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Review of the Australian Prudential Regulation Authority Annual Report 2014 (Third Report)

House of Representatives
Standing Committee on Economics

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Canberra

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Chair's foreword

At our most recent public hearing with APRA in October 2015 the committee learned of a number of actions the regulator had taken to reinforce prudential practices across APRA regulated institutions in the financial sector.

The committee notes that this year APRA released a study on the relative capital strength of the major Australian banks against their overseas peers and also announced that effective 1 July 2016 it will increase the risk weight for residential mortgage exposures for banks that are accredited to use internal models to determine their capital ratios.

We also note from our discussions with APRA that the recommendations of the Financial System Inquiry (FSI) report and the work of the Basel Committee are likely to influence the capital requirements of Australian banks further and look forward to following the progress that is anticipated in this area.

Additionally, the committee notes APRA's continued supervision of the residential mortgage lending practices of authorised deposit-taking institutions in the current environment of heightened risk. However, the committee notes reports by the RBA that data problems regarding lenders' housing loans have emerged following increased supervisory scrutiny, and will be investigating the matter further with APRA at future hearings.

In relation to superannuation, the committee will continue to scrutinise APRA on its oversight of the industry's implementation of prudential standards, particularly in light of the recent Stronger Super reforms.

The transition of responsibilities for the prudential supervision of private health insurance funds from the Private Health Insurance Administration Council (PHIAC) to APRA occurred from 1 July 2015 and the committee looks forward to observing the development of the prudential regime for private health insurers in the long term.

On behalf of the committee I would like to thank the Chairman of APRA, Mr Wayne Byres, and his colleagues for appearing at the public hearing on 23 October

2015. The committee looks forward to further discussions on upcoming prudential issues at the next hearing with APRA on Friday, 18 March 2016 in Canberra.

Craig Laundry MP
Chair



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Membership of the Committee

Chair	Mr Craig Laundry MP
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Terms of reference

The House of Representatives Standing Committee on Economics is empowered to inquire into, and report on, the annual reports of government departments and authorities tabled in the House that stand referred to the committee for any inquiry the committee may wish to make. The reports stand referred in accordance with the schedule tabled by the Speaker to record the areas of responsibility of the committee.



List of abbreviations

ADI	Authorised deposit-taking institution
AML/CTF Act	<i>Anti-Money Laundering and Counter-Terrorism Financing Act 2006</i>
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
AUSTRAC	Australian Transaction Reports and Analysis Centre
FSI	Financial System Inquiry
IRB	Internal ratings-based
PHIAC	Private Health Insurance Administration Council
RBA	Reserve Bank of Australia
RSE	Registrable Superannuation Entity

Introduction

Background

- 1.1 The House of Representatives Standing Committee on Economics (the committee) is empowered to inquire into, and report on, the annual reports of government departments and authorities tabled in the House, that stand referred to the committee in accordance with the Speaker's schedule.
- 1.2 The 2014 annual report (annual report) of the Australian Prudential Regulation Authority (APRA) stands referred to the committee in accordance with this schedule and the committee resolved at its meeting on 26 November 2014 that it would conduct an inquiry into the annual report.
- 1.3 Regarding APRA's appearance before the committee on 23 October 2015, the committee chair stated that 'the ongoing scrutiny of APRA is an important part of the committee's oversight role. Some of the issues that will be examined include APRA's new reporting standards for the superannuation industry, the increased capital requirements for Australian residential mortgage exposures by authorised deposit taking institutions (ADIs), and the new disclosure requirements for ADIs under the Basel III framework.'¹
- 1.4 APRA was established by the *Australian Prudential Regulation Authority Act 1998* (Cth) as the prudential regulator of the Australian financial services industry. It oversees Australia's banks, credit unions, building societies, life and general insurance companies and reinsurance companies, friendly societies, and most of the superannuation industry. APRA currently

1 House of Representatives Standing Committee on Economics, 'APRA to appear before Economics Committee in Canberra', *Media Release*, 21 October 2015.

- supervises institutions holding \$4.9 trillion in assets for Australian depositors, policyholders and superannuation fund members.²
- 1.5 The annual report describes APRA's mission as '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
- 1.6 All deposit-taking institutions, life and general insurance and reinsurance companies and friendly societies must hold an APRA licence to operate in Australia. APRA also licenses trustees of prudentially regulated superannuation funds.⁴
- 1.7 After an institution is licensed, it is subject to ongoing supervision by APRA to ensure that it is managing risks prudently and meeting prudential requirements. APRA aims to identify potential weaknesses in its regulated institutions as early as possible. It applies a risk-based approach under which institutions facing greater risks receive closer supervision.⁵
- 1.8 APRA employs a cooperative approach to resolving issues with supervised institutions. However, where an institution is unwilling or unable to cooperate, APRA is empowered to take enforcement action against an institution, or against individuals associated with that institution. Some enforcement options include formal investigation, imposing conditions on an institution's licence, appointment of a replacement trustee and taking criminal action against a person or institution.⁶
- 1.9 Responsibilities for the prudential supervision of private health insurers were transferred to APRA from the Private Health Insurance Administration Council (PHIAC), effective 1 July 2015.

2 Australian Prudential Regulation Authority, *2014 Annual Report*, 13 October 2014, p. 1.

3 Australian Prudential Regulation Authority, *2014 Annual Report*, 13 October 2014, p. 3.

4 Australian Prudential Regulation Authority, 'Protecting Australia's depositors, insurance policyholders and superannuation fund members', <<http://www.apra.gov.au/AboutAPRA/Publications/Pages/APRA-Brochure.aspx>> viewed 6 November 2015.

5 Australian Prudential Regulation Authority, Supervision, <<http://www.apra.gov.au/AboutAPRA/Pages/Supervision.aspx>> viewed 6 November 2015.

6 Australian Prudential Regulation Authority, 'Factsheet 6 - APRA's enforcement activities', <<http://www.apra.gov.au/AboutAPRA/Publications/Documents/APRA-FS6-062015.pdf>> viewed 6 November 2015.

Scope and conduct of the review

- 1.10 APRA appeared before the committee at its third public hearing to review the 2014 annual report in Canberra on 23 October 2015.
- 1.11 The proceedings of the hearing were webcast over the internet, through the Parliament's website, allowing interested parties to view or listen to the proceedings as they occurred. The transcript of the hearing is available on the committee's website.⁷
- 1.12 This report focuses on the issues raised in the annual report and, in particular, on matters raised at the public hearing in Canberra on 23 October 2015.
- 1.13 At the public hearing, the committee examined the current policy settings and regulatory framework for enforcement of prudential standards and practices by APRA. Issues canvassed at the hearing included the Government's response to the Financial System Inquiry (FSI) report, property lending practices of ADIs, the review of capital requirements for ADIs following the FSI report and the work of the Basel Committee, and reforms to the prudential and reporting standards in superannuation, in particular those relating to governance.

