



# FINANCIAL SYSTEM INQUIRY SUBMISSION

31 March 2014

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## GLOSSARY

ADF	Approved deposit fund
ADI	Authorised deposit-taking institution
ANAO	Australian National Audit Office
APRA	Australian Prudential Regulation Authority
APRA Act	<i>Australian Prudential Regulation Authority Act 1998</i>
ASIC	Australian Securities and Investments Commission
ATO	Australian Taxation Office
Banking Act	<i>Banking Act 1959</i>
Basel Committee	Basel Committee on Banking Supervision
Basel I	Basel Committee July 1988, <i>International convergence of capital measurement and capital standards</i> ; and Basel Committee January 1996, <i>Overview of the amendment to the capital accord to incorporate market risks</i>
Basel II	Basel Committee June 2006, <i>International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version</i>
Basel III capital	Basel Committee December 2010, <i>Basel III: A global regulatory framework for more resilient banks and banking systems</i> (revised June 2011)
Basel III liquidity	Basel Committee January 2013, <i>Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools</i>
CET1	Common Equity Tier 1
D-SIB	Domestic systemically important bank
ERF	Eligible rollover fund
FHSA	First Home Saver Account
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
G-SIB	Global systemically important bank
IAIS	International Association of Insurance Supervisors
IMF	International Monetary Fund
Insurance Act	<i>Insurance Act 1973</i>
IOPS	International Organisation of Pension Supervisors

IRB	Internal ratings-based
Life Insurance Act	<i>Life Insurance Act 1995</i>
LMI	Lenders mortgage insurance
MPR	Money Protection Ratio
NOHC	Non-operating holding company
PAIRS	Probability and Impact Rating System
PER	Performing Entity Ratio
PPG	Prudential practice guide
RBA	Reserve Bank of Australia
RCAP	Regulatory Consistency Assessment Programme
RCDF	Religious charitable development fund
RFC	Registered financial corporation
RIS	Regulation Impact Statement
RSE	Registrable Superannuation Entity
SIFI	Systemically important financial institution
SIS Act	<i>Superannuation Industry (Supervision) Act 1993</i>
SOARS	Supervisory Oversight and Response System
Wallis Inquiry	Commonwealth of Australia 1997, Financial System Inquiry

# EXECUTIVE SUMMARY

The 2014 Financial System Inquiry provides a timely and important opportunity to reflect on the performance of the Australian financial system and its regulatory arrangements over the period since the ground-breaking 1996 Financial System Inquiry (the Wallis Inquiry).

The Inquiry has been asked to refresh the philosophy, principles and objectives underpinning the development of a well-functioning financial system, including the role, objectives, funding and performance of financial regulators. In short, to revisit the Wallis vision.

The Wallis Inquiry laid the foundations for Australia's 'twin peaks' regulatory arrangements, based on two strong financial regulatory agencies with distinct mandates and effective coordination mechanisms. One of two peaks would be an integrated prudential regulator, the Australian Prudential Regulation Authority (APRA), with a clear purpose to safeguard financial promises and comprehensive powers to set and enforce prudential rules.

The Wallis vision was prescient and remains relevant today, even though not all predictions about the financial industry materialised. In particular, capital markets have not come to challenge the dominance of regulated financial institutions in credit intermediation.

Moreover, the Wallis Inquiry could not have foreseen the global financial crisis, a period of unprecedented turbulence. Australia and its financial system were not immune from the crisis. It has provided a stern test of Australia's financial regulatory arrangements, and they stood firm – Australia's arrangements have proven to be robust and effective. Arguments for changes to these arrangements should take this conclusion, widely supported globally, as their starting point.

APRA was established as an independent statutory authority with clear accountability to Parliament and the Australian community, and responsibility for prudential oversight of banking, insurance and much of superannuation. In the Wallis vision, an integrated approach would enable the prudential regulator to be flexible and proportionate in its regulation and supervision, in that way dealing efficiently with the development of financial conglomerates. APRA's integrated structure and approach have been one of its main strengths.

APRA's effectiveness as a prudential regulator – its ability and willingness to act – depends crucially on having a clear and unambiguous mandate and operational independence, a robust set of prudential requirements, an active program of risk-based supervision, and adequate staffing and financial resources to meet its statutory objectives.

APRA's original mandate required it to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality. An overarching requirement to promote financial system stability in Australia was added in 2006. This is a clear mandate but one that requires a careful balancing act. With guidance provided by the February 2007 *Statement of Expectations for APRA*, the mandate remains appropriate in APRA's view. The crisis has dispelled any simplistic notion that there is a 'trade-off' between financial safety and sustainable competition. Strong financial institutions make strong competitors. APRA's prudential requirements may affect the relative position of competitors in particular regulated industries by imposing differential capital costs, but other factors – such as scale, business models and operating and funding costs – are likely to have larger impacts on the competitiveness of smaller institutions.

APRA has substantial independence from Government in most respects but, over time, constraints on its prudential, operational and financial flexibility have eroded its independence. As a consequence, Australia falls short of global standards in this area.


A strong prudential framework is the foundation for effective supervision. Over recent years, APRA has pursued a substantial prudential policy agenda in each of its regulated industries. Implementation of the global reforms of the G20 Leaders, particularly the Basel III capital and liquidity framework, has been a major driving force, but APRA also had significant initiatives, domestic in their origin, in general and life insurance and superannuation. APRA's extensive consultation process aims to ensure that the prudential framework keeps pace with industry developments; the framework has also been assessed as consistent with strengthened global benchmarks. Hence, regulated institutions are now on a more secure footing to respond to market needs and emerging opportunities, and to deal with future stress. With the hard yards won, further substantial reforms are not in APRA's view required, nor are they proposed, at this point.

APRA takes a risk-based approach to supervision that is designed to identify and assess those areas of greatest risk to a regulated institution (or to the financial system as a whole) and then direct supervisory resources and attention to these risks. APRA seeks to ensure that its supervisory judgments are perceptive, timely and robust and that its responses are targeted and proportionate. APRA eschewed light touch supervision in the wake of the collapse of HIH Insurance in 2001, and it has significantly strengthened its supervisory approaches and practices since then. In APRA's view, its most enduring contribution to the resilience of institutions in the crisis came from its 'close touch' efforts to promote their financial health prior to the crisis, and to deal conclusively with struggling institutions.

APRA's risk-based supervision approach requires astute judgment on the part of supervisory staff and confidence based on experience. APRA's staff are its most important asset, and building and retaining a high-quality workforce with the necessary blend of industry understanding and supervisory instincts has been, and remains, a major priority for APRA. APRA has to date been successful in this task, and current staffing levels will enable it to meet its mandate and the current scope of its supervisory and prudential policy responsibilities in a strong and effective way. The skills that APRA needs, however, are also in demand in the financial sector and it is critical that APRA maintain its attractiveness as an employer when market conditions for skilled and experienced staff, currently subdued, tighten again.

As envisaged by the Wallis Inquiry, APRA is primarily funded on an 'industry pays' basis. The arrangements for collecting annual levies from regulated institutions have been reviewed and refined over the past decade, and a recent performance audit by the Australian National Audit Office confirmed that APRA's administration of the levies has been generally effective.

Over recent years, APRA has been subject to general 'efficiency dividend' requirements under which the Government has reduced agency funding with the objective of driving efficiency savings and improving its overall budget position. APRA acknowledges that it is for Government to determine the quantum of community resources it wishes to have devoted to prudential regulation. However, the mechanism of efficiency dividends is not well-suited to an industry-funded regulatory agency. Continued efficiency dividends will ultimately compromise financial safety but make no contribution to the Government's budgetary objectives.



The promotion of financial system stability is the overarching objective in APRA's mandate. Australia's framework for financial stability, building on a history of close and effective collaboration between regulatory agencies in good times and under stress, was tested during the crisis and found to be flexible and effective. Looking ahead, APRA has a range of macroprudential tools and would use them if and when necessary. APRA's legal powers to respond to situations of financial stress have been materially strengthened since the crisis began. Nonetheless, there are some areas where these powers could be further strengthened to align them more closely with international standards and best practice and enable APRA to respond more effectively to financial distress.

The performance of Australia's financial regulatory arrangements, and of APRA's role in particular, have been subject to a number of reviews by global bodies, particularly since the crisis began. These reviews, by the International Monetary Fund, the Financial Stability Board and global standard-setting bodies, provide an objective and independent assessment of APRA against internationally accepted standards. Overall, the reviews have provided strong endorsement of Australia's financial regulatory arrangements and of the effectiveness of APRA's supervision. At the same time, the reviews have warned that the Australian financial system continues to face risks that will need to be carefully managed. APRA also publishes the results of regular stakeholder surveys and some quantitative indicators of its supervisory performance.

In APRA's view, the consistency of Australia's prudential framework with international standards is critical to ensuring the attractiveness of regulated institutions to providers of funding and capital. That attractiveness results in greater appetite for the debt and equity instruments of these institutions, lower costs in raising funding and capital in global markets, and business opportunities that rely on an institution's creditworthiness being readily transparent.

In summary, this Inquiry has a very positive backdrop for its deliberations.

# CHAPTER ONE / THE WALLIS VISION

The 1996 Financial System Inquiry (the Wallis Inquiry), which issued its final report in March 1997, provided the blueprint for a more efficient and effective regulatory architecture for Australia, known as the ‘twin peaks’ model. The Wallis Inquiry was tasked with making recommendations on the nature of the regulatory arrangements that would best ensure an efficient, responsive, competitive and flexible financial system.<sup>1</sup> The Wallis vision, implemented almost in full by the Government, forms the basis of Australia’s current regulatory arrangements that, having been tested by the global financial crisis, have proven to be robust and effective.

One of the twin peaks recommended by the Wallis Inquiry was an integrated prudential regulator that would have clear objectives and broad powers to execute its mandate, operational and budgetary independence from government, a flexible supervision approach and sufficient resourcing to do its job. Thus was the Australian Prudential Regulation Authority (APRA) born.

The 2014 Financial System Inquiry (the Murray Inquiry) has been asked, *inter alia*, to refresh the philosophy, principles and objectives underpinning the development of a well-functioning financial system, including the role, objectives, funding and performance of financial regulators. In short, to revisit the Wallis vision.

This chapter provides a broad overview of the Wallis vision and its relevance to the evolution of the Australian financial system over the past 17 years. It also reviews the regulatory philosophy underpinning Australia’s regulatory arrangements and the contribution these arrangements have made to a safe, stable, efficient and competitive financial system. The subsequent chapters provide more detail on the role of APRA. They discuss APRA’s mandate and independence, the prudential framework, APRA’s approach to supervision at an institutional and system level, and APRA’s resourcing and performance. The final chapter provides background on some particular issues that will be of relevance to the Murray Inquiry.

Four annexes give a brief overview of each industry regulated by APRA.

## 1.1 Evolution of the financial industry

The Wallis Inquiry was prompted by changes to the Australian financial system over preceding years. Customers’ needs were evolving due to technological innovation, and the funding of an ageing population was to be supported by a new compulsory superannuation framework. Deregulation following the 1981 Campbell Report and government divestments of interests in financial institutions had significantly altered the financial industry landscape, and growing international integration of markets promised to expose Australian institutions to greater foreign competition. The Wallis Inquiry considered these trends and laid out a vision for the future of the financial industry and its regulatory architecture.

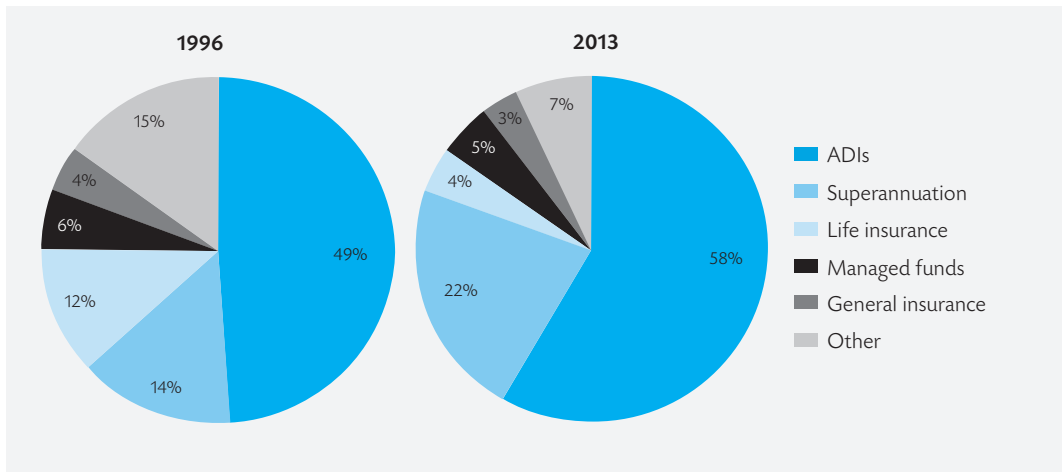
The Wallis vision was prescient and it remains relevant today. For the most part, broad trends already evident in 1996 have continued. Not all of the Wallis Inquiry predictions about the financial industry have come to pass, however. Indeed, the Wallis Inquiry could not have anticipated a test of industry resilience as extreme as the global financial crisis.

Since the Wallis Inquiry, the importance of the financial industry in the Australian economy has increased significantly. In 1997, the ratio of financial institution assets to Gross Domestic Product (GDP) stood at 200 per cent; by 2013 this ratio had increased to around 350 per cent. Over this period, financial sector assets under APRA’s supervision have more than quadrupled, from under \$900 billion in 1996 to about \$4.5 trillion in 2013. Contrary to the expectations of the Wallis Inquiry, however, capital markets have not come to seriously challenge the dominance of financial institutions in credit intermediation; unregulated institutions have not materially threatened the regulated sector; and markets for risk have not fully replaced the ownership and management of risk by financial institutions. The domestic banking system has remained the primary

1 Commonwealth of Australia 1997, *Financial System Inquiry Final Report*.



**Figure 1: Share of total financial system assets**



Note: Life insurance includes friendly societies; superannuation includes non-APRA-regulated superannuation funds.

Source: RBA 2013, 'Assets of financial institutions – B1', Statistical Tables.

means of funding for all but the very largest Australian corporates. More generally, a substantial 'shadow banking' sector did not emerge and the share of financial assets in this sector has declined since the crisis. In particular, unregulated credit intermediaries depending on securitisation markets and short-term funding saw those funding sources dry up in the crisis.

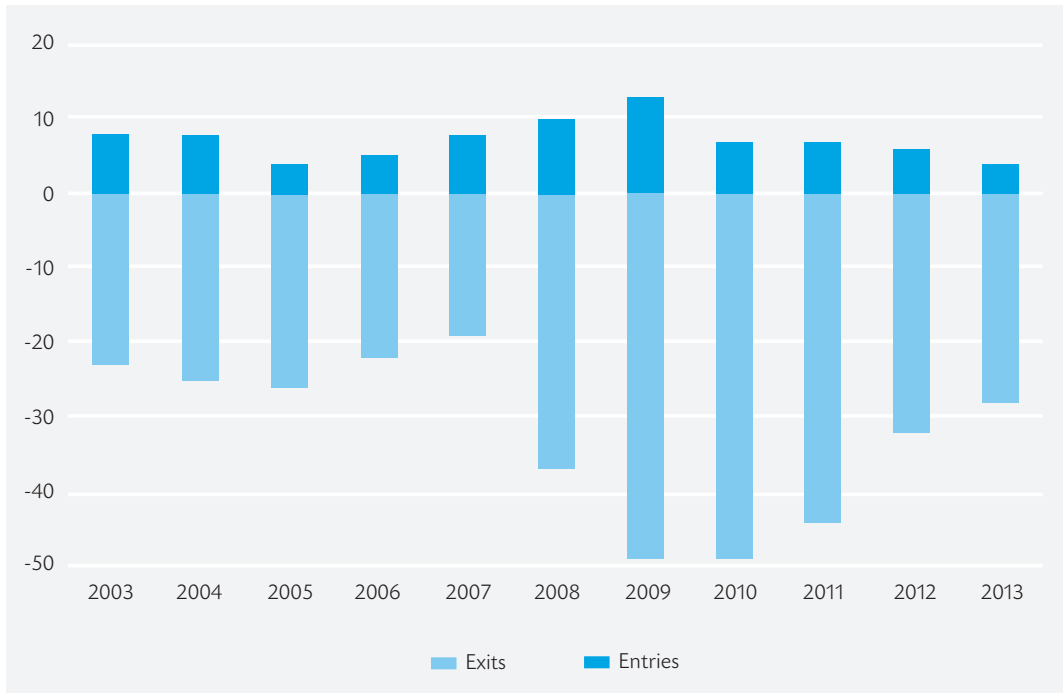
The financial industry has long been dominated by banks and other authorised deposit-taking institutions (ADIs), which currently hold around 60 per cent of financial system assets (Figure 1). Superannuation funds now hold over 20 per cent of assets, up from 14 per cent in 1996. While ADI assets can be expected to expand in line with the credit needs of households and business, the growth in superannuation assets is a steady and pervasive trend that, if current policy settings continue, will continue to shape the financial industry for years to come.

Consolidation within the financial industry has continued apace. The number of institutions supervised by APRA fell by more than two-thirds since 2001. This has reflected an ongoing wave of mergers of smaller institutions in each of the APRA-regulated industries, acquisitions of foreign-owned subsidiaries by local institutions and the exit of other foreign financial institutions. Superannuation funds in particular have shrunk in number, due in part to companies transferring their corporate superannuation funds to public offer funds.<sup>2</sup> The average size of APRA-regulated superannuation funds has, however, grown markedly, from about \$50 million in 1997 to over \$3.4 billion at end-June 2013.<sup>3</sup>

<sup>2</sup> Refer to Annex D.

<sup>3</sup> These amounts exclude eligible rollover funds, approved deposit funds and small APRA funds.

**Figure 2: Number of entries (new licences granted) and exits (revoked licences) of APRA-regulated institutions**



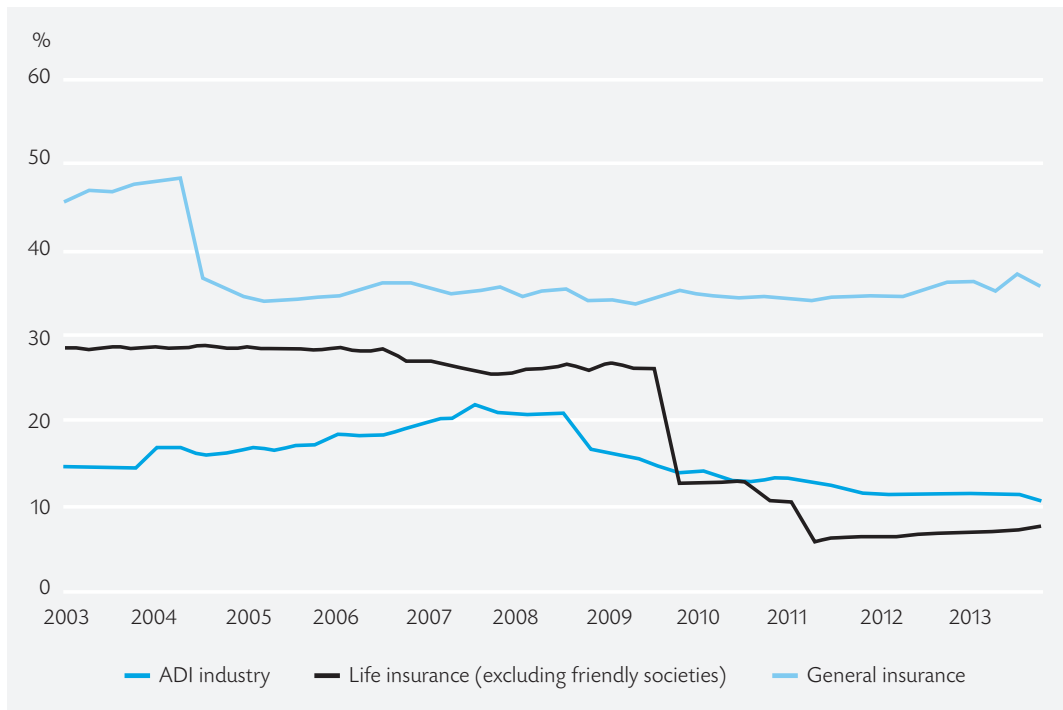
Note: Data reflects ADIs, general insurers, life companies, friendly societies and RSE licensees. For RSE licensees, there is no data before 2006/07 as new licensing requirements were introduced on 1 July 2006.

Consolidation has often been driven by the pursuit of economies of scale and other efficiencies, but it has resulted in greater market concentration. The top five groups account for 78 per cent of assets in the ADI industry, 62 per cent in general insurance, 80 per cent in life insurance (including friendly societies) and 38 per cent in the APRA-regulated superannuation industry. However, concentration does not necessarily mean a market is less competitive.<sup>4</sup> No doubt, the Murray Inquiry will explore the complex issue of concentration versus competition. Suffice it to say, small and large financial institutions have been able to coexist profitably in Australia over extended periods.

The attractiveness of the Australian financial industry to new entrants also suggests that markets are contestable. Between 2003 and 2013, APRA granted 72 new licences, many to foreign financial institutions, particularly in the banking sector (Figure 2). However, domestic institutions have remained dominant and profitable. Many of the exits shown in Figure 2 are associated with consolidation, particularly corporate superannuation funds, rather than departure from the Australian market.

<sup>4</sup> See Davis K. 2007, 'Banking Concentration, Financial Stability and Public Policy', in Reserve Bank of Australia Conference Volume, *The Structure and Resilience of the Financial System*.

**Figure 3: Market share of total assets of foreign subsidiaries and branches**



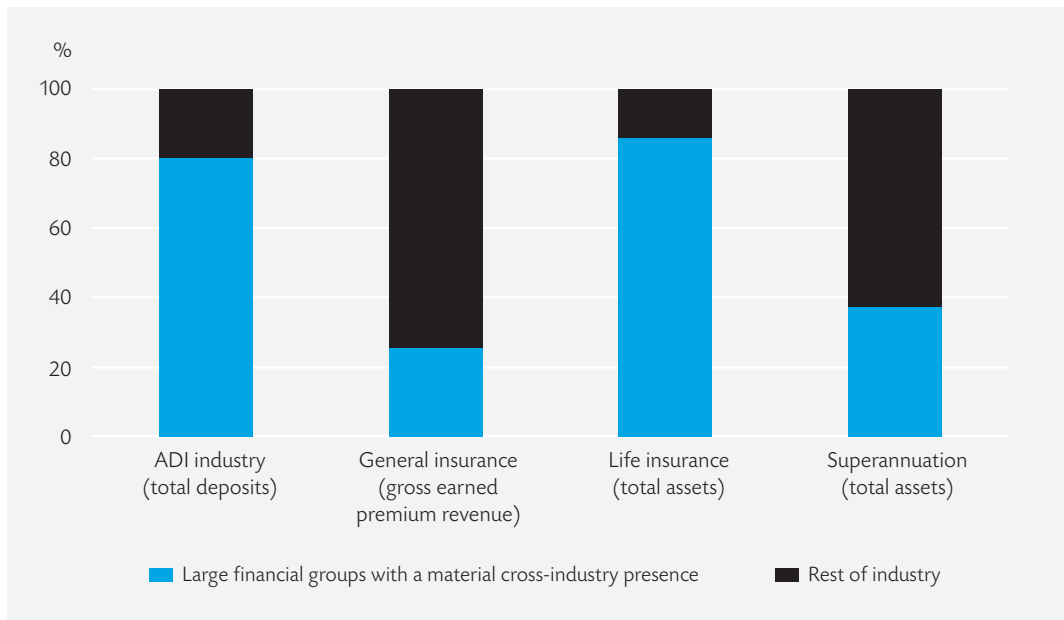
The crisis has had a discernible impact on the market share of foreign subsidiaries and branches in banking and life insurance (Figure 3). Several foreign banks had extended themselves into riskier segments of the local property and private equity markets and suffered significant losses during the crisis; others have closed branches due to pressures on the parent bank or have sold subsidiaries to Australian institutions. Foreign-owned insurers have been successful in the life insurance industry for many years but, since the crisis, some parent companies needing to refocus their global business have sold their local operations to domestic institutions. In contrast, the general insurance industry has seen a more sustained presence of foreign-owned competitors.

In addition to consolidation among existing players, the Wallis Inquiry foreshadowed new entrants that would contribute to a blurring of boundaries between financial sectors:

*'Increased conglomeration and further market widening will continue to challenge traditional institutional and regulatory boundaries. New competitors are also emerging from outside the finance industry. As competition intensifies, many firms will seek to specialise in those activities they perform best, causing the value chain to disaggregate. Alliances, joint ventures and outsourcing are likely to become commonplace.'*<sup>5</sup>

5 See page 138, *Financial System Inquiry Final Report*.

**Figure 4: Domestic market share of large financial groups with a material cross industry presence (June 2013)**



Note: General insurance includes direct business only. Life insurance includes friendly societies. Superannuation reflects APRA-regulated funds only.

It was expected that wide-ranging conglomerates covering financial and commercial (non-financial) services would emerge to challenge incumbents. Utilities and retail companies, for example, were considered potential competitors in direct provision of retail financial services.

As it has turned out, competition from non-traditional sectors has appeared only at the margins and conglomerates blending finance and commerce have not emerged. However, consistent with the Wallis vision, there has been a marked growth in the size of financial conglomerates: banks with life insurance and funds management subsidiaries; life insurers with superannuation and funds management operations; and APRA-regulated non-operating holding companies (NOHCs) with subsidiaries active in

banking, wealth management and general insurance.<sup>6</sup> Figure 4 provides an indication of the importance to the financial industry of large, locally owned financial groups with material operations across two or more APRA-regulated industries. Taken together, domestic financial conglomerates account for around 70 per cent of total financial system assets. This share has changed little since the Wallis Inquiry, although mergers across regulated industries have changed the conglomerate landscape. This is not a feature of a particular regulatory regime but a long-term outcome of periods of market stability followed by periods of market stress and change.

<sup>6</sup> International bodies have come to define 'financial conglomerates' strictly in relation to groups performing activities in more than one financial sector. See Joint Forum 2012, *Principles for the supervision of financial conglomerates - final report*.

The Wallis Inquiry anticipated that the Australian financial system would become increasingly global in its outlook and influences:

*'The Australian economy and its financial system are now closely linked to international markets. Financial services participants in Australia face increasing competition from offshore providers and are simultaneously pursuing international opportunities themselves.'*<sup>7</sup>

This trend toward greater globalisation and integration appears to have reached a plateau after the Wallis Inquiry. Although the major Australian banks are active issuers in international debt markets, the overall share of their funding sourced from wholesale markets offshore has changed little over the past decade (although the duration of that funding has increased). The mixed experience of foreign competitors in Australia, which for the most part have not made major inroads, is discussed above. In terms of outward investment, the Wallis Inquiry noted that Australia's largest financial institutions had overseas assets of around 24 per cent of group operations at that time; today, that proportion is about the same for the major banking groups. Superannuation funds invest around 17 per cent of their assets offshore, compared with the figure of about 15 per cent for managed funds at the time of the Wallis Inquiry.

Overall, with few exceptions, regulated institutions have generated the bulk of their profits at home. Some institutions have pulled back from attempts to grow overseas while others are now looking to expand in Asia at a measured pace. However, in light of difficulties in the cross-border resolution of failed financial institutions during the crisis, some countries are now considering limiting the scope of operation of foreign institutions. Globalisation and its impacts, therefore, appear to be driven by cycles in domestic and international economic and policy conditions and at present do not appear a leading force for further change in the financial industry in Australia.

Technology has been a force for change in the financial industry, but perhaps not in the more radical manner that the Wallis Inquiry envisaged. The core transactional banking and payment systems relied upon 17 years ago are, in many instances, still used today and branch banking continues to be popular; however, current enhancements to core systems should improve efficiency in the delivery of banking and payment services. Traditional credit and financial service providers have not been displaced by new entrants from the technology industry. That said, online savings accounts and internet and mobile phone banking services are rapidly taking hold, and greater direct access by customers for products such as insurance and funds management is also creating more competition through online channels. Moreover, this picture is changing rapidly. Developments in mobile broadband technology and 'cloud' computing, and continuous reductions in the costs of data storage and communications, promise continued evolution in the interface between financial institutions and their customers.

Technology has also been driving locational issues, allowing functions to move more easily to where they are provided most efficiently. At the time of the Wallis Inquiry, outsourcing of various aspects of operations was not common in Australia but was on the horizon. Today, particularly within the ADI and general insurance industries, outsourcing to specialist providers is increasingly common where comparable or greater external expertise, often offshore, can be accessed at lower cost and greater efficiency.

An overview of changes in the Australian financial industry since the Wallis Inquiry would not be complete without reference to the global financial crisis. The crisis had its origins abroad in the emergence of large losses on sub-prime mortgages in the United States and reached Australian shores after late 2007. Australia's experience of the crisis confirmed that the Wallis blueprint of strong and clearly focussed regulatory agencies, with effective coordination mechanisms, was particularly far sighted.

<sup>7</sup> See page 137, *Financial System Inquiry Final Report*.

The Australian economy and financial system have emerged largely unscathed from the crisis and its continuing aftershocks. Financial dislocations were serious but short-lived and the longer-term impacts in Australia have been more muted than in most other countries. The Australian banking system remained profitable and well capitalised throughout the crisis and impacts on other APRA-regulated industries were well managed. Public sector intervention was confined to a Government guarantee for deposits and wholesale funding to backstop the access of ADIs to funding and, subsequently, support for the residential mortgage-backed securities (RMBS) market.

Many commentators, including APRA, have articulated the factors that contributed to this outcome.<sup>8</sup> These included:

- a strong domestic economy driven by a mining boom in the years leading up to and during the crisis;
- strongly supportive monetary and fiscal policy once the crisis broke; and
- a generally prudent approach by APRA-regulated institutions and their boards to risk management and capital, although the crisis did expose the vulnerability of banks to dislocations in global funding markets.

Another factor contributing to Australia's success in weathering the crisis, now widely acknowledged, has been its financial regulatory arrangements, including APRA's performance as prudential regulator. As the International Monetary Fund (IMF) noted:

*'Banks were resilient to the global crisis, mainly because of sound regulation and supervision. Prudential rules, often tighter than the minimum international standards... together with a proactive approach to supervision, helped maintain a healthy and stable financial sector.'*<sup>9</sup>

8 See for example, Reserve Bank of Australia 2009, *Financial Stability Review*; Laker J. 2009, 'APRA: The global financial crisis and beyond', speech to the Australian British Chamber of Commerce, 26 November.

9 International Monetary Fund 2011, *Australia 2011 Article IV Consultation*, IMF Country Report no. 11/300.

The lessons from the crisis for Australia's regulatory arrangements are discussed later in this chapter.

In summary, over the period since the Wallis Inquiry, the Australian financial industry has enjoyed sustained growth and demonstrated its resilience. The industry has been safe, stable and profitable, despite the most turbulent period in modern financial history.

This provides a positive backdrop to the Murray Inquiry's consideration of the functioning of the Australian financial system and the effectiveness of its regulatory arrangements.

## 1.2 Wallis' prudential philosophy

*'Financial safety is fundamental to the smooth operation of the economic system. Government intervention in the form of prudential regulation provides an added level of financial safety beyond that provided by conduct and disclosure regulation.'*<sup>10</sup>

The Wallis Inquiry highlighted the important role of prudential oversight of financial institutions and laid out a set of characteristics for an oversight regime. This included a separate, independent agency with a clear purpose to safeguard financial promises, and comprehensive powers to set and enforce prudential rules. The new agency should structure its activities in an integrated manner, looking across industries in order to minimise competitive distortions, while adhering to international standards of supervision. The supervisory approach should be proportionate and flexible in order to respond to differing circumstances across supervised institutions and changing industry conditions.

The Wallis Inquiry's approach to prudential regulation was based on the concept of the 'intensity of promise' inherent in a financial product. This could include 'promises to make payments at specified times, in specified amounts and in specified circumstances... Financial promises are among those products and services which incorporate risk, including the risk that the promise will not be kept'.<sup>11</sup> A high intensity

10 See page 297, *Financial System Inquiry Final Report*.

11 Ibid, page 179. See also Laker J. 2013, 'Ideas and Issues in Prudential Regulation', The Third Warren Hogan Memorial Lecture, University of Sydney, 26 November.

promise was one that was inherently difficult for an institution to honour, where the creditworthiness of the institution making the promise was difficult to assess, and where a breach of the promise would have adverse consequences, particularly for financial stability. Since it was often impractical to regulate products directly, the Wallis Inquiry argued, the focus of prudential regulation should be on the institution making the promise. Institutions offering promises of highest intensity should be subject to a consistent scope of regulation. On this basis, deposit taking and insurance would come under prudential oversight, as would superannuation due to its special role and in the interests of regulatory efficiencies and flexibility.<sup>12</sup>

The Wallis Inquiry recommended that the then-current regulatory framework based on four institutional regulators be replaced by three agencies established along functional lines. This ‘twin peaks’ model of financial regulation involved two separate and independent agencies that would be responsible for prudential supervision and market conduct oversight, respectively. Vesting prudential supervision in APRA, market conduct in the Australian Securities and Investments Commission (ASIC) and monetary and payments system responsibilities in the Reserve Bank of Australia (RBA) would give each agency clear objectives, and various mechanisms were recommended to minimise potentially counterproductive overlap. In particular, the Wallis Inquiry recommended that the three financial regulatory agencies continue to pursue operational cooperation through a Council of Financial Regulators, replacing the previous Council of Financial Supervisors. The role of this Council is discussed in Chapter 6.

The Wallis vision embraced an approach to prudential regulation that would be proportionate and flexible to minimise adverse effects on efficiency, and would promote competition by avoiding regulatory distinctions between types of entities. This vision was summarised in the mandate recommended by the Wallis Inquiry for the new prudential supervisory agency:

*[APRA’s] charter should emphasise the need to approach prudential regulation in a way that balances the objective of promoting financial safety with the need to minimise the adverse effects on efficiency, competition, innovation and competitive neutrality.<sup>13</sup>*

This vision was captured in APRA’s enabling legislation, which makes clear that APRA’s primary purpose in exercising its prudential powers is to protect depositors and other members of the community holding financial promises issued by regulated financial institutions. The *Australian Prudential Regulation Authority Act 1998* (APRA Act) requires APRA to balance financial safety with efficiency, competition, contestability and competitive neutrality (an overarching requirement to promote financial system stability was added in 2006). APRA’s publicly stated mission also reflects the Wallis vision, and it has been unchanged since APRA’s establishment:

*‘Our 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.’<sup>14</sup>*

12 Brown R. and Davis K. 1997, ‘The Wallis Report: Functionality and the Nature of Banking’, *Australian Economic Review*, vol 30. no. 3.

13 See page 321, *Financial System Inquiry Final Report*.

14 APRA’s Mission Statement can be found at: [www.apra.gov.au/AboutAPRA/Pages/Default.aspx](http://www.apra.gov.au/AboutAPRA/Pages/Default.aspx).

APRA's mandate and the balancing of financial safety with other objectives are discussed in Chapter 2. In principle, strong and effective prudential oversight is not at odds with efficiency and sustainable competition. As the global financial crisis showed emphatically, weak prudential regimes can foster unsustainable competition and unsafe financial institutions cannot be relied upon to deliver on their financial promises over time.

The Wallis Inquiry took into account the changing face of the financial industry in recommending a new regulatory structure:

*'The framework for the provision of prudential regulation should be designed to ensure that its objectives are clear; that it deals efficiently with the development of financial conglomerates and the blurring of product and institutional boundaries...'*<sup>15</sup>

Responding to industry evolution and emerging risks requires a flexible prudential regime but one based on strong and consistent principles. To this end, APRA has sought, where it can, to harmonise its prudential standards across its regulated industries so as to provide a consistent view of its expectations for prudent risk management (see Chapter 3). In addition, APRA's supervisory approach is risk-based and based on principles of good risk management and a focus on outcomes; APRA benchmarks good risk management practices across similar types of institutions, ensuring that like institutions are held to comparable standards (see Chapter 4). This prudential regime is consistent with the desire expressed to the Wallis Inquiry by smaller institutions that they be held to standards comparable with large institutions, in order to maintain competitive neutrality.<sup>16</sup> At the same time, APRA's supervisory approach provides flexibility in how institutions achieve sound prudential outcomes, having regard to their size, complexity and business model.

The Wallis Inquiry called for prudential regulation by an integrated agency with expertise in banking, insurance and superannuation funds management, a key recommendation aimed at overcoming the 'blurring of boundaries' between sectors. The establishment of APRA replaced the prior structure of industry-based or 'silo' regulators and its regulatory remit encompassed the substantial majority of financial sector assets. This considerably reduced opportunities for regulatory gaps and arbitrage across different types of entities. APRA reinforced this integrated structure by breaking down the silos it inherited and introducing a supervisory approach that distinguished between conglomerates and single-industry institutions. Having supervisory teams for conglomerate groups ensures that the same staff assess risks in each group across banking, insurance and superannuation, as well as consider the risks arising from any non-regulated activities being conducted within the group.

The Wallis Inquiry's strong emphasis on an integrated prudential regime set a very important direction. Siloed industry-based regulatory structures have been blamed for gaps in oversight that contributed to the failure of at least one major financial institution during the crisis, that of American International Group (AIG). Excessive exposures in an opaque part of the business brought down the entire group, requiring a US Government bail-out, in part because 'there was no one regulator with a complete picture of AIG or a comprehensive understanding of how it was run'.<sup>17</sup>

<sup>15</sup> See page 297, *Financial System Inquiry Final Report*.

<sup>16</sup> National Credit Union Association 1996, *Submission to the Financial System Inquiry*; Credit Union Services Corporation (Australia) Limited 1996, *Submission to the Financial System Inquiry*; Australian Association of Permanent Building Societies 1996, *Submission to the Financial System Inquiry*.

<sup>17</sup> Statement of Henry Paulson, former US Treasury Secretary to the hearing on *The Federal Bailout of AIG* before the Committee on Government Oversight and Reform, 27 January 2010.



Finally, the Wallis Inquiry noted that the Australian financial system was becoming increasingly globalised. To reflect this, the Wallis Inquiry recommended that banks in particular should be subject to internationally agreed standards such as those issued by the Basel Committee on Banking Supervision (Basel Committee). APRA has delivered on that recommendation. In APRA's view, the implementation of relevant global standards, adapted where needed to meet local circumstances, has been a significant underpinning of the international standing of Australian financial institutions, enhancing their ability to compete internationally and retain the confidence of rating agencies and global investors. The financial industry has spoken supportively of this approach:

*'Australia's favourable experience of the GFC [global financial crisis] and the fact that our approach to regulation anticipates many of the reforms proposed offshore is a significant advantage in securing international credibility. Willingness to act unilaterally and to calibrate global regulatory principles to local conditions can also be leveraged to advantage in the eyes of financial market participants. Such flexibility speaks well of Australian regulators' understanding of local conditions and their relationship to global requirements.'*<sup>18</sup>

### 1.3 Lessons from the global financial crisis

The global financial crisis provided a searching test of Australia's prudential regime and financial stability arrangements. That test has been passed. As noted above, the 'twin peaks' model and the strength of the prudential regime is widely accepted as an important contributing factor to Australia's continued economic and financial stability through the crisis. A senior RBA official provided this recent summary:

*'At least as important as [other factors] is that Australia was well served by its prudential regulatory framework. The post-Wallis framework that was put in place in 1998 established APRA as the integrated prudential regulator, affirmed the financial stability role of the RBA and set up the Council of Financial Regulators to ensure appropriate coordination among the regulatory agencies. Under APRA's leadership, Australian banks were held to much higher standards of resilience than many of their international counterparts. The banks remained profitable and well capitalised.'*<sup>19</sup>

The Australian financial industry also has publicly acknowledged that APRA has made a significant contribution to the relative success of the industry in navigating the global financial crisis. For example, the Australian banking industry attributes its strength in part to the fact that it is 'prudently managed using international best practice, well regulated and, for these reasons, retain[s] amongst the highest credit ratings in the world'.<sup>20</sup>

18 See page 13 of the Access Economics report for the Financial Services Institute of Australasia 2009, *Navigating Reform: Australia and the Global Financial Crisis*, October.

