



# GUIDE

## Supervision Risk and Intensity Model

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# Introduction

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APRA is an independent statutory authority that supervises institutions across banking, insurance and superannuation, and promotes financial system stability across Australia.

APRA's mandate is to protect the Australian community by establishing and enforcing prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by entities it supervises are met within a stable, efficient and competitive financial system. Through its supervision function, APRA seeks to protect the community by identifying and responding to significant risks in financial institutions and the financial system in a timely and effective manner.

As a risk-based supervisor responsible for the oversight of a very diverse range of entities across a number of industries, APRA needs to have a structured framework to identify, assess and effectively target its limited resources to areas and entities of greatest risk. Central to this process is its risk rating model, which is used to assess the level and nature of risk within each APRA-regulated entity.

Since 2002, APRA has utilised the Probability and Impact Rating System (PAIRS) and the Supervisory Oversight and Response System (SOARS) to identify and assess risk and to determine the appropriate supervisory response. By 30 June 2021, APRA will have formally migrated to a new system to assess risk and determine supervisory intensity: the **Supervision Risk and Intensity (SRI) Model**.

Grounded on the three core attributes of APRA's supervision philosophy<sup>1</sup> – risk-based, forward-looking and outcomes-focused – the SRI Model will be the new common platform by which all APRA-regulated entities can be assessed, and their level of supervision intensity determined.

The SRI Model is more contemporary than its predecessor with the revised design features ensuring greater elevation of non-financial risks whilst preserving the importance of financial resilience. It also introduces recovery and resolution considerations and factors in the impact of the external environment on an entity's risk profile. It caters for industry nuances and is sufficiently flexible to adapt to changes in the external risk landscape. The model is also aligned with APRA's Enforcement Approach<sup>2</sup> to ensure a timely and appropriate supervisory response.

This document provides an overview of the SRI Model and its key components. It forms part of a series of publications explaining how APRA undertakes its responsibilities as a prudential regulator.

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<sup>1</sup> Refer to: [www.apra.gov.au/supervision-philosophy](http://www.apra.gov.au/supervision-philosophy)

<sup>2</sup> Refer to: [APRA's Enforcement Approach, September 2019](#)

# Chapter 1 - Purpose and overview

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APRA's SRI Model is designed to enable supervisors to:

- make robust and timely risk assessments of an entity; and
- develop appropriate supervision strategies and plans to address this level of risk.

The SRI Model requires risk assessments to be conducted for all APRA regulated entities. For superannuation, these assessments will only be completed for the registrable superannuation entity licensees (RSEL) and will incorporate the associated registrable superannuation entities (RSE) and small APRA funds as appropriate.

The SRI Model captures the level of prudential risk within APRA regulated entities across a number of risk categories, and helps focus APRA's resources to the entities of greater risk. Prudential risks include financial, operational and behavioural risks that could have an adverse impact on the outcomes for bank depositors, insurance policyholders and superannuation members, or indeed the broader financial system.

Prudential supervision is a continuous process. The views and judgements generated by APRA supervisors, as the result of the risk identification supervision activities, come together in the SRI Model risk assessment process, which is an input to the development of a risk response supervisory action plan, as illustrated in Figure 1 below.

*Figure 1. Supervision cycle*



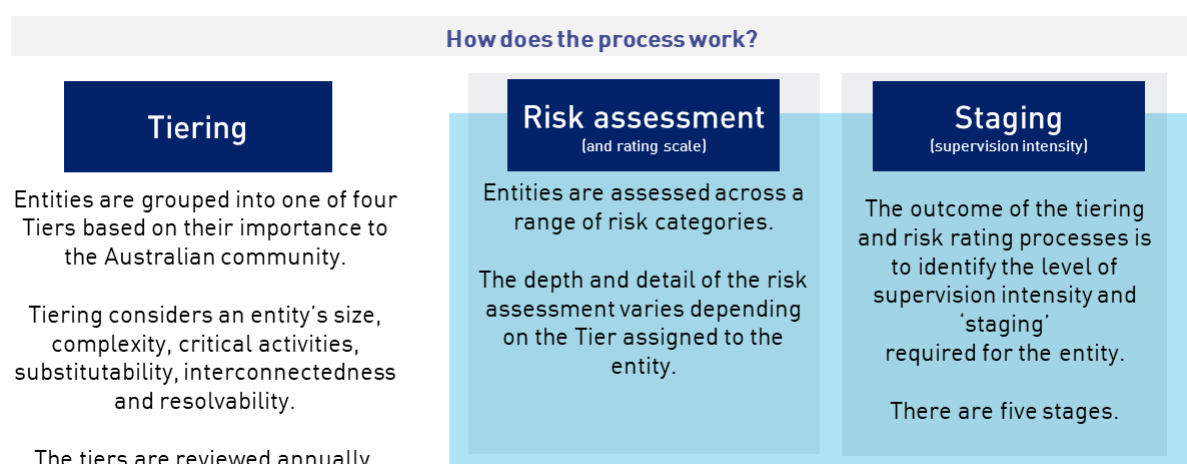
In an ever-changing environment, risk assessments conducted under the SRI Model need to be dynamic and updated where a material change is identified.

