
The Parliament of the Commonwealth of Australia

Review of the Australian Prudential Regulation Authority Annual Report 2017

House of Representatives
Standing Committee on Economics

June 2018
Canberra

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Chair's foreword

On 28 March 2018, the Australian Prudential Regulation Authority (APRA) appeared before the committee, and discussed its activities supervising and enforcing prudential standards and practices in the Australian financial system.

APRA explained that its focus has been on improving resilience in the financial system. The committee scrutinised APRA on its work on issues of governance, risk management and culture in financial institutions. In particular, on measures to reinforce sound lending practices and ensure that Australian banks remain prudentially strong, and the new Banking Executive Accountability Regime (BEAR).

APRA is seeking to improve responsible lending practices in the Australian financial sector. However, there is still a lot of work to be done in this area. The disturbing evidence coming out of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry suggests that, in a number of cases, the major banks are moving from a low base when improving their responsible lending practices.

In recent years, APRA has provided guidance on lending practices, which was aimed at maintaining strong lending in an environment of heightened risks. The benchmark limiting the growth of investor loans to 10 per cent, issued in December 2014, was updated in guidance from APRA on 26 April 2018. From 1 July 2018, financial institutions will no longer have to meet this requirement if they are able to provide APRA with certain assurances about the strength of their lending practices. The benchmark limiting the flow of new interest-only lending, established in APRA guidance on 31 March 2017, remains in place.

Strengthening accountability measures for senior executives was a key recommendation of the committee's Review of the Four Major Banks. The BEAR will provide mechanisms to make senior bank executives more accountable and subject to additional oversight by APRA. It comes into effect on 1 July 2018 for the major banks. There will be a measured transition for smaller institutions.

The committee also sees a need to continue to improve competition in the banking sector. In its *Review of the Four Major Banks*, the committee previously called for removing barriers to new entrants to the sector. It welcomes the recent changes to the restrictions on institutions using the term 'bank' in lifting this barrier to new entrants.

The new crisis management powers introduced by the Government provide important new tools for APRA. They will empower APRA to better prepare, and take decisive action, to more quickly and effectively address crises in Australia's financial system.

The proposed changes to superannuation will improve governance and transparency in the industry. The committee expects that, once the measures are implemented, it will better position APRA-related superannuation licensees to deliver sound outcomes for their members. The committee notes that APRA has extended its strategic focus to superannuation, and will monitor APRA's performance in this area.

On behalf of the committee, I thank the Chairman of APRA, Mr Wayne Byres, and other APRA representatives for appearing at the public hearing.

Sarah Henderson MP
Chair



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Membership of the Committee

Chair	Ms Sarah Henderson MP
Deputy Chair	The Hon Matt Thistlethwaite MP
Members	Mr Adam Bandt MP Ms Julia Banks MP Mr Scott Buchholz MP Mr Trevor Evans MP Mr Jason Falinski MP (from 20 June 2018) Mr Kevin Hogan MP (until 27 March 2018) Ms Ged Kearney MP (from 21 May 2018) Mr Craig Kelly MP Mr Matt Keogh MP Mr Josh Wilson MP (until 10 May 2018)

Committee Secretariat

Secretary	Mr Stephen Boyd
Inquiry Secretary	Ms Samantha Mannette
Office Manager	Ms Jazmine Rakic



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.



Abbreviations

ACCC	Australian Competition and Consumer Commission
ADI	Authorised Deposit-taking Institution
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
AUSTRAC	Australian Transaction Reports and Analysis Centre
BEAR	Banking Executive Accountability Regime
CBA	Commonwealth Bank of Australia
CPS 220	Prudential Standard CPS 220 Risk Management
RSE	Registrable Superannuation Entity

Introduction

Background

- 1.1 The House of Representatives Standing Committee on Economics (the committee) is empowered to inquire into, and report on, the annual reports of government departments and authorities tabled in the House that stand referred to the committee in accordance with the Speaker's schedule.
- 1.2 The Australian Prudential Regulatory Authority (APRA) Annual Report 2017 (annual report) stands referred to the committee in accordance with this schedule. On 7 February 2018 the committee resolved to conduct an inquiry into the annual report.
- 1.3 APRA is the prudential regulator of the Australian financial services industry, and is funded largely by the industries it supervises. It is one of four independent agencies with oversight of the Australian financial system.¹
- 1.4 APRA describes its oversight activities as follows:

It oversees Australia's banks, credit unions, building societies, general insurers and reinsurance companies, life insurers, private health insurers, friendly societies and most members of the superannuation industry.

1 The Reserve Bank of Australia, the Australian Securities and Investments Commission, and the Australian Competition and Consumer Commission (ACCC) are the other three independent agencies. The committee also conducts regular reviews of the annual reports of these agencies.

APRA currently supervises institutions holding \$6.1 trillion in assets for Australian depositors, policyholders and superannuation fund members.²

- 1.5 The annual report sets out APRA's vision and mission:
- to be a world-class prudential regulator, with excellence of supervision as the foundation;
 - to establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by supervised institutions are met within a stable, efficient and competitive financial system; and
 - to act as a national statistical agency for the Australian financial sector.³
- 1.6 All deposit-taking institutions, life and general insurance and reinsurance companies and friendly societies must have an APRA licence to operate in Australia. APRA also licenses trustees of prudentially regulated superannuation funds.⁴
- 1.7 Licensed institutions are subject to ongoing supervision by APRA to ensure they are managing risks prudently and meeting prudential requirements. The two main supervisory tools APRA uses are on-site and off-site analysis, undertaken by prudential supervisors with in-depth knowledge of institutions in a particular sector, and supported by specialist risk experts.
- 1.8 APRA described its supervisory approach as 'forward-looking, primarily risk-based, consultative, consistent and in line with international best practice'.⁵
- 1.9 APRA noted that one of its core functions is to plan and implement prompt and effective responses to the failure of a regulated institution, or a crisis in the financial system.⁶
- 1.10 APRA stated that it prefers to take a cooperative approach to resolving prudential issues with the institutions it supervises. However, where an institution is unwilling or unable to cooperate, APRA is empowered to
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2 Australian Prudential Regulation Authority (APRA), *Annual Report 2016-17*, p. 3.

3 APRA, *Annual Report 2016-17*, p. 6.

4 APRA, *About APRA*, 'Protecting Australia's depositors, insurance policyholders and superannuation fund members', <<http://www.apra.gov.au/AboutAPRA/Publications/Pages/APRA-Brochure.aspx>>, viewed 17 April 2018.

5 APRA, *About APRA*, <<http://www.apra.gov.au/AboutAPRA/Pages/Default.aspx>>, viewed 17 April 2018.

6 APRA, *Annual Report 2016-17*, p. 50.

take action against an institution, or individuals associated with that institution, to protect the interests of depositors, policyholders and members of superannuation funds. Enforcement action may include:

- formal investigations;
- imposing conditions on an institution's licence or issuing directions;
- appointing a replacement trustee to manage an institution's affairs;
- seeking a restraining order; and
- taking criminal action against a person or institution.⁷

1.11 In its annual report, APRA indicated that a focus underpinning 2016-17 was on building resilience. It suggested that this is far easier to do when times are relatively prosperous than trying to restore it after a period of adversity.⁸

Scope and conduct of the review

1.12 APRA appeared before the committee on 28 March 2018 in Canberra as part of the review of its 2017 Annual Report. This was APRA's third appearance at a public hearing with the committee in the 45th Parliament. APRA officials who appeared are listed at Appendix A.

1.13 The proceedings were webcast 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 webpage.⁹

1.14 This report focuses on issues raised in the annual report and, in particular, on matters raised at the public hearing.

7 APRA, *APRA's enforcement activities*, <<http://www.apra.gov.au/AboutAPRA/Publications/Documents/1408-APRA-FS-6.pdf>>, viewed 17 April 2018.

8 APRA, *Annual Report 2016-17*, p. 10.

9 House of Representatives Standing Committee on Economics, *Transcript*, 28 March 2018, <https://www.aph.gov.au/Parliamentary_Business/Committees/House/Economics/APRA/AnnualReport2017/Public_Hearings>, viewed 17 April 2018.

