



# Risk-based Supervision

## The Australian case

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- Introduction
- IOPS Principles of Private Pension Supervision
  - Principle 5: Risk orientation - pension supervision should seek to mitigate the greatest potential risks to the pension system*
- Overview of the Australian pension system
- Risk-based supervision in Australia
- Challenges in introducing risk-based supervision

# Australia's retirement income system



Australia's retirement income system is a three-pillar system encompassing:

- Age pension (non- contributory safety net);
- Compulsory Superannuation (the Superannuation Guarantee); and
- Voluntary Savings, including Superannuation

# Size of the system



- In 2007, superannuation assets first exceeded AUD 1 trillion, representing 100% of GDP, making it by far the largest component of household financial assets
- As at December 2009, superannuation assets totalled \$1.23 trillion.
- As at June 2009, there are approximately 32 million separate superannuation accounts across 415,252 funds.
- Contributions were \$112.1 billion in the 2008-2009 year, while benefit payments were \$61.9 billion.
- A feature of the Australian superannuation industry is the very high level of outsourcing of major business functions to commercial providers (eg. administrators, investment managers, custodians)

# Fund structure



- **Accumulation funds:**
  - individual account balance = contributions + earnings less taxes.
  - most common arrangement, especially for new funds.
- **Defined benefit schemes:**
  - benefits based on factors like length of service, wage and age of retirement (e.g. benefits equals 60% of final average salary), for example, Commonwealth and State public sector schemes and some corporate schemes.
- **Trust based**
- **Benefits – generally may choose a lump sum or a pension**
- **Pensions are encouraged by way of taxation concessions.**

# Types of funds according to membership source



- **Corporate / Employer funds - where the employer runs their own superannuation fund**
- **Industry Funds - for employees in particular industries e.g. employees in construction industry.**
- **Public Sector funds - Government employees**
- **Public offer (or retail) funds - open to anyone to join - normally run by large banks or life insurance companies.**
- **Small funds - self managed funds - often family or business partners - limited to 4 members.**

# Regulatory structure



Main legislation: *Superannuation Industry (Supervision) Act 1993* and supporting regulations

There are 3 Government regulatory agencies:

- Australian Prudential Regulation Authority (APRA);
- Australian Taxation Office (ATO);
- Australian Securities and Investment Commission (ASIC).

# AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY (APRA)



- APRA is responsible for prudential regulation (the financial soundness of the fund and ensuring funds operate in an appropriate manner in compliance with relevant Government legislation)
- **Elements of APRA's prudential approach:**
  - Risk based supervision
  - Consultative
  - Consistent and in line with international best practice
  - Our approach recognises that management and boards of supervised institutions are primarily responsible for financial soundness

# AUSTRALIAN TAXATION OFFICE (ATO)



- The ATO is responsible for regulation of self managed superannuation funds - it ensures they comply with relevant Government legislation.
- The ATO is also responsible for the compulsory Superannuation Guarantee - it ensures employers pay the necessary contributions.
- The ATO also has responsibility for taxation of superannuation.



- ASIC is the market conduct and disclosure regulator.
- ASIC is responsible for consumer protection issues, for example disclosure of information to members about their superannuation fund and licensing of financial advisers.
- ASIC administers the *Corporations Act 2001* and supporting regulations

# More about APRA - supervisory population



At 30 June 2009

- Banks (57)
- Life Insurers (32)
- General Insurers (132)
- Building Societies (11)
- Credit Unions (117)
- Friendly Societies (19)
- Superannuation Funds (4919)
  - Includes 4277 small funds
- Licensed Trustees (278)
- Non Operating Holding Companies (17)

# Risk-based supervision v. rules-based



## *RULES -BASED*

- *Main Goal: entities follow the rules*
- *Prevent/punish explicit violations*
- *Tools: fines, litigation, prosecution*
- *Focus on present & past*
- *Lawyers*
- *In public - deterrence*

