2. Current Issues in Prudential Regulation

Overview

2.1 APRA appeared before the committee at a public hearing on 14 October 2016 as part of the review of the APRA 2014-2015 Annual Report. Key issues examined at the hearing included competition in the banking sector, recent stress testing of authorised deposit-taking institutions (ADIs) that APRA conducted, increased margins in small business lending, increased supervision of investor lending in the property market, rate tracker mortgages, executive accountability in APRA-regulated institutions, reviews into the life insurance industry and related party arrangements and fees in superannuation.

2.2 In his opening statement to the committee the Chairman of APRA, Mr Wayne Byres, updated the committee on key areas of APRA's work and regulatory agenda through the course of the year since the previous hearing with the committee in March 2016.

2.3 The Chairman noted that APRA was continuing to improve the resilience of the banking system, following lessons learned from the financial crisis, by employing measures to 'strengthen bank capital, bolster the stability of bank funding and facilitate a simpler and more resilient securitisation market.'[1]

2.4 Additionally, the Chairman welcomed the Treasurer's commitment to implement the Financial System Inquiry's (FSI) recommendations to pursue proposed legislative improvements to the statutory toolkit for crisis management stating 'preparing for a possible crisis involving one or more regulated institutions with serious threats to their immediate viability is also a wise investment.'[2]

2.5 In relation to housing lending standards, the Chairman informed the committee of APRA's recent work to reinforce and improve current standards, particularly in relation to lenders' assessments of borrower serviceability, stating:

> … we are keen to see the industry's competitive instincts directed towards pricing, product features and customer service, rather than pursuing market share by reducing the quality of loans written.[3]

2.6 The Chairman commented that the industry's response to APRA's activities was positive, resulting in improved lending standards:

> …all material lenders are now assessing borrower serviceability using interest rate buffers of least two per cent and a minimum rate of at least seven per cent, and some of the overly generous assumptions in affordability models have been tightened up.[4]

2.7 The Chairman also advised the committee of APRA's work progress around understanding and assessing risk culture within organisations.[5] Noting the introduction of specific prudential requirements in this area from January 2015, he commented:

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1 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 1.

2 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 1.

3 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 1.

4 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 1.

5 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 2.

> … in the year ahead we will be continuing to refine our supervisory approach and methodologies for making assessments of risk culture within regulated institutions and will be looking more closely at the influence of remuneration arrangements on that culture.[6]

2.8 In relation to Colonial Mutual Life Assurance Society Limited trading as CommInsure, the Chairman stated that APRA has commenced significant investigations alongside the Australian Securities and Investments Commission (ASIC) into the review that was commissioned following a number of serious allegations that were made against the life insurer.[7]

2.9 He noted that the work was ongoing and specifically included:

- engaging with the board and senior management of CommInsure to gain assurance over the robustness and completeness of the independent reviews commissioned;
- meeting with the whistleblower involved and considering whether the whistleblowing provisions in the Life Insurance Act have been adhered to in this matter;
- writing to the boards of all active life insurers to seek information about the effectiveness of their governance and oversight mechanisms for matters such as claims handling, benefit definitions, rejected claims and customer complaints; and
- writing to a selection of superannuation trustees, as some of the claimants that had experienced unacceptable outcomes were members of group risk schemes via their superannuation funds.[8]

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6 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 2.

7 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 2.

8 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 2.

2.10 The Chairman reiterated in his opening statement APRA's view that 'a strong, stable and competitive financial sector is essential for the ongoing prosperity of the Australian community,'[9] further stating:

> Importantly, we do not see enhanced safety as necessarily requiring a trade-off with competition—rather, the two are complementary since only sound financial institutions will be able to support their customers, both existing and new, through good times and bad.[10]

Banking sector

Competition

2.11 The committee was interested in issues affecting competition in the banking sector and asked APRA's view on whether the application process to gain approval from APRA to operate as an ADI in any way inhibited start-up companies from entering the market.

