SUPERVISORY OVERSIGHT AND RESPONSE SYSTEM

April 2017

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Chapter 1 - Introduction

In October 2002, APRA introduced risk assessment and supervisory response tools known as the Probability and Impact Rating System (PAIRS) and the Supervisory Oversight and Response System (SOARS).

These supervisory tools are the centrepiece of APRA's risk-based approach to supervision and assist APRA in:

- making better risk judgements;
- quickly and consistently taking supervisory action where necessary;
- strengthening the ability of supervisors to take effective action; and
- improving oversight and reporting on problem entities.

SOARS is used to determine how supervisory concerns based on PAIRS risk assessments should be acted upon. It is intended to ensure that supervisory interventions are targeted and timely. All APRA-regulated entities that are subject to PAIRS assessment are assigned a SOARS stance.

The SOARS stance of an entity will affect APRA's level of response, in order for it to meet its objective of identifying potential threats to beneficiary interests in a timely fashion. Supervision responses can range from a normal cycle of review, to a heightened supervisory stance, to active preparation for non-viability.

An explanation of SOARS is the subject of this document.

Chapter 2 - SOARS stances

Consistency is a vital element in supervisory professionalism. APRA needs to treat like entities similarly and, in particular, to match supervisory intensity consistently to the probability and impact of failure signals coming out of PAIRS. SOARS is APRA's main tool to achieve consistent application of supervisory intervention.

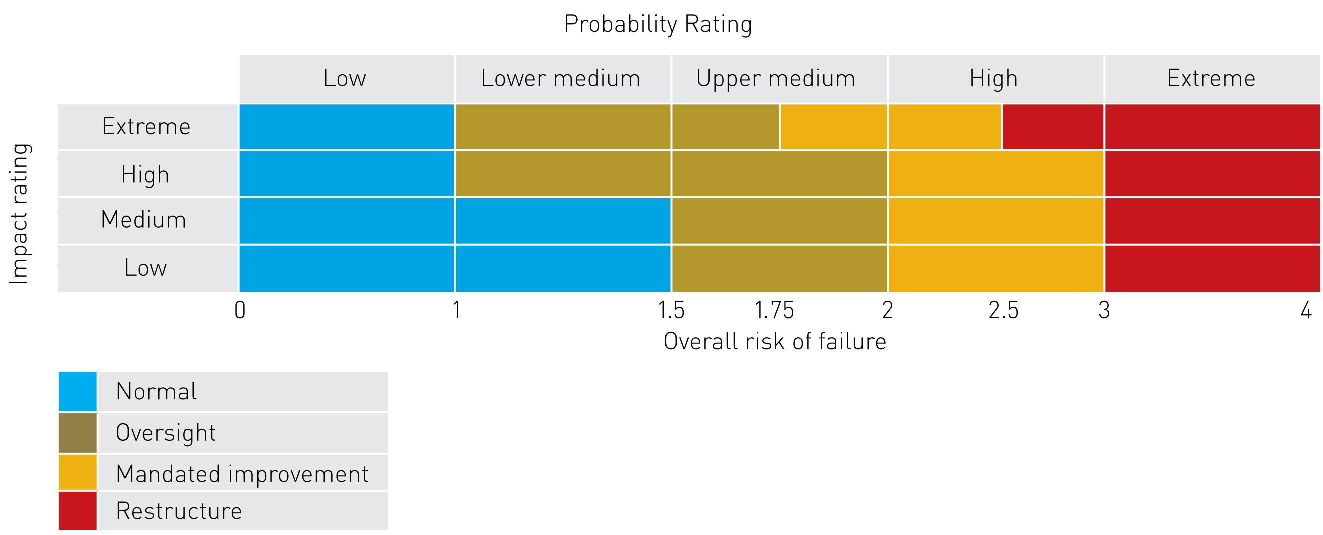
SOARS comprises four supervision stances:

- Normal
- Oversight
- Mandated Improvement
- Restructure

The supervision stance of a regulated entity is derived from the combination of the PAIRS probability rating and impact rating, as illustrated in Figure 1 below.

The risk profile and typical supervision activities for regulated entities in each supervision stance are described below.

Figure 1: Supervision stance



Chapter 3 - Normal

3.1 Risk profile

Entities categorised as Normal are expected to remain able to meet their obligations to beneficiaries under reasonably foreseeable circumstances. Such entities are assessed by APRA as having robust governance and control frameworks, responsible persons of sound calibre (individually and collectively) and a strong capital position.

Normal entities generally have the ability to absorb unexpected losses within existing resources, without any significant pressure on their financial health.

