INTERNATIONAL MONETARY FUND

IMF Country Report No. 19/54

AUSTRALIA

FINANCIAL SYSTEM STABILITY ASSESSMENT

February 2019

This Financial System Stability Assessment paper on Australia was prepared by a staff team of the International Monetary Fund. It is based on the information available at the time it was completed on September 14, 2018.

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International Monetary Fund
Washington, D.C.

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FINANCIAL SYSTEM STABILITY ASSESSMENT

January 18, 2019

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This report is based on the work of the Financial Sector Assessment Program (FSAP) missions that visited Australia in June and August–September 2018. The FSAP findings were discussed with the authorities during the Article IV Consultation mission in November 2018. More information on the FSAP may be found at: http://imf.org/external/np/fsap/fssa.aspx

- The FSAP team was led by Nigel Jenkinson and comprised Mustafa Saiyid (Deputy Mission Chief), Rachid Awad, Charles Cohen, Tumer Kapan, Peter Lohmus, Nobuyasu Sugimoto, Narayan Suryakumar, and Froukelien Wendt (all MCM); Yu Ching Wong (APD); Steve Dawe (LEG); and Timothy Clark, Graydon Paulin, and Heidilynne Schultheiss (all IMF external experts); and was supported by Moses Kitonga and Carol Franco (MCM).
- The team met with Australian Treasury Secretary Gaetjens; Reserve Bank of Australia (RBA) Governor Lowe; Australian Prudential Regulation Authority (APRA) Chairman Byres; Australian Securities and Investments Commission (ASIC) Chairman Shipton; as well as senior staff at these and other government authorities including the Australian Transaction Reports and Analysis Centre (AUSTRAC), the Productivity Commission, and the Australian Competition and Consumer Commission (ACCC). The team also held extensive discussions with commercial banks, insurance companies, the Australia Securities Exchange (ASX), auditors, rating agencies, investment funds, real estate experts, and academics. The mission is grateful to all counterparts for their help.
- FSAPs assess the stability of the financial system as a whole and not that of individual institutions. They are intended to help countries identify key sources of systemic risk in the financial sector and implement policies to enhance its resilience to shocks and contagion. Certain categories of risk affecting financial institutions, such as operational or legal risk, or risk related to fraud, are not covered in FSAPs.
- Australia is deemed by the Fund to have a systemically important financial sector according to SM/13/304 (11/18/2013), and the stability assessment under this FSAP is part of bilateral surveillance under Article IV of the Fund's Articles of Agreement.
- This report was prepared by Nigel Jenkinson and Mustafa Saiyid, with contributions from members of the FSAP team.

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ACCC	Australian Competition and Consumer Commission
ADI	Authorized Deposit-taking Institution
AML / CFT	Anti-Money Laundering / Combating the Financing of Terrorism
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ASX	Australian Securities Exchange
AUSTRAC	Australian Transactions Reports and Analysis Centre
BEAR	Banking Executive Accountability Regime
BCP	Basel Core Principles for Effective Banking Supervision
BIS	Bank for International Settlements
CCP	Central Counter Party
CAR	Capital Adequacy Ratio
CET1	Common Equity Tier 1 Capital Ratio
CFR	Council of Financial Regulators
CLF	Committed Liquidity Facility
CRE	Commercial Real Estate
DNFBP	Designated Non-Financial Businesses and Professions
D-SIB	Domestic Systemically Important Bank
DLT	Distributed Ledger Technology
DTI	Debt to Income Ratio
DSTI	Debt Service to Income Ratio
ELA	Emergency Liquidity Assistance
FATF	Financial Action Task Force
FCS	Financial Claims Scheme
FIU	Financial Intelligence Unit
GDP	Gross Domestic Product
GFC	Global Financial Crisis
G-SIB	Global Systemically Important Bank
HQLA	High Quality Liquid Assets
ICAAP	Internal Capital Adequacy Assessment Process
ICR	Interest Coverage Ratio
IRB	Internal Ratings Based (approach to risk-weighted assets)
IFRS	International Financial Reporting Standard
IO	Interest Only
IOSCO	International Organization of Securities Commissions
LCR	Liquidity Coverage Ratio
LGD	Loss Given Default
LTV	Loan-to-Value Ratio
MER	Mutual Evaluation Report
MoU	Memorandum of Understanding
MPE	Multiple Point of Entry (in banking resolution)

NBFI	Nonbank Financial Intermediary
NPL	Nonperforming Loan
NSFR	Net Stable Funding Ratio
OECD	Organization for Economic Cooperation and Development
P&I	Principal and Interest
PAIRS	Probability and Impact Rating System
PC	Productivity Commission
PFMI	Principles for Financial Market Infrastructures
RBA	Reserve Bank of Australia
RBNZ	Reserve Bank of New Zealand
RC	Royal Commission
RMBS	Residential Mortgage Backed Security
RITS	Reserve Bank Information and Transfer System
RWA	Risk-Weighted Assets
SSS	Securities Settlement Systems
SOARS	Supervisory Oversight and Response System
SMSF	Self-Managed Superannuation Fund
TTBC	Trans-Tasman Council on Banking Supervision
WEO	IMF World Economic Outlook

EXECUTIVE SUMMARY

The Australian authorities have taken welcome steps to further strengthen the financial system since the previous FSAP. Bank capital requirements have been raised and applied more conservatively than minimum Basel standards. Funding risks have been lowered. Financial supervision and systemic risk oversight have been enhanced. And the authorities have taken successful policy action to calm rapid growth in riskier segments of the mortgage market.

The system nonetheless faces challenges. Stretched real estate valuations and high household leverage pose significant macrofinancial risks. 27 years of uninterrupted growth, low inflation, low policy rates, tax incentives, and easy credit have stimulated a rise in household debt and fueled a build-up of real estate exposure in a concentrated banking system, which together with pension ('superannuation") funds dominates the large Australian financial sector. Household debt has risen by some 25 percentage points since the previous FSAP to about 190 percent of disposable income, one of the highest levels in the world. Banks continue to draw extensively on overseas wholesale funding, though reliance has declined in recent years. The ongoing Royal Commission (RC) inquiry has revealed a pattern of misconduct in the financial sector, including at the four major banks that comprise 80 percent of the system.

The major banks run similar business models, raising the vulnerability of the system to a common shock. All are heavily exposed to real estate—residential forming about 60 percent of loans, and commercial (CRE) a further 7 percentage points. Wholesale funding dependence has diminished but remains around one-third of total funding, of which nearly two-thirds is from international sources. Banks' direct international exposures are mainly to New Zealand, where subsidiaries of the four major Australian banks play a dominant role in the banking system.

Bank solvency appears relatively resilient to stress. A test of resilience to a combination of a significant slowdown in China, a severe correction in real estate valuations, and a marked tightening of global financial conditions, revealed some pressures on capital, although the 10 largest banks would all still meet regulatory minima. Liquidity pressures may arise more abruptly. Given high maturity transformation, banks' continued reliance on overseas wholesale funding leaves them exposed to global liquidity shocks.

Policy action has lowered financial stability risks. Restrictions on the growth of investor loans and the share of interest-only mortgages, as well as the introduction of stronger lending standards, appear to have led to a slowdown in mortgage credit growth, and the housing market is now cooling. Given this background, additional tightening measures do not appear warranted at this juncture, though, given prevailing vulnerabilities, the authorities should stand ready to recalibrate policies as necessary to continue to reduce systemic risk. Over time, broader tax reforms could reduce structural incentives for leveraged investment by households, including in residential real estate. Further reduction in banks' use of wholesale funding and extension of the duration of their liabilities would help to lower structural funding risks.

Australia benefits from a robust regulatory framework. Financial supervision shows generally high conformity to international best practices, although there are opportunities to close identified gaps and strengthen arrangements**.** Steps are recommended to bolster the independence and resourcing of the regulatory agencies, by removing constraints on their policy making powers and providing additional budgetary autonomy and flexibility. Enforcement powers should be strengthened, and their use expanded, to support effective risk management and mitigate future misconduct. Supervisory approaches would also be enhanced by periodic in-depth reviews of banks' governance and risk management, and by improving coordination of supervision of internationally active insurance groups.

Greater formalization and transparency of the work of the Council of Financial Regulators (CFR) would further buttress the financial stability framework. While the authorities have a strong track record of addressing financial stability issues in a productive and collaborative manner, the current arrangements are informal, and there is limited transparency surrounding the work of the Council. Greater formalization could further strengthen collaboration, boost confidence in the collective work of the regulatory agencies, and guard against possible delay in addressing nascent systemic risks. The CFR is encouraged to boost transparency by publishing records of its meetings and tabling an Annual report to Parliament, highlighting the identification of systemic risks and actions taken to mitigate them.

Additional investment in data and analytical tools would strengthen financial supervision and systemic risk oversight. Relative to international experience, the assessment identified shortfalls in the granularity and consistency of data to support the analysis of supervisory and systemic risks and the formulation of policy. The CFR agencies are recommended to conduct a major review of potential data needs and implement improvements, publishing the resulting data where feasible. Improved data would also facilitate enhancements in stress testing and support closer integration of the results into prudential supervision, crisis preparedness and policy discussions. It would also help harness the collective expertise of the Reserve Bank (RBA) and the Australia Prudential Regulation Authority (APRA) in the analysis and evaluation of policy options.

Expansion of the set of policy tools would enhance flexibility to address systemic risk and structural vulnerabilities. A 'readiness' assessment of potential policy options would enable the authorities to address the associated data requirements and tackle any legal or regulatory obstacles to their use. Priorities for review include DTI/DSTI and LTV restrictions, time-varying risk weights, as well as tools to address risks from nonbanks and from highly cyclical assets such as CRE.

Reinforcing financial crisis management arrangements is a priority. Encouraging progress has been made in strengthening APRA's resolution powers and expanding banks' recovery planning to cover additional institutions. Building on this progress, there is scope for better integration of banks' recovery planning into their risk management framework. It is also important to complete the resolution policy framework quickly, to ensure that banks expand their loss absorbency capacity to bear the costs of their own failure. Bank-specific resolution plans should be rolled out and validated swiftly. The Australian and New Zealand authorities have developed a strong and effective supervisory relationship, but there is a need to advance mutual understanding of approaches to resolution in order to establish clear cross-border bank resolution modalities. Some progress has also been made in developing a resolution framework for Financial Market Infrastructures (FMIs) and its finalization is a priority.

Table 1. Australia: FSAP Key Recommendations

Recommendations and Authority Responsible for Implementation	Time[1]
Banking and Insurance Supervision	
Strengthen the independence of APRA and ASIC, by removing constraints on policy making powers and providing greater budgetary and funding autonomy; strengthen ASICs enforcement powers and expand their use to mitigate misconduct (Treasury, APRA, ASIC).	ST
Enhance APRA's supervisory approach by carrying out periodic in-depth reviews of governance and risk management (APRA).	ST
Strengthen the integration of systemic risk analysis and stress testing into supervisory processes (APRA, RBA).	I
Financial Stability Analysis	
Commission and implement results of a comprehensive forward-looking review of potential data needs. Improve the quantity, quality, granularity and consistency of data available to the CFR agencies to support financial supervision, systemic risk oversight and policy formulation (CFR agencies).	MT
Enhance the authorities' monitoring, modeling and stress testing framework for assessing solvency, liquidity and contagion risk. Draw on the results to inform policy formulation and evaluation (CFR agencies).	ST
Encourage further maturity extension and lower use of overseas wholesale funding (APRA).	I
Systemic Risk Oversight and Macroprudential Policy	
Raise formalization and transparency of the CFR and accountability of its member agencies through publishing meeting records as well as publication and presentation of an Annual Report to Parliament by CFR agency Heads (CFR agencies).	I
Undertake a CFR review of the readiness to apply an expanded set of policies to address systemic risks, including data and legal/regulatory requirements; and address impediments to their deployment (CFR agencies).	I
Commission analysis by the CFR member agencies on relevant financial stability policy issues, including: policies affecting household leverage; as well as factors affecting international investment flows and their implications for real estate markets (CFR agencies).	MT
Financial Crisis Management and Safety Nets	
Complete the resolution policy framework and expedite development of resolution plans for large and mid-sized banks and financial conglomerates, and subject them to annual supervisory review (APRA, Treasury).	ST
Extend resolution funding options by expanding loss-absorption capacity for large and mid-sized banks and introduce statutory powers (APRA, Treasury).	ST
Advance mutual understanding between the Australia and New Zealand resolution authorities on cross-border bank resolution modalities, through the Trans-Tasman Banking Council (CFR agencies).	ST
Financial Market Infrastructures	
Strengthen independence of RBA and ASIC for supervisory oversight, enhance enforcement powers and promote compliance with regulatory requirements (RBA, ASIC, Treasury).	I
Finalize the resolution regime for FMIs in line with the FSB Key Attributes (RBA, ASIC, Treasury).	ST
Anti-Money Laundering / Countering the Financing of Terrorism (AML/CFT)	
Expand the AML/CFT regime to cover all designated non-financial businesses and professions (DNFBPs) and strengthen AML/CFT supervision by: improving data collection and risk analysis; increasing oversight of controls and compliance; and undertaking more formal enforcement action in the event of breaches (Department of Home Affairs, Treasury, AUSTRAC).	I

[1] I Immediate (within 1 year); ST Short -term (within 1–2 years); MT Medium-term (within 3–5 years)

BACKGROUND AND VULNERABILITIES

A. Macrofinancial Setting

1. The Australian economy has notably delivered 27 years of uninterrupted growth, despite having operated somewhat below potential in recent years (Figure 12). While Australia has historically benefited from vast natural resources and a strong mining industry, the modest impact of the fall in global commodity prices during 2014–2016 reflects the benefits of a more diversified economy, increasingly coupled through rising trade and investment links to a dynamic Asian region. Activity was also buttressed by a flexible exchange rate, flexible labor markets, high population growth, strong institutions, and prompt monetary policy easing. Over the past decade, the easy availability of credit at low interest rates, tax incentives, population growth, and foreign capital inflows, have spurred strong housing demand. Combined with supply limitations in the major cities, this led to a real estate boom and build-up in gross household debt to elevated levels.

2. The economy is approaching full employment and inflation is just below the target range. Banks have been tightening credit conditions since 2014 due to prudential measures taken by the authorities to encourage responsible lending, rising concerns about household debt and creditworthiness, and recent government inquiries into underwriting practices (see Appendix II). Banks are also starting to raise interest rates on mortgage lending as the RBA is adopting a tightening bias in terms of monetary policy and they are facing higher costs on external funding and reportedly from compliance with new regulation. The housing market has started to cool after a long boom, and house prices are now falling.

B. Key Risks

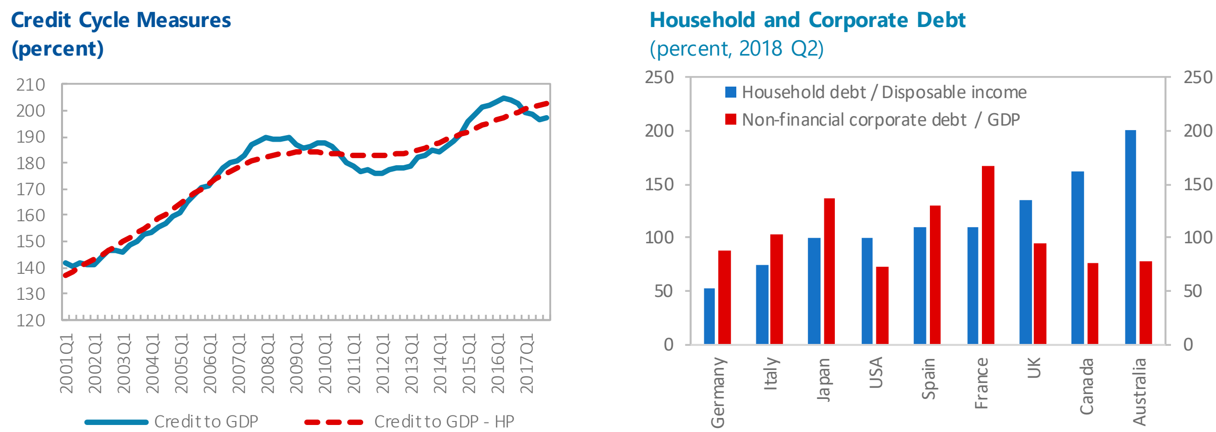
3. Stretched real estate valuations and high household debt pose macrofinancial risks:

- House prices, after rising by about 70 percent over the past decade at the national level have now started to decline. The price appreciation following the global financial crisis had been even higher in Sydney and Melbourne, where prices had doubled on average over 10 years, though these two cities have also experienced sharper falls in recent months. Commercial real estate prices, particularly for office space, also rose sharply in the major cities over the past decade but have shown few signs of cooling as yet. Housing affordability linking incomes to prices is near all-time lows.

- In recent years, benign credit conditions and the surge in house prices contributed to rapidly rising household leverage. Household debt currently stands at some 190 percent of disposable income (some 20–25 percentage-points above the level in the 2012 FSAP) and is very high by international standards (Figure 1). Debt is overwhelmingly secured by housing and financial assets. Substantial pension savings through the mandatory superannuation system provide an additional counterbalance.

- While macroprudential measures have contributed to the easing of pressures in the housing market, and a soft landing of the housing market is the most likely baseline, there are risks of a stronger downturn. A sharp correction in real estate markets could lead to a vicious feedback loop of falling real estate valuations, higher nonperforming loans, tighter bank credit, falling consumer confidence, and weaker growth, as happened during the Global Financial Crisis (GFC). The impact on banks would be largely through credit losses as they all carry large exposures to the housing market and to CRE. Additionally, weaker banks could experience an outflow of customer deposits or a significant decline in wholesale funding.

Figure 1. Macrofinancial Cycle and Vulnerability



Source: APRA, Haver Analytics, and IMF staff estimates.

4. A further key risk is that growth in China could slow significantly. Rising global protectionism could provide one catalyst. While Australian banks' direct exposure to China is relatively small (about 4 percent of overall claims), the economy has much larger exposure via the trade channel. One-third of Australian goods exports, including 40 percent of commodities, go to China. Moreover, the growth of services exports to China in recent years has been particularly strong in the areas of tourism and education. A sharp slowdown in Chinese growth would lower Australian export revenues markedly. Banks would likely face higher losses on corporate lending, as well as on their broader credit portfolio due to the overall decline in economic activity.

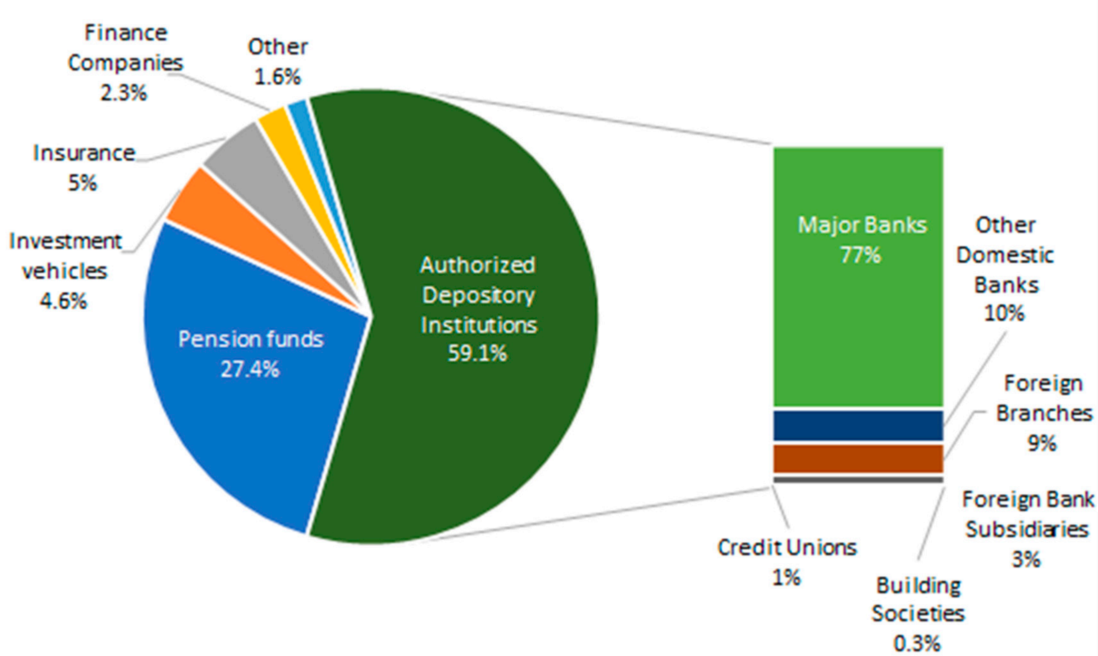
5. An abrupt tightening of global financial conditions could also affect macrofinancial conditions. As observed during the GFC, a spike in risk premia or more volatile financial conditions could lead to significantly higher funding costs for Australian banks as they continue to rely on international funding markets (see below). As lending is mainly at variable rates, such higher funding costs would likely be passed on to banks' customers swiftly, weakening the debt servicing capability of those with already-stretched balance sheets.[1] Higher funding costs might also be accompanied by a disorderly correction in asset prices and a depreciation of the Australian dollar.

C. Banking Environment

6. Banks and pension ("superannuation") funds dominate the large financial sector (Figure 2 and Table 4). The financial sector, with assets of about 400 percent of GDP, has grown rapidly since the 2012 FSAP, when its size was estimated as 340 percent of GDP. It comprises 84 commercial banks (59 percent of financial assets); pension funds (27 percent); insurance companies (5 percent); investment vehicles (5 percent); and other finance companies (4 percent). The banking system is highly concentrated—the four largest banks, regarded as Domestic Systemically Important Banks (DSIBs), represent about 80 percent of overall system assets. The systemic importance of these banks, as well as their continued dependence on overseas funding markets, has led APRA to insist on high levels of regulatory capital.

Figure 2. Financial System Structure

(2017 Q4; percent of total assets)[1]



Source: Reserve Bank of Australia.
[1]Total assets of A$7 trillion (about 400 percent of GDP).

[1] To the extent that banks are unable or unwilling to pass through the rise in funding costs (for example by adverse business conditions), net interest margins would be squeezed, hurting profitability through that route.

7. Banks are well-capitalized, though a conservative regulatory approach lowers their published ratios relative to international comparators of comparative capital strength (Figures 13, 14, and Table 6). Banks' total regulatory capital ratio is 14.9 percent (CET1 ratio of 10.6 percent) against the phased-in Basel III requirement of 9.9 percent as of 2018 (including the capital conservation buffer).[2] In implementing the Basel capital framework in Australia, APRA has traditionally adopted a conservative approach.[3] In particular, it used national discretion within the Basel capital framework to adopt a more conservative approach towards banks' risk-weighted assets, requiring, for example, minimum risk weights on mortgage lending by banks following internal-ratings based (IRB) models that are well above Basel guidelines. DSIBs are subject to a 1 percent surcharge. Each of the major banks' CET1 ratios is well above the minimum requirement including the surcharge, and around the top quartile of large, international banks—one of the reference metrics identified by APRA to support the policy objective recommended by the 2014 Financial System Inquiry (FSI), that banks are "unquestionably strong." APRA announced in July 2017 that the four major Australian banks need to have CET1 capital ratios of at least 10.5 percent to meet the "unquestionably strong" benchmark, effectively increasing minimum capital requirements for all IRB banks by the equivalent of about 150 bps and for other authorized deposit-taking institutions (ADIs) by around 50 bps. All ADIs are requested to meet the new benchmarks by January 1, 2020 at the latest.

8. Banks are also reasonably liquid. Banking sector liquidity complies fully with Basel standards for the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) standards though the system does rely on central bank facilities to meet these requirements, as permitted within the Basel standard given the relatively low volume of domestic government securities.

9. Australian banks make extensive use of wholesale funding markets. The bulk of banks' funding comprises domestic deposits, although wholesale debt still contributes a sizable proportion. There are also differences between the funding composition of large versus mid-sized banks[4]—with large banks relying more heavily on debt markets, including those overseas. Banks' dependence on wholesale funding has come down in recent years, partly in response to encouragement by the authorities, but remains high at about one-third of total liabilities (Figure 13), of which nearly two-thirds is from international sources. Since the GFC, banks have taken steps to reduce rollover risk by increasing the average duration of their wholesale funding and hedging out currency risk with swaps whose tenors match the average duration of their funding.

10. Banking sector profitability remains high in global terms although it has declined in recent years (Figures 13,14). Asset quality remains relatively high, with average nonperforming loans

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[2] The five large banks are those subject to the Major Bank Levy and comprise: CBA, NAB, Westpac, ANZ, and Macquarie.

