



## APRA - ISSUES ON THE RADAR

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### Introduction

The opportunity to explain – to de-mystify, perhaps – the critical role that APRA plays in promoting the financial security of the Australian community is one that I am always keen to seize. So I am grateful to the South Australian Division of the Australian Institute of Company Directors for the invitation to join its Directors Luncheons and to address this large gathering of business leaders in South Australia.

My topic is “APRA – Issues on the Radar”. Note I said radar, not crystal ball! While APRA places great store on being forward-looking and pre-emptive in its supervisory approach, we cannot foretell the future and we do not know how the strong economic fundamentals that have sustained the Australian financial system for many years will evolve. Our radar focuses rather on the potential threats to the soundness of our regulated financial institutions that can arise when the combination of good times and competitive pressures tempts these institutions to lower their guard on managing risks. Risks can emerge in a number of areas and my comments today are intended to illustrate the breadth of APRA’s current interests.

Just as importantly, however, I want to talk about APRA’s radar itself. Over the past three years, we have put a considerable effort into developing supervisory tools that help us identify and evaluate problems in regulated institutions and to target our response. Experience with these tools provides valuable insights into the timeliness and effectiveness of APRA’s supervisory intervention. A retrospective tells a positive story that I would like to share with you. In this sense, my talk today is a companion-piece to my address to the NSW Division of the Institute in March this year.<sup>1</sup>

But before that, let me say a few words about APRA in South Australia.

### APRA in South Australia

South Australia is home to a small but vibrant group of financial institutions regulated by APRA. Headquartered in this State are two banks, a building society and eleven credit unions, including three of the five largest credit unions in Australia by asset size. There are also four general insurers, two friendly societies and 14 superannuation trustees licensed under the new superannuation licensing regime. One of these trustees is responsible for the large bulk of Small APRA Funds, superannuation entities regulated by APRA that have fewer than five members. Some finance companies and other types of financial institutions have their home base here as well but they are outside APRA’s purview.

APRA is a national regulatory agency with a network of offices in most State capitals. We supervise almost all of the South Australian financial institutions out of our Adelaide Office, where we have a small but skilled team led by one of our seasoned senior managers. This ‘coal-face’ contact works very well for us. Our supervisory approach is grounded on understanding and being comfortable with the governance of the institutions we supervise, and it is essential that we know the

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<sup>1</sup> *The Prudential Regulator at Work*, Australian Institute of Company Directors, NSW Division, 22 March 2006.

people who make up the board and senior management, and they know us. This is more easily achieved when the contact with those key people is regular and face-to-face, and their access to APRA is convenient.

Our regional network has other advantages as well:

- it enables APRA to stay attuned to regional economic conditions and issues, and to how national concerns impact on institutions throughout Australia;
- it facilitates closer contact with service providers and professional advisers such as auditors and actuaries; and
- it permits APRA to be more responsive and mobile in deploying its supervisory resources.

At the same time, technology permits our regional staff to be easily linked into Head Office and to share fully in APRA's extensive knowledge bases. And we have taken steps to ensure that our regulated institutions are treated consistently, no matter where located.

In short, provided APRA can retain minimum critical mass in each State capital, our regional network is here to stay.

#### **APRA's radar**

The Australian financial system of which the South Australian institutions are a part is strong, diversified and innovative. Our regulated institutions are, generally speaking, well-capitalised and soundly managed. Business volumes and balance sheets have been growing briskly but problem assets are at historically low levels. And profitability across all our regulated industries is buoyant.

What is underpinning the strength of our financial system? The most obvious factor is Australia's economic fundamentals. For over a decade and a half, Australia has had an economy with consistent forward momentum and low and stable inflation. Over recent years, consumer sentiment has for the most part been well above long-run average levels and unemployment and interest rates have touched generation lows. The Australian share market has also surged. In such an environment, the household sector's appetite for housing credit and superannuation products has been strong as has, particularly recently, the corporate sector's demand for funding and for a range of financial instruments.

