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Review of the Australian Prudential Regulation Authority Annual Report 2015 (First Report)

House of Representatives
Standing Committee on Economics

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Chair’s foreword

At the recent public hearing with APRA in March, the committee was updated on the state of the Australian financial sector and on APRA’s recent activities and priorities for 2016.

It is pleasing that Australia’s financial system remains sound in the face of recent volatility. The committee agrees with APRA’s view that complacency must be avoided and it will continue to monitor any future changes and subsequent APRA responses.

In the banking sector, APRA states that its activities will continue to be strongly influenced by the Financial System Inquiry (FSI) recommendation for ‘unquestionably strong capital ratios’. We will monitor and scrutinise APRA’s planned framework to achieve this over the next few years.

APRA’s measures to reinforce sound residential mortgage lending practices, announced in its letter to all authorised deposit-taking institutions (ADIs) in December 2014, are of particular interest to the committee. We will continue to scrutinise whether the objectives of these measures are being achieved.

The committee will also examine at future hearings the outcomes of the higher mortgage risk weights for larger banks that APRA is implementing from July of this year.

The governance of APRA-regulated institutions is a major focus for APRA and is of continuing interest to the committee. APRA informed the committee that a good corporate ‘culture’ within the entities that it supervises protects against poor outcomes and is therefore a key area of its focus. APRA also stated that this emphasis reflects its prudential mandate.

In the superannuation sector, APRA advised that board appointments, strategic planning, performance assessment processes, and conflict management, were priorities in 2016. APRA also indicated that it is consulting on changes designed to improve governance standards for superannuation funds which it intends to introduce at a future date. The committee looks forward to future updates from APRA on the implementation of these standards and their impact.

The committee was also advised by APRA that it has been engaging with the Directors of ADIs and insurers to make certain that they understand their obligations under the prudential framework.

APRA indicated that it would release a road map later this year for its new prudential oversight of the private health insurance industry. The committee will seek advice from APRA on the progress of this framework at future hearings.

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 18 March 2016. The committee looks forward to continuing discussions with APRA on its regulatory activities and on prudential issues in the Australian financial sector.

David Coleman MP
Chair

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Deputy Chair	The Hon Ed Husic MP
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	Mr Kevin Hogan MP
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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

ADI	Authorised deposit-taking institution
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
FSI	Financial System Inquiry
GST	Goods and services tax
IRB	Internal ratings-based
LVR	Loan-to-value ratio
NSFR	Net stable funding ratio
OTC	Over-the-counter
PHIAC	Private Health Insurance Administration Council
RBA	Reserve Bank of Australia
SMSF	Self-managed superannuation fund

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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 2015 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 12 November 2015 that it would conduct an inquiry into the annual report.

1.3 A summary of APRA's activities is provided in the annual report as follows:

> APRA 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 is funded largely by the industries that it supervises. It was established on 1 July 1998. APRA currently supervises institutions holding $5.4 trillion in assets for Australian depositors, policyholders and superannuation fund members. From 1 July 2015, APRA also became the prudential regulator of private health insurance funds.[1]

1 Australian Prudential Regulation Authority (APRA), *2015 Annual Report*, 7 October 2015, p. [2].

1.4 The annual report describes APRA's mission in the following terms:

- to be a world-class prudential regulator, with excellence of supervision as the foundation;
- to establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by institutions we supervise are met within a stable, efficient and competitive financial system;
- to act as a national statistical agency for the Australian financial sector.[2]

1.5 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.[3]

1.6 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. The two main supervisory tools APRA uses are on-site and off-site analysis. These reviews are undertaken by prudential supervisors with in- depth knowledge of institutions in a particular sector, and supported by specialist risk experts.[4]

1.7 APRA states that it 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. Some 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.[5]

2 APRA, *2015 Annual Report*, 7 October 2015, p. 3.

3 APRA, 'Protecting Australia's depositors, insurance policyholders and superannuation fund members', <http://www.apra.gov.au/AboutAPRA/Publications/Pages/APRA-Brochure.aspx> viewed 30 March 2016.

4 APRA, 'Protecting Australia's depositors, insurance policyholders and superannuation fund members', <http://www.apra.gov.au/AboutAPRA/Publications/Pages/APRA-Brochure.aspx> viewed 30 March 2016.

5 APRA, 'Factsheet 6 – APRA's enforcement activities', <http://www.apra.gov.au/AboutAPRA/Publications/Documents/APRA-FS6-062015.pdf> viewed 30 March 2016.

Scope and conduct of the review

1.8 APRA appeared before the committee at its first public hearing to review the 2015 annual report on 18 March 2016 in Canberra. Details are provided at Appendix A.

1.9 The proceedings of the hearing were webcast over the internet, through the Parliament's website, allowing interested parties to view or listen to the proceedings as they occurred. The transcript of the hearing is available on the committee's website.[6]

1.10 This report focuses on the issues raised in the annual report and, in particular, on matters raised at the public hearing on 18 March 2016.

1.11 At the public hearing, the committee examined the current policy settings and regulatory framework for enforcement of prudential standards and practices by APRA. Issues canvassed at the hearing included the housing market, with new residential mortgage lending standards, mortgage risk weights, the use of macroprudential tools, loan-to-value ratios (LVRs), and house prices and supply among the topics discussed. Other issues raised during the hearing included governance and culture in APRA-regulated institutions, securitisation, and APRA's oversight of the private health insurance sector.

