Joint Standing Committee on Trade and Investment Growth

ANSWERS TO QUESTIONS ON NOTICE

Prudential regulation of investment in Australia’s export industries

Friday 13 August 2021

Division/Agency: Australian Prudential Regulation Authority
Question No: APRAQON01
Topic: Picnic Labs submission and recommendations
Reference: Hansard p. 11
Senator/Member: Ged Kearney, MP

Question:

Ms KEARNEY: Thank you for that. We had a submission from an organisation called picnic lab and they recommended that prudential standards were changed to formally recognise mutual capital instruments and allow 100 per cent of mutual capital instruments to be included in the definition of common equity tier 1 capital. At the moment, APRA rules that only 25 per cent of common equity tier 1 capital can be sourced from mutual instruments. Can you explain that? What's the rationale behind putting a cap of 25 per cent on mutual capital instruments? What's your view of raising the threshold to 100 per cent. I'd be very interested in APRA's response more broadly to the Picnic Labs submission to this inquiry, if you could take that on notice.
Mr Byres: We'll take that last bit on notice, but I'll ask Mr Kohlhagen to talk on the policy in relation to mutual equity interests
[…]
Ms KEARNEY: That's very interesting. Thank you for that. It's not a hard rule, basically, is what you're saying. I'll put this on question on notice, because we really don't have time, but I am interested in your views more broadly on the Picnic Labs submission, particularly with regard to the idea of an 'insurance mutual' for the resources sector to provide self-insurance for the industry. I'd be very keen to know APRA's view on that. We probably don't have time to talk about it today, so I'll put that on notice.
Mr Byres: I'm happy to take that on notice. Thank you.

Answer:

<u>Mutual equity instruments</u>

APRA’s limit (currently included in the banking capital framework) on the use of mutual equity instruments in the definition of Common Equity Tier 1 capital aims to strike an appropriate balance between enhancing capital management flexibility for mutual organisations, and preventing over-reliance on mutual equity instruments. APRA’s concerns relate to the fact mutual equity instruments remain largely untested as loss absorbing capital, and there is a risk that authorised deposit-taking institutions (ADIs) dilute their future earnings and reduce long-term growth capacity if the cash distribution rate on a mutual equity instrument exceeds the issuing ADI’s return on equity.

Please also note that this limit is in relation to the amount of mutual equity instruments on issue that are eligible for inclusion in Common Equity Tier 1 capital. Any additional mutual equity instruments that an ADI issues can be counted towards meeting other regulatory capital requirements such as additional Tier 1 and Tier 2 capital.

In regards to general insurers, mutual equity instruments have not been included as a feature in APRA’s capital frameworks. However, APRA is able to work with general insurers on a case-by-case basis to consider the merits of mutual equity instruments as a form of capital.

Insurance mutuals

Mutual arrangements are used in a range of industries to assist in managing the cost and availability of insurance. It is worth noting there are two types of mutual pools:

1. A licensed insurer that is mutually owned by relevant policyholders. In this case, the insurer is effectively issuing a guarantee of payment in the event of a valid claim and would therefore need to be authorised by APRA with requirements to hold very high-quality capital given the strength of the promise to policyholders.
2. A discretionary mutual pool that is not authorised by APRA. In this case payment of claims is ultimately discretionary (not guaranteed). There is more flexibility on capital in these circumstances.

APRA has observed examples of both types of mutual structure assisting industries, and both types of mutual structures are currently possible under the existing legislative and regulatory framework.

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Division/Agency: Australian Prudential Regulation Authority
Question No: APRAQON02
Topic: Corporate plan – Contribution to broader government initiatives
Reference: Hansard p. 14
Senator/Member: Senator David Van

Question:

Senator Van: […] Will APRA look at doing stress tests on, say, the collapse of a large part of the energy export industry and the flow-on effects that that would have on other industries, or the collapse of, for example, the ability to get insurance for resource projects et cetera? Given that either or those scenarios would provide major stress for institutions, is that the sort of stress test that you may look to do in the future?
Mr Byres: We haven't done those scenarios specifically, but depending on what comes out of the climate vulnerability assessments that we're doing now we may learn some things that help us think about how we might best do those sorts of scenarios in the future if we thought they warranted it. More generally though what I would say is, short of stress testing and looking at the worst scenario, we are very conscious of issues around particularly insurance affordability and availability. **Even if it's not the scenario that you painted in a potential stress test, we have in our corporate plan last year—and it will be in our corporate plan this year—highlighted that issue as one on which we need to contribute to broader government initiatives to try and help the community, not just in northern Australia but increasingly in other parts of Australia, make sure that there is access to affordable insurance, which we know is an increasing problem and we recognise we can probably help with**. We won't necessarily be able to solve it but we have identified it as work that we need to contribute to.
Senator VAN: While it's probably easy for me to find, could you provide that part of your plan to the committee on notice?
Mr Byres: Yes, no problem.