3.2 Typical supervision activities

Typical supervision activities for entities categorised as Normal include:

- prudential consultations and reviews;
- analysis of data and other information received on a monthly, quarterly and/or annual basis;
- contact with home regulators for foreign owned entities; and
- other risk based supervision activities as determined by the responsible supervision team.

These entities are expected to maintain up to date contingency plans, including a recovery plan proportionate to the nature, scale and complexity of its activities.

Chapter 4 - Oversight

4.1 Risk profile

Entities categorised as Oversight are expected to remain able to meet their obligations to beneficiaries over the short to medium term, but there are aspects of their risk position that may create vulnerabilities in extremely adverse circumstances and that require more extensive examination by APRA.

The area of concern may arise from a higher level of inherent risk - for example, aggressive business plans, or narrow product or geographic scope – or from an identifiable but non-fatal weakness or weaknesses in governance and/or management and controls that require remediation, or from a combination of both.

APRA's broad strategy with entities in oversight is close monitoring and communication. APRA wants to ensure that the responsible persons of these entities understand APRA's view and areas that require attention and put appropriate focus on remediation.

Where APRA identifies specific weaknesses in governance or management and control – it usually adopts a suasion approach to ensure there is improvement in these areas. However, responsible persons should have no doubt as to APRA's concerns and the consequences of ignoring them. Entities in Oversight usually take ownership of issues and agree on an action plan with APRA.

4.2 Typical supervision activities

For entities in Oversight, APRA lifts its supervisory intensity and closely monitors key risk areas. Supervisors need to consider the appropriate activities to be undertaken in each specific case. These might include options such as:

- more frequent and/or more targeted prudential reviews by supervision and risk/technical specialist teams;
- more frequent and more detailed collection and analysis of data and reports;
- targeted communication with auditors and actuaries;
- special investigations by external experts eg auditors, actuaries, etc;
- requests for revisions to business plans or governance arrangements;
- assessing the remediation plans put in place by the entity;
- direct interaction between APRA and the Board of the entity; and/or
- expressing views/ concerns to relevant overseas regulators where applicable.

Depending on the nature of the issues identified, APRA may also review the appropriateness of the entity's contingency plans, including its recovery plan, and its readiness to activate the plans if required.

Chapter 5- Mandated Improvement

5.1 Risk profile

For entities in Mandated Improvement, APRA's assessment is that operations are being conducted in a way that, or the circumstances of the entity, potentially puts beneficiaries and/or the financial system at risk, so improvements to the operations or the circumstances of the entity are needed.

Depending on the nature of the identified issues, Mandated Improvement entities may become non-viable in the medium term if issues of significant prudential concern are not adequately addressed

Entities will not be permanently classified as Mandated Improvement. A Mandated Improvement entity will either remediate identified issues and move to Oversight, move to Restructure or exit the industry via merger, wind-up or some other means.

Once an entity moves into Mandated Improvement, APRA supervisors must promptly communicate this to the entity, clearly identify the reasons for the move, and require the entity to commence remediation in the short term to stabilise and then address the identified issues.

5.2 Typical supervision activities

For entities in Mandated Improvement, APRA intervenes actively. Supervisors need to consider the appropriate activities to be undertaken in each specific case. These might include options such as:

- increased reporting requirements;
- requiring remediation plans and monitoring milestones;
- requiring revised business plans;
- requiring governance changes;
- increasing capital/ liquidity requirements, limiting capital distribution, limiting balance sheet growth;
- restrict dealings with related party service providers;
- issuing directions;
- accepting enforceable undertakings;
- engaging external resources (specialist investigator, actuary etc) to report to APRA;
- formal notification of concerns to overseas regulators where applicable;
- require changes in responsible persons;

- restrictions to business activities; and/or
- discussions about medium term viability and exit strategy with the Board of the entity.

APRA requires Mandated Improvement entities to present and execute a remediation plan that addresses the issues identified within an agreed timeframe. APRA will require that the entity be clear on the steps it will take in the remediation plan.

Depending on the nature of the areas specified for improvement, remediation activities undertaken by the entity are likely to include actions identified in its recovery plan. Where there are viability issues, APRA expects that the recovery plan will be activated. Upon activation, APRA will monitor the implementation of the recovery plan, including, where appropriate, encouraging an escalation of recovery actions.

APRA usually allows the responsible persons of entities in Mandated Improvement to retain control, but clearly signals that changes must occur. Either the entity will rapidly produce and execute a remediation plan or APRA will commence firm enforcement action.

APRA puts pressure on Mandated Improvement entities to ensure that remediation occurs as agreed. APRA steps up its planning in the event the remediation plan is not successful. This will include APRA examining potential resolution strategies and, if relevant, the entity's readiness for implementation of the Financial Claims Scheme (FCS).

