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WAYNE BYRES
Chair

30 April 2021

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

[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

INFORMATION PAPER

APRA's objectives

11 November 2019

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Executive summary

The Australian Prudential Regulation Authority (APRA) is an independent statutory authority responsible for the prudential supervision of financial institutions and for promoting financial system stability in Australia.

APRA's prudential objectives are clear: the financial safety of institutions and the stability of the Australian financial system. In meeting these objectives, however, APRA has a number of supplementary considerations — efficiency, competition, contestability and competitive neutrality. These objectives are interlinked. Sometimes they can be mutually reinforcing; at other times, a balance between competing objectives needs to be found. APRA must also seek to maintain a sustainable balance over the longer run, focusing not on the circumstances of the day but the longer term financial health and sustainability of the Australian system.

In performing this role, APRA is responsible for protecting the interests of depositors, insurance policyholders and superannuation fund members—collectively referred to in this paper as beneficiaries. The financial interests of these beneficiaries lie at the centre of APRA's mission. APRA fulfils this purpose by promoting the financial safety of institutions through measures to address financial, operational and behavioural risks with a view to achieving sound outcomes for beneficiaries.

APRA's remit involves regulating financial entities in accordance with the prudential laws of the Commonwealth, setting prudential standards for those entities, monitoring compliance with those laws and standards through day-to-day supervision, and intervening early to resolve issues. APRA therefore seeks to be a forward-looking regulator that identifies prudential risks proactively and takes action to prevent harm *before* it occurs. When this cannot be achieved, APRA is also responsible for managing the orderly exit of those institutions that fail.

In doing so, APRA also seeks to promote financial system stability. This objective is critical to the Australian community's long-term financial well-being. Financial failures and shocks have broad and significant negative consequences, both for individuals and for the general economy. APRA therefore seeks to reduce both their likelihood and impact.

However, APRA is not tasked to pursue a 'safety at all costs' agenda. To seek to establish a zero failure regime would require severe limits on the risk-taking of financial institutions. That would prevent them from fulfilling vital and productive roles in the economy. APRA's statutory objectives therefore require it have regard to, and avoid unduly hindering, other desired objectives for the financial system: efficiency, competition, contestability and competitive neutrality. Balancing these additional objectives in undertaking its prudential role is important, as they support Australia's long-term growth and productivity.

Through various cycles of the financial system, the appropriate balance between financial safety and these other considerations can shift. Where there are a range of options available to APRA, some will deliver greater benefits than others to financial safety, financial system stability, efficiency, competition, contestability and competitive neutrality. APRA seeks to balance these over the longer term. This paper provides an overview of how APRA approaches this task.

Glossary

APRA	Australian Prudential Regulation Authority
APRA Act	*Australian Prudential Regulation Authority Act 1998*
ADI	Authorised deposit-taking institution
FSI	Financial System Inquiry, 2014
Industry Acts	*Banking Act 1959*, *Insurance Act 1973*, *Life Insurance Act 1995*, *Private Health Insurance (Prudential Supervision) Act 2015* and the *Superannuation Industry (Supervision) Act 1993.*
Prudential risks	Prudential risks are risks to the financial safety of an institution or that may affect outcomes for beneficiaries or the financial system. Prudential risks may be financial, operational or behavioural.
Royal Commission	Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry

Chapter 1 - APRA's objectives

Financial regulation in Australia

A stable and efficient financial system is crucial to the effective functioning of an economy. Without confidence and stability in the financial system, individuals and corporations would be less able and less willing to save, borrow, protect their assets and invest. Financial crises can deeply damage an economy and have a long-lasting, adverse impact on people's lives.

In Australia, the financial system is regulated by five main Government agencies:

- the Australian Prudential Regulation Authority (APRA), responsible for prudential supervision of particular individual financial institutions and for promoting financial system stability in Australia;
- the Australian Securities and Investments Commission (ASIC), responsible for financial market integrity, business conduct and disclosure, and consumer protection in the financial system;
- the Reserve Bank of Australia (RBA), responsible for monetary policy, systemic stability and payments system regulation;
- the Australian Competition and Consumer Commission (ACCC), responsible for competition policy; and
- the Australian Transaction Reports and Analysis Centre (AUSTRAC), which is Australia's financial intelligence unit and anti-money laundering and counter-terrorism financing regulator.

Each agency is subject to legislation that sets out their key objectives and powers.

This paper outlines APRA's approach to meeting its legislative objectives. In fulfilling its mandate, APRA works with each of these agencies where relevant to achieve strong outcomes for the broader community.

Prudential regulation

APRA's core role is the prudential regulation of banks, insurance companies and most of the superannuation industry.[1]

Prudential regulation is a form of regulation that requires financial institutions to control risks to reduce the possibility of failure and, in particular, the possibility that they may fail to

[1] It also acts as a central statistical agency for the Australian financial sector, plays a role in preserving the integrity of Australia's retirement incomes policy and administers the Financial Claims Scheme.

meet their promises to their beneficiaries. In particular, APRA seeks to ensure that, under all reasonable circumstances:

- a bank that accepts deposits from members of the public has the ability to repay them, on demand or in the future, at an agreed rate of interest;
- an insurance company that accepts premiums has the wherewithal to pay claims to policyholders when a specified event occurs; and
- a superannuation fund trustee that receives contributions manages them in members' best interests to generate retirement income.

Risks to these outcomes may be financial (e.g. risks of poor investment returns), operational (e.g. a failure of a computer system) or behavioural (e.g. risks relating to governance, culture and remuneration). Prudential regulation requires institutions to have the appropriate governance, risk management, internal controls and financial strength to mitigate these risks.

APRA carries out its role through three core functions:

- Policy – APRA's policy function is directed at protecting the Australian community by establishing minimum expectations for financial institutions and empowering APRA's supervisors to achieve desired outcomes.
- Supervision – APRA's supervision function is directed at protecting the Australian community by identifying and responding to significant risks to financial institutions and the financial system in a timely and effective manner.
- Resolution – APRA's resolution function is directed at protecting the Australian community from financial loss and disruption by planning for and implementing prompt and effective responses to a crisis in the financial system.

APRA's objectives

In performing its role, APRA's prudential objectives are clear: the financial safety of institutions and the stability of the Australian financial system with a view to achieve sound outcomes for beneficiaries and the Australian community. In meeting these objectives however, APRA has a number of supplementary considerations and parameters within which it must operate. These objectives are set out in APRA's governing legislation and are supplemented by the Government's published expectations on how APRA should meet them.

OUR ROLE FOR THE AUSTRALIAN COMMUNITY

PROMOTE FINANCIAL SYSTEM STABILITY

FINANCIAL SAFETY

BALANCED WITH EFFICIENCY, COMPETITION, CONTESTABILITY, AND COMPETITIVE NEUTRALITY

APRA's governing legislation

The main pieces of legislation that authorise APRA are its governing legislation, the *Australian Prudential Regulation Authority Act 1998* (APRA Act), and five primary industry Acts[2] that provide the legislative powers for APRA and broad parameters for how APRA must operate.

All emphasise APRA's role as seeking the financial safety of prudentially regulated institutions to protect beneficiaries' interests. The APRA Act also provides that, in carrying out this role, APRA must balance other desired objectives of efficiency, competition, contestability and competitive neutrality of the financial system. The APRA Act also says that, in balancing these considerations, APRA is to promote financial system stability in Australia.[3, 4] These objectives are referred to as APRA's mandate.

The explanatory memorandum for the original APRA Act noted the intention behind APRA's mandate:

> *'in carrying out its function of prudential regulation, [APRA] does not unduly hinder other desired objectives of promoting efficiency, competition, contestability and innovation in the financial system...This would be reflected, for example, in account being taken of risk management arrangements that regulated entities are currently using, or propose to use in future. This flexibility is considered to be of particular importance at a time when the financial system is, and will continue to be, subject to rapid change arising from such factors as globalisation and technological change.'*[5]

This statement provides important context on the original intentions as to how APRA was expected to balance its broader objectives under the APRA Act. It has led, for example, to APRA adopting a principles-based approach to its prudential framework, avoiding excessive prescription where possible to allow for the diversity of practice according to the size, business activity and sophistication of the institutions being supervised.

The various industry Acts from which APRA derives its specific powers for each industry focus more directly on APRA's role to protect and promote the interests of beneficiaries. These Acts set out powers for APRA to maintain a robust framework of prudential standards that establish minimum requirements and for a program of active

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

[3] See APRA Act, s8(2).

[4] The APRA Act (s8A) also obliges APRA to support the New Zealand authorities in meeting their statutory responsibilities relating to prudential regulation and financial system stability in New Zealand, and to the extent reasonable practicable, avoid any action that is likely to have a detrimental effect on financial system stability in New Zealand. A reciprocal obligation applies to the New Zealand authorities.

[5] Australian Prudential Regulation Authority Bill 1998, Explanatory Memorandum, clause 4.10.

supervision, which together are designed to minimise the risk of loss to beneficiaries and to promote financial stability.

Government expectations

The outcomes expected of APRA by Government in meeting its objectives are set out in periodic Ministerial Statements of Expectations and Treasury's annual Portfolio Budget Statements.[6] These can change over time according to priorities of the Government of the day but must always be framed with regard to, and cannot override, the statutory mandate given by Parliament under the APRA Act. Various Statements of Expectation have therefore consistently acknowledged:

- APRA cannot and should not seek to guarantee a zero failure rate for regulated institutions or provide absolute protection for market participants. Doing so would impose an unnecessary burden on institutions and the financial system and ultimately reduce the efficiency and growth of the Australian economy. Instead, the prudential regulation regime should operate to maintain a low incidence of failure while not unnecessarily hindering efficiency, competition, or otherwise impeding the competitive neutrality or contestability of the financial system;
- APRA should focus on preventative aspects to identify likely failure early enough so that corrective action can be promptly initiated or an orderly exit achieved to safeguard Australia's financial system;
- APRA should maintain its risk-based approach to supervision and its principles-based prudential framework which identifies desired outcomes and allows industry participants to achieve the outcomes in their own way, recognising the principles-based approach is more flexible and likely to accommodate change within the economy, allow for innovation and enterprise and reduce compliance costs by allowing regulated entities to determine the best way to meet regulatory objectives; and
- balancing APRA's objectives may not be straightforward and the appropriate balance requires a degree of judgment.

[6] There have been three Statements of Expectations, in 2007, 2014 and 2018. The latest version, and APRA's response (Statement of Intent), are available on APRA's website. Portfolio Budget Statements are available on Treasury's website.

Chapter 2 - Meeting APRA's objectives

APRA's objectives are interlinked. Sometimes they can be mutually reinforcing; at other times, a balance between competing objectives needs to be found. This chapter outlines APRA's approach to this responsibility.

A strong and stable financial system is a prerequisite to a healthy and vibrant economy. A strong financial system that is able to withstand economic cycles also offers efficiency benefits by ensuring critical financial functions can be relied upon to be available when needed, and at a reasonable cost. Such a system also ensures competition is sustainable through good times and bad. Similarly, a financial system that is efficient and competitive is likely to be able to generate valuable financial services that the community values in a profitable manner, reinforcing the strength and stability of the system as a whole and providing capacity for future growth.

At times, however, these objectives can conflict. The most common example is when excessive competitive and allocative inefficiency—for example, mispricing due to the aggressive pursuit of short-term profits without regard to risk—lead to periods of disruption or financial instability. APRA therefore needs to find an appropriate balance between its objectives.

Financial institution failures, or broader system instability, impose substantial costs on the community that are best avoided. Moreover, it is difficult for individual consumers and other market participants to make judgements about the creditworthiness of institutions, or the health of the system more broadly (the so-called information asymmetry problem). These factors provide the justification for regulatory intervention in the form of prudential regulation. But these costs of failures and information asymmetry must be balanced against the cost from regulatory intervention, and the prudential framework must be designed to ensure that the costs of intervention do not outweigh the benefits that safety and stability bring.

In undertaking its role, APRA has at its disposal a wide range of policy and supervisory tools, including enforcement and resolution tools. These will differ in their benefits to, or impact on, APRA's objectives and balancing considerations. APRA's task is to understand and weigh up these benefits and take account of any trade-offs when considering action (or inaction). In making these decisions, APRA must also seek to maintain a sustainable balance between the objectives over the longer run, focusing not on the circumstances of the day, but on the long-term financial health and sustainability of the Australian system.

Examples of the considerations APRA takes into account when making these decisions are included in Attachment A.

Financial safety

Core to APRA's financial safety objective is ensuring that institutions are soundly managed. APRA seeks to achieve this outcome by establishing and enforcing prudential standards that are designed to ensure the prudent governance, risk management and (where relevant) financial capacity of each regulated institution. This in turn ensures that depositors, policyholders and superannuation fund members can have confidence that there is a high probability their claims on APRA-regulated institutions will be able to be met.

Wherever possible, APRA seeks to avoid overly prescriptive regulation, and generally does not prescribe a financial institution's business model, products or business lines. 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. In this way, APRA seeks to allow competitive and efficient outcomes for consumers, while at the same time providing an appropriate level of assurance to beneficiaries that their interests are being protected.

It is impossible, however, to guarantee that an individual institution will not fail. That means an important function of APRA is its ability to resolve a failing institution in an orderly manner. Ensuring that failing institutions can be exited from the industry in an orderly fashion, with minimal (if any) loss to beneficiaries, is essential to maintaining confidence in the financial system as a whole, and minimising the risk of contagion from a failing institution to other (otherwise healthy) competitors.

The failure of HIH Insurance Limited*

The 2001 collapse of one of Australia's largest general insurers, HIH Insurance, demonstrates the high costs to the community of the failure of a regulated institution. The effect was immediate: ill or disabled policyholders claiming income protection stopped receiving payments, including those essential for day-to-day living. In Queensland alone, car accident victims insured with HIH were left waiting for operations and other medical procedures worth $190 million. Without insurance cover, the Australian Rugby Union cancelled games across the country until replacement cover could be found and injured players were left stranded without compensation.

As Australia's dominant professional indemnity insurer, HIH's collapse had a major effect on professional service providers. Services were suspended by many of Australia's 150 community legal centres after their professional indemnity insurance was put under a cloud. Other professionals, such as accountants and engineers, were also impacted by the loss of cover. Without public liability cover, councils and not-for-profit organisations became reluctant to hold community and sporting events. In New South Wales (NSW), local councils were left with $65 million of uncovered public liability claims.

As one of the largest builders' warranty insurers, the collapse of HIH left thousands of builders without insurance cover, resulting in almost $2 billion of construction activity being placed on hold while builders sought replacement cover. For many, this was not a quick process as the few remaining builders' warranty insurers were flooded with applications.

The failure of HIH Insurance highlighted the weakness within the (then) prudential framework, with weak capital requirements and very limited supervisory oversight of governance and risk management. The subsequent overhaul of the prudential framework has helped facilitate a much more robust, efficient and competitive insurance industry, able to much more readily withstand economic cycles and natural disasters, and provide stronger protection to the Australian community.

* See C Damiani, N Bourne and M Foo, The HIH Claims Support Scheme, 19 June 2015, available at: https://treasury.gov.au/publication/economic-roundup-issue-1-2015/economic-roundup-issue-1/the-hih-claims-support-scheme.

Financial system stability

Beyond ensuring individual institutions meet their financial promises to beneficiaries, APRA also has an overarching objective to promote financial system stability.

The benefits of a stable financial system are wide and pervasive.

History suggests that events of instability will occur, but the timing, severity and causes cannot be reliably predicted.[7] Financial institutions need the resilience to withstand shocks and to continue to provide critical economic functions, such as the provision of credit or essential insurance products, in the face of these shocks. Operational resilience is also important, such as banks continuing to support a stable payments system. Without resilience, financial crises 'can deeply damage an economy and have lasting effects on people's lives.'[8] Citing work of the Basel Committee on Banking Supervision, the 2014 Financial System Inquiry (FSI) noted that the average financial crisis could see 900,000 additional Australians out of work and an average total cost of 63 per cent of annual gross domestic product (GDP). It estimated the cost of a severe crisis to be around 158 per cent of annual GDP.[9]

APRA makes its financial stability mandate operational through bringing an industry-wide or systemic perspective to its supervisory practice and policy settings.

A system-wide view involves looking both at the whole system as a single unit and at the way interactions of different parts of the system might feed back onto others. Taking a system-wide view also involves a recognition that financial instability can begin to occur long before the median or average member of a particular sector becomes distressed.

