

The prudential
supervision framework

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APRA's agenda to strengthen the prudential supervision framework in Australia, a major priority over the past few years, came closer to completion during 2006/07 with the release of new prudential standards on outsourcing, capital adequacy for general insurers and risk management and business continuity management for life insurers and friendly societies. The new Basel II Capital Framework, now nearing its implementation date, also continued to receive considerable attention. Any prudential supervision framework must remain responsive to changing market and industry circumstances, but further substantial reforms are not currently envisaged. Australia's prudential supervision framework received strong endorsement during the year from the International Monetary Fund (IMF) under its Financial Sector Assessment Program.

In its *Statement of Intent*, APRA has confirmed its commitment to a supervisory approach that is focussed on outcomes. This has two main and complementary elements:

- a 'principles-based' approach to prudential regulation that recognises the complexity and diversity that exists among financial institutions; and
- a 'risk-based' approach to the supervision of individual institutions that ensures supervisory attention and resources are directed to institutions whose activities are posing greater risks (discussed in the following Chapter).

Over the past couple of years, new prudential standards introduced by APRA have, where possible, moved to being more principles-based. In brief, a principles-based prudential framework is one that emphasises outcomes in setting regulatory requirements and expectations, but does not seek to specify or prescribe the exact manner in which those outcomes must be achieved. Such a framework provides regulated institutions with greater flexibility in meeting prudential requirements and avoids one-size-fits-all rules that do not discriminate suitably

by the size, complexity or risk profile of individual institutions. One example of this principles-based approach is APRA's prudential standards on the fitness and propriety of 'responsible persons'. The standards outline high-level criteria to determine if a person is fit and proper and they require that regulated institutions have their own policies, and take all prudent steps, to ensure their responsible persons meet those criteria. Each institution is allowed to develop its own checks and methods for making these judgments. Another example is the high-level principles in APRA's prudential standards on governance that boards assess their performance on a regular basis and ensure that they remain open to new ideas and independent thinking. The governance standards do not prescribe how institutions must satisfy these principles. Rather, APRA now provides non-binding guidance on these and other principles through prudential practice guides. These guides aim to assist institutions understand APRA's expectations and outline a range of acceptable practices and approaches. Institutions can employ any of those practices or an alternative that is consistent with their business objectives, so long as it delivers the prudential outcome APRA is seeking.

In APRA's view, the combination of a principles-based prudential framework and a risk-based supervisory methodology should lead to cost-effective outcomes, both for regulated institutions and for APRA, that minimise the impact on the dynamics and further development of the Australian financial system. For regulated institutions, the approach should help to minimise regulatory burden by allowing them more flexibility in meeting prudential requirements. For APRA, the approach allows supervisory expertise and resources to be deployed on the more pressing risk problems and greater use to be made of supervisory judgment to produce sensible, rather than simply 'compliant', outcomes.

A supervisory approach focussed on outcomes is not without its challenges, however. For one thing, there are areas of the prudential framework that do not lend themselves to a principles-based approach. In particular, capital adequacy requirements – a fundamental plank on which the prudential framework is built – are by necessity prescriptive: these must be clear and applied consistently so as not to generate unnecessary debate about whether they are met, or to grant any material competitive advantage to one institution over another. For another, principles-based regulation provides flexibility at the cost of certainty. Under a prescriptive set of rules, regulated institutions have clarity as to what they must do to meet prudential requirements, but little room for compromise or alternative approaches. A principles-based approach provides greater scope for institutions to design their business arrangements and risk management systems according to their particular circumstances, rather than ticking a checklist; at the same time, institutions need to explain their approach and accept APRA's judgment as to the adequacy of their systems and controls. The increased emphasis on supervisory judgment, in turn, puts demands on the quality and experience of supervisory staff.