7 House of Representatives Standing Committee on Economics, Past Public Hearings and Transcripts, <http://www.aph.gov.au/Parliamentary_Business/Committees/House/Economics/2014_APRA_Annual_Report/Public_Hearings> viewed 4 November 2015.

Current Issues in Prudential Regulation

Overview

- 2.1 APRA appeared before the committee at a public hearing on 23 October 2015 as part of the review of APRA's 2014 annual report. Key issues examined at the hearing included the Government's response to the Financial System Inquiry (FSI) report, the residential mortgage lending practices of Authorised Deposit-Taking Institutions (ADIs); APRA's announcement to increase capital adequacy requirements for ADI's using the internal ratings-based (IRB) approach; reforms to the prudential and reporting standards in the superannuation industry and the proposed changes to governance requirements for the superannuation industry.
- 2.2 In his opening statement to the committee the Chairman of APRA, Mr Wayne Byres reported on a number of APRA's activities since its last appearance before the committee in March 2015.
- 2.3 In particular, the Chairman notified the committee of the response APRA had observed from the ADI sector as a result of the letter the regulator sent to all ADIs on 9 December 2014:

In many cases, this led to ADIs making changes to their lending policies and growth aspirations to ensure that sound practices were being maintained. Many of these changes have only recently come into effect, so we are watching carefully to see how they play through the system. Based on the latest available data, the rate of growth in credit for housing is, in aggregate, still accelerating. However, within this there is a compositional switch underway, as a moderation in the growth of lending to investors has been offset by somewhat stronger growth and more competition in lending to owner-occupiers. In such an environment, APRA remains very

alert to any signs of deteriorating credit standards and is monitoring that those ADIs identified as needing to strengthen their lending practices do indeed do so.¹

- 2.4 The letter advised ADIs of APRA's intent to reinforce prudent residential mortgage lending practices through a number of measures, in particular increasing supervision of ADIs with annual investor credit growth materially above a benchmark of 10 per cent.²
- 2.5 The Chairman also commented on the Government's response to the FSI report noting that, in relation to the recommendations addressing capital requirements for ADIs, APRA released a study in July this year on the relative capital strength of the major Australian banks against their overseas peers.³
- 2.6 He commented that APRA's study indicated Australia's major banks' capital ratios were not in the top quartile globally, as the FSI had advocated in its recommendation to make ADI capital unquestionably strong. He added that 'while this sort of international comparison is a useful sense check, we should not tie ourselves too tightly to it.'⁴
- 2.7 The Chairman advised the committee of APRA's announcement in July 2015 to change the risk weight for residential mortgage exposures for banks that are accredited to use internal ratings-based models to determine their capital ratios.⁵
- 2.8 The Chairman informed the committee that the change will take effect from 1 July 2016 and will apply to five lenders, the four major banks and Macquarie Bank who are, to date, the banks that are accredited to use internal models.⁶ This change reflected the recommendation of the FSI which advocated that the difference in risk weights between model-using banks and other ADIs using standard risk weights should be narrowed.⁷ The Chairman commented:

As an interim measure, we adjusted the risk weight for model-using banks to the bottom of the range recommended by the FSI – that is, to an average of at least 25 per cent. We referred to this as an interim measure because it may not be the final calibration. That will ultimately need to wait for more clarity on the full set of

1 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 2.
2 Appendix B: Letter from APRA to all ADIs, 9 December 2014, p. 29.
3 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 1.
4 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 1.
5 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 1.
6 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 6.
7 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 1.

reforms to the international framework that are currently being considered by the Basel committee. But we were comfortable moving ahead on the mortgage risk weight issue given it was consistent with the direction the international work is taking.⁸

- 2.9 The Chairman also reported that APRA has been consulting with industry on potential changes to the prudential framework in accordance with the government's introduction of the *Superannuation Legislation Amendment (Trustee Governance) Bill 2015* to Parliament.⁹ The proposed legislation supports revised governance requirements for the superannuation industry. The Chairman commented:

APRA supports the direction of the proposed changes in the bill, as they will more closely align board composition requirements for the superannuation industry with those of other APRA-regulated industries. APRA's experience over many years and across all industries suggests that having at least some independent directors on boards supports sound governance outcomes. Superannuation is fundamentally about investing money on other people's behalf, and, therefore, strong governance frameworks are critical to protecting the best interests of fund members.¹⁰

- 2.10 The Chairman added that while the Stronger Super reforms had largely contributed to better governance practices within the superannuation industry, there was still room for improvement.¹¹

- 2.11 The Chairman also noted that the transition of responsibilities for the supervision of private health insurance funds from the Private Health Insurance Administration Council (PHIAC) to APRA was successfully achieved.¹² He commented on APRA's actions to progress the transition:

In the months leading up to the transition, APRA established new prudential standards for private health insurance that, to the maximum extent possible, replicated the standards that had been put in place by PHIAC. Data collections and the administration of the Risk Equalisation Trust Fund have also been maintained largely unchanged so that the transition from PHIAC to APRA was as seamless as possible for the insurers themselves. APRA has committed not to make any material changes to the prudential

8 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 1.

9 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 2.

10 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 2.

11 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 2.

12 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 2.

regime for private health insurers in the short term, but over time we will look to align supervisory practices and prudential standards with those of other APRA-regulated industries, where it makes sense to do so.¹³

Banking sector

Property lending

- 2.12 The committee sought commentary from APRA regarding the banking sector's ability to continue to support accelerating credit growth at a time when wages growth is historically low.
- 2.13 APRA agreed that the subdued income growth experienced recently combined with increased house prices and household debt, historically low interest rates, and strong competition were the key factors contributing to the heightened risk in the property market.¹⁴
- 2.14 APRA explained that these factors were considered in APRA's December 2014 decision to reinforce mortgage lending practices of ADIs and, in particular, in determining a reasonable rate of growth for investor lending:
- That is why, for example, when we are asked to reflect on why a 10 per cent growth in investor lending might be high or low or something in the middle, we think about 10 per cent growth in credit as being a reasonably healthy growth, given those other factors.¹⁵
- 2.15 APRA further explained its decision to set the benchmark of investor lending growth at 10 per cent:
- Even if investor lending is growing at 10 per cent, of the major classes of credit in the banking system it is still the fastest growing class of credit and will continue to be for the foreseeable future. It is still growing significantly faster than incomes. It is still growing at twice nominal GDP so it was not seen as a particularly tight constraint. Nonetheless, it was useful in getting some moderation where competition was hottest and where lending standards seemed to be eroded the most. We thought that if we could moderate everyone's aspirations some of those competitive

13 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 2.