Specific aspects of APRA's approach aimed at financial system stability include:

- The key attribute of APRA's supervision approach being risk-based, subjecting institutions that pose greater systemic risks to more intensive supervision, and potentially higher capital or other prudential requirements;
- APRA's work on crisis preparedness seeks to limit the impact of a financial failure;
- APRA monitors emerging systemic risks and takes mitigating actions to limit the impact should these risks play out. This may involve sector-wide prudential action of a supervisory or policy nature; and
- APRA uses tools such as industry-wide stress tests, horizontal reviews and thematic analysis of emerging risks to inform its supervisory focus and actions.

It is sometimes considered that there must be a trade-off between safety and stability, on the one hand, and competition and efficiency in the financial system on the other. APRA is of the view that, with the right balance, the goals can be mutually reinforcing. Stability can support a competitive environment, with competition bringing increased efficiency, welcoming innovation and enhancing outcomes for customers. Moreover, competition amongst strong and efficient institutions is more likely to be long-lasting, since market participants have the resilience to withstand cycles in economic conditions. Good regulatory settings can deliver

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[7] Financial System Inquiry, 2014, *Final Report*, p 5

[8] FSI, *Final Report,* p 33

[9] FSI, *Final report*, p 33

financially strong competitors, creating both financial stability and a dynamic and innovative marketplace for financial services.

However, there can be instances in which excessive competition can lead to instability. There will therefore be times when it is important for APRA to actively temper competitive spirits within the financial sector, particularly where they are leading to imprudent behavior that is producing inefficient outcomes and jeopardising financial stability. Similarly, a drive to maximise efficiency will not be desirable if it is pursued without regard to risks.

Lending standards in the banking sector

Residential mortgage lending is an important segment of the Australian financial system and the economy, representing the largest single asset class held by the banking system and the largest source of household debt. Mortgage lending has important benefits for households, lenders and the economy, but needs to be undertaken prudently.

Authorised deposit-taking institutions (ADIs) and other lenders compete on loan pricing and service as an expected aspect of a healthy market. However, competition on lending standards can lead to significant prudential risks.

Between 2014 and 2018, APRA significantly increased its supervisory intensity for residential mortgage lending in response to an erosion in lending quality amid heightened competitive pressures. Such an outcome was unhealthy for individual institutions and for the long-run interests of the community as a whole.

APRA's supervisory interventions were aimed at strengthening resilience at both an ADI and financial-system level. This included: industry-wide portfolio benchmarks to constrain higher-risk lending, such as interest-only and investor loans; more prescriptive, regulatory guidance on appropriate lending standards; and deep dive reviews of actual lending practices.

By reinforcing sound mortgage lending standards, APRA's supervisory measures helped to reduce a potential build-up of systemic risk. These measures have improved both the banking and household sectors' resilience to future adverse developments.

APRA is also obliged to undertake its activities with a view to financial system stability in New Zealand. This reflects the interlinked nature of the two economies and the dominant market presence of Australian-owned bank and insurance subsidiaries in New Zealand. To that end, APRA and other domestic Australian agencies work closely with the NZ authorities on matters of common interest. For example:

- APRA works with the Reserve Bank of Australia (RBA) and the Reserve Bank of New Zealand (RBNZ) in the development of stress scenarios to be used in system-wide stress tests of banks and on the analysis of regulated entity stress test submissions; and

- APRA participates in the Trans-Tasman Banking Council along with other domestic and Trans-Tasman entities. This Council considers financial stability related matters such as the resolution of banking groups that operate in the Trans-Tasman.

Efficiency

An efficient financial system provides many benefits to Australia. 'An efficient system allocates Australia's scarce financial and other resources for the greatest possible benefit to our economy, supporting growth, productivity and prosperity'.[10] The financial system should also be operationally efficient, providing financial services at a relatively low cost using the most efficient means of production and distribution available.

Efficiency can be enhanced in the market in a number of ways, including through competition, innovation and technology. Ideally, APRA's prudential framework would not hinder these. This can be achieved by, for example, setting standards that allow for competition amongst financial institutions and treating like risks in a like manner, focusing on regulating economic functions rather than setting product-specific requirements, and, where possible, establishing standards that are technology-neutral in their design and application.

However, some financial risks cannot be adequately priced or managed by the market. Some financial promises can be difficult for institutions to meet, hard for beneficiaries to assess and, if breached, also have major impacts on beneficiaries and third parties. The FSI noted that 'large or frequent financial crises create volatility and uncertainty, which impede the efficient allocation of resources and harm dynamic efficiency by discouraging investment. In addition, the long periods of high unemployment following crises reflect under-utilised resources.'[11]

Efficiency considerations are therefore at the heart of many of APRA's decisions. APRA seeks to take a proportionate approach to its prudential requirements, and to tailor its activities according to risk in both supervision and in policy settings.

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[10] FSI, *Final report*, p 33

[11] FSI, *Final Report*, p 33

Linking capital requirements to risk management capabilities

Within APRA's capital adequacy framework for banking and insurance institutions, minimum capital requirements are set according to an assessment of an institution's risk profile. The framework is also designed to address system-wide risk, with some capital requirements based on an entity's contribution to systemic risk. This is designed to ensure capital is allocated across the financial system according to the risk being undertaken. In this way, capital requirements avoid hindering competition and efficiency by providing incentives to price and manage risk effectively.

In addition, for a given risk profile, capital requirements may vary according to the institution's ability to understand and manage risk. APRA mandates a default simple/standardised approach to calculating capital requirements that is used by the majority of institutions. Given its relatively unsophisticated nature, this approach must be appropriate for a range of circumstances and necessarily contains a degree of conservatism to reflect the fact that risk will be imperfectly measured. In some areas, APRA also provides an alternative approach for institutions that are able to demonstrate a sophisticated ability to understand, measure and manage their risks at a more granular level. Allowing this achieves a better alignment between risk and capital, and requires a lesser degree of conservatism in its calibration, in turn allowing for greater efficiency in risk and product pricing.

Competition

Competition is vital to a healthy financial system. Generally speaking, maintaining or enhancing competition generates better consumer outcomes through greater choice and lower prices. For businesses, a competitive environment promotes innovation and efficiency, both of which contribute to greater productivity and output growth in an economy.

Effective competition is most likely to occur within a sound policy framework. In undertaking its role, APRA seeks to maintain financial stability without unduly hindering market competition. With the right balance, competition and financial stability will be mutually reinforcing: competition will support stability, and stability will support a competitive environment. If imbalances exist between these objectives, market and regulation failures are likely to occur.

Onerous regulation can create barriers to entry for new firms and promote excessive market concentration that leads to reliance on a small number of institutions within the financial system. However, the FSI noted market concentration can also be a by-product of strong competition if more efficient firms grow at the expense of their less efficient competitors.[12]

On the flipside, the absence of effective regulation enables financial firms to act in ways that have the potential to threaten financial stability and thereby impose costs on the wider

[12] FSI, *Interim Report*, July 2014, p xvii

community. Historical events such as the lead-up to the 2008 financial crisis have shown the potential for a lax regulatory environment to lead to higher risk-taking and hence to a higher risk of financial institution failure.

In recognising that there should not be a trade-off between competition and stability in the financial system, APRA is continually seeking to improve the way in which it promotes competition while upholding financial stability. APRA's policy development process involves consideration of international best practices and comprehensive industry consultation. Furthermore, to sustain the dynamics of a competitive market, APRA assists institutions to compete through a proportionate approach to supervision and strives to minimise the impact of firms exiting an industry by improving resolvability.

Proportionate approach

In establishing and implementing the prudential framework for regulated institutions, APRA takes the approach that the framework should allow for proportionate supervision, such that institutions are subject to expectations commensurate with the size, complexity, critical activities, substitutability, interconnectedness and resolvability of their business. This principle is important in assisting smaller institutions to compete without jeopardizing APRA's prudential objectives. For example, to assist smaller or specific types of institutions, APRA may tailor the prudential framework for a subset of the industry:

- small entities are typically subject to simpler regulatory requirements than larger ones, either through proportional application or, in some cases, a simplified framework;
- statistical reporting requirements are commonly stratified by size of institution, to reduce reporting burden where the level of risk and complexity do not require more detailed information; and
- working with the mutual industry, APRA (and ASIC) developed a form of equity capital that can be issued without jeopardising the mutual status of these entities.

Improving resolvability

An important aspect of normal competitive market dynamics is that strong competitors are successful and weaker competitors may exit the market, providing appropriate consequences for relevant stakeholders of non-viable entities, including management, shareholders and other providers of capital.

APRA is not expected to operate a zero failure regime, and nor does it seek to prevent institutions with limited viability from exiting the market. Therefore, in the expectation that one or more financial institutions could no longer be viable and/or encounter severe stress, APRA undertakes contingency planning for how to manage the failure or near-failure of a regulated institution. This includes requiring institutions to prepare their own recovery plans, developing and planning strategies through which APRA would use its powers in a crisis, and ensuring the Financial Claims Scheme can be properly administrated when activated. This work seeks to ensure that, to the extent possible, exits from the industry that would be expected to occur in a competitive market do so in an orderly fashion, without beneficiary loss or broader financial stability impacts.

Contestability

A contestable market—one with relatively low barriers to entry and exit—can drive efficiencies and encourage innovation. This is because a contestable market increases competition, enabling new entrants to readily challenge incumbents. In a healthy market, viable players can enter a market or provide a product or service, without undue delay, and individuals and the broader market are not unduly disrupted if a new entrant fails.

It is well accepted internationally that contestability in financial services should be limited to some degree, and that financial services markets should come with a higher degree of regulation. This is particularly the case for prudentially regulated industries, where the ability of financial institutions to meet their financial promises is difficult for customers to assess, and the consequences of a failure to fulfil those promises can be severe. As a result, the Australian Parliament has decided that, to operate in prudentially regulated industries, institutions must first meet minimum licensing requirements established by APRA.

In setting entry standards, APRA needs to ensure they are adequate to ensure safety and engender confidence in the financial system, but not so high as to unnecessarily impede potential viable entrants from establishing a market presence. They should also accommodate non-traditional business models, where the risks can be adequately managed at the same standard as those in the business models of incumbents.

APRA therefore seeks to maintain a robust and fair licensing environment, with clear and transparent rules, that does not impede viable entrants and is responsive to market developments, while at the same time not advantaging new entrants over established participants.

ADI licensing

Since the introduction of the centralised licensing unit in 2017, APRA has significantly increased its engagement with potential new entrants, as well as the speed of licence approvals. Along with the finalisation of the Restricted ADI framework in 2018, this has aided contestability and supported increased competition in the banking sector. By granting a restricted licence at an earlier stage, APRA provides new entrants time to establish the full complement of resources and systems necessary to be able to meet all aspects of the prudential framework. This makes it easier for entrants to navigate the licensing process, and to improve competition to the banking sector.

The restricted licence framework seeks to maintain community expectations regarding the safety of deposit-taking institutions along with confidence that deposits with any licensed ADI are adequately safeguarded. At the same time, the restrictions on the licence ensure that the restricted ADI entry route does not create competitive advantages for small new entrants over existing incumbents.

Competitive neutrality

Competitive neutrality refers to ensuring state-owned and private businesses compete on a level playing field. Competitive neutrality is embedded within all three levels of government in Australia through the Competition Principles Agreement, which forms part of *Australia's National Competition Policy Statement*. According to the Statement, 'competitive neutrality requires that government business activities should not enjoy net competitive advantages over their private sector competitors simply by virtue of public sector ownership.'[13]

At the time of APRA's creation in 1998, public sector involvement in the financial sector was greater than it is today. Currently, this is the most straightforward of APRA's balancing considerations to assess, as there is limited public sector involvement in prudentially regulated markets. Moreover, APRA's preferred methodology (principles-based regulatory frameworks supported by a strong supervisory focus) arguably lends itself to a more consistent approach to regulated entities, independent of their ownership structure.

[13] For the Statement and more information, see https://www.pc.gov.au/about/core-functions/competitive-neutrality.

Chapter 3 - APRA's accountability framework

APRA is held accountable in meeting its mandate in a number of ways. Important aspects of APRA's accountability are its public performance reporting, oversight by the Australian Parliament and independent review.

Public performance reporting

There are a number of important public performance reporting requirements, including:

- requirements under the *Public Governance and Performance Accountability Act 2013* to publicly report on performance against APRA's objectives—for example, through an Annual Report, and an Annual Performance Statement assessing APRA's performance against the key performance indicators described in its Corporate Plan;
- requirements under the Regulator Performance Framework to report publicly against six key performance indicators covering reducing regulatory burden, communications, risk-based and proportionate approaches, efficient and coordinated monitoring, transparency, and continuous improvement.

In addition to these required reports, APRA issues numerous publications and other material to the public. This includes a high level assessment, whenever prudential policy proposals are issued for consultation, of the potential impact of the proposals on APRA's objectives and balancing considerations. APRA invites comments on these assessments, as well as regulatory cost information, as part of its consultation process. APRA's assessment of the regulatory impact of its prudential framework are included in Regulation Impact Statements that are published on APRA's website and on the website of the Government's Office of Best Practice Regulation.

APRA also publishes information papers that outline APRA's approach to particular matters, such as an annual outline of its policy priorities, its work on residential mortgage lending and approach to the risks posed by climate change.

Accountability to the Australian Parliament

APRA regularly appears before Parliament and its various committees—on average, at least once a quarter. This includes both regular appearances, such as before Senate Estimates (three times a year), and the House of Representatives Standing Committee on Economics (at least once a year), as well as before *ad hoc* committees and inquiries. These appearances are public hearings, and APRA's opening statements to these committees, which typically explain APRA's activities and operations relevant to its mandate, are usually published.

APRA's prudential standards making power is also subject to Parliamentary oversight. Prudential standards made by APRA may be disallowed by the Parliament. This ability to veto

APRA's standards is designed to ensure APRA use of its rule-making power is used consistent with its objectives.

Independent review and assessment

APRA is also subject to a number of regular external reviews and assessments. These include:

- annual financial account audits and *ad hoc* performance reviews conducted by the Australian National Audit Office;
- the periodic Financial Sector Assessment Program conducted by the International Monetary Fund, which assesses Australia's implementation of international standards such as the *Basel Core Principles for Banking Supervision* and the International Association of Insurance Supervisors' *Core Principles for Insurance Supervision*;
- *ad hoc* peer reviews by international bodies such as the Financial Stability Board and Basel Committee on Banking Supervision;
- internal reviews and appeals to the Administrative Appeals Tribunal of specified 'reviewable decisions' made by APRA under the industry Acts;
- the forthcoming financial regulatory oversight authority recommended by the Royal Commission, and periodic Capability Reviews; and
- APRA's biennial Stakeholder Survey, conducted independently to seek broad feedback on APRA's performance and from which the results are published.

Chapter 4 - Concluding comments

APRA plays an important role in the financial sector, ultimately contributing to the wellbeing of the Australian community.

APRA's primary objectives are clear: the financial safety of institutions and the stability of the Australian financial system. However, in undertaking its role as Australia's prudential regulator, APRA should not, and does not, pursue these objectives without regard to other important considerations.

APRA therefore seeks to pursue financial safety and promote financial stability as its primary goals, but in a manner that does not unduly hinder the efficiency, competition, contestability and competitive neutrality of the financial system. In this way, APRA helps to facilitate a strong, competitive, efficient and innovative financial system for the benefit of the Australian community.

Attachment A: Balancing the mandate considerations

Efficiency	Could the proposal impact (whether positively or negatively) allocative, productive or dynamic efficiency? For example: • by aligning regulatory requirements to industry sound practice or limiting data reporting to what has most value in supervision or through publication; • by prohibiting certain activities or creating incentives (such as implicit guarantees or opportunities for arbitraging) that may be out of alignment with market forces; • by distorting price signals that may alter how regulated entities allocate credit or savings to economic agents or impacting risk transfer mechanisms that may alter investment decisions by economic agents (for example, incentivising the funding of lower risk investments over higher risk but potentially more productive investments, or reducing the affordability of certain classes of insurance business); • by constraining innovative approaches, including adoption of new technologies, that may impact dynamic efficiency; or • by imposing excessive compliance costs, or potentially removing or lowering regulatory burdens (such as duplication with existing requirements).
Competition	Could the proposal impact (whether positively or negatively) competition in a sector or subsector of the financial system. For example: • by reducing the number of market participants; this may (in limited cases) include positive impacts through the rationalisation of inefficient firms that may improve the sustainability of the industry more generally; • by posing risks of reduced price or product choice competition (for example, by focusing on product-specific requirements rather than risk alignment) or possible excessive market power developing in specific markets (for example, APRA regulated entities becoming price makers rather than price takers); • by disproportionately impacting smaller or more innovative firms (in effect favouring incumbents or 'conventional' business models); there may be examples where this is a deliberate and a positive outcome, for example, proposals seeking to lessen the impact of existing requirements or frameworks on smaller players (such as

	phased licensing requirements or CET1 instruments for mutual ADIs); or • by impacting the regulatory playing field between different sectors, for example, between ADIs and the 'shadow banking' sector
Contestability	Does the proposal create or otherwise increase (or alternatively lower) entry (or exit) barriers? For example: • by requiring significant investments in systems and controls; • by imposing significant minimum capital requirements; or • by lowering barriers or otherwise seeking to encourage or allow more innovative or smaller players (such as licensing hurdles), for example, by flexibly applying regulatory requirements to new APRA-regulated institutions in a manner proportionate to the risk to the community
Competitive neutrality	Does the proposal have any potential impacts on competitive neutrality? For example: • by creating advantages for public sector entities relative to other market participants

APRA

INFORMATION PAPER

APRA's Policy Priorities

1 February 2021

Contents

Executive summary

APRA's prudential framework provides the foundation for financial safety for banks, insurers, superannuation funds and the financial system as a whole. The framework sets minimum standards designed to ensure that, under all reasonable circumstances, financial promises made by regulated entities are met within a stable, efficient and competitive financial system.