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6 House of Representatives Standing Committee on Economics <http://www.aph.gov.au/Parliamentary_Business/Committees/House/Economics/APRA_Annual_Report_2015/Public_Hearings > viewed 31 March 2016.

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Current Issues in Prudential Regulation

Overview

2.1 APRA appeared before the committee at a public hearing on 18 March 2016 as part of the review of the APRA 2015 annual report. Key issues examined at the hearing included the housing market, with new residential mortgage lending standards, mortgage risk weights, the use of macroprudential tools, loan-to-value ratios (LVRs), and house prices and supply among the topics discussed. Other issues raised during the hearing included governance and culture in APRA-regulated institutions, securitisation, and APRA's oversight of the private health insurance sector.

2.2 In his opening statement to the committee the Chairman of APRA, Mr Wayne Byres, updated the committee on the Australian financial sector in light of recent volatility and also on APRA activities since the previous hearing with the committee in October 2015.

2.3 The Chairman noted that Australia was continuing to benefit from a sound financial system and whereas there were no grounds for complacency, recent volatility in equity markets and credit spreads were well within the capacity of the Australian financial system to handle.[1]

2.4 The Chairman advised that APRA's regulatory agenda for 2016 would be strongly influenced by the Financial System Inquiry (FSI) recommendations. The Chairman stated:

> An important focus will be on how we refine the prudential framework for the deposit-taking sector such that it delivers on the

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1 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 1.

> FSI's recommendation for unquestionably strong capital ratios. In doing this, we need to be mindful of the still evolving international regulatory framework. But, as things stand today, we should be in a position around the end of the year to set out how an unquestionably strong framework will be achieved. Actual implementation of any changes will occur in an orderly fashion over the following couple of years.[2]

2.5 The Chairman also remarked that APRA was undertaking important work in relation to securitisation and bank funding through proposals for a simpler regulatory framework to establish a more resilient securitisation market. This includes formal consultations on implementing a new regulatory requirement in Australia, the net stable funding ratio (NSFR).[3] The Chairman stated:

> The ratio is a new international standard designed, in simple terms, to discourage banks from becoming overly reliant on volatile short-term borrowing when funding illiquid assets. Australian ADIs—Australian authorised deposit-taking institutions—have necessarily strengthened their funding profiles relative to the pre-GFC period. To a degree, the NSFR will reinforce and continue this trend. It will also help contribute to the FSI's objective of unquestionably strong capital ratios.[4]

2.6 The Chairman emphasised that APRA would continue to supervise lending standards for housing in 2016 and that there was 'further work to do to ensure that improved lending policies are fully implemented, monitored and enforced.'[5]

2.7 The Chairman further outlined some of the main areas of focus for APRA in the superannuation sector in 2016, which include the robustness of strategic planning by boards, board appointments and performance assessment processes, and conflicts management.[6] The Chairman also commented that APRA would have an ongoing focus on the prudential soundness of the life insurance industry and the 'gap between community expectation and industry practice that needs to be closed.'[7]

2.8 The Chairman also informed the committee that having taken over the prudential supervision of private health insurance from the previous

2 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 1.

3 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 1.

4 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, pp. 1-2.

5 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 2.

6 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 2.

7 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 2.

regulator, the Private Health Insurance Administration Council (PHIAC), APRA planned to release a roadmap of the private health insurance prudential framework by mid-2016. This will be 'for the alignment, where appropriate, of the private health insurance prudential framework with those that apply to other sectors that APRA supervises.'[8]

2.9 In concluding his opening remarks, the Chairman commented that the issue of 'culture' across all of the sectors that APRA supervises would be an area of continuing focus. The Chairman stated:

> Our interest in culture reflects our prudential mandate. A good culture helps to protect against poor outcomes. Our work is primarily directed to detecting the potential for financial institutions that we supervise to be badly mismanaged such that they put their own viability at risk. We are not the lead regulator when it comes to instances of consumers being unfairly treated but we are very interested in what those episodes tell us about the culture within financial institutions and the extent to which incentives might be operating to encourage imprudent behaviour.[9]

Banking sector

Mortgage risk weights

2.10 APRA was asked to comment on whether changes to mortgage risk weights had achieved their policy objective. The Chairman responded that in accordance with FSI recommendation 2, mortgage risk weights would be increased from July 2016 for larger banks that use internal models to determine these weights. The Chairman stated:

> The requirement, in effect, asked banks to hold more capital. They did that and the major banks were primarily the banks affected. Those four banks all went out and sought to raise additional capital well ahead of the new requirements coming into force. So, as we sit here today, when that change comes into effect, the banks are well positioned to accommodate that without any further difficulty.[10]

2.11 The Chairman further remarked that it was always unclear how the smaller institutions would respond to the mortgage rate increases adopted by the major banks to meet higher capital requirements, that is, whether

8 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 2.

9 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 2.