The SRI Model has three core components: tiering, risk assessment and staging.

- **Tiering** – an entity’s tier reflects the potential impact that entity failure, imprudent behaviour or operational disruptions could have on financial stability, economic activity and the welfare of the Australian community. An entity’s tiering is critical in determining the level of routine supervisory attention that is required to ensure adequate identification of risks and follow up of actions.
- **Risk assessment** – within a given tier, different entities will operate with different levels of risk. The assessment and rating of key risk categories provides a consistent approach for assessing an entity’s overall risk profile. While the categories provide a level of consistency across entities and industries, the SRI model does incorporate industry nuances and provides flexibility for capturing emerging risks.
- **Staging** – the outcome of the ratings in the risk assessment will be an overall supervisory stage for the entity. This staging will impact APRA’s overall supervision strategies and actions and require supervisors to consider the appropriate use of APRA’s powers and tools.

*Figure 2. Core components of the SRI Model*

The **purpose** of a dynamic, integrated risk assessment of a regulated entity is to ensure that supervisory judgements made about an entity are accurate, timely and robust, and the supervisory attention afforded to each entity is appropriate.



# Chapter 2 - Tiering

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Tiering is one of the enablers for APRA to undertake a risk-based approach to supervision (i.e. applying greater resources and supervision focus to the entities of greater systemic impact) while ensuring there are sufficient activities for all entities to capture key risks and trends.

The process categorises entities into one of four tiers based on the potential impact that entity failure, imprudent behaviour or operational disruptions could have on financial stability, economic activity and the welfare of the Australian community, especially bank depositors, insurance policyholders and superannuation fund members.

An entity's tiering will determine the depth of risk assessment undertaken. It also helps drive an expected level of supervisory intensity, to allow APRA to apply a sufficient level of attention to all entities in line with APRA's risk appetite.

**Table 1. Overview of tiers**

<b>Tier 1</b>	Individual entities that could have a large systemic impact.
<b>Tier 2</b>	Individual entities that could have a systemic impact.
<b>Tier 3</b>	Individual entities that are unlikely to have a systemic impact.
<b>Tier 4</b>	Individual entities would not have a systemic impact.

APRA has a structured approach to assigning entities to tiers. This is determined by six key indicators. The first is a quantitative indicator based on market share; the remaining are based on supervisory judgement:

**Size:** Entity failure, imprudent behaviour or operational disruptions are more likely to have a systemic impact if an entity's activities comprise a large share of industry activity.

**Interconnectedness:** Highly interconnected entities can have a significantly larger impact than implied by their size alone. For example, financial distress at one entity can materially increase the likelihood of distress at other entities if they are highly interconnected within the financial system.

**Substitutability:** This concept refers to how easily other entities can provide substitutes for an entity's functions and products. Certain activities or products may not be readily substitutable, and therefore difficult to transfer to other providers without significant disruption to the Australian community; for example, some long-tail insurance business.

**Complexity:** Overly complex entity structures and business models have the potential to obscure significant vulnerabilities that could have a wider systemic impact. Such entities can unravel rapidly and often lead to difficulties in resolvability - see over. The more complex



an entity, the likely greater the costs and time needed to resolve it should it fail financially, and therefore the greater the risk of disruption to the Australian community.

**Critical functions:** Some entities may conduct certain activities or functions that are vital for the functioning of the economy and financial stability. Criticality is also largely influenced by size, interconnectedness, substitutability or complexity in certain activities or business lines. Examples could include entities with significant market shares in payments or clearing and settling. Entities that provide critical functions to other entities, such as IT outsourcing, are also considered.

**Resolvability:** Credible and feasible resolution strategies are fundamental to reducing the potential impact on the community from entity failure. The ability of an entity to be resolved effectively helps minimise the systemic impact of its failure. APRA is developing its framework for resolution, and will incorporate this into tiering assessments as this area develops.

A review of all entity tiering generally occurs on an annual basis. Individual entities may move tiers at other times to reflect a material change in the entity's impact to the community, for example, as a result of a merger or acquisition.

# Chapter 3 - Risk assessment

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The ratings approach comprises three 'category groups':