A third challenge is achieving an appropriate balance between consistency of decision-making and risk-based supervision. It is important that the judgment of one supervisor, looking at a given set of facts, be similar to that of another supervisor presented with the same set of facts. APRA has taken a number of steps in recent years to improve the consistency of its supervisory decisions, including requiring supervisors to seek advice from expert areas in APRA for certain decisions and centralised decision-making for others. At the same time, a risk-based approach requires supervisors to judge each situation on its merits and different institutions may find that they get different responses on the apparently same issue. A request for a particular prudential treatment on an issue, for example, will be assessed differently when received from a well-managed institution with

a strong risk management framework compared with another institution with weak management and controls. This should not be seen as a sign of inconsistency in decision-making but, rather, a willingness by APRA to look at a given situation holistically and respond in a manner that has regard to the risk profile of the institution and the overall outcome APRA is seeking. In this context, open dialogue between APRA and regulated institutions about the basis for APRA's judgments is essential, and something APRA is keen to encourage.

Harmonised prudential standards

As an integrated prudential regulator, APRA is committed to harmonising its prudential standards across APRA-regulated industries, where appropriate. Given that an increasing number of conglomerate financial groups in Australia have operations in more than one of these industries, a harmonised approach improves the integrity and efficiency of the prudential framework; there is, after all, no logical reason why behavioural standards, in particular, should differ across the industries. During 2006/07, harmonised prudential standards for 'fit and proper' and governance came into effect, a new outsourcing standard was released and new standards on risk management and business continuity management for life insurers and friendly societies brought these industries into line with other APRA-regulated industries.

Fit and proper

APRA's prudential standards on the fitness and propriety of 'responsible persons' of ADIs, general insurers, life insurers and friendly societies came into effect from 1 October 2006. They were accompanied by separate prudential practice guides. The standards establish minimum benchmarks for acceptable practices for appointments to positions of responsibility and, as noted above, place the onus for judgments about fitness and propriety squarely on the regulated institutions themselves.

Where practicable, APRA has harmonised its fit and proper requirements with ASIC's fit and proper regime for responsible officers. The Taskforce on Reducing Regulatory Burdens on Business recommended that the APRA and ASIC regimes be reviewed with a view to achieving greater consistency. A joint APRA/ASIC working group responding to the Taskforce (and discussed in Chapter 5) has found that there is not a large overlap of responsible positions covered by both regimes; nonetheless, existing reporting requirements will be clarified to ensure that institutions are not reporting unnecessary information to both APRA and ASIC.

Governance

APRA's prudential standards on governance, and associated prudential practice guides, also came into effect from 1 October 2006. The standards set out minimum foundations for good governance of APRA-regulated institutions and brought APRA's previous governance requirements in line with what has become accepted in Australia as good practice in corporate governance. In developing its standards, APRA aligned its requirements and definitions, where possible, with the *Corporations Act 2001* and with the Australian Stock Exchange (now Australian Securities Exchange) Corporate Governance Council's *Principles*.

At the time it released the standards, APRA noted that it had the flexibility to respond to genuine concerns from institutions that believe they have sound reasons for not meeting a specific requirement. In that spirit, a number of institutions sought and were granted either longer transition periods to meet various requirements or exemptions from requirements. The exemptions responded to the unique circumstances of particular institutions or groups of institutions (mainly captive insurers) and were granted where institutions could demonstrate to APRA's satisfaction that they had alternative arrangements that were consistent with the objectives of the governance standards.

Outsourcing

In October 2006, APRA released new and harmonised prudential standards on managing risk from outsourcing. These standards adopted a principles-based approach detailing APRA's minimum outsourcing requirements but leaving the way open for institutions to develop their own outsourcing policy in a way that meets the principles. The standards allow institutions greater flexibility in their approach to intra-group outsourcing and deal explicitly with outsourcing to an offshore party ('offshoring'). On the latter point, regulated institutions must consult with APRA prior to entering into a material offshoring contract but APRA will not be approving individual arrangements.

The outsourcing prudential standards took effect on 1 April 2007.

