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The Parliament of the Commonwealth of Australia

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

House of Representatives  
Standing Committee on Economics

May 2015  
Canberra

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## Chair's foreword

It was pleasing to learn at our most recent public hearing with APRA in March 2015 that the Australian financial sector has continued to demonstrate stability overall. However, there are clearly some emerging risks in the housing market which need to be carefully monitored.

The committee notes that APRA has recently written to authorised deposit-taking institutions to outline its plans around sound lending practices. An increased scrutiny of mortgage portfolios is an appropriate response to this issue and we will be requesting updates on APRA's activities and processes in this regard at future hearings.

The progress in implementing the new prudential standards through the Stronger Super reforms is of continuing interest to the committee. APRA stated at the public hearing in March that the superannuation industry's approach to managing conflicts of interest needed to be improved.

We also note from our discussions with APRA on its oversight of the super industry that new disclosure requirements are yet to be fully implemented and enforced. We welcome APRA's undertaking that it is continuing to monitor the efforts of this sector to strengthen governance and risk management frameworks and practices.

The prudential responsibilities of the Private Health Insurance Administration Council will be transferring to APRA in July 2015. APRA outlined the resourcing of this transfer and its proposal to implement only the minimum changes required to achieve it. The committee will be monitoring this transition with interest over the coming months.

The outcomes of the Financial System Inquiry (FSI) and the work of the Basel Committee may well influence the capital requirements of the Australian banking sector and we look forward to discussing this with APRA more broadly at the next public hearing.

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 20 March

2015. The committee looks forward to further discussions on upcoming prudential issues at the next hearing with APRA on Friday 23 October 2015 in Canberra.

John Alexander OAM MP  
Chair



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## Membership of the Committee

Chair	Mr John Alexander OAM 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 Stephen Boyd
Inquiry Secretary	Dr Kilian Perrem
Research Officer	Ms Marina Katic
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 Investments Commission
ATO	Australian Taxation Office
FSI	Financial System Inquiry
GFC	Global Financial Crisis
IRB	Internal ratings-based
LCR	Liquidity coverage ratio
LVR	Loan to valuation ratio
PHIAC	Private Health Insurance Administration Council
RBA	Reserve Bank of Australia
SMSF	Self-Managed Super Fund



## 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 20 March 2015, the committee chair stated that 'we are looking forward to continuing our scrutiny of APRA on important issues in prudential regulation including governance and accountability in the superannuation industry, the resilience of the banking sector to possible global shocks, the implications of new capital requirements for banks, and property lending standards.'<sup>1</sup>
- 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

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1 House of Representatives Standing Committee on Economics, 'APRA to appear before Economics Committee in Canberra', *Media Release*, 17 March 2015.

- supervises institutions holding \$4.9 trillion in assets for Australian depositors, policyholders and superannuation fund members.<sup>2</sup>
- 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'.<sup>3</sup>
- 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.<sup>4</sup>
- 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.<sup>5</sup>
- 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.<sup>6</sup>

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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 1 April 2015.

5 Australian Prudential Regulation Authority, Supervision, <<http://www.apra.gov.au/AboutAPRA/Pages/Supervision.aspx>> viewed 1 April 2015.

6 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 April 2015.

## Scope and conduct of the review

- 1.9 APRA appeared before the committee at its second public hearing to review the 2014 annual report in Canberra on 20 March 2015.
- 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.<sup>7</sup>
- 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 20 March 2015.
- 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. Issues canvassed at the hearing included the superannuation industry's progress implementing the Stronger Super reforms, the future of property lending standards and capital requirements for authorised deposit-taking institutions, and the potential impact of the Financial System Inquiry's (FSI) suggested reforms and Basel III on the Australian banking sector.

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7 House of Representatives Standing Committee on Economics, Past Public Hearings and Transcripts, <[http://www.aph.gov.au/Parliamentary\\_Business/Committees/House/Economics/2014\\_APR\\_Annual\\_Report/Public\\_Hearings](http://www.aph.gov.au/Parliamentary_Business/Committees/House/Economics/2014_APR_Annual_Report/Public_Hearings)> viewed 1 April 2015.



## Current Issues in Prudential Regulation

### Overview

- 2.1 APRA appeared before the committee at a second public hearing on 20 March 2015 as part of the review of APRA's 2014 annual report. Key issues canvassed at the hearing included APRA's oversight of Australia's banking sector, in particular the residential mortgage lending standards of Authorised Deposit-Taking Institutions (ADIs); the adequacy of ADI capital requirements in Australia; the potential impact of Financial System Inquiry (FSI) suggested reforms and Basel III on ADI risk-weight calculations and liquidity requirements; and reforms to the prudential and reporting standards in the superannuation industry.
- 2.2 APRA's annual report states that a major part of its supervision of ADIs is focused on their property lending standards.<sup>1</sup> In his opening statement to the committee on 20 March 2015 the Chairman of APRA, Mr Wayne Byres reported on APRA's activities to reinforce sound lending standards in the ADI sector since its last appearance before the committee in November 2014. In particular, Mr Byres notified the committee of the letter APRA sent to all ADIs on 9 December 2014 (the letter is reproduced in Appendix B) to further outline its plans for sound residential mortgage lending practices:

When we made our last appearance before this committee, we were still contemplating potential actions with respect to emerging risks in the housing market. Since then we have written to all of the authorised deposit-taking institutions, ADIs, encouraging them to maintain sound lending standards and we have identified

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1 Australian Prudential Regulation Authority, *2014 Annual Report*, 13 October 2014, p. 9.

some benchmarks that APRA supervisors will be using in deciding whether additional supervisory action such as higher capital requirements might be warranted.<sup>2</sup>

- 2.3 The Chairman noted that APRA's actions to alert ADIs of new benchmarks to assess the need for higher capital requirements was intended to maintain lending standards and avoid future material risks:

I would like to emphasise that in alerting ADIs to our concerns in this area, we are seeking to ensure that emerging risks and imbalances do not get out of hand. We are not targeting house price levels – as I said elsewhere, that is beyond our mandate – and we are not at this point asking banks to materially reduce their lending. We have identified some areas where we have set benchmarks that we think will be useful indicators of where risks could be building and in doing so will help reinforce sound lending practices amongst all ADIs.<sup>3</sup>

- 2.4 The Chairman reported that APRA is also considering the capital requirements of ADIs in the context of the recent FSI recommendations and the Basel Committee's international review of risk-weight calculations by banks. He commented that the outcomes resulting from these two reviews will impact APRA's approach to current capital requirements in Australia:

Beyond this immediate issue, we are also giving thought to the more fundamental issues in relation to ADI capital contained in the recommendations of the financial system inquiry. There are two key influences on how we will proceed on these issues: first, the submissions being made through the government's consultation process and, second, the work still underway on a number of related issues. In the international standard setting bodies, particularly the Basel Committee on Banking Supervision, helpfully, the FSI and the international work are pointing us in the same direction. There are, however, complexities in the detail that we need to work through carefully.<sup>4</sup>

- 2.5 The Chairman also discussed APRA's timeframe for responding to the FSI recommendations:

In terms of timing, we do not need to wait for every 'i' to be dotted and 't' to be crossed in the international work before we turn our

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2 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 1.

3 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 1.

4 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 1.



minds to the appropriate response to the FSI's recommendations. But it will be in everyone's interest if over the next couple of months we are able to glean a better sense of some of the likely outcomes of the international work before we make too many decisions on proposed changes to the Australian capital framework.<sup>5</sup>

2.6 The Chairman also reported on the progress of the reforms to conflict management in the superannuation industry since the introduction of new prudential standards for superannuation in 2013. He stated that 'unfortunately we still see instances where actual and potential conflicts are viewed narrowly.'<sup>6</sup>

2.7 The Chairman discussed APRA's findings from its recent review of conflict management in approximately 40 superannuation funds and its oversight action:

APRA supervisors are engaging with the entities that were covered by the review to ensure that appropriate and timely action is taken on any specific issues that were identified. We are also issuing a general letter to industry – in fact, that was issued yesterday – providing the key findings from the review and identifying a range of specific questions for trustees to consider in reviewing and enhancing their conflicts management frameworks.<sup>7</sup>

2.8 The Chairman reported to the committee that the transfer of the prudential responsibilities of private health insurance from the Private Health Insurance Administration Council (PHIAC) to APRA was proceeding according to schedule and is set to take place on 1 July 2015.<sup>8</sup>

2.9 The Chairman commented on the impact that transferring the supervisory responsibilities to APRA would have on health insurers:

We are proposing only the minimum change necessary to the prudential standards and rules to align them with the proposed new legislation. In practice, health insurers should notice very little difference in their prudential arrangements from 1 July.<sup>9</sup>

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5 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, pp. 1-2.

6 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 2.

7 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 2.

8 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 2.

9 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 2.

## Banking sector

### Property lending

2.10 At the public hearing, the committee was interested in the differences between APRA's supervisory responsibilities within the property lending market, in comparison to other bodies, such as the Reserve Bank of Australia (RBA) and the Australian Securities and Investments Commission (ASIC). APRA responded that whilst both the RBA and APRA have financial stability mandates, the RBA considers the economics of the housing market from a broad, whole-market perspective whilst APRA identifies emerging risks across the property lending portfolio and focuses on issues within individual institutions. The Chairman added:

Clearly, the RBA comes at this issue from very much a macroeconomic perspective, as one would imagine. Their responsibility is for the broader Australian economy and, obviously, their interest in issues of financial stability. Our interest comes from perspective that if they have a top-down perspective, we have more of a bottom-up perspective. So we are looking at individual institutions, at their soundness and, ultimately, their ability to, in the case of banks, meet their obligations to their depositors. We are interested in lending standards because it is very important to make sure that they maintain prudent lending portfolios in making use of depositor's money.<sup>10</sup>

2.11 The Chairman added that while ASIC doesn't have a financial stability objective, it has a legislative responsibility within its mandate to foster prudent lending practices.<sup>11</sup>

2.12 Further to this, the Chairman explained that the Council of Financial Regulators coordinates the work of each agency to ensure the regulators act in a way that is consistent with their respective objectives:

The work that we are doing is very much coordinated through the Council of Financial Regulators, which, in itself, does not have any authority or powers but is an important vehicle for making sure that the various actions that the regulators are undertaking are coordinated and consistent with the objectives that we all have. Treasury is also part of the council, and so it contributes to those discussions as well.<sup>12</sup>

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10 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 6.

11 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 6.

12 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 6.

2.13 APRA commented on recent activities it has undertaken to support responsible mortgage lending. In particular, APRA discussed the letter it sent to all ADIs in December 2014, outlining its plan to reinforce sound lending practices.

2.14 The Chairman explained that the rationale behind the letter to ADIs was to ensure housing credit growth did not accelerate further, and lending standards did not fall, following the increasing prudential risks in the housing market:

We were not really trying to constrain the banks or force them to significantly pull back from the sorts of positions most of them were already in. What we were trying to do was, in a sense, put a floor under standards and put some degree of moderation on growth so it did not accelerate. We did not want growth to accelerate or standards to erode any further. It was about reinforcing existing practice.<sup>13</sup>

2.15 The Chairman outlined to the committee, the four key risk indicators included in APRA's letter that were to be monitored closely to determine if individual ADIs were undertaking riskier lending practices:

So, in our letter, I would say we flagged four issues. We flagged serviceability as quite important, and that is clearly important because we are in a very low interest rate environment. Interest rates are historically low... it is highly unlikely that they will stay that low forever... we also flagged the strong growth in investor lending as an area where we needed to watch carefully what was happening. The other two which we mentioned in our letter as areas we were watching, because they are traditionally going to be loans of higher risk, are high loan-to-value ratio loans and high loan-to-income ratio loans.<sup>14</sup>

2.16 The Chairman further explained that APRA was monitoring the lending practices of ADIs at the individual level. He stated that ADIs who do not maintain prudent lending practices may have further capital requirements applied, in addition to the across-the-board review of capital requirements likely to occur in the future:

What we have said is that that will be a trigger for our supervisors to think about whether additional supervisory action is required... It is really trying to be transparent about where our tolerance

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13 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 5.