This Information Paper outlines APRA's policy priorities for the next 12 to 18 months. It sets out the key areas of policy development that will strengthen the framework through new and revised standards and guidance. The aim is to ensure the framework is comprehensive, enforceable and proportionate, supporting APRA's strategy for the financial system.

Ultimately, the prudential framework establishes both minimum expectations for regulated entities and the standards that supervisors use to assess and enforce prudent practice. This Paper should therefore be read in conjunction with *APRA's Supervision Priorities Paper 2021*, which outlines APRA's supervisory areas of focus for the year ahead.

Policy agenda for 2021-2022

Aligned to APRA's long-term strategy, the aim of policy development in the period ahead is to help deliver four key community outcomes:

- maintaining financial system resilience;
- improving outcomes for superannuation members;
- transforming governance, risk culture, remuneration and accountability (GCRA) across all regulated entities; and
- improving cyber resilience across the financial system.

In looking ahead, the events and experience over the past year are important to take into account. The financial and economic impact of the COVID-19 pandemic has underlined the importance not only of reinforcing a strong and sound financial system in stable times, but also a resilient one that can respond to and recover from adverse conditions. A robust financial system is able to weather such conditions, and continue to support households, businesses and the broader community throughout.

To that end, APRA's primary focus in policy development in the period ahead is heavily weighted towards financial system resilience, and completing key reforms. For all industries, this includes the development of new prudential requirements for recovery and resolution, and enhanced requirements for operational resilience.

APRA also plans to complete important reforms for banks and insurers, with revisions to the bank capital framework and implementation of *AASB 17 Insurance Contracts* (AASB 17). In superannuation, APRA is supporting the Government's *Your Future, Your Super* reforms to improve member outcomes, and progressing enhancements to the prudential framework in the key areas of insurance in superannuation, investment governance and governance.

Chapter 1 - Introduction

1.1 APRA policy development

APRA's prudential framework is comprised of legislation, prudential standards and guidance.[1] The framework provides the basis for APRA to fulfil its mandate and deliver its strategy, with prudential standards that aim to be comprehensive, enforceable and proportionate. The prudential standards for each regulated industry are summarised at a high level in Attachment A.

APRA ensures that its policy development process reflects better practice. New requirements are scaled relative to the size and nature of sectors within industries where possible to avoid undue impost on entities, and APRA complies with the Australian Government Guide to Regulatory Impact Analysis.

APRA also takes into account developments in policy internationally, and consults domestically with the Treasury and other financial regulators, including the Reserve Bank of Australia (RBA), the Australian Securities and Investments Commission (ASIC), and the Australian Competition and Consumer Commission (ACCC). This is important, to ensure that policy is well-coordinated with other arms of government.

1.2 Drivers of policy priorities

APRA's policy priorities are regularly reviewed, maintaining a focus on the key aspects of the framework that need to be strengthened in line with the goals in APRA's Corporate Plan. In developing policy, APRA balances the objectives of financial safety and efficiency, competition, contestability and competitive neutrality, with the ultimate goal of promoting financial system stability in Australia.[2]

Policy initiatives also reflect the findings and recommendations of significant inquiries and reviews in recent years. This includes the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Royal Commission), the Australian Prudential Regulation Authority Capability Review (Capability Review), the Productivity Commission's Review of Efficiency and Competitiveness of the Australian Superannuation System, and the International Monetary Fund's Financial Sector Assessment Program review of the Australian regulatory system.

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[1] Relevant legislation includes the five industry acts (*Banking Act 1959*, *Insurance Act 1973, Life Insurance Act 1995*, *Private Health Insurance (Prudential Supervision) Act 2015*, *Superannuation Industry (Supervision) Act 1993)*, and the *Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act 2018*. These Acts, together with the *Australian Prudential Regulation Authority Act 1998*, articulate APRA's prudential objectives and provide APRA with authority to issue prudential standards and other legislative instruments.

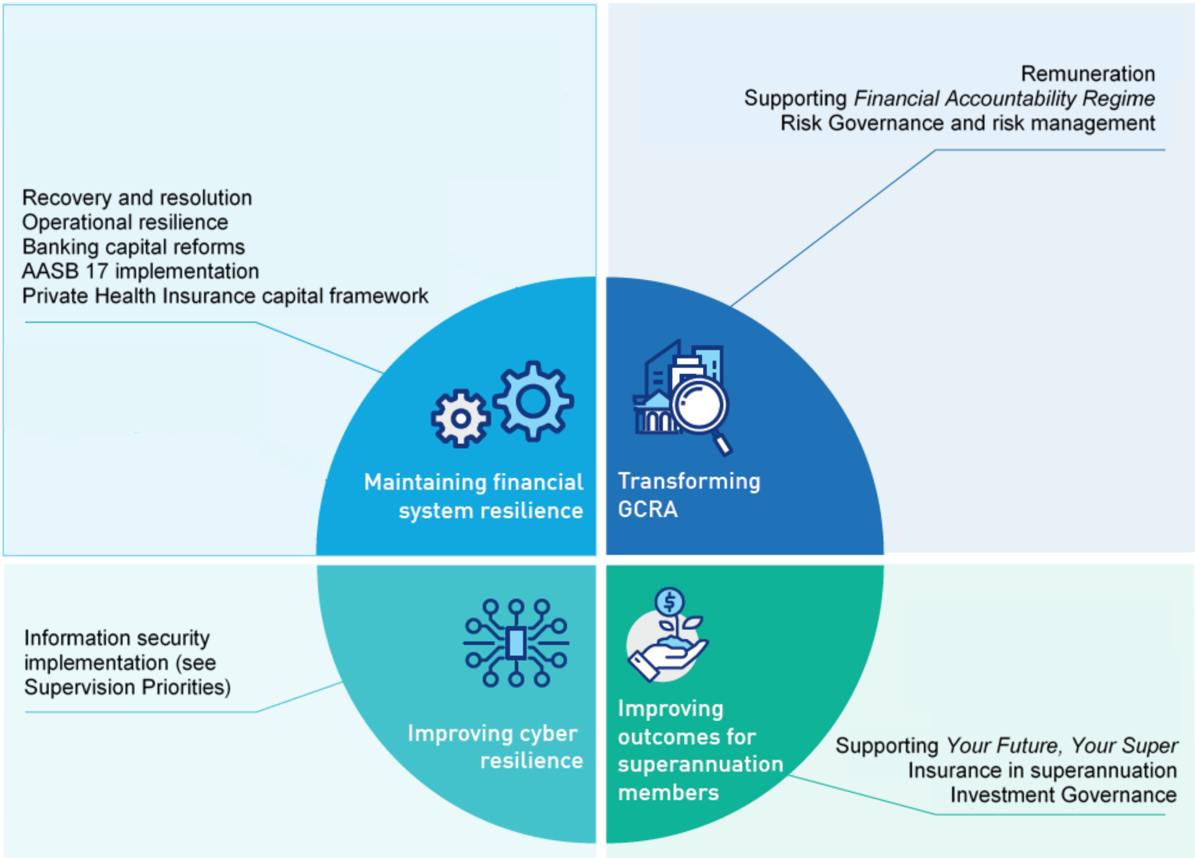
[2] For a fuller explanation of how APRA considers the various components of its mandate, see *APRA's objectives* (Information Paper, November 2019).

Many of APRA's policy priorities therefore reflect and respond to externally-driven drivers. This includes changes to remuneration standards, Basel III bank capital reforms, implementation of AASB 17, and supporting the Financial Accountability Regime and *Your Future, Your Super* reforms.

1.3 Policy agenda for 2021-2022

Consistent with the strategic priorities outlined in APRA's Corporate Plan for 2020-2024, APRA's policy agenda aims to deliver four key community outcomes: maintaining financial system resilience, improving outcomes for superannuation members, transforming governance, culture, remuneration and accountability across all regulated entities and improving cyber resilience.

APRA's key policy priorities are summarised below, and detailed in the chapters that follow. A full list of all policy initiatives, together with timelines, is presented in Attachment B.



Chapter 2 - Cross-industry

The policy priorities outlined in this chapter apply to all regulated entities, unless otherwise specified. They cover policies to maintain financial system resilience and strengthen governance, culture, accountability and remuneration.

2.1 Maintaining financial system resilience

The impact of COVID-19 has demonstrated the importance of a strong and resilient financial system. Over the next 12 to 18 months, APRA will continue to progress the development of policy initiatives aimed at strengthening entities' preparedness for managing through periods of stress, including recovery and resolution planning, operational resilience, stress testing and climate-related financial risks.

2.1.1 Recovery and resolution

Recovery and resolution planning are central to maintaining system resilience, and it is important that all regulated entities are able to effectively plan for, and manage, crisis events and periods of stress. As part of strengthening crisis preparedness, APRA will develop a new prudential standard for recovery and resolution planning, implementing reforms from the *Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act 2018*.

The standard is intended to drive improvements in entity recovery planning, as well as establishing new requirements to support APRA in resolution planning and to safeguard critical functions. APRA expects to progress the development of the prudential standard in the year ahead, with a view to releasing a draft standard for consultation in late 2021 or early 2022.

2.1.2 Operational resilience

APRA is also conducting a comprehensive review of prudential requirements for operational resilience. As COVID-19 has demonstrated, the management of operational risks and business continuity are core components of financial system resilience.[3] In 2021 APRA plans to consult on new and revised standards for operational resilience. This is expected to include the introduction of a new prudential standard specifically focused on operational risk management, revisions to the existing *Prudential Standard CPS 231 Outsourcing* and *Prudential Standard CPS 232 Business Continuity Management*, and guidance for entities. These new and revised standards will form part of a suite of standards covering operational resilience, which also includes *Prudential Standard CPS 234 Information Security*.

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[3] APRA Chair Wayne Byres, Remarks to the BCBS outreach meeting on operational resilience (Speech, October 2020).

2.1.3 Stress testing

Stress testing provides a critical forward-looking assessment of an entity's ability to withstand a downturn in conditions, as well as insights into risk management and recovery planning. As APRA increases the intensity of its supervisory focus on stress testing, entities also need to ensure they invest in and improve their own approaches. Building on lessons learned from recent and previous supervisory industry exercises, APRA intends to consult on new guidance for entities on stress testing in late 2021.

2.1.4 Climate-related financial risk

In 2020, APRA wrote to all regulated entities on understanding and managing climate-related financial risks. APRA's letter to industry outlined plans to increase industry resilience through guidance, vulnerability assessments and increased supervisory attention.[4] The development of guidance will assist entities in developing frameworks for the assessment and monitoring of climate-related financial risks. This includes governance, strategy, risk management, scenario analysis and disclosure. The guidance is expected to be released for consultation in the first half of 2021 and finalised before the end of the year.

2.2 Governance, culture, remuneration and accountability

Strengthening the prudential framework to support APRA's strategic goal of transforming governance, culture, remuneration and accountability remains a key priority. This involves a broad multi-year program of policy development to strengthen standards and guidance, to in turn ensure expectations are clear and improvements in industry practices are made where needed. These reforms will help address issues identified by the Royal Commission, the CBA Prudential Inquiry and other reviews, which highlighted weaknesses in board governance and oversight, a lack of clear accountability, and incentive structures that encouraged poor conduct.

2.2.1 Governance and risk management

APRA's review of the governance and risk management prudential standards will continue in 2021. This covers a range of key areas of governance, including board and senior management roles and expectations, board obligations for risk culture, the relative emphasis on financial and non-financial risks, and requirements for compliance and audit. APRA intends to consult on revised versions of *Prudential Standard CPS 510 Governance* and *Prudential Standard CPS 220 Risk Management* in 2022. The relevant superannuation standards, *Prudential Standard SPS 510 Governance* and *Prudential Standard SPS 220 Risk Management*, will also be reviewed (see Chapter 5 - Superannuation).

4 APRA, Understanding and Managing the Financial Risks of Climate Change (Letter, February 2020).

2.2.2 Remuneration

In 2020, APRA released for consultation a revised draft of *Prudential Standard CPS 511 Remuneration* (CPS 511), which is designed to improve remuneration practices and ensure appropriate consequences for poor risk management.[5] Following consultation, APRA intends to finalise and release the new standard in mid-2021, ahead of a phased implementation from 2023. CPS 511 will be supported by a new prudential practice guide (PPG), and reporting and disclosure requirements, which will be consulted on in mid to late 2021. Finalisation of the revised prudential standard will address key recommendations from the Royal Commission.

2.2.3 Accountability

APRA and ASIC continue to support the Treasury in the development of the Financial Accountability Regime (FAR). While the introduction of the FAR into Parliament was delayed due to COVID-19, the Government has indicated its intention to complete the remaining Royal Commission recommendations, including the FAR. Consultation on FAR legislation is likely to be in 2021. Subject to the finalisation of the FAR, APRA plans to revise *Prudential Standard CPS 520 Fit and Proper* (CPS 520). This will align the legislative requirements under FAR and the prudential standard requirements under CPS 520, minimising burden and ensuring consistency in expectations for industry.

[5] APRA, *Strengthening prudential requirements for remuneration* (Response Paper, 12 November 2020).

Chapter 3 - Banking

APRA's policy priorities for the banking industry are outlined in this chapter, in addition to the cross-industry initiatives outlined in Chapter 2. The priorities are focused on financial system resilience, consistent with APRA's supervisory priorities. They centre on the key areas of capital and credit, as well as revisions to the approach to licensing for new authorised deposit-taking institutions (ADIs).

3.1 Capital

3.1.1 Basel III reforms

The finalisation of revisions to the ADI capital framework is a key policy priority for 2021, completing reforms to ensure ADI capital ratios are 'unquestionably strong', improving the flexibility of the framework and increasing transparency of capital strength.

In 2020, APRA released for consultation draft prudential standards for the revised capital framework, as well as a quantitative impact study to assess the impact of the proposals.[6] The standards will be finalised by the end of 2021, along with the requirements for interest rate risk in the banking book. This timeline will provide the industry with a 12-month implementation period before the revised framework comes into effect on 1 January 2023.

APRA will also consult on updated PPGs and reporting standards to accompany the revised capital standards in 2021. In addition, there will be a number of consequential amendments to other prudential standards. Consultation on these changes is expected to commence in the second half of 2021. APRA also intends to consider policy options for the fundamental review of the trading book in 2021, as well as the role of Additional Tier 1 instruments in providing loss absorbing capacity.

3.1.2 Measurement of capital

APRA is revising *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (APS 111).[7] The proposed revisions to APS 111 incorporate further technical information to assist ADIs in issuing capital instruments, reflect recent international standards, and introduce changes to the capital treatment for equity investments in banking and insurance subsidiaries. APRA intends to finalise the changes in 2021, with the revised standard expected to take effect from 1 January 2022.

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[6] APRA, *Revisions to the capital framework for authorised deposit-taking institutions* (Consultation Package, December 2020).

[7] APRA, *Revisions to APS 111 Capital Adequacy: Measurement of Capital* (Discussion Paper, October 2019).

3.1.3 Disclosure requirements

APRA intends to consult on a draft *Prudential Standard APS 330 Public Disclosure* (APS 330) in the second half of 2021. The revised standard will reflect the Basel Committee's amended Pillar 3 disclosure requirements and other consequential amendments as a result of the capital reforms outlined above.

The APS 330 consultation will include a proposal to reduce the disclosure burden for smaller ADIs through centralised publication by APRA. This proposal has previously been highlighted as part of APRA's recent consultations on changes to the ADI capital framework. The recent consultation on the publication of ADI key metrics by APRA will facilitate this initiative.

3.2 Credit risk

In September 2020, the Government announced a series of proposed reforms to consumer credit laws. In response, APRA is seeking to ensure appropriate alignment between the ADI and non-ADI lender regimes.