Current issues in prudential regulation

Overview

- 2.1 The Australian Prudential Regulation Authority (APRA) appeared before the House of Representatives Standing Committee on Economics (the committee) at a public hearing on 28 March 2018 as part of the review of the Australia Prudential Regulation Authority (APRA) 2017 Annual Report (annual report).
- 2.2 Key issues examined at the hearing included measures to reinforce sound lending practices and ensure that Australian banks remain prudentially strong, the new Banking Executive Accountability Regime (BEAR), risk management in financial institutions, and the crisis regulatory framework.
- 2.3 The committee also questioned APRA on measures to strengthen the Australian superannuation system, particularly improving outcomes for members, fund performance and governance.
- 2.4 At the hearing, the APRA Chairman, Mr Wayne Byres, noted that while the annual report was tabled some months ago, a number of issues discussed remain highly relevant as part of APRA's ongoing agenda to build resilience in the Australian financial system. These include:
- APRA maintaining a strong focus on the quality of residential mortgage lending and measures to reinforce sound lending standards;
 - ensuring there is a strong regulatory framework, particularly in times of crisis, with the recent passage of the crisis powers bill¹ providing a

1 Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Bill 2017.

substantial improvement to APRA's crisis management powers, better equipping it to deal with the actual or imminent failure of a financial institution;²

- highlighting the increasing risk to Australian financial institutions of cyber criminals seeking money or customer data as 'one of the most important risks that the financial system faces', and proposing a new cross-industry prudential standard on information security management to respond to this growing threat;³
- building resilience and improving governance and decisions making in the private insurance sector, and extending this strategic focus to superannuation; and
- finalising policies and practices for setting senior executive remuneration at large financial institutions, to ensure that remuneration outcomes are 'consistent with good risk management and long-term financial soundness'.⁴

Banking sector

2.5 In July 2017, APRA announced 'unquestionably strong' capital benchmarks for the four major banks, and took additional supervisory measures to reinforce sound residential mortgage lending practices, in what it considers to be an environment of heightened risks. APRA also established an independent prudential inquiry into the Commonwealth Bank of Australia (CBA) focusing on governance, culture and accountability frameworks, and practices within the CBA group.

2.6 The Government has introduced measures to broaden APRA's responsibilities and powers, in particular:

- the Banking Executive Accountability Regime (BEAR) that will make senior executives more accountable and subject to additional oversight by APRA; and
- removed restrictions on the use of the term 'bank', to promote a reduction of barriers to new entrants to the banking sector and provide a more level playing field.

2 Mr Wayne Byres, Chairman, Australian Prudential Regulation Authority (APRA), *Transcript*, 28 March 2018, p. 2.

3 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 2.

4 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 2.

- 2.7 As part of its Review of the Four Major Banks, the committee recommended the introduction of accountability measures for senior executives, and called for reducing barriers to entry to enhance competition in the banking sector.⁵
- 2.8 The Government has also provided APRA with new powers in respect of the provision of credit by entities that are not Authorised Deposit-taking Institutions (non-ADIs), to complement APRA's existing powers in respect of ADIs.

Measures to reinforce sound residential mortgage lending practices

- 2.9 In December 2014, APRA wrote to all ADIs advising of its intent to reinforce prudent residential mortgage lending practices through a number of measures, in particular increasing supervision of ADIs with annual investor credit growth materially above a benchmark of 10 per cent.⁶
- 2.10 On 26 April 2018, APRA announced plans to remove the 10 per cent benchmark on investor loan growth, and replace it with more permanent measures to strengthen lending standards. APRA wrote to ADIs advising that it is prepared to remove the benchmark, where the boards are able to provide assurance of the strength of their ADI's lending standards.⁷
- 2.11 In March 2017, APRA again wrote to all ADIs advising that it expects ADIs to:
- limit the flow of new interest-only lending to 30 per cent of new residential mortgage lending, and within that:
 - ⇒ place strict internal limits on the volume of interest-only lending at loan-to-valuation ratios (LVRs) above 80 per cent; and
 - ⇒ ensure there is strong scrutiny and justification of any instances of interest-only lending at an LVR above 90 per cent;

5 House of Representatives Standing Committee on Economics, *Review of the Four Major Banks (First Report)*, November 2016.

6 APRA, Letter from APRA to all ADIs – Reinforcing sound residential mortgage lending practices, 9 December 2014, <<http://www.apra.gov.au/adi/Publications/Documents/141209-Letter-to-ADIs-reinforcing-sound-residential-mortgage-lending-practices.pdf>>, viewed 20 April 2018.

7 APRA, Letter from APRA to all ADIs – Embedding sound residential mortgage lending practices, 26 April 2018, <<http://www.apra.gov.au/adi/Publications/Documents/Letter-Embedding-Sound-Residential-Mortgage-Lending-Practices-26042018.pdf>>, viewed 26 April 2018.

- manage lending to investors in such a manner so as to comfortably remain below the previously advised benchmark of 10 per cent growth;
- review and ensure that serviceability metrics, including interest rate and net income buffers, are set at appropriate levels for current conditions; and
- continue to restrain lending growth in higher risk segments of the portfolio (e.g. high loan-to-income loans, high LVR loans and loans for very long terms).⁸

2.12 The committee mentioned the level of household debt, and as discussed at previous hearings, raised concerns about banks increasing interest rates on all interest-only loans, not just new lending as targeted by APRA's 30 per cent benchmark introduced in March 2017.

2.13 In response to questioning on whether the banks should have passed the interest rate rises on to existing customers, APRA stated:

No but it would be wrong to assert that it was solely and only a result of that measure. Banks have a range of other factors that are impacting on their pricing and some of those are other regulatory measures like the FSI measures around unquestionably strong capital and other things. I don't want to suggest that regulation is not playing a role here but I think it is more nuanced and more complicated than just saying, 'That 30 per cent benchmark led to those interest rate increases.'⁹

2.14 The committee also referred to the Productivity Commission draft report *Competition in the Australian Financial System*, February 2018. In the draft report the Commission claimed that 'the cost borne by taxpayers as a result of APRA's intervention was up to \$500 million a year'.¹⁰ When questioned on APRA's view on this figure, the Chairman stated:

I can understand the calculation that they've done, but that's a product of tax policy. We can't set policy based on that. The same way that the Reserve Bank, when it sets interest rates for everybody and moves them up and down, doesn't work out the impact on the budget and take that into account. Tax policy is set by the government, and the outcomes will be what the outcomes

8 APRA, Letter from APRA to all ADIs – Further measures to reinforce sound residential mortgage lending practices, 31 March 2017, <<http://www.apra.gov.au/adi/Publications/Documents/Further-measures-to-reinforce-sound-residential-mortgage-lending-practices.pdf>>, viewed 20 April 2018.

9 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 8.

10 Productivity Commission, *Competition in the Australian Financial System*, Draft Report, January 2018, Draft finding 6.1, p. 173.

will be. We do what's right from a prudential and financial stability perspective.¹¹

- 2.15 When asked if slowing interest-only lending could have been achieved by other mechanisms, such as changes to tax concessions, APRA reiterated that its approach is to take tax policy as a given. The Chairman stated:

...for investors there is an incentive to borrow and maintain debt at high levels, that helps with the economics of it, but we are in an environment where interest rates are very low and that is encouraging people to take on debt. That's partly why interest rates are very low, particularly in the housing sector. We would say that perhaps it has created an excessive incentive to take on debt more generally...What I'm trying to say is I don't deny, in any way, that regulatory actions produce costs. They have an impact on competition, but I would come back to the status quo was not really one that we could be comfortable with. Someone needed to do something.¹²

- 2.16 The committee also questioned APRA on whether its measures restricting interest-only lending could have the effect of stifling competition, as the costs had risen for interest-only lending with the big banks, but potential customers were not able to go to competitors as they cannot grow their books either. APRA stated that to the extent it stopped people eroding lending standards it has had 'a positive effect on competition because it stopped poor-quality lending'.¹³ It remarked that:

'The way competition was playing out was in poor lending.' So to the extent we pushed back on that, it is pushing back on some of that competition but that competition was, in our view, detrimental to the health of the financial system in the long run and detrimental to the community.¹⁴

- 2.17 APRA told the committee that its goal was to reduce the overall amount of lending in the system as it was getting to 'quite excessive' levels, with too many borrowers not paying a cent back on their mortgages which was unhealthy in the long run. However, APRA stressed that the 30 per cent benchmark measure was designed to impact the largest banks, as the smaller banks tended to already operate below that level.¹⁵

11 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 9.

12 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, pp. 8-9.

13 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 9.

14 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 8.

15 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 8.

