

---

The Parliament of the Commonwealth of Australia

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

House of Representatives  
Standing Committee on Economics

March 2015  
Canberra

---

© Commonwealth of Australia 2015

ISBN 978-1-74366-280-9 (Printed version)

ISBN 978-1-74366-281-6 (HTML version)

This work is licensed under the Creative Commons Attribution-NonCommercial-NoDerivs 3.0 Australia License.



The details of this licence are available on the Creative Commons website:  
<http://creativecommons.org/licenses/by-nc-nd/3.0/au/>.



## Chair's foreword

The House of Representatives Standing Committee on Economics is continuing its important inquiry into Australia's prudential standards for the banking, insurance and superannuation sectors by reviewing the 2014 Annual Report of the Australian Prudential Regulation Authority (APRA).

It was pleasing to learn from the last public hearing with APRA in November 2014 that the Australian financial sector is demonstrating stability. APRA reports that the authorised deposit-taking institutions (ADIs) are largely in good health and remain profitable. Residential property lending has steadily increased and APRA has informed the committee that it is monitoring lending standards to ensure residential mortgages remain a source of growth and profitability for ADIs.

The committee notes APRA's view that the superannuation industry has made reasonable progress implementing the new prudential standards through the Stronger Super reforms. APRA states that it has focussed particularly on reviewing the efforts of this sector to strengthen governance and risk management frameworks and practices. This is appropriate and should continue to be a priority for APRA.

APRA has also commented that further improvements to the management of conflicts of interest in the superannuation industry are required to meet the heightened expectations of the new prudential standards. Such improvements are to be welcomed and should remain an important part of APRA's future oversight of this industry. APRA also commented that progress is being made to improve the disclosure of information around investment risks for superannuation fund members.

The committee understands that much of APRA's policy agenda in 2015 will be significantly influenced by the Government's response to the Financial System Inquiry (FSI) final report. The committee looks forward to exploring the potential impact of FSI suggested reforms on APRA's future activities.

On behalf of the committee I would like to thank the Chairman of APRA, Mr Wayne Byres, and his colleagues for appearing at the public hearing on

28 November 2014. The committee looks forward to further discussions on the issues raised in this report at the next hearing with APRA on Friday 20 March 2015 in Canberra.

**John Alexander OAM MP**

**Chair**



# Contents

Chair's foreword .....	iii
Membership of the Committee .....	vii
Terms of reference .....	viii
List of abbreviations .....	ix

## REPORT

<b>1 Introduction .....</b>	<b>1</b>
<b>Background .....</b>	<b>1</b>
<b>Scope and conduct of the review .....</b>	<b>2</b>
<b>2 Current Issues in Prudential Regulation.....</b>	<b>5</b>
<b>Overview .....</b>	<b>5</b>
<b>Superannuation.....</b>	<b>8</b>
Overview .....	8
Oversight of trustees .....	9
Disclosure Requirements .....	13
Fees .....	14
Performance of industry versus retail funds .....	17
Related Party Services.....	17
Choice of fund.....	19
<b>Basel III .....</b>	<b>21</b>
<b>European Central Bank .....</b>	<b>23</b>
<b>Property Lending .....</b>	<b>24</b>

Capital Requirements..... 26  
**Financial System Inquiry..... 28**  
Conclusion ..... 31

**APPENDIX**

**Appendix A – Public hearing details and submission.....33**



## **Membership of the Committee**

<b>Chair</b>	Ms Kelly O’Dwyer MP (to 12 February 2015) Mr John Alexander OAM MP (from 12 February 2015)
<b>Deputy Chair</b>	The Hon Ed Husic MP
<b>Members</b>	Mr Scott Buchholz MP Dr Jim Chalmers MP Mr David Coleman MP Mr Pat Conroy MP Dr Peter Hendy MP Mr Kevin Hogan MP Mr Craig Kelly MP Mr Clive Palmer MP

## **Committee Secretariat**

<b>Secretary</b>	Mr Peter Banson
<b>Inquiry Secretary</b>	Dr Kilian Perrem
<b>Research Officer</b>	Ms Marina Katic
<b>Administrative Officers</b>	Ms Jazmine Rakic Ms Sarah Tutt



## **Terms of reference**

The House of Representatives Standing Committee on Economics is empowered to inquire into, and report on, the annual reports of government departments and authorities tabled in the House that stand referred to the committee for any inquiry the committee may wish to make. The reports stand referred in accordance with the schedule tabled by the Speaker to record the areas of responsibility of the committee.





## List of abbreviations

ACCC	Australian Competition and Consumer Commission
ADI	Authorised deposit-taking institution
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investment Commission
ATO	Australian Taxation Office
ECB	European Central Bank
FSI	Financial System Inquiry
GDP	Gross Domestic Product
GFC	Global Financial Crisis
IRB	Internal Ratings-Based
LVR	Loan to valuation ratio
MOU	Memorandum of Understanding
RBA	Reserve Bank of Australia
RSE	Registrable Superannuation Entity
SPG	Superannuation Prudential Practice Guide
SPS	Superannuation Prudential Standard



## Introduction

### Background

- 1.1 The House of Representatives Standing Committee on Economics (the committee) is empowered to inquire into, and report on, the annual reports of government departments and authorities tabled in the House, that stand referred to the committee in accordance with the Speaker's schedule.
- 1.2 The 2014 annual report (annual report) of the Australian Prudential Regulation Authority (APRA) stands referred to the committee in accordance with this schedule and the committee resolved at its meeting on 26 November 2014 that it would conduct an inquiry into the annual report.
- 1.3 The committee chair stated that APRA's appearance before the committee on 28 November 2014 is a 'continuation of the committee's important discussions with APRA on the current policy settings and regulatory framework underpinning Australia's prudential standards'.<sup>1</sup>
- 1.4 APRA was established by the *Australian Prudential Regulation Authority Act 1998* (Cth) as the prudential regulator of the Australian financial services industry. It oversees Australia's banks, credit unions, building societies, life and general insurance companies and reinsurance companies, friendly societies, and most of the superannuation industry. APRA currently supervises institutions holding \$4.9 trillion in assets for Australian depositors, policyholders and superannuation fund members.<sup>2</sup>

---

1 House of Representatives Standing Committee on Economics, 'APRA to appear before Economics Committee in Canberra', *Media Release*, 27 November 2014.

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

- 1.5 The annual report describes APRA's mission as 'to establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by institutions we supervise are met within a stable, efficient and competitive financial system'.<sup>3</sup>
- 1.6 All deposit-taking institutions, life and general insurance and reinsurance companies and friendly societies must hold an APRA licence to operate in Australia. APRA also licenses trustees of prudentially regulated superannuation funds.<sup>4</sup>
- 1.7 After an institution is licensed, it is subject to ongoing supervision by APRA to ensure that it is managing risks prudently and meeting prudential requirements. APRA aims to identify potential weaknesses in its regulated institutions as early as possible. It applies a risk-based approach under which institutions facing greater risks receive closer supervision.<sup>5</sup>
- 1.8 APRA employs a cooperative approach to resolving issues with supervised institutions. However, where an institution is unwilling or unable to cooperate, APRA is empowered to take enforcement action against an institution, or against individuals associated with that institution. Enforcement options include formal investigation, imposing conditions on an institution's licence, appointment of a replacement trustee and taking criminal action against a person or institution.<sup>6</sup>

## Scope and conduct of the review

- 1.9 APRA appeared before the committee at its first public hearing to review the 2014 annual report in Canberra on 28 November 2014.
- 1.10 The proceedings of the hearing were webcast over the internet, through the Parliament's website, allowing interested parties to view or listen to

---

3 Australian Prudential Regulation Authority, *2014 Annual Report*, 13 October 2014, p. 3.

4 Australian Prudential Regulation Authority, 'Protecting Australia's depositors, insurance policyholders and superannuation fund members', <http://www.apra.gov.au/AboutAPRA/Publications/Pages/APRA-Brochure.aspx> viewed 16 January 2015.