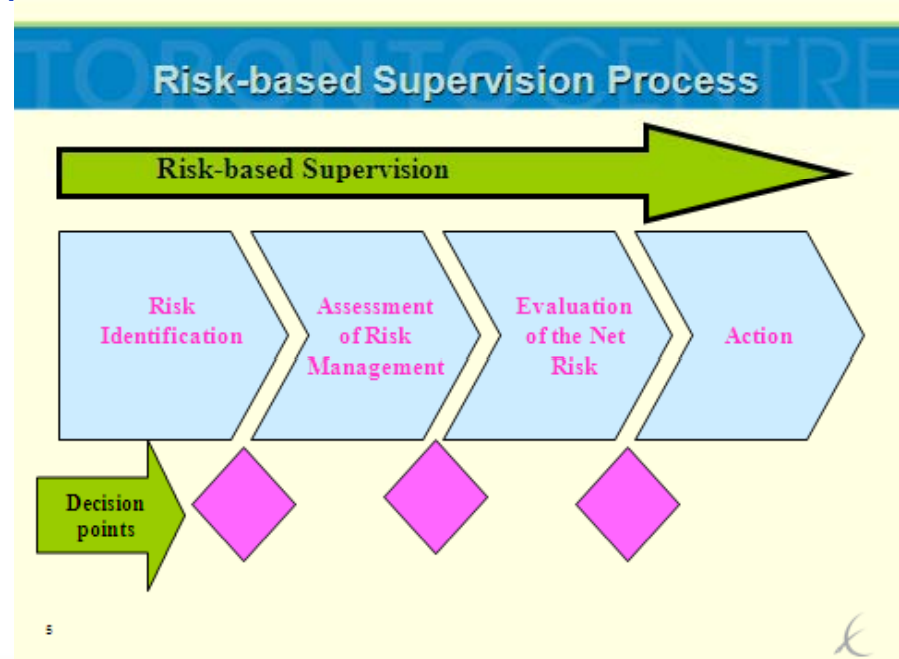
## *RISK-BASED*

- *Main Goal: reducing failure/loss rates*
- *Modify legal but risky behaviour*
- *Tools: suasion, escalating pressure*
- *Focus on present & future*
- *Accountants, economists, actuaries*
- *In private: cooperation*

