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

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Ms Carolyn Wilkins
Professor Renée Fry-McKibbin
Dr Gordon de Brouwer PSM

Dear RBA Review Panel,

APRA welcomes the opportunity to assist the Panel in the Review of the Reserve Bank of Australia. This submission seeks to provide additional context to the Review, by explaining APRA's role in promoting financial stability and APRA's framework for macroprudential policy. It is intended to provide factual material to assist the Panel in its deliberations.

Executive Summary

The Terms of Reference for the Review includes the interaction of monetary policy with fiscal and macroprudential policy. APRA understands that the Panel is exploring ways that these policies can better complement each other, while not amending APRA's existing statutory role and functions.

To assist the Panel in reviewing the interactions between macroprudential policy and monetary policy, APRA's submission sets out:

- **APRA's mandate**: under the APRA Act, APRA's objectives are to maintain the financial safety of institutions and to promote the stability of the Australian financial system. Macroprudential policy forms part of APRA's toolkit for pursuing these objectives. It can mitigate risks to financial system stability through its direct impact on financial institutions' risk taking and their financial resilience.

- **Coordination arrangements**: clear accountabilities among agencies is essential to effective and efficient regulatory outcomes. In Australia, APRA is accountable for the determination and implementation of macroprudential policy decisions, while the Council of Financial Regulators (CFR) plays an important role in identifying risks and coordinating policy responses among regulatory agencies. APRA views consultation with the CFR as a prerequisite for initiating macroprudential policy.

- **Summary of prior actions**: since 2015, APRA has implemented a range of measures to mitigate risks to financial stability from banks' housing lending, including through macroprudential policy. These measures have sought to address systemic weaknesses in serviceability assessments and have moderated growth in higher-risk lending.

- **Recent changes**: in recent years, APRA has taken steps to reinforce the effectiveness of its macroprudential policy toolkit. APRA's aim has been to strengthen the transparency, implementation and enforceability of future macroprudential policy responses.

Annex A explains these areas in more detail, providing context relevant to the Review's Terms of Reference.

Yours sincerely,

John Lonsdale
Chair

ANNEX A: Macroprudential policy

APRA's mandate

APRA is an independent statutory authority established for the purposes of prudential supervision of financial institutions and promoting financial system stability in Australia. APRA's mandate, set out in the *Australian Prudential Regulation Authority Act 1998* (APRA Act), is to protect the Australian community by establishing and enforcing prudential standards and practices.

The aim of prudential regulation is to ensure that, under all reasonable circumstances, financial promises made by the institutions APRA supervises are met within a stable, efficient and competitive financial system. Importantly, APRA is required to balance these considerations in a manner that promotes financial system stability in Australia.

Financial regulatory context

Australia's current financial regulatory framework, and APRA's mandate, has its origins in the 1997 Wallis Inquiry into the financial system.[1] This Inquiry proposed several changes to increase the efficiency and effectiveness of financial regulation, underpinned by clear accountabilities and independence among individual regulatory agencies. The Wallis Inquiry laid the foundations for:

- the establishment of Australian Securities and Investments Commission (ASIC), responsible for market-conduct and consumer-protection for financial services;
- the establishment of APRA, responsible for the prudential supervision of financial institutions and for promoting the stability of the Australian financial system; and
- changes to the responsibilities of the Reserve Bank of Australia (RBA), removing its function as prudential regulator of banks, leaving it accountable for monetary policy and the payments system.

As the only regulator with an explicit direction to promote financial stability, coupled with the fact that prudential tools are within APRA's discretion to deploy, the Wallis Inquiry ensured that APRA would have clear accountability for the determination and implementation of macroprudential policy in Australia.

Macroprudential policy framework

In October 2021, APRA published its macroprudential policy framework.[2] APRA's aim was to provide the public with a greater understanding of APRA's approach to using macroprudential policy measures in promoting the stability of the Australian financial system. The framework explains the risk factors APRA uses to identify emerging risks to financial stability, the policy tools that APRA can choose from and APRA's approach to implementing macroprudential policy measures.