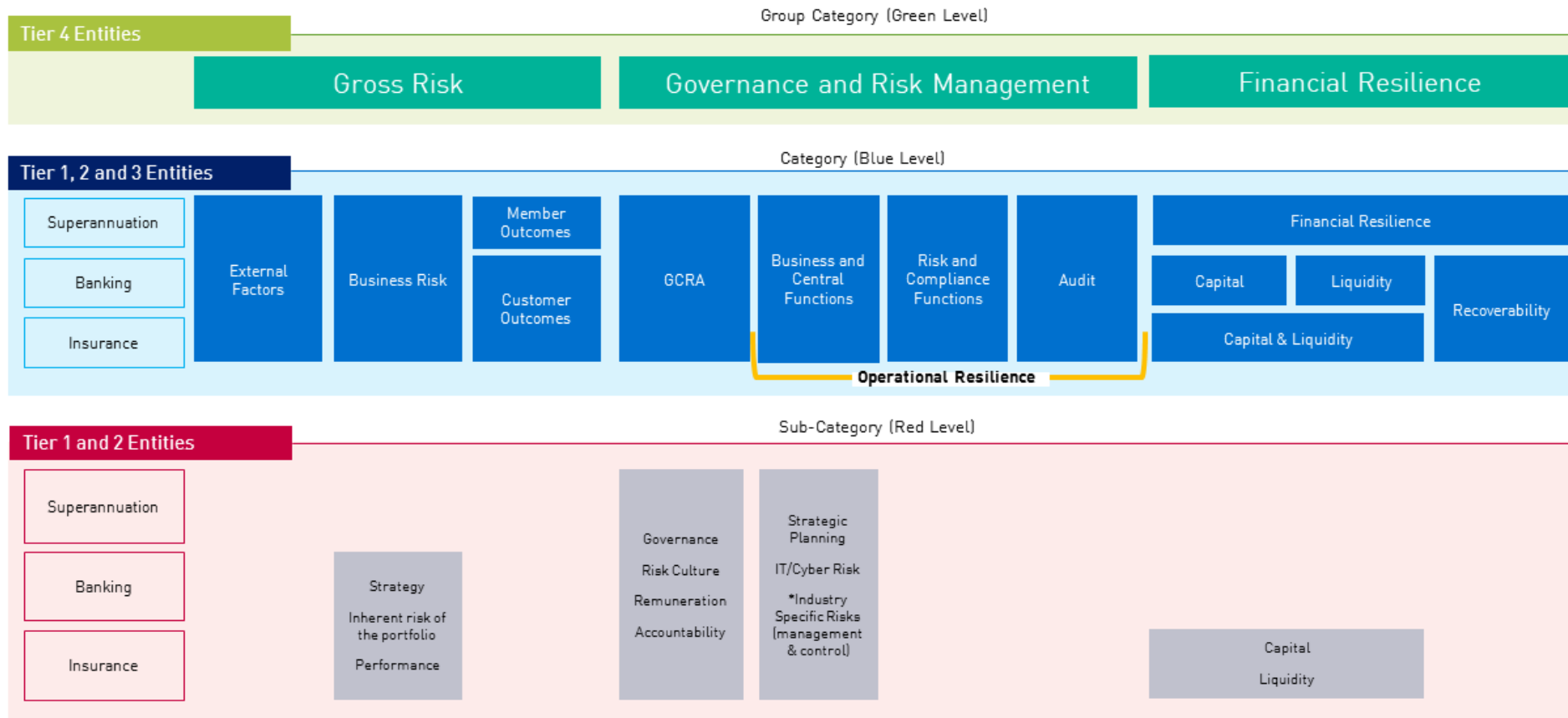
- **Gross Risk:** How an entity's external environment, business risk and customer/member outcomes could affect its risk profile;
- **Governance and Risk Management:** The strength of an entity's governance and risk management; and
- **Financial Resilience:** The strength of an entity's financial resilience, including its capital and liquidity resources and the entity's ability to recover from stress.

For tier 1, 2 and 3 entities, supervisors assess 8-10 core categories within the three category groups; the number of core categories varying by industry to reflect specific characteristics of the different industries. For tier 4 entities, assessments are only recorded for each of the three category groups as a whole.

For tier 1 and 2 entities, there is a further, more detailed assessment of certain sub-categories to provide additional industry information and a deeper, more robust assessment of the core categories of risk. A feature of the SRI model is the ability to have greater flexibility around the inclusion and deletion of these more detailed sub-categories, to ensure the model is capturing emerging issues and key thematic areas of risk. This aspect reflects the fundamental element of flexibility built into the model to allow APRA to adjust to the changing risk landscape.

Figure 3 provides an overview of the risk assessment categories. While the risk assessment structure and risk group categorisation are consistent across each of the APRA-regulated industries, as noted above, adjustments have been made to the specific risk categories and sub-categories to reflect industry differences. The industry specific risk category models are set out in Attachment A.

Figure 3. Risk assessment categories



\* Superannuation (Investments, Business Operations), Banking (Credit, Market, Operational), Insurance (Insurance, Credit, Investments, Operational)

The key categories of risk include:

## 3.1 Gross risk

The first section of the model involves assessing the Gross Risk of the entity and its operating environment. Essentially, this means assessing the overall risk of the entity before taking into account the associated governance and risk management elements that may be in place to manage this risk.

This assessment covers the environment in which the entity operates, the business it undertakes and the impact its business has on its customers/members.

### 3.1.1 External factors

The External Factors category recognises that an entity does not operate in isolation and its prudential risk will be impacted by factors outside of its control. In particular, these factors may impact an entity's viability, community trust and market confidence. APRA's assessment focuses on the external operating environment and the risks it may present to the entity's long-term viability. It includes an assessment of political, economic, social, technological, environmental and legal factors, competition, and industry-wide risks. Entities operating in similar markets with comparable businesses will have commonality in the assessment of relevant external factors.