2.12 The Chairman described the application process ADI's must undertake to obtain a banking licence from APRA as a 'fairly iterative process' in which APRA works with the applicants.[11] He reported that there was an initial $80 000 application fee to recover the costs of processing the application, noting that the applicant was required to hold $50 million dollars in capital before APRA signed their banking licence.[12]

2.13 The Chairman clarified that the requirement to hold $50 million dollars in capital was 'a threshold below which you are not able to use the word 'bank' in your business name.'[13] Furthermore, he commented:

> But we have a large number of ADIs that operate below the $50 million—typically credit unions and building societies—but there are some other

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9 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 2.

10 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 2.

11 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 5.

12 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 5.

13 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 5.

> organisations that choose not to have the word 'bank' in their name. They have an ADI authority, they meet the prudential requirements and they can do banking activity without the $50 million.[14]

2.14 The Chairman commented on a number of other conditions an ADI was required to meet before gaining approval. In relation to the legislative requirement that no one individual can own more than 15 per cent of an ADI the Chairman stated:

> … the act has said that the Treasurer has the authority to grant exemptions from that 15 per cent limit, to allow shareholders or groups of associated shareholders to go above that limit. He has delegated to us some approval capacity for low-value applications. So, for the new entrants it is largely APRA's decision, but under delegation from the Treasurer, and obviously we are reflecting that the national-interest test still applies.[15]

2.15 The Chairman also stated that APRA's assessment of the financial health of the potential organisation and whether the owners of that organisation have the financial capacity to support it if it encounters difficulty is usually the criterion that applicants struggle to meet.[16]

2.16 The committee raised the issue of barriers to competition that may arise from the higher capital requirements imposed on banks using standardised models to calculate risk-weights compared to the four major banks and Macquarie bank that use their internal ratings-based models (IRBs) to calculate risk-weights.

2.17 APRA noted that the difference in capital requirements for banks using standardised risk-weight calculations and those using IRBs to calculate risk had been narrowed, effective from the middle of 2016.[17]

2.18 Additionally, APRA noted that this adjustment was an interim measure that would be finalised over the course of 2017, after the Basel international

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14 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 5.

15 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, pp. 5-6.

16 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 6.

17 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 6.

framework had been revised and any potential changes around mortgage risk rates made.[18]

2.19 The committee asked APRA whether the difference in capital requirements gave the banks using IRB models an unfair commercial advantage. In response, the Chairman stated that the banks using advanced modelling to calculate risk are better and more efficient at allocating capital to risk which benefits the community more broadly,[19] further stating:

> The difficulty is that as soon as you allow any kind of advanced approach then inevitably differences will emerge for individual products. The FSI said to not let those differences get too big. We take that on board and we will give that attention as we go about revising the framework next year.[20]

2.20 The committee was interested in whether any other ADIs besides the four major banks and Macquarie bank had received approval to use IRB models to calculate risk weights. The Chairman noted that in 2015 APRA changed the framework to apply for approval to use IRB models to make it easier for smaller banks to apply.[21] He added:

> A number of those banks have since made applications. We are at different stages, in some cases fairly advanced stages, of assessing those applications.[22]

2.21 The committee sought APRA's view on whether the four major banks benefit from implied government support distinct from the smaller ADIs. The Chairman responded:

> I think they do, yes. There is a perception that exists that they are more likely to receive government support in a time of crisis, and, most obviously, that is reflected in their credit rating . The rating agency assesses the banks first of all on their stand-alone financial position, and then, potentially, gives them an upgrade on the basis of, in a sense, the likelihood of government support in

18 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 6.

19 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 6.

20 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 6.

21 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 15.

22 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 15.

> times of difficulty. The four major banks get more of an upgrade than other organisations. To the extent that that lowers their cost of funds and other things, then that clearly provides a benefit to them.[23]

2.22 The committee was interested in APRA's view about what could be done from a legislative perspective to increase competition in the banking sector.

