AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY
1 Martin Place (Level 12), Sydney, NSW 2000
GPO Box 9836, Sydney, NSW 2001

T 02 9210 3000 | W www.apra.gov.au

WAYNE BYRES
Chair

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Committee Secretary
Joint Standing Committee on Trade and Investment Growth
PO Box 6021
Parliament House
Canberra ACT 2600

Dear Secretary

APRA welcomes the opportunity to assist the Joint Standing Committee on Trade and Investment Growth's *Inquiry into the prudential regulation of investment in Australia's export industries*. This submission provides background information on the prudential framework applying to the institutions APRA regulates.

APRA is an independent statutory authority established under the *Australian Prudential Regulation Act 1998* (the APRA Act). It is responsible for prudential supervision of particular individual financial institutions and for promoting financial system stability in Australia. In carrying out its functions and powers, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, is to promote financial system stability in Australia.

In 2019, APRA published a paper which explained in more detail how APRA goes about balancing these objectives. A copy of that paper is attached to this submission.

The prudential framework

Prudential regulation is a form of regulation that requires financial institutions to manage risks to reduce the possibility of failure and, in particular, the possibility that they may fail to meet their financial promises to certain classes of liability-holders. The financial institutions that APRA supervises are authorised deposit-taking institutions (ADIs, such as banks and credit unions), general insurers, life insurers and friendly societies, private health insurers, and most of superannuation industry.

Working under a number of industry-based Acts,[1] APRA's objective is that, under all reasonable circumstances:

- a bank that accepts deposits from members of the public has the ability to at all times repay the deposits, on demand or in the future, along with the contracted rate of interest;
- an insurance company that accepts premiums has the ability to pay claims by policyholders when an insured event occurs

[1] These are the *Banking Act 1959, Insurance Act 1973, Life Insurance Act 1995, Private Health Insurance (Prudential Supervision) Act 2015* and *the Superannuation Industry (Supervision) Act 1993*.

- a superannuation fund trustee that receives contributions from members manages those to generate retirement income in members' best interest; and

- that the Australian financial system more broadly remains stable and resilient.

Risks to these outcomes may be financial (e.g. risks of poor lending decisions or investment returns), operational (e.g. a failure of a computer system) or behavioural (e.g. risks relating to poor governance, culture and remuneration). Prudential regulation requires institutions to have the appropriate governance, risk management, internal controls and financial strength to mitigate these risks. Institutions' compliance with these requirements is overseen through supervisory oversight and, where necessary, formal enforcement action.

For the most part, prudential regulations applying to Australian financial institutions are set out in prudential standards that APRA determines. These standards are disallowable instruments issued under legislation applying to each of the industry-based Acts. These legally enforceable standards are supplemented by (non-binding) prudential practice guides that explain APRA's expectations and set out examples of good practice.

The full suite of APRA's prudential standards and guidance are available on APRA's website:

- Banking - Prudential and Reporting Standards for Authorised deposit-taking institutions

- General insurance - Prudential and Reporting Standards for General insurance

- Life insurance and friendly societies - Prudential and Reporting Standards for Life insurance and friendly societies

- Private health insurance - Prudential and Reporting Standards for Private health insurance

- Superannuation - Prudential and Reporting Standards for Superannuation

APRA seeks to avoid overly prescriptive regulation, and APRA's standards adopt a principles-based approach wherever possible. Given the diversity of institutions that APRA oversees, APRA considers this is more cost-effective, enables the application of regulation to be better tailored to individual circumstances, and reduces barriers to innovation. It is also aligned with the Government's Statement of Expectations for APRA.[2]

Given this approach, APRA's standards generally do not prescribe a financial institution's business model, products or business lines. Prudential standards rarely make reference to specific industries or geographies. Rather, APRA adopts a general philosophy that financial institutions should be free to design their own structure, products and services, provided they have the commensurate governance, risk management, internal controls and financial strength to mitigate the risks involved.