2.18 In response to committee questioning on APRA comments on the interest-only lending intervention, the Chairman stated that the benchmarks were not how APRA would normally operate. He explained that:

Normally, the way we would seek to work is to make sure that banks have good risk management and then that they have financial resources sufficient to deal with whatever risks they take on. There were various reasons why we were working on capital standards, but that was taking some time because we needed to take into account FSI recommendations, things coming internationally from the Basel committee. There was work needed to build capital requirements, but that was going to take time.¹⁶

2.19 APRA told the committee that improving lending standards and 'getting the whole industry to lift is quite difficult, because they all want to move together.' The Chairman reiterated that the measures are temporary; aimed at dampening 'some of the excess competitive spirit that was producing lower-quality lending and higher-risk lending.'¹⁷

2.20 In response to committee questioning on when the measures would be lifted, the Chairman stated that while he had said the 10 per cent investor growth benchmark was becoming redundant, he cautioned that:

We need to be a bit careful of setting ourselves down, but I think we're in a position where that could be removed sooner rather than later. The 30 per cent interest-only benchmark is one that we've only just got in place; the industry and the market are still settling. I wouldn't foreshadow removing that in the short term, but, obviously, we watch and see how the markets evolve.¹⁸

2.21 The Chairman did add that as the government has now mandated comprehensive credit reporting, and as the new capital standards come into force, the temporary measures will no longer be needed.¹⁹

2.22 The committee questioned APRA on whether there was a risk that the new comprehensive credit reporting and open data could disadvantage low-to-middle income Australians in terms of accessing credit, since their credit reports will be more available. APRA responded that it did not have a firm view on this yet, but acknowledged that:

16 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 9.

17 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 9.

18 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, pp. 9-10.

19 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 10.

...we need to be careful about how we go about many of these measures because, as you restrict availability to credit, it won't be those with high incomes and lots of assets who don't have access to credit any more. We need to be careful as we calibrate these things. The issue you've raised there is certainly something to be mindful of as we think about the design of the system and how lenders of all sorts will use that data.²⁰

- 2.23 In relation to the interest-only lending limits, the committee asked what numbers APRA was seeing, in terms of outcomes or trends. APRA stated that currently, 'every ADI is below the 30 per cent benchmark', and the system as a whole was 'probably running at about 20 per cent'.²¹
- 2.24 APRA also observed that it was not trending down, as in the six months the industry had to adjust their flow of interest-only loans it had overachieved. The Chairman explained that when the benchmark was announced on 31 March 2017, APRA indicated that institutions would need to be able to operate below the benchmark as soon as possible, but by the final quarter of 2017. However, by the final quarter of 2017, it was under 20 per cent. Consequently, the Chairman said that he 'would not be surprised if it bounced back a little bit', moving closer to 30 than 20 per cent.²²
- 2.25 The committee noted that previously APRA had provided some reassurance that it was using some flexibility when applying the interest-only rules, so that smaller and atypical lenders were not unreasonably disadvantaged. At the hearing, the committee sought an update on this matter. The Chairman responded that:

When it comes to interest-only lending, as I mentioned before, the issue of complying with the benchmark was, for most ADIs, very easy because they weren't above 30 per cent so all they had to do was keep doing what they were doing and not worry. As long as they didn't accelerate the volume of that lending, they just carried on with their business. There were a few who were above and they have adjusted back down on a similar trajectory. But, from the smaller institutions, the interest-only benchmark has not been the one that has caused the most angst. The investor growth

20 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 10.

21 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 13.

22 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 14.

benchmark that we've talked about previously has been more the subject of discussions.²³

- 2.26 APRA noted that its focus has been on the larger institutions, and it has allowed the smaller ones 'more time to think about how they adjusted'. To illustrate its flexibility, APRA stated that:

...over the three and a bit years that that measure has been in place, the four major banks have grown 18 per cent in total over that three-year period. The next tier of banks, the next dozen or so banks, have grown a bit over 20 so slightly faster than the big guys. And then the remainder of the industry, which are 100-plus institutions, have grown over that period 37 per cent or 35-plus per cent in aggregate.²⁴

- 2.27 However, the Chairman also told the committee that while it has been more flexible with smaller institutions, it was 'not a complete free pass', because ultimately lending standards remained a concern. APRA stated:

Lending standards across the industry are not what they should have been. Large or small – it doesn't matter who you are – you should lend with sound lending standards. We were also concerned about the potential for higher risk loans, which were no longer being written by the major banks, to flow down and concentrate in the smaller institutions. So there was a trade-off to be had there.²⁵

Royal Commission and UBS findings

- 2.28 The committee questioned APRA on problems with bank lending practices identified in the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Royal Commission),²⁶ and reports on mortgage mis-selling risks from the financial services firm UBS.²⁷ APRA stated that 'there has been a general sloppiness in the processes banks have pursued' and noted that 'corners

23 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 14.

24 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 14.

25 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 14.

26 Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, <<https://financialservices.royalcommission.gov.au/Pages/default.aspx>>, viewed 17 April 2018.

27 UBS, *Australian Banking Sector Update: Overstated income raises mortgage mis-selling risk*, 5 February 2018; and *Australian Banking Sector Update: "Easily falsified" payslips further raises mortgage mis-selling risk*, 8 March 2018.

have been cut'.²⁸ However, APRA did stress that this did not mean depositors' money was at risk:

I don't think there's any threat at all, and we shouldn't suggest there is any threat at all, to depositors' money here. That's not the case at all. This is where APRA and ASIC have a common interest, and we're working together on the issue. Fundamentally, the task of making proper inquiries about a borrower, and a borrower's capacity to service a loan, is, at its heart, in the responsible lending obligations that are administered by ASIC that apply to not just banks but all licensed credit providers. We are working with ASIC to see how we can do more to re-enforce and mutually re-enforce that issue.²⁹

2.29 In light of the disappointing evidence from the Royal Commission on banks' lending practices, the committee pressed APRA on whether it had been fulfilling its role in enforcing prudential standards of the banks. In its response, APRA firstly distinguished its regulatory role from ASIC's:

...the issues that have been the primary focus of the royal commission to this point have largely been adherence with responsible lending obligations in the law. Those laws are administered by ASIC, and so, in the first instance, those are matters for ASIC. As a general principle, issues of conduct, instances of fraud, will be pursued by the corporate regulator and potentially by the police, as some of these cases have been.³⁰

2.30 Secondly, APRA said that it has an interest in these issues, and outlined that:

The prudential interest in these issues is trying to understand the extent to which they indicate failings in the governance, oversight and accountability within organisations and then the extent to which those failings or shortcomings or areas for improvement might jeopardise the prudential soundness of those institutions.³¹

2.31 When pressed by the committee that the Royal Commission evidence may reflect not just individual cases but systemic issues, the Chairman responded:

28 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 18.

29 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 5.

30 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 3.

31 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 3.

There are clearly shortcomings in what the banks have done, and I'm not in any way disputing that. As I said, we've been on the record for three, four or five years in saying, particularly in housing lending, where we have focused our attention, that lending standards have not been what they should be. We have been working with the industry, and sometimes engaged in something of a tug of war with the industry, to try and improve standards across the board.³²

2.32 In response to further questioning on the nature of the conduct identified during the Royal Commission, APRA reiterated it was not its primary task to pursue matters of conduct; that is ASIC's responsibility.³³

2.33 However, APRA assured the committee that it has focused on the issue of sound lending standards for the last few years. The Chairman remarked:

I think where we are today is much better than where we were three or four years ago. I think it was, in fact, before this committee, three or so years ago, I said the standards that were being applied were horribly low. We've done a lot of work and we've been very interventionist in trying to raise standards since that time.³⁴

2.34 APRA told the committee that it had engineered a lot of improvements across the industry to make sure that banks are doing the work properly. In responding to questioning on what APRA was doing to enforce better standards, the Chairman provided the following examples:

...through 2014, 2015, 2016, we tightened up what we expected to see in terms of good lending and what we thought was good risk management within mortgage lending. In the latter part of 2016, we sent auditors into the larger institutions to see how well their processes were working and where remaining gaps were. As a result of that, there were a range of issues identified where further improvements were required. We have been monitoring the actions that each of those banks have been taking to close those gaps. Some of the actions that you talked about before – I think you mentioned Westpac; that's been in the paper – are in response to the issues that were identified. We're about to embark on a

32 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 3.

33 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 3.

