



SPEECH TO FINANCIAL SECTOR ACCOUNTANTS ASSOCIATION
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REGULATORS - THE FUTURE

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Thank you very much for the opportunity to speak at the FSAA's Annual Conference for 2005.

I am particularly pleased with the topic I have been asked to speak about: the future for regulation. With so much concern about the extent of regulatory change that is occurring in the financial services sector, it is pleasing to see at least some in the industry are keen to look beyond the current issues that we are all grappling with, and give some thought to what might be coming over the horizon. While I do not have a crystal ball that allows me to predict the future with certainty, I will at least try to give you some insight into the principles and themes that will guide APRA going forward.

APRA's Role

Let me start with some basics to help set the scene.

As most of you know, APRA was created out of the 1996 Wallis Inquiry. We were given the task of making sure that, in all reasonable circumstances, financial institutions meet their promises to particular classes of customers. Collectively, we in APRA call these customers our 'beneficiaries'. In the case of banks, our role is to protect depositors, by making sure banks are able to repay deposits and pay interest due. For insurers, we aim to make sure they can pay valid claims by policyholders. For superannuation funds, the promise is a little different. The basic promise is that trustees work for the members of the fund with, in the terms used in the legislation, due care, skill and diligence.¹ That is obviously somewhat wide-ranging, and in fact leads to a range of subsidiary promises, but is the core of superannuation supervision.

It is important to note that, unlike our sister regulator ASIC, we have no direct interest in the well-being of shareholders. Having said that, there is one important aspect of our task that is often over-looked: that the best form of protection we can offer our beneficiaries is that they are dealing with a financially-sound, well-managed and profitable institution. We have no interest in constraining the operations of our entities so tightly that they cannot operate, innovate and compete successfully. If we did, we have no doubt in the long run it would be counter-productive to the interests of the very people we are trying to protect. We need our regulated entities to earn a reasonable return on capital for the benefit of their shareholders, so capital will continue to be invested in the industries, as and when needed. As a result, in developing the prudential regulation framework, for all parts of the financial sector, APRA is mindful of the need to balance prudential needs with commercial reality. In fact, the APRA Act - our governing legislation - obliges us to do so.² The extensive consultation process we go through when introducing new policies is a reflection of this.

¹ See section 52 of the *Superannuation Industry (Supervision) Act 1993*.

² See section 8 of the *Australian Prudential Regulation Authority Act 1998*, which requires APRA to "balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality."

It is also important, as we look at what regulatory initiatives might emerge in the future, to remember that APRA was created as an integrated prudential supervisor for a reason. That is, as banking, insurance and wealth management products are increasingly offered within a single corporate group, it is important that regulation does not distort market behaviour as a result of different requirements being placed on different licence holders doing essentially the same activity. An obvious example is superannuation, particularly in the new world of choice. Whether it is offered by a bank, a life insurer, an industry-based public offer fund, or a staff fund established by an individual company, it is important that, to the extent possible, the prudential standing of those funds is the same from the fund member's perspective.

This leads me to two basic principles that are guiding the prudential regulatory framework: (i) we need to achieve a reasonable degree of safety without stifling the strong competitive dynamics of the financial services sector, and (ii) like risks should be treated in a like manner across all entities we regulate. Indeed, we would hope that in many ways these guiding principles are mutually reinforcing, since promoting regulatory harmonisation across industry sectors should help to foster competition, by eliminating any advantage one sector might enjoy over another due to previously uneven regulation.

The Evolution of Prudential Regulation

Before I talk briefly about the current state of the prudential regulatory framework, let alone make an attempt at forecasting where regulation might be headed over the next 10 or so years, it's probably worthwhile recapping where we have come from over the past twenty.

