The Parliament of the Commonwealth of Australia

Review of the Australian Prudential Regulation Authority Annual Report 2013
(First Report)

House of Representatives
Standing Committee on Economics

September 2014
Canberra

ISBN 978-1-74366-190-1 (Printed version)

ISBN 978-1-74366-191-8 (HTML version)

Chair’s foreword

The Australian Prudential Regulation Authority (APRA) is the primary regulator of the Australian financial services industry. The last review of APRA’s activities by this committee was in 2004. This current review is timely given the changes in Australian and global financial systems since then.

APRA-regulated industries include banking, insurance and superannuation. In the banking industry, Australia is well placed to implement the global prudential reforms recommended by the Basel Committee on Banking Supervision. Australia’s major banks are operating well and continue to be closely supervised by APRA.

APRA has been active in monitoring and imposing capital requirements on banks and has reviewed these requirements for insurance companies. The ‘Stronger Super’ reforms have brought the same prudential standards to the superannuation industry that apply to banks and insurance companies.

Appearing before the committee on 18 July 2014, the Chairman of APRA Mr Wayne Byres stated that the financial sector is broadly in good health. There are some concerns about housing lending standards but this area is being closely monitored. APRA notes in its 2013 annual report that the Australian economy grew at a relatively steady pace over 2012-13 and that the effects of the global financial crisis have begun to lift.

It is pleasing that APRA regulated industries are performing well and that Australia is emerging from the global financial crisis on a relatively good footing. The implementation of Basel III international banking standards is of continuing interest and should remain appropriate to the needs of our financial sector. The new Stronger Super reforms have had a positive start but need to be further evaluated over time. The ‘Future of Financial Advice’ reforms are yet to be completed but there no concerns at present in this area.

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 18 July 2014.

The committee has requested that APRA appear at public hearings twice a year, similar to the committee's oversight of the Reserve Bank of Australia. The next hearing will be held in Canberra on 28 November 2014.

Kelly O'Dwyer MP
Chair

Contents

APPENDIX

Membership of the Committee

Chair	Ms Kelly O'Dwyer MP
Deputy Chair	The Hon Ed Husic MP
Members	Mr Scott Buchholz MP
	Dr Jim Chalmers MP
	Mr David Coleman MP
	Mr Pat Conroy MP
	Dr Peter Hendy MP
	Mr Kevin Hogan MP
	Mr Craig Kelly MP
	Mr Clive Palmer MP

Committee Secretariat

Secretary	Mr Peter Banson
Inquiry Secretary	Dr Kilian Perrem
Research Officer	Mrs Jacqueline Mayer
Administrative Officers	Ms Jazmine Rakic
	Ms Sarah Tutt

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
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investment Commission
DSIB	Domestic systemically important bank
EFIC	Export Finance and Insurance Corporation
FoFA	Future of Financial Advice
FSAP	Financial Sector Assessment Program
FSI	Financial Services Inquiry
IMF	International Monetary Fund
LCR	Liquidity coverage ratio
LVR	Loan to valuation ratio
SMSF	Self-managed superannuation fund

1

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 2013 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 19 March 2014 that it would conduct an inquiry into the annual report.

1.3 The committee chair stated that 'this will be a timely review of the primary regulator of Australian institutions holding $4.5 trillion in assets'[1] and that:

> The effective supervision of our financial services industry is vital to safeguarding these assets and protecting the future financial wellbeing of all Australians.[2]

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 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, 'The Australian Prudential Regulation Authority to appear before the House Economics Committee in Canberra', *Media Release*, 15 July 2014.

2 House of Representatives Standing Committee on Economics, 'The Australian Prudential Regulation Authority to appear before the House Economics Committee in Canberra', *Media Release*, 15 July 2014.

supervises institutions holding $4.5 trillion in assets for Australian depositors, policyholders and superannuation fund members.[3] From 1 July 2015, APRA will also assume responsibility for the prudential regulation of private health insurance.[4]

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'.[5]

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.[6]

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.[7]

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. Enforcement options include formal investigation, imposing conditions on an institution's licence, appointment of a trustee and taking criminal action against a person or institution.[8]

---

3 Australian Prudential Regulation Authority, *2013 Annual Report*, 14 October 2013, p. 1.

4 Mr Ian Laughlin, Deputy Chairman of APRA, *Transcript*, 18 July 2014, p. 16.

5 Australian Prudential Regulation Authority, *2013 Annual Report*, 14 October 2013, p. 3.

6 Australian Prudential Regulation Authority, 'Protecting Australia's depositors, insurance policyholders and superannuation fund members', <http://www.apra.gov.au/AboutAPRA/Publications/Documents/APRA_CB_022012_ex_online.pdf> viewed 4 August 2014.

7 Australian Prudential Regulation Authority, Supervision, <http://www.apra.gov.au/AboutAPRA/Pages/Supervision.aspx> viewed 4 August 2014.

8 Australian Prudential Regulation Authority, 'Fact Sheet 6 – APRA's enforcement activities', <http://www.apra.gov.au/AboutAPRA/Publications/Pages/APRA-Fact-Sheet-6.aspx> viewed 1 September 2014.

Scope and conduct of the review

1.9 The first public hearing of the committee with APRA during the 44th Parliament was held in Canberra on 18 July 2014.

1.10 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.[9]

1.11 This report focuses on the issues raised in the annual report and, in particular, on matters raised at the public hearing in Canberra on 18 July 2014.