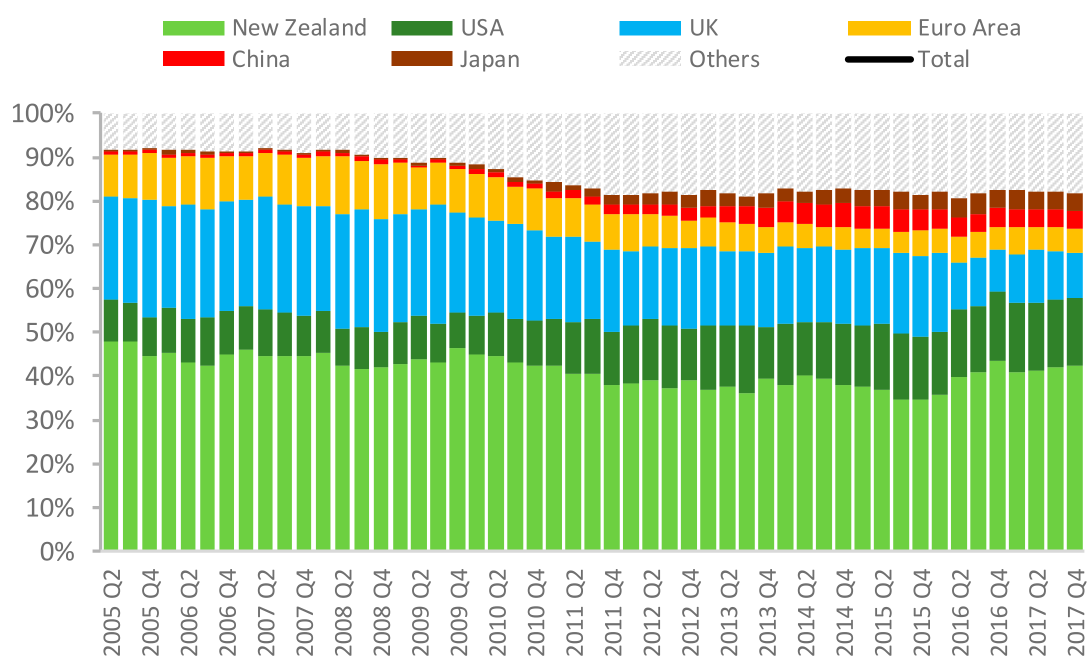
[3] See "Improving the transparency, comparability and flexibility of the ADI capital framework," APRA Discussion Paper, August 2018. APRA estimates the average internationally comparable add-on to Tier 1 capital at 485 basis points for the four major banks as at June 2017.

[4] For the FSAP analysis, mid-sized banks comprise: Bank of Queensland, Bendigo, HSBC, ING, and Suncorp.

(NPLs) of only one percent.[5] Provisions are about 40 percent of NPLs, which might appear modest, but which reflect expectations of low loan losses driven by low historical loss rates, the full recourse nature of bank lending, loan portfolios that are mainly secured against collateral (with unsecured consumer loans comprising only 4 percent of the total), loan mortgage insurance paid out to banks not borrowers, and a swift recovery process.

11. In recent decades, banks have oriented their business models towards real estate lending (Figure 15). Residential mortgages, which are contracted at variable rates, form over half of bank lending and about one-third of these are higher-risk interest-only mortgages. Commercial real estate averages around an additional 7 percent of major banks' loan portfolios. Moreover, banks' mortgage loan customers appear increasingly levered on a gross basis, a concern raised by some credit rating agencies.[6] Nevertheless, LTVs on the overall stock of mortgage loans average about 60 percent.

Figure 3. Banks' Consolidated Cross-Border Claims
(2017 Q4; percent of total claims on all sectors-ultimate risk basis)



Source: BIS

[5] NPLs have come down since the GFC when mid-sized and small banks in aggregate faced higher NPL ratios than the four largest banks due to less diversification of business models and higher real estate exposure (Figure 12).

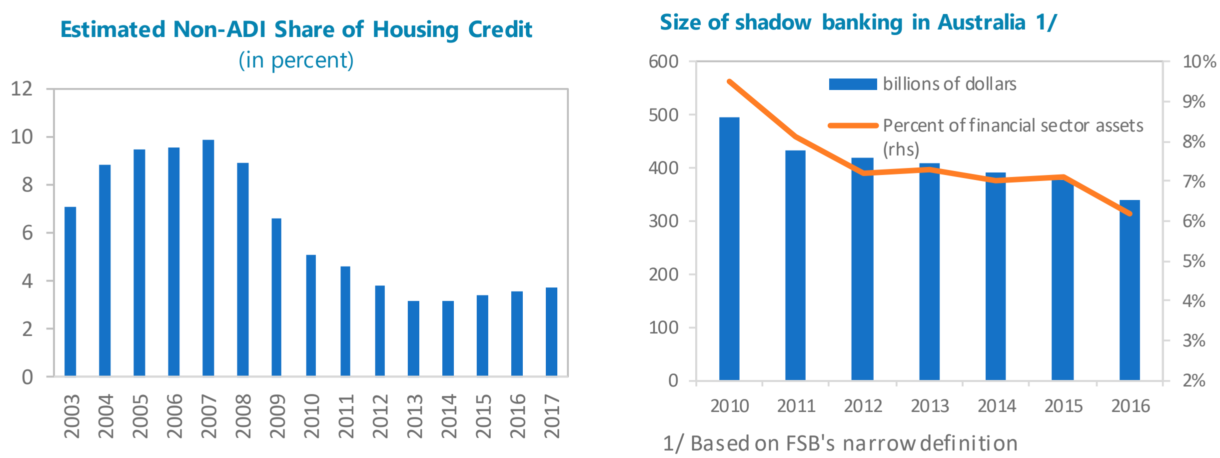
[6] In May 2017, Standard & Poor's downgraded 23 institutions but affirmed the ratings of the five large banks on concerns about banks' high exposure to the real estate market; while Moody's downgraded 12 institutions, bringing ratings for the major banks in line with the other ratings agencies at AA–.

12. Banks' cross-border exposures are mainly to New Zealand through subsidiaries. Australian banks' consolidated data, which includes their global banking subsidiaries, shows total foreign claims of about 20 percent of banks' assets, with claims on New Zealand-based entities comprising over 40 percent of the total (Figure 3). Meanwhile, claims on global banks amount to roughly 3 percent of total assets for Australian banks with the largest exposures to banks operating in the United States, China, and the United Kingdom. Cross-border exposures appear to be concentrated among the big four banks.

D. Nonbank Financial Intermediaries

13. Credit provision outside the banking sector is currently small but growing. At present, shadow banking assets make up only 7 percent of financial system assets, based on the most recent FSB analysis. In the housing market, non-ADIs make up only about a 4 percent share of housing credit, down from 10 percent in 2007 (Figure 4). However, tighter post-crisis prudential regulation of banks increases the chance that some credit provision will migrate out of the banking sector. Indeed, nonbank residential mortgage backed securitizations (RMBS) have risen significantly over the past two years. In addition, numerous private funds have been set up to engage in the types of corporate lending from which banks have moved away.

Figure 4. Nonbank Credit



Source: APRA, Haver Analytics, and FSB.

14. While superannuation funds form a large part of the Australian financial sector, their structure poses a low risk to financial stability. The large superannuation funds sector holds A$2.7 trillion in assets, or about one-quarter of the overall financial sector, but these are primarily defined-contribution based schemes, in which risks are borne by individual participants. Defined benefit plans have largely been phased out over the past 20 years, and currently make up only about 14 percent of pension liabilities.

15. Nevertheless, as a major investor in the Australian economy, the superannuation sector should continue to be closely monitored by the authorities. Superannuation funds allocate about 10 percent of their assets to real estate and have become more active in other forms of lending. Lightly regulated self-managed superannuation funds (SMSFs), which hold about 28 percent of all superannuation assets, can use leverage for real estate investment.[7] While such exposures are currently small (no more than A$60 billion), the use of leverage in long-term retirement accounts runs contrary to best practice and may be supporting over-concentration of household exposure to real estate assets.

E. Household Sector

16. Household debt is very high by international standards, although households' financial assets in aggregate appear to provide some buffer to support repayment. After a period of stabilization during the GFC, household debt has continued to trend upward, reaching 190 percent of disposable income in 2017, high in comparison with other advanced economies, and some 25 percentage-points higher than at the time of the previous FSAP. However, most of household debt is mortgage debt, which is collateralized by real estate, although a significant price correction in the housing market would erode its collateral value. Households, in aggregate, also have substantial other assets, including financial assets and cash in offset deposit accounts, which provide repayment buffers, as well as large superannuation funds, which do not (Figure 17).[8] Mortgage buffers have been rising over the past few years, with those for owner-occupiers of mortgaged properties amounting to almost three years of scheduled repayments at interest rates in 2017.[9] The debt-servicing ratio of households, which includes scheduled principal and interest mortgage repayments, has also remained broadly unchanged at about 10 percent, partly because of a prolonged period of low interest-rates. Nevertheless, there is considerable variation across households in their debt burden and asset holdings—a quarter carry debt of more than three times income.

F. Corporate Sector

17. The nonfinancial corporate sector is much more dependent on capital markets than banks for financing. Liabilities are mainly from equity and debt issued in capital markets, which are largely held by nonresidents and nonbank financial intermediaries, for example superannuation funds (Figure 17). Larger firms, particularly those in the materials, industrial and real estate sectors with strong ratings, typically access international debt capital markets to raise U.S. dollar financing and swap these proceeds into Australian dollars. Bank loans comprise only about 15 percent of total

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[7] There is currently a regulatory exemption that allows the use of leverage in SMSFs. There are also limited examples of financial derivatives being present in SMSFs.

[8] See "Superannuation accounts by age and gender," Ross Clare, Director of Research, Association of Superannuation Funds of Australia, Sydney, October 2017.

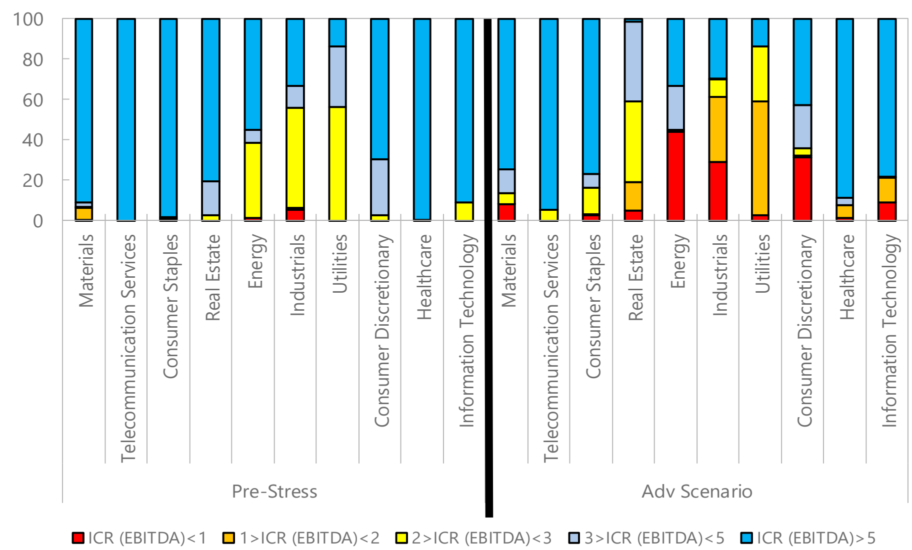
[9] See "Household Indebtedness and Mortgage Stress,"speech by RBA Assistant Governor Bullock, Summit for Responsible Lending and Borrowing, Sydney, February 2018.

corporate liabilities (including equity), which are about 250 percent of GDP.[10] Corporate leverage has risen somewhat since the GFC but remains low with debt of only about 60 percent of equity. Gross operating profits recovered sharply after 2016 following a slump in global commodities, and the level of corporate insolvencies has fallen from the GFC-related peak.

18. The nonfinancial corporate sector appears generally resilient despite some pockets of vulnerability. On average, corporates carry relatively low leverage, and generate earnings that easily cover debt servicing costs even in stressed situations. However, leverage is higher in some corporate sectors such as energy, industrials, utilities, consumer discretionary, and real estate, for which combined debt liabilities are about half of those for the overall corporate sector (Figure 17).[11] Under a low-probability adverse scenario characterized by a sharp fall in corporate earnings and a simultaneous increase in interest servicing costs on debt, a high proportion of firms in these leveraged sectors could face emerging debt-servicing pressures in the absence of remedial action by corporate management (Figure 5). Debt repayment capacity may be weaker for firms in sectors heavily exposed to China and the domestic real estate market.

Figure 5. Corporate Sector Debt-At-Risk

Percent of firms in each sector



Source: S&P Capital IQ, IMF Staff calculations

[10] Based on a sample of 250 firms from S&P Capital IQ. which have a combined debt of around A$1 tn.

[11] The sensitivity analysis assumes a 1 standard deviation negative shock to both earnings and interest expense and uses quarterly earnings and interest expense data over a 10-year period ending 2017.

G. Recent Developments

19. Financial sector conduct and competition issues have come to the fore recently. An interim report issued in March 2018 by the Australian Competition and Consumer Commission (ACCC) found evidence of oligopolistic behavior by the major banks in the pricing of mortgage products.[12] This was also highlighted in a major report issued by the Productivity Commission (PC) in June 2018.[13] Strengthening bank competition is a public policy objective in view of the 'four pillars' policy, under which the major four banks are not allowed to merge with each other or with a foreign bank. Separately, the ongoing independent Royal Commission established by the government is uncovering evidence of significant misconduct by Australia's banks and other financial service entities.[14] These include instances of fees being charged by banks and wealth managers for no service, deception of clients and regulators, data losses for client accounts, inadequate verification of borrower creditworthiness for loan products, and violations of AML/CFT rules. The breaches of conduct and trust have raised concerns about the dominance and culture of the big four banks as well as at other financial institutions.

FINANCIAL SECTOR RESILIENCE

20. The FSAP assessed the resilience of banks to credit, liquidity, and contagion risks.[15] The exercise covered the 10 largest banks, accounting for nearly 90 percent of total system assets.[16]

A. Credit Risks

21. Banks' solvency was assessed in relation to credit developments in two hypothetical future scenarios over a three-year time horizon. One was a baseline scenario (using April 2018 WEO projections) and the second, an adverse stress scenario, which combined the three shocks noted earlier (see Table 2 and Appendix I): (i) A severe decline in real estate prices; (ii) A significant slowdown in China, and a decline in global economic growth, which could arise for example from

[12] "Residential Mortgage Products Inquiry," Australian Government ACCC, Interim Report, March 2018. (https://www.accc.gov.au/focus-areas/inquiries/residential-mortgage-products-price-inquiry/interim-report). The Final Report by the ACCC was published in December 2018, after the FSAP missions. (https://www.accc.gov.au/publications/residential-mortgage-price-inquiry-final-report)

[13] "Competition in the Australian Financial System," Australian Government Productivity Commission Inquiry Report, June 2018. (https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.pdf)

[14] See Interim Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, September 2018, published after the FSAP missions. (https://financialservices.royalcommission.gov.au/Documents/interim-report/interim-report-volume-1.pdf)

[15] See accompanying FSAP Technical Note: "Stress Testing the Banking Sector and Systemic Risk Analysis."

[16] The authorities have recently completed an extensive two-year bank-by-bank bottom-up stress testing exercise. See "Preparing for a rainy day," speech by Wayne Byres, APRA Chairman to the Australian Business Economists (ABE), Sydney, July 2018 (https://www.apra.gov.au/media-centre/speeches/preparing-rainy-day).

rising global trade protectionism; and (iii) sharper-than-expected tightening of global financial conditions.

22. The hypothetical, adverse scenario simulates the impact of a sharp contraction of the economy, similar to the experience of the United States during the GFC. GDP is assumed to fall for the first two years of the scenario, before starting to recover in the third year.[17] This path corresponds to a cumulative GDP shock of about 10 percentage points relative to the baseline, or 3.75 times the standard deviation of three-year cumulative GDP growth rates observed in the past 30 years. The cumulative real estate price decline was assumed to exceed 30 percent at the national level, much more severe than any previous housing market downturn in the past 30 years. In the first year of the scenario, monetary policy is assumed to respond swiftly, with a 100-basis points reduction in the policy rate, while increased risk aversion leads to a steeper sovereign yield curve and wider credit spreads, raising overall borrowing costs for the private sector.

Table 2. Australia: Solvency Stress Test Results

CET 1 Ratio (in percent)

	Starting Position	Adverse		
	2017	2018	2019	2020
Full Sample	10.5	9.4	7.9	7.2
Largest 5 Banks	10.6	9.4	8.0	7.2
Mid-sized Banks	9.7	8.6	7.3	7.0

Source: IMF Staff estimates

CAR (in percent)

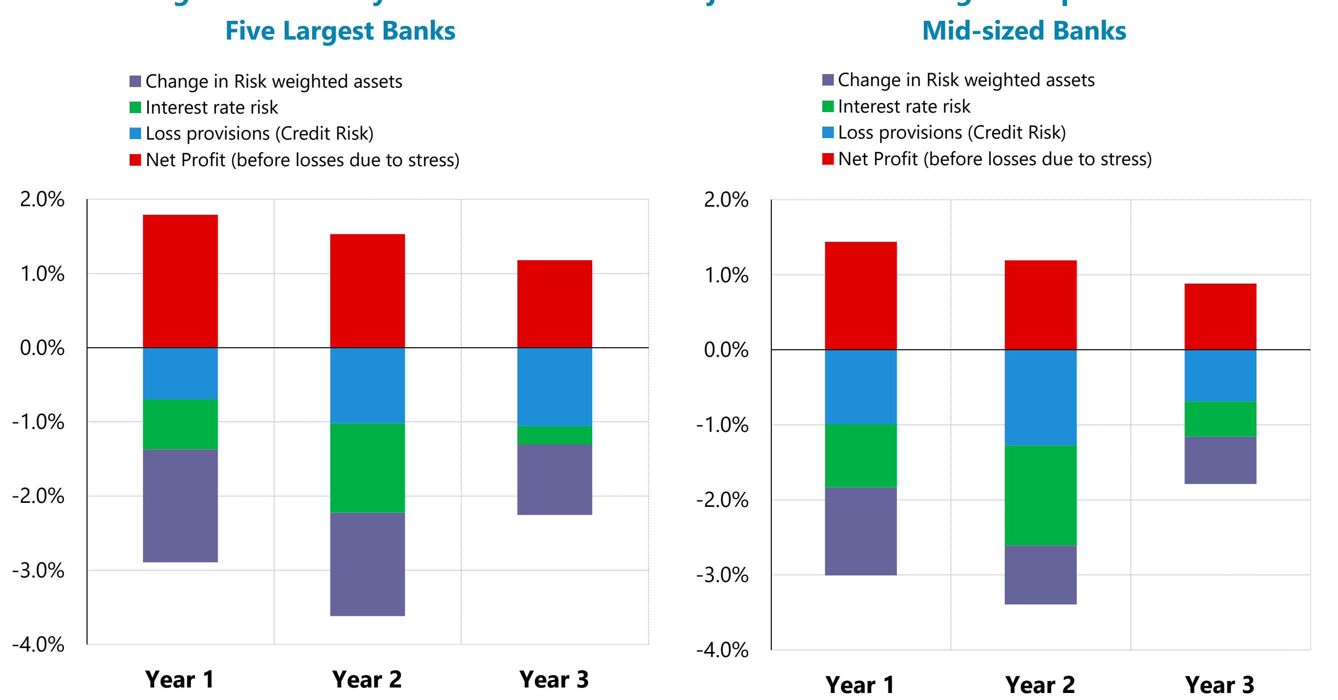
	Starting Position	Adverse		
	2017	2018	2019	2020
Full Sample	14.7	13.1	11.3	10.3
Largest 5 Banks	14.9	13.3	11.4	10.4
Mid-sized Banks	12.9	11.5	10.0	9.5

Source: IMF Staff estimates

[17] Specifically, GDP is assumed to fall at annual rates of 2.5 and 0.5 percent in the first two years of the scenario, before recovering by 1.6 percent in the third year.

23. The solvency stress test found that all banks met the regulatory minimum capital requirement in both the baseline and adverse scenarios.[18] All banks were found to be comfortably above the minimum requirement in the baseline scenario. In the hypothetical adverse scenario, the capital ratio of the five largest banks fell from 10.6 percent to 7.2 percent, well above the phased-in minimum CET1 capital requirement of 4.5 percent but only just above the 7 percent capital level that would include the capital conservation buffer of a further 2.5 percent.[19] The five mid-sized banks would experience smaller declines in capital, with the average ratio falling from 9.7 percent to 7.0 percent (Table 2).[20] These results are broadly similar to those obtained by APRA in its bottom-up stress test conducted one year earlier if banks' capital ratios are adjusted to the same starting level. Even though the composition of the banks' portfolios is roughly similar, there are differences in stress test outcomes among banks due to variation in the composition of portfolio assets, for example the relative riskiness of mortgage portfolios in terms of LTV ratios or holdings of securities; and the structure of funding, in particular the relative dependence on wholesale funding (Figure 6).

Figure 6. Solvency Stress Test Results – Major Drivers of Change in Capital Levels



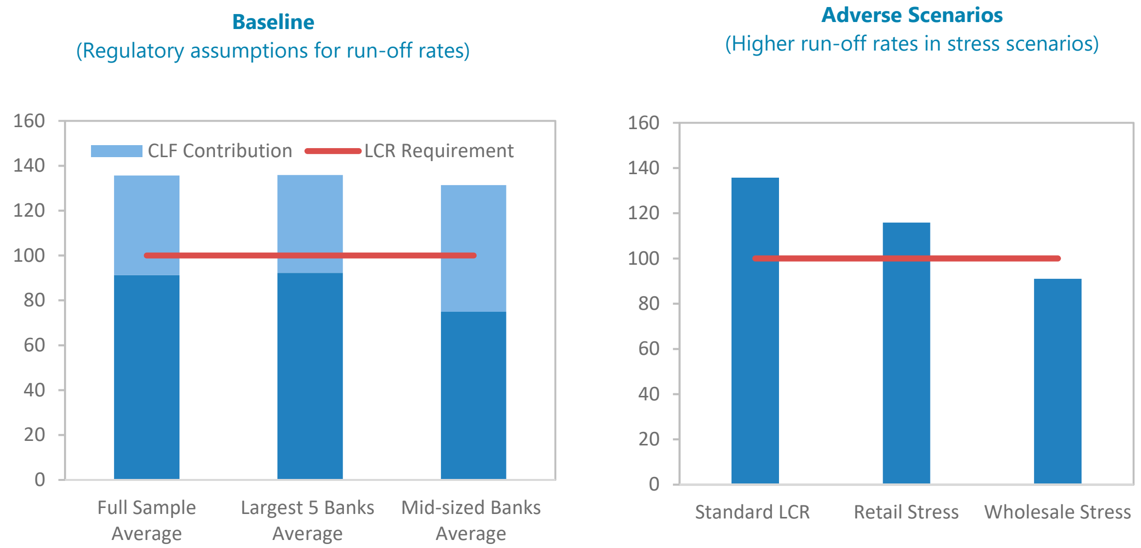
Source: IMF Staff Estimates.

[18] The stress test analysis does not cover certain categories of risk affecting banks, including operational risk, legal risk, or unexpected costs arising from inquiries into financial sector misconduct.

[19] This hurdle does not include the D-SIBs surcharge of a further 1 percentage point of RWA.

[20] Due to data limitations, the FSAP team was unable to capture differences in the Interest Only (IO) composition of banks' mortgage portfolios and potential risks related to conversion to Principal and Interest (P&I) loans.