5 Australian Prudential Regulation Authority, Supervision, <http://www.apra.gov.au/AboutAPRA/Pages/Supervision.aspx> viewed 16 January 2015.

6 Australian Prudential Regulation Authority, 'Fact Sheet 6 - APRA's enforcement activities', <http://www.apra.gov.au/AboutAPRA/Publications/Pages/APRA-Fact-Sheet-6.aspx> viewed 16 January 2015.

the proceedings as they occurred. The transcript of the hearing is available on the committee's website.<sup>7</sup>

- 1.11 This report focuses on the issues raised in the annual report and, in particular, on matters raised at the public hearing in Canberra on 28 November 2014.
- 1.12 At the public hearing, the committee examined the current policy settings and regulatory framework for enforcement of prudential standards and practices by APRA. The committee was updated on changes to the regulation of the superannuation industry through APRA's implementation of the new Stronger Super reforms; and APRA's continued oversight of the prudential standards of the ADI sector, particularly, capitalisation in the banking sector, and the increased scrutiny of property lending standards.

---

7 House of Representatives Standing Committee on Economics, Past Public Hearings and Transcripts, <[http://www.aph.gov.au/Parliamentary\\_Business/Committees/House/Economics/2014\\_APR\\_Annual\\_Report/Public\\_Hearings](http://www.aph.gov.au/Parliamentary_Business/Committees/House/Economics/2014_APR_Annual_Report/Public_Hearings)> viewed 16 January 2015.



## Current Issues in Prudential Regulation

### Overview

2.1 The 2014 APRA annual report details APRA's supervisory activities, policy agenda, governance arrangements and the prudential framework over the 2013-14 financial year. In its annual report, APRA describes its supervisory focus as forward-looking, and that its broad objective in the current circumstances is to ensure the institutions it regulates are prepared to respond to future challenges.<sup>1</sup>

2.2 APRA's annual report states that a major part of its supervision of Authorised Deposit-Taking Institutions (ADIs) focused on the lending standards they apply when conducting residential mortgage lending.<sup>2</sup> At the public hearing on 28 November 2014, the Chairman of APRA, Mr Wayne Byres summarised the current condition of the ADI sector:

The authorised deposit-taking sector, or ADI sector as we call it, continues to be characterised by good asset quality and as a result strong profitability. Loan growth is beginning to pick up again, particularly in the housing sector.<sup>3</sup>

2.3 The Chairman commented that the life insurance industry had experienced a higher than expected level of disability claims and policy lapse rates.<sup>4</sup> He stated:

The group insurance schemes that support the large industry super funds have had particularly poor claims experience, and

---

1 Australian Prudential Regulation Authority, *2014 Annual Report*, 13 October 2014, pp. 3, 9.

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

3 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 1.

4 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 1.

that has led to substantial increases in premiums in some cases, which unfortunately flows directly to the members of the superannuation funds in the form of sharply higher costs of cover.<sup>5</sup>

- 2.4 The Chairman commented that although life insurance profitability levels had fallen slightly, this industry remained well capitalised overall. The Chairman also reported on the performance of the general insurance industry in his opening statement:

The general insurance industry has had a lengthy period of reasonable, stable profitability helped by relatively benign weather conditions... Falling reinsurance prices following significant increases a few years ago have also contributed to that. Retail prices have stabilised somewhat following a period of increases, and there is evidence of increasing competition from smaller and more recent entrance to the market. Pricing and profitability in commercial lines has been under pressure in what is currently a very competitive sector. But the industry continues to hold sound levels of capital, so it is relatively well equipped to deal with the risks that might emerge in the future.<sup>6</sup>

- 2.5 The prudential responsibilities of the current health insurance regulator, the Private Health Insurance Administrative Council (PHIAC), are due to be transferred to APRA on 1 July 2015, and the Chairman reported that the transition was progressing according to schedule.<sup>7</sup>

- 2.6 At the public hearing, the Chairman also announced the superannuation sector was growing strongly with total assets for the industry reported at \$1.9 trillion at the end of September and growing at an annual rate of about 10 per cent.<sup>8</sup> He further stated:

... we have been focused very heavily on the implementation of the new prudential standards, and particularly how the industry is strengthening its governance and risk management frameworks and practices.<sup>9</sup>

- 2.7 APRA's annual report noted that its particular areas of focus in supervising the superannuation sector are 'governance (including conflicts of interest), risk management/risk appetite/risk culture, investments

---

5 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 2.

6 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 2.

7 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 2.

8 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 2.

9 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 2.



(especially liquidity management and stress testing), insurance and data integrity'.<sup>10</sup>

- 2.8 The Chairman remarked that generally the superannuation industry had made reasonable progress implementing the new prudential standards.<sup>11</sup> He added:

Our assessment is that the majority of the industry is progressing reasonably well with this task, although as always the outcomes of our thematic reviews on conflicts of interest management and insurance risk management suggest that further work is needed in a range of areas to meet the heightened expectations of prudential standards.<sup>12</sup>

- 2.9 The Chairman reported that APRA is considering the Government's request to contribute to its broader deregulatory agenda to reduce red tape and compliance costs for business and community.<sup>13</sup> He outlined APRA's approach to identify cost savings related to APRA's regulatory and supervisory framework:

Our goal in doing this has been to see what changes we might be able to implement that would reduce the regulatory burden on industry without jeopardising the fundamental strength of the prudential regime that has served Australia quite well.<sup>14</sup>

- 2.10 The Chairman further explained the steps APRA is taking to identify these cost savings:

... we formally sought input from each of the industries we regulate. Industry representatives were asked to provide ideas and expected cost savings to help us kick off the task. The response was mixed. Some industries provided quite a wide range of ideas; others less so. We have also generated our own list of ideas internally.<sup>15</sup>

- 2.11 The Chairman added that an information paper with suggestions on how to accommodate the deregulation agenda would be issued following consultations with each of the industries APRA regulates:

---

10 Australian Prudential Regulation Authority, *2014 Annual Report*, 13 October 2014, p. 10.

11 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 2.

12 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 2.

13 Australian Prudential Regulation Authority, *Statement of Intent*, July 2014, p. 2.

14 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 2.

15 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 2.

We have now triaged all suggestions received and will shortly [be] issuing an information paper outlining a number of the suggestions that we think we can implement quite quickly.<sup>16</sup>

- 2.12 At the public hearing, the Chairman noted that some of the institutions APRA regulates were incurring greater costs than anticipated, in order to comply with APRA's prudential framework.<sup>17</sup> He added that in some cases APRA may seek to respond to this by providing the institutions it regulates with greater clarification of their obligations to meet prudential standards.<sup>18</sup>

## Superannuation

### Overview

- 2.13 During 2013-14, APRA continued to implement the new Stronger Super reforms. As noted in the annual report, these reforms aim to 'strengthen the governance, improve the efficiency and transparency, and enhance the regulatory settings of the superannuation system in Australia.'<sup>19</sup>
- 2.14 APRA's annual report comments that 'in particular, the reforms strengthen trustee duties, establish a new superannuation product (MySuper), and streamline superannuation transactions (SuperStream).'
- 2.15 In its annual report, APRA also reports on the completion of a suite of prudential standards for superannuation that took effect from 1 July 2013 and are available on APRA's website.<sup>21</sup> APRA states that these standards 'address areas such as RSE licensee governance, risk management, investment governance and insurance in superannuation.'<sup>22</sup>
- 2.16 APRA has also reported the completion of 18 prudential practice guides for superannuation. The prudential practice guides do not create enforceable requirements and form APRA's view of sound practice in

---

16 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 3.

17 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 3.

18 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 3.