As noted in APRA's framework, the objective of macroprudential policy is to mitigate risks to financial stability at a system-wide level. Macroprudential policy measures can play an important role in reducing risks to financial stability, as they can build additional resilience in

[1] Commonwealth of Australia, *Financial System Inquiry Final Report* (Wallis Inquiry) (March 1997) https://treasury.gov.au/publication/p1996-fsi-fr

[2] See APRA, *Macroprudential Policy Framework* (Information Paper, November 2021) https://www.apra.gov.au/sites/default/files/2021-11/Macroprudential%20Policy%20Framework.pdf

the financial system or reduce excessive risk taking during an upswing in the financial cycle. They can also provide flexibility for the financial sector in absorbing the impacts of a downturn. While some overseas jurisdictions have sought to use macroprudential policy for broader economic or social objectives, such as to dampen housing price growth, APRA's mandate for using macroprudential policy is to promote financial stability.

The scope of macroprudential policy is deliberately broad. It can be deployed through the APRA-regulated banking, insurance and superannuation sectors and, in certain cases, it can be extended to non-APRA regulated lenders.[3] Traditionally, macroprudential policy has been deployed through the banking sector; this is consistent with the critical role that leverage plays in the financial cycle. However, this need not always be the case. For example, during the COVID-19 pandemic in 2020, APRA set an expectation that banks and insurers would limit discretionary capital distributions so that they could maintain capacity to continue to lend and underwrite insurance in a period of heightened uncertainty.

Effective implementation of macroprudential policy requires clear accountabilities and ownership of the prudential toolkit. As noted in APRA's macroprudential policy framework, prudential tools such as capital requirements can be used for micro (financial safety of individual institutions) and macro-prudential purposes (resilience of the system as a whole); this requires strong coordination between prudential levers. Incomplete ownership or blurred accountability for the prudential toolkit would present significant challenges to APRA's effectiveness in achieving its dual objectives of financial safety and financial stability.

Coordination arrangements

Decisions on macroprudential policy are ultimately for APRA to determine, in line with its mandate and ownership of the prudential toolkit. However, the Council of Financial Regulators (CFR) plays a key role as a discussion and information-sharing forum for its members: APRA; ASIC; RBA; and Treasury. As set out in its Charter, the CFR seeks to:

'facilitate cooperation and collaboration between member agencies, with the ultimate objectives of promoting stability of the Australian financial system, and supporting effective and efficient regulation by Australia's financial regulatory agencies.'

While the key tools for macroprudential policy are for APRA to deploy, APRA views consultation with the CFR as an essential prerequisite for initiating any actions. As set out in APRA's macroprudential policy framework, the purpose of this consultation is to:

- ensure there is alignment on the assessment of the risk outlook and the need for action;
- challenge and review policy options; and
- ensure effective coordination of any other actions by other agencies.

As a non-statutory group, the CFR has no formal regulatory or policy decision-making powers: those powers reside with its members under their respective Acts. This is consistent with the original design of the CFR, recommended by the Wallis Inquiry. The Wallis Inquiry proposed establishing the CFR, chaired by the Governor of the RBA, to act as a coordinating forum, to discuss developments in the financial system and to coordinate responses to any areas of concerns. The CFR was to have no formal mandate or powers separate from those held by its members. This design was subsequently endorsed by the Financial System Inquiry in 2014.[4]

[3] Under Part IIB of the *Banking Act 1959*, APRA has powers that can be used to extend macroprudential policy to non-ADI lenders where their provision of finance is materially contributing to risks of instability in the Australian financial system (Subsection 38C(1), *Banking Act 1959*).

[4] Commonwealth of Australia, *Financial System Inquiry Final Report* (Murray Inquiry) (November 2014) https://treasury.gov.au/publication/c2014-fsi-final-report

The CFR is a key feature of the Australian regulatory system. It balances the need for agencies to remain independent and individually accountable for discharging their mandates, while facilitating cooperation and collaboration. With regards to macroprudential policy, the CFR provides a forum for assessing systemic risks, sharing analysis and market intelligence, and discussing the need for policy responses. Depending on the nature of the measures being proposed, APRA may also consult with other Government agencies, such as the Australian Competition and Consumer Commission (ACCC), to ensure the wider impacts of any proposed measures are well understood.

Prior policy actions

Unlike other prudential requirements, macroprudential policy is only implemented where there are heightened risks to financial stability. Risks to financial stability can come from a range of sources, and can generally be categorised according to the point in the financial cycle during which they emerge: either during an upswing in the cycle or a downturn.

Upswing scenario

An upswing in the financial cycle is generally associated with rising asset prices and credit growth, and can often coincide with expansionary monetary policy. These trends can have a positive impact on economic growth and employment, but can also create risks to financial stability if not managed prudently. For example, growth that is fuelled by higher risk appetites or looser lending standards can also create significant financial stability risks, as evidenced during the 2008 global financial crisis.

