

From the Chairman

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The Australian financial system in 2006/07 continued to reap the dividends of Australia's long run of economic success. However, some of the shine from this positive picture has been lost in the volatility that has affected financial markets, globally and in Australia, since year end.

All industries supervised by APRA performed well over the year in a very competitive environment. Deposit-taking institutions enjoyed further brisk growth in activity that generated good profitability; capital levels and asset quality overall remained sound, although pockets of weakness in mortgage lending have emerged. Insurance companies maintained a strong underwriting performance and capital position. The superannuation industry, now well settled into the new supervisory regime, garnered substantial inflows from the Government's 'Better Super' reforms and, together with the life insurance industry, recorded another year of high growth and favourable investment returns.

Throughout 2006/07, dealing with the implications of sustained good economic times captured much of APRA's attention. These are the times in which APRA must keep its day-to-day supervision squarely focussed on its preferred role – prevention rather than cure – and continually test that Australia's supervisory framework is capable of underpinning the safety of the financial system in less favourable times. These were APRA's main priorities in another busy year. With major reform initiatives completed a year earlier, however, APRA's agenda for strengthening the supervisory framework was lighter.

Recent market turbulence, triggered by the sharp deterioration in the US sub-prime mortgage market, has put an end to any complacent view that markets will not ultimately penalise participants that have underpriced risk in good economic times, or whose own risk profile is opaque. Markets are now playing out themes that have been emphasised by prudential regulators and central banks for some time – the importance of identifying risk, ensuring it is priced appropriately, managing risk carefully and holding adequate capital against unexpected losses. In this context, price transparency is also critical.

The Australian financial system has only very limited direct exposures to the US sub-prime mortgage market but it is not immune to recent increases in wholesale funding costs nor to the market's heightened caution about certain types of credit products and business models. That said, the fundamental strength of the financial system and Australia's robust supervisory framework leave financial institutions well positioned to weather the turbulence. Moreover, the strong momentum of the global and Australian economies looks set to continue, which augurs well for the range of financial activities in which supervised institutions participate.

APRA's mandate

During 2006/07, APRA's mandate as Australia's integrated prudential regulator was reconfirmed in the Government's *Statement of Expectations* of APRA. This was part of a reform to the governance arrangements for statutory authorities, endorsed as well by the Government's Taskforce on Reducing Regulatory Burdens on Business (the 'Regulation Taskforce'). The *Statement of Expectations* and APRA's *Statement of Intent* in response are reproduced in this Report.

In the *Statement of Expectations*, the Government acknowledged that it was very pleased with the overall performance of APRA and that it recognised and will continue to respect the operational independence of APRA. These acknowledgments were welcome.

Importantly, the Government has confirmed that prudential regulation should not pursue a 'zero failure' objective. Rather, the objective is to maintain a low incidence of failure of supervised institutions while not impeding continued improvements in efficiency or hindering competition. APRA fully supports this objective. From its establishment, APRA has accepted that it cannot eliminate the risk of failure and that any attempt to do so would impose unnecessary burden on financial institutions and harden the arteries of the Australian financial system.

The *Statement of Expectations* provides helpful signposts for APRA's future direction but does not call for any fundamental change of course. APRA's response focusses on further improvements to the efficiency and effectiveness of its supervisory activities, and on enhancing transparency and accountability.

On the latter, APRA will be releasing a Service Charter that sets out the key rights and responsibilities of APRA, its supervised institutions and members of the community who have dealings with APRA. It will also be developing a broader suite of performance indicators beyond the safety measures it has been publishing in recent years. A word of caution is appropriate here. Meaningful analysis of the contribution of prudential regulation is a challenging task for APRA, and its overseas counterparts as well. The 'costs' can easily be overstated, particularly if they cannot be readily disentangled from the day-to-day costs of conducting business well; 'benefits' can also be hard to discern if public confidence in the financial system is also supported by a range of positive macroeconomic and other factors. The real test of the contribution of prudential regulation comes during periods of financial stress, where a robust supervisory framework would be more likely to contain the damage. However, this potential contribution does not lend itself to simple quantitative indicators.

On this score, APRA welcomes the findings from the benchmarking of Australia's regulatory arrangements conducted by the International Monetary Fund under a global review program. These arrangements were judged to have a generally high level of compliance with international standards and, in a number of areas, Australia is at the forefront of best practice. The review concluded that the Australian financial system is mature and strong, and financial supervision is sound.

APRA's supervisory approach

APRA's efficiency and effectiveness depend crucially on the supervisory framework – the 'rules of the game', so to speak – and how APRA applies these rules in its normal supervisory activities.

In its *Statement of Intent*, APRA re-affirmed its commitment to moving to a more flexible, principles-based approach in its development of the supervisory framework. A principles-based approach recognises the complexity and diversity that exists among financial institutions and seeks to avoid a one-size-fits-all solution. APRA took further steps in this direction in 2006/07.

The period of intense reform activity in previous years, in which the new licensing regime for superannuation and second-round reforms in general insurance were prominent, had brought APRA much closer to its goal of upgrading Australia's supervisory framework. In 2006/07, APRA's main priorities were the implementation of the new global capital adequacy regime for deposit-taking institutions (the Basel II Framework), the harmonisation of prudential standards in life insurance and further development of the supervisory framework for general insurance conglomerates. APRA also worked closely with the Government to implement the 'streamlining regulation' recommendations of the Regulation Taskforce, which are aimed at improving the flexibility and consistency of the supervisory framework and reducing compliance burdens.