19 Edey M. 2014, 'Reflections on the Financial Crisis', address to the CFO Summit, 16 March.

20 Australian Bankers' Association 2011, *A Strong Banking System Fact Sheet*, page 1.

The impacts of the crisis elsewhere show that the 'bullet dodged' by Australia was substantial. Worldwide output losses from the crisis had been estimated in 2010 at a minimum of 90 per cent of world GDP rising to as high as 350 per cent if the losses turn out to be permanent.<sup>21</sup> In the countries most affected, the social costs have been distressingly high. Unemployment reached 26.5 per cent in Spain, 15.1 per cent in Ireland, 8.4 per cent in the United Kingdom and 10.0 per cent in the United States. Overall, European GDP has not yet recovered to pre-crisis levels. In Australia, in contrast, economic output has risen nearly 20 per cent, virtually uninterrupted, since 2007. The causes and consequences of the crisis have been the subject of extensive analysis in official, academic and other circles.<sup>22</sup> Many lessons have been learned. In APRA's view, there are three lessons that are particularly relevant to the Murray Inquiry's deliberations.

Firstly, market discipline – on which many policymakers (and the Wallis Inquiry itself) had placed great store – has not proven effective in restraining excessive risk-taking. Risk in many financial markets was badly mispriced. This was nowhere more obvious than for the toxic structured instruments created in the US sub-prime mortgage market, or in the pricing of bank shares and bank risk, the latter reflected in credit default swap spreads. In his detailed *post mortem* of the crisis, Lord Turner of the UK Financial Services Authority noted that share prices of major global banks failed to indicate that bank risks were increasing ahead of the crisis but, on the contrary, provided apparent vindication of aggressive growth strategies. And credit default swap spreads for major global banks were at historical lows, but should have been at historical highs, immediately before the crisis.

In Lord Turner's words:

*'A reasonable conclusion is that market discipline expressed via market prices cannot be expected to play a major role in constraining risk taking, and that the primary constraint needs to come from regulation and supervision.'*<sup>23</sup>

Secondly, global regulation also proved inadequate in constraining excessive risk-taking and in ensuring that global banking institutions could absorb the resulting losses in their lending and trading activities. Prudential requirements to hold high-quality capital were too low to prevent institutions from building up excessive on- and off-balance sheet leverage, while liquidity buffers were too thin to cope with serious dislocations in global liquidity and funding markets. Remuneration arrangements in many financial institutions, on which global regulations had been silent, encouraged risk-taking in many financial institutions that did not have sufficient regard to longer-term risks.

In the wake of the crisis, a substantial global reform effort has been underway, under the auspices of the G20 Leaders, to promote a more resilient global financial system. Australia, as a member of the G20 (and currently holding the presidency) has fully supported that effort. Key pillars of the reform agenda are a stronger regulatory framework, more effective supervision of financial institutions, reducing the risks posed by systemically important financial institutions, and transparent international assessment and peer review. This agenda has helped to shape the prudential framework in Australia and APRA's supervisory approach.

21 Basel Committee on Banking Supervision 2010, *An assessment of the long-term economic impact of stronger capital and liquidity liquidity requirements*, August, page 11.

22 Financial Stability Forum 2008, *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience*, April; Financial Services Authority 2009, *The Turner Review: A regulatory response to the global banking crisis*, United Kingdom.

23 *Ibid*, page 45.

APRA's involvement in the global reform effort has related mainly to the initiatives of the Basel Committee to raise the quality, quantity and international consistency of capital in the global banking system (Basel III capital) and to promote stronger liquidity buffers and more stable sources of funding (Basel III liquidity). ADIs in Australia were well-capitalised going in to the crisis; for this reason, implementation of the higher *minimum* requirements of the Basel III capital regime has occurred without difficulty. APRA has also implemented the Financial Stability Board's (FSB's) principles for sound executive remuneration arrangements.<sup>24</sup>

Thirdly, the effectiveness of prudential supervision was shown to vary widely across jurisdictions. Some supervisory agencies had favoured light-touch supervision, a minimally intrusive approach based on a belief that markets generally were efficient and market discipline would ensure that institutions had proper incentives to act prudently and responsibly. Such agencies tended to place heavy reliance on assurance from institutions' senior management and boards as to strategy and governance, and on the effectiveness of their control functions including internal audit and risk management.<sup>25</sup> This approach was found wanting.

The IMF concluded that supervision in many jurisdictions tended to stay on the sidelines, did not intrude sufficiently or in a timely way into the affairs of regulated institutions and did not always see an issue through.<sup>26</sup> Some institutions failed even when they were reported to be, and were assessed by their prudential regulator to be, well capitalised and liquid. As a consequence, prudential regulators are being pressed to take a tougher, more challenging approach, be less trusting of boards and senior management and exercise more supervisory judgment.<sup>27</sup>

Fortuitously, APRA had received its wake-up call on light-touch supervision with the collapse of HIH Insurance in 2001, with a policyholder shortfall of \$5.3 billion. The collapse was a stark demonstration of the pitfalls of the light-touch approach. A report commissioned by APRA from an international expert on prudential regulation (the Palmer Report) described APRA's supervisory approach at the time as 'a relatively high level and collegial process', where it was assumed that 'complex financial groups... would be well managed with good internal controls and strong infrastructures'.<sup>28</sup> The HIH Royal Commission recommended that APRA develop 'a more sceptical, questioning and, where necessary, aggressive approach to its prudential supervision'.<sup>29</sup> This recommendation referred to general insurance but APRA took the message to heart more broadly.

24 Financial Stability Board 2009, *Principles for Sound Compensation Practice*, September.

25 Financial Services Authority 2011, *The failure of Royal Bank of Scotland*, United Kingdom.

26 Viñals and Fiechter et al. 2010, *The Making of Good Supervision: Learning to Say "No"*, International Monetary Fund Staff Position Note No. 2010/8.

27 The UK Financial Services Authority, for example, publicly abandoned its light-touch approach in favour of what it termed an 'outcomes-focused' approach through 'intensive supervision'. See Financial Services Authority, 2010/11 *Business Plan*, page 9.

28 Palmer J. 2002, *Review of the role played by the Australian Prudential Regulation Authority and the Insurance and Superannuation Commission in the collapse of the HIH Group of companies*.

29 HIH Royal Commission 2003, *The failure of HIH*, Volume 1, Chapter 8 paragraph 5.6.

From that point, APRA increased the frequency of its on-site visits to and regular liaison and follow-up with regulated institutions and began to engage directly with boards on matters of prudential concern. Supervisors questioned and, where necessary, challenged boards and senior management on how their business decisions affected the institution's risk tolerances and whether the decisions were commensurate with its financial resources, including under stressed conditions.

In the process, APRA has gained a reputation as a robust and determined prudential regulator. Indeed, as APRA sees it, its most enduring contribution to the resilience of regulated institutions during the crisis came from its efforts to promote their financial health *prior* to the crisis. Tough decisions were taken in good times, including establishing more conservative ADI capital requirements relative to overseas peers, developing a risk-based capital framework for general insurers consistent with leading practice globally, and introducing meaningful governance requirements. Constant oversight of and, at times, pressure on institutions ensured that APRA had a good understanding of each institution's strengths and frailties, enabling APRA to achieve improvements in (or orderly exit of) struggling institutions well before the crisis and to quickly target vulnerabilities when the crisis struck.

As the IMF has noted,

*'[p]rudential supervision is most valuable when it is least valued; restricting reckless banks during a boom is seldom appreciated but may be the single most useful step a supervisor can take in reducing failures.'*<sup>30</sup>

This is a core lesson that APRA has taken to heart.

Drawing on different crisis experience, global policymakers have identified two main attributes that an effective prudential regulator must have:

- the *ability to act*, in law and in practice, which means having the authority to be robust in approach and to challenge board and management judgment when necessary, the skill to adapt to innovation and the tenacity to follow an issue through to its resolution; and
- the *willingness to act*, which manifests itself in timely and effective intervention, in intruding on poor decision-making and in questioning common wisdom, at times in the face of industry or media criticism.<sup>31</sup>

The Wallis Inquiry established key requirements for the prudential regulation of the Australian financial system and, with minor differences in emphasis, the Wallis vision remains relevant to meeting these two attributes. Accordingly, APRA would encourage the Murray Inquiry to assess APRA's mandate, resourcing and performance against the key requirements that APRA have:

- a clear and unambiguous mandate and operational independence;
- a robust set of prudential requirements, consistent with global standards, to promote prudent risk management and, where relevant, ensure there are adequate capital resources to absorb shocks;
- an active program of risk-based supervision focussed on outcomes; and
- adequate staffing and financial resources to perform its role and meet its statutory objectives.

These key requirements are discussed in the following chapters of this submission.

30 Viñals and Fiechter 2010, *The Making of Good Supervision: Learning to Say "No"*, page 13.

31 Ibid.

# CHAPTER TWO / APRA'S MANDATE AND INDEPENDENCE

A clear and unambiguous mandate and operational independence are fundamental requirements underpinning a prudential regulator's willingness to act.

These requirements have been given particular emphasis by the FSB, which has identified them as key preconditions for effective supervision.<sup>32</sup> The IMF has concluded that a lack of supervisory independence in a number of countries was a critical factor in weaknesses leading up to the global financial crisis.<sup>33</sup>

The requirements are also enshrined in the Basel Committee's *Core Principles for Effective Banking Supervision* and the International Association of Insurance Supervisors' (IAIS) *Insurance Core Principles* (for life and general insurance). These Core Principles provide global benchmarks for member countries for establishing, revising or implementing their regulatory and supervisory systems.

## 2.1 APRA's mandate

APRA's mandate is established in legislation in the APRA Act and in specific industry Acts that preceded the APRA Act.

As discussed in Chapter 1, the APRA Act captured the Wallis vision for a new prudential regulator. Section 8 of the original legislation stated:

### *'Purpose for establishing APRA*

- (1) *APRA is established for the purpose of regulating bodies in the financial sector in accordance with other laws of the Commonwealth that provide for prudential regulation or for retirement income standards, and for developing the policy to be applied in performing that regulatory role.*
- (2) *In providing this regulation and developing this policy, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality.*<sup>34</sup>

A specific mandate to promote financial system stability in Australia was added to the APRA Act in 2006.

The specific industry Acts reinforce this broad mandate. These Acts, which are discussed further in Chapter 3, are the *Banking Act 1959* (Banking Act), the *Insurance Act 1973* (Insurance Act), the *Life Insurance Act 1995* (Life Insurance Act), and the *Superannuation Industry (Supervision) Act 1993* (SIS Act). These Acts give APRA authority to license and prudentially supervise specific types of institutions to do business defined in each Act. APRA has no mandate to regulate or supervise other types of financial institutions. In APRA's view, it is important to maintain a clear distinction between prudentially regulated and other institutions to avoid customer and market confusion and moral hazard.

In addition to granting it specific powers, the industry Acts also set out APRA's broad objectives with respect to prudential supervision of each industry. The Banking Act focusses exclusively on safety in directing APRA to exercise its powers and functions:

*'...for the protection of the depositors of the several ADIs and for the promotion of financial system stability in Australia.'*<sup>35</sup>

For general insurance (and comparably for life insurance), the objectives are somewhat broader:

*'...to protect the interests of policyholders and prospective policyholders under insurance policies... in ways that are consistent with the continued development of a viable, competitive and innovative insurance industry.'*<sup>36</sup>

In the case of superannuation, APRA's role is focussed more on the sound operation of trustees and funds and less on protection of members:

*'The main object of this Act is to make provision for the prudent management of certain superannuation funds... and for their supervision.'*<sup>37</sup>

32 See Financial Stability Board 2010, *Intensity and Effectiveness of SIFI Supervision – Recommendations for Enhanced Supervision*, November.

33 Viñals and Fiechter 2010, *The Making of Good Supervision: Learning to Say "No"*, page 13.

34 *Australian Prudential Regulation Authority Act 1998*, s8.

35 *Banking Act 1959*, s12(1).

36 *Insurance Act 1973*, s2A(1).

37 *Superannuation Industry (Supervision) Act 1993* s3.

APRA is also directed to monitor prudential matters by:

*'...encouraging and promoting the carrying out of sound practices in relation to prudential matters by RSE licensees of registrable superannuation entities.'*<sup>38</sup>

Taking the various legislation together, APRA operates under a very concise set of primary objectives with respect to protection of holders of financial promises and the prudent management of regulated institutions in each industry, complemented by a more general mandate to consider the implications for efficiency and competition as well as for the financial system as a whole. In APRA's view, these objectives clearly mean that the Australian community – i.e. depositors, insurance policyholders and superannuation fund members – are APRA's primary stakeholders and the ultimate beneficiaries of APRA's mandate.

## 2.2 The balancing of objectives

APRA's mandate is a clear one but not entirely unambiguous – it requires a careful balancing act. Ultimately, the appropriate balance between financial safety and other objectives for the financial system is a matter for Government, and the Australian community. Recognising that, in February 2007 the Government provided its *Statement of Expectations for APRA*, which set out the Government's views on APRA's objectives and priorities. The *Statement* was a response to two earlier reports dealing with the governance of statutory authorities and with the appropriate balance that financial regulatory agencies should pursue between financial safety and investor protection, and market efficiency.<sup>39</sup>

The *Statement* provided the following guidance to APRA on the balancing of objectives:

- prudential regulation cannot and should not seek to guarantee a zero failure rate of prudentially regulated institutions or provide absolute protection for market participants (including consumers); and
- it is important that the prudential regulation regime maintain a low incidence of failure of regulated institutions while not impeding continued improvements in efficiency or hindering competition.

In its *Statement of Intent* in reply, APRA confirmed that it intended to achieve this latter objective through the setting of prudential requirements and its approach to the supervision of individual institutions.<sup>40</sup>

The *Statement of Expectations for APRA* also provided guidance on how the Government expected APRA to approach its prudential task:

- APRA should avoid unnecessarily prescriptive regulation and its prudential regulation should identify the outcomes that are desired from financial institutions rather than prescribe how those outcomes should be achieved; and
- APRA should regularly and proactively review the effectiveness and continuing relevance of the prudential regulation regime in the context of market developments.

38 Ibid, s34F.

39 Letter from the Treasurer to the APRA Chairman, 20 February 2007; The *Statement of Expectations* formed part of the implementation of the Government's *Review of Corporate Governance of Statutory Authorities and Office Holders* (Uhrig Report), 2003; and the *Taskforce on Reducing Regulatory Burdens on Business* (Banks Report), 2006.

40 APRA 2007, *APRA's Statement of Intent*, Letter from the APRA Chairman to the Treasurer, 18 May.

This guidance reinforced APRA's approach to the prudential regime. In the setting of prudential requirements, APRA takes a principles-based approach where it can, particularly in relation to risk management. This approach, which is discussed in Chapter 3, is based on the fundamental premise that the primary responsibility for financial soundness and prudent risk management rests with an institution's board of directors and senior management. In its supervision of regulated institutions, APRA takes a risk-based approach under which institutions exposed to greater risks, or whose failure would have greater impact, receive closer supervisory attention. This approach, which is focussed on outcomes, is discussed in Chapter 4. APRA also regularly undertakes reviews of its prudential requirements. As it has turned out, the period since the *Statement of Expectations for APRA* was issued has been one of unprecedented reform during which the prudential framework for each of the industries APRA regulates has been substantially updated.

The balancing of financial safety and the other objectives in APRA's mandate, particularly competition and efficiency, will be a natural focal point for the Murray Inquiry. The timing is particularly appropriate. The global financial crisis has dispelled any simplistic notion that there is a trade-off between financial stability and *sustainable* competition. It is often forgotten that the pursuit of financial stability and of competitive and efficient outcomes has the same ultimate goal, *viz.* to facilitate the efficient allocation of resources. The crisis fall-out, discussed in Chapter 1, has confirmed that stability is a prerequisite for a competitive and efficient financial industry; the objectives are not mutually exclusive.

Economic analysis confirms that achieving an appropriate balance in objectives is considerably more complex than any implied and simple trade-off may suggest. One strand of analysis concludes that, in the shorter-term, greater competition leads to greater incentives for risk-taking and hence to a higher risk of financial institution failure.<sup>41</sup> Certainly, a cyclical pattern of exuberant competition coupled

with perverse risk management incentives is observed repeatedly in practice, most recently in the context of US sub-prime lending prior to the crisis. That particular context is a telling example of a lax regulatory environment facilitating unsustainable and ultimately destructive competition. However, empirical evidence on the longer-term relationship between financial stability and market competition is more mixed.<sup>42</sup> In some cases, more competitive markets with viable new entrants and mid-sized players may enhance stability by reducing the 'too-big-to-fail' problem. Nonetheless, this outcome can only be obtained, researchers have concluded, if supported by an appropriate regulatory and supervisory framework.

The lessons from the crisis need not await detailed empirical research. The contrast between Australia's (and others') experience and that of the crisis-affected countries makes a compelling point. In the case of banking:

- strong prudential regimes make for strong banking institutions and these, in turn, make robust competitors, willing providers of banking services and ready magnets for funding; and
- more lax prudential regimes make for weaker banking institutions and these, in turn, make for transitory competitors, unreliable providers of banking services and reluctant targets for investors and funders.

In response to concerns about the impact of higher capital requirements on UK banks, the Governor of the Bank of England recently noted:

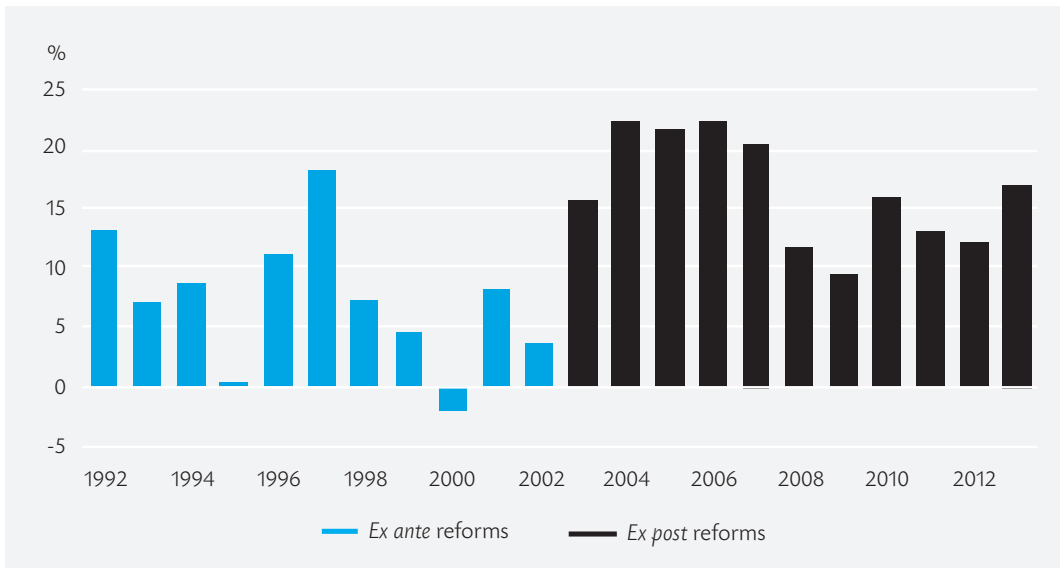
*'Those who argue that requiring higher levels of capital will necessarily restrict lending are wrong. The reverse is true. It is insufficient capital that restricts lending. That is why some of our weaker banks are shrinking their balance sheets. Capital supports lending and provides resilience. And, without a resilient banking system, it will be difficult to sustain a recovery.'*<sup>43</sup>

41 For a summary of this research see: Allen and Gale 2011, *Competition and Financial Stability*, Journal of Money, Credit and Banking Volume 36, Issue 3, Part 2, June.

42 The Organisation for Economic Co-operation and Development 2011, *Competition in Retail Banking and Financial Stability*, July.

43 King M. 2013, 'A Governor looks back – and forward', speech by the Governor of the Bank of England, 19 June.

**Figure 5: General insurance industry return on equity**



Note: Statistics prior to 2003 relate to Australian business only.  
Sources: APRA and the Insurance and Superannuation Commission.

Well before the crisis, Australia learned that a focus on financial stability can improve long-term competitive dynamics in an industry, in this case the general insurance industry. The activities of HIH Insurance in the years prior to its collapse demonstrated the dangers of unsustainable competition. HIH Insurance aggressively drove down premiums and forced other insurers to withdraw from certain segments of the liability insurance market. Aside from the direct policyholder losses, which the Government needed to compensate, the collapse of HIH Insurance and the subsequent reduction in market capacity left segments of the Australian community without a viable source of (in some cases, compulsory) insurance products. The reform of the prudential regime that followed in 2002, including the introduction of risk-based capital requirements and implementation of other recommendations of the HIH Royal Commission, saw insurers gradually re-enter these market segments, and

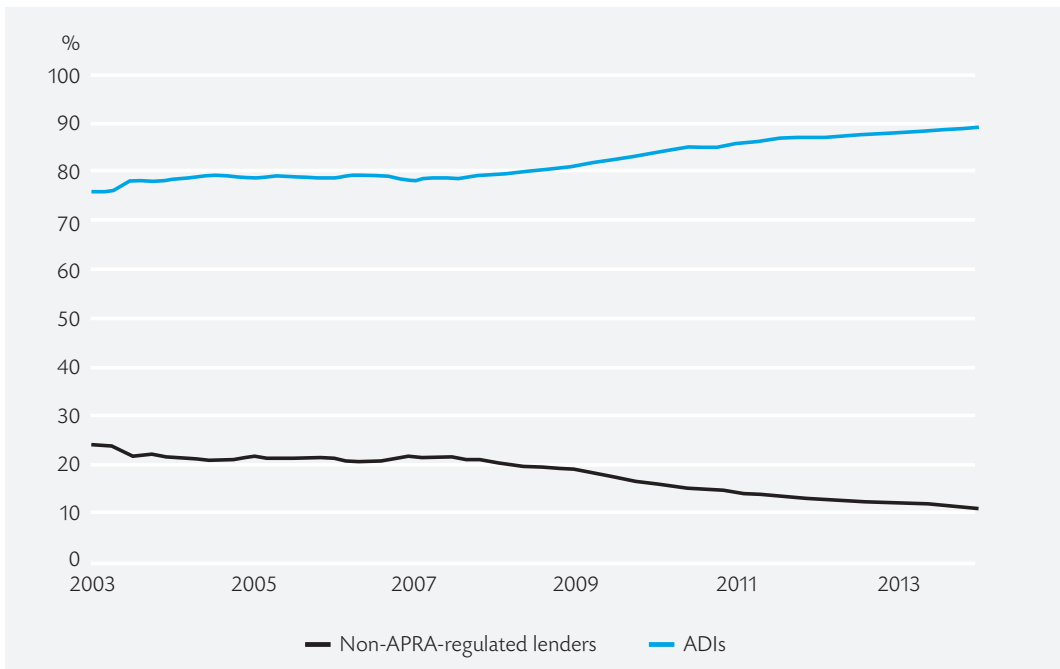
the segments have enjoyed strong competition from a range of insurers over a number of years.

The more robust prudential regime has had broader benefits for the general insurance industry. Prior to the reforms, the industry's performance had been erratic, and driven largely by investment returns rather than underwriting profits. Following the reforms, industry performance has improved significantly and profitability has been more stable, due to sound product pricing, improved and more consistent underwriting performance and more stable investment returns (Figure 5). Policyholders have ultimately benefited from a safer, more efficient and more competitive industry able to meet claims obligations as they fall due.

Overall, in APRA's view, evidence of a negative trade-off between the *current* prudential regime in Australia and general levels of competition in the industries regulated by APRA is yet to be put forward.



**Figure 6: Share of total lending by regulated status**



If APRA's prudential regime were having such an impact, the evidence would be apparent in two forms:

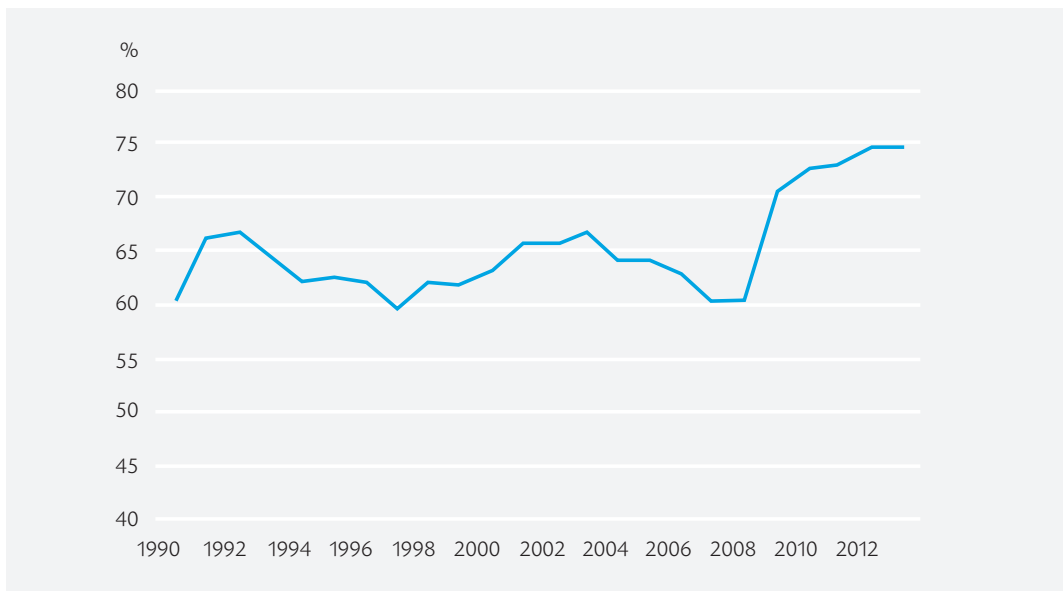
- regulated institutions would be losing market share to unregulated or 'shadow' competitors; and
- domestically owned regulated institutions would be losing market share to foreign-owned competitors, particularly foreign bank branches that are not subject to APRA's capital requirements.

The evidence suggests the opposite. ADIs have been taking market share from unregulated lenders (such as finance companies) for many years, including over the past decade. As Figure 6 shows, the ADI share of total lending has grown from 76 to 89 per cent from 2002 to 2013. A similar story applies when looking at competition between domestically owned and foreign-owned institutions regulated by APRA. As outlined in Chapter 1, Australian-owned ADIs have around an 85 per cent market share compared to

foreign-owned competitors, and that share has grown since the crisis began.

The lack of evidence of a trade-off is also apparent in the case of the other objectives APRA is required to balance against financial safety. Firstly, competitive neutrality. APRA acknowledges that the prudential regime can affect the relative position of competitors by imposing differential costs. For that reason, APRA aims to ensure that its prudential requirements are applied in a competitively neutral manner. All ADIs, for example, are subject to the same set of behavioural requirements and minimum capital requirements; so too are general and life insurers. However, APRA also aims to ensure that its prudential requirements and supervisory approach are proportionate to risks. APRA works actively to ensure that it does not place unreasonable expectations on smaller regulated institutions. For example, in areas such as data management and analysis, capital planning

**Figure 7: Major bank share of total ADI assets**



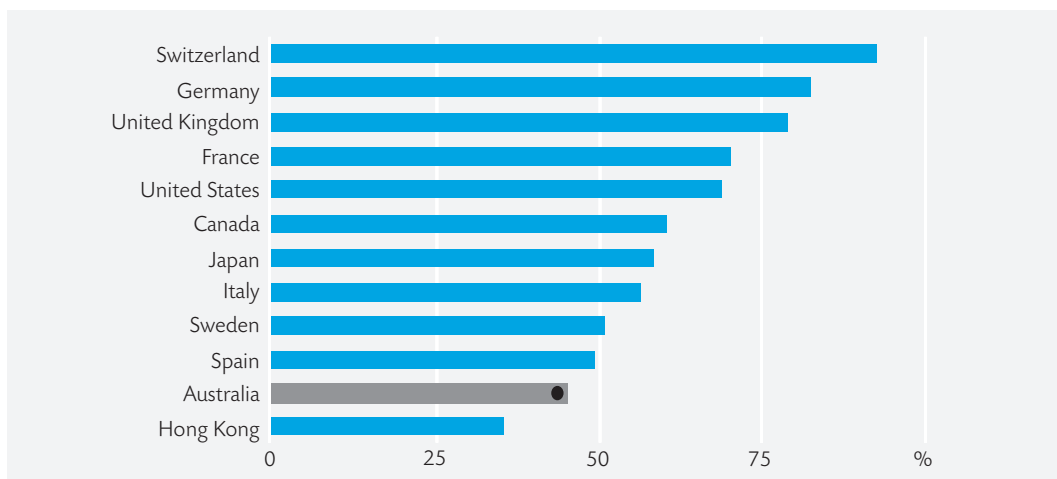
and stress testing, APRA sets proportionately higher expectations for large ADIs and insurance companies than for smaller institutions, commensurate with their structure, resourcing and size and complexity of risks.

One aspect of the prudential regime – the differential ADI risk-weights for housing lending – has been raised as a concern on competitive neutrality grounds. This issue is discussed in Chapter 8. APRA’s view is that, even if the differential impact were to be eliminated by moving all ADIs onto a one-size-fits-all methodology, the gains for smaller ADIs would be overshadowed by their disadvantages on funding and operating costs in competing with the largest ADIs. As noted in Chapter 1, large and small institutions have coexisted for decades and the industry landscape is by no means static. Consolidation has come in cycles; increases in the market share of the major banks have been followed by noticeable declines in the 1980s, 1990s and 2000s (Figure 7).<sup>44</sup>

Secondly, efficiency. Competitive pressures drive efficiencies and reduce the costs of financial services to the community. Notwithstanding APRA’s relatively conservative approach to capital and its intensive supervisory approach, the prudential regime does not appear to have proved detrimental to efficiency. Figure 8 shows, for example, that when efficiency is measured in a narrow sense of cost-to-income ratios, the major Australian banks are among the most efficient in the world. A strong prudential regime enhances an institution’s credit rating and lowers its cost of funding; the improved credit standing, in turn, will support its ability to compete in certain business lines where creditworthiness is a key consideration. Stronger institutions are also better able to make long-term investments in new technology and operational improvements that enhance services to customers.

<sup>44</sup> Henry K. 2010, ‘The Australian Financial System – emerging from the global financial crisis’, address to the Count Financial Conference, 15 March.

**Figure 8: International banks' cost-to-income ratios**



Note: Data for 2012. The • represents the 2013 value.  
 Source: RBA 2014, Financial Stability Review, March, page 25.

Clear prudential expectations for risk management contribute to a broader concept of efficiency – i.e. how well institutions manage their balance sheets – by promoting a consistent understanding of risk across regulated institutions, regardless of their size or sophistication. APRA publishes risk management guidance that is accessible to all institutions, and routinely provides feedback to institutions on better practices as part of its supervision activities. As a result, smaller institutions benefit from more ready access to information on better practice risk management than may otherwise be available to them. An example is APRA’s recently issued guides on data risk management and capital planning. These were developed on the basis of APRA’s detailed knowledge of practices in large and small institutions, which has allowed benchmarking and identification of sound practices.<sup>45</sup>

Finally, contestability. Contestability is strengthened when new entrants to a market have the potential to challenge the incumbents. Notwithstanding the exit of some foreign-owned participants during the crisis, a number of major foreign banks and insurance companies with significant resources from their parents are active in Australia, and nearly 20 new licences have been granted by APRA over only the last three years. APRA does not grant a licence without a careful review of the applicant’s capacity to manage a regulated business in Australia; from time to time applicants are found wanting. However, it would not be in the interests of a stable financial system, or of the community, for APRA to permit unsuitable operators to hold the badge of ‘ADI’ or ‘insurer’. The entrance and continuing presence of new (including foreign) participants suggest that the industries regulated by APRA are contestable.

<sup>45</sup> APRA 2013, *Prudential Practice Guide CPG 235 Managing Data Risk*, September; APRA 2013, *Prudential Practice Guide CPG 110 Internal Capital Adequacy Assessment Process and Supervisory Review*, March.

## 2.3 APRA's independence and accountability

The Wallis Inquiry argued that regulatory agencies should operate independently of sectional interests and with appropriately skilled staff. In addition, it proposed that the regulatory structure must be accountable to its stakeholders and subject to regular reviews of its efficiency and effectiveness.

Reflecting the Wallis vision, APRA's independence was acknowledged in the Explanatory Memorandum accompanying the original APRA Act:

*'It is intended that APRA will be an authority that will have a high degree of independence and operational autonomy.'*<sup>46</sup>

Notwithstanding this aspiration, APRA's independence has been eroded since its establishment.

The independence of a prudential regulator can usefully be delineated in four dimensions: institutional, regulatory, supervisory and budgetary.<sup>47</sup>

Institutional independence refers to the status of the prudential regulator as an institution separate from the executive and legislative branches of government. This includes the terms of appointment and dismissal of senior personnel, the governance structure and transparency of decision-making. APRA is a statutory authority set-up as a body corporate and legally a separate entity to the Commonwealth. The Government appoints the APRA Members and the limited circumstances under which the appointment of an APRA Member may be terminated are set out in section 25 of the APRA Act. Within the constraints of its approved funding (discussed in Chapter 5), APRA determines its own staffing needs and structure.

Regulatory independence refers to the ability of the prudential regulator to have an appropriate degree of autonomy in setting prudential requirements for the industries under its supervision, within the confines of the law. APRA has authority, without the need for Government approval, to issue enforceable prudential standards that apply to regulated institutions, to issue enforcement orders, to appoint a statutory manager and to take other prudential actions as set out in the APRA Act and the relevant industry Acts. Because they are legislative instruments, prudential standards must be tabled in each House of Parliament and may be disallowed by Parliament within 15 sitting days. In developing or revising its prudential standards, APRA consults extensively with Government, industry and other stakeholders and complies with Government policy on best practice regulation.

APRA's regulatory independence has been reduced through amendments to the APRA Act. As noted above, section 8 of the original 1998 APRA Act included as one of the purposes for establishing APRA '... developing the policy to be applied in performing [its] regulatory role'. The Explanatory Memorandum stated that 'Prudential regulation will cover both policy development and implementation.'<sup>48</sup>

In 2003, however, section 8 of the APRA Act was amended to replace the word 'policy' with 'administrative practices and procedures'. The accompanying Explanatory Memorandum stated that this amendment was intended to 'remove some confusion that has arisen in the past and led to uncertainty about where responsibility resides for formulating the policy behind the prudential regulatory framework'.<sup>49</sup> APRA understands that the change was in response to Government concerns at the time about early APRA attempts to involve itself in broader policy issues without prior consultation with the Government.

46 Commonwealth of Australia 1998, 'Australian Prudential Regulation Authority Bill', Explanatory Memorandum.

47 Quintyn, Ramirez and Taylor 2007, *The Fear of Freedom: Politicians and the Independence and Accountability of Financial Sector Supervisors*, IMF Working Paper.

48 Commonwealth of Australia 1998, 'Australian Prudential Regulation Authority Bill', Explanatory Memorandum, paragraph 4.9.

49 Commonwealth of Australia 2003, 'Australian Prudential Regulation Authority Amendment Bill', Explanatory Memorandum.

The 2003 legislative changes also eliminated the consultative processes in section 12 of the original APRA Act, which were designed to mediate any differences in views on APRA's policies between APRA and the Government. These consultation processes were identical to those applying (and still applying) to the RBA. They provided that, in the case of a disagreement between the Treasurer and APRA on one of APRA's policies, the Treasurer and APRA are to try to reach agreement. If they cannot, the Treasurer may give a recommendation to the Governor-General, who could with advice from the Executive Council determine the policy to be adopted by APRA. The 2003 amendments replaced section 12 with the new section under which the Minister may, after consultation with APRA, give a direction to APRA about the policies and priorities it should pursue, without any requirement to reach agreement through a formal mediation process. However, the Minister must not direct APRA about a particular entity. The Explanatory Memorandum explained that the new ministerial directions power was consistent with directions powers in relation to other statutory agencies, in particular ASIC.

Supervisory independence concerns a prudential regulator's ability to exercise its judgment and powers in such matters as licensing, on-site inspections and off-site monitoring, sanctioning, and enforcement of sanctions (including revoking licences); these are the main tools available to supervisors to achieve safety and promote stability. APRA has strong supervisory independence in these key matters. The exception is decisions in relation to changes in control, i.e. licensing and merger and acquisition decisions, where the Treasurer has decision-making authority above particular size thresholds under the relevant Acts.

Budgetary independence refers to the ability of the prudential regulator to determine the size of its own budget and the specific allocation of resources and setting of priorities. The Wallis Inquiry recommended that APRA should be 'off-budget', that is, not included in the Government budget but funded through direct recovery of regulatory costs from industry. This proposed approach was accepted by the Government.

APRA's budget is proposed by the APRA Members and approved by the Government. Since 1 July 2007, APRA's financial arrangements have been subject to the *Financial Management and Accountability Act 1997*, which imposed a range of measures designed to improve financial accountability and promote appropriate and economical use of resources by the Government departments and most statutory authorities.<sup>50</sup> Under current arrangements:

- APRA's budget is subject to scrutiny by the Department of Finance;
- APRA is subject to 'whole-of-government' procurement and cost reduction initiatives, particularly in areas such as travel and information technology, that have not always provided flexible and cost-effective outcomes in APRA's case; and
- APRA's staff enterprise agreement (covering remuneration and conditions) is vetted by the Australian Public Service Commission and approved by the relevant Minister.

APRA is also subject to general 'efficiency dividend' requirements, under which agency funding is reduced to drive efficiency savings (see Chapter 5).

<sup>50</sup> Department of Finance and Deregulation 2005, *Governance Arrangements for Australian Government Bodies*, Chapter 3, paragraph 70. The Act will be replaced by the *Public Governance, Performance and Accountability Act 2013* from 1 July 2014. This new Act promises a more flexible financial framework for Government departments and statutory authorities but specific rules and guidelines have not been finalised.

APRA's financial arrangements have not to date materially affected its ability to conduct effective supervision. However, APRA is likely to face increasing constraints on its funding and operating flexibility. This is an important issue for a risk-based prudential regulator like APRA, where the ability to attract and flexibly utilise highly skilled staff is critical to the delivery of its mission. Most recently, the APRA Members have lost the authority to approve overseas travel by APRA staff, singly or collectively, over \$20,000, much of which is associated with on-site reviews of overseas operations of the largest internationally active regulated institutions. Decisions on whether these reviews may be undertaken are now effectively determined at Ministerial level.


APRA's compliance with the relevant *Core Principles* for the independence of a prudential regulator were assessed by the IMF as part of its Financial Sector Assessment Program (FSAP) review of Australia in 2012. The grading was 'Largely Compliant'. The IMF raised two particular areas where APRA's independence might be compromised:

- the Parliamentary disallowance procedure could result in the failure to introduce what are considered essential prudential standards that necessitate a new initiative. At the same time, the IMF acknowledged that the disallowance procedure has never been invoked and would be likely to be invoked in extreme circumstances only; and
- the ministerial directions power could limit APRA's ability to act in a fully effective manner, although the IMF acknowledged here as well that the power has never been invoked and is unlikely to be invoked in normal circumstances.

The IMF also argued that the involvement of the Treasurer in approving changes of control above a particular size threshold be removed and that APRA be given a binding right of veto over changes of control on prudential grounds.