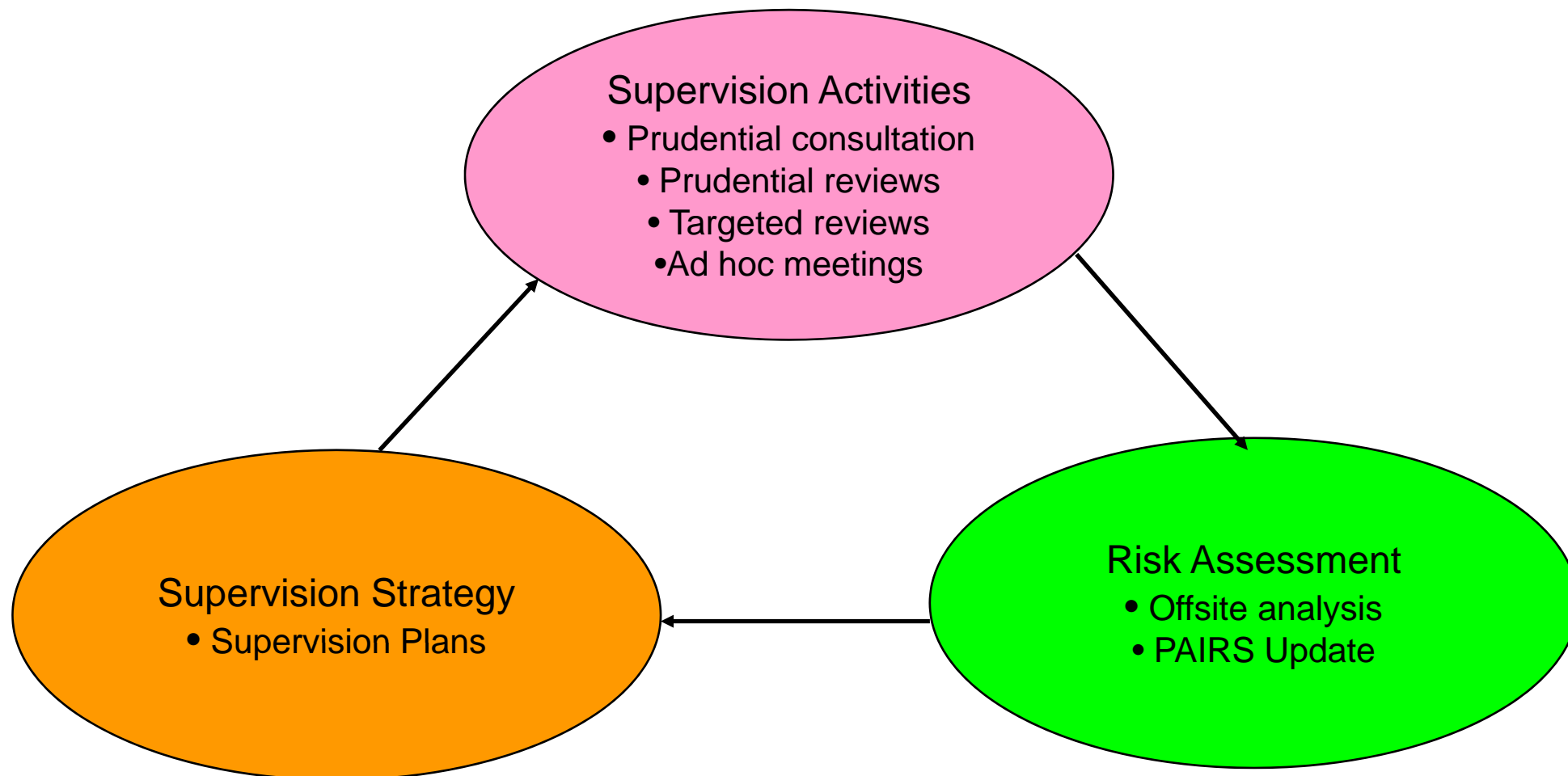
# Supervision process - model



- A risk-based approach to pension supervision contains the following steps:
  - Identifying the risks faced by the pension industry and individual funds that bear on the pension supervisory authority’s risk appetite
  - Establishing a methodology for mapping and weighting risks faced to the authority’s risk appetite
  - Establishing a quality assurance process
  - Match supervisory response to risk assessment



