SUBMISSION

Productivity Commission - Competition in the Australian Financial System

September 2017

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Executive summary

The Productivity Commission's Inquiry into competition in the Australian financial system provides a valuable opportunity to reflect on efficiency and competition within Australia's financial marketplace and potentially improve long-term consumer outcomes. APRA welcomes the opportunity to provide input into the Inquiry. This submission focuses on APRA's role in the financial system, potential indicators of competitive dynamics within the industries APRA supervises and its approach to balancing the objectives of financial safety and stability with considerations of competition and competitive neutrality.

APRA is the prudential regulator of the Australian financial services industry. It oversees banks, credit unions, building societies, general insurance and reinsurance companies, life insurance, private health insurance, friendly societies and most of the superannuation industry. As at 30 June 2017, these entities held a combined $6.1 trillion in assets.

APRA's mandate requires it to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, to promote financial system stability in Australia. An appropriate balancing of these objectives helps ensure a financial system that delivers significant benefits to the Australian community. APRA's prudential framework and approach to supervision are geared toward these outcomes.

A strong prudential framework contributes to strong financial entities and these, in turn, help create robust competitors and intermediaries that are able to support economic growth and activity, throughout the economic cycle. APRA's prudential framework and approach to supervision has been informed by the outworkings of the global financial crisis, which saw less financially strong competitors that were unable to maintain their viability through a period of adversity forced to leave the industry, leading to a more concentrated industry as a result.

APRA recognises that its prudential requirements may affect the relative position of competitors in regulated industries by imposing differential costs in some areas. As a result, over recent years, APRA has been developing its framework for more explicitly considering the competition and efficiency impacts in reviewing and updating the prudential framework. Consequently, there are a number of recent and forthcoming prudential developments which are likely to support increased competition in the financial sector without unduly compromising the stability of the financial system.

APRA also aims to ensure that its approach to supervision is proportionate to the risk profile of each regulated entity so that, amongst other things, smaller regulated entities are not subjected to unreasonable expectations or regulatory burden.

Most industry sectors regulated by APRA display relatively high levels of concentration, with a small number of large entities holding a significant combined share of the market. However, industry concentration may not, of itself, be a comprehensive measure of the level of competition in individual markets for financial services products. There appear to be strong indicators of competition in certain financial services product markets, for example residential mortgages. Other segments, however, appear less competitive given a reduced

number of providers, which appears driven in part by a lack of expertise and systems capabilities, along with an aversion to higher risk activities by certain entities.

APRA's submission has been guided by the areas of focus of the Productivity Commission outlined in the consultation paper. In particular, APRA has focused on the issues associated with competition in the banking industry. This submission does not address the superannuation industry as this is subject to a separate review by the Productivity Commission, to which APRA has contributed.

Glossary

Term	Definition
ADI	Authorised Deposit-taking Institution
AMA	The Advanced Measurement Approach to calculating regulatory capital requirements for operational risk as set out in *Prudential Standard APS 115 Capital Adequacy: Advanced Measurement Approaches to Operational Risk*
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
Basel Committee	Basel Committee on Banking Supervision
FSI	Financial System Inquiry
GI	General Insurance
IRB	The Internal Ratings-Based approach to calculating regulatory capital requirements for credit risk as set out in *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-Based Approach to Credit Risk*
LI	Life Insurance
PHI	Private Health Insurance
Standardised	The standardised approach to calculating regulatory capital requirements for credit risk as set out in *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk*

Chapter 1 – APRA's mandate

APRA's mission is founded on the promotion of stability of the Australian financial system by ensuring the prudent management of regulated institutions in each industry. The *Australian Prudential Regulation Authority Act 1998* (APRA Act) and relevant industry Acts provide the necessary authority and legislative powers for APRA to fulfil its function, and set broad parameters for how APRA must operate.[1] These Acts mandate APRA to protect the interests of depositors, policyholders, and superannuation fund members, and APRA is required to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, to promote financial system stability in Australia. Additionally, the Government provides APRA with guidance on APRA's functions and activities through the Portfolio Budget Statement and the Statement of Expectations.

APRA has reflected these expectations in its Statement of Intent, which was published in 2014[2], and via its Corporate Plan. The mission of APRA as expressed in the 2017 – 2021 Corporate Plan is:

> *… to establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by institutions we supervise are met within a stable, efficient and competitive financial system.*[3]

Balancing competition considerations

APRA recognises that its objectives are interlinked, with a strong and stable financial system delivering significant efficiency benefits and the promotion of a competitive financial sector. The efficiency and competition benefits of a stable financial system are not limited to the financial sector but extend to the broader Australian economy.

The benefits of financial stability are often expressed in terms of the costs of financial instability. The uncertainty and volatility associated with periods of financial crisis can, for example, readily result in a contraction in lending activity which is deeply damaging to economic growth and prosperity. The impact of such events on measures of efficiency and competition in the economy often persist for much longer than the crisis that produced them.

APRA is of the view that, with the right balance, stability and competition are mutually reinforcing objectives. However, competition can also lead to instability in the financial system and there are times where it is important for APRA to actively temper competitive forces. Periods of excessive and unsustainable competition can result in financial institutions

[1] The main industry-based Acts are the *Banking Act 1959*, the *Insurance Act 1973*, the *Life Insurance Act 1995*, the *Superannuation Industry (Supervision) Act 1993*, and the *Private Health Insurance (Prudential Supervision) Act 2015*.

[2] APRA Statement of Intent 2014, available at http://www.apra.gov.au/AboutAPRA/Pages/Statement-of-Intent-2014.aspx

[3] APRA Corporate Plan 2017-2021, available at http://www.apra.gov.au/AboutAPRA/Publications/Pages/index.html

inappropriately pricing risk or unintentionally accepting excessive risk in order to gain or retain market share.

Facilitating an appropriate balance between financial stability and competitive dynamics requires a considerable amount of judgement in understanding and weighing potential trade-offs when considering action. In making these judgments, APRA also seeks to maintain a sustainable balance between its objectives, focusing not purely on the circumstances of the day, but on the long-term needs of the Australian community. Recent efforts by APRA to address concerns about lending standards for residential mortgages are an example of APRA balancing the stability and competition components of its mandate. The residential mortgage prudential measures are detailed further in Chapter 4.

APRA also endeavours to maintain competitive neutrality in its prudential framework and supervisory activities by minimising unnecessary or artificial regulatory distinctions between different entities undertaking activities which exhibit similar risk profiles. Competitive neutrality is aligned with an approach to prudential supervision whereby similar risks are subjected to similar prudential treatment. Such an approach contributes to efficiency, contestability and competition.

However, in establishing and implementing the prudential framework for regulated institutions, APRA also takes the approach that the framework should be proportionate, such that smaller institutions are subject to expectations commensurate with the scope and complexity of their risk profile. This means that APRA avoids a 'one size fits all' approach where possible. Policy measures that reflect this approach are outlined in Chapter 4.

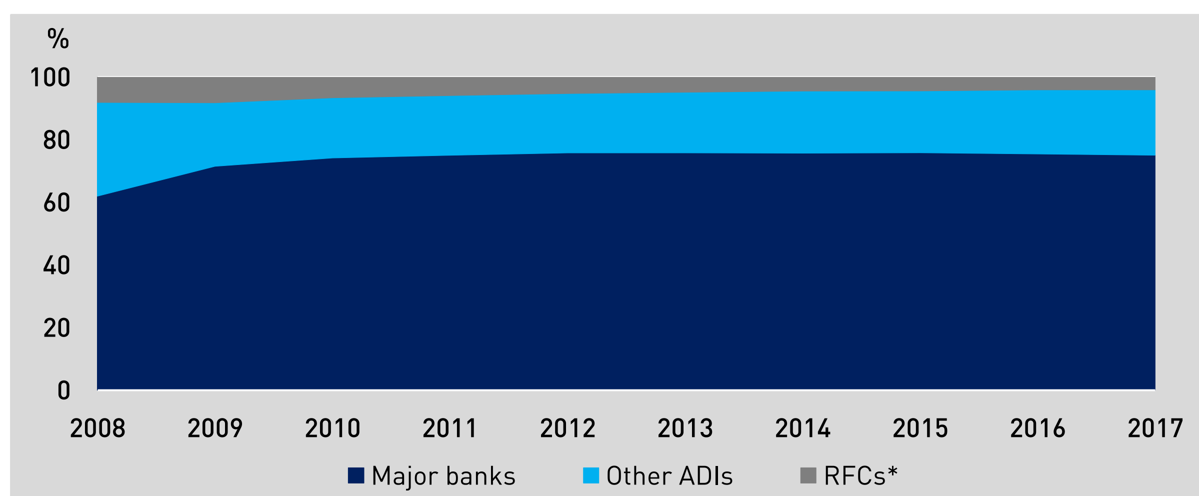
Chapter 2 – Overview of industries supervised by APRA

This chapter provides an overview of the industries supervised by APRA, other than superannuation, and, where relevant, presents data collected by APRA. The data is focused on metrics traditionally utilised in assessing the level of competition in a given market, including concentration, number of providers and level of profitability. Where possible APRA has provided data at a product level, however in most cases APRA's data is at an industry level. Concentration of certain banking products is considered in more detail given the scope of the Commission's Inquiry.