14 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 8.

15 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 8.

pressures would be eased and some of that continual erosion of credit standards would be stopped.¹⁶

- 2.16 The Chairman noted that in addition to setting a benchmark for growth in investor lending, APRA was also closely monitoring banks' loan serviceability assessments, given the very low interest rate environment, commenting:

What we want banks to be doing is making sure they are assessing a borrower's capacity to service a loan on the assumption that interest rates were materially higher than they are today.¹⁷

- 2.17 The committee asked APRA whether its measures of introducing a 10 per cent benchmark to investor lending growth had contributed to a number of banks' recent decisions to increase interest rates. The Chairman responded:

I think it has – not just that there is a chance. We have seen banks increase the interest rates that they apply to investor loans. The connection is perhaps a little bit indirect because what we were saying was, 'We'd like you to say "yes" to a few less people. We would like you to say "yes" a bit less frequently to new customers.' We were focused on the volume of the new lending.¹⁸

- 2.18 The Chairman further remarked that there have been a range of responses from ADIs to APRA's measures, adding that while it was difficult to assess how directly APRA's actions have impacted the decisions of specific ADIs 'these changes that have happened have been driven by the sorts of outcomes we are aspiring to.'¹⁹

- 2.19 In relation to the supervision of property lending in the banking sector, the committee notes the recent concerns of the Reserve Bank of Australia (RBA) that data issues around banks' owner-occupier and investor housing loan have emerged following increased supervisory scrutiny.²⁰

- 2.20 The RBA announced on 5 November 2015 that over the past six months there have been very large upward revisions to the value of investor loans outstanding, resulting in the increase of this value by around \$50 billion, or 10 per cent. The RBA stated that 'according to these new data, investor

16 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 18.

17 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 16.

18 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 18.

19 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 19.

20 Dr Philip Lowe, Deputy Governor of the RBA, *Speech: Remarks at FINSIA Regulators Panel*, see: <<http://www.rba.gov.au/speeches/2015/sp-dg-2015-11-05.html>>.

loans now account for 40 per cent of total housing loans outstanding, not the 35 per cent reported earlier in the year.²¹

Risk-weights for IRB model-using banks

- 2.21 Earlier this year APRA announced it would increase the average IRB risk weight for residential mortgage exposures, measured across all IRB model-using banks, to at least 25 per cent, effective 1 July 2016.²²
- 2.22 At the public hearing, the committee asked APRA to briefly explain its decision to increase capital adequacy requirements for residential mortgage exposures under the internal ratings-based approach currently approved for use by five lenders.
- 2.23 The Chairman identified three major factors that prompted the decision. The first was the recommendation of the FSI to narrow the capital adequacy requirements between banks using standardised models and banks using IRB models. The Chairman stated 'they felt that the difference in risk rates was, in their view, creating some problems for competition.'²³
- 2.24 Secondly, APRA felt the decision would ensure risk rates were commensurate with the environment of heightened risk in the housing market. The Chairman commented 'generally, when you see heightened risk, bank supervision will tend to say that we probably need some high capital to match that.'²⁴
- 2.25 Lastly, the Chairman stated that the decision aligns with the likely direction of the international framework through the work of the Basel Committee to limit or restrict the use of IRB models. This is mainly due to concerns in the international community about the reliability of some of the modelling practices and whether they were sufficiently conservative.²⁵
- 2.26 The Chairman reiterated that the decision to increase capital adequacy requirements using the IRB approach to calculate risk-weights only affected five lenders, and will not directly impact ADIs using standardised approaches:

It does not have a direct impact. Your institution, whatever it might be, is competing in a marketplace. What the FSI was driving

21 Dr Philip Lowe, Deputy Governor of the RBA, *Speech: Remarks at FINSIA Regulators Panel*, see: <<http://www.rba.gov.au/speeches/2015/sp-dg-2015-11-05.html>>.

22 *Media Release: APRA increases capital adequacy requirements for residential mortgage exposures under the internal ratings-based approach*, see: <http://www.apra.gov.au/MediaReleases/Pages/15_19.aspx>.

23 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 8.

24 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 8.

25 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, pp. 8-9.

at was trying to make it easier for smaller institutions to compete with the largest institutions.²⁶

- 2.27 The Chairman also confirmed that on average the amount of capital that the five banks using IRB models are required to hold is still less than the amount of capital that banks using standardised models are required to hold.²⁷
- 2.28 The Chairman outlined the likely responses from ADIs using standardised models following APRA's decision:

They could do one of two things. They could leave their current pricing unchanged, in which case you might expect there to be a marginal increase in their market share because their relative positioning has improved. At the other end of the spectrum they could say, 'Well, we will just match what these big guys have done. We'll maintain our relative price, in which case we improve our profitability.' It is an opportunity to improve returns.

In likelihood, I suspect that you end up somewhere in the middle across the industry.²⁸

Capital requirements

- 2.29 The committee expressed concern that the recent move by three of the four major banks to increase variable interest rates following APRA's decision to increase capital requirements is more than what is actually needed for those banks to meet the costs associated with the new capital requirements.
- 2.30 The committee asked APRA to respond to concerns that the change will simply boost the profits of some of the most profitable banks in the world and consumers will have to carry the cost of this increase to capital requirements instead of shareholders.
- 2.31 The Chairman commented that 'when the FSI advocated strengthening capital, it acknowledged that there is a cost that comes with this...that it does change banks' cost of funds.'²⁹ He added that APRA expected that the impact from the change in capital requirements would differ for individual institutions:

The impact of the changes will be different on different banks and even within the banks that are affected the impact will be different because there are a range of factors that go into pricing – their cost

26 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 9.

27 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 9.

28 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 9.

29 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 6.

of debt, their cost of equity, their target capital ratio. All sorts of things will produce different estimates of the cost...³⁰

- 2.32 In relation to banks increasing the costs to consumers beyond what is required to meet new capital requirements, the Chairman further remarked:

We do rely on the fact that there are 100 plus ADIs that do housing lenders. There is a raft of unregulated non-bank housing lenders out there as well. We do have to rely on the competitive forces in the market to provide constraint on any excessive pass through of those costs, but it is difficult. I think you asked: am I concerned that it will all fall on one set of stakeholders? Ideally, you would like to see the costs shared around in proportion to those that benefit from it...³¹

- 2.33 The committee noted another example where there was a significant lag between the decision by the RBA to lower the cash rate and the drop in interest rates for consumers that followed. Notwithstanding the evidence provided at the hearing the committee remained concerned that ordinary home owners and first home buyers were bearing costs that are in excess of those resulting solely from higher capital requirements imposed on banks.
- 2.34 The committee drew attention to discussions from previous hearings in relation to the current home ownership inquiry and the use of capital requirements as macroprudential tools to moderate and improve residential mortgage lending practices, particularly in the investor space.
- 2.35 The committee asked APRA whether industry wide reforms to ADI capital requirements of this nature would also result in homeowners and borrowers bearing most of the associated costs.
- 2.36 APRA clarified that the costs of increasing capital requirements across the industry, or for a very large part of the market as is the case for higher risk rates for IRB model banks, could more easily be passed on to consumers than the cost resulting from an increase in capital requirements for an individual institution,³² adding:

The previous discussion we had was about where we might have concerns about the lending practices of individual institutions, and we might respond to that with a higher capital requirement for an individual institution. It becomes much harder for that institution to pass that on if it is the only one because its competitors are all

30 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 6.