A second element underpinning our financial system is a robust supervisory framework. By this I mean the legislative requirements and APRA prudential standards and guidance put in place to promote prudent business behaviour and risk management on the part of our regulated institutions. The supervisory framework in Australia is as good as any in a mature economy. Don't take my word for it. As the Government's Regulation Taskforce noted earlier this year:

“Australia’s financial and corporate sectors, and the associated regulatory structures, are highly regarded internationally. Moreover, the broad policy framework has widespread support within business and the wider community in Australia” <sup>2</sup> (p.88)

The International Monetary Fund and World Bank have also been running their ruler over Australia’s financial arrangements as part of their Financial Sector Assessment Program (FSAP). Although the FSAP review is yet to be formally presented, we are confident that it will judge Australia’s approach to prudential regulation to be sound overall and, in a number of areas, to be in the forefront of international best practices.

A third contributing factor has received little public attention. That is the work APRA has been doing over recent years, almost always behind the scenes, to weed out potential problems in our regulated institutions and to improve standards of risk management. Compared to our founding years, our approach has been more forceful, something the HIH Royal Commission recommended and the Australian community expects. Now, with three years of data to draw on, we are able to judge whether our approach has also been more effective.

A prudential regulator must do two things well. Firstly, we must identify and evaluate potential risks at an early stage. We should not be relying on luck or tripping over the ‘bleeding obvious’. Secondly, our supervisory response must be targeted, proportionate and timely. We are not in the undertaking business!

This is where APRA’s radar is critical. We have two supervisory tools designed to ensure that APRA supervisors assess risks rigorously and consistently and that our supervisory interventions are indeed targeted and timely. Our Probability and Impact Rating system (PAIRS) is our risk assessment model and our Supervisory Oversight and Response System (SOARS) guides us in responding to the risks we identify. A substantial intellectual effort has gone into developing this framework, which was introduced in October 2002. By June 2006, around 1,330 institutions accounting for over 99 per cent of APRA-regulated assets had been PAIRS rated.

APRA has explained these two key supervisory tools in recent Annual Reports and speeches, and I can only summarise them today.

Our regulated institutions have a broad spectrum of risk characteristics, some of which are universal, others specific to particular industries and others, again, exclusive to the institution. Ultimately, each regulated institution has its own unique risk profile. PAIRS provides a disciplined and systematic process to assess this profile. The risk assessment covers the inherent risks facing the institution, the effectiveness of management and controls in mitigating these risks, and the extent of capital support to meet unexpected losses.

The bottom line is a rating for ‘Overall Risk of Failure’ – an assessment of the likelihood that the institution will fail to honour its financial promises to beneficiaries (depositors, policyholders and superannuation fund members). For us, ‘failure’ is not the same as commercial insolvency. APRA has no obligation to look after the interests of shareholders and it may, in a crisis situation, have to compromise those interests to protect beneficiaries.

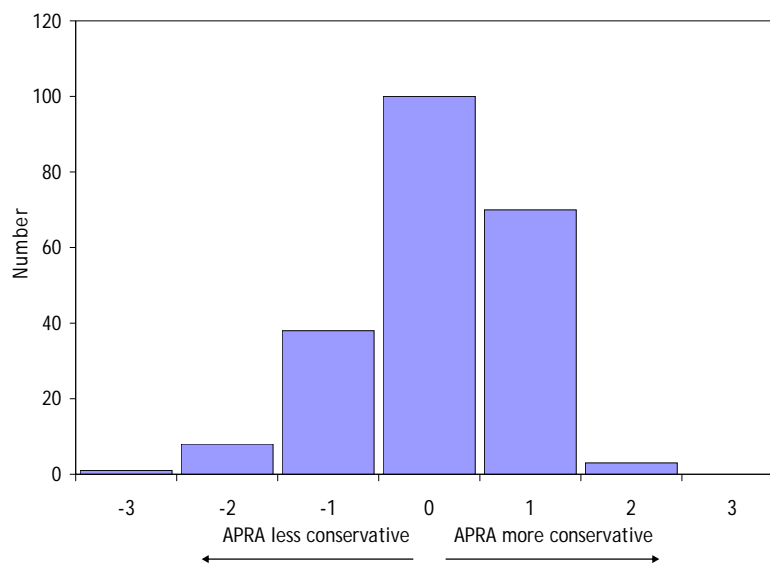
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<sup>2</sup> *Rethinking Regulation*, Report of the Taskforce on Reducing Regulatory Burdens on Business, January 2006.