14 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 5.

levels are and where institutions, if they want to operate in particular areas, are more likely to get more intense supervision. That more intense supervision could include a range of things. The issue that is most prominent in everyone's mind is higher capital requirements. That is certainly an obvious tool in the tool kit that we would have to use.<sup>15</sup>

- 2.17 The Chairman also commented on APRA's decision to assess the lending practices of each individual institution separately:

There are plenty of ADIs out there, who are lending for housing, who are using quite reasonable serviceability metrics. They are not growing at particularly rapid rates. There is not any obvious cause for concern in their particular business practices and their growth aspirations. It would not be our intent to load any additional regulatory requirements on those institutions for particular concerns in the housing market.<sup>16</sup>

- 2.18 The committee discussed APRA's approach to consulting with and notifying ADIs in relation to its assessment of their lending standards. The committee understands that APRA's dealings in this regard are conducted with transparency between APRA and the given institution but are not disclosed to the broader public. The committee queried whether this particular practice of non-disclosure was in the interest of the institution's stakeholders.

- 2.19 The Chairman responded:

There are some competing objectives that have to be balanced here. Prudential regulators are traditionally the people who try to operate behind the scenes – below the surface, below the radar. Financial institutions survive and thrive because they have confidence and the community has confidence in them, and you are happy to put your money into the bank, you are happy to take out your insurance policy and you are happy to invest your superannuation money because you have confidence that, when the time comes, you will get your deposit back, your policy will be paid and your super money will be there.<sup>17</sup>

- 2.20 The Chairman also outlined APRA's consultation and notification process to assess the lending practices of individual institutions:

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15 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 3.

16 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 3.

17 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 7.

When we deal with individual banks, it tends not to get into the public domain. What we are doing here is something that, in this case, is a little more transparent because we think that it is important that all the banks know they are being treated on a level playing field, that everyone is being held to the same standards, and they have visibility up-front about some of the key benchmarks that APRA is going to use in making its decision.<sup>18</sup>

2.21 The Chairman further stated that APRA would assess and respond to the riskier lending of ADIs individually, on a case-by-case basis:

... we are targeting those ADIs that are pursuing the most aggressive lending strategies and, to the extent there are additional capital requirements imposed, they will be imposed on those housing portfolios where the risks are and not on the other lending books that banks have.<sup>19</sup>

2.22 The Chairman advised the committee that APRA intended to undertake sufficient consultation and monitoring of ADI lending practices, before applying additional capital requirements under the new benchmarks:

The whole point of writing our letter in December and then saying we would be thinking about this in the second quarter of the year was to give them plenty of time to think through their plans, think through their lending policies and make any changes they want to make. It was not going to be a spur-of-the-moment thing that caught them by surprise. There is quite a deliberate process here of allowing us to talk to them, them to talk to us, go through all the nuances and then decide something.<sup>20</sup>

2.23 When asked by the committee what other macroprudential tools APRA would consider applying to ADIs, the Chairman responded that capital requirements for individual institutions 'would be a key tool in the tool kit' and the main tool used at this stage.<sup>21</sup> He added:

We will just have to observe how things change and evolve to decide whether something firmer or higher or tougher is required at some point in the future.<sup>22</sup>

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18 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 6.

19 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 23.

20 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, pp. 5-6.

21 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 4.

22 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 4.

2.24 The Chairman explained that the decision to employ more restrictive macroprudential tools would depend on the institutional behaviour and market conditions observed during further supervision of lending activity:

If there is a moderation of growth in some of those areas that had been identified in the Reserve Bank *Financial stability review* as emerging imbalances, it may be that no further action is required. If, on the other hand, those imbalances and risks continue to grow, maybe some action is required. But I would be very reluctant to say we will make a decision at a certain point in time. I think it very much depends on observing how the banks and the market more generally respond to a changing environment...<sup>23</sup>

2.25 Further to this, the Chairman added:

But, if risks continue to grow, then clearly we will need to think about how else we respond to that to make sure that the banking system remains stable and able to absorb whatever happens in the marketplace.<sup>24</sup>

2.26 The committee asked APRA for its views on proposals to assist first home buyers to use their superannuation as a deposit for a house. The committee was interested in whether this would adversely affect the current superannuation system.

2.27 Mrs Helen Rowell, APRA member, noted that some commentators were concerned of the impact the premature withdrawal of retirement funds may have on the total accumulation of these funds over time and the end retirement goal.<sup>25</sup> She further stated:

Some of the other jurisdictions that are referred to when this is floated are places like Singapore. You need to bear in mind that in Singapore, the total contribution that is being put away into the central provident fund is something of the order of 30 to 35 per cent. Of course, it is there to fund retirement, health and housing, but you are starting with a much bigger contribution compared to where we are, with 9½ going to 12 per cent.<sup>26</sup>

2.28 The committee asked APRA to identify, on notice, what it perceives the current risks in the housing sector to be. In response to this, APRA provided an extract from its letter to ADIs on 9 December 2014 describing a number of risks in the housing market:

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23 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 5.

24 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 23.

