



APRA

# INFORMATION PAPER

## APRA's objectives

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# Executive summary

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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

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<b>APRA</b>	Australian Prudential Regulation Authority
<b>APRA Act</b>	<i>Australian Prudential Regulation Authority Act 1998</i>
<b>ADI</b>	Authorised deposit-taking institution
<b>FSI</b>	Financial System Inquiry, 2014
<b>Industry Acts</b>	<i>Banking Act 1959, Insurance Act 1973, Life Insurance Act 1995, Private Health Insurance (Prudential Supervision) Act 2015 and the Superannuation Industry (Supervision) Act 1993.</i>
<b>Prudential risks</b>	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.
<b>Royal Commission</b>	Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry

# Chapter 1 - APRA's objectives

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## 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.<sup>1</sup>

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

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<sup>1</sup> 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.





## 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<sup>2</sup> 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.<sup>3,4</sup> 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.'*<sup>5</sup>

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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<sup>2</sup> 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*.

<sup>3</sup> See APRA Act, s8(2).

<sup>4</sup> 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.

<sup>5</sup> 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.<sup>6</sup> 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.

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<sup>6</sup> 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

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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.<sup>7</sup> 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.'<sup>8</sup> 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.<sup>9</sup>

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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<sup>7</sup> Financial System Inquiry, 2014, *Final Report*, p 5

<sup>8</sup> FSI, *Final Report*, p 33

<sup>9</sup> 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'.<sup>10</sup> 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.'<sup>11</sup>

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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<sup>10</sup> FSI, *Final report*, p 33

<sup>11</sup> 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.<sup>12</sup>

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

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<sup>12</sup> 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 administered 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.'<sup>13</sup>

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.

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

# Chapter 3 - APRA's accountability framework

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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

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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

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## 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



	<p>phased licensing requirements or CET1 instruments for mutual ADIs); or</p> <ul style="list-style-type: none"> <li>• by impacting the regulatory playing field between different sectors, for example, between ADIs and the 'shadow banking' sector</li> </ul>
<b>Contestability</b>	<p>Does the proposal create or otherwise increase (or alternatively lower) entry (or exit) barriers? For example:</p> <ul style="list-style-type: none"> <li>• by requiring significant investments in systems and controls;</li> <li>• by imposing significant minimum capital requirements; or</li> <li>• 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</li> </ul>
<b>Competitive neutrality</b>	<p>Does the proposal have any potential impacts on competitive neutrality? For example:</p> <ul style="list-style-type: none"> <li>• by creating advantages for public sector entities relative to other market participants</li> </ul>



APRA