31 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 6.

32 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 7.

unaffected... As we said when we appeared before the homeownership inquiry, what has happened in practice is that lenders, faced with a choice between higher capital requirements and strengthening their lending standards, have universally chosen to strengthen their lending standards...³³

Superannuation

Governance

- 2.37 Earlier in the year APRA released a consultation package for APRA-regulated super funds, proposing amendments to APRA's governance prudential framework.
- 2.38 This was in light of the Government's proposed legislative amendments outlined in the *Superannuation Legislation Amendment (Trustee Governance) Bill 2015* to require at least one third independent directors, including an independent chair, on the boards of APRA-regulated super funds.³⁴
- 2.39 At the public hearing, the committee asked APRA to respond to criticism from members of the superannuation industry for providing proposed amendments to the current governance prudential framework while the relevant legislation is currently before the parliament.
- 2.40 APRA Member, Mrs Helen Rowell commented:
- There was some criticism about APRA releasing its prudential standards at the same time as the government released the bill for consultation. Given the structure of the superannuation legislative framework, the legislation and APRA's prudential standards go hand in hand. To understand how the policy will actually work in practice you need to see all relevant parts of the regulatory framework. So we felt it was important that our, if you like, implementation by the prudential standards was out in public domain for consultation at the same time as the legislation that was being considered so that industry had the opportunity to review and comment on the legislative package as a whole.³⁵
- 2.41 Mrs Rowell also noted that 'the development process for any policy position is that the government and Treasury will work with relevant

33 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 7.

34 *Media Release: APRA releases consultation package on governance arrangements for superannuation trustees*, see: <http://www.apra.gov.au/MediaReleases/Pages/15_28.aspx>.

35 Mrs Helen Rowell, APRA Member, *Transcript*, 23 October 2015, p. 10.

stakeholders and, in particular, the regulators, around implementation issues associated with that policy position.’³⁶

- 2.42 The committee sought APRA’s view on the government’s proposed changes to the board composition requirements of APRA regulated super funds. Mrs Rowell replied:

APRA's long-held position across all industries is that there is value in having independent directors on boards. We have mandated that in banking and insurance since 2006 and we see benefits in it in the superannuation sector, given the size, importance and role that it plays.³⁷

- 2.43 Additionally, Mrs Rowell noted that the rationale for having independent directors on the boards of Registrable Superannuation Entity (RSE) licensees was not about investment performance but rather to ensure that the ‘governance, oversight and decision making is as robust as it should be.’³⁸

- 2.44 The committee asked APRA what evidence it had received that there have been governance practices in the superannuation sector that have delivered lower returns to members, that APRA has sought to address.

- 2.45 APRA noted that there were examples of funds where decisions about investment strategies that did not have appropriate oversight had delivered poor outcomes to members, adding:

I think our concerns are not just limited to investment performance, and in fact good governance practice is much broader than investment performance and needs to look at a range of factors, including management of conflicts, related party arrangements, general decision making and making sure that all strategic and operational decisions look at the range of factors that need to be looked at and take those into account without undue conflicts. We have seen a number of examples where funds are not operating at best practice across all of those spheres... How that manifests varies from fund to fund, and we obviously cannot talk about specific cases... but they do exist and we do seek to address them where we can. There are limitations to how much we can do under the current legislative framework.³⁹

- 2.46 The committee drew attention to APRA’s earlier comments noting that, in banking and insurance, independent directors on boards has been
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36 Mrs Helen Rowell, APRA Member, *Transcript*, 23 October 2015, p. 10.

37 Mrs Helen Rowell, APRA Member, *Transcript*, 23 October 2015, p. 10.

38 Mrs Helen Rowell, APRA Member, *Transcript*, 23 October 2015, p. 10.

39 Mrs Helen Rowell, APRA Member, *Transcript*, 23 October 2015, p. 22.

mandated since 2006. The committee asked APRA how the presence of those independent directors prevented the type of unscrupulous behaviour observed in the wealth management space that triggered the Future of Financial Advice reform.

- 2.47 The Chairman responded to the committee's specific example of the financial planning industry and noted that, while independent directors on the boards of superannuation funds would reduce the probability of poor governance and decision making occurring, it would not safeguard the funds against all potential future problems:

I do not think we would pretend that independents on the board is a panacea for every possible problem that could happen in future, but we do think it is a strengthening of the framework and reduces the probability of that happening. As to the specific cases you talked about in financial planning, I think there was an issue that within these corporate groups governance was perhaps unclear and then when you went down to the boards of some of the specific entities – financial planning entities, wealth management entities – where the specific problems lay, in some cases they were not APRA regulated entities so they were not subject to the governance requirements and in many cases they were boards where some or all were executives. In a number of instances the boards that had the legal responsibility for overseeing these activities did not have the degree of independence, did not have the degree of non-executive oversight, that we would certainly hope to see.⁴⁰

- 2.48 The committee drew attention to another example where the Australian Securities and Investments Commission (ASIC) conducted a review of the performance of insurance industry advice and commented in a media release following the review that 'more than one third (37%) of the advice consumers received failed to comply with the laws relating to appropriate advice and prioritising the needs of the client.'⁴¹
- 2.49 The committee asked for APRA's response, given that it advocated the requirement of independent directors in the insurance sector suggesting this would likely lead to better outcomes, yet evidence from the previously mentioned cases in the banking and insurance sectors appear contrary to this view.

40 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 23.

41 *Media Release: 14-263MR Higher standards needed for life insurance industry*, 9 October 2014, see: <<http://asic.gov.au/about-asic/media-centre/find-a-media-release/2014-releases/14-263mr-higher-standards-needed-for-life-insurance-industry/>>.

