

# CHAPTER ONE: APRA'S BACKGROUND AND OPERATING ENVIRONMENT

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# CHAPTER 1: APRA'S BACKGROUND AND OPERATING ENVIRONMENT

## APRA's mandate

APRA is the prudential regulator of the financial services industry.

APRA regulates the industry under five 'industry' Acts and administers the Financial Claims Scheme (FCS) for depositors and insurance policyholders.<sup>3</sup> The industry Acts provide for licensing and regulatory oversight of:

- ADIs — including banks, credit unions and building societies;
- General insurers (including reinsurers);
- Life insurers and friendly societies;
- Private health insurers (PHI); and
- Superannuation funds (excluding self-managed funds).

### SECTION 8 OF THE AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY ACT (APRA ACT) — PURPOSE FOR ESTABLISHING APRA

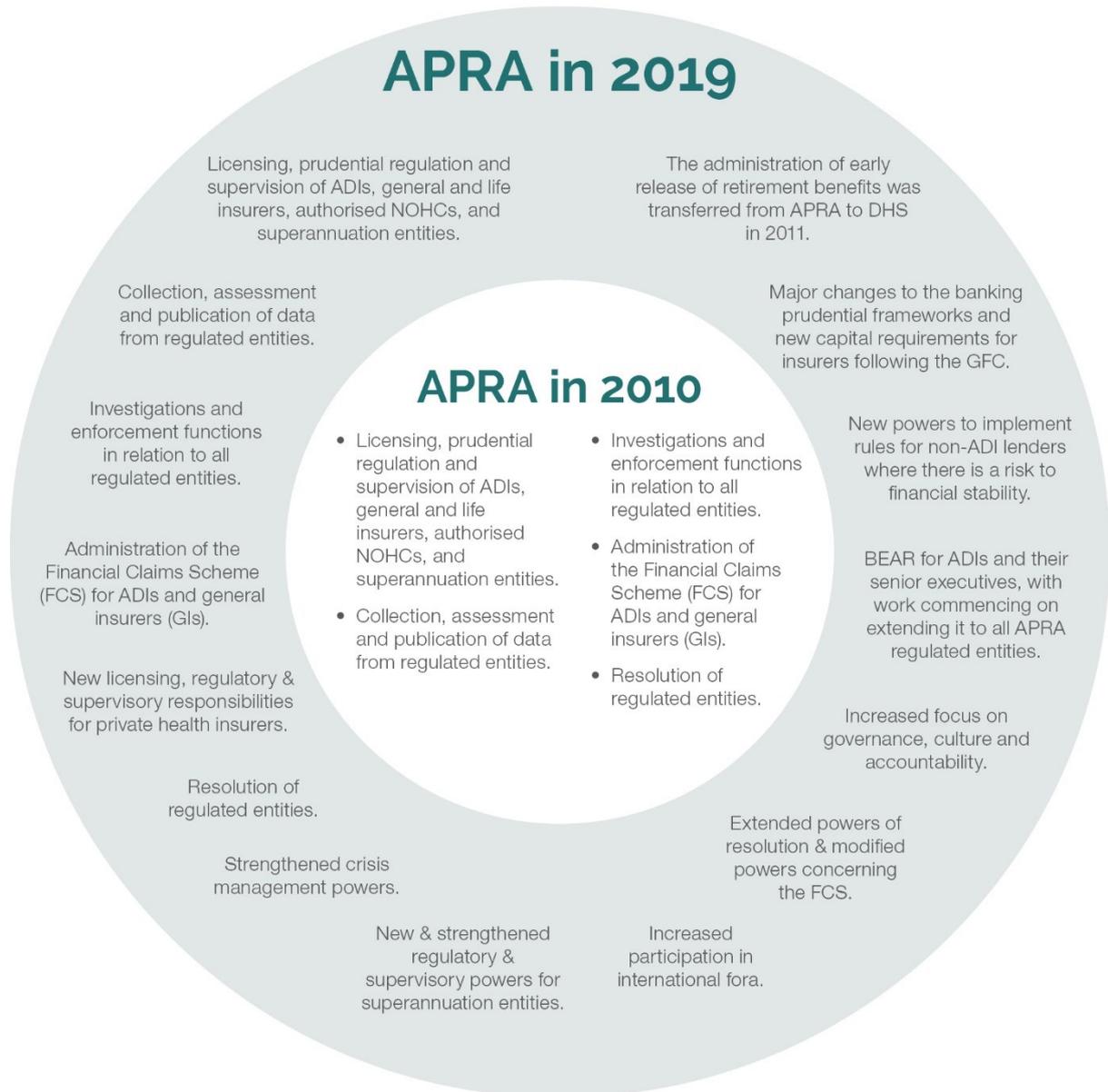
1. The main purposes for which APRA exists are as follows:
  - a. regulating bodies in the financial sector in accordance with other laws of the Commonwealth that provide for prudential regulation or for retirement income standards;
  - b. administering the financial claims schemes provided for in the *Banking Act 1959* and the *Insurance Act 1973*; and
  - c. developing the administrative practices and procedures to be applied in performing that regulatory role and administration.
2. In performing and exercising its functions and powers, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, is to promote financial system stability in Australia.

A number of reviews such as the 2014 Financial System Inquiry (the Murray Inquiry), the Hayne Royal Commission and the Productivity Commission (PC) reviews into competition in the financial system and into superannuation have not recommended a fundamental change to APRA's mandate.

<sup>3</sup> The FCS operates to protect Australian depositors and general insurance policyholders where an ADI or general insurer fails.

Currently APRA regulates around 510 entities. Its regulated population consists of approximately 150 ADIs with \$4.4 trillion in assets; 190 superannuation entities with \$1.7 trillion funds under management; and over 170 insurers with just under \$400 billion in assets.

Figure 1.1: APRA's expanded remit 2010-2019



APRA's remit has expanded over recent years (Figure 1.1). Most notably, it was given oversight of the FCS for ADIs and general insurers in 2008 and 2010. In addition, legislative changes in 2012 provided it with a major increase in supervision powers for superannuation entities. It assumed supervisory responsibilities for PHIs in 2015. APRA's work has been further expanded by major post-crisis reforms and more recent events such as the heightened focus on governance, culture and accountability (GCA).

## APRA's strategy and vision

APRA publishes a four-year rolling Corporate Plan every year to set out its functions, capabilities and its strategic initiatives. In 2018, APRA updated its plan for the 2018-2022 period, stating that its primary focus is on the need for APRA to be fit-for-purpose into the future. APRA's current strategy identifies six strategic priorities for organisational change and capability improvement:

- Broadening risk-based supervision;
- Improved data-enabled decision-making;
- Building resolution capabilities;
- Strengthening external engagement and collaboration;
- Enhancing leadership, people and culture; and
- Lifting organisational capability.