Our risk assessments are judgment calls. PAIRS is a structured framework for expert judgments, not a 'black box' model, and it is where the skills, experience and acumen of APRA's supervisors must come to the fore. Our judgments are broadly based on our on-site and off-site supervision, statistical returns, communication with boards and management, audit and actuarial reports and on various sources of market intelligence. It is crucial that the PAIRS ratings are as accurate as possible and we have a number of mechanisms, including benchmarking, to ensure that the ratings are not dominated by the views of particular supervisors.

As a reality check, we also compare our PAIRS ratings with those of ratings agencies for those 110 or so regulated institutions with external credit ratings. As Graph 1 shows, APRA's PAIRS ratings are centred very close to external ratings but tend to be a little more conservative. This is a comforting result. The ratings agencies include in their assessment a judgment about the likelihood that APRA will intervene effectively should an institution find itself in trouble. PAIRS, on the other hand, is meant to drive APRA's decision as to how and when to intervene, and pre-judging our own effectiveness would simply be circular. We have considered all the cases where PAIRS ratings vary substantially from external ratings and are satisfied that the differences exist for good reason.

**Graph 1: PAIRS and external rating agencies:  
combined rating differences**



Having looked at the *probability* of failure, the second component of PAIRS is the relative *impact* that the failure of a financial institution would have on the financial system. As a general rule, the larger the institution, the more inertia it is likely to possess, and the more serious are the likely economic and social consequences of its failure. Steering a super tanker is the obvious analogy. Hence the premium on early supervisory intervention when needed. APRA uses asset size as its basic measure of impact and, though a workable approach, it is clearly one for further research.

The PAIRS rating system can be thought of as a matrix, with probability of failure on one axis and impact of failure on the other. This matrix is one we use internally to monitor the number of institutions and the amount of assets in each

box. Obviously, our antennae twitch very nervously if large numbers are starting to appear towards the top right-hand corner of the grid.

Where PAIRS involves substantial calculation and judgment, SOARS is simply an overlay of supervisory stances on top of the PAIRS grid. The discipline, nonetheless, is a critical one. Regulatory forbearance – that is, softening our response, avoiding hard decisions and prolonging the life of a troubled institution in the hope that a problem will solve itself – is not a discretion available to our supervisors.

There are four supervisory stances involving a step-up in the intensity of APRA's involvement. 'Normal' needs no explanation. Institutions in 'Oversight' have some aspect of their risk position or operations – such as minor but persistent weaknesses in the control framework or insufficient capital – that requires more extensive examination by APRA. The risk profile of some institutions with particular geographic, product or customer concentration, or unsophisticated risk management, may see them in Oversight for extended periods.

'Mandated Improvement' institutions are operating outside APRA's acceptable bounds for prudent risk management. These institutions must have a sensible remediation plan and they may be subject to more intense supervisory attention via formal directions or enforceable undertakings, although APRA's persuasive powers and a cooperative response are often sufficient. Institutions in 'Restructure' are no longer viable in their current form and need some combination of new management, new ownership or new capital, or a new business arrangement. As you would expect, these institutions are subject to vigorous supervisory intervention.

Currently, around 70 per cent of our risk-rated institutions are in the 'Normal' category and almost all the remainder are in 'Oversight'. Only a very small percentage is in 'Mandated Improvement' or in 'Restructure'. This gets to the heart of my remarks.

The SOARS grid has been set so that the larger the regulated institution, the earlier and more proactively APRA responds to a given risk of failure. This approach contrasts with APRA's less intrusive approach of earlier years – and one criticised by the HIH Royal Commission – that was based on the fundamental premise that large regulated institutions were sophisticated, well managed and well controlled, and subject to strong market and other disciplines. Experience has taught us that once large entities begin to exhibit financial stress, they typically require more time than smaller entities to turn around. We are careful, however, to avoid unnecessary intrusion into the affairs of institutions and we look for pragmatic solutions. We take no pride in being heavy-handed for its own sake.