In upswings in the financial cycle, APRA's objective is to ensure that banks' lending practices are prudent and their balance sheets are sound. As reductions in interest rates drove the housing cycle upwards over the past 10 years, APRA's objective has been to ensure competitive exuberance did not undermine basic credit standards and create risks to financial stability. In 2015, 2017 and 2021 APRA introduced policy measures aimed at addressing systemic weaknesses in serviceability assessments and moderating growth in higher-risk lending.[5]

These measures reduced financial stability risks through their direct impact on banks' risk taking, and by strengthening the resilience of banks' balance sheets. Recent reviews by the RBA and APRA have noted that APRA's policy measures were effective in controlling the composition and quality of banks' lending, but may have had limited impact on overall credit growth.[6] It is challenging to assess the indirect impacts of macroprudential measures on, for example, housing prices; housing prices are influenced by many factors beyond bank capital requirements or lending standards, including monetary policy and fiscal policy.

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5 APRA, *Reinforcing Sound Residential Mortgage Lending Practices* (Letter to ADIs, December 2014) https://www.apra.gov.au/sites/default/files/141209-Letter-to-ADIs-reinforcing-sound-residential-mortgage-lending-practices.pdf; APRA, *APRA Announces Further Measures to Reinforce Sound Residential Mortgage Lending Practices* (Media Release, March 2017) https://www.apra.gov.au/news-and-publications/apra-announces-further-measures-to-reinforce-sound-residential-mortgage; and APRA, *Strengthening Residential Mortgage Lending Assessments* (Media Release, October 2021) https://www.apra.gov.au/strengthening-residential-mortgage-lending-assessments

6 APRA, *Review of APRA's Prudential Measures for Residential Mortgage Lending Risks* (Information Paper, January 2019) https://www.apra.gov.au/sites/default/files/review_of_apras_prudential_measures_for_residential_mortgage_lending_risks_-_january_2019.pdf; and RBA, *Financial Stability Review – 5. Assessing the Effects of Housing Lending Policy Measures* (October 2018) https://www.rba.gov.au/publications/fsr/2018/oct/assessing-effects-housing-lending-policy-measures.html

Downturn scenario

Just as APRA-regulated entities can amplify risks to financial stability during an upswing in the cycle, they can also exacerbate risks during a downturn. For example, when economic conditions are deteriorating, there can be a tendency for banks and insurers to conserve capital by constraining credit or limiting the underwriting of new business to preserve capacity to absorb expected losses. However, excessive risk aversion has the potential to worsen the impact of any initial stress and undermine financial stability.

In 2020, APRA implemented measures to provide banks and insurers with additional flexibility during a period of heightened financial stress. APRA announced temporary changes to expectations on bank capital benchmarks and bank and insurer capital distributions, in response to concerns over the impact of COVID-19 on economic activity and financial stability. These changes provided additional flexibility for entities to use their capital buffers to absorb losses, while continuing to lend and underwrite insurance to support the economy.

Recent steps to reinforce effectiveness

In addition to the publication of APRA's macroprudential policy framework, APRA has recently implemented several measures aimed at reinforcing the effectiveness of its macroprudential policy toolkit.[7] These measures have focused on:

- **pre-positioning**: through reforms to its credit risk standards, APRA now requires ADIs to be operationally ready to implement a broader set of macroprudential policy measures, if needed. This will support more timely policy responses to financial stability risks.

- **flexibility**: through reforms to the ADI capital framework, which will come into effect from 2023, APRA will enhance the effectiveness of the Countercyclical Capital Buffer (CCyB) as a macroprudential tool. In recalibrating the capital framework, APRA has set a 'base' level for the CCyB at 1.0 per cent of risk-weighted assets. This can be increased as risks are building and can also be reduced in an economic downturn, with the aim of supporting the banking sector in absorbing losses and supplying credit.

- **transparency**: in addition to setting out its decision-making framework, APRA plans to publish regular reviews of its macroprudential policy settings. From December this year, APRA will publish an annual update on macroprudential policy, providing greater transparency of APRA's risk considerations and impacts of prior actions.

These changes are in line with international better practice. They provide APRA with a strong and effective toolkit that can be used, where appropriate, to mitigate risks to financial stability.

[7] APRA, *APRA Finalises its Macroprudential Policy Framework* (Media Release, June 2022) https://www.apra.gov.au/news-and-publications/apra-finalises-its-macroprudential-policy-framework#:~:text=The%20Australian%20Prudential%20Regulation%20Authority,industry%20participants%20late%20last%20year.