1.12 At the public hearing, the committee examined the current policy settings and regulatory framework for enforcement of prudential standards and practices by APRA. The committee also sought APRA's views on the current financial system inquiry and on global prudential reforms under the Basel Committee on Banking Supervision, of which Australia is a member.

9 House of Representatives Standing Committee on Economics, Past Public Hearings and Transcripts, <http://www.aph.gov.au/Parliamentary_Business/Committees/House/Economics/2013_APR_Annual_Report/Public_Hearings > viewed 4 August 2014.

2

Current Issues in Prudential Regulation

Overview

2.1 The 2013 APRA annual report reported on APRA's priorities and activities over the financial year ending 30 June 2013. This included APRA's supervisory activities, governance arrangements and the prudential framework.

2.2 One of APRA's activities, identified in the annual report, was consultation with the superannuation industry ahead of the implementation of new superannuation prudential standards on 1 July 2013.[1] At the public hearing on 18 July 2014, the Chairman of APRA, Mr Wayne Byres (the Chairman), was questioned on the process of considering the impact of new prudential regulation and regulatory standards. He noted that 'all of our proposals go out for consultation with industry and any other stakeholders who are interested in commenting on them'.[2] He further commented:

> Submissions from interested stakeholders come in to us…. We would then publish a response to those submissions, identifying how we have worked through them and thought about them. Then, ultimately, we would go through a final process of determining what we think the final policy framework should be. That, of course, is subject to review ultimately by the Office of Best Practice Regulation to make sure that we have met the required standards in policy making.[3]

---

1 Australian Prudential Regulation Authority, *2013 Annual Report*, 14 October 2013, p. 36.

2 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 3.

3 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 3.

2.3 APRA's other activities in the financial year 2012/13 included:

- the release of a prudential practice guide on managing data risk, applying across all APRA regulated industries;[4] and
- 250 enforcement actions including formal investigations into a superannuation trustee, resulting in two directors giving enforceable undertakings to remain out of the superannuation industry.[5]

2.4 In his opening statement at the public hearing, the Chairman began by describing APRA's 'supervision-led approach'.[6] The Chairman stated:

> We certainly believe in sound regulation and enforcement and, over recent years, have introduced a more robust regulatory regime... But regulation on its own is not a substitute for proactive, informed and confident supervision.[7]

2.5 The Chairman further stated:

> Regulatory requirements are, by their nature, minimums, and it is best for all concerned if regulated entities operate a safe distance from that minimum in the normal course of business. Our supervisors seek to ensure that that is the case. To try and put it another way: we primarily seek to identify and prevent problems rather than deal with the wrongdoers after the event'.[8]

2.6 One of the tools that APRA uses to identify risk in its regulated institutions is the Probability and Impact Rating System (PAIRS). Mrs Helen Rowell, APRA member commented that 'PAIRS looks at eight different aspects of the operation of any entity'.[9] She stated:

> … it looks at governance, risk management, strategy, assets or investments, capital, operational risk, credit risk and insurance risk… For each institution, we would make an assessment of the particular risk in the category that we are looking at—the controls around that risk and how they are effectively being applied, or not, in a particular institution.[10]

4 Australian Prudential Regulation Authority, *2013 Annual Report*, 14 October 2013, p. 36.
5 Australian Prudential Regulation Authority, *2013 Annual Report*, 14 October 2013, p. 38.
6 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 1.
7 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 1.
8 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 1.
9 Mrs Helen Rowell, APRA member, *Transcript*, 18 July 2014, p. 8.
10 Mrs Helen Rowell, APRA member, *Transcript*, 18 July 2014, p. 8.

2.7 The Chairman noted that 'we are not targeting a zero failure regime'.[11] He stated:

> Thankfully, the number is relatively low, but it does happen that regulated institutions fail. What we are trying to do, to the extent we can, is to solve problems before they become big. But if they become significant, then the second leg is to try and make sure that an exit from the industry is done in a dignified manner—in an orderly manner.[12]

2.8 The Chairman then identified the most important reforms that have been, or are in the process of being, completed.[13] The first of these was banking reforms generated by the Basel III recommendations.

2.9 Basel III is described by the Basel Committee on Banking Supervision (the Basel Committee) as:

> … a comprehensive set of reform measures, developed by the Basel Committee on Banking Supervision, to strengthen the regulation, supervision and risk management of the banking sector.[14]

2.10 The Chairman noted that 'implementation of the full suite of reforms is not envisaged until 2019, but Australian institutions are very well placed to meet them already'.[15]

2.11 The Chairman next commented on the insurance sector, where 'the most important reform has been the comprehensive review of capital requirements for both life and general insurance'.[16] The Chairman stated that:

> … the final standards came into force at the beginning of 2013. Our assessment is that, by and large, the industry has coped well with the new requirements and adjusted practices as required. As it stands at present, the industry is choosing to hold capital almost twice the minimum level required by APRA.[17]

2.12 Finally, the Chairman noted the superannuation reforms undertaken as part of the Stronger Super reforms. He described the key development as being 'the implementation of prudential standards for superannuation,

11 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 4.

12 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 4.

13 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 2.

14 Basel Committee on Banking Supervision, International Regulatory Framework for Banks (Basel III), <http://www.bis.org/bcbs/basel3.htm> viewed 13 August 2014.

15 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 2.

16 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 2.