10 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 3.

they would follow suit to improve their own returns or try and maintain their existing rates to improve market share.[11] The Chairman stated:

> I think the results were fairly mixed across the board, to be honest, and the response was a bit of both. There were clearly increases in rates that followed the major banks by the next tier of institutions but, in many cases, they were less than or at least no more than the increases that the majors had instituted. So I think where we ended up was that the change certainly does improve the relative competitive dynamics of the smaller banks versus the larger banks but, in many cases, it has allowed those smaller banks to improve their returns.[12]

2.12 The committee queried whether it was reasonable from a prudential perspective for smaller institutions that do not comply with internal ratings-based (IRB) rules to hold more capital against mortgages.

2.13 APRA commented during the hearing that the IRB system allows the institution to see emerging trends and potential problems in its book at an earlier stage.[13]

2.14 The Chairman replied that this issue was related to whether there should be any gap and how large this difference should be. The Chairman stated:

> … I think there is a case to say there can be a difference for banks that have invested in advanced risk management. Certainly, the philosophy of the Basel framework was that, where banks had advanced risk management techniques that enabled them to manage their risk better, diversify their risk better and price their risk better, that should be rewarded in some sense by the regulatory framework or recognised by the regulatory framework.[14]

2.15 The Chairman emphasised however that 'what the FSI called out was that, in practice, that difference had got too large and was having an adverse competitive impact' and that the steps APRA had taken were designed to respond to this.[15]

2.16 Further to the issue of risk weights, the Chairman further remarked that the new requirements were still only interim measures. The Chairman stated:

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11 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 3.

12 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 3.

13 Mr Charles Littrell, Executive General Manager, APRA, *Transcript,* 18 March 2016, p. 10.

14 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 3.

15 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 3.

> … all of this work—both the standardised approach risk weights and the internal model risk weights—is currently subject to review by the Basel committee. They are in the process of being recalibrated and reset. We will need to come back to this as part of looking at how we take that work forward at the end of this year. It may be that the gap is narrowed further.[16]

Lending standards and macroprudential tools

2.17 The committee asked APRA to revisit the circumstances that led to its letter to all ADIs in December 2014 (included at Appendix B) advising of APRA's intent to reinforce prudent residential mortgage lending practices through a number of measures, in particular increasing supervision of ADIs with annual investor credit growth materially above a benchmark of 10 per cent.[17]

2.18 The Chairman responded that there had been discussions amongst the members of the Council of Financial Regulators (APRA, ASIC, the RBA and the Treasury) in 2014 about the very strong lending growth in the housing sector. The Chairman stated:

> The environment in which that was occurring in many parts of the country was rapidly increasing but high house prices, high household debt levels, historically low interest rates and subdued income growth. Those four factors put together suggested that a degree of caution was needed. At that same time, in its Financial Stability Review in I think September the Reserve Bank explicitly called out the very strong growth in lending to investors as leading to—and I cannot remember the quote, so this is not a quote—emerging imbalances in the housing market.[18]

2.19 The Chairman further stated that these discussions led to a couple of measures being implemented in December 2014. These were APRA's letter to all ADIs focusing on mortgage lending practices and a 10 per cent investor lending growth benchmark, and work by ASIC that looked at whether banks were meeting their responsible lending obligations.[19]

2.20 The committee queried whether APRA had in its tool kit a figure indicating that if house prices grow at a certain rate, or if debt levels exceed a certain level, it would employ macroprudential tools to manage the response.

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16 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 3.

17 Appendix B: Letter from APRA to all ADIs, 9 December 2014.

18 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 5.

19 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 5.

2.21 The Chairman responded that there is no specific threshold or mechanical response that is used by APRA in this circumstance. The Chairman stated:

> It is not a formulaic assessment that says that if you cross this threshold or that threshold, you must act in a particular way. We have been very keen, and when I say 'we' I think there is agreement at the Council of Financial Regulators, that those sort of formulaic approaches are not ones that we want to pursue. But, clearly, if we had called out those trends and said, 'These factors, taken together, have caused us concern,' and, if those trends had continued, then it is reasonable to say that we would have had to act further.[20]

2.22 The committee queried whether APRA's new requirements for mortgage lending practices would have a negative impact in more subdued parts of the Australian housing market, such as in regional areas.

2.23 APRA commented that its guidance is to constrain the growth of investment property lending to overextended borrowers and that this makes as much sense in subdued markets.[21] APRA stated:

> Remember, we have not actually clamped the supply of house lending; we have moderated how aggressive the most marginal borrowers can be and we have moderated some of the growth in the sector and we have improved the capitalisation of the sector. None of that stops an individual from getting a loan.[22]

2.24 In response to the same query, the Chairman stated that there is often an incorrect suggestion that constraints on investor lending reduce the supply of credit.[23] The Chairman stated:

> … the total supply, the total speed of growth of credit to the housing sector, has actually run pretty much unchanged for the last six months. There is this substitution of owner-occupiers for the investors that may not be as prevalent any more. But total housing finance is not actually greatly changed from where it was six months ago or 12 months ago.[24]

2.25 The committee queried APRA about its responsiveness in regulating home lending when warranted by market conditions. APRA commented that it always responds in a proactive way and has in fact consciously restrained

20 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 6.

21 Mr Charles Littrell, Executive General Manager, APRA, *Transcript,* 18 March 2016, p. 9.

22 Mr Charles Littrell, Executive General Manager, APRA, *Transcript,* 18 March 2016, p. 9.

23 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 9.