A number of APRA's reform measures, particularly some of those dealing with capital adequacy, are highly technical in nature and do not suit a principles-based approach. However, in other areas – such as outsourcing and market risk – APRA was able to recast previously detailed prescriptive requirements into the form of non-binding prudential practice guides to assist institutions to reconcile their specific business objectives and models with APRA's principles for prudent risk management. APRA has also foreshadowed a less intrusive approach in areas such as securitisation and the appointment of auditors and actuaries, where the need for prior approvals by APRA can subtract from the responsibility of the institutions themselves. When these latter changes are complete, APRA will no longer be involved in the prior vetting of any senior appointments to a supervised institution, from board director down.

In its normal supervision, APRA pursues a risk-based approach that targets its attention and supervisory resources on those institutions facing greater risk. Timely and proportionate intervention is essential to APRA's effectiveness. APRA aims to bring any substantial concerns to the attention of boards and senior management early and enlist them in corrective action, well before a heavier hand becomes necessary. APRA's relationships with boards, which APRA's Executive Group has been keen to promote, are proving time and again a very constructive way of bringing supervisory issues and commercial realities face-to-face.

APRA's risk-based approach is underpinned by a rigorous and sophisticated system for assessing emerging risks in a supervised institution and for determining the supervisory response. The signals from this risk-rating system are critical and receive careful scrutiny within APRA. A dull warning signal when an institution is coming under financial stress would discourage a prompt and appropriate APRA response; on the other hand, a strong warning signal when an institution is not in financial difficulty may encourage an over-zealous and unnecessary response. A prudential watchdog must bark, but not constantly at shadows! The review conducted by the International Monetary Fund, mentioned above, found that APRA's risk-rating system was at the leading edge of current approaches to risk-focussed supervision.

APRA's risk-rating system is complemented by a range of other supervisory tools that have been developed in-house to meet immediate needs. Ideally, this toolkit would ensure a consistent and integrated 'end-to-end' supervision process by which prudential data and other information are received, judgments made, and supervision activities performed and documented (and all in timely fashion). APRA has made the attainment of this ideal a major strategic priority.

In a dynamic and complex financial system, a supervisory toolkit – no matter how well integrated – needs to be in the hands of skilled supervisors. No APRA tool can substitute for mature and incisive supervisory judgment. The need is even more pressing under a principles-based approach where supervisors must be able to assess, in a variety of circumstances, whether the specific solutions proposed by supervised institutions are capable of meeting the relevant prudential principles.

APRA's Executive Group is committed to building and retaining a seasoned, high-quality workforce that is on top of market developments and risk issues, and respected by industry. Progress on this score has been very positive but hard-won. APRA has been able to attract experienced staff from industry and the professions, locally and overseas, and maintains an active graduate recruitment program. At the end of 2006/07, staff numbers were 582, a slight fall over the year but close to target. However, this outcome belies the challenges that have faced APRA in competing for financial and risk management skills that are also highly

sought after in the marketplace. APRA's staff turnover continued at around the level of the previous year and with much the same pattern: mobile younger staff but a settled cadre of more senior supervisors.

Additional and welcome funding was provided in the 2007/08 Commonwealth Budget to enable APRA to better attract and retain qualified staff. This funding will help to address salary relativities in areas where APRA remuneration has fallen well behind market, and to bolster APRA's extensive training programs. These measures will reinforce a series of internal initiatives aimed at greater staff motivation and retention, through improvements to management and leadership practices, the distribution of financial rewards, the development of career opportunities and staff recognition. APRA is also expanding its program of secondments to prudential regulators and major financial institutions abroad; however, staff exchanges with local financial institutions, which some see as a way of broadening APRA's experience, remain problematic on confidentiality grounds.

Looking ahead

The current year will see the last major plank of APRA's recent reform agenda fall into place, when the Basel II Framework is introduced. This fundamental reform of regulatory capital for deposit-taking institutions will provide stronger and more accurate management of and pricing for risk – a reward in itself for the investment incurred whatever the individual capital impacts prove to be. Other reform initiatives include conglomerates, refinements to the supervisory framework for general insurance to facilitate the licensing of foreign insurers, and further follow-up on the recommendations of the Regulation Taskforce. This list may seem long but industry can be assured that the hard yards of reform have already been secured.

Beyond its normal supervisory activities, APRA's organisational energies in 2007/08 will be directed at further improving its efficiency and effectiveness. Importantly, APRA has strengthened its strategic focus on its supervisory processes and corporate infrastructure to ensure that their development is not piecemeal – hard to achieve in the formative period of a new organisation – but pursued within a comprehensive, best practice blueprint. As part of this drive, APRA is also reviewing its supervisory cycles and the level of routine



APRA Members in 2006/07 – (left to right) Mr Ross Jones, Dr John Laker and Mr John Trowbridge.

interaction with supervised institutions. APRA's aim is to be well-placed to deal with changing economic currents, minimise unnecessary burdens on supervised institutions and make best use of its valuable staff resources.

In the current environment, financial institutions are facing a level of financial market uncertainty they have not had to confront for some period. At the time of writing, the highly unsettled state of global credit markets was expected to persist, at least until the size and ownership of losses in the US sub-prime mortgage market became clearer and markets determined more prudent and sustainable pricing for risk. Though global market volatility had its origins in poor lending practices and aggressive funding strategies by certain US credit providers, there are lessons for all financial institutions to learn in recent events. Boards and management need to satisfy themselves that risks in current and new ventures and investments are clearly identified and monitored, that incentive structures promote enduring rather than transitory success and that any greater appetite for risk is matched by robust risk management systems, the necessary skills and adequate capital resources.

Our people

Now entering its tenth year as Australia's prudential regulator, APRA is maturing into a vigorous, confident and skilled organisation with an unquestioned commitment to the Australian community. Some staff have been with APRA from the outset and have helped to build the organisation from the ground up; many others have lent their weight to this task over recent years. APRA's staff can be proud of what has been achieved to date, and APRA's Executive Group thanks each one of them for their enthusiasm and support.

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