Risk management and business continuity management

In October 2006, APRA released a discussion paper and draft prudential standards and guidance on risk management and business continuity management for the life insurance and friendly society industries. The package aimed to establish APRA's minimum expectations in these areas and to bring a number of prudential requirements for these industries into line with other APRA-regulated industries. Final prudential standards, developed in consultation with industry, were released in March 2007, together with a number of prudential practice guides on various aspects of risk management, asset and liability management, conflicts of interest and reinsurance management. The two new standards, which come into effect from 1 January 2008, also replace a series of existing, but dated and prescriptive standards for friendly societies.

New Basel Capital Framework

During 2006/07, further substantial progress was made towards the implementation of the Basel II Framework in Australia. This new capital adequacy regime for deposit-taking institutions is a major global initiative designed to harness best practices in risk management into the regulatory process and provide more risk-sensitive capital requirements. The Basel II Framework will come into effect in Australia from 1 January 2008 through APRA's prudential standards. Preparing for this implementation has required a significant commitment of APRA resources since the Basel Committee released its original proposals in 1999, and particularly over the past three years.

The great majority of Australian banks, building societies and credit unions will use the standardised Basel II approaches in determining their regulatory capital charge. The Basel II capital adequacy requirements that will apply to most of these ADIs relate largely to credit and operational risk. Some changes to risk management and reporting systems will be required for ADIs using the standardised approaches but the changes should not be onerous.

ADIs wishing to adopt the more sophisticated approaches available under Basel II must be accredited by APRA. Those Australian-owned ADIs wishing to be accredited from January 2008 applied to APRA in September 2005. There are no subsidiaries of foreign-owned banks seeking full accreditation from January 2008.

APRA expects that around a dozen larger Australian banks and subsidiaries of internationally operating banks will eventually be accredited to use the advanced Basel II approaches. In aggregate, these banks would represent a substantial majority of total ADI assets. Once accredited, they will be able to use their own quantitative risk estimates as inputs into their regulatory capital charge, rather than apply the supervisory rules of the standardised approaches. Given the importance of

capital in maintaining the financial strength of an ADI, as well as market and public confidence in the institution, APRA believes the accreditation process must be robust. In their applications, ADIs must undertake a detailed self-assessment of their compliance with the Basel II rules and address a number of other requirements that would demonstrate the extent to which the use of their own risk-based capital and associated risk-adjusted performance measurement permeates the management of the ADI's business. APRA also requires that each ADI's application be signed off by its board.

ADIs' preparations for the advanced Basel II approaches have been demanding, in terms of resources, data and time, and those preparations have not ended with the applications. Applicants are continuing with their risk modelling work, with some substantially reviewing their systems and models to ensure that their quantitative risk estimates meet the stringent initial and on-going Basel II requirements. For its part, APRA has analysed the details of the applications and is undertaking on-site reviews and benchmarking exercises. For those banks seeking accreditation from January 2008, APRA expects to make its determination in late 2007.

During 2006/07, APRA released six revised draft prudential standards relating to Basel II (some being second round revisions) and released a further seven in the first quarter of 2007/08. APRA has now released its proposed approach to Pillar 1 (minimum capital requirements), Pillar 2 (supervisory review process), Pillar 3 (market disclosure) and the associated draft prudential reporting standards. In all, consultation documents on ten prudential standards and the associated reporting standards have been issued over the past fifteen months, continuing an extensive consultation process on the Basel II Framework since 2004. APRA expects to determine the final Basel II prudential and reporting standards in late 2007.

