FINANCIAL SYSTEM INQUIRY

RESPONSE TO THE INTERIM REPORT

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AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY

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Glossary

ADI	Authorised deposit-taking institution
ANAO	Australian National Audit Office
AOFM	Australian Office of Financial Management
APRA	Australian Prudential Regulation Authority
APRA Act	*Australian Prudential Regulation Authority Act 1998*
ASIC	Australian Securities and Investments Commission
ATO	Australian Taxation Office
Banking Act	*Banking Act 1959*
Basel Committee	Basel Committee on Banking Supervision
Basel I	Basel Committee 1988, *International convergence of capital measurement and capital standards*, July, and Basel Committee 1996, *Overview of the amendment to the capital accord to incorporate market risks*, January
Basel II	Basel Committee 2006, *International Convergence of Capital Measurement and Capital Standards. A Revised Framework — Comprehensive Version*, June
Basel III capital	Basel Committee 2010, *Basel III: A global regulatory framework for more resilient banks and banking systems*, December (revised June 2011)
Basel III liquidity	Basel Committee 2013, *Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools*, January
CET1	Common Equity Tier 1
CFR	Council of Financial Regulators
CLF	Committed Liquidity Facility
Corporations Act	*Corporations Act 2001*
D-SIB	Domestic systemically important bank
FCS	Financial Claims Scheme
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
G-SIB	Global systemically important bank
IAIS	International Association of Insurance Supervisors
IMF	International Monetary Fund
Insurance Act	*Insurance Act 1973*
IRB	Internal ratings-based
IRRBB	Interest rate risk in the banking book
LCR	Liquidity coverage ratio
LGD	Loss-given-default
Life Insurance Act	*Life Insurance Act 1995*

LMI	Lenders mortgage insurance
LVR	Loan-to-valuation ratio
NSFR	Net Stable Funding Ratio
PPF	Purchased payment facility
RBA	Reserve Bank of Australia
RFC	Registered financial corporation
RIS	Regulation Impact Statement
RMBS	Residential mortgage-backed security
RSE	Registrable Superannuation Entity
SCCI	Specialist Credit Card Institution
SIFI	Systemically important financial institution
SIS Act	*Superannuation Industry (Supervision) Act 1993*
SMSF	Self-managed superannuation fund
SOE	Statement of Expectations
SOI	Statement of Intent
Wallis Inquiry	Commonwealth of Australia 1997, *Financial System Inquiry*

APRA's response to the Interim Report

The Financial System Inquiry's Interim Report sets out a diverse set of observations and policy options. In this submission, the Australian Prudential Regulation Authority (APRA) responds to those most relevant to APRA and its mandate, with the intention of providing further information and perspectives to aid the Inquiry as it proceeds to develop its final recommendations.

APRA agrees with many of the Inquiry's initial observations. In particular, APRA welcomes the Interim Report's observations that:

- the current regulatory model has proven robust and effective;
- regulatory mandates and powers are generally well defined and Australia's regulatory coordination mechanisms have been strong;
- the strong prudential framework, together with a proactive approach to supervision, contributed to Australia's resilience during the global financial crisis;
- in the post-crisis period regulators have applied the global reform framework in a manner and timeframe to best suit Australian market circumstances;
- strong, independent financial regulators are crucial to the efficient, stable, fair and accessible operation of the financial system; and
- to be able to perform their roles effectively, regulators need to be able to attract and retain suitably skilled and experienced staff.

Overall, the Interim Report indicates that Australia's current regulatory model has served Australia well and notes that, while submissions have not called for significant change, there is scope for improvement across a number of areas. Many of the challenges the Inquiry has set out to examine, such as the problem of 'too big to fail', are longstanding and complex. This submission is therefore intended to help identify advantages and disadvantages of various options. The submission also highlights that a number of areas examined by the Inquiry are interdependent, and each cannot be viewed in isolation.

In developing its vision for a financial system, including associated regulatory arrangements, it is important that the Inquiry bears in mind that the Australian financial system has already experienced a significant period of change. Both regulators and the regulated industry need time for these changes to be fully embedded, and for their benefits to be realised. Stability of policy settings and, where appropriate, simplification should be important goals, to minimise unnecessary costs arising from the need to assess fundamental structural changes or revised regulatory requirements.

APRA's responses to key issues raised in the Interim Report are summarised below, with references to APRA's initial submission where appropriate. Detailed responses on specific questions and policy options of most relevance to APRA are provided in the second part of this submission, presented in the order in which they appear in the ten chapters of the Interim Report.

Financial system stability

APRA welcomes the Inquiry's conclusion that Australia's prudential framework has held the Australian financial system in good stead. APRA supports broadly maintaining the current calibration of the framework, which it considers to be at the more conservative end of the global spectrum but not unduly so. Australia has been among the leaders in adopting the post-crisis international reform programme and this has ultimately benefited both industry and the Australian public by providing investors, both domestic and international, with confidence that Australian financial institutions are fundamentally sound. The cost of any lack of confidence would be significant.

The Interim Report points out that ongoing compliance with international minimum standards is important for maintaining the international market access and competitiveness of Australian institutions. At the same time, there are important reasons why APRA should, and does, exercise a degree of discretion in establishing appropriate prudential requirements in an Australian context. In implementing the post-crisis reforms, APRA has been sensitive to domestic conditions and policy objectives.

The Interim Report discusses the desire to promote cross-border comparability in prudential ratios, but this needs to be viewed against the primary goals of ensuring Australian institutions have adequate capital, and that the regulatory framework provides appropriate incentives for prudent risk management. Additional disclosures may help provide greater transparency, particularly in relation to the impact of APRA's policy choices, and APRA would support these. Most importantly, however, markets and rating agencies clearly understand that Australian authorised deposit-taking institutions (ADIs) are well capitalised. It is not evident that the current reporting of capital ratios leads to any material impact on access to, or cost of, funding for Australian ADIs.

The additional capital required by domestic systemically important banks (D-SIBs), which will apply to the major Australian banks from 2016, is a relatively new prudential tool and has been established taking into account the full suite of prudential requirements imposed by APRA. The calibration of the D-SIB capital surcharge will be monitored by APRA, having regard to future industry and international developments. Other proposals ultimately put forward by this Inquiry, including those in relation to competitive issues and financial stability, may also impact the appropriate level for D-SIB capital requirements.

APRA's prudential supervision of individual institutions not only protects the interests of depositors, policyholders and superannuation fund members, but also supports financial stability. Existing tools, supervisory processes and coordination mechanisms are adequate to address industry-level risks to financial stability: there seems little need for new instruments designed purely for macroprudential purposes, particularly as these tools are untested and the purpose for which they might need to be used is unclear.

The recent financial crisis demonstrated the importance of being able to quickly and effectively deal with failing financial institutions; where this could not be achieved, problems were significantly exacerbated. Strengthening APRA's resolution powers is an important and low-cost means of helping to address these concerns. Some modifications to the ADI Financial Claims Scheme could also be made to simplify its operation without undermining its effectiveness.

The Interim Report is appropriately concerned with the perception of an implicit government guarantee for the largest institutions, or those perceived to be too big to fail. While this perception may be mitigated somewhat by providing greater clarity regarding the circumstances in which private-sector stakeholders will bear losses should a large bank need to be restructured or recapitalised, achieving this objective while maintaining financial stability will not be easy. APRA welcomes the Inquiry's support for exploring practical approaches that may be appropriate for Australia. However, given many of these proposals are new and untested, a degree of caution is warranted in proceeding too quickly to firm recommendations ahead of international developments.

Competition

The Interim Report considers whether there is scope for ADI capital requirements to facilitate greater competition between large and small ADIs, particularly in relation to housing lending. As noted in APRA's initial submission to the Inquiry, although a differential does exist, it is considerably narrower than that suggested by a simple comparison of headline risk weights.

Nevertheless, the size of the differences that have emerged between the ADIs that use advanced credit risk modelling versus standardised methods to calculate capital requirements is currently the subject of review internationally. There is scepticism that modelled capital requirements are sufficiently conservative across the global banking system. This process ultimately is likely to generate policy proposals that will increase capital required for ADIs that use advanced modelling approaches for residential mortgages and other credit exposures. The Basel III leverage ratio will also reduce the benefit received by the large ADIs by effectively imposing a floor on the average risk weight across their portfolios.

More broadly, APRA is not supportive of policy proposals that would further increase the incentive for ADIs to provide housing finance over other forms of lending.

Superannuation and retirement incomes

The Interim Report discusses the important role of superannuation within the financial system, its regulatory structure and options for better supporting the post-retirement phase. Superannuation would benefit from policy stability to build long-term confidence and trust in the system and encourage long-term savings. It is critical, however, that there is holistic consideration of the policy settings in both the pre-retirement and post-retirement phases of the system so that a coherent, sustainable and stable retirement income policy framework, that is suitably flexible and principles-based, is able to be established and effectively implemented.

Longevity risk is a major risk for the sustainability of retirement income systems around the world. Changes to the superannuation regulations and the Age Pension means test to remove impediments to issuing products such as deferred lifetime annuities are desirable. However they are unlikely, on their own, to address all of the underlying reasons for the current and historic low level of demand for longevity protection products. The ability of the private sector to offer attractive longevity risk products will depend, among other things, on the extent of risk sharing between retirees and product providers, the availability of reinsurance or other risk transfer mechanisms, access to long-dated securities and the ability to adequately price longevity risk.

The Interim Report put forward the option of aligning regulation of APRA-regulated superannuation trustees and funds with that of responsible entities and registered managed investment schemes. APRA firmly supports the status quo. There were sound reasons for establishing the current regulatory approach at the time of the Wallis Inquiry – including the compulsory nature of superannuation savings, the lack of effective choice for a large proportion of members, the long-term nature of superannuation and the contribution of superannuation to tax revenue forgone – and these features remain prominent.

The Inquiry's focus on the efficiency of the superannuation sector and its costs and fees is appropriate. Assessment of the efficiency of the superannuation sector must, however, be framed in terms of the ultimate outcomes achieved for members. For any given pattern of contributions, members' outcomes are driven primarily by investment performance, but insurance and other benefit design aspects, fees, costs, taxes and the form and timing of benefits taken by members are also relevant considerations. It is important to take into account all of these factors when making comparisons with other jurisdictions.

APRA agrees with the Inquiry's view that it is too early to assess whether the MySuper reforms will achieve their objectives, including in reducing industry costs and fees. A review to assess the effectiveness of the MySuper regime would most appropriately be undertaken in a few years' time to allow a sufficient period for the reforms to be fully implemented.

Regulatory independence and accountability

APRA welcomes the Inquiry's support for the importance of regulator independence, including for APRA, and fully acknowledges that independence must be accompanied by strong and effective accountability mechanisms. As noted in its initial submission, APRA has substantial independence from Government in most respects but, over time, this has been eroded by constraints on its prudential, operational and financial flexibility.

APRA would therefore strongly support mechanisms that move it to a more autonomous budget and funding process, thereby enhancing APRA's operational independence and ability to conduct efficient forward planning for its operations. A more autonomous funding process would need to be accompanied by increased accountability and transparency regarding how APRA utilises its resources. APRA is committed to exploring enhanced accountability mechanisms that reinforce its independence while also providing relevant stakeholders with greater confidence that APRA is operating efficiently and effectively.

To effectively perform its role, APRA needs to be able to attract suitably skilled and experienced staff. This is more difficult if APRA is unable to maintain the relativities of its own employment conditions with those of the financial sector, from which APRA does the bulk of its recruitment. Any enhanced budgetary process should be designed with this in mind.

Response to specific issues raised in the Interim Report

Chapter 2 of the Interim Report: Competition

Regulatory capital requirements (page 2-11)

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Assist ADIs that are not accredited to use IRB models in attaining IRB accreditation.
- Increase minimum IRB risk weights.
- Introduce a tiered system of standardised risk weights.
- Lower standardised risk weights for mortgages.
- Allow smaller ADIs to adopt IRB modelling for mortgages only.

The Inquiry seeks further information on the following area:

- How could Government or APRA assist smaller ADIs attain IRB accreditation?

Under the internationally agreed Basel I capital framework that was introduced by the Reserve Bank of Australia (RBA) in 1988, loans for the purpose of housing were assigned a 50 per cent risk weight, which resulted in lower capital requirements relative to other forms of lending. This regime, with some minor refinements, continued until the Basel II framework was implemented by the Australian Prudential Regulation Authority (APRA) in 2008. Under Basel II, there are two methodologies for determining risk weights:

- a standardised approach, under which authorised deposit-taking institutions (ADIs) assign prescribed risk weights to particular types of loans; or
- with supervisory approval, an advanced (internal model-based) approach under which ADIs estimate the probability a customer will default, the exposure at the time of default and the loss-given-default (LGD), and input these into a supervisory formula which determines the relevant risk weight.

In developing the Basel II regime, the Basel Committee on Banking Supervision (Basel Committee) considered that, on average, banks utilising the model-based approaches should generate a slightly lower capital requirement than would be determined under the standardised approach. This was intended to provide incentives for banks to invest in the necessary data capture, risk analysis and risk management framework requirements, which should have benefits to banks more broadly than simply meeting regulatory capital requirements. APRA's implementation of Basel II was consistent with this objective: relative to Basel I, the overall outcome for Australian ADIs using the standardised approach was a five per cent reduction in total required capital and between zero and ten per cent for ADIs accredited to use the advanced approaches.

As detailed in APRA's initial submission to the Inquiry, the average risk weight for residential mortgage exposures for ADIs using the standardised approach is currently in the order of 39 per cent; the comparable figure under the internal ratings-based (IRB) approach is around 18 per cent.[1] These figures are, however, not directly comparable. Standardised risk weights are, by their nature, broad-brush representations of risk and are designed to achieve an appropriate aggregate level of capital for the ADI as a whole. IRB risk weights, on the other hand, are far more granular; they may be lower or higher than the standardised risk weights, depending on the specific risk characteristics of borrowers and the nature of the ADI's portfolio. The higher risk weight for residential mortgage exposures for smaller ADIs appropriately provides a buffer to cover risks associated with their high degree of geographic or product concentration and their relatively greater business, strategic and credit concentration risks compared with the larger, more diversified ADIs. The larger ADIs are also subject to other capital requirements that are not applied to ADIs using the standardised approach. These additional requirements include a mandatory capital charge for interest rate risk in the banking book (IRRBB) and, for the major banks, an additional capital surcharge of one percentage point reflecting their systemic importance.

Nevertheless, as presently calibrated, the more risk-sensitive IRB approach generates, on the whole, a lower capital requirement for residential mortgage exposures than the standardised approach. As noted above, the differential is partly explained by risk, and by the deliberate structure of incentives within the framework. However, the benign housing experience in Australia over a very long period means that it is difficult to derive an appropriately conservative calibration for the IRB approach based on historical losses. This requires continued vigilance as to the robustness of risk estimation by ADIs using the IRB approach. APRA has already reflected this concern in its 20 per cent LGD floor for residential mortgage exposures; a number of other jurisdictions have, in more recent times, implemented similar measures in response to concerns about low IRB risk weights for residential mortgage exposures.

The Interim Report seeks further information regarding the potential for Government or APRA to provide assistance to smaller ADIs in attaining IRB accreditation. This could involve the development of a central database of the historical default experience across Australian ADIs that would be available to the smaller ADIs that may lack sufficient historical data. Industry investment in a pooled credit loss database facility (which could extend beyond residential mortgage exposures to cover other common types of credit) would be a welcome development.

IRB accreditation is not, however, solely based on sufficiency of data for approval of credit risk models for regulatory capital purposes. Pooling of default data may address data paucity issues, but ADIs would still need to make, and maintain, substantial investment in risk measurement and modelling systems and controls including in specialist staff skills, to ensure such models were fit for purpose. Using the models within an ADI's own internal risk management, capital planning and remuneration practices (the so-called 'use test') is an important prerequisite for supervisory accreditation. APRA would not accredit 'black box' models developed and maintained by parties other than the ADI seeking accreditation and that were not sufficiently understood by the ADI itself or embedded into its risk management system.

[1] APRA 2014, *Financial System Inquiry Submission*, 31 March, page 74.

It is important to note that, if smaller ADIs were to successfully obtain approval for use of the IRB approach for their credit portfolios, it is unlikely that the average risk weight for residential mortgage exposures for these ADIs would automatically settle at the same level as that of the major banks. As detailed above, the level of geographic and product concentrations, and the impact such concentrations have had on each ADI's default experience, would likely produce an average risk weight higher than that of the larger, more diversified ADIs.

An important feature of APRA's advanced modelling accreditation process is that ADIs seeking accreditation to model one type of risk (e.g. credit risk) must also seek accreditation for all other types of risk. For the largest ADIs that use the IRB approach for their credit portfolios, this has involved accreditation to also use the advanced approaches for IRRBB and operational risk.[2] This 'all-in' approach is designed to prevent ADIs from 'cherry picking' the risks for use of the advanced approaches. This could otherwise lead to a situation in which ADIs only seek accreditation for models where the capital requirement would fall, but not for other risks where modelling indicates risk is being underestimated. APRA also favoured the all-in approach to foster improved risk management and risk measurement practices across all material risks facing ADIs.

This all-in approach is not followed universally in other jurisdictions. In particular, the modelling of operational (i.e. non-financial) risk is often not a requirement for IRB accreditation. Operational risk can be particularly difficult to model, especially for smaller ADIs; it is considerably more challenging than modelling credit-related risks. APRA is open to reconsidering whether to maintain the requirement that ADIs must model non-financial (i.e. operational) in addition to financial (credit and market) risks as a condition to be accredited to use the IRB approach. APRA considers it appropriate to await further international developments, including potential revisions to the standardised approach to operational risk, before committing to change the current framework.

Beyond separating broad classes of risk, however, the Basel framework does not allow for the selective implementation of the IRB approach across individual credit portfolios. This stance is critical for protecting against cherry picking; it would also undermine the ability of ADIs to demonstrate they meet the use test. APRA has always made clear that in order to achieve accreditation to use the IRB approach, ADIs needed to have commensurately stronger and more sophisticated risk management and governance across all of their activities. Cherry picking portfolios for use of the IRB approach runs contrary to the underlying conceptual approach.

Other options canvassed in the Interim Report involve changes to risk weights under the standardised approach, which would be contrary to the Basel framework. There is no compelling reason to adopt policy changes that are weaker than the internationally agreed Basel framework in an attempt to address competitive concerns. Indeed, as noted in the Interim Report, '[t]he Inquiry considers it appropriate for Australia to maintain its compliance with the global standards, such as the Basel framework for banking'.[3] Furthermore, it is undesirable to make changes to the prudential framework that would provide further incentives for residential mortgage finance over other forms of credit.

The Interim Report suggests that 'standardised risk weights do not provide incentives for the ADIs that use them to reduce the riskiness of their lending'.[4] This is not the case in Australia: a simple tiered system of risk weights already exists. By way of example, consider a standard residential mortgage loan with no mortgage insurance. If the loan-to-valuation ratio (LVR) is greater than 90 per cent, the loan receives a 75 per cent risk weight. Capital requirements decrease by one third (i.e. to a 50 per cent risk weight) if the LVR is reduced below 90 per cent and by a further third (i.e. to a 35 per cent risk weight) if the LVR is reduced below 80 per cent. There are also incentives for ADIs to obtain mortgage insurance; in general, risk weights for higher LVR loans are reduced by around one-quarter if mortgage insurance is obtained.

[2] These ADIs already had accredited models for traded market risk.

[3] Financial System Inquiry 2014, *Interim Report*, July, page 3-39.

[4] Ibid, page 2-10.

The opposite is true for non-standard loans, where risk weights relative to standard loans are increased by 25 to 50 per cent.

The effect of this tiering of risk weights is that under a minimum Common Equity Tier 1 (CET1) capital ratio of 7 per cent, ADIs with low-risk housing portfolios, i.e. all loans receiving a 35 per cent risk weight, could operate with leverage of around 40:1. In this case they could fund their portfolio with $40 of deposits and other debt for each $1 of equity. At the other end of the spectrum, a loan portfolio of 100 per cent risk-weighted mortgages would be limited to leverage of around 14:1. It is not, therefore, correct to conclude that the standardised approach to credit risk is insensitive to risk.

If the Inquiry concludes that it is appropriate for APRA to consider a narrowing of the differential in risk weights for residential mortgage exposures between the standardised and IRB approaches to credit risk, the only proposed option in the Interim Report that would ensure continued compliance with the internationally agreed Basel framework would be to increase the average risk weight used by banks operating under the IRB approach.

As detailed in APRA's initial submission, the Basel Committee is currently reviewing the validity and reliability of risk weights generated under the IRB approach in response to studies showing that the variability in such measurements is much greater than could be explained by differences in underlying risks. The studies have, in particular, focused on low-default portfolios, where loss history is scarce and reliable risk estimation and modelling is therefore problematic. Internationally, this work has focused on sovereign, bank and large corporate exposures. Many aspects of this work also have relevance to Australian residential mortgage markets, where given the paucity of data generated by periods of genuine stress, default and loss estimates inherently require judgement.

A plan for dealing with this variability will be submitted by the Basel Committee to the G20 for endorsement later this year. In all likelihood, this will involve some degree of limitation on bank modelling practices, as well as potentially including some floors or benchmarks against which IRB risk weights will need to be assessed. As a Committee member, APRA is actively participating in this review.

In addition, the leverage ratio contained in the Basel III reforms will, as currently calibrated, effectively place a floor on the average risk weight across a bank's entire loan book.[5] Depending on the final calibration, this effective floor is likely to be in the order of 35-50 per cent. Analysis by APRA indicates that the leverage ratio will have a more significant impact on ADIs using the IRB approach than those using the standardised approach.

Increasing IRB risk weights could be accomplished in various ways, including further increases to APRA's minimum LGD requirement for residential mortgage exposures, or preferably through revised technical assumptions within the IRB framework. This issue should be considered in the context of the broader work being undertaken by the Basel Committee, as the impact of changes to risk weights needs to be carefully analysed. Greater prescription in IRB estimates may reduce incentives ADIs currently have to invest the resources and management attention required to model these estimates accurately. It may also make risk weights potentially less risk sensitive, and may change relative capital requirements across asset classes. Any considerations on this issue also need to be viewed within the context of the Inquiry's deliberations regarding the positioning of Australia's prudential framework relative to the global median.

[5] The final calibration of the leverage ratio remains to be agreed by the Basel Committee. The leverage ratio is not scheduled to become a binding requirement on ADIs before 2018, although disclosure requirements are scheduled to commence in 2015.

Funding costs (page 2-16)

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Provide direct Government support to the RMBS market.
- Allow RMBS to be treated as a high-quality liquid asset for the purpose of the liquidity coverage ratio.

Securitisation offers a number of advantages to ADIs. Through securitisation an ADI may borrow at rates determined by the quality of the expected cash flows from the securitised assets, rather than its own credit rating. This enables ADIs, particularly smaller ADIs that have lower comparative ratings or limited access to wholesale funding markets, to raise funds at more competitive rates from a wider range of sources. Another advantage is that ADIs may be able to reduce the amount of regulatory capital APRA requires them to hold against the risks they take by removing securitised assets from their balance sheet for capital adequacy purposes. In general, smaller ADIs use securitisation for both funding and regulatory capital relief whereas larger ADIs, which may have more diverse funding sources, often undertake some securitisations for funding purposes only.

During the global financial crisis, public sector intervention was required to underpin demand in the Australian securitisation market. The Australian Office of Financial Management's (AOFM) purchase of AAA-rated tranches of Australian issuers' residential mortgage-backed securities (RMBS), including non-ADI issuers, supported competition in Australia's residential mortgage market and provided liquidity to some ADIs that were constrained in their ability to raise funding. The AOFM's intervention was designed as a temporary measure to encourage a transition towards a more sustainable securitisation market not reliant on public sector support. By 2013, this support had been phased out and issuance of Australian dollar-denominated RMBS was at the highest level since 2007, as private sector demand increased.[6] Issuance has increased not only for the largest banks but also for other ADIs and mortgage originators, with a number of smaller issuers returning to the market after an absence of several years.