25 Mrs Helen Rowell, APRA Member, *Transcript*, 20 March 2015, p. 10.

26 Mrs Helen Rowell, APRA Member, *Transcript*, 20 March 2015, p. 10.

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.<sup>27</sup>

- 2.29 In the same response, APRA also noted an extract from the RBA's most recent *Financial Stability Review*, where the RBA referred to the risks in the housing and mortgage markets:

Ongoing strong speculative demand would tend to amplify the run-up in housing prices and increase the risk that prices in at least some regions might fall significantly later on. In the first instance, the consequences of such a downturn in prices are more likely to be macroeconomic in nature because the effects on household wealth and spending would be spread more broadly than just on the recent property purchasers. However, the further housing prices fall in that scenario, the greater the chance that lenders would incur losses on their housing loans...

In this environment of low interest rates and strong demand, it is important that lending standards do not decline, and the measures announced by the Australian Prudential Regulation Authority and the Australian Securities and Investments Commission in December are designed with that intent.<sup>28</sup>

## Interest-only loans

- 2.30 The committee asked APRA to explain its responsibilities surrounding supervision of interest-only loans, given the recent increases in such loans in the mortgage market. The Chairman commented that this is not a concern if the increase is attributed to growth in investor loans and not owner-occupier loans:

... it is quite common for investors to borrow on an interest-only

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27 Australian Prudential Regulation Authority, *Submission 1*, p. [6].

28 Australian Prudential Regulation Authority, *Submission 1*, p. [6].

basis. The issue that we have been more alert to is the fact that there seems to be an increasing number of owner-occupiers who are borrowing on an interest-only basis.<sup>29</sup>

- 2.31 The Chairman further explained the risks that an increase in interest-only owner-occupier loans may pose to the domestic loan portfolio:

Those loans are obviously of a higher risk, because, first of all, the fact that a borrower might be forced into that situation tells you that their capacity to meet the debt is fairly marginal and, secondly, it means, should something happen in the future such that the customer defaulted, or house prices fell or whatever it might be, the potential for the bank to be exposed to loss is greater because the borrower has not built up equity over time in the property.<sup>30</sup>

- 2.32 The committee also asked APRA to provide, on notice, the default rate of interest-only loans relative to principal-and-interest loans. APRA responded:

Based on data collected on an informal basis from the four major banks, the default rate for both types of loans averaged around 0.7 per cent over the past four years.<sup>31</sup>

## Capital requirements

- 2.33 At the public hearing, APRA discussed various aspects of its consultation process with ADIs to assess their risk profiles and inform them that further capital requirements may be applied in cases of higher risk lending.

- 2.34 The committee asked what potential impacts of additional capital requirements may have on bank customers. The Chairman responded:

The potential for that [additional capital requirements] to create a higher cost for the customer will depend on, first of all, how material the capital add-on is relative to how much buffer the bank currently has above its minimum requirements. It may be that the bank could absorb an additional capital requirement within its existing buffer, such that its overall funding did not need to change. It would be running at a slightly lower buffer, but it would not incur any costs.<sup>32</sup>

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29 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 11.

30 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 11.

31 Australian Prudential Regulation Authority, *Submission 1*, p. [4].

32 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 4.



2.35 The Chairman added that the strong competition in the ADI sector would, in many cases, prevent these additional capital requirements being passed on to consumers:

... there are 160 ADIs out there. It is a very competitive market... For most of the banks, given the competition in the marketplace, it would be very difficult for them to just say, 'We can just completely pass on any of this to our customers.'<sup>33</sup>

2.36 The committee was interested in the disclosure arrangements of APRA's consultation process with ADIs. The Chairman reported that APRA is authorised to prevent regulated institutions from disclosing information to the broader market, that is provided to them by APRA:

... we do not wish to advertise that any financial institution may have some issue that requires our intervention, we do not disclose those things, and within our powers we have the capacity to tell regulated institutions that they should not disclose them as well.<sup>34</sup>

2.37 In addition, APRA informed the committee that it is not required to disclose its history, practice and activities to institutions it regulates. The Chairman explained that its assessment of institutions can often be subjective in nature and these disclosure arrangements are necessary to operate with discretion and prevent unnecessary concern within the industry:

It is a general approach we have to work behind the scenes, without publicity, and because of the concern that a lot of what we do is judgemental. It can be subjective. It can have significant commercial detriment if it is not very carefully managed. So we do have that authority. Particularly, you can envisage situations where the disclosure of a problem, even if it is very readily fixed, might create unnecessary concern and exacerbate the problem<sup>35</sup>

2.38 The Chairman further explained that being able to operate with confidentiality significantly enhances APRA's capacity to deliver outcomes that enhance financial stability whilst preserving market confidence:

Prudential regulators tend to try to operate behind the scenes to get issues fixed and to avoid them becoming a source of concern to the community. If we can do that well and head off problems

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33 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 4.

34 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 8.

35 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 18.

before they become serious problems, that is actually reinforcing of financial stability, because it is preserving the confidence that exists in the system.<sup>36</sup>

2.39 He added that confidentiality arrangements enable APRA to gain information from and foster productive working relationships with the institutions it regulates:

Institutions give us information because they know that there is a statutory obligation on us not to disclose it. So we do get a great deal of information that is confidential and commercially sensitive. If there was a sense that APRA might disclose or disclose its actions as a result of receiving that information, I think it would significantly impair our ability to do our job.<sup>37</sup>

2.40 The Chairman clarified that APRA was primarily concerned with the unauthorised disclosure of information about APRA's actions and activities, and not with the reporting obligations that institutions have to disclose the activities and financial position of their own business.<sup>38</sup>

2.41 The committee asked APRA whether it is able to enforce capital requirements on ADIs that do not voluntarily comply with these requests. The Chairman responded that there are a number of enforcement measures available to APRA but that the majority of disagreements are normally resolved with parties using a more collaborative approach:

The answer to your question is we have a range of escalation powers where we can commence formal action. But by virtue of having those powers we rarely need to use them because people know they need to engage with us constructively or else we resort to more formal enforcement. It is in everyone's interest to try to avoid those. They are just costly and time-consuming and, as I said, ultimately we have the power there to use.<sup>39</sup>

2.42 The committee queried what assurances APRA regulated institutions have that they are being dealt with equally, fairly and using the same criteria. The Chairman described the mechanisms APRA uses to ensure institutions are treated in accordance with their risk in a consistent manner:

We have common people looking at issues across the industry and providing good benchmarks and consistency in the views that we

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36 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 7.

