Staying Ahead of the Curve

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Introduction

Good morning and thank you for the opportunity to address this forum.

I have to say I am particularly pleased with the topic I have been asked to speak on today. Risk management, current issues, regulatory developments etc. Well, to a prudential regulator, basically that is carte blanche to speak of whatever I wish!

There has been considerable commentary on some of APRA’s initiatives of late. In particular, our governance proposals have generated some lively comment.

While I will come back specifically to the issue of our governance proposals a little later, I am of the view that some of the commentary to date has missed the point of our initiatives in this area. As you would all be aware, a primary area of focus for APRA is on prudent behaviour.

Prudential regulators are well titled as our primary focus is on prudent behaviour - we seek and if necessary, demand prudence in governance and risk management in our regulated institutions. We establish a framework of legislation and prudential standards which we require our regulated institutions to operate within.

We do, however, recognise the need for commercial reality - in fact, the APRA Act requires that we balance the objectives of financial safety and efficiency with competition, contestability and competitive neutrality. Of course, the difference and point of contention with our regulated flock that arises from time to time, is where that line should be. On occasion, APRA will opt for a more conservative line in the sand while some of our regulated institutions will seek to push that line further.

While APRA and regulated institutions will not always see ‘eye to eye’, we are, for the most part, ‘on the same side’. After all, regulated institutions too have a strong self interest in prudent risk management.

Overall, we need our institutions to be able to trade profitably and attract new capital when they need it. So we are certainly not against business making a buck!

That said, what we are particularly interested in is long-run sustainable profitability in our institutions. Sustainability comes from keeping a close eye out for emerging troubles, steering to avoid them where possible, or reacting quickly to them when they emerge. Put simply, we want institutions to watch for and avoid the reefs, but also have a good recovery plan in place if they happen to hit one.

To our mind in APRA, this is nothing more than good business management - indeed, our prudential framework strives to establish an environment in which good business practice can flourish.
Staying Ahead of the Curve

APRA works hard to stay ahead of the curve - by that, what I am saying is that we commit considerable resources to identifying and researching emerging issues, considering their potential prudential ramifications and where necessary, responding accordingly.

Responding with a change in our prudential rules is not something we undertake lightly. We understand that innovation and change is a necessity in business, but good public policy is set with the long-term in mind and provides a degree of certainty about what the rules of the game will be. Nevertheless, from time to time, it is necessary for us to amend our prudential rules accordingly to temper the behaviour of institutions.

Examples of this include our reaction to non-standard lending products where we have tightened the prudential framework for low doc and other non-standard loans as well as the work we did on stress testing the housing loan portfolios of our authorised deposit taking institutions (ADIs) which have now led to reforms in the capital rules for lenders mortgage insurers (LMIs).

Changes are, however, very much the exception rather than the rule. For example, the work which we did on valuation practices of ADIs (which may I add is available on our website) did indicate to us a potentially increasing risk profile in the practices of institutions but our reaction to this will be on a case by case basis.

A prudential regulator’s success is difficult to measure because our success lies in preventing problems, not in how we pick up the pieces. What we seek to do is to prevent issues from becoming significant problems. It is when problems go unchecked and are compounded that solvency is placed at risk. That imperative necessitates an approach that is partially pre-emptive and much of our good work is done behind the scenes. Being able to act pre-emptively requires a strong set of powers to enable us to intervene where we see the need - and of course there is a significant onus on us to use those powers very judiciously!

The Environment Today

Looking at the environment which ADIs are operating in today.....

ADIs have, over a reasonably long period now, experienced what would be their most successful period - ever. We have seen:

- Enormous balance sheet growth
- Strong profitability
- Low levels of impaired assets; and
- Strong capitalisation

All ADIs have shared in this growing pie - banks, building societies and credit unions. It’s been a great period to be in financial intermediation.

Our economy has been particularly supportive - low interest rates and low inflation has seen an enormous demand for housing finance.
In 2003, APRA conducted a project to stress test the resilience of ADIs to a significant correction in the housing market. The scenario we undertook was a 30% reduction in housing values and a significant increase in mortgage defaults. The results of our test were that the system could withstand a housing value correction of that magnitude without putting depositors at risk. We did, however, identify a need to tighten the prudential framework for LMIs and that is what our reforms in that area have been focused on.