Authorised deposit-taking institutions

The banking industry comprises the largest component of the Australian financial sector, accounting for around 60 per cent of Australian financial institution assets. This proportion is largely unchanged over the last eight years. Authorised deposit-taking institutions (ADIs) hold a dominant share in lending activity, with non APRA-regulated lenders having lost market share since the global financial crisis (Figure 1).

Figure 1: ADI and RFC share of gross loans and advances

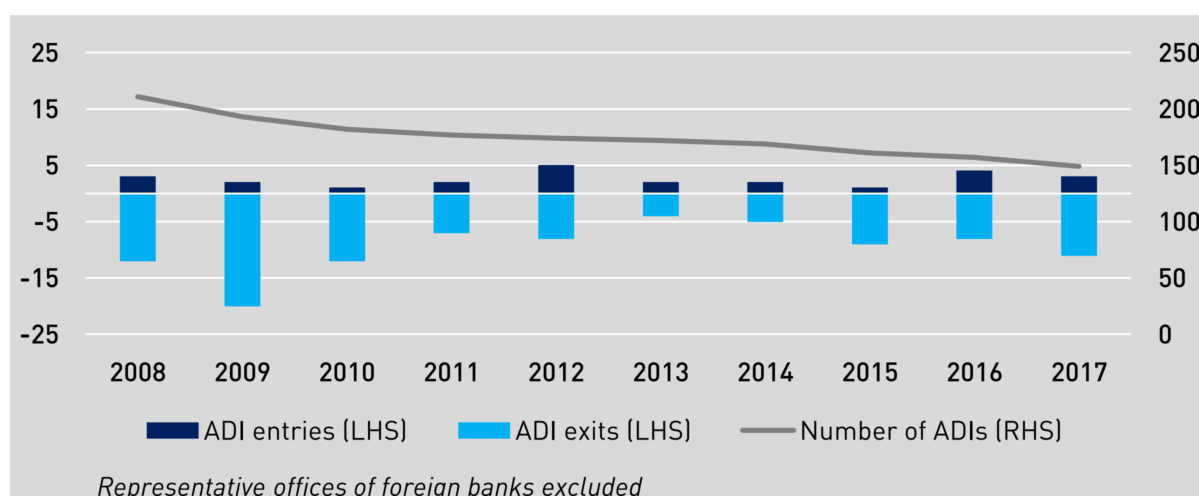


** RFCs denotes Registered Financial Corporations as defined in Section 7 of the Financial Sector (Collection of Data) Act 2001.*

The majority of ADIs remain focused on the traditional banking services of deposit-taking and extending credit, primarily within the domestic market. Loans contribute more than two-thirds of the value of ADIs' domestic balance sheets. For the most part, trading and investment activities remain a relatively small part of ADIs' operations and risk exposures.

Ongoing consolidation among smaller entities continues to lead to a reduction in the total number of ADIs operating in Australia, as illustrated in Figure 2.

Figure 2: Number of ADI entries and exits



Representative offices of foreign banks excluded

As detailed in Table 1, as at end-June 2017 there were 148 ADIs; eight less than 12 months prior, and half the number that existed in 1999. Consolidation is often driven by the pursuit of economies of scale and other efficiencies amongst smaller entities, particularly mutual entities with limited access to capital.

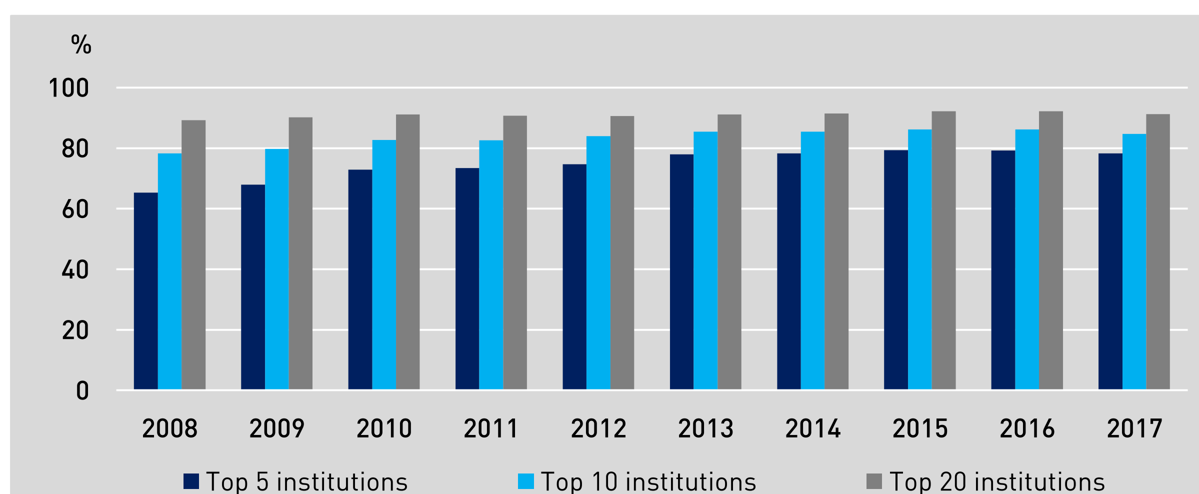
Table 1: Number of ADIs by type

ADI sector	1999	2004	2009	2013	2017
Domestic banks[4]	15	14	14	21	33
Foreign subsidiary banks	11	10	9	8	7
Foreign bank branches	25	28	35	40	44
Credit unions and building societies	241	188	125	95	58
Other ADIs	4	7	8	7	6
Total ADIs	**296**	**247**	**191**	**171**	**148**

Industry concentration, as measured by the share of industry assets, remains relatively flat compared to 12 months earlier, with 78 per cent of industry assets held by the five largest ADIs. Five years ago, the corresponding figure was 75 per cent (Figure 3).

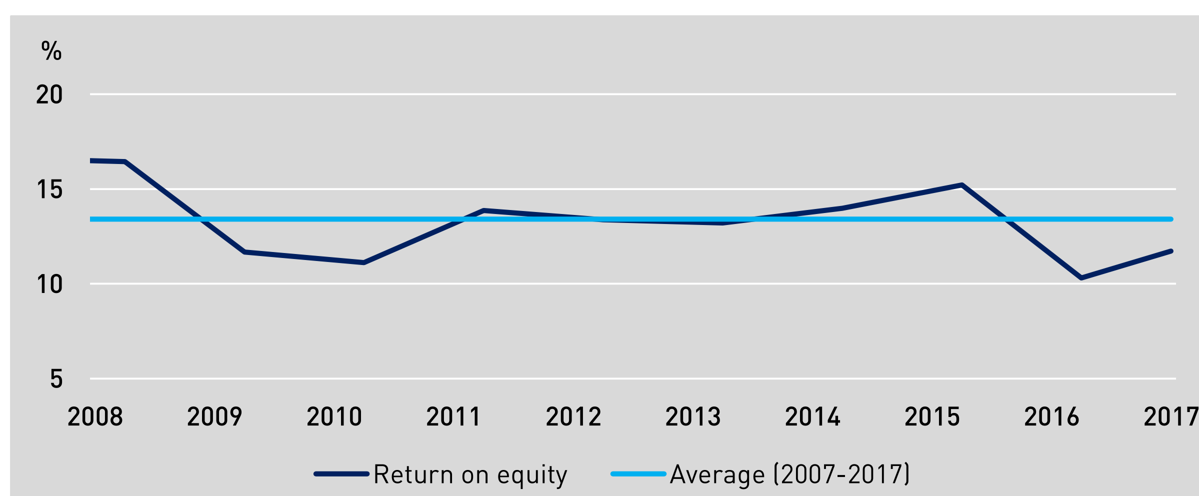
[4] Over recent years, a number of mutual credit unions and building societies have chosen to change their names to include the term 'bank' and now fall within the category 'Domestic banks'.

Figure 3: Largest institutions' share of ADI industry assets



Assessments of the extent of competition within the Australian banking sector typically focus on the combined market share of the four major banks. It is worth noting that there has been no material growth in the combined market share of the major banks over recent years. The share of the four major banks as at end-June 2017 was 75.2 per cent, compared with 75.8 per cent as at end-June 2016. Five years ago, the corresponding figure was 74.5 per cent.