24 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 9.

home lending even though all of the relevant metrics had indicated it is a low-risk business.[25] APRA stated:

> What we have done in 2014 and 2015 on home loan markets and what we do fairly routinely in various insurance and other banking markets is that, if something has gone wrong, we look at that closely, but if something seems to have gone too right we look at that too. Very often, that generates some sort of response like what we have talked about today with home lending. The actual metrics today on Australian home lending show that the loss rates are vanishingly small and it is a very, very profitable business. But we are consciously restraining it, because we are proactively thinking that we are in a position where industry could be vulnerable if it goes very badly wrong. We are not predicting it, but we are ensuring that industry is ready for it if that is where we end up. That is not unique to home loans. We try to do that across all substantial exposures of the banking and insurance business.[26]

2.26 APRA noted in response to questions about the history of these types of macroprudential tools that they have been used increasingly around the world but in slightly different ways. The Chairman remarked that New Zealand has more prescriptive rules about maximum LVRs and that the United Kingdom has placed limits on bank lending at high loan to income ratios.[27]

2.27 APRA commented that the most relevant past example of macroprudential tools used in Australia was its global pioneering of stress testing in 2002 to 2003 due to overheating in the home lending sector. APRA stated that its measures at that time included changing the rules on how to apply lenders mortgage insurance, steepening the capital curve for higher loan-to-value lending, and discouraging any lending that was subprime.[28]

2.28 The committee asked APRA to describe any other macroprudential tools that it had available. APRA replied that the term 'macroprudential' has become something of a global buzzword and that it believes in good prudential supervision, which is its job. APRA stated:

> The sorts of tools we have available, broadly speaking, break down into regulation and supervision on the regulatory side. We can talk about different industries, but let us talk about banking.

25 Mr Charles Littrell, Executive General Manager, APRA, *Transcript,* 18 March 2016, p. 17.

26 Mr Charles Littrell, Executive General Manager, APRA, *Transcript,* 18 March 2016, p. 17.

27 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 6.

28 Mr Charles Littrell, Executive General Manager, APRA, *Transcript,* 18 March 2016, p. 7.

> To an extent, we are ensuring that the banking industry is well capitalised, is managing its capital to its risk and is soundly funded. That, in itself, is a macroprudential tool even though it is focused on helping each bank be sound… Under the Banking Act and the prudential standards, we have a broad range of powers in theory we could pull out. We have not, typically, felt it necessary to extend beyond what we do now, which is conservative regulation, proactive supervision and quite often focusing the attention of the industry on what we think are emerging risks.[29]

2.29 The committee questioned whether APRA's recent actions in relation to mortgage lending were the result of the Basel reforms or due to concerns about increases in interest-only loans. APRA replied that this was a one-off tightening and that they had 'constrained the acceleration of something that we thought was getting a little bit reckless at the margin.'[30] APRA further commented that it hoped that this tightening of lending standards would be permanent.[31]

High LVR lending and potential shocks

2.30 The committee asked APRA to outline its views on high LVRs and why they might be of concern.

2.31 The Chairman responded that a high LVR has less margin for error and that 'if something goes wrong, the value of the loan is very close to the value of the property, and any fall in the value of the property would mean that, if the customer defaulted, there was less likelihood that [the lender] would get repaid on the loan.'[32]

2.32 APRA was further queried about the level of exposure in Australia to high LVR lending if asset values declined and the number of loans that may be involved.

2.33 The Chairman commented that loans with a greater than 90 per cent LVR represented just under 10 per cent of new lending, with those with a 95 percent LVR at around three per cent. The Chairman also indicated that stress testing in 2014 by APRA which involved a scenario of double digit unemployment, a 40 percent drop in house prices, and other factors, revealed that the banking system would be able to cope with the losses.[33] The Chairman stated:

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29 Mr Charles Littrell, Executive General Manager, APRA, *Transcript,* 18 March 2016, p. 8.

30 Mr Charles Littrell, Executive General Manager, APRA, *Transcript,* 18 March 2016, p. 8.

31 Mr Charles Littrell, Executive General Manager, APRA, *Transcript,* 18 March 2016, p. 8.

32 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 21.

33 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 21.

> The result of that stress test was, pleasingly, that the level of losses across the banking system were able to be accommodated within the capital that the system has. So, in really simple terms, we did not break anybody, but clearly it did involve a substantial level of loss across the banking system.[34]

2.34 The Chairman emphasised that banks would not suffer any material level of loss in the face of falling house prices if borrowers could continue to service their loans:

> If we had some kind of shock, as I said, the key here is not that prices have gone down because, in and of themselves, if people can continue to service their loans, history tells us that Australians will do that. They will, in a sense, ride it out and, hopefully, come out the other side. The key shock would be if there was something that led to a significant increase in unemployment that would jeopardise people's abilities to service their loans.[35]

2.35 The Chairman remarked also on this same issue that although APRA collects statistics and monitors the proportion of high-LVR lending for housing, it does not put limits on this because there are sometimes legitimate reasons to have these loans.[36] The Chairman stated:

> If you want to get first-home buyers, for example, into the market, you cannot require extremely large deposits because you would make it too hard for those people. But, equally, if a bank had an extremely high proportion of very high LVR lending in its portfolio, then that would be a trigger for further investigation.[37]

House prices and supply

2.36 The committee asked APRA whether it had specific measures it would implement in response to excessive house price inflation.