All of that said, it is apparent that the environment is changing. Housing lending growth has been slowing as the housing market has cooled. Even so, we now see levels of household debt and corresponding servicing burdens, unheard of in this country. Since 1992, the ratio of household debt to income has risen enormously (grown almost three times) and as a result, people today are more exposed than ever to interest rate increases and changes in their individual circumstances that may affect their income level and hence debt servicing capacity.

With the slowdown in household credit growth, there has been an intensification of competition in the housing lending market. At the same time, we have seen an increasing focus on business lending.

As you would expect, the reaction of ADIs to this changing environment and how they have attuned their strategies to this environment is of great interest to us today. Simply attempting to repeat the growth of the past few years may be a very ambitious target in a slowing market.

Areas of Supervisory Focus

Leading me to “what is APRA focussing on currently in its supervision of ADIs?”

Before going into that specifically, let me touch on APRA’s supervision approach and tools.

Supervision Approach

APRA’s supervision approach comprises both on-site supervision (at the premises of regulated institutions) and off-site analysis and monitoring. It is both forward-looking as well as retrospective (backward-looking). From a retrospective viewpoint, what we are trying to obtain is a picture of what the institution has been doing - its risk management practices in the recent past, new products and how they have been deployed etc because these will impact on the institution in the future.

In looking forward, we want to try to get a good understanding and picture of where the institution could be heading. This is particularly important to us if we are to prevent issues becoming problems in the future. Our prudential consultation process is an important part of this when we meet with senior executives and sometimes, board members to discuss significant issues.

Our general supervision approach focuses heavily on governance and risk management - for the simple reason that deficiencies in these two areas are key factors that will impact heavily on the prudential standing of a regulated institution.
Risk management is of course a subset of governance but we look and assess the specific building blocks separately in our risk rating of regulated institutions.

It would be fair to say that while governance has always been an area of interest to prudential regulators, it is now today a more important area of focus than it has ever been in the past. This is not just an area of domestic interest. The whole corporate world has been caught up in a flood of governance developments - Sarbanes-Oxley, for one.

Some well-known corporate failures internationally, as well as HIH locally, have really bought home the need to understand how an institution is governed. The failure of HIH is a most drastic example of what can happen when governance goes awry.

There is an old saying among prudential regulators that “capital is king”. That has certainly not changed but if capital is king, then governance is equally entitled to a royal title. If anything, it is almost certainly the “queen” for without the queen, there is no succession and hence, no future. I don’t think I can find a better analogy than that.

In order for capital to provide adequate protection against the risk of loss, an institution must be able to reliably identify and measure all potential risks. This is where good governance and risk management processes come in.

Boards and management, how they perform, how they plan, how they manage the relevant risks to which their institutions are exposed, the oversight functions in place, their understanding of the business they conduct - assessments of all these areas are now an integral part of our supervision approach.

**Areas of Supervision Focus for ADIs**

As I mentioned a little earlier, we are today particularly interested in the business strategies (particularly growth targets) and risk appetites as well as on the risk management practices of institutions.

Looking at these in turn - and I would point out that they are all interrelated - with business strategies - what we are seeking to establish is whether the business strategies of institutions are realistically matched to the market today.

APRA has continued to caution ADIs in this environment about being realistic. In a nutshell (as an example), if an institution has in its business plans a growth target of double the industry average, then, on face value, it is either taking on more risk or it is running a superior business.

If it is the latter, then our view is good luck to them but if it is the former (ie - taking on more risk), the institution will have to demonstrate to APRA that its risk profile has not increased significantly - and if it has - what the ADI has done to manage this risk. In both cases, the onus is on the institution to persuade APRA that what it is doing is prudent.

Risk appetite - risk appetite is a key factor in determining the business strategy of an institution. In addition, a higher risk appetite may see an ADI pushing or perhaps relaxing its risk management practices to support its growth targets.
In this context, risk management can be compromised in two ways - the first is in an ADI relaxing its risk management practices for the sake of growth and the other is in de-investing in risk management. By de-investing, what I mean is reducing the resources applied to risk management.

It is important to also recognise that as the world changes, so do the demands on risk management. Even if risk management budgets and staff headcounts do not decline, there may well be a need to increase resources just to stand still.

Certainly, any institution that is not investing significantly in risk management in the current environment may be falling behind its more forward-looking peers.

This is an area which has the potential to become a significant issue. The issue comes down to cost cutting. Realistically, how far can an institution go in staff and system cost reductions without ultimately compromising key functions? (and I would point out I am not singling out regulated institutions).