APRA is currently consulting on potential minor revisions to *Prudential Standard APS 220 Credit Risk Management* (APS 220), contingent on the Government's proposed reforms passing as legislation. APRA may also consult on minor amendments to *Prudential Practice Guide APG 223 Residential Mortgage Lending*, and anticipates releasing the finalised *Prudential Practice Guide APG 220 Credit Risk Management* (APG 220) in the first half of 2021. APRA also plans to finalise the proposed *Reporting Standard ARS 220.0 Credit Exposures and Provisions* in 2021.

3.3 Licensing

APRA intends to implement a revised approach to licensing new ADIs, following a recent review of the pathways to a licence that built on lessons learned to date. APRA plans to publish a consultation package in the first half of 2021. Following consultation, APRA plans to publish an information paper setting out its approach.

APRA is also currently reviewing its authorisation guidelines for ADIs, including for foreign ADI branches and non-operating holding companies (NOHCs). APRA intends to publish revised ADI authorisation guidelines and revised NOHC authorisation guidelines in 2021.

In 2020, the Government announced its support of the Council of Financial Regulators (CFR) recommendations for an updated and simplified framework for Stored-Value Facilities, including Purchased Payment Facilities (PPFs). APRA is reviewing its approach to PPFs to ensure it is commensurate to the risks of activities undertaken, and appropriate in the context of the CFR's recommendations. APRA plans to consult on a revised prudential standard in the second half of 2021.

Chapter 4 - Insurance

APRA's policy priorities for the insurance industry are outlined in this chapter, in addition to the cross-industry initiatives in Chapter 2. As with the banking industry, the priorities are focused on financial system resilience. They comprise three key long-term capital framework initiatives, consistent with previous years.

4.1 AASB 17 Insurance Contracts and LAGIC updates

The implementation of AASB 17 remains a key priority. The introduction of AASB 17 will modify a number of important accounting concepts that underpin APRA's prudential framework and introduce some new concepts. If APRA were to make no adjustments, this would result in a divergence between the accounting and prudential standards which would require insurers to maintain dual valuation, actuarial, accounting and reporting systems. This would be a significant impost on the insurance industry.

The implementation of AASB 17 is expected to result in amendments to a number of prudential standards. APRA is also taking the opportunity to update other areas across the Life and General Insurance Capital (LAGIC) framework to ensure it remains fit-for-purpose.

In 2020, APRA released a discussion paper and a targeted Quantitative Impact Study (QIS) on the integration of AASB 17 into the capital and reporting framework and other updates to the LAGIC framework for insurers.[8] After considering feedback from the current consultation, APRA expects to release a response paper, draft capital and reporting standards and a full QIS towards the end of 2021. APRA is proposing that the new standards commence from 1 July 2023.

4.2 Review of the PHI capital framework

APRA is reviewing the private health insurance (PHI) capital framework, seeking to ensure private health insurers are financially resilient and policyholders are protected. The current framework is less robust than the requirements that apply in other insurance sectors in Australia. APRA is concerned that the current framework does not appropriately reflect the risks faced by insurers, with inadequate consideration of extreme adverse events. The completion of this review will be the final stage of bringing the PHI prudential framework into alignment with the frameworks for life and general insurers.

In 2019 APRA released a discussion paper with proposals to revise the PHI capital framework to:

8 APRA, *Integrating AASB 17 into the capital and reporting frameworks for insurers and updates to the LAGIC framework* (Discussion Paper, November 2020).

- align with the LAGIC framework, where appropriate;
- apply the capital framework to the insurer's entire business, rather than just the health benefits fund; and
- integrate changes stemming from the Australian Accounting Standard Board's new standard AASB 17.[9]

APRA will be seeking to engage with industry in the first half of 2021 to undertake data analysis, discuss the feedback received on APRA's proposals, and obtain additional feedback on some of the more detailed requirements pertaining to the revised framework. APRA expects to release a response paper and consult on draft prudential standards in the second half of 2021.

4.3 Review of LPS 117 and offshore reinsurers

APRA is reviewing *Prudential Standard LPS 117 Capital Adequacy: Asset Concentration Risk Charge* (LPS 117). This review is being undertaken to ensure APRA remains able to effectively supervise the industry, in the context of an increase in the use of offshore reinsurers. Particular focus is being placed on addressing concerns from the increased use of offshore reinsurers in the group risk market, which plays an important role in Australia's superannuation system.

In 2019, APRA wrote to all life insurers outlining its position on offshore reinsurers and other policy proposals.[10] APRA received extensive industry feedback on these proposals. Due to COVID-19, no further industry consultation was conducted during 2020. APRA plans to release a consultation package inviting feedback on the draft standard in the first quarter of 2021. The final standard is expected to be released by the end of 2021.

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9 APRA, *Private Health Insurance Capital Standards Review* (Discussion Paper, December 2019).

10 APRA, Offshore reinsurers and the review of Prudential Standard LPS 117 Capital Adequacy – Asset Concentration Risk Charge (Letter, March 2019).

Chapter 5 - Superannuation

APRA's policy priorities for the superannuation industry are outlined in this chapter, in addition to the cross-industry initiatives in Chapter 2. The policy priorities are focused on financial system resilience and the delivery of improved outcomes for superannuation members. In addition to the priorities below, APRA is also considering ways of reinforcing RSE licensee resilience, following the experience in 2020 that highlighted that risks to solvency can exacerbate poor member outcomes.

5.1 Supporting legislative changes

In 2020, a number of significant legislative reforms were announced by the Government in the Budget. The *Your Future, Your Super reforms* included:

- an amendment to the existing best interests duty for trustees to act in the best financial interests of members;
- a requirement for APRA to conduct an annual performance test for MySuper products, which will later be extended to other superannuation products;
- a resolution planning prudential standard making power for APRA; and
- a requirement for employers to make contributions for employees into their existing superannuation fund if a new employee has an existing 'stapled' superannuation fund and does not choose a fund to receive contributions.

APRA will support the implementation of these reforms. This will include conducting the proposed annual performance test aimed at addressing underperformance for MySuper products. APRA will look to update its *Prudential Standard SPS 515 Strategic Planning and Member Outcomes* (SPS 515) and associated guidance in *Prudential Practice Guide SPG 515 Strategic and Business Planning* (SPG 515) and *Prudential Practice Guide SPG 516 Business Performance Review* (SPG 516) to ensure they reflect any changes that may be required.

5.2 Enhancing the superannuation prudential framework

Another key priority for APRA in the year ahead is progressing the suite of enhancements outlined in the 2019 post-implementation review of the superannuation prudential framework. The review found that the prudential framework had materially improved industry practices, but also highlighted the need to strengthen several prudential requirements. This included life insurance in superannuation, board appointment processes and management of conflicts of interest.

As an initial step, APRA released a revised version of the insurance in superannuation standard, *Prudential Standard SPS 250 Insurance in Superannuation* (SPS 250) in 2019.[11] Following consultation, a second consultation on a revised draft SPS 250 and draft guidance, *Prudential Practice Guide SPG 250 Insurance in Superannuation* (SPG 250), was released on 20 January 2021.[12] APRA intends to finalise changes to the standard and guidance in mid-2021.

APRA also plans to release a consultation package in 2021 on *Prudential Standard SPS 530 Investment Governance* (SPS 530).[13] APRA will be seeking feedback on a consultation paper in the first half of 2021, which will include a draft standard and guidance. Consultation on enhancements to *Prudential Standard SPS 231 Outsourcing* (SPS 231) will follow in the second half of the year. APRA proposes to review *Prudential Standard SPS 220 Risk Management* (SPS 220) and consult on updates in 2022.

APRA intends to continue progressing further enhancements to the governance framework with a discussion paper in 2022, covering *Prudential Standard SPS 510 Governance* (SPS 510), *Prudential Standard SPS 521 Conflicts of Interest* (SPS 521) and *Prudential Standard SPS 520 Fit and Proper* (SPS 520). Updates to the governance framework will be made based on responses to the discussion paper and the findings of APRA's governance thematic review (see Supervision Priorities Paper 2021).

5.3 Royal Commission recommendations

In line with APRA's response to the Royal Commission, and as noted above, APRA released a revised SPS 250 with amendments to implement Recommendations 4.14 and 4.15, to be finalised in mid-2021.[14] In addition and following the passage of various Bills to implement the Royal Commission's recommendations, APRA will also consider whether any guidance to the industry will be necessary to set out expectations regarding associated legislative changes (for example, deduction of advice fees in super and trustee indemnity changes which take effect from 1 January 2022). APRA will also continue to support the Government in the implementation of the outstanding Royal Commission recommendations.

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[11] APRA, 'Proposed revisions to Prudential Standard SPS 250 Insurance in Superannuation' (Letter, November 2019).

[12] APRA, 'Proposed revisions to Prudential Standard SPS 250 and Prudential Guidance SPG 250 Insurance in Superannuation'(Letter, January 2021).

[13] Consultation package includes *Prudential Standard SPS 530 Investment Governance*, *SPG 530 Investment Governance*, *SPG 531 Valuations*.

[14] APRA, 'APRA's response to Royal Commission recommendations'. Recommendation 4.14 - Additional scrutiny for related party engagements; and Recommendation 4.15 - Status attribution to be fair and reasonable.

Attachment A: Prudential framework

APRA's prudential framework is comprised of legislation, prudential standards and guidance. The prudential standards for each regulated industry are summarised below, with the key areas that are under active policy development in 2021 highlighted in bold.

Prudential standards for ADIs

Governance

- Governance (CPS 510)
- **Remuneration (CPS 511)**
- **Public disclosure (APS 330)**
- Fit and proper (CPS 520)
- Audit and related matters (3PS 310, APS 310)

Risk management

- Risk management (CPS 220)
- **Credit risk management (APS 220)**
- Large exposures (APS 221)
- Aggregate risk exposures (3PS 221)
- Associations with related entities (APS 222)
- Intra-group transactions and exposures (3PS 222)
- Margining and risk mitigation for non-centrally cleared derivatives (CPS 226)
- **Outsourcing (CPS 231)**
- Information security (CPS 234)
- Prudential requirements for providers of purchased payment facilities (APS 610)

Liquidity

- Liquidity (APS 210)
- Securitisation (APS 120)
- Covered bonds (APS 121)

Capital

- **Capital adequacy (APS 110)**
- **Measurement of capital (APS 111)**
- **Standardised approach to credit risk (APS 112)**
- **Internal ratings-based approach to credit risk (APS 113)**
- Standardised approach to operational risk (APS 114)
- Advanced measurement approaches to operational risk (APS 115)
- Market risk (APS 116)
- **Interest rate risk in the banking book (APS 117)**
- Counterparty credit risk (APS 180)

Contingency planning

- **Recovery and resolution**
- **Business continuity management (CPS 232)**
- Financial Claims Scheme (APS 910)

Note: In addition, APS 001 and 3PS 001 Definitions apply to all ADIs.

Prudential standards for Insurance

Governance

- Governance (CPS 510)
- **Remuneration (CPS 511)**
- Audit and related matters (3PS 310, GPS/LPS/HPS 310)
- Actuarial and related matters (CPS 320)
- Disclosure to APRA (HPS 350)
- Fit and proper (CPS 520)

Risk management

- Risk management (CPS 220)
- Aggregate risk exposures (3PS 221)
- Intra-group transactions and exposures (3PS 222)
- Margining and risk mitigation for non-centrally cleared derivatives (CPS 226)
- Reinsurance management (GPS/LPS 230)
- **Outsourcing (CPS 231)**
- Information security (CPS 234)

Capital

- **Solvency Standard** (LPS 100, **HPS 100**)
- **Capital adequacy** (GPS 110, LPS 110, **HPS 110**)
- Capital adequacy: Measurement of capital (GPS 112, LPS 112)
- Capital adequacy: Internal model-based method (GPS 113)
- Capital adequacy: Asset risk charge (GPS 114, LPS 114)
- Capital adequacy: Insurance risk charge (GPS 115, LPS 115)
- Capital adequacy insurance concentration risk charge (GPS 116)
- **Capital adequacy asset concentration risk charge** (GPS 117, **LPS 117**)
- Capital adequacy operational risk charge (GPS 118, LPS 118)
- Assets in Australia (GPS 120)
- Insurance liability valuation (GPS 340, LPS 340)

Other requirements

- **Recovery and resolution**
- **Business continuity management (CPS 232)**
- Termination Values Minimum Surrender Values and Paid-up Values (LPS 360)
- Cost of Investment Performance Guarantees (LPS 370)
- Transfer and amalgamation of insurance business for general insurers (GPS 410)
- Statutory Funds (LPS 600)
- Friendly Society Benefit Funds (LPS 700)

Note: In addition, GPS/LPS/HPS 001 and 3PS 001 Definitions apply. The majority of GI, LI, and PHI standards will be updated to reflect changes from implementing AASB 17. For PHI capital adequacy, APRA proposes to introduce LI/GI equivalent standards. APRA also proposes to remove HPS 100 and GPS 113.

Prudential standards for superannuation

Governance

- Defined benefit matters (SPS 160)
- Audit and related matters (SPS 310)
- Governance (SPS 510)
- Remuneration (CPS 511)
- Strategic planning and member outcomes (SPS 515)
- Fit and proper (SPS 520)
- Conflicts of interest (SPS 521)
- Investment governance (SPS 530)

Risk management

- Operational risk financial requirement (SPS 114)
- Risk management (SPS 220)
- Margining and risk mitigation for non-centrally cleared derivatives (CPS 226)
- Outsourcing (SPS 231)
- Information security (CPS 234)

Other requirements

- Recovery and resolution
- Business continuity management (SPS 232)
- Insurance in superannuation (SPS 250)
- Eligible Rollover Fund (ERF) transition (SPS 450)

Attachment B: Policy timelines

Cross-industry

	2020	1H 2021	2H 2021	2022	Expected effective
Recovery and resolution planning			Consult	Finalise	2023
Operational Risk, Service Provision (CPS 231), and Business Continuity Management (CPS 232)			Consult	Finalise	2023
Stress testing PPG			Consult	Finalise	-
Climate-related financial risk PPG		Consult	Finalise		-
Governance (CPS 510)				Consult	2023
Risk management (CPS 220)				Consult	2023
Remuneration (CPS 511)	Consult	Finalise			2023
Fit and proper (CPS 520)					TBC

Banking

	2020	1H 2021	2H 2021	2022	Expected effective
Overall approach to capital requirements (APS 110)	Consult	Consult	Finalise		2023
Standardised Approach to Credit Risk (APS 112)	Consult	Consult	Finalise		2023
Internal Ratings-based Approach to Credit Risk (APS 113)	Consult	Consult	Finalise		2023
Interest Rate Risk in the Banking Book (APS 117)			Finalise		2023
Measurement of capital (APS 111)	Consult	Finalise			2022

	2020	1H 2021	2H 2021	2022	Expected effective
Disclosure requirements (APS 330)			Consult	Finalise	2023
Credit risk management (APS 220 and APG 220)	Consult	Finalise			TBC
ADI and NOHC authorisation guidelines			Finalise		-
Stored-value facilities			Consult	Finalise	2023

Insurance

	2020	1H 2021	2H 2021	2022	Expected effective
AASB 17 and LAGIC updates	Consult	Consult	Consult	Finalise	2023
PHI Capital framework	Consult		Consult	Finalise	2023
Offshore reinsurers and LPS 117		Consult	Finalise		2023

Superannuation

	2020	1H 2021	2H 2021	2022	Expected effective
Strategic Planning and Member Outcomes (SPS/SPG 515 and SPG 516)		Consult Finalise			TBC
Insurance in Superannuation (SPS 250/SPG 250)		Consult Finalise			2022
Investment Governance (SPS 530)		Consult	Finalise		2022
Outsourcing (SPS 231)			Consult		2023
Risk Management (SPS 220)				Consult	TBC
Governance (SPS 510)				Consult	TBC
Conflicts of Interests (SPS 521)				Consult	TBC
Fit and Proper (SPS 520)				Consult	TBC

Attachment C: Finalised standards

During 2020, APRA deferred the implementation dates and transition timeframes for prudential and reporting standards that were finalised but not yet implemented. This decision was made to ensure entities could dedicate time and resources to responding to COVID-19 impacts.

Industry	Prudential Standard or Policy proposal	Revised effective date
Cross-industry	CPS 226 Margining and Risk Mitigation for Non-Centrally Cleared Derivatives (phase-in of initial margin requirements)	Phased from 1 September 2021 and 1 September 2022
	CPS 234 Information Security (third-party arrangements transition provision)	1 July 2020 with a six-month extension to 1 January 2021 available on a case-by-case basis
Banking	APS 220 Credit Risk Management	1 January 2022*
	APS 222 Associations with Related Entities ARS 222.0 Exposures to Related Entities ARS 222.2 Exposures to Related Entities – Step-in risk	1 January 2022
	APS 115 Capital Adequacy: Standardised Measurement Approach to Operational Risk	1 January 2023

*APS 220 implementation date currently subject to consultation.