37 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 18.

38 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 21.

39 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 21.

are forming about different aspects of the way organisations operate. Then at the heart of our system we have our risk rating framework which is a common risk rating framework for all organisations. We have quite detailed assessment criteria that our supervisors use to provide and develop overall risk assessment to the organisations that we supervise.<sup>40</sup>

## Risk-weight calculations

- 2.43 The committee discussed the FSI recommendation to adjust the requirements to calculate risk-weights for housing loans. The FSI report noted that this may create more consistency between the capital requirements of banks that use standardised models to calculate risk-weights and those that use internal ratings-based (IRB) models.
- 2.44 The Chairman explained that the IRB approach of calculating risk-weights generates lower capital requirements because it reflects a more granular assessment of an institution's risk management arrangements compared to the standardised approach.<sup>41</sup>
- 2.45 The Chairman further commented that it was unlikely that decisions would be made around the methods used to calculate risk-weights before the outcomes of the consultation process for the FSI recommendations was known, stating:
- ... as I said in my opening statement, we are not making any decisions on how to proceed on that until we see what comes through the consultation process on the FSI report.<sup>42</sup>
- 2.46 The Chairman further explained that the concern raised in the FSI report was that the difference in the amount of capital needed for a bank to fund a mortgage using internally calculated risk-weights compared to a bank using standardised risk weights, was too wide and was creating competitive imbalances in the ADI market.<sup>43</sup>
- 2.47 The Chairman additionally commented that international developments in this area will also affect APRA's response to the FSI recommendation:
- We will get a better sense over the next couple of months of some of the international developments and how the broader Basel framework might be modified. When we have those two pieces of

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40 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 22.

41 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 12.

42 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 12.

43 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 12.

information, then we can think about how to proceed on that recommendation.<sup>44</sup>

## Liquidity requirements

2.48 At the public hearing, the committee drew attention to the new liquidity requirements that were introduced to banks as a result of Basel III, known as the Liquidity Coverage Ratio (LCR). APRA explained that the LCR is a requirement for banks to hold enough liquidity to withstand a 30-day stress period. The committee was interested in APRA's views on the implications of the cost associated with extra liquidity, and whether that will potentially flow through to customers.

2.49 The Chairman reported that the types of liquid assets the international regulatory framework expected banks to hold to meet the new liquidity requirements are not available to Australian banks.<sup>45</sup> He provided the reasons for this:

One of the difficulties we have in Australia is that because we have relatively low levels of government debt and certainly relatively low levels of government debt relative to the size of our banking system, the sorts of liquid assets that the international framework envisaged banks would hold are not available here. In most other jurisdictions banks would be holding more government paper, but there simply is not enough government paper in Australia to meet the needs of the banking system.<sup>46</sup>

2.50 The Chairman reported that an option was negotiated into the Basel agreement to allow the central bank to provide a secured line of credit to Australian banks to fill the gap.<sup>47</sup> He outlined the proposed strategy for implementing the LCR in Australian banks and the associated costs:

As part of our implementation of the LCR the banks have made arrangements to sign up to these agreements and establish these agreements with the central bank. The aggregate amount of those lines of credit with the RBA are about \$275 billion across about 14 banks. They pay an annual fee for that of 15 basis points, so in dollar terms it turns out across the banking system in total as a

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44 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 12.

45 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 14.

46 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 14.

47 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 14.

little bit over \$400 million per year that the banks pay to the RBA in return for that liquidity line.<sup>48</sup>

- 2.51 The Chairman stated that the cost of the additional liquidity requirements ‘in terms of the aggregate profitability of the banking system, is actually very small’.<sup>49</sup> He added that in APRA’s view, they are a worthwhile investment to strengthen the liquidity of the system:

It was pretty clear in the financial crisis that banks around the world did not hold enough liquidity for market turbulence and for significant shocks, and that was the case right around the world. It was a necessary investment in making banks hold some additional liquid assets.<sup>50</sup>

- 2.52 The Chairman further commented that the LCR was targeted at the larger ADIs in the sector, and APRA did not intend to impose it on smaller scale institutions, particularly credit unions and building societies.<sup>51</sup>

## Superannuation

### Self-Managed Super Funds

- 2.53 The committee discussed the regulatory framework for Self-Managed Super Funds (SMSFs) and asked APRA for its views on the oversight of SMSFs by the Australian Taxation Office (ATO). Mrs Rowell responded that it was appropriate for SMSFs to have different regulatory arrangements than APRA-regulated funds. She explained that there is an alignment of interests within SMSFs that does not exist in APRA-regulated funds, given that the trustees of SMSFs are also the fund members:

I think the comment that we made at one of our first sessions for this was that it was appropriate that there were different oversight arrangements for SMSFs than for APRA-regulated funds, given their nature and the fact that the trustees are also the members and so there is an alignment of interests, if you like, which is not necessarily there in the APRA-regulated space.<sup>52</sup>

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48 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 14.

49 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 14.

50 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 14.

51 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 14.