Options included in the Interim Report relating to direct government support of the RMBS market effectively transfer the credit risk associated with the underlying securitised exposures to the public sector. Unlike the intervention during the global financial crisis, the options in the Report extend beyond the support of highly rated tranches of RMBS to lower-rated tranches and to the outright purchase of residential mortgage exposures from originating ADIs. The consideration of the appropriateness of these options is an issue for Government, but the general provision of additional funding for housing purposes does not seem necessary given the current level of housing finance availability. A more nuanced approach might be to consider the merits of pre-positioning appropriately priced backstop arrangements, which would only be activated in the event of severe financial market disruption. This may help alleviate the risk of a sharp contraction in credit provision during a period of financial stress, while at the same time avoiding support for credit expansion when it is not demonstrably needed.

[6] Debelle, G. 2014, 'The Australian Bond Market', speech to the Economic Society of Australia, Canberra, April.

APRA recently released a discussion paper regarding the potential for simplification of the prudential approach for securitisation in the capital adequacy framework.[7] The proposed approach to securitisation includes the following features:

- a set of key principles that apply to securitisation, rather than an expanded set of prudential requirements;
- a simple two credit class structure, which reduces the likelihood of opaque risk transfer and enhances benefits for system stability;
- a simple 'skin-in-the-game' requirement to mitigate agency risks;
- explicit recognition of funding-only securitisation, with a simple but robust prudential regime that also allows for revolving securitisations or master trusts;
- simpler requirements for capital relief, matching risk to the amount of regulatory capital held;
- better integration of securitisation with the ADI liquidity regime; and
- clarification of the treatment of warehouses and similar structures.

Given the securitisation market in Australia has been an important contributor to competition, efficiency and contestability in the ADI industry, the reforms to the capital adequacy framework are intended to assist in the further development of the securitisation market by instituting a prudential framework that is clear and simple for stakeholders to understand.

As detailed in APRA's May 2013 Discussion Paper *Implementing Basel III liquidity reforms in Australia*, the use of RMBS as liquid assets within the liquidity framework is subject to a number of qualifying criteria. High-quality liquid assets must trade in large, deep and active repo or cash markets characterised by a low level of concentration, and must have a proven record as a reliable source of liquidity even during stressed market conditions. Subject to APRA's discretion, RMBS rated AA or higher and not issued by the ADI itself or any of its affiliated entities can be recognised for this purpose, within certain quantitative constraints.

Consistent with the review of the eligibility of marketable instruments for the purpose of the Liquidity Coverage Ratio (LCR), RMBS were considered by APRA against the qualifying criteria. This review took into account the amount of these instruments on issue, the degree to which the instruments were broadly or narrowly held, and the degree to which the instruments were traded in large, deep and active markets. Particular attention was given to the liquidity of these instruments during the market disruptions of 2007–2009 in the more acute phases of the global financial crisis, when the market for RMBS effectively closed at the same time that ADIs' need for liquidity was most acute.

Based on this review, APRA concluded in 2013 that RMBS in Australia were not eligible as liquid assets for the purpose of the LCR. To rely on instruments that were not reliably liquid in times of stress would undermine the intent of the LCR, and give a false sense of comfort that ADIs could survive a period of stress without the need for public sector support.

[7] APRA 2014, *Simplifying the prudential approach to securitisation*, April.

The market for RMBS has not materially changed since 2013. The recognition of such securities as liquid assets for the purpose of the LCR would be a concessionary treatment and, therefore, a deviation from the Basel framework and inconsistent with the Inquiry's view that it is appropriate for Australia to maintain its compliance with that framework. If the Government chose to provide direct support to the RMBS market, this could provide greater potential for a liquid RMBS market to develop and, importantly, be maintained even in times of stress. Even so, full recognition of RMBS as liquid assets would be dependent not simply on the capacity of ADIs to issue new RMBS (which most support mechanisms are designed to aid), but critically on the ability of holders of those securities to liquidate their holdings quickly, and without material loss, when needed.

Despite the above, it is not the case that holdings of RMBS do not receive any recognition within APRA's LCR framework: RMBS, including those issued by smaller ADIs, that are repo-eligible with the RBA for normal market operations are also eligible collateral for the Committed Liquidity Facility (CLF) with the RBA.[8] Therefore, ADIs subject to the LCR regime that use the CLF to meet part of their requirement for liquid assets can support this using eligible RMBS.

8 Reserve Bank of Australia 2011, *Media Release: The RBA Committed Liquidity Facility*, 2011-25, 16 November.

Lenders mortgage insurance (page 2-23)

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Decrease the risk weights for insured loans.

The regulatory capital framework for ADIs has long reflected the risk-mitigating properties of lenders mortgage insurance (LMI) in determining the amount of capital necessary to support insured residential mortgage exposures. The distinction between insured and uninsured loans was first made by the RBA in its then role of prudential supervisor in 1994: broadly speaking, high-LVR and non-standard loans received a 50 per cent capital concession if covered by LMI.[9]

Since the introduction of the more risk-sensitive Basel II framework in 2008, the difference in regulatory capital requirements for insured and uninsured loans has narrowed somewhat:

- under the standardised approach to credit risk, a more granular set of residential mortgage risk weights was introduced. For all standard mortgage loans with an LVR above 80 per cent, the reduction in risk weight (and hence capital requirements) is between one-quarter and one-third. For non-standard loans, there is a similar sized reduction across all LVR levels, with the exception of loans with LVRs above 100 per cent; and
- under the IRB approach, ADIs may also recognise LMI in their LGD estimates, although APRA has set a floor of 20 per cent to the LGD estimate that may be used. This floor is in response to ADIs' inability to satisfy APRA regarding the credibility of their downturn LGD estimates. One effect of this floor is to limit the extent of the capital benefit to ADIs approved to use the IRB approach that can be recognised for the use of LMI.

APRA also reduced the criteria for eligible LMI under the capital framework: eligible LMI need only provide cover for losses of 40 per cent or more of the original loan amount (or outstanding balance if subsequently higher), rather than 100 per cent coverage as previously required.

Following these changes, LMI continues to be used as a risk mitigant by ADIs, including the ADIs that are accredited to use the IRB approach. For these lending institutions, LMI continues to be seen as useful in smoothing out the normal variability in losses that occurs over time. LMI also provides useful support for ADIs in the event of substantial idiosyncratic lending losses and helps diversify regional concentrations of risk. However, given their stronger credit ratings relative to the independent LMI providers, it would not be appropriate for the largest ADIs to seek to rely entirely on LMI to provide protection against losses in periods of severe stress. In the event of a major system-wide housing downturn, the equity available to the largest ADIs is many multiples of the financial resources available to the LMI industry.

With respect to the assumption of a minimum 20 per cent LGD estimate, APRA remains open to the prospect of ADIs accredited to use the IRB approach being able to model and demonstrate the amount of risk reduction that should be credited to LMI for capital purposes. To date, the industry has not produced convincing evidence for relaxing this assumption. Indeed, there have been suggestions that the current floor is too low.

[9] Reserve Bank of Australia 1994, *Press Release: Statement by the Governor, Mr Bernie Fraser - Monetary Policy to Tighten*, 94-11, 17 August.

The above considerations have important implications for financial system stability and establishing appropriate ADI capital requirements. As noted elsewhere in this submission, given the systemic importance of housing-related risks to the Australian banking system, the Inquiry should be wary of proposals that would facilitate further reductions in capital requirements due to risk transfer arrangements unless it could be demonstrated that the risk transfer would be effective even in times of system-wide stress. Decreasing the risk weight under the IRB approach for residential mortgage exposures covered by LMI also potentially sits at odds with the other policy options proposed in the Interim Report to reduce the differential in risk weights between the standardised and IRB approaches.

Accordingly, APRA does not support any proposition to further decrease risk weights for LMI-insured loans.

Insurance sector (page 2-41)

The Inquiry would value views on the costs, benefits and trade-offs of the following alternatives:

- No change to current arrangements.
- Ensure aggregators are able to use automated processes to seek quotes from general insurance websites.
- Create comparison categories for insurance products that aggregators could use to compare the value of different products.

The Inquiry seeks further information on the following areas:

- Would opening up state- and territory-based statutory insurance schemes to competition improve value for consumers?
- How could insurance aggregators provide meaningful comparisons of policies with different levels of coverage?

Role of aggregators

Aggregators can serve as a useful 'one-stop shop' to provide information to consumers about products available for purchase. Aggregation services will generally deliver the best outcome for consumers where the product being sourced is largely homogenous and hence where price is a (if not the) key distinguishing feature. In these circumstances, consumers can readily compare and contrast products and pricing to ensure they find one that best suits their needs.

As noted in the Interim Report, the price of insurance is important, but value can only be adequately assessed with an understanding of the key benefits and conditions of the product (e.g. coverage, limits on amount of cover, exclusions, excesses and service levels). If an aggregator focuses almost exclusively on the comparison of insurance premiums, consumers may not be aware of, let alone actively consider, differences in the terms and conditions of the policies they are comparing. This issue was highlighted in a recent review by the United Kingdom Financial Conduct Authority which found that some aggregators in that market have not always taken reasonable steps to provide consumers with the appropriate policy information to allow them to make informed choices.[10] Not only does an over-emphasis on price potentially lead to ill-informed consumer decisions, it also encourages competition by insurers purely on the basis of premium rates rather than the full value of the services they offer.

The widespread use of aggregators could conceivably lead to increases in premium rates because of the impact they can have on insurer experience. First and foremost, aggregators earn income from commissions paid by insurers for business written. This can add to insurers' costs, which in turn would likely be reflected in premium rates. In addition, insurance pricing is not an exact science and different insurers will typically have different prices for the same risk. This means that, at any one time, an insurer will likely be under-pricing some risks, and over-pricing others. The use of aggregators can lead to insurers winning a disproportionate share of business for which they have inadvertently under-priced. This will adversely affect their profitability and the profitability of the industry as a whole. Insurers may respond by increasing premium rates to allow them to continue to earn an acceptable return to shareholders. While this has benefits in the form of driving more accurate insurance pricing, any benefit to consumers from initially lower premiums may be reduced over time.

[10] Financial Conduct Authority 2014, *Thematic Review TR14/11 - Price comparison websites in the general insurance sector*, July.

Where aggregators generate increased frequency of customer switching, insurers' costs will increase because of the associated administration expenses. Again, insurers can be expected to increase premium rates to restore profitability.

As to the specific proposals identified in the Interim Report, APRA notes that:

- compelling insurers to provide their products through aggregator websites is potentially problematic since there are no barriers to entry for aggregators and insurers need to be satisfied with the associated commercial arrangements for each one;
- comparison categories may aid comparison, but do not solve the underlying problem of comparing differences in terms and conditions that can exist even where policies are targeted, for example, at particular consumer categories; and
- in principle, it would be possible to design a comparator site that enabled consumers to compare both price and key policy terms and conditions. However, there is a balance between simplicity and complexity, and meaningful comparisons may not always be feasible.

State- and territory-based statutory schemes

Private insurers currently operate in a number of state-based statutory insurance schemes, including the compulsory third-party insurance schemes in New South Wales and Queensland. APRA works cooperatively with the state-based regulators of these schemes to ensure the effective performance of their respective regulatory functions. There should be no in-principle concerns with private insurers increasing their participation in state- and territory-based statutory insurance schemes, provided they continue to meet APRA's prudential requirements. These requirements are designed to ensure that an insurer's governance, risk management and financial strength are appropriate, and they play an important role in protecting the interests of policyholders.

The impact on premiums and consumer value from opening up statutory schemes to private insurers will depend to a large extent on the existing basis for pricing. If the state- and territory-based schemes include organisations that operate on terms that may be unprofitable, or involve price controls that limit the ability of insurers to earn an appropriate return on the capital they need to invest, the attractiveness to new entrants of entering these markets will be limited.

Chapter 3 of the Interim Report: Funding

Housing and household leverage (page 2-57)

The Inquiry seeks further information in the following area:

- What measures can be taken to mitigate the effects of developments in the housing market on the financial system and the economy? How might these measures be implemented and what practical issues would need to be considered?

APRA concurs with the Interim Report's conclusion that since the Wallis Inquiry, the exposure of the financial system to the housing market has significantly increased. Residential mortgages now account for about 60 per cent of the banking system's domestic loan portfolio, compared with around 50 per cent two decades ago and a current range of 20–40 per cent for most other developed economies.[11] As outlined in APRA's initial submission, the level of housing lending reflects a complex interplay of demand and supply factors, including the continuation of longer-term trends in the economy that are largely outside the influence of prudential regulation.

Given its significance to ADIs' business, developments in the housing market have been a significant area of supervisory focus for APRA over much of the past decade – well before the lessons of the global financial crisis became apparent. At present, this closer supervisory attention has been driven by a combination of factors, including:

- the continued growth in the share of residential mortgage exposures on the banking system's aggregate balance sheet;
- higher levels of household leverage, albeit that this has plateaued in more recent times;
- the low interest-rate environment persisting at present;
- house prices that currently are at the higher end of the recent historical range relative to income;
- strong investor demand (particularly in Sydney and Melbourne), which could be a sign of increasing speculative activity;
- competitive pressure on credit standards; and
- greater access to credit by marginal borrowers.

Housing lending has historically demonstrated a low and stable risk profile compared with other lending exposures in Australia. Nevertheless, this has not always been the case overseas and ADIs' aggregate housing exposures, simply by virtue of their size, represent a source of systemic risk. The best means of mitigating the effects of adverse developments in the housing market on the financial system is continued vigilance by both regulated institutions and APRA, including active monitoring of credit quality and capital sufficiency, undertaking regular stress-testing exercises and, most importantly, strong oversight of ADI risk management and lending standards.

[11] APRA 2014, *Financial System Inquiry Submission*, 31 March, Figure A.4, page 89.

As part of its routine supervisory activities, APRA undertakes regular onsite prudential reviews of ADIs' lending practices. These reviews enable the identification of emerging issues and trends across the industry. APRA also analyses data to monitor the performance of ADIs' housing portfolios and regularly surveys ADIs as to any changes in their credit standards, which allows benchmarking across the industry and identification of potential outliers. APRA's recent communication with the boards of the largest ADIs also sought assurance regarding their own oversight of the risk associated with their housing portfolios.

Earlier this year APRA consulted on new guidance for ADIs on sound risk management practices for residential mortgage lending.[12] APRA expects to finalise this guidance shortly.

In addition to this programme of active supervision, the impact of risks on APRA-regulated industries is periodically assessed through stress-testing exercises. Stress testing is an integrated part of prudential supervision and the stress test results provide additional insights into areas of potential vulnerability. Industry stress tests, in combination with supervisory reviews of institutions' own stress-testing programmes, provide a basis to assess higher-risk lending, sources of potential loss, and capital resilience. This is an important part of APRA's supervision of risks in the housing market.

APRA's 2014 stress-testing exercise covers 13 large ADIs, which together account for around 90 per cent of total industry assets. The stress test focuses on potential risks in the housing sector, with scenarios involving sharp increases in unemployment, significant falls in house prices and changes in interest rates. Australia has not, in recent history, experienced a severe housing market downturn. Scenarios based on historical experience therefore tend to produce fairly benign outcomes and APRA's scenarios are therefore also benchmarked against overseas experience. These scenarios are generally more severe than those considered to date by Australian institutions in their own stress-testing programmes.

With respect to regulatory settings, it is sometimes asserted that the relative prudential capital requirements have influenced the allocation of ADI lending to housing. Capital requirements are designed to reflect the risk of particular exposures, and on that basis should be broadly neutral with respect to the relative cost to the business. Nevertheless, as discussed previously, the Basel II reforms in 2008 did lead to a substantial reduction in the capital requirement for residential mortgage exposures relative to prior levels. It is likely that the benign housing experience in Australia over a very long period, coupled with profitable margins, has been a much greater factor in the expansion in ADI lending in this area. In addition, for both the standardised and IRB approaches to credit risk for housing lending, APRA implemented more stringent capital requirements relative to the Basel requirements. This has proved prescient given recent similar moves among other Basel Committee member countries.

[12] APRA 2014, *Draft Prudential Practice Guide 223 Residential Mortgage Lending*, May.

Impact investing and social impact bonds (page 2-75)

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Provide guidance to superannuation and philanthropic trustees on impact investment.

The requirements and guidance regarding investment strategy and investment governance that are currently provided in the *Superannuation Industry (Supervision) Act 1993* (SIS Act), as well as APRA's prudential standards and prudential practice guides, are relevant to all investment decisions by superannuation trustees. The SIS Act does not prohibit or preclude impact investment as long as the requirement to act in the best interests of beneficiaries is met. *Prudential Standard SPS 530 Investment Governance* (SPS 530) sets out APRA's requirements regarding an investment governance framework for Registrable Superannuation Entity (RSE) licensees. This framework must include the investment strategies for the whole of each RSE, and for each investment option, as required by the SIS Act. SPS 530 does not prohibit impact investment where appropriate risk and return considerations are met. Indeed, the standard does not make any distinction between different types of investments.

The requirements and guidance regarding investment strategy and investment governance in the SIS Act and SPS 530 are relevant to all investment decisions by superannuation trustees, including decisions on impact investment. Trustees must consider such investments on their merits and in the context of their overall investment strategy, and are expected to have a sound understanding of the risk and return characteristics of all of the investments used to implement the strategy. APRA would be opposed to weakening the existing requirement that trustees act in the best interests of beneficiaries as a means of encouraging more social impact investment. Working within the existing statutory framework APRA would, however, be open to considering the need for additional guidance regarding social impact investment, to the extent that a lack of clarity regarding APRA's expectations was seen to be an unnecessary barrier to additional social impact investment by trustees.

The banking system (page 2-81)

The Inquiry seeks further information on the following areas:

- What effect is the implementation of the Basel III capital and liquidity regimes in Australia expected to have on the cost of funds, loan pricing and the ability of banks to finance new (long-term) loans? How large are these effects expected to be?
- What share of funding for ADIs is expected to come from larger superannuation funds over the next two decades? What effect might this have on bank funding composition and costs? What effect will this have on the ability of ADIs to write long-term loans?

Any analysis of the impact of regulatory changes on ADIs' cost of funds and loan pricing needs to take account of the changed operating environment faced by Australian ADIs before and after the global financial crisis. Prior to 2007, wholesale funding was relatively inexpensive, as risk premiums were low. As a result, a number of ADIs became more dependent on offshore wholesale funding to augment traditional retail deposit bases, and some ADIs made extensive use of securitisation markets to fund their residential mortgage lending. The ready availability of cheap wholesale funding from offshore also meant that there was less need to compete for domestic sources of retail funding to meet lending growth.

The global souring of confidence in banks and structured credit arrangements from late 2007 onward resulted in large increases in wholesale funding costs, particularly for longer maturities, and reduced access to longer-term funding sources, other than for the most highly rated banks. During the crisis, securitisation markets virtually ceased to function. Since 2008, the spike in funding costs has significantly abated, but retail deposit funding has subsequently also become more expensive, as ADIs have more aggressively competed for this source of funding in the face of higher wholesale borrowing costs.

These shifts make it difficult to isolate the direct impact of regulatory reform. Changes to ADIs' cost of funds and loan pricing reflect the complex interaction of a range of factors: regulatory reform is but one. Internationally, the analysis of the programme of post-crisis reforms has followed a cost and benefit model.[13]

The cost impact in the chain of economic effects of, for example, higher regulatory capital ratios involves:

- higher equity ratios for banks;
- higher weighted funding costs (including debt and equity funding) and lower return on equity;
- banking institutions increasing lending rates to restore some of their lost return on equity;
- borrowers increasing their aggregate borrowings more slowly than would otherwise have been the case; and
- gross domestic product (GDP) growing more slowly than would otherwise have been the case, for most of the business cycle.

[13] Basel Committee on Banking Supervision 2010, *An assessment of the long-term economic impact of stronger capital and liquidity requirements*, August.

The benefit chain involves:

- higher equity ratios for banks;
- safer banks, which can therefore borrow funds and raise capital more cheaply;
- reduced failure of banks and impairment rates; and
- reduced risk and potential depth of financial crises.

Various international studies have concluded that the costs of reforms are outweighed by the benefits. In calibrating the Basel III requirements, the Basel Committee was guided by, among other things, the work of its Long-term Economic Impact working group, which found that:

> *'While empirical estimates of the costs and benefits are subject to uncertainty, the analysis suggests that in terms of the impact on output there is considerable room to tighten capital and liquidity requirements while still yielding positive net benefits.'*[14]

Subsequent analyses have supported that conclusion. For example, the International Monetary Fund (IMF) concluded that:

> *'[A]ssessments of the economic costs and benefits, both transitional and long term, of the Basel III capital and liquidity standards have shown that the long-term benefits vastly exceed the transitional costs.'*[15]

Similar conclusions have been reached in studies by the Bank for International Settlements and the Organisation for Economic Cooperation and Development (OECD).[16]

APRA agrees with the conclusions of the international studies that the immediate costs of the Basel III reforms are relatively minor and outweighed by the benefits of maintaining an appropriately conservative level of banking regulation in Australia. The Basel III reforms were developed in response to deficiencies in the capital framework identified during the global financial crisis, which saw the collapse of banking institutions around the world and significant long-lasting impairment of many national economies.

Leaving aside any reform of prudential requirements, the Australian banking industry and its funding providers quickly understood that sound ADIs need much more resilient balance sheets than prevailed before the crisis. In response to market expectations, the industry strengthened its capital and liquidity position well in advance of APRA's new prudential requirements. As other countries have implemented higher minimum capital requirements, including for systemically important banks, these expectations have only increased over time. Some of this strengthening may have occurred in anticipation of prudential reforms, but APRA's view is that Australian ADIs, in common with widespread global practice, had already revealed their preference for substantially stronger balance sheets. As a result, Australian ADIs have been well placed to meet the higher Basel III requirements.

[14] Ibid, page 1.

[15] International Monetary Fund 2012, *Global Financial Stability Report: Restoring Confidence and Progressing on Reforms*, October, page 83.

[16] Bank for International Settlements 2010, *Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements. Final report*, December, and Slovik P. and Cournède B. 2011, *Macroeconomic Impact of Basel III*, OECD Economics Department Working Papers, No. 844.

APRA has set out a quantification of potential impacts in its Basel III capital and liquidity Regulation Impact Statements (RISs).[17] The estimated loan rate increase following implementation of the Basel III capital rules for an average non-housing loan by a large Australian bank was estimated to be of the order of 0.10 per cent per annum. The increase for a home loan was estimated at around 0.04 per cent per annum.[18] These outcomes will vary depending on the size of the ADI, its capacity to pass through the cost of higher equity funding, the extent to which the increased security of the ADI reduces the return on equity demanded by shareholders, the relative riskiness of the loan and a range of other factors. Irrespective of the assumptions made, the key point is that the loan pricing effects of the new minimum capital requirements are very small relative to other factors. The impact of changes in the risk-free rate and the spread of funding costs over the risk-free rate, for example, would be far more significant than any reasonable estimate of the loan pricing effects associated with enhanced minimum capital requirements.

APRA's RISs also addressed the estimated impact of the implementation of the LCR, which will come into force on 1 January 2015 and will only apply to larger ADIs.[19] As detailed in the RIS, the average loan rate increase following implementation of the Basel III liquidity rules is estimated at 0.03 per cent per annum, which is again a relatively small increase relative to overall changes in funding costs that can occur from year to year.