Answer:

The 2020-2024 APRA Corporate Plan can be found at:
https://www.apra.gov.au/sites/default/files/2020-08/APRA%27s%202020-24%20Corporate%20Plan.pdf

Relevant sections of the 2020-2024 APRA Corporate Plan are provided below:

Australia's general insurance industry (page 9)
Australia's general insurance sector incurred a particularly severe level of claims arising from a series of natural catastrophes prior to the onset of COVID-19. Whilst the events so far have impacted earnings rather than capital, there remains significant future risk of decreased business volumes, increased claims activity and more expensive reinsurance. The ultimate claims impact of COVID-19 is likely to remain uncertain for some time given the prospect of litigation across multiple classes of business (most prominently in business interruption insurance) and with further potential concerns arising in regard to the future availability and affordability of particular classes of insurance more broadly. However, in the face of these challenges, the general insurance industry continues to be resilient and well capitalised. Climate-change related impacts, including physical and transition risks of extreme weather events (e.g. bushfires, water scarcity), continue to be assessed by industry and reviewed by APRA.

Outcome: Maintain financial system resilience (page 18)
Insurance

- *APRA will protect the financial safety and soundness of insurers by focussing on key risk areas including capital, the sustainability of insurance products and responding to material risks and issues that could impact the viability/solvency of insurers.*
- *APRA will continue to focus on influencing the direction of the insurance industry in Australia to address sustainability and affordability issues and poor customer outcomes.*
- *APRA will continue to review reinsurance arrangements by analysing the impact of COVID-19 and the economic downturn on the stability of reinsurers, and take regulatory action where needed.*

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Friday 13 August 2021

Division/Agency: Australian Prudential Regulation Authority
Question No: APRAQON03
Topic: Climate risk – level of prioritisation
Reference: Hansard p. 15
Senator/Member: George Christensen, MP

Question:

CHAIR: The questions that I have, really have to do with the concept of climate risk. Again, all these you can take on notice. I'm just wondering where climate risk sits with APRA vis-a-vis other risks—wars, pandemics, cyberattacks, sovereign debt, political meltdown, all the rest of it. It would be interesting to know in what order you put these risks forward and how much emphasis you put on them to your regulated institutions.

Answer:

APRA is tasked to ensure the financial safety of individual financial institutions and promote the stability of the Australian financial system. To this end, APRA's prudential standards, and APRA's supervisory activities, cover the full spectrum of risk classes to which regulated financial institutions are exposed. This includes – depending on the industry and the entity's business model – risk classes such as credit risk, liquidity risk, market risk, outsourcing risk, business continuity risk, IT and information security risk, and risks relating to governance, culture, remuneration and accountability.

Further, APRA's supervisory activities will cover a wide range of risks – such as pandemics, cyberattacks or rapid credit growth – and APRA increases its supervisory intensity with respect to these risks where global or domestic circumstances warrant. APRA has only devoted quite limited resources to climate-related financial risks, relative to other risks, at this stage. However, APRA does consider that climate change poses financial risks to financial institutions, and in this context it is important that there is a good understanding of the implications for individual regulated entities and for the Australian financial system as a whole.

APRA's 2019-2023 Corporate Plan (available at https://www.apra.gov.au/sites/default/files/APRA%20Corporate%20Plan%202019-23_0.pdf) identified four key community outcomes that APRA would seek to achieve, and these community outcomes remained the longer-term objectives of APRA's 2020-2024 Corporate Plan (available at https://www.apra.gov.au/sites/default/files/2020-08/APRA%27s%202020-24%20Corporate%20Plan.pdf). These include:

- maintaining financial system resilience;
- improving outcomes for superannuation members;
- transforming governance, culture, remuneration and accountability across all regulated institutions; and
- improving cyber resilience across the financial system.

APRA's work in ensuring that its regulated entities understand and manage climate risks supports APRA's requirement that each entity's risk management framework must provide a structure for identifying and managing each material risk to ensure the institution is being prudently and soundly managed, having regard to the size, business mix and complexity of its operations.

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Friday 13 August 2021

Division/Agency: Australian Prudential Regulation Authority
Question No: APRAQON04
Topic: Risks associated with 'green bubble'
Reference: Hansard p. 16
Senator/Member: George Christensen, MP

Question:

CHAIR: A concern that I'd like a response to is that APRA seems to be focused on the very long term, at the risk of more immediate issues. Does APRA have a view on the inherent risks from the 'green bubble' that is government propping up the renewables sector with things like the renewable energy target and whether that poses a risk to financial institutions that have invested heavily in that area?

Answer:

Financial and other support for specific industries is a matter for Government. Industry-specific government support, together with a wide range of other factors, will however inform risk and investment decisions for lenders and investors. A focus of APRA's principles-based approach to supervision is that entities have effective processes in place to identify and manage risks, and that entities incorporate a comprehensive view of risk when making investment, underwriting and lending decisions. APRA expects that these risk management processes would also include consideration of any portfolio concentrations with respect to specific sectors or geographies.

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Friday 13 August 2021

Division/Agency: Australian Prudential Regulation Authority
Question No: APRAQON05
Topic: Risk analysis of subsidised intermittent power sources
Reference: Hansard p. 16
Senator/Member: George Christensen, MP

Question:

CHAIR: Has APRA undertaken or will it undertake any real-world analysis of real-world financial risks posed by increased levels of subsidised intermittent power sources driving out baseload plants, leading to power shortages?

Answer:

APRA has not undertaken any such modelling.