2.23 The Chairman noted that work on a number of regulatory reforms had commenced that will likely reduce the implicit subsidy around cost of funding for the big banks.[24] These reforms are designed to reduce the probability, and extent of taxpayer support for a failing bank[25] and include:

- strengthening the capital requirements of banks;
- improving the crisis management framework;[26] and
- developing a loss-absorption framework.[27]

2.24 The Chairman also noted that measures to improve transparency and accountability of institutions would improve customers' capacity to understand, compare and switch between financial products and the institutions providing them, and this, more generally, promoted competition.[28]

2.25 The committee noted that the four largest companies in Australia by market capitalisation are all banks and asked APRA to comment on this. The Chairman explained that this did not necessarily indicate that the companies are oversized, relative to the Australian economy:

> Clearly, they are big and important and they dominate the financial system. I would say, though, that if you measure our banking system or our top four banks relative to GDP, as the measure, rather than looking at them relative to

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23 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, pp. 15-16.

24 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 16.

25 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 16.

26 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 16.

27 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 18.

28 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 16.

> the stock market, our banking system is not noticeably larger than comparable jurisdictions. The fact that they have the largest four listed institutions is an interesting perspective but it is not necessarily that they are oversized, relative to the Australian economy, at least when we compare with some other jurisdictions.[29]

2.26 In relation to the size of Australia's financial services sector as a proportion of gross domestic product (GDP) relative to other countries, the Chairman added:

> We have a large financial system partly because we have a very large superannuation system, and our pool of superannuation money relative to GDP is one of the largest in the world. So, if you take the total financial system, there is no doubt that it is sizeable, but my comment was particularly if you took the pure banking system and measured that relative to GDP.[30]

2.27 The committee asked APRA to provide a comparison of the size of Australia's banking system to other jurisdictions.

2.28 APRA compared banking system assets as a proportion of GDP in Australia, and as a proportion of the market capitalisation of listed domestic companies, to other jurisdictions. APRA noted that, in Australia, the global consolidated group assets of all ADIs was 281 per cent of GDP for the year end June 2016, while the global consolidated group assets of Australia's top four banks was 218 per cent of GDP for the same period.[31]

2.29 Similarly, APRA reported that the global consolidated group assets of all Australian ADIs was 281 per cent of the total market capitalisation of Australian listed companies as at December 2015, while the global consolidated group assets of Australia's top major banks was 220 per cent of

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29 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 23.

30 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 23.

31 APRA, *Response to Questions on Notice*, 1 November 2016, p. [13].

the total market capitalisation of Australian listed companies for the same period.[32]

2.30 APRA commented that Australia's total banking assets are not noticeably larger, relative to GDP, or market capitalisation, than comparable jurisdictions. For example, the ratio for Australia, in both cases, was lower than the ratio for the UK and a number of other European nations.[33]

2.31 The committee commented that, notwithstanding the many factors that affect the cost of funds for banks, it would be reasonable in a competitive market over an extended period of time for changes to the interest rate relative to the cash rate that are to the detriment of the consumer to be approximately equal to the changes to the interest rate that are of benefit to the consumer.

2.32 The committee asked APRA whether further examination of market competition would be appropriate if there was evidence to suggest that this was not the case and, in fact, it appeared that collectively the changes to the interest rate that were to the detriment of customers significantly outweighed changes that were to the benefit of customers.

2.33 APRA stated 'if that were the outcome, it certainly deserves further investigation.'[34]

Stress testing

2.34 The committee was interested in the outcome of the recent stress testing APRA conducted on ADIs, and asked APRA to explain the findings. The Chairman described the parameters of the test conducted:

> The test was a pretty severe one. House prices were down by 40 per cent. GDP was significantly negative. Unemployment was in the double digits. So, it was

32 APRA, *Response to Questions on Notice,* 1 November 2016, p. [13].

33 APRA, *Response to Questions on Notice*, 1 November 2016, p. [14].

34 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 24.