Figure 4: ADI return on equity

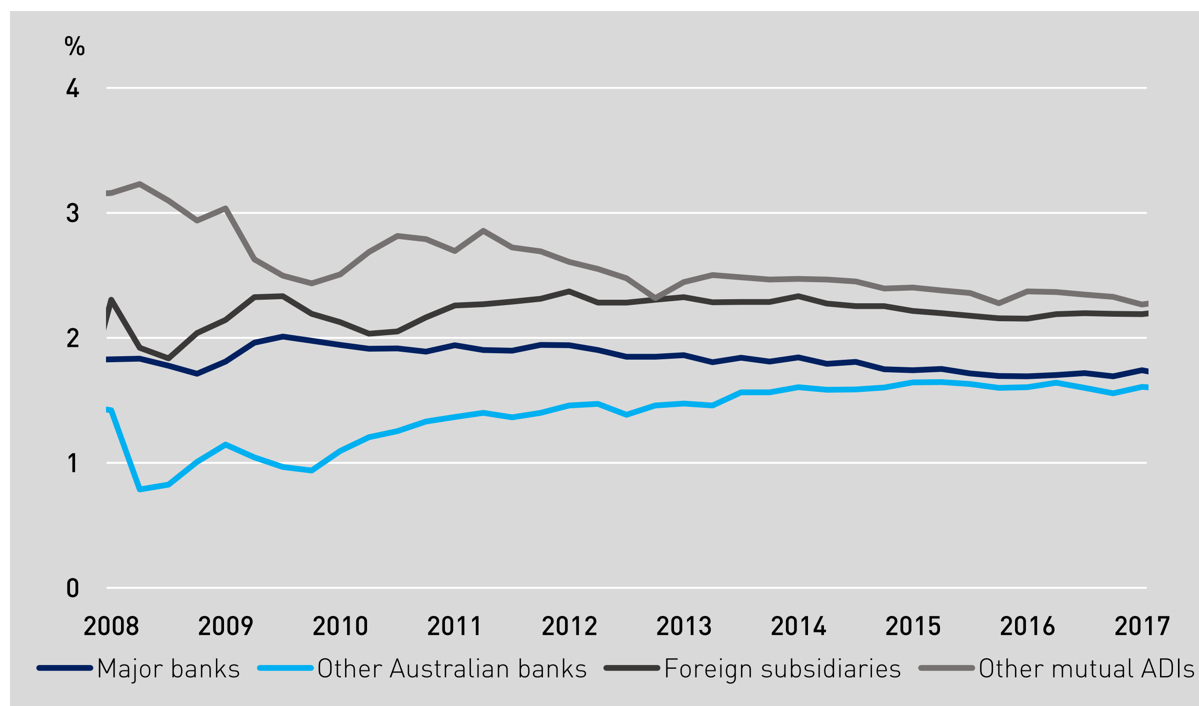


Return on equity (ROE) for the banking industry for the twelve months to 30 June 2017 was 11.7 per cent (Figure 4). This remains below the ten-year average of 13.4 per cent (which itself has declined in recent years) and is primarily driven by net interest margins, which continue to be challenged by the low interest rate environment (Figure 5). Margin pressure has eased following recent mortgage repricing actions (particularly on investor and interest-only products); however, rising funding costs and slowing credit growth may offset much of the benefit afforded by upwards repricing. All else being equal, increasing regulatory capital expectations will also likely negatively impact industry ROE.

Since the global financial crisis there has been a significant convergence in ADI net interest margins. The net interest margins of other Australian banks (including the large regional banks) as shown in Figure 5 have increased over the past ten years, from 0.8 per cent at June

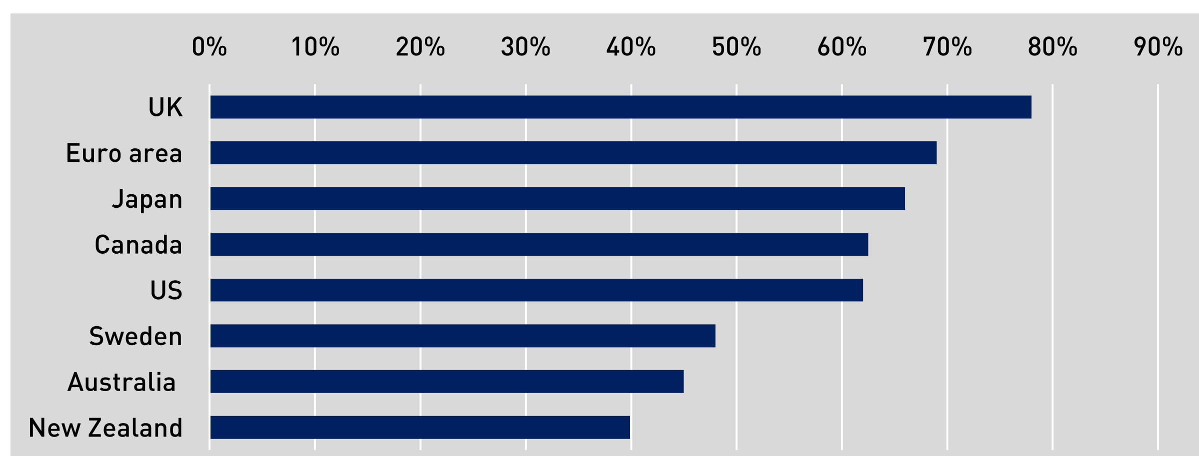
2008 to 1.6 per cent at June 2017, partly driven by wholesale funding being replaced with cheaper funding as volatility in funding markets has eased. Conversely, the net interest margins of other mutual ADIs have been compressed over the same period, falling from 3.2 per cent at June 2008 to 2.3 per cent at June 2017, driven by a combination of pricing competition in both lending and retail deposit markets.

Figure 5: Net interest margins



Expense management and efficiency continue to be a focus as both large and small ADIs seek to become more competitive and profitable. Cost to income ratios for the majority of ADIs continue to trend downward. The cost to income ratios of large banks compare favourably to those of peers in foreign jurisdictions (Figure 6).

Figure 6: Cost-to-income ratios – large banks



Source: RBA, S&P Global Market Intelligence

In an effort to improve ROE and refocus on core business, some banks have taken steps to unwind their vertically integrated business models by divesting components of their wealth

management operations. A significant driver of this trend is that many of these businesses have failed to fulfil performance and shareholder return expectations; ADIs have typically been unable to realise all of the benefits that were expected of such financial activities.

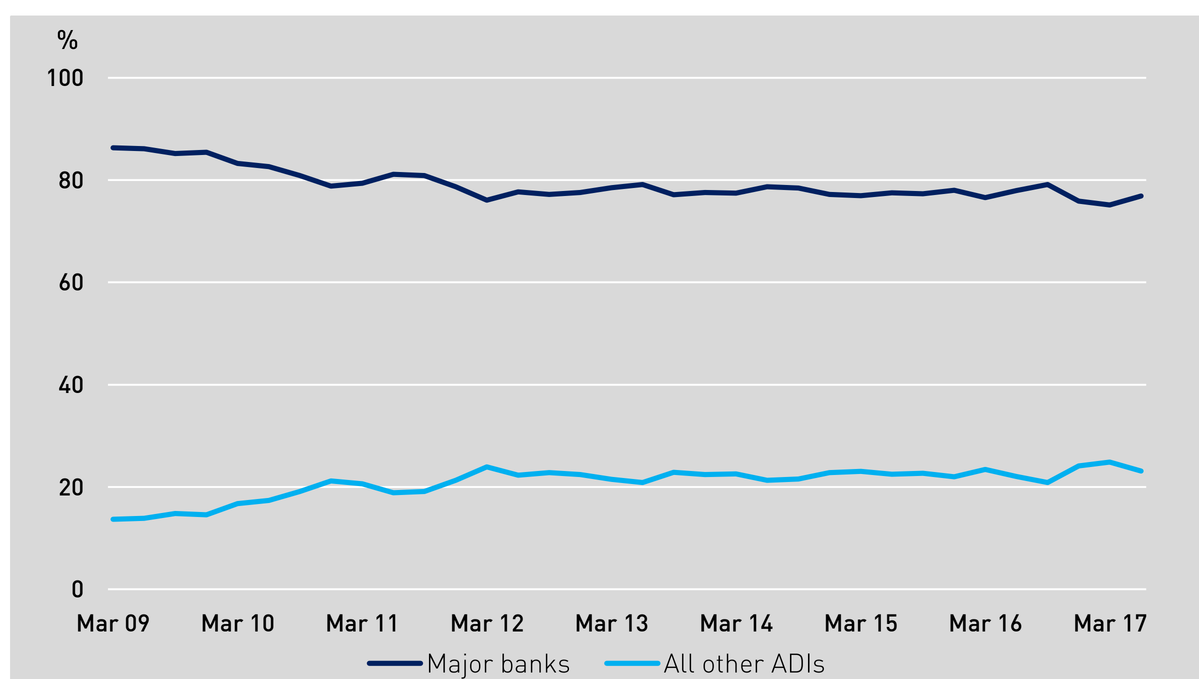
Product concentration

APRA's data collection reveals that the ADI industry is concentrated; however, certain product markets or segments are less concentrated than others.