34 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 4.

follow-up round of reviews to make sure that what the banks committed to do has actually been delivered.³⁵

2.35 In response to further questioning on how to give the Australian community confidence that APRA was able to ensure that the banks are meeting their prudential standards, it recognised that the cases of bank misconduct has 'shown the industry in a very poor light'. However, APRA emphasised that:

The prudential standards are about safety. In particular, when it comes to banking, our task, boiled down to its absolute essence, is: is depositors' money safe? I don't think anyone has said, anywhere along the way, that Australian financial institutions are not financially sound.³⁶

2.36 The committee mentioned the February 2018 UBS report on 'overstated income raises mortgage mis-selling risk', and the March 2018 report on "'easily falsified" payslips further raising mortgage mis-selling risk'. In particular, the committee noted UBS findings that the major banks' disclosure of mortgage borrowers' gross household income is not consistent with the total population's income as disclosed in the census, the ABS Household Income and Wealth Survey and ATO data.³⁷

2.37 APRA stated that in relation to the specifics of income distribution the UBS report 'relies on a fair few assumptions to reach conclusions.'³⁸ It observed that the report on mortgage mis-selling risks analyses major bank public disclosures on borrower income distributions, and 'draws its conclusions by combining these disclosures and several other public data sources', which are compiled on different bases. APRA outlined the following ways in which these data sources could differ:

- in some cases, borrower income distributions are defined by number of loans, and in other cases they are defined by the value of loans. Where loan value is used, distributions are likely to be skewed to higher incomes;
- census data is based on number of households, while the bank disclosures are based on loan facilities (by number or value). There can be a mismatch in comparisons between the two, given that some households may have multiple loan facilities; and

35 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 4.

36 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 5.

37 UBS, *Australian Banking Sector Update: "Easily falsified" payslips further raises mortgage mis-selling risk*, 8 March 2018, p. 1.

38 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 18.

- for some banks, the disclosures represent the income distribution of the entire mortgage portfolio, while in other cases they represent data for a particular period of lending.³⁹
- 2.38 APRA commented that in reaching the specific qualitative conclusions in the analysis, UBS would have assumed these differences were immaterial. APRA contended that while it was not in a position to quantify the specific impacts of these differences, they 'may have a bearing on the ability to draw definitive conclusions.'⁴⁰
- 2.39 APRA stated that its *Prudential Practice Guide APG 223 – Residential Mortgage Lending* (APG 223) provides industry guidance specifically on income assessment and verification. APG 223 sets out that 'a prudent ADI would be expected to make reasonable inquiries and take reasonable steps to verify a borrower's available income.'⁴¹
- 2.40 APRA also observed in relation to income serviceability assessments that it would also expect prudent ADIs to discount or disregard temporarily high or uncertain income, applying discounts of typically at least 20 per cent on most types of non-salary income.⁴²
- 2.41 APRA advised that in recent years it has been working on improving controls over the accuracy of data that loan applicants are providing to ADIs. This included a targeted review of residential lending practices at large ADIs, covering controls around the assessment of borrower income and expenses. The review concluded that ADI controls were generally designed effectively, however there was scope for strengthening the operating effectiveness at some ADIs, for example in the management of serviceability policy overrides. APRA indicated that ADIs are in the process of addressing the findings from the review.⁴³
- 2.42 The committee noted that Westpac had recently tightened up its requirements in relation to the income and spending information borrowers are required to provide. Westpac, and its subsidiaries, BankSA, St George Bank and Bank of Melbourne, have increased the number of expense categories in their home loan applications from six to 13 categories, to enable 'more detailed conversations' to better understand an applicant's financial situation.

39 APRA, *Response to question on notice*, QON 1, 18 April 2018, p. 1.

40 APRA, *Response to question on notice*, QON 1, 18 April 2018, p. 1.

41 APRA, *Response to question on notice*, QON 1, 18 April 2018, p. 1.

42 APRA, *Response to question on notice*, QON 1, 18 April 2018, pp. 1-2.

43 APRA, *Response to question on notice*, QON 1, 18 April 2018, p. 2.

- 2.43 The committee noted that these changes appear to be in direct response to the matters raised by the Royal Commission, and not due to APRA's actions. It questioned APRA on whether it had been tough enough with the banks in relation to these matters. APRA stated that it had 'engineered a lot of improvements across the industry to try and make sure that banks are doing that work properly'.⁴⁴
- 2.44 In response to further committee questioning on the 'systemic failings' being brought out in the Royal Commission evidence, APRA stated:
- Many of those case studies that are being looked at are case studies from some years ago and loans that were granted some years ago, where I fully accept standards were not where they should be. Standards today are better than they were. Standards are not, as I said in my opening statement, where we're completely comfortable with, but there has been a lot of improvement enforced by APRA to make sure banks are taking their responsibilities seriously in this regard.⁴⁵
- 2.45 When questioned on whether it would like to see similar changes as those being made by Westpac made by other banks, APRA agreed and stated that based on the reviews it did in late 2016 to early 2017, banks were still not doing enough to properly assess borrower living expenses.⁴⁶
- 2.46 The committee asked APRA what actions it could take, that it has failed to do so far, to ensure banks implement more appropriate lending standards. The Chairman responded:
- I don't know that we've failed to take any action. I think we are keeping the pressure on the industry to lift its game, and it is doing that. But, unfortunately, it's easier said than done. The difficulty that banks face – and I'm not trying, in any way, to sound sympathetic towards them – is that, when it comes to a borrower knowing their living expenses, we collectively – members of the general public – are not very good at knowing what we spend money on and how much money we spend each week in different categories.⁴⁷
- 2.47 APRA suggested that the government's decision to mandate comprehensive credit reporting will help considerably to address the borrower expenses 'blind spot' that currently exists. It observed that
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44 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 4.

45 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 4.

46 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 5.

47 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 5.

‘unless a borrower volunteers the information, banks do not have good visibility of that borrower's financial commitments, particularly and obviously where those financial commitments exist with other financial institutions.’⁴⁸

- 2.48 The committee noted that the problems with lending practices were not new, and questioned what APRA had been doing to address the issue. APRA stated it has built more conservatism into the assessment process, by effectively introducing ‘higher interest rate buffers into the serviceability assessments that banks were using.’⁴⁹
- 2.49 When the committee observed that this had been on the income side and that no action has been taken on the expenses side until recently, APRA stated that, jointly with ASIC, under responsible lending laws it has tried to get people to take collecting borrower information more seriously.
- 2.50 APRA suggests that with banks using modern technology, and the introduction of open data, it will allow them to draw information from customer accounts and other things that will give alternative views about borrower living expenses.⁵⁰

Risk weightings for small-to-medium sized enterprises

- 2.51 The committee made reference to the Productivity Commission draft report *Competition in the Australian Financial System*, which went into difficulties experienced by small-to-medium sized enterprises (SMEs) in accessing financing, particularly when a loan is not secured by a residential property. APRA’s view was sought on whether a more nuanced approach with calibrating risk weights could better reflect the risk of individual loans and a schedule of risk weights for SMEs.
- 2.52 APRA noted that independently of the report the Productivity Commission is already consulting on new risk weights for SMEs, and stated that it was open to going down that path, but cautioned that:
- ...you can have a general risk weight that's average for everybody or you can have a risk weight that is lower for people with more security or different sorts of security and better cash flow and that means it will probably have to be higher for those who are unsecured. That may have some implications for those SMEs who are in the really early areas of start-up that don't have security or

48 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 5.

49 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 19.

50 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 19.

don't have other things. They may face higher costs as a result of a more graduated set of risk weights leading into the way banks price those things. So that's a consideration you have to balance up in deciding how far you go down this path. You've got to decide the aggregate amount of capital for the risk in the portfolio and then how you want to allocate it to different sorts of risks.⁵¹

- 2.53 When asked to indicate how the weightings will change in terms of quantitative values, APRA stated that pending feedback, the main risk weight under consultation is proposed to move from 100 per cent to 85 per cent. It noted that while this represented a 'reasonably material shift', it is still a higher risk weight, reflecting the risk of the SME portfolio.⁵²

Improving banking competition

- 2.54 A key recommendation of the committee's Review of the Four Major Banks was to reduce the high barriers to entry into Australia's concentrated banking sector. The Government agreed with the committee's recommendation in its government response to the report.⁵³
- 2.55 In relation to APRA's powers, the *Treasury Laws Amendment (Banking Measures No. 1) Act 2018* enables APRA to make rules and directions relating to the provision of finance by non-ADI lenders that APRA has identified may materially contribute to risks of instability in the Australian financial system.
- 2.56 The legislative changes give APRA new powers in respect of the provision of credit by entities that are non-ADIs, to complement APRA's existing powers in respect of ADIs. To enable APRA to monitor the non-ADI lending sector and determine when, and if, to use this new power, non-ADI lenders will need to register with, and provide data to, APRA.
- 2.57 Restrictions on the use of the term 'bank' were also removed, to promote a reduction of barriers to new entrants to the banking sector and provide a more level playing field.
- 2.58 The committee raised findings in the Productivity Commission draft report *Competition in the Australian Financial System*, which noted that

51 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 10.