In addition to the LCR, the Net Stable Funding Ratio (NSFR) will also apply to some ADIs from 1 January 2018. The NSFR will likely prescribe a minimum amount of longer-term and stable funding that must be sourced by ADIs as a result of the volume of longer-term assets on their balance sheet. This requirement is designed to limit over-reliance on short-term wholesale funding and encourage a better assessment of liquidity risk. The NSFR requirement has not yet been finalised by the Basel Committee, which makes it difficult for APRA to quantify the impact of its implementation at this stage. It is unlikely, however, that the final implementation of the NSFR will force ADIs to materially increase the average tenor of their funding beyond that which has already occurred in response to vulnerabilities that became apparent during the financial crisis.

It is difficult to assess the extent of superannuation investments flowing, directly and indirectly, into the banking system. Over the past decade, the share of large superannuation funds' assets directly invested in cash and deposits with ADIs has risen from under three per cent in 2004 to almost eight per cent in 2013.[20] Most of this increase occurred after the onset of the global financial crisis, as trustees (often as a result of member investment choice) sought lower risk exposures in capital guaranteed products in the face of significant market volatility. This also reflected an increased awareness of liquidity risk, and the subsequent premium placed by large superannuation funds on assets that are at-call, including during times of stress. There will be an ongoing need for superannuation funds to maintain some level of liquid assets, but it is not yet clear the extent to which levels held may change as liquidity management practices of trustees are enhanced over time following the implementation of APRA's prudential standards.

[17] The RIS process is described in APRA 2014, *Financial System Inquiry Submission*, 31 March.

[18] APRA 2012, *Regulation Impact Statement: Implementing Basel III capital reforms in Australia*, page 15.

[19] APRA 2013, *Regulation Impact Statement: Implementing Basel III liquidity reforms in Australia*.

[20] Data from the 2013 edition and previous editions of the APRA Annual Superannuation Bulletin. It excludes indirect investments through, for example, managed investment schemes and life policies.

When short-term deposits are placed by superannuation funds with larger ADIs, it is not expected that LCR requirements will impede the ability of ADIs to on-lend those funds to other borrowers due to the availability and operational requirements of the RBA's CLF.[21] Where superannuation funds invest in longer-dated banking liabilities, the LCR will impose minimal constraint on the ADI, as the LCR only captures such investments when they are within one month of maturity.

Although not yet finalised, the NSFR requirement is also expected to encourage ADIs to seek longer-term funding, including from superannuation funds which may be well placed to provide this type of funding. Greater focus on retirement incomes (as discussed elsewhere in this submission) may well generate greater demand for longer-term fixed interest investments generally, which ADIs are well placed to offer. Over time, these factors may encourage a greater share of stable ADI funding to be sourced from the superannuation sector, thereby supporting ADIs' ability to provide longer-term finance to customers.

[21] Reserve Bank of Australia 2011, *Media Release: The RBA Committed Liquidity Facility*, 2011-25, 16 November.

The corporate bond market (page 2-91)

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- Allow listed issuers (already subject to continuous disclosure requirements) to issue 'vanilla' bonds directly to retail investors without the need for a prospectus.

If listed issuers were permitted to issue 'vanilla' bonds directly to retail investors without the need for a prospectus, care would be needed to ensure that investors were not under the impression that such products offer the same level of security as deposits in an ADI. Australia currently has a differential regime for registered financial corporations (RFCs), which may raise non-deposit funds from retail investors through the issue of debentures. However, shortcomings in this regime have become evident, with some investors lacking an understanding of the important differences between these products and ADI deposits, despite the requirement for RFCs to issue Product Disclosure Statements. As a result, APRA is currently proposing to tighten this regime in such a manner as to ensure there should be no confusion between RFC-issued debentures and transactional accounts traditionally held with ADIs.

The need for clarity about the nature of a bond-type product would be amplified if the vanilla bond issuer was itself an ADI. Here, the distinction between term deposits (which are subject to depositor preference under the *Banking Act 1959* (Banking Act) and may also be covered by the Financial Claims Scheme (FCS)) and non-deposit bonds would need to be carefully delineated.

It will also be important to ensure that subordinated debt and 'hybrid' securities issued by APRA-regulated institutions continue to require a prospectus. These products have increasingly complex features, and as a result of recent regulatory reforms are designed to ensure they bear loss in the event the issuing institution encounters difficulty. They are therefore much more akin to equity instruments than debt instruments in their risk profile. Given the discussions in Chapter 5 of the Interim Report regarding the possibility of introducing additional means of imposing losses on creditors, and the complexity such arrangements would necessarily entail, the ability for unsophisticated investors to hold these instruments is of increasing relevance. To this end, the United Kingdom Financial Conduct Authority recently announced restrictions in relation to the British retail distribution of contingent convertible instruments.[22]

[22] Financial Conduct Authority 2014, *Temporary product intervention rules. Restrictions in relation to the retail distribution of contingent convertible instruments*, August.

Chapter 4 of the Interim Report: Superannuation

Efficiency (page 2-114)

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements and review the effectiveness of the MySuper regime in due course.
- Consider additional mechanisms to MySuper to achieve better results for members, including auctions for default fund status.
- Replace the three-day portability rule:
  - With a longer maximum time period or a staged transfer of members' balances between funds, including expanding the regulator's power to extend the maximum time period to the entire industry in times of stress.
  - By moving from the current prescription-based approach for portability of superannuation benefits to a principles-based approach.

APRA agrees with the Inquiry's view that fees should not be considered in isolation; assessment of the efficiency of the superannuation sector must be framed in terms of the ultimate outcomes that are achieved for members.[23] For any given pattern of contributions, members' outcomes are driven primarily by investment performance, taking into account risk and return objectives as well as investment time horizons. Insurance and other benefit design aspects, fees, costs, taxes and the form and timing of benefits taken by members are also relevant considerations. There are also a number of different types of fees and costs that need to be considered separately when assessing efficiency, including fees and costs for investment management, administration, insurance and advice. It is important to take into account all of these different factors when making comparisons with other jurisdictions; this makes like-for-like international comparisons particularly complex.

Superannuation funds should be assessed based on a range of factors, including after-fee and after-tax returns for the selected risk profile. The risk and expected after-fee and after-tax return profile of a superannuation product will be influenced by a range of considerations, some of which will influence the selected investment strategy. These considerations include: the benefit structure; membership profile including age characteristics and occupational profile; overall expectations for fund size, stability and growth rate of assets under management; the broader state of financial markets; and the decisions taken by trustees to reflect the best interest of members.

A range of different investment strategies, and also overall cost and fee structures, may be expected to deliver appropriate member outcomes over the long term. It is not necessarily the case that the lowest fee structure will provide better outcomes for members over the long term. Similarly, a focus on other ways in which to enhance overall long-term member outcomes, such as more tax-effective investment management, may have a more material impact than achieving relatively small reductions in investment or administration fees for members.

[23] Financial System Inquiry 2014, *Interim Report*, July, page 2-101.

From a prudential perspective, ultimate member outcomes are enhanced by a robust and well-managed superannuation sector. This requires adequate investment in, and maintenance of, infrastructure and controls consistent with meeting APRA's requirements for sound risk management. In determining the appropriate level of costs incurred and fees to be charged to members, trustees must therefore strike an appropriate balance between the amount required to maintain adequate systems, processes and controls over time with a desire to ensure that the fees charged to members do not unduly reduce ultimate member outcomes.

Effectiveness of the MySuper regime

Trustees that have met the authorisation requirements have been able to offer MySuper products since 1 July 2013. MySuper products must meet certain criteria that are, in part, intended to enable the public to more easily compare key attributes, including fees. Although the MySuper regime is still in its infancy, there are signs that its introduction has encouraged an increased focus by trustees on the features of the superannuation products they offer, the related operating costs, and hence the level of fees charged to members. This, in turn, has led to some evidence that such costs and fees are beginning to fall.[24] As the Inquiry notes, however, it is too early to assess whether the MySuper reforms will achieve their objectives, in particular in reducing industry costs and fees.[25]

APRA has collected data on authorised MySuper products since they became available. Publication of detailed product-level data, including fees charged, costs incurred and net return information, will significantly improve transparency in relation to MySuper products, in line with the objectives of the MySuper reforms. It is also expected to enhance competition. APRA has published summary information about MySuper products and is proposing to commence more detailed product-level publications in the near future. By publishing more detailed information APRA expects to intensify the focus by trustees and other industry stakeholders on the efficiency of operations such as investments, administration and insurance, and associated cost and fee structures, across the sector. However, it is important that there is continued focus on the achievement of adequate overall outcomes for members over the long term.

It should be noted that, from the information available to APRA, there is variation in industry practices regarding cost and fee reporting and disclosures. APRA is working to refine the relevant prudential reporting returns and instructions to support a more consistent approach across the industry. This has been done in concert with the Australian Securities and Investments Commission (ASIC), which has been reviewing industry disclosure practices, and should enhance the quality of the published information over time.

24 Rice Warner 2014, *FSC Superannuation Fees Report 2013*, commissioned by the Financial Services Council, May.

25 Financial System Inquiry 2014, *Interim Report*, July, page 2-106.

A review to assess the effectiveness of the MySuper regime in achieving its objectives, including its impact on the level of fees and costs by type and in total, would most appropriately be undertaken in, say, three years' time. This will allow a sufficient period for the reforms to be fully implemented. A review in three years would align, for example, with the end of the transition period for trustees to transfer balances of members in existing default funds into a MySuper product on 1 July 2017. The SuperStream reforms, which are expected to reduce costs and hence fees over time, will also have been in operation for a few years.

Auctions for default fund status

In outlining options for reducing fees and increasing after-fee returns, the Interim Report identifies as worthy of consideration the approach taken in Chile, where the government mandates that the superannuation contributions of new members be placed in the same default fund. For the purposes of the mandatory default arrangement, fund investment management is auctioned on the basis of fees. The Report notes that since the introduction of this arrangement, the fees charged by successful bidders in Chile have fallen by 65 per cent, although fees for other funds have not fallen to the same degree.[26]

While this reduction is significant, a focus on fees alone may compromise overall outcomes for members given, for example, the likelihood that in seeking lower costs there may be a trend to use investment approaches and asset classes with lower transaction costs and potentially lower returns. As with the MySuper regime in Australia, the Chilean system has only been in place for a short time and, notwithstanding the observed impact on fees charged, it is likely too early to assess its success in terms of overall member outcomes.

In addition, the superannuation framework in Chile is characterised by detailed controls, the nature of which are inconsistent with the more principles-based approach adopted in Australia. The Australian market is also structurally different from that of Chile in that in Australia there are a larger number of superannuation funds and hence there is greater scope for competition.

For these reasons, care needs to be taken in placing too much focus on comparisons with the Chilean approach.

The three-day portability rule

The three-day portability rule for outbound rollovers replaced a previous obligation on trustees to roll over funds within 30 days. The industry had in practice, however, been operating within a 5-10 day timeframe for processing the majority of rollovers.

The introduction of the three-day portability rule has created operational difficulties for elements of the superannuation industry, particularly in circumstances where, for example, a superannuation fund undertakes weekly forward unit pricing or has peak administration processing periods. This has resulted in a number of relatively immaterial breaches where trustees have found themselves in a position of technical non-compliance in circumstances that do not otherwise raise prudential concerns.

APRA supports a change to a slightly longer period, such as five to seven days. This would achieve the objective of ensuring most rollovers are processed quickly and address the operational difficulties superannuation funds are experiencing in meeting the current requirement.

[26] Ibid, page 2-112.

While APRA generally favours adopting a principles-based approach across the prudential framework, there are strong arguments in favour of a prescriptive approach within the payment standards, given the transactional nature of the activities under consideration and the need for clarity and certainty for participants. As the Inquiry has noted, without an objective benchmark with which to judge the amount of time to complete a transfer to another superannuation fund, a principles-based approach may create more ambiguity for all parties involved.[27]

As noted in the Interim Report, under the provisions of the *Superannuation Industry (Supervision) Regulations 1994*, in specific circumstances a trustee may apply to APRA for relief from the portability requirements in respect of part or the whole of a fund for a limited period of time.[28] APRA provided relief to a number of funds' choice options which had invested in assets which became illiquid during the global financial crisis. This process was effective and provided sufficient flexibility for APRA and the affected funds to address the issues being faced at that time. Further, the powers to provide relief can be applied to the whole of the industry if necessary. There does not appear to be a need for any changes to, or extension of, APRA's current powers in this area.

The superannuation industry has increased its focus on liquidity risk management practices since the global financial crisis. Monitoring processes have improved and superannuation funds are developing frameworks to facilitate liquidity stress testing. However, there are perceptions that a perhaps unduly high level of liquidity is needed to manage stress situations, to facilitate member switching, and as a counterbalance to greater investment in illiquid investments such as infrastructure.

APRA notes that the change to the portability rules does not appear to have materially affected the investment strategies of superannuation funds by altering trustees' decision-making in relation to holding liquid and illiquid assets. Indeed, member choice may have had a bigger impact in this regard. As superannuation funds become more familiar with the prudential requirements and guidance and develop more nuanced approaches to liquidity management, APRA expects any misperceptions in relation to the required level of liquidity to be less likely.

[27] Ibid, page 2-114.

[28] r.6.37 of the *Superannuation Industry (Supervision) Regulations 1994*.

The Inquiry seeks further information on the following area:

- Does, or will, MySuper provide sufficient competitive pressures to ensure future economies of scale will be reflected in higher after-fee returns? What are the costs and benefits of auctioning the management rights to default funds principally on the basis of fees for a given asset mix? Are there alternative options?
- Is there an undue focus on short-term returns by superannuation funds? If this is a significant issue, how might it be addressed?

Competitive pressure in the MySuper regime

Although the MySuper regime is still in its infancy, its introduction does appear to have encouraged an increased focus by trustees on the features of the superannuation products they offer, the related costs incurred, and hence the level of fees charged to members. This, in turn, has led to some evidence that such costs and fees are beginning to fall.[29] The publication of detailed MySuper product-level data by APRA, including fees charged, costs incurred and net return information, will significantly improve transparency and competition in this sector, further supporting the objectives of the MySuper reforms. However, APRA agrees with the Inquiry's view that it is too early to assess whether the MySuper reforms will achieve their objectives, including in reducing industry costs and fees.[30]

The product dashboard requirements for both MySuper and 'choice' products are also intended to provide engaged members, their advisers and other industry stakeholders with key forward- and backward-looking information about these products. In the case of disengaged members, this information is primarily aimed at advocates including employers, promoters and product rating houses. The dashboard information for a product includes the return target, the level of investment risk, the returns for previous financial years, a comparison between the return target and the returns for previous financial years and a statement of fees and other costs.

As noted above, a focus on fees alone may compromise overall outcomes for members given, for example, the likelihood that in seeking lower costs there may be a trend to use investment approaches and asset classes with lower transaction costs and potentially lower returns. The auctioning of investment management rights to default funds principally on the basis of fees for a given asset mix may therefore adversely affect member outcomes.

Focus on short-term returns

Superannuation is structured to be a long-term saving vehicle for members during their working life, in order to provide adequate income during retirement. Consequently, investment strategies set by superannuation funds for their members should reflect this long-term objective.

In practice, however, there has often been a disconnect between the long-term investment objective and the shorter-term measures of investment performance communicated to members by trustees and market commentators. Longstanding industry practice has been to report on and compare short-term investment performance relative to peers (based on for example monthly, quarterly and annual returns) for a product that should be managed and assessed based on performance relative to established investment objectives over a much longer time horizon.

[29] Rice Warner 2014, *FSC Superannuation Fees Report 2013*, commissioned by the Financial Services Council, May.

[30] Financial System Inquiry 2014, *Interim Report*, July, page 2-106.

This short-term focus is typical where defined contribution arrangements are operated as investment accounts, retirement outcomes are stated in terms of growth in asset value and investment decisions focus on returns, with risk measured as volatility of those returns. While the extent and actual impact of this short-term focus is unclear, anecdotally there is some evidence of a negative impact on investment behaviour.

APRA considers it important to publish information on the longer-term performance against established investment objectives for both MySuper and choice products, consistent with the basis on which the investment strategies are set. APRA's new publications will therefore include an increased focus on such longer-term performance measures. It will take some time, however, for sufficient and reliable long-term performance information to be available on MySuper products.

In seeking to discourage an overly short-term perspective on returns in the superannuation industry, a broader reconsideration of the focus of retirement savings may be merited. By focusing on retirement income adequacy and sustainability rather than wealth accumulation at retirement date, performance and risk metrics can be more effectively aligned with members' goals of maximising the likelihood of achieving and maintaining a desired level of income throughout retirement. This will require the superannuation industry to significantly change its approach in a number of areas, including in particular investment management and communication and engagement with members.

Leverage (page 2-117)

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- Restore the general prohibition on direct leverage of superannuation funds on a prospective basis.

APRA has long had reservations about extending the ability of superannuation funds to borrow and was reluctant to facilitate relaxation of the borrowing rules, which took place in 2007, to accommodate instalment warrants.

A degree of indirect leverage already exists within many assets commonly held by superannuation funds, including listed equities, fixed income and property investments. Additional direct leverage may amplify returns but exposes superannuation fund members to greater financial risks.

APRA remains of the view that the risks associated with direct leverage are incompatible with the objectives of superannuation and cannot adequately be managed within the superannuation prudential framework. Direct leverage can multiply the returns from investment in rising markets but it can also multiply losses in falling markets. Where borrowing is undertaken for investment in illiquid assets such as property, it can form a relatively large part of the portfolio, reducing the opportunity for diversification and hence further increasing risks.

Chapter 5 of the Interim Report: Stability

Imposing losses on creditors (page 3-12)

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Increase the ability to impose losses on creditors of a financial institution in the event of its failure.

The Inquiry seeks further information on the following area:

- Is it possible to reduce the perceptions of an implicit guarantee for systemic financial institutions by imposing losses on particular classes of creditors during a crisis, without causing greater systemic disruption? If so, what types of creditors are most likely to be able to bear losses?

The failure of several overseas banks during the global financial crisis highlighted the risks and challenges of trying to deal with distressed banks through a standard corporate insolvency regime. The web of connections between financial institutions and the rapid spread of risk across the financial system meant that it was difficult for regulatory authorities to impose losses on bank creditors while still achieving financial stability objectives. Furthermore, the lack of adequate contingency planning and alternative mechanisms for handling bank failure in many cases exacerbated an already fragile environment. This left little option but to resort to government-backed recapitalisations of several banks. While undoubtedly stabilising the financial system, these actions have reinforced perceptions of an implicit guarantee for systemic banks and reduced the perceived likelihood of unsecured bank creditors being exposed to the risk of loss on their investments. In such circumstances, market discipline is reduced and moral hazard increased.

No Australian ADI failed during the global financial crisis. However, the industry did receive substantial public sector support. The Australian Government and the agencies of the Council of Financial Regulators (CFR), recognising the risks emerging at that time, took a number of steps at a system-wide level to support financial stability. As noted in APRA’s initial submission to the Inquiry, the experience of the crisis has raised broader questions about how Australia’s regulatory agencies can ensure the continuity of the critical functions provided by financial institutions in a future crisis, while protecting the interests of depositors and insurance policyholders and minimising the possibility of losses being borne by the public sector.

The Australian response to the global financial crisis has largely mirrored steps taken in other jurisdictions, and has been guided by the agreements reached by international standard-setters. The primary set of reforms has been the implementation of the Basel III capital regime in Australia, which is a critical step in increasing the resilience of Australian ADIs to financial shocks, and hence reducing the *probability* of their failure. With the design of Basel III now largely complete, international attention, driven by the G20 and the Financial Stability Board (FSB), is now shifting towards measures that reduce the *impact* of the failure of systemically important banks.

Australia has already taken some steps of its own in this area, including the establishment of the FCS and the work of the CFR to improve crisis management arrangements and resolution planning. More work needs to be done to strengthen the resolution framework in Australia, and APRA welcomes the consideration by the Inquiry of ways in which the effects of an ADI failure might be made more manageable and create fewer risks of disruption to the wider financial system as well as economic activity more generally.

The larger ADIs have started to consider their own recovery actions should they encounter a period of significant financial stress. This would include options to raise additional capital, liquidate assets, generate liquidity and funding, and preserve core functionality. ADIs need to consider and develop viable options in cases of both idiosyncratic and system-wide stress. If substantial actions are activated promptly when a period of stress occurs, an ADI will ideally be able to restore and preserve its financial health without the need for regulatory intervention. There always remains a risk, however, that these recovery actions are insufficient, in timeliness or scale, to deal with the extent of the problems an ADI may face.

At the point when an ADI's own recovery actions have proven inadequate and APRA considers that the ADI is no longer viable, the ADI is likely to have incurred, or is about to incur, significant losses. In addition, there is likely to be substantial uncertainty about the value of the ADI's remaining assets and liabilities, and community nervousness about the potential for similar problems in other ADIs. In insolvency, shareholders absorb losses first, followed by subordinated debt-holders and then senior unsecured creditors, with the amounts recovered determined at the end of the insolvency proceedings.[31] But for many financial institutions, and particularly ADIs, financial stability objectives typically mean that there is no time to allow normal commercial insolvency proceedings to run their course. A major corporate liquidation may require years to resolve through the courts; the necessary timeframe for resolving a substantial ADI failure is more typically measured in days and hours.

[31] Under the Banking Act, Australian depositors are preferred in the creditor hierarchy.

There are two fundamental sources for this urgency in dealing with a failing ADI:

- a loss of critical functionality provided by the ADI (e.g. access to transactional banking accounts and payment facilities); and
- a loss of confidence by depositors and market participants spreading disruption to other parts of the financial system.

An inability to have mechanisms to respond quickly to these two concerns without resorting to the need for public sector support is at the heart of the 'too big to fail' problem. More precisely, ADIs may be too big, too interconnected or too important to allow the authorities to rely upon standard liquidation tools in the event of a failure, as to do so would impose unacceptable costs on the broader community.

The FCS provides one mechanism for depositors to access their funds in a failed ADI in a timely manner, thereby reducing the risk of disruption spreading more broadly, while the ADI is wound down over time. In this scenario, losses are absorbed by general creditors through the liquidation of the remaining assets and liabilities. If these are insufficient, a levy is applied to other ADIs to cover any residual losses and to ensure depositors can receive the full amount of their covered deposits. Some form of deposit insurance system has been established in almost all OECD countries, with widespread recognition that they provide important financial stability benefits.

Deposit insurance on its own is insufficient to deal with all circumstances of a failing ADI, however. Although all ADIs incorporated in Australia are covered by the FCS, there may be circumstances in which the CFR authorities consider that resolution of a failing ADI simply by placing it into liquidation and utilising an FCS payout would be insufficient to meet financial stability objectives. For example, an ADI may perform certain functions which need to be continued, or at the very least wound down in an orderly manner outside normal insolvency in order to avoid potential contagion to the financial system. APRA considers that other resolution options are needed for such circumstances. Where possible, these options should minimise the need for public sector support.

Any resolution option that avoids reliance on public sector solvency support must provide for losses made by the failing ADI to be absorbed by, first, its capital providers and then its unsecured creditors. For such an approach to be credible and feasible there needs to be a level of transparency and understanding among market participants about how losses would be allocated. In addition, the authorities need a set of resolution powers that are flexible enough to allow them to implement the plan as efficiently as possible in a manner that meets financial stability objectives.

A primary objective for global policymakers, under the direction of the G20 Leaders, is that global systemically important banks (G-SIBs) should no longer be seen as too big to fail. One of the most important elements of this policy goal is the effort to devise credible and transparent mechanisms that will allow losses incurred by a failing bank to be imposed on certain classes of bank creditors. This should help reduce any perception of an implicit guarantee for the holders of bank funding and capital instruments, and thereby promote market discipline and reduce moral hazard.