> a sort of macroeconomic shock that fed through to domestic macroeconomic settings and then the question was how that affected the balance sheets.[35]

2.35 The Chairman commented on the outcome of APRA's testing, stating that the banks were able to withstand the shock, however the capacity for the banking system to recover was impaired for some period of time afterwards, adding:

> At a time when you want the banking system to be providing credit to the economy to get it started again, after a shock, there was a question about whether the banking system would be able to serve that purpose. So we wanted banks to think harder about contingency arrangements and preparations for those things beforehand rather than be wondering what to do after the crisis hit.[36]

Small Business Lending

2.36 The committee scrutinised the banks' moves to increase their margins in small business lending in previous years, an issue that was raised with the Reserve Bank of Australia (RBA) and the banks at previous hearings.[37] The committee asked APRA to comment on the claims the banks have made that the increase is due to increased capital requirements and a repricing of credit risk in the small business lending area.

2.37 The Chairman noted that the higher capital requirements imposed by APRA applied to any given ADI's entire loan portfolio and is not a requirement specific to small business lending, and added his view that 'credit generally in the financial system pre the financial crisis was underpriced, and now a repricing has taken place.'[38]

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35 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 17.

36 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 17.

37 Dr Philip Lowe, Governor of the RBA, *Transcript*, 22 September 2016, p. 15.

38 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 18.

Housing

2.38 The committee sought an update from APRA on the outcome of its activities to reinforce sound residential mortgage lending practices in all ADIs, and in particular its aim to keep investor credit growth below a benchmark of 10 per cent.

2.39 The Chairman responded that the exercise had been broadly successful in achieving improvements in bank lending standards:

> Investor lending has now slowed significantly. We said 10 per cent was our benchmark. Currently, it is only running at about five per cent. So, in many respects, we are not necessarily the constraint on that particular measure at present. I think the more important issue, rather than a particular growth rate, is that the quality of new loans being written now is higher than it was before, and that is a good thing for the system. Our job now is to try and say, 'There are much more prudent lending standards now existing, so how do we make sure they are preserved?'[39]

2.40 The committee expressed concern about reports of an oversupply of investment properties entering the market over the next few years and asked APRA about the impact this might have on banks if they are particularly exposed to those sorts of investor loans. APRA responded:

> … we are keeping an eye on that from a couple of dimensions. One is understanding the extent to which they are exposed to that risk from an individual investor perspective. But, in parallel, we have been doing some work on commercial real estate lending and getting a better handle on who is funding the developers who are relying on those investors to buy the properties, because, as you say, in a couple of markets it does look like there is a considerable supply coming on stream and there may be difficulties in the market actually being able to accommodate that supply. So that is a piece of work that is ongoing at present, and we will probably have more to say on that in the near future.[40]

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39 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 21.

40 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 22.

2.41 The Chairman added that all of the banks have similar proportions of lending to commercial property, and a significant proportion of the growth in market share has originated from foreign banks:

> Where I think a lot of the growth, and the growth in market share, has come from has been foreign banks, particularly banks from Asia, who have undoubtedly grown their market share in this area. But they are here operating as branches, so they are supervised in a slightly different way and they pose slightly different risks. They are obviously not taking retail deposits or anything of that nature, and they are often funded by the parent bank. So I can answer your question by saying: who has been picking up market share in that category? It has largely been foreign banks competing strongly for that business.[41]

Rate Tracker Mortgages

2.42 The committee was interested in discussing the feasibility of offering rate tracker mortgages in Australia similar to those offered in the UK and had raised the issue with the banks at previous hearings. The committee asked APRA to comment on the risk profile of such products. APRA responded:

> Our approach is to say, 'If that's the product you want to offer, what are the risks that it poses? How are you going to manage or hedge those risks and what capital does it need to support it?'… I do think it is correct to say that there are some additional risks that they would face compared to their current set of products, and either you have to pay to hedge those risks or you have to have some extra capital to cover those risks. That, all other things being equal, is likely to potentially lead to a tracker mortgage being more expensive, but if a customer wants to pay for certainty that is the choice.[42]

2.43 In addition, the Chairman stated 'I would be concerned if there was a suggestion that the product should be mandated, because I am not sure that all organisations, down to the smallest ADIs, would want to offer the

41 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 22.