- 2.50 The Chairman remarked that increases in the number of independent directors has generally led to an improvement in governance, oversight and decision making across the sector, regardless of the problems that have been identified in various individual institutions.⁴² He added that in relation to poorly performing institutions: ‘none of us know what would have happened had those governance arrangements, in any institution, been different.’⁴³
- 2.51 Mrs Rowell also added that ASIC’s review of advice in the life insurance industry would have captured a substantial number of non-APRA-regulated advising of businesses.⁴⁴
- 2.52 The committee was interested in APRA’s expectations of how funds would respond to and implement the changes proposed to the current legislation, if they were to be adopted. Mrs Rowell responded:
- ... if there is a requirement to go through a process of saying what the board composition is and why you might not have a majority of directors or why you do, we would expect that to be done rigorously and well... as proposed currently, the bill says minimum one-third, disclose on an if not why not basis whether you should have a majority, and if that is implemented then I think APRA or ASIC, depending on who has oversight of that, would expect that process to be undertaken in a rigorous way.⁴⁵

Reporting requirements

- 2.53 APRA updated the committee on the reporting obligations of all APRA-regulated superannuation funds, and in particular the type of data that was routinely provided to APRA by these funds. Mrs Rowell advised that APRA received information beyond what was published in funds’ annual general reports:

We have a quite extensive data collection, which requires all superannuation funds to submit a range of data on many aspects of their operations. In part, that captures financial statement information – balance sheet and profit-and-loss type statements – but it also goes beyond that to get into information on asset allocation, investment performance, membership breakdown and various other attributes across the board. We publish some of the information, both at an aggregate level and at an individual fund

42 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 24.

43 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 24.

44 Mrs Helen Rowell, APRA Member, *Transcript*, 23 October 2015, p. 24.

45 Mrs Helen Rowell, APRA Member, *Transcript*, 23 October 2015, p. 24.

level, and other information is kept confidential. Beyond that regular data collection, we also get a lot of ad hoc information from entities as part of our normal supervision activities. That varies from fund to fund to a degree but, again, covers a wide range of information.⁴⁶

2.54 The committee was interested in following up on APRA's comments during the last public hearing in March 2015 where APRA reported that there had been changes to the reporting and disclosure requirements of funds that will require the publication of more granular information about expenses, and that this transition was still in progress.

2.55 At the October 2015 public hearing APRA updated the committee on the progress of the transition to publish more detailed information at the individual fund level:

We have to go through a process of getting the industry to agree to publication of data that might otherwise be viewed as confidential. We have been through that process with industry. It is substantially complete and we have reached agreement on the information that will be made publicly available. I think it is probably fair to say that it does not go as far as some segments of the industry would like, but there was a range of views about how much information should be in the public domain – how much should be made nonconfidential. So APRA tried to seek a balance in getting suitably granular information but also took into consideration the concerns that some segments of industry raised about confidentiality.⁴⁷

Performance reporting

2.56 The committee also sought information about APRA's actions to monitor the performance reporting of APRA-regulated funds. In particular, the committee asked whether APRA monitored the valuation methodologies of different funds irrespective of their structure in order to substantiate the veracity of their claims of returns and fees.

2.57 Mrs Rowell noted that, broadly, APRA had an understanding of the different approaches adopted across the industry to conduct valuations and unit pricing, and the methods funds use to measure performance.⁴⁸ She added:

46 Mrs Helen Rowell, APRA Member, *Transcript*, 23 October 2015, pp. 2-3.

47 Mrs Helen Rowell, APRA Member, *Transcript*, 23 October 2015, p. 3.

48 Mrs Helen Rowell, APRA Member, *Transcript*, 23 October 2015, p. 4.

I would observe that there is a range of practices across the industry and across all segments of the industry as to how that is done... The vast majority of funds use market basis valuations and performance measurement with daily unit pricing, or close thereto, but there are some in the industry that do not. But that is across all segments of the industry, not in any one particular segment of the industry.⁴⁹

- 2.58 APRA advised the committee that it would generally have a private conversation with funds it identified were using valuation methods that in APRA's view risked overvaluation and overstatement of return.⁵⁰
- 2.59 APRA noted its collaboration with ASIC some years ago to produce a good practice guide on unit pricing in order to build a more robust valuation methodology for different types of investment vehicles, particularly in relation to infrastructure type investments.⁵¹
- 2.60 Additionally, APRA commented that it also monitors funds' liquidity management to ensure super funds are able to meet their financial obligations to pay members' benefits when required.⁵²
- 2.61 APRA remarked that across the industry a number of different methodologies are used to match liquidity with investment nature and pricing, and APRA engages in discussions with individual funds where it has specific concerns about liquidity management.⁵³
- 2.62 Executive General Manager, Specialised Institutions Division, Mr Keith Chapman commented on APRA's actions to identify investments of particular concern in individual institutions, stating 'like most things we do, we look at all regulated institutions at a particular depth and then when there are issues we will delve deeper for particular institutions.'⁵⁴

Conflict management

- 2.63 At the public hearing, the committee was interested in APRA's role in monitoring conflicts of interest in the superannuation industry, and the prudential standards targeting the management of conflicts of interest.
- 2.64 The committee sought APRA's view on whether as a regulator it received sufficient information from funds, beyond what was publicly available, to identify conflicts.

49 Mrs Helen Rowell, APRA Member, *Transcript*, 23 October 2015, p. 4.

50 Mrs Helen Rowell, APRA Member, *Transcript*, 23 October 2015, p. 4.

51 Mrs Helen Rowell, APRA Member, *Transcript*, 23 October 2015, p. 5.

52 Mrs Helen Rowell, APRA Member, *Transcript*, 23 October 2015, p. 5.

53 Mrs Helen Rowell, APRA Member, *Transcript*, 23 October 2015, p. 5.

54 Mr Keith Chapman, Executive General Manager, APRA, *Transcript*, 23 October 2015, p. 5.

- 2.65 Mrs Rowell advised the committee of various methods APRA could adopt to obtain information from individual funds in relation to potential conflicts:

In terms of the information that we have available then, obviously, we can look at the public information. And we do get specific information from funds. We have the power, really, to request whatever information we would like to get in relation to any aspect of the operations of the fund, and from time to time we do make specific data requests to get more information on actual or potential conflicts – how those are being managed, identified and mitigated. So in that sense we certainly feel that we have the ability to get the information that we need.⁵⁵

- 2.66 APRA reported that the prudential standard around conflict management requires funds or trustees to have in place conflicts registers which must be made publicly available. These are typically accessible on the given fund's website.⁵⁶

- 2.67 She added that APRA would go beyond the routine investigation of a fund to request more detailed information where it had concerns that a fund had not disclosed all relevant conflicts on the public register.⁵⁷ In these circumstances APRA would seek more information from the fund before encouraging them to make their registers more complete.⁵⁸