Following endorsement of the concept by the G20, the FSB is currently developing proposals that would require G-SIBs to issue a minimum amount of liabilities that could credibly and feasibly absorb losses in resolution and contribute to the failing bank's recapitalisation. Australia is contributing to this work through its membership of the FSB and Presidency of the G20, as well as through APRA's membership of the Basel Committee. Current plans are for a proposal on the structure and minimum amount of loss-absorbing and recapitalisation capacity to be released for consultation towards the end of this year.

The Australian authorities will need to be mindful of the emerging international requirements for G-SIBs, given:

- some jurisdictions will extend the implementation of the loss-absorbing and recapitalisation capacity requirements beyond G-SIBs;
- Australian ADIs will be competing against banks meeting these requirements when seeking debt funding in wholesale markets, where the existence or absence of a layer of liabilities designed to absorb losses and recapitalise a bank in resolution would potentially impact relative pricing; and
- rating agencies may well adjust their ratings to take account of the additional loss-absorbing capacity available to senior creditors of some banks and not others.

Instruments comprising loss-absorbing and recapitalisation capacity may take a number of different forms, each of which has advantages and disadvantages. For example, the FSB's proposals may establish a form of prescribed instruments (as for existing bank capital), or it could establish a framework that recognises more generally any liabilities that have certain characteristics that would allow them to credibly absorb losses at the point of failure.

It should also be noted that the existing Basel III regime already contains a form of 'gone concern' capital. Term subordinated debt is eligible to be included in Tier 2 capital only if it includes a 'point of non-viability' trigger. This trigger provides additional loss-absorbing capacity through the write-off of the liability or its conversion into ordinary shares, if APRA considers the ADI to be no longer viable. Tier 2 capital therefore already provides some loss-absorbing and recapitalisation capacity for Australian ADIs.

Under the current Basel framework, however, there is no requirement for ADIs to issue a minimum amount of Tier 2 capital. ADIs are free to use other, higher quality capital instruments to meet their total capital requirement and have tended to do so in recent years. While this approach serves to reduce the probability of failure, it provides little additional loss-absorbing capacity once the ADI has failed. If the Inquiry considers a minimum loss-absorbing and recapitalisation capacity requirement would be appropriate for Australia to improve the resilience and resolvability of Australian ADIs, a minimum Tier 2 capital requirement, at least for banks designated as D-SIBs, might help meet some part of this requirement. Utilising existing regulatory requirements and established instruments would also avoid the need to devise additional new requirements and instruments and will, in all likelihood, be consistent with emerging international standards. However, before establishing a specific Tier 2 requirement, it would be important to consider the relative cost, and availability, of greater issuance of Tier 2 instruments, and the extent to which this would be sufficiently aligned with other approaches being developed by the FSB.

The design of the appropriate mechanism through which losses are imposed on relevant creditors in resolution is dependent on the form of loss-absorbing capacity held by Australian ADIs. Tier 2 capital instruments are required to have a contractual mechanism for conversion or write-off at the point of non-viability of the institution. On the other hand, other forms of loss-absorbing capacity may require the use of a statutory power by the resolution authority in order to be genuinely loss-absorbing in resolution.

To this end, some jurisdictions have introduced a statutory 'bail-in' power, which gives resolution authorities the power to write down, or convert into equity, unsecured and uninsured creditor claims to the extent necessary to absorb losses. The resulting reduction in liabilities is intended to recapitalise the failed bank in such a way that it can continue to provide critical economic functions. Although this approach is attractive because it provides a means to transfer the risk of a bank failure away from the public sector to the bank's own creditors, it does not come without costs and risks. At a minimum, the holders of debt subject to bail-in may seek additional spreads to cover any perception of increased risk. In a systemic crisis, bail-in of the creditors of one bank may lead to a run on other banks as creditors seek to avoid a similar bail-in.

Australia does not have a statutory bail-in power. APRA does have compulsory transfer of business powers, which, in certain circumstances, could be used to achieve a similar economic effect to a bail-in.[32] Subject to certain triggers and safeguards, this power could be used to transfer a failing ADI's assets to another entity, leaving behind capital instruments and certain unsecured liabilities to absorb losses.

[32] APRA notes that the FSB does not consider these powers to be fully equivalent to a statutory bail-in instrument. This is, in part, due to the considerable increase in operational complexity and execution risk in implementing such a transfer.

If increased powers to bail-in creditors were to be introduced in Australia, consideration would need to be given to whether there should be limitations on the holdings of debt subject to bail-in by certain classes of investors, particularly retail investors. To be effective in providing an orderly means of quickly resolving a failed ADI, it is likely that any requirement for loss-absorbing and recapitalisation capacity will include disincentives for ADIs to hold such instruments issued by other ADIs. This is designed to ensure that the conversion or write-off of these instruments does not simply transfer losses elsewhere in the banking system, causing further instability. To be able to ensure that debt subject to bail-in could be credibly and reliably written-down when needed, it would be important that, as far as possible, holders understood the risks to which they were exposed. This may suggest that bail-in debt is best held by sophisticated wholesale investors, who are more likely to be able to assess, and appropriately price, such risks. As detailed in the section on the corporate bond market in APRA's response to Chapter 3 of the Interim Report, the United Kingdom Financial Conduct Authority recently announced restrictions in relation to the British distribution of contingent convertible instruments.

With all of the above as background, APRA does not advocate any particular framework for, or form of, loss-absorbing and recapitalisation capacity at this time, given the nuances of different approaches are yet to be well understood. Moreover, there seems little benefit in Australia moving ahead of international developments in this area.

Resolution powers (page 3-13)

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Strengthen regulators' resolution powers for financial institutions.

APRA's current crisis resolution powers, which are detailed in the Industry Acts, are a vital component of the prudential framework. Having a robust set of legal powers is important in ensuring that APRA can respond effectively to situations of distress at regulated institutions.

The global financial crisis highlighted the lack of credible resolution options and the inability of regulators to resolve failing financial institutions quickly without resorting to significant public sector support. The FSB has since urged member countries to undertake necessary legal reforms to equip national authorities with the capacity to respond effectively to an institution under severe stress. It has emphasised the need for clear and comprehensive legal powers to enable distress to be managed in a manner consistent with minimising financial system instability, avoiding or minimising taxpayer risk and facilitating effective cross-border crisis resolution.

To assist in the process of strengthening resolution regimes, the FSB published the *Key Attributes of Effective Resolution Regimes* (Key Attributes) to provide an international standard on financial crisis resolution. Although some parts of the Key Attributes apply only to global systemically important financial institutions (SIFIs), of which there are none in Australia, most of the Key Attributes have been drafted for wider application to domestic SIFIs and other financial institutions, including insurers and financial market infrastructure. Accordingly, the Key Attributes provide an international benchmark relevant to much of the Australian framework for resolving regulated institutions.

APRA's resolution regime is broadly consistent with minimum international standards, including the Key Attributes.[33] As noted in the Interim Report, there are some remaining gaps and deficiencies in APRA's resolution regime when compared with the Key Attributes. In any future crisis, having a wider range of tools available will mean that it is more likely that a credible, low-cost option for preventing a disorderly failure can be found that responds effectively to the specific circumstances and without putting taxpayer funds at risk.

APRA therefore concurs strongly with the Inquiry's view that current proposed legislative reforms to its crisis management powers are important and should be implemented as a matter of priority. These legislative measures were initially raised in the September 2012 Consultation Paper, *Strengthening APRA's Crisis Management Powers*, and include the following measures:

- directions powers, including clarifying that APRA may direct a regulated institution to pre-position for resolution, and ensuring that directors are protected from liability when complying with an APRA direction;
- group resolution powers, including extending APRA's power to appoint a statutory manager to an ADI's authorised non-operating holding company and subsidiaries in a range of distress situations, and widening the scope of application of the *Financial Sector (Business Transfer and Group Restructure) Act 1999* to related entities;
- resolution of branches of foreign banks, including enabling APRA to apply to the Court for the winding up of the Australian business of a foreign ADI, and clarifying that APRA may direct a compulsory transfer of business to or from a foreign branch;
- statutory and judicial management powers, including widening the moratorium provisions applicable when a statutory or judicial manager is appointed, and extending more robust immunities to statutory and judicial managers; and
- investigation powers, including removal of the 'show cause' notice in the *Insurance Act 1973* (Insurance Act) and *Life Insurance Act 1995* (Life Insurance Act), and providing an appointed investigator with the power to conduct an examination of persons relevant to an investigation.

As detailed in APRA's initial submission to the Inquiry, although many of the reforms proposed are individually minor, cumulatively their implementation would significantly enhance APRA's resolution toolkit and align APRA's crisis resolution powers more closely with the Key Attributes. Each of the proposals would be devised with strict legal triggers and safeguards designed to ensure that the augmented powers would only be exercised in appropriate circumstances and when feasible recovery actions by the institution are unlikely to succeed. The vast majority of these powers also have no compliance cost for industry; the powers are only relied upon when an institution is facing acute financial distress. Ensuring APRA's powers to deal with a distressed institution are robust and effective is therefore a low-cost investment in helping to ensure the safety of the financial interests of beneficiaries of regulated institutions, and in the stability of the financial system more broadly.

[33] International Monetary Fund 2012, *Australia: Financial System Stability Assessment*, IMF Country Report No. 12/308.

Pre-planning and pre-positioning (page 3-14)

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Invest more in pre-planning and pre-positioning for financial failure.

A comprehensive set of crisis management powers is necessary, but not sufficient, for dealing with a failed or failing financial institution. To be truly effective, statutory powers must be combined with regular and robust contingency planning, by both the public sector authorities and regulated institutions, and appropriate pre-positioning. During the global financial crisis, many financial institutions were insufficiently prepared to adopt and implement recovery actions – often across multiple business lines and countries – to promptly address the severe capital depletion and liquidity shortages they encountered. Public sector authorities also found themselves ill-equipped to deal with the scale of the problems they faced, other than by providing significant public sector support. Consequently, recovery and resolution planning has become central to international discussions on measures for reducing the impact of failure.

'Recovery planning' refers to a regulated institution developing its own contingency plans to demonstrate that it has identified a range of plausible actions available to it such that it could recover from a severe financial shock without the need to seek public sector support. In the Australian context 'resolution planning' refers to planning by the public sector for how it would deal with a failing financial institution in such a way as to minimise the economic cost of the failure.

As detailed in APRA's initial submission to the Inquiry, APRA has been working with a number of regulated institutions on recovery planning. APRA started the process by completing a pilot programme for the larger banks, and has recently extended recovery planning to a number of medium-sized ADIs. APRA is considering a further extension to the larger general and life insurers in due course. The recovery plans provided to APRA under the pilot programme provide a starting point for further work to develop credible recovery actions across a range of scenarios. This work is at a relatively early stage. More remains to be done to develop robust and reliable recovery plans that could be implemented in a timely manner under a range of adverse scenarios.

In conjunction with the other CFR agencies, APRA has also continued its work on general resolution planning, by focusing on measures that would enable a cost-effective resolution of a regulated institution where recovery is not feasible. The work has primarily involved exploration of resolution options for a distressed ADI, funding issues related to the FCS, including options for pre-funding, and refinement of ADI crisis resolution coordination procedures.

APRA is committed to enhancing its recovery and resolution framework. In this context, APRA intends that recovery planning will become a permanent component of APRA's supervision activities.[34] Further work is required to enhance the credibility of recovery plans, and APRA expects that the larger banks will continue to develop their recovery plans in the context of their normal stress-testing programmes and Internal Capital Adequacy Assessment Process. This will include the consideration of the pre-positioning steps that could improve the likelihood of recovery, particularly for recovery actions that would need to be taken very quickly.

APRA is currently considering how best to engage with industry on individual resolution plans. International experience has shown that a useful first step in developing individual resolution plans is to collect data on critical economic functions and shared services, as well as ascertaining the internal dependencies between legal entities and business units, and the quantum and location of loss-absorbing capacity. This would help inform possible resolution strategies for APRA, including, for example, the preferred structure of any transfer of business resolution.

Planning for adversity and potential failure is a necessary investment for regulated institutions, with minimal cost implications, as it ensures that they have a robust risk management framework for responding to a range of adverse financial shocks. Many steps taken under the guise of pre-positioning may involve costs, but may also have broader business benefits (e.g. simplification of corporate structures, rationalisation of licences and improved understanding of contingent commitments). One-off compliance costs such as investment in IT and staff training should have already been made during the development of initial recovery plans, and are able to be minimised depending on the degree of integration and dovetailing with existing contingency plans.

During the resolution planning process, if APRA were to identify any potential barriers to an orderly resolution, it would need to consider on a case-by-case basis whether a regulated institution should implement specified pre-positioning to improve its resolvability. For example, it might be desirable for certain business units that would be potentially saleable in a resolution to be operated on a more stand-alone basis, with independent access to IT resources or funding sources.

As noted in the previous section, APRA does not currently have an explicit power to direct an institution to pre-position for resolution if necessary. This statutory shortcoming would be addressed through implementation of the legislative changes proposed in the September 2012 Consultation Paper, *Strengthening APRA's Crisis Management Powers*. The costs and benefits of restructuring measures to pre-position a regulated institution for resolution are difficult to quantify in the Australian context. The costs would most likely depend on the complexity of the institution's business model, legal and organisational structure, and the extent of any changes necessary.[35] APRA has not, to date, explored these areas in any detail. If needed, however, APRA would work closely with the institution to consider practical options to achieve the required pre-positioning at least cost.

[34] APRA 2012, *Insight*, Issue 3.

[35] By way of example of specific pre-positioning, based on initial industry feedback, APRA estimates that the one-off implementation costs for complying with the single customer view requirements of *Prudential Standard APS 910 Financial Claims Scheme* for small institutions are likely to be less than $100,000. For the major banks such costs will be in the order of millions, depending on the scope of the IT changes necessary to be undertaken.

Capital requirements (page 3-16)

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Further increase capital requirements on financial institutions considered to be systemically important domestically.

In light of the higher costs that their failure would impose on the community, the designation as a domestic systemically important bank (D-SIB) is designed to ensure that banks perceived to be too big to fail are subject to more intense supervisory oversight and have greater capacity to absorb losses, thereby increasing their resilience to failure.

In line with the internationally agreed framework for D-SIBs, APRA has put in place a higher capital requirement for D-SIBs in Australia effective from 2016.[36] The additional D-SIB capital requirement is a tool supporting APRA's intensive supervision approach for the largest institutions.

APRA conducted a range of quantitative and qualitative analyses to inform the establishment of this requirement for Australia, but acknowledges that there is significant room for judgement in calibrating a capital surcharge for a D-SIB. The one per cent surcharge adopted by APRA is in line with peer countries such as Canada but, as noted in the Interim Report, is at the lower end of the global spectrum. On the one hand, it is clear that the largest Australian banks are more systemic in a domestic context than the largest G-SIBs are in an international context. On the other hand, a key factor in determining the level of the surcharge was APRA's more conservative approach to the measurement of capital adequacy relative to international minimum standards. These local adjustments already tend to impact the largest banks more acutely relative to smaller institutions.

The Interim Report indicates that higher regulatory capital requirements could be used as a tool to reduce the funding advantage larger ADIs have due to the perception of these institutions being too big to fail, and as a means of enhancing the competitive positon between smaller and larger ADIs. While there may be a case for a higher D-SIB surcharge for these reasons, it would need to be considered in conjunction with other potential policy responses being canvassed by the Inquiry which may also affect the largest banks (e.g. higher IRB risk weights or requirements for increased loss-absorbing capacity).

Any proposal for a higher D-SIB surcharge should also consider whether the increased requirement need be met by CET1 capital, or might be met by a wider range of capital instruments. If the Inquiry is more concerned about reducing the impact, rather than the probability, of a D-SIB failure, a Tier 2 or loss-absorbing capital requirement for D-SIBs might be preferable to increasing further the CET1 requirement.

APRA does not rule out increasing the higher loss absorbency requirement applying to D-SIBs in the future. Consistent with its approach to determining capital adequacy in general, APRA will continue to monitor the calibration of the D-SIB surcharge in light of domestic and international developments. APRA's stress-testing programme will also provide insights into the appropriate level of capital for different types of ADIs.

Insurers are less likely to be a source of systemic risk than ADIs and international thinking is still evolving on how the systemic impact of an insurance failure should be measured. APRA therefore intends to monitor international developments in this area, and will consider any need to extend the domestic SIFI framework to cover insurers in due course.

[36] APRA 2013, *Domestic systemically important banks in Australia,* December.

The Financial Claims Scheme (page 3-18)

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Modify the FCS, possibly including simplification, lowering the insured threshold or introducing an ex ante fee.

The Inquiry seeks further information on the following areas:

- What measures could be taken to simplify the FCS with minimal burden on industry, while still ensuring the effectiveness of the scheme?
- What is an appropriate threshold for the FCS guarantee of deposits?

Simplification

APRA is the administrator of the FCS for ADIs and general insurers. For ADIs, APRA sets prudential standards for the payment, reporting and communications associated with an FCS declaration, as well as standards to establish a so-called 'single customer view'. However, the fundamental structure of the FCS (for both ADIs and general insurers) is set out in primary legislation and associated regulations.[37]

There is some scope to streamline the ADI FCS without undermining its effectiveness through proposals that have the potential to reduce the regulatory burden for the industry without having a material impact on APRA's ability to administer the FCS. Possible streamlining options are set out below, although each of these options would require amendments to legislation to enable them to be implemented.

- *Simplify the calculation of the FCS entitlement*. The starting point for calculation of the FCS entitlement in respect of a protected account is the balance shown in the ADI's system at the time of declaration. Several adjustments then need to be made under subsection 16AF(1) of the Banking Act, including to take into account accrued interest, fees, charges and duties payable and withholding tax components. This level of complexity may be inconsistent with the general objective of the FCS, which is to rapidly and readily resolve the smaller deposit claims of a failed ADI. It should be noted, however, that given much, and in some cases all, pre-positioning work has already been completed by ADIs, development costs savings from such simplifications may now be limited.
- *Clearance of transactions*. When calculating a protected account-holder's entitlement, an ADI must also make adjustments for the clearance of transactions that occurred in a specified period before the declaration of the FCS. The *Banking Regulations 1966* prescribe this period as five business days even though current industry practice is to clear most transactions within three business days. Reducing this period in the Regulations to three business days would reflect current industry practice and could help reduce pre-positioning costs for the FCS.
- *Reducing the reporting burden in relation to withholding tax*. Under section 16AHA of the Banking Act, APRA must report separately any interest paid and applicable withholding tax to the protected account-holder and to the Australian Taxation Office (ATO). Reducing this APRA reporting requirement could lower the pre-positioning costs for ADIs under the FCS, especially as there are also separate reporting requirements in place between the liquidator and the ATO.

[37] The legislative framework for the FCS for ADIs resides in Part II Division 2AA of the Banking Act and for general insurers resides in Part VC of the Insurance Act. There are also provisions relevant to the FCS in the *APRA Act 1998*, *Financial Claims Scheme Levy (ADIs) Act 2008* and *Financial Claims Scheme Levy (General Insurers) Act 2008*. Provisions relevant to the administration of the FCS are included in the *Banking Regulations 1966* and *Insurance Regulations 2002*.

- *Automatic activation of the FCS*. Currently, under the Banking Act and the Insurance Act, the Minister has discretion as to whether the FCS should be declared for an ADI or a general insurer. Amending both Acts to provide for automatic FCS activation would create certainty for depositors and eligible policyholders and claimants that they are protected by the FCS. Under this proposal, where an ADI or general insurer has liabilities covered by the FCS, the FCS would be activated automatically either at the time that APRA applies to the Court for the winding up of an insolvent ADI or general insurer or at the time that the Court issues a winding-up order.

The Government has previously consulted on proposals for streamlining the FCS provisions in the Insurance Act. These proposals, should they be implemented, would reduce compliance costs of the FCS for general insurers, based on amendments to the ADI FCS and APRA's experience of administering the Scheme for one general insurer. The following two proposals would have the most direct impact on streamlining the Scheme and are discussed in more detail in the Treasury's 2012 Discussion Paper:[38]

- *Interim payments*. Enabling APRA to make interim payments to claimants under the FCS would reflect industry practice and reduce administration costs for APRA that are subsequently levied on the industry. This may be appropriate, for example, where an insurer has admitted liability in respect of a personal injury claim, but the exact quantum of the claim is not known for many years; and
- *Cut-through payments*. Where a policyholder is in liquidation and there is a third party with entitlements to an insurance policy, allowing cut-through payments to the third party would remove the need for APRA to negotiate with liquidators to ensure that the payouts are distributed to the claimants. This would reduce the administration costs for APRA, and thus the levy imposed on the industry.

Threshold guarantee of deposits

There are no strong reasons to change the insured threshold for the ADI FCS. In 2011, the CFR advised the Government that the FCS limit be set between $100,000 and $250,000. The Treasury's subsequent RIS considered that a threshold of $250,000 would be consistent with the identification of retail depositors elsewhere in Australia's prudential regime.[39] While higher than some jurisdictions, the ratio between the FCS limit and Australia's per-capita GDP is by no means an outlier when compared to deposit insurance caps in other jurisdictions. Whatever the threshold, APRA notes that Australia's general depositor preference regime offers additional protection in liquidation to depositors whose account balances exceed the FCS coverage limits.

Ex ante funding

When the IMF reviewed Australia's financial system in 2012, one of its high-priority recommendations was to re-evaluate the merits of *ex ante* funding for the FCS, with a view to converting it to an *ex ante* funded scheme. The CFR considered this issue in March 2013 and recommended to the Government at that time that an *ex ante* funding model for the FCS should be introduced in Australia.[40] An *ex ante* funding model is consistent with the principle of ADIs paying for the benefits of Government guarantees and would, at least in part, compensate the Government for the risks of providing such guarantees. It would also, if appropriately segregated from broader Government finances, build up a fund to assist in meeting any future resolution costs. There could be considerable benefits in being able to use such a resolution fund to support alternative resolution strategies to FCS payout in some circumstances, such as transfers of business.

[38] The Treasury 2012, *Strengthening APRA's Crisis Management Powers*, September. These measures to streamline the FCS for general insurers did not raise any material industry concerns in the consultation.

[39] The Treasury 2011, *Post-Implementation Review and Regulation Impact Statement: Financial Claims Scheme*, August.

[40] Refer to the Government's Economic Statement for August 2013, page 33.

Ring-fencing (page 3-20)

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Ring-fence critical bank functions, such as retail activities.

The Inquiry seeks further information on the following areas:

- Is there a case for introducing ring-fencing in Australia now, or is there likely to be in the future?
- If ring-fencing is pursued, what elements should be protected and from what risks? For example, should deposit-taking functions be protected from proprietary trading. Is one of the models used overseas appropriate for Australia?
- How 'high' should any ring-fence be? Do ring-fenced activities need to occur in entirely separate financial institutions, or could they be part of a group structure that has other business activities? Within a group, what level of separation would be necessary?
- Are there ways to achieve the same benefits as ring-fencing without the costs of structural separation?

There does not appear to be a strong case for introducing a general ring-fencing requirement in Australia. The largest Australian ADIs largely retain a traditional commercial banking business model, dominated by retail and corporate lending. Relative to many of the large global banks with universal banking models, most Australian banks have a relatively low exposure to higher risk investment banking business, and undertake only modest proprietary trading activities.