APRA's current vision is 'to deliver a sound and resilient financial system, founded on excellence in prudential supervision'.

## APRA's operating model

### Core functions

#### *Licensing and supervision*

Supervision of regulated entities is APRA's core business. This starts with licensing entities under the relevant industry Acts. In 2017, APRA established a separate licensing team to provide more consistent and efficient engagement with entities seeking to be authorised by APRA, including those with innovative or non-traditional models. In 2018, APRA finalised a phased licensing framework for ADIs. This aims to provide a pathway to assist entities navigate the licensing process, including the introduction of restricted banking licences. These allow new entrants to conduct some banking business while they build resources and capabilities.

Once licensed, entities are subject to supervision, which is APRA's core activity and capability. Every supervised entity is assigned a responsible supervisor. For larger entities, this may be a team of supervisors. For smaller entities, a responsible supervisor may cover a number of entities.

APRA's supervision is underpinned by the prudential framework, which is the set of requirements and expectations applicable to regulated entities as articulated through legislation, prudential standards, reporting standards and guidance.

## A PRUDENTIAL LENS

APRA applies a risk-based prudential focus to supervision. Prudential supervision focusses on the financial safety of financial institutions. It seeks to ensure that risks taken by financial institutions are within reasonable bounds and effectively managed so that the financial system is protected and institutions are well placed to meet the financial commitments made to their customers. For example, a bank accepts deposits and promises to repay them on demand and an insurer accepts premiums on the promise of meeting claims when a specified event occurs.

A prudential lens is forward-looking and emphasises preventative measures (ex-ante focus) by supervising institutions against outcomes, rather than ex-post punitive action designed to punish and deter misconduct. The conduct of an institution is assessed with regard to how it may impact on the stability of the institution or sector rather than through a consumer lens.

APRA has stated that its aim is to identify the likely failure of an APRA-regulated institution early enough so there is timely corrective action or an orderly exit. APRA and successive governments note that it does not pursue a 'zero failure' regime. Instead, it seeks to maintain a low incidence of failure of APRA-regulated institutions while not impeding continued improvement in efficiency or hindering competition in the financial system.

The nature of the promise by superannuation trustees is different to that of APRA's other regulated entities — rather than having a fixed obligation to pay future amounts, the promise relates to managing members' savings in their best interests solely for their retirement. Because of this, superannuation trustees are not subject to the broader capital requirements that apply to ADIs and insurers. Consequently, APRA's supervision of superannuation is focussed on how the trustee manages and carries out its business operations fairly, efficiently and effectively to achieve appropriate member outcomes.

The prudential framework and prudential standards are 'principles-based'. APRA's stated approach is to set out expectations and allow regulated entities to adopt a suitable approach pursuant to their complexity, business model and size. There are important exceptions, such as in relation to minimum capital requirements.

Day-to-day supervision is the responsibility of teams in APRA's frontline divisions, supported by risk specialists who: provide in-depth risk assessments at an entity and industry level; identify emerging risks; and offer horizontal risk insights across industries. Further intelligence is gathered through statistical and industry analysis. Supervisors are also supported by technical advice, legal and resolution specialists.

All regulated entities are supervised according to a common supervision methodology.

Two fundamental elements of this methodology are the Probability and Impact Rating System (PAIRS) and Supervisory Oversight and Response System (SOARS) both introduced by APRA in 2002.

- The purpose of PAIRS is to determine an entity's overall risk rating. This is calculated with reference to the assessment of inherent risk and / or management and control for key risk classes or risk areas.

- The purpose of SOARS is to determine APRA's supervision stance for each regulated entity. There are four stances: Normal, Oversight, Mandated Improvement, and Restructure. The SOARS stance is a function of the output of the PAIRS assessment and the impact rating were the entity to fail.

For each regulated entity, the major supervision activities planned for the year are captured in the Supervisory Action Plan. The SAP is developed by incorporating top-down industry risks and themes captured in APRA's industry risk registers and bottom-up assessment of the responsible supervisor or team.

APRA is currently reviewing its supervision model to take into account recommendations and insights of the Hayne Royal Commission, the IMF's 2019 Financial Sector Assessment Program (FSAP) and the CBA Prudential Inquiry.

### *Policy*

APRA's policy function is responsible for establishing and maintaining a fit-for-purpose prudential framework that reflects all elements of APRA's mandate. APRA's prudential framework aims to protect beneficiary interests by requiring prudent practice from institutions and enabling prompt, effective and proportionate supervisory responses to significant risks. APRA aims to set requirements that are clear and well understood by institutions and supervisors. Where appropriate, requirements are principles-based and allow a range of prudent practices to achieve an outcome.

### *Resolution*

APRA aims for institutions to be appropriately prepared to recover from severe adversity, supported by credible plans for effective resolution at a point of failure. This involves working with institutions to ensure that they are prepared for the effective implementation of resolution plans and, working with domestic and international counterparts, to ensure readiness for international cooperation if needed.

The operational capability to resolve failures and near-failures in an orderly manner, and the ability to identify any potential threats to the viability of institutions early enough so that corrective action can be initiated or orderly exit achieved, is key. It is also important to have sound operational processes for communications, enforcement activity, maintaining or applying resolution strategies and readiness to administer the FCS.

APRA is continuing a large body of work to develop its resolution capabilities following the passage of major legislative reform in 2018.