### 3.1.2 Business risk

Business Risk involves an assessment of the sustainability of an entity's business model and captures elements within the control of an entity that impacts the overall risk of the business. This includes the entity's strategy, risk appetite and ability to respond to changing circumstances. Risks derived from the structure of the business (such as its reliance on outsourced providers and distribution channels) and reputational risks from the broader business are also key considerations. An entity's business risk can also be evidenced by the quality of its portfolio and the stability of its performance.

For non-superannuation tier 1 and 2 entities, the model requires separate ratings and assessments of their strategy, portfolio quality and performance.

**Strategy** assesses the risk associated with the business model and how the entity aims to position itself strategically. It involves an understanding of the entity's strategic direction and an assessment of the associated risks.

**Inherent risk of the portfolio** assesses the nature of assets and liabilities, off-balance sheet exposures, adequacy of reserves, sufficiency of valuations, concentration risks, exposure to country risks and the impact of international operations.

**Performance** assesses the robustness of earnings, claims experience, the nature and level of expenses, charges for reserves and other profit and loss implications. The assessment focuses on the drivers behind an entity's financial performance and the potential sources of future stress.

For superannuation entities, the assessment of these sub-categories is captured, where relevant, within the overall assessment of business risk.

### **3.1.3 Customer outcomes (non-superannuation entities)**

Poor customer outcomes can be a strong indicator of whether an entity is being prudently managed. An entity's actions can have significant impacts on its customers and its prudential risk outlook. There can be direct risks to financial soundness and the community's trust and confidence in the entity from poor customer outcomes, as well as indirect impacts from the root causes of those outcomes, e.g. systemic deficiencies in governance, risk management or culture.

### **3.1.4 Member outcomes (superannuation)**

APRA's assessment of member outcomes focuses on whether trustees, through the products and investment options offered, are promoting the financial interests of members and consistently delivering quality member outcomes. APRA assesses the trustee's strategic objectives and how these reflect the outcomes it seeks for members. While it is expected that there will be outcomes that may be common across all members of a superannuation fund, APRA's assessment also captures the outcomes for specific member cohorts and the extent to which these are duly considered by the trustee.

## **3.2 Governance and risk management**

Having assessed the risk of the business and its environment, assessments of governance and risk management enable APRA to review how the business seeks to manage and control those risks. As outlined further below, this section of the model focuses on the core governance, culture, remuneration and accountability (GCRA) risks, and the role of the business and its central functions (first line of defence), risk and compliance functions (second line of defence) and audit (third line of defence) in identifying, managing and mitigating risks.

A key focus within the assessment of governance and risk management is operational resilience, which is the entity's ability to identify risks, protect itself, detect, respond and adapt to events, recover, learn and minimise potential shocks that could impact the routine functioning of its critical business services. In this regard, the assessment of the business value chain and end-to-end process considers the interconnectedness of all non-financial risks and the effectiveness of the control environment to manage risk exposure.

### **3.2.1 Governance, culture, remuneration and accountability (GCRA)**

Effective GCRA frameworks and systems support the board and senior management to make decisions that promote the resilience of the entity. GCRA includes: governance structures and processes designed to inform prudent decisions and actions by the board and senior management that are guided by the entity's risk management framework; a risk culture that supports the entity to operate within risk appetite; a remuneration framework that clearly articulates what the entity values and what behaviours and outcomes are rewarded; and clear accountabilities to empower groups and individuals to perform their role.

Separate ratings for the four components of GCRA are required for entities in tiers 1 and 2.

### 3.2.2 Business and central functions

Business and central functions are responsible for operating the business on a day-to-day basis. This includes implementing the entity's strategy and managing risk in a prudent manner while maintaining operational resilience.

The assessment focuses on the entity's core business divisions, including the supporting central functions, and considers the effectiveness of the risk management and controls through the review of policies, processes, procedures, systems and people.

Separate ratings for specific sub-categories within business and central functions are required for entities in tiers 1 and 2. These sub-categories focus on the traditional and emerging areas of risk, and are industry specific. This includes the risk management of:

- strategic planning (all industries);
- IT/cyber risk (all industries);
- insurance risk (insurance);
- investment risk (insurance and superannuation);
- credit risk (banking and insurance);
- market risk (banking);
- operational risk (banking and insurance); and
- business operations (superannuation).

These categories may vary over time to reflect emerging risks in each industry.

### 3.2.3 Risk and compliance functions

An organisation's risk and compliance function is commonly referred to as the 'second line of defence'. This function provides independent oversight of, and challenge to, the business and central functions. An effective and independent risk and compliance function is critical to ensuring risks are identified, controlled and managed within appropriate boundaries.

### 3.2.4 Audit

Internal and external audit functions play a key role in providing assurance on the design and effectiveness of an entity's internal controls, risk management and governance systems.

An effective internal audit function is vital to ensuring an entity's policies are appropriate and operating effectively and that management takes timely corrective actions where weaknesses have been identified. External audit complements internal audit and is especially important for assurance around financial reporting and associated controls. Both audit functions provide a level of independence and must be sufficiently robust to support the prudential soundness of the entity.