- 2.68 Mrs Rowell informed the committee of the type of information that would generally be publicly disclosed on a conflicts register, stating 'we would expect to be able to find information about who was on the board and what their other related party arrangements and connections might be.'⁵⁹

- 2.69 Furthermore, in response to whether particular cash payments would be disclosed, Mrs Rowell explained that the legislative requirements in relation to conflicts disclosure go to the nature of the relationship rather than the specifics of the amounts involved:

The disclosure requirements are limited to the nature of the relationship and the fact that it exists and some general information around how conflicts and related party arrangements are managed. In terms of the specific information that we might be interested in, it would go beyond that and we would be interested in understanding the extent and nature of the relationships and

55 Mrs Helen Rowell, APRA Member, *Transcript*, 23 October 2015, p. 3.

56 Mrs Helen Rowell, APRA Member, *Transcript*, 23 October 2015, p. 3.

57 Mrs Helen Rowell, APRA Member, *Transcript*, 23 October 2015, p. 3.

58 Mrs Helen Rowell, APRA Member, *Transcript*, 23 October 2015, p. 3.

59 Mrs Helen Rowell, APRA Member, *Transcript*, 23 October 2015, p. 3.

how they were being managed and mitigated, although we would not necessarily do that on a routine basis. We would only do that if we had some specific concerns about the particular arrangements or felt that they were not being adequately managed.⁶⁰

2.70 Mrs Rowell noted that APRA was able to obtain additional information on related party arrangements, if necessary, including details of specific cash payments made to different organisations. However, details of cash payments were not disclosed to APRA on a routine basis.⁶¹ She added:

The key point from our perspective is the prudential management of the operations of the fund and understanding what is going on there. From that point of view, it is clearly very important that we understand all the material operations, relationships and activities. The issue of what information should be in the public domain is more a public disclosure ASIC issue than an APRA issue.⁶²

2.71 The committee asked APRA to respond to concerns that there has been significant focus on the independent component of governance, and insufficient action in managing related party transactions in the superannuation industry where potential conflicts may lead to suboptimal outcomes for members.

2.72 APRA disagreed with this view, stating that part of its role is to supervise the management of conflicts in related-party arrangements across the sector and that this 'certainly would not be at the expense of focusing unduly on governance.'⁶³ Mrs Rowell added however that improving governance practices will generally have positive flow-on effects to reduce related-party arrangements that lead to poor outcomes:

To a degree they go hand in hand. If you have the right people with the right skills sitting around the board table asking the right questions then that helps. Given our resourcing, we cannot be looking at every fund all of the time, so we need to rely on trustees and the boards as a whole making the right decisions and making sure that the control frameworks are in place and operating effectively. So, to a degree, having the right governance, the right skill set and the right level of challenge at the board should also be helping to tackle those related-party arrangements and conflicts when we are not there challenging.⁶⁴

60 Mrs Helen Rowell, APRA Member, *Transcript*, 23 October 2015, p. 4.

61 Mrs Helen Rowell, APRA Member, *Transcript*, 23 October 2015, p. 4.

62 Mrs Helen Rowell, APRA Member, *Transcript*, 23 October 2015, p. 4.

63 Mrs Helen Rowell, APRA Member, *Transcript*, 23 October 2015, p. 22.

64 Mrs Helen Rowell, APRA Member, *Transcript*, 23 October 2015, p. 22.

Venture capital

- 2.73 The committee asked APRA to respond to claims that superannuation funds' focus on fees combined with the expensive asset class of venture capital is preventing funds from directing more support to venture capital and therefore the early-stage innovation space.
- 2.74 The Chairman replied that APRA recently had discussions with venture capital groups and has always advocated that 'it is not low cost that is important; it is outcomes for members.'⁶⁵
- 2.75 Mrs Rowell commented that APRA's focus was on whether investment decisions are made by funds in an appropriate way with due consideration given to risk return and outcome costs, however the investment strategy was ultimately up to the trustee to determine:

From our perspective, there is absolutely nothing in the prudential framework that precludes super funds investing in venture capital and having that as part of their investment strategy, as long as they have been through the process of identifying the risks that are involved and the likely return outcomes. I have also been on the public record as saying that focusing too much on fees is inappropriate and, as Wayne said, it is very much the net outcome, after taking into account all costs, that is important.⁶⁶

Anti-Money Laundering and Counter-Terrorism Financing Act 2006

- 2.76 The committee was interested in whether APRA had given any consideration to the compliance costs and commercial risk banks were faced with as a result of the provisions in the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (AML/CTF Act), and the risk management approaches adopted by banks in response to this.
- 2.77 In particular, the committee asked whether Australian banks were exposed to commercial risk due to the significant fines they would be subject to if found in breach of the legislation, and, if so, would this commercial risk be taken into consideration by APRA.
- 2.78 APRA noted it was not the primary regulator of AML/CTF Act matters, and these issues fall within the remit of the Australian Transaction Reports and Analysis Centre (AUSTRAC), adding:

65 Mrs Helen Rowell, APRA Member, *Transcript*, 23 October 2015, p. 21.

66 Mrs Helen Rowell, APRA Member, *Transcript*, 23 October 2015, p. 21.

We might see AML issues as a by-product of looking at the things we are doing. If so, we communicate with AUSTRAC and, if they have a significant issue with one of the institutions, they would let us know about that so that we are aware that something is going on.⁶⁷

- 2.79 In relation to whether APRA considered the commercial risks to banks of being found in breach of this legislation Mr Chapman responded ‘no because the extent to which banks might do things which crystallise that risk would be an AUSTRAC test.’⁶⁸ Further to this, he added:

Based on experience to date, and I accept the fact that particularly in the UK and the US there have been fines of such a ilk that it actually could have prudential implications, but in Australia we have not seen that size of potential fines that would cause us to think that there is a prudential risk to the operations of the bank.⁶⁹

- 2.80 Mrs Rowell stated ‘we would expect banks, as part of their risk framework, to be considering that risk, the potential for it and factoring that into consideration of their financial resources and the like.’⁷⁰

- 2.81 APRA commented that it would likely be made aware, either by AUSTRAC or an equivalent foreign regulator, of the risk to an individual institution of being exposed to some sort of sanction due to inadequate control frameworks.⁷¹

- 2.82 The Chairman added that there is nothing to directly suggest that Australian banks are exposed to large commercial risks in the current circumstances as a result of the AML/CTF Act, adding:

... but partly that is because they are scaling back activities and doing things to constrain the risks. So the assurance I give you is partly because of the constraints that the banks are imposing to reduce that commercial risk.⁷²

- 2.83 The committee asked APRA why the banks were not passing the additional costs of complying with the legislation on to the remittance industry instead of closing down their accounts and ‘de-banking’ the remittance industry.