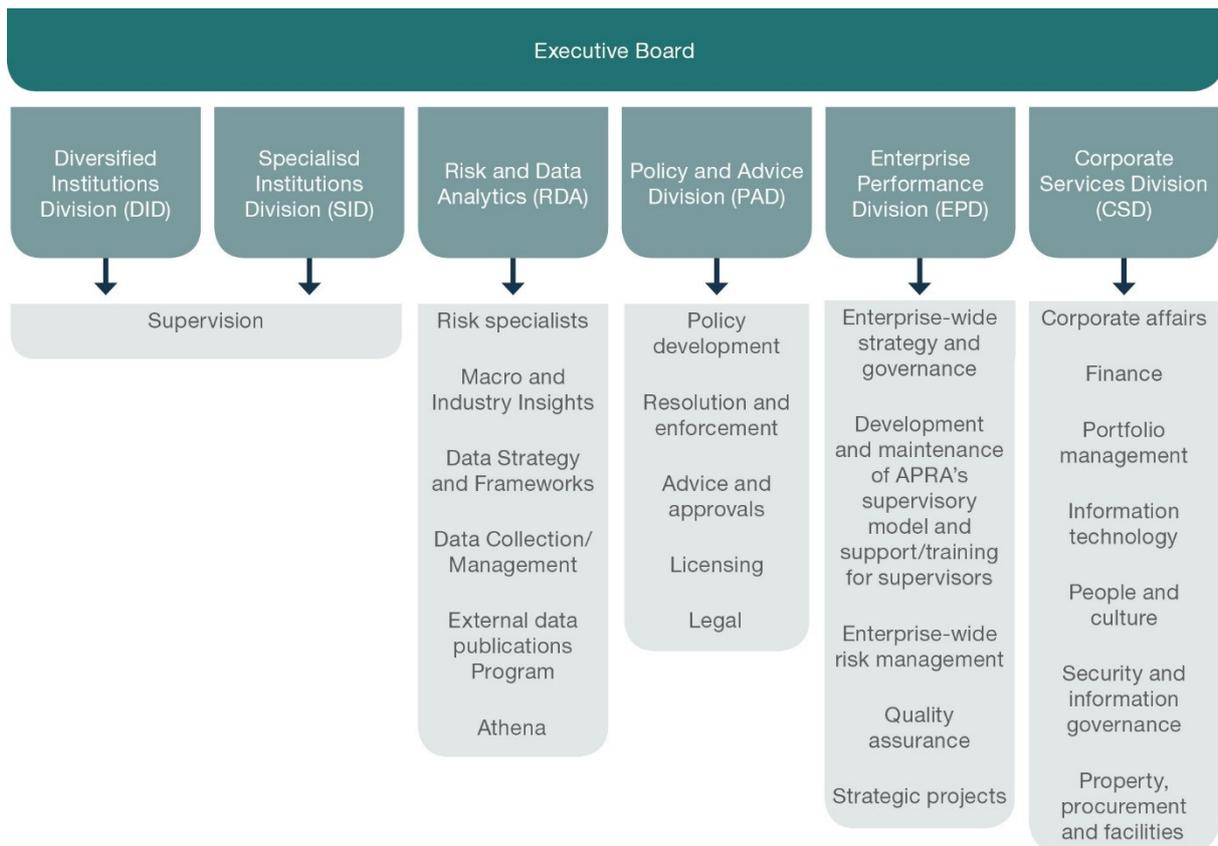
## APRA's organisational structure

APRA's current organisational structure comprises six divisions, each headed by an EGM (Figure 1.2):

- Two 'frontline supervision' divisions: Diversified Institutions Division (DID) and Specialised Institutions Division (SID):
  - DID supervises the approximately 122 functionally diversified financial institutions. These include large financial conglomerates, banks, insurance companies and superannuation funds. They account for around 70 per cent of total assets in the APRA-regulated industries.
  - SID supervises over 340 smaller entities, including regional banks, credit unions, building societies, friendly societies, insurers and superannuation funds. Superannuation is by far the largest industry in SID, both in terms of assets and in number of entities.

- **Policy and Advice Division (PAD):** PAD works closely with Treasury on legislative issues and develops prudential standards and industry guidance material. This division provides technical advice, interpretations and approvals. It includes APRA's crisis management and investigations specialists, APRA's licensing team and the legal team that provides legal advice across all APRA activities.
- **Risk and Data Analytics (RDA):** RDA provides specialist expertise across credit, investment, liquidity, market, governance, culture, remuneration, operational and insurance risks. It includes data analytics teams that perform industry analysis. These teams also manage APRA's data collection and publications. RDA has responsibility for Project Athena, a major program of work to transform APRA's data analytical capabilities by modernising the way APRA collects, stores and provides access to data.
- **Enterprise Performance Division (EPD):** EPD supports the development and maintenance of APRA's enterprise-wide strategy, internal governance structure and organisational performance reporting. It is responsible for the development of APRA's supervisory approach and framework, guidance materials, supervisory training and supervisory IT systems. EPD includes the risk management and compliance function, the quality assurance function and manages organisation wide strategic projects.
- **Corporate Services Division (CSD):** CSD provides corporate support services, including handling internal and external communications, web services and development, project and change management. It includes the finance, people and culture, information technology, security and information governance, portfolio and project management, property, procurement and facilities management functions.

Figure 1.2: APRA's organisational chart



## APRA's funding

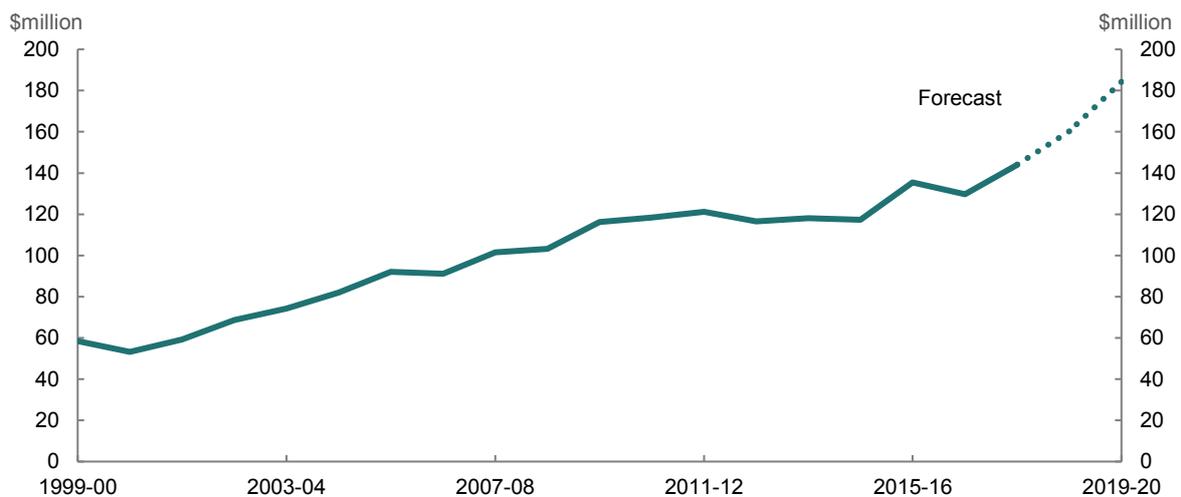
APRA is part of the Treasury portfolio of agencies. APRA's annual budget is subject to the usual government agency review and approval processes. APRA is in turn funded primarily from appropriations, for which the Commonwealth is substantially reimbursed through levies collected from regulated financial institutions. In addition to levies, APRA directly charges certain institutions fees for services. There is a small appropriation in lieu of interest on funds held within the APRA Special Account.

Changes to APRA's operating budget are met with a corresponding change to the levies recovered from industry. Therefore, the majority of funding for APRA does not have an impact on the Australian Government's budget 'bottom line'. Levy-recovered appropriations account for approximately 95 per cent of APRA's total funding with the other five per cent recovered from various fees for services.