## 3.3 Financial resilience

Within the model, the financial resilience section requires an assessment of an entity's ability to absorb shocks arising from financial and economic stress, including the ability to meet liabilities as and when they fall due.

For superannuation, there is one assessment category for financial resilience which focuses on the adequacy of reserves, adequacy of surpluses for defined benefit funds, ability to deal with extreme liquidity events and the adequacy of financial resources or trustee insurance to deal with unexpected losses.

For banking and tier 1 and 2 insurers there are separate assessments for capital, liquidity and recoverability. For tier 3 insurers, the assessment of capital and liquidity is combined into a single assessment. These assessments consider the adequacy of buffers and the effectiveness of capital and liquidity management plans and resources. The quality and plausibility of the recovery plans are assessed separately.

### 3.3.1 Capital

Capital, particularly in the form of common equity, acts as a shock absorber for unexpected losses. Strong capital position and robust capital planning and management is a key element of an entity's financial resilience and an important determinant of how likely an entity is to fail or experience stress.

### 3.3.2 Liquidity

Entities must maintain a sufficient stock of high quality liquid assets that can be used to meet funding outflows in a variety of stressed conditions. A strong funding and liquidity position, with complementing liquidity risk management framework, is an important determinant of an entity's overall financial resilience.

### 3.3.3 Recoverability

Recoverability assessments focus on an entity's readiness and ability to restore its financial resilience in the aftermath of a stress event. An effective recovery plan is crucial to an entity's overall financial resilience.

# Chapter 4 - Rating scale and formula

The rating scale for the new SRI Model is a simple six-point scale from A to F. The ratings are in respect of prudential risks and issues that could have an adverse impact on the outcomes for bank depositors, insurance policyholder and superannuation members, raise concerns regarding the entity's viability or indeed pose a risk to the broader financial system.

As highlighted in Figure 4 below, a rating of 'C' or worse indicates that there are issues or concerns identified that are outside of APRA's risk appetite and are to be rectified. In those instances, supervisors will establish supervisory strategies to address and oversight the entity's rectification of the issues driving the rating.

**Figure 4. Rating scale**



## Formula

Once all relevant categories are rated, the SRI Model utilises a formula to establish the entity's 'stage' - which determines APRA's supervisory response (see Chapter 5). The formula takes the average rating unless there is an outlier in an individual category or combination of categories. The poorest rating outcome of the averages or outliers determines the overall staging.

The formula converts the A to F ratings into a numeric rating. Scalars are applied to the combinations and individual ratings to ensure the categories and combinations have the appropriate impact on the staging.



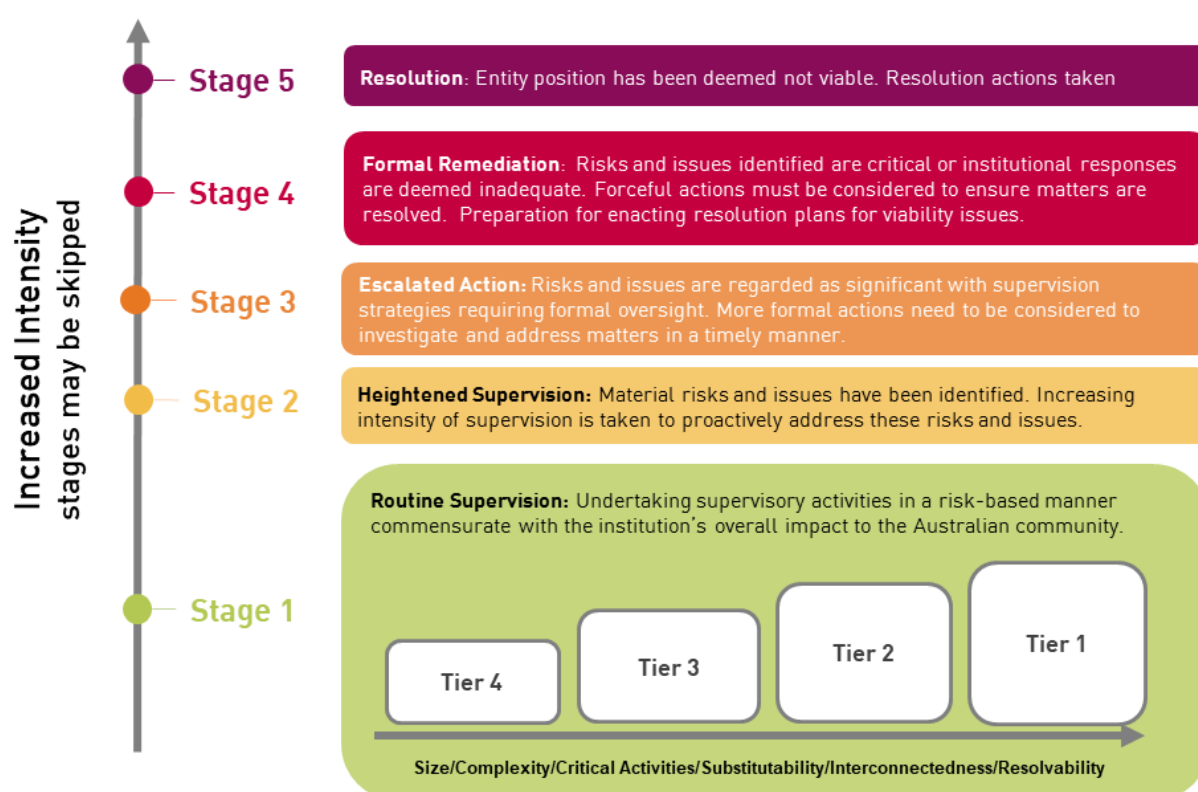
The external factors rating applies as a multiplier over the gross risk and financial resilience scores for entities in tier 1 to 3 to reflect that a worsening of the external environment can have an adverse impact on an entity's core business (gross risk) and their ability to raise capital and funding (financial resilience).