19 Australian Prudential Regulation Authority, *2014 Annual Report*, 13 October 2014, p. 55.

20 Australian Prudential Regulation Authority, *2014 Annual Report*, 13 October 2014, p. 55.

21 Australian Prudential Regulation Authority, Superannuation Prudential Standards, <<http://www.apra.gov.au/Super/PrudentialFramework/Pages/superannuation-prudential-standards.aspx>> viewed 8 January 2015.

22 Australian Prudential Regulation Authority, *2014 Annual Report*, 13 October 2014, p. 56.

particular areas, mostly replacing previous superannuation circulars and guidance notes.<sup>23</sup>

- 2.17 Furthermore, a set of final reporting standards for superannuation, developed as part of the Stronger Super reforms, were issued by APRA in June 2013, and are available on APRA's website.<sup>24</sup> Some of the areas covered by the reporting standards are: financial performance, membership profile, fees, investment flows, services and MySuper products. APRA explains the purpose of collecting data from the institutions it regulates in its annual report:

APRA requires regulated institutions to provide APRA with comprehensive statistical data on a regular basis. The objective of these data collections and publications is to inform and support APRA's prudential supervision, and to provide appropriate transparency and disclosure in relation to the operations of the industries it regulates.<sup>25</sup>

- 2.18 The Stronger Super reforms give APRA the power to issue prudential standards in superannuation.<sup>26</sup> APRA noted in its annual report that this has brought the superannuation sector in line with the ADI and insurance sectors, where prudential standards have played a central role in APRA's prudential framework for some time.<sup>27</sup>

## Oversight of trustees

- 2.19 The committee was interested in potential material conflicts of interest in the superannuation industry. In particular, the committee queried whether a recent example of financial arrangements between a particular fund and an associated union constituted such a conflict. APRA board member, Mrs Helen Rowell responded that the expectations for trustees around the management of conflicts of interest are set out in Prudential Standard SPS 521 that was recently issued.<sup>28</sup> She stated:

It is not our role necessarily to determine which particular conflicts

---

23 Australian Prudential Regulation Authority, *2014 Annual Report*, 13 October 2014, p. 56.

24 Australian Prudential Regulation Authority, *Final Reporting Standards for Superannuation – June 2013*, <http://www.apra.gov.au/Super/ReportingFramework/Pages/Final-reporting-standards-for-Superannuation-June-2013.aspx> viewed 8 January 2015.

25 Australian Prudential Regulation Authority, *2014 Annual Report*, 13 October 2014, p. 56.

26 Australian Prudential Regulation Authority, *2014 Annual Report*, 13 October 2014, p. 56.

27 Australian Prudential Regulation Authority, *2014 Annual Report*, 13 October 2014, p. 56.

28 Australian Prudential Regulation Authority, *Superannuation Prudential Standard SPS 521 Conflicts of Interest*,

<<http://www.apra.gov.au/Super/PrudentialFramework/Pages/superannuation-prudential-standards.aspx>> viewed 8 January 2015.

may or may not be appropriate or how those are managed. The onus is very much on the trustees of the individual funds to take appropriate steps to identify and to manage conflicts.<sup>29</sup>

2.20 Mrs Rowell added that APRA normally aims to resolve the majority of disagreements with trustees around conflicts of interest through discussions with the parties:

Our first step would normally be to have a discussion with the board and the chairman around the issue and how they plan to address it and, if possible, seek to achieve a convergence of views on the issue.<sup>30</sup>

2.21 The committee asked APRA its view on whether more requirements relating to the number of independent directors on superannuation boards should be added to the current governance arrangements for superannuation. APRA summarised its position on this issue by recognising the importance of independent directors serving on the boards of APRA-regulated institutions:

APRA has publicly stated its view on this position in other forums. I would summarise it by saying that we see value in having independent directors on the boards of APRA regulated institutions, be they banks, insurers or superannuation funds. We think that it strengthens the governance and provides an independent perspective. The number and precise composition is a matter of government policy, but we support this for all boards and, in fact, have voluntarily encouraged trustees to consider the value that independent directors could bring.<sup>31</sup>

2.22 The committee questioned APRA further about the effect of board composition on governance, in particular whether the number of directors and trustees beyond an upper threshold reduces the quality of the governance of funds. Mrs Rowell commented that the 'right number is really a matter for individual boards to determine'.<sup>32</sup> She stated:

You need enough directors and different perspectives around the table to bring the right skill sets and experience to bear on any decision making. That suggests that five might be on the low side,

---

29 Mrs Helen Rowell, APRA Member, *Transcript*, 28 November 2014, p. 3.

30 Mrs Helen Rowell, APRA Member, *Transcript*, 28 November 2014, p. 3.

31 Mrs Helen Rowell, APRA Member, *Transcript*, 28 November 2014, p. 4.

32 Mrs Helen Rowell, APRA Member, *Transcript*, 28 November 2014, p. 4.

relatively speaking. I think it is probably fair that if a board gets too big it can potentially become unruly and less effective.<sup>33</sup>

- 2.23 APRA was asked whether an increase in board members would likely result in better governance of superannuation funds on the whole, noting that an increased number of board members would likely increase board remuneration costs which could impact on fund performance. In response, Mrs Rowell commented:

I do not think you can draw any firm conclusions along those lines. I think the question of the board composition, the overall remuneration cost and what that means as an overall cost for the fund is something that trustee boards should be considering very seriously.<sup>34</sup>

- 2.24 At the public hearing, APRA informed the committee that it had recently conducted a thematic review on conflicts of interest management across approximately 40 funds.<sup>35</sup> APRA's annual report states that the review formed part of APRA's assessment of the superannuation industry's progress in implementing the new prudential requirements for superannuation.<sup>36</sup> APRA outlined the objectives of the review to the committee at the public hearing:

... it was not an accident that the first topic of our thematic reviews under the new prudential standards was around conflicts of interest and how those are being identified and managed. That is a real area of focus, and one where we are providing specific feedback about the weaknesses in practice that we have identified to all of those funds that were subject to that review, which was about 40 funds. We will provide some general observations to the industry and then over the next year we will follow up at an industry level with how the industry has responded to our observations of where we thought practice was weak and they needed to improve.<sup>37</sup>

- 2.25 APRA reported the key findings of its thematic review to the committee at the public hearing. APRA found that generally, many trustees in the superannuation industry had focused primarily on actual conflicts rather than broadening their focus to include potential or perceived conflicts. Mrs Rowell stated that overall, the superannuation industry would need

---

33 Mrs Helen Rowell, APRA Member, *Transcript*, 28 November 2014, p. 4.

34 Mrs Helen Rowell, APRA Member, *Transcript*, 28 November 2014, p. 5.

35 Mrs Helen Rowell, APRA Member, *Transcript*, 28 November 2014, pp. 3, 14.

36 Australian Prudential Regulation Authority, *2014 Annual Report*, 13 October 2014, p. 33.

37 Mrs Helen Rowell, APRA Member, *Transcript*, 28 November 2014, p. 14.

to take further steps to ensure 'actual and potential conflicts are identified and adequately addressed or avoided where necessary.'<sup>38</sup>

2.26 APRA was also asked whether the pursuit of profit rather than the governance structure poses a greater risk of conflicts of interest arising in the superannuation industry. In response, Mrs Rowell noted:

... our thematic review on conflicts of interest covered both not-for-profit and for-profit funds. We found there was room for improvement across the board. Weaknesses in dealing with conflicts of interest are not particular to one particular segment of the industry.<sup>39</sup>

2.27 APRA also responded to concerns raised by the committee about the potential for abuse of fund resources, particularly at board and executive management levels, commenting:

A core part of our supervision activity is assessing the nature and quality of the board and how the board is running itself and governing itself. Where we do have concerns, we act promptly to get those concerns addressed. Those cases to date have been quite limited. They have been there in the industry fund space and in the retail space – and they have been addressed and dealt with reasonably quickly. As I said, however, there is room to improve governance generally, but we do not necessarily see any material risks at the present time.<sup>40</sup>

2.28 The committee sought an explanation of the options available to APRA to enforce the prudential standards regulating the superannuation industry boards. APRA responded:

We are not an organisation that levies fines. Our actions, in the extreme case, would be to do one of two things: to impose change at the top in terms of governance – and we have done that in the past; and, potentially, if there were individuals who were found to have engaged in inappropriate or egregious behaviour of some sort or another, to remove them from the industry – to ban them from the industry. They are essentially the two main tools at our disposal if we find things that we think are unacceptable.<sup>41</sup>

---

38 Mrs Helen Rowell, APRA Member, *Transcript*, 28 November 2014, p. 3.

39 Mrs Helen Rowell, APRA Member, *Transcript*, 28 November 2014, p. 24.

40 Mrs Helen Rowell, APRA Member, *Transcript*, 28 November 2014, p. 11.

41 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 13.