# Supervision process - APRA



# Supervisory activities - APRA



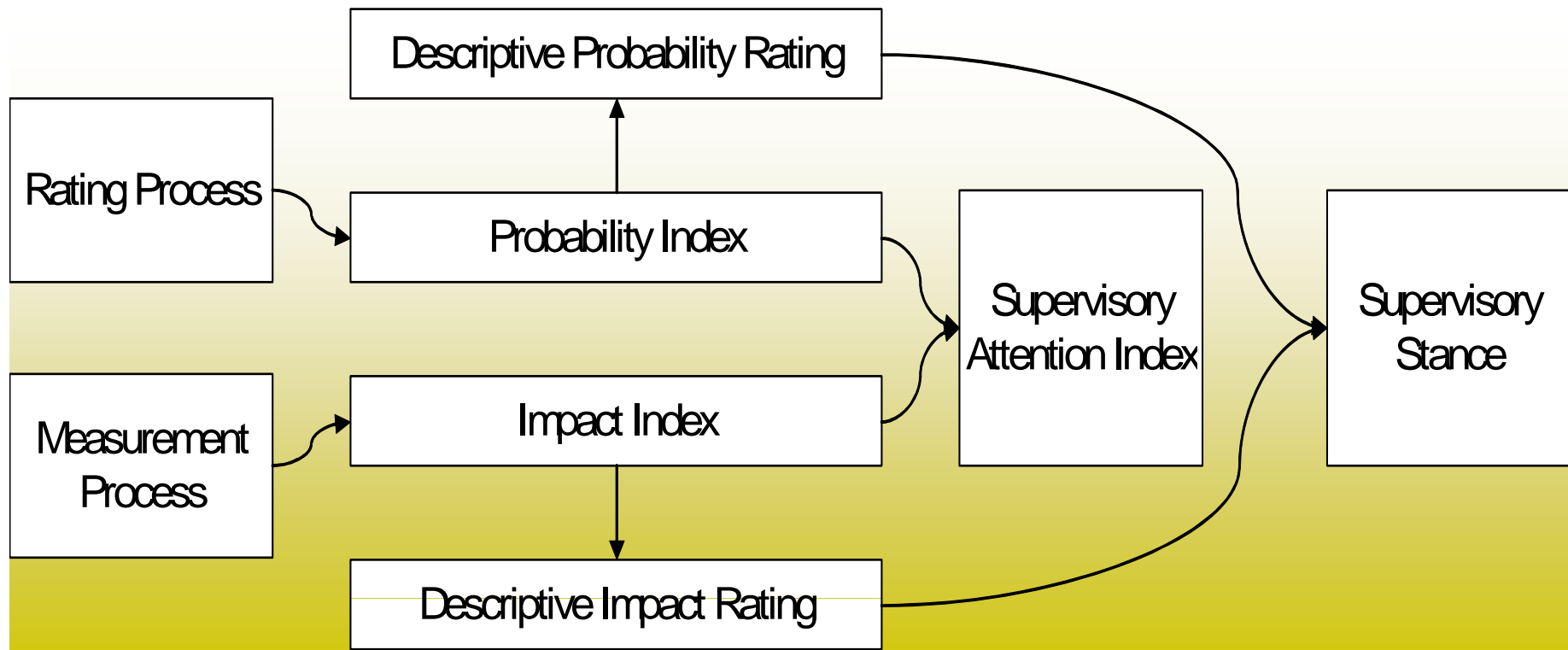
- Prudential reviews - on-site
- Analysis of financial and other data
- Superannuation funds with >\$50M assets, data is received on a quarterly and annual basis
- Examination of exceptions and outliers
- Analysis of other market and regulatory information

# PAIRS (Probability & Impact Rating System)



- Ratings tool used by APRA to determine the probability of failure of a regulated institution and the potential impact on the financial system of the failure.
- Five probability rating categories: Low; Lower-Medium; Upper-Medium; High; and Extreme.
- Four impact rating categories (based on total assets): Low < \$400m; Medium - between \$400m and \$4.0bn; High - between \$4.0bn and \$40bn; Extreme - above \$40bn
- APRA assesses the likelihood of an institution's failure based on the "inherent risk" of the institution, balanced by the "management and controls" and the "capital support" available in the absence of APRA intervention.
- Rating is based on the accumulated knowledge from APRA's onsite reviews and offsite analysis

# PAIRS Conceptual Framework



# Main risk areas for PAIRS assessment



## PAIRS

Board	
Management	
Risk Governance	
Strategy & Planning	#
Liquidity Risk	
Operational Risk	#
Credit Risk	
Mk & Investment Risk	#
Insurance Risk	
Capital - Coverage	
Capital - Earnings	
Capital – Access to Add	