Ideally, APRA would like to see institutions in the Normal and Oversight categories improving, or at least not deteriorating, and institutions in Mandated Improvement and Restructure transitioning to those other categories or exiting the industry, preferably without loss to beneficiaries. This has been our experience over the past three years.

The first table shows the current SOARS stance for institutions that have been in Mandated Improvement at some point between 1 July 2003 and 30 June 2006. The second table shows the current SOARS stance for institutions in Restructure at some point over the same period. The great majority of these institutions have either improved or exited the industry, with no failures as such. Of the 168

institutions concerned, 57 have improved, 16 remain in their SOARS category, one has been downgraded and 94 have exited. Within these numbers are 16 larger institutions that have been in Mandated Improvement whose problems have largely been resolved or, in three cases, have exited the industry without loss.

**Table 1: Entities in Mandated Improvement (2003-06)**

Current stance	Total
Normal	10
Oversight	44
Mandated Improvement	9
Restructure	1
Exit	67
Total	131

**Table 2: Entities in Restructure (2003-06)**

Current stance	Total
Normal	2
Oversight	1
Mandated Improvement	0
Restructure	7
Exit	27
Total	37

We in APRA draw three important messages from this retrospective. Firstly, APRA's move to a more pro-active, risk-based supervisory approach for larger entities has been paying off, both in identifying problems and in resolving them. Not surprisingly, then, we currently have very few institutions in the Mandated Improvement category. Secondly, the exits are confirmation that the normal disciplines of the market-place have been working. APRA's role is not to prevent failures or exits or regulate the financial system so heavily as to remove all risk from it. Some financial institutions simply couldn't make the grade. Finally, however, we are very conscious that it may be harder to achieve orderly exits on the scale of recent years if economic conditions became less supportive. Over the past three years, with asset markets strong and finance readily available, troubled institutions have been able to find willing buyers for their businesses or their assets. This may not always be the case.

#### Issues on the radar

This evidence on APRA's effectiveness as a prudential regulator is very encouraging. Of course, our PAIRS/SOARS radar has not operated over a longer period of both good and bad times, when our ability to identify distress early and to discern genuine changes in risk profiles from spurious changes would be sharply tested. Frankly, we hope our radar is never tested in this way!

Naturally, APRA welcomes the continued strength of the Australian economy and its low inflation record. For financial institutions, it has been an excellent environment in which to do business. With one caveat! As I have said elsewhere, good times can breed complacency in the management of risks. This can take many forms – the short-sighted pursuit of market share, starting new business ventures unprepared, building inadequate risk margins into pricing and under-investing in or under-resourcing the risk management function. The watchword in good times is vigilance.

For APRA, there are two other developments in the Australian financial system that are shaping our supervisory agenda. The first is the inexorable process of consolidation. Even in the last five years, the number of banks, building societies and credit unions – known as authorised deposit-taking institutions (ADIs) – has fallen from 281 to 223; general insurers from 162 to 133; life insurers and friendly societies from 84 to 62; and superannuation funds, where licensing has spurred the process, from 4,233 to 1,147. The combination of industry consolidation, innovation and strong balance sheet growth means that APRA is now supervising a

smaller number of institutions of increasing size and complexity, many seeking to grow their business offshore and/or tapping into offshore service providers.

The second development is the intensification of competition across a range of financial products. We see it in mortgage and small business lending, in on-line deposit accounts and in classes of life and general insurance business. We see it also in superannuation following the introduction of 'choice of fund'. The Australian community is clearly benefiting from lower cost financial products and product innovation. However, these gains will not prove enduring if competitive juices blind the boards and senior management of our regulated institutions to the attendant risks.

With these developments as the backdrop, let me canvass a number of issues currently on APRA's supervisory radar. The list is by no means exhaustive nor is it indicative of APRA's priorities. Rather, I have chosen the list to illustrate the breadth of issues with which a prudential regulator must deal and how it builds up its supervisory acumen and judgments. The issues are credit standards; pricing for risk; product innovation; 'offshoring'; and pandemic planning.