Ultimately, the formula seeks to ensure that, where there is a material prudential risk, it persists into the overall staging and is not unduly diluted by strong ratings in other categories. For example, if the risk culture of an entity is assessed as E (significant risk) this E rating will drive the final rating and the associated supervisory intensity stage, despite the entity having, say, a strong capital position. This ensures important 'non-financial' risks receive timely and effective supervisory attention to reduce the likelihood they could impact stronger financial health markers if unaddressed.

# Chapter 5 - Staging

The ratings within the SRI Model enable APRA to rank supervised entities based on their level of risk. This ranking then enables APRA to assign a level of supervisory intensity based on the associated risk. APRA assigns one of five stages of supervisory intensity to each entity based on the ratings model: routine supervision, heightened supervision, escalated action, formal remediation and resolution.

*Figure 5. Supervision intensity*



No entity should remain permanently in any of the elevated stages of supervision. Supervisory strategies and action plans applied by APRA seek to return an entity to Stage 1 - routine supervision.

Across all these stages, APRA's actions will also take into account the need to signal poor practices to the industry and the associated actions to deter other entities from allowing the same issues to arise in their operations.

APRA's Enforcement Approach provides insights into the types of actions that may be taken as part of these supervisory stages. Broadly speaking, there is an expectation that as an entity moves from routine supervision to formal remediation, there will be a transition from informal actions to formal actions and use of coercive enforcement powers. However, this does not prevent coercive powers being utilised at any stage, including routine supervision.

## 5.1 Routine supervision

Routine supervision ensures that APRA undertakes sufficient supervision activities to identify the key risks associated with the entity and has capacity to address and monitor minor risks identified as part of its supervisory processes. The nature and scope of activities within routine supervision are commensurate with the tiering of the entity, account for the nuances of each industry and align to APRA's overall supervisory risk appetite.

## 5.2 Heightened supervision

Heightened supervision requires an increase in supervisory intensity as a result of material prudential risks and/or issues being identified in the risk assessment. Supervisors will undertake targeted actions to specifically address the identified issues, including, but not limited to, the use of more regular and intensive supervisory actions through to coercive actions outlined in APRA's Enforcement Approach.

## 5.3 Escalated action

The escalated action stage is where identified risks and issues could have a significant and/or immediate impact on the entity. This may be the result of the magnitude of concerns relating to one risk/issue or several areas of concern across the entity. Supervisors will consider more formal and specific actions to both further investigate and have the entity address identified issues. Entities in this stage will be escalated to APRA's Resolution and Enforcement Committee to ensure an appropriate and consistent strategy and action plan are being undertaken.

## 5.4 Formal remediation

The formal remediation stage will be utilised in two broad instances: where critical issues have been identified and/or the regulated entity is not responding to APRA's requirements in an appropriate or timely manner. More formal and forceful actions will be utilised for entities in the remediation stage to ensure issues are resolved in a timely manner. APRA will also undertake additional activities to ensure resolution plans are ready to be utilised should the issues ultimately impact the entity's viability.

## 5.5 Resolution

The resolution stage is reserved for entities that have been deemed no longer viable. This also includes entities that, in APRA's assessment, will not be viable in the near future without significant restructuring. Supervisory actions in this stage will focus on APRA's resolution plans. APRA will utilise whatever powers are necessary to achieve an appropriate outcome for the Australian community.

# Chapter 6 - Quality and consistency

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The quality and consistency framework for the SRI Model comprises three levels:

- support foundations to aid supervisors in determining risk assessments and supervision action plans. The support foundations include five key components – assessment criteria, supervisor training, quantitative decision support, validations process and sign-off protocols;
- portfolio reports and watch list reports designed to monitor higher risk and higher impact entities, and risk profile shifts from a portfolio perspective; and
- hindsight review and assessment to evaluate the effectiveness and outcomes of current supervision practice and make changes where necessary. This level consists of peer group benchmarking sessions and peer reviews.

Each level is represented by a mix of challenge and control elements. The combination of all three levels is designed to lead to better risk assessments and planning of supervisory actions in APRA and overall improvements in supervisory judgements.

# Attachment A: Industry specific risk category models

The following sets out the risk category models for the banking, insurance and superannuation industries.