- 2.84 The Chairman responded it was difficult for banks to quantify the costs of compliance, and make commercial decisions about whether customers

67 Mr Keith Chapman, Executive General Manager, APRA, *Transcript*, 23 October 2015, p. 11.

68 Mr Keith Chapman, Executive General Manager, APRA, *Transcript*, 23 October 2015, p. 12.

69 Mr Keith Chapman, Executive General Manager, APRA, *Transcript*, 23 October 2015, p. 12.

70 Mr Keith Chapman, Executive General Manager, APRA, *Transcript*, 23 October 2015, p. 12.

71 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 12.

72 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 12.

will bear these costs, due to the nature and size of the fines imposed to date.⁷³ Additionally, he commented that banks faced further uncertainty due to their exposure to foreign regulatory systems as a result of the international environment payments are generally made in.⁷⁴

- 2.85 The committee asked APRA whether the substantial de-banking of the remittance industry posed a risk to Australia's financial system more broadly by encouraging businesses to use unregulated practices.
- 2.86 Mr Chapman responded that all remitters, and not just banks, are subject to reporting requirements through AUSTRAC.⁷⁵ So while the compliance issue remitters are faced with may have left the banking system and the APRA regulated space as a result of 'de-banking', that does not necessarily mean that it is outside the government controlled space.⁷⁶
- 2.87 In relation to whether an increase in remittance activity outside the banking sector would pose a higher risk to the financial stability of the economy more broadly, the Chairman further added:

That risk exists. It could occur through the banking system or it could occur through other means. The banks have put in place what they think, based on their commercial pros and cons, are a set of constraints that protect the banking system – protect them and therefore the banking system. That does not mean the risk has gone away, which is your point, but it is somewhere else, not in the banking system.⁷⁷

Technology and Financial Services

- 2.88 The committee was interested in APRA's response to rapid innovations in technology in the financial services sector, and asked whether APRA was adapting its regulatory approach to deal with technological disruptions that have occurred within this sector.
- 2.89 The Chairman commented that APRA was generally aware of technological disruptions and security issues that are emerging in this sector.⁷⁸ He added that APRA continues to monitor these developments

73 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 13.

74 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 13.

75 Mr Keith Chapman, Executive General Manager, APRA, *Transcript*, 23 October 2015, pp. 13-14.

76 Mr Keith Chapman, Executive General Manager, APRA, *Transcript*, 23 October 2015, pp. 13-14.

77 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 14.

78 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 20.

closely, but that regulatory intervention by APRA in the current circumstances would not be appropriate:

We are observing those things, but it is difficult for us – and I think wrong for us – to try and get ahead of the game and anticipate too much about how this might play out. Those players who have come into the space and are now doing some kind of financial intermediation activity have been careful to construct themselves in a way that they do not fall under the Banking Act. It is perfectly legitimate for them to do that as long as they adhere to the laws and do not pretend they are taking deposits from the public and, if people are clear about what they are investing in, that is all part of the financial system we are meant to have.

We have to be a bit wary of jumping to try and capture those things and sweep them into the regulatory net too quickly. In the grand scheme of things they are still very small and, to the extent that they keep the existing financial players on their toes, then that is in everyone's interest. So that is not a particular concern for us.⁷⁹

- 2.90 The Chairman remarked that the FSI response noted payments and purchase-payment facilities as an area of increasing technological innovation requiring a more graduated regulatory regime that allowed new ideas and technologies to progress before capturing them under the regulatory framework to any great extent.⁸⁰ He added that APRA 'will have to work with the other agencies that are interested in that space on the development of that kind of framework.'⁸¹

Conclusion

- 2.91 The committee acknowledges APRA's actions to reinforce sound residential mortgage lending practices for ADIs over the past 12 months. However, the committee notes reports by the RBA that data problems regarding lenders' housing loans have emerged following increased supervisory scrutiny,⁸² and considers this a serious concern. The committee intends to investigate the matter further with APRA at the next public hearing.

79 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, pp. 20-21.

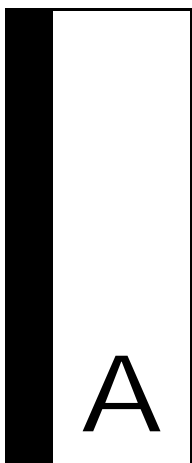
80 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 21.

81 Mr Wayne Byres, Chairman of APRA, *Transcript*, 23 October 2015, p. 21.

82 Dr Philip Lowe, Deputy Governor of the RBA, *Speech: Remarks at FINSIA Regulators Panel*, see: <<http://www.rba.gov.au/speeches/2015/sp-dg-2015-11-05.html>>.

- 2.92 In addition, the committee will continue to monitor developments regarding increases in capital adequacy requirements for residential mortgage exposures under the IRB approach, and the banking sector's response to this. Of particular interest to the committee are the international developments that are anticipated in this area, as well as APRA's continued consideration of the recommendations of the FSI report.
- 2.93 The committee will continue to scrutinise APRA on its oversight of the superannuation sector in relation to the Stronger Super reforms and the industry's implementation of APRA's prudential standards.

Craig Laundry MP
Chair
11 December 2015



Appendix A – Public hearing details and submission

Public hearing

Friday, 23 October 2015 – Canberra

Australian Prudential Regulation Authority

Mr Wayne Byres, Chair

Mrs Helen Rowell, Member

Mr Keith Chapman, Executive General Manager, Specialised Institutions Division

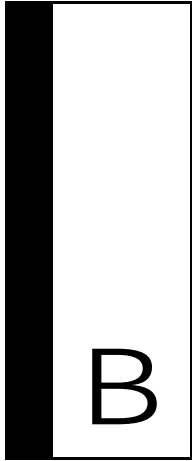
Mr Neil Smith, Special Counsel, Policy and Advice Division

The hearing transcript is available online at:

http://www.aph.gov.au/Parliamentary_Business/Committees/House/Economics/2014_APRA_Annual_Report/Public_Hearings

Submission

Submission 1 Australian Prudential Regulation Authority (Answers to Questions on Notice)



Appendix B – Letter from APRA to all ADIs
9 December 2014

Australian Prudential Regulation Authority

400 George Street (Level 26) T 02 9210 3000
Sydney NSW 2000 F 02 9210 3411
GPO Box 9836 W www.apra.gov.au
Sydney NSW 2001



9 December 2014

To: All authorised deposit-taking institutions

REINFORCING SOUND RESIDENTIAL MORTGAGE LENDING PRACTICES

In the current economic environment, prudential risks in the housing market appear to be increasing. Interest rates remain at historically low levels, household leverage remains high, and housing loans represent a large and increasing concentration on many ADI balance sheets. Strong competition in the housing market is also evident, which is accentuating pressure on lending standards. Against this backdrop, housing credit growth has accelerated, with lending to property investors particularly strong; the Reserve Bank of Australia (RBA) has noted that this could be funding additional speculative activity in the market. These forces have contributed to strong house price growth, particularly when viewed against the more subdued growth in household incomes.