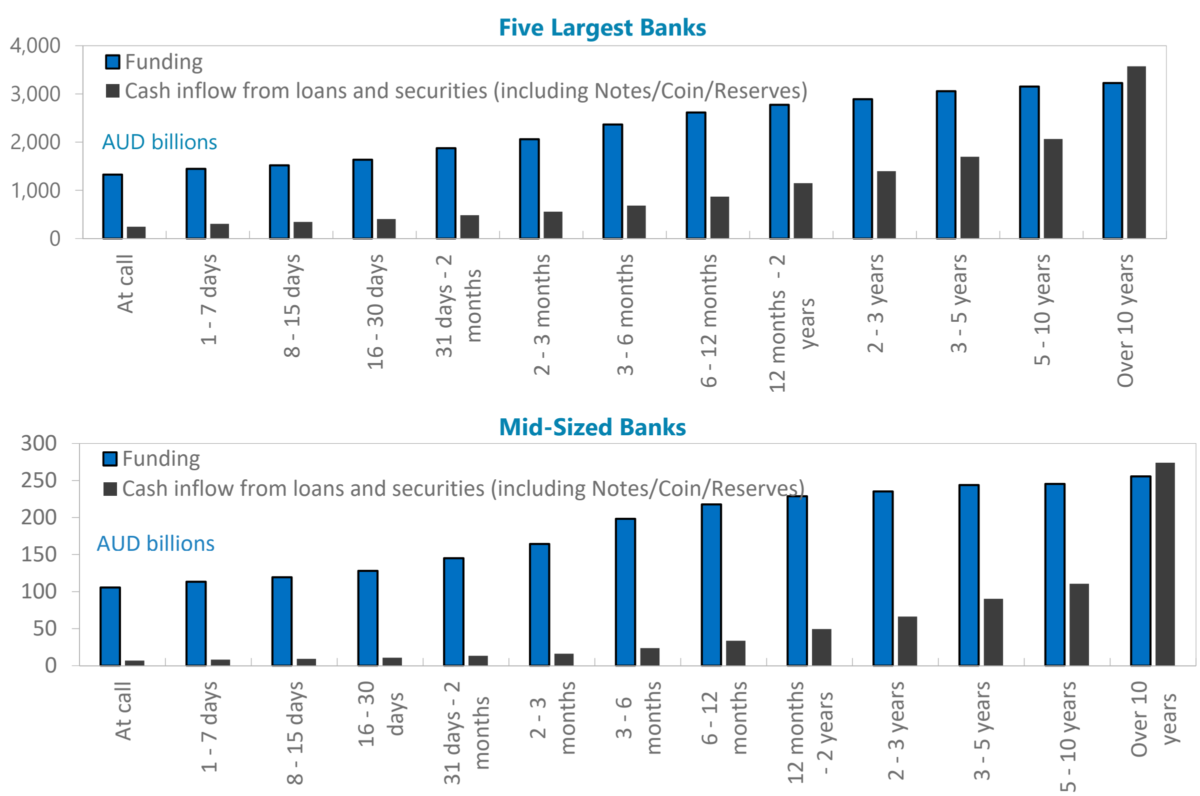
Figure 7. Banks Under Liquidity Risk Scenarios
(percent coverage of liabilities assumed to occur in 1 month)



Note: The red line is 100 percent coverage of assumed liabilties / outflows occurring in 1 month

Source: APRA, IMF staff calculations

Figure 8. Maturity Structure of Banks' Cumulative Cashflows



Source: APRA, IMF staff calculations

B. Liquidity Risks

24. The liquidity stress tests revealed some vulnerabilities to severe stress given continued reliance on wholesale funding. Each of the top 10 banks satisfies Basel LCR and NSFR requirements comfortably. However, applying greater stress than the Basel standard for the assumed run-off rates of various funding sources showed some variation in banks' liquidity buffers under the following scenarios:

- "Retail stress" (Figure 7). In an event of large retail deposit withdrawals, 1.5 to 2 times higher than regulatory assumptions in baseline LCR calculations, the aggregate system fully covered the assumed outflows, demonstrating that banks would be relatively resilient to such an episode.

- "Wholesale stress" (Figure 7). In case of a drying-up of wholesale funding similar to the conditions experienced in other countries during the GFC, the aggregate liquidity coverage of the system fell to about 90 percent over a 30-day period, with six banks below the 100 percent threshold. Large banks were more severely affected than mid-sized institutions given their higher dependence on wholesale debt.

- "Protracted stress" (Figure 8). A separate cash flow-based liquidity stress test highlighted some vulnerabilities to protracted funding pressure, that could raise reliance on central bank funding. The analysis tested banks' net cash balance under longer-term stress in funding conditions (up to one year) compared with the 30-day Basel measure and assumed severe funding outflows with run-off rates higher than those assumed in baseline LCR calculations. The system met the test in aggregate, however, three banks faced cash shortfalls after several months of severe funding stress even after utilizing the central bank Committed Liquidity Facility (CLF).

These results suggest that further extending banks' funding maturity profile and reducing their reliance on wholesale funding would lower overall structural funding risks.

C. Contagion Risks

25. Cross-border analysis of banking sector exposures also highlights banks' vulnerability to external funding shocks.

- **Network analysis using correlations between daily returns of equities suggests a relatively low degree of interconnectedness between major Australian banks and G-SIBs** (Figure 9).[21] Australian banks are, however, themselves quite tightly interconnected in terms of equity price movements, reflecting their direct exposures to each other and their broadly similar business models and balance sheets.

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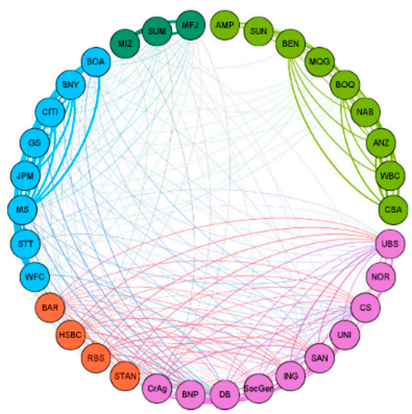
[21] Diebold, Francis, and Kamil Yilmaz, 2014, "On the network topology of variance decompositions: Measuring the connectedness of financial firms," *Journal of Econometrics*, 182, 119–134.

- **Australian banks are exposed to potential funding shocks from several advanced economies.** A stylized network analysis based on balance sheet linkages of Australian banks vis-à-vis their global counterparts shows banks' sensitivity to credit or funding shocks emanating from the United Kingdom, the United States, and to a lesser extent from the regional financial trading hubs of Singapore and Hong Kong SAR (Figure 10).[22] Banks also carry extensive parent-subsidiary linkages with New Zealand. A cross-border, inward spillover analysis, which measures the extent of capital impairment for each of the top 10 Australian banks based on varying assumptions of losses on its cross-border credit exposure and rollover of cross-border funding, highlights the difference in external vulnerability of the five large banks compared with mid-sized banks. Domestically, Australian banks carry relatively small, on-balance sheet interbank exposure, comprising about 5 percent of assets, however, off-balance sheet exposure through the derivatives market has been growing in recent years.

Figure 9. Australian Banks' Linkages with G-SIBs

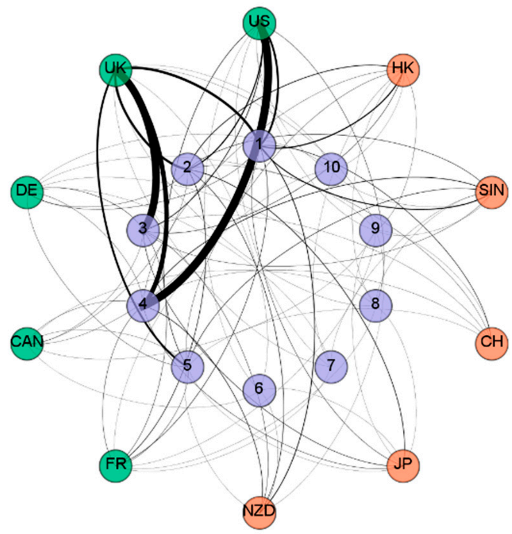


Note: The sample includes 25 of the 30 G-SIBs identified by the FSB in 2017 (5 banks were excluded due to data limitations). The light green nodes represent large Australian banks, while blue, orange, purple and dark green nodes denote banks in the United States., the United Kingdom, Europe, and Asia.

Source: IMF staff calculations based on Diebold and Yilmaz (2014) using daily equity returns during 2003–2018.

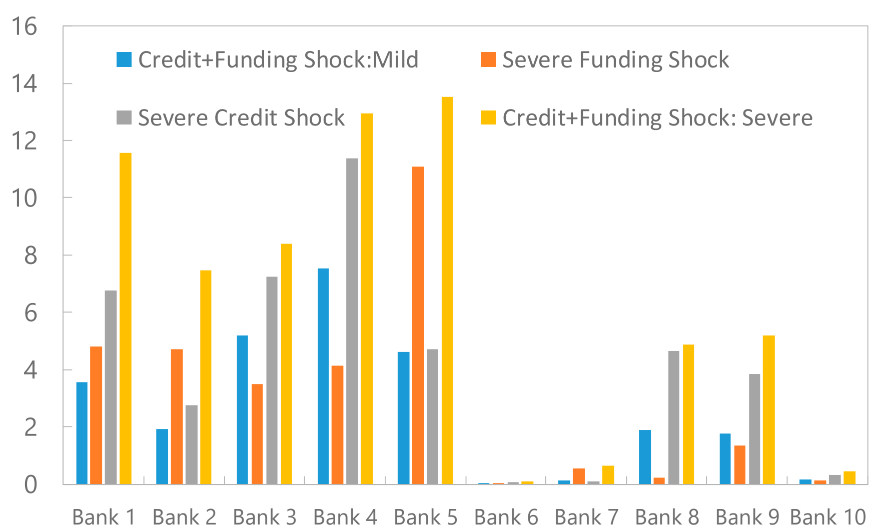
[22] Espinosa-Vega, Marco, and Juan Solé, 2010, "Cross-Border Financial Surveillance: A Network Perspective," IMF Working Paper, WP/10/105.

Figure 10. Cross-border Linkages and Vulnerabilities



Note: The purple colored nodes represent the 10 largest Australian banks, while the green and orange nodes indicate advanced economies and Asia-Pacific countries respectively. The thickness of the lines corresponds to the size of balance sheet (asset or liability) exposures.

Inward Spillover Index
(percent of capital impairment due to counterparty failure)



Assumptions for shock scenarios:

Mild credit / funding (LGD= 40 percent, funding rollover rate= 65 percent, haircut on fire sale of assets= 50 percent);
Severe funding (LGD= 0 percent, funding rollover rate= 0 percent, haircut on fire sale of assets = 100 percent).
Severe credit (LGD of 100 percent, funding rollover rate=100 percent)
Severe credit and funding (LGD=100 percent, funding rollover rate= 0 percent, haircut on assets=100 percent).

Source: IMF Staff Calculations based on the Vega-Sole (2010) methodology using APRA bank-level data as of June 2018.

FINANCIAL STABILITY POLICY

A. Oversight Framework[23]

26. Based on the recommendations of a government inquiry in 1997, Australia created a financial sector oversight framework with responsibilities spread across different agencies:[24]

- *The Australian Prudential Regulation Authority (APRA)*, which is responsible for prudential regulation and supervision of authorized deposit-taking institutions (ADIs) and their resolution, as well as regulation and supervision of general, life, and private health insurance companies and most of the superannuation industry.

- *The Australian Securities and Investments Commission (ASIC)*, which is responsible for the registration and supervision of corporations and, in the financial sector, for licensing of financial service and credit providers, and for market conduct regulation and supervision.

- *The Reserve Bank of Australia (RBA)*, which is responsible for monetary policy, as well as overseeing financial system stability, and supervision of clearing, settlement and payment systems.

- *The Treasury*, which is responsible for providing advice to the Australian Government on the financial sector's regulatory framework, as well as on policy and possible reforms to promote the stability and efficiency of the financial system.

27. Australia has a less formal institutional framework for financial stability policy than many other countries. The Council of Financial Regulators (CFR) chaired by the RBA Governor serves as a forum for discussion and information-sharing on financial stability issues among the regulatory oversight agencies but has no powers or decision-making responsibilities and does not publish records or reports of its activities, except for a short high-level description in RBA's semi-annual FSR.[25] This relatively informal arrangement has historically worked well in terms of flexibility and cooperation, but it could lead to a bias towards inaction on financial stability related issues. A more concrete macroprudential framework should be put in pace to strengthen accountability and promote policy action regarding financial stability risks.

28. While the RBA, APRA, ASIC, and Treasury all have roles for promoting financial system stability, the prudential toolkit is largely controlled by APRA. Given APRA's primary role as a prudential regulator, it has historically been conscientious in consulting its CFR colleagues on important policy actions to address systemic risk, although it is under no obligation to do so. In taking such policy action, APRA has to balance its objectives of financial safety and efficiency,

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[23] See the accompanying FSAP Technical Note: "Systemic Risk Oversight and Macroprudential Policy."

[24] Financial System Inquiry Final Report ("the Wallis Report"), 1997. (http://fsi.treasury.gov.au/content/FinalReport.asp)

[25] The CFR does, however, publish occasional specialist reports and consultation papers, on regulatory issues as relevant, including where advice to the government has been sought or is otherwise appropriate.

competition, contestability, and competitive neutrality. For example, at end-2014, APRA introduced prudential debt serviceability metrics for banks, which were aimed directly at improving banks' loan quality but have also helped to serve the broader objective of moderating the buildup of debt on household balance sheets (Appendix II).

29. Greater formalization and transparency of the work of the CFR on its analysis of systemic risks would help to increase the accountability of its member agencies. The CFR is recommended to adopt the following:

- **Publication of CFR views on critical financial stability matters in an Annual Report.** This could take the form of a short, published report that could be presented to Parliament by CFR agency Heads annually. It would not aim to replace the RBA's Financial Stability Review but highlight views of the member agencies on the most significant risks facing the Australian financial system and steps to address them to promote stability. It could also summarize the broader work of the CFR on emerging risks, data gaps and other issues.

- **Publication of records of meetings.**[26] While it is important that regulators maintain the ability to have open discourse on systemic risks, increased transparency would help garner greater understanding and support for policy actions.

- **Enhancement to the monitoring framework for systemic risk.** More consistent and in-depth monitoring of systemic risk issues, for example of the impact of tax and other policies on household leverage, or the influence of international investment flows on real estate markets, could strengthen stability-related analysis and aid in the effective formulation of policy responses. The authorities should consider development and publication of a series of metrics to track systemic risk and key vulnerabilities, while recognizing that these metrics will often need to be augmented by case-specific analyses of structural issues and emerging factors.

- **A comprehensive review of data needs in the areas of financial stability and supervisory policy.** As noted elsewhere, there are currently significant data gaps and consistency issues that impede the ability of agencies to analyze systemic risk and conduct system wide analyses such as stress tests.[27] While much of this review will necessarily be undertaken by individual agencies, the CFR is the natural body through which to coordinate the effort.

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[26] In December 2018, after the completion of the FSAP missions, the authorities took a welcome step in the direction of greater transparency by deciding to publish a statement following each of the regular quarterly meetings of the CFR.

[27] Data limitations include, for example, absence of granular data on lending and NPLs such as on IO and CRE categories, loan-loss provisioning of certain banks, historical recovery rates for certain types of loans, and consistent cross-border interbank and bank-NBFI exposures.

B. Macroprudential Policy and Tools

30. In recent years, the authorities have taken steps to strengthen banks' lending standards and resilience. Of particular importance were limits on investor loans and interest-only (IO) loans, given the previously rapid growth in these traditionally higher risk and higher leverage products.[28] While most of these actions were implemented by APRA, they were reinforced by additional measures by ASIC in line with its mandate to enforce responsible lending practices. In addition, the RBA has used its public communication channels (e.g., the semiannual *Financial Stability Review* and speeches) to raise awareness of systemic risks to the financial system and support the improvement in the quality of lending (see Appendix II). In addition, APRA has asked banks to pay particular attention to high-LTV loans and borrowers' DTI metrics in recent years requiring enhanced reporting on the latter. A Comprehensive Credit Reporting (CCR) regime has also been introduced in 2018.

31. These measures have been effective in modifying behavior, dampening growth in targeted areas of lending and reinforcing sound lending practices generally. The growth of investor loans slowed after 2014 and the share of IO loans in new approvals dropped sharply in the wake of the 2017 measures. Banks have also moved to strengthen lending standards and serviceability requirements more broadly, especially with respect to high LTV borrowers. While housing markets are influenced by a broad array of factors, recent data suggest that these measures have contributed to a cooling of the housing market along with lower demand from foreign buyers (Figure 16). Given that recent measures appear to have been effective in lowering conjunctural risks, the FSAP considers that additional tightening measures do not appear warranted at this time though, given prevailing financial vulnerabilities, the authorities should stand ready to recalibrate policies as needed to continue to reduce systemic risks.

32. Significant structural vulnerabilities persist in the financial system. Household indebtedness remains very high, while banks' portfolios continue to be concentrated and heavily exposed to the residential mortgage sector. Banks are exposed to rollover risk on their overseas funding. Wholesale funding dependence has diminished but remains around one-third of total funding, of which nearly two-thirds is from international sources. As highlighted in successive Article IV reports, the tax system provides incentives for leveraged investment by households, including in residential real estate that contributes to the elevated structural vulnerabilities. There are also few signs of cooling in the commercial real estate sector where prices have risen sharply in recent years. While bank exposures to the sector are significantly smaller than to households, the sector is highly cyclical and typically experiences high default rates during severe downturns.

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[28] APRA announced in April 2018 that the supervisory benchmark on investor loans would be removed from July 2018, subject to ADIs providing assurance on the strength of their lending standards. In December 2018, following the FSAP missions, APRA announced that the benchmark on IO loans would be removed from January 2019 subject to the same assurance.

33. The authorities are recommended to explore extension of the policy toolkit, to enhance their ability to respond to persistent vulnerabilities and new systemic risks. In particular, the authorities are recommended to carry out a 'readiness' assessment of potential policy options that would facilitate the introduction of new or expanded policy measures if needed. This would entail examining and addressing any data requirements or limitations associated with potential policy options, as well as reviewing whether there are any legal or regulatory impediments to overcome in advance of their possible deployment. While such a readiness assessment should be relatively broad-based, a particular emphasis given prevailing vulnerabilities should be on potential borrower-based constraints, which have proved effective in restraining credit growth in similar economies with high household debt. As well as caps on loan-to-value (LTV) ratios which are a commonly used instrument, such tools could include income-based ratios, such as limits on loan-to-income (LTI) or broader debt-to-income (DTI), which would become binding when housing prices (and mortgage loans) grow faster than households' disposable income and are effective in cyclical upswings. Such measures could also be complemented by other tools such as caps under a debt servicing test or a refinement of the existing net income serviceability test, to provide additional flexibility. The authorities should also continue to refine their metrics for considering activation of the counter-cyclical capital buffer in the event of a rise in systemic risk, as such a buffer could build additional resilience to adverse shocks. The buffer could also help constrain the growth of credit during cyclical upswings, and could be gradually reduced as systemic risk declined, thus lowering the burden on banks.

C. Banking Supervision

34. Australia has significantly strengthened its oversight of the banking sector since the 2012 FSAP. The IMF conducted a detailed assessment of Australia's supervisory oversight of the banking sector.[29] It found that APRA has implemented key elements of the international regulatory reform agenda, at times going beyond the agreed minimum standards.

35. APRA has achieved a high degree of compliance with the Basel Core Principles for Effective Supervision (BCPs). Notwithstanding the revision to the BCP methodology, which raised the standards for achieving supervisory objectives, APRA has demonstrated clear progress in strengthening the effectiveness of supervision. APRA has focused on strengthening the capital framework, implementing Basel III liquidity standards, reinforcing sound mortgage lending standards, improving governance and accountability, and strengthening crisis management and preparedness. However, some of these reforms have not been fully completed and remain on APRA's priority agenda, including recovery and resolution planning. Other broad policy reforms have also been enacted, including: a cross-industry risk management standard applying to all

[29] See Appendix III: Report on the Observance of Standards and Codes, Basel Core Principles for Effective Banking Supervision for additional information, as well as the accompanying FSAP publication: "Detailed Assessment of Observance: Basel Core Principles for Effective Banking Supervision."

APRA-regulated institutions, a governance and risk management framework for conglomerates, and a phased approach to licensing.

36. Improvements to the independence and funding capacity of the regulatory agencies would facilitate continued high-quality supervision. While both APRA and ASIC have clear responsibilities and broad powers, they are subject to powers of government direction that could potentially impact this independence. APRA and ASIC would also benefit from additional budgetary autonomy and flexibility as current constraints may limit their potential to attract and retain staff, particularly those with specialized skills, such as IT, cyber risks, advanced risk analytics, and compliance.

37. There is scope to further enhance APRA's supervisory approach. APRA should perform comprehensive assessment of banks' risk management and governance frameworks periodically. These periodic assessments would allow APRA to achieve a better balance between relying on firms' attestations of the effectiveness of their risk management and governance, and ensuring, with a high degree of confidence, that critical governance, risk management, and control processes are in place. APRA supervisory assessment of governance should also incorporate banks' management of nonfinancial risks, based on a closer engagement with the relevant domestic agencies, mainly ASIC and AUSTRAC on AML/CFT and conduct issues. While APRA prefers to address issues at banks in a less formal way, for example, by issuing recommendations and requirements to banks, it is encouraged to consider escalating the severity of its actions and using formal corrective measures, such as directions, more actively. APRA should also finalize its recovery planning framework for banks and develop resolution planning, particularly for major cross-border banks.[30]

38. While ADIs are subject to a conservative regulatory capital regime and exhibit relatively strong regulatory capital ratios, APRA should consider greater focus on banks' future capital plans. The planned implementation of "unquestionably strong" capital benchmarks on top of the full and conservative use of Basel risk-based capital standards is a positive step in strengthening capital in the banking sector. However, this led APRA to reduce its focus on ICAAP assessments. APRA should undertake more in-depth reviews of the inputs into and controls around ICAAPs and stress testing programs associated with assessing capital needs for risks that may not be suitably captured in regulatory capital regimes.

39. APRA should continue its thematic reviews and assessments of credit risk at major banks and should consider performing more thorough periodic reviews of banks' credit risk management processes. While these reviews have been rightly focused on banks' residential mortgages and commercial real estate lending, periodic deep dives into banks' credit risk management frameworks would help ensure that key gaps in credit risk management processes are addressed. APRA should also progress with its plan to revise prudential standards on credit quality (particularly in relation to treatment of problem assets) and proceed with proposed revisions to its related party standard to align with international standards.

[30] See the section below on Financial Crisis Management and Safety Nets.

40. While AUSTRAC has the authority to oversee banks' AML/CFT systems, its significant reliance on banks' self-reporting of weaknesses has not always proved effective. Recent events have shown that some banks' processes for ensuring compliance with AML/CFT requirements have not worked as reported, which have resulted in failure to comply with rules and laws. AUSTRAC should enhance its supervisory approach by performing end-to-end periodic thematic reviews of AML/CFT systems particularly for major banks and should take swift formal action to address weaknesses and critical compliance issues.

D. Insurance Supervision[31]

41. Supervisory oversight of insurers faces new challenges. The authorities have made considerable progress in updating the regulatory regime since the last FSAP but new supervisory challenges include risks arising from:

- offerings of investment products that are created synthetically with derivatives;
- the creation of non-transparent offshore reinsurance and investment vehicles;
- holdings of foreign bonds used to supplement the limited supply of domestic government securities for hedging duration exposure; and,
- the activities of insurers within complex, financial groups particularly those with material intragroup transactions, which might be taking place to skirt regulation at the level of the insurance entity and to take advantage of the lack of capital requirements at the group level.

42. There is scope to further raise the effectiveness of supervision, particularly on conduct and governance issues, as well as to strengthen the regulation of complex, financial groups. While ASIC has improved the effectiveness of its supervision by shifting to a risk-based supervisory approach, supervisory activities should focus on pro-active risk assessment and mitigation rather than ex-post remediation. The FSAP recommends that the authorities: impose group-level capital requirements to avoid risks arising from regulatory arbitrage of insurers' activities within complex financial groups; take additional steps to mitigate future misconduct risks by strengthening the governance and risk management framework applicable to insurers, and by boosting ASIC's powers to apply more punitive penalties or invoke suspension of licenses as appropriate; and promote further coordination between APRA and ASIC on governance and conduct issues.

E. Financial Market Infrastructures[32]

43. Financial Market Infrastructures (FMIs) in Australia generally operate reliably, and the competitive landscape has seen new entrants and competitors emerge. The Reserve Bank

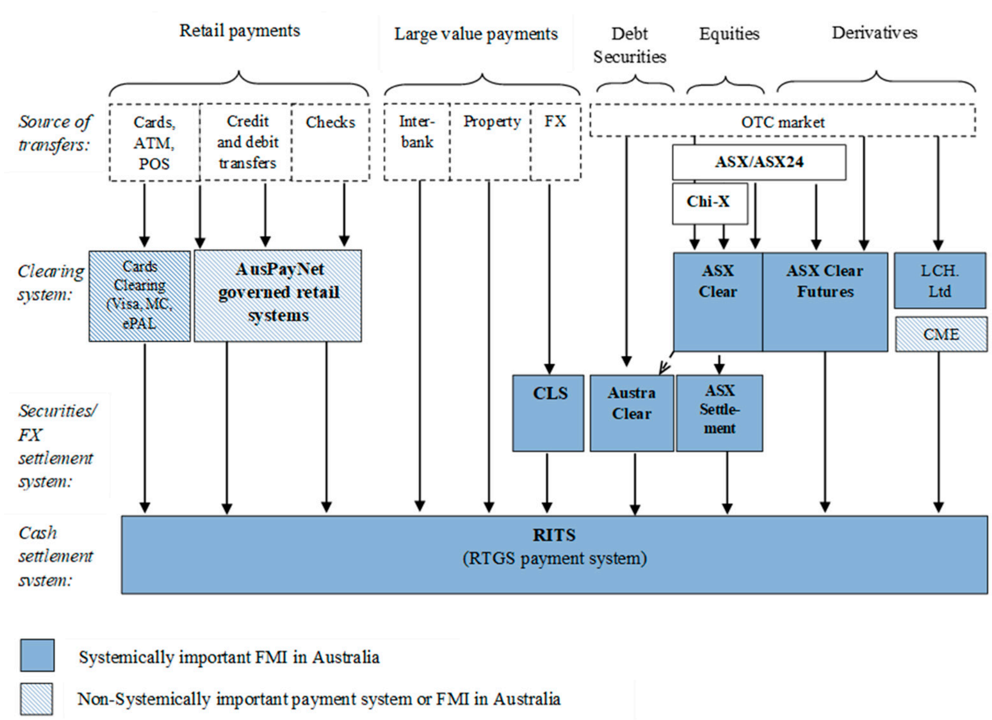
[31] See the accompanying FSAP Technical Note: "Insurance Sector: Regulation and Supervision."