Ring-fencing proposals such as those of Vickers (United Kingdom) and Liikanen (European Union) are primarily targeted at universal banks with a much higher proportion of volatile trading exposures than has traditionally been conducted by Australian banks.[41] The Inquiry notes that, as a result, establishing ring-fencing requirements in Australia at this point in time, while costly, would nevertheless be less costly than if it were to occur at a time in the future when Australian ADIs had a greater involvement in a broader range of activities. However, the need for such a pre-emptive ring-fencing requirement is lessened by current and planned regulatory policy settings, which will help limit the extent to which Australian ADIs might be encouraged to shift to a universal banking model:

- amendments to the market risk regime in the Basel capital framework will reduce incentives for excessive growth in trading businesses;
- APRA's existing capital framework effectively insulates ADIs from the risks of commercial and non-banking financial institution investments by requiring them to be funded by equity; and
- *Prudential Standard APS 222 Associations with Related Entities* requires an ADI to have in place systems, policies and procedures to manage, monitor and control all forms of risks arising from its associations with other members of a group, not just those arising from direct financial dealings with group members.

[41] United Kingdom Independent Commission on Banking 2011, *The Vickers Report & Parliamentary Commission on banking standards*, and European Commission 2012, *Report of the European Commission's High-level Expert Group on Bank Structural Reform* (Liikanen Report).

Unlike ring-fencing proposals being pursued elsewhere, APRA's longstanding approach has been to avoid prescribing the particular businesses or products that a regulated financial group may be involved in, or imposing particular corporate structures. In dealing with the risks that emanate from financial groups, APRA's philosophy has been to allow regulated groups a large amount of freedom to conduct their affairs as they see fit, provided they can demonstrate appropriate governance arrangements, risk management capabilities and capital strength.

APRA's requirements regarding an appropriate framework for the supervision of financial conglomerates were recently published.[42] The framework is founded on four basic requirements:

- there must be a robust governance framework that is applied throughout the group;
- intra-group exposures, and external aggregate exposures, must be transparent and prudently managed;
- a group must have an effective group-wide risk management framework in place; and
- a group must have sufficient capital such that the ability of its APRA-regulated institutions to meet their obligations is not adversely impacted by risks emanating from elsewhere in the group.

APRA's risk-based, group-level supervision regime is designed to ensure that any higher risk activities, whether in the ADI itself, its subsidiaries, or other group members, are subject to ongoing prudential monitoring and review. This approach is more prudent and less interventionist than ring-fencing. Countries that have embarked on a ring-fencing approach as a solution to risks that became evident during the global financial crisis have also found it complex and costly to define and implement. Although it is too early to draw any conclusions, it is not clear that the jurisdictions undertaking ring-fencing and associated techniques will in fact gain substantial systemic stability benefits, given that there may still be considerable risk of contagion between activities inside and outside the ring fence.

Ring-fencing may nevertheless be beneficial in some situations; in particular, where there are substantial risks (including from non-financial businesses) or significant organisational complexity that might impede supervision or an orderly resolution. In particular, resolution frameworks are typically designed with conventional business models in mind; the existence of complex structures and unusual businesses may impede the ability of the resolution authority to act in an expeditious manner. Where ring-fencing is being proposed to facilitate resolution, it is more appropriate to address these issues on a case-by-case basis and for this to be reviewed regularly as a bank's business evolves, rather than establishing a single structural ring-fencing model in legislation. The resolution powers discussed above, if implemented, would provide the capacity to deal with this issue more effectively.

[42] APRA 2014, *Media release: APRA releases framework for supervising conglomerates but defers implementation*, August.

Assess the prudential perimeter (page 3-29)

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Establish a mechanism, such as designation by the relevant Minister on advice from the Reserve Bank of Australia (RBA) or the Council of Financial Regulators (CFR), to adjust the prudential perimeter to apply heightened regulatory and supervisory intensity to institutions or activities that pose systemic risks.

The Inquiry seeks further information on the following areas:

- Is new legislation the most appropriate mechanism to adjust the prudential perimeter to respond to systemic risks, or could a more timely mechanism be of benefit? What alternative mechanisms could be used?
- What accountability processes would be necessary to accompany any new mechanism?
- What criteria could determine when an institution or activity was subject to heightened regulatory and supervisory intensity?

The current perimeter of prudential regulation is defined by the Australian Parliament in the Industry Acts and the *APRA Act 1998* (APRA Act) that establish the scope and objectives of APRA's supervision. Thereafter, APRA operates independently to supervise the relevant entities in line with its statutory mandate and objectives. APRA's view is that this division of responsibilities remains appropriate.

The shadow banking sector, or the non-bank financing sector, is not large in Australia and very little of it is currently a particular source of systemic concern. There are institutions operating outside the regulated ADI industry that take funds from the public and provide credit (e.g. RFCs). New entities and business models may also emerge over time, sometimes with the aim of avoiding regulation.

APRA is therefore alert to risks emerging at the edge of the regulatory perimeter. Where the risks associated with a particular type of business (or institution) generate a material degree of concern, APRA would discuss the risks with the other CFR agencies and consider if any further action is needed.[43] Where necessary APRA, individually or jointly with the other CFR agencies, could recommend to the Government that the regulatory perimeter be adjusted, on systemic risk or other grounds. It would then be a matter for the Government as to whether it wishes to act on this advice.

Legislation remains the most appropriate mechanism to adjust the prudential perimeter. Amendments to the regulatory perimeter on the grounds of systemic risk are, as acknowledged in the Interim Report, relatively rare and likely to remain so. Further, any new sector or activity brought within the scope of prudential regulation may require additional regulatory powers, or indeed a completely different regulatory regime, from those applied to the industries that APRA already supervises. The transition to a new regulatory framework and supervisory environment will require considerable time and consultation. In these circumstances, even a more flexible approach to adjusting the prudential perimeter would be unlikely to result in substantially faster implementation.

[43] The RBA provides a regular update to the CFR on shadow banking.

A pertinent example that may challenge regulators and the definition of the regulatory perimeter is the rise of technology-based payment mechanisms, which are increasingly provided by non-bank entities. Although these payment facilities have initially been relatively narrowly focused, the potential exists for them to expand over time. Attempts to bring such businesses under local regulatory oversight, particularly if they are based overseas or have no clear geographic nexus to Australia, would likely require revision to statutory powers and supervisory practices.

There may also be alternatives to prudential regulation to tackle systemic risks in institutions beyond the perimeter:

- most, if not all, participants in the financial sector interact regularly with regulated institutions. APRA may impose measures on regulated institutions and hence indirectly influence the behaviour of unregulated entities and effectively manage the activity giving rise to the systemic risks;
- prudential regulation may not be the most appropriate response to some forms of systemic risk. Conduct regulation or other market measures may better address the threat. For example, the move to increased central clearing of derivatives since the financial crisis is designed to reduce systemic risk. This change has not been implemented by changes to prudential regulation; and
- similarly, the RBA and ASIC also regulate parts of the financial system. Where an entity outside the regulatory perimeter appears to pose a systemic threat, it may be more appropriately supervised alongside more similar entities within the purview of these other members of the CFR. In such cases, heightened regulatory and supervisory intensity by other regulators would be a more appropriate response to the systemic risk than prudential regulation by APRA.

An example: Shadow banking

As noted above, Australia does not have a large non-bank financing sector. However, there are some firms that are not regulated as ADIs but nonetheless accept funds from the public and provide credit. These very limited forms of shadow banking are outside the prudential perimeter. APRA's initial submission describes the role of RFCs which have, for historical reasons, been granted exemptions from the need to be authorised as ADIs. APRA has been consulting on proposals to amend these exemptions so that, for all practical purposes, investments with RFCs are not able to be used for transactional banking activities. APRA is currently finalising its proposals in this area, which will enable it to more effectively enforce the existing prudential perimeter around 'banking business'.

Additional macroprudential powers (page 3-30)

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Introduce specific macroprudential policy tools.

The Inquiry seeks further information on the following areas:

- Are there specific macroprudential tools that Australia should adopt to manage systemic risk?
- What agency or agencies should have these macroprudential tools?

APRA views macroprudential policy as subsumed within the broader and more comprehensive financial stability policy framework, under which APRA and other Australian financial regulators consider a system-wide view an essential part of effective prudential supervision, inextricable from the supervision of individual institutions.[44] From time to time, this may require changes to prudential policy settings or supervisory interventions that could be considered 'macroprudential' in nature. This approach has as its goal the resilience of the financial sector: it recognises that financial cycles are inevitable, and seeks to use prudential tools to ensure that regulated institutions build up their financial resilience to future shocks or downturns. It may also have broader, indirect effects, but these are not the primary policy purpose.

Another, more ambitious view of macroprudential policy is for prudential interventions to be used to attempt to manage financial or economic cycles. The goal of such an approach could include addressing concerns about asset prices or household balance sheets. Such an approach raises questions about which arm of government should be responsible for decisions about instruments used to manage these risks, as such decisions become part of the realm of economic policy even where they involve prudential tools imposed on regulated institutions. APRA agrees with the Interim Report, which considered that Australia should be cautious about adopting an ambitious approach while empirical evidence of their effectiveness remains limited.

Consideration of, and response to, aggregate industry risks have long been part of APRA's supervisory framework and do not require new tools or powers. For example:

- In 2003 APRA made significant adjustments to the risk-weighting of residential mortgage exposures and the capital regime for lenders mortgage insurers in response to stress testing of ADIs' housing loan portfolios.[45]
- As noted in APRA's initial submission to the Inquiry, APRA and the RBA have already adopted a number of measures to help contain risks in the current Australian housing lending market. APRA is working closely with ADIs to ensure they maintain prudent lending practices, including issuing a draft prudential practice guide for consultation.
- Should APRA determine that a more prescriptive approach is necessary to mitigate housing lending risks, it can use existing standard-making powers. However, regulator-imposed lending limits and loan underwriting criteria can have unintended consequences

[44] APRA and Reserve Bank of Australia 2012, *Macroprudential Analysis and Policy in the Australian Financial Stability Framework*, September.

[45] Refer to APRA 2003, *Proposed Changes to the Risk-Weighting of Residential Mortgage Lending*, November, and APRA 2004, letter to all ADIs (excluding locally licensed branches of foreign banks), *Changes to the Risk-Weighting of Residential Mortgage Lending - AGN 112.1 Attachment C*, 16 September.

and be circumvented by market developments. While regularly assessing the need for such policies, APRA's preference generally is to remain vigilant in targeting imprudent lending practices through proactive supervision.

- APRA may adjust capital requirements applying to lending to specific sectors, such as residential or commercial property. Under Basel II, ADIs approved to use the IRB approach to credit risk must apply a minimum LGD for residential mortgage exposures that is greater than that of the Basel framework. Some other countries have recently adopted similar measures for macroprudential purposes.[46]
- APRA conducts regular stress tests to understand system-level vulnerabilities in the Australian banking sector.

The Basel III reforms introduced an additional explicit macroprudential tool: the countercyclical capital buffer. The Basel Committee describes the primary aim of the countercyclical capital buffer as supporting the resilience of the financial system: to ensure the banking system has a buffer of capital to protect it against future potential losses, following a build-up of system-wide risk.[47] The countercyclical capital buffer, should it be activated, effectively increases aggregate capital requirements for all ADIs. In order to ensure that the banking system has a buffer of capital to protect it against further potential losses, APRA could deploy this tool in periods when excess aggregate credit growth was judged to be associated with a build-up of system-wide risk. APRA would expect to consult closely with the RBA, and the other CFR agencies, in implementing a countercyclical capital buffer requirement.

APRA's existing tools are appropriate to implement macroprudential policies which, like the countercyclical capital buffer, are aimed at increasing the resilience of the financial system, rather than at macroeconomic objectives. The use of supervisory tools in this manner is entirely consistent with APRA's prudential mandate.

[46] Refer, for example, to the discussion of the risk-weight floor introduced by the Swedish authorities in Finansinspektionen and Sveriges Riksbank 2013, *Minutes of the meeting of the Council for Cooperation on Macroprudential Policy*, October.

[47] Basel Committee on Banking Supervision 2010, *Basel III: A global regulatory framework for more resilient banks and banking systems*, December (revised June 2011).

Stress testing (page 3-31)

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Australian regulators make greater use of stress testing with appropriate resourcing.

Stress testing is a forward-looking analytical tool, useful for both supervisors and APRA-regulated institutions in understanding and managing risk. There are clear benefits in systematically considering severe but plausible scenarios that challenge a regulated institution's viability, and to consider the impact of these scenarios at the financial system level.

As detailed in the Interim Report, the IMF's 2012 Financial Sector Assessment Program (FSAP) review of Australia recommended that APRA devote more resources to stress testing. Since then, APRA has increased resources for stress testing as part of a comprehensive strategy, including specialist resources within a central coordination team, although not to the same extent as other regulators that have made stress testing one of their main supervisory activities. APRA has also invested in specialist training for frontline supervisors, to ensure that stress testing is an integrated part of prudential supervision rather than a stand-alone exercise. Stress testing is intended to support and enhance prudential analysis and supervision, rather than operate as an adjunct to it.

Central to this strategy for stress testing is a regular cycle of APRA-led industry stress tests. APRA has conducted industry stress tests on the banking sector, with recent major exercises in 2009 and 2011-12. APRA is currently in the process of conducting an industry stress test focused on risks that may emerge in a severe economic and housing market downturn. As in previous years, the stress tests will be used to identify vulnerabilities, assess risks and resilience, and as a catalyst to improve stress-testing capabilities across the industry. Given the inherent uncertainties of stress testing, APRA does not set prudential capital requirements on the basis of specific industry tests, and does not disclose the results of individual institutions. The scenarios, impact and results at a system level from industry stress tests have been, and will continue to be, presented publicly.

In addition to industry stress testing, APRA has also increased its focus on regulated institutions' own stress-testing practices. Ensuring that institutions build and improve their own stress-testing capabilities is a key part of APRA's approach. Regulated institutions are expected to consider stress test results in their own capital planning and risk management, and to build effective internal capabilities. This includes strong internal governance, scenario development, reliable data and robust modelling. APRA has conducted offsite and onsite reviews of institutions' stress-testing programmes, and will continue to invest attention in this critical area of capital management.

Stress testing can also provide a perspective on financial stability at a systemic level. APRA therefore works closely with the RBA on a 'top-down' stress-testing framework at the aggregate industry level, as well as conducting internal research and methodologies for stress testing at a 'bottom-up' level. Developing these capabilities in tandem will provide a stronger framework and greater flexibility to assess vulnerabilities across different risks and segments of the industry. Increasing the speed and depth with which these modelling capabilities are developed would either require additional resources or careful cost-benefit analysis of the trade-offs involved in reprioritisation through diverting resources from other activities.

Calibrate the prudential framework (page 3-41)

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Maintain the current calibration of Australia's prudential framework.
- Calibrate Australia's prudential framework, in aggregate, to be more conservative than the global median. This does not mean that all individual aspects of the framework need to be more conservative.

The Inquiry seeks further information on the following area:

- Is there any argument for calibrating Australia's overall prudential framework to be less conservative than the global median?

APRA welcomes the Inquiry's conclusion that the historical approach to calibrating Australia's prudential framework has held the Australian banking system in good stead, particularly during the global financial crisis. The current calibration of the Australian prudential framework remains, in APRA's view, broadly appropriate. By their nature, capital adequacy and other prudential requirements require regular review to ensure they remain fit for purpose, but there is little evidence that current calibrations are materially at odds with APRA's statutory objectives.

As noted in the following section, a direct comparison of ADI capital ratios internationally is difficult. Evaluating the calibration of the broader prudential framework is even more complex. While Australian capital requirements are, in some areas, more conservative than international requirements, other countries have also adopted additional measures that are at this point not part of the Australian framework. As a result, comparing the overall calibration of the prudential framework is extremely challenging.

APRA's assessment is that, on the whole, the Australian prudential framework remains towards the more conservative end of the international spectrum. Since 2013 the gap between Australia and the global median has likely narrowed, given the impact of the post-crisis reforms has been felt far more acutely in a number of other jurisdictions. For example, a number of the Basel III capital reforms introduced requirements into the international framework that were the same or similar to those that had been required in Australia for many years. APRA has also not seen fit to follow the United States, Canada and the United Kingdom in introducing a leverage ratio (at least until such time as international deliberations are complete) or the ring-fencing requirements that are being imposed on many international banks in other jurisdictions (e.g. the Volcker rule in the United States, the Vickers proposals in the United Kingdom, and the Liikanen proposals in the European Union).

There are sound reasons why the Australian prudential framework should be calibrated above the global median: the concentrated nature of the Australian banking system, its dependence on offshore borrowings, and the Australian economy's openness to international economic shocks. Many peer regulators have also introduced local requirements over and above the global minimums: the conservatism of Australia's framework is not an outlier in international terms. Furthermore, as noted in the Interim Report, there is little evidence that this approach has placed Australian ADIs at a significant competitive disadvantage.

Australian institutions benefit in their international dealings from being domiciled in a country with a highly regarded prudential regime. Markets, rating agencies, and offshore regulators all give credit to the strength of APRA's prudential framework when assessing the strength of Australian institutions. Any proposal to shift the Australian prudential framework in such a manner that it became less conservative than the global median, particularly for those banks that seek access to international capital and funding markets, would be short-sighted. There is little evidence to suggest such a move would generate material short-term benefit.

The largest Australian banks enjoy some of the world's highest credit ratings, and some of the world's highest share market capitalisations and market-to-book ratios; this would not necessarily be the case under a weaker regime. In the long run, a diminution in the robustness of the prudential framework would reduce the resilience of the Australian financial system to shocks, and risk a repeat of the extraordinarily painful lessons learned by other jurisdictions from the global financial crisis.

International comparability of APRA's prudential requirements (page 3-42)

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Develop public reporting of regulator-endorsed internationally harmonised capital ratios with the specific objective of improving transparency.
- Adopt an approach to calculating prudential ratios with a minimum of national discretion and calibrate system safety through the setting of headline requirements.

The Inquiry seeks further information on the following areas:

- Would adopting a more internationally consistent approach to calculating capital ratios materially change Australian banks' cost of accessing funding?
- How would using minimal national discretion distinguish between prudent banks that hold capital as currently defined and those that rely on less loss absorbing capital?
- How might APRA need to adjust minimum prudential requirements to ensure system safety is not altered if using minimal national discretion in calculating prudential ratios?

In implementing the Basel framework in a manner suitable to the Australian environment, APRA considers a number of objectives: adequacy, incentives and comparability. Ensuring ADIs have *adequate* capital is the primary goal of the capital framework: that is, APRA sets the aggregate outcome for each ADI at an amount of capital sufficient to ensure that the ADI will meet its obligations even under severe but plausible adversity. Achieving this outcome efficiently is best accomplished by ensuring the capital adequacy framework is risk-based, and therefore provides appropriate *incentives* for ADIs to manage their affairs in a prudent manner. APRA also sees value in appropriate *comparability* of capital ratios, particularly for the largest banks operating internationally. APRA optimises comparability by diverging from the internationally agreed minimum framework only when there are well-founded prudential reasons for doing so. Any such divergences are extensively consulted on and disclosed.

APRA has typically taken a more conservative approach to the measurement of ADI capital adequacy relative to international minimum standards. This has been the case for many years and continues the approach adopted by the RBA when it had responsibility for the prudential supervision of banks prior to APRA's creation.

This approach may inhibit capital comparisons for Australia's internationally active ADIs to some degree. However, as discussed further below, it is not clear there has been any material cost that would justify adoption of a different approach. The Australian approach is also far from unusual. The standards of the Basel Committee are intended to serve as *minimum* standards: there has never been an intention by the international standard-setters to prevent individual jurisdictions from adopting stronger standards where they deem it necessary. Many jurisdictions have, as a result, adopted domestic measures that are more conservative than the internationally agreed minimum standards. National authorities are also increasingly making use of macroprudential adjustments within the regulatory framework, which can lead to additional changes to capital requirements and risk weights in response to increased levels of risk. As a result of these additional requirements imposed by national authorities, computing a precise 'internationally harmonised' capital ratio is not practically possible. A recent study commissioned by the Australian Bankers' Association, which attempts to provide truly comparable capital ratios, only serves to emphasise this point.[48]

In addition to disclosing their capital ratios based on APRA's minimum requirements, APRA has no objection to ADIs reporting a capital ratio based on international *minimum* requirements. Indeed, as the Inquiry has already noted, APRA has already committed to work with the industry to develop such a reporting regime. A capital ratio calculated by stripping out the impact of APRA's national adjustments, and using the least conservative requirements available under the Basel framework, would help identify and measure the impact of APRA's exercise of national discretion in many areas (some, though, may still be unobservable). Such a calculation, however, would not generate a capital ratio that is harmonised with those reported by banks from other jurisdictions, unless similar adjustments were made to the capital ratios of other banks for the idiosyncrasies in their domestic frameworks. In the absence of such adjustments, calling such a ratio 'internationally harmonised' is a misnomer.

Nor would such a calculation inform investors about the true capital buffer an ADI holds. Investors are interested in capital ratios to make two basic comparisons: against other banks and against minimum requirements. The discussion in the Interim Report focuses on the potential to improve investors' ability to make the first of these comparisons. But equally critical is investors' understanding of the capital buffers ADIs hold against various minimum regulatory requirements. An apparently healthy capital ratio measured on an 'international minimum' basis is of limited value in understanding how close or far a bank is from breaching its minimum requirements, and hence from incurring some form of regulatory intervention. Only by comparing the bank's capital ratio, calculated under local requirements, can this be understood. For this reason, in developing disclosure requirements for bank capital ratios to promote transparency, the Basel Committee elected to require banks to report in terms of their local implementation of Basel III.

The only internationally consistent approach to calculating capital ratios would be to calculate ratios using international minimum requirements as a baseline. The Basel Committee debated this in developing its capital adequacy disclosure standards, but rejected the notion on the basis that it may well mislead investors as to the true nature of a bank's financial health when local authorities have seen the need to impose additional requirements, including for macroprudential reasons, to respond to domestic risks. The Basel framework also includes discretions that allow each member jurisdiction the ability to tailor the regime to the circumstances of its own banking market – in some places, there is no definitive minimum standard *per se*.

International investors appreciate that there are differences in the 'headline' capital numbers across institutions in different regulatory regimes and understand that the largest Australian ADIs are well capitalised. The largest differences, such as those due to capital deductions, are already disclosed. As the major banks remain among only a small number of listed global banks with AA ratings it is highly unlikely that any change in determining

48 Australian Bankers' Association 2014, *International comparability of capital ratios of Australia's major banks*, August.

capital sufficiency would have an impact on Australian banks' cost of funds. Equity investors also seem to view the major banks more favourably than many of their international peers: the major banks' market capitalisation is around twice the book value of their equity, a broadly similar ratio to their Canadian peers, but significantly higher than British, American and European banks (where the ratio is around one times). Similar trends are observed in debt markets, where the cost of default protection against the major Australian banks is, on average, lower than for large British, American and European banks. Rating agency Standard & Poor's rates Australia as one of the five least-risky banking systems of the 86 that they cover.[49]

Initiatives to improve comparability of capital ratios need to be careful not to undermine the broader objectives of the capital regime. To achieve a given level of capital adequacy, APRA can adopt one of two broad approaches:

- simply adopt the minimum international requirements for determining eligible capital and establishing risk weights, and calibrate the entire system using only the minimum capital ratios; or
- fine-tune the specific requirements within the framework as needed, and maintain the internationally accepted benchmarks for minimum capital ratios (the most well-known being the minimum capital ratio of 8 per cent).

Consistent with its strong belief in establishing appropriate incentives by using risk-based requirements, APRA has traditionally adopted the second of these approaches.

APRA's approach has a number of advantages:

- rather than requiring additional capital across all of an ADI's assets, specific adjustments can be targeted at (and only at) specific risks, thereby promoting efficiency within the capital framework;
- comparability across ADIs is enhanced, and competitive neutrality is maintained, as the requirements fall on those ADIs where the additional capital is most needed;
- targeted adjustments enhance the incentives within the capital framework to ensure the prudent management of risk and the maintenance of high-quality capital;
- the adjustments are transparent and, with appropriate disclosures, their impact can be readily understood; and
- the adjustments allow for the preservation of the internationally well-known minimum benchmarks.