42 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 21.

product or would have the capability to handle the additional risks that it might pose to them.'[43]

2.44 APRA compared the risk profile of tracker mortgages to that of fixed rate loans, noting the main differences between the two products is the timeframe over which they are offered and the uncertainty of the customer's ability to repay the loan increasing with tracker mortgages:

> Banks offer fixed rate loans typically out to five years… they have funding sources—either fixed rate or where the margin can be locked in—for a similar period, so there is an element of balancing. With a tracker mortgage, the term could be significantly longer and there is an uncertainty on the term as well: will the customer repay or not? This, actually, gives you a second risk in the symmetry. If risk is symmetrical—rates go up, one thing has happened; rates go down, another thing has happened—there is a potential to hedge. But with a customer's ability to repay a loan, which you probably do not want to lose, that gives an asymmetry to risk, which is much more difficult to manage.[44]

2.45 The committee commented on its previous hearing with ASIC where it was noted that corporate tracker loans based on the Bank Bill Swap Rate (BBSW) have been available since the 1980s.[45] The committee asked APRA to explain the difference between products such as these compared to rate tracker mortgages.

2.46 APRA stated that the corporate loans referred to were based on the BBSW while Rate Tracker Mortgages are based on the cash rate set by the RBA. While the two products share the same tracker concept they are tied to different rates and there is a difference in the capacity to which those rates can be hedged.[46]

2.47 The Chairman clarified that there is more of a liquid market of securities available that are linked to the BBSW, making it easier for banks to hedge

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43 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 21.

44 Mr Pat Brennan, Executive General Manager, Policy & Development, *Transcript*, 14 October 2016, p. 21.

45 Mr Greg Medcraft, Chairman of ASIC, *Transcript*, 14 October 2016, p. 5.

46 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 24.

risks on the asset and liabilities sides of their balance sheet compared to the difficulty in finding the hedging instruments around the cash rate.[47]

2.48 APRA also noted the difference in the duration of the two loan products stating 'the term of the tracker mortgage is far longer than traditional banking when spreads are locked in.'[48]

Governance and culture in APRA-regulated institutions

Executive accountability

2.49 The committee was interested in whether the current level of executive accountability for recent systemic malfeasances in banking institutions was adequate and appropriate, and asked APRA if these institutions had failed to address the issues surrounding the risk culture of their organisation.

2.50 APRA responded that whilst appropriate attention in the banking industry had been given to traditional risk capital such as liquidity and managing the financial risks to the balance sheet, cultural issues and the impacts that they can have on the financial wellbeing of organisations has been an underinvested area.[49] The Chairman further commented:

> A lot of work has gone in over many years in banks and in regulators to the stuff you can measure—capital ratios, liquidity ratios and financial stuff. Work has also gone into structures of risk management, limits, controls, reporting mechanisms—what I would call systems. But then the tough bit is actually how people behave within the various structures that have been set up. That is not something that is easy to measure and manage, particularly when you have organisations of tens of thousands of people, as the largest institutions

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47 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 24.

48 Mr Pat Brennan, Executive General Manager, Policy & Development, *Transcript*, 14 October 2016, p. 24.

49 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 9.

> do… It is very difficult to manage and assess. But we have said time and time again that that is no reason not to try to do better at that.[50]

2.51 In his opening statement the Chairman described APRA's focus as a prudential regulator on culture within financial institutions, compared to ASIC's focus as a financial conduct regulator:

> It is important to note that prudential and conduct regulations—that is, APRA and ASIC—both have a legitimate interest in the culture within financial institutions but that our respective interests stem from different underlying objectives. ASIC's focus on culture is from the perspective of ensuring fair outcomes for customers and investors. APRA's focus on risk culture reflects our prudential mandate that, as a result of undesirable behaviours and attitudes towards risk-taking and risk management, the viability of an APRA regulated institution itself and, in severe cases, financial stability might be threatened.[51]

2.52 The committee asked APRA whether robust frameworks that address culture and the escalation of consumer issues should receive the same level of consideration that is given to commercial strategy decision making and accountability and asked APRA to comment on whether a senior manager's accountability regime similar to that of the UK would be appropriate in Australia.