Over the last decade, APRA's average annual expenses were \$122 million.<sup>4</sup>

4 Over the period 2008-09 to 2017-18, in nominal terms.

Figure 1.3: APRA's expenses 2000-2018 (nominal terms)



As part of the 2019-20 Budget, the Government announced it would increase APRA's four-year funding by a total of \$150 million (a 25 per cent increase in its annual funding compared to 2017-18). This extra funding was to strengthen APRA's supervisory and enforcement activities and address key areas of concern identified by the Hayne Royal Commission. Specifically, the funding will be used by APRA to:

- Extend the BEAR to all APRA-regulated entities;
- Boost supervision intensity across APRA-regulated entities, including focussing on underperforming superannuation funds and member outcomes; and
- Enhance the supervisory framework for governance, culture and remuneration applying to all APRA-regulated entities, including through building and accessing technical expertise.

This funding is in addition to the \$58.7 million provided to APRA (and recovered from industry) over three years as part of the 2018-19 Mid-Year Economic and Fiscal Outlook (MYEFO). This funding was given so that APRA could:

- Enhance its supervision by increasing the number of frontline supervisors for the largest and most complex financial institutions;
- Enhance its ability to identify and address new and emerging risk areas such as cyber, fintech and culture, by building internal expertise and increasing access to technical specialists outside APRA;
- Improve its data collection capabilities in order to leverage the benefits of inter-agency intelligence sharing; and
- Provide for a review of its enforcement strategy and its use of formal enforcement powers across the industries it supervises, including superannuation.

The Government has indicated that it will exclude APRA from the most recently announced efficiency dividend.

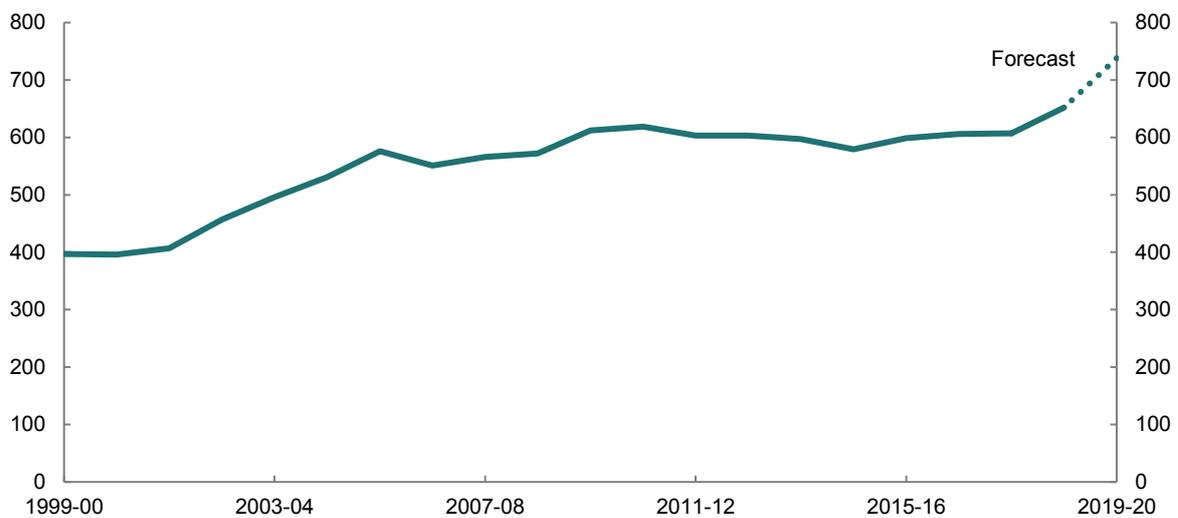
## APRA's staffing

APRA's mandate requires it to maintain a workforce with a diverse set of skills and a broad range of educational backgrounds including actuarial, financial, legal and economics. While APRA is not a public service agency, it is subject to the Australian Public Service (APS) Workplace Bargaining Policy.<sup>5</sup>

At the time of the HIH Insurance collapse in 2001, APRA's staff numbers were just below 400. Post-HIH there was a significant increase in staffing between 2003 and 2005. Since that time APRA has operated with staffing levels at around 600.

At the end of February 2019 there were 656 full-time equivalents across six offices (Sydney (two offices), Melbourne, Brisbane, Adelaide and Canberra) and across six divisions. This number is forecast to increase to 738 in 2019-20 as part of APRA's increased funding (Figure 1.4).

Figure 1.4: Average APRA staffing



Since 1999 APRA has targeted remuneration at the 25th percentile of the financial services sector with the aim of recruiting and retaining good quality staff. An independent benchmarking report in 2015 found that APRA was operating well below the 25th percentile of the sector. In the 2018-19 MYEFO, APRA was provided with funding to support it to return to the 25th percentile of the sector.

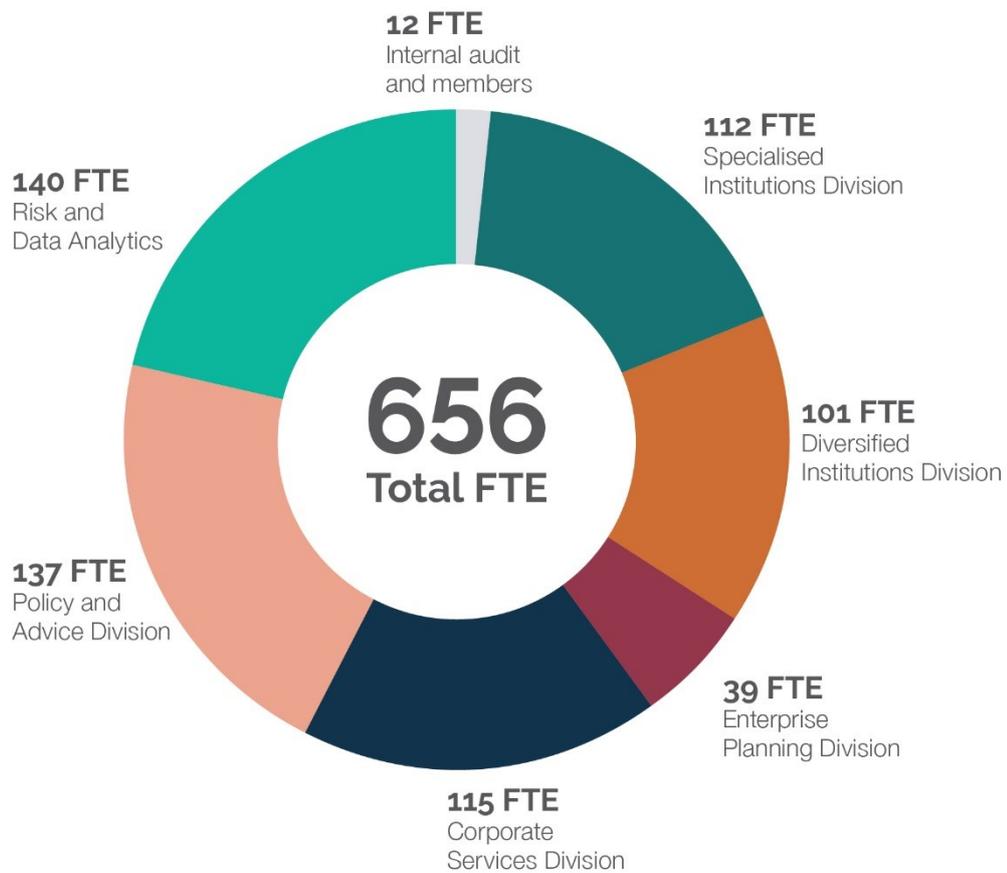
### *Distribution of staff*

As a risk-based supervisor, APRA deploys resources to areas of greatest risk. This means that for a given level of risk, larger institutions receive more supervisory attention than smaller institutions, reflecting the fact that larger institutions carry a greater systemic risk; and for a given size, institutions with a higher risk profile will receive more intensive supervision than those with a lower risk profile.