2.29 APRA officials described the methods APRA would adopt to address material concerns that the interests of trustees were being prioritised over the interests of members:

**Mrs Rowell:** ... If we held material concerns, we would take action either to change the nature of the arrangements or to take steps to change the composition of the board; or, potentially, to orchestrate a marriage of the fund with another fund to achieve our objectives.

**Mr Byres:** Yes, it need not be a marriage. It could just be that we would take the fund and give it to a new trustee.

**Mrs Rowell:** Or appoint an acting trustee to run the fund whilst we went through that process.<sup>42</sup>

## Disclosure Requirements

2.30 The committee was interested in issues surrounding disclosure and transparency in superannuation. APRA was asked at the public hearing whether the new reporting standards will ensure adequate transparency in the superannuation industry, and also what steps could be taken by APRA to assist Australians to make informed choices about superannuation.

2.31 APRA noted that there were new disclosure requirements in place, although their implementation was not fully complete and it was yet to determine if this regime enabled adequate transparency throughout the industry.<sup>43</sup> Mrs Rowell commented:

... having disclosure that is simple, informative and understandable at the member level is very important and it is something that the industry and ASIC need to work on. We are certainly part of those conversations but we are not a primary driver of them.<sup>44</sup>

2.32 In respect of the presentation of information to help Australians make informed choices, Mrs Rowell noted:

Those disclosure issues are primarily the responsibility of the individual funds and ASIC rather than APRA. APRA is focused on the potential aspects of the management of funds. We do collect a lot of information. We publish information. We are looking at ways to enhance the presentation of that information. The information we publish is primarily directed at the reasonably

---

42 Mrs Helen Rowell, APRA Member, *Transcript*, 28 November 2014, p. 18.

43 Mrs Helen Rowell, APRA Member, *Transcript*, 28 November 2014, p. 5.

44 Mrs Helen Rowell, APRA Member, *Transcript*, 28 November 2014, p. 5.

informed industry stakeholders rather than individual members.

Disclosure to individual members is, as I said, much more a matter for individual funds and trustees and ASIC.<sup>45</sup>

- 2.33 Further to this, APRA was asked whether fund members are adequately informed of the investment risks surrounding the decisions made by their fund. APRA reported that progress had been made in this area through industry disclosure of information and concepts aimed at giving members a better understanding of the level of risk for alternative investment choices.<sup>46</sup> However, APRA recognised the difficulties in making like-for-like comparisons of the risks involved in such a diverse range of investment options:

I think the industry would acknowledge that it is an area that requires further work and further development because it is quite difficult to understand and to compare, in a like-for-like way, different investment options and the risks involved.<sup>47</sup>

## Fees

- 2.34 APRA's views were sought on the remuneration arrangements of superannuation boards. In particular, the committee noted the variances in the fees paid to directors between industry and retail funds in this area and asked whether this constituted a cause for concern. APRA stated:

The structures of the arrangements in the different industries are very different. In the industry fund, the not-for-profit sector, the money has to come directly out of the funds of the members. In the retail sector it can be paid directly out of the fund or it can be paid by the ultimate owner. Indirectly, those costs would be recouped through the fees and expenses charged at the super funds.<sup>48</sup>

- 2.35 Mrs Rowell explained that regardless of the different processes used by superannuation funds to facilitate board remuneration, ultimately remuneration costs are paid by the members:

... on balance, I am not sure you could draw a conclusion that the members in one fund or another are being disadvantaged; it is just

---

45 Mrs Helen Rowell, APRA Member, *Transcript*, 28 November 2014, p. 5.

46 Mrs Helen Rowell, APRA Member, *Transcript*, 28 November 2014, p. 5.

47 Mrs Helen Rowell, APRA Member, *Transcript*, 28 November 2014, pp. 5-6.

48 Mrs Helen Rowell, APRA Member, *Transcript*, 28 November 2014, p. 5.



about the different nature of the arrangement and the flows and where the directors' costs are being met from.<sup>49</sup>

- 2.36 Further to this, APRA commented on the effect that the new reporting standards for the superannuation industry will have on the transparency of board remuneration:

The transparency around this is increasing, and that is witnessed by the amount of disclosure that has recently been made under the new requirements to disclose more information about directors and their remuneration. As to whether there needs to be further transparency, I think it is too early to tell. The first reporting under the new standards was only last month. I think the practices will evolve.<sup>50</sup>

- 2.37 The committee noted recent comments that the fees paid by members of Australian superannuation funds are on average higher than those in other international jurisdictions. APRA was asked about the feasible options to reduce these fees and increase competition in the superannuation sector.

- 2.38 APRA remarked there was generally a capacity to reduce fees in the superannuation industry in Australia.<sup>51</sup> Similar to the difficulties in comparing the risks involved in different investment options, APRA identified the difficulty in making relative cost comparisons of products that represent various services and investment options:

It is very hard to make international comparisons, as a number of commentators have said, because you need to drill down to understand whether you are comparing like with like. For example, a very different level of costs might be involved in running a defined benefits fund – a closed fund which is effectively managed by the employer or in a public sector sense – and an open offer fund to retail investors that offers a lot of other services that might then have fees and costs associated with those services ... One of the cautionary things APRA has said to the industry is that we do not want to see them pushing to reduce fees at the expense of having sound systems, processes and governance in place that mean they can actually look after the members' money in the way it needs to be looked after.

When you are talking about relative costs and comparisons, you need to think about all of the services that are being offered

---

49 Mrs Helen Rowell, APRA Member, *Transcript*, 28 November 2014, p. 5.

50 Mrs Helen Rowell, APRA Member, *Transcript*, 28 November 2014, p. 5.

51 Mrs Helen Rowell, APRA Member, *Transcript*, 28 November 2014, p. 6.

around advice, insurance, investment options and the like. Again, while some of those features might be in place in overseas jurisdictions, they are not necessarily in place. So you need to strip down to a much greater level of granularity to do that.<sup>52</sup>

- 2.39 The committee asked APRA to confirm figures around directors/trustee fees for retail and industry funds. These figures drawn from APRA's *Annual Superannuation Bulletin* stated that directors fees for industry super funds were \$88 million and directors fees paid by retail super funds totalled \$449 million.<sup>53</sup> These statistics confirmed that despite only managing 26 per cent of total Australian superannuation funds, retail super funds paid 82 per cent of all superannuation directors' fees. In their response, provided on notice, APRA noted that the data available regarding such fees and expenses are not necessarily comparable across different funds and outlined the enhanced transparency around board remuneration introduced as part of the Stronger Super reforms:

APRA now also collects separate information on directors' and trustees' remuneration at the Registrable Superannuation Entity (RSE) licensee level. Specifically, RSE licensees must report all directors and the remuneration paid to a director, individual trustee or alternate director... That is, remuneration should include direct and indirect payments to directors for their management of the RSE, from the RSE licensee or any related party.<sup>54</sup>

- 2.40 The committee also asked APRA to provide information, on notice, on the practices in place to ensure superannuation funds undertake the relevant processes to certify their investment decisions are in the interest of members. APRA provided comment on performance-based remuneration arrangements as part of its response:

Under Superannuation Prudential Standard (SPS) 510 an RSE licensee must establish and maintain a documented Remuneration Policy. The Remuneration Policy must outline the remuneration objectives and the structure of the remuneration arrangements, including, but not limited to, the performance-based remuneration components of the RSE licensee. Any performance-based

---

52 Mrs Helen Rowell, APRA Member, *Transcript*, 28 November 2014, p. 6.

53 Australian Prudential Regulation Authority, *Annual Superannuation Bulletin*, June 2013 (revised 5 February 2014), p. 27.