2.53 Regarding the prioritisation of frameworks that address cultural issues relating to risk management within a given organisation APRA responded 'yes, it should get the priority because it is essential to long-run financial health and long-term community trust in the financial system.'[52]

2.54 Furthermore APRA stated that it would be supportive of strengthening accountability more broadly through stronger prudential standards. The Chairman stated:

50 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 9.

51 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 2.

52 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 9.

> The idea of having sharp accountability is an important thing. There are instances that suggest where problems emerge it is because it is not quite clear who was accountable for something.[53]

2.55 In particular, the Chairman commented that the appointment of senior executives by the regulator 'undermines the accountability for appointments'[54] and held the view that the appointment should be the responsibility of the organisation.[55]

2.56 The Chairman also pointed out that in the UK there was a difference in standards between banking and insurance regimes that could cause confusion when both are working within a single corporate group.[56]

2.57 The committee noted APRA was empowered to take enforcement action against institutions where prudential issues arise and asked APRA if it had issued specific directions to either banks or insurers, to date, to introduce certain risk management regimes or particular requirements around risk management.

2.58 The Chairman described APRA's approach to address instances where certain prudential standards are not being met by a specific institution:

> If we go about our supervision activity and we find some evidence to suggest that some organisation, ADI, insurer, whatever it might be, is not meeting those standards, then we issue what we call a requirement, which would be, 'You must do X by Y time.'[57]

53 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 12.

54 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 11.

55 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 11.

56 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 12.

57 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 12.

2.59 The Chairman explained that APRA's powers under the *Australian Prudential Regulation Authority Act 1998* are generally meant for use in a crisis situation where fairly severe intervention is needed,[58] adding:

> We also have a separate set of powers which, essentially, say we have the capacity to make prudential standards and we have the capacity to direct organisations to comply with those prudential standards if they are not doing so.[59]

2.60 Further to this, the committee was interested in APRA's powers under the *Banking Act 1959* to remove a director, prevent the appointment of a director, or appoint a director and asked whether APRA had ever used these powers in respect of an ADI.

2.61 The Chairman stated that he was not aware of any instances where these powers had been administered and they were largely designed for use when an organisation is failing.[60] He noted, however, that APRA had, in rare cases enforced its capacity to remove and disqualify individuals[61] but not in relation to ADI directors.[62]

2.62 Additionally, Deputy Chairman Mrs Helen Rowell noted that APRA monitors instances where it has expressed significant prudential concerns regarding particular institutions and the individuals that may be involved.[63] Mrs Rowell explained:

> Many organisations will actually talk to us about senior appointments before they are made, particularly the very senior appointments, or appointments of directors. If we had any concerns, we have an opportunity to signal that, and at times we will find that the appointment does not proceed...we actually have

58 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 13.

59 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 13.

60 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 13.

61 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 13.

62 APRA, *Response to Questions on Notice*, 1 November 2016, p. [1].

63 Mrs Helen Rowell, Deputy Chairman, *Transcript*, 14 October 2016, p. 13.

> an enforcement area that keeps track of instances where we have dealt with significant concerns with institutions and with individuals that might have been involved in that...we have very regular liaison meetings with ASIC around enforcement matters, where that information would be shared.[64]

2.63 The Chairman noted APRA often does not need to use the powers available to it under the *Banking Act 1959*, stating that:

> Usually we do not use it simply because we get cooperation without having to use it. It is like having a big stick in your back pocket. You do not necessarily have to hit people with it. It is the same way we ask for information, often, just via a letter that asks for information and people give it to us.[65]

Life insurance

2.64 The committee asked APRA to outline its role in supervising the life insurance industry and explain how it collaborates with ASIC to address governance matters in this industry.

2.65 Mr Geoff Summerhayes, APRA Member, noted that while APRA 'does have a parallel focus with ASIC on this matter'[66] ASIC pursues its mandate as it relates to consumers whereas APRA supervises institutions for the purpose of monitoring risks they may be taking that could potentially impact the prudential stability of the institution.[67]

2.66 APRA updated the committee on work it had progressed to monitor the reviews commissioned in response to the CommInsure allegations. Mr Summerhayes noted:

> Our role in those has been to ensure that the governance, oversight and independence of those reviews is of such a nature that we are able to rely on

64 Mrs Helen Rowell, Deputy Chairman, *Transcript*, 14 October 2016, p. 13.

65 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 13.