[32] See the accompanying FSAP Technical Note: "Supervision, Oversight and Resolution Planning of Financial Market Infrastructures."

Information and Transfer System (RITS), operated by the RBA, is the only domestic systemically important interbank payment system. In addition, the domestically incorporated Australian Securities Exchange (ASX) group operates an integrated infrastructure including trading platforms, two central counterparties (CCPs) and two securities settlement systems (SSSs) (Figure 11). Since 2011, the ASX has faced competition from foreign infrastructures in some markets, including Chi-X for cash equities trading and the London Clearing House Limited (LCH Ltd) and the Chicago Mercantile Exchange (CME) for some over the counter (OTC) derivatives clearing.

44. FMIs are subject to strong supervisory oversight though enforcement powers should be strengthened further. Supervisory oversight of FMIs by the RBA and ASIC is well-established, with supervisory expectations importantly strengthened over the past few years. Legal and regulatory frameworks for FMIs are generally clear and transparent; and regulatory requirements sufficiently detailed due to the adoption of the PFMI and subsequent guidance. The FSAP recommends that the authorities strengthen enforcement powers for the supervision of CCPs and SSSs to promote compliance with regulatory requirements and to take corrective actions in accordance with the PFMI, as well as to promote effective competition between FMIs (given that one entity operates several systemic FMIs). Steps should also be taken to further enhance already close cooperation between domestic and foreign authorities in case of a crisis event affecting FMIs.

Figure 11. Landscape of Financial Market Infrastructures



Source: IMF Staff

45. Further attention is warranted to strengthen ASX Clear's governance and risk management framework to promote compliance with the authorities' guidelines. ASX Ltd and the authorities are encouraged to consider the impact of the current governance structure on compliance with risk management requirements. Additional improvements to risk management systems should be considered to facilitate separation of house and client accounts, implementation of concentration limits on collateral, holding of adequate pre-funded liquid resources and improvements in the operation of intraday margin calls. Operational risks should also be further addressed.

46. The authorities should prioritize finalization of the special resolution regime for FMIs. Some progress has already been made. The CFR authorities are in the process of drafting legislation that establishes a resolution regime for FMIs consistent with international standards and that incorporates feedback from stakeholders on a past consultation paper.[33] To finalize the regime, the authorities will need to address issues specific to Australia's financial market structure, such as clearing and settlement facilities that are part of a vertically-integrated exchange group, the dominance of a few domestic financial institutions and a few global banks, and issues regarding the diversity and capacity of private liquidity providers.

F. AML / CFT

47. The authorities have made some progress in addressing the main short-comings identified in the last FATF assessment of 2015.[34] The 2015 assessment found that Australia had strong legal, law enforcement, and operational measures for combating money laundering and financing of terrorism (ML/FT), as well as for combating proliferation financing, but FATF also identified important areas for improvement. Since the assessment, Australia has strengthened aspects of its AML/CFT legislative framework,[35] undertaken ground work to expand the AML / CFT regime to cover all designated non-financial businesses and professions (DNFBPs) and through its "Fintel Alliance" established an innovative public-private partnership to improve the sharing of financial intelligence to better pursue those who launder proceeds and fund terrorism.[36] In addition, AUSTRAC has refined its supervisory model, reorganized its supervisory teams, focused supervision

[33] See "Resolution Regime for Financial Market Infrastructures," Treasury, February 2015, and "Resolution Regime for Financial Market Infrastructures: Response to Consultation," CFR, November 2015.

[34] Australia was assessed jointly by the Financial Action Task Force (FATF) and the Asia-Pacific Group on Money Laundering. The mutual evaluation report (MER) was adopted on February 27, 2015 and published on April 21, 2015, see http://www.fatf-gafi.org/countries/a-c/australia/documents/mer-australia-2015.html.

[35] FATF has upgraded Australia's ratings on seven Recommendations, see http://www.fatf-gafi.org/media/fatf/documents/reports/fur/FUR-Australia-2018.pdf. Australia remains in the FATF's enhanced follow-up process because 14 Recommendations remain non- or partially- compliant, including several related to priority improvements identified in the MER.

[36] Financial intelligence is analysis derived from reports submitted to FIUs and from other information sources, aimed at assisting criminal investigations into money laundering, its underlying offences or terrorist financing by: identifying the extent of criminal networks and/or the scale of criminality; identifying and tracing the proceeds of crime, terrorist funds or any other assets that are, or may become, subject to confiscation; and developing evidence, which could be used in criminal proceedings.

on higher ML/TF risk firms, introduced a new system to assess responses to self-reported breaches of compliance, obtained record financial penalties for breaches of requirements, and collaborated with other agencies to publish ML / TF risk assessments.

48. However, there is scope for further improvements to the AML / CFT regime ahead of the next FATF assessment planned for 2020. The AML/CFT regime should be expanded to cover all DNFBPs, including lawyers, real estate agents, and trust and company service providers. The planned increases in staffing at AUSTRAC during 2018-2019 could help strengthen onsite supervision of compliance by banks and high-risk remitters, especially in regard to customer due diligence requirements. The authorities are also recommended to make more frequent use of formal enforcement actions to encourage compliance as well as to strengthen data collection.

CRISIS MANAGEMENT AND FINANCIAL SAFETY NETS

49. The recently enacted Crisis Management Act confers new powers on APRA to resolve financial institutions (banks and insurance companies) in distress.[37] It strengthens APRA powers regarding conglomerate groups, statutory management, directions, transfer, conversion and write-off of capital instruments, stays, foreign branches, the Financial Claims Scheme (FCS), wind-up, and resolution planning.[38] In particular, it provides that the statutory management tool can be applied in a group context; provides new statutory management powers in relation to foreign-owned ADIs; widens the scope of the directions powers; and broadens the use of the FCS to finance business transfers. APRA has started to translate the new powers into prudential standards and internal work processes.

50. APRA has made progress in developing recovery planning requirements for the banking industry, extending these from large to smaller banks. APRA has provided guidance to ADIs on recovery planning, which suggests that they should conduct regular tests focusing on internal escalation processes, functioning of crisis management teams, and determination of communication plans. In recent years, APRA has concluded a thematic review and benchmarking exercise of recovery plans submitted by the larger ADIs. APRA provided entity-specific feedback on the plans, which outlined the key areas assessed as requiring improvement. APRA has asked for revised submissions which it plans to update on an annual cycle. APRA plans to extend its recovery planning work to include foreign-owned ADI subsidiaries and branches.

51. Recovery planning should be better integrated within the risk management framework and operational testing exercises of the largest banks. Recovery plans should become an integral part of the bank's risk management framework and should thus be consistent and integrated with the bank's stress testing and capital and liquidity planning exercises. A guiding framework for a set

[37] See the accompanying FSAP Technical Note: "Bank Resolution and Crisis Management."

[38] The conversion applies only to AT1 and T2 capital instruments, but in the absence of provisions on statutory bail-in, such conversion and write-off powers cannot be applied more broadly to other bank liabilities (excluding insured deposits).

of triggers and early warning indicators should be developed by APRA to highlight when recovery options might need to be activated. Regular tests of recovery plans should be undertaken. APRA's work on a pilot resolution planning project, along with a resolvability assessment, will be fed into a framework for establishing credible resolution plans, which would use as a basis for resolving a failed or failing institution. Recovery and resolution planning requirements for financial conglomerates should also be applied on a group basis.

52. Notwithstanding the recent progress in strengthening the resolution framework, steps to operationalize these tools still need to be completed. While the mechanics of the bridge bank and asset separation tools are established, the modalities to finance the relevant operations should be clarified. Since the resolution tools are untested in Australia, efforts should be maintained to conduct intra- and cross-institutional crisis simulation tests. Also, given the significant interconnectedness and potential spill-over effects, the Australian authorities should enhance cooperation with the New Zealand financial regulators within the Trans-Tasman Council of Banking Supervisors (TTBC) in the context of bank resolution by advancing the focus from generic resolution issues to the formulation of specific resolution plans, including funding strategies. The authorities should also consider introducing a statutory recognition of action taken by foreign regulators.

53. More needs to be done to ensure that the authorities are well-positioned to resolve a systemically important bank or to address a systemic banking crisis. While it is important to ensure, as is the case in ongoing work, that banks bear the costs of their own failures through an increase in their loss-absorbing capacity[39] (in the form of contractual bail-in instruments), the resolution authority should be able, upon entry into resolution, to convert or write down any contingent convertible or contractual bail-in instruments, whose terms had not been triggered prior to entry into resolution. To facilitate effective resolution, retail investors' exposure to complex loss-absorbing instruments should be subject to strong investor protection.

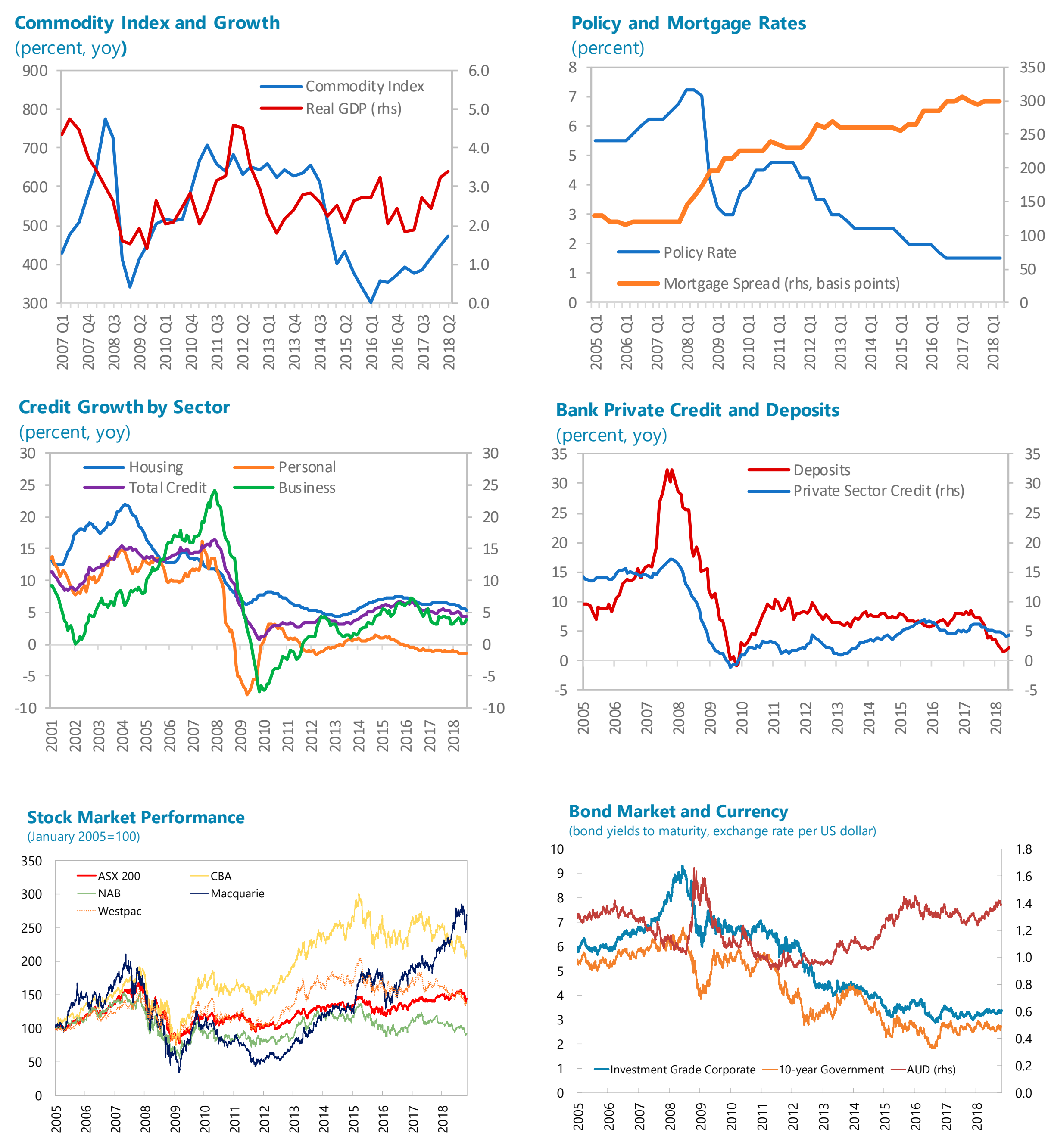
54. The authorities should also introduce an ex-ante funded deposit insurance scheme (FCS) and a statutory bail-in regime, based on best international practice. The goals and operational modalities of the Financial System Stability Special Account, the standing budgetary authorization for financial crisis management purposes, should be also clarified. The "no creditor worse off" regime should be added as an additional legal safeguard to the bank resolution framework.

55. The RBA is encouraged to formalize the Emergency Liquidity Assistance (ELA) framework and draw up clearly defined conditions for it. As crises tend to escalate at a rapid speed, the RBA would benefit from a more predefined emergency liquidity assistance framework. This should include, inter alia, modalities for solvency assessment (moving from point-in-time to a forward-looking assessment of viability), applying and receiving government indemnity, and for

[39] In November 2018, after the FSAP missions, APRA published a discussion paper on 'Increasing the loss-absorbing capacity of ADIs to support orderly resolution' see https://www.apra.gov.au/increasing-loss-absorbing-capacity-adis-support-orderly-resolution .

decisions whether the RBA can lend to an undercapitalized bank in a recovery or possibly in a resolution mode. The framework should consider applicable risk control measures for lending to banks beyond the CLF. The IMF recommends that ELA should only be provided to solvent financial institutions on a temporary basis against adequate collateral.

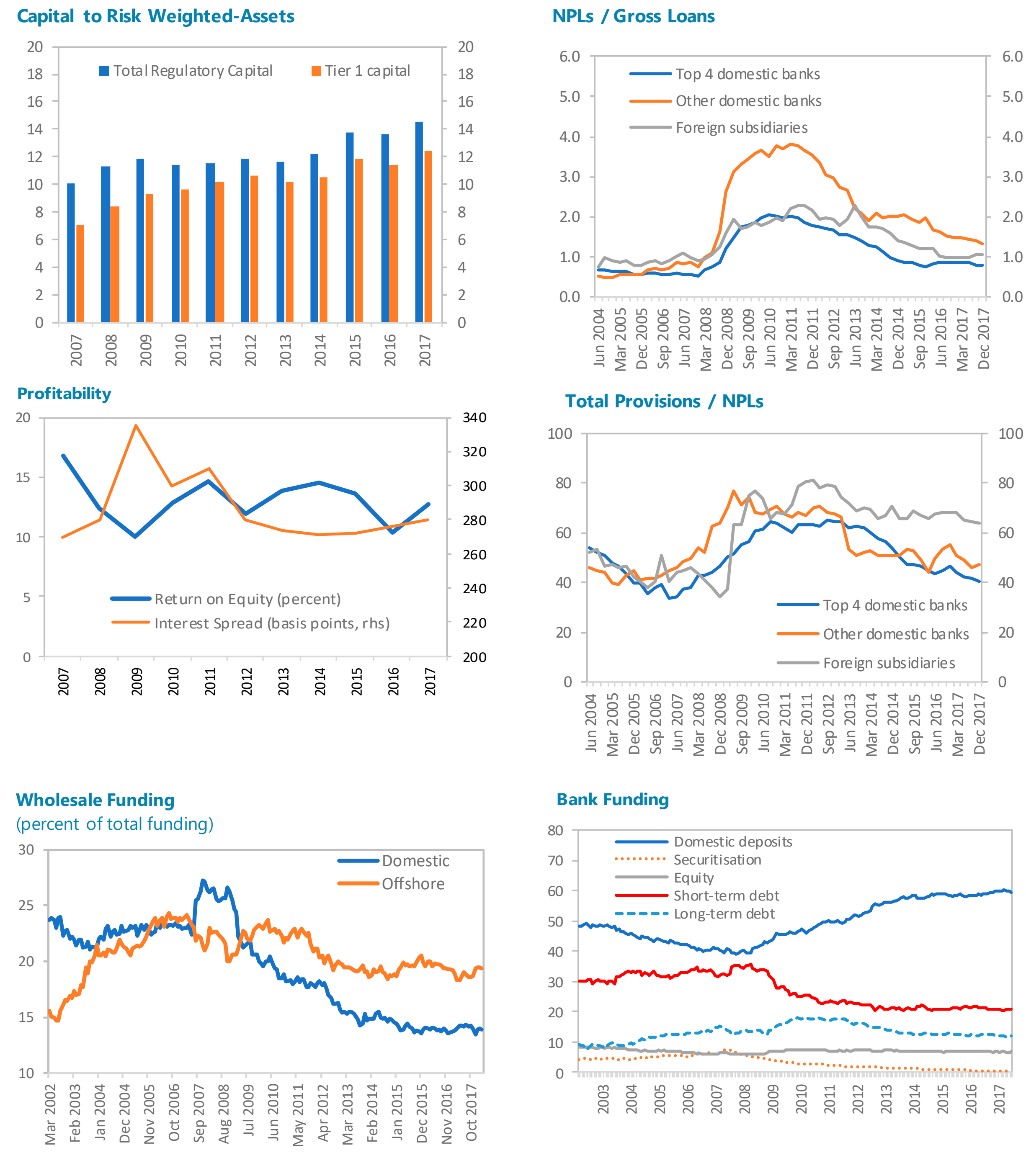
Figure 12. Indicators of Macroeconomic and Financial Market Conditions



Source: APRA, Haver Analytics, Bloomberg, and IMF WEO database.

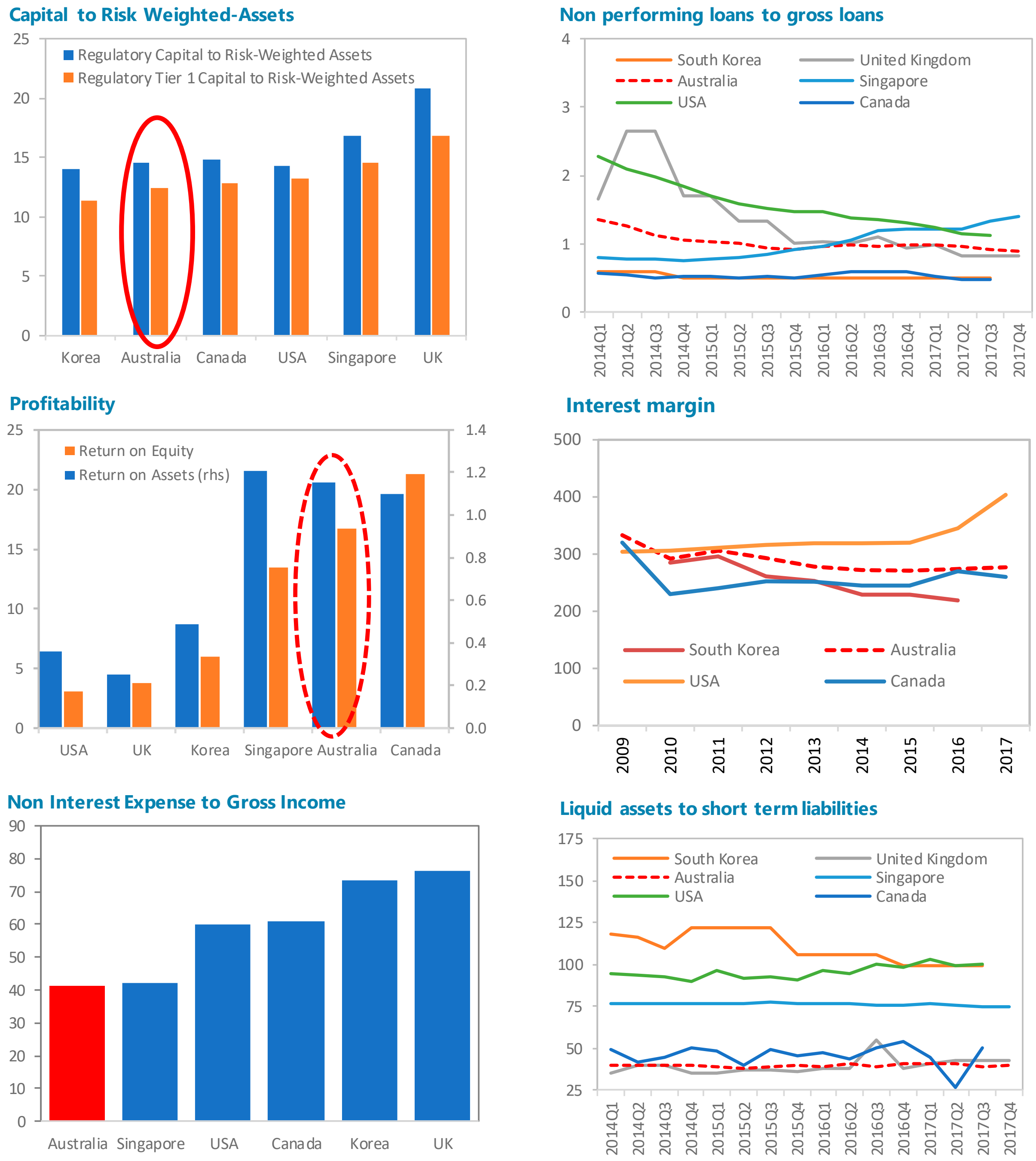
Figure 13. Financial Soundness Indicators, 2017 Q4

(in percent)



Source: APRA, Haver Analytics, Pillar 3 Reports, and IMF FSI database.

Figure 14. Comparison of Financial Soundness Indicators, 2017 Q4
(in percent)

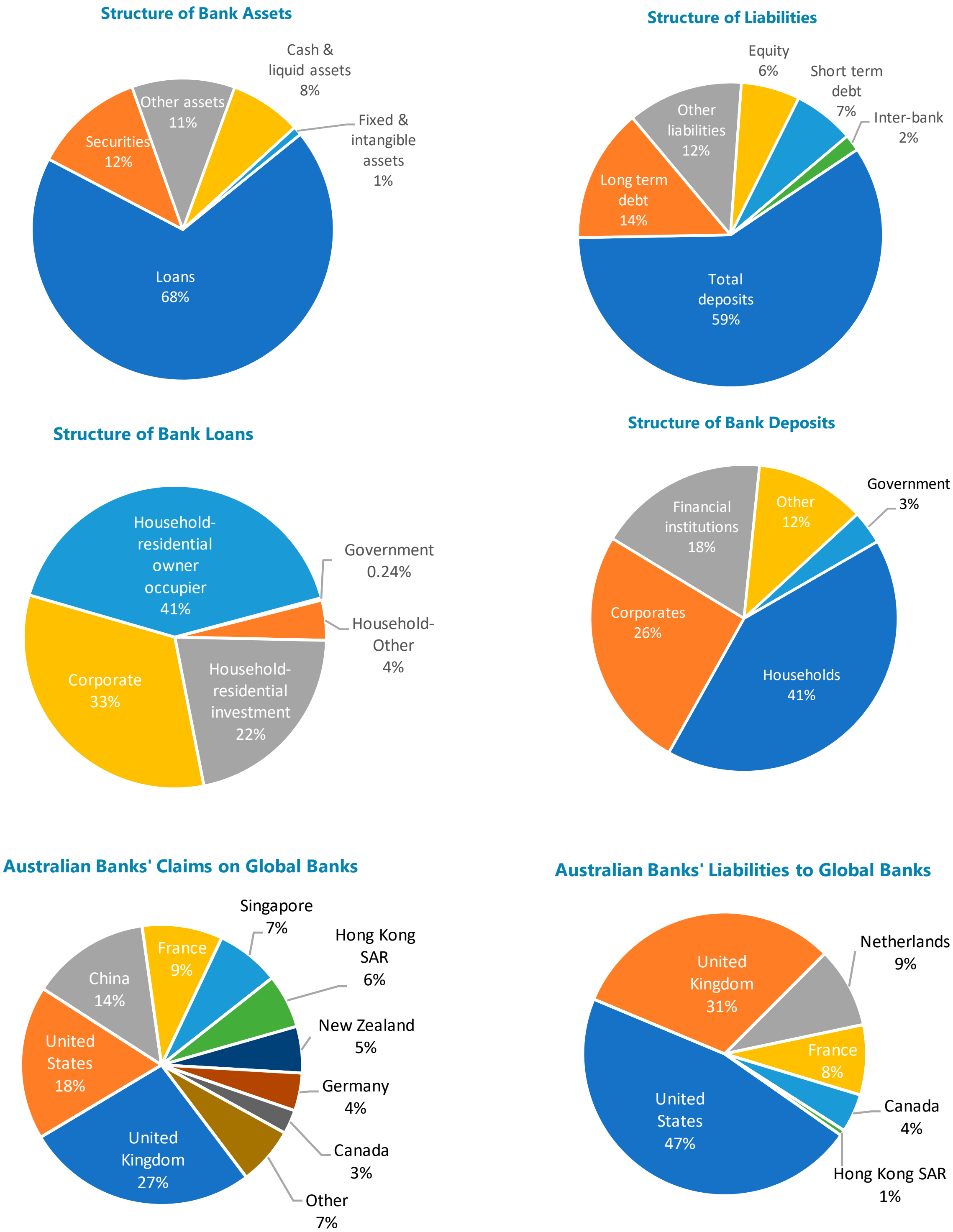


Notes:

- Cross-country comparisons of banks' capital ratios are difficult due to local differences in risk-weighting methodologies. Australia follows a more conservative approach than the Basel framework.
- The chart on liquid assets coverage of short-term liabilities does not include use of RBA's CLF.