17 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 2.

bringing the superannuation industry onto the same prudential footing as already applied for ADIs [authorised deposit-taking institutions] and the insurance sector'.[18]

2.13 The Chairman concluded, in relation to the financial sector generally, that 'the industry is broadly in good health',[19] but that:

> … challenges and vulnerabilities will always exist, including from offshore. APRA needs to remain alert to the threat that potential risks may become real problems.[20]

2.14 In addition to the areas of reform identified in the Chairman's opening remarks, the committee further inquired into a range of issues including self-managed superannuation funds; the financial advice market; and APRA's supervision of major banks.

International Regulatory Framework

The Basel Committee on Banking Supervision

2.15 The Basel Committee on Banking Supervision describes itself as 'the primary global standard-setter for the prudential regulation of banks and provides a forum for international cooperation on banking supervisory matters'.[21] There are currently 42 institutions from 27 jurisdictions represented on the Basel Committee.[22] As outlined by the Basel Committee:

> Countries are represented on the Committee by their central bank and also by the authority with formal responsibility for the prudential supervision of banking business where this is not the central bank.[23]

2.16 Together with the Reserve Bank of Australia, APRA was invited to become a member of the Basel Committee in 2009. The Chairman of APRA at the time, Dr John Laker, stated:

18 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 2.

19 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 2.

20 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 2.

21 Basel Committee on Banking Supervision, About the Basel Committee, <http://www.bis.org/bcbs/about.htm> viewed 4 August 2014.

22 Basel Committee on Banking Supervision, Basel Committee Membership, <http://www.bis.org/bcbs/membership.htm> viewed 4 August 2014.

23 Basel Committee on Banking Supervision, 'A Brief History of the Basel Committee', <http://www.bis.org/bcbs/history.pdf> viewed 4 August 2014.

> The invitation to become a member is an acknowledgement of the high regard in which Australia's financial regulatory regime is held in international circles, and confirmation that Australian regulatory authorities can make a significant contribution to global standard-setting in the future.[24]

2.17 The Basel Committee's members come from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.[25]

2.18 The Basel Committee describes its mandate as 'to strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability'.[26]

2.19 Decisions of the Basel Committee have no legal force, however it should be noted that countries that do not adhere to Basel standards are not considered 'best practice'. The Basel Committee states:

> … [standards] are developed and issued by the agreement of members, and in the expectation that individual national authorities will implement them. In this way, the Committee encourages convergence towards common standards and monitors their implementation, but without attempting detailed harmonisation of member countries' supervisory approaches.[27]

2.20 The Basel Committee has created a timetable for phase-in arrangements of the Basel III requirements, but member countries are able to adopt accelerated implementation timetables as appropriate.[28]

2.21 For example, the timetable sets a start date of 1 January 2015 for implementation of the LCR. It allows for a gradual phase-in with a

24 Australian Prudential Regulation Authority, 'APRA Joins Global Banking Body', *Media Release*, 16 March 2009.

25 Basel Committee on Banking Supervision, Basel Committee on Banking Supervision, <http://www.bis.org/bcbs/> viewed 4 August 2014.

26 Basel Committee on Banking Supervision, About the Basel Committee, <http://www.bis.org/bcbs/about.htm> viewed 4 August 2014.

27 Basel Committee on Banking Supervision, The Basel Committee's Work, <http://www.bis.org/bcbs/bcbs_work.htm> viewed 4 August 2014.

28 Basel Committee on Banking Supervision, 'Basel III Phase-in Arrangements', <http://www.bis.org/bcbs/basel3/basel3_phase_in_arrangements.pdf> viewed 4 August 2014.

minimum requirement of 60% from the original start date, rising in annual steps of 10 percentage points to reach 100 per cent on 1 January 2019.[29]

2.22 APRA is not proposing to adopt the phase-in arrangements and will implement 100% of the LCR from 1 January 2015.[30] APRA has noted that 'these arrangements were introduced in light of the considerable stress facing banking systems in some regions'.[31] APRA further noted that:

> Australia, however, is not one of those regions. Moreover, most large internationally active banks are already compliant with the LCR… Accordingly, APRA proposes to retain its original implementation timetable for the LCR. This is a conservative approach, but one that is fully consistent with the capabilities and needs of the Australian banking system.[32]

2.23 Similarly, as Australian ADIs were already compliant with the Basel III minimum common equity capital ratio of 4.5%, no phase-in arrangements for implementation were necessary in Australia.[33]

Basel III Framework

2.24 The Basel Committee first introduced a recommended capital measurement system known as the Basel Capital Accord in 1988. The Basel Committee has stated that this first set of recommendations 'was always intended to evolve over time'.[34] A Revised Capital Framework known as Basel II was released in June 2004.[35]

2.25 The most recent International Regulatory Framework, known as Basel III, is described by the Basel Committee as part of its 'continuous effort to

29 Basel Committee on Banking Supervision, 'Basel III Phase-in Arrangements', <http://www.bis.org/bcbs/basel3/basel3_phase_in_arrangements.pdf> viewed 4 August 2014.

30 Australian Prudential Regulation Authority, *Discussion Paper: Implementing Basel III Liquidity Reforms in Australia*, May 2013, p. 9.

31 Australian Prudential Regulation Authority, *Discussion Paper: Implementing Basel III Liquidity Reforms in Australia*, May 2013, p. 9.

32 Australian Prudential Regulation Authority, *Discussion Paper: Implementing Basel III Liquidity Reforms in Australia*, May 2013, p. 9.

33 Australian Prudential Regulation Authority, *Response to Submissions: Implementing Basel III Liquidity Reforms in Australia*, 30 March 2012, p. 29.