I have been involved in prudential regulation for most of those twenty years, first at the Reserve Bank and now at APRA. In that time, the focus of prudential regulators has changed significantly. When I first got into the game it was during the period of deregulation following the Campbell Inquiry of the early 1980's. At that time, prudential regulation was essentially about balance sheet financial ratios. There were capital and liquidity requirements imposed - usually in the form of very simple ratios - and most supervisors spent their time reviewing balance sheets and other statistical returns to assess compliance and examine historical trends. Of course, we met with the management of financial institutions on occasions - usually over a cup of tea in the boardroom - but discussions were invariably kept at a high level. In a highly-regulated world, this was probably all that was necessary, but as the financial sector was freed to compete more directly, these discussions were, with hindsight, of limited value. There was only so much that a supervisor, armed with backward-looking financial statistics, could be expected to achieve.

The lessons of the late 1980's, however, have taught us that in a deregulated environment a more dynamic form of prudential oversight was necessary. On-site reviews, which are now an established part of the regulatory landscape, were introduced for the first time. This allowed

supervisors to look not only at the financial performance and health of institutions, but to assess first-hand the quality of the internal controls and risk management systems that were being employed to manage the business being written. The goal was to identify institutions with weak risk management and control systems *before* those weaknesses could show up in the statistical reports as a deterioration in the firm's financial position.

More recently, prudential regulators have sharpened their focus on governance. Corporate failures, including HIH, have highlighted the need for a prudential regulator such as APRA to look at the means by which a regulated entity is governed, since plenty of capital and seemingly adequate internal controls will only go so far to protect our beneficiaries if, at the very top of the organisation, the Board and senior executives are not fulfilling their roles with a sufficient degree of diligence and integrity.

It is a fundamental premise of our supervisory approach that the primary responsibility for the prudent management of the regulated entity rests with that entity's Board and management. Given such a premise, it is not surprising (except perhaps that we have not done so earlier) that we are seeking to ensure Boards, in particular, are appropriately structured and equipped to do their jobs. I will talk more about our proposals in this area shortly.

Along with governance, prudential regulators are also focussing on the difficult area of individual behaviours. This is most evident in our proposed new standards on fitness & propriety. Most prudential regulators around the globe have some form of fit & proper test that directors and senior executives need to meet. So far, APRA has been something of an 'odd one out' in this regard, although it does mean that we can build the best elements of others into our new regime.

But beyond these minimum standards, we are increasingly drawn into what could be the most difficult assessment of all to make - that of culture and ethics. While to some extent cultural issues are reflected in our governance and fit & proper requirements, it is necessary to also go beyond that to look at the openness and accountability that exists right through an organisation. Needless to say, this is a difficult and subjective assessment to make, and requires supervisors with considerable experience to be able to judge. But it is difficult to find an example of a failed financial institution in which shortcomings in the culture of the organisation did not play a significant role. Justice Owen, the HIH Royal Commissioner, put it simply when he said:

“... a drastic fall from grace can occur if those in charge lose their way.”³

So, to try to summarise this evolution in a few words, we have moved over the past 20 years from relying solely on statistical information and balance sheet ratios to oversee financial institutions, to a regulatory regime where

³ The HIH Royal Commission, *The Failure of HIH Insurance*, April 2003, Vol 1, p101.

financial information, risk management, internal controls, and human behaviours are all considered of equal importance. In essence, we are saying that financial strength is of limited comfort to our beneficiaries if management is not up to the task. I will talk more about what this means for many of you in the room, and for the future of regulation, later in my presentation.

Current Policy Program

Having looked back, let's now do something of a stocktake of APRA's current policy program. Essentially, there are 5 primary workstreams: one for each main industry sector, as well as a range of cross-industry initiatives. Let me start with the cross-industry initiatives first.

– Cross-Industry Work

Consistent with APRA's mandate to treat like risks in a like manner, there are a range of current policy proposals being examined which cover more than one industry sector. Within this stream, **governance** is the current focal point. Our proposals are designed to ensure that our regulated institutions are managed prudently, that the composition of boards provides both independent oversight and industry experience, and that - without delegating their responsibilities - board members have access to appropriate independent expertise to assist them in their task.

