



## OPENING STATEMENT

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OPENING STATEMENT TO THE SENATE STANDING COMMITTEE ON ECONOMICS  
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Since APRA last appeared before this Committee in late May 2007, global credit and equity markets have suffered a prolonged period of turbulence, which shows few signs of abating in the near term. This turbulence had its origins in the sharp deterioration in the US subprime mortgage market and it is now casting a broad pall over the global economy. In my opening remarks tonight, I would like to comment on the implications of this turbulence for the financial institutions which APRA supervises and on APRA's activities over the period.

My comments are directed mainly, but not entirely, at the impact of global financial market developments on authorised deposit-taking institutions (ADIs) in Australia, a collective term we use for banks, building societies and credit unions.

ADIs have reported only minimal direct exposures to the US subprime mortgage market, but some ADIs have exposures – albeit relatively modest – to institutions such as bond insurers and other financial institutions caught in the fall-out from US subprime problems. As a group, ADIs have been affected by recent turmoil in other ways as well:

- ADIs have faced increased wholesale funding costs as global credit markets, on which many ADIs have relied increasingly over recent years, have turned much more risk-averse;
- those ADIs in particular that make use of securitisation markets to fund their residential mortgage lending have found that source of funding has virtually dried up;
- in addition, some ADIs have exposures to certain high-profile domestic corporates now under stress because of their reliance on short-term debt to fund their businesses.

In commenting on market turbulence, APRA's 2007 Annual Report offered the judgment that "... with strong and diversified balance sheets and prudent management of key risks, the ADI sector is well-positioned to withstand the impact of these global developments, were they to continue". Since these words were written, early in the piece, turbulence has indeed continued but APRA's judgment on the ADI sector stands.

This judgment is based on a number of supportive factors and I would single out four.

Firstly, the Australian economy remains robust, with considerable momentum in domestic demand, rapid growth in household incomes and an unemployment rate at a generation low. In this environment, ADIs have continued to enjoy strong balance sheet growth, particularly in business lending.

Secondly, despite the difficult conditions in global credit markets, ADIs have been able to raise sufficient amounts – but at higher costs – to fund this balance sheet growth, although institutions without large retail deposit bases have found the going harder than others.

Thirdly, the asset quality of ADIs remains high, by both historical and international standards. A slow rise in arrears rates appears to have paused in recent months although signs of stress have emerged in a small proportion of household borrowers and, as just mentioned, in some corporates.

Finally, ADI profitability and capital levels are sound. Increases in funding costs and provisioning against distressed borrowers will inevitably weigh on profitability in the period ahead; that said, profits for many ADIs are still running above or at previous record levels. On the capital front, a new and more risk-sensitive capital adequacy regime for ADIs, known as the Basel II Framework, was introduced in Australia on 1 January this year. The capital impacts of this new regime are not entirely certain but the dividends of stronger and more accurate risk management are already being realised by the larger ADIs.

In offering this positive assessment, APRA has nonetheless been cautioning ADIs, and our regulated financial institutions more generally, that the period ahead will require very careful management. Globally, market sentiment has soured and the outlook for global economic growth has deteriorated. A Working Group of the Financial Stability Forum has recently stated that “[i]t is likely that we face a prolonged adjustment, which could be difficult”. Domestically, the Reserve Bank has tightened monetary policy settings and its latest *Statement on Monetary Policy* has a very cautionary tone. In this uncertain world, there is little margin for error. We now have telling examples around the globe of how quickly and savagely markets can penalise financial institutions with a risk profile that is opaque, which do not have assured and diversified funding sources to meet growth aspirations or which have not been prudently husbanding their capital resources.

Throughout this period of market turbulence, APRA has been in what could be called a “heightened state of alert”. Supervisory intervention in individual cases has not been necessary to date nor have we sought a broader regulatory response – considerable effort has already gone into building a prudential framework in Australia that is resilient to shocks. Nonetheless, we have stepped up our supervisory intensity and been very busy, across a range of fronts.

We have had a dedicated team of front-line supervisors and specialised risk staff closely monitoring the liquidity position of ADIs and in regular, sometimes daily, contact with the treasuries of the larger institutions. We have been able to scale this activity back over recent weeks as short-term money market conditions have been more settled, but our close monitoring will be quickly re-activated if there were any signs of renewed market pressures. The Reserve Bank has been a valued ally in this monitoring work.

In December, we requested the funding plans of the larger ADIs for 2008, which we are now reviewing to ensure plans are realistic and attuned to the current market environment. We are looking for individual entity weakness and any industry-wide issues.

We have asked the larger ADIs to supply details of their ‘watchlist’ exposures, ie, those exposures that have not become impaired but which the ADIs themselves consider to be most vulnerable to problems and requiring close scrutiny. Our preliminary review of these watchlists does not reveal any worrying concentration of exposures and confirms that most exposures on the lists are not significant in size. This is consistent with the general assessment that business balance sheets are in sound condition overall, notwithstanding the stresses of some high-profile entities in recent months.

We have also been reviewing the margin lending activities of ADIs – banks in this case – against the background of recent sharp equity market falls. Margin lending activities have grown substantially in recent years as increasing numbers of retail investors have sought to leverage their exposure to booming share markets. Banks have taken a relatively conservative approach to this form of lending. Margin lending portfolios represent only a very small proportion – less than two per cent – of banking industry assets and the portfolios are conservatively geared, with average loan-to-valuation ratios around 50 per cent or lower. Banks have reported to us that they currently have, at most, a handful of loans where losses are possible. Further losses would undoubtedly emerge if equity markets were to fall rapidly again, but any such losses would not be material in the context of banks' current profitability.

To complete the outline of APRA's recent supervisory activities, we have been analysing the impact of the recent equity market declines on the insurance and superannuation industries as well. These declines have unwound all of the 2007 market gains in major industrial countries and in Australia. The prudential framework in Australia aims to ensure that regulated financial institutions can survive adverse conditions such as these and, in brief, equity market developments have not created any unforeseen prudential concerns.

Our preliminary analysis suggests that the declines in equity markets will not have a significant impact on the profitability or capital levels of the general insurance industry. The focus for many insurers is, instead, the impact of recent weather-related events such as hailstorms and heavy rains on their previous good claims experience. The life insurance industry has also entered this period of market turmoil in a strong capital position and it holds resilience reserves to cover shocks of recent dimensions.

In superannuation, recent declines in equity markets will reduce the asset values of accumulation funds but these losses must be set against the substantial cumulative gains over the past few years. Defined benefit funds will have experienced similar losses but most of these funds have built up strong funding positions because of those same cumulative gains. The superannuation licensing regime now in operation requires trustees to develop risk management strategies and plans that deal with changing market conditions, and trustees are now in better shape to manage the risks from market volatility than they may have been in the past.

On a final note, central banks and regulatory authorities have, naturally, been closely analysing the causes of recent market turbulence and the longer-term policy responses that might be required. These responses are likely to address issues such as prudential frameworks, the underpinnings of the securitisation model, the role of credit ratings, market transparency and regulatory co-operation and co-ordination. APRA participates in a number of international fora and we are involved in different aspects of this work. For the moment, however, our preoccupation is to ensure that our regulated financial institutions identify and manage all of the risks thrown up by the market turbulence and that they continue to hold adequate buffers of liquidity and capital for these uncertain times.

My colleagues and I are now happy to take the Committee's questions.