2.37 The Chairman responded that APRA has no mandate to target particular house prices in Australia but that its role was to ensure that banks were lending sensibly, regardless of any fluctuations in these levels.[38]

2.38 In response to further questions from the committee on whether APRA could guarantee that substantial declines in house prices would not occur,

34 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 21.

35 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 19.

36 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 15.

37 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 15.

38 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 15.

the Chairman commented that APRA could not give any such guarantee.[39] The Chairman stated:

> The best thing we can do to protect against the sorts of concerns that you have raised is to make sure that people get loans they can afford in the first place—that banks are not doing reckless lending and are meeting their responsible lending obligations. That is an ASIC responsibility. We make sure that the lending policies more generally are sound, which maximises the probability that a borrower can continue to service the loan.[40]

2.39 The committee canvassed APRA's views on the impacts of increased taxation in the property market on participant behaviour and investment levels.

2.40 The Chairman responded:

> Changes in policy have impact. That is their intent. Some people will find there are negative impacts; it may have positive impacts for others. How that will all play out is very difficult to say.[41]

2.41 APRA indicated however that it did not have any other relevant information that could address whether tax changes in the property market would change investor behaviour.[42]

2.42 In reply to questions about possible APRA responses to supply side issues in the housing market, the Chairman stated that whereas APRA has no role in supply-side policies for housing, it does monitor this information to keep abreast of how the market is developing.[43] The Chairman further stated on this issue:

> To the extent that there is the supply-demand imbalance and that has led to some significant increases in house prices, we have commented on what we are observing in terms of house prices. I would try and characterise it by saying we keep an eye on it; we are very interested in it. But we have not gone so far, because it is probably beyond our mandate, to comment on what housing supply policy should be.[44]

39 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 18.

40 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 18.

41 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 21.

42 Mr Charles Littrell, Executive General Manager, APRA, *Transcript,* 18 March 2016, p. 22.

43 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 15.

44 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 16.

Securitisation

2.43 The committee asked APRA to expand on its current priorities in terms of securitisation. APRA responded that it has two broad views, which are to create a much more explicit environment for 'funding-only' securitisation and to bring in reforms that do away with capital relief structures for home loans that do not actually relieve the risk.[45]

2.44 The committee further queried whether APRA was seeking to address a current lack of underlying capital for the various products that are securitised. APRA remarked that it would like the securitisation market to be bigger in asset securitised terms, and is looking to make regulatory reforms to assist with this.[46]

Governance and culture in APRA-regulated institutions

Superannuation boards

2.45 The committee requested an update from APRA on the work it had been doing to improve the governance standards for superannuation funds. APRA indicated that it had consulted on possible amendments to its prudential standards and guidance in this area and had received positive responses.[47] APRA stated:

> In essence, industry was quite supportive of our proposals, because they were principles based and essentially said that: boards had to have appropriate governance charters with rigorous appointment, removal and nomination processes that looked at getting the right skill sets and capabilities around boards. So, at an appropriate time, which we have not yet settled on, we will implement those indicated changes into our prudential standards and guidance, if you like, to assess the response of industry to what we have signalled is the direction we think the industry needs to go.[48]

2.46 The committee further queried APRA on the possible consequences of poor governance processes for superannuation fund investors. APRA commented that the manifestation of poor practices can vary depending on the type of decision and can include mergers, investment choices, fees,

45 Mr Charles Littrell, Executive General Manager, APRA, *Transcript,* 18 March 2016, p. 5.
46 Mr Charles Littrell, Executive General Manager, APRA, *Transcript,* 18 March 2016, p. 5.
47 Mrs Helen Rowell, Deputy Chairman of APRA, *Transcript,* 18 March 2016, p. 4.
48 Mrs Helen Rowell, Deputy Chairman of APRA, *Transcript,* 18 March 2016, p. 4.

costs, member services and overall financial outcomes. APRA emphasised that its focus is on robust and rigorous decision making by boards that are in the best interests of the fund members.[49]

Directors of ADIs and insurers

2.47 APRA was queried on the progress of its new standard initiated in 2014 for directors of ADIs and insurers in relation to risk management and APRA's 'aid to directors' to assist with their understanding of prudential regulation and their obligations under this framework. The Chairman informed the committee that there had been concerns from the director community that the standard was mixing up their roles and those of management.[50] The Chairman stated:

> … we had to try to explain how we saw the role of directors of an APRA regulated institution. That particular aid to directors was designed to be a document that you could give to a new director of an APRA regulated institution and say, 'You may be a director of a toy company or a coalmine'—or whatever it might be—'but, when you come into the APRA regulated space, there are some additional obligations on you when you are a director of a financial institution.' That aid was part of setting out and explaining what they are.[51]

2.48 APRA further explained that this standard applies to banks and insurers, in which a cross-prudential standard around governance applies, but that the superannuation framework is different because 'there is more prescription in the superannuation legislation and a little less in [APRA's] prudential standards around governance and, in particular, board composition and other requirements.'[52]

Commonwealth bank – CommInsure

2.49 The committee queried whether APRA had been investigating the governance and culture of the Commonwealth bank, given recent allegations that its insurance business arm, CommInsure, had acted unethically in rejecting a number of claims from life insurance policy holders. The committee also queried whether the remuneration program at CommInsure played any part in this.

