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THE FINANCIAL ENVIRONMENT

Globally, 2013/14 was marked by generally buoyant financial market conditions. The low interest rate environment stemming from accommodative monetary policies in major jurisdictions continued to aid the recovery in the global economy, as well as the strengthening of domestic banking systems. Sovereign bond yields reached historically low levels, credit spreads substantially narrowed, and equity prices in a number of countries touched record highs.

A surprising aspect of 2013/14 was that financial markets were remarkably stable for much of the year. After a bout of volatility in mid-2013 in anticipation of a change in monetary policy in the United States, historically low levels of volatility persisted for most of the year despite a range of financial and geopolitical events that might normally have expected to have had a more unsettling effect on financial markets. The absence of volatility reflected, to a large degree, confidence amongst investors that interest rates will remain low for extended periods.

While this financial environment is, as intended, likely to be conducive to economic growth, it also provides incentives for financial intermediaries and investors to take risk and search for yield. Vigilance is therefore warranted, particularly as there are signs of increasing volatility in recent months. While much has been done to strengthen the resilience of the financial system and reduce leverage therein, current conditions have been likened to those evident in the lead-up to the financial crisis, leading in turn to concerns about the potential for a sudden shift in investor sentiment and a sharp retraction in markets.

Against this backdrop, the Australian economy remains slightly subdued, with moderate growth, stable inflation and unemployment elevated in comparison to recent years. The decline in mining investment has continued, and while there have been signs of growth in non-mining sectors, the transition to more balanced growth still has some way to go.

Nevertheless, the Australian financial system remains, on the whole, quite healthy. The authorised deposit-taking institution (ADI) sector is profitable, with the largest ADIs continuing to produce high returns on equity. While credit growth at ADIs has been relatively slow, reflecting general economic conditions, non-performing loans have remained subdued. Funding conditions, particularly for the largest banks accessing international markets, have eased considerably, supporting improvements to liquidity and funding profiles.

In the insurance sector, performance was mixed. The general insurance sector recorded strong profits in 2013/14, reflecting recent pricing increases for retail business, a relatively benign period for natural perils, and reduced reinsurance costs. On the other hand, the life insurance industry suffered from poor claims and lapse experience in a number of business lines, and this cut profitability to relatively low levels.

The long term trend of superannuation industry consolidation continued in 2013/14, albeit at a slower pace than several years ago. Over the year, superannuation funds experienced sound growth supported by good investment performance due to continuing strength in global and domestic equity markets. Overall, the industry continues to mature as its adjusts to an environment of continuing increases in the level of total benefit payments, as a larger proportion of members move into retirement.
APRA’S SUPERVISORY FOCUS

As benign as Australia’s economic environment appears, a forward-looking supervisor such as APRA must continue to scan the horizon for emerging risks.

APRA’s broad objective in the current circumstances is to ensure that regulated institutions are resilient and prepared to respond to challenges that may arise in the future. It is impossible to predict with precision what the nature of those challenges will be, but that does not mean institutions cannot improve their readiness for periods of future adversity. In part, this means ensuring the financial resilience built up in recent years is maintained. It also requires the ongoing enhancement of technology systems and risk management capabilities.

Critical to this task will be strong governance frameworks within regulated institutions. APRA’s supervisory philosophy is founded on the premise that primary responsibility for the soundness of a regulated institution rests with its board and management. APRA does not expect boards to engage in day-to-day management responsibilities but it does expect them to provide strong governance and robust oversight of the operations of each institution. In this context, there is a range of issues to which APRA has urged boards and management of institutions to give heightened attention.

Lending standards, particularly for residential mortgage lending, have been a high priority in APRA’s supervision of ADIs. In an environment of historically low interest rates, high household debt, high and rising house prices, and strong competitive pressures, supervisory intensity of residential lending standards has been ratcheted up. This has included instituting additional data collections, developing a prudential practice guide on residential lending standards, and seeking assurances from the boards of the largest lenders that they are providing strong oversight of lending standards. In the current circumstances, however, lending practices that may appear prudent at the individual institution level may still, in aggregate, fuel systemic risks. As a result, the Council of Financial Regulators has been discussing the risks that arise from emerging imbalances in the housing market, particularly in relation to investment housing. APRA, with input from other Council members, is considering what further steps might be appropriate to temper potential threats to the health of individual ADIs, or financial stability more generally, from these developments.