### *Credit standards*

Credit standards have been a major focus of APRA's supervisory attention for some time now. In mortgage lending, there is no question that strong competition – which is providing the community with cheaper housing loans, sold and structured more effectively – has been accompanied by an easing in credit standards. Only at the margin, we are always told. Perhaps, but the cumulative effect of the easings is a source of vulnerability for ADIs. To this point, credit quality has been extremely strong but past-due loans have been ticking up. And recent monetary policy tightenings bring the day of reckoning for unwise lending decisions that much closer.

APRA does much more than hand-wringing on this subject. Our front-line supervisors and specialist credit risk team have been working closely with ADIs to review their credit policies and assess the robustness of internal controls. Recently, we have brought another pair of eyes to the task. As part of our 'tripartite arrangements' with external auditors, we asked the external auditors of selected lenders to undertake a targeted review of the compliance of mortgage lending practices with Board-approved internal credit policies and procedures and with APRA's prudential requirements. The results of this external review are reassuring. Though some areas for improvement were identified – particularly in the verification of critical loan application data and in documentation – the compliance frameworks have been assessed as broadly adequate and effective.

APRA has also been analysing changing market practices in mortgage lending. Last year, we published the results of a survey of property valuation practices which confirmed the movement away from the traditional full valuation. This year, we are reviewing how ADIs assess the ability of their customers to service their mortgages. Our analysis confirms that industry is shifting from traditional rules of thumb under which debt servicing is constrained by gross income, to what are called 'income surplus' models under which debt servicing is constrained, ultimately, by the need of the borrower to maintain 'subsistence' spending. Put another way, many lenders now assume that borrowers will accept near or actual subsistence levels of family consumption in order to maintain mortgage payments. These models allow ADIs to materially increase the maximum amount they are

prepared to lend to a given borrower. The old '30 per cent of income rule' is giving way to the '50 per cent of income rule', and beyond!

Our analysis also shows a wide dispersion in maximum loan amounts across institutions. The most aggressive ADIs appear to be willing to lend almost twice as much as the most conservative ADIs to a hypothetical household with the same basic characteristics. For example, the maximum owner-occupied loan ADIs are prepared to offer a couple with a gross annual income of \$150,000 and one child ranges from \$300,000 to almost \$600,000.

We are now surveying ADIs on how much of their current mortgage lending portfolios involve loans with very high debt-servicing ratios. As with the survey on property valuation practices, the results will provide useful benchmarks on industry practice and enable APRA to direct its attention to institutions pursuing the more aggressive strategies.

### *Pricing for risk*

Sustained good times create the danger that investors and financial intermediaries underestimate and underprice risk. Optimism and myopia rule! This is an issue not just for Australia but for the global economy, where solid growth and a benign credit environment over recent years have seen credit spreads fall to their lowest levels in a decade.

APRA is focussing on developments in pricing for risk in two particular areas. The first is the low-doc loan market. Although originally pioneered by lenders outside the ADI sector, low-doc loans – where borrowers self-certify their income because they lack the necessary documentation – are now offered by all of the large ADIs and, aggressively in some cases, by a number of smaller ADIs. Experience in overseas markets indicates that low-doc loans are much more likely to default than conventional loans and this experience may be asserting itself in Australia, where the arrears rate for securitised low-doc loans is around three times higher than for conventional loans. The concern is whether the higher risk of default of low-doc loans is being factored into their pricing. Low-doc loans are now being advertised at rates comparable to the 'headline' rate for fully verified mortgages, and the spread between actual rates paid on low-doc and conventional loans has halved over the past few years. Time and an adverse turn in Australia's economic circumstances will tell whether this margin for risk is adequate.

The second area is pricing in the general insurance industry. This industry has, in the past, been characterised by what is known as the 'premium cycle' – the pursuit of market share by relaxing pricing discipline and underwriting standards, followed by increases in premiums to recoup accrued losses and the cost of capital from the endeavour.

This cycle has been considerably muted in recent years. Our supervision work indicates that, since the 2002 prudential reforms in the general insurance industry, insurers are now much more disciplined in their approach to risk pricing and seek to ensure that business written is profitable from day one rather than (potentially) down the track once market share has been captured. Nonetheless, there has been increasing commentary about general insurers becoming more aggressive on price. Anecdotal evidence suggests premium reductions of around 15 to 25 per cent in the large corporate property area and the new National Claims and Policies Database has confirmed that public liability premiums fell by around 13 per cent over 2005. High retention rates currently being achieved in some business lines

would also suggest that price matching has been taking place. Provided it is properly managed, price matching is a legitimate commercial decision given that it is normally much less costly to retain existing business than to obtain new business.