Many of you will know that our proposals generated a good deal of debate, and many asked whether we even had a role in this area. Following the period of consultation, we have not been dissuaded from our view that this is an important area in which we need to set standards. But we have adapted our proposals to fit neatly with existing requirements, such as the ASX Corporate Governance Council's *Principles of Good Corporate Governance*.

As an example, we have removed some of the prescription on Board tenure, and our definition of independence has been aligned with that set out in the ASX *Principles*. APRA-regulated institutions listed on the ASX already have to meet these principles on an "if not, why not" basis. However, these are a relatively small percentage of our institutions - most APRA-regulated entities are not listed on the ASX - and our approach will impose a level playing field on governance matters across all our institutions. A board that does not wish to follow the ASX definition would need to put the "why not" case to APRA. We hope in this way our new requirements will be robust, and minimise any additional burden.⁴

A complementary initiative to our work on governance is our proposals on **fitness & propriety**. As I have noted previously, most corporate and prudential regulators have some form of fit & proper test that directors and other responsible persons are required to meet. However, in Australia, there are no fit & proper tests in banking or life insurance. In general

⁴ For more information, see <http://www.apra.gov.au/Policy> and view 'Policy Discussion Papers'.

insurance, a basic test was introduced as part of our 2002 reforms, and the new superannuation licensing regime requires trustees to develop and implement a fit and proper policy.

In this area, let me stress that we have no intention of implementing a regime which requires APRA to get involved in day-to-day hiring and employment decisions. Our approach has two main elements:

- a requirement that each regulated institution has its own rigorous fit & proper policy; and
- a *reserve* power for APRA to identify and deal with unacceptable behaviour when the institution concerned is unwilling, or unable, to act on its own.

We certainly see our own role in this part of the prudential framework as being minor. Our reserve power is one we hope we can use sparingly. And it needs to be acknowledged that this approach cannot totally prevent a person lacking the necessary skills or integrity from being hired into a senior role, or that an institution might be brought down because of incompetent or dishonest management. At best, we can hope to reduce these risks and prevent individuals who have fallen short of the required standards once, from doing so again.

Also on the cross-industry front, we have recently introduced a new prudential standard on ***business continuity management*** (BCM) for banks and general insurers.⁵ The new standard, which comes into full force after a 12-month transitional period, aims to ensure that institutions implement a “whole of business” approach to BCM appropriate to the nature and scale of their individual operations. As well as all the technical aspects of developing, maintaining and testing a good BCP, the Standard makes it clear that the Board of Directors and senior management of the institution must consider business continuity risks and controls as part of the company’s overall risk management framework. So, even on the face of what appears to be a rather technical matter like BCM, the governance theme continues to be present.

– **Banking**

For banks, the big policy issue on the immediate horizon is the implementation of ***Basel II***.

For those not familiar with it, Basel II is the internationally-agreed framework for assessing bank capital adequacy. It will be applied to all banks and other deposit-takers in Australia from 1 January 2008. Basel II is far more risk-sensitive than the Basel I framework, which was viewed as insightful and sophisticated when introduced in 1988, but which has in recent times been severely tested by the evolution of financial institutions, markets and products.

⁵ See <http://www.apra.gov.au/Policy/Prudential-Standards-Guidance-Notes-for-ADIs.cfm>

Unfortunately, the increased risk-sensitivity which Basel II offers does not come without some cost. The minimum requirements necessary to obtain regulatory approval to use the most sophisticated (and potentially most capital-efficient) measures are not insignificant. But banks should also recognise that Basel II is not just a regulatory cost; indeed, the entire philosophy of the new framework is that banks should not be building risk measurement systems to meet the needs of supervisors, but rather supervisors should adopt the risk measurement tools being used by banks to govern and manage themselves (provided, of course, they are adequately tested and suitably robust).