**Figure 6. Banking risk categories**

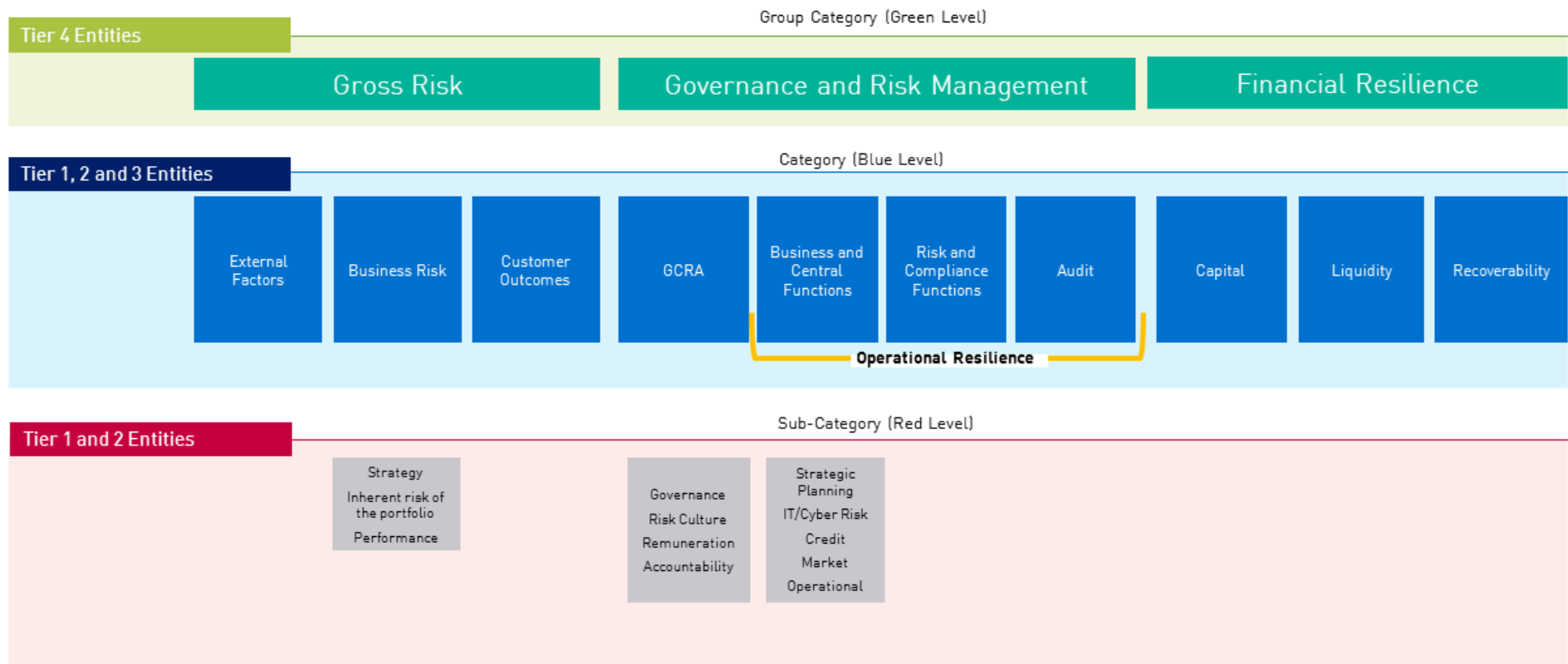


Figure 7. Insurance risk categories