52 Mrs Helen Rowell, APRA Member, *Transcript*, 20 March 2015, p. 12.

## Conflict management

- 2.54 The committee was interested in an update on conflicts of interest management in the superannuation industry since APRA's last public hearing in November 2014. In his opening statement, the Chairman commented on how conflicts of interest were being managed in the superannuation industry, remarking that 'unfortunately we still see instances where actual and potential conflicts are viewed narrowly.'<sup>53</sup>
- 2.55 The Chairman stated that there seemed to be more focus on addressing materialised conflicts than employing preventative measures to avoid future conflicts arising:
- Some trustees also take a reactive approach to dealing with conflicts rather than ensuring regular and appropriate prior consideration of conflicts and a proactive approach to their effective management.<sup>54</sup>
- 2.56 The Chairman further informed the committee of its response to the findings of its recent conflict management review of approximately 40 super funds:
- APRA supervisors are engaging with the entities that were covered by the review to ensure that appropriate and timely action is taken on any specific issues that were identified. We are also issuing a general letter to industry – in fact, that was issued yesterday – providing the key findings from the review and identifying a range of specific questions for trustees to consider in reviewing and enhancing their conflicts management frameworks.<sup>55</sup>
- 2.57 The committee asked APRA to outline the prudential and reporting requirements that apply to superannuation entities in relation to conflicts of interest management. Mrs Rowell broadly outlined the new prudential standards for superannuation that specifically addressed this issue:
- We issued – and it took effect in July 2013 – a number of prudential standards. One of them was specifically targeting management of conflicts of interest. That prudential standard effectively requires trustees to have in place a conflicts-management framework, to have in place registers of conflicts of duties and conflicts of interest across the institutions. They might

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53 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 2.

54 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 2.

55 Mr Wayne Byres, Chairman of APRA, *Transcript*, 20 March 2015, p. 2.

pertain to directors, to responsible persons within the organisation or at the entity level itself. Those conflicts registers need to be publicly disclosed.<sup>56</sup>

2.58 Mrs Rowell further remarked that ‘the framework means that the trustees have to have a robust process in place for identification of conflicts and appropriate management of those conflicts of interest’.<sup>57</sup>

2.59 Mrs Rowell advised the committee it has been monitoring the industry’s implementation of the standards to ensure trustees are improving their practices to meet the expectations of the new prudential requirements. She commented:

We found some areas where improvements need to be made and we will be expecting all of the industry to have a look at their frameworks and make sure that those improvements, in practice, are implemented.<sup>58</sup>

2.60 The committee queried the approach APRA used to notify trustees of its assessment of their conflict management practices. Mrs Rowell advised that if an individual institution’s conflict management framework did not meet APRA’s expectations of best practice, APRA would generally consult with the fund’s trustees in confidence to notify them accordingly.<sup>59</sup>

2.61 The committee asked APRA whether the confidential nature of these consultations is in the best interest of the fund members. Mrs Rowell responded:

It is probably important to say that, when we rated conflicts management frameworks, for example, as being weak or vulnerable, that just means that they fell well short of our expectations of better practice. It does not necessarily equate to us having a fundamental concern about the risk of any particular fund in terms of outcomes for members. Our view is that, having made those observations and put those to the funds, we expect those issues to be addressed so that they move up to at least an adequate if not a sound standard; and, if they do that within a reasonably short time frame, then there are no concerns that really would warrant more public disclosure of the issues.<sup>60</sup>

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56 Mrs Helen Rowell, APRA Member, *Transcript*, 20 March 2015, p. 15.

57 Mrs Helen Rowell, APRA Member, *Transcript*, 20 March 2015, p. 15.

58 Mrs Helen Rowell, APRA Member, *Transcript*, 20 March 2015, p. 15.

59 Mrs Helen Rowell, APRA Member, *Transcript*, 20 March 2015, p. 15.

60 Mrs Helen Rowell, APRA Member, *Transcript*, 20 March 2015, pp. 16-17.

2.62 In addition, Mrs Rowell outlined a number of mechanisms available to APRA to identify emerging risks of conflicts of interest and protect the security of members' investments before material losses occurred:

Again, if we had a concern about the security of members' investments or assets, we would take steps to have that dealt with very, very quickly and we would, in those circumstances, be able to use a number of mechanisms, including replacement of the trustee, transfer of the funds to another trustee, those sorts of things, to ensure that the members' retirement savings were protected well ahead, ideally, of any losses emerging.<sup>61</sup>

## Disclosure requirements

2.63 APRA updated the committee on the recent changes to the disclosure requirements in the superannuation sector to more granular reporting of the administrative costs of funds. Mrs Rowell advised that the new requirements are still being implemented and are yet to be fully enforced:

There have been some changes in the reporting and disclosure requirements that have recently been implemented that will require more breakdown of expenses and publication of more granular information about expenses. Those requirements are relatively new and are still being implemented so at the moment they are not fully in force, but over time they will be.<sup>62</sup>

2.64 Mrs Rowell outlined how the new requirements will affect the superannuation industry's responsibility to report to APRA as well as disclose the required information to their members:

Primarily, disclosure by funds to their members is an ASIC issue rather than an APRA issue but, under the framework introduced from 1 July, there are provisions for alignment between reporting to APRA and disclosure by funds, which is under ASIC's purview. Going forward, when we start publishing the more granular information that is reported to us and the trustees are also reporting that more granular information on their websites, then you will see more breakdown of the components of expenses by funds.<sup>63</sup>

2.65 Further to this, Mrs Rowell clarified that ASIC is responsible for monitoring superannuation funds to ensure the individual funds are

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61 Mrs Helen Rowell, APRA Member, *Transcript*, 20 March 2015, p. 17.