54 Australian Prudential Regulation Authority, *Submission 1*, pp. [1-2].

components of remuneration must be designed to encourage behaviour that supports protecting the interests of beneficiaries.<sup>55</sup>

## Performance of industry versus retail funds

2.41 The committee questioned APRA on statistics it published that suggest industry funds are performing better than retail funds on average. APRA's Annual Superannuation Bulletin found that the average return over the past 10 years for industry super funds was 6.7 per cent per annum compared to 4.9 per cent per annum for retail super funds.<sup>56</sup> On notice, APRA also stated that only one superannuation fund classified as a retail fund type is ranked in the top 47 superannuation funds, based on a ranking of ten-year rates of return (2004-2013).<sup>57</sup> Mrs Rowell stated that the statistics referred to represent rates of return at fund-level and may not necessarily be like-for-like comparisons. She explained:

Those numbers at a fund level are not necessarily comparing apples with apples, because a much smaller proportion of what is in that retail figure is related to default fund membership, where the trustees are making the asset allocation and the investment decisions. The significant majority of the retail fund assets are actually in what is called choice products, where the individual members are making their own selection of investment options and choices. So you have a very much blended asset allocation decision and performance.<sup>58</sup>

2.42 Mrs Rowell added:

Comparing it at fund level, relative performance is not necessarily the best comparison, which is why in our new collection we are looking to compare at product level and investment option level, because that comparison is a much better way to assess relative performance, because you are comparing like with like.<sup>59</sup>

## Related Party Services

2.43 The committee was interested in APRA's oversight of related party services. These include any financial services, investment vehicles or financial products that are provided to a given superannuation fund, by

---

55 Australian Prudential Regulation Authority, *Submission 1*, p. [10].

56 Australian Prudential Regulation Authority, *Annual Superannuation Bulletin*, June 2013 (revised 5 February 2014), p. 33.

57 Australian Prudential Regulation Authority, *Submission 1*, p. [5].

58 Mrs Helen Rowell, APRA Member, *Transcript*, 28 November 2014, p. 15.

59 Mrs Helen Rowell, APRA Member, *Transcript*, 28 November 2014, p. 15.

an entity that is associated with the super fund. Section 10(1) of the *Superannuation Industry (Supervision) Act 1993* (Cth) defines a 'related party' as:

- (a) a member of the fund;
- (b) a standard employer – sponsor of the fund;
- (c) a Part 8 associate of an entity referred to in paragraph (a) or (b)<sup>60</sup>

2.44 The committee sought an explanation from APRA of the selection process superannuation funds need to undertake when engaging related party services, and any measures that are in place to ensure that members are paying the appropriate market value for these services. This questioning was provoked by an APRA working paper which found on average retail fund members paid \$485.13 for related services, while not-for-profit super fund members paid \$184.48.<sup>61</sup>

2.45 In explaining the responsibilities for trustees around related party service provision, Mrs Rowell commented:

There was a change to the legislation as part of the stronger super reforms that, in essence, overrode any trusted restrictions that were in place on requirements to use related party service providers. So going forward there is an onus on trustees to make sure that, when they are looking at who provides the services that they need, they are going through some rigorous process. It is not a requirement necessarily to undertake a tender process, but there is certainly an onus and an obligation both in the legislation and under the prudential standards for the trustees to make sure that they go through an appropriate due diligence and selection process, and they have those arrangements appropriately documented with contractual terms and appropriate service-level agreements, and the like, in place.<sup>62</sup>

2.46 APRA was also asked to describe the supervisory activities it undertakes to ensure funds are engaging an appropriate process to acquire service providers. APRA responded:

... we would get into a reasonable amount of detail to understand the process that was gone through and the basis on which the decisions were being made – particularly where the arrangement

---

60 *Superannuation Industry (Supervision) Act 1993*, s. 10 (1).

61 Australian Prudential Regulation Authority, *Working Paper: Australian superannuation outsourcing – fees, related parties and concentrated markets*, 12 July 2010, p. 4.

62 Mrs Helen Rowell, APRA Member, *Transcript*, 28 November 2014, p. 16.

has been made with a related party, what have been the assessment criteria and the benchmarks that have been used by the trustee to satisfy themselves that that arrangement is in the best interests of members?<sup>63</sup>

2.47 APRA provided further information on this matter, on notice, by naming the specific prudential standards that apply to the service provider selection process and related party arrangements. These prudential standards are *Prudential Standard SPS 231 Outsourcing* and *Prudential Practice Guide SPG 231 Outsourcing*. In addition, *Prudential Standard SPS 521 Conflicts of Interest* and *Prudential Practice Guide SPG 521 Conflicts of Interest* apply to related party arrangements.<sup>64</sup>

2.48 In the same response, APRA also summarised the findings about related party arrangements that were identified as part of its recent thematic review on conflicts-of-interest:

There were some cases where the engagement process for related parties could be improved, including the identification and management of conflicts for directors and other responsible persons in relation to decision making. There were also some cases where product features, or other terms and conditions for services offered by related parties were not necessarily competitive or established on arm's length terms. In these cases, APRA has advised the relevant funds that it expects all RSE licensees to benchmark the terms and conditions for the relevant arrangements and/or for negotiations to take place between RSE Licensees and related party service providers to ensure that competitive and arm's length terms are provided for superannuation fund members. APRA will continue to review related party arrangements, and ensure corrective action is taken where necessary, as part of its ongoing supervision activities.<sup>65</sup>

## Choice of fund

2.49 At the public hearing, APRA was asked whether current policy settings allowed adequate competition in the superannuation industry, and in particular whether default fund provisions that exist in some employers' superannuation contribution arrangements result in this industry being less competitive. Mrs Rowell responded:

---

63 Mrs Helen Rowell, APRA Member, *Transcript*, 28 November 2014, p. 16.

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

65 Australian Prudential Regulation Authority, *Submission 1*, pp. [8-9].

I do not think we would necessarily have a concern about that contestability point per se from a prudential perspective. One of the issues that we have raised with the industry and asked trustee boards to think about is their future strategy. At the moment, there are a set of arrangements in place around selection for default funds. In thinking about their future strategy and viability, all funds need to be thinking about the implications of the current approach versus any different approach and what that would mean in terms of their ability to continue to attract members or compete in the industry.<sup>66</sup>

2.50 Mrs Rowell added that the issues that fall under APRA's directive are not necessarily affected by a given employer's choice-of-fund arrangements:

Obviously, ongoing membership and cash flow is an important element of any super fund's viability and ability to run itself effectively and efficiently going forward. So in that sense, contestability may be an issue for us. But it is not necessarily linked to what the specific default fund arrangements are. It is more just about where funds are targeting their member base and how they are ensuring that they are maintaining their viability in an ongoing sense because they are getting ongoing contributions.<sup>67</sup>

2.51 Mrs Rowell commented that the processes by which default funds are selected are currently a 'feature of the policy settings in the superannuation industry'.<sup>68</sup> The Chairman added that it was not something APRA would seek to influence under its mandate.<sup>69</sup>

2.52 In responding to a question on notice about whether any existing industrial agreements restricting employees' choice of fund are in breach of current Australian law, APRA summarised the current legislation governing the choice of fund obligations of employers:

*The Superannuation Legislation Amendment (Choice of Superannuation Funds) Act 2004* imposed obligations upon employers to make superannuation contributions on behalf of their employees to complying superannuation funds in compliance with the new 'choice of fund' requirements. Sections 32C and 32D of the *Superannuation Guarantee (Administration) Act 1992*, expressly

---

66 Mrs Helen Rowell, APRA Member, *Transcript*, 28 November 2014, p. 19.

67 Mrs Helen Rowell, APRA Member, *Transcript*, 28 November 2014, p. 19.

68 Mrs Helen Rowell, APRA Member, *Transcript*, 28 November 2014, p. 21.

69 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 18.

excluded employers with certain existing arrangements from 'the choice of fund' obligations ...