Quantitative impact studies undertaken by the Basel Committee had earlier suggested that Australian ADIs seeking accreditation to use the advanced Basel II approaches could have a larger reduction in minimum regulatory capital levels than in many other countries. That, at least in part, reflected the larger proportion of housing loans on the books of Australian ADIs compared to their overseas peers; in Australia's case, as well, the data on credit risk were reflective of a benign part of the economic cycle. During 2006/07, APRA's accreditation process identified a number of areas in which applicants were making assumptions that in APRA's view were not sufficiently robust to any eventual downturn in the economic cycle. This has generally been accepted by applicant banks. They have now adopted more conservative assumptions in their capital models, which will considerably narrow the likely reductions in minimum regulatory capital levels compared to earlier expectations. In any event, reductions in regulatory capital for banks accredited to use the advanced Basel II approaches, relative to what would have applied had the current Basel Capital Accord remained in place, will be limited to 10 per cent in 2008 and this limit will be retained in 2009 pending a review of experience with these approaches.

During 2006/07, APRA conducted a separate quantitative impact study involving 12 representative ADIs that will be using the standardised Basel II approaches. This study indicated that, in general, adopting the standardised approaches will lead to a modest reduction in regulatory capital requirements. Under the Basel II Framework, no limit on capital reductions applies to this group.

APRA does not view Basel II as a vehicle for changing the competitive landscape for ADIs but as an opportunity to align regulatory capital more closely with the risks that ADIs assume and how well those risks are managed.

General insurance reform

Major elements of APRA's second round of general insurance reforms were completed when three new prudential standards, dealing with risk management, reinsurance management, and audit and actuarial reporting and valuation, came into effect from 1 October 2006. The standards include requirements for a rigorous

business plan addressing the insurer's ability to meet future capital requirements; an annual declaration on the accuracy and completeness of financial information; documentation of reinsurance arrangements including a reinsurance arrangements statement; prior approval of limited risk transfer arrangements; and preparation of an annual Financial Condition Report on each insurer by its Approved Actuary. With these reforms in place, there remains only one recommendation of the HIH Royal Commission referred to APRA that is still outstanding and it deals with the supervision of conglomerate groups involving general insurers (see below).

In September 2006, after extensive industry consultation, APRA released new prudential standards on capital requirements for general insurers that aligned the general insurance prudential framework with International Financial Reporting Standards (IFRS). The standards decoupled the definition of Tier 1 capital instruments and the assessment of securitised assets for capital adequacy purposes from Australian Accounting Standards; they also introduced new definitions of Tier 1 capital instruments and new limits on Tier 1 capital. These changes were consistent with the changes earlier introduced for ADIs and covered the nature and classification of capital, not its quantum. The standards came into effect from 1 January 2007.

Conglomerates

In October 2006, APRA released a paper setting out its response to industry submissions on its proposed approach to the prudential supervision of conglomerate groups involving general insurers. APRA's proposed approach, set out in a discussion paper in May 2005, was focussed on contagion risk: the risk that adverse developments in activities conducted by other group members could affect the soundness of the regulated insurer (or insurers) in the group. The proposed approach envisaged a three-level supervision framework for general insurance groups.

Submissions on the proposals were clouded by fears that APRA's approach to group supervision would be accompanied by burdensome reporting requirements. In response to these concerns, APRA elected to prepare, after informal industry consultation, a separate discussion paper on proposed reporting requirements for consolidated

general insurance groups. This paper was released in August 2007. The proposed group reporting requirements involve a significant reduction in the level of data collected compared with individual APRA-authorized insurers, and a lower frequency of collection, without compromising APRA's ability to undertake consolidated group supervision.

Rather than a three-level supervision framework, APRA is now proposing a staged implementation of corporate group supervision. APRA will continue to supervise individually authorized general insurers (Level 1 supervision) and proposes to supervise the general insurance group, including all general insurers in the group, on a consolidated basis (Level 2 supervision). The APRA approach is intended to ensure that the minimum capital requirements for consolidated general insurance groups are equivalent to those of stand-alone APRA-authorized insurers. Level 3 supervision, which will take into account all entities within the group, including any entities not authorized by APRA, will be developed later on a cross-industry basis.

After further consultation, APRA intends to release the full package of draft prudential standards and reporting standards for Level 2 insurance groups in late 2007.