The IMF recommended that APRA 'explore with the Australian Government possible avenues which would ensure unambiguous independence within APRA'.<sup>51</sup> APRA would welcome such an opportunity. APRA fully supports the Parliamentary disallowance procedure since it provides an appropriate accountability mechanism. However, the ministerial directions powers and the circumscribing of its role in prudential regulation policy have diminished the clarity around APRA's prudential authority. APRA accepts that it is necessary and appropriate for the Government to decide matters of financial system policy, such as those affecting the structure of the financial industry and how it best serves the needs of the Australian community. Nonetheless, the original APRA Act recognised APRA's authority to develop and implement prudential policies that it has judged as necessary to meet its statutory objectives, and restoration of that authority would be consistent with the independence of a prudential regulator envisaged by the Wallis Inquiry. There are now sufficient accountability mechanisms in place, including consultation with the relevant Minister and through the Council of Financial Regulators, as well as the Parliamentary disallowance process, to address any concerns that APRA might act in a manner inconsistent with broader Government policy.

51 International Monetary Fund 2012, *Australia: Report on the Observance of Standards and Codes (ROSC) – Summary Assessments*, Washington, page 18.



With independence comes accountability. APRA fully supports the need for independent statutory authorities to meet high standards of accountability to the Parliament and the community.

APRA is accountable to the Parliament and it reports regularly on its performance through its Annual Report and appearances before Parliament's *ad hoc* and standing committees. In addition, APRA is subject to financial and performance audits by the Australian National Audit Office (ANAO). The reports of the ANAO are tabled in Parliament and are publicly available. APRA is also subject to the Government's best practice regulation process administered by the Office of Best Practice Regulation. This process involves a rigorous cost-benefit analysis of the impact of any proposed new regulation (and alternatives) on different groups in the Australian community and on the community as a whole, culminating in publication of a Regulation Impact Statement (RIS). Over the years, APRA has maintained full compliance with the RIS requirements.

Beyond these formal accountability mechanisms, APRA also actively explains and engages on its activities with the financial industry and the wider community. This includes, for example, regular speeches by the APRA Members and senior executives to explain APRA's thinking and approach on topics of current interest; extensive consultation on policy proposals (including publishing a response to submissions received) (see Chapter 3); and an independent survey of key stakeholders on APRA's performance, the results of which are published (see Chapter 7).

# CHAPTER THREE / THE PRUDENTIAL FRAMEWORK

A robust prudential framework is the foundation for effective supervision. The Wallis Inquiry recognised this in its vision of an integrated prudential regulator that would provide:

*'greater flexibility, responsiveness and efficiency in the face of potentially major changes in the financial landscape. In pursuing these outcomes, it is important that the [new regulator] have wide powers to establish and enforce prudential regulations.'*<sup>52</sup>

The prudential framework establishes the objectives and legal powers of the prudential regulator and its minimum expectations for financial soundness and prudent risk management. All regulated institutions must meet these expectations in order to operate in the financial industry. These minimum expectations must be set out in sufficient detail to provide clarity and certainty to institutions and to give supervisors objective benchmarks against which to assess an institution's performance and risk management. Importantly, however, the prudential framework does not need to be highly prescriptive but can be principles-based and focussed on outcomes.

In Australia, the prudential framework comprises three tiers: primary legislation in the form of Acts of Parliament and regulations under those Acts, subordinate legislation in the form of prudential standards, and prudential guidance. This structure, in APRA's view, strikes an appropriate balance between 'hard coding' key prudential requirements in primary legislation and taking a more flexible and adaptive approach for the detailed requirements set out in prudential standards. Since its establishment, APRA has worked closely with the Government to strengthen, modernise and harmonise the prudential framework in all four APRA-regulated industries, beginning well before the global financial crisis unfolded.

## 3.1 Legislative framework

A strong and clear legal framework for prudential supervision is necessary to enable a prudential supervisor to effectively discharge its duties. The *Core Principles for Effective Banking Supervision* and the *Insurance Core Principles* expect minimum provisions to be included in a country's laws to ensure the prudential regulator is empowered to do its job.<sup>53</sup> Specifically, the prudential regulator must have the legal authority to authorise regulated institutions to conduct business, to perform ongoing supervision of licensed entities, to enforce compliance with laws and to undertake timely corrective actions to address safety and soundness concerns.

As outlined in Chapter 2, the APRA Act established APRA as the authority responsible for the prudential supervision of financial sector entities in accordance with the Acts applicable to each regulated industry. These Acts comprise the Banking Act, the Insurance Act, the Life Insurance Act and the SIS Act. The industry Acts that APRA inherited, however, varied significantly across industries, particularly in terms of the powers granted to the prudential regulator. Following APRA's establishment, successive Governments have given priority to modernising and, to a large extent, harmonising the industry Acts.

One of the most important legislative changes was providing APRA with prudential standards-making powers. This was done firstly for the ADI industry in 1998, then for life insurance in 1999 and general insurance in 2002. In 2007, the Life Insurance Actuarial Standards Board was disbanded and its responsibility for setting standards in relation to actuarial matters transferred to APRA. Most recently, APRA was granted prudential standards-making powers in superannuation in 2012, as part of the Government's Stronger Super reforms. This has allowed risk

52 See page 318, *Financial System Inquiry Final Report*.

53 Basel Committee on Banking Supervision 2006, *Core Principles for Effective Banking Supervision*, Principle 2 (revised 2012); International Association of Insurance Supervisors 2011, *Insurance Core Principles, Standards, Guidance and Assessment Methodology*, Principle 1 (revised 2013).



management requirements in superannuation to be addressed by APRA in a more flexible and forward-looking manner, and with greater consistency with the other regulated industries. These reforms followed earlier changes to the SIS Act designed to streamline the superannuation industry and enhance superannuation safety. In particular, the introduction of licensing for Registrable Superannuation Entities (RSEs) in 2006 substantially enhanced risk management expectations.

A second important change was establishing a framework for conglomerate financial groups. Facilitating conglomerate arrangements was a key element of the Wallis vision to support industry evolution and innovation, and a primary rationale for establishing APRA as an integrated regulator. The banking and insurance industry Acts now allow a regulated institution, be it an ADI or insurer, to be owned by a NOHC that may also own other subsidiaries and engage in other activities, including regulated and unregulated financial and non-financial activities. The Acts further provide for APRA to have oversight of a parent NOHC and an ADI's or insurance company's subsidiaries in order to ensure that their supervision, by APRA, adequately addresses contagion risk from those entities. A clear, coherent and consistent legal framework across industries is critical to the effective supervision of these conglomerate groups.

Thirdly, more comprehensive enforcement powers have been provided to APRA in the ADI and insurance industries. The industry Acts give APRA the power to issue directions to regulated institutions, for example to comply with a prudential requirement or to issue new capital. Failure to comply with a direction is a criminal offence. From time to time, APRA has used these directions powers in more serious situations. However, APRA does not see itself as a law enforcement agency that engages primarily in policing compliance and prosecuting breaches; rather, it follows a risk-based approach to supervision, as described in Chapter 4.

Fourthly, APRA's legal powers to respond to the financial distress of a regulated institution were materially strengthened in the years immediately following the outbreak of the global financial crisis. These changes were in train well before the crisis but acquired new urgency as the crisis unfolded.

Finally, a variety of other changes have been made to modernise provisions of the industry Acts or to respond to changing circumstances. For example, certain overly prescriptive requirements, such as pre-approval of auditors and actuaries, were removed from the insurance Acts, providing greater flexibility to regulated institutions and for APRA in setting standards. Reflecting Government policy, the Banking Act was amended to support supervisory coordination with New Zealand in pursuit of financial stability in both countries, and to allow ADIs to issue covered bonds.

In summary, the intensive legislative reforms of the last decade have built a robust legal framework that has kept pace with toughened global regulatory benchmarks. In APRA's view, no further substantial legislative reforms are required at this point. As discussed in Chapter 6, however, there are some areas where APRA's crisis resolution powers could be further strengthened, to align them more closely with international standards and best practice and enable APRA to respond effectively to financial distress in a regulated institution.

## 3.2 Prudential standards

The legislative framework outlined above does not generally include prudential requirements that apply directly to regulated institutions. Rather, it makes provision for APRA to establish these requirements.<sup>54</sup> Minimum expectations for the prudent operation and financial soundness of an institution are set out in APRA's prudential standards.

Before it had prudential standard-making powers in all four industries, APRA (and its predecessor agencies) issued prudential expectations in other forms, ranging from informal non-binding guidelines or policy statements to regulations. These arrangements were unsatisfactory for a prudential regulator. Informal guidance can provide a clear benchmark for industry and can be flexible and adaptive, but it does not have the force of law. Informal guidance alone will therefore be ineffective in achieving prudential objectives if compliance with the guidance is opposed by a regulated institution in particular circumstances and APRA has no authority to require compliance. In contrast, setting expectations by formal regulation can often lead to an overly legalistic and inflexible approach, with little room for consideration of evolving industry practice. Highly prescriptive, rules-based approaches to prudential requirements, which is the norm in some countries, can lead to a culture of compliance with the 'black letter' of the rules but easy evasion of the principle behind them, often undermining the effectiveness of the rule.

Prudential standards are intended to provide a plain English, non-legalistic exposition of APRA's expectations for risk management and financial soundness that can be understood by boards and senior management and applied by risk and financial personnel. As legislative instruments, prudential standards are subject to formal Parliamentary oversight through the disallowance process and, once implemented, have the force of law. Unlike the position with regulations, APRA has authority to modify a prudential standard to respond to a particular circumstance, subject to appropriate governance and accountability processes. APRA may and does use this authority, for example, to provide transitional relief in special cases for implementation of new prudential requirements.

APRA's prudential standards-making powers have been supported by industry as they provide a common, easily understood set of expectations for prudent risk management for all regulated institutions. For example, all submissions on APRA's new prudential standards for superannuation in 2012 supported APRA being given prudential standards-making powers in the SIS Act.<sup>55</sup>

APRA's prudential requirements are developed in consultation with all stakeholders, particularly regulated institutions and industry bodies. All proposed changes to prudential standards are issued for public consultation in draft form, often more than once. APRA typically issues a discussion paper with each proposal, which outlines the objectives and reasoning behind the proposed changes and invites comments from interested parties.

<sup>54</sup> Exceptions to this include, for example, statutory requirements for appointed auditors and actuaries for insurers and the requirement under the Banking Act for ADIs to hold assets in Australia at least as large as deposits in Australia.

<sup>55</sup> APRA 2012, *Regulation Impact Statement: Superannuation Prudential Standards*.

APRA treats the comments received seriously and carefully considers feedback and suggestions made through consultation. Written submissions from regulated institutions and peak industry bodies are published on APRA's website (unless requested to be kept confidential) and are usually followed up with a range of face-to-face meetings. Draft prudential standards undergo multiple rounds of revisions during the consultation process.

In the development of its conglomerates framework, for example, APRA held two workshops (one of which was in conjunction with an industry organisation) and numerous meetings with all affected groups prior to and following each of the multiple rounds of revised draft standards. Similar extensive consultations took place before APRA finalised its recent reforms to capital standards for the general and life insurance industries.

As part of the consultation and development process, APRA considers the balance between safety, efficiency, competition and competitive neutrality, and industry views on that balance. For example, in developing the superannuation prudential standards, APRA originally proposed a narrow approach that did not allow income protection insurance within superannuation to be obtained from general insurers. Following submissions and discussions with industry, a more principles-based approach was adopted in the final standards that focussed on adequate due diligence undertaken by RSE licensees when selecting an insurer, and identification and monitoring of risks associated with insurers.<sup>56</sup>

APRA provides a response paper after each consultation round and with the final version of the prudential standard, explaining how the main themes in comments received have been addressed. Prudential standards are finalised only after APRA has met the Government's requirements for best practice regulation (see Chapter 2). For more than a decade, APRA has maintained a 100 per cent compliance record with these requirements. Prudential standards are reviewed after their implementation and on an ongoing basis to ensure they continue to reflect good practice and remain relevant and effective, both for regulated institutions and for APRA's supervisory purposes.

Over the past few years, APRA has had a substantial prudential policy agenda in each of its regulated industries. Implementation of the global reform agenda, particularly the Basel III capital and liquidity framework, has been a major driving force, but APRA also had significant initiatives of domestic origin. These have involved the updating and harmonisation of capital requirements for general and life insurers, a substantial enhancement to the prudential regime for superannuation as part of the Stronger Super reforms, and the development of a prudential framework for conglomerates (Level 3) groups. With the exception of some remaining elements of Basel III and finalisation of the conglomerates framework, APRA's prudential policy agenda is very largely complete. In the process, most prudential standards for ADIs and insurers have been revised or replaced since they were first issued.

<sup>56</sup> Ibid.

### 3.3 Prudential guidance

APRA issues prudential guidance where it can to provide further information that may assist regulated institutions in meeting APRA's expectations under prudential standards. Guidance most commonly takes the form of prudential practice guides (PPGs) but can also be communicated through industry letters, articles in APRA's Annual Report or *Insight* publication, or answers to 'frequently asked questions' on specific topics. APRA has published 54 PPGs covering most of the core prudential standards across the four regulated industries.

PPGs do not contain prudential requirements. Rather, PPGs set out prudent practice in specific areas and provide guidance, but not prescription, on how institutions can satisfy prudential requirements contained in legislation and APRA's prudential standards. Through PPGs and other guidance material, APRA provides industry benchmarking information that may not be available otherwise to regulated institutions to help them enhance their risk management capabilities. This helps to ensure APRA's prudential expectations are aligned with what industry itself demonstrates to be good practice. In APRA's most recent stakeholder survey, the value of PPGs in explaining APRA's requirements was rated very highly by respondents (see Chapter 7).

### 3.4 Key elements of APRA's prudential standards

In its 2007 *Statement of Intent* (see Chapter 2), APRA confirmed its commitment to a principles-based approach to the prudential framework that recognises the complexity and diversity that exists among regulated institutions. A principles-based approach is one that emphasises outcomes in setting prudential requirements and expectations, but does not seek to specify or prescribe the exact manner in which those outcomes must be achieved. Such an approach, rather than one-size-fits-all rules, helps to promote compliance with the spirit, rather than just the letter, of APRA's prudential requirements. However, prudential requirements need to be clear, so that regulated institutions know what is expected of them and APRA is able to enforce the requirements as needed. The need for clarity necessarily places a limit on the extent to which APRA can rely on high-level principles alone: a careful balance is needed. The extensive consultation process involved in the development of prudential standards aids APRA in ensuring this balance is correctly struck.

Within this approach, APRA's prudential standards aim to ensure that risk-taking is conducted within reasonable bounds, that risks are clearly identified and well managed and that, where appropriate, regulated institutions hold adequate capital to deal with unexpected stress and losses. These objectives guide the development of all prudential standards.

APRA's prudential standards take two broad forms:

- *behavioural standards*, which set out expectations for risk management and the calibre and decision-making processes of boards and management; and
- *technical standards*, which establish minimum requirements for financial soundness in matters such as capital and liquidity, risk measurement and asset and liability valuation.

Requirements for sound governance are a core element of APRA's behavioural standards. Experience consistently demonstrates the importance of strong governance standards in APRA-regulated industries. In the 1980s and 1990s, failures in regulated institutions in Australia were often caused by weak internal controls and unchecked actions by dominant directors or managers. Abroad, shortcomings in how boards met their responsibilities have been identified as a material contributor to the global financial crisis. In the United Kingdom, for example:

*'The crisis exposed significant shortcomings in the governance and risk management of firms and the culture and ethics which underpin them. This is not principally a structural issue. It is a failure in behaviour, attitude and in some cases, competence.'*<sup>57</sup>

Until the early 2000s, however, there were few formal APRA prudential requirements for governance, risk management and the role of the board. Lifting governance and risk management practices was therefore a priority for APRA well before the global financial crisis. Ahead of some other countries, APRA developed prudential standards on governance, fitness and propriety of directors and senior officers and various aspects of risk management for ADIs and insurers. Similar standards have also been implemented recently in superannuation. APRA's enhanced expectations have helped regulated institutions avoid the basic governance failings identified abroad in the crisis, such as a lack of independent challenge from the risk management

function, questionable audit outcomes or board inability to monitor basic balance sheet and risk exposure measures.

APRA's principles-based approach explicitly recognises that regulated institutions may meet its requirements in a manner best suited to their size, business mix and complexity; indeed, diversity is often beneficial as more efficient and innovative approaches are allowed to emerge. For example, APRA's governance standards require that each board have a policy on board renewal to ensure that the board remains open to new ideas and independent thinking.<sup>58</sup> APRA has not prescribed the details that should be in the policy. Similarly, APRA's 'fit and proper' prudential standard does not mandate a 'tick-the-box' exercise to enable institutions to screen out unsuitable persons. Rather, it outlines high-level principles on fitness and propriety and requires regulated institutions to have their own policies, and take prudent steps, to ensure their responsible persons meet those principles. Each institution has flexibility to develop its own methods to do this, in keeping with the spirit and intent of the standard.

Ultimately, boards of regulated institutions are responsible for establishing an appropriate governance regime within which the institution's risk and capital management can effectively operate. While the *Corporations Act 2001* establishes general obligations for board directors and other officers to act with care, diligence and in good faith, it does not fully address all the essential elements of good corporate governance in regulated institutions, as identified in the *Core Principles* of the two global standards-setting bodies and by the FSB. These include requirements on matters such as board composition and skills, responsibilities for risk management, remuneration principles and the roles of the Chief Risk Officer and board committees. APRA recognises that boards themselves do not manage the day-to-day operations or risks of their institutions, and nor should they. However, APRA expects that a board, in properly carrying out its governance responsibilities, will do more than simply make appropriate delegations;

57 Sants H. 2012, Chief Executive of the Financial Services Authority, 'Delivering effective corporate governance: the financial regulator's role', 24 April.

58 APRA 2013, *Prudential Standard CPS 510 Governance*, January.

rather, APRA looks for evidence that the board has taken proactive steps and made appropriate enquiries to assure itself that the institution will meet its prudential requirements.

For some time, APRA has been committed to harmonising behavioural standards across regulated industries, particularly in the area of governance. There is no compelling reason why such standards should differ across the industries, and harmonised standards facilitate the migration of best prudential practice across industries. APRA has now issued five harmonised (cross-industry) standards, covering governance, fit and proper, outsourcing, business continuity management and, most recently, risk management. This approach also gives effect to the Wallis vision of integrated regulation that would deal efficiently with financial conglomerates.

As discussed in Chapter 1, financial conglomerates account for a significant proportion of the financial industry. Inconsistent regulatory requirements across regulated institutions within a group can increase the cost of compliance for these groups and, in the extreme, may encourage arbitrage of prudential standards by adjusting legal or financial structures.

The financial industry has been supportive of APRA's principles-based approach to prudential standards. For example, comments on APRA's proposed superannuation prudential standards suggested these were sufficiently flexible for RSE licensees to meet the requirements in a way that was suitable to the size, business mix and complexity of their business operations.<sup>59</sup>

Technical standards, in contrast, tend to be less amenable to a principles-based approach than behavioural standards. These standards address management of the main prudential risks in each regulated industry; these comprise capital, credit and investment risk, market and liquidity risk, insurance risk and operational risk. To be effective, APRA's requirements in these areas generally need to be quantitative in nature and reasonably detailed in approach. Capital requirements, in particular, are by necessity prescriptive: they must be clear and applied consistently so as not to grant any material competitive advantage to one regulated institution over another and to prevent regulatory arbitrage or evasion. The particular requirements are designed to provide a clear and consistent signal, though not a definitive indication, of financial soundness or prudent risk levels. Verifying that institutions have not breached these quantitative requirements forms part of the tasks of supervisors in assessing an institution's overall health.

Technical standards are also more difficult to align across industries, given different accounting standards and different financial concepts used. However, APRA has made progress in this area. For example, APRA has adopted consistent terminology and eligibility criteria for the quality of regulatory capital for ADIs and insurers. Consistent eligibility criteria are particularly important where different types of regulated institutions are issuing capital instruments in the same markets. Further, in its recent reforms to insurance capital standards, APRA sought to align more closely the structure of capital requirements for general and life insurance.

<sup>59</sup> See APRA 2012, *Regulation Impact Statement: Superannuation Prudential Standards*.

Achieving a consistent cross-industry view of governance and financial soundness will culminate in APRA's release of final standards for conglomerate (Level 3) groups. These standards have been developed over a number of years, reflecting the complexity in striking an appropriate balance between ensuring safety and protection of beneficiaries and acknowledging the commercial realities for conglomerate groups.<sup>60</sup>

### 3.5 International consistency

The Wallis Inquiry explicitly acknowledged the importance, in view of the growing linkages between financial markets internationally, of Australian financial institutions operating within international norms and according to international standards. In particular, the Wallis Inquiry recommended that prudential regulation of all ADIs should be consistent with standards approved by the Basel Committee.

The Basel capital framework has applied to Australian banks since 1988, when the original Basel Capital Accord, the first agreed international framework for capital adequacy, was introduced.<sup>61</sup> APRA's first suite of harmonised prudential standards for ADIs extended that framework to all ADIs in 1999. Since then, APRA has implemented the more risk-sensitive Basel II framework in 2008 and the Basel III reforms, which aim to raise the quality, quantity and international consistency of bank capital, from 2013. APRA's implementation of the Basel capital framework has been assessed favourably by the IMF (2009) and the Basel Committee (2013). These assessments are discussed in Chapter 7.

As a general matter, APRA strives to implement prudential requirements that are consistent with emerging global standards and global best practice. These go beyond capital and other technical standards to matters of governance, risk management and executive remuneration. A global capital framework (comparable to that for banking) does not exist for the insurance industry, though one is being developed under the auspices of the IAIS. However, APRA pays close heed to the *Insurance Core Principles*, as it does to the supervisory principles for superannuation that are being developed by the International Organisation of Pension Supervisors (IOPS).

In APRA's view, the consistency of the Australian prudential framework with international standards is critical to ensuring the attractiveness of regulated institutions to providers of funding and capital. That attractiveness results in greater appetite for the debt and equity instruments of these institutions, lower costs in raising funding and capital in global markets, and business opportunities that rely on an institution's creditworthiness being readily transparent. In the most recent APRA stakeholder survey, regulated institutions demonstrated clear agreement with the statement 'It is important to your organisation that APRA closely follows international best practice in making prudential standards for your industry.'<sup>62</sup>

International consistency has particular benefits to regulated institutions. Firstly, rating agencies regard the nature and quality of regulation as an important factor in assessing industry risk and anchoring individual credit ratings. For example, Standard & Poor's has noted in Australia's case:

*'The structure of the banking industry--being dominated by a small number of strong retail and commercial banks and underpinned by a strong regulatory and governance framework--tends to be accommodative of strong bank ratings.'*<sup>63</sup>

60 APRA 2013, *Supervision of conglomerate groups (Level 3)* - May.

61 Basel Committee on Banking Supervision 1988, *International convergence of capital measurement and capital standards*, July (Basel Capital Accord); Basel Committee on Banking Supervision 1996, *Overview of the amendment to the capital accord to incorporate market risks*, January (modified September 1997).

62 This question was not asked of superannuation trustees.

63 Standard & Poor's Financial Services 2013, *Banking Industry Country Risk Assessment: Australia*, McGraw Hill, page 3.

Moody's has also commented that APRA's strong and effective implementation of global standards has a positive impact on credit ratings:

*'APRA's new liquidity standards are credit positive for Australian banks, as they are more conservative and follow a tighter implementation timetable than those required by the Basel Committee.'*<sup>64</sup>

Secondly, prudential regulators abroad, and markets, increasingly make use of internationally accepted benchmarks in assessing whether to authorise, or deal, with cross-border institutions. APRA takes the same approach. Australia's compliance with global standards provides a basis for prudential regulators abroad to permit regulated institutions to operate in some overseas jurisdictions, as well as under certain mutual recognition regimes. A recent example is the new swap dealer requirements issued by the US Commodity Futures Trading Commission that apply to those Australian banks active in the US derivatives markets.<sup>65</sup> The Commission has granted 'substituted compliance' on the basis of the Australian regulatory framework, allowing Australian banks to avoid duplicative and costly regulation.

By their very nature, of course, global frameworks are not always best placed to accommodate particular conditions in domestic markets. For that reason, global standards allow some elements of national discretion, although the increasing focus since the crisis on international regulatory consistency and transparency means that any inconsistencies, no matter how minor, will be fully transparent. In exercising its discretion, APRA has on occasion applied requirements that are more conservative than the *minimum* requirements in global standards, based on strongly held principles regarding core elements of financial soundness. In contrast, APRA has provided a more concessional treatment of residential mortgage lending to investors,

as highlighted by the recent Basel Committee review.<sup>66</sup> The implications of APRA's more conservative approach are discussed in Chapter 8.

APRA's participation in the global standard-setting bodies for prudential regulation (it joined the Basel Committee in 2009 alongside the RBA and was a founding member of the IAIS and IOFS) enables APRA to inject supervisory knowledge and practical considerations (from an Australian perspective) into the development of regulatory reforms, and early acquaintance with the reforms and their context has helped APRA with eventual implementation. In the case of Basel III liquidity, for example, APRA's presence in the international discussions allowed it to propose a pragmatic response to domestic considerations (the shortage of high-quality liquid assets) that might otherwise have disadvantaged Australian ADIs, and this alternative was adopted as part of the Basel III liquidity standard.

64 Moody's Investors Services 2014, *Moody's: APRA announces framework for D-SIBs; maintains conservative approach with Basel III liquidity*, Global Credit Research Announcement.

65 Commodity Futures Trading Commission 2013, 'CFTC approves comparability determinations for six jurisdictions for substituted compliance purposes', 20 December.

66 Basel Committee on Banking Supervision 2014, *Regulatory Consistency Assessment Programme (RCAP) Assessment of Basel III regulations – Australia*.



# CHAPTER FOUR / APRA'S SUPERVISORY APPROACH

The Wallis Inquiry recognised that a robust prudential framework and effective supervision are both needed to ensure regulated institutions meet their promises to beneficiaries. Consistent with its view of the workings of efficient markets, the Wallis Inquiry envisaged a supervisory approach that was flexible and proportionate. However, the Wallis Inquiry made no mention of light touch supervision.

The global financial crisis clearly demonstrated that a robust prudential framework alone is not sufficient to achieve the objectives of prudential regulation. As discussed in Chapter 1, one key lesson from the crisis was that the effectiveness of prudential supervision varied widely across jurisdictions and that light touch approaches were found wanting. APRA eschewed light-touch supervision in the wake of the failure of HIH Insurance in 2001. Rather, it has worked to significantly strengthen its supervisory approach and practices, incorporating 'good practice' from overseas counterparts as well as lessons from its own experiences. It has become an active, and if necessary intensive, supervisor in the process. APRA's approach is hands-on and 'close touch', particularly with its largest regulated institutions and any institutions that have demonstrated deficiencies in governance or risk management.

Supervision is more than the enforcement of rules and prudential requirements. APRA's supervisory approach places particular emphasis on assessing the effectiveness of a regulated institution's governance and risk management framework. No set of formal requirements can adequately and efficiently deal with all aspects of complex financial institutions, so effective supervision requires judgment, understanding and interaction on APRA's part to ensure that it can identify the strengths and weaknesses of an institution.

In its 2007 *Statement of Intent*, APRA committed itself to a risk-based approach under which regulated institutions facing greater risks receive closer supervisory attention. This enables APRA to deploy its resources in a targeted and cost-effective manner. This chapter provides a high-level overview of APRA's supervisory approach and its key strengths.

## 4.1 Risk-based supervision

APRA's approach to supervision has a clear goal. It is to ensure that supervisory assessments about a regulated institution are perceptive, timely and robust, and that the supervisory attention afforded to each institution is appropriate. APRA's risk-based approach to supervision is a structured and methodical process designed to identify and assess those areas of greatest risk to an institution (or to the financial system as a whole) and then direct supervisory resources and attention to those risks. Under this approach, more supervisory resources are devoted to those institutions that have higher risk profiles or identified risk management weaknesses, or that pose a potential systemic threat. Risk-based supervision enables APRA to apply its limited resources to maximum effect. It also enables APRA's supervisory approach to be flexible and proportionate, as Wallis envisaged, with supervisory responses tailored to the risk profile of an institution and taking into account its size, complexity and the robustness of its risk management.

APRA's supervisory approach is based on the fundamental premise that primary responsibility for the prudent management of a regulated institution rests with its board and management. It is the responsibility of the board to establish an appropriate governance structure for risk and set the institution's overall risk appetite. APRA's role is therefore to assess the frameworks and controls that have been implemented by an institution's board and management, and ensure they are consistent with prudential requirements and with industry good practice more generally.

APRA's supervisory approach seeks to understand a regulated institution's strengths, weaknesses and major risks. To achieve this, each institution has assigned to it a 'responsible supervisor' – for the largest institutions, this involves a team of supervisors – whose responsibility is to develop an in-depth understanding of that institution, identifying areas of potential risk and, when necessary, requiring rectification action. Supervisors are assisted in building up this knowledge by drawing on the expertise of

APRA's specialist teams (including risk management experts, actuaries, accountants and lawyers). It is frontline supervisors, however, that are accountable for the risk assessment undertaken and the decisions arising from it.

The foundation for supervising a regulated institution is the forward-looking supervisory action plan that is developed by the supervision team, and tailored for the particular institution. APRA has baseline supervision requirements for all institutions, designed to ensure that every institution receives the minimum level of supervisory oversight considered necessary to confirm the risk assessment of that institution. The baseline supervision requirements reflect APRA's appetite for risk within a non-zero failure regime as envisaged in the 2007 *Statement of Expectations for APRA*. They seek to strike a balance between achieving a desired level of comfort about an institution's prudential soundness and APRA's risk-based approach. Limited resourcing necessarily restricts the supervisory activities that can be completed and supervisors must prioritise activities to ensure the most important issues are dealt with.

Each supervisory action plan builds on the baseline requirements and sets out the key risks APRA supervisors see facing the regulated institution and, in response, the desired supervisory outcomes and activities necessary to achieve them over the next one to three years. The plan targets particular risks that have been identified as emerging or heightened risks through an APRA-wide industry risk assessment process. The plan encompasses a range of activities, including regular off-site review and analysis of financial, statistical and other information provided to APRA; it also includes detailed on-site reviews at which risk management and internal controls are rigorously assessed. Supervisors will use APRA's specialist teams to assist with reviews of highly specialised areas such as capital models, market and operational risk management, and insurance reserving and actuarial projections.

APRA's supervisors seek to identify and evaluate potential risks at an early stage and ensure that these are addressed before they pose a threat to a regulated institution or its beneficiaries. For example, if an institution's risk profile was assessed to be deteriorating, supervisors will ask for more frequent reports on those parts of the balance sheet that were causing concern. If a key risk management area was found to be under- or ineffectively resourced, APRA would require the institution to make the necessary system or staffing changes. If an institution is moving into new ventures or introducing new products, APRA would expect to see robust due diligence processes at work. APRA's prudential requirements do not place any explicit restrictions on these latter types of activities but, given the financial and operational risks that may arise, APRA supervisors will review the due diligence conducted by the institution and will want to be satisfied that the risks involved are well understood and being adequately addressed by management.

Supervisors meet regularly with staff from both business and risk areas of regulated institutions, to develop and maintain a thorough understanding of the institution and, in particular, the quality of its staff and management. APRA also meets with the board and separately with board committee chairs (at least annually for the largest institutions), and with senior management on a regular basis, for high-level strategic discussions and, when necessary, to raise any specific prudential concerns.

For the largest Australian banks and insurance companies, overseas operations have at times proved to be a significant source of risk. To the extent permitted by budgetary resources, APRA supervisors conduct on-site reviews at major operational centres overseas where there is the possibility of material risks arising; a structured program for such visits was recommended by a performance audit by the ANAO. Recently, these reviews have included reviews of outsourcing and offshoring arrangements of major banks in Asia, regulated subsidiaries of banks and insurance companies in New Zealand and the United States, as well as other operations in Europe and Asia. APRA works closely

with local supervisors in these instances and organises, and participates actively in, 'colleges' of supervisors established to facilitate coordination and cooperation between supervisors in different jurisdictions.

Effective supervision needs a robust process for bringing together the institutional knowledge, prudential data, market intelligence and financial analysis needed to assess the risk profile of a regulated institution and its risk management capabilities. In APRA, a core element in that process is its formal risk-rating system, which helps to ensure that risk judgments of APRA's supervisors are rigorous and consistent, and that supervisory interventions are targeted and timely. The Probability and Impact Rating System (PAIRS) is APRA's risk assessment model.<sup>67</sup> The risk assessment covers the inherent risks facing an institution, the effectiveness of management and controls in mitigating these risks, and the extent of capital support available to the institution to meet unexpected losses. This assessment of the overall risk of failure of the institution is combined with an impact rating, which is a measure of the potential adverse consequences that could ensue from the failure of the institution, to produce the institution's overall PAIRS rating. This provides a unified framework and language for comparing institutions and risks and helps APRA make resourcing decisions.

Based on the outcomes of supervisory activities, PAIRS ratings are updated to reflect APRA's assessment of an institution's risk profile and its ability to manage its risks. APRA also conducts internal benchmarking sessions to compare risk assessments and supervisory actions listed in supervision action plans. These sessions typically focus on groups of like institutions and involve the responsible supervisors and risk specialists. One of the most powerful tools available to a supervisor is a strong 'compare and contrast' function, which enables the supervisor to readily identify good practices that can be shared among peer institutions.

Complementing the PAIRS system is APRA's Supervisory Oversight and Response System (SOARS), which is used to determine the nature and intensity of APRA's supervisory actions and to discourage supervisory 'forbearance'.<sup>68</sup> There are four supervisory stances, ranging from baseline supervision for regulated institutions rated Normal, to progressively more intensive supervisory intervention for institutions rated as Oversight, Mandated Improvement or Restructure. Many larger, more complex institutions are considered to require an Oversight level of supervisory intensity even in routine times and so may remain in this stance indefinitely; smaller institutions can also remain in this stance if they face concentration risks in terms of products offered or location of activities. Moving an institution to the Mandated Improvement or Restructure supervision stance indicates that there are more serious issues that APRA requires the institution to address with a degree of urgency. Institutions in Mandated Improvement or Restructure may be subject to formal enforcement action, such as directions to raise capital or take other actions to restore their financial position, make changes to management or limit activities until the identified concerns are rectified. The vast majority of actions APRA takes in these cases, however, do not involve any formal exercise of APRA's enforcement powers. Rather, APRA works with the boards of the relevant institutions as they take appropriate steps to address issues.

Chapter 7 provides details of the transition of regulated institutions between these different supervisory stances. This provides a broad quantitative indicator of APRA's performance.

To support structured decision-making, APRA has been rebuilding its systems infrastructure to provide a more robust and efficient IT platform on which to run APRA's supervision processes. This is a substantial exercise requiring a shift from APRA's suite of internally built supervisory systems to a new suite of integrated software. The first wave of new systems capabilities has been rolled out.

67 APRA 2012, Probability and Impact Rating System, June, available at: [www.apra.gov.au/AboutAPRA/Pages/PAIRS-1206-HTML.aspx](http://www.apra.gov.au/AboutAPRA/Pages/PAIRS-1206-HTML.aspx).

68 APRA 2012, Supervisory Oversight and Response System, June, available at: [www.apra.gov.au/AboutAPRA/Pages/SOARS-1206-HTML.aspx](http://www.apra.gov.au/AboutAPRA/Pages/SOARS-1206-HTML.aspx).

## 4.2 Attributes of effective supervision

A successful risk-based approach is characterised by high-quality and astute analysis leading to the early identification of key risks and issues, a capacity to escalate the intensity of supervision rapidly, and the ability and willingness to intervene promptly and assertively as and when required. These are demanding requirements, and the crisis showed that prudential regulators in some overseas jurisdictions fell short. Accordingly, there has been considerable focus by global policymakers and the prudential regulatory community on the attributes of effective supervision. This focus has been reinforced by the G20 Leaders, who have identified more effective oversight and supervision as a key pillar of their global reform agenda.

The FSB has made a number of recommendations to strengthen supervisory approaches and techniques, including better use of peer comparisons, financial analysis, thematic reviews, assessment and communication with boards, and consolidated supervision.<sup>69</sup> The IMF has also provided its views on 'good' supervision, identifying five key elements that would strengthen a prudential regulator's ability and willingness to act.<sup>70</sup> These elements are that supervision is intrusive, sceptical but proactive, comprehensive, adaptive, and conclusive. These words echo the HIH Royal Commission's recommendation that APRA develop a 'sceptical, questioning and, where necessary, aggressive approach' to prudential supervision. APRA has assessed itself against these elements and concluded that it stands up well, although there is always room for improvement.<sup>71</sup> This assessment is worth summarising for the benefit of the Inquiry.

An **intrusive** prudential regulator is not a hands-off or distant observer but a 'presence that is felt continuously'. APRA does not shy away from obtaining detailed information or requiring changes to internal processes where prudential concerns are identified, even if the regulated institution resists these changes. As outlined above, APRA's 'close touch' approach involves regular interactions with institutions, up to the board, and reasonably frequent on-site reviews. APRA's supervisors engage in discussions about changes in business strategy or operations, complex transactions, regulatory issues such as breaches and complaints, and follow-up on findings from prudential reviews.

APRA's focus is on outcomes. In APRA's view, sound risk management is not merely having what appears to be strong internal processes in place but demonstrating that these processes are resulting in appropriate outcomes. These might be measured in terms of exposures being held, changes in the riskiness of an institution's business over time, credit losses incurred or the number of major operational failures over a period of time.

APRA's supervisors review relevant reports and information provided by regulated institutions, such as internal and external audit reports on risk management systems and controls, but they do not just accept the information at face value. APRA sends its supervisors on-site to test and confirm the effectiveness of the institution's risk management systems by reviewing internal documentation, assessing control mechanisms and talking directly to staff to determine the calibre of resources in, and the status afforded to, the risk and compliance units. However, APRA's on-site visits are not multi-week affairs with lengthy checklists; they are targeted and

69 Financial Stability Board 2010, *Intensity and Effectiveness of SIFI Supervision: Recommendations for enhanced supervision*, November.

70 Viñals and Fiechter 2010, *The Making of Good Supervision: Learning to Say "No"*.

71 See Laker J. 2010, 'What makes good prudential supervision', speech to the American Chamber of Commerce Business Briefing, 25 August; Laker J. 2010, 'Supervisory lessons from the global financial crisis', speech to the AB+F Leaders Lecture Lunch, 8 December.

structured and result in a clear set of findings, if needed, for the institution to address within an agreed timeframe. APRA believes this framework of periodic, targeted on-site reviews to be an efficient and effective means of monitoring, assessing and testing an institution's operations; APRA has not sought to utilise supervision teams stationed permanently on-site within the larger institutions, as is the case for some prudential regulators overseas.

APRA's prudential framework requires a broad range of approvals and notifications which increase interactions with regulated institutions. For example, institutions seek approval of capital instruments and need to notify APRA of material outsourcing arrangements, new board directors and material changes to internal risk models. Ahead of the crisis, APRA engaged in numerous rounds of meetings and queries on new product approval processes and the appropriate regulatory capital treatment for a range of more complex financial products. In some cases, transactions needed to be amended in order to meet APRA's capital or securitisation requirements. However, APRA does not make business judgments for institutions, and some institutions did take on complex exposures ahead of the crisis that proved ill-fated.

A **sceptical but proactive** supervisor questions a regulated institution's or industry's direction or actions, most usefully in good times, and does not act only after troubles have surfaced. This is a demanding requirement. Identifying emerging risks in advance of the broader industry is particularly difficult, even for the most insightful and forward-looking supervisor. No prudential regulator has claimed that it saw the crisis coming in its full severity, although some were warning about the under-pricing of risk in the period before the crisis. However, APRA did flash warning lights on credit standards in housing lending when those standards came under pressure during Australia's housing market boom in the early years of the last decade. APRA has repeated these warnings in the current environment of increasing housing market pressures. APRA also commenced early consultations on strengthening liquidity management by ADIs, identifying this as a potential vulnerability.