Where these types of industrial agreements are in place, there is a legal basis for not extending the 'choice of fund' requirements to the employees captured by these agreements.<sup>70</sup>

- 2.53 APRA advised that arrangements were in place with other relevant agencies to facilitate the exchange of confidential information, ensuring that any issues of concern are channelled to the authority that can most appropriately respond to them:

If we came across something that we thought was of that nature, somehow untoward, that was not within our primary legislative responsibilities but we felt that it might be of an interest to another agency, then we would pass that on... we have arrangements – formal MOUs with the ACCC and with ASIC and with a number of other regulatory agencies, such as the ATO et cetera – which allow us to exchange confidential information with them and them to us; if they see anything in their duties that they think is important from a prudential perspective then they will pass that on to us.<sup>71</sup>

## Basel III

- 2.54 The Basel Committee on Banking Supervision describes itself as 'the primary global standard-setter for the prudential regulation of banks'.<sup>72</sup> It is composed of members from 28 jurisdictions (including Australia) that are represented by their central banks in addition to the authority with formal responsibility for the prudential supervision of banking business where this is not the central bank.<sup>73</sup>
- 2.55 The Basel Committee states its mandate is to 'strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability'.<sup>74</sup> It aims to achieve this by developing and issuing supervisory standards and guidelines that promote global

---

70 Australian Prudential Regulation Authority, *Submission 1*, p. [11].

71 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 21.

72 Basel Committee on Banking Supervision, About the Basel Committee, <<http://www.bis.org/bcbs/about.htm>> viewed 8 January 2015.

73 Basel Committee on Banking Supervision, History of the Basel Committee, <<http://www.bis.org/bcbs/history.htm>> viewed 8 January 2015.

74 Basel Committee on Banking Supervision, About the Basel Committee, <<http://www.bis.org/bcbs/about.htm>> viewed 8 January 2015.

financial stability, with the expectation that individual national authorities will implement them.<sup>75</sup>

2.56 The Basel Committee describes Basel III as a ‘comprehensive set of reform measures... to strengthen the regulation, supervision and risk management of the banking sector.’<sup>76</sup> The Basel Committee states that the Basel III reforms aim to:

- improve the banking sector’s ability to absorb shocks arising from financial and economic stress, whatever the source
- improve risk management and governance
- strengthen banks’ transparency and disclosures.<sup>77</sup>

2.57 APRA noted in its annual report that the Basel III reforms focus on ‘revisions to the capital and liquidity frameworks of banks’,<sup>78</sup> adding:

Another important priority of the Basel Committee is determining whether the Basel capital framework is delivering consistent outcomes: both in terms of the consistent implementation of Basel standards in national regulatory frameworks, and in the practices adopted within individual institutions.<sup>79</sup>

2.58 The annual report highlighted that in 2013-14, Australia’s Basel III capital framework was subject to peer review by other Basel Committee jurisdictions.<sup>80</sup> The overall framework for ADI capital adequacy in Australia was assessed as ‘Compliant’.<sup>81</sup>

2.59 The annual report also commented that APRA’s prudential requirements go beyond the minimum requirements set out by the Basel Committee to improve the quality and adequacy of the capital held by ADIs.<sup>82</sup>

---

75 Basel Committee on Banking Supervision, The Basel Committee’s work, <[http://www.bis.org/bcbs/bcbs\\_work.htm](http://www.bis.org/bcbs/bcbs_work.htm)> viewed 8 January 2015.

76 Basel Committee on Banking Supervision, International regulatory framework for banks (Basel III), <<http://www.bis.org/bcbs/basel3.htm>> viewed 8 January 2015.

77 77 Basel Committee on Banking Supervision, International regulatory framework for banks (Basel III), <<http://www.bis.org/bcbs/basel3.htm>> viewed 8 January 2015.

78 Australian Prudential Regulation Authority, *2014 Annual Report*, 13 October 2014, p. 47.

79 Australian Prudential Regulation Authority, *2014 Annual Report*, 13 October 2014, p. 68.

80 Australian Prudential Regulation Authority, *2014 Annual Report*, 13 October 2014, p. 44.

81 Australian Prudential Regulation Authority, *2014 Annual Report*, 13 October 2014, p. 44.

82 Australian Prudential Regulation Authority, *2014 Annual Report*, 13 October 2014, p. 48.



## European Central Bank

2.60 The committee asked APRA at the public hearing whether any issues had arisen from the recent stress testing of banks by the European Central Bank (ECB). Specifically, the committee wished to know whether any of these issues would inform APRA's views on capital requirements domestically, in the current or future environment.

2.61 In responding, APRA noted that the standout elements of the ECB testing were the resources allocated to the exercise:

It was a huge endeavour, but it was an important endeavour for the Europeans because there has been, since the financial crisis, this lingering question mark over the health of European banks. It was very important for the ECB, as the new supervisor, to be able to say, 'We've been through these things; we've stressed them very hard; we've revalued assets; we've had a lot of scrutiny; and we think they're actually reasonably robust.'<sup>83</sup>

2.62 APRA explained that Australia would be most likely to learn from its own stress testing, as opposed to the recent stress testing of the ECB.<sup>84</sup> APRA also noted that, in part, the improvements to the regulatory framework in Australia have occurred in recent years as a result of lessons learned from the past:

People can say, 'Well, isn't that looking backwards and closing the gate after the horse has bolted?' But I would say that, if we were sitting here now and saying, 'Well, we found all these shortcomings in the regulatory framework, but they're behind us, so we didn't fix them,' the community would quite rightly ask, 'What are you guys doing?' So there has been an element of backward looking... and you have to respond to those lessons and fix things that you observed did not work as well as they could.<sup>85</sup>

2.63 The committee asked APRA to outline the potential domestic risks that are currently of highest priority to APRA for future crisis prevention. APRA listed the current systemic risk that exists in property lending, Australia's susceptibility to volatility in the global financial markets, and the potential for offshore shocks to affect the domestic environment.<sup>86</sup> Mr Byres commented:

---

83 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 23.

84 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 23.

85 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 23.

86 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 23.