The alternative approach of calibrating the entire framework using only the minimum capital ratios might marginally improve international comparability. However, it would come at the cost of a considerably less risk-sensitive regime. This reduction in risk sensitivity would reduce both the efficiency and effectiveness of the capital adequacy framework. A less risk-sensitive regime would also, perversely, be likely to place much greater emphasis on APRA's Pillar 2 adjustments to ensure ADIs remain appropriately capitalised. Because Pillar 2 adjustments are not disclosed, this would undermine the very transparency and consistency that the approach is designed to achieve: investors would have less visibility of where an ADI's capital ratio stood relative to the minimum requirements APRA has imposed.

As discussed above, the best approach to improving the international comparability of capital adequacy ratios, without compromising the veracity of the measure, is through disclosure of the impact of APRA's policies. This approach is similar to the Inquiry's option of separately reporting harmonised capital ratios, but acknowledges that disclosure of a truly comparable ratio is not possible without international cooperation. APRA has implemented the Basel Committee's common disclosure template for ADI capital adequacy information. APRA is working with the industry on a reporting template to further facilitate comparisons between the capital ratios of Australian and overseas banks.

[49] Standard & Poor's 2014, *Australian Banking Sector Outlook: Ratings Resilience Anticipated For 2014*, 11 February.

Main differences in the application of the Basel framework

APRA imposes a minimum LGD requirement on residential mortgage exposures of 20 per cent under the IRB approach. This is imposed given the inability of the relevant ADIs to provide convincing estimates of LGDs under a downturn scenario. As detailed in APRA's initial submission, a number of other Basel Committee member countries are making similar adjustments to IRB risk weights for housing lending, reflecting concerns that modelling practices may not capture the full range of risks inherent within housing markets.

For those ADIs that are accredited to use the advanced approaches to credit and operational risk, APRA requires a mandatory (Pillar 1) capital requirement for IRRBB. This is consistent with the Basel II framework that states that where supervisors consider that there is sufficient homogeneity within the banking industry regarding the nature and methods for monitoring and measuring this risk, a mandatory minimum capital requirement could be established.

Since 1990 banks' holdings of other banks' capital instruments in Australia have been required to be deducted from capital for the purpose of calculating minimum capital ratios. A similar requirement for deferred tax assets was introduced in 1991.[50] This approach is based on two longstanding points of principle: assets that rely on future profitability (of the ADI) or that are potentially uncertain in value cannot be included in the calculation of capital, and regulatory capital cannot be used more than once in the financial system to absorb losses. This policy continued with the implementation of Basel III. The additional amount of capital is somewhat offset by APRA's less conservative stance on certain holdings of ADIs' own capital instruments.

APRA has an additional deduction for certain capitalised expenses, such as capitalised software costs. These exposures are classified as intangibles under Australian accounting standards and rely on the future profitability of the ADI in order to realise their value. The requirement for deduction from capital is based on a similar principle as that for deferred tax assets.

Requirements on boards (page 3-48)

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Review prudential requirements on boards to ensure they do not draw boards into operational matters.
- Regulators continue to clarify their expectations on the role of boards.

The Inquiry seeks further information on the following area:

- Is it appropriate for directors in different parts of the financial system to have different duties? For example, differences between the duties of directors of banks and insurers and trustees of superannuation funds. Who should directors' primary duty be to?

[50] Reserve Bank of Australia 1990, *Press Release: Capital Adequacy: Bank's Holdings of other Bank's Capital Instruments*, 90-24, 27 September, and Reserve Bank of Australia 1991, *Press Release: Capital Adequacy: Future Income Tax Benefits*, 91-19, 4 October.

Role of boards

As detailed in APRA's initial submission, requirements for sound governance are a core element of APRA's behavioural standards. Experience consistently demonstrates the importance of strong governance standards in APRA-regulated industries. In the 1980s and 1990s, severe problems in regulated institutions in Australia were often the product of poor governance and control frameworks. Until a decade ago, however, APRA had little in the way of prudential requirements relating to governance, risk management and the role of the board.

Building on the lessons from a number of significant losses by Australian institutions in the early 2000s, raising governance and risk management standards has been a priority for APRA over most of the past decade. APRA's focus on this area has been validated by the experience of the global financial crisis: shortcomings in how boards met their responsibilities have been identified as a material contributor to the crisis that occurred. In the United Kingdom, for example:

> *'The crisis exposed significant shortcomings in the governance and risk management of firms and the culture and ethics which underpin them. This is not principally a structural issue. It is a failure in behaviour, attitude and in some cases, competence.'*[51]

It is sometimes asserted that APRA's requirements extend beyond those considered appropriate for directors and thereby require board involvement in operational matters that should generally be the responsibility of senior management. This is not APRA's intent. Ultimately, boards of regulated institutions are responsible for establishing an appropriate governance regime within which the institution's risk and capital management can effectively operate. While the *Corporations Act 2001* (Corporations Act) establishes general obligations for board directors and other officers to act with care, diligence and in good faith, it does not fully address all the essential elements of good corporate governance in prudentially regulated institutions, as identified in the Basel Committee's *Core Principles for Effective Banking Supervision*, the International Association of Insurance Supervisors' (IAIS) *Insurance Core Principles* (for life and general insurance) and by the FSB. These include requirements on matters such as board composition and skills, responsibilities for risk management, remuneration principles and the roles of the Chief Risk Officer and board committees.

APRA agrees that regulatory requirements should not confuse or blur the delineation between the role of the board and that of management. APRA expects the board to provide oversight of key aspects of policies and frameworks, and to challenge management as appropriate. In light of industry concerns, APRA is currently reviewing its prudential requirements to identify areas that may be perceived as leading to a blurring of duties. This includes engaging with experienced directors to hear firsthand how they think the current framework can be improved.

The Interim Report notes that it may be possible to identify areas where management could more appropriately undertake certain obligations. It is important that the Inquiry understands that, in many cases, obligations imposed on boards are designed to demonstrate that appropriate oversight and challenge of management is occurring. Delegating such responsibilities to management may be ineffective or counter-productive. Therefore, consideration may also need to be given to additional external (third-party) review to achieve the prudential objective.

Differences in board responsibilities

As detailed in the Interim Report, directors in different parts of the financial system have different duties. All directors have duties under the Corporations Act, while some have additional duties imposed on them by the relevant Industry Acts.

[51] Sants H. 2012, Chief Executive of the Financial Services Authority, 'Delivering effective corporate governance: the financial regulator's role', 24 April.

In the case of superannuation, section 52A of the SIS Act contains covenants which apply to the directors of a corporate trustee of an RSE. These provide that the directors must, among other requirements, perform their powers and functions in the best interests of beneficiaries. These duties are expressed to override the Corporations Act duties. Section 48 of the Life Insurance Act places a similar duty on directors of life insurers to give 'priority to the interests of owners and prospective owners of policies referable to the fund'. Section 2A of the Insurance Act notes that the Act imposes primary responsibility for protecting the interests of policyholders on the directors (and senior management) of general insurers, although the Act does not include provisions in the same terms as those of the SIS and Life Insurance Acts. The Banking Act is silent on the requirements of directors of ADIs in relation to depositors.

For superannuation and life insurance, the Industry Acts are clear regarding the duty of directors to fund members and policy owners respectively. In both industries, the existence of the special director duties can be seen as consistent with the legal basis upon which the assets supporting beneficiaries' claims are held:

- in the case of superannuation, the trustee company - that is the RSE licensee - holds the assets in trust on behalf of members. The SIS Act makes clear as to whom trustee-directors owe their duty of loyalty in relation to those assets. APRA regards this as fundamental to the integrity of the superannuation system; and
- the duties in section 48 of the Life Insurance Act are closely related to the statutory fund regime, which is intended to separate the assets and liabilities referable to a class of policy owners from the general assets and liabilities of the life company. The directors of a life company have a duty to see that the company gives priority to the interests of policy owners, with the statutory fund having some resemblance to a trust.

In contrast, ADIs and general insurers are not required to segregate assets and liabilities referable to their customers.

The difference between directors' duties under the various Industry Acts also reflects the difference in the nature of products provided to beneficiaries. Investment-based products offered by superannuation funds and life companies are not (or not always) defined by readily verifiable, quantitative obligations for a particular return or benefit. In contrast, a deposit with an ADI is offered at a specified rate of interest and general insurance policies cover specified loss or damage of, for example, property. In the case of superannuation and life insurance, the objective is for the trustee or life company director to strive to maximise the rate of return (either generally, or in relation to a given class of investments), and this requires a greater emphasis on the best interest of members or policyholders.[52]

In summary, the current requirements placed on directors by the respective Industry Acts are in line with differences in operational structure, and the nature of the 'promise' contained in the traditional products of each industry. Beyond that, APRA's requirements of directors are largely harmonised within its prudential standards, and further harmonisation of requirements of directors in the relevant Industry Acts does not seem warranted.

[52] It is worth noting that directors of Responsible Entities of managed investment schemes, which are also investment funds that have the purpose of maximising the rate of return, have similar duties to those required of directors of superannuation trustee companies and life insurance company directors. Refer to section 601FG of the Corporations Act.

Chapter 6 of the Interim Report: Consumer outcomes

Product rationalisation of ‘legacy products’ (page 3-87)

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Government to renew consideration of 2009 proposals on product rationalisation of legacy products.

As detailed in APRA’s initial submission, legacy products arise particularly in life insurance and superannuation. In these industries, consumers may purchase financial products that often last a lifetime, even though the financial, taxation and regulatory environment continually changes. Over time, older products become expensive to administer, particularly if they are no longer offered, as the IT systems used to support the product age and the corporate memory of the product provider fades. Quite often, the legacy products are no longer meeting the needs of beneficiaries, but there is no effective means to move these beneficiaries into newer, more cost-effective products.

The Banks Report recommended that the Australian Government, State and Territory governments, APRA and ASIC should, in consultation with industry stakeholders, develop a mechanism for rationalising legacy financial products.[53] Its main purpose would be to remove legacy products by transferring investors into newer, more efficient products. Appropriate safeguards can be designed so that this can be done in such a way as to benefit both product providers and their customers.

Progress in this matter has stalled since 2010, yet the problem associated with legacy products will arguably become greater the longer the issue remains unaddressed. APRA strongly supports the resumption of work on this issue. It would help mitigate the increasing operational risk that such products create in the superannuation and life insurance industries, as well as reduce the operational costs that financial institutions, and ultimately consumers, are currently incurring.

[53] Regulation Taskforce 2006, *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business*, page 103.

Chapter 7 of the Interim Report: Regulatory architecture

Regulatory burden (page 3-97)

The Inquiry seeks further information on the following areas:

- Is there evidence to support conclusions that the regulatory burden is relatively high in Australia when considered against comparable jurisdictions?
- Are there examples where it can be demonstrated that the costs of regulation affecting the financial system are outweighing the benefits?
- Are there examples where a more tailored approach could be taken to regulation; for example, for smaller ADIs?
- Are there regulatory outcomes that could be improved, without adding to the complexity or volume of existing rules?
- Could data collection processes be streamlined?
- If new data is required, is there existing data reporting that could be dropped?
- Instead of collecting new data, could more be made of existing data, including making more of it publicly available?

Regulatory burden

The Interim Report notes that measuring whether benefits of regulation outweigh the costs is challenging, given the indirect nature of these costs and the intangible aspects of the benefits. The Report outlines some specific concerns related to regulatory burden that were raised in submissions, including issues such as inadequate consultation, uncertain timing and excessive prescription.

A key determinant of total regulatory burden imposed by APRA on the financial sector is the overarching approach to regulation and supervision. APRA seeks to take a principles-based and proportionate approach to its oversight of financial institutions, which recognises that there can be more than one method to effectively and efficiently achieve a particular prudential outcome. For example, APRA's governance standards allow tailored approaches for large and small institutions and for different operating structures, provided the institution can demonstrate that the principal prudential objective is achieved. Another example of this proportionate approach is the ADI liquidity requirements: smaller institutions are not expected to be able to devote the same resources to complex modelling as larger institutions, and nor is this required to appropriately reflect the risks in their business models.

Once a sound policy framework is established, APRA is more likely to achieve effective prudential outcomes through constructive and intensive supervisory interaction with regulated institutions on issues of concern, and through prudential guidance rather than through the continued addition of detailed rules. Current issues of prudential concern – for example, housing underwriting standards and group life insurance risk – are being dealt with primarily by discussions with, and detailed reviews of, institutions about appropriate risk management, rather than developing new regulations. APRA's supervision-led approach offers three key benefits to minimise regulatory burden:

- it allows for greater supervisory attention to be targeted at issues and institutions of greatest risk;
- it avoids imposing regulatory cost where it is not needed; and
- it provides scope to meet regulatory objectives in a manner best suited to the size, nature and complexity of the institutions concerned.

The regulatory structure is also a factor in driving regulatory costs. Compliance with multiple sets of regulatory expectations leads to excessive and duplicative regulatory costs. Australia appears relatively well placed in this regard. Prudential supervision of ADIs, insurers and superannuation funds is undertaken solely by APRA. As a result, overlap with other Australian regulators is minimal and respective roles are clearly delineated.[54] In contrast, in a number of other countries, two or more domestic regulatory agencies have prudential responsibilities relevant to the same institutions. Examples include the multitude of banking supervisors in the United States, the new supervisory mechanism in the European Union, and the joint supervisory responsibilities between the prudential supervisor and the central bank of Japan.

Costs and benefits

APRA is subject to the Government's best practice regulation process administered by the Office of Best Practice Regulation. This process involves a cost-benefit analysis of the impact of any proposed new regulation (and alternatives) on different groups in the Australian community and on the community as a whole, culminating in the publication of a RIS. Since this framework has been in place, APRA has maintained full compliance with the RIS requirements. Following recent changes, all RISs must now specifically quantify the costs of all new regulations to business, not-for-profit organisations and individuals, and must be at least cost neutral, as determined using the Business Cost Calculator.

As part of the Government's policy to boost productivity and reduce regulation, APRA is currently undertaking a project to identify areas where regulatory cost savings for the industry and APRA may be achieved, without jeopardising the overall effectiveness of the prudential framework. Working with input from industry, APRA has identified a range of areas where refinements to the prudential framework may be able to be made without unduly compromising sound prudent outcomes. A prioritisation process is being undertaken to identify specific options to pursue, having regard to the extent of compliance cost savings available, effort likely to be involved in making any changes and the likely prudential impact. APRA expects to be able to announce an initial set of proposals in the near future.

The Productivity Commission's Regulator Audit Framework also provides useful guidance for assessing the extent to which regulators are imposing costs on regulated institutions.[55] APRA has provided input to the Government on appropriate implementation of the proposed framework for APRA and is working toward implementing appropriate reporting on relevant performance measures in this area.

APRA agrees with the Interim Report's comment that '[c]osts and benefits go beyond the content of the regulation: how it is implemented also matters.'[56] APRA carefully considers the timing of the implementation of new requirements on the affected industries, and takes into account the extent of change likely to be required by industry to meet these requirements. Where new requirements involve a significant learning or adaptation process, APRA engages with the industry from an early stage to ensure effective implementation is achieved. Extended timeframes for compliance are generally provided where many institutions are materially affected by the regulatory changes. Bespoke transitional arrangements for specific institutions or segments of an industry that are more materially affected will be established where necessary. This was the case, for example, for the implementation of APRA's reforms to life and general insurance capital requirements, which involved significant changes to practices and overall capital levels at some particular institutions. On the other hand, in the case of the Basel III capital requirements, nearly all institutions were in full compliance with the new requirements at the effective date. As a result, there was no need for protracted implementation timelines.

54 In particular, the Regulation Taskforce 2006, *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business* investigated the issue of regulatory overlap between APRA and ASIC, and found very little in the way of duplicated or conflicting requirements. The recommendations of the Report, designed to help ensure this remained the case, have been implemented by the respective agencies.

55 Productivity Commission 2014, *Regulator Audit Framework*, March.

56 Financial System Inquiry 2014, *Interim Report*, July, page 3-94.

Tailored approach for smaller ADIs

Submissions to the Wallis Inquiry indicated a desire by credit unions and building societies to be held to the same standards as banks. This was viewed as critical to being seen to be of equivalent financial strength, and to maintain competitive neutrality. The Wallis Inquiry generally supported this proposition, but nevertheless encouraged a degree of flexibility in the prudential framework to recognise that one size did not always fit all.

APRA's principles-based prudential approach for all APRA-regulated industries is specifically designed to support tailored approaches for institutions of different scale or with specific business models. Across APRA's prudential standards, there is considerable scope for smaller institutions to demonstrate their compliance using less complex, more streamlined approaches. Some requirements already contain explicit size-based gradations; for example, a less sophisticated approach to the Pillar 3 disclosure requirements for smaller ADIs has been in place since the implementation of Basel II. Small ADIs are also subject to a simplified loan-loss provisioning methodology and reduced regulatory reporting requirements. In some cases, simplified or tailored approaches can be provided through the exercise of supervisory discretion or exemptive authority under prudential standards (for example, exemption of some small ADIs from the requirement for an institution to staff its own internal audit function).

As part of its efforts to identify potential regulatory cost savings, APRA is open to considering options to simplify the prudential framework for smaller ADIs. However, a graduated approach should not lead to an overall weakening of the prudential requirements applying to ADIs, and should avoid creating the perception of a 'second-class' group of institutions.

Data collection

A modern economy requires considerable and high quality data to facilitate informed and effective public-sector policy decision-making and efficient interaction with the financial sector. In the context of total assets of APRA-regulated institutions of $4.5 trillion, the total costs of data collection are small relative to the costs that would flow from APRA and other agencies not having access to adequate, accurate and timely data.

APRA is a central repository of statistical information on the Australian financial system and collects and publishes a broad range of financial and risk data that are essential input to its supervision of regulated institutions. In addition, APRA collects data from APRA-regulated and non-APRA-regulated financial institutions to assist the RBA, the Australian Bureau of Statistics and ASIC to fulfil their roles; APRA also collects some data to fulfil international reporting expectations of organisations such as the Bank for International Settlements. Much of the data is shared between agencies to reduce the reporting burden on institutions.

APRA concurs with the need to regularly review both data collection processes and the supporting infrastructure. As part of its project to reduce regulatory compliance costs, APRA will be assessing whether its data collection processes could be made more efficient. Consideration will also be given to whether any current data collections could be streamlined, such as through less frequent or less detailed reporting.

The infrastructure that supports APRA's data collection, the electronic system 'Direct to APRA' (D2A) is now 15 years old. Despite being upgraded over time, stakeholder feedback is that it is not as easy to use as other more modern technology. D2A has also become costly for APRA to maintain, and is not well integrated with recent Government initiatives. For example, D2A is Standard Business Reporting (SBR) compliant, but SBR is not integrated into D2A. Nor does D2A allow software providers to access D2A from within their own environment, which makes it difficult for these providers to verify that their software works for regulated institutions. APRA considers the future life of D2A to be limited; any replacement data collection system is likely to cost in the tens of millions of dollars. While the benefits are likely to be substantial, APRA does not currently have funding for such a major capital project. APRA will investigate potential replacement systems for D2A when this becomes feasible.

Data reporting and publication

APRA regularly reviews its data reporting requirements and publications. Typically, this occurs as part of the implementation of broader changes to the prudential framework. Over time, prudential data collection needs change and previously useful data can become obsolete. The APRA project to reduce regulatory compliance costs will systematically look at areas where longstanding data collections can be scaled back or ceased. APRA also has underway a wholesale review of its ADI data collection, which may lead to discontinuation of some data items where costs of collection outweigh benefits for supervision or other uses. Particular attention is being given to data collections that do not have any prudential purpose.

New or revised prudential data is often required, however, as new industry trends emerge and regulatory requirements change. Where new data is considered necessary for prudential or other purposes, APRA is mindful of existing reporting requirements and the burden on regulated institutions of introducing new or revised reporting forms. In the case of the new reporting forms required to support the implementation of the Stronger Super reforms, for example, APRA had regard to the existing suite of returns and chose to phase in the new statistical returns in order to reduce the burden on superannuation funds. In response to industry concerns, APRA is reviewing the initial suite of reporting requirements and is currently undertaking consultation on proposals to pare back the original proposals for select investment option reporting.

APRA aims to ensure that all data it collects is actively used and is useful, be it for prudential, macroeconomic, industry or other purposes. Prudential and other data is of considerable value in understanding key industry trends and risks.

APRA generally supports making more of the data it collects from regulated institutions publicly available. Over the years, APRA has published an increasing amount of prudential data. For example, APRA has recently begun publishing greater detail on aggregate property-related exposures of ADIs. APRA has proposed to make certain general insurance, life insurance and superannuation data non-confidential and therefore publicly accessible.[57] APRA also plans to introduce a new online data dissemination tool that will enable enhanced access to data in a manner that facilitates manipulation, visualisation and analysis.

APRA has a legal obligation under the APRA Act to protect confidentiality and privacy of information it collects from regulated institutions, but has authority to determine which information is not confidential and can therefore be published. Typically, industry submissions are very supportive of publication of aggregate-level data; however, institution-specific information is considered more sensitive. This usually stems from concerns that publication of some types of institution-specific data could result in disclosure of confidential business strategies or otherwise be of commercial detriment to regulated institutions. APRA will continue to work with the industry on expanded access to regulatory data, and welcomes views from the Inquiry on areas where additional publication of regulatory data would be beneficial. It needs to be acknowledged that publication requires a high level of data reliability, requiring greater resourcing for data quality validation at both APRA and regulated institutions.

[57] APRA 2013, *Confidentiality of general insurance data and changes to general insurance statistical publications*, February, APRA 2013, *Confidentiality of life insurance data and changes to life insurance statistical publications*, February, and APRA 2013, *Publication of superannuation statistics and confidentiality of superannuation data*, November.

Prudential regulation of superannuation (page 3-103)

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Align regulation of APRA-regulated superannuation trustees and funds with responsible entities and registered managed investment schemes.

In 1997 the Wallis Inquiry specifically reviewed the appropriateness of prudential regulation of superannuation funds. It recognised that superannuation and managed investment schemes were operationally equivalent in many respects, but recommended that superannuation's unique characteristics continued to provide a case for prudential supervision. These characteristics included the compulsory nature of superannuation savings, the lack of effective choice for a large proportion of members, the long-term nature of superannuation and the contribution of superannuation to tax revenue forgone.

The Inquiry notes that these characteristics have persisted, and APRA considers them to be of greater significance given the continued growth of superannuation and hence its importance in the context of retirement income policy. Accordingly, there is no strong case for change to this model. Indeed, the costs and disruption that would flow from such a change would be material and would appear to significantly outweigh any possible benefits.

The 2010 Cooper Review noted that due to its compulsory nature, many members of superannuation funds do not have the necessary capabilities to make optimal decisions about their investment strategies.[58] The superannuation system is complex and, unlike many investors who choose to place funds in managed investment schemes, many superannuation members either choose not to monitor the performance of their superannuation fund or do not possess the necessary financial literacy to do so.

As the superannuation sector continues to increase in size and complexity and members' expectations of achieving an adequate retirement income increase, fiduciary duties for trustees will remain high. A primary objective of APRA's prudential requirements and supervision is to ensure trustees act appropriately and with members' best interests at the forefront of their thinking. APRA seeks to promote safety and soundness through trustee governance and risk management practices, and competence and effectiveness of the trustee board and senior management, to enhance the likelihood that members' expectations, and the Government's retirement income policy objectives, are met.

[58] Super System Review 2010, *Final Report - Part 1: Overview and Recommendations*, page 8.