**NOTE - For DC pension funds, the Capital components do not apply**

**# NOTE - Significant risks for pension funds**

**NOTE - guidance manuals for supervisors on each PAIRS component**

## Example – Module 7 - Operational risk



EXAMINE		FEATURES WHERE LOW OPERATIONAL RISK	FEATURES WHERE HIGH OPERATIONAL RISK
<ul style="list-style-type: none"> <li>• Nature &amp; Complexity</li> <li>• Internal &amp; External Fraud</li> <li>• IT Systems</li> <li>• Business Disruption</li> <li>• Board &amp; Management Awareness</li> <li>• Operational Risk Management Framework</li> <li>• Outsourcing Arrangements</li> </ul>	<ul style="list-style-type: none"> <li>• Administration</li> <li>• Information Technology</li> <li>• Business Continuity Management</li> <li>• Project Management (IT)</li> <li>• New &amp; Varied Products</li> <li>• Independent Review of Operational Risk</li> </ul>	<ul style="list-style-type: none"> <li>• Simple legal &amp; organisational structure, clear reporting lines</li> <li>• No reliance on related entities for core or complementary activities</li> <li>• No outsourcing of major business functions</li> <li>• Simple products, low transaction volumes</li> <li>• IT systems are simple, off-the-shelf, adaptable</li> <li>• Minimal disaster threat from external activities</li> <li>• No reliance on a key person</li> </ul>	<ul style="list-style-type: none"> <li>• Complex structure, unclear reporting lines</li> <li>• Extensive reliance for core or complementary activities on related entities not wholly owned within the same group</li> <li>• Outsourcing to unrelated third parties with history of unresolved problems</li> <li>• Complex business, many products, high volume</li> <li>• IT systems unable to meet business needs, inherited / legacy systems</li> <li>• Vulnerable to external disaster</li> <li>• Heavy reliance on one person</li> </ul>



# Impact rating

Size, measured by assets under management, is the sole determinant of impact

Asset ranges	$\$0 \leq x < \$400\text{m}$	$\$400\text{m} \leq x < \$4\text{b}$	$\$4\text{b} \leq x < \$40\text{b}$	$x \geq \$40\text{b}$
Impact Rating	Low	Medium	High	Extreme

**NOTE:** Impact rating drives frequency of review

**NOTE:** Impact rating determines whether specialist risk experts join supervision staff in review of institution

# Outcome of PAIRS process = SOARS



		Probability Rating				
		Low	Lower Medium	Upper Medium	High	Extreme
Impact Rating	Extreme	Normal	Oversight	Mandated Improvement	Restructure	Restructure
	High	Normal	Oversight	Oversight	Mandated Improvement	Restructure
	Medium	Normal	Normal	Oversight	Mandated Improvement	Restructure
	Low	Normal	Normal	Oversight	Mandated Improvement	Restructure

Normal	Normal
Oversight	Oversight
Mandated Improvement	Mandated Improvement
Restructure	Restructure

# Supervisory Approach



<b>Normal</b>	On going collection and analysis of data supported by routine prudential reviews on a cyclical basis.
<b>Oversight</b>	Significant increase in supervision intensity however entity is not considered likely to fail. More frequent information and visits. Board and senior management given strong signals of concern.
<b>Mandated Improvement</b>	Entity produces and executes a remediation plan. Transitional classification. Either improve or exit the industry.
<b>Restructure</b>	Entities have failed or are about to fail. Full use of supervisory and legislative powers to protect beneficiaries.

# PAIRS & SOARS - quality and consistency



- Dedicated support unit for supervisors
- Predictive analysis tools
- Portfolio reports and watch lists
- Peer review and assessment
- Reporting changes in assessment to top management in APRA

The combination of these four support levels and the reporting framework leads to better risk assessments and strategy setting practices in APRA and overall improvements in supervisory judgements.

# Challenges in moving to risk based supervision (see IOPS WP4)



- **Difficulties in adapting existing models**
  - Consult widely, be flexible
- **Re-organisation of the supervisory authority**
  - Needs time, do gradually
- **New data collections**
  - Engage industry, try pilot scheme, use existing data as far as possible
- **Changing the mind set of supervisory staff**
  - Cultural change, training, lead from top, use experts
- **Industry understanding and acceptance**
  - Communicate early and often, explain, provide guidance
- **Appropriate powers**
  - Available and flexible, but use 'suasion' first



**Thank you**

**Questions?**