It is now common reading upon the appointment of a new CEO or the announcement of annual results that there are plans for major cost cutting exercises in the short term.

This is announced citing reasons such as the imperative to return more value to shareholders - that shareholders have a right to expect further profits. There is no question that shareholders are a key stakeholder - after all, they are the owners of the company.

That said, I think it is valid to ask whether compromises are being made that are in the long-term interest of shareholders. Cost-cutting is relatively easy in the short term, because the consequences are generally not manifested until some time in the future.

ADIs of course have an additional obligation to depositors and as the prudential regulator, APRA has an expectation that ADIs will be cognisant of this. As the prudential regulator, it is our role to ensure that ADIs understand this obligation otherwise it may be necessary for APRA to mandate a level of protection that it feels is appropriate.

In particular, I make the point that we would not want to see cost cutting jeopardise key risk management or oversight areas as that could potentially increase the risk to depositors.

In July, Michael Chaney (the former CEO of Wesfarmers and new chairman of the NAB) used the term “short termism” to describe the infatuation with improving financial results in the short term at the expense of long term stability.

In the corporate sector in Australia, short term EPS seems to have become a significant driver. This desire to improve upon previous years’ results needs to be tempered with reality. For ADIs, in a slowing market for housing credit, how realistic is it to be looking to maintain or improve on previous years’ results? What compromises will need to be made to achieve this? As I mentioned previously, looking to maintain results of previous years in a slowing market may be a very ambitious target.
Onsite Supervision Issues - Credit
Onto some observations on credit practices. This is one of the principal areas of focus for APRA in its supervision of ADIs, as you would expect.

I think it would be fair to say that, in general, we have found that ADIs are willing to carry more risk in their lending practices today. This is not necessarily a problem provided there are compensating controls and functions in place.

From our on-site supervision activity, there are a number of issues which we have identified in the recent past and I’m going to cover a few examples briefly:

Debt servicing capacity - on debt servicing capacity, we have seen a move from the more traditional rule of thumb methodologies to more innovative approaches. We have also identified some issues with slippages in the actual verification process.

Don’t get me wrong, innovation is important but while institutions have been arguing that these new methodologies (like scorecards) are more granular, the reality is that these methodologies do permit higher amounts to be lent. We are concerned that these methodologies have never been tested in adverse scenarios and we are currently conducting some analysis on debt multiples (loan size to income) and comparing it to historical norms.

Valuations - as I mentioned earlier, APRA conducted a survey of valuation practices by ADIs and LMIs in the past year. What we identified was that from a housing perspective, the past five years or so has seen a move by ADIs away from the more traditional full valuation in favour of more streamlined valuation methodologies. These include kerbside valuations or valuations drawn from sources such as contracts of sale, valuer-general records or desk based electronic methods.

As with our concerns on debt-servicing, these new methodologies have not been tested in a scenario of stress before and they may expose ADIs to increased losses if appropriate controls are not in place.

While I am on the issue of valuations - I would also point out that we have noted an increasing preparedness on the part of ADIs to lend on commercial properties at increasingly higher loan to valuation ratios (LVRs). This does appear to be a trend in the industry.

Another issue we have noted is that in the case of some ADIs, there doesn’t appear to be an adequate level of granularity in terms of LVR policy. By that, what I mean is that we have noted examples of “one size fits all” LVR policies. We expect that prudent lending behaviour would determine LVRs on criteria such as geography, overall exposure size, developer expertise etc.

Interest-only lending - We have noted an increasing willingness on the part of ADIs to extend the period of interest-only lending for commercial purposes. We are now seeing interest only periods in some cases extending out to ten years and there seems to be a trend towards longer periods. In some cases, we have questioned whether these structures have the cash flow to repay principal or sink further monies as required.
We have a view that interest-only lending is one area that does need to be better controlled and we expect that ADIs should establish more distinct rules in terms of where they will and won’t conduct lending of this type.

*Pricing* - we have also noted examples where “meeting the competition” has been the primary criterion rather than pricing for risk. In particular, we have identified numerous instances where commercial facilities are being priced at almost housing lending rates.

*Documentation* - It is apparent that new products and processes (scorecard validations, risk processes etc) are, at times, being delivered without the correct overarching documentation being laid down.

Overall, we have a feeling that ADIs are pushing that little bit further today to write business. Notwithstanding APRA tightening up its prudential rules on non-standard lending products, we have noted some ADIs are now willing to accept even higher LVRs and higher portfolio limits in the case of low-doc loans.