34 Basel Committee on Banking Supervision, 'A Brief History of the Basel Committee', <http://www.bis.org/bcbs/history.pdf> viewed 4 August 2014.

35 Basel Committee on Banking Supervision, 'A Brief History of the Basel Committee', <http://www.bis.org/bcbs/history.pdf> viewed 4 August 2014.

enhance the banking regulatory framework'.[36] The Basel Committee describes the aim of the Basel III reforms as to target the two main elements of the banking industry:

- microprudential, bank level regulation, to raise the resilience of individual banking institutions; and
- macroprudential, system wide risks that can build up across the banking sector.[37]

2.26 The Basel Committee explains that 'these two approaches to supervision are complementary as greater resilience at the individual bank level reduces the risk of system wide shocks'.[38] The Basel III framework sets out recommendations on capital and liquidity requirements; comprising standards for risk coverage, leverage ratios, risk management and market discipline, including:

- a liquidity coverage ratio (LCR) which will require banks to have sufficient high-quality liquid assets to withstand a 30-day stressed funding scenario that is specified by supervisors; and
- the minimum common equity capital ratio to be raised to 4.5% of risk weighted assets, after deductions.[39]

Application of Basel III in Australia

2.27 As noted in the annual report, 'APRA has committed to implementing the new Basel III capital and liquidity framework as globally agreed, except where APRA has strong in principle reasons to take a more conservative approach'.[40]

2.28 The Chairman acknowledged in his opening statement that 'it is often said that APRA is tough because we sometimes impose requirements faster or stronger than the Basel standards'.[41] In noting that Australia has acted more quickly than some countries, he explained that:

> … countries that have had more difficulties in their financial system during the crisis and have weakened banking systems

36 Basel Committee on Banking Supervision, International Regulatory Framework for Banks (Basel III), <http://www.bis.org/bcbs/basel3.htm> viewed 4 August 2014.

37 Basel Committee on Banking Supervision, International regulatory framework for banks (Basel III), <http://www.bis.org/bcbs/basel3.htm> viewed 4 August 2014.

38 Basel Committee on Banking Supervision, International regulatory framework for banks (Basel III), <http://www.bis.org/bcbs/basel3.htm> viewed 4 August 2014.

39 Basel Committee on Banking Supervision, 'Basel Committee on Banking Supervision Reforms', <http://www.bis.org/bcbs/basel3/b3summarytable.pdf> viewed 4 August 2014.

40 Australian Prudential Regulation Authority, *2013 Annual Report*, 14 October 2013, p. 14.

41 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 2.

> have taken advantage of the longer timetable simply because, as a practical matter, they have had to in many cases take advantage of the transition path because they have got broader problems in their banking systems that they are trying to address.[42]

2.29 The Chairman further noted:

> … there are peer jurisdictions that have gone further and/or faster in implementing the reforms than APRA. We certainly would not want to be perceived in any way as a soft regulator, but the claim that APRA is way out in front of the rest of the world on its own is, in our view, incorrect.[43]

2.30 The Chairman also noted from the findings of the Financial Services Inquiry (FSI) that 'a more conservative approach has not placed Australian banks at a significant competitive disadvantage' and that 'regulators have applied the framework in a manner and time frame to best suit Australian market conditions'.[44]

2.31 The Chairman then drew comparisons with Canada and Singapore, countries 'that have similar banking systems, similar structures and also similarly healthy banking systems [that] have moved faster and further than Australia as in implementing Basel III'.[45]

2.32 The Chairman added that there are 'lots of other examples where jurisdictions have done things further or faster than APRA has done… we should not be out in front—but I do not think we are.[46]

Capitalisation

2.33 The Committee asked the Chairman for his views on the effect of Basel III on a possible international shift towards increased reliance on a simple leverage ratio to determine capital requirements. In response, the Chairman first noted the Basel Committee's findings on the risk-weighted assessments generated by banks using internal models:

> There were reports published last year by the Basel Committee into the variability in risk weighted asset calculations that were being generated by banks using internal models. This had been

42 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 15.

43 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 2.

44 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 2.

45 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 15.

46 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 15.

> something that had been a long-standing issue. It had generated some questions about credibility of bank capital ratios.[47]

2.34 He further noted that 'the chairman of the Basel Committee has made clear that the status quo is clearly not acceptable and there will have to be changes made to the framework'.[48] However, in relation to the nature of the proposed changes, the Chairman explained that:

> … resort[ing] all the way back to a very simple crude leverage ratio… is not the Basel Committee's first priority or first preference.[49]

2.35 The Chairman noted that a simple leverage ratio is a 'part of the package of reforms'[50] recommended by the Basel Committee but that,

> … it has never been the committee's intention and it continues not to be the committee's intention that the leverage ratio is the primary capital constraint on banks. The leverage ratio has been included as a backstop measure or a supplementary measure.[51]

2.36 The Chairman described the Basel Committee's approach as instead being to 'improve the credibility of the existing regime rather than replace it with something else'.[52] The Chairman stated that:

> … improvements are likely to take the form of some combination of restrictions on bank modelling… some improved disclosure… potentially using some flaws or benchmarks in the framework to try to put limits on the extent to which particularly outlier banks can produce very low-risk weights; and some more guidance to supervisors to try and make sure that the way supervisors are assessing, validating and approving these models in domestic jurisdictions is more consistent.[53]

2.37 In relation to APRA's view on the application of leverage ratios in Australia, the Chairman stated definitively that 'it is not intended, and we are certainly not advocating that the leverage ratio should be the binding constraint that would force banks in Australia to be managing to a leverage ratio rather than to a risk-sensitive regime'.[54]

---

47 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 5.