Stress-testing has proven a useful tool to reduce any complacency on the part of boards and management, particularly in good times. Thinking through the variety of severe but plausible scenarios where things can go wrong focusses a board's mind, and is essential input into the development of appropriate contingency plans. APRA conducted macroeconomic stress tests of the ADI industry in 2010 and 2012 and will conduct another stress test in 2014. APRA has also directed more attention to the stress testing undertaken by insurers and will include insurers in its stress testing program over the coming years.

**Comprehensive** supervision is vigilant about risks emerging at the edge of the regulatory perimeter, including risks in unregulated subsidiaries. As an integrated regulator, APRA takes a group-wide supervisory approach that enables a broader view of the main activities of the larger banking and insurance conglomerates. This gives APRA a more comprehensive picture of the risks to the group, including those emerging from outside APRA's immediate reach from offshore activities or from unregulated members of the group. APRA's group-wide supervisory approach will be further strengthened when its prudential framework for conglomerate (Level 3) groups becomes effective. APRA's comprehensive approach to risk assessment was also demonstrated in early work it did on mortgage-related stress testing in 2003; the original focus was on ADI lending practices but it was subsequently expanded to examine the corresponding impact on lenders mortgage insurers.

**Adaptive** supervision meets the challenge of a constantly evolving financial system and stays in tune with best industry practice, both in Australia and offshore. APRA keeps abreast of market innovations and evolving industry and regulatory practices to ensure that the prudential regime remains current. Its 'close touch' approach is vital in this regard; in particular, it helps APRA to align its prudential requirements where it can with what industry itself deems to be good practice. APRA's use of a consistent risk assessment model enables peer comparisons that provide valuable information about outliers in terms

of business model and risk management practices. Subject to confidentiality obligations, APRA will share peer group information with regulated institutions to encourage the adoption of better practices. This proved particularly useful during the more acute phases of the crisis when APRA identified some outliers in short-term liquidity management practices in the ADI industry.

Finally, good supervision is only **conclusive** if outstanding prudential issues are followed through to their satisfactory resolution. Taking timely and decisive action when a prudential concern is identified may seem straightforward but can be difficult in practice. Regulated institutions may seek to challenge APRA on enforcement of the prudential requirements or argue for special treatment. Rules inevitably have grey areas that may invite testing and, at times, institutions may not place the same importance on an issue as the supervisor.

Supervisors must be ready and able to act and respond; importantly, they must also have the full support of their senior management when deficiencies are uncovered and regulated institutions are required to take remedial actions. Supervisory issues are discussed widely within APRA and are not dependent on the view of any single individual. This means that APRA supervisors can get clear and immediate management endorsement to take a strong position on an issue. Findings from APRA's on-site reviews, for example, may include requirements to address major breaches of rules or risk management weaknesses, as well as recommendations to improve practices. After review within APRA, these are communicated promptly to the institution's board and management, and are tracked and followed through to ensure that APRA's concerns are addressed appropriately. When needed, APRA's Members and senior management can and do take supervisory concerns directly to an institution's board and CEO.

One other factor that has contributed to APRA's effectiveness is consistency of implementation. Inconsistency in applying prudential requirements can tempt institutions to push for lenient treatment and, in the extreme, can undermine the credibility of the supervisory process. APRA takes this issue seriously. From time to time, claims of inconsistent treatment are made in respect of individual institutions, or between APRA's Head Office and regional offices, and these claims are investigated. Generally, the claims do not take into account the different risk profiles of the institutions concerned, which justifies a different response on APRA's part to what might seem similar circumstances. In the case of the large complex institutions, frontline supervisors and specialist risk staff are all in Head Office. This facilitates the sharing of information across institutions that is needed for proactive and consistent supervision since supervisors are able to interact with one another on a daily basis. Within APRA's supervisory teams, with senior-level representation on each, critical issues are immediately escalated. Team members do not become overly specialised and are able to see the overall risk picture for an institution rather than just one small element.

In summary, APRA has demonstrated, well before and during the crisis and its aftermath, that it has the authority to intervene and challenge regulated institutions when needed and the tenacity to follow issues through to resolution. APRA is a robust, risk-based prudential regulator and its approach has been endorsed in a range of independent assessments. These are discussed in Chapter 7.

# CHAPTER FIVE / APRA'S RESOURCES AND FUNDING

APRA's risk-based supervision approach, described in the previous chapter, requires astute judgment on the part of supervisory staff and confidence born of experience. For this reason, building and retaining a high-quality workforce with the necessary blend of industry understanding and supervisory instincts has been a major priority for APRA from the outset. APRA's staff are its most important asset.

Prudential supervision is a resource-intensive activity. As the IMF has noted:

*'Offsite reporting and surveillance requires access to technology and data sources. Onsite inspection requires significant human capital. Together, they require constant skill development to keep pace with market developments. The follow-through on issues can be particularly resource intensive, which is why this often is observed as a problem for supervisory agencies. Technical skills require sufficient compensation to attract and support to retain.'*<sup>72</sup>

The adequacy of staffing levels and skills in a prudential supervisor is a critical determinant of its ability and willingness to act. This point is emphasised in the requirements for staffing policies in supervisory agencies set out in the Basel Committee's *Core Principles for Effective Banking Supervision* and in the *Insurance Core Principles* of the IAIS.<sup>73</sup> For example, Principle 2 of the *Core Principles for Effective Banking Supervision* defines 'essential criteria' for resourcing to include staff in sufficient numbers and with skills commensurate with the risk profile and systemic importance of the banks supervised, salary scales that allow the agency to attract and retain qualified staff, and a budget and program for the regular training of staff.

In light of crisis experience, peak global industry bodies have also called for national governments to recognise the need for adequate resources and staffing for prudential supervisors.<sup>74</sup>

This chapter reviews APRA's staffing and financial resources and the 'user pays' model that provides these resources.

## 5.1 APRA's staffing resources

At the time of APRA's establishment in 1998, around 550 staff were engaged in prudential supervision and associated corporate functions in its 11 predecessor agencies. By eliminating duplicate functions, integration was expected to produce an efficiency dividend in terms of staff positions, and it did. Staff positions in the corporate areas particularly were reduced. However, integration and the movement of the majority of functions to Sydney also saw APRA lose experienced staff in frontline supervision and specialist risk areas. By the time of HIH Insurance's collapse, APRA staff numbers were below 400. At these levels, APRA was exposed as being substantially under-resourced.

In the wake of HIH Insurance's collapse, APRA commissioned the Palmer Report (see Chapter 1) dealing with APRA's role in that collapse.<sup>75</sup> It also commissioned an independent resource review by a leading consultancy, which benchmarked APRA's resources and supervisory intensity against its international regulatory peers. Both reports concluded that APRA was under-resourced, in terms of both level and quality of resources, for the task of supervising large and complex financial groups; APRA was at the light-touch end of the spectrum. APRA's ability to supervise such groups was significantly compromised because it could assess fewer risks less often and in less depth than most prudential supervisors in similar economies. The Report of the HIH Royal Commission also supported this conclusion as far as the supervision of general insurance was concerned.

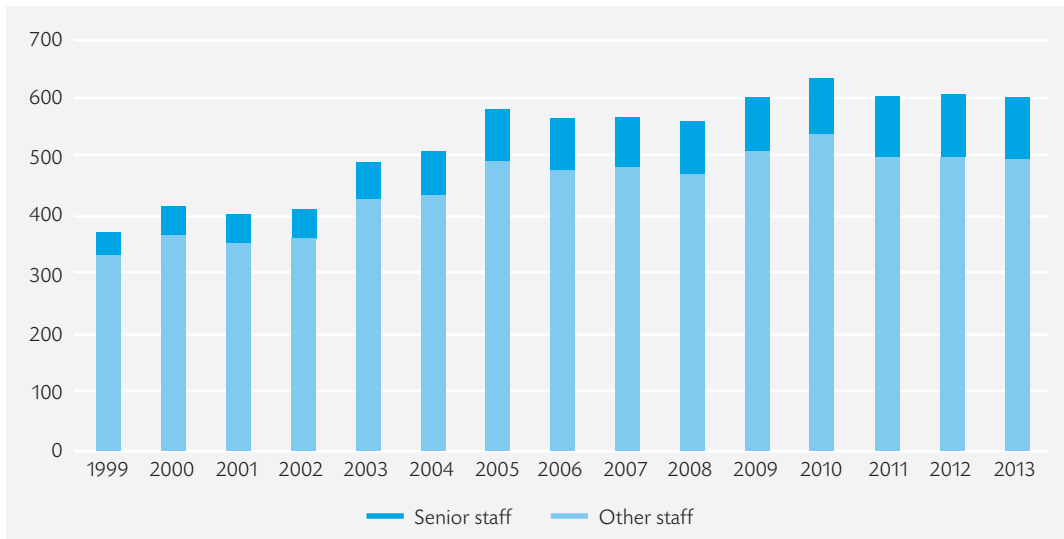
72 Viñals and Fiechter 2010, *The Making of Good Supervision: Learning to Say "No"*, page 14.

73 Basel Committee on Banking Supervision 2006, *Core Principles for Effective Banking Supervision* (revised 2012); International Association of Insurance Supervisors 2011, *Insurance Core Principles, Standards, Guidance and Assessment Methodology* (revised 2013).

74 G30 Working Group 2013, *A New Paradigm: Financial Institution Boards and Supervisors*.

75 Palmer J. 2002, *Review of the Role Played by the Australian Prudential Regulation Authority and the Insurance and Superannuation Commission in the Collapse of the HIH Group of Companies*.

**Figure 9: APRA staffing**



Note: Data as at end-June.

With support from Government and industry, APRA stepped up its recruitment program and increased its staffing numbers from their early lows to around 570 in mid-2008 when the global financial crisis began to intensify. This increase positioned APRA at an intermediate level of supervisory intensity compared with overseas peers. As the crisis intensified, additional Government funding enabled APRA to quickly increase its staffing levels to around 600, where they have remained over recent years. This has allowed APRA to maintain a heightened intensity of supervision during the crisis, undertake a substantial prudential policy agenda to meet global and domestic commitments, and resource some additional functions assigned to it by the Government.

Figure 9 shows the evolution of APRA's staffing levels since 1999.

APRA considers that staffing levels of around 600 will enable it to continue to meet its mandate and the current scope of its supervisory and prudential policy responsibilities in a strong and effective manner. With the completion of major elements of its prudential

policy agenda, APRA has more flexibility to reallocate staff to the supervision of systemically important and other large, complex financial institutions. The dynamic nature of the global and Australian financial system does, of course, require APRA to keep its staffing numbers and supervisory intensity under constant review.

Benchmarking of APRA's staff levels against overseas peers is difficult, since no two financial regulators have the same mandate and scope of responsibilities, and financial systems vary considerably in their total size and number of institutions. For that reason, simple benchmarking based on the number of regulated institutions per staff member, or the supervisory budget per regulated institution, primarily provides indicators of the relative concentration of regulated industries rather than the efficiency or supervisory intensiveness of the prudential regulator. However, prudential regulators do share information on resources and approach, and informal benchmarking suggests that APRA's supervisory teams dealing with large, complex financial institutions are now moving towards the size of some other, well-respected peers.



Adequate staff numbers must be complemented by supervisory and prudential policy skills. In its supervisory activities, APRA must have staff who collectively understand as much about the identification and management of risk as do the leading APRA-regulated institutions in this area. The demands on supervisory skills become more pressing as financial institutions grow in size and complexity – the organisational structure and business activities of such institutions, including their offshore operations, the complexity of transactions in which they engage and the sophistication of their risk management systems all require insight and careful scrutiny on APRA's part.

To augment the skills inherited from predecessor agencies, APRA's recruitment program has given priority to attracting senior staff from industry and the professions, both in Australia and overseas, to sharpen its frontline, specialist risk and industry technical areas and to raise overall levels of experience. About 100 of APRA's net staff growth of 140 or so over the past decade has been in these areas. APRA's senior staff now average around 24 years combined industry and prudential supervision experience.

This blending of seasoned supervisory staff and market-based skills, supported by heavy investment in staff training and development programs, has given APRA considerable 'bench strength' to deal with the global financial crisis and its aftermath, and with the various risks confronting its regulated industries. APRA's staffing capabilities are now well acknowledged. The IMF's 2012 FSAP report, for example, noted:

*'The assessors were very impressed by the quality and caliber of APRA staff. The organization appears to have a very well-trained, experienced and professional staff who are committed to carrying out their function to the highest standards. This impression was confirmed at meetings with industry sources who commended APRA staff on their professionalism, level of knowledge and general receptiveness. It was clear that APRA staff is well*

*respected within the industry and among service providers (e.g., accountancy/audit regulators and accountancy firms).'<sup>76</sup>*

APRA's success in building and retaining a high-quality workforce has not come easily. The skills APRA seeks, particularly in the risk management area, have also been in strong demand in the financial industry and APRA itself has proven a popular recruiting ground. The challenge was recognised some years earlier by the Government's Taskforce on Reducing Regulatory Burdens on Business (Banks Report), which noted in relation to both APRA and ASIC that:

*'Performing their supervisory and compliance functions... not only requires staff with strong technical skills, but also market experience. However, the regulators compete in a very strong labour market for staff with this profile, which is likely to lead to difficulties in attracting and retaining sufficient staff with the requisite skills.'<sup>77</sup>*

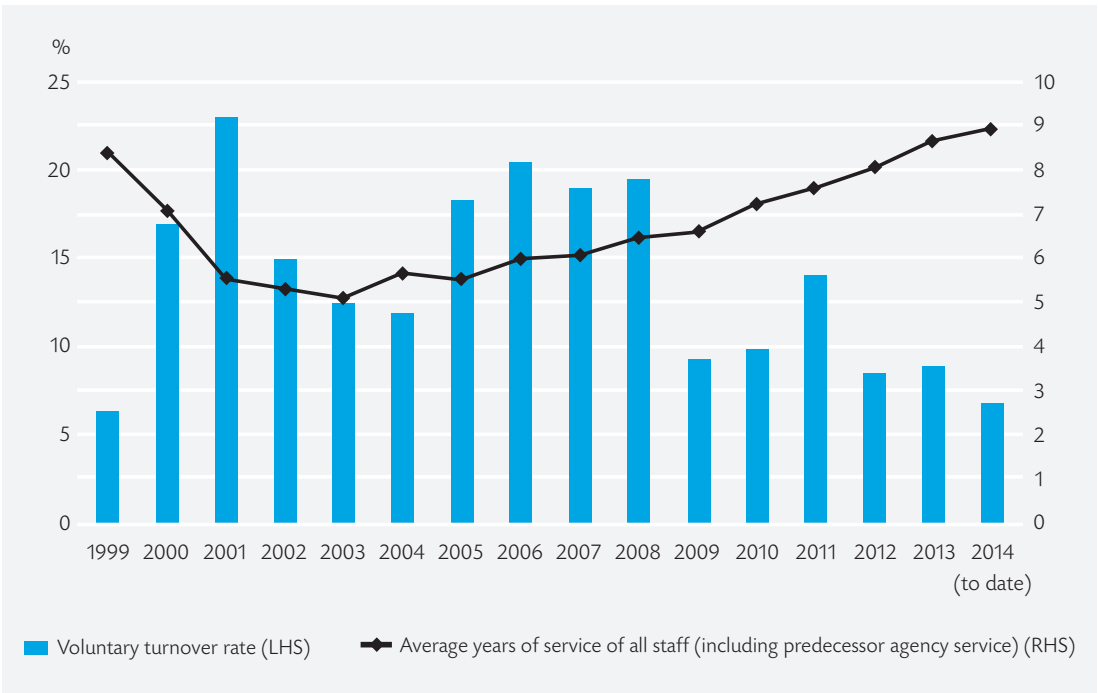
APRA's salary scales are benchmarked externally, on an annual basis, to ensure that they generally align with movements in the financial industry. However, when the market for financial skills runs 'hot', as it did in the years immediately preceding the crisis, APRA's remuneration arrangements quickly become uncompetitive. In those years, voluntary turnover of operational staff reached rates of 30 per cent for a time, with losses most acute in middle-level staff ranks. The generally subdued hiring conditions in the financial industry since the crisis began have assisted APRA's recruitment and retention efforts and voluntary turnover has fallen to relatively low rates. Nonetheless, it is critical that APRA maintain its attractiveness as an employer when market conditions for skilled and experienced staff again tighten.

Figure 10 shows voluntary turnover rates and average length of service for APRA staff.

<sup>76</sup> International Monetary Fund 2012, *Australia: Basel Core Principles for Effective Banking Supervision – Detailed Assessment of Observance*, Washington, page 26.

<sup>77</sup> Regulation Taskforce 2006, *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business*, (Banks Report), page 118.

**Figure 10: APRA staff voluntary turnover and average length of service**



## 5.2 APRA’s financial resources

APRA’s staffing costs account for around three-quarters of APRA’s operating budget. Recruiting and retaining the quality and level of staffing needed to maintain its effectiveness therefore requires that APRA have adequate funding, and funding that is also responsive to changing economic circumstances. Adequate resources are also a key determinant of will – they demand a degree of budgetary autonomy, which in turn drives operational independence.<sup>78</sup>

APRA’s budget is proposed by the APRA Members and put to the Government for consideration and endorsement. Once endorsed, it is included in the annual Treasury Portfolio Budget Statements. If APRA is asked to undertake significant new activities, or considers it is inadequately resourced to meet future demands, it will submit a New Policy Proposal. As part of the standard Budget process, any public comments or concerns about APRA’s resourcing and activities are able to be raised in pre-Budget submissions.

<sup>78</sup> Viñals and Fiechter 2010, *The Making of Good Supervision: Learning to Say “No”*, page 14.

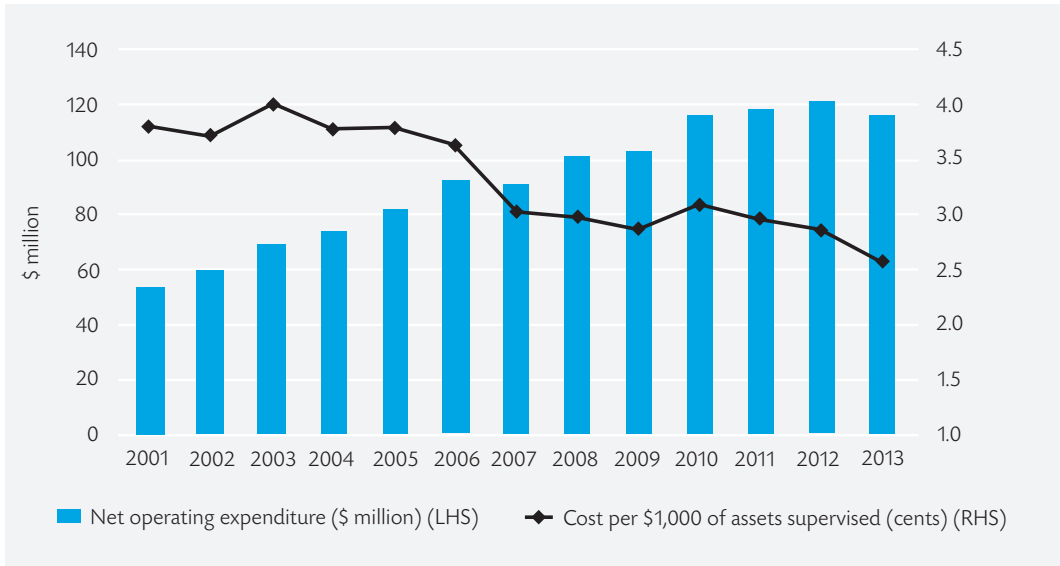
Since APRA's establishment, successive Governments have strongly supported APRA, ensuring that APRA's financial resources are sufficient to enable it to discharge its supervisory and other responsibilities. Nonetheless, endorsement of the budget proposed by the APRA Members is not guaranteed and, on occasion, New Policy Proposals by the APRA Members have been reduced.

As Figure 11 illustrates, operating expenditure showed a moderately rising profile over the period preceding the global financial crisis, reflecting the build-up in APRA's staffing numbers and the priority given to attracting high-calibre recruits, particularly around middle to senior levels. Following the additional funding provided to deal with the crisis, APRA's operating expenses have changed little over the past four years, consistent with its relatively stable workforce. The Forward Estimates show that, after an increase in 2013/14 (reflecting the deferment of some activities from prior years), APRA's operating expenditure will grow only slightly to 2017/18. This is likely to put pressure on APRA's staffing resources (Table 1). The Forward Estimates may change as a result of the 2014/15 Budget processes and any further efficiency dividends (discussed below).

To put APRA's operating expenditure into perspective, Figure 11 also compares operating costs to the value of assets of institutions supervised. Costs per \$1,000 of assets supervised have declined steadily from a high of four cents in 2001/02 to around 2.6 cents in 2012/13, a decline of over one-third in relative terms. Put in simpler terms, APRA's supervision can be thought of as costing the ADI industry 26 cents per year for each \$10,000 deposit, or \$2.60 a year for a \$100,000 superannuation account.<sup>79</sup> The interim report of the Wallis Inquiry had estimated that the costs of financial regulation were then around 11.3 cents for each \$1,000 of financial system assets. Though the numbers are not strictly comparable (the earlier costs included some conduct activities), the costs of prudential regulation would appear to be significantly lower than the pre-Wallis regulatory framework. In addition to budgetary resources, APRA holds a modest level of reserves to enable it to meet unexpected funding or other demands outside of the normal Government Budget cycle. These include a Contingency Enforcement Fund, which is available to be used for large unexpected investigation and enforcement activities.

79 These examples are indicative only; the exact cost depends on various factors including the amount of time attributed by APRA to supervising each industry and the relative size of a supervised institution.

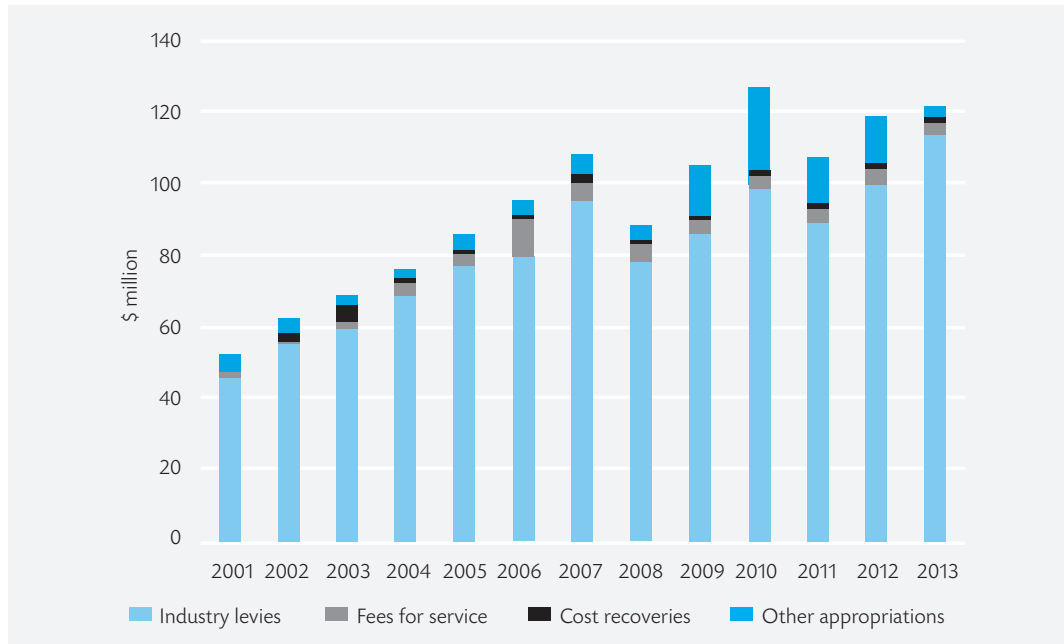
**Figure 11: APRA's costs**



**Table 1: APRA's current and future budgets (\$'000)**

	Previous year budget 2012/13	Current year budget 2013/14	Draft budget 2014/15	Forward estimate 2015/16	Forward estimate 2016/17	Forward estimate 2017/18
Operating expenses	116,515	124,548	122,744	125,758	125,372	126,372
Capital expenditure	9,022	10,105	10,035	5,257	5,000	5,000

**Figure 12: APRA's income**



Note: Data as at end-June.

### 5.3 APRA's funding

The Wallis Inquiry recommended that, for reasons of equity and efficiency, industries should be levied to meet the cost of regulation incurred by regulatory agencies. Further, fees and charges imposed to cover the cost of regulation should be determined by each regulatory agency, subject to approval by the Treasurer.

In APRA's case, these 'user pays' recommendations were broadly accepted by the Government. The Explanatory Memorandum to the original APRA Act stated:

*'APRA will be funded by the industries it regulates on a full cost recovery basis. The funding will come from two sources: a share of funds raised by a levy imposed*

*on all institutions that are regulated; and income from fees and charges related to the cost of providing services or processing specific applications.'*<sup>80</sup>

Consistent with the Government's cost recovery principles, APRA is funded primarily from annual levies collected from supervised institutions, with a smaller contribution from interest earnings, fees for services and miscellaneous cost recoveries (Figure 12). Levies are determined by the Government after consultation with industry, and are raised according to the *Financial Institutions Supervisory Levies Collection Act 1998* and a suite of imposition Acts applying to the regulated industries. In 2012/13, industry levies comprised 93 per cent of APRA's funding.

80 Commonwealth of Australia 2003, 'Australian Prudential Regulation Authority Amendment Bill', Explanatory Memorandum, paragraph 4.39.

The levy methodology used to recover APRA's costs is based on the time APRA estimates that it spends on the supervision of each regulated industry.

In APRA's early years, levies were structured as a percentage of the assets of regulated institutions, subject to minimum and maximum amounts. The use of floors and caps reflected the view that there were certain minimum costs in supervising even the smallest institutions but that, beyond a certain size, there was no extra cost in supervising the institutions. Imposing a cap was intended to prevent larger institutions funding the costs of supervision to a far greater extent than would be justified by the share of APRA's resources expended on these institutions.

A review of the levies arrangements in 2003 identified two particular issues with this simple levies structure.<sup>81</sup> Firstly, the review noted that, taking a broader approach to the purpose of prudential regulation, the failure of a large financial institution could be expected to have a larger systemic impact than the failure of a smaller institution. Larger institutions might also be seen to have a greater interest in system stability as well as a greater capacity to pay. This suggested relaxing or removing the cap on larger institutions on 'system impact' grounds. Secondly, the review noted that the interaction of asset growth with the cap had pushed the levies on middle-sized institutions much closer to those on larger institutions, undermining vertical equity within regulated industries.

In response to these issues, the levies structure was changed from 2005/06 to a two-tiered one, reflecting the primary cost drivers:

- a restricted levy component based on a 'cost of supervision' rationale, which includes activities associated with APRA's onsite and offsite supervision of individual institutions and its legal and enforcement activities. It is structured as a percentage rate on assets, subject to minimum and maximum amounts; and

- an unrestricted levy component based on a 'system impact' and 'vertical equity' rationale, which includes activities associated with the development of APRA's prudential framework for the industries it supervises, as well as its statistical data collections and publications. It is structured as a low percentage rate on assets with no minimum or maximum amounts.

The design and operation of the levies framework is subject to periodic consultation and review. Refinements have emerged from these reviews but the two-tiered structure remains intact. The latest review is based on Treasury's discussion paper, *Financial Industry Supervisory Levy Methodology*, which was released for comment in April 2013.<sup>82</sup> Recommendations from this review are currently being considered by the Government.

In addition, the ANAO has recently undertaken a performance audit of APRA's approach to the determination and collection of levies. In its report, released in November 2013, the ANAO concluded that APRA's administration of financial industry levies has been generally effective.<sup>83</sup> This report is discussed further in Chapter 7.

From time to time, the Government has provided funding directly to APRA through special appropriations, and this funding has not been recovered from industry. In addition to the funding provided to deal with the global financial crisis, these appropriations have covered:

- enforcement actions in relation to the collapse of HIH Insurance; and
- the implementation of Standard Business Reporting.

81 Australian Treasury and APRA 2003, *Report of the Review of Financial Sector Levies*.

82 The discussion paper is available at: [www.treasury.gov.au/ConsultationsandReviews/Consultations/2013/Proposed-Financial-Industry-Levies](http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2013/Proposed-Financial-Industry-Levies).

83 Australian National Audit Office 2013, *Determination and Collection of Financial Industry Levies*, ANAO Performance Audit Report no. 9, page 535.

In discussing its preferred 'user pays' funding model for regulatory agencies, the Wallis Inquiry (page 535 of the Final Report) recommended that:

*'funding should be determined by reference to policies for financial system regulation rather than targets for the overall budget balance. Their funding would not affect these targets because the costs of the agencies' regulatory functions would be recovered from regulated entities.'*

This recommendation remains relevant to an *in principle* issue of the application of efficiency dividends to APRA.

Over recent years, APRA has been subject to general efficiency dividend requirements under which the Government has reduced agency funding with the objective of driving efficiency savings and improving its overall budget position. Agencies are typically required to meet reductions in their base expenditure levels at a set percentage amount per year. Over the period 2011/12 to 2016/17, APRA's total expenditure will have been reduced by around \$21 million from its originally approved budgets because of efficiency dividends. However, because APRA is industry funded, these reductions will make no contribution to the Government's budget position; rather, they will reduce the size of industry levies, though only by insignificant amounts for individual institutions.

In its 2012 FSAP report, the IMF noted that Government approval of the budgets of APRA (and ASIC) leaves the agencies exposed to cutbacks for financial or political reasons. APRA acknowledges that it is for Government to determine the quantum of community resources it wishes to have devoted to prudential regulation of the financial system. However, the mechanism of efficiency dividends is not well-suited to an organisation such as APRA, and can constrain APRA's strategic planning and the pursuit of its statutory objectives.

As noted earlier in this chapter, prudential supervision is largely a knowledge-based and skills-based activity. There are very limited opportunities for automation or economies of scale, particularly in the supervision of large, complex financial institutions. Hence, continued efficiency dividends would require APRA to reduce current levels of supervisory intensity, for example, by cutting back on the frequency or depth of routine activities and thematic risk reviews, to recruit staff of reduced experience or to de-prioritise prudential policy and operational projects. These would not be APRA's preferred choices if current levels of safety in the Australian financial system are to be maintained.

APRA would support a transparent process of consultation on its funding needs with interested stakeholders as part of the normal pre-Budget submissions process, before Government approval of APRA's budget, rather than afterwards through the levies determination process. This would ensure that APRA's funding has full regard to the Government's expectations for beneficiary protection and financial system stability, rather than budgetary objectives to which, as an industry-funded agency, APRA cannot contribute.

# CHAPTER SIX / FINANCIAL SYSTEM STABILITY

The Wallis Inquiry viewed the stability, integrity and efficiency of the financial system as critical to the performance of the entire economy. It concluded that a major case for regulation to prevent systemic instability arose:

*'...because certain financial promises have an inherent capacity to transmit instability to the real economy, inducing undesired effects on output, employment and price inflation. The more sophisticated the economy, the greater its dependence on financial promises and the greater its vulnerability to failure of the financial system.'*<sup>84</sup>

The Wallis Inquiry recommended that the RBA should retain overall responsibility for the stability of the financial system, in consultation as necessary with the Government and other financial regulatory agencies. This was consistent with the longstanding responsibility of central banks for financial stability. As Australia's arrangements evolved, APRA and the RBA have shared responsibilities for financial stability. APRA's mandate in this area was made explicit in amendments to the APRA Act in 2006, which added the overarching requirement that APRA, in balancing financial safety and other objectives, '...is to promote financial system stability in Australia'.

The terms of reference for the Murray Inquiry ask it to review how systemic risk is managed. In response to this reference, this chapter discusses the concepts of financial system stability and how it is safeguarded in the Australian context. The financial stability policy framework in Australia has already been described in detail in a joint RBA/APRA document prepared for the IMF's FSAP review of Australia in 2012.<sup>85</sup> Hence, this chapter highlights only some key themes.

## 6.1 Defining financial system stability

There is no single or broadly accepted definition of financial system stability. It is possible, however, to identify the functions and characteristics of a stable financial system. In the case of banking, stability would be associated with confidence amongst depositors and market counterparties and accessible funding through debt and capital markets. Credit would remain available to qualified borrowers on reasonable terms and banking institutions would continue to provide critical transactional and payment functions to their customers. Domestic financial market infrastructure, including payment and settlement systems and wholesale money and derivatives markets, would remain open and functional, in the sense that large volumes and transactions could continue to be conducted on reasonable commercial terms. Similar attributes can be applied to insurers, particularly in terms of public confidence and continued provision of insurance coverage across standard (and particularly compulsory) product lines.

Financial system instability is a disruption to these critical functions with potentially damaging implications for the economy as a whole. This has many possible causes, including broad macroeconomic developments, political and other events, or the failure of one or more financial institutions.

While the failure of any small or medium-sized financial institution would be disruptive to its customers, creditors and other stakeholders, the failure may not have wider repercussions and can be handled through orderly exit procedures. As the Wallis Inquiry noted, however, '...some financial failures may have onerous consequences for financial system stability and hence the real economy'.<sup>86</sup> The term 'systemically important financial institution' (SIFI) has been coined to describe an institution of such size, market importance and interconnectedness

84 See page 190, *Financial System Inquiry Final Report*.

85 RBA/APRA 2012, *Macprudential Analysis and Policy in the Australian Financial Stability Framework*.

86 See page 182, *Financial System Inquiry Final Report*.



that its distress or failure would have a direct and material impact on the economy; would likely lead to a cascading of problems within the financial system through its exposures to other institutions; or has the potential to act as a trigger for broader contagion among other institutions. When the threatened failure of a SIFI leaves public authorities with no option but to bail it out using public funds to avoid financial stability and economic damage, a ‘too-big-to-fail’ problem arises.<sup>87</sup>

The ‘too-big-to-fail’ problem was sharply highlighted during the crisis, when the failure and impairment of a number of global financial institutions had wide-ranging impacts on the global financial system and, in turn, the global economy. As a consequence, substantial public sector intervention was needed to restore financial stability during the crisis. However, this intervention may have exacerbated the problem of moral hazard that arises when institutions are deemed ‘too-big-to-fail’; it also severely damaged government finances in many countries.

In response to this experience, a framework for identifying and dealing with global systemically important banks (G-SIBs) has been established by the Basel Committee and endorsed by the G20 Leaders, and is being implemented by relevant jurisdictions.<sup>88</sup> The framework aims to address the moral hazard that arises from the perception that certain institutions are too big or too interconnected to fail; such a perception can encourage institutions to take excessive risks, reduces market discipline and creates competitive distortions. No Australian bank is on the current list of G-SIBs.

The broad objectives of the G-SIB framework, though not the specific policy details, have been carried over to deal with the ‘too-big-to-fail’ problem at the national level. A principles-based framework for dealing with domestic systemically important banks (D-SIBs) was finalised by the Basel Committee in 2012.<sup>89</sup> Consistent with that framework, APRA has determined that the four major banks are D-SIBs in Australia and they will be subject, from 1 January 2016, to a higher loss absorbency requirement of one per cent of risk-weighted assets, to be met by Common Equity Tier 1 (CET1) Capital.<sup>90</sup> These D-SIBs are also subject to a heightened level of supervisory attention and are expected to meet more stringent financial soundness standards than other ADIs. Although there is a range of competitors for these D-SIBs, in troubled times none would be able to quickly assume a major bank’s financial obligations or would have the operational capability to continue customer services on a sufficient scale.

The issue of systemic importance is also relevant to the insurance industry. The failure of HIH Insurance, then Australia’s second-largest general insurance company, had impacts on the real economy through dislocations, in particular, to the provision of builders’ warranty insurance, a market which HIH Insurance had dominated and in which substitute providers took time to emerge. Significant public sector intervention became necessary. The resulting slow-down in the construction industry had a discernible, though not long-lived, impact on overall economic activity. Similarly, the near-failure of Australia’s largest medical indemnity insurer in 2002 demonstrated that relatively specialised insurance companies can have potentially significant impacts on particular economic activity if they come under stress.

87 See Financial Stability Board 2013, *Progress and Next Steps Towards Ending “Too-Big-To-Fail” (TBTF) – Report of the Financial Stability Board to the G20*, page 2.

88 Basel Committee on Banking Supervision 2013, *Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement* (updated July). The International Association of Insurance Supervisors is developing a comparable framework for global systemically important insurers.

89 Basel Committee on Banking Supervision 2012, *A framework for dealing with domestic systemically important banks*.

90 APRA 2013, *Information Paper – Domestic systemically important banks in Australia*.

Generally, the superannuation industry poses less significant risks to financial stability than the banking and insurance industries. This is due to the largely defined-contribution and preserved nature of superannuation. Risks are borne by superannuation funds members who are not easily able to withdraw their funds prior to retirement. In addition, superannuation assets are reasonably diversified and any stresses confronting a particular fund and its members are unlikely to generate contagion to other funds or the wider financial system. However, material losses or changes in asset allocation by a large proportion of superannuation funds over a short period could have system-wide impacts. Moreover, as superannuation funds are often embedded within conglomerate groups, the superannuation industry would not be immune from contagion risk arising in other parts of those groups.

## 6.2 Responsibility for financial stability in Australia

The prudential elements of the financial stability policy framework in Australia rest with APRA, with analytical support from the RBA. The RBA pursues its responsibility for financial stability through its role as liquidity provider to the financial system and its regulatory powers in respect of the payments system; it also conducts and publishes a formal semi-annual assessment of the stability of the financial system. ASIC is responsible for taking certain regulatory actions to minimise systemic risk in markets and, working with the RBA, in clearing and settlement systems. The Treasury has responsibility for advising the Government on financial stability issues and on the legislative and regulatory framework underpinning financial system infrastructure.

These four agencies collaborate on financial stability matters through their membership of the Council of Financial Regulators, a non-statutory body that has no regulatory functions separate from those of its members. Its ultimate objectives are to contribute to the efficiency and effectiveness of financial regulation and to promote financial system stability. Chaired by the Governor of the RBA, the Council provides a forum for identifying important issues and trends in the financial system, including those that may impinge upon overall financial stability. It is also responsible for ensuring that there are appropriate coordination arrangements for responding to actual or potential instances of financial instability.

Internationally, the term 'macroprudential policy' is often used to describe the approaches and tools used to tackle risks arising at the level of the financial system as a whole and to preserve financial stability. Australian authorities view macroprudential policy as subsumed within the broader and more comprehensive financial stability policy framework. Under this framework, APRA and other Council agencies consider a system-wide view an essential part of effective prudential supervision, inextricable from the supervision of individual institutions. Consideration of and response to aggregate industry risks has long been part of APRA's supervisory framework.

APRA makes its mandate for financial system stability operational through a number of elements of its supervisory framework. Under its risk-based approach, regulated institutions that pose greater systemic risks are subject to more intensive supervision, and potentially higher capital or other prudential requirements. Additionally, APRA employs tools such as industry-wide stress tests, horizontal reviews and thematic analyses of emerging risks to inform its supervisory focus and actions. These various analyses are shared with the RBA and its input is sought on appropriate responses that could be taken at the industry level. Assessments of systemic risks can also motivate industry-wide prudential activity, either of a supervisory or prudential policy nature.

