mortgage-insured loans.

Formal consultation with the industry will be followed by the release of draft prudential and reporting standards and guidance notes in late 2004, with a planned implementation date of July 2005.
Fit and Proper

The development of harmonised prudential standards took an important step when APRA, in March 2004, released for consultation proposed fit and proper prudential standards for ‘responsible persons’ of ADIs, general insurers and life insurers. (Fit and proper standards in superannuation were addressed in the superannuation reforms.) The standards would apply to directors, senior managers, auditors and (where relevant) actuaries of these institutions, and are intended to ensure that these persons have the competence and integrity necessary to perform their roles. APRA sees these standards as an essential element in ensuring the safety and stability of regulated institutions.

The draft standards put the onus on regulated institutions to develop formal policies that deal with the fitness and propriety of ‘responsible persons’, and propose minimum criteria to which a regulated institution must have regard. If a responsible person does not meet the standards, the employing institution would be expected to remove that person. APRA would intervene only when it has explicit concerns about an individual which have not been adequately addressed by the employer.

APRA received a number of submissions on these proposals and is consulting with respondents. Revised draft standards, taking into account comments received, are expected to be released for further consultation later in 2004.

Business continuity management

A draft prudential standard on business continuity management, applying to ADIs, general insurers and life insurance companies, was released in July 2004 for public consultation. The objective of the proposed standard is to ensure that regulated institutions are able to adequately manage business disruptions arising from internal and external events. A harmonised framework for business continuity risk management across the three APRA-regulated industries will reduce the potential for service disruption to customers and increase the level of protection provided to depositors and policyholders.

Discretionary Mutual Funds (DMFs) and Direct Offshore Foreign Insurers (DOFIs)

The HIH Royal Commission raised concerns about the provision of insurance products by DMFs and DOFIs outside APRA’s regulatory reach. In response, the Government commissioned an inquiry (the Potts Review) to determine whether it is necessary and possible to provide the same level of protection to consumers (and third parties) of products supplied by DMFs and DOFIs as is currently provided to customers of authorised general insurers.

The Potts Review recommended that DMFs be required to offer discretionary mutual cover only as a contract of insurance under the Insurance Act 1973, unless APRA considers that a DMF is not carrying any contingent risk that would need to be met by additional undefined member contributions. DMFs that do not carry contingent risk would not be subject to prudential supervision. They would, however, be required to comply with an enhanced consumer protection framework requiring increased disclosure. With respect to DOFIs, the Potts Review recommended that DOFIs marketing insurance in Australia be exempt from APRA prudential regulation if they are domiciled in a country APRA considers to have comparable prudential regulation, subject to a market significance threshold to prevent established authorised insurers moving offshore. DOFIs not meeting this test would be able to market insurance in Australia as an authorised insurer, through a branch or subsidiary.

The Government has accepted these recommendations and APRA is currently working with the Treasury on their implementation.
Medical indemnity insurance reform

The Medical Indemnity (Prudential Supervision and Product Standards) Act 2003 (MI Act), which commenced from 1 July 2003, prohibits an institution from providing medical indemnity cover unless the institution is authorised under the Insurance Act 1973. APRA has consulted extensively with industry and interested parties to help ensure the smooth implementation of this legislation. Regulations have been issued to clarify the intent of the legislation and address some anomalies that have emerged.

The previous requirement under section 24 of the MI Act that APRA issue guidelines for determining whether premiums for certain types of medical indemnity cover were reasonable has been repealed. A new section 7A sets out matters that must be considered in determining whether premiums payable under a contract of insurance are reasonable.

In December 2003, the Medical Indemnity Policy Review Panel made a number of recommendations to strengthen the Government’s reforms of medical indemnity insurance. APRA provided advice to the Panel, and it has subsequently assisted in the development of protocols between the Health Insurance Commission and medical indemnity insurers to give effect to the changes.

Under the MI Act, certain institutions providing medical indemnity cover have up to five years to comply with the minimum capital requirements imposed by prudential standards made under the Insurance Act 1973. Most of the medical indemnity insurers have availed themselves of these transitional arrangements and APRA is closely monitoring their progress against funding plans. All medical indemnity insurers have been required to prepare a Financial Condition Report, similar to that currently required by life insurers and proposed for general insurers in APRA’s latest round of reforms.

Financial statistics

APRA collects financial statistics from a wide range of financial institutions, regulated and unregulated. Data on individual regulated entities are a vital input into risk assessments by APRA supervisors. Published aggregate data are important to market participants – whether senior management of financial institutions, market analysts or researchers – and to policymakers. APRA also collects extensive data on behalf of the Reserve Bank of Australia (RBA) and the Australian Bureau of Statistics (ABS). As the central repository of financial sector information in Australia, APRA has been seeking to reduce the complexity and cost to the finance sector of providing data and, over time, has been improving the quality and usefulness of these data.

APRA is currently revamping its suite of statistical publications to provide a wider range of more relevant information on APRA-regulated industries. The revised publications will provide regulated institutions with comparative data upon which to judge organisational performance, set competitive direction and assess both the relative exposure to risk and adequacy of management controls. The publications will provide greater industry transparency for market analysts and researchers and will provide a firmer foundation for public debate on policy issues.

In designing the new statistical publications, APRA needs to balance the requirements of users against its own obligations to preserve the confidentiality of individual institution data. Over the coming year, APRA will consult on a number of statistical publications to ensure that the requirements of users and providers of data are fully considered.
This consultation process has already been completed in the case of superannuation entities and more detailed reporting requirements came into effect for the 2003/04 financial year. The first annual return is due by end October 2004. The new reporting framework will strengthen APRA’s ability to supervise superannuation entities and will lead to material improvements in published data on the industry.

The provision of more relevant quantitative information has been made possible by APRA’s program to modernise reporting requirements across the industries it regulates. APRA inherited six disparate reporting regimes from its predecessor agencies, but the financial statistics now collected are more closely aligned with accounting standards, prudential standards and the products and services offered by financial institutions. This ensures that these statistics are more relevant for prudential supervision and can be readily generated by the internal reporting systems of regulated institutions.

Managing the change from one reporting regime to another has been a large exercise for regulated institutions and APRA, requiring a significant investment of resources. Now that the majority of institutions have become more accustomed to the new statistical framework and are submitting more accurate data on time, APRA can realise and share the full benefits of the exercise with regulated institutions and industries.