In the general insurance industry, catastrophe risk management has been a particular focus for APRA. Although 2013/14 was a relatively benign year in terms of catastrophe claims, it is important that the lessons of earlier years when claims were much higher have been incorporated into catastrophe risk management practices. APRA has also been focussing on the impact on general insurers of the prevailing low interest rate environment, which has depressed investment returns and has the potential to put pressure on premium and reserving levels.
The repercussions from the poor experience in the group risk market have been the major area of supervisory attention in the life insurance industry. The impact on insurer profitability from aggressive pricing in group risk tenders has been compounded by higher total and permanent disablement and disability income claims. The adverse experience in turn led to a substantial reduction in reinsurance capacity. The result of this cycle was sharp increases in premiums, which helped to restore insurer profitability but have adversely affected superannuation fund members.

In 2013/14, APRA’s supervisory priority in the superannuation industry was the implementation of the new prudential framework that came into force in July 2014. These reforms aim to strengthen the governance, improve the efficiency and transparency, and enhance the regulatory settings of the superannuation system in Australia. APRA’s objective was to ensure that enhanced policies and processes required under the new prudential standards were truly embedded in trustees’ practices. Specific areas of focus are governance (including conflicts of interest), risk management/risk appetite/risk culture, investments (especially liquidity management and stress testing), insurance and data integrity.

THE POLICY AGENDA

Compared to recent years, 2013/14 was somewhat quieter on the policy front; the major components of APRA’s ‘home-grown’ policy agenda had largely been completed in 2012/13. Considerable effort was therefore directed during the year toward ensuring these earlier policy reforms were being effectively implemented. This included the Stronger Super reforms and a substantial revision of the capital adequacy regime for life and general insurers. The latter reforms have now been successfully bedded down, and there has been reasonable progress made in the implementation of the reforms in superannuation.

However international policy developments, driven by the G20, continued to require changes to domestic policy settings, particularly for the ADI sector. In 2013/14, the primary focus was on the remaining elements of the Basel III package, most notably a new liquidity regime, as well as the development of additional capital requirements for ADIs deemed systemically important in a domestic context. While the global reform agenda being pursued by the G20 is gradually being finalised, a range of initiatives that will impact on the domestic regulatory framework still remain to be completed.

Australia has been well served by adhering to, and being seen to adhere to, international minimum prudential standards. In implementing these standards, APRA must also consider how they are best applied to Australia’s domestic context. A degree of tailoring is often necessary, requiring close dialogue between APRA and affected institutions to ensure balanced outcomes.
An important element of the global reform mandate is subjecting national regulatory arrangements to greater external scrutiny of their adherence to minimum global standards. In this context, in 2013/14 APRA’s implementation of the Basel III capital framework was subject to peer review as part of the Basel Committee on Banking Supervision’s Regulatory Consistency Assessment Programme. The assessment team found APRA’s capital requirements closely aligned with the Basel capital framework, and Australia was assigned a ‘Compliant’ rating.

In addition to the international agenda, APRA also proposed revisions to the prudential framework for securitisation, and made improvements to capital raising options for mutual ADIs. These initiatives were designed, at least in part, to aid a restoration of sound securitisation markets, and to improve the capacity of mutual ADIs to compete on a more equitable basis with shareholder-owned institutions.

A further significant domestic initiative is the development of a prudential framework for conglomerate groups and, related to this, harmonising and enhancing APRA’s requirements for risk management. Much progress was made in 2013/14 and the work is now nearing completion.

WORKING WITH THE AUSTRALIAN GOVERNMENT

In April 2014, the Australian Government renewed its Statement of Expectations (SoE) for APRA. The SoE outlines the Government’s expectations of APRA’s role and responsibilities, its relationship with the Government, issues of transparency and accountability, and operational matters. Amongst other things, the SoE sets out the Government’s expectations that APRA:

- continue to act independently and objectively in performing its functions and exercising its powers;
- establish standards and practices that support Australia’s financial sector in globally integrated markets by implementing international standards – including the G20 reforms endorsed by the Government – in a way that is appropriate for Australia’s domestic circumstances;
- monitor regulatory frameworks and practices in other countries, and engage actively with international regulatory counterparts;
- maintain open and sound working relationships between APRA and the institutions it supervises, such that industry participants can communicate considered and candid views to APRA in order to enhance the regulatory framework while minimising compliance costs; and
- look for opportunities to reduce compliance costs for business and the community, consistent with the Government’s broader deregulatory agenda.
APRA’s Statement of Intent (soi), issued in early July 2014, set out its intention to ensure the Government’s broad policy framework, including its deregulation agenda, is accommodated in the course of APRA performing its role and meeting its responsibilities.