Figure 1.5 provides an overview of staffing across APRA's six divisions and executive.

5 Statement of expectations 2018.

Figure 1.5: APRA's staffing composition per division<sup>6</sup>



Over time APRA's core supervisory resources have been reduced (both in absolute and relative terms), and central teams have been increased.

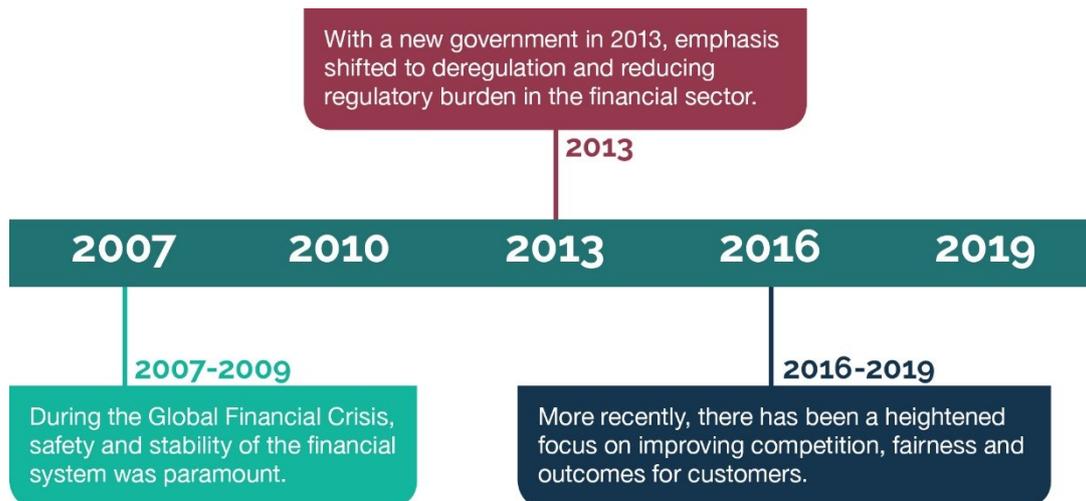
### External accountability

As an independent statutory body, a number of accountability mechanisms are imposed on APRA to allow the public, the Parliament and the government to assess APRA's priorities, its performance and whether it is using its delegated powers appropriately. One mechanism is the government's Statement of Expectations (SoE) for it and APRA's Statement of Intent (Sol).

Figure 1.6 illustrates how expectations of APRA have evolved in recent years.

6 As at February 2019.

Figure 1.6: Changing expectations of APRA



The current external accountability framework is focussed on governance and financial accountability. There is no existing process requiring regular and systemic review of how well APRA discharges its statutory functions or exercises its statutory powers. As a result, the Hayne Royal Commission recommended the establishment of a financial regulator oversight authority for both APRA and ASIC, and quadrennial capability reviews.

## APRA's beginning — 1997 Financial System Inquiry (the Wallis Inquiry)

APRA was established by the APRA Act, following the 1997 Financial System Inquiry (the Wallis Inquiry) which proposed a new regulatory framework for Australia's financial system.

In the two decades prior to the Wallis Inquiry, Australia's financial system had experienced significant change as a result of deregulation, the rapid growth in the number of financial products, industry consolidation, technology advancements, the introduction of the Superannuation Guarantee charge and increased interconnectedness with global markets. The then-Government commissioned the Wallis Inquiry to examine the adequacy of the regulatory framework governing the financial services sector.

The Wallis Inquiry recommended:

- That the disparate sector-based agencies be replaced by standalone agencies operating on functional lines. It recommended a single, national prudential regulator (which became APRA) and another entity responsible for market conduct and consumer protection (which became ASIC). APRA consequently replaced the former Insurance and Superannuation Commission, the prudential supervision function of the Reserve Bank of Australia (RBA) as well as nine other state and Commonwealth regulatory bodies;
- That the new regulators operate with autonomy from executive government to provide public confidence in their impartiality in exercising discretion and applying the law; and
- That the new prudential regulator supervise segments of the financial sector where the financial promises made by entities were deemed to be the most intense.

The implementation of separate prudential and conduct regulators has become known as the 'twin peaks model' for the regulation of the financial system.

## Significant events that have shaped APRA

### The collapse of HIH Insurance

The collapse of HIH Insurance had a profound impact on APRA's framework, organisational structure, culture and supervisory approach. At the time of its collapse in 2001, HIH Insurance was the second largest insurance company supervised by APRA. It was the largest corporate collapse in Australia at the time, with losses estimated at up to \$5.3b.

The collapse of HIH Insurance, and APRA's subsequent response, highlighted the importance of active supervision and a willingness to intervene where appropriate. APRA's efforts to build a more forceful supervisory culture following the HIH Insurance collapse is often cited as a contributing factor to Australia's strong economic performance during and after the GFC. Key APRA changes following the HIH Insurance episode include:

- Replacing the previous governance structure of a CEO and non-executive board. Since 1 July 2003, APRA has been governed by full-time members;
- Increasing the focus on specialist supervisory expertise; and
- Introducing PAIRS and SOARS to underpin APRA's risk-based supervisory approach.

Almost two decades after the collapse of HIH Insurance, efforts to further improve APRA's supervision — to identify risks early and respond promptly — remain at the forefront of APRA's latest Corporate Plan. The need to further strengthen a 'questioning, sceptical and, where necessary, aggressive approach' was also highlighted in APRA's Enforcement Strategy Review.

### Overturing of APRA's AXA director disqualifications

In 2005, APRA attempted to disqualify seven directors of AXA under allegations they were not fit and proper.<sup>7</sup> These individuals appealed APRA's decision to the Administrative Appeals Tribunal (AAT), which overturned the decision.

Following the AAT decision, the then-Government replaced APRA's administrative disqualification process with a court-ordered disqualification process. APRA's power has recently been reinstated for Accountable Persons in ADI groups under the BEAR (explained below).<sup>8</sup>

### Strengthening of superannuation oversight

In the 25 years since the introduction of the Superannuation Guarantee,<sup>9</sup> Australia's superannuation framework has significantly evolved as a result of the sector's rapid growth and its increasing importance for individuals and society at large.