52 Mr Pat Brennan, Executive General Manager, Policy and Advice Division, APRA, *Transcript*, 28 March 2018, p. 10.

53 The Treasurer, The Hon Scott Morrison MP, *House Economics Committee's Review (Coleman Report) of the four major banks* – Government response, May 2017, <https://www.aph.gov.au/Parliamentary_Business/Committees/House/Economics/Four_Major_Banks_Review/Government_Response>, viewed 20 April 2018.

institutional responsibility in the financial system for supporting competition is loosely shared across APRA, the Reserve Bank of Australia (RBA), Australian Securities and Investments Commission (ASIC) and the Australian Competition and Consumer Commission (ACCC), and suggested that more needed to be done on improving competition in the financial sector.

- 2.59 In its draft report, the Productivity Commission stated that ‘competition in Australia’s financial system is without a champion among the existing regulators’, and suggested that the regulators consider competition, including whether the ACCC ‘is well-placed to do more than it currently can for competition in the financial system.’⁵⁴
- 2.60 APRA was asked its view on the Productivity Commission’s suggestion that the ACCC could be given additional powers and responsibilities in relation to competition in the financial system. The Chairman responded that who will be deemed a ‘competition champion’ was ultimately a matter for government. He stated:

Obviously, powers for other regulators and whether other regulators are sufficiently strong is a matter for the government. I don’t have a particular issue or concern with that. We have, ourselves, been trying to develop better relationships with the ACCC. Now that they are funded to do more work in the financial services sector and they have a dedicated financial services unit within the ACCC, we’ve got a good counterpart with which we can engage with them on issues and we’re working on building up the infrastructure that will help that happen.⁵⁵

Lines of regulatory responsibility: APRA and ASIC

- 2.61 The Productivity Commission’s draft report on competition observed that the lines between Australia’s financial regulators, the RBA, APRA and ASIC, have become ‘increasingly blurry’ over the past two decades.⁵⁶ In reference to this point, the committee asked APRA if it has a clear focus

54 Productivity Commission, *Competition in the Australian Financial System*, Draft Report, January 2018, pp. 17, 49. The Productivity Commission provided two options for considering which regulator can advance competition in the Australian financial system: Option 1 – that ACCC be afforded new proactive functions to supplement its current reactive role in the financial system; Option 2 – that ASIC’s existing financial system focus be expanded beyond participant conduct and consumer outcomes to include the advancement of competition.

55 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 11.

56 Productivity Commission, *Competition in the Australian Financial System*, Draft Report, January 2018, p. 421.

of responsibility. APRA responded that while there are issues of common interest that it works well together with ASIC on, it stressed that:

Fundamentally our core purpose is about, 'Is people's money safe?' And for ASIC it is about, 'Are people being treated fairly?' Those things are very clearly understood by the two agencies.⁵⁷

2.62 The Chairman stated that where there was a degree of overlap in some areas, that it was 'healthy overlap', which is preferable to having a regulatory gap.⁵⁸

Inquiry into the CBA

2.63 On 28 August 2017, APRA announced it would establish a prudential inquiry into the CBA. According to APRA, this inquiry is a response to several issues that relate to the governance, culture and accountability frameworks within the CBA group, which APRA says 'have damaged the bank's reputation and public standing'.⁵⁹

2.64 At the hearing, in response to committee questioning on the purpose of the inquiry, APRA described its investigation as a circuit-breaker, as it was important that someone other than CBA investigated the issue. It stated:

While we would normally go about this job anyway, the one commitment we made, given the focus and public interest in this issue, was to publish the report at the end, which we wouldn't normally do.⁶⁰

2.65 The committee raised concerns about whether real actions would come out of the inquiry, noting that to a large extent the BEAR, and outcomes of the committee's Review of the Four Major Banks, have already focused on addressing board and senior executive influence.

2.66 In response, APRA said that it would have to wait and see what that the panel comes up with, and noted that the panel is:

...looking at a range of work streams across leadership, accountability, culture, remuneration, governance structures – a number of areas across the bank that fit within that general terms of reference... They're looking at what CBA itself is doing... and

57 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 11.

58 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 11.

59 APRA, 'APRA announces panel members and terms of reference for prudential inquiry into CBA', Media release, 8 September 2017, <http://www.apra.gov.au/MediaReleases/Pages/17_38.aspx>, viewed 18 April 2018.

60 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 23.

judging whether CBA's own actions are going to be adequate or sufficient, and they'll be recommending anything that they think is necessary over and above that.⁶¹

- 2.67 APRA released the Final Report of the prudential inquiry on 1 May 2018, and accepted an Enforceable Undertaking from the CBA. The Final Report contains a large number of findings and 35 recommendations in relation to governance, accountability and culture.⁶² In its media release, APRA commented that the inquiry panel's overarching conclusion is that 'CBA's continued financial success dulled the senses of the institution', particularly in relation to the management of non-financial risks.⁶³
- 2.68 While noting CBA's efforts to date and its new remediation program, the inquiry panel concluded that more needs to be done to ensure that the shortcomings identified in the report are addressed. The Final Report sets out a series of remediation initiatives,⁶⁴ and the Enforceable Undertaking establishes the framework for CBA to address the recommendations in a timely manner. APRA will monitor the bank's remedial action, and has also applied a \$1 billion add-on to CBA's minimum capital requirement.⁶⁵
- 2.69 The committee notes the APRA Chairman's comments that the findings provide important insights for all financial institutions, and that all regulated financial institutions will benefit from conducting self-assessments to gauge whether similar issues might exist in their institutions. APRA has indicated that for the largest financial institutions it will be seeking written assessments that have been reviewed and endorsed by their boards.⁶⁶

61 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 24.

62 APRA, *Prudential inquiry into the Commonwealth Bank of Australia*, April 2018, p. 102.

63 APRA, Media Release, 'APRA releases CBA Prudential Inquiry Final Report and accepts Enforceable Undertaking from CBA', 1 May 2018, <<https://www.apra.gov.au/media-centre/media-releases/apra-releases-cba-prudential-inquiry-final-report-accepts-eu>>, viewed 14 June 2018.

64 APRA, *Prudential inquiry into the Commonwealth Bank of Australia*, April 2018, pp. 95-101.

65 APRA, Media Release, 'APRA releases CBA Prudential Inquiry Final Report and accepts Enforceable Undertaking from CBA', 1 May 2018, <<https://www.apra.gov.au/media-centre/media-releases/apra-releases-cba-prudential-inquiry-final-report-accepts-eu>>, viewed 14 June 2018.

66 APRA, Media Release, 'APRA releases CBA Prudential Inquiry Final Report and accepts Enforceable Undertaking from CBA', 1 May 2018, <<https://www.apra.gov.au/media-centre/media-releases/apra-releases-cba-prudential-inquiry-final-report-accepts-eu>>, viewed 14 June 2018.

Senior executive remuneration and accountability

2.70 In response to questioning on the role of senior leadership teams and senior executives on organisational and risk culture, APRA suggested that culture cannot purely be attributed to the attitudes and behaviour of senior executives, however, acknowledged that 'senior executives have a crucial role in setting the culture of the organisation and the risk culture in particular.'⁶⁷ It stated:

The culture and the accountability of the organisation is the way senior executives behave, the way they're incentivised to behave and the way their influence permeates through the organisation.⁶⁸

Remuneration review

2.71 APRA indicated that it is doing work on 'the way incentives are encouraging the right kind of behaviour.'⁶⁹ APRA told the committee that it was reviewing remuneration of large financial institutions, which included examining the extent to which remuneration outcomes were consistent with good risk management and long-term financial soundness. It observed that the financial crisis had revealed that:

...incentives that executives and staff have strongly influence behaviour, and, if those incentives don't give enough attention to good risk management and the long-term financial soundness of the business, they can generate behaviour which might be very profitable in the short term but come back to bite you later on.⁷⁰

2.72 APRA observed that remuneration requirements were only introduced following the financial crisis, and cautioned that while things have come a long way, there is more to do in this area.⁷¹

2.73 The remuneration review found there was 'considerable room for improvement in design and implementation of executive remuneration structures', and called for improvement in the following areas:

- ensuring practices were adopted that were appropriate to the institution's size, complexity and risk profile;

67 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 24.

68 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, pp. 24-25.

69 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 25.

70 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 12.

71 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 13.