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49 Mrs Helen Rowell, Deputy Chairman of APRA, *Transcript,* 18 March 2016, p. 4.

50 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 10.

51 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, pp. 10-11.

52 Mrs Helen Rowell, Deputy Chairman of APRA, *Transcript,* 18 March 2016, p. 11.

2.50 APRA responded that it has been following up on this issue, including the possible role of remuneration incentives, and had met with the board of CommInsure and had requested documents under its powers which it was now reviewing. APRA also indicated that it was working in consultation with ASIC but that the two regulators have different roles in relation to this inquiry.[53] The Chairman stated:

> … ASIC is particularly focused on the issues with individual customers and making sure that customers are treated fairly and to the extent customers have not been treated fairly that that matter is put right, in some shape or form. I would expect, as a result of that, that there will be—I cannot, obviously, commit ASIC's timetable—some public response. ASIC has made it clear that they are doing an investigation and, usually, when they do those investigations there is some public response at the end. We tend to work in a different way by virtue of the confidentiality constraints on us, so we would not, in the normal course of events—unless we launched a formal investigation, which we have not yet done—produce a particular report at a conclusion.[54]

2.51 APRA stated that it was too early to determine whether it would launch a formal investigation into CommInsure.[55]

2.52 The committee asked APRA whether it still maintained the view that its activities and assessments in relation to individual financial institutions, such as CommInsure, should be conducted confidentially and not in public.

2.53 The fact that APRA does not disclose certain activities and interventions has been discussed by the committee at previous hearings.[56]

2.54 The Chairman responded that APRA is required under its legislation to act confidentially and that this underpins its ability to act successfully.[57] The Chairman stated:

> … there is a confidentiality requirement on us in the act. That is there for very good reasons. The secret of whatever success we have had has been our capacity to operate behind the scenes to get information when we ask for it and to have access to individuals, information, reports, data or whatever it might be. Our ability to

53 Mr Geoff Summerhayes, APRA member, *Transcript,* 18 March 2016, pp. 12, 13.

54 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 13.

55 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 13.

56 House Standing Committee on Economics, *Review of the Australian Prudential Regulation Authority Annual Report 2014 (Second Report)*, May 2015, p. 15.

57 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 23.

> do that is founded on the fact that institutions have faith that they are talking to us on a confidential basis and issues will remain confidential. As I said, it is critical to our ability to do our job. If we had to operate in a way where everything we did was public, I actually do not know how we would operate.[58]

2.55 The Chairman further stated in response to this question that this way of operating was not unique.[59] The Chairman stated:

> It is the way prudential regulators around the world do operate. I know there is always a public desire to know more, but many of the things we deal with are best dealt with behind the scenes. They get fixed, and the community has continued confidence in the system.[60]

2.56 Following further questions from the committee about how the public can be confident in the effectiveness of a confidential process, the Chairman indicated that the measure of success was the public's confidence in the health and soundness of the financial system which is very important to preserve.[61]

Self-managed superannuation funds

2.57 Whilst acknowledging that self-managed superannuation funds (SMSFs) are not regulated by APRA, the committee queried whether APRA has any concerns about their significant growth.

2.58 APRA replied that the SMSF sector has grown quite considerably over the past 10 years and now represents about one-third of the total superannuation assets, but that APRA's role is focussed on the other two-thirds of the sector that is not self-managed. APRA indicated however that it does monitor the cash flows between the APRA-regulated sector and the self-managed super fund sector in terms of the implications for APRA-regulated superannuation funds' ongoing viability.[62] APRA stated:

> The point is that the APRA-regulated superannuation sector has cash flows coming in and out from all sorts of sources. Part of that is outflow to self-managed super funds. We are not oversighting the self-managed super funds per se; we are looking at what is

58 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 23.

59 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 23.

60 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 23.

61 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 23.

62 Mrs Helen Rowell, Deputy Chairman of APRA, *Transcript,* 18 March 2016, p. 13.

> changing, in terms of the flows within the APRA-regulated sector, and the implications of that for how they are managed.[63]

Private health insurers

2.59 The committee requested more details from APRA on its planned road map for the private health insurance prudential framework, which the Chairman had indicated would be released in the middle of the year.

2.60 APRA responded that it has no prudential concerns in relation to the private health insurance market, and that PHIAC had done a good job in overseeing this sector.[64] APRA also indicated that there would be no significant changes made during this first year of its oversight of this industry. APRA stated:

> We have flagged to the institutions to give them some certainty about what the next two to three years would look like and we want to progressively align areas around risk management, governance, and at some stage in the future capital models, to ensure that those standards are at best practice. We would typically align those around what we have done within other sectors that APRA regulates and, most notably, across the other insurance sectors. We will put out a discussion paper before the middle of the year.[65]

2.61 The committee also queried whether any aspects of this road map would address recent APRA analysis showing a widening gap between premium revenue that health funds receive and the benefits that their members are paid.