Under the *Superannuation Industry (Supervision) Act 1993* (SIS Act), APRA is responsible for most of the general administration of the Act, including the oversight of licensing, trustee duties, default

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7 AAT decision in *Re VBN and Ors and Australian Prudential Regulation Authority* (2008).

8 Section 37J of the *Banking Act 1959*.

9 In 1992, the then-Government introduced a national compulsory system of superannuation through the *Superannuation Guarantee (Administration) Act 1992*. Under this system, employers are required to make contributions on behalf of eligible employees to a superannuation fund.

MySuper requirements and operating standards. Broadly, ASIC is responsible for disclosure regulation and financial services licensing and associated obligations.

There have been a number of significant legislative developments which have expanded APRA's remit in superannuation. In 2004, new APRA licensing requirements for trustees of registerable superannuation entities (RSEs) came into effect, requiring trustees to obtain a licence and to register all entities under their trusteeship. Today, RSEs are subject to APRA prudential standards which set out certain minimum governance and risk management requirements.

In response to the 2010 Super System Review (the Cooper Review), in 2012 APRA was given the power to make prudential standards for superannuation trustees. Clearer duties to improve the governance and integrity of the system were placed on directors of superannuation trustee boards. APRA was also charged with the role of authorising and oversight of default MySuper products.

In 2014, the Murray Inquiry re-examined the superannuation system and concluded that while it has considerable strengths, further changes were necessary to modernise it. In response, APRA was granted stronger supervision powers, including a broad directions power in 2019.

In 2019, the Productivity Commission's Inquiry into the Efficiency and Competitiveness of the Superannuation System (PC Superannuation Inquiry) was released. The report made a number of wide-ranging recommendations to ensure that the system is fit-for-purpose in the future, including recommendations to assist in rationalising the tail of underperforming superannuation funds and a capability review of APRA — especially its capability to fulfil its member outcomes mandate.

## Regulatory response to the GFC

APRA's most meaningful contribution to the resilience of the financial system during the GFC came from its efforts to strengthen entities' financial health prior to the crisis. In the years preceding the crisis, APRA implemented more conservative ADI capital requirements than most of its international peers and maintained a strong focus on credit underwriting standards. APRA's effectiveness was also supported by the constructive working relationships it had developed with regulated entities prior to the crisis. This enabled it to quickly increase the intensity of its supervision, request more information and give clear direction to institutions when needed.

### *Strengthening financial safety and stability*

These lessons helped to shape APRA's post-GFC response. In the years following the crisis, APRA focussed on further strengthening financial safety and system stability. This includes through Life and General Insurance Capital (LAGIC) requirements implemented in 2013. These sought to enhance the existing capital requirements to strengthen the resilience of the insurance industries. For ADIs, minimum capital and liquidity requirements were significantly strengthened.

### *Regulator toolkit: crisis management powers*

Following the GFC, it was recognised that APRA should be equipped with powerful, flexible and timely powers to manage the potential failure of a regulated financial entity. In 2018, APRA's crisis management powers were enhanced by providing clear powers to enable it to set requirements on resolution planning and ensure banks and insurers are better prepared for a crisis and an expanded set of crisis resolution powers that enable APRA to act decisively to facilitate the orderly resolution of a distressed bank or insurer.

### *Focus on macro-prudential policy*

The GFC also brought about an increased focus on macro-prudential policy as regulators explored ways to respond to emerging financial risks in a more dynamic way. From 2014 to 2018, APRA steadily strengthened system-wide mortgage lending standards, reversing an earlier erosion in policies and practices that had flowed from strong competitive pressures. These measures have strengthened the resilience of individual ADIs and promoted the stability of the financial system overall.

Macro-prudential regulation is still in its infancy. There is considerable variation in views internationally on how these policies should be applied and governed and no consensus on a preferred framework has emerged to date.

### *Greater recognition of the role of GCA structures*

The GFC was a reminder that non-financial risks arising from poor GCA structures can have significant financial impacts. This led to greater international focus on developing ways to strengthen regulators' capacity to supervise these risks to complement the strengthening of regulation of capital and liquidity requirements.

In 2018, the Government introduced the BEAR. This established clear and heightened expectations of accountability for ADIs, their directors and senior executives. It ensures that there are clear consequences in the event of a material failure to meet those expectations. The BEAR complements existing APRA prudential standards covering governance, risk management and the fitness and propriety of responsible persons of an APRA-regulated entity. The regime commenced on 1 July 2018 for large ADIs and is due to commence on 1 July 2019 for medium and small ADIs. The Hayne Royal Commission recommended extending the BEAR to all APRA-regulated entities.<sup>10</sup> The Government has agreed to this recommendation.

#### **PRUDENTIAL INQUIRY INTO THE COMMONWEALTH BANK OF AUSTRALIA**

In 2017, APRA established a prudential inquiry into the Commonwealth Bank of Australia (CBA Prudential Inquiry), following a number of issues which raised concerns about the frameworks and practices in relation to the governance and accountability within the CBA group.

The review made 35 recommendations and resulted in CBA entering into an enforceable undertaking with APRA. The enforceable undertaking established a framework by which the bank will demonstrate that it is addressing the Prudential Inquiry panel's recommendations. APRA also imposed an additional \$1 billion capital requirement on CBA.

### *Restoring trust and social licence*

Globally, to restore trust and confidence in the financial services industry following the GFC, there are heightened expectations that financial service providers should be responsive to changing community concerns and expectations and make a positive contribution to society. This is often referred to as institutions maintaining a 'social licence' to operate. Similarly, the community expects executives within these entities to act with a high degree of care and diligence.