APRA

INFORMATION PAPER

APRA's Supervision Priorities

1 February 2021

Contents

Executive summary

APRA is a supervision-led agency, seeking to maintain a sound and resilient financial system founded on excellence in prudential supervision. Following publication of its supervision priorities early in 2020, APRA's focus necessarily shifted from planned activities to ensuring the financial system remained resilient in the face of the COVID-19 pandemic and its broader economic and financial impacts.

APRA's supervision played an important role in supporting financial system stability in Australia during 2020. In collaboration with the Council of Financial Regulators (CFR) and peer agencies, APRA's actions supported the financial system's ability to act as a shock absorber of the pandemic's economic fallout. Led by both intense supervisory liaison and targeted regulatory interventions, APRA's actions included:

- providing guidance to banks and insurers on capital management;
- providing capital relief on deferred loans;
- facilitating the implementation of Government's early release of super program; and
- scrutinising and challenging entities' approaches to managing business disruption.

APRA's supervisory response continues to evolve in light of the changing impacts of COVID-19. APRA's planned activities balance the need for it to respond to the impact of the pandemic on regulated entities while ensuring that the regulatory burden is minimised, where possible.

This Information Paper outlines APRA's planned supervisory priorities for each industry over the next 12-18 months. The agenda includes significant cross-industry elements. Importantly, APRA's priorities are aligned to the four key community outcomes in APRA's 2020-2024 Corporate Plan:[1]

- maintaining financial system resilience;
- improving outcomes for superannuation members;
- transforming governance, risk culture, remuneration and accountability (GCRA) across all regulated financial entities; and
- improving cyber-resilience across the financial system.

COVID-19 has meant that while work has continued on all four outcomes, APRA has prioritised maintaining financial system resilience in the short term. APRA's supervisory priorities may vary as the risk outlook evolves, not least in response to the ongoing impacts

[1] APRA, *Corporate Plan 2020-2024* (August 2020)

of COVID-19. In protecting the stability and soundness of regulated entities, APRA will work to maintain public confidence in the financial system and aid the economic recovery.

APRA's supervisory program is risk-based, forward-looking and outcomes-focused. This approach is reflected in APRA's recently updated supervision methodology, facilitated through the introduction of the Supervision Risk and Intensity (SRI) Model.

Complementing the SRI Model, the upcoming introduction of a new data collection solution, APRA Connect, will see APRA enhance its use of technology and data to support supervisory assessments and guide decision-making at an industry and entity level.

While the Australian financial system is, on the whole, in a sound financial position, APRA will strive to ensure that the balance sheet strength and very low incidence of disorderly failure among APRA-regulated entities is maintained. This is supported by APRA's heightened focus on recovery and resolution planning and stress testing.

In superannuation, improving outcomes for members remains a core supervisory priority. In December 2020 APRA published the first full refresh of the MySuper Heatmap, followed soon after by the issue of notices requesting further information from trustees of MySuper products where underperformance persists. This enhanced transparency of investment performance and fees in MySuper products enabled APRA to target its supervisory efforts on particular MySuper products, and in 2021 APRA will further sharpen its supervisory focus on underperformance, including the use of enforcement powers where appropriate.

Improving cyber resilience is an area of major strategic focus for APRA underpinned by the its 2020-2024 Cyber Security Strategy. APRA will be seeking to ensure regulated entities significantly improve their cyber resilience practices. In 2021, APRA will focus on the effective implementation of its information security standard by all regulated entities.

APRA remains committed to delivering on its community outcome of transforming GCRA. In addition to the implementation of the upcoming remuneration prudential standard, a range of GCRA-related supervisory reviews and 'deep-dives' will be conducted over the next 12-18 months. APRA is also investing in new tools to assess and benchmark GCRA practices across entities, such an industry-wide risk culture survey. APRA's insights will increasingly be shared with industry and the public to reinforce prudential expectations and drive accountability.

This paper should be read in conjunction with APRA's Policy Priorities Information Paper which outlines forthcoming changes to APRA's prudential framework that support these priorities and the supervision effort.[2]

[2] APRA, *APRA's Policy Priorities* (Information Paper – January 2021)

Chapter 1 - Introduction

1.1 APRA's mandate and role of supervision

APRA's mandate is to protect the Australian community by establishing and enforcing prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by the entities APRA supervises are met within a stable, efficient and competitive financial system.

APRA's supervision activities are fundamental to APRA's ability to meet its mandate. Supervision plays a critical role in identifying significant risks to entities and the financial system and ensuring these are appropriately addressed in a timely and effective manner.

A key strategic initiative within APRA's corporate plan is to improve and broaden risk-based supervision. As part of this initiative, APRA is now implementing its new SRI Model that is responsive to a rapidly changing environment, as outlined below.[3]

In addition, in 2021, APRA will be introducing a new data collection solution, APRA Connect, which will enable APRA to collect more granular data, strengthening our data-driven decision-making and enabling enhanced data submission capabilities.

APRA applies a **risk-based** approach by directing supervision resources towards areas that pose the greatest risk or impact; focuses on being **forward-looking** through anticipating the impact of current and emerging risks; and holds entities and individuals to account for delivering desired, clear and timely **outcomes**. This relies on supervisory judgement and expertise, informed by evidence and analysis.[4]

1.2 Transition to the SRI Model

A fundamental element of APRA's supervisory approach is the use of a structured framework to identify and assess risks, so that APRA can effectively direct its resources towards the areas and entities of greatest risk. From 2012, APRA used the Probability and Impact Rating System (PAIRS) and the Supervisory Oversight and Response System (SOARS) to identify and assess risk and to determine the appropriate supervisory response. By 30 June 2021, APRA will have completed migration to a new system to assess risk and determine supervisory intensity: the SRI Model. During this time, regulated entities can expect to be engaged by APRA in regard to their SRI tier and stage; details of which will remain confidential to the entity, consistent with that of PAIRS and SOARS ratings. The SRI tier and stage will provide a foundation for the intensity of APRA's supervisory engagement with entities ensuring clarity of expectations.

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[3] APRA, *Supervision Risk and Intensity (SRI) Model* (November 2020)

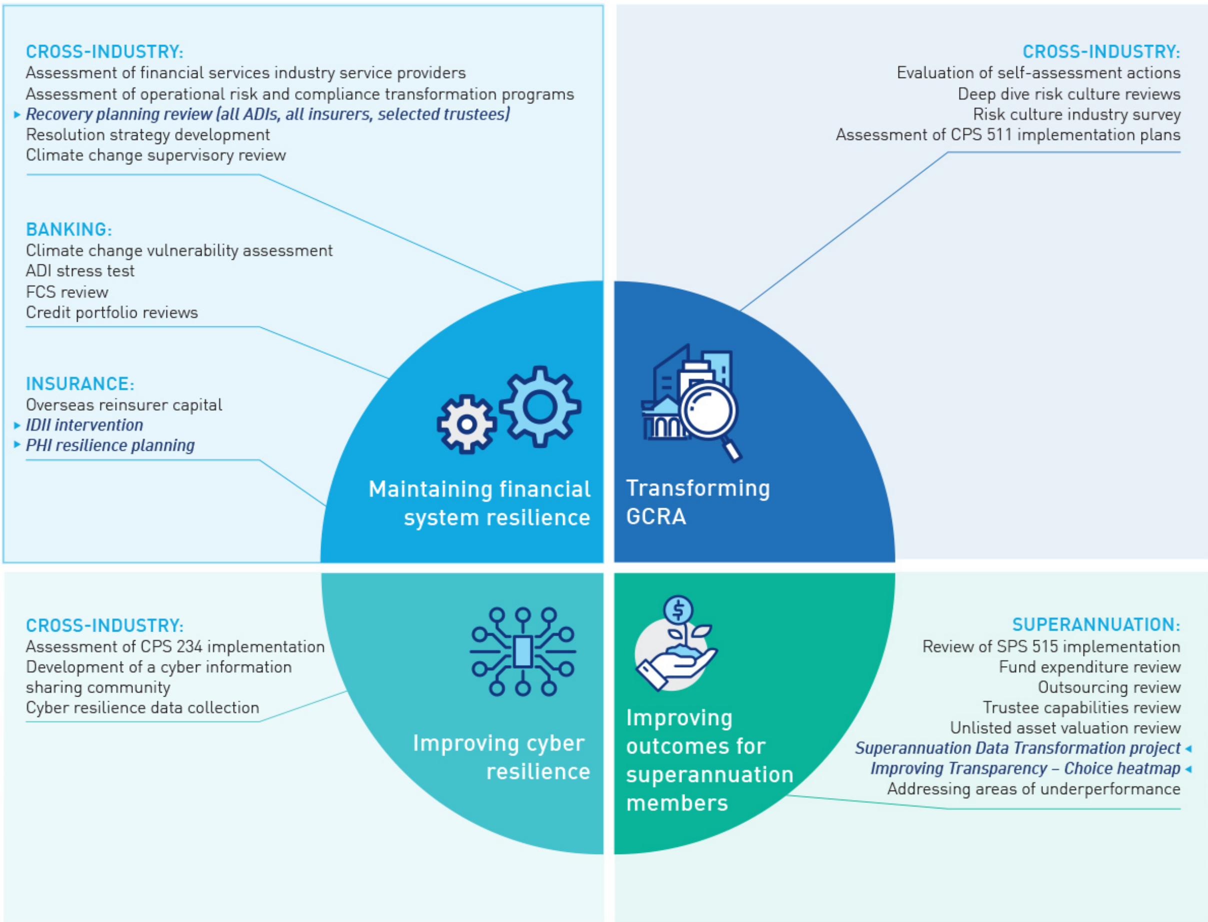
[4] APRA, *APRA's Supervision Philosophy* (October 2020)

The SRI Model applies a more contemporary categorisation of risks, elevating non-financial risks whilst preserving the importance of financial resilience. It better caters for the different industries and changing risk assessments. The model is also aligned with APRA's enforcement approach ensuring a timely and appropriate supervisory response.[5]

1.3 APRA's supervision priorities

Consistent with the strategic priorities outlined in APRA's Corporate Plan for 2020-2024, APRA's supervision priorities aim to deliver four key community outcomes: maintaining financial system resilience, transforming GCRA, improving cyber-resilience and improving outcomes for superannuation members.

APRA's supervisory priorities are summarised below and detailed in the chapters that follow.



KEY: ▸ *Denotes those supervision activities which are relevant for all APRA-regulated entities within the industry/industries*

[5] APRA, *APRA's Enforcement Approach* (September 2019)

Chapter 2 - Cross-industry

This chapter outlines APRA's planned supervisory activities for cross-industry risks. These activities cover three of APRA's four key community outcomes: maintaining financial system resilience; improving cyber resilience; and transforming GCRA.

2.1 Maintaining financial system resilience

2.1.1 Protecting the financial safety and soundness of APRA-regulated entities

During 2020, many countries, including Australia, experienced their largest economic contractions since the Great Depression as a result of COVID-19. Volatility in asset and funding markets early in the downturn was also elevated. Historically, economic and financial market disruptions of this size have often caused stress and failures in the financial system.

Significant monetary and fiscal support played a key role in limiting the impact of the downturn on households, businesses, and ultimately the financial system. This allowed financial systems to play a role in supporting economies. Their ability to do this was facilitated by resilience built up in the post-GFC period, supported by regulatory actions.

On the whole, Australian financial entities have sufficient resilience to continue to support economic recovery. APRA remains alert to changes in economic, financial and health conditions as the system continues to recover from the effects of the pandemic. Over the next 12-18 months, APRA will focus on ensuring that the resilience of regulated entities is maintained through regular stress testing and other activities.

2.1.2 Fostering the operational resilience of APRA-regulated entities

Weaknesses in operational resilience can have both financial and non-financial impacts on entities, and can undermine their ongoing viability. Ongoing access to financial services, such as banking, insurance and superannuation, is essential to supporting economic activity. For these reasons, operational resilience was one of APRA's key areas of focus as the threat posed by COVID-19 became apparent.

APRA is incorporating the lessons learned from COVID-19 into its supervisory practices to further strengthen the operational resilience of the Australian financial system. APRA expects entities to significantly strengthen their operational resilience practices.

APRA is updating its operational resilience standards and guidance as outlined in its Policy Priorities paper. To complement the policy updates, APRA's supervision activities over the next 12-18 months will focus on:

- The impact of changes made to their operations by entities in response to the pandemic and the effectiveness of existing contingency arrangements to protect against any risks that may have arisen;
- The extent to which regulated entities' risk profiles reflect changes to business practices and strategy as a result of COVID-19, and any operational risk losses; and
- Assessment of the range and concentration of service providers used by APRA-regulated entities.

APRA has work underway focusing on ADIs' management of operational and compliance risks. Several ADIs have transformation programs underway to address issues identified in self-assessments of their management of operational risk. APRA has also conducted reviews in this respect and will continue to assess the state of entities' operational and compliance risk management transformation programs and practices. In addition, APRA intends to release a compliance risk management information paper in 2021 to help drive further improvements in entities' compliance management.

2.1.3 Enhancing contingency planning for adverse events, informed by regular stress testing

Stress testing is a core component of APRA's toolkit used to enhance financial resilience. It provides a risk-based, forward-looking assessment of the ability to withstand stress at an industry, cohort and individual entity level.

APRA regularly conducts stress tests across the banking and insurance sectors to assess their resilience to severe but plausible adverse scenarios. These tests help to improve both APRA's and industry's understanding of the impact of future potential risks, allowing appropriate safeguards to be put in place.

In response to the onset of COVID-19, APRA increased its use of stress testing across all regulated industries, enabling timely assurance and insight. In 2021, APRA's stress testing program will include regulator-led common scenario stress tests across nominated industries for select scenarios, as well as engaging with entities on the stress test activities they undertake as part of their Internal Capital Adequacy Assessment Process.

Significant focus will continue to be given to stress testing the ADI industry, given the importance of the ADI sector to financial system stability. In early 2021, APRA will conclude its analysis from the final cycle of the 2020 ADI 'streamlined' stress tests, providing feedback to relevant entities. A more comprehensive stress test of the largest ADIs is planned for 2021.

For the insurance industry, targeted stress test activities will continue, subject to the economic and macro environment and emerging risks. For the superannuation industry, APRA plans to sharpen its supervision by advancing the role of stress testing in providing assurance and insight at both industry and entity level.

2.2 Improving cyber resilience

APRA seeks to reduce the impact of cyber incidents on the financial system and Australian community. In the face of escalating risks, APRA expects regulated entities to significantly improve their cyber resilience practices and be able to withstand cyber-attacks.

Cyber resilience is an area of major strategic focus for APRA, underpinned by its 2020-2024 Cyber Security Strategy.[6] The updated strategy seeks to influence the practices of regulated entities and involves acting in concert with peer regulators and other government agencies, while supporting the Australian Government's 2020 Cyber Security Strategy.

As part of its Cyber Security Strategy over the next 12-18 months, APRA will:

- initially as a pilot with a small group of select APRA-regulated entities, instruct entities to engage independent auditors to assess compliance with *Prudential Standard CPS 234 Information security* to identify and address weaknesses in cyber practices;
- continue to collect cyber resilience data which will be used to generate cross-industry insights on better practice examples. These insights will be shared with regulated entities to strengthen cyber practices;
- launch a pilot for a cyber information sharing community across APRA regulated entities to improve industry situational awareness and the sharing of technical information; and
- in concert with the CFR, test cyber resilience of Australia's financial services industry via a pilot Cyber Operational Resilience Intelligence-led Exercise.[7]

2.3 Transforming governance, risk culture, remuneration and accountability

APRA is continuing its work to transform GCRA across APRA-regulated entities' management of financial and non-financial risk. Over the next 12-18 months, APRA will:

- following the finalisation of *Prudential Standard CPS 511 Remuneration*, conduct an implementation review across a sample of regulated entities and share these insights in due course with all regulated entities;
- drive improvement in the governance and risk culture practices by continuing risk culture deep dives at a small number of large Australian financial entities, follow up and evaluation of entities' actions in response to risk governance self-assessments and regular prudential engagements. This will include working to close issues currently resulting in capital overlays or enforceable undertakings; and

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[6] APRA, Speech by Geoff Summerhayes '*Strengthening the chain*' (November 2020)

[7] CFR, *CORIE framework launched to test cyber resilience of Australia's financial services industry* (December 2020)

- implementing a tool to benchmark and assess trends in risk culture across regulated entities, after undertaking a risk culture survey for a pilot group of regulated entities.