Consolidation during the height of the global financial crisis, particularly the acquisitions of St George and Bankwest by Westpac and Commonwealth Bank respectively, increased the market share held by the four major banks. Absent the impact of these acquisitions, however, it appears that for a number of key products, the four major banks have not materially increased market share since the crisis.

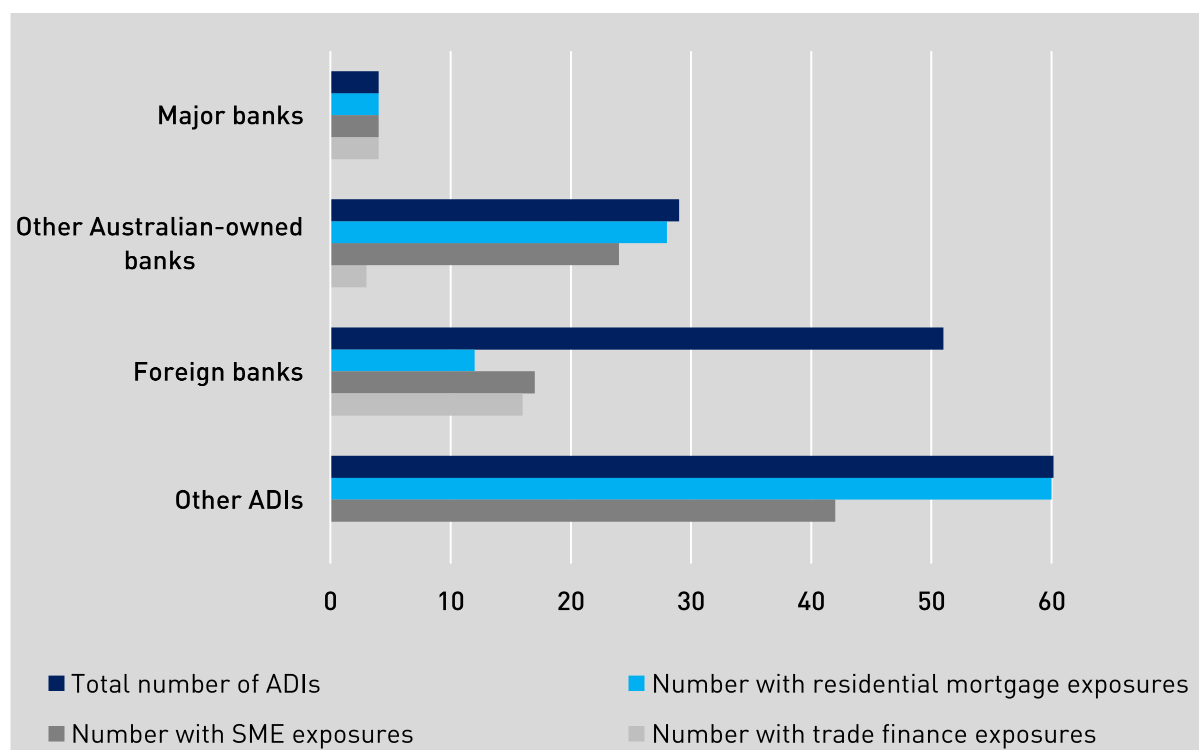
In some cases, particularly for residential mortgage lending, the four major banks have lost market share to smaller entities. As illustrated in Figure 7 the four major banks' share of mortgage approvals peaked at 86.3 per cent in Mar 2009. By June 2017 this share had fallen to 76.9 per cent, reflecting a gradual but consistent downward trend.

Figure 7: Share of residential mortgage loans approved



While smaller banking providers do not always offer the same account-based service or features, for instance widely available ATM or branch networks, they are to a large degree able to obtain wide distribution through the use of brokers and technological advances. These factors, in addition to competitively priced products, appear to have assisted smaller providers in gaining market share in the supply of residential mortgages. As illustrated in Figure 8, a considerable number of ADIs offer housing finance products to Australian consumers.

Figure 8: Number of providers of selected finance products



Conversely, APRA data indicates that there is likely to be less competition occurring in lending to small- and medium-sized businesses. Figure 8 illustrates that the number of ADIs providing funding to small- and medium-sized enterprises is lower than the number of ADIs providing residential mortgage products.

Large banks are likely to have a strong competitive and information advantage in supplying lending products to these businesses through their ability to cross sell or bundle other banking products, particularly payment systems/merchant terminals and transaction accounts. For many smaller ADIs, offering finance to small and medium enterprises would potentially result in the ADI operating outside tolerance levels established by their own risk appetite. However, as an alternative to accessing funding from the larger banks, small businesses may also access trade credit or asset/equipment finance from specialist companies that are not regulated by APRA to fund their establishment or expansion.

Trade finance products also represent an important tool for small businesses in facilitating access to foreign customers and suppliers. Figure 8 illustrates that, in comparison to small- and medium-sized enterprise finance and residential mortgage providers, the number of ADIs offering some type of trade finance product is particularly limited. This trend is also likely driven by a lack of expertise, systems and scale to meet business viability hurdles, including international banking relationships.

The provision of finance to small- and medium-sized enterprises is an important area of the economy which may benefit from the increase in the number of innovative financiers such as peer-to-peer or marketplace lenders. Additional new entrants are beginning to appear and generally utilise online platforms to connect with customers. Market data indicates that a

number of these innovative lenders are growing swiftly, with compound annual growth rates exceeding 100 per cent over recent years.[5]

General insurance

Concentration within the General Insurance (GI) industry has steadily increased by a number of measures over the past 10 years, predominantly due to acquisitions. This is reflected in the five largest insurers now accounting for 55 per cent of gross written premium at June 2017, compared to 42 per cent at June 2007 (Figure 9). For householders insurance the concentration represented by the five largest insurers as at June 2017 is markedly higher at approximately 80 per cent.[6] A feature of the industry wide increase in concentration has also been a steady decline in the number of APRA authorised general insurers as reflected in Figure 10. This decline is, however, partly attributed to a rationalisation of insurance licenses resulting from past acquisitions, in addition to a fall in the number of run-off insurers and limited new entrants.

Figure 9: Largest institutions' share of general insurance gross written premium

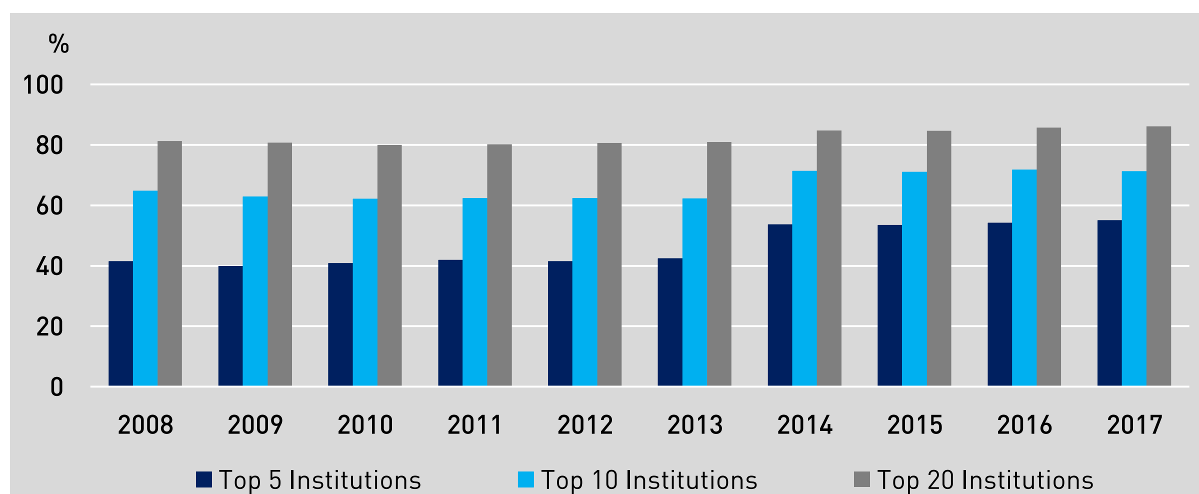
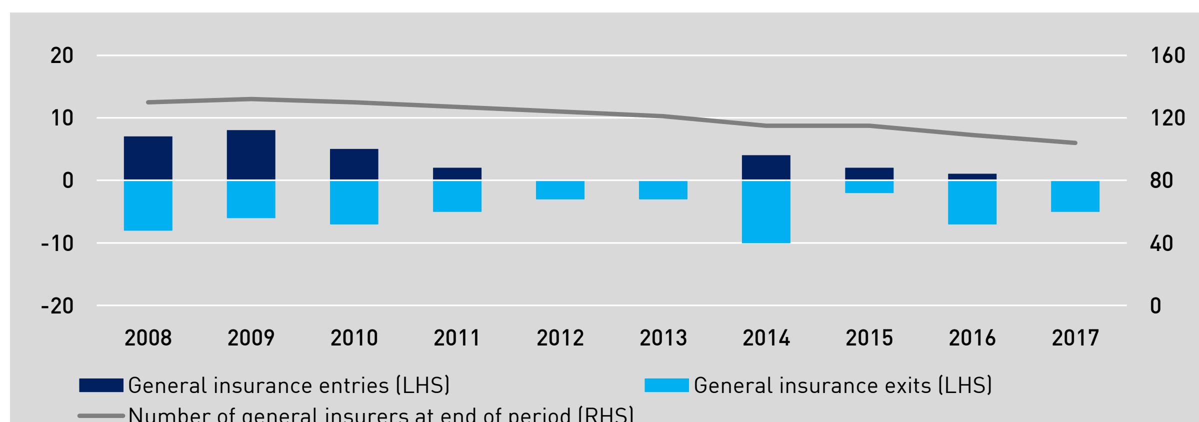