Source: RBA, APRA, IMF FSI database, and staff estimates.

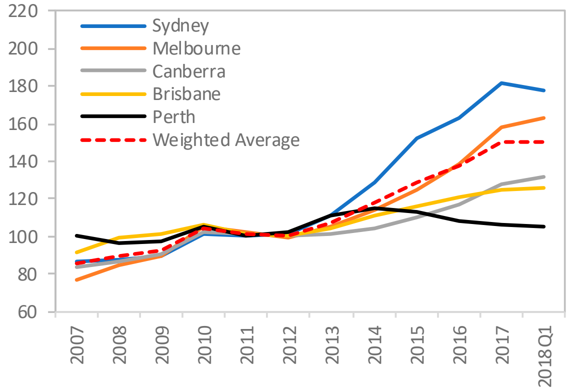
Figure 15. Banking Sector Detail, 2017
(in percent)



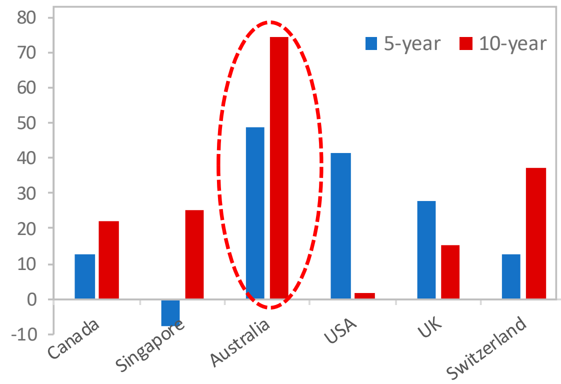
Source: APRA, RBA, BIS locational data and staff estimates.

Figure 16. Real Estate Market Developments

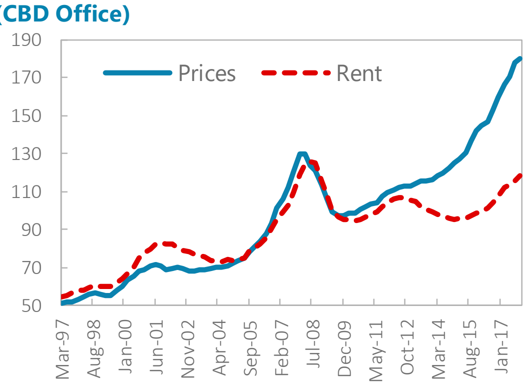
Nominal House Price Indexes
(Q3 2011 - Q2 2012=100, NSA



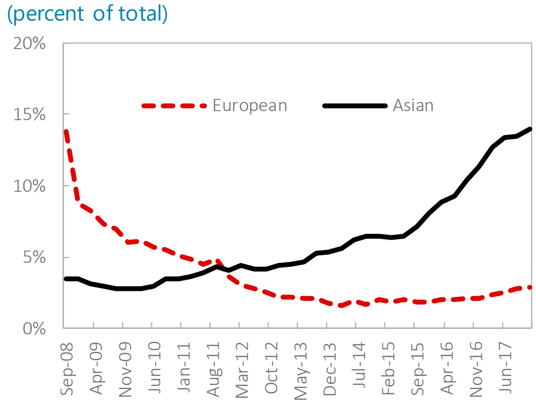
Housing Price Change
(percent)



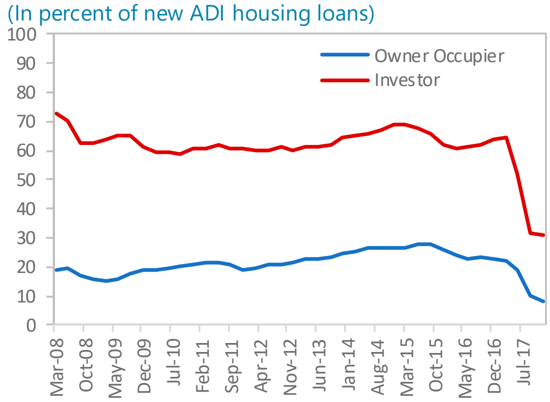
Commercial Real Estate Index
(CBD Office)



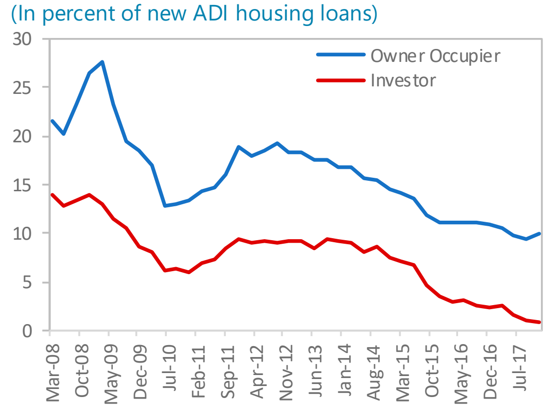
Proportion of CRE held by foreign banks
(percent of total)



Interest Only Loans
(In percent of new ADI housing loans)

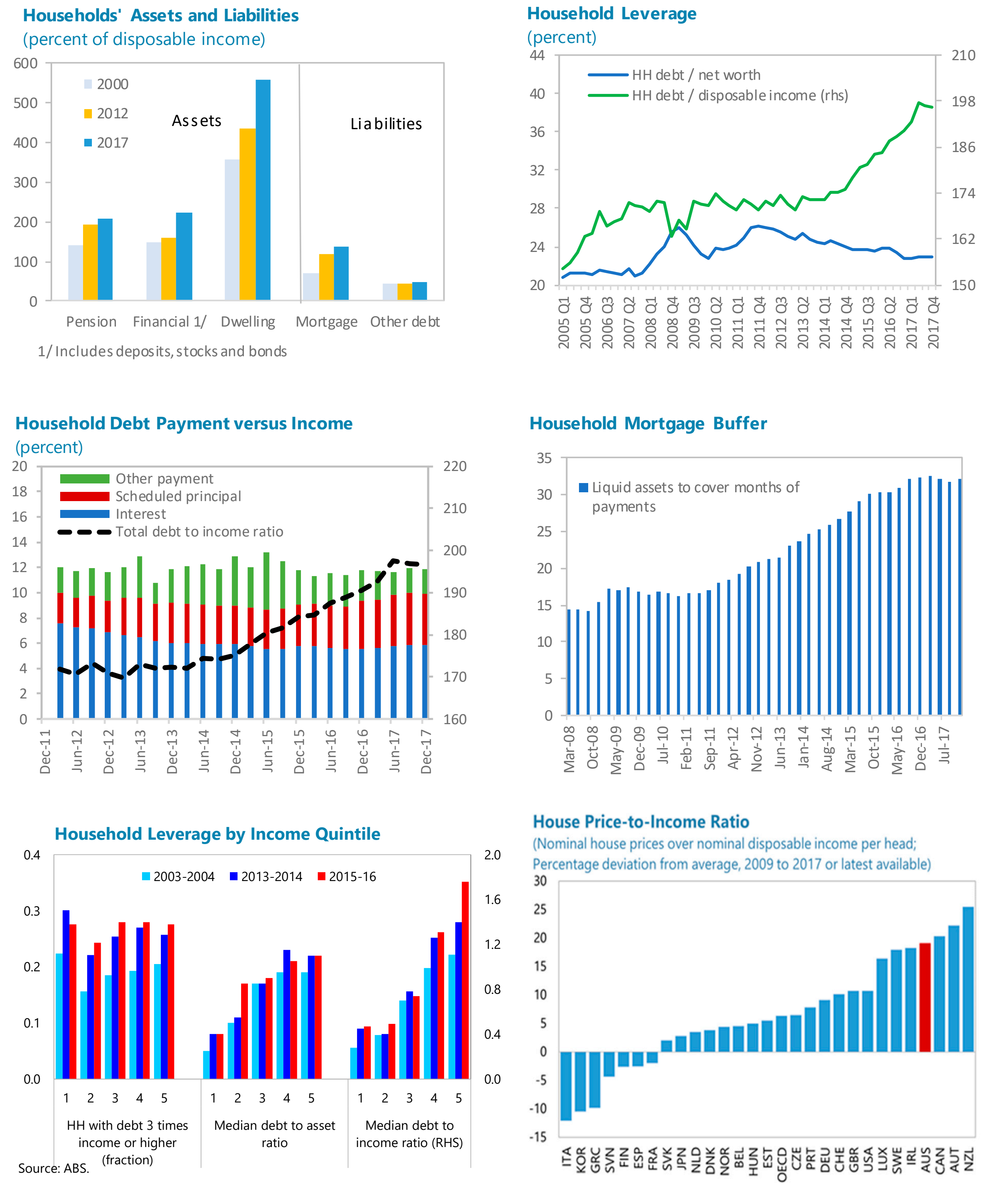


Loans with LTVs > 90 percent
(In percent of new ADI housing loans)



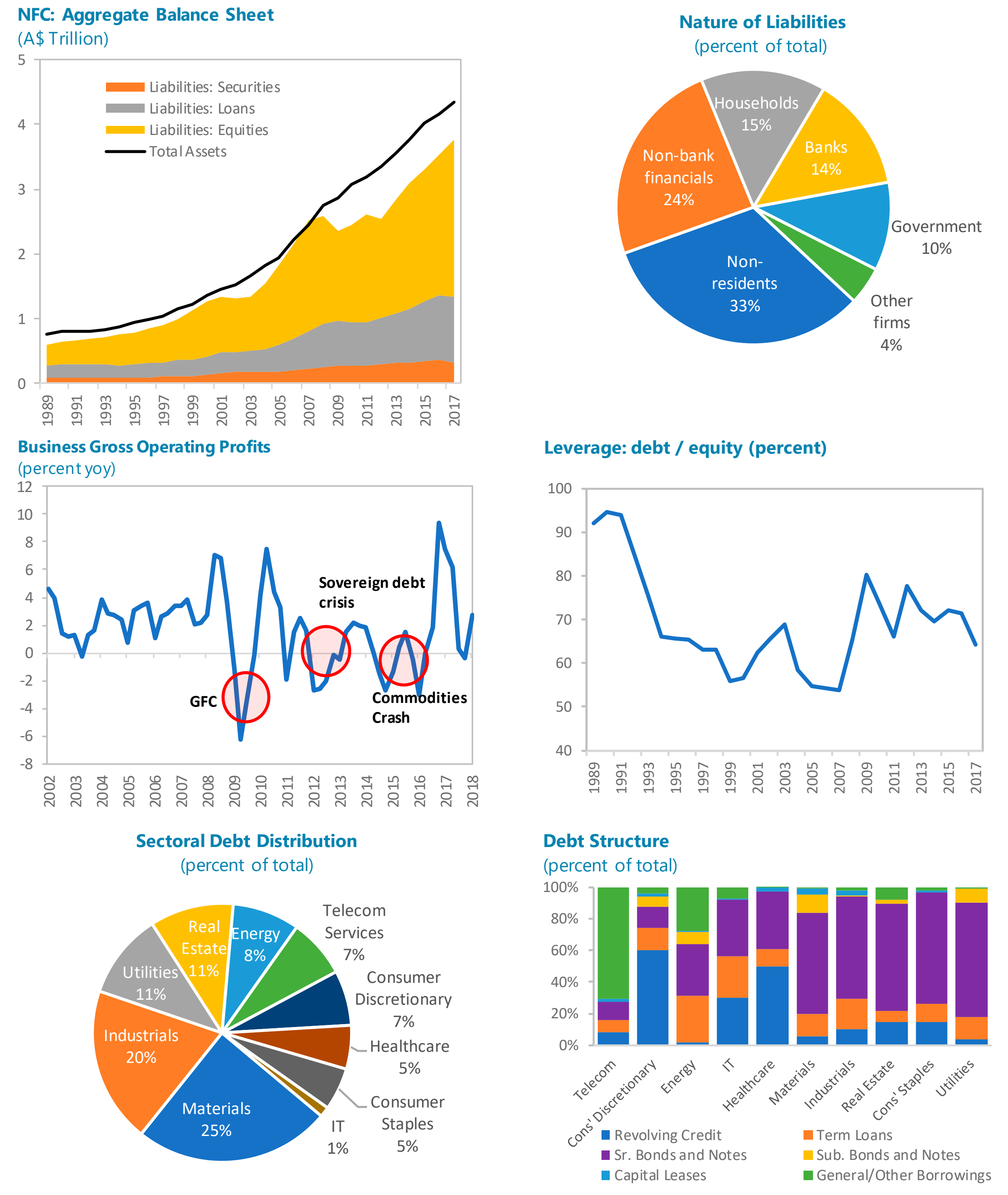
Source: APRA, RBA, Haver Analytics, and IMF WEO database.

Figure 17. Household Sector



Source: APRA and Haver Analytics

Figure 18. Nonfinancial Corporate Sector



Source: ABS National Accounts

Table 3. Australia: Risk Assessment Matrix

Nature/Source of Main Threats	Overall Level of Concern	
	Likelihood of Severe Realization of Threat in the Next 1–3 Years (high, medium, or low)	Expected Impact on Financial Stability if Threat is Realized (high, medium, or low)
1. Severe real estate market downturn.	**Low / Medium** • Rising interest rates and low housing affordability reduce demand for additional housing purchases. • Nationally falling housing and commercial real estate prices lead to a dramatic increase in risk aversion in both these real estate markets. • Reversion of capital flows as international buyers leave the market. • Sharp price declines in domestic equity and bond markets.	**High** • A sharp real estate market correction would lower residential and corporate investment and private consumption and thereby growth. • A vicious feedback loop of falling house and commercial real estate prices, higher non-performing loans, tighter bank credit, and lower activity could amplify the downturn. • The impact on banks would be largely through higher credit losses on mortgage and commercial real estate loans, but also on their broader loan portfolios due to the overall decline in economic activity and increasing unemployment.
2. Significant China slowdown and weaker-than-expected global growth.[1]	**Low / Medium** • This shock could affect Australia via both trade and financial channels. • Lower export revenue for Australia would lead to lower growth and consumption, leading to lower profits for the corporate sector and lower investment, higher structural unemployment, and lower foreign direct investment (FDI), with reduced tax revenues for the government. • There would be a negative feedback for broad economic growth from reduced credit growth from banks.	**Medium / High** • A China slowdown would lead to a sustained decline in commodity prices and a downturn in Australia. Could be exacerbated by a trade dispute with the United States. • Banks would face higher credit losses on corporate loans, and also on their broader loan portfolio due to the overall decline in economic activity. • Rising losses on loan portfolios might induce banks to cut back lending.

[1] In line with Risks #1 and 4 of the July 2018 Global Risk Assessment Matrix (G-RAM)

Table 3. Australia: Risk Assessment Matrix (concluded)		
3. Sharp tightening of global financial conditions.[2]	**High** • This shock would be accompanied by a spike in risk premiums, disorderly correction in asset prices, heightened volatility, and a sharp depreciation of the Australian dollar. • Tighter financial conditions would lead to capital outflows from Australia and could put pressure on government bond yields.	**Medium** • The impact on banks would be largely through market risk (via the repricing of banks' financial assets and the impact of a weaker Australian dollar on their net open position) and through higher funding costs, which would be exacerbated by the higher credit losses caused by this shock. • Banks could experience a significant decline in wholesale funding available from abroad. • Banks' asset quality could also deteriorate as their customers would face rising borrowing rates on variable-interest rate loans (the bulk of banks' lending).

[2]In line with Risk #3.

Table 4. Australia: Selected Economic Indicators, 2014–2024
(Annual percent change, unless indicated otherwise)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
					Est.	Projections					
NATIONAL ACCOUNTS											
Real GDP	2.6	2.5	2.8	2.4	3.0	2.7	2.6	2.6	2.6	2.6	2.6
Domestic demand	0.9	1.2	1.8	2.9	3.0	2.6	2.7	2.6	2.6	2.6	2.6
Private consumption	2.5	2.4	2.7	2.4	2.6	2.5	2.7	2.6	2.6	2.6	2.6
Public consumption	0.3	4.4	4.8	4.0	4.1	2.8	2.4	2.0	2.1	2.2	2.2
Investment	-1.9	-3.6	-2.3	3.0	2.9	2.3	2.7	3.0	2.9	2.8	2.8
Public	-3.3	-1.8	13.3	9.1	0.2	5.4	1.5	0.6	0.4	0.4	0.4
Private business	-6.1	-9.6	-11.2	3.2	4.0	3.7	4.9	4.3	4.3	4.2	4.3
Dwelling	9.6	8.9	7.9	-2.4	5.5	-1.3	-0.1	2.4	2.3	2.0	1.7
Net exports (contribution to growth, percentage points)	1.6	0.9	1.3	-0.8	0.3	0.2	0.0	0.1	0.1	0.1	0.1
Gross domestic income	1.0	-0.1	2.8	4.8	3.1	1.7	2.5	2.2	2.3	2.6	2.7
Investment (percent of GDP)	26.4	25.9	24.7	24.1	24.3	24.2	24.2	24.2	24.2	24.1	23.9
Public	4.4	4.4	4.8	5.0	4.9	5.0	4.9	4.8	4.7	4.6	4.4
Private	22.0	21.4	19.7	19.1	19.3	19.2	19.2	19.3	19.4	19.4	19.4
Mining investment	6.3	5.4	3.9	3.2	2.9	2.8	2.8	2.7	2.7	2.6	2.6
Non-mining investment	15.7	16.1	15.9	15.9	16.4	16.4	16.4	16.6	16.7	16.8	16.8
Savings (gross, percent of GDP)	23.3	21.6	20.9	22.0	21.7	21.5	21.3	21.2	21.1	21.1	21.2
Potential output	2.8	2.6	2.5	2.5	2.6	2.5	2.6	2.6	2.6	2.6	2.6
Output gap (percent of potential)	-0.9	-1.0	-0.8	-0.9	-0.5	-0.3	-0.2	-0.1	-0.1	0.0	0.0
LABOR MARKET											
Employment	0.6	2.0	1.8	2.3	2.7	2.1	1.9	1.7	1.7	1.7	1.7
Unemployment (percent of labor force)	6.1	6.1	5.7	5.6	5.3	4.8	4.8	4.8	4.8	4.8	4.8
Wages (nominal percent change)	2.5	2.1	1.9	1.9	2.1	2.5	3.0	3.3	3.2	3.3	3.3
PRICES											
Terms of trade index (goods, avg)	103	90	90	103	104	98	97	95	94	94	94
% change	-8.0	-12.4	-0.4	14.4	0.9	-5.5	-0.8	-1.8	-1.4	-0.3	0.5
Iron ore prices (index)	77	44	46	56	55	48	47	47	47	47	47
Coal prices (index)	81	67	75	101	120	108	102	99	99	99	99
LNG prices (index)	95	61	42	41	56	49	45	44	44	44	44
Crude prices (Brent; index)	91	48	40	50	65	57	57	56	57	57	58
Consumer prices (avg)	2.5	1.5	1.3	2.0	2.0	2.1	2.4	2.5	2.5	2.5	2.5
Core consumer prices (avg)	2.6	2.3	1.7	1.6	1.6	2.1	2.3	2.5	2.5	2.5	2.5
GDP deflator (avg)	0.3	-0.8	1.0	3.6	1.7	1.0	2.1	2.1	2.3	2.6	2.4
FINANCIAL											
Reserve Bank of Australia cash rate (percent, avg)	2.5	2.1	1.7	1.5	1.5	1.5	1.8	2.3	2.7	3.2	3.5
10-year treasury bond yield (percent, avg)	3.7	2.7	2.3	2.6	2.8	3.2	3.5	4.0	4.5	5.0	5.1
Mortgage lending rate (percent, avg)	6.0	5.6	5.4	5.2	5.6	5.6	6.1	6.6	7.1	7.6	7.6
MACRO-FINANCIAL											
Credit to the private sector	7.4	8.1	7.0	4.6	4.7	3.7	3.6	4.0	4.6	4.7	4.8
House price index	120	131	141	148	141	135	136	137	141	144	148
% change	6.7	8.7	7.7	5.0	-4.4	-4.1	0.3	1.0	2.5	2.5	2.5
House price-to-income, capital cities (ratio)	4.2	4.5	4.7	4.8	4.5	4.1	3.9	3.8	3.7	3.6	3.5
Interest payments (percent of disposable income)	8.9	8.8	8.6	8.9	9.7	9.2	9.9	10.6	11.3	11.9	11.8
Household savings (percent of disposable income)	7.4	6.3	4.9	3.9	2.5	2.3	2.5	2.6	2.7	3.0	3.1
Household debt (percent of disposable income) 1/	167	173	180	187	188	176	174	171	169	167	165
Business credit (percent of GDP)	48	51	51	50	50	50	50	50	50	50	50
GENERAL GOVERNMENT (percent of GDP) 2/											
Revenue	33.9	34.6	34.8	34.9	35.6	36.0	35.9	35.8	35.7	35.6	35.6
Expenditure	36.8	37.4	37.4	36.4	36.7	37.5	36.6	35.9	35.6	35.6	35.6
Net lending/borrowing	-2.9	-2.8	-2.6	-1.5	-1.2	-1.5	-0.7	-0.1	0.1	0.0	0.0
Operating balance	-1.6	-1.5	-1.1	-0.1	0.4	0.4	1.1	1.6	1.7	1.6	1.6
Cyclically adjusted balance	-2.5	-2.4	-2.1	-1.1	-0.9	-1.3	-0.6	0.0	0.1	0.0	0.0
Gross debt	34.1	37.8	40.5	40.7	40.7	41.4	40.8	40.1	39.3	37.9	36.7
Net debt	15.5	17.9	18.9	18.4	19.3	20.6	20.3	19.8	19.1	18.0	17.0
Net worth	52.0	49.4	49.3	49.0	48.6	50.3	50.3	50.4	50.0	49.1	48.5
BALANCE OF PAYMENTS											
Current account (percent of GDP)	-3.1	-4.6	-3.3	-2.6	-2.4	-2.7	-2.9	-3.0	-3.1	-3.0	-2.8
Export volume	6.9	6.5	6.8	3.5	5.3	2.4	2.5	2.9	3.1	3.2	3.2
Import volume	-1.4	1.9	0.1	7.7	3.8	1.7	2.6	2.7	2.9	2.9	2.9
Net international investment position (percent of GDP)	-52	-56	-57	-54	-50	-51	-52	-52	-53	-53	-53
Gross official reserves (bn US$)	66	63	74	85	...	...	...	...	...	...	...
MEMORANDUM ITEMS											
Nominal GDP (bn A$)	1,615	1,641	1,704	1,808	1,894	1,965	2,059	2,158	2,265	2,385	2,506
Percent change	3.0	1.6	3.9	6.1	4.8	3.7	4.8	4.8	5.0	5.3	5.1
Real net national disposable income per capita (% change)	-0.8	-2.1	1.1	2.7	1.2	0.2	0.4	0.1	0.2	0.4	0.6
Population (million)	23.6	24.0	24.4	24.8	25.2	25.6	26.0	26.4	26.8	27.2	27.7
Nominal effective exchange rate	99	92	92	94	...	...	...	...	...	...	...
Real effective exchange rate	100	93	93	96	...	...	...	...	...	...	...

Sources: Authorities' data; IMF *World Economic Outlook* database; and IMF staff estimates and projections.

1/ Reflects the national accounts measure of household debt, including to the financial sector, state and federal governments and foreign overseas banks and governments. It also includes other accounts payable to these sectors and a range of other smaller entities including pension funds.

2/ Calendar year.