APRA will also be working with Government to extend the accountability regime to all APRA-regulated entities.

2.4 Improving recovery and resolution capability

COVID-19 emphasised the importance of APRA's strategic priority to enhance its recovery and resolution capability and that of the industry via effective contingency planning and regular testing of those plans. In 2020 APRA was focused on contingency planning for near-term risks to the financial system. Stabilisation in the external environment will enable APRA to refocus on its planned supervisory priorities over the next 12-18 months. APRA is proposing to release for consultation a draft cross-industry prudential standard on recovery and resolution planning as outlined in its Policy Priorities Paper. This will be reinforced by the following supervisory priorities:

- strengthening the credibility of recovery plans across all APRA-regulated industries to ensure that supervised entities have and maintain a credible recovery capability, with APRA's assessment of an entity's recoverability as a key input into the SRI Model assessment;

- ensuring that simple, credible resolution strategies are in place for more vulnerable entities across each industry. These are critical for situations where an entity is facing financial stress and private sector recovery is not possible; it means that the entity and APRA are prepared to implement an orderly exit or resolution that maintains financial stability and minimises any impact on public funds and beneficiaries (depositors, policy-holders and members); and

- driving improvements in small ADIs' compliance with *Prudential Standard APS 910 Financial Claims Scheme* to ensure that entities are adequately prepared should the Financial Claims Scheme safety net be required.

Expanding recovery and resolution planning in the superannuation industry is also an important priority over the coming period and will help underpin the Government's implementation of the *Your Future Your Super* reforms.[8]

2.5 Climate-related financial risks

Climate change is a driver of financial risks, as well as business opportunities, for all APRA-regulated entities. While the financial nature of these risks is increasingly understood, there remains a need for regulated entities' to enhance their capacity to manage and respond to climate risks. APRA continues to increase its scrutiny of the manner in which ADIs, insurers and superannuation trustees are managing the impact of risks arising from climate change.

[8] Australian Government Treasury, *Your Future, Your Super package* (November 2020)

In a letter to industry in 2020, APRA outlined areas of focus for its climate risk activities.[9] Though some supervision initiatives were deferred due to COVID-19, APRA remains committed to ensuring that regulated entities take a strategic and risk-based approach to the management of climate-related financial risks. APRA intends to develop climate risk guidance in 2021 to assist with this, as highlighted in the Policy Priorities paper.

APRA is currently completing a supervisory review of the regulated entities that participated in APRA's 2018 climate risk survey. The outcomes of these reviews are being used to inform the development of APRA's climate risk guidance and ongoing supervision activities.

As part of APRA's actions to both uplift the scenario analysis capability and strengthen the understanding and management of climate-related risks within the financial sector, APRA is leading work on a climate vulnerability assessment (CVA) together with the CFR. Beginning with large ADIs in 2021, the CVA will:

- explore the potential financial exposure and macroeconomic risks to large ADIs, the financial system and economy from both physical and transition climate risks; and
- assist APRA in understanding how the large ADIs might adjust their business models in response to different climate change scenarios.

APRA is currently designing the CVA and expects to engage with the ADIs participating in the assessment in 2021. The design of the CVA will reflect APRA's cooperation with international peer regulators. APRA also recognises that there have been significant investments by large ADIs in recent years to improve their climate risk assessment and response capabilities, and where possible the CVA will leverage this capability. The CVA also presents an opportunity for enhanced consistency across ADIs in their approach to assessing climate-related risks, improving the value of the climate risk analysis for both individual ADIs and the wider market.

[9] APRA, *Understanding and Managing the Financial Risks of Climate Change* (Letter, 24 February 2020)

Chapter 3 - Banking

The banking industry entered COVID-19 well-capitalised and with sound liquidity and funding. COVID-19 presented unprecedented risks and the potential for significant adverse outcomes for customers and banks. Government, central bank and prudential support programs have been provided to mitigate this. These programs will be gradually unwound in the period ahead.

APRA is focused on maintaining the banking industry's resilience and enhancing its crisis readiness, supporting prudent outcomes through the pandemic and in the transition to the post-pandemic recovery. In response to COVID-19, APRA made a necessary shift from baseline supervision to a sharpened focus on financial resilience. In 2021, in addition to the cross-industry initiatives outlined in Chapter 2, APRA will focus on the three key areas outlined below. In doing so, APRA recognises that its supervisory approach must be tailored and proportionate to the various cohorts of the industry, recognising differing business models and challenges.

3.1 Credit Risk

While Government support measures, including APRA's temporary capital relief for loan repayment deferrals, have played an important role in assisting borrowers, credit risk increased significantly for banks as a result of COVID-19. Banks are expected to experience an increase in credit losses as government support is withdrawn and they will need to work through elevated volumes of problem loans.

Credit quality, problem loan management and provisioning will therefore be areas of focus in the period ahead. APRA will maintain a heightened level of supervisory engagement as it monitors credit risk, with a particular emphasis on the identification of problem loans and higher risk portfolios, including undertaking 'deep dives' to obtain assurance about effective portfolio management. Progress on reducing and ultimately clearing loan repayment deferral portfolios will continue to be monitored. To facilitate this, banks may be asked for portfolio specific data and other credit information.

The pending finalisation of *Reporting Standard ARF 220 Credit Exposures and Provisions*, which is the enhanced data collection for credit risk, will allow APRA to undertake improved analysis and monitoring. For banks accredited to use the internal ratings-based approach to credit risk, APRA will be assessing portfolio re-rating and model performance. Reflecting the importance of credit to the operation of the broader economy, APRA will also be monitoring the availability of credit to different types of borrowers.

3.2 Capital Management

APRA expects that at all times banks maintain capital adequacy, and during COVID-19 there has been a need to ensure that banks use buffers to absorb losses and continue to provide credit to support the economy if needed.

APRA has provided capital guidance to banks, including on dividend payouts and will continue to monitor ADIs to ensure ongoing prudent capital management. APRA will continue to assess banks' capital management, including their stress testing capabilities, the scenarios they consider and how recovery planning options have been integrated, in order to identify gaps and ensure that they deliver on their capital management plans.

3.3 Liquidity

Bank funding and liquidity positions have benefited from extraordinary central bank support provided during COVID-19. APRA will continue to focus on the stability of bank liquidity and funding in the face of uncertainty and will be examining how, when appropriate, ADIs will be able to transition away from the extraordinary support that has been provided in an orderly manner.

APRA has a program of supervisory work aimed at ensuring reliability and stability in funding and liquidity, including:

- addressing risk management deficiencies identified at peak times of COVID-19;
- facilitating a smooth reduction in Committed Liquidity Facility limits given the increasing availability of Commonwealth and State government securities to provide High Quality Liquid Assets; and
- supporting the transition of the banking industry to funding self-reliance as external support measures are phased out.

Chapter 4 - Insurance

Overall, the insurance industries that APRA regulates remain well-capitalised, and have flexed and adapted to the operational issues arising from COVID-19. Each industry is experiencing its own challenges, either as a result of underlying sustainability issues or due to the COVID-19 driven economic disruption.

4.1 General insurance

In 2020 general insurance industry profitability declined due to the catastrophic bushfire and storm events and the early impacts of COVID-19 on investment returns. Despite this, the industry's capital coverage has remained stable.

The pandemic has raised questions around the role of insurers in protecting the community against pandemic risks. These risks are extremely difficult to insure as they frequently manifest globally and are therefore highly correlated, meaning coverage is unlikely to be affordable. The most prominent example of this has been in business interruption (BI) insurance.

Recovery and resolution planning for insurers remains a priority in line with APRA's broader cross-industry work on crisis readiness and work has also continued on managing the risks associated with insurers' high reliance on overseas reinsurance.

4.1.1 Business interruption insurance

The economic and social disruption from COVID-19 has put the spotlight on insurers and the role of business interruption (BI) cover in assisting the business community with the recovery from COVID-19 impacts. APRA has been closely monitoring the industry's exposure to business interruption policies, given the uncertainty that has arisen over the effect of policy wordings. Some of these matters are currently being tested in the Courts, and early indicators are that insurers may be liable for exposures beyond their original intent because of insufficient attention to the precision of policy terms and conditions.

The ongoing uncertainty has caused challenges for insurers and policyholders and resolving that uncertainty as quickly as possible is critical, to allow all parties to move forward. APRA is working with peer regulators, industry and other stakeholders towards this objective.

APRA expects that insurers will reserve prudently for potential claims, and pay all legitimate claims in a timely fashion. APRA has undertaken intense monitoring of the potential impact BI could have on insurers and this will continue into 2021. Entities can expect APRA to maintain a close watch over the BI legal proceedings and seek regular updates on insurers' exposures, provisioning levels, stress testing and the extent of support from reinsurers, in an effort to assess the potential impact on capital levels. APRA is also assessing the readiness of insurers to deploy recovery options in the event of a severe adverse outcome and will be monitoring steps being taken by insurers to facilitate the availability and affordability of appropriate cover into the future.

More broadly, BI provides a case study in the efficacy of insurers' governance and risk management practices in relation to how products are developed, reviewed and updated. This will be a focus area for supervisors in the short to medium term including the robustness of pricing processes and the link between policy wordings and reinsurance to assess any potential misalignment in coverage.

4.1.2 Overseas reinsurance

The global reinsurance market is critical to the functioning of the Australian insurance industry and supports the availability of insurance to the Australian community. While reliance on reinsurance is a necessary feature of the insurance industry, it presents certain risks should that reinsurance not be available. To manage this risk, APRA will continue with supervisory activities aimed at understanding the parent group's capital management approach and capital support available to Australian reinsurers, both in times of business-as-usual and stress situations. During COVID-19, APRA increased its engagement with home regulators and parent groups of offshore reinsurers in order to identify and respond to broader institutional and systemic impacts of the pandemic, and this will continue in 2021.

4.2 Life insurance and friendly societies

While capital coverage in the life insurance industry has remained relatively stable, the industry continues to face significant product sustainability and profitability challenges. COVID-19 is expected to exacerbate these challenges. As a result, maintaining financial resilience and sustainability is an area of heightened supervisory focus.

Due to COVID-19, certain areas of focus prior to the pandemic, such as product sustainability and data quality, have been reinforced. Activities such as regular stress testing exercises using COVID-19 related scenarios, new data collections, and recovery planning are either underway or planned in the near future.

In response to the industry's challenges, APRA has increased its engagement at the industry level, reinforcing its message that accountability for improving the ongoing sustainability of the industry sits with a broad set of stakeholders in the life insurance and friendly society ecosystem. If the sustainability challenges are not appropriately addressed by the industry, then there is a risk that some types of life insurance may not be available to the Australian community in the future.

4.2.1 Sustainable products

The life insurance industry faces long-standing challenges, substantially in relation to legacy products with unsustainable features. Instances of poor product design and unsustainable product offerings are threatening affordability of retail products. Pricing and design of insurance offerings available through superannuation are also facing sustainability challenges.

APRA will maintain its heightened supervisory focus and willingness to intervene, reflecting concerns about the sustainability of certain products. Individual disability income insurance

(IDII) is a particular area of focus. APRA has already intervened in relation to IDII with a number of measures, including higher capital requirements, to incentivise the industry to change market practice.[10]

The higher capital requirements will remain in place until individual insurers can demonstrate they have taken adequate steps to address APRA's concerns. In instances where individual insurers fail to meet expectations, APRA may impose further capital requirements, or if appropriate, take more forceful action, such as issuing directions or imposing licence conditions.

APRA has observed worsening claims experience and a decline in profitability of insurance offered through superannuation funds, as well as instances of premium volatility and material changes in product design. In December 2020 APRA highlighted these warning signs at a roundtable of senior participants in both the life insurance and superannuation industries. APRA will shortly be communicating with industry on observed threats to the sustainability of insurance in superannuation and APRA's expectations of respective industry participants to act decisively to address them. APRA will actively monitor the industry's response and will intensify its actions if needed.

4.2.2 Friendly societies

APRA has established a three-year supervision roadmap, tailored to enhance the financial resilience of friendly societies. The roadmap was communicated to the industry in December 2020. In 2021, APRA will be reviewing the impact of the prolonged low interest rate environment on business model sustainability; board composition; and recovery planning. Planning work for other components of the roadmap (risk management, minimum capital requirement, and stress testing) will begin in the second half of 2021.

4.3 Private health insurance

While PHIs are generally financially sound, the effect of COVID-19 on investment returns, deferred claims liabilities, and the industry's response through the provision of financial hardship assistance and deferred premium increases underpinned a continued decline in profitability over the past 12 months. While investment incomes have stabilised, insurance margins remain under pressure as health (and hence claim) costs continue to rise faster than premiums.

The industry continues to face sustainability challenges due to rising premiums that are causing affordability issues and resulting in declining membership, particularly among the younger population. APRA expects that the economic impacts from COVID-19 will exacerbate sustainability challenges, as unemployment has increased amongst the younger population and wage growth remains subdued. In June 2019, APRA outlined its expectations that PHIs would develop robust, actionable strategies to address sustainability risks, as well as

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[10] APRA, *Sustainability measures for individual disability income* (Letter, December 2019)

recovery plans that outline how they will respond if their strategy is not successful or other material risks threaten their solvency.

Continuing the work commenced in 2020, in 2021 APRA will remain focused on building industry resilience and preparedness through recovery planning. APRA supervisors will also be assessing PHIs' progress in addressing affordability and sustainability risks. PHIs that take a passive approach to these risks can expect more intense supervision. More broadly, APRA will continue to drive an uplift in the practices of PHIs to ensure that they are well positioned to address new challenges in a rapidly changing operating environment. This will include working towards improving the industry's governance and controls around IT and outsourcing services, recognising that PHIs are using a growing range of material service providers.

Chapter 5 - Superannuation

The superannuation industry withstood significant and unexpected headwinds in 2020, including a weakened economic environment, shrinking superannuation inflows (driven by increasing unemployment) and an entrenched low interest rate environment. The temporary expansion of the Early Release Scheme (ERS) for COVID-19 led to a sharp increase in member outflows. Operational resilience was also tested on a number of fronts.

Despite the challenges 2020 posed, the industry performed reasonably well, ending the year in a sound position. However, there remains a need for the industry to maintain its focus on enhancing member outcomes and tackling areas of underperformance. This was a continued area of focus for APRA throughout 2020. As APRA's first full refresh of its MySuper Product Heatmap showed in December, a number of funds continue to display entrenched underperformance, and will face heightened scrutiny and possible enforcement action as APRA further steps up its efforts to lift member outcomes in 2021.

5.1 Sharpening APRA's supervisory approach

Improving outcomes for superannuation members continues to be one of APRA's key community outcomes. APRA is focused on embedding a superannuation trustee culture that is continuously improving the quality of outcomes delivered to members and ensuring areas of underperformance are addressed. APRA's overall strategy for improving outcomes for superannuation members is centred around four key areas:

- strengthening the prudential framework;
- sharpening APRA's supervisory approach;
- enhancing superannuation data and insights; and
- improving industry transparency.

APRA's initiatives for strengthening the prudential framework are outlined in APRA's policy priorities paper.

In addition to supervision of individual entity risks, APRA will conduct a number of thematic supervisory activities in the next 12 – 18 months as follows:

- Complete its review into unlisted asset valuation practices that commenced in 2020 after observing some trustee valuation practices during COVID-19. APRA will engage with poorer performing entities to ensure their practices are enhanced.
- Review trustees' implementation of requirements under *Prudential Standard SPS 515 Strategic Planning and Member Outcomes* (SPS 515) by examining:
  - the Business Performance Reviews for a range of trustees. One of APRA's focus areas will be on how trustees demonstrate they are responding to the impact of COVID-19 on their business operations; and

- expenditure management of certain advertising, promotion, sponsorship and payments to parent organisations by a select group of trustees.

- Continue heightened supervision of MySuper products identified as underperforming on APRA's MySuper heatmap, and extending to underperforming choice products based on the expansion of APRA's heatmap to choice products in 2021. APRA will take enforcement action where appropriate to require trustees to improve performance or transfer members to another product.

- Complete an in-depth review of selected large trustees' management of outsourcing providers, focusing on related party arrangements and managing conflicts of interest.

- Build on APRA's cross-industry GCRA initiatives, and set clear expectations that trustees address actual and perceived barriers that hinder boards from achieving the optimal mix of skills and experience required to fulfil trustee obligations. A broad thematic review and analysis will be undertaken over 2021 which will include review of the adequacy of skills and experience on boards, effectiveness of board appointment and renewal processes, and the quality of board and director performance reviews.