66 Mr Geoff Summerhayes, APRA Member, *Transcript*, 14 October 2016, p. 2.

67 Mr Geoff Summerhayes, APRA Member, *Transcript*, 14 October 2016, p. 2.

> the work that the independent experts are doing to inform our judgements about the institution going forward.[68]

2.67 Mr Summerhayes further advised the committee that APRA sought some adjustments to the governance and oversight structure of those reviews to ensure they are appropriately independent and being managed by the board of CommInsure.[69]

2.68 APRA provided further information in the hearing in response to the committee's questions, about the allocation of responsibility for the recently reported incidences relating to life policies issued by CommInsure:

> These policies were issued by Colonial Mutual Life Assurance, which is a life company authorised under the Life Insurance Act. That act imposes obligations, including obligations on the way in which policy holders are to be treated and on the senior executive, the chief executive and the board of Colonial Mutual Life Assurance. First and foremost, where are the accountabilities? It is actually those people. One of the things that we have been very keen not to undermine is to in any way suggest that actually the responsibility for some of the statutory obligations that are on those people is somehow held by the shareholder. It is not held by the shareholder.[70]

2.69 The committee noted its previous hearing with ASIC where the committee was informed of a number of issues the regulator had identified when conducting a review of life insurance claims in the industry such as data integrity issues, a lack of electronic record keeping and a lack of reporting on claims management and outcomes. The committee asked for APRA's comment in relation to these matters.

2.70 Mr Summerhayes confirmed these matters were of concern to APRA as a prudential regulator:

> …we have been active in this area over recent years as it relates to operational risk and the supervision of those entities. While I cannot comment on the specifics of the entities referred to, we will get to a stage of matching the ASIC

68 Mr Geoff Summerhayes, APRA Member, *Transcript,* 14 October 2016, p. 3.

69 Mr Geoff Summerhayes, APRA Member, *Transcript,* 14 October 2016, p. 3.

70 Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 10.

> findings with the APRA supervisory stance on those entities. I suspect that there will be a correlation between where we have identified issues from a prudential risk management point of view and those issues that ASIC has identified.[71]

Data collection

2.71 The committee asked APRA to outline its role in collecting data from the insurance sector and the instruments it has available to enable the publication of that data.

2.72 APRA commented that greater transparency of the performance of individual institutions would improve community trust in the sector, noting that it could request performance data from institutions and subsequently make this information available to the public:

> APRA has the more appropriate powers to seek the information from the life companies as it relates to the number of claims paid, their performance by distribution channel, performance by product and performance at an entity level.[72]

2.73 Mrs Helen Rowell, Deputy Chairman, noted that data collection of this nature has not occurred in the past because 'APRA's focus is on prudential safety of the institution as a whole rather than individual customer outcomes, and hence to date our data collection has been focused on that overall aggregate claims information at an insurer level rather than necessarily drilling down.'[73]

Superannuation

Conflicts of interest

2.74 The committee asked APRA to respond to concerns that customers switching superannuation products over to the institution they bank with

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71 Mr Geoff Summerhayes, APRA Member, *Transcript,* 14 October 2016, p. 11.

72 Mr Geoff Summerhayes, APRA Member, *Transcript,* 14 October 2016, p. 3.

73 Mrs Helen Rowell, Deputy Chairman, *Transcript*, 14 October 2016, p. 3.

based on advice from that institution may lead to poor outcomes for the customers.