As one current example, APRA and the RBA have remained vigilant about any potential loosening of credit standards in the face of record low housing lending rates and competitive pressures in the housing lending market. In the past couple of years, APRA has conducted stress tests, targeted data analysis, tripartite reviews involving external auditors, and thematic reviews of different aspects of credit risk management for housing lending. APRA has also engaged actively with the boards of the larger ADIs about the need to maintain prudent lending standards and set clear risk tolerance limits. These supervisory actions are APRA's standard response to emerging risks in the housing market and, under a risk-based approach, are sharply targeted at outlier institutions. APRA's more heightened response could involve the use of macroprudential tools similar to those used recently in other jurisdictions, such as 'speed limits' on high loan-to-valuation lending, floors on housing loan risk-weights and early implementation of the Basel III countercyclical capital buffer. These options are available and would be used if APRA viewed it as necessary to do so.

## 6.3 Steps taken to enhance financial stability

The global financial crisis was a serious test of the flexibility and effectiveness of the Australian framework for financial stability.

During the crisis, the Government worked closely with the regulatory agencies bilaterally, and through the Council, to preserve financial stability. The Council was the natural focal point for agency coordination. The contribution of the various agencies is well chronicled in their Annual Reports. As outlined in Chapter 1, heightened prudential oversight, aggressive monetary policy and strong RBA liquidity support, and the timely introduction of a (temporary) Government guarantee for ADI large deposits and wholesale funding and a (permanent) Financial Claims Scheme were all pivotal in dealing with ADI funding disruptions in the more extreme period of the crisis, and in helping to maintain the flow of credit to households and business.<sup>91</sup>

The IMF's 2012 FSAP report, discussed further in Chapter 7, provided a strong endorsement of Australia's financial stability policy framework and the effectiveness of APRA's oversight of systemic stability.

Nonetheless, the crisis has raised broader questions about how Australia's regulatory agencies can ensure the continuity of critical financial functions in a future crisis, while protecting the interests of depositors and insurance policyholders and avoiding public sector support. Steps have subsequently been taken to improve the financial stability policy framework in a number of areas, steps described by the IMF's FSAP report as 'commendable'.

<sup>91</sup> A permanent deposit insurance scheme was considered by the Wallis Inquiry, but at that time the benefits of a scheme were not considered strong enough to warrant its introduction. Depositor preference in insolvency was preferred as the primary means of depositor protection.

Firstly, APRA's legal powers to respond to situations of financial distress have been materially strengthened. New legislative provisions include the power to apply to the Court for the appointment of a judicial manager to a general insurer, a widening of powers available to a statutory manager (of an ADI) or a judicial manager (for a general or life insurer), and a broadening of the grounds on which APRA may appoint a statutory manager to an ADI.<sup>92</sup>

Secondly, APRA has been working closely with a number of regulated institutions on recovery planning. In recovery plans, institutions set out the actions they would take to survive a severe crisis, without public sector intervention. APRA completed a pilot program on recovery planning for a number of the larger ADIs, which were asked to prepare comprehensive plans identifying a list of possible actions to restore financial soundness in the event of a major depletion of capital and associated liquidity pressures. The recovery actions had to be able to generate a material improvement in capital and funding within a reasonable time period, and be credible and realistic. The recovery plans provided to APRA included reasonably extensive lists of recovery actions, and most plans provided alternative projections of recovery adopting different selected actions; however, many of the plans tended to adopt a recovery horizon over weeks and months. In its follow-up, APRA has encouraged ADIs to challenge their recovery planning with alternative and potentially more severe events, and to consider the preparatory steps ('pre-positioning') that could improve the likelihood of recovery, particularly for recovery actions that would need to be taken very quickly.

APRA has recently extended this initiative to a number of medium-sized ADIs and is considering a further extension to the larger general and life insurers in due course.

Thirdly, the Council has continued its work on crisis management arrangements, with a particular priority on resolution planning. This form of planning focusses on measures that would enable a cost-effective resolution of a regulated institution by the authorities where recovery is not possible. The work has involved exploration of resolution options for a distressed ADI, funding issues related to the Financial Claims Scheme (including options for pre-funding the Scheme) and refinement of ADI crisis resolution coordination procedures. The Council has also continued to work closely with the New Zealand Treasury and the Reserve Bank of New Zealand on trans-Tasman crisis management arrangements, under the auspices of the Trans-Tasman Council of Banking Supervision.

## 6.4 Further legislative reform

With the strengthening of its preventative directions and failure management powers in recent years, APRA now has a relatively robust set of legal powers to enable it to respond effectively to situations of financial distress, particularly distress short of outright failure. As part of an ongoing review of the efficiency and operation of financial sector legislation, APRA has worked closely with the Treasury to develop proposals to further strengthen APRA's ability to respond effectively to financial distress. The proposals address some remaining gaps and deficiencies in APRA's crisis resolution powers.

92 APRA used the provision relating to the appointment of a judicial manager to a general insurer in 2009/10, when judicial managers were appointed to two small insurers that have been in run-off since 2002.

The review culminated in the release in September 2012 of a Government Consultation Paper, *Strengthening APRA's Crisis Management Powers*, which sought comments on a range of options to enhance APRA's supervision and resolution powers.<sup>93</sup> The options canvassed in the paper aim to:

- strengthen APRA's crisis management powers in relation to all APRA-regulated industries, including extending APRA's power to appoint a statutory manager to an ADI's authorised NOHC and subsidiaries in a range of distress situations and providing APRA with the option to appoint a statutory manager to a general insurer or life insurer (and to its authorised NOHC and subsidiaries) as an alternative to a judicial manager appointed by the Court;
- provide APRA with direction powers to require superannuation entities to take pre-emptive action to address prudential concerns;
- simplify and harmonise APRA's regulatory powers across the various industry Acts it administers; and
- make a number of technical amendments to streamline and simplify these Acts, thereby reducing compliance costs.

Although many of the options proposed are of themselves relatively minor, cumulatively their implementation would significantly enhance APRA's resolution toolkit, and align APRA's crisis resolution powers more closely with international standards and best practice.<sup>94</sup> The proposals would enable APRA to respond to regulated institution distress in a timely, flexible and cooperative manner, in a way that preserves financial stability and protects the interests of depositors and policyholders. Each of the proposals also includes strict legal triggers and safeguards designed to ensure that the augmented powers would only be exercised by APRA in appropriate circumstances and when feasible recovery actions by the institution have been exhausted.

APRA's crisis resolution powers are an important component of APRA's prudential toolkit. However, they differ in one important respect from other ongoing regulatory requirements. The vast majority of the powers, including those proposed in the September 2012 Consultation Paper, have no compliance cost for industry; the powers are only relied upon by APRA when an institution is facing acute financial distress. The regulatory burden is therefore negligible or non-existent in normal times. Ensuring APRA's powers to deal with a distressed financial institution are robust and effective is therefore a low-cost investment in ensuring the safety of the financial interests of APRA's beneficiaries, and in the stability of the financial system more broadly.

93 The Treasury 2012, *Strengthening APRA's Crisis Management Powers*, September.

94 In particular, the Financial Stability Board's *Key Attributes of Effective Resolution Regimes*, endorsed by the G20 in November 2011.

# CHAPTER SEVEN / APRA'S PERFORMANCE

Appropriate accountability for a prudential regulator requires that its performance be subject to regular assessment and reporting. Performance in this context has a number of aspects, including the robustness of the prudential regime, the effectiveness of supervision activities to implement that regime and promote prudent risk management, and financial and operational performance.

As a statutory authority, APRA is accountable to the Australian Parliament and it reports regularly on its performance through its Annual Report and appearances before Parliament's *ad hoc* and standing committees. In this context, APRA's financial performance and aspects of its operational performance are subject to regular review by the ANAO. This accountability is discussed in Chapter 2. In addition, APRA is subject to a range of independent external assessments. The most searching is the FSAP review of Australia by the IMF, which is conducted every five years. The FSAP review is backed-up by peer reviews by the FSB and by the two global standard-setting bodies, the Basel Committee and the IAIS. FSAP review findings, among other matters, are also a discussion topic during the IMF annual Article IV reviews of Australia.

APRA itself uses a range of approaches and metrics to regularly assess its performance, and publishes some broad quantitative indicators of supervisory performance.

This chapter outlines the challenges involved in assessing the performance of a prudential regulator, summarises the key sources of external scrutiny and their findings, and reproduces APRA's quantitative indicators.

## 7.1 Challenges in assessing performance

Objective measurement of the performance of prudential regulators, and in particular their supervisory effectiveness, is difficult. The principal challenge is demonstrating causality or an explicit link between the prudential regime or supervisory actions and the outcomes for individual financial institutions or the financial system as a whole. It is not easy to isolate the contribution of a prudential regulator from other external influences on the behaviour of financial institutions, such as the economic environment, credit rating agencies and market discipline. Obviously, as has been widely acknowledged, one factor underpinning the resilience of Australian banking institutions through the crisis was the strong prudential regime in Australia, including APRA's conservative (relative to global minima) capital requirements and proactive supervisory approach. Shortcomings in the regulatory framework and supervisory approaches in some overseas jurisdictions have been cited as an important factor in the collapse or near-collapse of a number of banks abroad during the crisis. Nonetheless, the *extent* to which the prudential regulator contributed to these various outcomes cannot be easily separated from the effects of other factors; hindsight gives no indication of what the outcome would have been had different regulatory and supervisory settings been in place.

An additional difficulty in assessing performance is that, as with most prudential regulators, APRA undertakes much of its supervisory activity behind-the-scenes. The secrecy obligations in the APRA Act prevent APRA from offering public commentary on its day-to-day activities, particularly in relation to individual institutions. APRA's expectation is that institutions will be open with it, particularly in regard to reporting realised and emerging risks; this expectation is balanced by APRA's commitment to keep the information disclosed to it confidential. Moreover, APRA prefers to act in a preventive way and work with institutions to address prudential concerns before these reach a point where the institutions' ability to meet their obligations to beneficiaries is compromised. This behind-the-scene approach is crucial if confidence in an institution and in the financial system as a whole is not to be undermined. As a result, the consequences of a successful APRA intervention often go unheralded while the consequences of supervisory failures are inevitably very public.

Finally, performance assessment of a prudential regulator does not lend itself to straightforward cost-benefit analysis. The direct costs of funding APRA are clearly measurable but other, more indirect, costs related to prudential regulation, such as APRA's capital, liquidity and risk management requirements, are not. Many of the specific benefits of prudential regulation and supervision, such as lower losses and increased trust within the financial system, are also difficult to isolate.

Published compliance costs for regulated institutions may overstate the costs of prudential regulation. In principle, these costs should be measured as the 'incremental' or marginal resource costs of activities that a well-managed and prudent financial institution would *not* choose to undertake in the absence of prudential regulation. These incremental costs are difficult to identify and, usually, total compliance costs are quoted. Similarly, the opportunity costs of prudential regulation, such as the costs of holding capital or liquidity, should in principle reflect only the additional cost involved if the institution maintains higher capital or liquidity than it would have held for its own purposes, such as to achieve a particular credit rating or return on equity. Measuring these marginal capital and liquidity costs is also difficult and hence rarely attempted.

The benefits of prudential regulation are not, conceptually at least, difficult to identify. A financial system underpinned by a robust prudential regime and high levels of consumer and investor confidence is much less prone to systemic risk and delivers better market outcomes for financial institutions and consumers of financial services. Financial institutions with strong risk management systems and controls, high-calibre board directors and managers, and appropriate levels of high quality capital and, where appropriate, liquidity are less likely to fail and inflict losses on beneficiaries. As discussed in Chapter 2, a sound financial system also provides a solid foundation for healthy competition. The substantial loss of economic output suffered by a number of countries during the crisis, and the impact on the financial security of their citizens, may be easy to see and measure. However, distinguishing the specific impact of lax prudential regulation, as opposed to other contributing factors to the crisis, is not practically achievable.

## 7.2 Global evaluation of APRA's performance

APRA has been subject to a number of reviews by global bodies since its establishment. By assessing APRA's prudential regime and supervisory approach against internationally accepted benchmarks, these reviews provide an objective and independent assessment of APRA's performance relative to overseas peers.

The most comprehensive are the IMF's periodic FSAP reviews, to which Australia has now been subject twice. The FSAP is an assessment by international experts of the stability of a country's financial system and its supporting infrastructure; it examines the system's strengths and potential vulnerabilities and how material sources of risk are managed. As part of FSAP reviews, supervision of the banking and insurance industries is evaluated against the Basel Committee's *Core Principles for Effective Banking Supervision* and the IAIS's *Insurance Core Principles*.

The FSAP review provides the opportunity to take stock of Australia's regulatory arrangements, having regard to global 'good practice' principles and codes, in a more thorough and holistic way than might otherwise be the case. It offers independent challenge to domestic views by peer supervisors, including, in the recent FSAP, peers with experience in jurisdictions that were badly affected by the crisis. Similarly, it provides an independent view to assist Government and authorities' discussions on priorities, desired resourcing and legislative or other reforms. From APRA's perspective, the review strengthens accountability, by providing a form of external 'audit' of APRA's performance that is difficult to achieve in other ways.

Following the crisis, the FSB has a mandate to assess and report on the implementation of financial sector policies in G20 countries to ensure complete and consistent implementation of agreed reforms by member jurisdictions. The Basel Committee, the IAIS and the International Organization of Securities Commissions are also undertaking peer reviews of implementation and compliance with relevant global standards.

The first FSAP review of Australia, which included a macroeconomic stress test of the capacity of the financial system to deal with certain shocks, was conducted in 2005/06. 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 regime at that time were:

- in a number of areas, including transparency, Australia was at the forefront of best practices;
- Australia had a very high level of compliance with the two sets of *Core Principles*;
- the prudential framework was principles-based and implementation was of a generally high standard;
- most prudential regulations and their implementation were of a very high standard;
- APRA's risk-based approach to supervision embodied many best international practices and the overall quality of supervision was good; and
- the approach to consolidated supervision was particularly noteworthy.<sup>95</sup>

This assessment, provided well before the global financial crisis began, is consistent with APRA's view in Chapter 1 that its most meaningful contribution to the resilience of regulated institutions during the crisis came from its efforts to promote their financial health in the years prior to its occurrence.

<sup>95</sup> International Monetary Fund 2006, *Australia: Detailed Assessment of Observance of Standards and Codes*, Washington.



The second FSAP of Australia, which also included a macroeconomic stress test and a review of Australia's crisis management arrangements, was conducted in 2011/12 during the crisis aftermath. As with the first review, the IMF report provided a strong endorsement of Australia's financial regulatory arrangements and noted that the robustness of the Australian financial system was '...due to a material contribution from a well-developed regulatory and supervisory structure.'<sup>96</sup> The main findings relevant to the prudential regime were:

- Australia's financial system is sound, resilient, and well-managed. Major banks are conservatively run, well capitalised and profitable, and they are likely to withstand severe shocks;
- the financial regulatory and supervisory framework exhibits a high degree of compliance with global standards; and
- commendable steps have been taken to strengthen crisis management.

The report noted that APRA maintains a conservative supervisory approach. APRA takes a proactive, risk-based approach to bank supervision, with notable strengths demonstrated by its strong risk analysis, its focus on bank boards' responsibility for risk management, and its assessment of banks on a system-wide basis.<sup>97</sup> The report also noted that APRA has made significant progress in updating the insurance regulatory regime since the first FSAP. In insurance, too, the risk-based supervision framework was judged to be comprehensive, with established internal policies and processes to promote prompt and consistent supervisory action.<sup>98</sup>

During 2008/09, between these two FSAP reviews, APRA's implementation of the Basel II capital framework was assessed by the IMF against a set of implementation criteria developed by the IMF, the World Bank and the Basel Committee. The IMF concluded that APRA had allocated sufficient resources, including highly skilled staff, prior to the Basel II start date of 1 January 2008 and the outcome was a robust and high-quality implementation that has built upon and substantially strengthened the risk management capabilities of the major banks.

In 2011, the FSB undertook a peer review of Australia under its *Framework for Strengthening Adherence to International Standards*, which focusses on the implementation of financial sector standards and policies agreed within the FSB. The FSB's report, published in September 2011, noted that APRA had continued to promote effective risk management practices and strong capital reserves and to closely monitor the adequacy of ADIs' liquidity, and had improved its stress-testing capabilities.<sup>99</sup> The report also noted that the regulatory and supervisory framework for general insurance had been considerably strengthened in recent years and that the introduction of insurance group supervision has enhanced APRA's ability to supervise the foreign subsidiaries of insurers domiciled in Australia.

In addition, the report noted that 'significant and commendable' progress has been made on failure resolution and crisis management, including the development of a crisis management framework, the establishment of the two Financial Claims Schemes and the strengthening of APRA's crisis resolution powers.

APRA has also contributed to the FSB's 'thematic' reviews of executive remuneration (2010 and 2011) and risk governance (2013). In these cases, the review report did not contain any conclusion or recommendations specific to Australia or APRA.

96 International Monetary Fund 2012, *Report on the Observance of Standards and Codes (ROSC) – Summary Assessments*, Washington, page 5.

97 International Monetary Fund 2012, *Australia: Basel Core Principles for Effective Banking Supervision – Detailed Assessment of Observance*, Washington, page 131.

98 International Monetary Fund 2012, *Australia: Insurance Core Principles – Detailed Assessment of Observance*, Washington, page 6.

99 Financial Stability Board 2011, *Peer Review of Australia*.

The Basel Committee has recently assessed APRA's implementation of the full Basel capital framework under its Regulatory Consistency Assessment Programme (RCAP). The RCAP was established to monitor, assess and evaluate the implementation of the Basel framework by member jurisdictions, and assessments under the RCAP aim to ensure that each member adopts the framework in a manner consistent with its letter and spirit. The RCAP report on Australia, published in March 2014, found that APRA's prudential capital regime for ADIs was compliant with the Basel framework.<sup>100</sup>

### 7.3 ANAO evaluation of APRA's performance

The ANAO has responsibility for the audit of government agencies and it conducts an annual audit of APRA's financial statements. APRA has also been included in a number of ANAO whole-of-government reviews of particular administrative topics. In addition, APRA's operational and supervisory performance have been subject to specific 'performance audits' and APRA has implemented the ANAO's recommendations as appropriate.

There have been four such audits since APRA's establishment. These have covered:

- APRA's approach to the supervision of banks, including cross-border banking (2001);
- APRA's supervision of superannuation institutions (2003);
- APRA's response to the recommendations of the 2001 performance audit (2005); and
- the determination and administration of financial industry levies (2013).

On the last topic, the ANAO's report concluded that:

*'...APRA's administration of financial industry levies has been generally effective. The methodology developed to apply the levies has met the Government's intent of recovering the full costs of APRA's administration, and has been administratively simple and uniform. APRA, and the Treasury, have continued to apply the principles of equity and competitive neutrality when imposing levies on financial entities. This has been an ongoing process, involving review of the levy methodology and its application, stakeholder consultation and feedback.'*<sup>101</sup>

The ANAO made two recommendations aimed at improving the effectiveness of industry consultations on the levy and the levy methodology itself. These are being considered by the Government.

### 7.4 APRA stakeholder surveys

Since 2009, APRA has undertaken stakeholder surveys every two years to obtain feedback on its performance in key areas. This is in line with the approach taken by some overseas prudential regulators. Regulated institutions, industry bodies and other stakeholders are surveyed by an external survey firm to assist APRA's understanding of the impact of its prudential framework and the effectiveness of its supervision. The survey results are published and are used by APRA as an important input into strategic planning, setting supervisory priorities and reviewing and enhancing performance.

<sup>100</sup> Basel Committee on Banking Supervision 2014, *Regulatory Consistency Assessment Programme (RCAP): Assessment of Basel III regulations – Australia*.

<sup>101</sup> Australian National Audit Office 2013, *Determination and Collection of Financial Industry Levies*, ANAO Performance Audit Report no. 9.

The three surveys conducted to date have reported relatively consistent perceptions of APRA and provided 'ongoing validation of APRA's prudential framework, its staff and its approach to supervision'<sup>102</sup> For the most recent survey, all topics had a majority of positive responses and 60 per cent of rated items had 75 per cent or more of respondents who *agreed* or *strongly agreed* with an item. The highest rating items were the demonstration of integrity, professionalism and collaboration by APRA staff; APRA's supervisory approach to groups; the effectiveness of the prudential framework in achieving APRA's mission; and the understanding of, and communication of findings to, regulated institutions by supervisory teams. The lower-rated items (although with average scores generally well above the *neutral* rating) related to aspects of statistical reporting, harmonisation of the prudential framework across APRA-regulated industries and APRA's consideration of the costs of changes to the prudential framework.

## 7.5 Published performance measures

The crisis provided some high-profile examples where the performance of prudential regulators fell well short of expectations and this, in turn, has prompted the search for useful *ex ante* indicators of supervisory intensity and effectiveness. For the reasons outlined earlier in this chapter, this is not proving an easy task.

For its part, APRA publishes information in its Annual Report from two different sources to provide broad quantitative indicators of its supervisory performance. These sources are APRA's 'transition matrices' and data on financial failures and losses to beneficiaries.

### 7.5.1 Transition matrices

As one performance measure, APRA has developed transition matrices to track the migration of regulated institutions across the four supervision stances in APRA's SOARS, which guides supervisors in responding to identified risks.

As an institution moves out of a Normal stance, routine supervision is likely to give way to more intrusive supervision, greater use of APRA's more specialised resources and, possibly, intervention and enforcement powers. Institutions in Oversight are not expected to fail but there are aspects of their risk position that may create vulnerabilities in extremely adverse circumstances and that require closer attention by APRA. APRA's goal is that institutions in Oversight take appropriate action that would see them return to Normal in due course. However, some institutions may remain in Oversight indefinitely if their size and complexity, business plans, risk appetite or risk concentration make that appropriate; APRA's strategy with such institutions is close monitoring and communication. If an institution is downgraded to Mandated Improvement, APRA requires the institution to take immediate and appropriate action that would, in a reasonably short timeframe, see it returning to an improved supervision stance or moving to Restructure. Institutions in Restructure are those in which APRA has lost confidence that financial promises to beneficiaries will be met in the absence of vigorous intervention, or which have ceased to be viable operating businesses and are being assisted to exit the industry in an orderly fashion. APRA strives to minimise the time an institution spends in Mandated Improvement. However, institutions in Restructure may spend years winding down their operations.

<sup>102</sup> APRA 2009, 2011, 2013, *APRA Stakeholder Survey*.

**Table 2: SOARS transition matrix 2007-13<sup>103</sup>**

<b>From\To</b>	<b>Normal (%)</b>	<b>Oversight (%)</b>	<b>Mandated Improvement (%)</b>	<b>Restructure (%)</b>	<b>Exit (%)</b>
Normal	42	19	0	0	40
Oversight	19	47	0	1	32
Mandated Improvement	6	47	0	0	47
Restructure	0	0	0	50	50

Note: One institution in Restructure was recorded as a failure in 2009/10 and four institutions in Restructure were recorded as failures in 2010/11.

**Table 3: Institutions in Mandated Improvement 2003-13**

<b>Current stance</b>	<b>Total</b>
Normal	16
Oversight	37
Mandated Improvement	3
Restructure	1
Exit without failure	118
Failure	5
<b>Total</b>	<b>180</b>

The transition matrix (Table 2) shows that almost half of the institutions in Normal and Oversight as at end-June 2007 remained in that stance over the following six years. A significant percentage of the remainder of institutions in Oversight either returned to Normal supervision stance or exited the industry in an orderly manner (for example, by running-off their liabilities or through merger). Around half of the institutions that began the period in Mandated Improvement have exited the industry while the others have moved to an improved supervision stance. Half of the institutions that began the period in Restructure have remained in that stance, with all others exiting the industry.

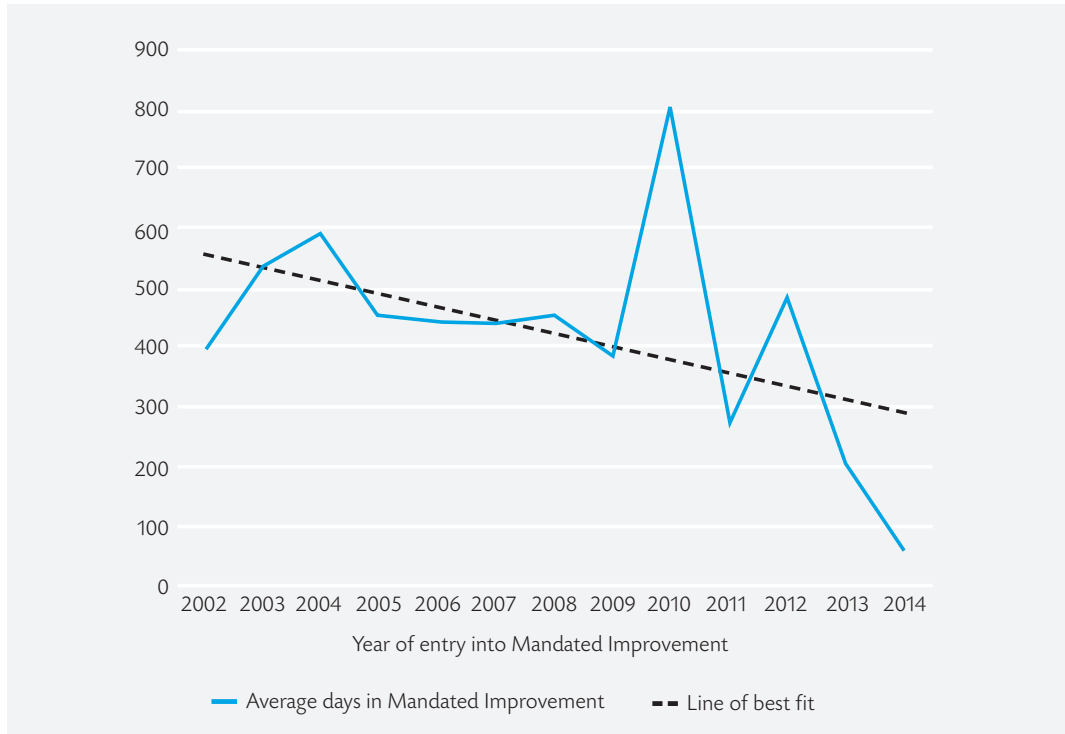
Over the ten years to end-June 2013, a total of 225 regulated institutions have been in the Mandated Improvement and/or Restructure supervision stances (of which 10 institutions moved through both SOARS categories). Of that total, 56 institutions improved stance to Normal or Oversight, nine remained in their SOARS category, 154 exited without loss to beneficiaries and six institutions failed (four of which moved through both Mandated Improvement and Restructure during that period). Figure 13 shows that, over the same period, the time spent by institutions in Mandated Improvement has been trending down as APRA has become more active in ensuring that the risk issues facing these institutions are addressed before they pass beyond a point of no return.

103 APRA 2013, *Annual Report*, pages 83-85.

**Table 4: Institutions in Restructure 2003-13**

Current stance	Total
Normal	0
Oversight	3
Mandated Improvement	0
Restructure	6
Exit without failure	41
Failure	5
<b>Total</b>	<b>55</b>

**Figure 13: Duration of institutions in Mandated Improvement**



It is not possible to compare these outcomes with what would have happened had APRA not intervened. However, the overall direction of movement of institutions in these two supervisory stances is consistent with APRA's objectives of focussing attention on institutions assessed as higher risk and identifying likely failures early enough so that corrective action can be promptly initiated. These indicators reinforce APRA's view that its more intensive supervision of struggling institutions before the crisis did much to avert financial distress during the crisis.

### 7.5.2 Indicators of financial failures/losses

The second set of quantitative indicators of supervisory performance is linked to financial failures and losses to beneficiaries (Table 5). These indicators are:

- the Performing Entity Ratio (PER), which is the number of regulated institutions that met their commitments to beneficiaries in a given year, divided by the total number of regulated institutions; and
- the Money Protection Ratio (MPR), which is the dollar value of liabilities to beneficiaries in Australia that remained safe in a given year, divided by the total dollar value of liabilities to beneficiaries in Australia in regulated institutions.

These indicators are, however, silent about target outcomes against which APRA's performance can be assessed. The Government's 2007 *Statement of Expectations for APRA* confirmed that prudential regulation should not pursue a 'zero failure' objective. Rather, the objective of APRA set out in that *Statement* was to maintain a low incidence of failure of regulated institutions while not impeding continued improvements in efficiency or hindering competition.

Since APRA's inception in 1998, the annual PER has averaged 99.91 per cent and the annual MPR, which is dominated by the losses associated with HIH Insurance, has averaged 99.96 per cent.

**Table 5: Performing Entity Ratio (PER) and Money Protection Ratio (MPR)**

Financial year	Number of failures <sup>1</sup>	Losses (\$million)	Number of institutions <sup>2</sup>	Protected Accounts <sup>3</sup> (\$million)	Annual PER (%)	Annual MPR (%)
1999	4	11	4,473	887,172	99.91	100.00
2000	3	308	4,407	993,369	99.93	99.97
2001	8	5,341 <sup>4</sup>	4,350	947,923	99.82	99.44
2002	6	140	3,803	1,006,847	99.84	99.99
2003	5	19	3,252	1,066,762	99.85	100.00
2004	1	0 <sup>5</sup>	2,745	1,207,224	99.96	100.00
2005	0	0	2,099	1,347,738	100.00	100.00
2006	0	0	1,596	1,546,709	100.00	100.00
2007	1	0 <sup>5</sup>	1,244	1,832,406	99.92	100.00
2008	0	0	1,129	1,922,973	100.00	100.00
2009	0	0	1,028	2,048,357	100.00	100.00
2010	1	1	965	2,231,881	99.90	100.00
2011	4	72	898	2,462,465	99.55	100.00
2012	0	0	827	2,650,610	100.00	100.00
2013	0	0	769	2,930,994	100.00	100.00

1 In the case of superannuation, failures refer to the number of funds affected and include failures due to employer sponsors.

2 The number of institutions excludes small APRA funds, representative offices of foreign banks and NOHCs.

3 Protected Accounts is an estimate of the funds protected by APRA as defined by relevant legislation and is less than the total assets held by APRA-regulated institutions.

4 Includes HIH Group's estimated \$5.3 billion loss incurred by creditors and policyholders, based on liquidator's advice to creditors in April 2002.

5 Losses incurred, due to the failure of an employer sponsor in a superannuation fund, were less than \$0.5 million.

# CHAPTER EIGHT / BACKGROUND ON SPECIFIC ISSUES

At any one time, APRA deals with a range of prudential issues in each of its regulated industries. These are discussed in APRA's Annual Report, its *Insight* publication and in speeches by APRA Members and senior executives.

This chapter does not attempt to cover these various issues. Rather, it provides background on some specific issues that are likely to be relevant to the Inquiry, given its terms of reference.

## 8.1 ADI capital requirements and impact on competition

### 8.1.1 Housing lending

The level of ADI lending for housing is determined by the complex interplay of demand and supply side factors. On the demand side, the willingness to borrow for housing, for owner-occupation or investment purposes, is influenced by mortgage interest rates, the pace of economic activity, expected housing price movements, household confidence (particularly about future employment prospects), demographic and other factors. On the supply side, the willingness of ADIs to lend is a function of the profitability of such lending relative to alternative lending opportunities, the creditworthiness of borrowers and lending underwriting standards. Profitability, in turn, is determined by mortgage interest rates, the operating costs of mortgage lending processes and funding costs, including a return on the capital employed. In principle, capital is allocated by ADIs on the basis of assessed risks, but it is subject to minimum APRA capital requirements.

Notwithstanding all the various factors involved, it has been argued that APRA's capital requirements for housing lending can be singled out as a major influence:

- in encouraging an 'excessive' concentration of ADI balance sheets on housing lending; and
- in distorting the competitive landscape for housing lending in favour of the four major banks.

The relevant capital requirements are the credit risk-weights of the Basel II capital framework, which was implemented in Australia from 1 January 2008. Prior to that date, housing lending under the original 1988 Basel Capital Accord (Basel I) was eligible for a 50 per cent minimum risk-weight. See Annex A for more details.

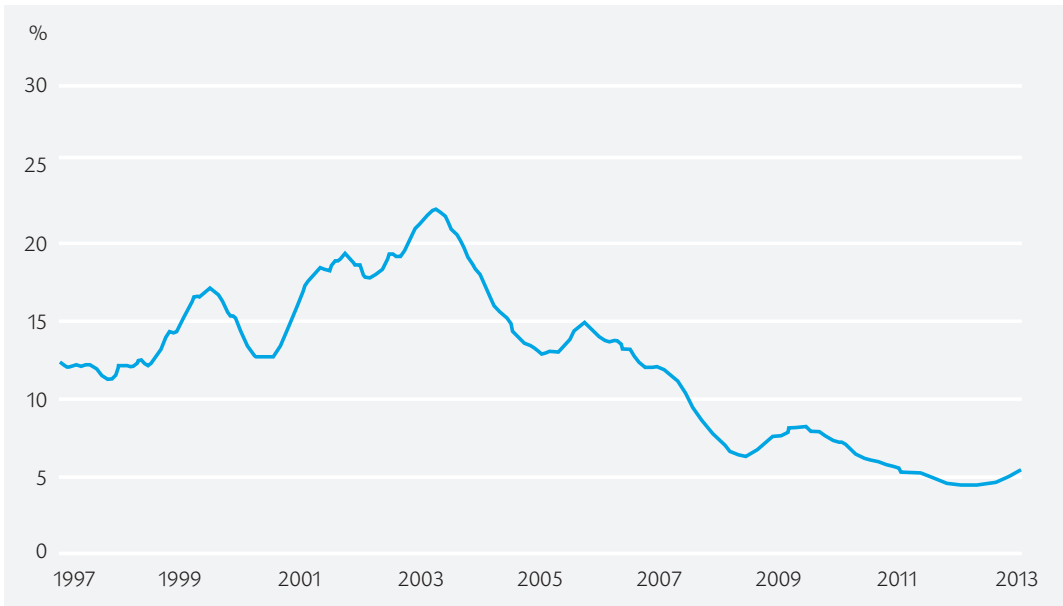
Basel II introduced two broad methodologies for calculating capital requirements for credit risk.

Under the standardised approach, the risk-weighting for housing loans is based on the loan-to-valuation ratio, whether the loans are standard or non-standard (which includes 'low doc' loans), and the coverage of lenders mortgage insurance (LMI). Depending upon these characteristics, a housing loan may be risk-weighted at 35, 50, 75 or 100 per cent. Under the advanced 'internal ratings-based' (IRB) approach, ADIs with sufficiently robust internal rating and estimation systems and risk management frameworks can be accredited by APRA to use their own internal modelling as inputs into determining the risk-weights for housing (and other) loans.<sup>104</sup> These models are designed to reflect more accurately than the standardised approach the risks of the individual ADI's mortgage portfolio. Drawing on extensive databases and subject to robust ongoing scrutiny from APRA, advanced ADIs may use their own estimates of the probability of customer default, the value of the exposure at the time the customer defaults, and the loss that will be incurred if the customer defaults (loss-given-default). However, Australia has not experienced a period of significant losses emanating from housing lending. APRA has introduced a 20 per cent floor on (downturn) loss-given-default for housing lending while advanced ADIs develop methodologies and estimates that are sufficiently granular and appropriately calibrated to a downturn period. Five ADIs – the major banks and Macquarie Bank – have approval to use the advanced modelling approaches. Some other ADIs are currently seeking that approval.

<sup>104</sup> To prevent cherry-picking, ADIs must be capable of using the IRB approach for all loan portfolios. Consistent with the Basel framework, APRA does not permit ADIs to use models for only selected portfolios where they perceive to be capital benefits.



**Figure 14: Housing credit growth (year ended)**

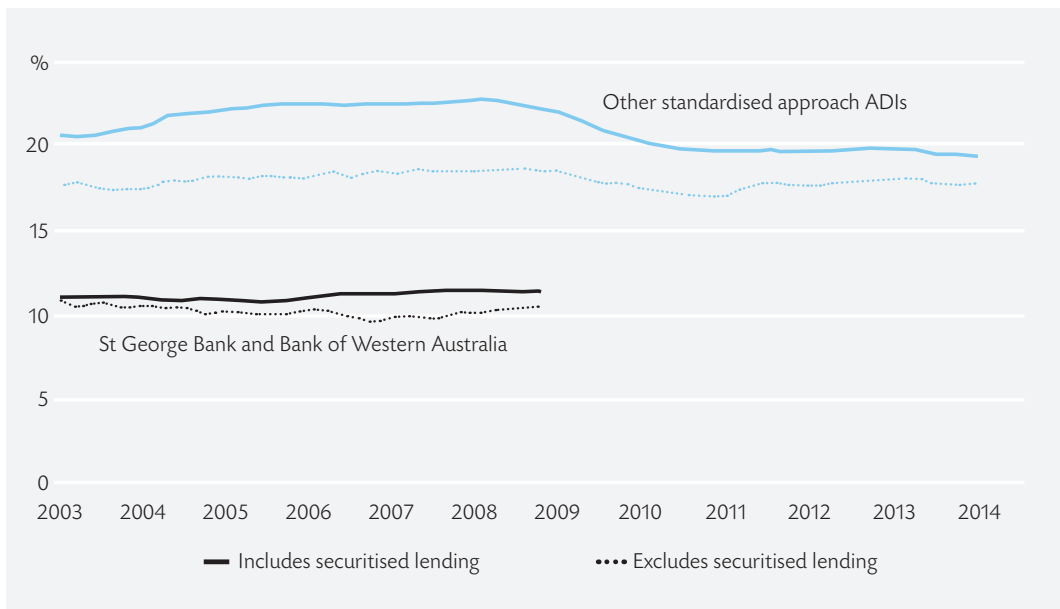


Source: RBA 2014, 'Growth in Selected Financial Aggregates – D1', Statistical Tables.

The difficulty in differentiating the impact of APRA's capital requirements is highlighted by two trend graphs on housing lending. Figure 14 shows that, until recently, housing lending growth had been on a sustained downward trend since its peak in 2003, falling to record low growth notwithstanding the implementation of lower housing risk-weights under Basel II. Clearly, against the backdrop of the crisis, consumers' caution about their finances, significant prepayment of housing loans and a tightening in lending standards dominated the impact, if any, of the lower housing risk-weights. Housing credit growth has picked up more recently as consumers began to regain their appetite for debt in response to record low mortgage interest rates and aggressive competition from lenders. It is difficult to conclude from this graph that APRA's capital requirements have been a major driver of changes in housing lending growth.

Figure 15 shows the share of ADI housing lending accounted for by ADIs on the Basel II standardised approach. Leaving aside St George Bank and Bank of Western Australia, later taken over by two of the four major banks, this share fell from around 30 per cent in the early 1990s to around 20 per cent in the early 2000s. At the time, this decline was viewed as consistent with the competitive advantage of the major banks in terms of extensive branch networks, access to cheaper wholesale funding and economies of scale in mortgage processing. The four major banks also made acquisitions of smaller ADIs during the 1990s. From around 2000, the share of standardised ADIs remained relatively constant until 2008, when it began to drift down again. This decline can be largely attributed to the drying-up of funding from the residential mortgage-backed securities market on which some of these ADIs had previously relied. If this effect is taken into account, there is no discernible change in the market share of standardised ADIs due to the implementation of Basel II.

**Figure 15: Housing lending by standardised ADIs**



Note: The series including securitised lending incorporates total securitised assets up to September 2006; from September 2006 it includes securitised housing loans only.

APRA has previously stated that it did 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. Further, it did not expect the different risk-weighting methodologies to produce markedly different competitive impacts compared to the uniform rules then in place.<sup>105</sup> These expectations were borne out. Broadly speaking, the initial implementation of Basel II resulted in overall reductions of capital for advanced ADIs of between zero and 10 per cent, and around five per cent on average for standardised ADIs.

Notwithstanding this general outcome, concerns about the competitive landscape have focussed specifically on the different risk-weights attaching to housing lending under the standardised and advanced approaches. As of early 2014, the weighted-average risk-weight for housing lending under the standardised approach is 39 per cent; the comparable figure under the advanced approach varies by institution with the average around 18 per cent.