APRA will make industry-level findings from thematic work public, outlining good practice and areas where trustees are expected to strengthen practices.

5.2 Enhancing superannuation data and insights

APRA is significantly enhancing its superannuation data collection in order to support supervision and enhance insights in areas such as performance, fund expenditures and insurance. The Superannuation Data Transformation (SDT) program will expand, deepen and refine the data collected from the superannuation industry.[11] APRA has completed consultation on phase one of the SDT program and will release a response package in early 2021. Trustees will be required to report under the new reporting standards in the second half of 2021. APRA intends to continue to work with industry throughout the year via its industry working groups to support trustees during the preparations for the new reporting requirements and the introduction of APRA Connect.

5.3 Improving industry transparency

Strengthening transparency will assist stakeholders to hold trustees accountable for the outcomes delivered, particularly where underperformance is identified. The release of MySuper product Heatmaps is a major element in this process, providing credible, clear and comparable information for all MySuper products.

APRA will expand this work by releasing a Choice Heatmap in the second half of 2021 that will cover multi-asset class choice options and will highlight areas of underperformance in those products. APRA will also publish the results from the Government's performance test under the *Your Future Your Super* reforms. The insights from the heatmaps and Government

[11] APRA, *Consultation on APRA's Superannuation Data Transformation* (August 2020)

performance test will enable more intense supervisory action against trustees who continue to underperform. As the SDT program progresses, APRA plans to further enhance transparency by publishing additional information on trustee operations and the outcomes they deliver.

Attachment A: Timelines

Key supervisory activities and timelines are summarised in the table below.

Strategic focus	Supervisory activity	Entities included	Expected commencement
Maintaining financial system resilience			
Cross-industry	Assessment of financial services industry service providers	Selected ADIs and trustees	Underway
	Assessment of operational risk and compliance transformation programs	Large ADIs and selected insurers and trustees	Underway
	Strengthening recovery planning	All ADIs and insurers, selected trustees	Underway
	Resolution strategy development	Selected ADIs, General Insurers and Life Insurers (LIs)	Underway
	Climate change supervisory review	38 large entities	Underway
Banking	Climate change vulnerability assessment	Large ADIs	2021 1H
	ADI stress test	Large ADIs	2021 2H
	FCS review	Selected small ADIs	2021 1H
	Credit portfolio reviews	Selected ADIs	Underway
Insurance	Overseas reinsurance – review of group capital management and support	Foreign general insurance reinsurers	Underway
	IDII intervention	All LIs	Underway
	Resilience planning	All PHIs	Underway
Improving cyber resilience			
Cross-industry	Assessment of CPS 234 implementation	Initially as a selection of APRA-regulated entities	Underway
	Development of a cyber information sharing community	Selection of APRA-regulated entities	Underway
	Cyber resilience data collection	Selection of APRA-regulated entities	Underway

Strategic focus area	Supervisory activity	Entities included	Expected commencement
Transforming governance, risk culture, remuneration and accountability			
Cross-industry	Evaluation of entities' risk governance self-assessment actions	36 large entities	Underway
	Deep dive risk culture reviews	3 entities per year	Underway
	Risk culture industry survey	Large and medium entities	Underway
	Assessment of CPS 511 implementation plans	To be determined	2021 2H
Improving outcomes for superannuation members			
Superannuation	Review of SPS 515 implementation – Business Performance review	Selection of trustees	2021 1H
	Fund expenditure review	Selection of trustees	Underway
	Outsourcing review	Selection of large trustees	Underway
	Trustee capabilities review	Selection of trustees	2021 1H
	Unlisted asset valuation review	Selection of trustees	Underway
	Superannuation Data Transformation project	All trustees	Underway
	Improving Transparency – Choice heatmap	All trustees	2021 2H
	Addressing areas of underperformance	Selection of trustees	Ongoing

APRA

PRUDENTIAL PRACTICE GUIDE

Draft CPG 229 Climate Change Financial Risks

April 2021

Contents

About this guide

Prudential practice guides (PPGs) provide guidance on APRA's view of sound practice in particular areas. PPGs frequently discuss legal requirements from legislation, regulations or APRA's prudential standards, but do not themselves create enforceable requirements.

This PPG aims to assist an APRA-regulated institution in complying with *Prudential Standards CPS 220 Risk Management* (CPS 220), *SPS 220 Risk Management* (SPS 220), *CPS 510 Governance* (CPS 510), *SPS 510 Governance* (SPS 510) and, more generally, to outline prudent practices in relation to climate change financial risk management.

In this PPG, the term:

- 'climate risks' refers to the financial risks arising from climate change, including physical, transition and liability risks; and
- 'APRA-regulated institution' refers to an authorised deposit-taking institution (ADI), a registrable superannuation entity (RSE) licensee (RSE licensee), a general insurer, a life company (including friendly societies), a private health insurer, an authorised non-operating holding company (NOHC) and, where applicable, Level 2 and Level 3 groups.

This PPG is designed to be read together with CPS 220, SPS 220, CPS 510 and SPS 510 but does not address all prudential requirements in relation to risk management and governance.

Subject to meeting the requirements of the prudential standards, an APRA-regulated institution has the flexibility to configure its approach to climate risk management in a manner best suited to achieving its business objectives. Not all of the practices outlined in this PPG are relevant for every institution and some aspects may vary depending upon the size, business mix and complexity of the institution.

Introduction

1. The risks of a changing climate extend to all sectors of the economy. The need to adapt to the changing climate will also bring new business opportunities. Within the financial sector, a prudent institution will consider both the opportunities and the financial risks of climate change as it sets its strategy.

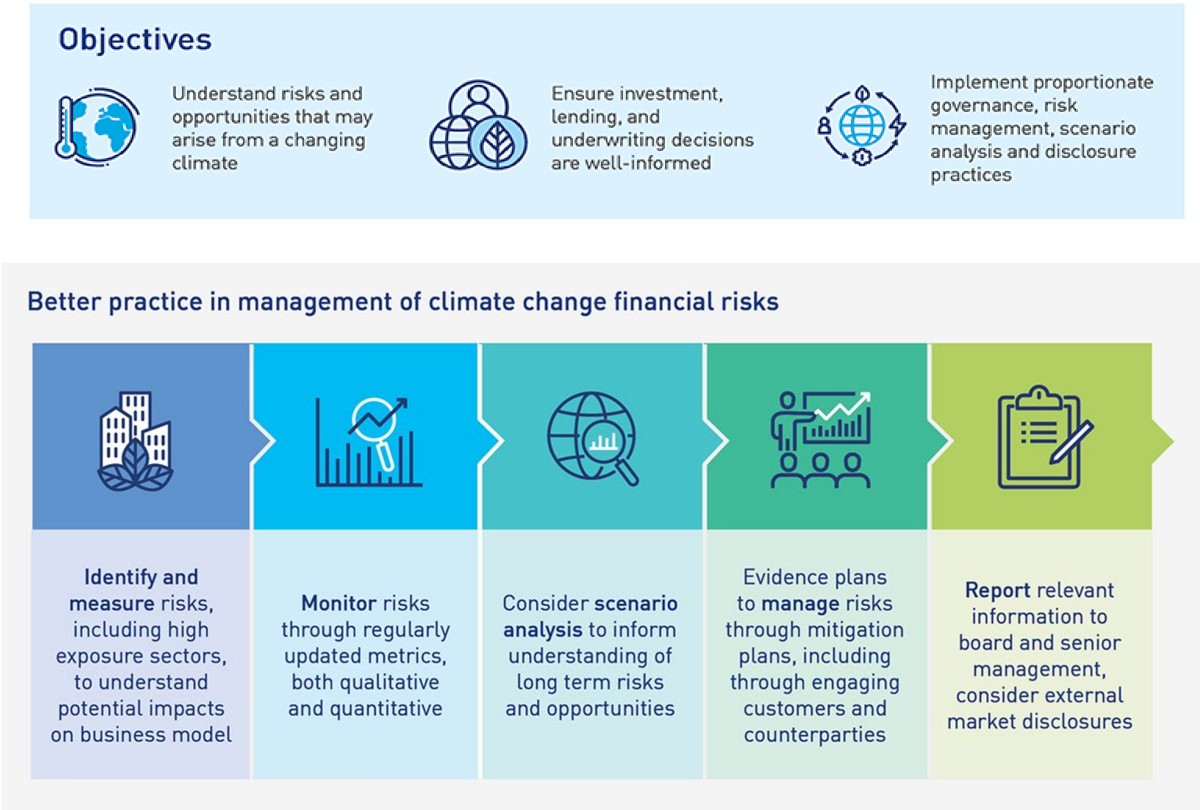
2. APRA's mandate is to ensure that, under all reasonable circumstances, financial promises made by APRA-regulated institutions are met within a stable, efficient and competitive financial system. APRA is seeking to ensure that APRA-regulated institutions are managing the risks and opportunities that may arise from a changing climate, in line with APRA's approach to other types of risks.

3. The information in this guide does not impose new requirements in relation to climate risks; rather, it supports compliance with APRA's existing risk management and governance requirements and provides guidance to assist an institution to manage climate risks. In keeping with APRA's mandate, this guidance does not seek to determine an institution's individual investment, lending or underwriting decisions, but does aim to ensure that these decisions are well-informed.

4. This PPG reflects the established framework for considering and managing climate risks developed by the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD)[1] as well as good practice observed through APRA's own analysis.

[1] Financial Stability Board Task Force on Climate-related Financial Disclosures, *Final Report: Recommendations of the task force on climate-related financial disclosures* (June 2017).

Figure 1. Overview of APRA's climate change financial risk guidance



The financial risks of climate change

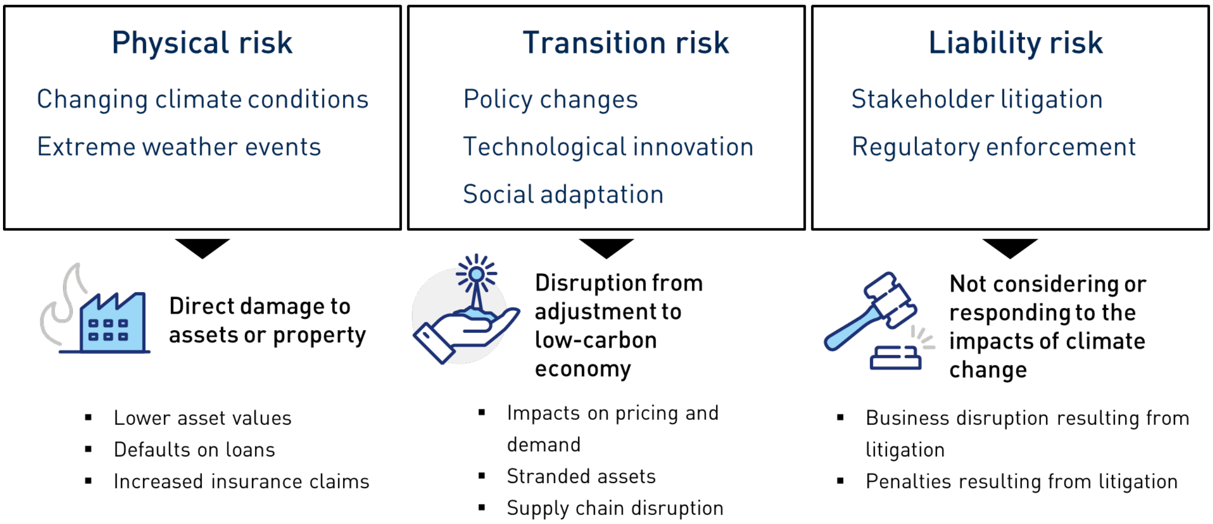
5. The financial risks of climate change, including the economic risks associated with domestic and international government, industry and community responses to a changing climate, are referred to in this guidance collectively as climate risks. Climate risks can be classified as physical climate risks, transition climate risks, and liability risks (Figure 2).

6. Physical climate risks, including both long-term changes in climate as well as changes to the frequency and magnitude of extreme weather events, can cause direct damage to assets or property, changes to income and costs, and changes to the cost and availability of insurance.

7. Transition climate risks include risks related to changes in domestic and international policy, technological innovation, social adaptation and market changes, which can result in changes to costs, income and profits, investment preferences and asset viability.

8. Climate change may also give rise to liability risks which have implications for businesses and directors' duties. Liability risks stem from the potential for litigation if institutions and boards do not adequately consider or respond to the impacts of climate change.

Figure 2. Climate change financial risks



9. A prudent APRA-regulated institution would take a strategic and risk-based approach to the management of the various risks and opportunities arising from climate change, recognising the unique nature and far-reaching potential impacts of a changing climate.

10. It is important for institutions to understand the interaction between climate risks and their business activities, as well as the compounding effect climate risks may have on an institution's other risks, including:

a) credit risk – through a potential increase in defaults on loans by businesses and households that may be affected by adverse climate events, as well as the potential for assets used as collateral to decline in value;

b) market risk – through the impact of potential re-pricing of financial instruments and corporate debt affecting the value of securities held on an institution's balance sheet;

c) operational risk – including the risk of supply chain disruption and forced facility closures;

d) underwriting risk – through a potential increase in insured losses as a result of more frequent and/or extreme weather events;

e) liquidity risk – through an increased demand for liquidity to respond to extreme weather events or the difficulties that may be faced in liquidating assets negatively impacted by climate risks; and

f) reputational risk – including an institution's ability to attract and retain customers and employees due to changing employee and community expectations.

11. While APRA considers that climate risks can and should be managed within an institution's broader risk management framework, the financial risks associated with climate change have a number of elements that distinguish them from other financial risks, and necessitate a strategic approach to their management. These elements include:

    a) the potential for irreversible changes in climate, leading to impacts that may not be easily mitigated or reversed;

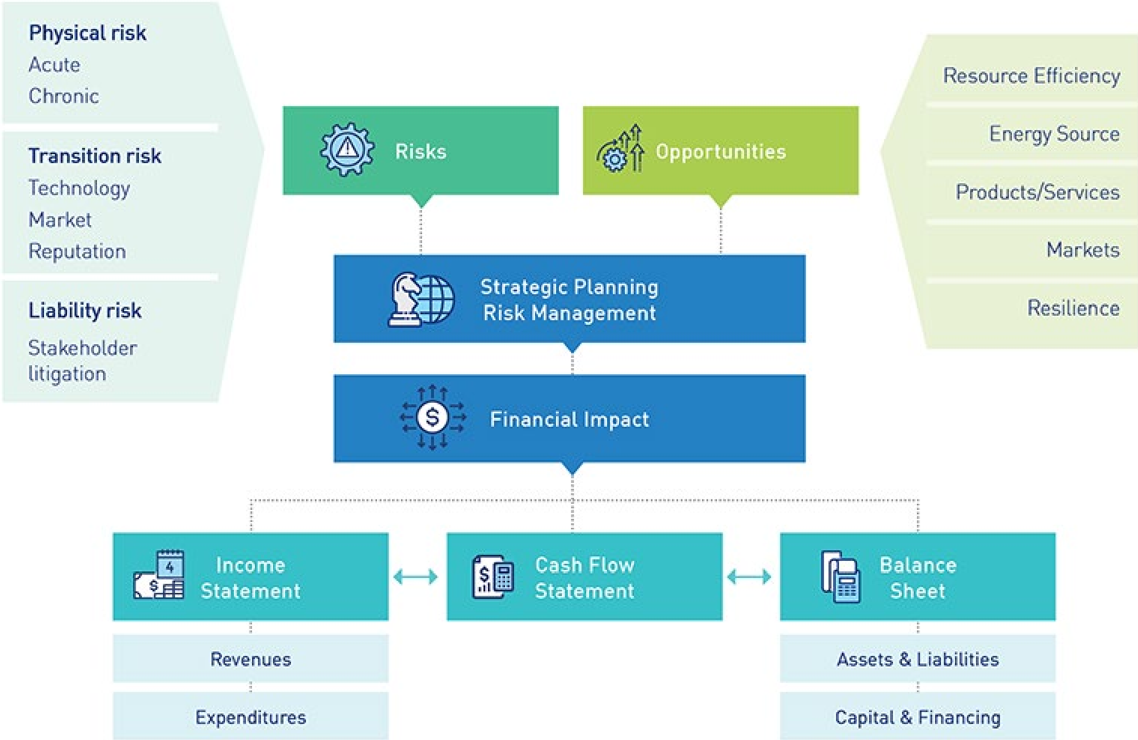
    b) the far-reaching impact that climate risks pose to all parts of the financial system, including different business types, geographical locations and economic sectors, as well as the potential for risks to manifest across multiple lines of business at the same time;

    c) the uncertain and extended time horizon over which climate risks may materialise, which is likely to extend beyond typical business planning cycles; and

    d) the unprecedented nature of climate change, meaning that historical data and traditional backward-looking risk assessment methods are unlikely to adequately anticipate future impacts.