For example, *Prudential Standard CPS 220 Risk Management* (CPS 220)[3] requires an APRA-regulated entity to have a risk management framework that identifies and manages all internal and external sources of material risk that could have a financial and/or non-financial impact on the institution, or on the interests of depositors and/or policyholders. However, how

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[2] Available from APRA's website: Statement of expectations 2018 | APRA

[3] CPS 220 applies to ADIs, general insurers, life insurers and private health insurers; a similar *Prudential Standard SPS 220 Risk Management* (SPS 220) applies to APRA-regulated superannuation funds.

an institution meets this requirement is ultimately a matter for the institution's Board of Directors.

Similarly, *Prudential Standard APS220 Credit Quality* requires an ADI to have a robust framework for the assessment, monitoring, and accurate and complete measurement of the credit risk arising from its lending activities. The standard does not, however, seek to prescribe the pricing or terms on which lending decisions are taken. These are, appropriately, commercial decisions for financial institutions to take.

Nevertheless, in addressing risks and imposing commensurate requirements, the prudential framework will have influence on an institution's business decisions. For example:

- ADIs and insurers are required to hold capital commensurate with the risk of particular exposures, such as the risk that a loan will not be repaid or an investment will decline in value. In the case of credit exposures, for example, an exposure to a business with a poor credit rating has more risk than a loan to the Australian Government. APRA therefore requires the regulated entity to hold more capital for the former than the latter. The amount of capital together with the institution's own risk appetite will affect the type of investments (such as to whom and on what terms) an institution wishes to make.

- While a superannuation fund trustee is not subject to capital requirements, it is required to implement a sound investment governance framework for the selection, management and monitoring of investments that ensures they are in the best interests of its members and consistent with the purpose of proving retirement income.[4,5]

Each year APRA sets out its policy and supervisory priorities. Copies of the latest publications are attached to this letter. In summary, APRA's current priorities are aimed at ensuring financial system resilience and recovery from COVID-19, improving outcomes for superannuation members, improving cyber-resilience in the financial sector, and transforming governance, culture, remuneration and accountability (GCRA) across all APRA-regulated institutions. Consistent with the general approach outlined above, these programs of work do not specifically address issues associated with particular industries (including export industries), but rather focus on ensuring overall financial system resilience.

One issue that may be of particular interest to the Committee is APRA's work on the financial risks of climate change. Since the Australian Government became party to the Paris Agreement in 2016, APRA has been ensuring financial institutions are aware of, and alert to, the risks arising from a changing climate, and the responses to it. Against that backdrop, APRA has recently released for consultation some proposed guidance to banks, insurers and superannuation trustees on managing the financial risks of climate change. The draft *Prudential Practice Guide CPG 229 Climate Change Financial Risks* (CPG 229) (a copy of which is attached to this letter) is designed to assist APRA-regulated institutions in managing climate-related risks and opportunities as part of their existing risk management and governance frameworks.

APRA developed CPG 229 in response to requests from industry for greater clarity of regulatory expectations in relation to how climate-related risks should be considered within existing risk management requirements (such as those outlined above in Prudential Standard CPS220), and examples of better industry practice. The guidance covers APRA's view of

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[4] *Prudential Standard 530 Investment Governance* (SPS 530).

[5] APRA will be undertaking consultation in the coming months on an updated standard, and associated guidance, in relation to Investment Governance.

sound practice in areas such as governance, risk management, scenario analysis and disclosure. The draft practice guide does not create new requirements or obligations on financial institutions, and is designed to be flexible in allowing each institution to adopt an approach that is appropriate for its size, customer base and business strategy.

CPG 229 is aligned with the recommendations from the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD), and was developed in consultation with both domestic and international peer regulators. APRA is seeking stakeholder feedback on the draft CPG 229 by 31 July 2021.

I trust the above is of use to the Committee in its inquiries, and APRA stands ready to assist the Committee with its work as needed.

Yours sincerely,

Wayne Byres