Applications will be open from July 1 to September 30 for Australian banks who wish to be in the first wave of institutions to use the most advanced methods available under Basel II. The early applications are necessary because banks need to complete a two-year parallel run for the existing and new regimes before totally switching over to the new regime in 2008. So while the official start date is some way off, the work to get Basel II up and running is very much underway. Boards have an important role to play here, as we are requiring them to sign off on the banks' applications to us, reflecting our view that the establishment of a strong risk management system must carry the endorsement from the very top of the organisation.

– General Insurance

APRA totally overhauled the prudential regime for general insurance in 2002, with the introduction of risk-based capital standards, new rules on liability valuation (including mandatory risk margins), and new rules on governance and risk management.

At the time, no one saw the 2002 reforms as limited in scope or weak in force. Yet the review of the reforms by the HIH Royal Commission found more could be done. As a result, a range of new policy proposals relating to **risk and financial management** have recently been reduced to put into practice the recommendations of the Royal Commission.⁶ These include:

- clarifying and strengthening existing requirements in business planning, risk management, reinsurance management and outsourcing;
- ensuring insurers adequately document reinsurance contracts;
- introducing strict requirements for the approval of limited risk transfer arrangements;
- requiring Approved Actuaries to complete an annual Financial Condition Report on each insurer, and have a peer review undertaken of actuarial valuations of insurance liabilities; and
- requiring CEO and CFO attestation of the financial information provided to APRA, the Approved Auditor and the Approved Actuary.

⁶ See <http://www.apra.gov.au/Policy> and view 'Policy Discussion Papers'.

Once again, you will see the themes of governance and personal accountability coming through, even though on the face of it the policy proposals cover what are primarily financial matters.

We have also recently released proposals on *conglomerate supervision* for general insurers.⁷ To better protect policyholders of insurers that operate as part of a corporate group, APRA is of the firm view that our oversight cannot stop exclusively with the solo supervision of the insurers themselves. The purpose of our conglomerate proposals are to ensure that the overall group is financially sound, and that group activities and inter-relationships will not unduly impinge on the financial soundness of the general insurer(s) in the group. The proposals mirror the principles that have governed banking supervision for more than a decade.

These proposals will undoubtedly be the subject of some debate over the coming months. While the principles on which the proposals are based may not be too offensive - that is, avoid 'double leveraging' of capital, limit intra-group exposures to a prudent level, encourage group-wide risk management, and make sure customers always know which entity they are dealing with - the practical application becomes much more difficult. So we will need to proceed slowly and carefully here, notwithstanding the compelling case for introducing the reforms.

– Life Insurance

The main focus for life insurers at present are the new *draft actuarial standards* recently released by the Life Insurance Actuarial Standards Board. These standards are designed to compensate for the impact of IFRS on the balance sheets of life insurers. Left unchanged, the combination of IFRS on the existing standards would have produced some undesirable outcomes. However, the LIASB have not merely sought to realign the standards with IFRS, but have sought to refine the standards, particularly in relation to solvency and capital adequacy, to produce a more robust resilience reserve calculation, and provide for a more consistent treatment of EMVONA with other regulated entities.

Returning once again to the governance theme, APRA recently released a draft Prudential Standard and Discussion Paper on establishing and operating a *Compliance Committee for life insurance branches* registered in Australia.⁸

To date, life insurers have not been permitted to operate in Australia as branches. This will change as a result of the Free Trade Agreement with the USA. The purpose of the proposed Compliance Committee is to provide greater assurance that branches will place the same emphasis on complying with domestic prudential requirements as locally-incorporated entities do.

I won't go into detail here with the specifics of the Compliance Committee role, but obviously it is consistent with our other governance initiatives.

⁷ See <http://www.apra.gov.au/Policy> and view 'Policy Discussion Papers'.

⁸ For more information, see <http://www.apra.gov.au/Policy>

And although no firm proposals have been released as yet, we have flagged our intention to consider applying a similar requirement to the branches of foreign general insurers as well.