62 Mrs Helen Rowell, APRA Member, *Transcript*, 20 March 2015, p. 2.

63 Mrs Helen Rowell, APRA Member, *Transcript*, 20 March 2015, p. 2.



disclosing the necessary information to their members in accordance with the new framework of disclosure requirements.<sup>64</sup>

- 2.66 Mrs Rowell explained that the new disclosure requirements applying to superannuation entities ensure that both APRA and the members of funds are provided with sufficient information of the fund's activities:

With the implementation of the Stronger Super reforms, which started from 1 July 2013, there were some enhanced transparency requirements introduced for superannuation. Some of that related to the information that trustees themselves needed to disclose to members, either through their website or by other means. Some of them relate to the information that is reported to APRA and that we ultimately may publish.<sup>65</sup>

- 2.67 Mrs Rowell also commented on the timeframe expected for the superannuation industry to fully implement the new disclosure requirements, and the consultations around this:

We have also been progressively publishing more of the information that we have been collecting, but we have had to go through a process of consultation with the industry about the confidentiality of that data and whether there would be any commercial sensitivity about some of the information that would be disclosed... we would expect over the next 12 to 24 months for there to be much more information available at a much more granular level about the funds, their investment performance, their fees and their other product features than has been the case in the past.<sup>66</sup>

- 2.68 In relation to disclosure of remuneration costs in particular, Mrs Rowell further commented that the superannuation industry undertook to report to APRA and its members on remuneration for the first time in 2013-14 in accordance with the new reporting requirements:

The other area that has been covered by the reporting and disclosure obligations is in relation to remuneration. The first time that the new requirements for reporting applied were for the last financial year. That information had to be reported to us and also disclosed in October last year in respect of the 2013-14 financial year... we did a little bit of the review to assess the quality of that

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64 Mrs Helen Rowell, APRA Member, *Transcript*, 20 March 2015, p. 2.

65 Mrs Helen Rowell, APRA Member, *Transcript*, 20 March 2015, p. 12.

66 Mrs Helen Rowell, APRA Member, *Transcript*, 20 March 2015, p. 13.

reporting and in particular the consistency of the information that was on websites versus reported to APRA.<sup>67</sup>

- 2.69 Mrs Rowell commented that APRA's review identified significant inconsistencies between the information published on the funds websites compared to the information reported to APRA:

We found some significant gaps. In terms of areas where we found examples where the reporting and disclosure perhaps are not up to scratch, remuneration of directors and responsible officers would be one area where we think there is room to improve.<sup>68</sup>

- 2.70 Mrs Rowell informed the committee of the steps it would take to consult with funds that had not met the reporting standards due to inconsistencies in the information disclosed:

We would typically go back to the individual funds, raise those issues and ask them to correct the reporting. That is certainly what we have done as an introductory process through the implementation of the new reporting requirements where we see that there are anomalies or errors.<sup>69</sup>

## Related party arrangements

- 2.71 The committee asked for an update on APRA's activities to ensure the superannuation industry's practices surrounding related party arrangements meet the expectations that APRA defined in its prudential standards.

- 2.72 APRA General Manager, Mr Stephen Glenfield, reported to the committee the measures APRA undertakes to reinforce good practice around related party arrangements:

There are a number of routes that we take, in terms of looking at related party. The first is probably like the Helen [Mrs Rowell] type speeches, where we get out into industry and talk to industry in general. APRA has expectations around related party transactions, which are documented in the prudential standards, and if you look at not just the conflicts of interest but also fit and proper and outsourcing – about how you have to assess whether it meets almost an arms-length type transaction.<sup>70</sup>

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67 Mrs Helen Rowell, APRA Member, *Transcript*, 20 March 2015, p. 13.

68 Mrs Helen Rowell, APRA Member, *Transcript*, 20 March 2015, p. 13.

69 Mrs Helen Rowell, APRA Member, *Transcript*, 20 March 2015, p. 13.

70 Mr Stephen Glenfield, APRA General Manager, *Transcript*, 20 March 2015, pp. 15-16.

2.73 Mr Glenfield further noted that APRA also engages with individual institutions to conduct on-site reviews. He explained that the on-site review process was two-fold, incorporating an assessment of both the institution's documented policy and the practical implementation of the policy:

So when we go on site, we look at not just their documented policy – which you would expect to meet this – but how it is actually employed in action. So you have two arms to it: it is not just the documented part; it is what they are actually doing in place. And we would discuss those findings with the board and with senior management and, in events where we think they are not doing enough, or they are not disclosing enough, or they are missing potential conflicts or perceived conflicts, we would go back and report to them, saying, 'hey, look: you need to do more in this area'. And that is then followed up in subsequent reviews.<sup>71</sup>

2.74 Further to this, the committee asked what enforcement powers were currently available to APRA to ensure institutions comply with the current standards. Mrs Rowell responded that APRA generally aims to resolve the majority of disagreements by making recommendations and having discussions with the parties.<sup>72</sup>

2.75 Further to this, Mrs Rowell described the formal disqualification process APRA is able to undertake in very serious cases:

To formally disqualify somebody, there would need to be a demonstrable breach of a law, and we would need to put together a case, and have that taken through the court system to achieve a disqualification. We have a process of entering into enforceable undertakings and so, again, if we found egregious behaviour and clear breaches of prudential or other legislative requirements, then we might use that as an avenue to have someone agree to not participate in the industry for an extended period. We can also issue directions to institutions to comply with prudential standards as well. They are powers that we rarely need to use and they are usually when there are very, very serious breaches.<sup>73</sup>

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71 Mr Stephen Glenfield, APRA General Manager, *Transcript*, 20 March 2015, pp. 15-16.