Credit practice is an area APRA is watching very closely. Our stance towards individual institutions depends, as you would expect, on the quality of risk management, the compliance culture, the oversight functions, the current portfolio and the institution’s capital position.

**Technology**

I’d like to spend just a little time speaking on some of the technology issues which currently concern us. These issues come under the area of operational risk which is an area we have been focussed on for some time.

APRA has a specialist team looking at IT operational risk which conducts regular visits to institutions. In our supervision framework, operational risk requires a specific assessment and the work and input of this team is essential in APRA forming its assessment of an ADI’s overall operational risk management.

Innovations in technology over the past decade have seen a fundamental shift in the way in which many ADIs deliver their services to their customers. It would have been difficult a decade ago to have imagined such a fundamental shift in customer behaviour. It is this dependency on technology that has made it essential for prudential regulators to have these specialist risk management skills in order to make the necessary assessments.

As some of you would have read in the media in mid-August, the Australian Federal Police charged a number of individuals with regard to an attempted fraud on a large superannuation fund. This attempt at fraud reflects the potential sophistication of crime today.

One of the most worrying facts about cyber-crime is that institutions can be targeted from almost anywhere in the world. Criminals no longer need to be physically present to perpetrate a crime.
Internet Banking

‘Phishing’ attacks on ADIs have now become commonplace and in this context, we are concerned about the potential for internet banking fraud.

Internet banking is no longer an ancillary service - it is a key aspect of service which customers demand from ADIs. Any system is only as secure as its weakest point and the area which most of these attacks are seeking to exploit is not at the ADI’s systems level (where controls are generally at their strongest) but at the customer level (where awareness and controls are at their weakest or are non-existent).

The very large number of customers using internet banking means more users are at risk and the fact that there is a concentration in internet service providers (ISPs) increases the ability of these criminals to exploit personal computers through the internet.

Last year, APRA wrote to all ADIs advising of its concerns in this area and the need for ADIs to educate their customers. The Australian High Tech Crime Centre (AHTCC) also launched the Joint Banking and Finance Sector Investigation Team to assist ADIs in responding to threats such as ‘phishing’. Both the Australian Bankers Association and Credit Unions Services Corporation supported these initiatives.

These initiatives are necessary. The only certainty which we all face is that criminals will only increase in sophistication and it is essential that ADIs have systems that will provide an adequate level of protection. It will be a continuing battle for ADIs to stay one step ahead.

One initiative which has, to date, seen limited uptake is that of two factor authentication. APRA of course welcomes such improvements. There has been, however, opposition to its introduction. The reasons for this vary but include issues such as the expense, that customers find it unwieldy to questions over the security by which passwords are stored in the token or device.

Two factor authentication may not be the panacea to the problem but it does add an additional layer making it more difficult for criminals. The likely impact is that these criminals will then seek “easier prey”.

In the past year, APRA has focused on internet banking controls at a number of ADIs and we will be continuing our work in this area.

I would like to emphasise that IT controls and safety are a particularly key area today, and ADIs should be very aware of the consequence of not spending the necessary resources to safeguard their systems.

Product Development

Onto a broader issue on operational risk.

Product development is an area where we see considerable variation in the quality of operational risk management.

The introduction of a new product can expose an institution to significant risk and we expect that institutions will have a robust methodology of ensuring that the relevant “i’s” are dotted and “t’s” are crossed.
APRA does review this area as we want to obtain satisfaction that the introduction of a new product or significant expansion of an existing product is supported by a formal, documented and structured process detailing the development, risk assessment and authorisation of the product by all relevant areas of the ADI (eg risk management, finance, data collection, internal audit, IT etc). In addition, we will be looking to see if exposure limits are introduced by the institution.

Failure to do so may significantly increase the likelihood of mis-pricing or risk management deficiencies occurring which may lead to significant losses from that product line.

**Governance and Fit and Proper**

APRA has recently issued draft prudential standards for governance and fit and proper.

**Governance**

Let me speak a little on some governance issues, particularly the rationale behind our proposed governance standard.

As many of you would be aware, APRA’s governance proposals were first aired as part of our reforms in the general insurance industry in 2003. The culmination of an extensive consultation process was our discussion paper and draft prudential standards covering the ADIs, general insurers, life insurers, friendly societies and non-operating holding companies which were issued in May 2005.