APRA takes concerns about 'underpricing' seriously and we raise them with the boards and senior management of general insurers. That said, we have seen no evidence of any substantial loss-leading in premium setting by Australian insurers or of insurers significantly increasing their risk profiles through the types of business they take on. To this point, any 'buy market share' mentality has been kept at bay. That is not to say, however, that premiums for any given insurance line will not vary, and sometimes sharply. Insurers price their products using a wide variety of assumptions, experiences and cost bases; insurers also vary in their capacity to access and properly analyse their historical data. If an insurer has a comparative advantage in underwriting, expenses, systems or claims processing, it would naturally want to exploit that advantage in its pricing.

### *Innovation*

Innovation in the Australian financial system is providing consumers with a widening array of savings, credit and risk transfer products. APRA welcomes these developments. We are not a product regulator; our focus is on whether our regulated institutions have effective controls around new product development to ensure that any risks involved are fully understood and addressed. Some products, however, have unique risk characteristics and we look at them closely.

One such product is a reverse mortgage. This form of 'second generation' mortgage is oriented towards older borrowers who own a home and wish to draw on this ownership to fund a better retirement lifestyle or to invest elsewhere. Reverse mortgages are currently only a small part of ADI lending portfolios but may grow significantly as the impending wave of 'baby boom' retirees seeks access to their housing equity.

Reverse mortgages are unique in that they carry little in the way of conventional credit risk – the risk that the borrower defaults on repayments. Unlike conventional mortgages, a reverse mortgage typically does not require interest or principal payments during the course of the loan. The lender capitalises the interest and relies solely upon the value of the house when the borrower (or their estate) repays the loan from proceeds from the sale of the house.

Instead, the major risks for the lender revolve around uncertainty about the duration of the loan and about the value of the collateral. These risks increase as housing price growth flattens or reverses, interest rates rise sharply and healthy Australians live longer than expected – the latter a pleasant prospect unfortunately named 'longevity risk'!

Consider a loan to a 60-year-old borrower, at a loan-to-valuation ratio of only 20 per cent. The lender might reasonably expect the loan to last for twenty years at, say, an eight per cent interest rate, and that housing prices grow by at least five per cent a year during that period. The loan would grow to 93 per cent of the original house value but the house price itself would grow to 265 per cent of its original value. The house would therefore be worth nearly three times the loan value. What could be safer for a lender? Now consider an alternative scenario: interest rates average 12 per cent and the borrower lives to 100. The loan grows by 93 times! That is, to about nineteen times the original house price. Even if

housing prices continued to grow at an average of five per cent a year – a brave assumption in a higher interest rate world – the value of the house would only grow by a factor of seven times. The lender would lose about two-thirds of the loan amount.

Put in simple terms, a reverse mortgage is a race between interest rates and housing price growth, with the finish line set at the borrower's death or moving. High interest rates and low housing price growth, combined with greater longevity, would make this a risky race for the lender.

Let me emphasise that APRA does not have issues with the reverse mortgage product as such. As a prudential regulator, our concern is whether ADIs manage risks carefully by establishing prudent policies and limits on the business and hold an appropriate amount of capital. We are keen to work with industry to investigate whether our current capital requirements for housing lending are appropriate in this case.

### *Offshoring*

The increasing complexity of our regulated institutions encompasses, as I noted above, a growing international footprint. Some of our largest banks and insurers have long had a presence in overseas markets. A more recent phenomenon is 'offshoring' – the practice of outsourcing business activities to a provider outside Australia. Outsourcing software development to Bangalore in India is an early example but we are now seeing a shift towards the offshoring of business processes, such as accounts payable and settlements processing, where the service provider remotely accesses the information from Australia. India has been the geography of choice for off-shore providers but as the cost structure of that country rises – in part from the success of the outsourcing phenomenon – institutions are looking to other parts of South-east Asia for solutions.