– Superannuation

Last, but certainly not least, is the task of *superannuation licensing* which is currently underway. In short, all trustees of superannuation funds (other than self-managed funds) need to obtain a licence before 30 June 2006 if they wish to continue to accept contributions. There are potentially around 2000 licences to be granted in the 2-year application window, and we are almost half-way through. So far we have issued about half a dozen!

What this is telling us is that we have a lot of work to do in the next financial year if we are to licence everyone who wants a licence before the 30 June 2006 deadline. It also means we are going to have to think seriously about closing the window early. The relevant legislation gives us the option of closing the application window any time after 31 December this year. While we have made no decision, trustees need to understand that they only have certainty up until the end of the year, and after that they run the risk of finding themselves closed to new business. Anyone planning to apply for a licence at the last minute might like to think again whether this is a sound risk management strategy.

Regulatory Burden

Clearly, there is a large amount of policy reform currently underway within APRA, let alone that which has emanated from other domestic and international initiatives. Therefore it has not been surprising that there has been a great deal of comment in the past year or so about the regulatory burden that IFRS, FSR, Basel II, superannuation licensing, superannuation choice, and the second round of general insurance reforms - to name a few - have placed on industry. For those of you with a connection to the US, there are also the requirements of Sarbanes-Oxley (SOX) to contend with. What is interesting to note about this reform 'program' is that each component of this wide-ranging set of initiatives has its own quite distinct origins:

- IFRS and Basel II are long-running international projects,
- SOX emerged from the aftermath of Enron, Worldcom and the demise of Arthur Andersen,
- FSR had its genesis in the 1997 Wallis Report,
- super licensing came from the recommendations of the Government's 2002 Superannuation Safety Working Group,
- superannuation choice has been a long-standing plank of Government policy, and
- the second round of general insurance reforms flowed from the findings

and recommendations of the HIH Royal Commission.

That all these initiatives - each valuable and necessary in their own right - have come together in the way they have is unintended, unfortunate, but unavoidable.

In response to the cries of 'reform fatigue' I would firstly like to point out that it is not all a one-way street. Within these initiatives there are 'wins' for industry. For example, Basel II will trade-off some additional complexity for banks with the ability to use their own in-house capital models and a modest reduction in regulatory capital requirements across the industry. Our Stage II general insurance reforms are another example; within the tightening of requirements in a number of areas, they will also see some improvements incorporated into the Prudential Standards that have been sought by industry, and allow certain captives to be exempted from a range of prudential requirements.

Secondly, as much as there are a large number of regulatory initiatives the industry is dealing with at present, at least from an APRA perspective there is another aspect worth noting. As much as we hear complaints about increased regulation, further investigation sometimes reveals this is not so much an objection to the regulatory change *per se*, but to the increased personal accountability the new regulatory framework is introducing. In many cases, the rules themselves are not new, but we are now making it clear who is responsible for making sure the rules are being followed.

As I have noted previously, our regulatory initiatives are increasingly moving beyond financial requirements and internal controls, and targeting personal behaviour and accountability. Instead of requiring an institution to comply with a set of minimum standards, our prudential framework will increasingly include a requirement for a senior officer - typically a director or executive, but perhaps also an auditor or actuary - to take personal responsibility that the institution is in compliance. These responsibilities will need to be treated seriously, particularly against the background of formal tests of fitness and propriety. An individual is potentially betting their career if they do not pay this responsibility adequate attention.

This element of personal accountability within the prudential framework is not new, although it is perhaps one that has not received as much attention as it should have. Let me give you an example. APRA places a great deal of importance on the extent to which institutions are able to provide accurate and timely financial statistics. It is fair to say that many in the industry probably attach less importance to this activity than we do. Yet I suspect that those who see APRA statistics as relatively unimportant are unaware that, in the case of one ex-HIH executive, the charges laid against him included signing APRA returns which were false, and that the offence was punishable with a gaol term. He is indeed now spending time in gaol for not taking this responsibility seriously enough.