Our framework for governance recognises the role and responsibility of the board and we have taken a principles based approach. That said, we have proposed some specific minimum requirements in areas such as board composition and committees as well as in some other areas. The rationale for these minima is that APRA must be able to enforce its requirements should it become necessary.

Our governance proposals focus on a number of key principles. These being:

*Responsibility* - the board and senior management are responsible for decisions and outcomes made by the ADI - particularly that these do not result in unacceptable prudential risk to the institution

*Independence* - directors must be independent in both thought and mind. The board must also perform its role independently of specific interest groups and conflicting business interests

*Renewal* - the board must have a policy for renewal to ensure there is a constant fresh insight and general invigoration of the board. This of course has to be balanced with retention of corporate knowledge

*Expertise* - obvious - the board needs to have the necessary expertise to fulfil its role (collectively)

*Diligence* - board and management should be diligent in discharging their responsibilities
Prudence - board and management should at all times discharge their responsibilities with a focus on prudent management

Transparency - the board and management must be open and honest in all their dealings on behalf of the ADI

Oversight - the board must be satisfied that its oversight is adequate so as to ensure that the management and operations are in accordance with the strategy of the institution.

Our objective is to improve the overall standard of governance in regulated institutions. We do not deny that the requirements are at the firmer end but prudentially regulated institutions should meet a higher benchmark. That is also why we have capital, risk management and a range of other requirements and a prudential regulator to oversight these.

As I have already covered today, many of the drivers which impact directly on the prudential standing of a regulated institution flow directly from the governance of the institution.

This includes risk appetite, the compliance and risk culture, strategy etc. Failure to cover these would give us an incomplete view of an institution and would severely compromise the forward-looking prudential picture which is so important to us.

If our governance proposals result in directors being more willing to question, more inquisitive, more demanding etc we will be pleased with that result. We need no reminder of recent problems in the corporate world that have arisen from directors that have permitted management excessively free rein. Of course, in no way are we suggesting that we want a adversarial relationship to develop between a board and management.

Claims have been made that our requirements are unrealistic for small institutions - “an overkill” - and that we need to separate our requirements for the big end of town from the small end.

We are certainly alert to this issue and we remain open to workable approaches. That said, we are not attracted to compromises that discount the level of protection for our beneficiaries in small institutions.

To date, we have received well over 50 submissions on our draft governance standards and another lively consultation round with institutions is underway.

Fit & Proper
APRA’s proposed fit & proper requirements are intended to be complementary to our governance proposals. This has been recognised by the regulated industries and many submissions were made on both proposals together.

Our proposals are based around the premise that a regulated institution is responsible for ensuring that its responsible persons are fit and proper. We will be requiring that regulated institutions develop fit & proper policies. However, APRA will have a reserve power to deal with unacceptable behaviour.
This is not an area in which we are unfamiliar. We have been dealing with fit & proper issues in the superannuation industry for a number of years and, more recently, in the general insurance industry.

**Tier 1 Capital**

As many of you would be aware, APRA issued a discussion paper last week on the prudential approach to tier 1 capital and securitisation in response to the adoption of International Financial Reporting Standards (IFRS).

While our primary driver was to provide a regulatory position on the impact of IFRS required changes, we also decided that it was an opportune time to review our rules on tier 1 capital.

Without going into detail on all the proposals as I do not have the time today, in a nutshell, our proposals introduce:

- A three component approach to tier one capital comprising Fundamental Tier 1, Residual Tier 1 and Innovative Tier 1
- A reduction in the limit of Innovative capital instruments to 15% of Net Tier 1 capital
- Removal of the prohibition on direct issuance by ADIs on innovative instruments
- Removal of the mandatory conversion requirement on innovative instruments

Our proposal for the 15% limit on innovative capital instruments will bring us into line with the pronouncements of the Basel Committee on Banking Supervision and the requirements imposed by many of our international peers.

The removal of the mandatory conversion requirement should permit mutual institutions to issue innovative capital instruments on a comparable basis to listed institutions. Mutual institutions currently have difficulties in issuing Tier 1 capital instruments without it impacting on their mutual status and this proposal should assist these institutions in their endeavours to develop a viable Tier 1 capital instrument.

**Closing**

I would point out that much of what we are requiring as prudential regulators from institutions in terms of governance and risk management should be no different to what an ADI should desire for itself.

Nearly all significant problems and failures that have occurred can be traced back to deficiencies in governance.

That makes it not just an appropriate, but in fact, an essential area for APRA to focus its efforts if it is to stay ahead of the curve.