Table 5. Australia: Structure of the Financial System, 2017

	Number 1/	Assets (billions of AUD)	Assets (billions of USD)	Percent of GDP
Authorized Deposit Insititutions	141	4,585	3,527	254.6
Major Domestic Banks	4	3,524	2,710	195.7
Other Domestic Banks	29	458	352	25.4
Foreign Banks	51	553	425	30.7
Pension funds	2338	2,129	1,638	118.2
Investment funds	N/A	359	276	19.9
Insurance companies	138	388	298	21.5
Finance companies	N/A	176	136	9.8
Specialized credit institutions	60	125	96	7.0
Total financial system	2677	7762	5971	431
Memorandum				
Nominal GDP (billions, AUD)	1801			
Exchange rate (AUD / US dollar)	1.3			

Source: APRA, IMF, World Economic Outlook (WEO), IMF staff estimates

1/ Number of licensed institutions

Table 6. Australia: Financial Soundness Indicators for the Banking Sector

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018 Q1
Capital adequacy												
Regulatory capital to risk-weighted assets	10.1	11.3	11.9	11.4	11.6	11.9	11.6	12.2	13.8	13.6	14.5	14.6
Regulatory tier 1 capital to risk-weighted assets	7.1	8.4	9.3	9.6	10.2	10.6	10.2	10.6	11.8	11.4	12.4	12.4
Asset quality												
Non-performing loans to total gross loans	0.6	1.4	2.0	2.1	2.0	1.7	1.4	1.0	0.9	1.0	0.9	0.9
Total provisions to non performing loans	41.1	49.2	60.1	66.0	64.1	66.2	62.2	54.9	48.9	48.9	43.4	41.3
Sectoral composition of loans												
Households: Housing loans	53.6	54.7	59.6	62.1	62.2	63.3	63.2	63.3	62.3	62.5	62.9	62.9
Non financial corporates	31.8	31.4	28.6	27.2	27.9	27.7	27.5	27.7	28.0	28.3	28.0	28.0
Inter-bank loans	5.0	5.7	4.0	3.3	3.7	3.4	3.5	3.6	4.3	4.2	4.5	4.5
General government	0.3	0.7	0.8	0.7	0.3	0.3	0.3	0.3	0.3	0.3	0.2	0.2
Other	9.3	7.6	7.1	6.7	6.0	5.4	5.5	5.2	5.1	4.7	4.4	4.3
Profitability												
Net income (yoy percent change)	…	21.5	-11.8	29.9	0.5	-13.9	6.8	-6.7	-1.6	-1.2	1.9	0.1
Return on assets (ROA)	1.2	1.3	0.9	0.8	1.2	1.2	1.2	1.4	1.4	0.8	1.2	0.8
Return on equity (ROE)	18.1	22.4	15.2	13.6	22.6	23.0	27.0	22.9	23.8	12.0	16.7	11.6
Interest margin to gross income	52.8	47.6	61.1	90.4	67.8	64.3	61.4	65.9	59.4	82.5	60.6	81.7
Non interest expenses to gross income	58.7	47.2	52.6	84.4	48.5	47.2	43.3	47.1	42.8	53.8	41.1	57.2
Liquidity												
Liquid assets to total assets	12.1	13.8	14.4	15.5	16.0	17.0	17.1	16.5	17.0	17.6	17.7	17.4
Liquid assets to short term liabilities	27.5	34.0	35.2	38.9	39.2	42.8	42.0	40.2	39.7	41.2	40.6	40.0
Loans to deposits	115.3	115.2	122.2	119.0	117.9	115.8	114.9	114.9	118.9	118.2	114.6	116.5
Liquidity coverage ratio (LCR)									125.1	132.9	124.8	135.5
Exchange rate exposure												
Foreign-Currency-Denominated Liabilities to Total Liabilities	17.2	20.1	20.1	19.1	20.8	19.8	20.3	21.1	23.3	21.8	20.1	20.8
Other												
Large exposures to capital	158.6	185.9	112.8	105.1	107.8	102.0	100.3	99.2	82.0	83.3	77.5	75.4
Housing Index	86	89.8	92.8	104.1	101.3	100.6	107.5	117.6	129	137.1	149.8	150.6

Source: APRA, IMF FSI database.

Table 7. Australia: Status of Key Recommendations of the 2012 FSAP

Recommendation	Progress
Systemic Stability	
Develop a top down stress testing framework and publish results in the Financial Stability Review (RBA).	**Done**, although framework remains under development. (October 2017 FSR)
Introduce higher loss absorbency (HLA) for systemic banks (APRA).	**Done.** In December 2013, APRA announced a D-SIBs surcharge of 1.0 per cent of risk-weighted assets (applied from January 2016). In July 2017, APRA suggested that for the banking sector to be considered 'unquestionably strong', banks (including D-SIBs) would have to increase capital further to a minimum of 10.5 percent (CET1) by 2021.
Financial Sector Oversight	
Intensify on-site supervision of bank liquidity and upgrade daily liquidity reporting requirements to ensure consistency (APRA).	**Done.** The daily liquidity reporting requirement became effective in April 2015. Reporting accuracy has been verified.
Improve the effectiveness of conduct of business supervision for insurance companies (Treasury).	**Done**. Progress was noted during the tailored review of insurance supervision.
Ensure sufficiency and stability of ASIC core funding (Treasury).	**Implementation uncertain.** While ASIC's funding has been supplemented by a levy on market participants, plans are verified by the government annually. In August 2018, the government announced additional funding of A$70.1 million for ASIC over two years from 2018-2019.
Extend risk-based capital requirements, large exposure rules, and reporting requirements for licensed providers of financial services (Treasury/ASIC).	**Not accepted.** The authorities do not support this recommendation.
Crisis Management	
Re-evaluate the merits of ex-ante funding for the Financial Claims Scheme (FCS) (Treasury/CFR).	**Not accepted.** The authorities do not support this recommendation.
Ensure implementation of single customer view (SCV) for authorized deposit-taking institutions (ADIs) (APRA).	**Done.** Completed by January 2014.
Conduct frequent and focused crisis simulations and other forms of resolution testing (APRA/CFR).	**Done.** The authorities are carrying out frequent simulations of distress for major Australian banks, and recently tested cross-border collaboration with New Zealand supervisors under the Trans-Tasman Council.

Appendix I. Banking Sector Stress Testing Matrix (STeM)

Domain		Top-own Stress Test by FSAP Team: Assumptions
		Banking Sector: Solvency Risk
1. Institutional Perimeter	Market share of institutions included	• Largest 10 banks (largest five banks subject to the Major Bank Levy and five mid-sized banks) which hold approximately 88 percent of the domestic banking sector assets.
	Data Source and Baseline Date	• Data Source: Supervisory and publicly-available data • Baseline date: End-2017. • Scope of Consolidation: Level 2 consolidated data (banking business data for banks that have their headquarters in Australia and subsidiary level data for the foreign subsidiaries).
2. Channels of Risk Propagation	Methodology	• Balance sheet-based approach.
	Satellite models for macro-financial linkages	• Satellite models for PDs, LGDs, NPL ratio, and provisioning ratio for credit losses. • Methodology to calculate market losses from holdings of debt instruments (sovereign and other issuers). Haircuts calculated based on modified duration. • Methodology to calculate shocks to bank funding costs. • Non-interest income projected based on nominal GDP growth and expert judgment.
	Stress test horizon	• Three years (2018–2020).
3. Tail Shocks	Scenario analysis	• Scenario-based tests, that assess the impacts on the entire portfolio including the loans and, if applicable, the trading book. • Variables in the scenarios include domestic macrofinancial variables (e.g., GDP, inflation, exchange rate, interest rates, unemployment rate, exchange rate, equity, and house prices), and global variables (the United States and China GDP, USD interest rates, and commodity prices). • Baseline scenario based on the April 2018 WEO projections. • The Adverse Scenario is simulated using IMF's Flexible System of Global Models. • The Adverse Scenario is driven by a combination of external shocks amplified by domestic characteristics, including existing vulnerabilities and policy constraints, see RAM. The three major drivers of the Adverse Scenario are: - Shock 1: Significant slowdown in China and weak growth in advanced economies. - Shock 2: Tightening of global financial conditions due to an abrupt change in risk appetite.

		- Shock 3: A sharp housing market correction. • Under the Adverse Scenario, the Australian economy goes through a V-shaped growth path, with annual GDP growth shocks of -5.5 percent, -3.6 percent, and -1.3 percent. These shocks correspond to a cumulative deviation of real GDP growth of close to 9 percentage points over the first two years compared to the Baseline path (more than 4 standard deviations). • This economic slowdown is accompanied by unemployment shocks of 3.5 percent, 4.7 percent, and 4.7 percent. The cumulative house price decline reaches 31 percent. • The AU$ depreciates by 25 percent in the first year, which only partially reverses in the second and third years leading to a cumulative depreciation of 16 percent at the end of the third year.
	Sensitivity analysis	• Sensitivity analyses conducted to supplement the scenario analysis. • They evaluate impacts of three different single risk factors on the existing capital buffers as of end-2017: - Interest rate risk - Spread increase for securities portfolios - Concentration risk.
4. Risks and Buffers	Risks/factors assessed	• Credit loss from banks' loan portfolios and sovereign exposures, including off-balance sheet credit exposures. • Market loss from valuation adjustments of banks' holding of debt securities and existing net open foreign exchange positions. • Losses from bonds and money market instruments (sovereign and other issuers) in the banking and trading books. • Increase in funding costs.
	Behavioral adjustments	• Passive balance sheet assumption: - the balance sheet growth is identical to the overall credit growth, which is linked to nominal GDP growth (with a 0-floor); - the balance sheet composition remains constant throughout the stress test horizon; - banks build capital only through retained earnings; and - maturing capital instruments are not renewed. • Dividends are paid out by banks that remain adequately capitalized throughout the stress period. The dividend payout ratio is assumed to be 50 percent.

5. Regulatory and Market-Based Standards and Parameters	Calibration of risk parameters	• Projected losses distributed across different asset classes. • Point-in-time credit risk proxies and parameters calibrated by the FSAP team and provided by APRA Phase 2 Stress test results.
	Regulatory/ accounting and market-based standards	• National regulatory framework. • Basel III approach.
6. Reporting Format for Results	Output presentation	• System-wide capital shortfall. • Number of banks and percentage of banking system assets in the system that fall below the capital hurdle. • Impact of different result drivers, including profit components, losses due to realization of different risk factors.

Banking Sector: Liquidity Risk		
1. Institutional Perimeter	Market share of institutions included	• Largest 10 banks (largest five banks subject to the Major Bank Levy and five mid-sized banks) which hold approximately 88 percent of the domestic banking sector assets.
	Data Source and Baseline Date	• Data Source: Supervisory and publicly-available data • Baseline date: End-2017. • Scope of Consolidation: Level 2 consolidated data (banking business data for banks that have their headquarters in Australia and subsidiary level data for the foreign subsidiaries).
2. Channels of Risk Propagation	Methodology	• Cash-flow based liquidity stress test using maturity buckets. • Basel III-LCR and NSFR ratios. • Analyses carried out separately for AUD and USD, based on availability of data.
3. Risks and Buffers	Risks	• Funding liquidity (liquidity outflows). • Market liquidity (price shocks) and haircuts.
	Buffers	• Counterbalancing capacity (HQLA). • Central bank facilities.
4. Tail shocks	Size of the shock	• Simulated run-off rates benchmarked against LCR/NSFR assumptions. • Bank run and dry up of wholesale funding markets, taking into account haircuts to liquid assets.
5. Regulatory and Market-Based Standards and Parameters	Regulatory standards	• National regulatory framework. • LCR: 100 percent. • NSFR: Basel Committee on Banking Supervision (2014), "Basel III: The Net Stable funding ratio" Basel, October 2014.
6. Reporting Format for Results	Output presentation	• System-wide liquidity gaps. • Survival period by bank, number of banks that can still meet their obligations.
Banking Sector: Interconnectedness		
1. Institutional Perimeter	Institutions included	• Largest 10 banks (largest five banks subject to the Major Bank Levy and five mid-sized banks) which hold approximately 88 percent of the domestic banking sector assets. • Major nonbank FIs.
	Data Source and Baseline Date	• Source: Supervisory data. • Baseline date: End-2017. • Scope of Consolidation: Level 2 consolidated data (banking business data for banks that have their headquarters in

		Australia and subsidiary level data for the foreign subsidiaries).
2. Channels of Risk Propagation	Methodology	• Balance sheet-based interbank model by Espinosa-Vega and Solé (2010). • Market price-based spillover model by Diebold and Yilmaz (2014). • Cross-border network model by Espinosa-Vega and Solé (2010).
3. Risks and Buffers	Risks	• Credit and funding losses related to interbank cross-exposures (and cross-border banking exposures).
	Buffers	• Banks' own capital and liquidity buffers.
4. Tail shocks	Size of the shock	• Pure contagion: Assumed failure of institutions.
6. Reporting Format for Results	Output presentation	• Network analyses with supervisory data. - System-wide capital shortfall. - Number of undercapitalized and failed institutions, and their shares of assets in the system. • Evolution and direction of spillovers.

Appendix II. Key Macroprudential Policy Measures, 2014-18[1]

Date	Authority	Measures

Dec 2014	APRA	Introduce Prudential Practice Guide (APG223), which outlined APRA's expectations for sound mortgage lending practices:
		
		• Speed limit curtailing annual growth in a bank's investor housing lending to 10 percent;
		• Serviceability assessments for new mortgage lending to include interest rate buffers of at least 2 percentage points above the effective variable rate applied for the term of the loan, and a minimum floor assessment rate of at least 7 percent to allow borrowers to accommodate future increases in interest rates; and
		• Supervisors to be alert to high levels of higher-risk mortgage lending with:
		    • high LVR and/or loan-to-income ratio
		    • owner-occupier loans with lengthy interest-only periods

Dec 2014	ASIC	ASIC commenced a review of interest-only home loans and published Report 445. The review found lenders had been falling short of their responsible lending obligations in the provision of interest-only loans and all 11 participating lenders agreed to change their practices in line with ASIC's recommendations
2015	APRA	To assess and compare lending standards across ADIs, in early 2015, APRA request a number of the larger ADIs to complete a Hypothetical Borrower Exercise (HBE), providing serviceability assessments for four hypothetical mortgage borrowers—two owner-occupiers and two investors—using their policies in place as at December 31, 2014. In a second HBE conducted in late 2015, ADIs that were the least conservative in December 2014 generally reported a significant drop in calculated net income surplus using their September 2015 policies.
Jul 2015	APRA	Announced an increase in capital adequacy requirements for residential mortgage exposures for ADIs accredited to use the internal ratings-based (IRB) approach to credit risk, effective from July 1, 2016. This change requires an increase of average risk weights to at least 25 percent from about 16 percent, equivalent of increasing minimum capital requirements for major banks by approximately 80 basis points.

[1] See 2017 Australia Article IV Consultation (pp. 14-18) for tax or capital flow measures enacted by individual states that relate to housing market vulnerabilities (https://www.imf.org/~/media/Files/Publications/CR/2018/cr1844.ashx).

Jan 2016	APRA	Countercyclical capital buffer (Basel III) was incorporated into the capital standards for locally incorporated ADIs. APRA has determined that the Australian jurisdictional countercyclical capital buffer applying from January 1, 2016 will be zero percent of risk-weighted assets. This rate will remain in force until APRA determines otherwise.
Oct 2016	APRA	Released for consultation a revised draft of Prudential Practice Guide APG 223 Residential Mortgage Lending to incorporate measures announced or communicated to ADIs since 2014.
2016	APRA	Conducted a thematic review of commercial property lending over 2016.
2016	ASIC	ASIC published Report 493 following a review of the lending practices of 11 large mortgage brokers. The review was intended to promote responsible lending and consumer confidence in the credit industry.

Mar 2017	APRA	• Limit the flow of new interest-only lending to 30 percent of new residential mortgage lending,[2] and within that:
		  • Strict internal limits on the volume of interest-only lending at loan-to-valuation ratios (LVRs) above 80 percent; and
		  • Strong scrutiny and justification of any instances of interest-only lending at an LVR above 90 percent;
		• Lending to investors to comfortably remain below the benchmark of 10 percent growth (first introduced in 2014). An ADI operating in excess of this level will prompt an immediate review of the adequacy of the ADI's capital requirements;
		• Serviceability metrics, including interest rate and net income buffers, to be set at appropriate levels for current conditions; and
		• Lending growth in higher risk segments of the portfolio, e.g., high LTI loans, high LVR loans and very long-term loans, continue to be restrained.

2017	APRA	• Targeted review of mortgage origination controls—Large ADIs
Apr 2017	ASIC	• ASIC announced the findings of a review of practices at eight lenders in relation to inquiring into consumer's living expenses when assessing their capacity to make repayments. ASIC also announced it had commenced a project to examine whether lenders and mortgage brokers were recommending interest-only loans in appropriate circumstances.
2018	APRA	• Targeted review of mortgage origination controls—Small ADIs.

[2] ADIs with levels of interest-only loans below the benchmark are expected to remain below it and not increase the share of new interest-only loans materially from current levels.

Apr 2018	APRA	• The 10 percent investment lending growth benchmark will no longer apply from July 1, 2018 where an ADI has been operating below it for at least the past 6 months, and the ADI's Board has provided the required assurance to APRA on both lending policies and practices: • Interest rate buffers comfortably above 2 percentage points over the loan product rate, and interest rate floors comfortably above 7 percent; • application of these interest rate buffers and floors to both a borrower's new and existing debt commitments, with sufficiently conservative proxies used where necessary; • discounts on uncertain and variable income, with haircuts of at least 20 percent for most types of non-salary income and expected rental income; and • for interest-only loans, an assessment of serviceability for the period over which the principal and interest repayments apply (i.e., excluding the interest-only term); • prudently managing overrides to lending policies, with risk tolerances set by the Board on the extent of exceptions to serviceability policy (negative serviceability) and serviceability verification waivers; and • developing internal risk appetite limits on the proportion of new lending at very high debt to income levels (where debt is greater than six times a borrower's income), and policy limits on maximum debt-to-income levels for individual borrowers.

Appendix III. Report on the Observance of Standards and Codes (ROSC)

Basel Core Principles of Effective Banking Supervision

A. Introduction

1. **At the request of the Australian authorities, this assessment of the implementation of the Basel Core Principles for Effective Banking Supervision (BCP) is part of the Financial Sector Assessment Program (FSAP) undertaken by the International Monetary Fund (IMF) during June 2018.[1]** It reflects the regulatory and supervisory framework in place as of the date of the completion of the assessment. It is not intended to represent an analysis of the state of the banking sector or the crisis management framework, which are addressed in the broader FSAP exercise.

2. **An assessment of the effectiveness of banking supervision requires a review of the legal framework, and a detailed examination of the policies and practices of the institution(s) responsible for banking regulation and supervision.** In line with the BCP methodology, the assessment focused on banking supervision and regulation performed by the Australian Prudential Regulation Authority (APRA) and did not cover the specificities of regulation and supervision of other financial institutions.[2]

B. Background Information and Assessment Methodology

3. **This assessment was performed according to the revised BCP methodology issued by the Basel Committee on Banking Supervision (BCBS) in September 2012.[3]** Since the previous assessment conducted in 2012, the BCP standard was comprehensively revised. The BCPs represent a framework of universally applicable minimum standards for sound supervisory practices. It is, therefore, important to note that this assessment cannot and should not be compared to the previous exercise, as the revised BCPs have a heightened focus on corporate governance and risk management, their practical application by the supervised institutions, and the assessment performed by the supervisory authority. The revised BCPs also place additional emphasis on the effectiveness of a supervisory framework not only through providing supervisors with the necessary powers to address safety and soundness concerns but also by heightening the focus on the actual use of those powers in a forward-looking approach.

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[1] The assessment team included Rachid Awad (IMF) and Tim Clark (IMF external expert).

[2] See the accompanying FSAP publication of the full assessment: "Detailed Assessment of Observance: Basel Core Principles for Effective Banking Supervision."

[3] Basel Committee on Banking Supervision: *Basel Core Principles for Effective Banking Supervision*, September 2012: http://www.bis.org/publ/bcbs230.pdf

4. The Australian authorities opted to be assessed and graded against both the essential and additional criteria, the highest standards of supervision and regulation. To assess compliance, the BCP Methodology uses a set of essential and additional assessment criteria for each principle. The essential criteria (EC) provide the foundational elements on which to gauge full compliance with a Core Principle (CP). The additional criteria (AC) are recommended best practices against which the authorities of some more complex financial systems may agree to be assessed and rated. The assessment of compliance with each principle is made on a qualitative basis, using a five-part grading system: compliant, largely compliant, materially noncompliant, noncompliant, and not applicable. The assessment of compliance with each CP requires a judgment on whether the criteria are fulfilled in practice. Evidence of effective application of relevant laws and regulations is essential to confirm that the criteria are met.

5. An assessment of compliance with the BCP is not, and is not intended to be, an exact science. The assessment criteria should not be seen as a checklist approach to compliance but as a qualitative exercise involving judgement by the assessment team. While compliance with the BCP can be met in different ways, compliance with some criteria may be more critical for the effectiveness of supervision, depending on the situation and circumstances in a given jurisdiction. Nevertheless, by adhering to a common agreed methodology, the assessment should provide the Australian authorities with an internationally consistent measure of the quality of their banking supervision framework in relation to the BCP.

6. The standards were evaluated in the context of the Australian banking system's structure and complexity. The BCP must be capable of application to a wide range of jurisdictions whose banking sectors will inevitably include a broad spectrum of banks. To accommodate this breadth of application, according to the methodology, a proportionate approach is adopted, both in terms of the expectations on supervisors for the discharge of their own functions and in terms of the standards that supervisors impose on banks. An assessment of a country against the BCP must, therefore, recognize that its supervisory practices should be commensurate with the complexity, interconnectedness, size, risk profile and cross-border operations of the banks being supervised. The assessment considers the context in which the supervisory practices are applied. The concept of proportionality underpins all assessment criteria. For these reasons, an assessment of one jurisdiction will not be directly comparable to that of another.

7. The assessment team reviewed the framework of laws, regulations, manuals and other materials mainly provided by APRA. The team held extensive meetings with APRA officials and additional meetings with the Australian Treasury, the RBA, AUSTRAC, ASIC, banks, external audit firms, and the Australian Banking Association. The authorities provided a BCP self-assessment, responses to additional questionnaires, and access to supervisory documents and files, staff and systems.

C. Overview of the Institutional Setting and Market Structure

8. **APRA is responsible for the prudential regulation and supervision of Authorized Deposit-taking Institution (ADIs) in Australia.** APRA is also responsible for the prudential oversight of general, life, and private health insurance companies, and most of the superannuation industry. 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 stability in Australia.

9. **Australia's financial regulatory framework include three other financial sector authorities responsible for financial regulation.** These are as follows:

- The Treasury has responsibility for advising the Government on financial stability issues and on the legislative and regulatory framework underpinning financial system infrastructure.
- The RBA is Australia's central bank responsible for monetary policy as well as the safety and efficiency of the payments system and for overall financial stability.
- ASIC is responsible for the registration and supervision of corporations and, in the financial sector, for licensing of financial service providers, credit providers and market conduct.

10. **In addition, the Council of Financial Regulators (CFR) is the primary coordinating body for Australia's main financial sector agencies.** It comprises the RBA (Chair), APRA, ASIC and the Treasury. The CFR ensures a structured, multilateral coordination process across the relevant agencies. However, each member is fully responsible for discharging its own responsibilities within its statutory mandate. The CFR's objectives are to promote stability of the Australian financial system and contribute to the efficiency and effectiveness of regulation.

11. **AUSTRAC administers Australia's anti-money laundering and counter-terrorism financing laws.** It is Australia's Financial Intelligence Unit to fight serious and organized crime and terrorism financing. It is also Australia's regulator for anti-money laundering and countering the financing of terrorism (AML/CTF), overseeing the compliance of more than 14,000 Australian businesses ranging from major banks and casinos to single-operator businesses.

12. **Banks and other ADIs are the most significant component of the system.** They represent nearly 67.6 percent of all APRA-regulated financial system assets, equal to around 2.3 times the level of nominal GDP. Banks accounted for 98.8 percent of ADI assets in March 2018. The general insurance, life insurance and superannuation industries together account for around 32.4 percent of total APRA-regulated financial assets.

13. **Australia's four major domestic banks dominate the ADI sector, accounting for 76.4 percent of total ADI assets in March 2018.** Each of the major banks has consolidated group assets that rank them among the top 50 banks worldwide, but their businesses are not global and generally focus on the domestic and New Zealand markets. The rest of the ADI sector comprises 4

mid-sized banks and a few other small Australian owned banks (9.8 percent of total ADI assets), and 51 foreign-owned banks, 44 branches, and 7subsidiaries (12.6 percent of total ADI assets). Building societies and credit unions account for the remaining 1.2 percent of total ADI assets in Australia with their share gradually declining over the last few decades.

D. Preconditions for Effective Banking Supervision

14. The Australian economy is experiencing relatively benign macroeconomic conditions with growth trending upwards while inflation remains low. See the section on Background and Vulnerabilities earlier in the FSSA for more details about the macroeconomic policies and situation in Australia.

15. The CFR is the coordinating body of the main financial sector agencies involved in promoting financial stability. Both the RBA and APRA have specific mandates to promote financial system stability. The CFR is not a statutory body and hence does not have a legal personality, nor does it have powers separate from its member agencies. Its members share information and views on developments in the financial system, discuss regulatory reforms and other issues related to areas where responsibilities overlap, and coordinate responses to potential threats to financial system stability.

16. Australia has a well-developed public infrastructure, including an independent judiciary system, comprehensive business laws and standards, and a number of dispute resolution mechanisms. There is a strict separation between the Judiciary on the one hand, and the Parliament and Executive on the other. Australia's legal system provides a secure framework for the operation of contracts between parties and offers a transparent and fair mechanism for resolving disputes about contracts. Australia has a number of options available for resolving disputes without going to a court or tribunal. These include mediation, conciliation, conferencing, neutral evaluation, and arbitration.