A conduct regulation approach such as that applied to managed investment schemes, with a narrow focus on compliance with licensing and disclosure requirements, would not provide an adequate level of confidence that superannuation trustees are operating their funds prudently and in members' best interests. As the Interim Report notes, consumers have experienced higher levels of failure from investing in managed funds that were not subject to prudential oversight, including failed agricultural and property development schemes, as well as in other institutions subject solely to conduct regulation.[59]

The benefits of APRA's integrated supervision approach further support continued prudential regulation of superannuation. As noted in APRA's initial submission, over the past 17 years there has been a marked growth in the size of financial conglomerates: APRA-regulated subsidiaries of large financial groups now make up nearly 40 per cent of the total APRA-regulated superannuation sector.[60] Given the current trend of consolidation within the financial sector, this share is expected to increase further. APRA considers that there are clear efficiency benefits from having an integrated prudential regulator using similar supervision techniques and broadly similar prudential standards to oversee the superannuation activities of financial conglomerates. In addition, integrated supervision avoids the risk of regulatory 'blind spots' with respect to the varied activities of complex financial groups, including their superannuation activities.

Prudential regulation does, of course, involve the direct cost of APRA supervision. In 2013, the levy on superannuation funds to fund APRA's activities was $38.4 million, or about 3.6 cents per $1,000 in superannuation assets supervised. A decade earlier, the levy equalled about 5.9 cents per $1,000. This cost does not seem excessive, particularly in the context of the low level of loss or failure as a result of gross mismanagement or fraudulent conduct for prudentially regulated superannuation funds since APRA's establishment.

Given the need for continued prudential regulation of superannuation, the collapse of Trio Capital highlighted a number of areas where the legislative powers available to APRA could be strengthened to reduce the likelihood of similar issues occurring in future. Several such areas were identified in a report by the Parliamentary Joint Committee on Corporations and Financial Services into that collapse, and related in particular to licensing and changes of ownership and control.[61] APRA has examined its legislative powers in superannuation and identified three key changes that would align its powers with those available in other APRA-regulated industries:

- a broad and robust power to give directions;
- broader discretion to refuse an RSE licence and powers to set licensing criteria; and
- powers to approve changes in ownership and control of RSE licensees.

APRA views it as important that these key changes be implemented.[62]

Finally, while there is a strong case for the prudential regulation of those superannuation funds that are currently APRA-regulated, that does not extend to self-managed superannuation funds (SMSFs). As the members of an SMSF are also its trustees (or directors of a company that is the trustee), the interests of members and trustees are naturally aligned. The cost of prudentially regulating SMSFs would, simply by virtue of the sheer number of such funds, be substantial and significantly outweigh any benefits. The current arrangement whereby SMSFs fall outside the prudential perimeter is therefore appropriate.

[59] As noted in the Interim Report, recent examples include Storm Financial, Trio Capital, Opes Prime, Westpoint and Commonwealth Financial Planning.

[60] APRA 2014, *Financial System Inquiry Submission*, 31 March, page 12.

[61] Parliamentary Joint Committee on Corporations and Financial Services 2012, *Inquiry into the collapse of Trio Capital*.

[62] Enhancements to APRA's directions powers were included in the 2012 Government Consultation Paper titled *Strengthening APRA's Crisis Management Powers*, but have yet to be implemented.

Retail payment systems regulation (page 3-106)

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Consider a graduated framework for retail payment system regulation with clear and transparent thresholds.

The Inquiry seeks further information on the following areas:

- Is there firm evidence to support opportunities for simplifying the regulatory framework for retail payment systems and participants?
- What are practical and appropriate options to simplify the current regulatory framework for retail payment systems and participants?

In 2003, APRA established requirements for the regulation of non-ADI credit card providers (Specialist Credit Card Institutions, or SCCIs) in support of policies for credit card scheme participation administered by the RBA. SCCIs are licensed as a class of ADIs subject to a less comprehensive prudential regime. To date, use of the SCCI regulatory regime has been minimal, with only two providers currently licensed.

Earlier this year the Payments System Board determined that the SCCI regime was no longer necessary, and that participants in credit card schemes should not need to be licensed by APRA. APRA supports this approach, given the very limited prudential risks inherent in credit card issuing and acquiring businesses. APRA will work with the RBA and the Government to implement the necessary regulatory changes.

As described in the RBA's March 2014 submission to the Inquiry, regulation of purchased payment facility (PPF) providers was mandated under the *Payment Systems (Regulation) Act 1998* as a result of concerns expressed in the Wallis Report about the potential growth of stored-value cards and online payment systems with deposit-like features.[63] A Banking Act regulation was established to prescribe that, in certain cases, this activity constituted banking business and therefore needed to be licensed and supervised by APRA. In particular PPF providers that operate such that the customer is able to obtain repayment of balances on demand, and where the system is available on a wide basis as a means of payment, are currently considered to be banking business. APRA established a PPF licensing regime to implement this requirement; like SCCIs, PPF providers are subject to a less comprehensive set of ADI prudential requirements.

To date, stored-value cards and online stored-value payment systems have not emerged as strongly as anticipated in the Wallis Report. The need for the PPF licensing regime has been very low, with only one PPF provider currently licensed by APRA. APRA concurs with the RBA's March 2014 submission to the Inquiry that where customer balances are not high, PPF regulation is largely a consumer protection issue and that ADI-style regulation may not be needed. APRA is open to working with the Government and RBA to achieve more targeted and streamlined approaches in this area.

[63] Reserve Bank of Australia 2014, *Submission to the Financial System Inquiry*, March.

Operational independence (page 3-110)

The Inquiry seeks further information on the following areas:

- Do Ministerial intervention powers erode regulator independence?

APRA's effectiveness as a prudential regulator – its ability and willingness to act – depends crucially on having a clear and unambiguous mandate and operational independence, a robust set of prudential requirements, an active programme of risk-based supervision, and adequate staffing and financial resources to meet its statutory objectives.

APRA agrees with the Inquiry's conclusion that independence of the financial regulators should be maximised to the greatest extent possible, with appropriate accountability mechanisms to provide the necessary checks and balances.[64] As noted in APRA's initial submission, the passage of time has seen the imposition of constraints on its prudential, operational and financial flexibility that have eroded its independence. As a result, it falls short of global standards in this area.

APRA's initial submission noted two aspects of the legislative framework under which APRA operates that are important in this regard:

- Changes to the APRA Act in 2003 diminished the clarity around APRA's prudential policy-making authority. It is preferable that the law clearly recognise APRA's ability to set prudential policy, within the bounds set out by the APRA Act and relevant Industry Acts. APRA's policy-making role could also be reflected clearly in the Government's *Statement of Expectations* (SOE) and APRA's *Statement of Intent* (SOI).
- The 2003 changes also made it easier for the Minister to give a direction to APRA (although not in relation to a particular entity). This power, while not used to date, has been identified by the IMF as potentially diminishing the ability of APRA to carry out its supervisory and regulatory functions effectively. While it is accepted that the Government should have a reserve power to override the decisions of regulatory agencies, the framework under which this power can be used is critical to ensuring its presence does not erode regulatory independence. The original model for issuing directions to APRA was based on those applying (and still applying) to the RBA. A similar process has since been instituted for the Future Fund in respect to its investment directions.

Strengthening APRA's independence in these areas could be appropriately combined with commensurate measures to improve transparency with respect to how APRA considers and balances its policy objectives, as discussed further below in the section on accountability.

64 Financial System Inquiry 2014, *Interim Report*, July, page 3-108.

Budgetary independence (page 3-113)

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Move ASIC and APRA to a more autonomous budget and funding process.

APRA supports the best case funding model set out in the Interim Report, as well as the Inquiry's conclusion that current arrangements could be enhanced to provide greater stability and certainty year to year, and thereby promote greater operational independence. A more autonomous budget and funding process for APRA, together with increased transparency and consultation regarding how APRA proposes to utilise its resources, would also be consistent with recommendations made in the 2013 Australian National Audit Office (ANAO) review of the current levies process.[65] The Interim Report proposed the following model, which is consistent with the approach put forward in APRA's initial submission:

- Industry and other stakeholders would receive an opportunity to provide feedback on the budget proposals and the level of APRA resourcing proposed (there are a range of mechanisms that could be instituted to give effect to this).
- A final budget and levies proposal would then be submitted to Government, including a summary of the feedback received from industry and other stakeholders and APRA's response to these.
- The Government would adopt the proposed budget, and efficiency dividends would not be applied to APRA.

APRA would also publish more detailed, and multi-year, budget projections as a basis for the consultation process.

A process along the lines set out above would provide greater certainty and stability of APRA's funding from year to year. The enhanced external consultation process would also drive greater internal and external scrutiny of the allocation of APRA's resources across functions, and assist APRA in identifying opportunities for efficiencies. This would further strengthen transparency, and hence APRA's accountability, as discussed in the next section.

The Interim Report also notes that a key principle underpinning a best-case funding model for financial regulators is that it promotes operational independence. The enhanced accountability framework that is proposed should reduce the need for APRA to be subject to broader whole-of-Government procurement and other requirements, which are not always well-suited to the needs of an agency of APRA's scale and scope.

[65] Australian National Audit Office 2013, *Determination and Collection of Financial Industry Levies*, ANAO Performance Audit Report no. 9.

Accountability (page 3-117)

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No changes to current arrangements.
- Conduct periodic, legislated independent reviews of the performance and capability of regulators.
- Clarify the metrics for assessing regulatory performance.
- Enhance the role of Statements of Expectations and Statements of Intent.
- Replace the efficiency dividend with tailored budget accountability mechanisms, such as regular audits and reviews to assess the regulators' potential for savings.
- Improve the oversight processes of regulators.

APRA is accountable for its activities and performance through a wide range of existing oversight mechanisms, including the following:

- APRA is required to publish an Annual Report, which provides a thorough account of its activities each year. The Report is tabled in Parliament and published on the APRA website.
- APRA makes regular appearances at Senate Estimates, as well as *ad hoc* appearances before other committees. It is proposed that APRA will also make a regular half-yearly appearance before the House of Representatives Standing Committee on Economics, on a similar basis as the RBA.
- APRA receives an SOE from the Government which sets out the Government's expectations about the role and responsibilities of APRA, its relationship with the Government, issues of transparency and accountability, and operational matters to guide its activities. In response, APRA issues an SOI to indicate how it will meet the Government's expectations. APRA's SOI provides details of its commitment to effective and efficient delivery of its activities and to ensuring that it operates in accordance with relevant legislation and Government requirements.[66]
- APRA publishes an Annual Regulatory Plan that sets out APRA's current policy agenda and the status of various policy initiatives.
- APRA's expense base is set annually by the Government, and its budget is subject to scrutiny by the Department of Finance.
- APRA is subject to annual financial audits by the ANAO, as well as occasional performance audits.
- APRA complies with the Government's best practice regulation process administered by the Office of Best Practice Regulation, which includes cost-benefit analysis and extensive consultation on policy proposals.
- APRA's regulation-making power is in the form of prudential standards, which are disallowable instruments and therefore subject to veto by Parliament.
- APRA's exercise of its supervisory powers is, for the most part, done confidentially, but it is ultimately subject to review by either the Administrative Appeals Tribunal or the courts under the *Administrative Decisions (Judicial Review) Act 1977*.

[66] The Treasury 2014, *Statement of Expectations—Australian Prudential Regulation Authority*, and APRA 2014, *Statement of Intent—Australian Prudential Regulation Authority*, July.

In addition to meeting these requirements:

- APRA senior executives regularly give speeches and public presentations to explain APRA's current priorities and activities.
- APRA commissions regular independent surveys of key stakeholders to elicit their feedback on its performance.
- APRA is subject to independent reviews by various international bodies, as detailed in APRA's initial submission to the Inquiry.

The outputs from these accountability and oversight mechanisms, such as audit reports, RISs, policy consultation responses and submissions, speeches and stakeholder survey reports are regularly published, along with other information on APRA's activities.

Given the desirability of strengthening APRA's operational and budgetary independence (as discussed in the preceding section), additional accountability mechanisms may be warranted to ensure an appropriate balance between independence and accountability is maintained. However, in light of the extensive set of accountability mechanisms already in place, it is important that any additional measures supplement, rather than duplicate, those already in place.

To enhance the effectiveness of APRA's accountability arrangements, and the level of transparency regarding APRA's activities and performance in the context of its statutory mandate, APRA is considering a number of additional measures that may be appropriate, including:

- APRA publishing its four-year Strategic Plan, annual Operating Plan and annual budget and three-year budget forecast as part of an enhanced consultation process in relation to APRA's funding and the determination of the annual industry levies (refer to the previous section);
- APRA commissioning additional periodic independent reviews, by appropriately qualified experts, of aspects of APRA's operations. Consistent with existing practice, reports from those reviews and APRA's response would be made public. These reports would also usefully complement the enhanced budget-setting process described above;
- enhancing reporting against key performance measures relevant to APRA's operations, broadly consistent with the approach outlined in the Productivity Commission's Regulator Audit Framework. APRA could also publish a regular self-assessment against relevant performance measures, consistent with the Regulator Audit Framework;
- APRA undertaking post-implementation reviews at a suitable period after the implementation of major policy reforms, to assess the impact on industry and the effectiveness of the reforms in achieving the intended objectives; and
- APRA enhancing its regular stakeholder survey to cover a broader range of areas and issues relevant to APRA's performance, including in key areas covered by the enhanced reporting framework referred to above.

A number of these ideas are similar to those suggested in the Interim Report, and are discussed in more detail below.

Enhanced Statements of Expectations and Statements of Intent

APRA concurs with the Interim Report's observation that the current SOE process could be enhanced to provide stronger guidance on the Government's expectations about regulatory outcomes to be achieved and metrics or expectations for measuring performance.[67] In APRA's case, a more explicit statement of the Government's tolerance for risk in the financial system, and in particular the failure of a regulated institution, would also help guide APRA's regulatory and supervisory activities. The SOE and SOI should also be regularly updated (e.g. every two to three years). Ideally, this would occur in conjunction with the broader process outlined above for publication of APRA's Strategic Plans in conjunction with consultation on

[67] Financial System Inquiry 2014, *Interim Report*, July, page 3-114.

APRA's budget and funding. Such a process would be consistent with the approach taken for the Reserve Bank of New Zealand's SOI, as referenced in the Interim Report.[68]

Regulatory performance metrics

Despite the focus on regulatory failings as a result of the global financial crisis, regulatory performance measurement remains an under-developed area. APRA is an active participant in emerging international work on this topic, but there are as yet no clear benchmarks that can be gleaned from overseas experience. Evidence to date suggests that Australia is at the forefront of assessing and communicating its regulatory impact and performance.

APRA already publishes a range of performance indicators in its Annual Report, and is seeking to provide greater transparency on how it accomplishes its mission. Initiatives such as the Productivity Commission's Regulator Audit Framework are useful developments in this regard. As part of this initiative, APRA is working to develop additional performance and efficiency indicators. These may include, for example, greater detail on supervisory activities and decisions, and use of financial and staff resources.

Budget accountability mechanisms

APRA has in recent years been subject to general 'efficiency dividend' requirements under which the Government has reduced agency funding with the objective of driving efficiency savings and improving its overall budget position. As noted by the Inquiry, the efficiency dividend is a 'blunt instrument that is not appropriate for smaller agencies with lower levels of discretionary costs'.[69] Efficiency dividends in an industry-funded regulatory agency also make no contribution to the Government's budgetary objectives.

As a result, APRA strongly supports a tailored budget process that would result in greater autonomy for APRA to determine its budget, within agreed parameters and subject to industry consultation and Government oversight, but without the *ad hoc* imposition of efficiency dividends and other blunt cost-saving directives.

As mentioned above, APRA is currently undertaking a project to look at opportunities to drive greater efficiency and effectiveness from a supervision and operational perspective. Although still early in the process, this exercise is likely to yield a range of options to consider. Publication of additional performance measures as discussed above, as well as greater use of independent reviews, would also support a more autonomous budget process.

Independent reviews

APRA has been subject to a number of independent reviews over the past decade on various aspects of its performance. In the wake of HIH Insurance's collapse, APRA commissioned the Palmer Review that prompted material changes to APRA's operations.[70] Reviews undertaken in more recent years by the IMF, FSB, and the Basel Committee have provided objective and independent assessments of APRA's performance against internationally accepted standards.[71] APRA has instituted many of the recommendations of these reviews.

[68] Reserve Bank of New Zealand 2014, *Statement of Intent for the period 1 July 2014 to 30 June 2017*.

[69] Financial System Inquiry 2014, *Interim Report*, July, page 3-114.

[70] Palmer J. 2002, *Review of the role played by the Australian Prudential Regulation Authority and the Insurance and Superannuation Commission in the collapse of the HIH Group of companies*.

[71] Refer to APRA 2014, *Financial System Inquiry Submission*, 31 March, pages 64-66 for further details on these reviews.

APRA does not consider that independent reviews need to be legislated, or be established as part of a rigid whole-of-Government process. Rather the need for, and scope of, external reviews could be dealt with through an enhanced SOE and SOI process. This allows the Government to exercise appropriate oversight of the scope, frequency and transparency of reviews, but in a manner that does not jeopardise regulatory independence. It also allows for reviews to be conducted in a manner tailored to each agency's circumstances, and having regard to the timing and frequency of other independent reviews that currently occur, such as the IMF FSAP.

Given the specialist nature of much of APRA's role and activities, it is important that any independent reviews are performed by suitably qualified organisations or individuals who understand in considerable depth the nature of the operations of prudential regulators. Typically, this would require current or former specialists from appropriate overseas regulators or international organisations. Existing domestic bodies, such as the ANAO, have the expertise to undertake reviews of some of the more operational aspects of APRA's activities, such as its financial and corporate activities. Even reviews that are focused on assessing operational efficiency, however, need to be undertaken by parties with an adequate understanding of the operations of a regulatory agency. As a result, both the scope of these reviews and who would perform them need to be carefully considered.

Improve oversight of regulators

The Interim Report notes that stakeholders have raised suggestions for improving the oversight processes for regulators and provides two examples: establish an Inspector-General of Regulation or establish a unified oversight authority for financial regulators. The steps outlined above to enhance APRA's accountability, including undertaking regular independent reviews of APRA's performance across a range of areas and implementing the Regulator Audit Framework, would be a preferable and more effective approach to improve oversight.

Regulator structure and coordination (page 3-120)

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Consider increasing the role, transparency and external accountability mechanisms of the CFR:
  - Formalise the role of the CFR within statute.
  - Increase the CFR membership to include the ACCC, AUSTRAC and the ATO.
  - Increase the reporting by the CFR.

The Australian regulatory framework provides a clearly defined mechanism for cooperation and coordination between regulatory agencies. APRA agrees with the Interim Report's observation that regulatory coordination mechanisms have been strong, and that the CFR is a flexible and low-cost approach to coordination.[72]

The focus of the CFR is financial stability, and hence it is the focal point for ongoing interagency work relating to strengthening crisis management and monitoring systemic risks. The approach to coordination has worked well and helped contribute to Australia's successful record of interagency cooperation during the global financial crisis. A more formalised approach, with the CFR's powers and functions defined in statute, substantially risks blurring regulators' existing responsibilities and powers, and muddying their accountabilities. On that basis, there is no strong reason to change the current arrangements.

Given its primary focus on financial stability and crisis management, there does not appear to be a need, and it is unlikely to be an efficient use of resources, to widen the permanent membership of the CFR. The CFR can, as it already does, invite other agencies to participate in meetings where there are issues relevant to their responsibilities.

In addition, APRA has a number of mechanisms to promote inter-agency cooperation and coordination with the Australian Competition and Consumer Commission, Australian Transaction Reports and Analysis Centre and the ATO. This includes bilateral Memoranda of Understanding to govern the exchange of information on mutual issues, and established liaison meetings to discuss financial sector policy and relevant enforcement issues.

The CFR publishes key publications on its website, and produced an Annual Report of its activities from 1998 to 2002. Since 2003, summaries of the CFR's activities have been included in the RBA's Financial Stability Review, with many of these issues also chronicled in CFR agencies' own Annual Reports. If the Inquiry formed a view that greater reporting by the CFR was warranted, this is probably best done through an expanded section of the Financial Stability Review. Such an approach would maintain the Review as the primary vehicle for publishing the authorities' views on financial stability matters in Australia.

[72] Financial System Inquiry 2014, *Interim Report*, July, page 3-118.

Regulator mandates (page 3-128)

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Strengthen competition considerations through mechanisms other than amending the regulators' mandates.

The Interim Report observes that the regulators' mandates and powers are generally well defined and clear, but that more could be done to emphasise competition.[73] APRA's approach to balancing its objectives, including competition, was discussed in its initial submission to the Inquiry. While competition is vital to a healthy financial industry, the idea that financial safety and competition are mutually exclusive is short-sighted. Strong prudential regimes make for strong financial institutions and these, in turn, make the most robust competitors through good times and bad.

The Interim Report makes two suggestions to strengthen regulatory consideration of competition impacts that are relevant to APRA:

- appointing an additional APRA Member, or establishing another mechanism, to specifically consider 'the impacts of regulatory intervention on competition'; and
- requiring APRA's Annual Report to include a section on competition.

APRA does not support the suggestion to appoint an additional APRA Member with a narrow mandate. Under APRA's current governance arrangements, APRA Members operate collaboratively and collectively in overseeing APRA's operations and taking prudential policy decisions. All are accountable for considering and balancing the entirety of APRA's objectives. Appointing a narrowly-focused Member with unique responsibilities would create ambiguity in APRA's governance framework; it might also potentially imply lessened responsibility of the other Members with respect to competition.

A preferable approach, if needed, is to strengthen the accountability mechanisms to demonstrate how APRA considers all of its objectives. Ideas in this area have been discussed in the earlier section on accountability. Requiring expanded detail in APRA's Annual Report could be implemented, for example, by including such a request in the Government's SOE for APRA.

[73] Ibid, page 3-121.

Talent management (Interim Report page 3-128)

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- Review mechanisms to attract and retain staff, including terms and conditions.

As set out in APRA's initial submission, in order to be able to effectively perform its role, APRA needs to be able to attract and retain suitably experienced and qualified staff. The most critical component of APRA's work involves supervisory judgement, and APRA and regulated institutions benefit when these judgements are made by professionals with a strong foundation of technical skills and financial sector experience.

Typically, APRA recruits from the financial sector: over the past five years, less than five per cent of staff have been recruited from the core of the Australian Public Service. Similarly, resigning APRA staff tend to leave for financial sector roles. As a result, since the sobering experience of the failure of HIH Insurance, APRA has sought to maintain its employment conditions relative to the broad financial sector. Although APRA's salaries are generally below the levels available in the private sector, overall working conditions along with the experience and challenge that comes from working in a prudential regulator has allowed APRA to attract and retain experienced and skilled staff.

The current Government-wide enterprise bargaining framework, and the constraints it imposes on APRA's ability to negotiate an appropriate enterprise agreement with its staff in a timely manner, is making it difficult to maintain these relativities. Financial sector salaries are growing in the order of 3-4 per cent per annum, and unless APRA can over time broadly keep up with this pace, it will be increasingly difficult to maintain the quality of APRA's workforce. The current APRA employment agreement expired in June this year and, due to the extensive approval process required under the revised bargaining framework, APRA has been unable to finalise an enterprise agreement or provide any annual general remuneration increase for staff. This is already being reflected in rising turnover and remuneration levels lagging targeted financial sector benchmarks.

The greater budget autonomy discussed earlier would be of limited benefit if it is not accompanied by greater freedom to set appropriate employment terms and conditions for staff, within the constraints of the overall agreed budget for APRA.