48 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 5.

49 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 5.

50 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 5.

51 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 5.

52 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 5.

53 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 5.

54 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 5.

2.38 The Chairman commented that the simple leverage ratio 'remains a backstop regime' in Australia.[55] The Chairman further stated that:

> Certainly for Australian banks, which tend to have fairly traditional balance sheets, the risk based regime should be the binding measure, the one that they primarily manage.[56]

Access to finance

2.39 The Chairman was asked about the effect of Basel III on access to long term project finance. The committee noted a media article in the *Financial Review* on 16 May 2014, which reported the CEO of the Export Finance and Insurance Corporation, Andrew Hunter, as saying that Basel III 'deterred commercial lenders from providing long term loans to resource mega-projects, forcing EFIC and other nation's export lenders to [fill] the gap'.[57]

2.40 The Chairman stated:

> … international standard setters have been very conscious of this issue. There was not anything in Basel III that particularly ratcheted up capital requirements for project finance or long-term finance generally.[58]

2.41 The Chairman added 'in fact, in the Basel framework—the maturity of a loan is a factor in the risk weight that is applied, because generally speaking longer loans are of greater risk than shorter loans'.[59] He explained:

> … but there is a cap in the framework beyond which it simply says that there are no further increases in capital requirements. Again, that should help rather than hinder longer-term infrastructure lending.[60]

2.42 The committee then enquired as to the effect of Basel III on access to finance for small business. The committee noted in particular, a concern highlighted in the interim report of the FSI that 'entities that are more

55 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 6.

56 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 6.

57 See: Australian Financial Review, 'Basel III will only "add costs" for Australia: Robb', <http://www.afr.com/p/business/companies/basel_iii_will_only_add_costs_for_ysf2z0jxLApQbo7Fc1wHZI> viewed 4 August 2014.

58 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 15.

59 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 15.

60 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 15.

reliant on loans, such as small businesses, would have some difficulty accessing funding'.[61]

2.43 The Chairman acknowledged that 'there are challenges for small business in getting finance'.[62] He stated:

> What I might question is whether that is purely a problem from Basel III… There are greater challenges than just the regulatory requirements for small business finance.[63]

Superannuation reform

2.44 The Stronger Super reforms to superannuation were progressively introduced by the previous government beginning in 2011, with the most recent reforms taking effect from 1 July 2013.[64] As noted in the annual report, 'APRA has for the first time been granted prudential standards-making powers in superannuation, a major step in the harmonisation of the prudential framework in Australia'.[65]

2.45 The Chairman stated at the public hearing, that the focus now for APRA 'is largely on how super funds are adjusting to the new prudential regime…'[66]

2.46 In relation to compliance with the new standards, Mrs Rowell stated that 'in terms of industry and where they are at in meeting those standards, I would say they are on a journey… because these are relatively new requirements and were only introduced from 1 July last year, the industry is probably a little bit behind...'[67]

2.47 However, Mrs Rowell noted that the industry is 'making very good efforts generally to improve and meet the requirements':[68]

> They have all met our minimum expectations in terms of having the policies and frameworks in place. It is now a question of

---

61 Financial System Inquiry, 'Interim Report', <http://fsi.gov.au/publications/interim-report/> viewed 4 August 2014, Chapter 2, p. 79.

62 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 16.

63 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 16.

64 The Treasury, 'Stronger Super', <http://strongersuper.treasury.gov.au/content/Content.aspx?doc=home.htm> viewed 4 August 2014.

65 Australian Prudential Regulation Authority, *2013 Annual Report*, 14 October 2013, p. 15.

66 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 2.

67 Mrs Helen Rowell, APRA Member, *Transcript*, 18 July 2014, p. 10.

68 Mrs Helen Rowell, APRA Member, *Transcript*, 18 July 2014, p. 10.

> getting those effectively implemented and embedded in their day-to-day operations.[69]

2.48 In relation to concerns relating to the superannuation industry, Mrs Rowell commented that 'there are some funds who perhaps take a more compliance rather than risk approach':[70]

> … they are doing the minimum necessary to get the tick to meet the standards rather than seriously embracing risk management and how to identify and manage risk effectively…[71]

2.49 Mrs Rowell described APRA's methods in ensuring compliance. She stated that APRA 'would typically write to the trustee, setting out any particular areas of concern and our expectations, and we would seek from the trustee how they were going to respond to those concerns and address them'.[72] She further explained:

> And then we would follow up to make sure that that had been done and, if it had not been, then we would press them again, and in really recalcitrant cases—which thankfully are few and far between—we would escalate and use powers, but typically we find that the engagement process… is effective in 95 to 99 per cent of cases.[73]

Self-managed superannuation funds

2.50 APRA supervises regulated superannuation funds, other than self-managed superannuation funds. Self-managed superannuation funds (SMSFs) are supervised by the Australian Taxation Office. Noting that APRA does not currently supervise SMSFs, the committee queried whether it is appropriate for APRA to supervise SMSFs.