<sup>105</sup> APRA 2003, Media Release: *APRA issues transition guidelines for Basel II Implementation*, June.

As APRA has argued elsewhere, it would be incorrect to consider the standardised and IRB credit risk-weights to be directly comparable for a given product.<sup>106</sup> Standardised risk-weights are, by their nature, broad-brush representations of risk and are designed to achieve an appropriate *aggregate* level of capital. IRB risk-weights, on the other hand, are far more granular. They may be lower or higher than the standardised risk-weights, depending on the specific risk characteristics of borrowers and the nature of the ADI's portfolio. It is important to note, firstly, that smaller ADIs generally do not have a high degree of geographic or product diversification and tend to have relatively greater business/strategic and credit concentration risks than the larger, more diversified ADIs using the IRB approach. Secondly, advanced ADIs are also subject to other capital requirements that are not applied to standardised ADIs, including the requirement to hold capital against interest rate risk in the banking book. The four major banks will also be subject to a higher loss absorbency requirement in the form of a one per cent CET1 D-SIB surcharge. Finally, advanced ADIs need to make, and maintain, substantial investment in risk measurement and modelling systems and controls, and in specialist staff skills, to be accredited by APRA to use the advanced approaches.

That said, for a typical housing loan portfolio, an ADI using the IRB approach will clearly hold less capital than a standardised ADI. This difference in capital requirements will have an impact on the relative profitability and return on equity for housing lending by standardised ADIs, which are generally price-takers in the housing market. Some simple figuring on reasonable assumptions, set out in the accompanying box, suggests that the difference in risk-weights translates to around 23 basis points.

## Capital impact of risk-weights on housing lending

The capital required for an ADI housing loan is the amount of the loan, multiplied by the risk-weighting, multiplied by the ADI's target CET1 ratio. The average risk-weighting on housing loans is around 18 per cent for advanced ADIs using the IRB approach and 39 per cent for standardised ADIs. For simplicity, a CET1 target ratio of 9 per cent is assumed.

Under these assumptions, for every \$100 in housing loans, an advanced ADI will hold  $\$100 \times 18 \text{ per cent} \times 9 \text{ per cent} = \$1.62$  in equity. A standardised ADI will hold  $\$100 \times 39 \text{ per cent} \times 9 \text{ per cent} = \$3.51$  in equity.

To calculate the impact of risk-weights on housing loan pricing differentials, assume that the cost of capital for standardised (and advanced) ADIs is 12 per cent. The housing loan pricing differential, for every \$100 in housing loans, is simply:

$(\$3.51 - \$1.62) \times 12 \text{ per cent} = 0.23 \text{ per cent}$  or 23 basis points

One interpretation of the 23 basis point figure is that, if advanced ADIs were to risk-weight using the standardised approach, they would seek to increase their home loan pricing by 23 basis points. Another interpretation is that, assuming the same cost of capital, standardised ADIs are operating with a 23 basis point pricing disadvantage due to not using the IRB approach. However, as discussed in this chapter, this disadvantage must be assessed against other cost disadvantages facing standardised ADIs.

<sup>106</sup> APRA 2010, *Submission to the Senate Economics References Committee, Inquiry into competition within the Australian banking sector*, 20 November.

**Table 6: Ratio of operating costs to assets**

	September 2005 (%)	September 2013 (%)
Four major banks	1.9	1.2
Credit unions and building societies	3.5	2.4
Other domestic banks	2.0	1.5

Note: Other domestic banks with substantial non-bank business have been excluded from these figures.

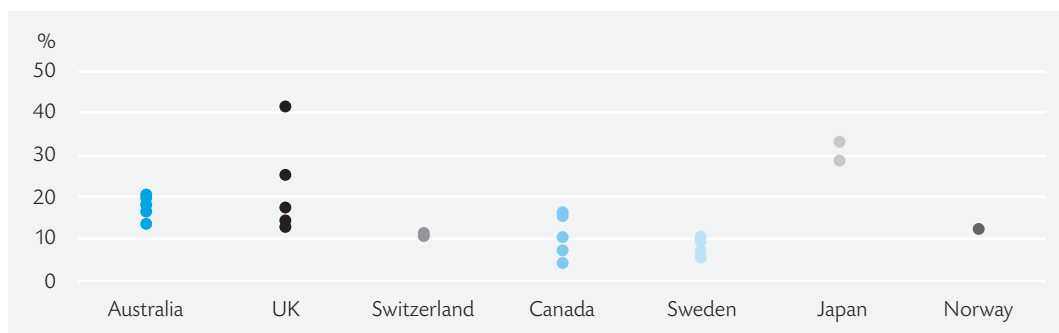
This particular impact on profitability needs to be assessed against:

- relative differences in funding costs, which are on average higher for standardised ADIs because of their more limited access to generally lower-cost wholesale funding; and
- relative differences in operating costs, which are also on average higher for standardised ADIs, as outlined in Table 6.

Table 6 shows that the ADI industry has delivered strong productivity gains over the past eight years and that credit unions and building societies have shrunk their cost disadvantage with respect to the four major banks, expressed in terms of costs per asset, from 1.6 per cent to 1.2 per cent. However, this disadvantage is still much larger than that due to differences in APRA's capital requirements. Differences in operating costs can reflect economies of scale as well as differences in business models and funding models; the operating costs of running a branch network, for example, are highly relevant to the cost of gathering retail deposits.

APRA does not see any compelling reasons to depart from the Basel II capital framework, now well-established globally, to seek to deal with residual competition issues in housing lending. Comparing the specific risk-weight for a particular loan under the two approaches will give a misleading impression of the competitive impact of Basel II. As noted earlier, there is a clear, risk-based logic in applying higher risk-weights on housing lending to standardised ADIs, which generally have more concentrated balance sheets. Moreover, in current circumstances of emerging housing price pressures, there would be no case to reduce standardised housing loan risk-weights on macroprudential grounds. The IRB approach is risk-sensitive and is available to ADIs that have the resources, data and capabilities needed to adopt it; in contrast, the standardised approach lacks that risk-sensitivity and is, in effect, the default methodology for determining an ADI's capital adequacy.

**Figure 16: IRB residential mortgage risk-weights by jurisdictions**



Source: Pillar 3 disclosures of banks within each jurisdiction. December 2012 data except for Canada (January 2013), Japan (March 2013) and Australia (September 2013).

Housing loan risk-weights under the IRB approach in Australia do not appear out of line with other jurisdictions (Figure 16). There is a wide dispersion in these risk-weights across large banks internationally, a reflection of differences in housing markets in which the banks operate but also, in part, of a lack of data on losses during periods of significant downturn in housing markets in many jurisdictions, especially prior to the crisis.

Regulators in some jurisdictions have recently made adjustments to IRB risk-weights for housing lending, reflecting concerns that modelling practices may not capture the full range of risks inherent within housing markets. Adjustments have been made in response to concerns about the availability of downturn data and modelling processes but, more generally, as part of a macroprudential response to concerns about domestic housing market conditions. Hong Kong and Sweden have introduced a 15 per cent risk-weight floor on housing lending (and the Swedish authorities have flagged a further increase to 25 per cent may

be appropriate); Norway has introduced a 20 per cent (downturn) loss-given-default floor identical to Australia; and New Zealand has increased the correlation factor in the IRB modelling formula for loans with high loan-to-valuation ratios. In all cases, the resulting minimum risk-weights are expected to remain below those in the standardised approach.

The Basel Committee is currently reviewing the risk-weighted asset measurements under the advanced approaches in response to studies showing that the variability in such measurements was much greater than could be explained by differences in actual risks. The Basel Committee’s objective is to reinforce – but not replace – the risk-based Basel II framework by developing a set of simplifications and safeguards (through the use of floors and benchmarks) that will help limit variability but still provide for appropriate risk-sensitivity in risk-weighted asset measures. This review is now extending to retail portfolios (including housing lending), with an APRA expert involved, but conclusions are some time away.

## 8.1.2 Small business lending

Claims have been made that APRA's capital requirements have affected the availability and/or pricing of lending to small business.

The relevant capital requirements in this case as well as the credit risk-weights of the Basel II capital framework. It is important to note that, with the implementation of that framework in Australia in 2008, APRA's requirements for ADIs to hold capital against small business loans have in general fallen substantially.

Loans to small businesses are often directly secured by residential mortgages or supported by personal guarantees (from owners and/or other related persons) that, in turn, are secured by residential mortgages. APRA's capital requirements recognise the risk mitigation provided by such arrangements.

The Basel II standardised approach does not discriminate between lending to small or large businesses. A risk-weight of 100 per cent generally applies to loans to individuals and businesses that are not secured by residential mortgages. As noted in the previous section, under APRA's prudential standards substantially lower risk-weights are generally applied to housing lending depending on the loan-to-valuation ratio and whether the loan is standard or non-standard and/or is covered by LMI. Where business lending is secured by residential mortgages, it receives the same (lower) risk-weight as housing lending that is not business-related. This is a concession from the Basel II capital framework, which confines lower housing risk-weights to exposures that are 'restrictively for residential purposes'. This concession was introduced in Australian standards in 1993 and APRA has retained it despite the subsequent evolution of the Basel framework.

Compared with the standardised approach, the Basel II IRB approach allows ADIs to take account of various indicators of creditworthiness and a range of pledged security in calculating risk-weights. Risk-weights applied to loans are more closely aligned with the underlying risk characteristics of the loans based on the ADI's default and loss experience for similar loans, other indicators of creditworthiness, amounts involved and security pledges.

For small businesses, that has meant two particularly important changes:

- the extent and quality of a much wider range of pledged security can be taken into account when calculating ADI capital requirements. For small business borrowers, this works to offset the impact of generally higher default rates compared with larger corporate borrowers; and
- a size adjustment has been introduced such that capital requirements are progressively discounted for loans to smaller businesses (with the discount factor tapering off for businesses with annual sales above \$50 million).

As a result, compared with APRA's previous requirements, capital requirements for small business loans determined under the IRB approach are generally lower, and a higher proportion are also lower relative to the requirements for large corporate loans. Compared with loans to larger businesses, IRB risk-weights average around 10 per cent lower for 'SME corporate' exposures, a little under 30 per cent lower for smaller 'retail' loans related to the running of a business that are not secured by residential mortgages, and 40 per cent lower for retail loans related to the running of a business that are secured by residential mortgages.<sup>107</sup> IRB risk-weights for housing lending that is not business-related are lower again. Arguments are sometimes raised that there should be no difference in risk-weights for the latter two types of loans. The difference, however, simply and appropriately reflects the lower default rates that tend to emerge on housing lending that is not business-related (Table 7).

<sup>107</sup> SME corporate exposures are defined as lending (of \$1 million or more) to businesses with turnover of less than \$50 million. See APRA 2013, *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk*, January.

**Table 7: IRB risk-weights**

Asset class	Average IRB risk-weights (%)	Average probability of default (%)	Average default rate (%)
Large corporate	61	0.8	
SME corporate	56	2.0	
SME retail (not secured by residential mortgages)	44	2.3	2.1
SME retail (secured by residential mortgages)	34	1.9	1.7
Residential mortgages not business-related	18	0.9	0.8

Source: Data submitted in prudential returns and APRA estimates.

A \$1 million boundary exists under the IRB approach between lending classified as retail or corporate. This is a Basel II requirement, and is set in the Basel II framework at €1 million. Minimum capital requirements increase as the boundary is crossed, other things being equal. An additional requirement is that for small business loans to be classified as retail, the exposures must be treated in a manner similar to other retail exposures in the ADI's internal risk management systems, including in respect of loan origination and ongoing management processes. In other words, the loans should be treated by the ADI in a highly standardised manner, as is the case for retail products such as credit cards, overdrafts and personal loans. Arguments have been raised that this boundary requires ADIs to spend more time and money making loans to customers who have in excess of \$1 million in borrowings, which might limit unduly the availability of funding to small business or the cost of that funding.

The retail/corporate boundary does not preclude ADIs under the IRB approach implementing retail-like lending processes for loans in excess of \$1 million. Retail-like processes, however, generally become inappropriate as loan size and complexity increase. For example, as a customer's financing requirements move away from a simple loan or overdraft facility well secured against a residential property, more individualised assessment and ongoing monitoring of the customer's financial position and pledged collateral would generally be expected as part of prudent risk management. APRA originally converted the €1 million boundary to \$1 million as this lower level was considered more in keeping with market practice at the time. Indeed, until very recently, some ADIs had set limits lower than \$1 million on what constituted retail lending processes.

Moreover, it would not be unexpected that, from time to time, some small business customers would be encouraged by ADIs to stick with simpler, better secured loan products that are less costly for the institution to provide or where the customer seems unwilling or unable to meet the higher monitoring requirements associated with alternative loan products. This is a commercial matter not related to any APRA requirement.

Against this background, there appears little compelling evidence to conclude that APRA's capital requirements significantly affect the prudent availability of ADI lending to small business in terms of overall amount, cost or type. That said, APRA would be willing to consult on raising the \$1 million retail/corporate boundary to \$1.5 million, which would bring it into line (at current exchange rates) with the Basel II framework. However, ADIs under the IRB approach would still need to demonstrate that the other qualitative criteria in APRA's prudential standards are met before any loans involved could receive retail capital treatment. In particular, ADIs would need to apply retail-like lending processes to this segment of the market, whilst also ensuring that the processes are commensurate with the risk and complexity of the relevant exposures. As is the case for the current boundary, not all exposures up to \$1.5 million are likely to be considered suitable for retail-like lending processes; for more complex products or customers, a more tailored and individualistic approach would be needed and prudent.

### 8.1.3 Competitive position of internationally active ADIs

It has been argued that APRA's conservative approach (relative to minimum requirements) to the implementation of the Basel capital framework in Australia, particularly Basel III, undermines the ability of international active Australian ADIs (banks in this case) to compete in global funding and capital markets.

Generally speaking, APRA does not set ADI capital requirements that are well above the minimum requirements of the Basel framework. However, APRA does take a strict approach to the measurement of capital and risk-weighted assets, and had done so well before the crisis. Two longstanding points of principle underpin APRA's conservatism: assets that rely on the future profitability of the ADI to be realised or that are highly uncertain in value cannot be included in the calculation of capital, and capital cannot be used more than once in the financial system to absorb losses. APRA also takes a conservative approach – though

not as conservative as some other regulators – to the measurement of risk-weighted assets for housing lending under the IRB approach.

The consequence is that ADIs in Australia will show lower 'headline' capital ratios for a given balance sheet than will be produced in jurisdictions where supervisors take a less conservative approach (such as applying only the Basel minimum requirements). Table 8 gives APRA's estimates of the impact of differences in its capital requirements compared to the Basel framework, based on the Basel Committee's recent RCAP review of Australia.

Some banks have expressed concerns that, as a consequence of these differences, they face difficulties in explaining their financial strength to international investors.

APRA is well aware of these concerns and has committed to working with the ADI industry on a reporting template to facilitate comparisons between the capital ratios of Australian and overseas banks. International comparability of capital measures, however, is not an end in itself. APRA's fundamental objective must be to ensure that capital held by ADIs in Australia is genuinely available to absorb losses.

Moreover, there is little evidence from the crisis that APRA's approach penalised ADIs in Australia in raising equity capital, accessing wholesale funds at competitive rates or maintaining their credit ratings. The opposite was more likely the case. In particular, it is difficult to reconcile the concerns with the recent outstanding performance of the four major banks. As shown in Figure 17, these banks have been earning returns on equity that are rivalled only by Canadian banks. The four major banks are among only a small number of listed global banks with AA ratings, with APRA's prudential framework generally seen as a ratings positive for the banks. The four major banks are also prominent borrowers in offshore wholesale funding markets and have moved into the top tier of global banks by market capitalisation.

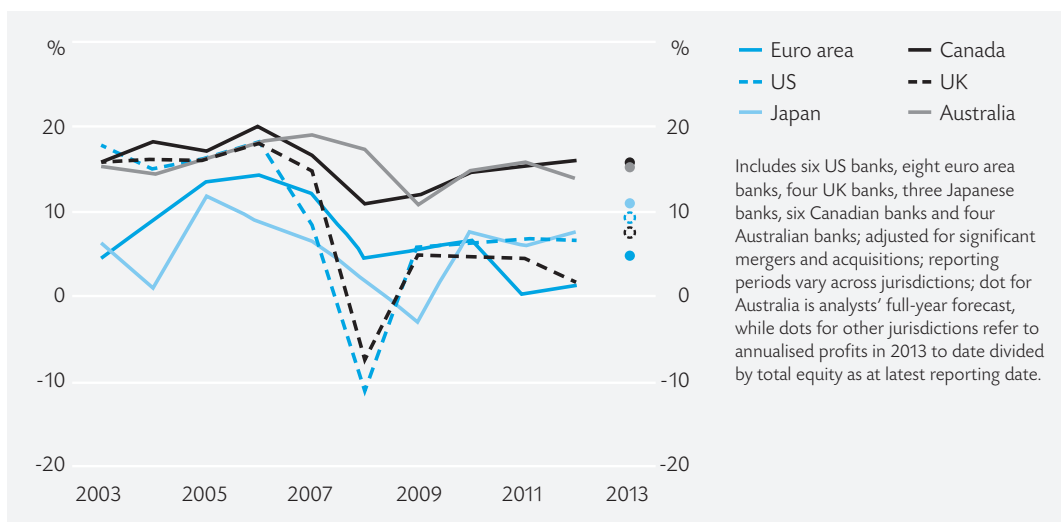


**Table 8: Impact of differences in the application of the Basel framework**

	Impact on CET1 ratio (bps)	Weighted average CET1 ratio (%)
APRA standards		8.28
APRA standards more conservative than the Basel framework:		
Non-recognition of Basel III threshold deductions	100	
Differences related to the internal ratings-based approach to credit risk	61	
Additional deduction of capitalised expenses	13	
Capital charge for interest rate risk in the banking book	28	
APRA standards less conservative than the Basel framework:		
Investments in own capital	-10	
Scaling factor related to specialised lending exposures	-6	
Other	-6	
Basel III rules		10.17

Note: The items are not additive as the impact on the CET1 ratio of each item is calculated independently of the impact of the other items.

**Figure 17: Large banks' return on equity**



Source: RBA 2013, Financial Stability Review, September, page 9.

APRA agrees that global funding and capital markets would be more efficient if they could confidently compare capital ratios of banks in different jurisdictions on an 'apples and apples' basis. Unfortunately, however, there is no fully harmonised Basel capital template. Many countries have exercised various national discretions for capital parameters under Basel II, or have implemented requirements above the Basel III minima in ways that may not be readily observable, such as through non-public (Pillar 2) adjustments to individual banks' minimum capital requirements.

The Basel Committee collects data on banks in member jurisdictions based on a standardised definition of regulatory capital.<sup>108</sup> This ensures a consistent numerator for capital calculations. On this basis, the capital ratios for the major Australian banks are on average not materially different from the average of other internationally active banks. The impact of the stricter capital settings in Basel III in reducing previous calculations of regulatory capital ratios has, however, been much smaller in Australia than in most other countries. This is because, in a sense, the rest of the world has moved toward APRA's more conservative approach.

The problem in international capital comparisons emerges more in the denominator, i.e. the measurement of risk-weighted assets.

The Basel Committee's recent studies of risk-weighted asset calculations on both the trading book and the banking book have identified a degree of variability globally in risk-weights that was much too wide to be explained by differences in underlying risk. In the extreme, capital ratios can vary by up to four percentage points for banks with exactly the same assets. The Basel Committee is now undertaking a substantial initiative to establish a comprehensive picture on risk-weighted assets and to develop

a range of appropriate supervisory and policy responses to encourage greater consistency in regulatory outcomes. This initiative, in which APRA is participating, offers a constructive, global response to the concerns raised by Australian banks and by many other market participants. Enhancing the accuracy of risk measurement will underpin confidence in the credibility of capital ratios and help to clearly distinguish well-capitalised banks. It will also reduce the pressure on prudential regulators like APRA to pursue the lowest common denominator, simply to make headline ratios look more attractive. It would be perverse in the extreme for APRA to weaken its capital requirements simply to make Australian banks look stronger.

## 8.2 Shadow banking and the regulatory perimeter

One of the concerns that crystallised in the crisis was the role of 'shadow banks' – institutions that perform credit intermediation functions that are not regulated in the same manner as banks.<sup>109</sup> The shadow banking sector is not large in Australia.<sup>110</sup> However, there are institutions operating outside the regulated ADI industry that do take funds from the public and provide credit.

Under the Banking Act, a body corporate that wishes to undertake 'banking business' in Australia must be authorised by APRA as a deposit-taking institution. Banking business is defined as taking deposits and making advances of money, as well as other financial activities prescribed by regulation.<sup>111</sup> Once authorised, the body corporate is an ADI. However, there are other institutions whose activities fall within the definition of banking business but that have been granted an exemption by APRA from the need to be authorised, under section 11 of the Banking Act.

<sup>109</sup> See Financial Stability Board 2011, *Shadow Banking: Scoping the issues – A Background Note of the Financial Stability Board*.

<sup>110</sup> Reserve Bank of Australia 2010, *Financial Stability Review September 2010: The Shadow Banking System in Australia*; Financial Stability Board 2011, *Peer Review of Australia Review Report: Framework for Strengthening Adherence to International Standards*, September.

<sup>111</sup> Refer to section 5(1) of the *Banking Act 1959*.

<sup>108</sup> See Basel Committee on Banking Supervision 2014, *Basel III Monitoring Report*, March.

Registered entities, or Registered Financial Corporations (RFCs), are one such class of institution. A registered entity is one whose sole or principal business activities in Australia are the borrowing of money and the provision of finance. While the business of registered entities falls within the definition of 'banking business' under the Banking Act, such entities – commonly referred to as finance companies – have historically been exempt from the need to be ADIs.

Another class of entity granted an exemption by APRA from the need to be authorised is religious charitable development funds (RCDFs). RCDFs are funds that have been set up to borrow and use money for religious or charitable purposes. This exemption is also historical in nature.

The current exemption orders require disclosures to an investor in products offered by an RFC or RCDF that such entities are not ADIs and are not supervised by APRA, and that the investments are not subject to the depositor protection provisions in the Banking Act.

The relevant global principle governing the permissible activities of banking institutions is set out in the *Core Principles for Effective Banking Supervision*. This principle requires, *inter alia*, that the taking of deposits from the public be reserved for institutions that are authorised and prudentially supervised as deposit-taking institutions. In its 2012 review of Australia's observance of these *Core Principles*, as part of its FSAP, the IMF recommended that APRA:

*'Revise the conditions for exemption from section 11 of the Banking Act for RFCs to ensure, at a minimum, that such exemptions be limited to institutions reliant wholly on wholesale funding.'*<sup>112</sup>

In response to the collapse of Banksia Securities, which was an RFC, APRA has been consulting on proposals aimed at reducing the likelihood that an investor, and particularly a retail investor, in an RFC would confuse such an investment with an ADI deposit or other deposit-like product. APRA also believes that similar measures are appropriate in respect of RCDFs that currently accept funds from retail investors. In particular, APRA has proposed to amend the section 11 exemptions such that RFCs and RCDFs would not be allowed to let their retail investors redeem their funds at call. Rather, retail offerings would be required to have a minimum initial maturity period of 31 days so that, for all practical purposes, investments with RFCs or RCDFs are not able to be used for transactional banking activities.

APRA is currently finalising its proposals in this area. However, consistent with the global principle governing the boundaries between prudentially regulated institutions and non-prudentially regulated institutions in the 'shadow banking' sector, the Inquiry may wish to consider whether it is appropriate to continue with any section 11 exemptions for institutions that offer deposit products, or those with features and characteristics that are clearly associated with 'products' offered by ADIs, to retail clients.

### 8.3 Directed investment of superannuation funds

Calls have been made for superannuation funds to invest more of their members' funds into certain asset classes. Commentators argue that as the pool of superannuation assets continues to grow, funds should be obliged to invest in, for example, infrastructure, social housing and venture capital.

112 International Monetary Fund 2012, *Australia: Basel Core Principles for Effective Banking Supervision - Detailed Assessment of Observance*, Washington, page 5.

APRA does not support the prescription of asset allocation for superannuation investment. A mandated approach to investment would undermine the RSE licensee's overarching obligation to act in the best interests of beneficiaries. This obligation is paramount as it is consistent with the objective of the Government's retirement income policy to ensure that individuals have an adequate income in retirement. If mandated investment were to occur, it is likely there would be instances where a forced investment into a specific asset class might not meet the needs of the membership of the fund; infrastructure investments may be inappropriate, for example, for a fund with members predominantly approaching retirement. RSE licensees are currently required to select investments that best suit their membership; superannuation funds have invested in infrastructure where they are satisfied this is appropriate under their investment strategy.

APRA's view is that the existing covenants in the SIS Act relating to investments, as well as APRA's new investment governance prudential requirements, appropriately govern the determination of investment decisions.

## 8.4 Streamlining opportunities in superannuation and life insurance

### 8.4.1 Streamlining the superannuation legislative framework

There is a significant amount of structural complexity in the SIS Act and associated regulations. This has resulted, in part, from the inclusion of a wide range of superannuation-like products within the SIS Act over the last 20 years. APRA's view is that a number of these products are either no longer serving the purpose for which they were originally designed or are an immaterial part of the superannuation industry. It may be an appropriate time to consider whether some of these products should be removed from the superannuation framework (subject to appropriate transitional arrangements if necessary).

The relevant products include:

- *Eligible Rollover Funds (ERFs)*. As APRA has recently been given power to authorise ERFs, with ERF trustees now required to meet higher trustee obligations, it expects that these heightened obligations will result in ERFs naturally transitioning out of the industry over time, potentially leaving just a single central repository for lost funds held with the Australian Taxation Office (ATO). An alternative to letting the reforms achieve this outcome over the medium term might be to hasten their exit by mandating the movement of monies to the ATO;
- *Approved Deposit Funds (ADFs)*. ADFs were introduced in 1984 as an 'approved' fund for receipt of superannuation lump sums (i.e. rollovers). Essentially, these funds acted as term deposit accounts offered through the superannuation system. There were 66 ADFs as at end December 2013, of which only a very small number have more than one member. Due to subsequent legislative changes, these facilities are now available in other permissible superannuation products, making ADFs effectively redundant. Consideration should be given to closing existing ADFs and transitioning these products out of the superannuation framework over time; and
- *First Home Saver Accounts (FHSAs)*. FHSAs were introduced in 2008 as a mechanism to facilitate the tax-efficient saving of money towards the purchase of first homes. These products are available to be offered by ADIs and RSE licensees (because of the relationship with superannuation money). While there is evidence of these products being taken up when offered by ADIs, APRA has to date authorised only one superannuation-related FHSA provider, and this provider has not opened any FHSA accounts. The legislative and prudential framework for these entities is complex and difficult to understand because of the interplay with the SIS Act. As these products have not been taken up by customers of superannuation entities, APRA's view is that the FHSA framework could be removed for RSE licensees, with no impact.

There are also significant grandfathering provisions throughout the SIS Act and regulations, including grandfathering put in place by the recent Stronger Super reforms (for example, regarding self-insurance). The complexity of the SIS Act and regulations means that there are relatively high costs involved in compliance. There may be merit in considering a comprehensive review of the overall legislative framework for superannuation with a view to removing as much of the complexity as possible.

#### 8.4.2 Rationalisation of legacy products

Legacy products arise particularly in life insurance and superannuation, where the financial products often last a lifetime, but the financial environment continually changes. Often such products are expensive to administer, particularly as the IT systems used to run the product age and the corporate memory of the product provider fades. At times, the legacy products no longer meet the requirements of the beneficiaries.

The Banks Report recommended that the Australian Government, State and Territory governments, APRA and ASIC should, in consultation with industry stakeholders, develop a mechanism for rationalising legacy financial products.<sup>113</sup> Product rationalisation is a process of converting or consolidating products of a similar nature into a single product with equivalent features and benefits. Its main purpose is to remove outdated, so-called 'legacy' products by transferring investors into newer, more efficient products. Where there are appropriate safeguards this can be done in such a way as to benefit both institutions and investors.

Progress in this matter has stalled since 2010. Although clearly not urgent, the problem associated with legacy products will arguably become greater the longer the issue remains unaddressed. APRA would like to see work on this project resume as it would be a key element to mitigating the increasing operational risk that such products create in the superannuation and life insurance industries.

### 8.5 Post-retirement considerations

The Australian population is continuing to age. Declining birth rates and longer life expectancy means there is a continually increasing proportion of people entering into retirement. This trend has implications for the financial sector and for providers of superannuation products in particular.

As more people enter into and stay in retirement for longer periods of time, the availability of suitable financial solutions becomes increasingly important if individuals are to have an adequate income without placing undue fiscal pressure on Government. APRA is closely monitoring these demographic trends. It does not expect them to necessitate material changes to the prudential framework for superannuation. These trends are likely, however, to require the review of policy settings by Government through, for example, taxation and welfare incentives, and the development of a wider range of investment options and products to assist superannuation fund members effectively mitigate longevity risk.

113 Regulation Taskforce 2006, *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business* (Bank Report), page 103.

# ANNEX A / OVERVIEW OF THE ADI INDUSTRY

## Industry structure

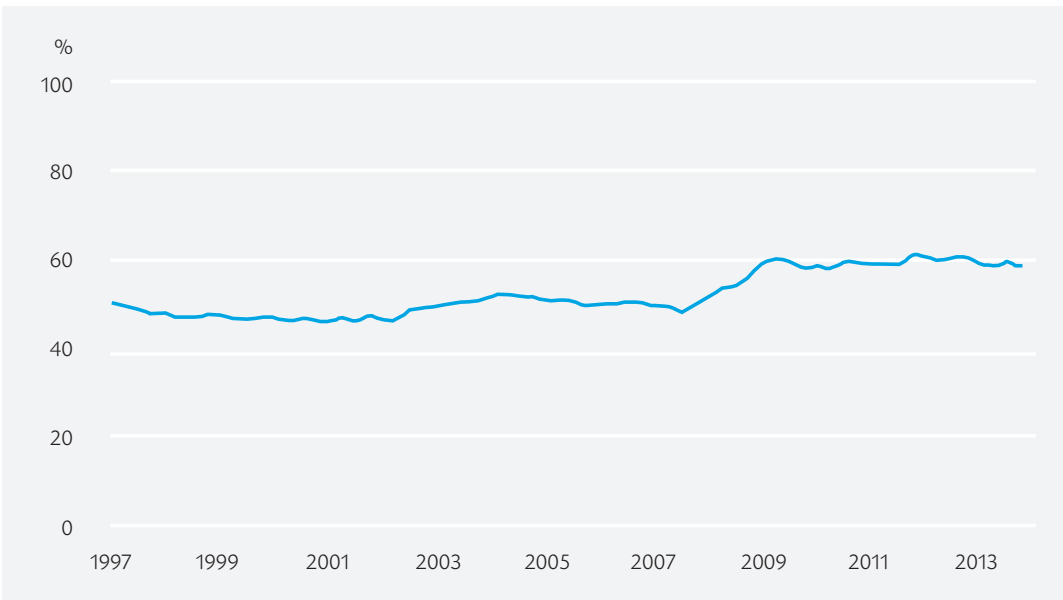
The ADI industry has grown in significance within the Australian financial system.<sup>1</sup> ADIs now account for around 60 per cent of Australian financial institution assets, up from 50 per cent in the late-1990s (Figure A.1). This increase primarily occurred between 2007 and 2009 as the share of assets held by superannuation and other managed funds declined following sharp falls in investment values. The vast majority of ADI assets (98 per cent) are held by banks.

Over the same period, the population of ADIs has declined significantly. In 2013, there were 171 ADIs in Australia, a little more than half the number operating in 1999 (Table A.1). This decline reflects continued consolidation among credit unions and building societies, which are for the most part localised institutions. More recently, a number of credit unions and building societies have converted to mutual banks.

The ADI industry has become more concentrated with the four major banks accounting for 75 per cent of ADI assets in June 2013 compared with 60 per cent in the late 1990s (refer to Figure 7 in Chapter 2). Much of this increase reflects the acquisition of smaller banks by the four major banks during the global financial crisis in 2008, and a steady decline in foreign banks' share of the market (Figure A.2).

While there are some differences among individual institutions, the majority of ADIs continue to be focussed on traditional banking services – deposits and loans – primarily to the domestic market. Loans make up more than two-thirds of ADIs' domestic balance sheets. For the most part, trading and investment activities remain a relatively small part of ADIs' operations and risk exposures, with capital held against market risk accounting for five per cent of the total capital requirement for all ADIs.

**Figure A.1: ADI share of financial institution assets**



Source: RBA 2013, 'Assets of financial institutions – B1', Statistical Tables.

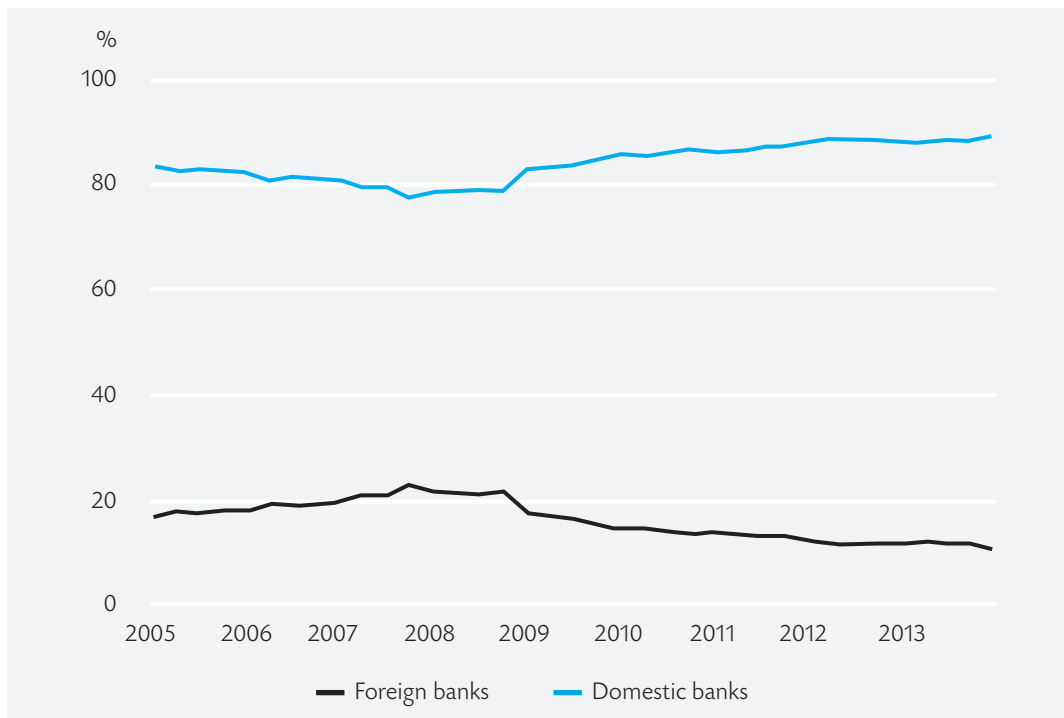
<sup>1</sup> ADIs comprise domestic and foreign banks, building societies, credit unions and certain other specialised entities.

**Table A.1: Number of ADIs by type**

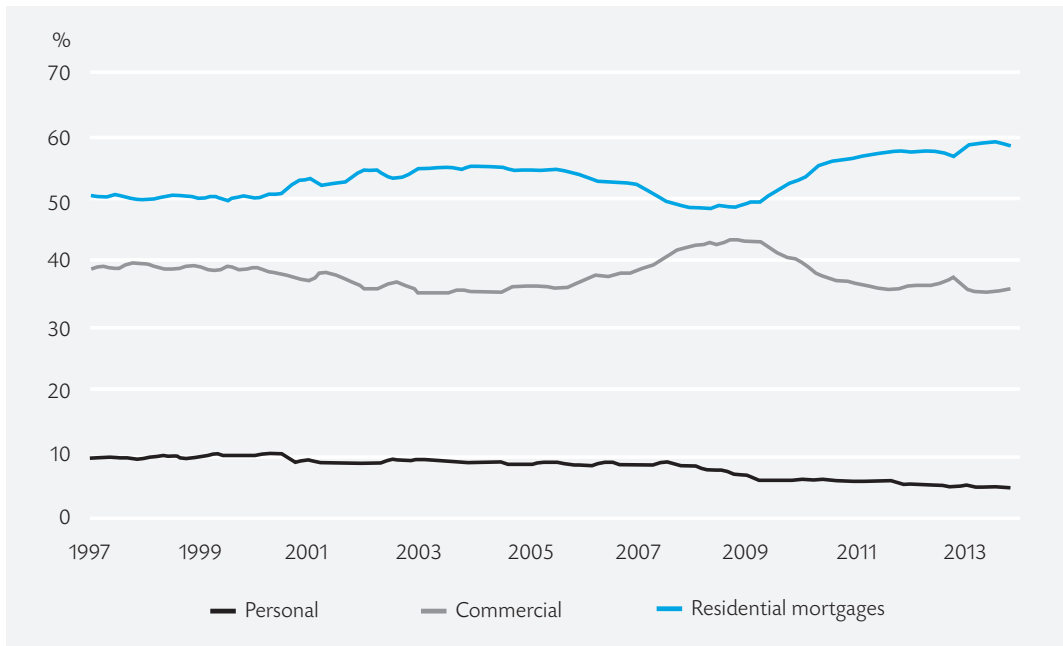
ADI sector	1999	2004	2009	2013
Domestic banks	15	14	14	21
Foreign subsidiary banks	11	10	9	8
Foreign bank branches	25	28	35	40
Credit unions and building societies	241	188	125	95
Other*	4	7	8	7
<b>Total ADIs</b>	<b>296</b>	<b>247</b>	<b>191</b>	<b>171</b>

\* Includes providers of purchased payment facilities, specialist credit card institutions and other specialised service providers. Figures as of September.

**Figure A.2: Domestic and foreign banks' share of resident assets**



**Figure A.3: Composition of banks' domestic loans**



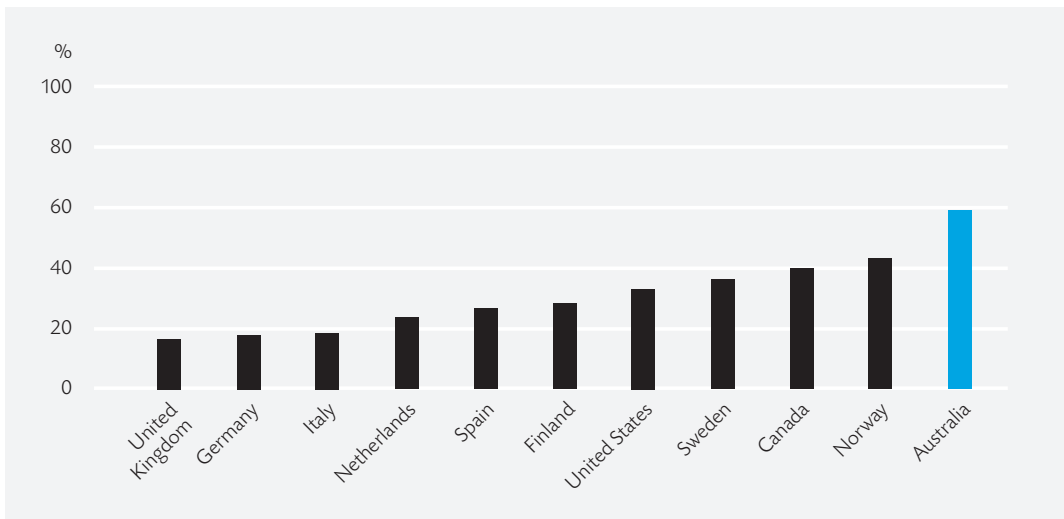
Source: RBA 2013, 'Banks Assets - B2', Statistical Tables.