Direct offshore foreign insurers and discretionary mutual funds

In response to the concerns of the HIH Royal Commission about the operation of direct offshore foreign insurers (DOFIs) and discretionary mutual funds (DMFs), which are not regulated by APRA, the Government commissioned a review of DOFIs and DMFs in September 2003. In 2005 and 2006, the Treasury conducted rounds of consultations on the recommendations from this review; APRA worked closely with the Treasury during this process.

In May 2007, the Government announced a package of reforms to enhance the integrity of the general insurance industry. Under the reforms, DOFIs will become subject to APRA's prudential regulation through amendments to the *Insurance Act 1973* that will extend the definition of 'carrying on insurance' in Australia. There will be some limited exemptions where the capacity of the Australian insurance market does not meet the full needs of large or specialised buyers of insurance.

DMFs will not be subject to prudential regulation at this stage but will be required to provide data to APRA. This will assist the Government to review DMFs within three years from the start of the data collection to determine whether they warrant prudential regulation.

To give effect to the Government's reforms, APRA released a discussion paper in July 2007 on proposed refinements to the general insurance prudential framework, applying not only to DOFIs but to all APRA-authorized general insurers. This paper was prepared after a number of informal discussions with key stakeholders, including APRA-authorized insurers, insurance agents, brokers, large corporations and DOFIs. The paper proposes refinements to the prudential framework that will clarify how APRA exercises judgment in the application of the framework to different categories of APRA-authorized insurers. These refinements are expected to deliver, among other things, a more hospitable environment for smaller insurers and for captives, as well as a clearer position for foreign insurers, whether branch, subsidiary or reinsurer.

Amendments to the *Insurance Act 1973* were passed by the Parliament in September 2007. Subject to consultations, the proposed refinements to the prudential framework will apply from 1 July 2008. APRA's proposals on data collection from DMFs will be addressed in a separate discussion paper to be released later in 2007.

Life insurance reforms

Streamlining Prudential Regulation

The report of the Taskforce on Reducing Regulatory Burdens on Business (April 2006) and the Government's response, *Streamlining Prudential Regulation: Response to 'Rethinking Regulation'* (December 2006) had particular implications for the prudential regulation of life insurers and friendly societies. The Government noted that the *Life Insurance Act 1995* (Life Act) had not been significantly modernised to reflect APRA's approach to prudential regulation over recent years and remained more prescriptive and less flexible than the legislation applying in the ADI and general insurance industries. The Government's proposals paper identified a number of

areas where it considered the Life Act could be simplified and made less prescriptive and, in so doing, ensuring that APRA has appropriate flexibility to modify prudential requirements for life insurers and friendly societies.

Following consultations, the Government introduced the Financial Sector Legislation Amendment (Simplifying Regulation and Review) Bill 2007 into Parliament in June 2007. The amendments relevant to prudential regulation of life insurance and friendly societies include:

- removing certain prescriptive provisions from the Life Act that are better placed in APRA's prudential standards;
- simplifying the appointment processes for auditors and actuaries (such that a life insurer may appoint its own auditor and actuary subject to meeting APRA's fit and proper prudential standard). APRA will no longer approve auditors or actuaries; and
- transferring to APRA the responsibility for setting standards in relation to actuarial matters, including capital adequacy and solvency, from the Life Insurance Actuarial Standards Board, which will cease to exist from 1 January 2008.

In August 2007, APRA released a consultation package confirming its intention to maintain an unchanged prudential framework in light of the amendments being made to the Life Act. The proposed new and amended prudential standards do not introduce any new requirements for, or impose additional costs on, life insurers and friendly societies. Nevertheless, they will give APRA flexibility to adapt the prudential framework to future industry developments. Subject to passage of the legislation, the new prudential standards are expected to be available in the fourth quarter of 2007 and take effect on 1 January 2008.

Financial Sector Assessment Program

In October 2006, the IMF released its Financial Sector Stability Assessment report on the strength of Australia's financial system and its regulatory infrastructure. The report was the culmination of a detailed review in 2005/06 by independent experts under the IMF's Financial Sector Assessment Program (FSAP).