APRA has no wish to discourage or prohibit prudently structured offshoring arrangements of material business activities. That said, offshoring does pose a unique set of risks. A fundamental risk is that the regulated institution may be limited or completely hindered in enforcing the offshoring agreement in an overseas jurisdiction. Other risks include the risk that overseas economic, political and/or social events will impact on service delivery (country risk) or that the regulated institution may not be able to obtain information about or retain records on the offshore provider (access risk).

Against this background, APRA is seeking to strengthen the management of offshoring arrangements by regulated institutions. We have been discussing with industry a proposal that regulated institutions consult with us prior to entering into a material offshoring contract. APRA is not planning to approve individual arrangements. Rather, we wish to review the Board's understanding and assessment of offshoring risks and the processes and controls to be introduced to mitigate them. APRA is well placed to identify emerging trends in offshoring arrangements, allowing us in turn to provide feedback to regulated institutions heading down that path.

### *Pandemic planning*

The risks that I have discussed thus far are, by and large, risks that financial institutions choose to accept as part of their normal business operations. Their destiny is in their own hands, so to speak. However, financial institutions are also

vulnerable to external, non-financial shocks entirely outside their control. One such potential shock that is galvanising global attention is an Avian flu pandemic. This is a topic for a full speech in itself and time allows only some brief comments on how APRA and financial institutions are planning to deal with this risk.

While not wanting to overstate the potential risk for Australia, APRA believes it is prudent for financial regulators to ensure that Australia's financial system is as prepared as practically possible for a pandemic – whether arising from the current Avian flu threat or other source. Our interest is in ensuring that institutions are able to meet core obligations to depositors, policyholders and other beneficiaries and to maintain their financial viability. There are a variety of scenarios that can be envisaged and considerable uncertainty as to the duration of any influenza pandemic and the extent of the population that might be affected. In a less severe outbreak, the impact on financial institutions might be limited to some increased staff absenteeism and possibly some reduction in business activity that could affect profitability. Even a temporary outbreak of a particular disease could affect business operations significantly, however. Financial impacts on institutions would obviously become more of a concern in a more severe pandemic scenario.

APRA has been working on pandemic planning with the larger financial institutions, the other financial regulators and with Government. The focus has been on identifying good practices, highlighting industry-level issues such as the identification of critical financial functions that need to be provided and functions that could be deferred during a pandemic, and analysing potential financial impacts on our regulated institutions. These impacts could be wide-ranging, raising such issues as insurance coverage for pandemic-related claims, increasing loan arrears in industries most affected by a pandemic (such as tourism) and impacts on asset values.

Overall, we are satisfied with the level of seriousness with which our larger regulated institutions are confronting the risk that Avian flu could find its way to Australia, but there is still much work to do. Institutions have structured plans underway to further develop pandemic responses. Most recognise that pandemic planning goes well beyond updating business continuity plans, and must include scenarios involving a sustained impact on staffing levels. Institutions with more significant overseas operations tend to be more advanced in their planning, particularly those who had a 'wake-up call' from the SARS outbreak in Hong Kong and Singapore.

### **Concluding comments**

A decade and a half of economic prosperity in Australia has, amongst its many positive legacies, helped to produce a financial system with considerable underlying strength and resilience. This is a very welcome outcome, but not one to be taken for granted. Good times can be the seeds of their own un-doing if current high levels of profitability lead institutions to take their eye off proper risk management or tempt them into riskier business ventures to meet investors' expectations for earnings growth. APRA's supervisory radar is not setting off any alarms at this point but, as my remarks confirm, nor is its sweep flashing 'all clear'.

The current economic environment, too, is supporting APRA in its role of promoting financial safety. Nonetheless, the old adage that "a rising tide floats all boats" does come to mind. The PAIRS/SOARS retrospective I have shared with you today has highlighted that, even in good times, a number of our regulated institutions

were not watertight and have come under closer APRA scrutiny. Obviously, they found our gaze an uncomfortable one, since the greater majority of them have either improved or exited the industry.

This has happened with little fanfare but with some inevitable comments about APRA intrusiveness. To the APRA Members, however, our risk-rating approach is evidence of a vigilant, vigorous and effective prudential regulator in action. In the ever more complex financial world, we cannot afford to be anything less.