17. Australia has comprehensive requirements for independence of auditors and accounting and auditing standards that are aligned to international standards. The Corporations Act contains extensive requirements for auditor independence. Auditors and audit firms must be registered with ASIC before they can conduct an audit for Corporations Act purposes. ASIC is also responsible for auditor oversight and ensures audit firms are complying with their auditor independence and audit quality obligations. Australia adopted Australian equivalents to International Financial Reporting Standards (A-IFRS) for reporting periods beginning on or after January 1, 2005. Accounting standards in Australia are made by the Australian Accounting Standards Board (AASB) who is involved in the IFRS standard-setting process and reviews the IFRS text to ensure they are appropriate for Australia's legal, economic, and institutional environment. Australian auditing standards are made by the Auditing and Assurance Standards Board (AUASB) and are based on the International Standards on Auditing.

18. The legislative reforms enacted through the Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act 2018 significantly expanded crisis

resolution powers, and more clearly defined APRA's mandate regarding resolution planning. These reforms also provide APRA with formal direction powers related to resolution planning and removing barriers to the resolvability of regulated entities or groups. Such a direction could require an ADI to address barriers to orderly resolution, such as making changes to ADIs' systems, business practices or operations in order to make them more resolvable. APRA intends to develop its formal prudential framework for resolution planning, with a view to starting consultation on a prudential framework on recovery and resolution planning in 2019. APRA has been conducting work on recovery planning of banks where it initiated a pilot recovery planning exercise for large and medium banks and followed it with a thematic review focused on large banks.

19. In October 2008, the Australian Government established the Financial Claims Scheme (FCS) for ADIs and general insurers. The FCS is post-funded. The FCS used to apply to deposit balances up to A$1 million per account-holder per ADI, which was set in the context of the global financial crisis and was intended to reinforce depositor confidence. Based on the CFR's recommendation, the Government reduced the FCS limit to A$250,000 from February 1, 2012.

20. Australia has a well-established framework governing company disclosure requirements and competition issues. Disclosure requirements are contained in the Corporations Act, and listed companies must also comply with the supplementary requirements in the relevant listing rules. Each financial year, entities that are subject to disclosure requirements must prepare a financial report and a directors' report (containing information about operations, activities, and a range of other matters). There are similar requirements for half-year financial and directors' reports. Australian competition law is contained in the Competition and Consumer Act which applies to all industries, including the financial sector. The Australian Competition and Consumer Commission (ACCC) is Australia's competition regulator and is responsible for enforcing the prohibitions on anti-competitive conduct contained in the Competition and Consumer Act.

E. Main Findings

21. Since the previous FSAP, APRA has kept an active pace in implementing reforms to enhance the resilience of the Australian financial system. APRA has implemented key elements of the international regulatory reform agenda, at times going beyond the agreed minimum standards to provide additional resilience. APRA has focused on strengthening the capital framework, implementing Basel III liquidity standards, reinforcing sound mortgage lending standards, improving governance and accountability, and strengthening crisis management and preparedness. Other broad policy reforms have been also enacted, including on risk management and governance and introducing a phased approach to licensing. While APRA has been aligning its resources to evolving market needs by developing a new risk and data analytics function, it would need to continue enhancing its resources and skillset to match the evolution in banking services and risks. APRA has also increasingly focused its risk-based supervisory activities on reviewing banks' practices and underwriting standards in the area of residential mortgages and commercial real estate lending, in addition to other risk areas.

22. **APRA has achieved a high degree of compliance with the BCPs.** Notwithstanding the revision to the BCP methodology, which raised the standards for achieving supervisory objectives, APRA has demonstrated clear progress in strengthening the effectiveness of supervision. This is most evident in the work of APRA on supervision of liquidity and credit risk, as well as the enhancement of banks' capital adequacy requirements, including the planned implementation of an "unquestionably strong" capital framework in line with the recommendations of the 2014 Financial System Inquiry (FSI). APRA could further enhance its supervisory approach by: (i) performing periodic more comprehensive assessments of banks' risk management and governance frameworks, (ii) incorporating banks' management of non-financial risks in its supervisory assessment, and (iii) applying enforcement measures in a more active way.

Responsibilities, Objectives, Powers, Independence (CP1-2)

23. **APRA has broad powers and clear responsibilities underpinned mainly in the Banking Act and the APRA Act.** In addition to promoting financial stability, the APRA Act states that this objective is to be pursued while balancing other objectives such as financial safety, efficiency, competition, contestability and competitive neutrality. This can be a challenging balance to make but APRA seems focused on financial stability even as the banking sector is becoming more open to new types of activities and to more competition. Therefore, it may be useful to consider clarifying further the primary nature of APRA's financial stability objective and that the other objectives are subordinate to the financial stability mandate.

24. **APRA has clear powers to set and enforce prudential standards, but these can be disallowed by the Parliament.** APRA has been applying a risk-focused and more proportionate approach to its regulation and supervision. However, the fact that its prudential standards can be disallowed by the Parliament weakens APRA's prudential standard setting powers in achieving its statutory mandate even if this case seems exceptional and has not taken place to date. Having said that, APRA has successfully introduced many regulatory reforms over the last few years to implement international standards and the recommendations of the 2014 FSI.

25. **APRA performs its operations based on a robust governance framework and a solid accountability mechanism.** APRA has set internal policies and processes that allow efficient decision making in normal and stressed times. Governance is strengthened by internal risk management and internal audit committees consisting of a majority of independent members. APRA is subject to a strong accountability framework to the Parliament, the government, and the general public.

26. **While APRA may currently have a reasonable degree of independence to meet its statutory goals, there are some constraints that could potentially impact this independence.** The power granted to the Minister to issue directions to APRA about policies it should pursue is a matter of potential concern (since it could lead to a direct or indirect interference in APRA's prudential standard setting powers) even if this power has never been exercised so far. Since objectives can be misaligned at times, it is always better to remove any potential loopholes in the framework. In addition, the APRA Act does not require public disclosure of the reasons for removal

of an APRA Member. The statement of expectations (SOE) issued by the Government to APRA and APRA's reply in its statement of intent (SOI) have served as a platform to publicly present the government's priorities and how APRA would respond to them. Notwithstanding, it may be useful to clarify the objective of the SOE and ensure that it does not direct APRA's priorities in a way that could conflict with its primary mandate of financial stability.

27. **A more flexible and autonomous budget process and a relaxation of the constraints on the framework for staff employment and remuneration would allow APRA to better discharge its increasing responsibilities.** While noting that APRA has received additional budgets over the recent years to implement new initiatives and projects, APRA is subject to "efficiency dividends", and additional budget proposals (new policy proposals) need approval by the Government. There is some forward view of expected funding, but uncertainty over the medium-term budget may present difficulties for APRA's resource planning. Therefore, it is important to provide APRA with higher flexibility and more autonomy in its budget planning and approval processes. In addition, the constraints on APRA's staff employment and remuneration framework, such as the Australian Public Service (APS) workplace bargaining policy, limit APRA's potential to attract and retain high quality staff. While some remuneration levers and individual flexibility arrangements seem to be available under APRA's current enterprise agreement, the policy is creating challenges for APRA to attract and retain the highly specialized skills that it currently needs to better oversee the evolving risks in Australia's banking sector, including those related to digital business models and cyber risk.

Licensing, Change in Control, and Acquisitions (CP 4-7)

28. **APRA has a very thorough licensing framework.** In assessing licensing applications, APRA follows criteria that are consistent with ongoing supervision requirements. It also reviews the proposed ADI strategy and financial viability, its business plan, the suitability of its owners and management, its governance framework, and its risk management framework.

29. **APRA has recently introduced a phased licensing regime to open the way for new market entrants.** The phased (or restricted) licensing regime will allow a more gradual approach to licensing that ensures closer follow-up by APRA throughout the licensing phase. The new ADIs are expected to have digitally focused business models. APRA has put limitations on the operations of these restricted licensees and requires them to have a two-year conversion strategy (to become full ADIs) and an exit strategy (with some resolution funds). APRA is recommended to adopt prudence as it implements this new approach and further develop the capacity and skills of its staff to oversee the new digital services offered by these firms.

30. **The regime for significant change in ownership is another area where APRA's independence and powers warrant strengthening.** The change in significant ownership of banks is governed by the Financial Sector Shareholdings Act (FSSA) which gives the Treasurer the power to decide on changes in ownership stakes of more than 15 percent. While the Treasurer has delegated APRA for approving changes in significant ownership for banks with assets of less than A$ 1 billion, this is only a partial delegation and can be withdrawn if the Treasurer decides so. In addition, the criteria for approval of a significant change in ownership are based on "national interest"

considerations which are not defined in the FSSA and may not give due consideration to the fitness, propriety and suitability of the significant shareholders. While the Treasurer practically seeks APRA's advice about any prudential concerns in relation to decisions affecting banks with assets exceeding A$1 billion, such advice is not binding.

Supervisory Cooperation and Cross Border Supervision (CP3,12,13)

31. APRA has a good level of interaction with the various domestic authorities involved in regulating and supervising financial sector issues, but these relationships can be further enhanced with some agencies. APRA has a good level of cooperation with the RBA on various financial stability and systemic risk issues. This cooperation also takes place at the CFR which provides a platform for discussion of financial stability topics among the main financial regulators. Cooperation with ASIC has been intensifying over the recent period given the increasing topics of mutual interest, including on market conduct and governance issues. Building a more thorough interaction with ASIC will help further enhance APRA's understanding of risks in the financial sector and the implications for APRA's risk assessment of ADIs, particularly in regard to the new Banking Executive Accountability Regime (BEAR). On the other hand, cooperation between APRA and AUSTRAC has not been as extensive and is currently primarily focused on high-level issues. This relationship should, therefore, be brought to a new operational level involving different layers of the agencies' hierarchies so that more substantive and entity-specific issues can be discussed on a much more frequent basis.

32. APRA has developed close working relationships with foreign regulators, particularly with the Reserve Bank of New Zealand (RBNZ), given the significance of banks' cross-border operations in New Zealand. APRA conducts onsite reviews, particularly for the major banks' subsidiaries in New Zealand and has contacts with other relevant regulators. APRA has conducted supervisory colleges for two of its banks, but the last one was about three years ago. While recognizing the shrinking global footprint of some Australian banks, there are still some Australian banks with a significant cross-border presence which may benefit from active supervisory colleges. In addition, APRA should implement its plan to develop a resolution planning framework and coordinate with foreign regulatory authorities to develop resolution plans for its major cross-border banking groups.

33. APRA consolidated supervisory approach is well integrated in its supervisory practices and activities. Prudential standards and financial data are collected on a consolidated basis. APRA's recent introduction of a governance and risk management framework for conglomerates is a positive step. However, APRA should enhance its understanding and reviews of the risks that banks and banking groups can be exposed to as a result of the non-banking activities in the wider financial group and be prepared to take actions as needed.

Supervisory Approach (CP 8-11)

34. APRA's supervisory approach is based upon the fundamental premise that it is the responsibility of banks' boards and management teams to ensure the firm is operating in a prudent manner and in compliance with applicable laws and prudential standards. This is supported by a host of formal requirements and a reasonably full set of effective supervisory processes and tools with which to assess the firms and an appropriate set of authorities with which to enforce compliance when that is necessary.

35. A key challenge of this approach is achieving the right balance between relying on firms' attestations/reporting and supervisors verifying with a high degree of confidence that the most critical governance, risk management and control processes are in place and effective. APRA's well-conceived and well-executed risk-focused approach to supervising the banks is a good starting point from which to address that challenge. However, APRA's supervisory oversight may benefit from a greater focus on the largest firms and on periodic 'end-to-end' reviews across the firms to review their systems and practices. APRA needs also to develop further its analysis of emerging risks across the system and continue to refine banks' reporting requirements to that end.

36. Another challenge in APRA's approach is finding the right balance between a desire to maintain good working relationships with firms and the willingness to take strong supervisory actions when needed. APRA's preferred approach is working with the firms to get them to address supervisory concerns and/or weak practices. While this is not unique to APRA, it is often reasonable as long as it does not lead to delayed identification or remediation of material weaknesses at large banks. There seems to be scope for APRA to escalate the severity of its corrective actions in a quicker and more active way if the concerned bank is not effectively cooperating. This includes escalation from 'recommendation' to 'requirement' and also a more active use of formal corrective actions, such as directions.

Corporate Governance and Internal Audit (CP 14, 26)

37. APRA sets appropriate bank governance requirements, but assessments of board and senior management effectiveness could be better informed by weaknesses observed in reviews of risk management and controls and should be given greater consideration in the overall ratings of the firms. The PAIRS assessment process covers all the necessary areas but may, at times, obscure the understanding of the root causes of, or ultimate accountability for, problems at a firm. This may weaken the articulation of expectations, particularly given APRA's supervisory philosophy which puts a strong emphasis on the role of the board and senior management.

38. APRA should better incorporate into assessments of governance the findings from assessments carried out by AUSTRAC and ASIC on AML/CTF and conduct issues, respectively. As the supervisor with responsibility for assessing overall risk management and governance practices in the banks, APRA's supervision process for governance should incorporate assessment of conduct risk and AML/CTF practices where material. Increased cooperation with both agencies, as mentioned above, would foster the process of developing a more comprehensive assessment of banks' risk profiles.

39. APRA could strengthen the emphasis on assessing the work of the internal audit function to inform APRA assessments of control processes. APRA does not collate the conclusions from its supervisory activities into a formal risk assessment of the internal audit function and has not performed an in-depth evaluation of the overall effectiveness of internal audit functions across the major banks for a number of years. Given the responsibilities and expectations placed on boards of directors, a greater emphasis on all aspects of internal audit effectiveness as an important element of governance by the board is warranted. In addition, the prudential standards should outline more comprehensively the main criteria and requirements for an effective internal control environment and internal audit function.

Capital (CP 16)

40. APRA applies a conservative regulatory capital regime and ADIs exhibit relatively strong regulatory capital ratios. APRA could increase the focus on the processes that support and inform the largest firms' decision making around capital planning by undertaking more in-depth reviews of the inputs into and controls around ICAAPs and stress testing programs. The recent move towards putting in place 'unquestionably strong' capital benchmarks on top of the full and conservative use of Basel risk-based standards is a positive step in strengthening capital in the industry.

Risk Management (CP 17-25)

41. Since the last FSAP assessment in 2012, APRA has issued an integrated risk management standard (CPS 220). The standard requires regular attestations and reporting of its effectiveness by the board and management relative to the size and risk profiles of the firms. This has been a positive development as firms are more focused on the importance of complying with prudential standards around risk governance, including risk management and controls requirements.

42. Supervision of risk management places a strong emphasis on the responsibilities of the board. This is well supported by a solid, if understaffed in some areas, supervision program for assessing risk management across the major risk categories. The increased use of 'thematic reviews' looking at the same set of risks and risk management practices across groups of firms is a good practice, which should continue to be utilized to the greatest extent possible for the largest firms.

43. APRA's supervisors have been increasingly assessing banks' credit risk management framework and practices, particularly focusing on assessing banks' underwriting practices and serviceability assessments. While these reviews should be continued to ensure credit risk management gaps are being addressed, APRA should also consider performing more thorough periodic analysis of banks' credit risk management frameworks, particularly for the major banks. The current risk reviews on concentration risk should be further enhanced to examine the impact of concentration in types of collateral, particularly real estate. APRA should also go ahead with its plan to revise its prudential standards on credit quality (particularly in relation to the treatment of problem assets) and related parties to be further aligned with international standards.[4]

44. Since the last FSAP, APRA has taken many actions to strengthen its capacity, tools, and prudential framework in relation to oversight of liquidity risk. It has established a team of risk specialists dedicated to oversight of liquidity risk. It has also implemented the LCR and the NSFR requirements for major banks. The October 2017 RCAP confirmed that Australia's Basel III LCR is overall compliant with Basel requirements. In addition, the prudential framework provides a thorough set of requirements and guidance in relation to liquidity risk management.

Disclosures and Transparency (CP 27-28)

45. APRA regulations and the Corporations Act require significant disclosures that enable the public to understand the risks in the banks and banking industry. APRA requires a wide range of Pillar 3 disclosures including quantitative and qualitative elements. Banking statistics are made available to the public on a monthly and quarterly basis. All Australian incorporated banks are required to issue audited financial reports to the public on an annual and half-yearly basis. ASIC reviews external audits, including with respect to asset valuations, and carries out ongoing surveillance of financial reporting.

Abuse of financial Services (CP 29)

46. While AUSTRAC has the authorities by law and rule, and the supporting processes needed to oversee money laundering and anti-terrorism financing, the significant reliance on firms self-identifying and reporting weaknesses has not always proved effective. Recent events have revealed that some banks processes for ensuring compliance were not working as reported, which resulted in failures to comply with rules and laws. AUSTRAC should consider steps it can take to increase the confidence it can get from firm's internal reporting, including taking swift and formal action when it discovers banks' control processes for ensuring compliance are missing key areas. This would likely require an end-to-end thematic review of these processes at the major banks on a periodic basis.

[4] In an effort to align the related parties framework with international standards, APRA released a discussion paper for consultation on July 2, 2018, outlining revisions to its prudential standard on associations with related entities and the associated reporting standard on exposures to related entities.

47. Appendix Table 1 offers a principle-by-principle summary of the assessment findings and conclusions.

Appendix Table 1. Summary Compliance with the BCPs
Principle 1. Responsibilities, objectives and powers
APRA has broad powers and clear responsibilities underpinned mainly in the Banking Act and APRA Act. The responsibilities of other agencies in relation to financial regulation and stability are also clear and well defined. APRA's objective of promoting financial system stability needs to be achieved by balancing other wider objectives such as financial safety, efficiency, competition, contestability, and competitive neutrality. APRA is focused on its financial stability objective while looking at promoting the other objectives too. However, this is a challenging balancing act and clarifying further the primary nature of APRA's financial stability mandate and the subordinate nature of the other objectives may help APRA in better achieving that balance. APRA has broad corrective action and sanction powers. Laws and regulations provide APRA with broad powers to set and enforce prudential regulations to support delivery of its statutory mandate. However, these prudential standards can be disallowed by the Parliament, although this case has not happened in practice. While this parliamentary veto powers can be considered part of the checks and balances in the Australian democratic process, it could potentially lead, in extreme situations, to the failure of APRA to introduce or change a key prudential standard, which could potentially limit APRA's ability to achieve its primary objectives.
Principle 2. Independence, accountability, resourcing and legal protection for supervisors
The APRA Act provides APRA with broad operational powers to deliver its functions. The Banking Act also provides APRA with a range of regulatory powers to license banks, regulate them, and apply corrective actions. However, the APRA Act grants the minister power to give APRA a written direction about policies it should pursue, or priorities it should follow, in performing or exercising any of its functions or powers. These powers could cause potential limitations over APRA's independence. While this power has never been exercised to date, it is always a potential concern. This written direction by the minister adds another potential constraint, on top of the Parliamentary veto powers (discussed in CP 1), which could potentially limit APRA's independence in relation to prudential standard setting. While these constraints can be considered part of the checks and balances in the Australian democratic process, they could potentially lead, in extreme situations, to the failure of APRA to introduce or change a key prudential standard, which could potentially limit APRA's ability to achieve its primary objectives. In addition, the APRA Act does not require public disclosure of the reasons for removal of an APRA Member if it happens in practice. While APRA is funded primarily by industry levies, the budget is set annually by the government after consideration of funding requests by APRA members. The need for APRA to submit a new proposal for funding increases and the "efficiency dividend" imposed by the government pose constraints that could potentially limit the flexibility of APRA in smoothly performing its operations and implementing its initiatives and getting clearer medium-term visibility about its budget.

Appendix Table 1. Summary Compliance with the BCPs (continued)
APRA's employment framework has been since 2014 subject to the APS Workplace Bargaining Policy. This policy sets many constraints on staff remuneration, particularly an annual cap on remuneration increase, and subjects the staff employment framework to a periodic approval, every three years. These limitations may not have impacted yet the overall ability of APRA to attract good and competent supervisory skills at the general level. However, they are increasingly limiting APRA's ability to retain high quality staff and causing difficulties in attracting highly specialized skills that are in high demand, such as in cyber risk and advanced risk analytics.
Principle 3. Cooperation and collaboration
APRA has cooperation agreements with various domestic and foreign supervisors. It also has a good framework for exchanging and dealing with confidential information. Cooperation has been improving lately with AUSTRAC but there is scope to significantly step it up.
Principle 4. Permissible activities
The Banking Law defines the term "banking business" and includes a general definition of the activities that can be carried on as banking business. While the Banking Act reserves the activities of taking deposits to institutions that are licensed as ADIs, some exemptions can be granted in this respect. Since the 2012 FSAP, the operating conditions of those exempted entities have been significantly tightened and their size has considerably decreased.
Principle 5. Licensing criteria
APRA has a very thorough licensing framework and process. In assessing licensing applications, APRA follows criteria that are overall consistent with ongoing supervision requirements. The new restricted licensing regime increases competition in the market and eases the market entry of firms with new business models. APRA has taken measures to limit potential financial stability issues associated with this new type of entities. APRA is aware of the risks associated with the change in the law allowing all ADIs to use the term "bank" and ensures that proposed ADIs have the capacity to meet prudential capital requirements, with the initial capital of restricted ADI taken as a minimum.
Principle 6. Transfer of significant ownership
APRA's power to review, reject, and impose prudential conditions on proposals to transfer significant ownership or controlling interests in ADIs is very limited. In fact, the FSSA has given the Treasurer the power to approve changes in ownership of more than 15 percent and this decision is made on "national interest" considerations. While the Treasurer has delegated the powers to APRA for banks with assets of less than A$1 billion, this delegation can be potentially withdrawn and does not provide APRA with adequate powers to oversee the suitability of the major shareholders in the overall banking sector, particularly the larger ADIs. In addition, no definition is provided under the FSSA for "national interest" criteria. And APRA does not receive regular reporting about the major shareholders of banks to keep itself updated about the actual and ultimate main shareholders in the banking sector.

Appendix Table 1. Summary Compliance with the BCPs (continued)
Principle 7. Major acquisitions
APRA Prudential Standard 222 establishes clear provisions on acquisitions and investments that need prior supervisory approval or prior notification to APRA. While regulations and prudential standards do not exactly define the criteria by which APRA assesses individual proposals, APRA's internal guidelines provide a detailed list of criteria and considerations to make when the supervisors assess individual cases, that include thorough prudential considerations among others.
Principle 8. Supervisory approach
APRA has a strong supervisory approach that provides for the identification of the significant risks facing the industry and individual banks, and prudential standards covering key governance, risk management and control practices across regulated banks and banking groups. The combination of onsite and offsite reviews and analyses allows for issues to be identified both through direct interaction with supervised firms and through analyses of individual firms and the industry more broadly. The input from risk specialists and offsite analysts conducted by the RDA Division, combined with the knowledge of the 'frontline' supervisors on the specific practices and strategies of individual firms, provides for a broad set of perspectives when considering supervisory direction and strategy. To support the requirements placed on the board and management, APRA requires a variety of periodic reporting from firms on the effectiveness of their processes. This puts a high degree of importance on the strength of the practices used for carrying out these reviews and on the level of comfort APRA can take from the firms' self-reporting on the effectiveness of their processes. More in-depth periodic reviews of key control processes can be done to complement the self-reporting and increase the confidence level in key areas of control. A supervisory regime for the assessment of resolvability is still a work in progress. APRA is working on the design of a supervisory regime for resolution planning and working closely with other agencies on processes for cooperation and collaboration in the event of a resolution situation for a major bank.
Principle 9. Supervisory techniques and tools
APRA has a good set of supervisory tools to allow for effective execution of its supervisory activities. Staff are knowledgeable, and the work done by frontline supervisors, risk specialists and offsite analysts to support the supervision planning process, is generally well executed. Written communications clearly articulate issues and through frequent engagement APRA provides clarity to the firms on the issues raised and the general high-level expectations for addressing them. The PAIRS assessment regime covers the full spectrum one would expect and is well supported by guidance for the supervisors in carrying out their work. The process of rolling the underlying PAIRS assessment categories up mechanically into one overarching rating may obscure the importance of underlying issues captured in the various assessment segments. Additionally, the relatively low weightings the board and senior management are given as inputs into the overall rating appear out of line with an approach that places a high degree of emphasis on their roles and responsibilities.

Appendix Table 1. Summary Compliance with the BCPs (continued)
Principle 10. Supervisory reporting
APRA has appropriate authority to collect the data that it needs to carry out its supervisory responsibilities. Prudential and statistical reporting by the banks provide an extensive array of information on supervised firms' risk exposures, operating performance and financial condition. APRA continues to refine its data gathering efforts and is currently working on a new system for collecting data from the firms that will support the deepening of supervisory analysis. APRA's strategy includes continuing to increase the use of quantitative analyses. They also make use of ad hoc data gathering to a considerable extent, which can create some issues with respect to consistency and data quality being provided by the firms.
Principle 11. Corrective and sanctioning powers of supervisors
APRA has a broad range of tools and authorities across the spectrum to address problems at supervised banks, from traditional measures such as supervisory requirements to address weaknesses in areas covered by prudential standards, to revoking a banking license and resolving a bank. These powers provide APRA with a strong base of support for requiring firms to address any areas of material concern. APRA's preferred approach is to identify potential concerns on an ongoing basis and work with supervised institutions to address them before a firm is in danger of breaching a prudential standard or requirement, rather than taking formal action. The supervision process provides for early intervention in the form of referring a firm to the watchlist of APRA's Enforcement and Escalation Committee and increasing supervisory scrutiny and intensity.
Principle 12. Consolidated supervision
APRA's consolidated supervisory approach is well underpinned in its supervisory practices and activities. Prudential standards and financial data are collected on a consolidated basis. APRA also reviews the oversight of a bank's foreign operations by management and ensures that the banking group risk management framework is applied on a consolidated basis. APRA conducts prudential reviews and visits covering the main cross-border activities of large Australian banking groups.
Principle 13. Home-host relationships
APRA has developed a good cross-border supervisory framework based on MOUs signed with various agencies and close working relationship with various foreign supervisors, particularly the RBNZ. APRA performs onsite reviews particularly for the operations of large Australian banks in New Zealand. While APRA has held supervisory colleges for some banks in the past, no recent college was organized recently due to the importance of bilateral work and the nature of banks' cross-border risks (focused in many cases on New Zealand). APRA has also not established a recovery and resolution planning framework for its banks, including cross-border banks.