2.51 Mrs Rowell stated:

> If you look at the mandate of APRA, we are there primarily to address situations where there is complexity and information asymmetry and you have third parties managing money on behalf of others.[74]

69 Mrs Helen Rowell, APRA Member, *Transcript*, 18 July 2014, p. 10.
70 Mrs Helen Rowell, APRA Member, *Transcript*, 18 July 2014, p. 11.
71 Mrs Helen Rowell, APRA Member, *Transcript*, 18 July 2014, p. 11.
72 Mrs Helen Rowell, APRA Member, *Transcript*, 18 July 2014, p. 11.
73 Mrs Helen Rowell, APRA Member, *Transcript*, 18 July 2014, p. 11.
74 Mrs Helen Rowell, APRA Member, *Transcript*, 18 July 2014, p. 6.

2.52 Mrs Rowell added that APRA's role 'limits us, in our view, to a situation where you have got third party trustees managing superannuation funds and particularly in the context of mandated superannuation contributions'.[75] She noted that:

> The self-managed super fund sector is somewhat different in that regard because it is something that the individuals in those funds choose to do themselves and they are themselves the trustees… you do not have the agency risk, information asymmetry or third-party effects that exist in other APRA regulated sectors.[76]

2.53 Mrs Rowell acknowledged the importance of appropriate advice and informed decision making in the SMSF sector. [77] However, she stated that:

> Our view is that that is not necessarily a role for APRA; it falls more under the purview of ASIC, for example, in terms of advice and disclosure and their role in financial literacy and the like. The issues you have raised are important but they are not necessarily within the scope of APRA's mandate.[78]

2.54 Mr Ian Laughlin, Deputy Chairman of APRA, added that:

> It is worth noting too that one of the major reasons for people setting up SMSFs is that they want to take control of their own investments. That is a primary driver.[79]

2.55 Mrs Rowell also noted that the self-managed superannuation industry has a degree of self-regulation.[80] She stated that:

> The super industry at large does not necessarily see a particular risk there at the moment, but it is something that would need to be monitored. If we were to see the risk that is being taken extended to a wider proportion of that sector, then something might need to be done. But, at the moment, most of those in SMSFs are making quite sensible investment decisions.[81]

---

75 Mrs Helen Rowell, APRA Member, *Transcript*, 18 July 2014, p. 6.
76 Mrs Helen Rowell, APRA Member, *Transcript*, 18 July 2014, p. 6.
77 Mrs Helen Rowell, APRA Member, *Transcript*, 18 July 2014, p. 7.
78 Mrs Helen Rowell, APRA Member, *Transcript*, 18 July 2014, p. 7.
79 Mr Ian Laughlin, Deputy Chairman of APRA, *Transcript*, 18 July 2014, p. 7.
80 Mrs Helen Rowell, APRA Member, *Transcript*, 18 July 2014, p. 7.
81 Mrs Helen Rowell, APRA Member, *Transcript*, 18 July 2014, p. 7.

Property investment lending

2.56 On 26 May 2014, APRA released a draft prudential practice guide that provides guidance to authorised deposit-taking institutions (ADI) on sound risk management practices for residential mortgage lending.[82] In the accompanying media release, APRA noted that:

> Residential mortgage lending has been a significant source of balance sheet growth and profitability for ADIs over a long period. Residential mortgages constitute the largest credit exposure in the Australian banking system and, for many ADIs, well over half their total credit exposures.[83]

2.57 APRA further noted 'the current environment of strong pricing pressures in some housing markets and very active competition between lenders'.[84] The Chairman of APRA at the time, Dr John Laker, stated that:

> In this environment, APRA is seeing increasing evidence of lending with higher risk characteristics and it does not want this trend to continue.[85]

2.58 The current Chairman also identified property investment lending as an area of interest for APRA in his opening statement at the public hearing. He stated that 'in the case of deposit takers, we have made it clear that we are watching housing lending standards with a great deal of interest'.[86] He explained that:

> … the previous APRA chairman wrote to all authorised deposit takers with a new draft prudential practice guide, which is not a hard standard but guidance on residential mortgage lending.[87]

2.59 The Chairman noted that:

> … we provided this practice guide and we have also been getting from the larger institutions a response from each of the boards, signed by the chairman of each of the institutions, about how the

82 Australian Prudential Regulation Authority, 'ADI Consultation Packages', <http://www.apra.gov.au/adi/PrudentialFramework/Pages/adi-consultation-packages.aspx> viewed 12 August 2014.

83 Australian Prudential Regulation Authority, 'APRA releases draft prudential practice guide on residential mortgage lending, *Media Release*, 26 May 2014.

84 Australian Prudential Regulation Authority, 'APRA releases draft prudential practice guide on residential mortgage lending, *Media Release*, 26 May 2014.

85 Australian Prudential Regulation Authority, 'APRA releases draft prudential practice guide on residential mortgage lending, *Media Release*, 26 May 2014.

86 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 2.

87 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 18.

> boards themselves are monitoring these risks—how they are keeping on top of the lending standards, the shape of the portfolio and the risks within it.[88]

2.60 In relation to the current risk areas in the property lending market, the Chairman stated that 'the sorts of things we are looking at are high-LVR [loan to valuation ratio] lending and high loan to income lending, particularly if those things are combined or are combined with interest-only lending…'[89]

2.61 Mr Charles Littrell, Executive General Manager, Policy, Statistics and International, APRA, added 'home lending is by far the largest exposure for the largest proportion of our ADIs, and it also connects to the rest of the economy'. [90] He further stated:

> … it is what we would call a wrong-way risk. If it goes wrong, a lot of other things will go wrong in the same direction at the same time.[91]

2.62 However, Mr Littrell noted that current home lending practices do not create cause for alarm.[92] Mr Littrell stated:

> … most institutions are reasonably cooperative with us, if we go in and say, "We really are concerned about your activity", they will take that on board quite handily.[93]

2.63 Mr Littrell went on to say:

> To the extent we were feeling we were not getting cooperation, we have abilities to say to institutions that we are increasing their capital requirements. We could take more drastic actions, but generally, if you increase an institution's capital requirements, the board will get the point that they need to change their behaviour. We also have powers to, in aggregate, lift the whole sector's capital requirement, though I think at this point we would say we would be much more focused on the outliers who were the rapid

88 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 18.