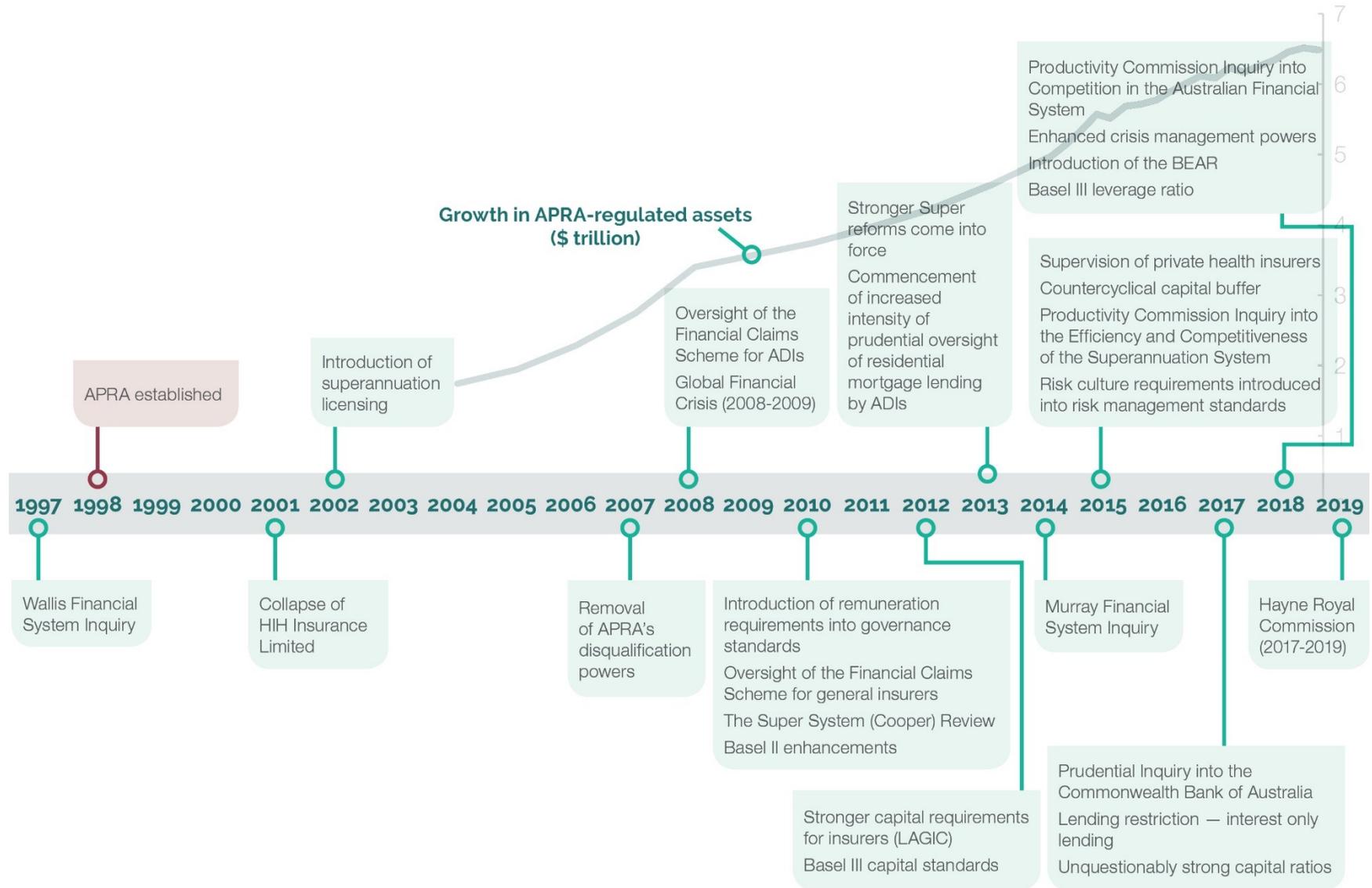
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10 Recommendation 6.8.

These heightened expectations will frame any public or Parliamentary assessment of APRA's success in the supervision of its regulated entities and its approach to its oversight of its GCA responsibilities.

Figure 1.7 highlights key events that have impacted APRA's mandate and operations. In recent years, the amount of change has significantly increased.

Figure 1.7: Timeline and overview of key APRA events



## Events that will continue to shape APRA in the future

### The Hayne Royal Commission

The Hayne Royal Commission concluded in February 2019. Along with the recommendation that APRA be subject to a capability review as soon as possible — forming the impetus of this Review — a number of key themes and recommendations are pertinent to APRA:

- That the primary responsibility for misconduct in the industry rests with the entities concerned, their boards and senior managers. It recommended that the BEAR be extended to all APRA-regulated institutions<sup>11</sup> and that APRA update its prudential standards regarding remuneration and incorporate the supervision of culture and governance into its prudential standards review.<sup>12</sup> It also recommended that APRA should internally formulate and apply to its own management accountability principles of the kind established by the BEAR;<sup>13</sup>
- The twin peaks established by the Wallis Inquiry should be reinforced in superannuation. APRA's remit in respect of the SIS Act should be shared with ASIC in a way that aligns with their traditional roles and strengths;<sup>14</sup>
- The law should require APRA and ASIC to cooperate, share information to the maximum extent practicable and notify the other whenever it forms the belief that a breach in respect of which the other has enforcement responsibility may have occurred;<sup>15</sup> and
- A new financial regulator oversight body for APRA and ASIC should be created to assess the effectiveness of each regulator in discharging its functions and meeting its statutory obligations. Capability reviews of the regulators should occur on a four-yearly basis.

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11 Recommendation 6.8.

12 Recommendation 5.7.

13 Recommendation 6.12.

14 Recommendation 6.3. Consistent with the recommendation in the Productivity Commission Superannuation Inquiry Report, recommendations 23 and 24.

15 Recommendation 6.9.

## APRA Enforcement Strategy Review

APRA completed its Enforcement Strategy Review in April 2019. The review was in response to a range of developments, including the creation of the BEAR, the CBA Prudential Inquiry, evidence presented to the Hayne Royal Commission and proposals to give APRA expanded enforcement powers, particularly in superannuation.

APRA's enforcement appetite has evolved over a number of years, with various internal and external factors shifting the enforcement pendulum back and forth. Following the failure of HIH Insurance in 2001, APRA moved to a more risk-based approach with a sharper focus on early intervention. However, several unsuccessful proceedings and overturned decisions, such as APRA's attempted disqualifications of several AXA directors in 2006, curtailed APRA's enforcement appetite.

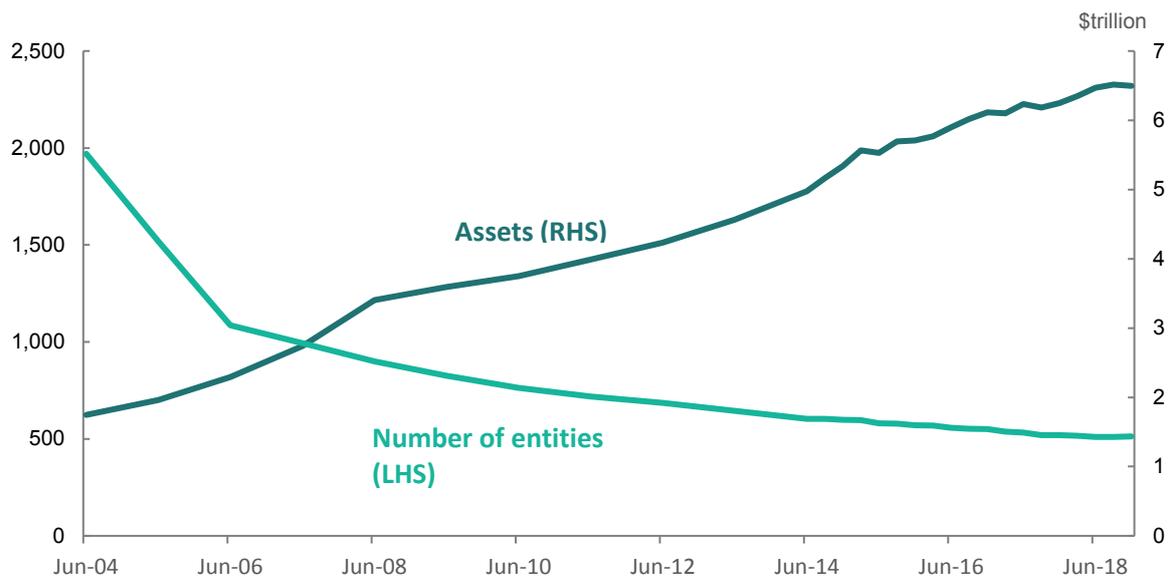
APRA is in the process of shifting to a 'constructively tough' enforcement approach. Under this approach, APRA has committed to using the full range of its powers more actively, such as direction powers and licence conditions, to achieve prudential outcomes and deter unacceptable practices.