Over the past year, APRA has taken a number of steps aimed at strengthening residential mortgage lending standards. This has centred on ensuring that ADIs increase their understanding and active monitoring of risks within their residential mortgage portfolios. In addition to a heightened level of supervisory activity at individual ADIs, APRA has:

- increased the level of analysis of mortgage portfolios, including regular review of detailed data on ADI underwriting policies and key risk indicators, to identify outliers. APRA also recently completed a stress test of the ADI industry, with two scenarios focused on a severe downturn in the housing market;
- written to boards and chief risk officers on their oversight of the evolving risks in residential mortgage lending. APRA supervisors have been following up on this communication through on-site prudential reviews of residential mortgage lending; and
- issued a prudential practice guide (APG 223) on sound risk management practices for residential mortgage lending.¹ Some ADIs are currently conducting self-assessments against APG 223, which APRA considers to be good practice.

With the current risk environment in mind, APRA has been discussing with other members of the Council of Financial Regulators (CFR) further steps that could be taken to reinforce sound lending practices and mitigate any speculative pressures that may be building.

¹ *Prudential Practice Guide APG 223 - Residential Mortgage Lending*, APRA, 5 November 2014.

Reinforcing sound lending practices

There are a number of additional regulatory and supervisory tools that APRA can apply to address emerging risks, building on the enhanced monitoring and review of recent years. These include additional supervisory monitoring and oversight, supervisory actions involving Pillar 2 capital requirements for individual ADIs, and higher regulatory capital requirements at a system-wide level.² Beyond this, there are also more direct controls such as regulatory limits on lending activities, as introduced in other jurisdictions to manage risks emerging in the housing market.

At this stage, APRA does not propose to introduce increases in system-wide capital to address current risks in the housing market, or introduce new regulatory limits, although we will keep these options under active review. Based on our current assessment of the risk outlook, however, APRA considers that it is necessary to further increase the level of supervisory intensity in this area, to reinforce sound lending practices, with a particular focus on some specific areas of prudential concern. These are set out below, providing transparency on the key aspects of mortgage lending that APRA supervisors will be focusing on in the period ahead. Where concerns on risk profile or serviceability are identified, this will lead to further supervisory action, including the consideration of individual Pillar 2 capital requirements.

Risk profile

There are many dimensions to assessing the soundness of mortgage lending practices. In recent years, supervisors have been discussing and reviewing these in depth. Higher risk lending includes, for example, a high proportion of lending at high loan-to-income ratios (LTI), lending at high loan-to-valuation ratios (LVRs), lending on an interest-only basis to owner-occupiers for lengthy periods and lending at very long terms. In the current environment, where an ADI is undertaking large volumes of lending in these categories, or increasing this higher risk lending as a proportion of new lending, this will be a trigger for the consideration of supervisory action.

Investor lending

Fast or accelerating credit growth can also be a key indicator of a build-up in risk, both at an individual ADI and at an aggregate system level. For an individual ADI, excessive housing credit growth can generate a rapid shift in risk profile, especially if new borrowers are increasingly stretched to compete in a quickly rising property market. Given the currently very strong growth in investor lending, supervisors will be particularly alert to plans for rapid growth in this part of the portfolio. For example, annual investor credit growth materially above a benchmark of 10 per cent will be an important risk indicator that supervisors will take into account when reviewing ADIs' residential mortgage risk profile and considering supervisory actions.³ The benchmark is not intended as a hard limit, but ADIs should be mindful that investor loan growth materially above this rate will likely result in a supervisory response.

² There are two principal mechanisms for changes to capital at a system level: changes to Pillar 1 capital requirements for individual assets (through changes to specific risk weights) or changes to overall capital requirements for all ADIs. From 1 January 2016, APRA will also have the option of applying the countercyclical capital buffer.

³ This benchmark has been established by APRA, after advice of CFR agencies, taking into account trend nominal household income growth and recent market trends.

Serviceability assessments

Serviceability assessments for new borrowers are critical in determining the capacity of the borrower to service and repay the loan. The serviceability buffer assumed by ADIs as part of this assessment accommodates not only future changes in interest rates but also unexpected changes in borrower income and expenses. Practice in setting the serviceability buffer varies across the industry, with some assessments allowing borrowers to take on debt at very high multiples of their income.

In APRA's view, prudent serviceability policies should incorporate a serviceability buffer of at least 2 per cent above the loan product rate, with a minimum floor assessment rate of 7 per cent.⁴ This is based on a number of considerations, including past increases in lending rates in Australia and other jurisdictions, market forecasts for interest rates, international benchmarks for serviceability buffers, and long-run average lending rates.

Good practice would be to maintain a buffer and floor rate comfortably above these levels, rather than operate at the minimum expectation: low serviceability buffers will prompt the consideration of further supervisory action. APRA supervisors will also be monitoring other elements of the serviceability assessment, including income acceptance, minimum living expenses, and other debt commitments. It will be important that these assumptions are not relaxed, to ensure that overall loan serviceability standards are maintained.

Next steps

In the first quarter of 2015, APRA supervisors will be reviewing key risk indicators, serviceability policies and ADIs' investor loan growth plans. Where an ADI is not, in APRA's view, maintaining prudent lending practices, this will lead to a graduated increase in the level of supervisory action. As with any supervisory response, this will include further communication with senior management and boards, changes to APRA's risk assessment as defined by the PAIRS and SOARS framework, and enhanced monitoring and review. In the first half of 2015, supervisors will also reflect any concerns through changes to Pillar 2 capital requirements, proportionate to the risks identified and the scale of the residential mortgage loan portfolio.

For higher risk lending, APRA will also conduct further investigation to better understand how ADIs are monitoring and managing origination flows and the associated credit risk during 2015. This may include additional detailed information requests and on-site and off-site reviews. For all ADIs, supervisors will continue to place a strong focus on reviewing loan origination practices in residential mortgage portfolios, given the risks in the current environment.

Together with other members of the CFR, APRA will continue to monitor and assess the risks in the housing market as they evolve. As outlined above, there are a range of further measures that APRA could apply. These options remain open, and we will consider the need for additional steps as market conditions and lending standards develop.

⁴ The loan product rate is the lender's current standard variable rate (SVR) minus any discount applied for the term of the loan.

Australian Prudential Regulation Authority

4

If you have any questions on the issues outlined in this letter, please contact your supervisory team.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Wayne Byres', with a stylized flourish at the end.

Wayne Byres
Chairman