89 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 18-19.

90 Mr Charles Littrell, Executive General Manager, Policy, Statistics and International, APRA, *Transcript*, 18 July 2014, p. 19.

91 Mr Charles Littrell, Executive General Manager, Policy, Statistics and International, APRA, *Transcript*, 18 July 2014, p. 19.

92 Mr Charles Littrell, Executive General Manager, Policy, Statistics and International, APRA, *Transcript*, 18 July 2014, p. 19.

93 Mr Charles Littrell, Executive General Manager, Policy, Statistics and International, APRA, *Transcript*, 18 July 2014, p. 19.

> growers, and maybe some of the ones that were not paying as much attention to risk, as opposed to hitting everyone with a capital increase.[94]

2.64 Mr Littrell noted that 'we are a few steps away from being at that point',[95] but added that 'we have lots of tools in the tool shed if we think the industry is going away and not listening to us'.[96]

Financial advice market

Future of Financial Advice reforms

2.65 Mandatory reforms to the financial advice market known as the 'Future of Financial Advice' (FoFA) reforms were introduced on 1 July 2013 (and were voluntary from 1 July 2012). The objective of the reforms is described by the Treasury as 'to improve the trust and confidence of Australian retail investors in the financial services sector and ensure the availability, accessibility and affordability of high quality financial advice'.[97]

2.66 The Treasury announced a package of changes to FoFA on 20 December 2013. Further changes to the FoFA reforms were announced on 20 June 2014. Among other things, these changes include:

- removal of an 'opt-in' requirement whereby investors must complete further paperwork every two years in order to continue their arrangement with their existing financial adviser;
- removing the retrospective application of the fee disclosure requirement, so that advisers will not need to provide fee disclosure statements to pre-1 July 2013 clients; and
- extension of the time period advisers are required to send a fee disclosure statement to a client in an ongoing fee arrangement.[98]

2.67 The committee noted the recent changes to FoFA and queried whether there were any resulting implications in the capital that banks should be

94 Mr Charles Littrell, Executive General Manager, Policy, Statistics and International, APRA, *Transcript*, 18 July 2014, p. 19.

95 Mr Charles Littrell, Executive General Manager, Policy, Statistics and International, APRA, *Transcript*, 18 July 2014, p. 19.

96 Mr Charles Littrell, Executive General Manager, Policy, Statistics and International, APRA, *Transcript*, 18 July 2014, p. 19.

97 The Treasury, Future of Financial Advice, <http://futureofadvice.treasury.gov.au/> viewed 4 August 2014.

98 Senator The Hon. Mathias Cormann, Acting Assistant Treasurer, 'The Way Forward on Financial Advice Laws', *Media Release*, 20 June 2014.

setting aside as big providers of financial advice in operational risk. Mr Littrell stated that 'At this point, we have not started any analysis on what those changes will do to operational risk capital going forward'.[99] Mr Laughlin added:

> A point worth noting is that we are in an advanced stage of development of what we call level 3 capital requirements… our level 3 framework will in fact capture those sorts of financial planning entities, and we would expect appropriate capital then to be set aside within the group to deal with those sorts of issues that you are talking about.[100]

2.68 In respect of whether the changes to the FoFA reforms would create more risk in the financial advice market, Mr Littrell stated:

> Not necessarily, for the same reasons that lifting speed limits does not necessarily increase car crashes; it depends on the response of the drivers. Either they drive more wildly and end up in more crashes or they will get more scared and have fewer crashes.[101]

Concentration of the financial advice market

2.69 The committee noted that the financial advice market is largely concentrated amongst the major banks and AMP and queried whether such concentration had any implications for capital requirements. Mr Laughlin replied:

> I do not think there are any obvious direct links between that concentration and capital requirements. First of all, in the prudentially regulated field you have got straight insurance in terms of business that financial planners might recommend. You have got insurance and the fact that you have concentration of financial planners in those hands is not a big issue because, even though they are aligned to those five entities, they in fact place insurance across a much broader range of entities. There are no particular capital flow-on requirements because of that.[102]

2.70 Mr Laughlin gave as another example the offering of annuity products. Noting that they are primarily offered through one insurer, he commented that:

---

99 Mr Charles Littrell, Executive General Manager, Policy, Statistics and International, APRA, *Transcript*, 18 July 2014, p. 13.

100 Mr Ian Laughlin, Deputy Chairman of APRA, *Transcript*, 18 July 2014, p. 13.

101 Mr Charles Littrell, Executive General Manager, Policy, Statistics and International, APRA, *Transcript*, 18 July 2014, p. 13.