APRA’s soi noted that it will continue to take a risk-based approach to supervision that centres on identifying and assessing those areas of greatest risk to an APRA-regulated institution or the financial system, and then directing supervisory resources and attention to these risks. This risk-based approach to supervision is designed to promote both efficiency and effectiveness within the prudential regime, with greater intensity given to areas of highest risk, and less attention given to areas where the risk to institutions, or the community more generally, is low.

In following such an approach, the soi noted that APRA does not pursue a zero-failure objective. Instead, the prudential framework seeks to maintain a low incidence of failure among APRA-regulated institutions without impeding continued improvement in efficiency or hindering competition. APRA endorsed the sentiment expressed by the Government in its SoE, that ‘...it is not possible or efficient to eliminate all risks and that trade-offs in risk reductions are necessary’. APRA cannot eliminate the risk that an institution might fail; indeed, attempting to do so would impose an unnecessary burden on the financial system. Instead, APRA’s objective is to identify the potential failure of a regulated institution sufficiently early to allow for prompt corrective action or an orderly exit.

Consistent with Government’s broader goals, APRA consulted in 2013/14 with industry representatives to identify specific and quantifiable options for cost savings within APRA’s regulatory and supervisory frameworks that can be made without compromising sound prudential outcomes. Through that process, APRA has identified a number of near term and longer term options to reduce regulatory costs. Many of the near term options are expected to be implemented in the year ahead, and work will continue on developing the other options. Formal industry consultation will occur in the usual manner for each set of proposals.

FINANCIAL SYSTEM INQUIRY

During 2013/14, the Government established a Financial System Inquiry (FSI) to examine how the financial system could be positioned to best meet Australia’s evolving needs and support Australia’s economic growth. The Inquiry was tasked with making recommendations by the end of 2014 that will foster an efficient, competitive and flexible financial system, consistent with financial stability, prudence, public confidence and capacity to meet the needs of users.

APRA has made two submissions to the Inquiry. The first round submission in March 2014 highlighted the strength of the existing regulatory architecture, the rationale for the domestic prudential framework, and the philosophy that underpins APRA’s supervisory approach.
In response to the range of submissions received, the FSI issued an Interim Report in July 2014 which noted, amongst other things, that:

- there was little evidence to support a case for significant changes to Australia’s regulatory framework, and furthermore the global financial crisis had tested domestic regulatory arrangements and Australia’s twin peaks model had proven robust and effective;
- a factor contributing to Australia’s resilience during the global financial crisis was APRA’s strong prudential framework, together with its proactive approach to supervision;
- that regulatory reforms in the post-crisis period had been applied in a manner and timeframe to best suit Australian market circumstances; and
- that APRA’s prudential requirements, often more conservative than minimum international standards, do not appear to have placed Australian institutions at a significant competitive disadvantage.

The Interim Report also posed a number of questions, and sought more information, on a range of issues and policy options relevant to APRA. APRA made a second submission in August 2014, which provided additional information on matters such as the importance of, and benefits from, a sound prudential policy framework; the costs and benefits of various measures to deal with ‘too big to fail’; limits to the international comparability of ADI capital ratios; the need for holistic consideration of retirement income policy settings, including those in relation to post-retirement options and product offerings; and the importance of regulator independence and accountability.

APRA will continue to engage with the FSI as it completes its recommendations, and stands ready to assist the Government as it formulates its response to the FSI’s final report.
OUR PEOPLE

APRA’s vision is to be a world-class prudential regulator, whose operations are founded in excellence of supervision. Achieving such excellence is only possible with the right people. Since its formation in 1998, APRA has been fortunate in being able to attract and retain high-calibre staff who, often in trying circumstances, repeatedly demonstrate skills, judgement and tenacity of the highest order.

APRA staff well understand the importance of their work to the Australian community and invariably respond to new challenges with a spirit of professionalism and commitment, which is a source of great pride to APRA Members. We thank them once again for their efforts.

On 30 June this year, Dr John Laker ended his 11-year term as Chairman of APRA. Dr Laker was appointed Chairman in the aftermath of the HIH Insurance failure, with the task of leading the restoration of APRA’s capabilities and reputation. In doing so, he laid the groundwork for APRA’s subsequent successes, not least of which was helping to navigate the Australian financial system through the global financial crisis. In more recent years, Dr Laker steered APRA through a busy period of major policy reform across the banking, insurance and superannuation industries. In meeting these challenges, he invariably displayed clarity of vision, intellectual rigour, a steady determination, and a calmness under pressure. Most of all, he brought a warmth of personality to the role of Chairman that was appreciated by all who worked with him.

APRA Members, on behalf of all APRA staff, extend their gratitude to Dr Laker for his dedication and great service.

Wayne Byres
APRA Chairman
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