Chapter 8 of the Interim Report: Retirement income

The retirement income system (page 4-25)

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- Provide policy incentives to encourage retirees to purchase retirement income products that help manage longevity and other risks.
- Introduce a default option for how individuals take their retirement benefits.
- Mandate the use of particular retirement income products (in full or in part, or for later stages of retirement).

APRA agrees with the observation in the Interim Report that the retirement phase of superannuation is underdeveloped. As noted in the Report, the ageing population presents a major challenge for the financial system and a suitable range of financial products and services is needed to enable a greater number of individuals to manage income and risks in retirement, as well as the transition from work to retirement.

Critical to determining what the financial sector can offer in the retirement phase is to have clarity as to the overall objectives for the retirement income system. These objectives should reflect the need for retirees to have adequate resources, either provided by government in a sustainable manner or from private means, to provide for an appropriate lifestyle in retirement.

Once the objectives are determined, all elements of the retirement income system should be considered in developing any proposals for change. This includes the role of the Age Pension and mandatory and voluntary superannuation contributions, together with the relevant tax and other policy settings, such as Age Pension eligibility criteria. As noted in the Interim Report, the current dominance of account-based pensions over annuities is due to a range of factors, and it is important that all of these are considered when making any recommendations for change. This is particularly important given the other observation made by the Inquiry that superannuation policy settings lack stability, which adds to costs and reduces long-term confidence and trust in the system.[74]

[74] Ibid, page 2-118.

APRA does not propose to make any comments at this stage on the specific policy options that are put forward in this section of the Interim Report. Before settling on specific details, it is critical that there is holistic consideration of the policy settings in both the pre-retirement and post-retirement phases of the system so that a coherent, sustainable and therefore stable retirement income policy framework is able to be established and effectively implemented. Recognising that policy settings in the tax and transfer system are outside the Inquiry's Terms of Reference, APRA would encourage the Inquiry to propose clear parameters for the scope and nature of a comprehensive process to consider and address the important issues identified in its Report, and how such a process may best be taken forward in the context of other relevant Government initiatives (such as the Tax White Paper) that are either in train or planned.

Reflecting a likely objective of providing adequate and sustainable income throughout retirement, the policy framework should include mechanisms that promote benefits being primarily taken as income streams rather than lump sums. A focus on retirement income adequacy and sustainability, rather than wealth accumulation at retirement date, is needed. No particular retirement income products will, however, meet the range of needs and adequately address the relevant risks for all retirees throughout retirement. Accordingly, a flexible and principles-based framework is desirable that supports product development and innovation and allows retirees to access a range of suitable products that meet their needs as they change throughout retirement.

If the Inquiry is minded to recommend default options in the retirement phase of the system, policy settings should encourage the development of a competitive market in the provision of a range of post-retirement default products. Existing providers in the accumulation phase should not be mandated to provide a post-retirement product. For example, provision of post-retirement products should not be required as a prerequisite for authorisation to provide a MySuper product. Many providers of accumulation products, including MySuper products, may wish to provide post-retirement options for competitive reasons, however some may choose not to and some may not have the capability to develop or provide the type of products needed.

Retirement income products (page 4-31)

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Take a more flexible, principles-based approach to determining the eligibility of retirement income products for tax concessions and their treatment by the age pension means-tests.
- For product providers, streamline administrative arrangements for assessing the eligibility for tax concessions and age pension means-tests treatment of retirement income products.
- Issue longer-dated Government bonds, including inflation-linked bonds, to support the development of retirement income products.

The Inquiry seeks further information on the following areas:

- Would deferred lifetime annuities or group self-annuitisation be useful products for Australian retirees? Are there examples of other potentially suitable products?
- If part of retirees' superannuation benefits were to default into an income stream product, which product(s) would be appropriate?
- Will the private sector be able to manage longevity risk if there is a large increase in the use of longevity-protected products? How could this be achieved?
- Should Government increase its provision of longevity insurance? How would institutional arrangements be established to ensure they were stable and not subject to political interference?
- What are some appropriate ways to assess and compare retirement income products? Is 'income efficiency' a useful measure?

As noted above, APRA supports the adoption of a comprehensive and holistic approach to addressing the issues identified through the Inquiry. Changes to policy settings should be implemented in a coordinated manner with a range of other Government initiatives, including fiscal and taxation policies, and in the context of broader retirement income policy objectives that consider the pre-retirement and post-retirement phases of the system. In developing policy responses, APRA generally supports the concept of more flexible, principles-based approaches for assessing aspects such as the eligibility of products for tax concessions and their treatment in the Age Pension means test. A principles-based approach is likely to be more conducive to product development and innovation over the medium term and enable appropriate risk sharing between retirees and product providers.

Although greater flexibility could be provided to allow product development, it is important to recognise that many retirement income products will be long-dated and involve considerable levels of risk to the providers, particularly where they include guarantees. They should therefore only be provided by entities which are able to manage these risks and carry sufficient capital to provide an adequate buffer against unexpected shocks.

Recommendations for the streamlining of approval processes need to recognise that the ATO, APRA, ASIC and Centrelink all deal with specific, disparate and discrete areas of policy which generally require stand-alone assessment. That said, APRA supports effective utilisation of existing mechanisms for cooperation between agencies, such as Memoranda of Understanding, to enhance the interaction between agencies and inter-agency communication. This could include, for example, 'round table' discussions, at least in the early stages of new product approval, with all the regulators present, rather than separate meetings with each agency.

Potential products

A suitable range of financial products and services is needed to enable a greater number of individuals to manage income and risks in retirement and to help manage the transition from work to retirement. In principle, both deferred lifetime annuities (DLAs) and group self-annuitisation (GSA) products could be useful additions to the suite of products available to retirees. The current dominance of account-based pensions over annuities reflects a range of factors including their flexibility, the perceived lack of value provided by annuities and the ability to rely on the Age Pension to help manage longevity risk. It is important that all of these factors are considered when making any recommendations for change.

Demand for lifetime annuities has been low for many years (though the market has shown signs of growth recently). The reasons for this are complex, but include perceived poor value, possible loss of capital on early death and lack of flexibility. DLAs may suffer from the same issues to a greater or lesser extent, but this has not been tested by the market. DLAs are not currently available because of tax and other reasons.

Absent these impediments, DLAs could provide a useful complement to account-based pensions as they protect retirees against the risk of outliving their retirement savings and provide a definite time horizon over which to manage the use of other assets to fund retirement. Behavioural biases such as a desire for flexibility and relative underestimation of life expectancy may keep demand for DLAs relatively low in the absence of compulsion. The cost and complexity of these products will also present challenges to their acceptance by retirees, particularly in the non-advised sector.

Providers of DLAs would need to invest funds over a long time horizon and, post the deferral period, make payments for the remaining life of the retiree at a rate guaranteed at the time the DLAs were purchased. The provider may also guarantee that payments will increase under an indexation arrangement. The price of DLAs will therefore reflect the significant uncertainty over the long time horizon in respect of future investment (and reinvestment) returns, mortality improvement rates and, where relevant, the inflation rate and the cost of capital required to be held against these risks. Inflation creates considerable uncertainty for product providers, especially if matching risk-free assets are not available to mitigate the risk. This is exacerbated in instances where better-than-expected mortality improvement lengthens the period over which benefits are paid, thus increasing the exposure to inflation risk. These risks therefore require careful consideration of indexation mechanisms.

DLAs have achieved some popularity in the United States market, though their attractiveness has decreased in the low interest rate environment that has been prevalent in recent years.

As outlined in the Interim Report, GSA products allow pool members to share, but not completely eliminate, longevity risk. Payments are designed to be relatively stable but they are not guaranteed; rather, they are adjusted to reflect actual investment returns and mortality. The risk of an individual outliving his or her savings is shared by pool members, whereas the risk of improvements in population mortality is factored into the initial annuity rate. As the income levels provided through GSA are not guaranteed, the level of

capital that would be required to adequately support payments from the pool would be lower (as compared to lifetime annuities or DLAs), which may make such products more attractive to issuers and, through the pricing of the product, to retirees. Some of the factors noted above, such as regulatory settings and behavioural biases, are equally relevant for GSAs and would also need to be addressed for any meaningful market to develop.

As the Interim Report notes, retirees with sufficient savings will typically best meet their objectives by using a combination of products. Innovation across a range of products is likely if policy settings are adjusted to remove impediments to product development. Products that have developed in overseas markets include variable annuities (which provide investment flexibility and a choice of guarantees), participating (with-profit) annuities, and impaired life annuities. Other potentially suitable products are likely to evolve – for example, it is quite possible to develop investment-linked lifetime annuities or DLAs, which would provide longevity protection without payment amounts being guaranteed.

The revised framework should be flexible and focus on desired objectives of retirees in different circumstances and stages of retirement rather than being product-specific.

Longevity risk

A recent Joint Forum Report noted that longevity risk is a major risk for the sustainability of retirement income systems around the world.[75] The ability of the private sector to manage longevity risk will depend on a number of variables including the extent of risk sharing between retirees and product providers, the level of demand for annuities, the availability of reinsurance or other risk transfer mechanisms and the availability of information to assist in adequately pricing the risks.

Providers of immediate lifetime annuities and DLAs must hold capital in respect of the longevity risk assumed. Issuers of participating annuities must also hold longevity risk capital, though to a lesser extent, due to the partial sharing of longevity risk with the annuitants. Given the nature of the financial promises being provided, these products should only be issued by prudentially-regulated life insurance companies.

With GSA products, payments are not guaranteed. Longevity risk is pooled but it is not transferred. A provider would need to have adequate policies and procedures to appropriately manage the pool, but would not necessarily need to be a life insurance company.

As noted in the Interim Report, annuities are made more costly by adverse selection. An increase in demand for annuities leading to higher take-up rates across the population could potentially make annuities more affordable. This would also benefit insurers, who would be able to make greater use of population mortality studies in their pricing. A market for index-based longevity swaps and other types of protection would also be more likely to develop, and this would assist the private sector in managing longevity risk.

The Interim Report notes that reinsurers may be reluctant to accept material longevity risk because of significant uncertainty around future longevity. Nonetheless, there is a reasonably healthy and developing market for longevity risk transfer, through both conventional reinsurance and through, for example, longevity swaps. Medical advances that increase the cost of longevity protection may reduce the cost of other types of insurance. Reinsurers can be prepared to accept a transfer of longevity risk because their other types of reinsurance provide a natural hedge against longevity risk. Longevity swaps involve a series of payments based on actual longevity with the insurer being liable for payments based on pre-determined longevity assumptions.

The availability of research into population mortality improvement, including development of models for predicting future mortality improvement, would assist the private sector in managing longevity risk. Extensive research exists in the United Kingdom where annuitisation has been compulsory, however, there is limited such research so far in Australia.

[75] Joint Forum 2013, *Longevity risk transfer markets: structure, growth drivers and impediments, and potential risks*, December.

Access to equity in the home (reverse mortgages) (page 4-33)

The Inquiry seeks further information on the following area:

- What, if any, regulations impede the development of products to help retirees access the equity in their homes?

The Interim Report notes that equity release products provide benefits to consumers by allowing them to access the equity of a property while retaining ownership. The market remains very small due most likely to the limited appeal of this type of financing. APRA's regulatory capital framework for ADIs does not include any regulations or constraints regarding the development of products to help retirees access the equity in their homes. APRA's capital framework requires ADIs to hold regulatory capital commensurate with the risk of these exposures.[76]

[76] APRA 2010, letter to all ADIs, *Basel II: treatment of reverse mortgages and shared equity mortgages*, 5 July.

Chapter 9 of the Interim Report: Technology

Data security and cloud technology (page 4-58)

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- Communicate to APRA continuing industry support for a principles-based approach to setting cloud computing requirements and the need to consider the benefits of the technology as well as the risks.

Cloud computing technology offers many potential benefits, not least in terms of efficiency, innovation and productivity. Applications utilising cloud computing technology may form an integral part of a financial institution's core business processes, including for both approval and decision-making purposes, and can be material and critical to the ongoing operations of the institution. Key prudential concerns regarding cloud computing relate to a regulated institution's ability to continue operations and meet core obligations following a loss of cloud computing services, confidentiality and integrity of sensitive (e.g. customer) data and compliance with legislative and prudential requirements. APRA's requirements are technology neutral as cloud computing is treated in the same manner as other business processes.

APRA has no specific prudential requirements regarding cloud computing, although the principles in the prudential standards and guidance material related to outsourcing and business continuity and the guidance on the management of security risk in information and technology are pertinent. By way of example, a key requirement of *Prudential Standard CPS 231 Outsourcing* is for an ADI or insurer to have a Board-approved policy relating to outsourcing of material business activities, the contents of which, beyond certain minimum high-level requirements, are for the regulated institution to determine. The same prudential concerns apply to cloud computing technology involving a third party as apply to any material outsourcing arrangement. Under this approach APRA seeks to ensure that a regulated institution adequately understands and manages the risks associated with outsourcing, given the nature of the solution and the benefits anticipated.

The business continuity management requirements are similarly high-level and apply to all business processes, including those utilising cloud computing technology.

APRA will consider whether any further guidance is required by regulated institutions specifically on the use of shared computing services including cloud solutions. The development of any further guidance would be subject to consultation and, among other things, would aim to clarify APRA's expectations regarding the use of shared computing services such that the benefits can be obtained while the risks are minimised.

Chapter 10 of the Interim Report: International integration

Impediments to financial integration (page 4-88)

The Inquiry seeks further information on the following areas:

- What are the potential impediments to integration, particularly their relative importance, and the benefits to the broader Australian economy that can be demonstrated if they were removed?

The Interim Report notes a number of impediments to greater integration that have been identified in submissions, many of which have some relevance to APRA. These include ownership restrictions, licensing processes, and aspects of the prudential settings. APRA welcomes the Interim Report's observation that efforts to drive greater financial integration should not be at the cost of appropriate standards for financial stability and conduct.

The impact of APRA's prudential settings on the international competitiveness of Australian ADIs was addressed in APRA's initial submission. It notes that 'there is little evidence from the crisis that APRA's approach penalised ADIs in Australia in raising equity capital, accessing wholesale funds at competitive rates or maintaining their credit ratings. The opposite was more likely the case.'[77]

One particular aspect of prudential settings that has been raised in this respect is the lack of comparability of capital ratios across different jurisdictions. This issue is discussed more fully in APRA's response to Chapter 5 of the Interim Report. In short, APRA does not consider that this issue has been an impediment to international competitiveness. The best approach to addressing the issue of international comparability of capital adequacy ratios, without compromising the veracity of the measure, is through disclosure of the impact of APRA's policies.

Another aspect noted in the Interim Report concerns the treatment within the capital framework of minority investments in offshore financial institutions. It has been longstanding policy in Australia that ADIs' holdings of other ADIs' capital instruments are deducted from capital for the purpose of calculating capital ratios; the policy predates the creation of APRA, having been established by the RBA almost 25 years ago when it had the responsibility for bank supervision.[78] This approach is based on the fundamental principle that regulatory capital cannot be relied upon more than once in the financial system to absorb losses.

As a consequence, capital invested in an offshore bank must be funded by shareholders, rather than depositors or other creditors, of the investing ADI. To do otherwise would mean ADIs were able to include the invested capital, but not the associated risks that capital is supporting, within the calculation of their capital ratios. In other words, capital would be double counted. APRA's approach also helps insulate the domestic business from the risks in investing in offshore financial institutions; historical experience suggests these are invariably riskier than domestic businesses where ADIs are likely to enjoy their greatest comparative advantage relative to foreign competitors.

[77] APRA 2014, *Financial System Inquiry Submission*, 31 March, page 80.

[78] Reserve Bank of Australia 1990, *Press Release: Capital Adequacy: Bank's Holdings of other Bank's Capital Instruments*, 90-24, 27 September.

The Interim Report also refers to the costs and requirements associated with licensing, and ongoing compliance costs, for foreign financial institution entrants to the Australian financial system. Anecdotal evidence suggests that APRA may take a more rigorous approach to licensing new ADIs and insurers, relative to some other jurisdictions. However, there is no evidence that APRA's more rigorous approach is hindering foreign access. Between 2003 and 2013, APRA granted 72 new licences, many to foreign financial institutions, particularly in the banking sector.

High entry standards, particularly for entrants into retail markets, are a key plank of APRA's prudential framework. APRA does not grant a licence without a careful review of the applicant's capacity to manage a regulated business in Australia. This process often takes some months and numerous interactions with the institution. It would not be in the interests of a stable financial system, or of the community, for APRA to provide easier access to the Australian market if this were to lead to unsuitable entities operating as an ADI or insurer in the Australian financial system. This could also impair the level playing field with established ADIs or insurers.

APRA is considering whether a more graduated approach to licensing may be warranted, with a view to achieving a more efficient and effective process for both applicants and APRA. This may be particularly appropriate for established foreign institutions with a demonstrated track record of successful international operations and that are based in jurisdictions considered compliant with international standards and equivalent to APRA in terms of supervisory oversight. APRA notes that the Bank of England recently adjusted the requirements for firms entering into the banking sector following a similar review.[79]

[79] Bank of England and Financial Services Authority 2013, *A Review of Requirements for Firms Entering Into or Expanding in the Banking Sector*, March.

Cross-border regulatory settings (page 4-97)

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- Improve domestic regulatory process to better consider international standards and foreign regulation — including processes for transparency and consultation about international standard implementation, and mutual recognition and equivalence assessment processes.

The Inquiry seeks further information on the following areas:

- What changes can be made to make implementing international standards more transparent and otherwise improved?
- What improvements could be made to domestic regulatory process to have regard to foreign regulatory developments impacting Australia?
- Are there priority jurisdictions and activities that might benefit from further mutual recognition or other arrangements? What are the identified costs and benefits that might accrue from such an arrangement?

The existing consultation process for the development and implementation of prudential standards and related requirements allows for stakeholders to provide feedback at both the international negotiation stage and at the national implementation stage. For example, the Basel III capital framework was subject to international consultation in 2009 and 2010, including a comprehensive quantitative impact study (QIS) in 2010.[80] Australian stakeholders provided feedback during the international consultation process, and the five most internationally active Australian banks participated in the comprehensive QIS. APRA also held a number of meetings with institutions and participated in public forums in Australia on Basel III. There was considerable transparency about the direction and potential impact of the planned policy changes. APRA has not, however, traditionally taken an active role in alerting domestic institutions to international policy consultations. APRA would be open to more actively promoting the opportunity for Australian industry to contribute to international policy-setting discussions if it was considered this would be beneficial to increasing Australia's 'voice' in the process.

[80] Refer for example to Basel Committee on Banking Supervision 2009, *Strengthening the resilience of the banking sector - consultative document*, December, and Basel Committee on Banking Supervision 2010, *Results of the comprehensive quantitative impact study*, December.

For the Australian implementation of internationally developed standards, APRA follows an identical consultation and implementation process to that which is used for proposals developed domestically, including compliance with the Government's enhanced Regulatory Impact Analysis requirements and Regulatory Burden Measurement framework. This process is described in APRA's initial submission to the Inquiry.

The Interim Report suggests that Australian representatives on international standard-setting bodies need to have regard for whole-of-Government objectives. Indeed, this is already explicitly required of APRA as set out in the recently updated SOE: '[t]he Government… considers it important that prudential regulation, and APRA's standards and practices, support Australia's financial sector in globally integrated markets through implementation of relevant international standards in a manner that is appropriate for our domestic circumstances.'[81] This is also reflected in APRA's responding SOI.[82] As an example of alignment with whole-of-Government objectives, the Basel III framework was developed following G20 recommendations on strengthening financial supervision and regulation which were endorsed by the Australian

[81] The Treasury 2014, *Statement of Expectations—Australian Prudential Regulation Authority*, page 3.

[82] APRA 2014, *Statement of Intent—Australian Prudential Regulation Authority*, July.

Government.[83] APRA briefs the Government, through its regular liaison arrangements with the Treasury, on material international developments with which it is engaged.

While internationally agreed standards necessarily provide a basis for the proposed domestic policies, APRA can and does consider the full range of options available within the international standards to ensure the implementation is appropriate for Australia. In many cases, APRA negotiates for inclusion of these options at the international standard-setting bodies. The Basel III liquidity reforms are a recent important example where Australia successfully influenced the international outcome by ensuring the final standard acknowledged Australia's particular domestic circumstances. This outcome was critical for ensuring Australian ADIs, particularly those that are internationally active, could continue to claim they are compliant with all international minimum standards.

Mutual recognition

In the banking sector, APRA adheres to the longstanding *Principles for the Supervision of Banks' Foreign Establishments* developed by the Basel Committee. These principles clarify the relative responsibilities of home and host regulators of bank branches, subsidiaries and joint ventures. The overarching premise is that both the home and host supervisor have their own responsibility to satisfy themselves of the adequate supervision of the branch, subsidiary or joint venture. There is no direct equivalent to these specific Basel Principles for the insurance sector. APRA takes account, however, of the IAIS's *Insurance Core Principles* when determining its prudential requirements and supervision approach for insurance branches, subsidiaries and joint ventures.

A particular challenge of prudential regulation is that the costs of failure are principally borne by the host regulator's jurisdiction, and host supervisors are ultimately accountable to domestic depositors and policyholders (and taxpayers). This limits APRA's ability to rely solely on home regulators' assessments of the financial adequacy of local establishments of foreign banks or insurers – just as foreign regulators are unable to rely entirely on APRA's supervisory assessments of Australian institutions operating offshore. APRA has participated in various efforts over the last few years to enhance international cooperation and coordination, for example through supervisory colleges in which national supervisors of internationally active regulated groups participate.

Although APRA is limited in its ability to rely on home regulators' prudential regulation, it has some scope to reduce compliance costs for internationally active institutions. Australia's compliance with global standards provides a basis for prudential regulators abroad to permit Australian regulated institutions to operate in some overseas jurisdictions, as well as under certain mutual recognition regimes. A recent example, highlighted in APRA's initial submission, is the new swap dealer requirements issued by the United States Commodity Futures Trading Commission that apply to those Australian ADIs active in the American derivatives markets.[84] The Commission has granted 'substituted compliance' on the basis of the Australian regulatory framework, allowing Australian ADIs to avoid duplicative and costly regulation. A second example relates to Solvency II, an upcoming European regulatory framework for insurers. APRA is engaging with European insurance regulators in an effort to ensure that the Australian framework is deemed equivalent to Solvency II, thereby reducing the compliance burden on Australian insurers with European operations.

[83] G20 2009, *London Summit—Leaders' Statement*, April.

[84] Commodity Futures Trading Commission 2013, *CFTC approves comparability determinations for six jurisdictions for substituted compliance purposes*, 20 December.

Coordination of financial integration (page 4-101)

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Amend the role of an existing coordination body to promote accountability and provide economy-wide advice to Government about Australia's international financial integration.

The Inquiry seeks further information on the following areas:

- Have appropriate elements been put forward for an effective coordination body?
- What role should industry play in any new coordination body, including its funding?

APRA considers that the existing coordination arrangements have been effective with respect to international aspects of prudential regulation. The CFR and industry bodies such as the Financial Sector Advisory Council (FSAC) are the appropriate forums to provide the Government advice about international financial integration as relevant to the agencies' respective mandates:

- APRA briefs the Government, through its liaison with the Treasury, on material international developments that it is involved in;
- industry is provided with ample opportunity to comment on policy formulation with respect to international standards; and
- industry has the opportunity through existing industry bodies to provide input to Government about where the Government's engagement efforts are most required or best directed.

The current arrangements are further supported by the Government's recently updated SOE and APRA's SOI, which clearly outline the Government's expectations and APRA's intent, respectively, regarding APRA's role in supporting international financial integration.

APRA views the current Charter of the CFR as appropriate. Expanding its role to explicitly encompass international integration could distract from its primary financial stability coordination role. Given the FSAC's focus on business facilitation, it may be an appropriate body to provide the Government with advice on international integration issues.