Figure 10: Number of general insurance entries and exits

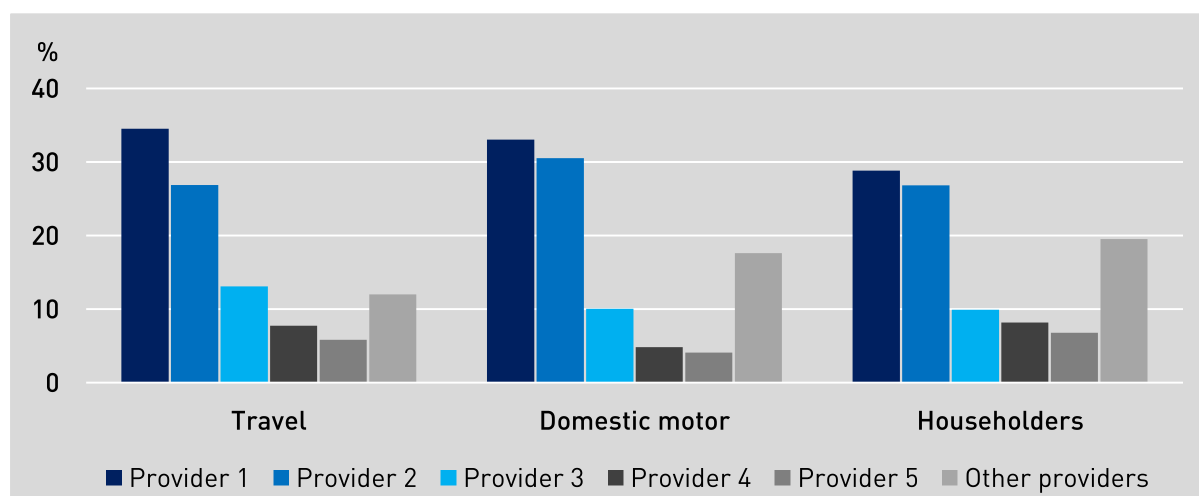


[5] Source: Morgan Stanley

[6] Householders insurance covers the common domestic policies inclusive of contents, personal property, arson, burglary and public liability normally attached to such policies.

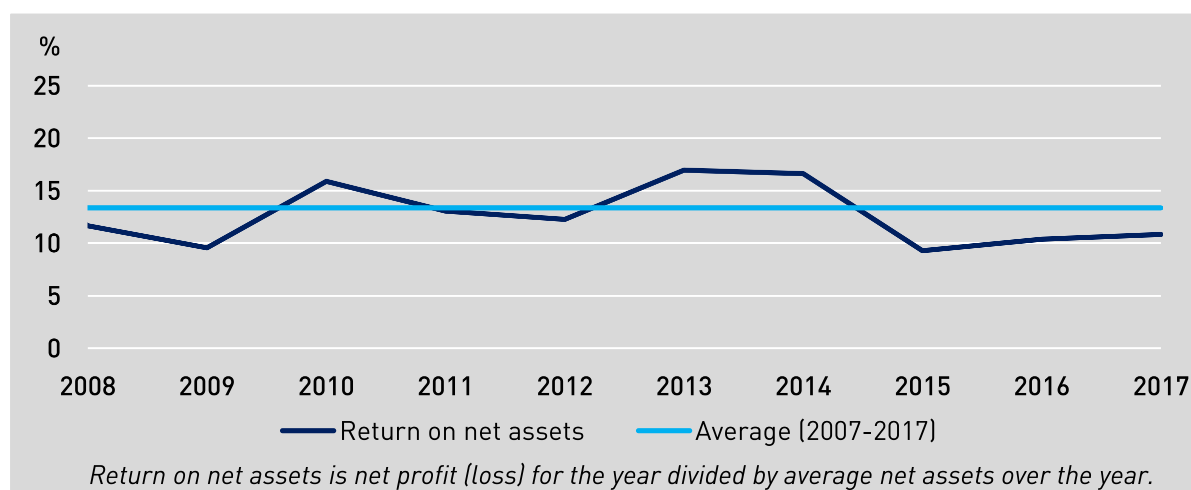
Concentration figures, based on premium pools, and the number of providers vary considerably in different GI product markets. Retail product markets are highly concentrated with the five largest providers representing a combined market share of approximately 80 per cent or greater in each of the householders, domestic motor and travel insurance markets (Figure 11) at June 2017.

Figure 11: Market share by product



The GI industry's profitability, as measured by return on net assets, rose marginally in 2016/17 to 10.8 per cent. This, however, remained below the industry's ten-year average of 13.4 per cent (Figure 12). The lower level of profitability in recent years has been attributable in part to a deterioration in the underwriting results in the property classes of business, with higher net loss ratios resulting from subdued premium growth and increased claims costs from severe weather events, including Cyclone Debbie in March 2017. The low interest rate environment has also contributed to the decline in profitability, with the interest income generated on insurers' substantial interest rate investment portfolios steadily falling in recent years.

Figure 12: GI return on net assets



Return on net assets is net profit (loss) for the year divided by average net assets over the year.

Life insurance

The Life Insurance (LI) industry is highly concentrated, with the five largest life insurers accounting for 80 per cent of gross industry assets at June 2017 (Figure 13). This level of concentration has been relatively stable despite a gradual reduction in the number of APRA licensed life insurers over the past 10 years (Figure 14). A recent trend in the LI industry has been divestments by Australian institutions of their life insurance businesses and an increase in foreign ownership. There have also been two new entrants in the past two years, compared to just one in the previous decade.

Figure 13: Largest institutions' share of life insurance industry assets

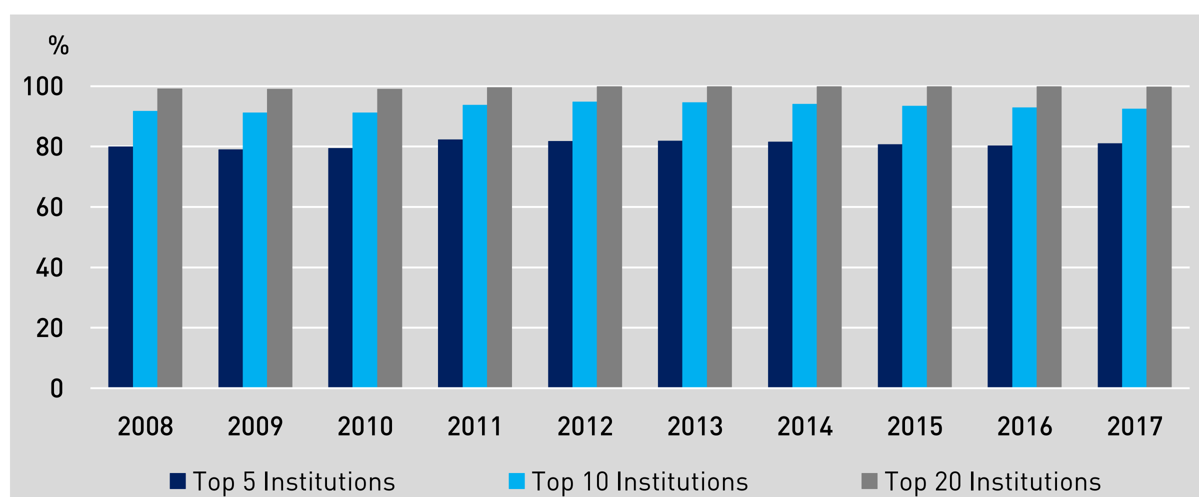
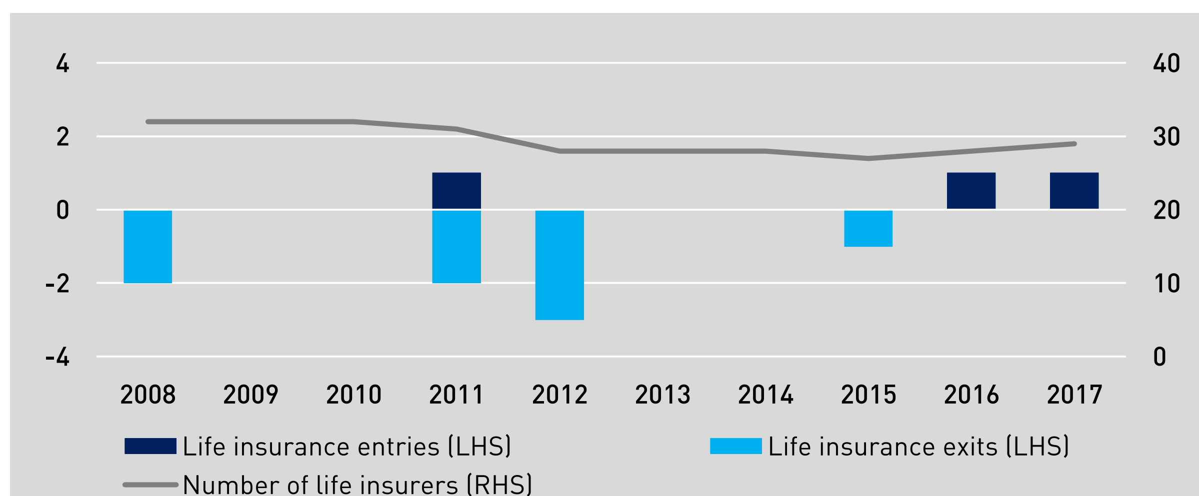