2.75 APRA commented that this type of switching does not necessarily indicate a disadvantage for the customer.[74] APRA went on to explain its role in educating institutions on the appropriate management of potential conflicts of interest:

> Our focus with institutions and our dialogue with superannuation funds and the boards of those superannuation funds is to ensure that they understand and are aware of the mechanisms that are being used to distribute their products and the incentives that are in place around that and that appropriate controls and disciplines are being applied.[75]

Related Party Arrangements

2.76 The committee asked APRA for an update on the work it was undertaking regarding related service provision and the obligations of the trustees of superannuation funds. APRA noted that the work was ongoing, stating:

> We did some high-level work on conflict frameworks more broadly in 2014 and 2015, and released our findings and signalled we had concerns. One area of concern was related party arrangements. We are now half through our thematic review on related party arrangements where we have identified a range of 20-plus institutions across the industry and have done some information gathering on the nature of the arrangements, the quantums that are involved and the information that has been reported to us around those arrangements. The next step in that process will be to do some deep-dive work looking at particular arrangements with particular institutions. That is probably going to take another six months or so. By mid next year, we hope to be able to provide our findings back to the industry and the participants in the review but also more broadly.[76]

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74 Mrs Helen Rowell, Deputy Chairman, *Transcript*, 14 October 2016, p. 7.

75 Mrs Helen Rowell, Deputy Chairman, *Transcript*, 14 October 2016, p. 7.

76 Mrs Helen Rowell, Deputy Chairman, *Transcript*, 14 October 2016, p. 7.

Fees

2.77 The committee raised concerns about the retail superannuation funds on average collecting 60 per cent higher operating expenses than the average for the rest of the sector. The committee asked APRA if more consumer protection and oversight and potentially more regulation was required in this market, given the findings of the recent Productivity Commission's report, noting evidence that a considerable number of Australians are disengaged with superannuation.[77] APRA responded:

> …I think that is part of why there are higher obligations on trustees of MySuper or default products, and we expect those higher obligations to be met. As part of the process of reviewing what trustees are doing in terms of delivering outcomes for members, that is a significant focus for us.[78]

2.78 APRA commented that 'there is room for some shifts in the high-fee poor-return funds across the board in the industry'[79] also noting that some of the outlier funds in relation to fees and costs have come down in recent years, with an expectation that this will continue.[80]

Staffing

2.79 The Chairman noted it was challenging for APRA to compete for employees within the financial sector, given its budgetary constraints as a public service organisation. The Chairman referenced FSI recommendation number 28, which refers to 'capacity to pay competitive remuneration',[81] however noted APRA was below its targets in pay in comparison to the financial sector.[82]

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77 Productivity Commission Draft Report, *How to Assess the Competitiveness and Efficiency of the Superannuation System,* August 2016, p. 186.

78 Mrs Helen Rowell, Deputy Chairman, *Transcript,* 14 October 2016, p. 8.

79 Mrs Helen Rowell, Deputy Chairman, *Transcript,* 14 October 2016, p. 8.

80 Mrs Helen Rowell, Deputy Chairman, *Transcript,* 14 October 2016, p. 8.

81 Murray, D. et al, *Final Report*, November 2014, p. xxvi.

Conclusion

2.80 The committee notes the work of APRA over the year to reinforce stability and improve the resilience of the banking system. The committee recognises that APRA have deemed the four major banks to be domestically systemically important due to their size and interconnectedness to Australia's financial system and broader economy. APRA has continued to closely supervise Australia's ADIs while also taking steps to ensure the major banks are sufficiently capitalised to withstand economic and financial shocks. The committee also notes APRA's work to develop tools to seek to ensure that if a bank was to become insolvent that taxpayer support would not be required and will continue to monitor this space closely.

2.81 The committee agrees with APRA's views on the importance of having a vigilant culture within regulated institutions in relation to risk management and compliance issues, and the need to develop ways to manage and assess risk culture within organisations. The committee notes APRA recently released a snapshot of industry practice in risk culture and looks forward to following progress in this area, in particular the industry's response to requirements introduced in the prudential standards by APRA in 2015 for boards to address this issue.

2.82 The committee notes APRA's comment in relation to the effect of prudential standards on competition in the sector and will continue to monitor this issue.

Mr David Coleman MP

Chair
9 November 2016

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82 APRA have a 'longstanding benchmark' of targeting pay levels for its staff at the 25th percentile of the financial system. See Mr Wayne Byres, Chairman of APRA, *Transcript*, 14 October 2016, p. 15.