As part of this review, APRA's supervision of the banking and insurance industries was evaluated against the Basel Committee's *Core Principles for Effective Banking Supervision* (for banks) and the International Association of Insurance Supervisors (IAIS) *Insurance Core Principles* (for life and general insurance companies). The IMF also conducted a macroeconomic stress test of the capacity of the Australian financial system to deal with certain shocks.

The IMF report provided a strong endorsement of Australia's regulatory framework and of the effectiveness of APRA's prudential supervision. The main findings relevant to the prudential framework were:

- in a number of areas, including transparency, Australia is at the forefront of best practices;
- Australia has a very high level of compliance with the two sets of Core Principles;
- the prudential framework is principles-based and implementation is of a generally high standard;
- most prudential regulations and their implementation are of a very high standard;
- APRA's supervisory activities embody many best international practices and the overall quality of supervision is good; and
- the approach to consolidated supervision is particularly noteworthy.

The IMF report recommended some areas for improving compliance with the two sets of Core Principles and APRA is responding to these, in conjunction with the Government.

APRA-regulated institutions

	Number			Assets (\$ billion) ¹		
	30 Jun 06	30 Jun 07	% change	30 Jun 06	30 Jun 07	% change
ADIs ²	223	220	-1.3	1,643.9	1,946.0	18.4
Banks	54	55	1.9	1,581.1	1,877.4	18.7
Building societies	14	14	0.0	17.9	20.6	14.8
Credit unions	148	143	-3.4	35.7	38.7	8.5
Other ADIs, including SCCIs	7	8	14.3	9.2	9.3	1.1
Representative offices of foreign banks	13	19	46.2			
General insurers	133	131	-1.5	83.0	90.4	8.9
Life insurers	35	34	2.9	226.8 ³	251.3 ³	10.8
Friendly societies	27	25	-7.4	6.6	6.9	4.5
Licensed trustees	307	306	-0.3			
Approved trustees ⁴	22					
Superannuation entities	7,812 ⁵	6,823 ⁵	-12.7	570.0	712.9	25.1
Public offer funds ⁶	248	223	-10.1	428.5	545.0	27.2
Non-public offer funds ⁶	576	309	-46.4	132.4	158.1	19.4
Small APRA funds	6,665	6,017	-9.7	3.2	3.3	3.1
Approved deposit funds	182	156	-14.3	0.4	0.5	25.0
Eligible rollover funds	18	17	-5.6	5.5	6.0	9.1
Pooled superannuation trusts ⁷	123	101	-17.9	58.9	81.1	37.7
Non-operating holding companies	12	14	16.7			
Total	8,584	7,572	-11.8	2,530.3	3,007.5	18.9

¹ Asset figures for end-June 2007 are based on most recent returns. Asset figures for end-June 2006 have been revised slightly from APRA's 2006 Annual Report in line with the audited returns received during the year.

² The ADI classification does not include representative offices of foreign banks. SCCIs refer to Specialist Credit Card Institutions.

³ Total life office statutory fund assets backing Australian policyholder liabilities.

⁴ The legislation (Part 2 of the SIS Act) under which certain trustees were approved was repealed effective 1 July 2006. The 22 approved trustees did not seek a Registrable Superannuation Entity (RSE) licence and their approval to operate a superannuation entity lapsed on 1 July 2006.

⁵ Includes RSEs that are either registered or unregistered; unregistered RSEs are in the process of winding up, transferring ownership to an RSE licensee or transferring to the Australian Taxation Office (ATO). Does not include uncontactable funds that are in the process of being formally wound-up or transferred to the ATO. At end-June 2007, there were 113 such funds, down from 127 funds at end-June 2006.

⁶ During 2005/06, some superannuation funds switched between categories.

⁷ Pooled superannuation trust assets are not included in totals as these assets are already recorded in other superannuation categories.