... we need to be alert to the sense that the GFC did not happen here therefore it could not happen here. And that there is not any complacency around that and that somehow we are bulletproof or immune from these sorts of issues and the problems that have been had elsewhere.<sup>87</sup>

## Property Lending

- 2.64 APRA stated in its annual report that 'residential mortgage lending has traditionally been a low risk and profitable business for ADIs'.<sup>88</sup> However, APRA also noted that it has increased its scrutiny of property lending standards in the current environment of rising house prices and low interest rates.<sup>89</sup>
- 2.65 APRA's annual report states that residential mortgage lending now accounts for 60 per cent of the banking system's domestic loan portfolio,<sup>90</sup> and constitutes the largest credit exposure in the Australian banking system.<sup>91</sup> In response to this, APRA noted in its annual report that over the course of the reporting period it increased its scrutiny of the lending standards of ADIs by implementing the following practices:
- Additional data collections which have allowed APRA to more readily identify, and provide feedback to, those ADIs pursuing more aggressive lending policies;
  - The issuance of *Prudential Practice Guide 223 Residential Mortgage Lending*, which outlines prudent practice in addressing housing credit risk within an ADI's risk management framework... ; and
  - Seeking renewed assurances from the boards of the largest housing lenders that they and senior management are actively monitoring their institution's residential mortgage risk profile, including the impact of any changes to credit standards.<sup>92</sup>
- 2.66 At the public hearing APRA also updated the committee on its activities to enhance its scrutiny of property lending standards, in consultation with the Council of Financial Regulators. The Chairman reported that APRA has increased its scrutiny of ADIs by monitoring their serviceability and

---

87 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 23.

88 Australian Prudential Regulation Authority, *2014 Annual Report*, 13 October 2014, p. 22.

89 Australian Prudential Regulation Authority, *2014 Annual Report*, 13 October 2014, p. 22.

90 Australian Prudential Regulation Authority, *2014 Annual Report*, 13 October 2014, p. 22.

91 Australian Prudential Regulation Authority, *2014 Annual Report*, 13 October 2014, p. 51.

92 Australian Prudential Regulation Authority, *2014 Annual Report*, 13 October 2014, p. 23.

buffer calculations, to ensure the assumptions within their calculations are conservative, and the buffers around these remain prudent:

Other things we are looking at are particularly serviceability buffers and calculations and the extent to which banks and other deposit takers are making sure they are taking a degree of conservatism within their serviceability calculations, so not assuming that rates will remain as low as they are forever, not assuming strong income growth and not assuming that borrowers will always have a completely stable and growing income.<sup>93</sup>

- 2.67 The Chairman also informed the committee that APRA was monitoring the recent growth in interest-only owner occupier lending. He commented that this behaviour would be a concern to APRA if it was a result of borrowers who were overextending their capacity to borrow by resorting to interest-only loans:

Investors quite regularly borrow on an interest-only basis. They do that because there are incentives to do so, but what we have seen in recent times is growth in the number of owner occupiers who are borrowing on an interest-only basis... The issue we are obviously concerned about is that it is a signal that borrowers who are unable to afford a traditional amortising loan are having to resort to interest-only loans to borrow to the absolute maximum capacity and might be overextending themselves.<sup>94</sup>

- 2.68 The Chairman added that APRA was also monitoring extremely long borrowing terms that may be beyond peoples working lives and longevity.<sup>95</sup>

- 2.69 APRA remarked that many of the measures it has adopted to boost its oversight of property lending standards are investigative and supervisory in nature, but that competitive pressures and credit growth have continued:

The question that we have been asking is: 'Okay, we have been doing that but nonetheless what we also see is very strong competitive pressure, credit growth rising not necessarily rapidly by historical standards but certainly rising faster than nominal GDP and certainly faster than income growth. So we need to keep an eye on that.' As to what we might do in response to that, to the extent that we reach a view that the things we have not done are not enough and that we need to just try and make sure that people

---

93 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 7.

94 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 8.

95 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 8.

are not getting overexcited, if you like, we have been thinking about what we might do.<sup>96</sup>

- 2.70 The committee further asked whether a market let response to temper the housing market, by which the major financial institutions would cooperate to restrict lending conditions to reduce systemic risk, would be regarded as a breach of competition laws. The Chairman commented:

There are two sorts of ways that you could have a market response, one is the sort of response that would interest the ACCC, which is that they all sit in a room together and do something. We would not be suggesting that as the way forward. But individually, if there was a recognition at the board tables of the major lenders that actually there is an increase in risk in the system and we should be alert to this and make sure we are tempering what we do and, as I said before, not getting too over-excited about things, that then feeds into the competitive dynamics to soften a little bit in the market, and then you may get that outcome.<sup>97</sup>

- 2.71 The Chairman further commented on this issue:

Why are we are starting to talk about the things we are talking about? Partly, because we have been talking with lots of people over the last couple of years. As we have said on numerous occasions, we have written to boards; we have sought assurances. Nonetheless, the competitive dynamics are such that we are still seeing lending standards being eroded, so maybe this is a time just to turn the dial up another notch.<sup>98</sup>

## Capital Requirements

- 2.72 The committee was interested in the actions APRA would take in the event that the measures adopted to date to mitigate the rising risk in the property finance market, due to the recent increase in residential property lending, do not adequately temper the market.<sup>99</sup>
- 2.73 The Chairman remarked in his opening statement that APRA has continued to encourage ADIs to reinforce sound lending standards in

---

96 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 8.

97 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 24.

98 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 24.

99 House of Representatives Standing Committee on Economics, *Transcript*, 28 November 2014, pp. 7-8.

response to these market conditions.<sup>100</sup> He later added that APRA's next level response to the increased credit exposure in Australia's domestic loan sector would involve adjusting the capital settings for banks:

So what are we looking at? It is things that are more capital related, consistent with our general philosophy of saying 'We need to make sure that banks are adequately capitalised if they are taking risks they have adequate capital to back it up.' If we reach a conclusion that the risk in some part of the system or all of the system is rising in some way, then it is appropriate to think about how we adjust the capital settings to respond to that.<sup>101</sup>

2.74 Also at the public hearing, the Chairman remarked on the interpretation of the comments in the Reserve Bank of Australia's (RBA) *Financial stability review*:

Many have been interpreting the comments in the Reserve Bank's Financial stability review as a sign that we are planning to implement the same sorts of so-called macro prudential measures that have been introduced in other jurisdictions, such as LVR caps and loan-to-income limits. We are still working through our options but, as I have said elsewhere and am happy to say again today, those sorts of tools are unlikely to be the ones that we reach for first.<sup>102</sup>

2.75 The Chairman added that past experiences demonstrate that the use of quantity restrictions such as limits on loan-to-income and loan-to-value ratios (LVRs) in mortgage lending 'did not necessarily produce significantly better outcomes.'<sup>103</sup>

2.76 The Chairman explained the two approaches APRA could adopt in order to adjust the capital settings of ADIs. He advised that the first approach, called 'Pillar 1', would involve changing the risk weight in APRA's prudential standard which would apply to all banks across the board. The second approach, called 'Pillar 2' would involve applying differential capital requirements to individual institutions where particularly aggressive lending is occurring.<sup>104</sup>

2.77 The Chairman outlined the various parameters that would require consideration if APRA decided to adjust the capital settings of ADIs, in order to achieve an optimal response from the property finance market:

---

100 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 1.

101 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 8.

102 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 1.

103 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 8.

104 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 8.

The challenge we have to think about, if we want to do something in a capital sense, is: which of those tools would we want to use? Then there is a whole set of questions that exist underneath that: what is the right quantum of impact you would want to have? How do you target it to the right sort of issue? How would you make sure it is proportionate to the risks involved? It is hard to solve any of those questions individually, because you tend to have to look at these things as a package.<sup>105</sup>

2.78 The Chairman also reported that APRA had recently conducted a stress test of the largest ADIs against a scenario that included economic slowdown and a major fall in house prices. He noted the outcome was positive, stating:

... the lenders subject to the test remained above minimum capital requirements even in the extreme scenario. The caveat to that is we also concluded a little more work needs to be done to make sure that, having survived the stress, they would also make a speedy recovery and be able to continue to support their customers through difficult times.<sup>106</sup>

## Financial System Inquiry

2.79 The committee notes the release of the Final Report of the Financial System Inquiry (FSI) on the 7 December 2014, which notes that a number of its recommendations are designed to increase the resilience of the Australian financial system to ensure institutions can withstand plausible shocks, and continue to provide critical economic functions in the face of these shocks.<sup>107</sup>

2.80 The report particularly notes the importance of capital levels, as they act as safety buffers to absorb potential losses, adding that reinforcing capitalisation of Australian ADIs would 'assist in ensuring capital levels are, and are seen to be, unquestionably strong.'<sup>108</sup>

2.81 The committee notes that the report's recommendations to enhance the resilience of the Australian financial sector by reinforcing strong capital ratios, and to improve the efficiency of the superannuation sector, will

---

105 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 8.