Appendix Table 1. Summary Compliance with the BCPs (continued)
Principle 14. Corporate governance
The Corporations Act, APRA's prudential standards and the supervisory approach articulate board and management responsibilities and emphasize the role of the board and senior management with respect to ensuring strong governance across the bank and group. Requirements for the board and board committees are appropriate, comprehensive and in line with the detailed criteria of this core principle. However, partial reliance on firms self-reporting of their governance practices for ensuring reliance with prudential standards should be further supported by greater use of in-depth supervisory assessments of key control areas underlying firms' risk management frameworks. PAIRS assessments of boards and management teams should explicitly incorporate their effectiveness with respect to their key governance roles over risk management. In addition, relevant findings from reviews by ASIC and AUSTRAC are often not incorporated into assessments of governance. The further clarity regarding responsibilities and accountability of responsible parties that will be provided by the BEAR Act will sharpen the focus of banks' boards and management teams with respect to their specific duties and obligations. At the same time, it will require APRA to engage with the firms to ensure a strong understanding of its expectations against which they will assess them under this new regime.
Principle 15. Risk management process
Underlying APRA's approach to the supervision of risk management is a strong and longstanding focus on the responsibilities of boards to ensure all appropriate processes are in place and effective. The issuance of CPS 220 since the last FSAP assessment (2012) has been a positive development. Discussions with supervisors and representatives of banks indicate that CPS 220 has proved effective at increasing banks' focus on financial risk management and internal controls. APRA does a good job of risk focusing related to supervision planning. The use of more in-depth supervisory assessments of risk management practices on a regular periodic basis would complement, and provide for greater confidence in, the reporting firms provide APRA on their compliance with prudential standards. APRA has conducted several recovery planning exercises and thematic reviews for large ADIs but the finalization of the recovery planning framework and requirements is still underway. While APRA requires risk-management related stress testing and regular ICAAPs, and reviews the results, assessing the key inputs, controls and governance around firm-wide stress testing practices and ICAAP warrant more focus.
Principle 16. Capital adequacy
APRA's regulatory capital regime uses a conservative approach to the definition of capital and includes a conservative floor to the calculation of RWA for residential mortgages. Reported regulatory capital ratios relative to other countries may be conservative as a result. The imposition of the 'unquestionably strong capital' benchmark adds a further buffer and will result in holding Australian banks to a high capital standard relative to Basel requirements.

Appendix Table 1. Summary Compliance with the BCPs (continued)
In addition, the process of determining the prudential capital ratio (PCR) allows APRA to increase required regulatory capital at individual firms based on a variety of analyses. Currently, the PCR and related practices are less of a focus than requiring firms to meet the 'unquestionably strong threshold'. As a result, APRA's focus on the use of stress testing and ICAAP by the firms to determine capital needs has not been an area of emphasis of late.
Principle 17. Credit risk
APRA prudential framework and guidelines have provided a thorough set of requirements and expectations in relation to credit risk management in ADIs. APRA supervisors have recently focused on undertaking thematically planned reviews of the four major banks targeting underwriting standards and serviceability assessments in residential loans as well as commercial real estate lending. As banks' practices are being reviewed and assessed, APRA supervisors should keep a close watch over these sectors to ensure banks effectively fix their gaps. APRA supervisors need to also continue ensuring a proper oversight by the banks' board over the banks' credit risk profile.
Principle 18. Problem assets, provisions, and reserves
APRA's prudential standard is still largely based on incurred loss rules. It also includes some concepts that do not fully align with sound practices and with Basel Guidelines on the prudential treatment of problem assets. However, Australian banks mainly apply accounting requirements, including IFRS 9, in relation to loan impairments. APRA supervisors perform certain activities to review in general terms the adequacy of loan impairments. APRA risk teams also perform some analysis on problem asset trends, but these are still at a very general level and can be further enhanced. Also, banks' reporting to APRA on impaired loans can incorporate additional useful information such as asset impairments in specific categories and areas.
Principle 19. Concentration risk and large exposure limits
The revised standard APS 221 on large exposures adopts the new Basel Framework on large exposure, with one carveout related to retail exposures in application of economically interdependent counterparties. The current and the revised standards include thorough requirements in relation to concentration risk and supervisors review some specific concentration issues in their work, particularly in relation to real estate lending.
Principle 20. Transactions with related parties
APS 222 sets requirements on associations with related entities. It includes a definition of related parties that does not include all the parties identified in this principle, including individual parties and their direct and indirect interests. The standard requires specific rules related to conflict of interest in related party transactions and exposures. APRA supervisors also monitor the banks' reporting on related parties and the compliance with the rules. However, the aggregate limits applied to related parties seem higher than the ones stipulated in the principle and there is no requirement on board approval for related party-transactions and write-off of related party exposures. APRA has released on July 2, 2018, for consultation, revisions to its related party prudential and reporting standards that address many of the above-mentioned gaps.

Appendix Table 1. Summary Compliance with the BCPs (continued)
Principle 21. Country and transfer risks
While APRA does not have an explicit prudential standard with respect to country and transfer risks, the overarching risk management standards in CPS 220, as well as standards for credit risk management and large exposures are sufficient for the assessment of firm's practices around these risks. The updated credit risk management standard (APS 221) includes enhancements related to transfer risk explicitly.
Principle 22. Market risk
APRA has a solid set of processes with respect to the risk management for market and trading related risks. APRA supervisors have a strong understanding of the key issues regarding measuring and managing exposures related to trading activities.
Principle 23. Interest rate risk in the banking book
APRA has solid practices and detailed guidance on interest rate risk management. Banks are expected to capture interest rate risk in their ICAAP. IRRBB is captured in capital as a Pillar 1 element for banks using advanced approaches. As with market risk, supervisors carry out a range of activities in this area including monitoring and analysis and in-depth reviews. Extensive prudential reporting is required and supports ongoing monitoring efforts.
Principle 24. Liquidity risk
Since the last FSAP, APRA has taken many actions to strengthen its capacity, tools, and prudential framework in relation to oversight of liquidity risk. It has established a team of risk specialists dedicated to liquidity risk. It has also implemented the LCR and the NSFR requirements and applied them for large more complex ADIs. The October 2017 RCAP confirmed that Australia's Basel III LCR is overall compliant with Basel requirements. In addition, the prudential framework provides a thorough set of requirements and guidance in relation to liquidity risk management. APRA frontline supervisors and liquidity risk specialists also review and actively monitor banks' liquidity risk management and conditions.
Principle 25. Operational risk
CPS 220, in addition to other prudential standards, provide a good overall regulatory framework on operational risk management requirements. APRA IT and operational risk specialists have been assisting frontline supervisors in performing reviews covering a range of operational and IT risk issues. Work has recently been performed on issues related to cyber security and systemic operational risks which are increasingly important as the ADIs deepen their use of digital technology.
Principle 26. Internal control and audit
Prudential standards place requirements on boards and management to have in place an appropriate set of internal controls given the size, complexity and risk profile of the firm. Internal and external audit both are expected to play a significant role with respect to assessing these controls and reporting to the board and, in the case of external audit, to APRA. However, there is no prudential standard that comprehensively outlines internal control and internal audit requirements for ADIs.

Appendix Table 1. Summary Compliance with the BCPs (concluded)
Explicit in-depth supervisory reviews of internal audit effectiveness and the role of the board in ensuring internal audit has appropriate stature, resources and access through has not been a consistent area of focus for APRA supervisors.
Principle 27. Financial reporting and external audit
Under the Corporations Act, ASIC is the regulator responsible for external audits. All Australian incorporated banks are required to issue audited financial reports to the public on an annual basis and reviewed or audited financial reports at the half-year. ASIC reviews external audits, including with respect to asset valuations, and carries out ongoing surveillance of financial reporting. ASIC and APRA have regular interaction and ASIC is expected to inform APRA if anything of concern arises in its reviews of banks' financial reporting. Additionally, prudential standards and financial reporting laws require the external auditor to report to APRA in a situation where it believes a firm is not complying with prudential requirements.
Principle 28. Disclosure and transparency
APRA prudential standards (APS 330) and the Corporations Act both require significant disclosures by banks that allow for the public to understand the condition of and risks in the banks and banking industry. Banking statistics are made available to the public on a monthly and quarterly basis.
Principle 29. Abuse of financial services
AUSTRAC has the authorities under laws and rules, and the supporting processes needed to effectively oversee anti-money laundering and counter terrorism financing requirements and regulations. Given its broad mandate to supervise covered entities and to serve as Australia's financial intelligence agency, it is faced with balancing a number of issues, including the deployment of scarce human resources, striking the right balance of working with banks as the financial intelligence agency while overseeing them as the supervisor and, related to the first two, how to concurrently address the objective of reducing financial crimes while ensuring banks (and others) are in compliance with the requirements set out under the various laws and rules. Banks are required to comply with all laws, rules and standards and to report to AUSTRAC that they have effective practices in place to ensure compliance. These requirements are extensive and comprehensive. To support this approach AUSTRAC carries out its supervisory activities using risk-focused practices driven largely by intelligence gathering and collecting and analyzing data reported by the firms. Recent events have provided clear evidence that the supervisory approach used by AUSTRAC faces some challenges associated with the practice of partial reliance on self-reporting by the firms. The processes some firms had in place to ensure compliance with AML/CTF laws and requirements were not working as reported, and the result of these deficiencies in risk assessment, management and control practices led to significant cases of lack of compliance with AML/CTF laws.

F. Recommended Actions

48. Appendix Table 2 below lists the suggested actions for improving compliance with the BCPs and the effectiveness of regulatory and supervisory frameworks.

Appendix Table 2. Recommendations to Improve Compliance with the BCPs
Principle 1. Responsibilities, objectives and powers
- APRA should be given clear powers in relation to prudential standard setting by removing the legal provision that subjects APRA prudential standards to being disallowed by the parliament. - As the banking sector is being opened to more competition, APRA should continue to be mindful of its overarching financial stability mandate. Providing further clarifications in the APRA Act and in other documents and communications about the primary nature of APRA's financial stability mandate and the subordinate nature of APRA's other objectives would be useful in this regard.
Principle 2. Independence, accountability, resourcing, and legal protection for supervisors
- The authorities should clarify the objectives of the Statement of Expectations that the Government periodically issues to APRA and make it of an advisory non-binding nature. - The authorities should remove the direction powers that the Minister can issue to APRA about policies it should pursue. - The laws should stipulate that the reasons for the removal of an APRA member be publicly disclosed. - The authorities should provide APRA with a higher level of autonomy and flexibility in determining its budget so that it can reasonably manage it to fulfill its financial stability mandate, and in a way that allows improved medium-term visibility for resource planning purposes. - The authorities should remove the constraints imposed by the efficiency dividends on APRA's budget. - The authorities should remove the requirement to subject APRA's staff employment and remuneration to the APS Workplace Bargaining Policy and conduct a periodic reassessment of APRA staff recruitment and remuneration policies and practices to ensure that APRA remains a competitive and efficient Workplace.
Principle 3. Cooperation and collaboration
- APRA should deepen the regular collaboration with ASIC, and explore the possibility of undertaking joint activities, where feasible and appropriate. - APRA and AUSTRAC should significantly step up the frequency and the level of their cooperation by creating operational level working groups that meet on frequent basis to discuss AML/CTF issues in specific entities to better integrate ML/TF risks into APRA's assessment of banks' risks as well as to support AUSTRAC's work.

Appendix Table 2. Recommendations to Improve Compliance with the BCPs (continued)
Principle 5. Licensing criteria
- APRA is encouraged to undertake a prudent and gradual approach to the licensing of restricted ADIs in order to assess the experience of this framework and avoid potential market disruptions. - APRA should further enhance its supervisory resources and capacity, particularly in relation to IT skills, to ensure a good oversight over the new business models and risks of restricted ADIs during and after their phased licensing.
Principle 6. Transfer of significant ownership
- The authorities should introduce legal changes to give APRA the power to approve changes in significant ownership of banks in the sector. The legal framework or the prudential standards should clarify that these powers apply also at the level of ultimate beneficiary owners and outline clear criteria APRA should consider in deciding about any such change. - The laws or regulations should provide at least a broad definition of "national interest" considerations and could also call on APRA to consult with the Treasurer in cases where changes in ownership might be contrary to the national interest. - APRA should proceed with issuing the revised reporting standard (issued for consultation in July 2018) which requires ADIs and NOHCs to periodically report their significant shareholders and ensure that it includes all types of ultimate beneficiary owners, as required by this CP. - APRA should require ADIs to notify it as soon as they become aware of any material information that may negatively impact the suitability of a significant shareholder.
Principle 7. Major acquisitions
- APRA should outline to banks the internal criteria it uses to assess major acquisitions, which have been already included in the initiated revisions to the prudential standard on related parties.
Principle 8. Supervisory approach
- APRA should put in place a formal program for the assessment of resolvability at the largest firms supported by prudential standards and detailed guidance. - To increase confidence in the various processes in place for firms to report on the adequacy of their risk management frameworks and practices for ensuring compliance with prudential standards, APRA should carry out periodic in-depth reviews of the largest firms' practices that allow for assessing the effectiveness of governance, risk management and control functions for key risks and/or important bank processes (e.g., capital assessments) on a regular periodic cycle.

Appendix Table 2. Recommendations to Improve Compliance with the BCPs (continued)
Principle 9. Supervisory techniques and tools
- APRA should review the PAIRS process and determine if it remains appropriate and well calibrated for their current supervision program, which has evolved significantly since the introduction of the PAIRS. - APRA should continue to expand the use of thematic reviews across groups of firms to ensure firm-specific assessments are informed by a strong understanding of practices across firms. - APRA should continue to enhance its offsite analytics functionality and ensure that information and analyses generated through all processes, including the work of frontline teams, risk specialists, stress testing experts and other offsite analysts, are inputs into the process of setting supervisory strategy and designing supervisory action plans.
Principle 10. Supervisory reporting
- APRA should assess potential data needs over the next five years to the best extent possible and revise reporting requirements to include identified data needs for firm and system-wide analyses. - APRA should periodically review the combination of validation tools and reliability checks (including the external audit limited assurance) and bring any changes necessary to ensure the integrity of the information submitted by banks, including possibly holding banks that have consistent issues in relation to data integrity to stricter validation checks (including possibly a "reasonable assurance" standard) around their prudential reporting.
Principle 11. Corrective and sanctioning powers of supervisors
- APRA should enhance its approach to corrective actions by being more proactive in escalating the severity of the corrective action in a quicker and more active way if the bank is not effectively cooperating. This includes escalation from 'recommendation' to 'requirement' and also using formal corrective actions, such as directions, in a more active way.
Principle 12. Consolidated supervision
- APRA should continue to enhance its approach to assessing how non-banking activities in the wider group impact the risk profile of the bank and the banking group and take proactive prudential measures to address these risks.
Principle 13. Home-host relationships
- APRA should consider organizing regular supervisory colleges for large banks with material cross-border exposures in multiple countries or regions, where needed. - APRA should develop and test a recovery and resolution planning framework for banking groups, and group-level resolution plans for large cross-border groups.

Appendix Table 2. Recommendations to Improve Compliance with the BCPs (continued)

Principle 14. Corporate governance

- APRA should more directly connect weaknesses in the practices underlying firms' risk management frameworks to its specific PAIRS assessments of the board and management. Specifically, it should consider revisiting the PAIRS rating framework to ensure appropriate consideration is given to how risk governance and controls weaknesses affect specific assessments of the board and senior management.
- Through enhancements of coordination and information sharing processes with AUSTRAC and ASIC, APRA should ensure that weaknesses in risk management and control processes identified through those agencies' efforts inform APRA's assessment of the board, senior management, the integration of compliance risk management and risk governance at the banks.

Principle 15. Risk management process

- To enhance assessments of the effectiveness of firms' practices for linking capital needs to risk profiles, APRA should increase its focus on the key inputs into and controls around ICAAPs and stress testing practices associated with banks' internal capital assessments and capital decision making.
- APRA should continue its implementation of the recovery planning program and move ahead to creation of a formal and fully documented program and expectations for the banks.

Principle 16. Capital adequacy

- APRA should increase the use of stress-testing analysis and assessments of firms' use of stress testing for their internal assessments of capital needs to enhance the forward-looking element of assessing capital adequacy from a supervisory perspective.
- APRA should increase its focus on assessing the underlying risk identification, measurement, management and controls practices used by firms in their internal assessment of capital needs.
- APRA is encouraged to consider the scope for reducing the reference significance weight for access to new capital in the assessment of a bank's capital in PAIRS, and ensure that the quality assessment of a bank's capital gives more consideration to the ability to have enough capital in a variety of circumstances, including under stress.

Principle 17. Credit risk

- APRA supervisors should continue scrutinizing banks' underwriting practices, particularly in retail loans (including residential mortgages) and in the commercial real estate lending sector.
- APRA supervisors should consider undertaking periodic deep dives into banks' credit risk management framework depending on the risks and controls of ADIs.
- In the course of revising APS 220, APRA should consider including the guidelines and main takeaways in relation to residential mortgage lending and commercial real estate lending in the new standard.

Appendix Table 2. Recommendations to Improve Compliance with the BCPs (continued)
Principle 18. Problem assets, provisions, and reserves
- APRA should revise its standard on credit quality APS 220 to incorporate expected loss rules and Basel guidelines on the prudential treatment of problem assets. - APRA reporting on impaired assets should be enhanced to provide more granular data showing past due loans (by days past due) and distribution of loan by specific categories. - APRA risk teams should continue to deepen their sectoral analysis of problem assets by looking at various loan categories and collateral types in order to identify any systemic risk issues.
Principle 19. Concentration risk and large exposure limits
- APRA teams should continue to enhance their analysis of concentration risk, including in relation to real estate lending and real estate collateral, and take actions to address systemic trends or bank-specific risks.
Principle 20. Transactions with related parties
- APRA should proceed in the revisions initiated in July 2018 to the prudential and reporting standards on related party transactions and exposures and ensure that the revised standard addresses all the gaps mentioned in this principle.
Principle 25. Operational risk
- As more entities with technology-based activities and business models enter the market, APRA should continue enhancing its capacity and skills in relation to IT risk, particularly in relation to cyber risk and risks associated with new financial technology (fintech). - APRA should continue developing its analytical capabilities and work in relation to systemic operational risk issues. - APRA should go ahead in its plans to develop a prudential standard focused on operational risk management.
Principle 26. Internal control and audit
- APRA should include a regular periodic in-depth assessment of internal audit in the supervision cycle. It should further focus on internal audit stature, independence, sufficiency of resources both in terms of quantity and expertise and the effectiveness of the board in its responsibility to ensure these are all sufficient. This include a determination of whether the board is getting sufficient information to understand the implications of strengths and weaknesses of its risk management and controls practices. - APRA should clarify the requirements in relation to internal control and internal audit in a more comprehensive way in its prudential standards.

Appendix Table 2. Recommendations to Improve Compliance with the BCPs (concluded)
Principle 29. Abuse of financial services
- AUSTRAC should increase its use of rapid, formal legal requirements for corrective actions when it finds that firms' processes for ensuring compliance with laws and regulations are not working as they have reported. - AUSTRAC should perform more in-depth periodic assessment of the banks' internal review processes in order to increase the level of comfort about firms' AML/CTF control practices and to enable it to take timely corrective actions as suggested by the above recommendation.

G. Authorities' Response

49. The Australian authorities thank the IMF and its assessment team for their assessment. Australia is strongly committed to the FSAP process and the insights that the FSAP provides into a country's financial system. Australia acknowledges that it is important to continually review and seek to improve the regulatory framework and supervision practices.

50. The Australian 2018 FSAP has taken place in the midst of a significant reform agenda for the financial sector and against the backdrop of a Royal Commission into Misconduct into Banking, Superannuation and Financial Services Industry. In 2014, the Australian Government commissioned a comprehensive review of Australia's financial system, the Financial System Inquiry. This Inquiry was aimed at providing a 'blueprint' for future reform of the financial system and made a number of recommendations focusing on resilience, consumer outcomes, innovation and the regulatory framework. Australian authorities have worked to implement these recommendations, including ensuring that banks have 'unquestionably strong' capital ratios, improving the crisis management framework and moving to industry funding for the Australian Securities and Investments Commission.

51. The Australian authorities share the view expressed in the report that Australia has a very high level of compliance against the Basel Core Principles for effective banking supervision. However, the Australian authorities note significant concerns with the 'materially non-compliant' ratings for CP2 Independence, accountability, resourcing and legal protection and CP6 Transfer of significant ownership. In particular, the Australian authorities do not consider the IMF's assessment accurately reflects the operation and risks in Australia's system.

52. Australia's framework does not pose material risks to the Australian Prudential Regulation Authority's (APRA's) independence or its ability to effectively carry out its supervisory function. While the IMF noted that APRA currently had a reasonable degree of independence, it concluded there were constraints which could have the potential to limit APRA's independence going forward. The Australian authorities agree with the need, and importance, of an independent supervisor. However, the Australian system provides for this and APRA maintains a high degree of independence to perform its role.

53. There is no evidence, past or present, of any Government or industry interference that compromises APRA's operational independence. Furthermore, successive Governments have strongly reiterated the importance of APRA's role as an independent regulator. In particular, the IMF has noted concerns with four aspects of Australia's system which are fundamental aspects of Australia's parliamentary system predicated on 'checks and balances', whereby government agencies are accountable to the Executive and the Parliament, which is ultimately responsible to the public.

- **The Minister may issue a direction to APRA:** No direction has ever been issued to APRA. The use of this power is subject to a number of conditions to ensure full transparency, both from the Parliament and the public, of any direction. Additionally, the Minister must consult with APRA prior to issuing any direction.

- **Prudential standards issued by APRA are disallowable by the Parliament:** No prudential standard has ever been disallowed by Parliament. The scope of APRA's standards making power is extensive; APRA may establish prudential standards in respect of any prudential matter. These standards are legally binding and make for a powerful supervision and enforcement tool. A breach of a prudential standard is a breach of the law. APRA exercises powers as a delegate of the Parliament; as such, oversight from the Parliament is fundamental.

- **The Government's Statement of Expectations (SOE):** The SOE aims to provide guidance and clarity on the broader Government policy framework to support APRA in exercising its legislative functions. Each previous SOE has reiterated the Government's commitment to APRA's independence and statutory objectives and are developed in consultation with APRA. APRA is also provided the opportunity to respond with a Statement of Intent indicating how and the extent to which they intend to meet the SOE.

- **APRA's budget, and staffing level, is subject to approval of Government:** All non-corporate Commonwealth entities are subject to the Government's budget process. This is an accountability mechanism to ensure appropriate use of taxpayers' funds and, in APRA's case, that industry is only levied for the cost of regulating it. The majority of APRA's budget comes from a standing appropriation which is not subject to annual approval or scrutiny which provides for a degree of medium-term certainty. APRA can seek additional funding through the twice-yearly budget process and the Government will also review the level of funding from time to time.

54. The Australian authorities do not consider these accountability mechanisms to be impeding on APRA's independence and therefore does not see a case for change (consistent with Australia's position in its 2012 FSAP). Rather, these mechanisms are 'checks and balances' to promote confidence in the financial system.

55. APRA's advice on prudential issues, including unsuitable influential person(s) and undue economic power, is the most significant consideration in approving transfers of ownership. While Australia's system requires approval by the Treasurer, the majority of applications are handled by APRA (through a standing delegation) or, where handled by the Treasurer, are primarily informed by APRA's prudential advice. The Treasurer's approval is required for certain applications as they raise additional issues pertaining to the national interest test (for example, national security and competition). As such, Australian authorities do not agree with the IMF's assessment that there are material shortcomings in Australia's compliance with CP6.

56. The Australian authorities welcome the IMF's recommendations and serious consideration will be given to these, alongside the outcomes of a number of other domestic financial sector reviews. Australia's FSAP coincides with a number of other review processes, including the Productivity Commission's reports into Competition in the Australian Financial System and Assessing Efficiency and Competitiveness in the Superannuation System, and the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry. The FSAP recommendations will need to be considered as part of broader reforms to the financial system (resilience, competition, and conduct) and prioritized accordingly.