72 Mrs Helen Rowell, APRA Member, *Transcript*, 20 March 2015, p. 16.

73 Mrs Helen Rowell, APRA Member, *Transcript*, 20 March 2015, p. 16.

## Governance

2.76 The committee queried recent developments in the area of governance of superannuation funds and APRA's views on whether the current skills and capabilities of APRA-regulated superannuation board trustees are sufficient. Mr Glenfield remarked that APRA did not believe there is 'a skill set lacking across the board.'<sup>74</sup> He went on to explain APRA's strategy to assess this:

We look at each board individually. We look at their skill sets, their assessments of their own skill sets and their outcomes. We ask them: 'Are there parts of a skill set that you are missing; how will you get skilled up to it; or, how will you get someone in who has that skill set?'<sup>75</sup>

2.77 Additionally, Mrs Rowell stated 'there would be room for the skill sets around superannuation boards to be enhanced relative to what we see in other industries.'<sup>76</sup>

2.78 The committee questioned the current legislative definition of an 'independent director' for the superannuation industry, noting that it does not exclude previous service providers to the fund and asked whether this was a concern to APRA. Mrs Rowell noted that while there may be a need to review the definition of independent director, the implications of the definition are limited because there are currently no requirements for independent directors in the superannuation industry.<sup>77</sup>

## Private Health Insurance

2.79 The committee asked APRA to provide on notice, details of the resources set aside to achieve the transition of the prudential responsibilities of the Private Health Insurance Administration Council (PHIAC) to APRA on 1 July 2015; the key milestones identified by APRA in preparing for the transition; and the extent and method of industry consultation to support the transition.

2.80 APRA responded, on notice, that a project team has been established to manage the transition of PHIAC's prudential responsibilities and

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74 Mr Stephen Glenfield, APRA General Manager, *Transcript*, 20 March 2015, p. 17.

75 Mr Stephen Glenfield, APRA General Manager, *Transcript*, 20 March 2015, p. 17.

76 Mrs Helen Rowell, APRA Member, *Transcript*, 20 March 2015, p. 17.

77 Mrs Helen Rowell, APRA Member, *Transcript*, 20 March 2015, p. 17.

associated staff to APRA.<sup>78</sup> The project team is primarily resourced by APRA and PHIAC staff with some involvement from the Department of Health and, where required, external suppliers.<sup>79</sup>

2.81 APRA also noted the key milestones in relation to the updated regulatory framework:

- Industry consultation for Private Health Insurance (PHI) industry reporting and prudential standards by the end of March 2015;
- Written submissions to the industry consultation to be received by 19 May; and
- APRA's paper responding to the industry's submissions together with the final requirements to be released before 1 July 2015.<sup>80</sup>

2.82 In the same response, APRA outlined the extent and method of industry consultation to support the transition:

APRA and PHIAC are actively working with the Departments of Health and Treasury and with private health insurers to ensure that the transition is relatively seamless. An important aspect of executing the transition is APRA's engagement with PHI industry stakeholders. APRA's focus is to ensure that the PHI industry understands APRA's approach as a regulator and that there will be continuity of supervision, which will be maintained by transferring PHIAC staff to APRA. Since the legislative change was announced, APRA has spoken at major PHI industry conferences, has met with industry bodies and various industry participants. Formal meetings with the boards of individual private health insurers have commenced, many of which will be undertaken prior to 1 July 2015.<sup>81</sup>

## Conclusion

2.83 APRA has continued to closely monitor the financial services industry, and the committee notes APRA's actions to facilitate improvements in the practices of the industries it regulates. This includes the Stronger Super reforms and the emerging risks in the housing market. The Australian

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78 Australian Prudential Regulation Authority, *Submission 1*, p. [7].

79 Australian Prudential Regulation Authority, *Submission 1*, p. [7].

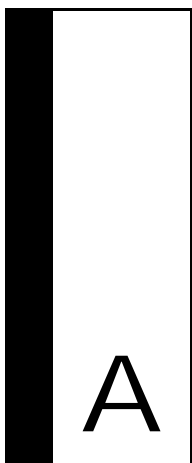
80 Australian Prudential Regulation Authority, *Submission 1*, p. [7].

81 Australian Prudential Regulation Authority, *Submission 1*, p. [8].

financial sector remains relatively stable overall and the recent work of the Basel Committee and the completion of the Financial System Inquiry may lead to future reforms to regulatory practices in this area.

- 2.84 The committee notes APRA's response to the increased risk in the domestic loan portfolio and is eager to follow up on APRA's approach to the supervision of property lending at subsequent hearings. The committee also looks forward to further discussing with APRA the outcomes that the FSI recommendations and the work of the Basel Committee may have on the capital requirements of the Australian banking sector more broadly.
- 2.85 The committee is also keen to evaluate at future hearings the potential impacts of APRA's new responsibilities for private health insurance.

**Mr John Alexander OAM MP**  
**Chair**  
**13 May 2015**



## Appendix A – Public hearing details and submission

### Public hearing

Friday, 20 March 2015 – Canberra

*Australian Prudential Regulation Authority*

Mr Wayne Byres, Chair

Mr Ian Laughlin, Deputy Chair

Mrs Helen Rowell, Member

Mr Stephen Glenfield, General Manager

The hearing transcript is available online at:

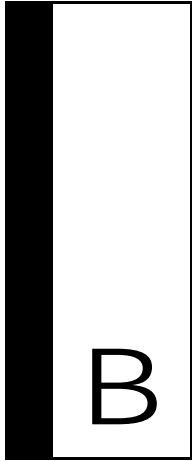
[http://www.aph.gov.au/Parliamentary\\_Business/Committees/House/Economics/2014\\_APRA\\_Annual\\_Report/Public\\_Hearings](http://www.aph.gov.au/Parliamentary_Business/Committees/House/Economics/2014_APRA_Annual_Report/Public_Hearings)

### 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.<sup>1</sup> 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.

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<sup>1</sup> *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.<sup>2</sup> 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.<sup>3</sup> 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.

<sup>2</sup> 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.

<sup>3</sup> 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.<sup>4</sup> 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.

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<sup>4</sup> 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

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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