12. While the exact form and extent to which climate risks will materialise is uncertain, there is a high degree of certainty that some financial risks will materialise as a result of climate change (Figure 3). An APRA-regulated institution can mitigate the magnitude of the financial impacts of these risks through action, particularly directed at improving understanding of these risks. Investing in better risk management will also allow institutions to identify and benefit from opportunities that arise from the transition to a low-carbon economy, including meeting increasing investor demand for sustainable finance and identifying customers that are well positioned to respond to climate change.

Figure 3. Climate risks, opportunities and financial impact[2]



[2] Adapted from Financial Stability Board Task Force on Climate-related Financial Disclosures, *Final Report: Recommendations of the task force on climate-related financial disclosures* (June 2017).

Governance

13. Prudential standards CPS 510 and SPS 510 set out the minimum governance requirements of an APRA-regulated institution. The ultimate responsibility for the sound and prudent management of an APRA-regulated institution's business operations rests with its board of directors[3]. APRA therefore considers it prudent practice for the board to seek to understand and regularly assess the financial risks arising from climate change that affect the institution, now and into the future.

14. APRA is of the view that climate risks can and should be managed within an institution's overall business strategy and risk appetite, and a board should be able to evidence its ongoing oversight of these risks when they are deemed to be material.

15. The board of an APRA-regulated entity may delegate certain functions of the management of climate risks but, as with other risks, needs to maintain mechanisms for monitoring the exercise of this delegated authority. Board-level engagement is important to ensure that work on climate risks holds sufficient standing within an institution, and gives the board the requisite institution-wide insights to strategically respond to the risks.

16. A prudent board of an APRA-regulated institution is, in overseeing the management of climate risks, likely to undertake the following roles:

    a) ensuring an appropriate understanding of, and opportunity to discuss, climate risk at the board and sub-committee levels, which may include appropriate training for board members;

    b) setting clear roles and responsibilities of senior management in the management of climate risks, and holding senior management to account for these responsibilities;

    c) re-evaluating the risks, opportunities and accountabilities arising from climate change on a periodic basis, and considering these risks and opportunities in approving the institution's strategies and business plans;

    d) taking both a short- and long-term view (which may be beyond the institution's regular business planning horizon) when assessing the impact of climate risks and opportunities; and

    e) where climate risks are found to be material, ensuring that the institution's risk appetite framework incorporates the risk exposure limits and thresholds for the financial risks that the institution is willing to bear.

[3] For the purposes of this PPG, a reference to the board, in the case of a foreign ADI, Category C insurer or an eligible foreign life insurance company (EFLIC), is a reference to the Senior Officer Outside of Australia or Compliance Committee (as applicable) as referred to in *Prudential Standard CPS 510 Governance*.

17. In light of the board roles above, an institution's senior management would typically be responsible for:

    a) utilising an institution's risk management framework to assess and manage climate risk exposures on an ongoing basis, including developing and implementing appropriate policies;

    b) regularly reviewing the effectiveness of the framework, policies, tools and metrics and making appropriate revisions;

    c) providing recommendations to the board on the organisational objectives, plans, strategic options and policies as they relate to climate risks that are assessed to be material, including the establishment and use of relevant tools, models and metrics to monitor exposures to climate risks, so as to enable the board to make informed decisions in a timely manner; and

    d) ensuring that adequate resources, skills and expertise are allocated to the management of climate risks, including through training and capacity building amongst senior staff.

Risk management

18. Under CPS 220 and SPS 220, the board of an APRA-regulated institution is ultimately responsible for both the institution's risk management framework, and for the oversight of its operation by management. Senior management of the institution monitor and manage all material risks consistent with the strategic objectives, risk appetite statement and policies approved by the board. APRA considers it prudent for climate risks to be considered within an institution's existing framework, including the board-approved risk appetite statement, risk management strategy and business plan.

19. A prudent institution would seek to ensure that its arrangements to identify, measure, monitor, manage, and report on its exposure to climate risks are conducted in a manner appropriate to the institution's size, business mix and complexity of its business operations.

Policies and procedures

20. APRA considers that prudent practice would be for an institution to evidence the management of climate risks within its written risk management policies, management information, and board risk reports. Where climate risks are material, this may require updating existing risk management policies and procedures.

21. As a matter of good practice, the policies and procedures developed under the risk management framework would include a clear articulation of the respective roles and responsibilities of business lines and risk functions (i.e. Line 1 and Line 2 activities) in relation to managing climate risks.

Risk identification

22. A prudent institution would seek to understand climate risks and how they may affect its business model, including being able to identify material climate risks and assess the potential impact on the institution. Scenario analysis, with both a short- and long-term time horizon, is a useful tool for informing the risk identification process (see further discussion on scenario analysis below).

23. CPS 220 and SPS 220 identify categories of risk that the risk management framework must cover at a minimum. Climate risks can be considered within these established risk categories. A prudent institution should be able to demonstrate how it determines the materiality of climate risk within each of these categories.

24. A prudent institution would likely seek to identify economic sectors with higher or lower exposures to physical and/or transition climate risks. The risk criteria for this identification may include a range of factors, such as: vulnerability to extreme weather events; the level of greenhouse gas emissions; potential exposure to changes in climate-related policy or technology; and/or linkages to unsustainable practices. The assessment of economic sectors may be used to develop sector-specific policies and procedures for the institution when undertaking business engagements (such as investing, insuring or

lending) with that sector. Good practice would see an integrated approach to climate risks taken across different business lines (such as underwriting, investment, product development and lending functions).

25. APRA considers the Internal Capital Adequacy Assessment Process (ICAAP) to be an appropriate framework to consider and record the material impact on capital adequacy of climate risks for those institutions required to complete an ICAAP. An institution that is not required to complete an ICAAP may benefit from adopting a similarly formal approach to recording material exposures and how the assessment of those exposures is considered.

Risk monitoring

26. Better practice in monitoring climate risks includes both a qualitative and quantitative approach, including developing metrics to measure and monitor climate risks appropriate to an institution's size, business mix and complexity of business operations. Such metrics might typically be used, for example, to assess portfolio exposures to geographical areas and economic sectors with higher or lower climate risk[4].

27. More advanced quantitative risk metrics may take a variety of forms, such as direct and indirect emissions (usually classified into scope 1, scope 2 and relevant scope 3 emissions[5]), exposure to physical risks, monitoring potential impacts to core business metrics such as credit risk, losses or investment returns, modelling the impact of climate scenarios on project returns and/or quantifying the impact of adaptation measures.

28. Quantitative metrics would assist an APRA-regulated institution to understand the potential current and future impacts of climate risks on its customers, counterparties, and organisations to which the institution has an exposure. Where an APRA-regulated institution does not have the necessary information to assess these impacts, it is appropriate for the institution to engage with customers and counterparties to form an understanding of the extent to which the impacts may be material to the institution's own risks.

29. A prudent institution is likely to use data from both publicly available and proprietary sources, and potentially seek assistance from external experts where necessary (including academics, specialist consultants, and scientific bodies), to better understand

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[4] Further guidance on the metrics an institution may develop is provided by the Financial Stability Board Task Force on Climate-related Financial Disclosures, *Implementing the Recommendations of the Task Force on Climate-related Financial Disclosures* (June 2017).

[5] Scope 1 refers to all direct greenhouse gas emissions arising from a business' own activities. Scope 2 refers to indirect greenhouse gas emissions from the use of purchased electricity, heat or steam. Scope 3 refers to other indirect emissions not covered in Scope 2 that occur in the value chain of the reporting company, including both upstream and downstream emissions. For finance sector entities, scope 3 emissions include the scope 1 and 2 emissions from businesses to which they have a financial exposure (e.g. through lending activities, insurance products, and investments). For further information, see Financial Stability Board Task Force on Climate-related Financial Disclosures, *Final Report: Recommendations of the task force on climate-related financial disclosures* (June 2017).

the possible impacts of climate change on its own operations as well as those of its customers, counterparties, and organisations to which the institution is exposed.

30. Given the evolving understanding of climate change, a prudent institution would ensure that climate risk data and metrics were updated regularly to support decision-making by the institution's board and senior management. It would also consider the circumstances which might trigger a review of its strategy or engagement with customers and counterparties.

31. Better practice in risk monitoring extends to monitoring the impacts that climate risks may have on outsourcing arrangements, service providers, supply chains and business continuity planning.

Risk management

32. Where an APRA-regulated institution has identified material climate risks, a prudent institution would establish and implement plans to mitigate these risks and manage its exposures, as well as regularly review and assess the effectiveness of those plans. For example, an institution might develop plans to manage concentrations in its portfolio to certain geographic or economic sectors with higher climate risks.

33. In most cases, APRA envisages that an APRA-regulated institution would choose to work with customers, counterparties and organisations which face higher climate risks, to improve the risk profile of those entities. Indeed, providing finance to assist customers to adapt to climate change is an important function of the financial system. However, where the institution considers this engagement will not result in the climate risks being adequately addressed, an institution may need to consider mitigation options such as:

    a) reflecting the cost of the additional risk through risk-based pricing measures;

    b) applying limits on its exposure to such an entity or sector; or

    c) where the risks cannot be adequately addressed through other measures, considering the institution's ability to continue the relationship.

Risk reporting

34. To facilitate well-informed decision-making, APRA expects that a prudent institution would establish procedures to routinely provide relevant information on its material climate risk exposures, including monitoring and mitigation actions, to the board and senior management. This information would allow the board and senior management to understand and review the activities, and to make decisions consistent with the institution's overall risk appetite and risk management approach.

35. The extent and frequency of reporting should be tailored to the nature and magnitude of the risks to which the APRA-regulated institution is exposed.

Scenario analysis

36. APRA considers it prudent for institutions to develop capabilities in climate risk scenario analysis and stress testing, or to have access to external scenario analysis and stress testing capabilities, to inform their risk identification in both the short and long term. Climate risk scenario analysis and stress testing is a developing area and APRA expects approaches to evolve and mature over time.

37. APRA expects the use of scenario analysis and stress testing for climate risks to be proportionate to an institution's size, business mix and complexity. In general, larger and more complex institutions, with a wide range of business, would be expected to have more advanced analytical capability. However, depending on its business model, a smaller institution may be highly concentrated in a particular market, sector or geographical location that is exposed to material climate risks. In such circumstances, it may be appropriate for the institution to seek assistance with scenario analysis and stress testing to assess the impact of climate risks on its risk profile and business strategies, and explore its resilience to financial losses under a range of outcomes.

38. An institution in the early stages of climate risk analysis is likely to begin by developing an understanding of the material risks to which it is exposed, including identifying industries and regions with particular risks within the institution's portfolio. A range of analytical approaches, from simple to complex, are available to support an institution's understanding of their material climate risks; institutions should choose approaches appropriate to their circumstances.

39. Where an institution lacks the data, resources or expertise to conduct climate risk stress testing with appropriate quantitative assessments, it may still benefit from narrative-driven scenario analysis[6]. Qualitative scenarios can still provide insights into the operations and channels of risk transmission, and findings from such an assessment can be reflected in business plans, strategies and risk management practices.

40. When conducting more advanced quantitative climate risk analysis, an institution would typically seek to identify and simulate scenarios which are both plausible and relevant to the institution's operations. Climate risk scenario analysis is a developing area, and not all institutions will have the capability to undertake best practice analysis. However, in developing their capability institutions should have regard to leading practice, which entails:

    a) A short-term assessment of the institution's current exposures to climate risks, in line with current business planning cycles.

[6] Climate risk narratives provide an overview of a climate scenario, and typically include a description of the economic, policy, technology and social (and other) features of the scenario. Narrative-driven scenario analysis can use these features of climate scenarios as a basis for a qualitative evaluation of potential climate risks.

b) A long-term assessment of the institution's future exposures based on a range of different climate-related scenarios, potentially extending to 2050 or beyond. Key considerations when building such scenarios include:

   i) Future temperature rise – scenarios could include:

      - global average temperatures continuing to rise in the absence of mitigating actions and policies (for example, temperature increases in excess of 4°C by 2100), leading to greater physical climate risks; and

      - global average temperatures rising by 2°C or less consistent with the Paris Agreement, reducing the magnitude of long-term physical risks;

   ii) Economic transition pathway – scenarios could include:

      - an orderly transition to a lower-emissions economy, with policies and activities to address climate change being introduced early and gradually becoming more stringent, minimising both physical and transition risks; and

      - a disorderly transition to a lower-emissions economy, with delayed action to reduce emissions leading to an increase in acute transition risks.

c) Incorporating both qualitative and quantitative factors into the scenarios used to project the future financial conditions of an institution[7].

d) Assessing both physical and transition risks within each scenario used.

e) Seeking input from external experts such as academics, scientific bodies and/or specialist consultants, while maintaining appropriate internal knowledge and oversight to ensure that the results of any outsourced analysis are credible, realistic and understood by the institution.

f) Measuring the impact of climate risks on a range of business obligations and considerations, including solvency, liquidity, and the ability (as appropriate) to meet obligations to depositors, policyholders and superannuation fund members.

g) Incorporating forward-looking information into its scenario analysis, such as by considering future trends in catastrophe modelling, technology innovation or policy development. Analysis that relies solely on historical data has the potential to systematically underestimate the impacts of climate risks, due to the complex dynamics of interconnected lines of business and the non-linear and unprecedented levels of disruption.

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[7] Qualitative factors could include direction of change (e.g. warmer temperatures) or economic features (e.g. increased trade and globalisation) of a scenario. Quantitative factors could include emissions budgets, targets and trajectories, emissions prices and a wide range of other factors.

41. When selecting inputs into its climate assessments, an institution seeking to adopt better practice would have regard to:

   a) the time horizon of datasets used, including the need for appropriate long-term timeframes as well as sufficient temporal resolution for the risks assessed (for example, some physical risks might require seasonal data, while annual or decadal data may be appropriate for other risks);

   b) geographic specificity, ensuring that local extreme weather events and locations to which an institution may be exposed are represented;

   c) the impact of multiple extreme weather events arising concurrently; and

   d) the range of global emissions pathways included in a dataset and the capacity for a model to evaluate simulations and projections, noting that testing scenarios at the extreme ranges is more likely to identify risks.

42. Useful guidance on conducting scenario selection and analysis to assess the impacts of climate risks has been produced by organisations such as the TCFD[8], the Climate Measurement Standards Initiative[9], and the Network for Greening the Financial System[10].

43. For an APRA-regulated institution required to complete an ICAAP, APRA considers a narrative-driven process to be a useful approach to considering climate risk scenario analysis and stress testing to assess potential risk exposures and available capital resources.

44. A prudent institution would maintain appropriate documentation of the process and results of its climate risk scenario analysis and stress testing. Where material, the results would be communicated to the institution's board and senior management, and used to inform business planning and strategy setting, as well as setting and reviewing the institution's overall climate risk management approach.

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[8] See Financial Stability Board Task Force on Climate-related Financial Disclosures *Technical supplement: The use of scenario analysis in disclosure of climate-related risks and opportunities* (June 2017).

[9] See Climate Measurement Standard Initiative, *Scenario analysis of climate-related physical risk for buildings and infrastructure: Climate science guidance* (September 2020).

[10] See Network for Greening the Financial System, *Guide to climate scenario analysis for central banks and supervisors* (June 2020).

Disclosure

45. The disclosure of decision-useful, forward-looking climate risk information allows interested stakeholders to assess an institution's resilience to climate risks.

46. With increasing demand from investors and other stakeholders for disclosure on climate-related risks, a lack of absolute certainty in relation to climate risks' future impacts should not be considered a reason to avoid disclosure of exposure to these risks.

47. Beyond any statutory or regulatory requirements, a prudent institution would likely consider whether additional, voluntary disclosures could be beneficial to the institution by enhancing transparency and giving confidence to the wider market in the institution's approach to measuring and managing climate risks.

48. APRA considers the framework established by the TCFD to be a sound basis for producing information that is useful for an institution's stakeholders[11].

49. APRA anticipates the demand for reliable and timely climate risk disclosure will increase over time, and for institutions with international activities there is a need to be prepared to comply with mandatory climate risk disclosures in other jurisdictions. APRA considers that a prudent institution would continually look to evolve its own disclosure practices, and to regularly review disclosures for comprehensiveness, relevance and clarity, to ensure it is well-prepared to respond to evolving expectations in relation to climate-related disclosures.

[11] For further guidance, see the Financial Stability Board Task Force on Climate-related Financial Disclosures *Recommendations of the Task Force on Climate-related Financial Disclosures: Final Report (June 2017).*

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