## An ever-evolving financial sector

Over the last 20 years there has been substantial consolidation across the financial services industry as a result of mergers, acquisitions of foreign-owned subsidiaries by local institutions, foreign entities acquiring life insurers and the exit of other foreign financial institutions. This activity has largely been driven by the pursuit of greater scale efficiencies and has resulted in greater market concentration.

Largely as a result of industry consolidation and due to a significant change in approach to licensing of the superannuation industry, the number of institutions supervised by APRA has fallen by more than two-thirds since 2001. While this means that APRA's supervisory population has declined, large conglomerates and blurring between financial sectors (as predicted by the Wallis Inquiry) has increased supervisory complexity at an entity level.

More recent trends include industry fragmentation and the general shift away from the 'bancassurance' model, growth from non-bank lenders and greater use of personal data for customer-level risk-based pricing.

Figure 1.8: APRA-regulated entities against growth in assets over time<sup>16</sup>

### Competition in the financial sector

As at June 2018, the top five APRA-regulated groups account for 78 per cent of assets in the ADI industry, 64 per cent in general insurance (based on gross written premiums), 81 per cent in life insurance (including friendly societies) and 28 per cent of assets in the superannuation industry.<sup>17</sup>

The Murray Inquiry brought the issue of competition in the system to the fore. Although it considered that competition was generally adequate, high concentration and increasing vertical integration in some parts of the system led it to recommend that competition should be proactively monitored over time. As part of the Government's response to the Murray Inquiry, in 2017 it tasked the Productivity Commission to review competition in Australia's financial system.

The PC's Inquiry into Competition in the Australian Financial System (PC Competition Inquiry) found that there was limited competition in the financial sector and that the larger financial institutions had the ability to exercise market power over their competitors and consumers. It found that:

- APRA was not well placed to consider competition effects and that the Australian Competition and Consumer Commission (ACCC) should act as a competition champion for the financial sector; and
- APRA should conduct and publish evaluations of its 'material interventions'<sup>18</sup> including the effects on competition.

<sup>16</sup> Asset figures have been revised slightly from APRA Annual Reports in line with the audited returns received during the year. The number of total superannuation entities comprises public offer funds, non-public offer funds and eligible rollover funds. It does not include small APRA funds and approved deposit funds.

<sup>17</sup> As at 30 June 2018. APRA, 2018, *2017-2018 Annual Report*.

<sup>18</sup> For example, how changes in APRA's 2017 *Prudential Standard APS 120: Securitisation* have affected the costs of funds and competitiveness of non-authorized (smaller) lenders. Recommendation 8.1.

### *Broad-based digital disruption*

In 2014, the Murray Financial System Inquiry observed that 'Australia is in the midst of one of the most ubiquitous, generally applicable technology changes the world has seen...'<sup>19</sup> Five years later, this remains the case. While digital disruption reflects healthy competition, and ultimately is of significant benefit to consumers, it carries certain inherent risks for existing APRA-regulated entities as part of the transition process.

It also raises significant strategic issues for APRA. New technology and new ways of delivering financial services offer the potential for a more competitive and innovative financial system. They may also increase the risks to financial stability in ways that are yet to be well understood. APRA has a key role in transparently presenting the issues to the public.

There are three key ways that digital disruption is affecting APRA and APRA-regulated entities:

- The ongoing transformation of existing regulated entities' IT landscape, including investment in online and mobile services, increased outsourcing (especially use of cloud services), greater interoperability (for example, through Application Programming Interfaces (APIs) and open banking), artificial intelligence-enabled decision-making, and ongoing digitisation of back-office functions. Established market participants face a major forward pipeline of major systems migrations and management of legacy systems;
- The emergence of new technology-enabled business models. In the decade to 2017, APRA authorised 93 new entrants (including 26 ADIs but only one new locally incorporated ADI). Since 2017, (and coinciding with the introduction of the new restricted licensing regime), APRA has observed a sharp increase in the number of new license applicants;
- The increased competition from niche and scale technology competitors, including from participants whose activities remain outside the APRA regulatory perimeter.<sup>20</sup> As an example, during the review period Apple announced its intention to launch a credit card product.

There is the potential for change to follow an exponential path: limited change apparent at first, with some false starts, only for the tempo of change to snowball as multiple technology and business model innovations reach maturity.

### *Ongoing and increasingly sophisticated cyber risk threats*

Cyber security threats to private and public sector organisations continue to grow in frequency and sophistication. A major cyber attack represents a top-tier operational risk for financial services companies both in Australia and globally. In contrast to other risks to which APRA-regulated entities are exposed (for example, credit, insurance, liquidity and funding risk), a cyber attack involves a hostile actor.

While APRA will never be able to prevent cyber attacks occurring or having an impact on regulated entities — nor should there be an expectation that APRA can do so — APRA will need to play a leadership role in fostering resilience amongst its regulated industries.

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19 Murray Financial System Inquiry, p. xiv.

20 For example, a lender whose business model does not involve taking deposits would not conduct 'banking business' for the purposes of the Banking Act, and would not be licenced or supervised by APRA but their activities could still influence competitive dynamics for APRA-regulated entities.

### *The future economic climate*

When assessing the capability required of a prudential regulator, it is useful to set aside the most likely 'central case' scenario and focus on the capability required in the event of potential 'downside' scenarios in the financial sector and economy.

Australia has experienced 28 years of annual economic growth, including through the Asian Financial Crisis and GFC. The last few decades since APRA's inception have provided a favourable external environment for Australian financial institutions and in turn a comparatively benign external environment for APRA.

A less favourable economic environment in the future would increase the pressure on APRA, including its organisational capacity, crisis management and resolution functions and credit risk capability.