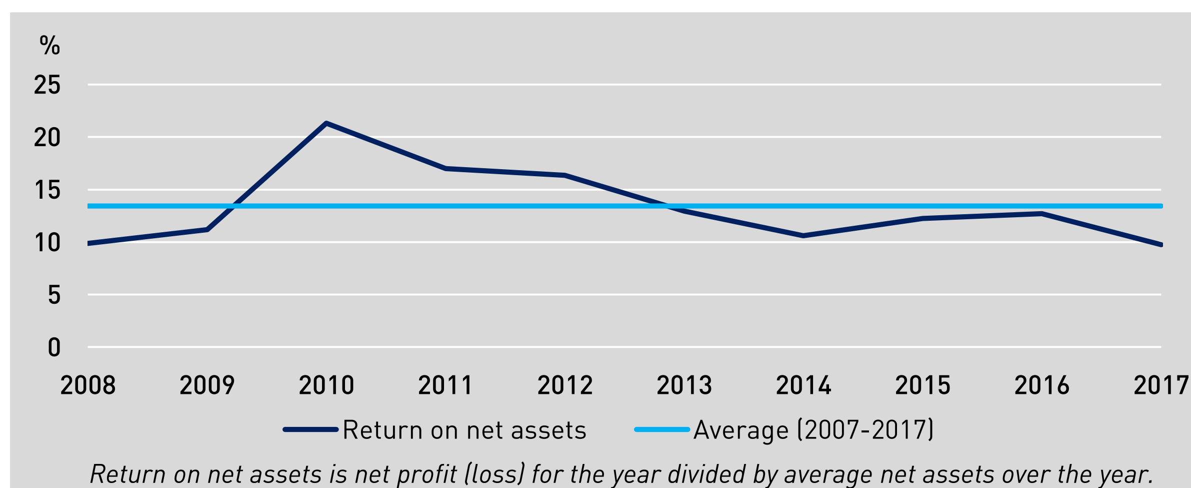
Figure 14: Number of life insurance entries and exits



The LI industry's profitability, as measured by return on net assets, in 2016/17 at 10 per cent was lower than the ten-year average of 13 per cent, reflecting a deterioration in insurance risk profitability (Figure 15). This deterioration is attributable to poor results across most product categories, but is most significant for individual disability income insurance, where the industry has incurred significant losses in recent years. Whilst premium rates in disability income insurance have increased since the substantial losses reported during 2015, the effect has been outweighed by significant reserve strengthening as insurers adopt revised

morbidity assumptions. LI industry profitability has also been impacted by the low interest rate environment, with overall net profit margins for 2016/17 at five per cent, well below the eight-year average of 8.5 per cent.

Figure 15: Life insurer return on net assets



Return on net assets is net profit (loss) for the year divided by average net assets over the year.

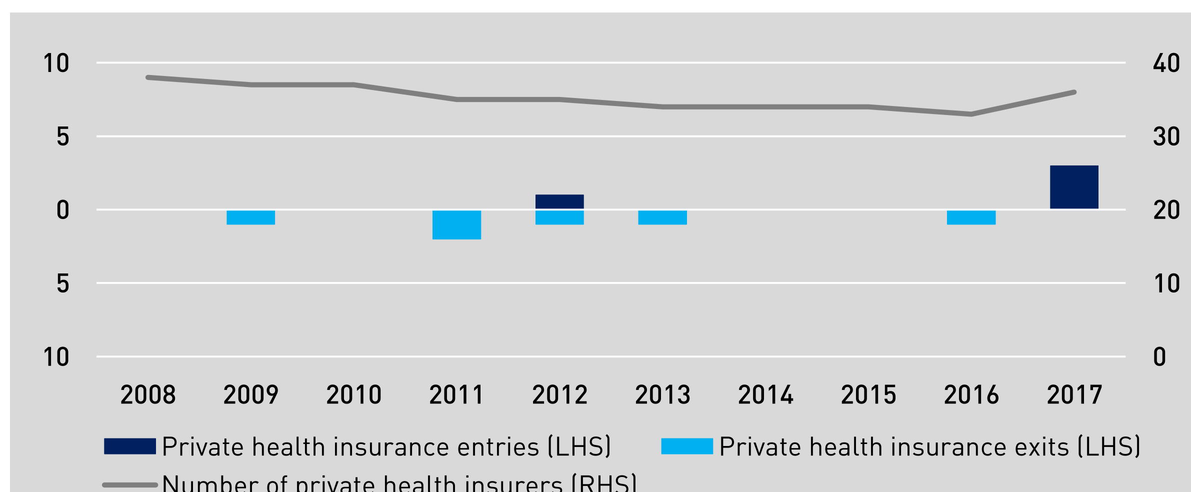
Private Health Insurance

Private Health Insurance (PHI) is a key element in the Australian health system with most insurers having long tenures in the industry. In 2015, APRA assumed responsibility for the prudential supervision of private health insurers from the Private Health Insurance Administration Council.

The main business of any PHI is to offer hospital and general treatment policies, with coverage definitions for these policies regulated by the *Private Health Insurance Act 2007*. PHIs are also able to provide goods and services through health-related businesses.

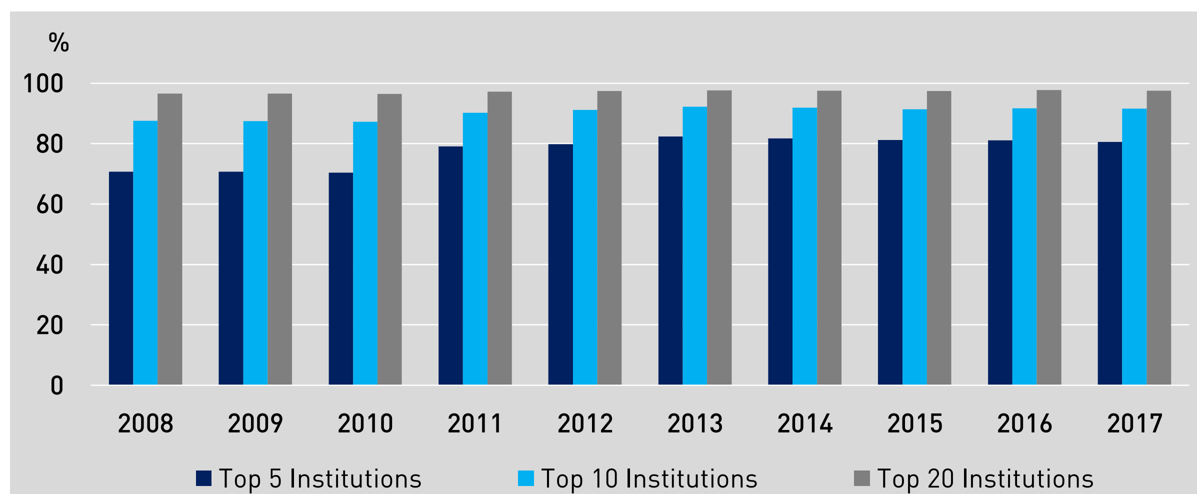
While the number of PHIs has trended gradually downward over the last 10 years, in the twelve months to June 2017 the PHI population rose from 33 to 36, reversing a large part of this decline (Figure 16).