106 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 1.

107 Financial System Inquiry, *Final Report*, November 2014, p. 33.

108 Financial System Inquiry, *Final Report*, November 2014, p. 34.

have a direct impact on APRA-regulated institutions' governance and practices.

- 2.82 The FSI report recommends that APRA raise capital requirements for Australian ADIs to align Australian ADI capital ratios with the top quartile of internationally active banks.<sup>109</sup> The report notes that while the Australian ADI sector is generally well capitalised, further strengthening of the banking sector would deliver significant benefits to the economy at a small cost:
- Making banks safer and enhancing investor confidence both contribute to reducing the likelihood of a financial crisis. Shocks will always buffet the financial system, whether they are generated domestically or overseas. Capital is one of the best protections against those shocks generating a crisis.<sup>110</sup>
- 2.83 The report recommends APRA adjust the requirements for calculating risk weights for housing loans to narrow the difference between ADIs that use standardised models to calculate risk weights compared to those that use an internal ratings-based (IRB) risk weight model.<sup>111</sup> This follows the findings of a recent international review by the Basel Committee which reported considerable variation across global banks calculating risk-weighted assets using IRB models.<sup>112</sup>
- 2.84 In the 'Standardised approach', ADIs use a common set of risk weights that are conservative and not specific to a given institution. In the 'Internal Ratings-Based (IRB) approach', accredited ADIs use their own internal models to determine risk weights for credit exposures, tailored to the internally assessed risks of the asset and institution.<sup>113</sup> The FSI report notes that one reason IRB risk weights are lower than standardised weights is because this method reflects a more refined calculation of the risks at IRB banks. To date, APRA has accredited the four major banks and Macquarie Bank to use IRB models.<sup>114</sup>
- 2.85 At the public hearing, the committee noted APRA's response to the interim report of the FSI. In this response APRA discusses the differences that were identified in the Basel Committee's recent review. Particular attention was drawn to APRA's comments that policy proposals will likely be generated in response to the findings of the Basel review, to increase

---

109 Financial System Inquiry, *Final Report*, November 2014, p. 41.

110 Financial System Inquiry, *Final Report*, November 2014, p. 42.

111 Financial System Inquiry, *Final Report*, November 2014, p. 60.

112 Australian Prudential Regulation Authority, *2014 Annual Report*, 13 October 2014, p. 68.

113 Financial System Inquiry, *Final Report*, November 2014, p. 60.

114 Financial System Inquiry, *Final Report*, November 2014, pp. 60-61.

capital requirements for ADIs that use IRB approaches for residential mortgages.<sup>115</sup>

- 2.86 In relation to this, APRA reported at the public hearing that the Basel Committee is considering a series of steps to reduce the capacity of banks using internal models, to generate very low risk-weights. APRA commented on its involvement in this:

... we are involved in that in two dimensions. First of all, we are a member of the Basel committee and, so, we are involved in that work from an international policy-setting perspective. Data from our banks has helped contribute to that discussion and debate. Then, in a domestic sense, we are thinking already about some of these issues alongside some of the issues that were raised in the FSI interim report. They are pushing in the same direction but they are not necessarily exactly aligned, and we have to think about how, eventually, we would respond to both sets of issues.<sup>116</sup>

- 2.87 The FSI Final Report also recommends APRA introduce a leverage ratio to act as a backstop to ADIs' risk-weighted capital positions:

In the inquiry's view, having a leverage ratio as a meaningful backstop provides appropriate insurance against the risks inherent in risk-based capital requirements, while retaining the advantages of having capital requirements commensurate with risk.<sup>117</sup>

- 2.88 The FSI report further comments that a minimum leverage ratio should be comparable with Australia's global peers stating that 'in the Inquiry's view, an appropriate range is likely to be 3 to 5 per cent, calculated in accordance with the Basel framework.'<sup>118</sup>

- 2.89 As noted earlier, the report also makes a number of recommendations in relation to Australia's superannuation system:

The Inquiry sees scope to improve the efficiency of the superannuation system in a number of areas. The superannuation system is not operationally efficient due to a lack of strong price-based competition and, as a result, the benefits of its scale are not being fully realised.<sup>119</sup>

---

115 House of Representatives Standing Committee on Economics, *Transcript*, 28 November 2014, p. 18.

116 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 18.

117 Financial System Inquiry, *Final Report*, November 2014, p. 85.

118 Financial System Inquiry, *Final Report*, November 2014, p. 84.

119 Financial System Inquiry, *Final Report*, November 2014, p. 89.



- 2.90 The committee notes that many of the recommendations involving the superannuation sector made by the FSI are directly relevant to the issues discussed at the public hearing on 28 November 2014. Recommendations of particular note include: introducing a formal competitive process to allocate new default fund members to MySuper products (unless a review by 2020 finds the Stronger Super reforms have significantly improved competition and efficiency in the superannuation system);<sup>120</sup> providing all employees with the ability to choose the fund into which their Superannuation Guarantee contributions are paid;<sup>121</sup> and mandating a majority of independent directors on the boards of public offer superannuation funds, including an independent chair.<sup>122</sup>
- 2.91 APRA stated at the public hearing that ‘much of our policy agenda in 2015 will be driven by the recommendations of the FSI and the government's response to those recommendations.’<sup>123</sup> The committee looks forward to following on from its recent discussions with APRA in light of the recommendations that have been made in the Final Report of the FSI.

## Conclusion

- 2.92 The committee notes that APRA regulated industries remain largely in good health. The Australian financial sector demonstrated stability over the course of the financial year, and ADIs in particular indicated strong profitability. Implementation of the Stronger Super reforms appear to be progressing well, however, some room for improvement around conflicts of interest management and insurance risk management were identified in APRA's recent thematic review. The committee encourages APRA's continued oversight of the implementation of the new prudential and reporting standards to improve this area of the superannuation industry.
- 2.93 The committee notes the concerns about increased property lending contributing to greater credit exposure in Australia's domestic loan portfolio and is pleased that APRA's response to boost scrutiny of lending standards has been implemented in a timely manner. The committee understands that the recommendations of the FSI will directly impact APRA's policies over the upcoming reporting period, and looks forward to reviewing APRA's strategy to respond to these recommendations.

---

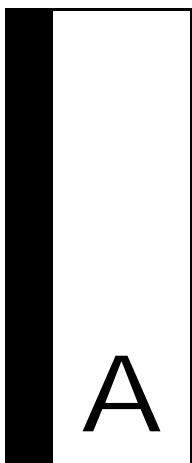
120 Financial System Inquiry, *Final Report*, November 2014, p. 101.

121 Financial System Inquiry, *Final Report*, November 2014, p. 131.

122 Financial System Inquiry *Final Report*, November 2014, p. 133.

123 Mr Wayne Byres, Chairman of APRA, *Transcript*, 28 November 2014, p. 2.

**Mr John Alexander OAM MP**  
**Chair**  
**10 March 2015**



## Appendix A – Public hearing details and submission

### Public hearing

Friday, 28 November 2014 – Canberra

*Australian Prudential Regulation Authority*

Mr Wayne Byres, Chair

Mr Ian Laughlin, Deputy Chair

Mrs Helen Rowell, Member

The hearing transcript is available online at:

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

### Submission

Submission 1      Australian Prudential Regulation Authority (Answers to Questions on Notice)