We are certainly hopeful that cases such as this - as unfortunate as they are - will lead to a heightened awareness of the responsibilities involved. Since

2001, we have found reason to disqualify close to 100 people from the financial sector. We do not apologise for this tough stance on personal accountability, and it should serve to provide strong incentive for those involved in the management of financial institutions, and in particular the production of financial data, to ensure that their systems and controls are of a high quality. We would find it difficult to put it better than Justice Wood, who said in sentencing:

“... a significant responsibility rests upon directors of insurance companies to ensure there is a complete and accurate compliance with the requirements arising under the Insurance Act.

“Policyholders, shareholders and APRA are entitled to expect nothing less, since upon the honesty, integrity and competence of such officers depends the viability of the insurance industry, upon which so many commercial and other activities are in turn reliant.”

Emerging Themes

Let me turn now to what I see as the emerging themes in prudential regulation.

The first is one that I have already spent a considerable amount of time discussing: ***governance and personal accountability***. The focus on this will not reduce, and will not just impact those who are asked to sign their name to formal correspondence with APRA. We hope that those asked to make attestations and to take responsibility for certain issues, will in turn insist on control mechanisms and other assurances being set in place within their organisations, to provide comfort that they can make statements which APRA can, in turn, rely upon. Indeed, we see the greatest benefit of these reforms as not merely the ability to remove a (hopefully) very small number of bad apples from the industry, but rather an across-the-board improvement in controls throughout organisations, as individuals at the top recognise the need to ensure their ability to meet the obligations imposed upon them. For those of you involved in the production of information for APRA, you may well have felt this already. For our part, we have already seen evidence of this ‘trickle down’ effect happening, and we are certainly encouraged by the developments.

Another workstream over the medium term is ***disclosure***. This is an area which prudential regulators are increasingly focussing; even though at first glance it may not be our natural turf. But beyond the general disclosure requirements that securities regulators such as ASIC impose on all entities participating in financial markets, whether prudentially-regulated or not, prudential supervisors see the disclosure of certain additional information as being supportive of their own specific objective. This will typically involve quantitative and qualitative information about their risk characteristics and processes of risk management.

What benefit do we see these prudential disclosures bringing? Put simply, prudential disclosures are an attempt to provide sophisticated market

participants with additional information to enable them to better assess the prudential standing of financial institutions. By doing this, we hope to harness market discipline as an ally in our efforts to ensure prudentially-regulated entities remain on a sound footing.

Promoting the prudent management of financial institutions via disclosure also recognises that we need to be mindful of not impeding the efficient operation of markets wherever possible. Since regulation will typically constrain commercial freedom, at least to some degree, there is an ongoing obligation on regulators like us to aim to achieve our objectives with minimum disruption to the smooth operation of markets. To the extent that disclosure and market discipline can help achieve prudential objectives, without the need to resort to more prescriptive and rigid regulatory policies, it can play an important role in the development of a least-cost, but nevertheless robust, system of regulation.

It is fair to say that our work on disclosure is proceeding less quickly than we might like. But we have made a conscious decision to recognise the burden of IFRS on industry, and to acknowledge that users of information will need time to understand the new IFRS framework, and what it means for the balance sheets of banks and insurers, before we impose any additional disclosures. But because of both Basel II and the HIH Royal Commission recommendations, which both advocate an expanded disclosure regime, prudential disclosure remains an issue firmly on our policy agenda.

Another issue on the longer-term policy agenda is **capital management**: more specifically, the issue that goes by the name of 'Pillar 2' in banking circles, and 'target surplus' in insurance. That is, beyond the basic regulatory minima, how much capital does an entity need to hold to ensure that, with certainty, it will not find itself in breach of its regulatory requirements? This is an area in which a lot of work needs to be done - both by APRA and by the industry - to better measure aggregate risks within a financial group, and to assess the capital needed to back those risks.