Figure 16: Number of private health insurer entries and exits



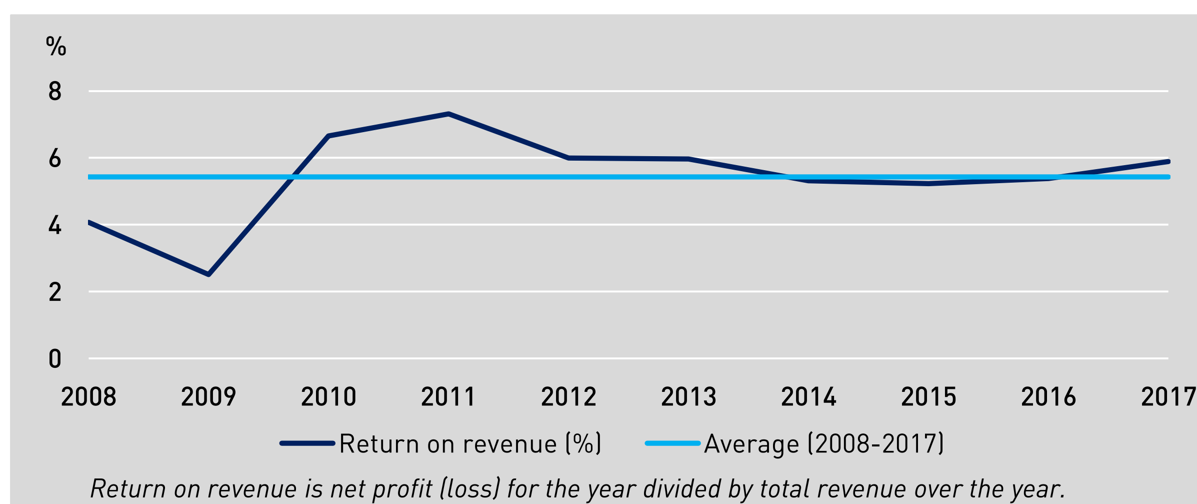
In its current structure, concentration within the industry is not dissimilar to a number of other sectors regulated by APRA. The five largest insurers represent approximately 80 per cent of the market by total policies (Figure 17).[7] This figure has been relatively stable over the last few years, despite strong competitive pressure from a relatively large number of smaller (often not-for-profit) insurers.

Figure 17: Largest institutions' share of health insurance policies



Despite a slowing in the growth of new policyholders, the industry is profitable, with stable profits reflected in relatively stable net margins averaging 4.5 per cent over the last decade. However, industry net margins fell to 3.3 per cent in the March 2017 quarter as a result of a jump in benefits paid. Notwithstanding this margin compression and a decline in health insurance business profitability, net profit increased by 18 per cent over the 12 months to March 2017, driven by a strong increase in investment and health-related business returns (Figure 18).

Figure 18: PHI industry return on revenue



Return on revenue is net profit (loss) for the year divided by total revenue over the year.

[7] The two largest insurers, Medibank Private Limited and BUPA Australia Pty Limited, have over 50 per cent of the market between them.

Chapter 3 – The prudential framework and approach to supervision

Overview

APRA's prudential framework is designed to promote behaviour amongst regulated entities that supports financial stability in an efficient manner. This is achieved through a combination of legislation, prudential standards, prudential guidance and reporting standards which aim to ensure that risk-taking by regulated entities is conducted within reasonable bounds and that risks are clearly identified and well managed. Prudential requirements are developed in consultation with all stakeholders, particularly regulated entities and industry bodies, and are applied in a proportionate manner.

Well before the global financial crisis, Australia learned that a focus on financial stability can improve long-term competitive dynamics in an industry. The activities of HIH Insurance in the years prior to its collapse demonstrated the dangers of unsustainable competition. HIH Insurance was a significant contributor to an unsustainable reduction in premiums and, as a result, forced other insurers to withdraw from certain segments of the liability insurance market. The subsequent reduction in market capacity left segments of the Australian community without a viable source of insurance products when HIH collapsed. The reform of the general insurance prudential regime that followed in 2002, including the introduction of risk-based capital requirements, saw insurers re-enter these market segments, and has prompted strong sustainable competition from a range of insurers.

In developing its policy framework, APRA seeks to balance the need for competitive and efficient outcomes against financial safety. The prudential framework can affect the relative position of competitors by imposing differential costs and, for that reason, APRA acts to ensure that its prudential requirements are applied in a competitively neutral manner where possible. All regulated entities are, for example, subject to behavioural and minimum capital requirements.

APRA also works to ensure that its prudential requirements are proportionate to the risk profile of a regulated entity. In this regard APRA's prudential framework is developed and implemented in a manner that is designed not to place unreasonable expectations on smaller entities. For example, in its recently-announced approach to implementing an internationally-agreed cross-industry framework for margining and risk mitigation for certain derivatives, APRA will apply margin requirements only to entities that have derivative activity in excess of qualifying levels. As a result, entities with immaterial activity in certain derivatives will be exempted from the new requirements.

Harmonisation

In addition to considering competitive neutrality issues within regulated-industries, APRA considers such issues across industries by, wherever possible, harmonising prudential standards across regulated industries. In particular, APRA has developed cross-industry behavioural standards, given that the core expectations regarding governance, fitness and propriety of directors and senior management, enterprise risk management and the approach to managing key operational risks are typically universal and do not differ significantly on an industry basis.[8]

In these prudential standards, APRA has taken a principles-based approach that recognises the complexity and diversity that exists among regulated entities. This approach focuses on the desired outcome of the prudential requirement, but does not specify or prescribe the exact manner in which the outcome must be achieved. In the case of risk management, for example, the cross-industry standard allows for alternative arrangements where an institution can demonstrate that a different approach can meet the objectives. In particular, APRA anticipates that alternative arrangements may be appropriate for some smaller, less complex institutions and will ensure the standard is implemented in a proportionate way, minimising regulatory costs.

APRA's conglomerates framework also applies equally across prudentially-regulated sectors. The conglomerate framework cuts across the boundaries of regulated and unregulated industries in order to mitigate the risks to beneficiaries posed by the unregulated operations of conglomerate groups. In this regard, APRA is agnostic to issues such as vertical- and horizontal-integration and seeks to apply a competitively neutral framework of prudential standards to regulated entities which are members of conglomerate groups.[9]

Risk-based supervision

APRA takes a risk-based approach to supervision which enables it to be flexible and proportionate, with supervisory intensity tailored to the risk profile of a regulated entity. A risk-based approach recognises that there can be a number of ways to effectively and efficiently achieve a particular prudential outcome and avoids imposing unnecessary regulatory costs. Proportionality is entrenched within the supervision process as the depth of financial analysis, frequency and scope of meetings with, and supervisory reviews of, the entity, among other factors, vary in direct connection with the entity's risk profile.

[8] APRA's cross industry supervision framework: http://www.apra.gov.au/crossindustry/Pages/default.aspx

[9] APRA's conglomerate supervision framework: http://www.apra.gov.au/CrossIndustry/Pages/Supervision-of-conglomerate-groups-L3-august-2016.aspx

Chapter 4 – Current prudential initiatives influenced by competition considerations

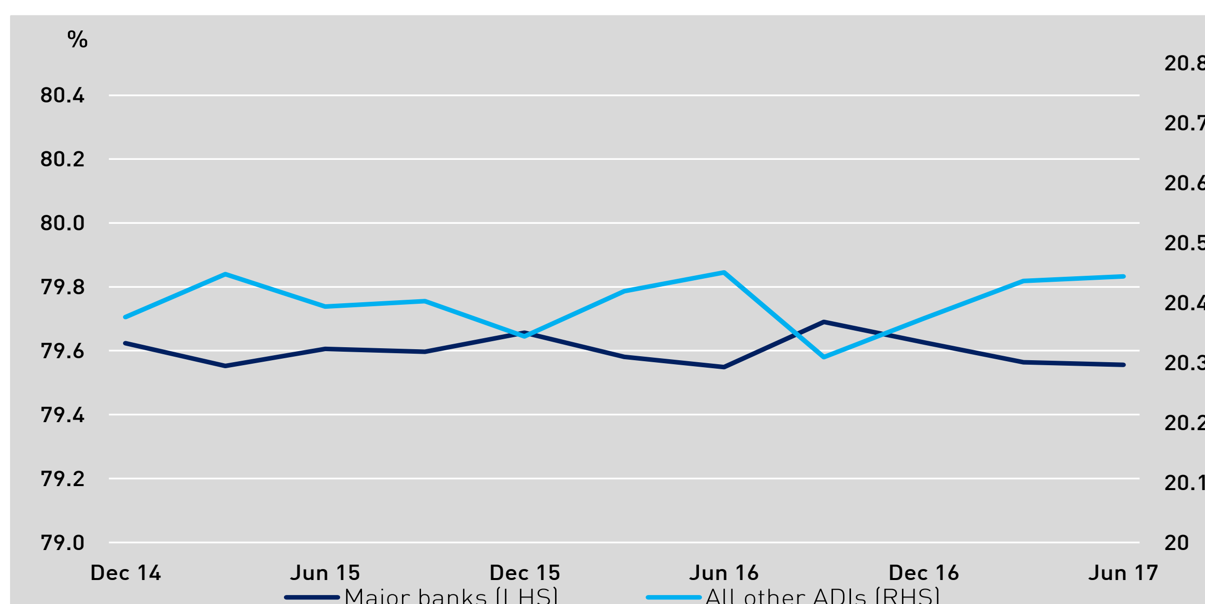
In line with industry developments and emerging risks, APRA's prudential framework and approach to supervision are subject to regular enhancement. A number of recent initiatives are likely to support increased competition between regulated entities without unduly compromising the stability of the financial system.