- the extent to which risk outcomes were assessed, and weighted, within performance scorecards;
- enforcement of accountability mechanisms in response to poor risk outcomes; and
- evidence of the rationale for remuneration decisions.⁷²

2.74 In the review report, APRA indicated its preference is that ‘boards and senior executives consider the findings of this review and take action to better align their remuneration arrangements with good risk management and the long-term soundness of their institutions’. The report noted that some institutions had advised APRA of changes to their remuneration frameworks already made, or underway.⁷³

2.75 However, APRA expressed its intention to strengthen its prudential requirements on remuneration, taking into account the introduction of the BEAR for ADIs, and insights from international practice.⁷⁴

Banking Executive Accountability Regime

2.76 The BEAR was announced in response to this committee’s recommendations to improve accountability and transparency within financial institutions. It puts in place a strengthened responsibility and accountability framework for the most senior and influential directors and executives of ADIs and their subsidiaries.

2.77 The BEAR measures will take effect from 1 July 2018, and will include new and strengthened powers for APRA in the following areas:

- ‘Accountable person’ – roles with respect to the responsibilities undertaken in the ADI must be filled at all times and registered with APRA. This includes providing APRA with the details of the roles and responsibilities of each accountable person, and accountability maps identifying the lines of responsibility through the ADI group.
- Penalties – APRA may disqualify an accountable person for breaching the obligations of BEAR, and may seek civil penalties of up to 1 million penalty units where an ADI breaches the obligations under BEAR.
- Deferring remuneration – An ADI must have a remuneration policy which is consistent with the requirements under the BEAR, and must

72 APRA, Media Release, ‘APRA seeks improvement in executive remuneration practices’, 18.15, 4 April 2018, < http://www.apra.gov.au/MediaReleases/Pages/18_15.aspx>, viewed 20 April 2018.

73 APRA, *Remuneration practices at large financial institutions*, Information Paper, April 2018, p. 5.

74 APRA, *Remuneration practices at large financial institutions*, Information Paper, April 2018, p. 5.

defer a proportion of the remuneration of an accountable person for a period of four years. The proportion to be deferred depends on the size of the ADI, although in some circumstances APRA may allow an ADI to defer a person's remuneration for a shorter period.

- Examination powers – An APRA investigator is empowered to require a person to give information relevant to an investigation, set out how the person's lawyer may participate during the examination, and how examination records must be kept and shared. Section 52F is also expanded to apply to production of a book, account or document or signing of a record.⁷⁵

2.78 When questioned on its work in preparation for the BEAR, APRA advised that it has been engaging with industry. It commented that conceptually the requirements are straightforward, but that the complexity was in the number and timing of employment contracts. It noted that the timing for complying with requirements would be staggered:

It's affecting the major banks on 1 July this year and other ADIs a year later, so that gives time for the smaller ADIs to prepare. ...The legislative requirements come in after a delay, and that is the very pragmatic fact that these are reflected in employment contracts, so they don't change automatically. The core requirements are for a set amount of variable remuneration to be deferred for at least four years. That is something that I think quite a large part of the industry will have to adjust to.⁷⁶

2.79 When asked what the public would see once the BEAR takes effect, APRA commented that in terms of remuneration for senior executives there will be 'a fixed percentage which is deferred for a fixed period and that the entities in question will need to review whether that gets paid, in the light of any events that may unfold between the time it's awarded and when it's actually paid.'⁷⁷ It also observed that it will be up to an ADI if it wants to disclose its remuneration arrangements.

2.80 In relation to consequences, APRA stated that it is expected that consequences would be clear, and that ADIs may volunteer their information, or will be called upon to do so. It also noted that there are

75 Treasury Laws Amendment (Banking Executive Accountability and Related Measures) Bill 2018, Revised Explanatory Memorandum, pp. 11-13.

76 Mr Pat Brennan, Executive General Manager, Policy and Advice Division, APRA, *Transcript*, 28 March 2018, p. 13.

77 Mr Pat Brennan, Executive General Manager, Policy and Advice Division, APRA, *Transcript*, 28 March 2018, p. 13.

‘clearer consequences in the powers that APRA has, but that’s more to do with disqualification and fines.’⁷⁸

Risk management

2.81 APRA advised that it has been doing work through its risk management standard *Prudential Standard CPS 220 Risk Management* (CPS 220), looking, by different sectors, at risks under that standard, which include credit risks, insurance risks, investment risks, operational risks and strategic risks.⁷⁹

Risk culture

2.82 The committee questioned APRA on the executive position that the regulator had established to conduct reviews of culture in financial institutions. The Chairman stated that a couple of years ago it had set up a team to focus on governance, culture and remuneration across the regulated sector. APRA explained that one of the lessons of the financial crisis was that:

...prudential regulators like APRA, which have traditionally focused on capital, liquidity and financial metrics, needed to have a stronger focus on the risk culture within organisations, and, so, attitudes to risk. That plays out in governance, culture and remuneration.⁸⁰

2.83 APRA advised that while it is not ‘embedding organisational psychologists into financial institutions’, it is drawing on their work, and are piloting different ways to get a better assessment of risk culture within financial institutions.⁸¹

2.84 APRA noted that it has introduced a prudential standard on risk management that includes a new requirement that puts the onus on the board of each regulated institution to:

...have a view, and be able to form a view, of what the risk culture within their organisation was and then, if they didn't like what

78 Mr Pat Brennan, Executive General Manager, Policy and Advice Division, APRA, *Transcript*, 28 March 2018, p. 13.

79 Mr Geoff Summerhayes, Member, APRA, *Transcript*, 28 March 2018, p. 20.

80 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 11.

81 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 11.

they saw or it was inconsistent with their strategy or objectives, obviously, to make sure something was happening to address that.⁸²

- 2.85 However, the APRA Chairman acknowledged that this is a 'very hard task' and is still 'a work in progress', with the industry working out how to do it well. He stated that some organisations have employed psychologists and other skills to help them develop methodologies to better meet this obligation.⁸³

Climate change

- 2.86 In relation to climate change, APRA stated that its intention in this area was to 'draw attention to the risk and to ensure that institutions are thinking about that risk in the context of their prudential soundness going forward.'⁸⁴

- 2.87 APRA confirmed that it had established an internal Climate Change Financial Risk Working Group, and maintained that 'climate change risk plays out in banks and credit risk' and is 'foreseeable, material and actionable now.' APRA explained that its consideration of climate change risk is from a financial risk perspective, not from an ethical or environmental perspective. It stated:

When banks are thinking about making loans, to what extent are they assessing the impacts of a change in climate on the credit assessment of making those loans, which are often long-dated? It applies in the investment and superannuation area, where investments have been made in sectors of the economy that might have a reliance on high-carbon-usage enterprises – how that might change over time? And likewise within the insurance sector, where, obviously, a change in climate has physical impacts on the environment in which we live. To what extent are those risks being assessed or priced into the institutions.⁸⁵

- 2.88 In response to questions on whether there has been a decline in the frequency of cyclones, APRA stated that it was not an expert on the science of these weather events or the changing climate. However, it reiterated that it is concerned with financial risk as it applies to

82 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 11. *Prudential Standard CPS 220: Risk Management*.

83 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 11.

84 Mr Geoff Summerhayes, Member, APRA, *Transcript*, 28 March 2018, p. 20.

85 Mr Geoff Summerhayes, Member, APRA, *Transcript*, 28 March 2018, p. 20.

institutions. APRA's view is that it is important that those institutions consider a change in climate, and the financial impacts of that, when making decisions to ensure that they are protecting their prudential soundness.⁸⁶

- 2.89 The committee noted comments by the ACCC Chairman that 'Australia faces an energy affordability crisis',⁸⁷ and asked APRA why it had not warned institutions about energy prices as they have done with the climate change risk. APRA responded that it was already a well-known category of risk and that:

...some APRA-regulated entities have highlighted the issues around high energy costs in terms of pressure on consumers, pressure on borrowers and other such matters, but those issues are to do with energy policy and the management of that energy policy. They're not to do with an APRA mandate.⁸⁸

Cyber-risk

- 2.90 At the hearing, APRA highlighted cyber-risk as 'increasingly one of the most important risks that the financial system faces', and stated that:

It affects large and small institutions alike and stretches across all industries. It's almost inevitable that institutions' defences will be breached in some way at some time, and it's no longer implausible to suggest that a cyberattack could be sufficiently severe to take a regulated institution out of business entirely with significant losses as a result. The financial institutions we supervise will need to place greater emphasis on, and devote more resources to, this risk into the future, as will APRA...⁸⁹

- 2.91 APRA indicated that evidence suggested that this risk is accelerating, with Australian financial institutions being 'among the top targets of cybercriminals seeking money or customer data'. In response to this risk, APRA is proposing the first cross-industry prudential standard on information security management. APRA outlined that the package of measures is aimed at 'shoring up the ability of APRA-regulated entities to

86 Mr Geoff Summerhayes, Member, APRA, *Transcript*, 28 March 2018, p. 21.

87 Mr Rod Sims, Chairman, ACCC, Annual address to the Committee for Economic Development of Australia: 2018 compliance & enforcement priorities', 20 February 2018, <<https://www.accc.gov.au/speech/2018-compliance-enforcement-priorities>>.