2.62 APRA responded that its mandate was the prudential oversight of the health insurers to ensure that they are operating with adequate capital, risk and governance frameworks to meet policyholder obligations, but that APRA has no direct involvement in the setting of premiums.[66]

63 Mrs Helen Rowell, Deputy Chairman of APRA, *Transcript,* 18 March 2016, p. 14.
64 Mr Geoff Summerhayes, APRA member, *Transcript,* 18 March 2016, p. 20.
65 Mr Geoff Summerhayes, APRA member, *Transcript,* 18 March 2016, p. 20.
66 Mr Geoff Summerhayes, APRA member, *Transcript,* 18 March 2016, p. 20.

OTC derivatives

2.63 The committee was interested in APRA's view on the impacts on investor behaviour of increases in the capital required to be held against over-the-counter (OTC) derivatives.

2.64 The Chairman responded that there was a three strand effort to improve the resilience of the derivative markets post-GFC, that is:

- to encourage a lot of standardised derivatives onto exchanges—standard interest rate swaps et cetera to be moved onto an exchange traded environment rather than over-the-counter;
- to encourage counterparties to derivative transactions to exchange margins or collateral with one another, that is to take some collateral to protect against the risk that the other would default; and
- if choosing not to utilise the first two strands, have higher capital requirements.[67]

2.65 The Chairman further commented that the ideal end result of these globally consistent measures will be market rules that increase integrity and reduce risk. Hence, there would be more derivatives trading under the first two strands, that is, on organised exchanges or with collateral, and therefore less uncollateralised OTC derivatives.[68]

Conclusion

2.66 APRA's intervention to curtail investor lending growth in the housing market is of continuing interest to the committee and updates will be sought on the impacts of this for home owners and property investors, and the housing sector overall, at future hearings. The implications of lower mortgage risk weights in the banking sector and high-LVR lending will also be important topics for future discussions.

2.67 The committee notes APRA's focus on improved governance standards and culture in its regulated institutions and will also continue to seek advice from APRA on its progress in applying these standards. The committee will also be interested in the progress of APRA's prudential roadmap for the private health insurance sector and its implementation.

2.68 APRA has a key role to play in ensuring the health of Australia's financial sector and it must remain vigilant and proactive in enforcing sound

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67 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 22.

68 Mr Wayne Byres, Chairman of APRA, *Transcript,* 18 March 2016, p. 22.

prudential standards that benefit the wider economy. The committee has an important role in holding APRA to account for its performance.

David Coleman MP
Chair
11 April 2016

A

Appendix A – Public hearing details and submission

Public hearing

Friday, 18 March 2016 – Canberra

Australian Prudential Regulation Authority

Mr Wayne Byres, Chairman
Mrs Helen Rowell, Deputy Chairman
Mr Geoff Summerhayes, Member
Mr Charles Littrell, Executive General Manager, Supervisory Support Division
Mr Keith Chapman, Executive General Manager, Specialised Institutions Division
Mr Neil Smith, Special Counsel,

The hearing transcript is available online at:
http://www.aph.gov.au/Parliamentary_Business/Committees/House/Economics/APRA_Annual_Report_2015/Public_Hearings

Submission

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

B

Appendix B – Letter from APRA to all ADIs 9 December 2014

Australian Prudential Regulation Authority

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Sydney NSW 2000

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9 December 2014

To: All authorised deposit-taking institutions

REINFORCING SOUND RESIDENTIAL MORTGAGE LENDING PRACTICES

In the current economic environment, prudential risks in the housing market appear to be increasing. Interest rates remain at historically low levels, household leverage remains high, and housing loans represent a large and increasing concentration on many ADI balance sheets. Strong competition in the housing market is also evident, which is accentuating pressure on lending standards. Against this backdrop, housing credit growth has accelerated, with lending to property investors particularly strong; the Reserve Bank of Australia (RBA) has noted that this could be funding additional speculative activity in the market. These forces have contributed to strong house price growth, particularly when viewed against the more subdued growth in household incomes.

Over the past year, APRA has taken a number of steps aimed at strengthening residential mortgage lending standards. This has centred on ensuring that ADIs increase their understanding and active monitoring of risks within their residential mortgage portfolios. In addition to a heightened level of supervisory activity at individual ADIs, APRA has:

- increased the level of analysis of mortgage portfolios, including regular review of detailed data on ADI underwriting policies and key risk indicators, to identify outliers. APRA also recently completed a stress test of the ADI industry, with two scenarios focused on a severe downturn in the housing market;

- written to boards and chief risk officers on their oversight of the evolving risks in residential mortgage lending. APRA supervisors have been following up on this communication through on-site prudential reviews of residential mortgage lending; and

- issued a prudential practice guide (APG 223) on sound risk management practices for residential mortgage lending.[1] Some ADIs are currently conducting self-assessments against APG 223, which APRA considers to be good practice.

With the current risk environment in mind, APRA has been discussing with other members of the Council of Financial Regulators (CFR) further steps that could be taken to reinforce sound lending practices and mitigate any speculative pressures that may be building.

[1] *Prudential Practice Guide APG 223 – Residential Mortgage Lending*, APRA, 5 November 2014.