Supervisory intervention in the residential mortgage market

In December 2014, APRA wrote to all ADIs to reinforce its expectations for sound residential mortgage lending practices and signal an increase in the level of supervisory intensity in this area. APRA also set a benchmark growth rate of ten per cent for investor lending, with additional supervisory action to be considered for ADIs exhibiting growth rates above this level. Additional measures were introduced in March 2017, including a 30 per cent benchmark on newly originated interest-only loans. These actions were taken in an environment of accelerated residential mortgage portfolio growth and against a backdrop of historically low interest rates and high levels of household debt. In APRA's view, competition amongst ADIs had contributed to underwriting standards for residential mortgages being eroded to an extent which, if left unchallenged, would have the potential to threaten the stability of the financial system.

APRA applied these restrictions on a competitively neutral basis across all ADIs (albeit that smaller entities, with less systemic impact, have generally been given more flexibility in the manner and time in which they are expected to adjust their lending practices). As reflected in Figure 19, since APRA's intervention the market share of the major banks and other ADIs are almost unchanged, with a slight increase for smaller ADIs.

Figure 19: Market share of residential mortgage exposures



APRA's interventions are designed to result in more favourable long-term competitive outcomes for consumers, by ensuring that competition will occur on a more sustainable basis. Although these temporary benchmarks on investor lending growth and the proportion of interest-only lending limit the extent to which individual ADIs can seek to gain market share from one another, many ADIs are already operating well below the benchmarks (so have the capacity to expand their share should they wish to do so). Further, APRA has only sought to constrain those areas of lending that are considered to be of higher risk (for example, beyond sensible serviceability requirements, traditional lending on an amortising basis to owner-occupiers is unaffected).

Licensing of new entrants

In order to undertake business within an APRA-regulated industry, an institution must be authorised by APRA under the relevant industry Act. Whilst APRA has traditionally taken an approach to the authorisation of new entrants that is agnostic to size and business model, and thereby competitively neutral, it is recognised that the licensing process may represent a regulatory barrier to entry for some small and innovative firms.

With a view to, amongst other things, better accommodating applicants with non-traditional business models, APRA is making changes to its licensing framework to increase transparency and assist new entrants in obtaining authorisation. This includes the creation of a centralised licensing team to increase efficiency and consistency within the licensing process, and improve communication with applicants. APRA is also currently consulting on a phased approach to licensing. Initially, the phased approach is intended to support increased competition in the banking sector by reducing barriers to new entrants, particularly those with innovative business models, including greater use of technology.[10] The overall objective of this set of changes is not to lower entry standards overall, but rather to make them easier to navigate.

Related legislative initiatives are also underway which are expected to reduce potential barriers to entry into regulated industries. These include proposed changes to ownership restrictions in the *Financial Sector (Shareholdings) Act 1998* and amendments to Section 66 of the *Banking Act 1959* to allow all ADIs to use to term 'bank' in naming or describing their business activities.

Capital instruments for mutually owned ADIs

Because of their structure, mutually owned ADIs have traditionally not been able to issue ordinary shares. APRA recently released a consultation package outlining proposed revisions to the capital framework to enable mutual ADIs to directly issue the highest quality form of capital that could be recognised for regulatory purposes.[11] This initiative has the potential to

[10] *Discussion Paper – Licensing: A phased approach to authorising new entrants to the banking industry*, August 2017, http://www.apra.gov.au/AboutAPRA/Pages/0817-Consultation-Licensing.aspx

[11] *Discussion Paper – Common Equity Tier 1 capital instruments for mutually owned ADIs,* July 2017, http://www.apra.gov.au/adi/PrudentialFramework/Pages/Consultation-CET1-Instruments-for-mutually-owned-ADIs-July-2017.aspx

provide mutually owned ADIs with increased capital flexibility and thereby enhance their ability to grow and compete.

Residential mortgage risk weights

One of the recommendations of the 2014 Financial System Inquiry (FSI) was to narrow the difference between the average mortgage risk weight for ADIs using the internal ratings-based (IRB) approach to credit risk and those using the standardised approach to credit risk. As recognised by the FSI, there a number of policy issues that justify a difference in residential mortgage risk weights between the IRB and standardised approaches to credit risk. In particular, the IRB approach encourages improved risk management and better aligns capital with risk. That said, the FSI questioned whether the policy objective justified the magnitude of the difference that existed at the time, which may well have been acting as an impediment to competition.

In response to the FSI's recommendation, APRA announced in July 2015 an interim increase in mortgage risk weights under the IRB approach. This technical adjustment to the IRB mortgage risk-weight curve was intended to achieve an increase in the average mortgage risk weight for IRB ADIs from approximately 16 per cent to at least 25 per cent.[12] This compared to an average risk weight under the standardised approach of approximately 39 per cent. As at 30 June 2017 the average mortgage risk weight for IRB ADIs was 26 per cent.

Later in 2017, APRA will begin consultation on changes to the ADI capital framework designed to implement the recently announced 'unquestionably strong' capital ratios and the anticipated changes from Basel Committee on Banking Supervision's (Basel Committee) internationally agreed standards for banks. In doing so, APRA will continue to ensure that the difference in capital requirements for residential mortgage exposures under the IRB and standardised approaches balances a range of competing objectives.

Accreditation to use the advanced approaches to capital adequacy

Since the FSI, APRA has taken a number of actions to make accreditation for the use of internal models to determine regulatory capital requirements more accessible to smaller ADIs. In response to industry concerns that APRA's approach to accreditation was too high a hurdle, APRA announced in December 2015 that it would adopt a staged approach to IRB accreditation based on asset class.[13] This allows ADIs which are able to demonstrate appropriate internal models for a certain asset class to begin using these models to calculate regulatory capital while continuing to develop internal modelling capabilities for other asset classes.

At the same time, APRA announced the removal of the longstanding expectation that ADIs wishing to adopt an IRB approach to credit risk also need to adopt the Advanced

[12] Media Release: *APRA increases capital adequacy requirements for residential mortgage exposures under the internal ratings-based approach*, 20 July 2015, http://www.apra.gov.au/MediaReleases/Pages/15_19.aspx

[13] Letter to all ADIs: *Internal ratings-based (IRB) approach to credit risk: accreditation process*, 16 December 2015, http://www.apra.gov.au/adi/Publications/Documents/20151216LetterADIsStagedDecoupled.pdf

Measurement Approach (AMA) to operational risk. The Basel Committee has subsequently announced the removal of the AMA as part of the international capital adequacy framework.

The combination of APRA's actions to narrow differences in average residential mortgage risk-weights detailed above and the removal of significant barriers to IRB accreditation for smaller ADIs should lessen competition-related concerns in respect of the differing approaches to determining regulatory capital.

Graduated ADI capital framework

APRA is currently considering amendments to its prudential framework (initially for ADIs) to better tailor requirements to the size, complexity and risk profile of smaller ADIs in order to reduce compliance costs and achieve a more efficient and less burdensome regulatory framework. These amendments are likely to initially focus on simplified calculation and disclosure of quantitative requirements, such as capital adequacy, and would enhance proportionality in the prudential framework.

Life claims data collection

APRA and the Australian Securities and Investments Commission (ASIC) are jointly undertaking a project to collect data on life insurance claims, with the objective of improving the accountability and performance of life insurers, and facilitating an informed public discussion about the value of insurance and performance of the life insurance industry. APRA and ASIC propose to achieve this by collecting and publishing credible, reliable and comparable data on an entity-level basis, with sufficient detail to allow meaningful comparisons of insurer performance, and with sufficient context to effectively inform consumers and other stakeholders.

Enhanced data on life claims is expected to result in greater transparency, and thereby facilitate informed market discipline of insurers.

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