88 Mr Geoff Summerhayes, Member, APRA, *Transcript*, 28 March 2018, p. 22.

89 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 2.

both repel cyberadversaries and respond swiftly and effectively in the event of a breach of their defences.⁹⁰

2.92 The draft *Prudential Standard CPS 234 Information Security* (draft CPS 234) is proposed as part of broader APRA updates to the prudential framework to ensure qualitative management of operational risk across all APRA-regulated industries. Draft CPS 234 aims to:

...ensure that an APRA-regulated entity takes measures to be resilient against information security incidents (including cyber-attacks) by maintaining an information security capability that is commensurate with information security vulnerabilities and threats.⁹¹

Crisis regulatory framework

2.93 The *Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act 2018* provides APRA with an enhanced suite of crisis resolution powers applicable to prudentially regulated ADIs, general insurers and life insurance companies, and certain group entities. The legislation:

- strengthens APRA's powers to facilitate the orderly resolution of an ADI or insurer so as to protect the interests of depositors and policyholders, and to protect the stability of the financial system; and
- ensures that APRA has powers to set appropriate prudential requirements and take action in relation to resolution planning so that ADIs and insurers are better prepared for resolution.

2.94 APRA welcomed the changes as a 'substantial improvement' to its crisis management powers, which will ensure it is better equipped to deal with 'the actual or imminent failure of a financial institution', and maximise the public sector's ability to 'preserve an orderly financial system in times of stress'.⁹²

2.95 However, APRA's Chairman was also keen to clarify that the enhanced powers did not put depositors' money at risk. He explained that:

90 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 2.

91 APRA, 'Consultation on information security requirements for all APRA-regulated entities - March 2018', <<http://www.apra.gov.au/CrossIndustry/Consultations/Pages/Information-security-requirements-Mar18.aspx>>, viewed 18 April 2018.

92 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 2.

Concerns have been expressed in some quarters that the [legislation] might allow APRA to confiscate or otherwise use depositors' money to save a failing bank, and I therefore would like to use this opportunity to state clearly that that is most definitely not the case. There's no such power in the [legislation]. Indeed, APRA's purpose under the Banking Act is to protect depositors, and the idea of bailing in deposits would be anathema to that core purpose.⁹³

2.96 The Chairman commented that the crisis management powers are important when time is of the essence. He noted that in instances like the global financial crisis, if regulators do not have a 'strong set of powers ready to be able to be used in those instances and good pre-prepared plans on how they will use those powers, you can often create a situation in which a problem in one organisation very quickly becomes a problem in the system'.⁹⁴

2.97 When asked whether these powers are consistent with international best practice, APRA noted that the legislation was fit for purpose for Australia. APRA stated that:

There is quite a range of practice right around the world, partly reflecting different legal structures, different banking systems et cetera. We've learned as much as we can from around the world, but this is very much a piece of legislation which is designed to work in Australia. When you look at some other systems, the cross-border risks are much higher. They are inherently difficult to deal with and tend to be done outside legislation but can be supported by it. I think the international learnings could be more relevant in the next phase as we improve both the financial systems and our own readiness to use those powers if they're ever needed. The work that other jurisdictions have done in, I guess, planning and preparedness is where we'll probably see more commonality.⁹⁵

93 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 2.

94 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 12.

95 Mr Pat Brennan, Executive General Manager, Policy and Advice Division, APRA, *Transcript*, 28 March 2018, p. 12.

Superannuation

Measures to improve member outcomes

- 2.98 In July 2017 the Government announced measures to enhance governance and transparency in the superannuation industry. The measures are designed to better position APRA-related superannuation licensees to deliver sound outcomes for their members.
- 2.99 The Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No. 1) Bill 2017 was introduced into the Senate in September 2017, and includes part of a broader package of Government reforms focused on protecting members' money and interests.
- 2.100 In relation to APRA's powers, the Bill aims to modernise and increase confidence within the superannuation system by 'giving APRA improved capability to take preventive and corrective action in response to breaches of the law or where funds may not be acting in the best interests of their members'.⁹⁶
- 2.101 APRA was asked for its view on whether the proposed legislation would enable it to more effectively supervise the superannuation industry for the benefit of members of APRA-regulated superannuation funds. It indicated its support for the proposals and stated that:
- There are a number of important measures in that package of bills that are very relevant from an APRA perspective: the directions power; the stronger MySuper authorisation and cancellation requirements; the governance reforms; the expense look-through provisions; and the change-of-ownership provisions. There are a number of elements of that package that we think will enhance practices in the industry and APRA's ability to supervise to ensure better outcomes for members.⁹⁷
- 2.102 In relation to work already underway, APRA told the committee that its emphasis on strong strategic focus extends to superannuation:
- As we said in our annual report, we've upped the ante on RSE licensees that appear not to be consistently delivering quality member outcomes or are not appropriately positioned for future

96 Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No. 1) Bill 2017, Explanatory Memorandum, p. 10.

97 Mrs Helen Rowell, Deputy Chairman, APRA, *Transcript*, 28 March 2018, p. 7.

effectiveness and sustainability. To that end, it is pleasing to note that this work is delivering results, with a number of funds restructuring activities and products in order to deliver better member outcomes in response to our observations.⁹⁸

Governance of fund payments to related or other parties

2.103 Some members raised concerns about the transfer of funds from industry super funds to unions, and how APRA was satisfying itself that this was in fund members' best interests. In response, APRA stated:

APRA has a role in overseeing the way in which superannuation funds operate, whether they be industry funds, retail funds, public sector funds or corporate funds. So one of the matters we look at is the flows and the relationships that trustees have with various parties, be they related parties or third parties. At the moment, we get some information about the nature and amounts of those relationships, although it's fair to say that our recent thematic review of related party arrangements across the industry showed that there was room to improve. We know that there are arrangements between industry funds and various nominating bodies and organisations in the same way as there are arrangements between retail funds and various other parties within those retail groups. We seek to understand the nature of those relationships and the purpose and quantum of various expenditure at a high level.⁹⁹

2.104 The Deputy Chairman told the committee that when APRA had any questions or concerns about those transactions, it will seek to understand at a more detailed level the purpose of the expenditure and the process the trustee has used to determine that it is in the best interest of its members. She noted that in recent years, APRA has asked a number of trustees to 'lift their approach in terms of the governance and oversight of those arrangements'.¹⁰⁰

2.105 The committee gave an example of a payment of \$90,000 to a union for two-and-a-half days' work as a super liaison officer. In relation to that

98 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 2.

99 Mrs Helen Rowell, Deputy Chairman, APRA, *Transcript*, 28 March 2018, p. 6.

100 Mrs Helen Rowell, Deputy Chairman, APRA, *Transcript*, 28 March 2018, p. 6.

specific arrangement, APRA stated that it was 'acknowledged as inappropriate and is unlikely to be seen going forward.'¹⁰¹

- 2.106 In response to questioning on how it had allowed such a transaction to occur, APRA observed that it did not monitor transaction level activity of APRA-regulated institutions, as it does not have the capability or information to do so, nor does it believe it is appropriate for it to do this level of monitoring. It maintained that this was a role for management and boards.¹⁰²
- 2.107 The committee pressed APRA on why it could not ask every super fund in the country to report on the details of their third-party transactions to enable greater oversight of governance arrangements. APRA conceded that this was possible, but took the view that this would not be a cost-effective way to regulate.¹⁰³ APRA stressed that it has undertaken reviews of those issues, which involved writing to institutions to ask for information about the arrangements and the trustee processes, and reviewing governance practices and asking for changes.¹⁰⁴
- 2.108 APRA was asked how cases like this were classified and whether they are frequent or common occurrences. APRA described this type of case as 'infrequent but more frequent' than it would like.¹⁰⁵
- 2.109 APRA advised that particularly in light of information that emerged from the trade union royal commission, it undertook an exercise a couple of years ago seeking more information from a number of industry funds about arrangements they had in place with various sponsoring organisations. It looked at the nature of these arrangements, and the processes funds had in place for determining if arrangements were appropriate, and for the ongoing monitoring and oversight of those arrangements. APRA stated that this exercise:

...led to a number of changes in some funds in terms of how they managed those related-party arrangements and other arrangements that they had in place and enhanced the reporting and the governance and the oversight around this. That means probably we have fewer concerns now than we did back then, but it is something that we remain focused on and where we think,

101 Mrs Helen Rowell, Deputy Chairman, APRA, *Transcript*, 28 March 2018, p. 15; Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 25.