Effective supervision and remediation of a Mandated Improvement entity is where APRA is likely to make the most difference to its ability to meet its obligations to beneficiaries.

Chapter 6 - Restructure

6.1 Risk profile

Entities are categorised as Restructure when non-viability is assessed as imminent, and/or the entity poses an unacceptable risk to the financial system or to beneficiary interests. Such entities have not displayed a willingness and/or ability to rectify serious weaknesses, or to exit voluntarily in an orderly fashion.

Where it deems necessary, APRA will look to resolve the entity.

6.2 Typical supervision activities

Generally, entities in Restructure need new capital, management, operations or ownership, or possibly all four.

Typical activities involve the use of APRA's formal powers to:

- withdraw licences;
- replace persons and/or service providers;
- appoint acting management or trustee;
- merge entities;
- run-off existing business;
- quarantine assets;
- appoint a statutory or judicial manager or provisional liquidator;
- issue directions or sanctions; or
- place the company into receivership/ liquidation.

Entities in Restructure have not displayed a willingness or ability to address concerns expressed by APRA in a timely manner. APRA will initiate resolution strategies as appropriate, which may be informed by actions detailed in recovery plans.

APRA's paramount concern for entities in Restructure is to minimise the risk of losses to beneficiaries. If the nature of the issues is such that failure of the entity is unavoidable APRA aims for an orderly exit, and to minimise the extent of losses and damage to the financial system.

Chapter 7 - Supervisory action plan

SOARS involves the development of a supervisory action plan which vary according to an entity's supervision stance.

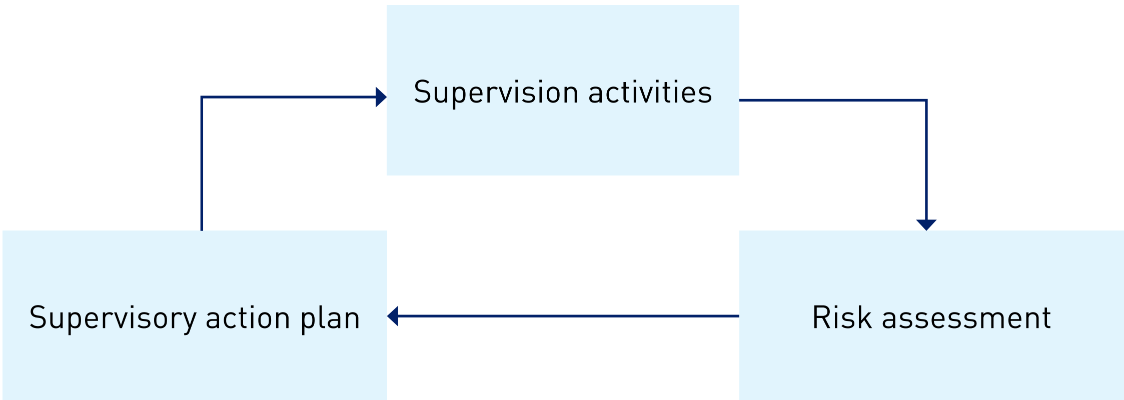
7.1 Objective

The objective of a supervisory action plan is to map out the supervision activities to be performed over the forthcoming supervision period, based on the PAIRS risk assessment process and the resulting supervision stance.

7.2 Process

Setting a supervisory action plan is an integral component of supervision, as depicted in Figure 2 below.

Figure 2: Supervision process



This figure shows the supervision process. This process are of 3 components: Supervison activities; Risk assessment and Supervisory action plan.

Supervisors are responsible for preparing supervisory action plans. Supervision activities included in the supervisory action plan are usually coordinated and/ or undertaken by the responsible supervision team.

As an entity moves up the SOARS stances, the level of routine supervision activities will likely decrease and the use of APRA's more specialised intervention and enforcement powers will come into effect.

7.3 Frequency

Supervisory action plans are revisited after the PAIRS risk assessment has been updated. This is to ensure that the activities and responses included in the supervisory action plan reflect the risks identified as part of the risk assessment process, even if the plan itself does not change.

7.4 Disclosure

APRA does not publish a regulated entity's SOARS supervision stance or supervisory action plan. However, APRA does inform each entity of its supervision stance and the broad activities to be performed over the forthcoming period, in the interests of open and direct engagement and for planning purposes.

Using its statutory confidentiality powers, APRA does not allow entities to disclose their PAIRS ratings or SOARS stance. However, entities need to have regard to any continuous disclosure obligations and may need to disclose matters relating to supervisory intervention, particularly more intrusive interventions such as being placed in run-off or having a licence suspended or withdrawn.