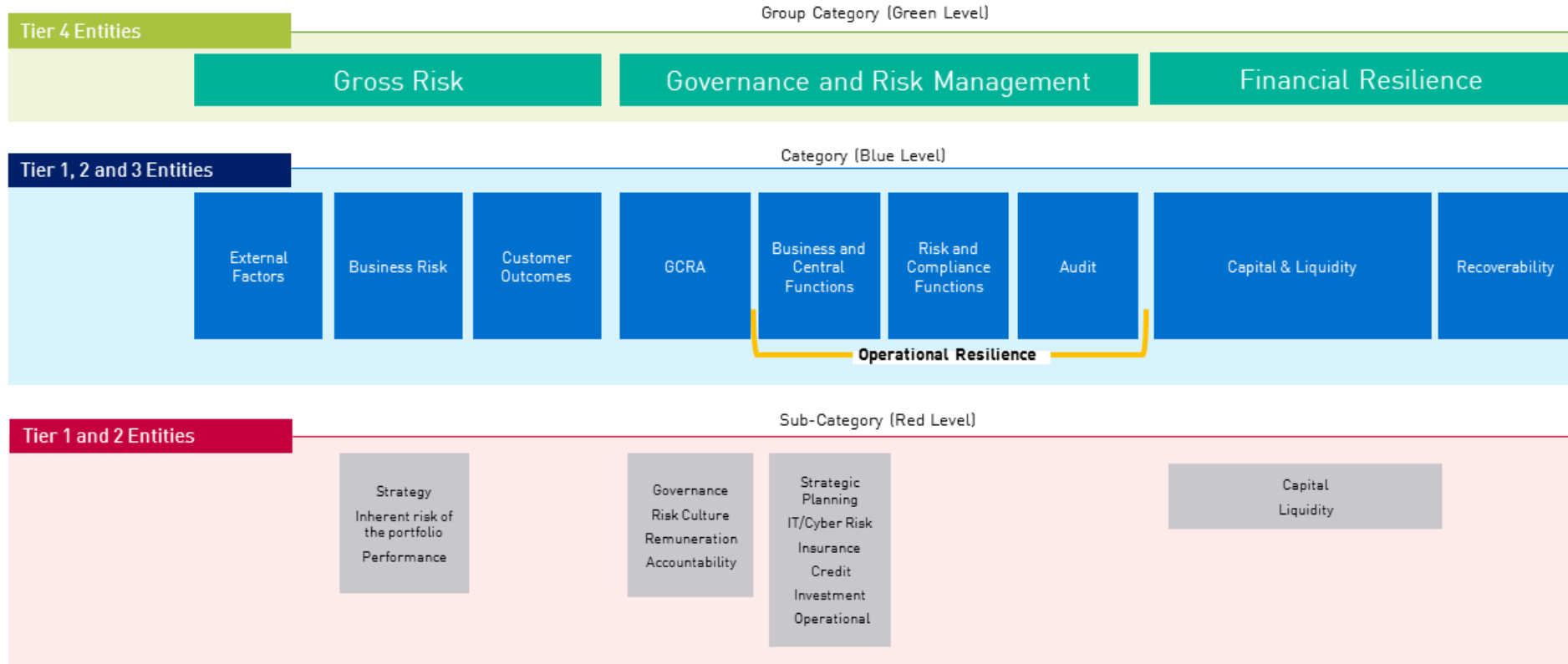
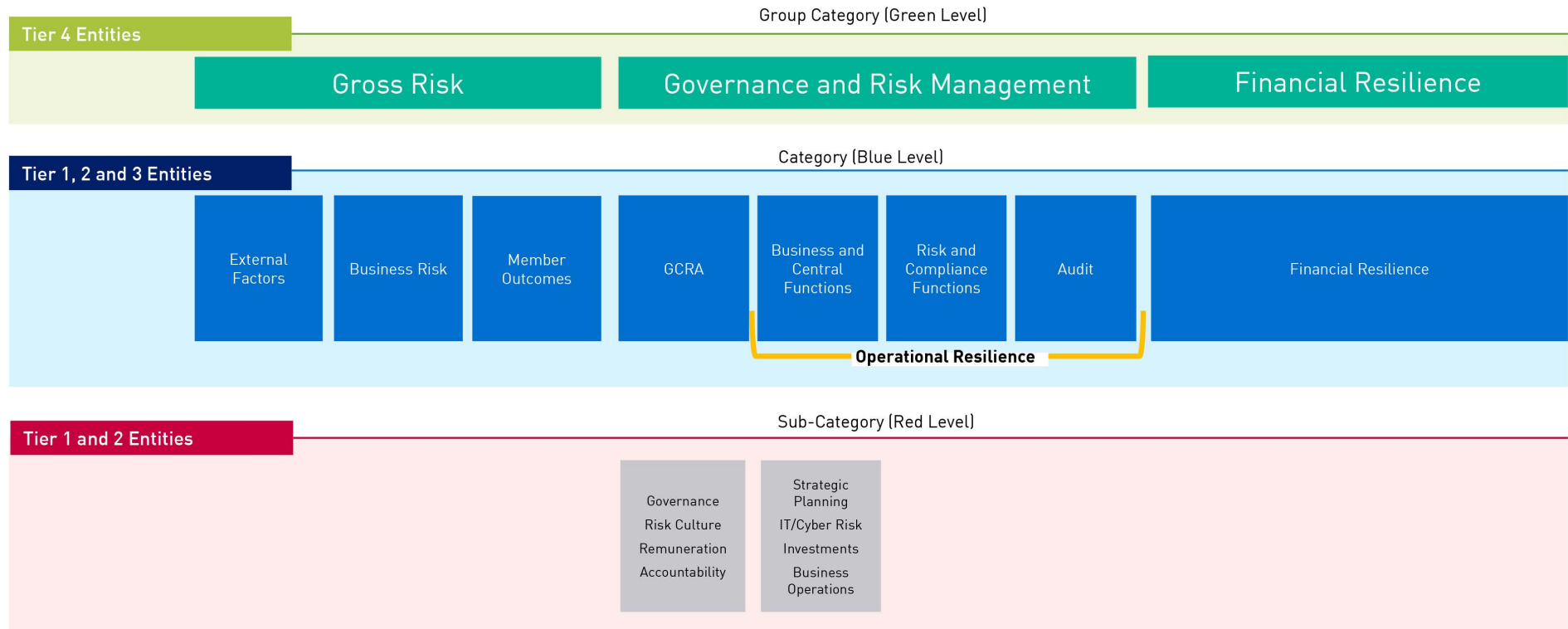


Figure 8. Superannuation risk categories





APRA