Reinforcing sound lending practices

There are a number of additional regulatory and supervisory tools that APRA can apply to address emerging risks, building on the enhanced monitoring and review of recent years. These include additional supervisory monitoring and oversight, supervisory actions involving Pillar 2 capital requirements for individual ADIs, and higher regulatory capital requirements at a system-wide level.[2] Beyond this, there are also more direct controls such as regulatory limits on lending activities, as introduced in other jurisdictions to manage risks emerging in the housing market.

At this stage, APRA does not propose to introduce increases in system-wide capital to address current risks in the housing market, or introduce new regulatory limits, although we will keep these options under active review. Based on our current assessment of the risk outlook, however, APRA considers that it is necessary to further increase the level of supervisory intensity in this area, to reinforce sound lending practices, with a particular focus on some specific areas of prudential concern. These are set out below, providing transparency on the key aspects of mortgage lending that APRA supervisors will be focusing on in the period ahead. Where concerns on risk profile or serviceability are identified, this will lead to further supervisory action, including the consideration of individual Pillar 2 capital requirements.

Risk profile

There are many dimensions to assessing the soundness of mortgage lending practices. In recent years, supervisors have been discussing and reviewing these in depth. Higher risk lending includes, for example, a high proportion of lending at high loan-to-income ratios (LTI), lending at high loan-to-valuation ratios (LVRs), lending on an interest-only basis to owner-occupiers for lengthy periods and lending at very long terms. In the current environment, where an ADI is undertaking large volumes of lending in these categories, or increasing this higher risk lending as a proportion of new lending, this will be a trigger for the consideration of supervisory action.

Investor lending

Fast or accelerating credit growth can also be a key indicator of a build-up in risk, both at an individual ADI and at an aggregate system level. For an individual ADI, excessive housing credit growth can generate a rapid shift in risk profile, especially if new borrowers are increasingly stretched to compete in a quickly rising property market. Given the currently very strong growth in investor lending, supervisors will be particularly alert to plans for rapid growth in this part of the portfolio. For example, annual investor credit growth materially above a benchmark of 10 per cent will be an important risk indicator that supervisors will take into account when reviewing ADIs' residential mortgage risk profile and considering supervisory actions.[3] The benchmark is not intended as a hard limit, but ADIs should be mindful that investor loan growth materially above this rate will likely result in a supervisory response.

[2] There are two principal mechanisms for changes to capital at a system level: changes to Pillar 1 capital requirements for individual assets (through changes to specific risk weights) or changes to overall capital requirements for all ADIs. From 1 January 2016, APRA will also have the option of applying the countercyclical capital buffer.

[3] This benchmark has been established by APRA, after advice of CFR agencies, taking into account trend nominal household income growth and recent market trends.

Serviceability assessments

Serviceability assessments for new borrowers are critical in determining the capacity of the borrower to service and repay the loan. The serviceability buffer assumed by ADIs as part of this assessment accommodates not only future changes in interest rates but also unexpected changes in borrower income and expenses. Practice in setting the serviceability buffer varies across the industry, with some assessments allowing borrowers to take on debt at very high multiples of their income.

In APRA's view, prudent serviceability policies should incorporate a serviceability buffer of at least 2 per cent above the loan product rate, with a minimum floor assessment rate of 7 per cent.[4] This is based on a number of considerations, including past increases in lending rates in Australia and other jurisdictions, market forecasts for interest rates, international benchmarks for serviceability buffers, and long-run average lending rates.

Good practice would be to maintain a buffer and floor rate comfortably above these levels, rather than operate at the minimum expectation: low serviceability buffers will prompt the consideration of further supervisory action. APRA supervisors will also be monitoring other elements of the serviceability assessment, including income acceptance, minimum living expenses, and other debt commitments. It will be important that these assumptions are not relaxed, to ensure that overall loan serviceability standards are maintained.

Next steps

In the first quarter of 2015, APRA supervisors will be reviewing key risk indicators, serviceability policies and ADIs' investor loan growth plans. Where an ADI is not, in APRA's view, maintaining prudent lending practices, this will lead to a graduated increase in the level of supervisory action. As with any supervisory response, this will include further communication with senior management and boards, changes to APRA's risk assessment as defined by the PAIRS and SOARS framework, and enhanced monitoring and review. In the first half of 2015, supervisors will also reflect any concerns through changes to Pillar 2 capital requirements, proportionate to the risks identified and the scale of the residential mortgage loan portfolio.

For higher risk lending, APRA will also conduct further investigation to better understand how ADIs are monitoring and managing origination flows and the associated credit risk during 2015. This may include additional detailed information requests and on-site and off-site reviews. For all ADIs, supervisors will continue to place a strong focus on reviewing loan origination practices in residential mortgage portfolios, given the risks in the current environment.

Together with other members of the CFR, APRA will continue to monitor and assess the risks in the housing market as they evolve. As outlined above, there are a range of further measures that APRA could apply. These options remain open, and we will consider the need for additional steps as market conditions and lending standards develop.

[4] The loan product rate is the lender's current standard variable rate (SVR) minus any discount applied for the term of the loan.

If you have any questions on the issues outlined in this letter, please contact your supervisory team.

Yours sincerely,

Wayne Byres
Chairman