102 Mrs Helen Rowell, Deputy Chairman, APRA, *Transcript*, 28 March 2018, p. 25.

103 Mr Wayne Byres, Chairman, APRA, *Transcript*, 28 March 2018, p. 27.

104 Mrs Helen Rowell, Deputy Chairman, APRA, *Transcript*, 28 March 2018, p. 26.

105 Mrs Helen Rowell, Deputy Chairman, APRA, *Transcript*, 28 March 2018, p. 14.

generally across the industry, there is this ongoing need to improve their oversight of the use of members' money and there needs to be more transparency around the use of members' money.¹⁰⁶

- 2.110 APRA stated that it undertakes a program of regular supervision of the whole population of the industry, which includes approximately 140 superannuation trustees and just over 200 superannuation funds. It receives regular information from the funds and has frequent dialogue with the boards and senior management. APRA's Deputy Chairman noted that:

...from time to time, we do see issues that cause us concern and cause us to ask questions. I couldn't tell you what the numbers are, but my guess would be in the area of maybe five per cent of the industry.¹⁰⁷

- 2.111 APRA commented that at a general level there was room for improvement in the regulatory framework, including:

...heightened requirements and reporting around all use of members' money and expenditure, whether it's for retail funds or for industry funds. That is something that we are looking to do through our member outcomes package and in changing the reporting and the degree of granularity and consistency around what is happening in that space so that we can have easier visibility than we do now, which is that we get very high level aggregate information.¹⁰⁸

- 2.112 The Deputy Chairman stated that APRA had no specific concerns about arrangements between industry funds and unions, assuming they meet the requirements of all arrangements: that they are properly documented, there is clear oversight and accountability for the services provided, and the trustee can justify the arrangement as value-for-money.¹⁰⁹

- 2.113 In response to questioning on the value-for-money propositions or processes used by funds, APRA also observed that it saw 'varying degrees of rigour' in approaches taken, and stated that one area in which it would like to see improvement is for funds to use 'more robust metrics' to assess the value that is being provided by its various arrangements.¹¹⁰
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106 Mrs Helen Rowell, Deputy Chairman, APRA, *Transcript*, 28 March 2018, pp. 14-15.

107 Mrs Helen Rowell, Deputy Chairman, APRA, *Transcript*, 28 March 2018, p. 15.

108 Mrs Helen Rowell, Deputy Chairman, APRA, *Transcript*, 28 March 2018, p. 7.

109 Mrs Helen Rowell, Deputy Chairman, APRA, *Transcript*, 28 March 2018, p. 6.

110 Mrs Helen Rowell, Deputy Chairman, APRA, *Transcript*, 28 March 2018, p. 15.

Fund performance

2.114 In relation to the performance of superannuation funds, when questioned on the differences in return on investment and cost of administration between industry funds and retail funds or managed fee cost, APRA responded that the industry as a whole showed a wide range of investment performance and expense and other cost benchmarks.¹¹¹

2.115 The Deputy Chairman cautioned that she would not necessarily equate an observation that high investment performance means better value for money in terms of the services provided. APRA's view is that when assessing performance and value-for-money, people need to look at it a number of different ways:

As we have expressed the view on a number of occasions, whilst there is no doubt that some industry funds deliver very strong investment performance, the range of performance in the industry fund sector is relatively wide. Similarly, the range of performance in the retail sector, the corporate sector and the public sector is quite wide. So we would not agree with an assertion that industry funds as a whole outperform retail funds or other segments of the industry as a whole. I think, similarly, the argument around costs and benchmarking of costs is quite complex.¹¹²

2.116 Further, APRA commented that it did not feel it had a really good picture of this at an industry level yet, and so would focus on this in its dialogue with funds, including identifying areas where it does not think a fund in 'stacking up' in terms of members focus and outcomes.¹¹³

2.117 In response to questioning on whether it made distinctions between different funds, APRA commented that its 'concern is for every trustee to meet their obligations to act in the best interests of members', and stated:

Depending upon which metric you look at, you see a slightly different pattern of the relativities, but in all dimensions you see some strongly-performing industry, retail, corporate and public sector funds, and some where there is room to pull their socks up.¹¹⁴

111 Mrs Helen Rowell, Deputy Chairman, APRA, *Transcript*, 28 March 2018, p. 16.

112 Mrs Helen Rowell, Deputy Chairman, APRA, *Transcript*, 28 March 2018, p. 16.

113 Mrs Helen Rowell, Deputy Chairman, APRA, *Transcript*, 28 March 2018, p. 16.

114 Mrs Helen Rowell, Deputy Chairman, APRA, *Transcript*, 28 March 2018, p. 16.

2.118 The committee also asked APRA about possible negative effects on parts of the superannuation sector of tax proposals to remove cash payments for excess franking credits. APRA responded that as a prudential regulator it was not its role to provide specific comment on tax policy, that it was a matter for government. It also stated that:

Our focus is on the ability of individual trustees and the superannuation system as a whole to deliver reasonable outcomes to members that support retirement income policy objectives. To the extent that there are changes in tax settings, which happens all the time, the industry needs to adjust to those tax settings.¹¹⁵

2.119 APRA also stated that in relation to superannuation its focus is on how the industry responds to the current legislative framework. However, it did comment that it is 'important that there is a level playing field in the industry and that there are no measures that would unduly impact on the ability of all trustees to be able to deliver sound outcomes for their members'.¹¹⁶

2.120 When APRA was asked whether it had any views on how reducing the utility of franking credits might alter the relative competitiveness of self-managed super funds compared to larger funds, or whether that might give rise to market distortions, APRA responded that it does not have 'any supervisory or regulatory role in relation to self-managed super funds', and that it was not an issue that it has looked into closely.¹¹⁷

Conclusion

2.121 APRA and other regulators have been seeking to improve responsible lending practices in the Australian financial sector. However, it is clear that there is still a lot of work to be done in this area. The disturbing evidence coming out of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, suggests that in a number of cases the major banks are moving from a low base when improving their responsible lending practices.

2.122 The committee notes that the Banking Executive Accountability Regime (BEAR) comes into effect from 1 July 2018. This was a key recommendation of the committee's Review of the Four Major Banks. The

115 Mrs Helen Rowell, Deputy Chairman, APRA, *Transcript*, 28 March 2018, p. 6.

116 Mrs Helen Rowell, Deputy Chairman, APRA, *Transcript*, 28 March 2018, p. 6.

117 Mrs Helen Rowell, Deputy Chairman, APRA, *Transcript*, 28 March 2018, p. 7.

BEAR will provide mechanisms to make senior bank executives more accountable and subject to additional oversight by APRA.

- 2.123 The committee also sees a need to continue to improve competition in the banking sector. In its Review of the Four Major Banks, the committee previously called for removing barriers to new entrants to the sector. It welcomes the recent changes to the restrictions on institutions using the term 'bank' in lifting this barrier to new entrants.
- 2.124 The new crisis management powers introduced by the Government provide important new tools for APRA. They will empower APRA to better prepare, and take decisive action, to more quickly and effectively address crises in Australia's financial system.
- 2.125 The proposed changes to superannuation will improve governance and transparency in the industry. APRA has indicated that once the measures are implemented, it will better position APRA-related superannuation licensees to deliver sound outcomes for their members. The committee notes that APRA has extended its strategic focus to superannuation, and will monitor APRA's performance in this area.

Ms Sarah Henderson MP
Chair
20 June 2018



Appendix A — Hearing and witnesses

Public hearing

Wednesday, 28 March 2018 – Canberra

Australian Prudential Regulation Authority

Mr Wayne Byres, Chairman

Mrs Helen Rowell, Deputy Chairman

Mr Geoff Summerhayes, Member

Mr Pat Brennan, Executive General Manager, Policy and Advice Division

Mr Sean Carmody, Executive General Manager, Diversified Institutions Division

Ms Carolyn Morris, Senior Manager, Policy Development