Within ADIs' domestic loan books, residential mortgages remain the largest exposure, accounting for 60 per cent of the value of banks' domestic loans, compared with 50 per cent in the late 1990s (Figure A.3). For credit unions and building societies, the share is higher still at 90 per cent. In comparison, personal loans, which comprise primarily credit card outstandings, have declined in relative size, accounting for less than five per cent of loans.

Commercial lending accounts for the remaining 35 per cent of banks' portfolios. Commercial lending grew strongly in 2007 and 2008, when access to corporate bond markets was scarce and companies increasingly turned to banks for funding; weak business credit growth in recent years has contributed to the decline in relative share since then.



**Figure A.4: Residential mortgages as a share of total bank loans**

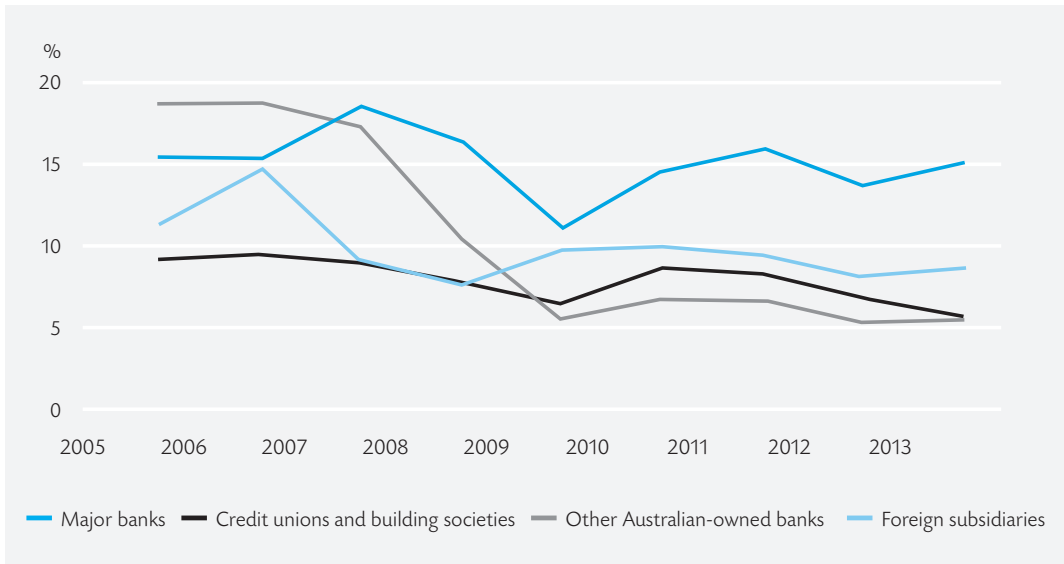


Source: IMF 2013, Financial Soundness Indicators Database. Data is as of September 2013 or latest available.

The share of residential mortgages on Australian banks' balance sheets is significantly higher than in many other developed economies (Figure A.4). In part this may reflect a more active securitisation market in other countries or public sector involvement in the housing sector, which reduces incentives for banks to hold (rather than originate and sell) these loans. ADIs have found their residential mortgage portfolios, in general, to be of high credit quality and a profitable asset class over the long term.

The four major Australian banks operate primarily domestically, with around 25 per cent of exposures and less than 20 per cent of earnings sourced offshore. New Zealand remains the largest source of foreign exposures, with each of the major banks having large retail operations there. The United Kingdom is the second-largest market for Australian banks, while exposures to Asia have grown strongly in recent years.

Figure A.5: Return on equity

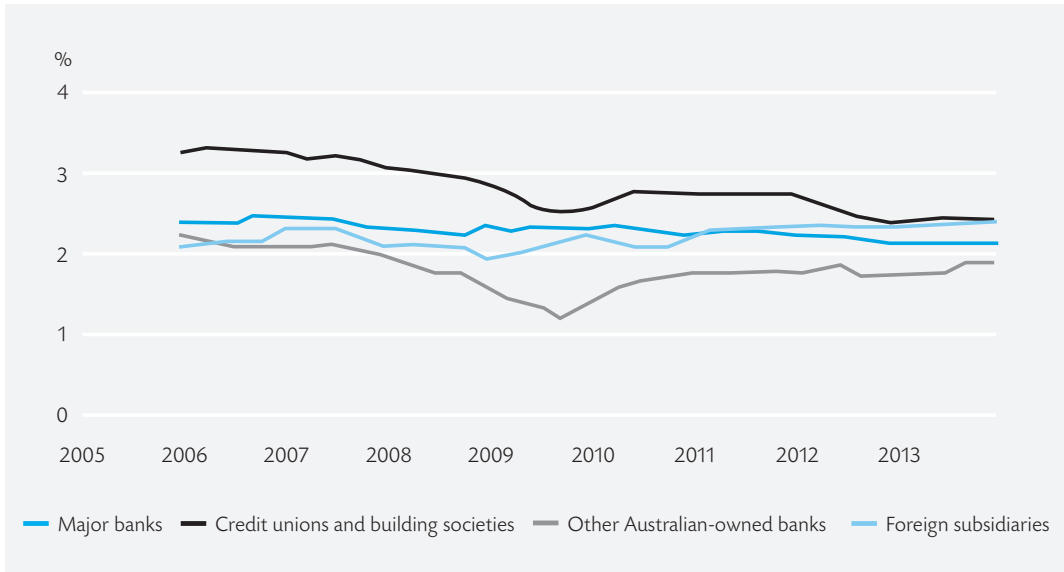


## Performance

In aggregate, ADIs have continued to report strong profits since 1997. At an industry level, return on equity averaged 16 per cent between 2005 and 2008, before dropping to about 10 per cent in 2009/10, mainly due to higher bad debt charges generated during the depths of the global financial crisis (Figure A.5). Since then, average ADI return on equity has picked up to about 14 per cent on average, as bad and doubtful debt charges have receded. The solid profit performance of ADIs in large part reflects a relatively benign asset quality experience since 1997.

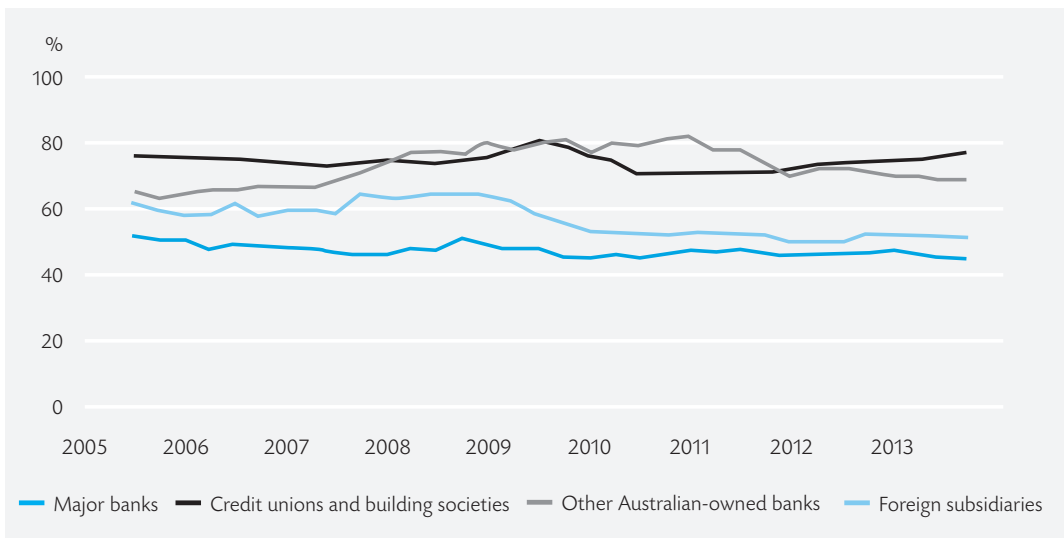
The major banks have consistently achieved double-digit returns on equity, even through the financial crisis (Figure A.5). The profitability of other Australian-owned banks declined considerably during the crisis as higher impairments and weak trading and investment income weighed on earnings. The return on equity of credit unions and building societies has also declined, in part reflecting net interest margin pressures and generally higher cost structures (Figures A.6 and A.7).

**Figure A.6: Net interest margin**

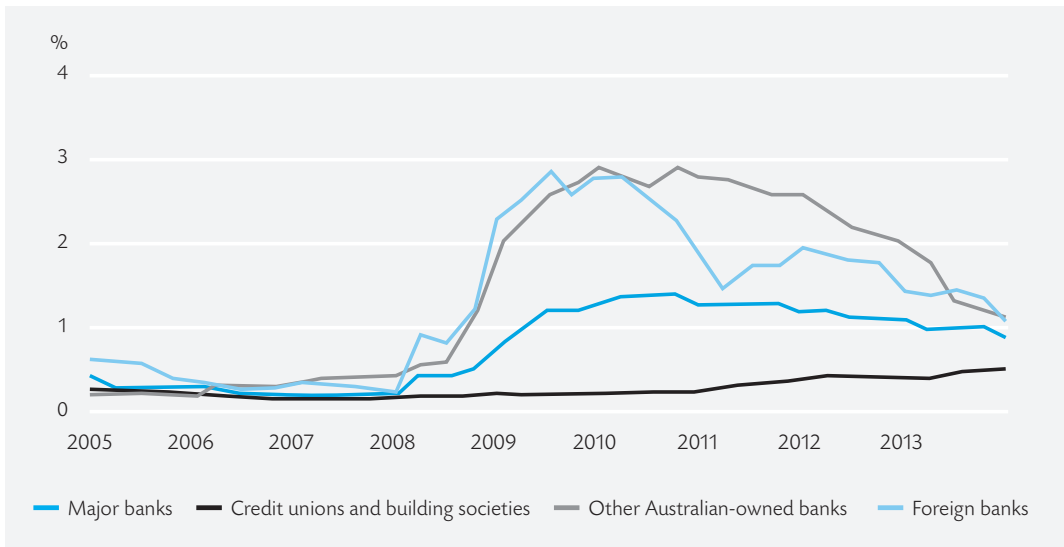


Note: Net interest income as a percentage of interest earning assets.

**Figure A.7: Cost-to-income ratio**



**Figure A.8: Impaired facilities as a share of loans and advances**

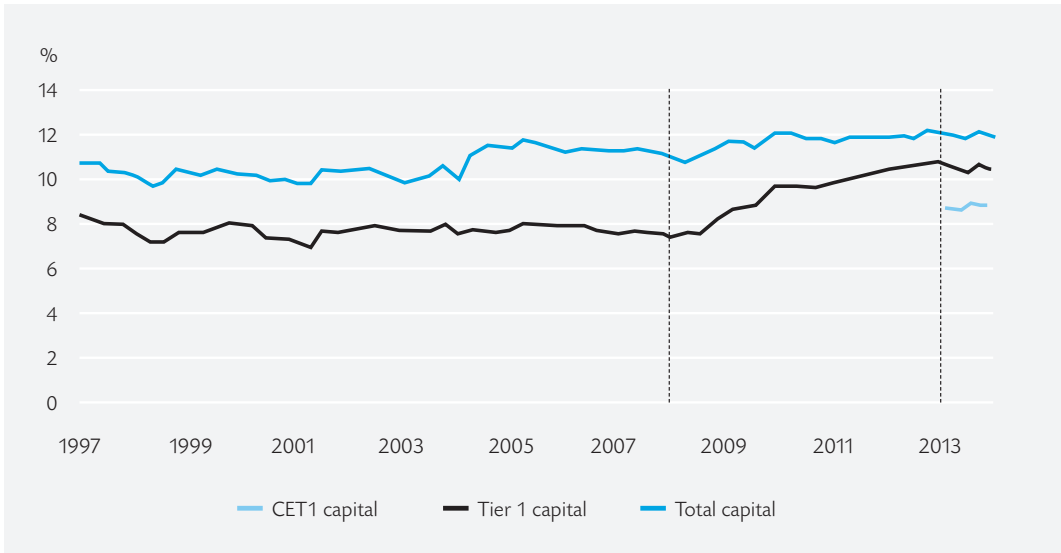


The cost-to-income ratios of the major banks, at roughly 43 per cent on average in 2013, are considerably lower than for many of their international peers (refer to Figure 8 in Chapter 2), reflecting productivity improvements and their focus on 'commoditised' business such as mortgage lending.

Though asset quality weakened during the global financial crisis, the deterioration was significantly less severe than that seen in Europe and the United States, or the Australian experience during the 1990/91 recession. Non-performing loan ratios in ADIs' mortgage portfolios, their largest asset class, have remained low and relatively stable at about 0.6 per cent of loans outstanding at end-2013.

The bulk of the increase in bad debts during 2008/09 was driven by business loans, initially reflecting a small number of exposures to highly geared companies and exposures to the commercial property sector, though bad debts later became somewhat more widespread as economic conditions slowed. Among ADIs, the deterioration in loan quality was more pronounced for foreign banks and other Australian-owned banks, compared to the major banks (Figure A.8).

**Figure A.9: ADI capital ratios**



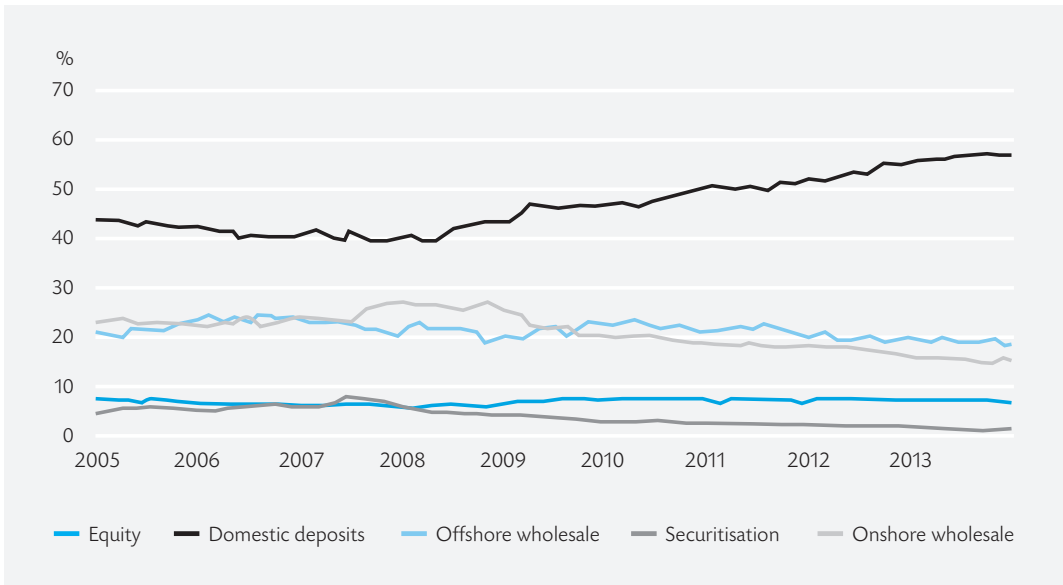
Note: Includes banks only prior to 2004. Broken lines represent the introduction of Basel II (2008) and Basel III (2013).

Capital is the cornerstone of an ADI’s financial strength. It supports the institution’s operations by providing a buffer to absorb unanticipated losses from its activities. APRA’s capital framework is described further below. ADIs have strengthened their capital position considerably in the last five years. Tier 1 capital ratios have risen from less than 8 per cent on average to about 10.5 per cent at the end of 2013. CET1 capital, the highest form of capital introduced under Basel III in 2013, accounted for 8.8 per cent of risk-weighted assets (Figure A.9). Total capital ratios have risen by a little less, in part reflecting ADIs replacing Tier 2 capital with higher quality capital.

The composition of banks’ funding has changed materially in recent years. In particular, the share of banks’ funding from domestic deposits has increased significantly, from 40 per cent of the total in 2007 to nearly 60 per cent at December 2013 (Figure A.10). Credit unions and building societies, which have historically been much more reliant on deposits, continue to fund around 85 per cent of their lending with domestic deposits.

Banks’ use of wholesale funding has declined to around one-third of the total, from a peak of about 50 per cent in mid-2008. The decline in wholesale funding has been largely driven by a reduction in short-term wholesale funding, which is typically perceived to be a less stable source of funding. The proportion of offshore wholesale funding has been little changed in recent years, at approximately 20 per cent.

**Figure A.10: Banks' funding composition**



Source: RBA 2014, Financial Stability Review, March, page 27.

Banks' use of securitisation as a source of funding primarily for residential mortgage loans has also declined, from about seven per cent of total funding in 2007, to one per cent at end-2013. In large part, this reflects difficult conditions in residential mortgage-

backed securities (RMBS) markets over recent years. RMBS had historically provided a significant source of funding for many smaller ADIs, including some credit unions and building societies.

## Overview of the prudential framework

There have been a number of significant changes to the prudential framework for ADIs since APRA was established. The first was a harmonised suite of prudential standards that APRA implemented in 1999 for all ADIs that came under its remit.<sup>2</sup> At that time, the prudential standards related to capital adequacy were based on the 1988 Basel Capital Accord.

In 2008, capital prudential standards were substantially revised to give effect to the Basel Committee's Basel II framework, a global initiative designed to strengthen risk management and provide more risk-sensitive capital requirements for deposit-taking institutions.<sup>3</sup> In response to the global financial crisis, Basel III came into effect on 1 January 2013. These global reforms were aimed at raising the quality, consistency and transparency of the capital base of ADIs. APRA has also issued new rules on liquidity management, including minimum quantitative requirements, consistent with the Basel III framework.

In addition to capital and liquidity requirements, ADIs are subject to prudential requirements relating to credit quality, large exposures, audit and related matters and the disclosure of prudential information.<sup>4</sup> From 2012, the prudential standards related to governance, fitness and propriety requirements for persons holding positions of responsibility, outsourcing and business continuity were harmonised across the ADI, general insurance and life insurance industries. A cross-industry risk management prudential standard comes into effect from 1 January 2015.

- 2 Prior to the creation of APRA, prudential requirements for banks were determined by the Reserve Bank of Australia and those for credit unions and building societies were determined by the Australian Financial Institutions Commission.
- 3 Revisions to the Basel II framework were subsequently issued in June 2006 and revisions to the Basel III rules were issued in June 2011. Refer to Basel Committee on Banking Supervision June 2006, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version* and Basel Committee December 2010, *Basel III: A global regulatory framework for more resilient banks and banking systems* (revised June 2011).
- 4 The disclosure requirements are generally referred to as 'Pillar 3' of the Basel II framework.

## Capital requirements

APRA's approach to the assessment of an ADI's capital adequacy is based on the risk-based capital adequacy framework set out in the Basel II and Basel III frameworks.

Consistent with the Basel framework, APRA's approach provides for prescribed quantitative ('Pillar 1') measures of an ADI's capital adequacy as follows:

$$\begin{array}{l} \text{CET1} \\ \text{capital ratio} \\ \text{(minimum 4.5 per cent)} \end{array} = \frac{\text{CET1 capital}}{\text{Total risk-weighted assets}}$$

$$\begin{array}{l} \text{Tier 1 capital ratio} \\ \text{(minimum 6 per cent)} \end{array} = \frac{\text{Tier 1 capital (CET1 capital} \\ \text{plus Additional Tier 1 capital)}}{\text{Total risk-weighted assets}}$$

$$\begin{array}{l} \text{Total capital ratio} \\ \text{(minimum 8 per cent)} \end{array} = \frac{\text{Total capital (Tier 1 capital} \\ \text{plus Tier 2 capital)}}{\text{Total risk-weighted assets}}$$

An important supervisory tool, known as 'Pillar 2', is the capacity for the supervisor to set capital requirements above the minimum requirements of the Basel framework. APRA has powers to, and in practice does, apply Pillar 2 adjustments to increase an individual ADI's Prudential Capital Requirement (PCR) beyond the minima listed above.

The denominator of the capital ratio, total risk-weighted assets, is a quantitative measure of the risks to which an institution is exposed. The current determination of risk-weighted assets is generally based on the Basel II framework and it is the sum of the amount required to be held for:

- the credit risk associated with an ADI's on-balance sheet and off-balance sheet exposures. The capital required for credit risk may be determined using either the Standardised Approach, which is based on simple risk-weights that are generally aligned to the external credit rating of an exposure, or, if approved by APRA, the IRB Approach, which is driven by an ADI's own measures of certain credit risk components such as the probability that a borrower would default within a given timeframe and the estimate of loss given such a default;
- the operational risk associated with an ADI's banking activities. The capital required for operational risk is determined using either the Standardised Approach, which uses a proportion of the ADI's total gross outstanding loans and advances as an indicator of operational risk exposure, or, if approved by APRA, the Advanced Measurement Approach (AMA), which uses the ADI's own internal quantitative model as a measure of operational risk; and
- the market risk arising from an ADI's trading activities and where applicable, the interest rate risk arising from normal financial intermediation, as distinct from trading activities. The amounts required are generally based on internal model approaches.

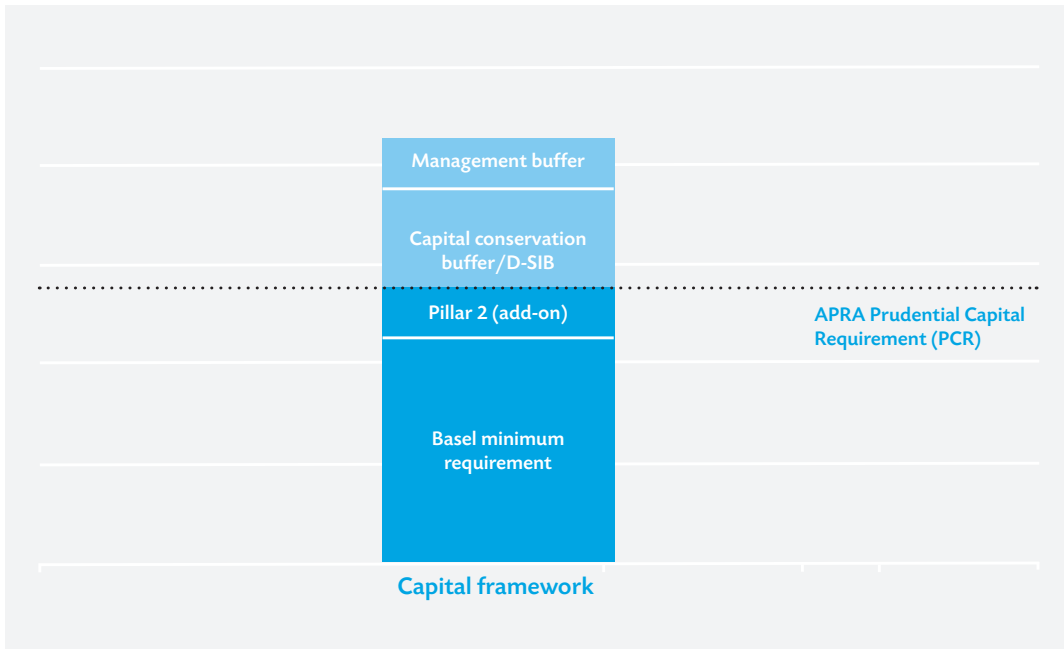
Basel III revised the requirements that determine an ADI's capital base – the numerator of the capital ratio – focussing on CET1 capital. In general, CET1 is the most subordinated class of capital and has no prospect of repayment outside liquidation; regular payments such as dividends are entirely discretionary for the ADI. Additional Tier 1 capital is also capable of absorbing losses on a going-concern basis but is less subordinated than CET1 capital. Tier 2 capital is generally issued in the form of debt, and is only available to absorb losses in liquidation.

ADIs must also hold a capital conservation buffer of 2.5 per cent of risk-weighted assets. This buffer is comprised of CET1 capital, and is designed to be drawn down in times of strain as losses are incurred. Another buffer, the countercyclical buffer, aims to ensure the banking system's capital requirements take account of the macro-financial environment in which the ADI operates. The countercyclical buffer would be deployed by APRA in periods when excess aggregate credit growth was judged to be associated with a build-up of system-wide risk to ensure the banking system has a buffer of capital to protect it against future potential losses.

The interaction of the buffers and the PCR is illustrated by Figure A.11.



**Figure A.11: Capital framework**



As discussed in Chapter 6, in recognition of their systemic importance to the domestic market, from 1 January 2016 the four major banks will also be subject to a higher loss absorbency (or D-SIB) capital requirement of one per cent of CET1. A non-risk-based

leverage ratio is also proposed to be implemented with effect from 1 January 2018; this will act as a supplementary measure to the risk-based capital requirements outlined above.

# ANNEX B / OVERVIEW OF THE GENERAL INSURANCE INDUSTRY

## Industry structure

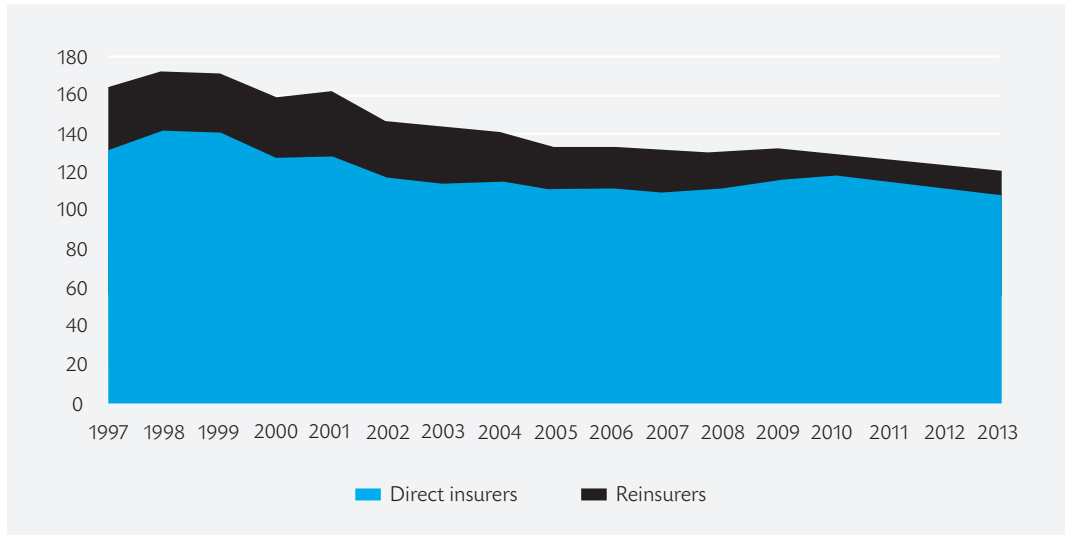
The general insurance industry is a significant sector of the Australian economy, writing annual gross premium income in excess of \$39 billion in 2013 compared with approximately \$15 billion in 1997.

Since 1997, the number of authorised general insurers in Australia has steadily declined as a consequence of industry rationalisation through mergers and acquisitions. There were 109 licensed direct insurers and 12 reinsurers in the Australian market at June 2013 compared to 133 direct insurers and 31 reinsurers at the end of 1997 (Figure B.1).

This rationalisation included the privatisation of state government insurers and demutualisation of mutually owned insurers and, in a number of such cases, their subsequent takeover. Three of the top five insurers in the general insurance industry in 1997 were either mutually owned or subsidiaries of foreign insurers. In contrast, four of the five largest general insurance groups in March 2014 are part of groups listed on the Australian stock exchange and the fifth is a subsidiary of a parent company listed on an overseas stock exchange.

As a consequence of the decline in insurer numbers the industry has become more concentrated, with the largest five direct insurance groups now accounting for over 70 per cent of direct insurance industry premiums, compared to well under 50 per cent in 1995.

**Figure B.1: Number of general insurers and reinsurers in Australia**



Concentration is more evident in the personal lines insurance market where the five largest insurance groups account for over 80 per cent of the market.<sup>1</sup> While the general trend has been one of consolidation, the past ten years has also seen the arrival of new entrants in the personal lines market, with a number of APRA-authorized foreign insurers as well as large retail brands adding to the level of competition present.

In comparison, the commercial lines market is more fragmented with the five largest insurance groups accounting for about 60 per cent of gross earned premium. An important factor contributing to competition in this market is the high level of capacity provided by APRA-authorized foreign insurance subsidiaries and branches and Lloyd's syndicates.

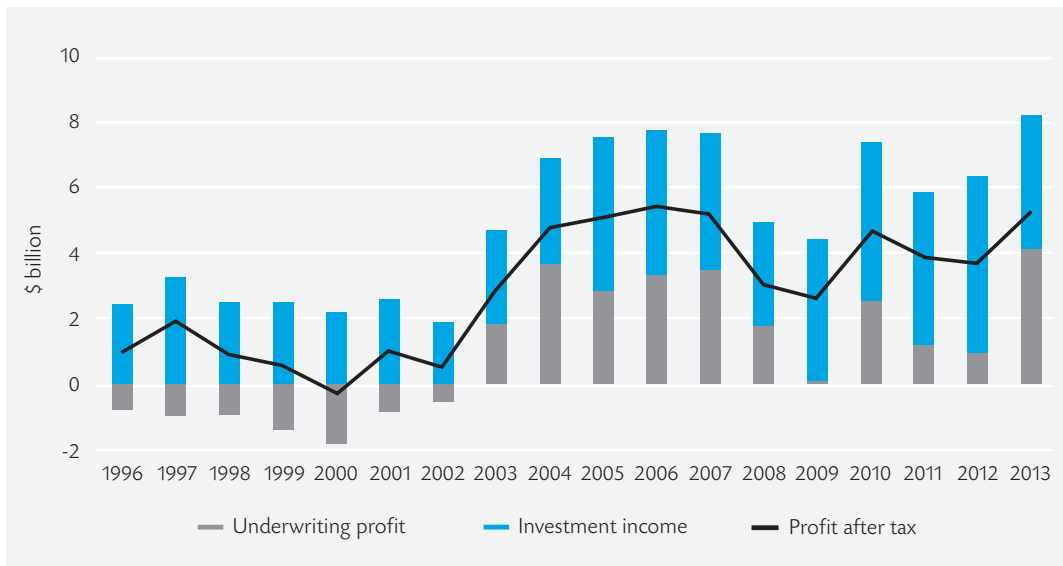
The reinsurance market in Australia is highly concentrated, with the two largest reinsurance groups accounting for about 75 per cent of the market. All general insurance reinsurers in the Australian market are foreign-owned.

## Performance

The performance of the general insurance industry in Australia has been strong over the past decade. Industry performance has been characterised in the main by both healthy underwriting returns and investment income, though the global financial crisis and various natural catastrophe events negatively impacted on insurers' returns in some years (Figure B.2).

This trend is in contrast to industry performance prior to 2003, when for a long period insurers reported underwriting losses, relying on investment income to maintain their profitability. The change from 2003 was attributable to a number of factors. In particular, more demanding capital markets and the departure of large mutually owned insurers in the market led to an increased focus on profitability. Another factor has been enhanced discipline among local insurers, including improved risk processes and greater actuarial involvement in pricing and reserving. This was brought about, in part, by APRA's strengthening of the prudential framework following the collapse

**Figure B.2: Annual industry performance**



1 Personal lines (and commercial lines) market share estimates are based on gross earned premium data collected by APRA for the 12 months to 30 June 2013.

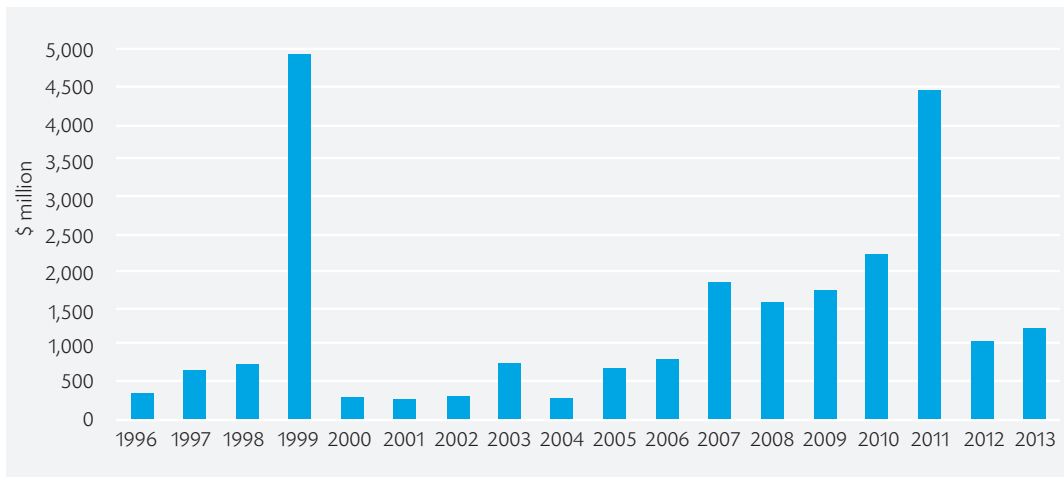
of HIH Insurance. Furthermore, lower claims costs in many insurance lines have had a positive impact on underwriting results, particularly in the public liability class of business following tort law reforms. These reforms were aimed at addressing problems in the affordability and availability of liability insurance.

The claims costs from a number of significant natural catastrophe events over the past decade have had an adverse impact on the underwriting results of property insurers. Most notable in terms of claims costs (Figure B.3) were the Victorian bushfires (2009), storm events in Melbourne and Perth (2010) and the Queensland flood and cyclone events (2011). Claims costs from the Christchurch earthquakes in 2011 also had a significant impact on Australian insurers with a New Zealand presence. This string of severe events contrasted with the previous decade when the Sydney hail storm event in 1999 was the only major event.

The industry's property catastrophe reinsurance programmes played an important role in dampening the effect of these events on profitability. Following the events, however, reinsurance prices increased, which prompted an increase in premiums charged by insurers in areas at risk, as well as changes in insurers' risk appetite.

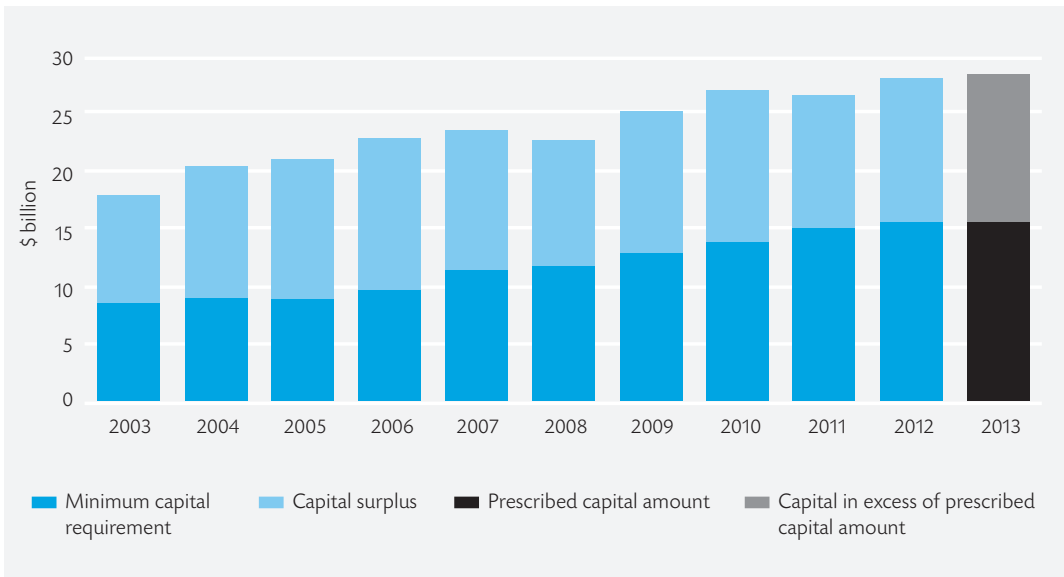
General insurer profitability was also affected by the global financial crisis, with reductions in interest rates increasing the value of insurers' long-tail claims provisions, and hence their claims costs. This adversely influenced underwriting profits. However the lower interest rates also increased the value of insurers' fixed-income investments, raising their investment income and thereby partially offsetting the impact of higher claims costs on overall profitability.

**Figure B.3: Gross claims costs from Australian natural catastrophes**



Source: Insurance Council of Australia, Natural Disaster Statistics. Claims costs prior to March 2010 have been indexed to 2011 values.

**Figure B.4: Industry eligible capital and capital requirement**



The economic slowdown in Australia in 2008/09 resulted in increased claims costs for underwriters of professional indemnity and directors and officers policies, with a large portion of these costs again being passed on to reinsurers. The LMI sector, which is more exposed to the macroeconomic environment than most other insurance segments, experienced an increase in mortgage defaults during this time, although default levels remained at relatively low levels.

The general insurance industry continues to be well capitalised, with insurers generally holding a healthy surplus of eligible capital above APRA's minimum capital requirements (Figure B.4).<sup>2</sup>

Industry profitability has aided the build-up of surplus capital; increasing retained profits over the past decade have played an important part in bolstering industry eligible capital.

<sup>2</sup> Figure B.4 omits data prior to 2003 as material changes to both accounting methodology and APRA's prudential requirements significantly limit their comparability with more recent data. The colour change in the figure represents the changes to APRA's capital requirements introduced 1 January 2013.

## Overview of the prudential framework

APRA has made a number of substantial improvements to the prudential framework for general insurance over the past fifteen years.

In 2002, APRA implemented a major strengthening of the framework for general insurers, introducing more rigorous and risk-based capital requirements and stronger requirements for actuarial, risk and reinsurance management. At that time, APRA re-authorised all general insurers. This was the culmination of a reform project initiated by APRA soon after it was established in mid-1998, and addressed some of the shortcomings identified as contributing to the collapse of HIH Insurance.

In 2006, further changes were made to implement the recommendations made in the report on the Royal Commission investigation into the collapse of HIH Insurance. As a result, APRA further strengthened its governance, actuarial and audit requirements and extended the prudential framework to cover consolidated general insurance groups. This included new prudential standards that set minimum requirements for good governance and extended the role and responsibilities of the Appointed Actuary. In 2009, APRA introduced a specific prudential framework for the supervision of general insurance groups to address contagion risk. These reforms ensured that insurance groups met essentially the same minimum capital requirements on a consolidated basis as applied to individual authorised general insurers, and other minimum prudential requirements (such as risk management and governance) on a group-wide basis.

Between 2009 and 2012, APRA conducted a review of the capital standards for life and general insurers to improve the risk-sensitivity and appropriateness of capital requirements, improve the alignment of the standards between industries where appropriate and incorporate developments in international better practice. The review took into account lessons arising from the global financial crisis and the series of natural disasters that occurred during the period of the review.

## Capital requirements<sup>3</sup>

Capital supports a regulated institution's operations by providing a buffer to absorb unanticipated losses from its activities. Similar to the approach taken for ADIs, APRA's capital adequacy framework for insurance companies is based on a three pillar approach.<sup>4</sup>

APRA's prudential standards establish a risk-based approach for measuring the capital adequacy of an insurer, and a minimum requirement referred to as the Prudential Capital Requirement (PCR). The PCR is intended to take account of the full range of risks to which an insurer is exposed. The PCR for an insurer is equal to a (Pillar 1) 'prescribed capital amount' under the prudential standards plus any (Pillar 2) 'supervisory adjustment' as determined by APRA.

The prescribed capital amount can be determined in three ways:

- by applying the Standard Method, as determined in conjunction with the capital prudential standards;
- by using an internal model developed by the insurer, and approved by APRA, to reflect the circumstances of its business; or
- by using a combination of these two methods.

Under the Standard Method, the prescribed capital amount is determined as:

- the Insurance Risk Charge: the risk that the value of net insurance liabilities determined in accordance with prudential standards is insufficient to cover associated net claim payments and associated claim expenses as they fall due; plus

3 Life insurers (including friendly societies) have materially similar requirements; Annex C describes the features of the framework that are unique to life insurance.