102 Mr Ian Laughlin, Deputy Chairman of APRA, *Transcript*, 18 July 2014, p. 12-13.

> If that concentration of financial planners were to recommend their own parent institutions, if you like, if anything it would probably fragment that market, so again I cannot see any obvious connection between the concentration of those financial planners or the notional ownership of those financial planners and the capital requirements in the system.[103]

Major banks

Government subsidies and capital requirements

2.71 The annual report noted that 'during 2013/13, the International Monetary Fund (IMF) completed its second review of Australia under its Financial Sector Assessment Program (FSAP), which evaluates the strength and potential vulnerabilities of a country's financial system and regulatory architecture'.[104]

2.72 The committee noted and sought APRA's comment on the following finding from the FSAP on Australia:

> The major banks are highly profitable, enjoying a funding cost advantage derived partly from implicit government support and earning larger net interest margins than smaller banks and international peers.[105]

2.73 The Chairman stated, 'I do not think it is difficult to agree that the banks are, quote, profitable. The question of the extent to which that profitability derives from subsidies is a difficult one to isolate'.[106]

2.74 The committee then sought the Chairman's view on proposals to apply levies to the major banks to balance out any competitive advantage derived from receiving subsidies. The Chairman responded:

> There are actually lots of studies internationally trying to assess the size of the perceived subsidy that too-big-to-fail banks get. The range is really quite diverse and it is very difficult to be precise on something like this. So I think it is very hard to set a particular annual levy which would come along and take back any somehow

103 Mr Ian Laughlin, Deputy Chairman of APRA, *Transcript*, 18 July 2014, p. 13.

104 Australian Prudential Regulation Authority, *2013 Annual Report*, 14 October 2013, p. 15.

105 International Monetary Fund, *Australia: Financial System Stability Assessment*, IMF Country Report No. 12/308, November 2012, p. 12.

106 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 16.

> calculated benefit… we have gone for a simpler approach of requiring those banks to hold some additional capital.[107]

2.75 The Chairman also stated:

> … late last year we announced that we would be imposing an additional capital requirement on the largest banks—the so-called domestic systemically important institutions, which we define as the four majors—which is in a sense in response to concerns about their size, their systemic importance and the difficulties that would exist if they were in financial difficulty. It is in response to the sorts of issues that have been raised by the IMF.[108]

2.76 Mr Littrell added 'the other point, just to be clear, is we did not impose a DSIB [domestic systemically important bank] surcharge to level the playing field; we imposed it because of a systemic risk of the major banks. It was a systemic risk calculation, not a competitive calculation'.[109]

2.77 In relation to the financial impact of these capital requirements on the major banks, Mr Littrell noted:

> … when we add capital, we do not necessarily harm an institution; we make it sounder. The effect of adding capital is that, all other things being equal, profits increase slightly, because you are replacing interest-bearing debt with non-interest-bearing equity, and return on equity drops slightly because you increase the equity by more than you have increased the earnings. That has the effect of making that institution sounder and more resilient to something going unexpectedly wrong.[110]

2.78 The Chairman added:

> We have raised the minimum capital requirements for those four banks relative to what applies generally to others. But, even then, the banks already held in excess of their new requirements. So it was not as though the Australian banks had to go out and raise additional capital to meet a requirement. What we were doing was pushing up the minimum closer to where they already were. When this new regime comes into effect, their minimum

107 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 17.

108 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 16-17.

109 Mr Charles Littrell, Executive General Manager, Policy, Statistics and International, APRA, *Transcript*, 18 July 2014, p. 18.

110 Mr Charles Littrell, Executive General Manager, Policy, Statistics and International, APRA, *Transcript*, 18 July 2014, p. 17.

> requirement will be higher than applies to other banks in the system.[111]

Derivative exposure

2.79 The committee noted the exposure of Australian banks in the derivatives market and sought APRA's comments on the issue. The Chairman acknowledged that 'there is no doubt our largest banks have big derivative exposures… although I would probably disagree with the comment that they are large in a global context'.[112]

2.80 Mr Littrell added that '… relatively, the proportion of market risk to total capital for our banks is about as low as anywhere in the developed world'.[113] He noted:

> … we are reasonably comfortable, in what is a very complicated area, that the capital we require banks to hold on trading and derivatives generally is adequate. [114]

Conclusion

2.81 The Committee notes that the APRA regulated industries are broadly in good health and that the Australian financial sector has emerged relatively unscathed from the financial crisis. Australia's major banks are profitable and continue to be supervised closely by APRA. The committee will continue its oversight to ensure that the Basel III international standards on banking have been introduced at a rate appropriate to the circumstances of the Australian financial sector. Implementation of the new Stronger Super reforms is in the early stages but appears to have started well. Analysis of the changes to the Future of Financial Advice reforms has yet to be completed but there are, as yet, no concerns in this area. The Committee notes that there are some concerns about housing lending standards, and is pleased that APRA is paying close attention to practices in this regard.

111 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 17.

112 Mr Wayne Byres, Chairman of APRA, *Transcript*, 18 July 2014, p. 20.

113 Mr Charles Littrell, Executive General Manager, Policy, Statistics and International, APRA, *Transcript*, 18 July 2014, p. 21.

114 Mr Charles Littrell, Executive General Manager, Policy, Statistics and International, APRA, *Transcript*, 18 July 2014, p. 21.

Kelly O'Dwyer MP
Chair
3 September 2014

A

Appendix A – Public hearing details

Public hearing

Friday, 18 July 2014 – Canberra

Australian Prudential Regulation Authority

Mr Wayne Byres, Chairman
Mr Ian Laughlin, Deputy Chairman
Mr Charles Littrell, Executive General Manager, Policy, Statistics and International
Mrs Helen Rowell, Member

The hearing transcript is available online at: http://www.aph.gov.au/Parliamentary_Business/Committees/House/Economics/2013_APR_Annual_Report/Public_Hearings