4 Pillar 1 encompasses quantitative requirements in relation to required capital, eligible capital and liability valuations. Pillar 2 consists of the supervisory review process, which includes supervision of the risk management and capital management practices of insurers and may include a supervisory adjustment to capital. Finally, Pillar 3 relates to disclosure requirements designed to encourage market discipline.

- for general insurers only, the Insurance Concentration Risk Charge: the risk of an adverse movement in eligible capital due to a single large loss or series of losses;<sup>5</sup> plus
- the Asset Risk Charge: the risk of adverse movements in the value of on-balance sheet and off-balance sheet exposures;<sup>6</sup> plus
- the Asset Concentration Risk Charge: the risk of a concentration of exposures to a particular asset, counterparty or group of related counterparties resulting in adverse movements in eligible capital; plus
- the Operational Risk Charge: the risk of loss resulting from inadequate or failed internal processes, people, systems or from external events; less
- the aggregation benefit: an allowance for the diversification between asset and insurance risks in the calculation of the prescribed capital amount.

While the Standard Method adequately captures the risk associated with the activities of the average insurer, APRA recognises that any measure of the adequacy of an insurer's capital involves judgment and estimation, including quantification of risks where it is quite difficult to do so. Therefore, when determining the PCR, supervisors may make a supervisory adjustment to the prescribed capital amount to ensure all risks are appropriately captured.

As with ADIs, there are three different classes of capital. The highest class is CET1 capital, followed by Additional Tier 1 capital and Tier 2 capital. The criteria for determining the eligibility of capital for each class are largely aligned with the criteria for ADIs.

Insurers must hold a minimum of CET1 capital at least equal to 60 per cent of their prescribed capital amount, and a minimum of Tier 1 capital at least equal to 80 per cent of their prescribed capital amount.<sup>7</sup>

5 For life insurers, the risk of such an event is included in the insurance risk charge.  
 6 The Asset Risk Charge is driven by the riskiness of the asset exposures of the institution and the extent to which the assets are matched to the liabilities. Riskier asset exposures generate higher capital requirements, with the opposite result for less risky asset exposures. As a result of this risk sensitivity, an insurer has a choice between reducing the riskiness of their assets and holding higher amounts of capital.

7 Tier 1 capital equals CET1 capital plus Additional Tier 1 capital. Refer to Annex A.

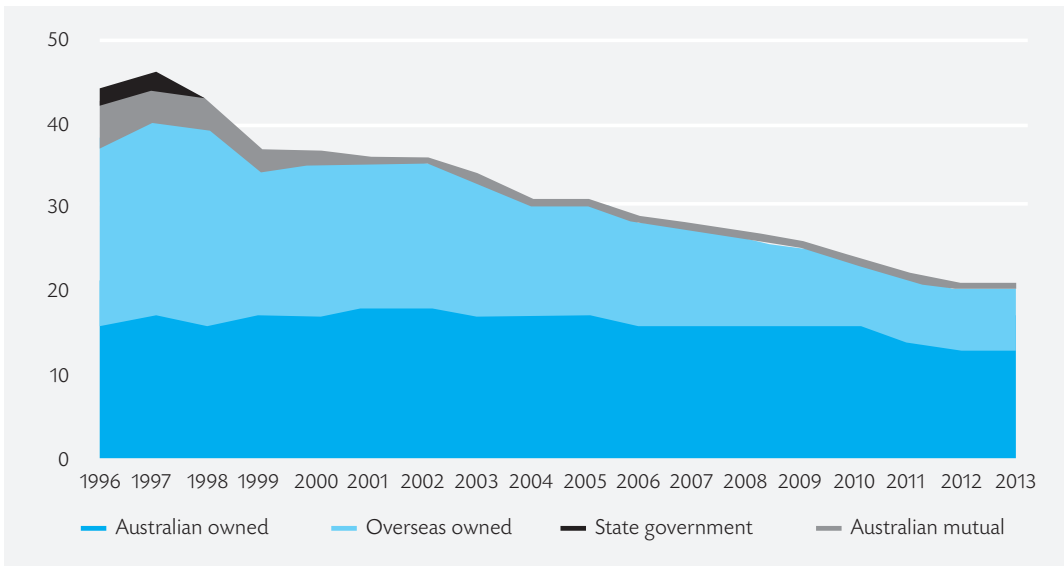
# ANNEX C / OVERVIEW OF THE LIFE INSURANCE INDUSTRY

## Industry structure

Leading up to the Wallis Inquiry, the structure of the life insurance industry in Australia had already undergone significant change, driven by the period of deregulation of the 1980s. The most obvious sign of this was the entry of the four major banks into life insurance through either acquisition or start-up operations. Another major structural shift began to emerge from about 1990 with a drawn-out period of consolidation through mergers and acquisitions (Figure C.1). This process of consolidation culminated in the merger of two of Australia's largest life insurers in 2011.

The period of consolidation was partly driven by a need to improve existing forms of revenue and create new ones, and to improve operating and capital efficiencies in the face of new forms of competition from non-life insurance sources. Further, life insurers were facing reduced profit margins as value was shifting away from manufacturers to other parts of the value chain, namely advisers, sales people and investment managers. The opportunity for local insurers to address these competitive and internal forces was assisted by a number of life insurers with offshore parents (most particularly those based in the United Kingdom) deciding, for their own domestic reasons, to divest their Australian operations (and others around the world). The percentage of life insurance assets under ultimate Australian ownership increased from 82 per cent in 1990 to 93 per cent in 2013.

**Figure C.1: Number of life companies**



Note: Excludes reinsurers.



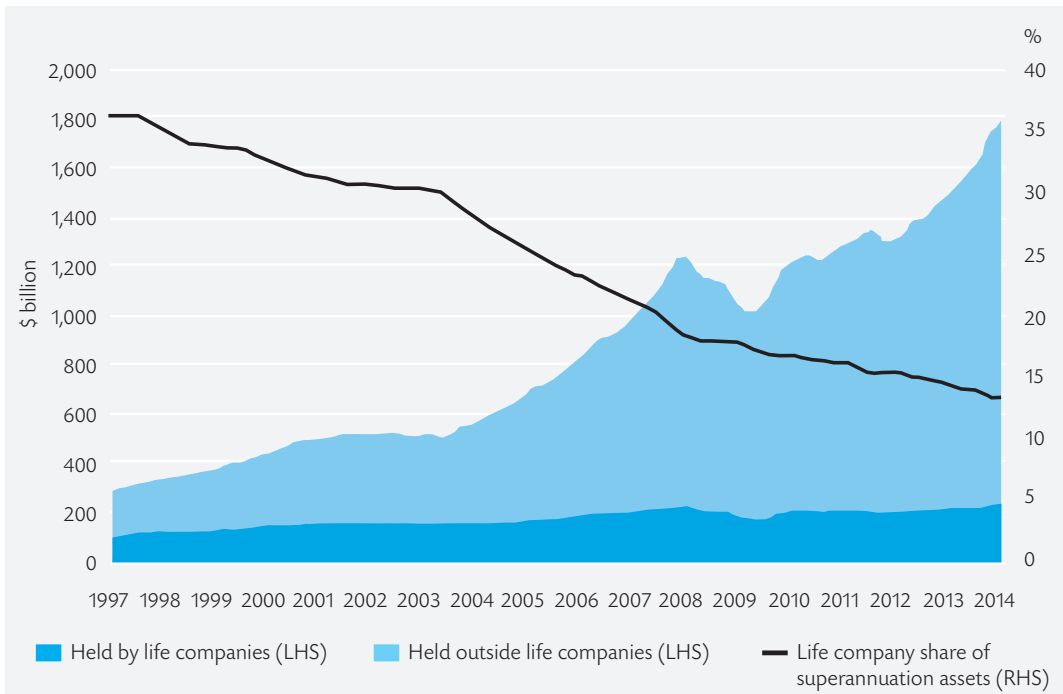
The early part of this period also witnessed a rapid decline (and the virtual disappearance) of the life insurance mutual structure which, up until then, had traditionally dominated the industry. The driving force for this development was the need to access new forms of capital to satisfy tightening prudential capital requirements, as well as support ambitious growth plans and rapid technological change. Apart from access to capital beyond the membership base through public listing, it also enabled a more efficient release of substantial amounts of surplus capital locked up in statutory funds.

Life insurers also needed to modify their businesses to adapt to significant changes in accounting, reporting, taxation and prudential capital requirements. This competitive pressure continues today and,

if anything, has increased with the rapid rise of industry superannuation funds and self-managed superannuation funds (SMSFs). Life insurers in the early 1990s managed well over 40 per cent of superannuation assets, but their market share has steadily reduced to about 13 per cent by 2013 (Figure C.2).

The life insurance industry has now broadly coalesced into seven large diversified groups (including those owned by the four major banks), a small number of prominent group life and investment specialists, and a few smaller niche insurance and investment writers. At the end of 2013, there were 28 registered life insurers (including seven reinsurers) with approximately \$270 billion in total statutory fund assets, compared to 51 life insurers and \$134 billion in assets at the end of 1996.

**Figure C.2: Life company share of superannuation assets**



The banking industry has taken on a prominent position in life insurance through a combination of organic growth and aggregation of other life insurers, either by direct purchase or through acquisition of smaller banks that had earlier established their own life insurer brands. This trend continued with a number of acquisitions during 2008 to 2010. Life insurers that are subsidiaries of banking groups now account for about 50 per cent of both life insurance industry assets and regular premium revenue.

Despite the significant shifts in industry structure over the past 20 years or more, the number of life reinsurers in Australia that support direct writers has remained reasonably stable at between five and seven.<sup>1</sup> At the end of 2013 there were six active reinsurers, all of which are foreign-owned.

Friendly societies originally evolved out of cooperatives providing sickness benefits in the United Kingdom. Today in Australia they are a subset of the life insurance industry, operating under substantially the same prudential framework as other life insurers. They have experienced similar patterns of consolidation as life insurers over the past 20 years. At the end of 2013 there were 13 friendly societies, with the two largest holding about 50 per cent of all friendly society assets. A number of friendly societies retain the mutual structure. Friendly societies represent less than three per cent of all life insurance industry assets and focus on investment products for market niches, in particular long-term funding of education and funeral expenses.

Despite the significant decline in the number of life insurers and the increasing prominence of bank-owned life insurers, standard measures indicate little has changed in market concentration over the past two decades. While there has been a large reduction in the number of life insurers in Australia, many of the insurers that no longer exist had only small to medium operations. By the end of 2013, about 80 per cent of total assets was held by the five largest life insurers. This pattern of asset concentration is comparable

1 Reinsurers are licenced under the Life Insurance Act and thus required to adhere to the same prudential requirements as other life insurers and friendly societies.

with that of the ADI industry. In terms of premium volumes, a somewhat different picture emerges: market concentration has reduced as a consequence of greater numbers of life insurers acquiring significant shares of the insurance risk market. By the end of 2013, about two-thirds of regular risk premium revenue was held by the five largest life insurers by premium volume.

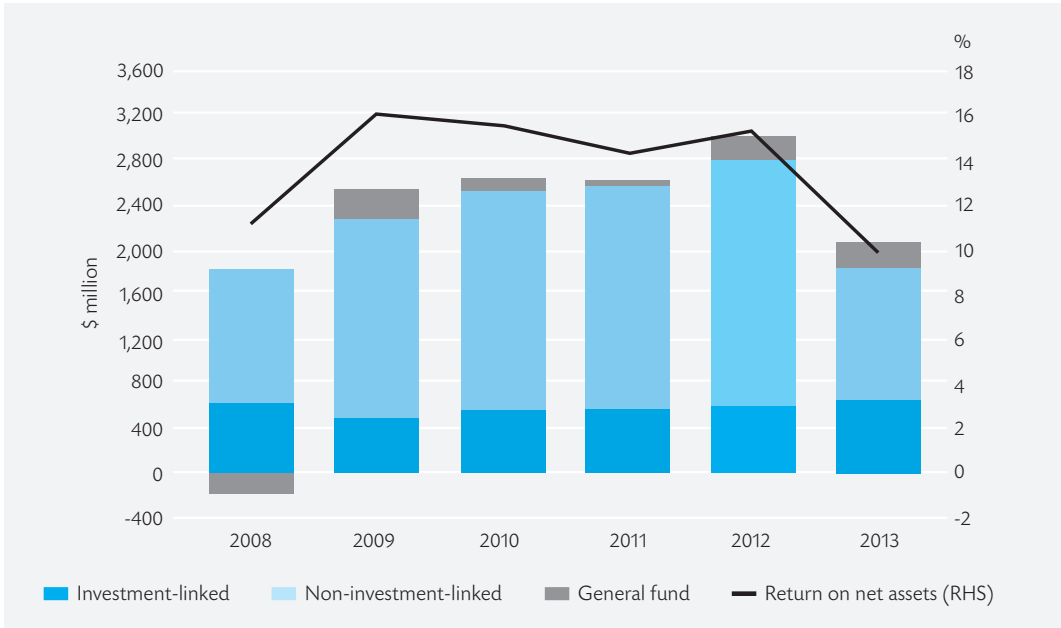
## Performance

Life insurer profitability was directly and severely affected by the global financial crisis, with losses arising mainly from reduced investment earnings on capital and reduced fee revenue from investment business (Figure C.3). This came after annual industry net shareholder profits in the years leading up to the crisis were of the order of \$2.5 billion. The industry was able to quickly recover, however, and despite continuing market fragility since then profitability has generally been maintained at those pre-crisis levels over the following years.

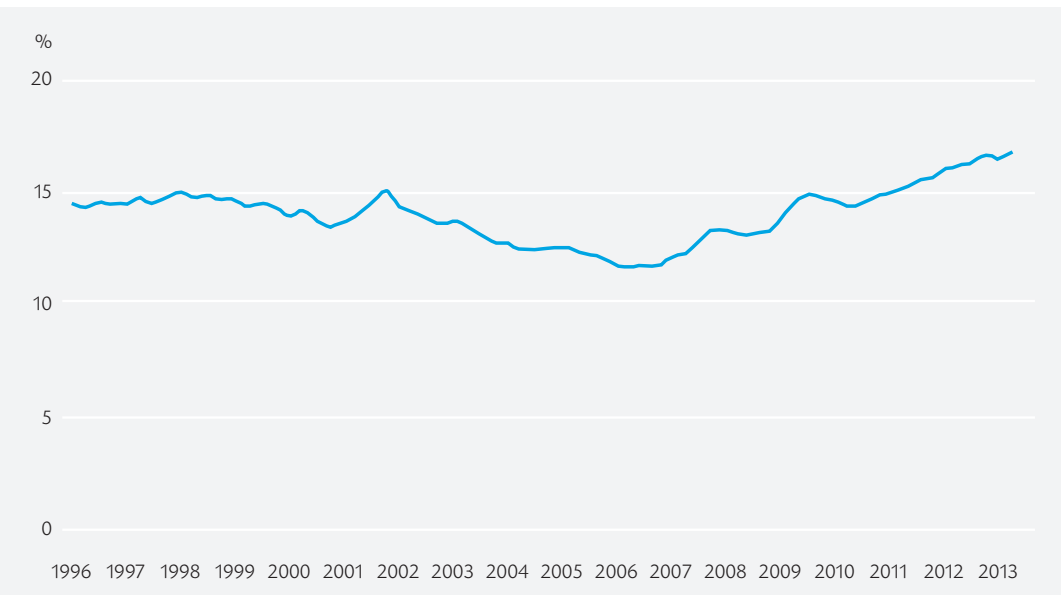
More recently, life insurer profitability has suffered a downturn following a severe deterioration in risk insurance claims experience. This has occurred for a variety of reasons but chief amongst them was that group insurance for large superannuation funds was oversold through inappropriate relaxation of underwriting practices and unsustainably low prices. There are also changes in legal practices and social attitudes to illness which are affecting industry claims experience and profitability.

In association with the deterioration of claims experience, life insurers have also been incurring a steady worsening in the rate of policy discontinuances for the past 10 years (referred to as 'lapses'). Figure C.4 shows that lapse rates for individual risk insurance have increased off an historic low reached in 2006 to levels now higher than at any point in the past 20 years. Possible reasons for this include external forces such as baby boomers nearing or entering retirement who are reappraising their financial needs, but may also include some 'churning' of business.

**Figure C.3: Life insurer net profits**



**Figure C.4: Individual risk insurance - annual lapse rates**



Source: Plan For Life, Life Insurance Statistics, June 2013.

**Table C.1: Capital adequacy of life insurers (as at 31 December 2013)**

	\$m
Capital base	11,774
Prescribed capital amount	6,295
Surplus over prescribed capital amount	5,479
<b>Capital coverage ratio</b>	<b>1.87</b>

The life insurance industry is well capitalised and retains capital buffers in excess of those preceding the global financial crisis. The introduction of new capital standards by APRA in 2013 has contributed significantly to the prudential strength of the industry, both in a quantitative and qualitative sense. For life insurers, the average capital coverage ratio – the ratio of the capital base to prescribed capital amount – at the end of 2013 is shown in Table C.1.

As at June 2013 the capital coverage ratio for friendly societies was 2.29 times the prescribed capital amount.

## Overview of the prudential framework

APRA and the Commonwealth Government have made a number of substantial changes to the prudential framework for life insurance.

In September 2007, the Life Insurance Act was simplified by the Government in response to the recommendations of the Taskforce on Reducing Regulatory Burdens on Business (Banks Report).<sup>2</sup> This involved removing certain provisions from the Act that were better placed in APRA's prudential standards. The intention was to align the Act with the legislative approaches applying in the ADI and general insurance industries, and to increase APRA's flexibility to adapt its prudential standards to developments in the life insurance industry. The legislation also transferred responsibility for actuarial standards from the Life Insurance Actuarial Standards Board, which was

disbanded, to APRA. APRA subsequently released a suite of new prudential standards, including actuarial standards, for life companies (including friendly societies), that came into effect from 1 January 2008.

Between 2009 and 2012, APRA conducted a review of the capital standards for life and general insurers to improve the risk-sensitivity and appropriateness of capital requirements, improve the alignment of the standards between industries where appropriate, and incorporate developments in international better practice. The review took into account lessons arising from the global financial crisis and from the series of natural disasters that occurred during the period of the review.

Annex B provides an overview of the regulatory capital framework for insurers. Certain features are, however, unique to life insurance:

- the prescribed capital amount calculation is carried out for each statutory or general fund (collectively 'funds'). Therefore each fund has a prescribed capital amount. The prescribed capital amount for a life company is the sum of the prescribed capital amounts of each of its funds; and
- each of a life insurer's funds must have eligible capital that, at all times, exceeds the Prudential Capital Requirement for that fund.

<sup>2</sup> Regulation Taskforce 2006, *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business* (Banks Report).

# ANNEX D / OVERVIEW OF THE SUPERANNUATION INDUSTRY

## Industry structure

Australia's superannuation system has grown strongly over the period 1997 to 2013. During that time total superannuation assets have increased fivefold from \$0.3 trillion (58 per cent of GDP) to \$1.6 trillion (106 per cent of GDP). This growth has been underpinned by strong investment earnings, notwithstanding the global financial crisis, and compulsory superannuation guarantee contributions.

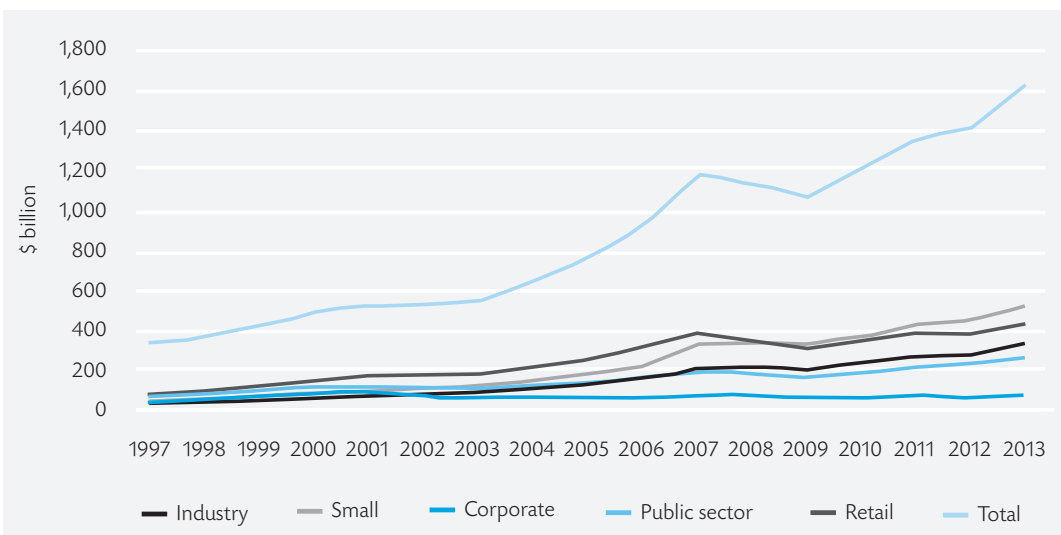
Rapid growth has been accompanied by significant changes in the composition of the industry (Figure D.1).

Corporate funds are superannuation funds for employees of a particular entity or a group of related entities, with joint member and employer control. Industry funds are superannuation funds for employees of employers, historically with members generally in the same industry, with joint member and employer control. Public sector funds are superannuation funds (or 'schemes') that provide benefits for Government employees, or a scheme or fund established by a Commonwealth, State or Territory law. Retail funds are superannuation funds

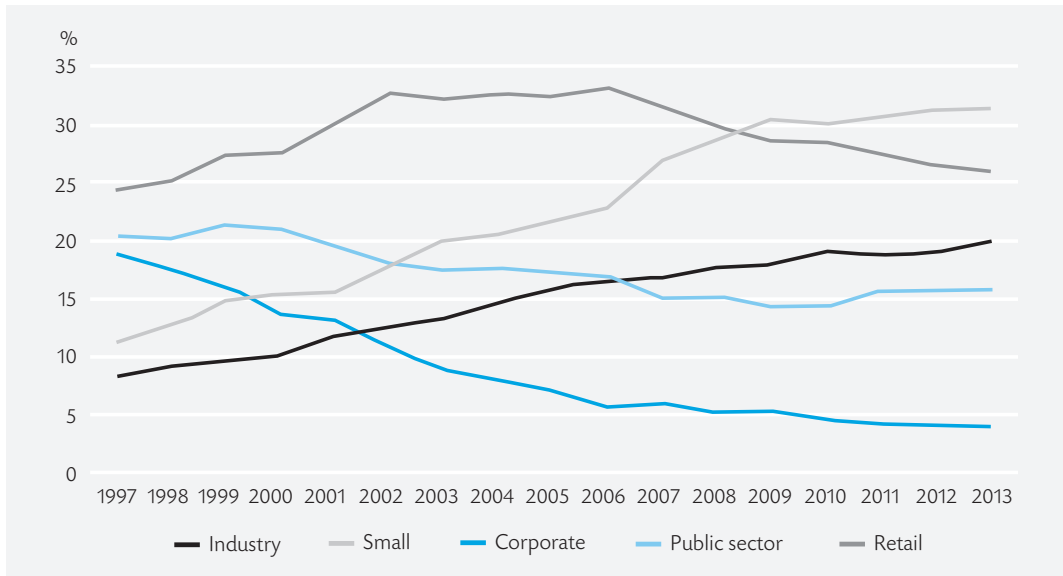
that offer superannuation products to the public on a commercial basis. They generally have an independent trustee and are sponsored by financial institutions or employment benefit consulting firms. Master trusts (umbrella trusts or funds which use a single trustee and a single common trust deed to operate the superannuation arrangements for unconnected individuals and/or companies) are classified as retail funds. Small funds include self-managed superannuation funds (SMSFs) that have fewer than five members where all members are trustees, and small APRA funds that have fewer than five members and with an independent licensed trustee. Small funds also include single-member ADFs. APRA regulates all of these types of superannuation funds with the exception of SMSFs, which are regulated by the ATO, and certain public sector funds.

Small funds held the largest proportion of superannuation assets, increasing from 11 per cent in 1997 to 31 per cent as at June 2013 (Figure D.2). The share of assets held by industry funds also increased over this period to 20 per cent, unlike public sector and corporate funds whose share decreased materially over this period.

**Figure D.1: Total superannuation assets by fund type**



## D.2: Proportion of superannuation assets by fund type



**Table D.1: Number of superannuation entities**

Entity type	1997	2005	2013
Corporate	4,106	962	108
Industry	176	90	52
Public sector	77	43	38
Retail	353	228	127
Entities with more than four members	4,712	1,323	325
Small	149,971	296,813	512,375
<b>Total superannuation entities</b>	<b>154,683</b>	<b>298,136</b>	<b>512,700</b>

There was a dramatic fall in the number of superannuation funds with more than four members over the period 1997 to 2013, as shown in Table D.1, from approximately 4,700 to 325. These entities operate under the trusteeship of 190 licensed trustees. By contrast, the number of small funds (including SMSFs, small APRA funds and single-member ADFs) grew strongly over the period, more than tripling in number from around 150,000 funds to more than 500,000 funds. The vast majority of assets and members in small funds are in the SMSF sector.

Consolidation and the steady influx of contributions into the system saw the average size of APRA-regulated superannuation funds (excluding eligible rollover funds, ADFs and small APRA funds) increase from about \$50 million in 1997 to over \$3.4 billion at end-June 2013. A typical public sector, retail or industry fund currently manages multi-billion dollar asset portfolios.

The industry continues to have low levels of concentration, with none of the 161 public offer superannuation funds holding a dominant market share. The largest 20 superannuation funds measured by assets comprised ten retail, six industry, three public sector and one corporate fund. Combined, these funds accounted for 58 per cent of total assets and 55 per cent of total membership of funds with more than four members.

The number of superannuation accounts has almost doubled from 17 million in 1997 to 31 million at June 2013. The average account balance across the entire industry has grown strongly from about \$15,000 to \$51,000 over that period.

The fact that the number of accounts exceeds the working population of Australia suggests that many Australians may have multiple accounts or 'lost and unclaimed' superannuation accounts. Anecdotal evidence points to changing employment patterns,

including increased casual and part-time employment, and an overall poor state of industry data as contributing to this problem. However, the number of accounts has begun to reduce in response to recent Government policy initiatives such as Stronger Super proposals making account consolidation easier, and reforms increasing the threshold for lost and inactive superannuation accounts to be transferred to the ATO.

## Performance

The superannuation industry experienced significant asset growth over the period 1997 to 2013. This growth has come from two sources: steady contributions and compounded investment earnings (Figure D.3).

Total contributions almost quadrupled from \$29 billion in 1997 to \$115 billion for the year to June 2013 (Figure D.4).

During the 1990s, increases in the superannuation guarantee rate had a positive effect on overall contributions, in particular when combined with strong growth in overall incomes.<sup>1</sup> Further planned increases in the superannuation guarantee rate from 9 per cent to 12 per cent over seven years to 2017 are expected to see growth in contributions accelerate.<sup>2</sup> Discretionary member contributions have also grown strongly over the period, boosted significantly in 2007 due to a one-off \$1 million concessional contribution limit that applied for that year only. However, the ratio of employer to member contributions varied significantly over this period, which reflected the impacts of various Government policy initiatives and a changing economic environment.

- 1 The superannuation guarantee requires employers to contribute compulsory superannuation contributions into a complying superannuation fund for their eligible employees at a legislated rate, known as the superannuation guarantee rate. The guarantee was introduced in 1992 and commenced at 3 per cent of salary, rising progressively to 9 per cent of salary by 2002. The superannuation guarantee rate currently stands at 9.25 per cent of salary.
- 2 The Government has signalled its intention to defer these increases by two years.

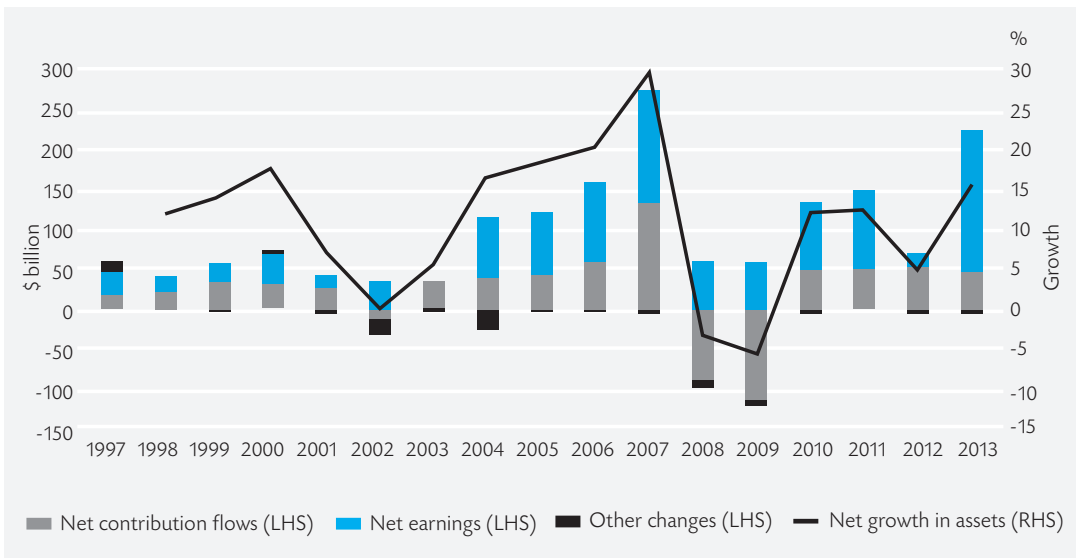
Total benefit payments also grew strongly over the period as the number of retirement-age and pension members increased. Total benefit payments quadrupled to \$75 billion in 2013 (Figure D.5). In addition, the proportion of benefits paid as pensions increased from about 20 per cent in 1997 to 50 per cent in 2013, while the proportion of benefits paid as a lump sum decreased from around 80 per cent in 1997 to 50 per cent in 2013. This reflects both changes in Government policy settings and the increased awareness by superannuation members reaching retirement age about alternative retirement payment options.

The ratio of benefit payments to contributions fluctuated over the period, with a steady rise in recent years signalling the growing maturity of the superannuation system.

Net contribution inflows almost tripled between June 1997 and June 2013 from \$16.8 billion to \$46.8 billion, underpinning strong growth in the industry's assets (Figure D.6).

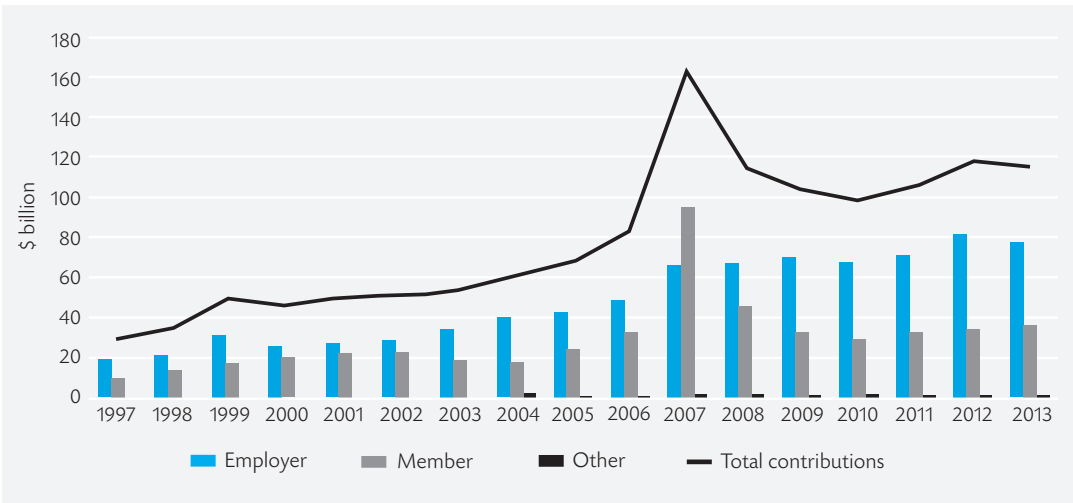
Investment earnings also contributed to the industry's growth over the period, although as expected the contribution varied in magnitude and direction over the period. The industry-wide rate of return was significantly negative during the global financial crisis, but has recovered since then. Over the period from 1999 to 2013, the industry-wide average annual rate of return for entities with more than four members was close to five per cent (Figure D.7).

**Figure D.3: Superannuation industry asset growth**



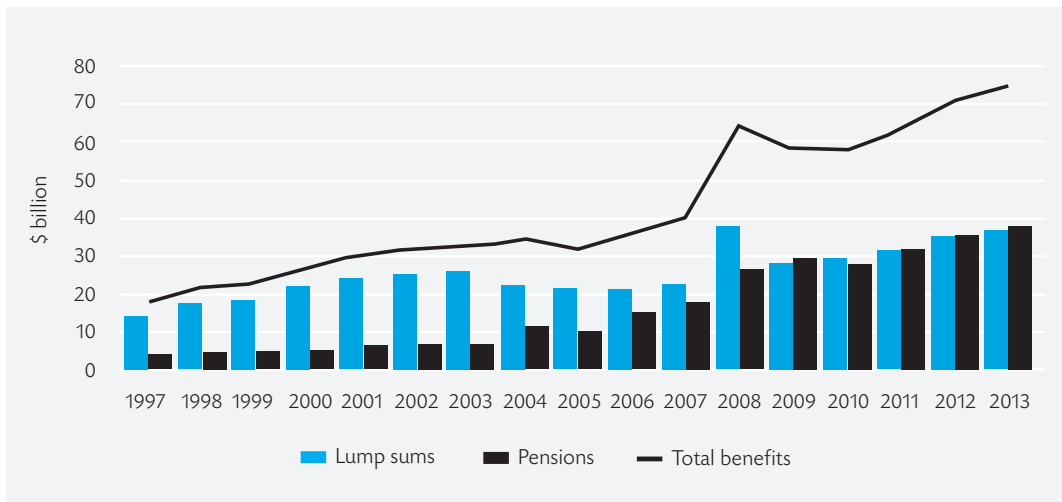


**Figure D.4: Total superannuation contributions**

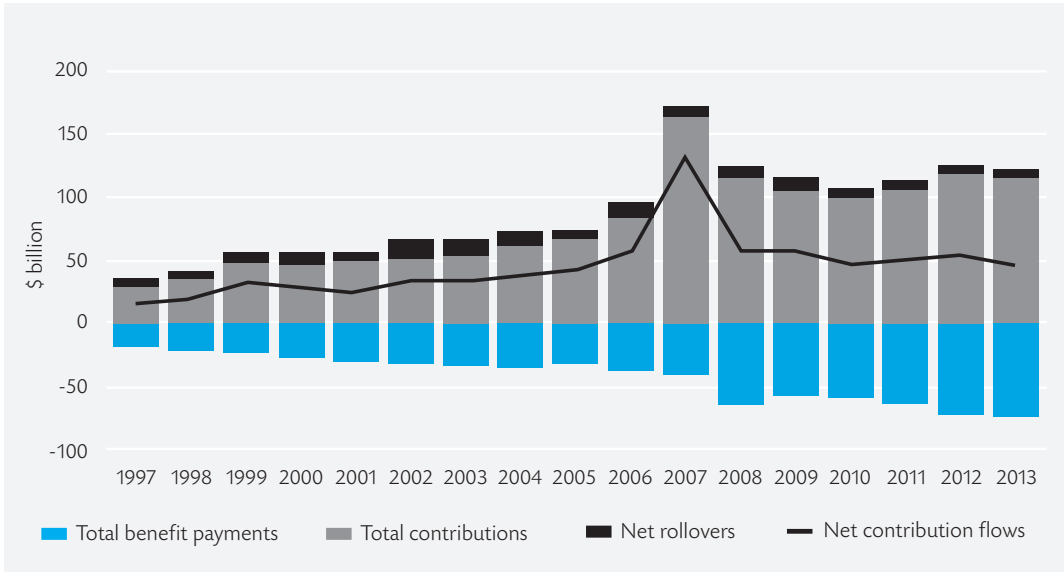


Note: 'Other' refers to contributions other than employer or member contributions and includes spouse contributions and government co-contributions.

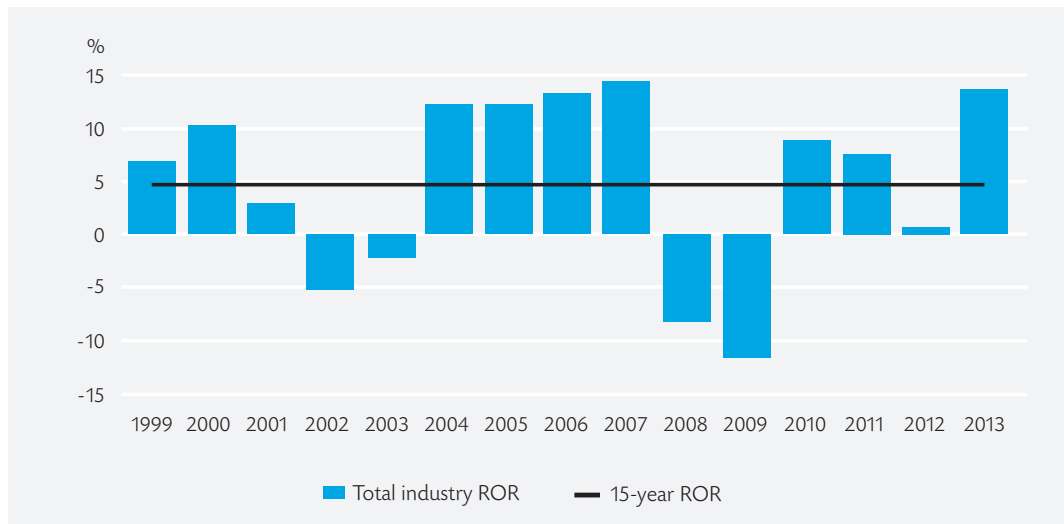
**Figure D.5: Total superannuation benefit payments**



**Figure D.6: Net contribution flows**



**Figure D.7: Superannuation industry-wide rate of return (ROR)**



Note: Reflects only entities with more than four members.

## Overview of the prudential framework

The prudential framework for superannuation has been the subject of significant enhancements over the past decade. On 1 July 2004, the Government's superannuation safety reforms came into effect through amendments to the SIS Act. For the first time, a licensing regime was introduced whereby trustees of all APRA-regulated superannuation entities were required to obtain a licence and to register all entities under their trusteeship. Trustees had to meet specific licence requirements covering matters such as governance and risk management, as well as operating standards on fitness and propriety, adequacy of resources and outsourcing.

The Government's Stronger Super reforms, enacted in September 2012, brought about fundamental changes in the way APRA regulates the superannuation industry, granting APRA for the first time the power to make prudential standards in superannuation. This was a major step in the harmonisation of the prudential framework and brought the superannuation industry onto the same regulatory footing as the ADI and insurance industries. APRA has subsequently issued prudential standards relating to, amongst other things, risk management and governance, fitness and propriety requirements for persons holding positions of responsibility, outsourcing, business continuity, audit and conflicts of interest. These are intended to encourage improvements in RSE licensee governance frameworks and the effectiveness of RSE licensees' decision-making for the benefit of superannuation members. SuperStream, another key component of the Stronger Super reforms, is designed to improve efficiency across the superannuation system by encouraging automated processing and reducing system reliance on manual intervention.

The third substantive change to the prudential framework over the last decade was the provisions included in the SIS Act in November 2012 that required APRA to authorise trustees to offer MySuper products. From 1 January 2014, amounts received by a trustee in respect of a member who has not provided written instruction as to their investment in an option other than the default option available to the member must be placed in a MySuper product. RSE licensees wishing to offer a MySuper product are required to satisfy an enhanced set of requirements, in terms of RSE licensee governance and specified product design features, to reflect the nature of this product and its membership.

Unlike the other APRA-regulated industries, there are no minimum regulatory capital requirements set by APRA for superannuation trustees or funds. However, an RSE licensee must determine a target amount of financial resources to address the operational risks of the RSE licensee's business operations.