From APRA's perspective, it is important to note that this is as much a governance issue as a financial or actuarial problem. We have set our minimum standards, and beyond that, entities are largely free to manage their capital as they see fit. The issue of how much capital is enough, given the range of objectives that need to be met by a financial institution, is very much an issue that Boards need to consider. What we are interested in is the extent of analysis, and the logic used to reach a decision, as much as the actual capital level itself.

Given the infancy of DFA and economic capital modelling, and the generally robust capital positions of Australian banks and insurers, we are happy to see this as an area where we can 'hasten slowly'. But there is no doubt that over time, as capital adequacy becomes more risk sensitive and finely tuned, the hidden conservatism within some of the simpler measures of capital adequacy we used to use are disappearing. As a result, the emphasis that prudential regulators need to place on the discipline of capital management will need to increase correspondingly. We are also mindful

that the best time to bring in reforms in an area such as this, is at a time of strength, like now, and not weakness.

The issue of *harmonisation* remains at all times on APRA's agenda, so to the extent that you are trying to predict likely regulatory initiatives from APRA over the next few years, you would do well to look at areas where the industry-based regimes continue to treat essentially the same activity, or risk, in a different manner. I am pleased to say that many of these have been addressed in our recent reforms - governance, fit & proper, business continuity management, and outsourcing are all areas that are largely complete. But, no doubt there are others that remain to be tackled.

Finally, there is one emerging supervisory issue that I should note. Beyond the policy agenda, APRA's *style of supervision* is changing. Over the past 12-18 months, those of you involved with APRA will probably have noticed a harder edge to our interactions, and hopefully a greater clarity about exactly what we are looking at institutions to do. We have also made it our policy to write directly to Boards with our review reports, rather than send them to the CEO or senior management. We have been granted more funding by Government to increase the intensity of our supervision, particularly on the large and complex entities within the market. And we are endeavouring to increase the frequency of our on-site supervisory review work, not just on risk management and internal controls, but also, as I mentioned earlier, we are beginning to delve more deeply into governance and culture.

The Next Decade

In trying to guess where we will all be in 2010 and beyond, we only need to look at where we have come from since 2000 to understand the difficulty of any forecast. In the general insurance sector, for example, we have moved from an inadequate and antiquated regulatory regime to a much more robust and rigorous supervisory framework. We have moved from a debate about whether actuaries even had a role in general insurance, to debating what should be in a financial condition report. And we have moved from an industry riddled with under-pricing and mismanagement, earning an average ROE over the previous 10 years of something like 6%, to one which is much more professional and disciplined in its approach to shareholder value. Other industry sectors have not exactly stood still either.

So where will we all be in 2010 and beyond? As I said at the start, I do not have a crystal ball, and in any event, it is dangerous for a prudential supervisor to presume to know what is likely to happen in the future. But since I have been asked to proffer some views, let me put the following thoughts forward as to what I hope can be achieved. I will focus on the insurance sector because this is probably the area of most interest to the audience today, but many points are relevant more broadly.

Firstly, there is no doubt that the financial sector as a whole is in good shape at present. Indeed, given economic conditions, it would be extremely disappointing if this were not the case. But it simply cannot last: volatility

in markets is inevitable. History tells us that, some time in the next decade, investment markets will go through one or more periods of instability, and economic activity will fluctuate. And there will inevitably be another major natural disaster somewhere, sometime. What we need to do now is try to ensure, to the extent possible, that we can 'fire-proof' ourselves from any downturn.

Particularly in the insurance sector, we are seeing strong profitability built not just on fortuitous investment markets, but also on more disciplined pricing, a better understanding of risk, and a clearer focus on capital management. It was not that long ago that industry performance was measured in terms of market share and premium volume written. Banks moved away from this simplistic view after the tough lessons of the early 1990's, and it is pleasing to see the insurance industry much better focussed on sustainable profitability and shareholder value than has been the case before. The fact that the major players in the insurance market are now mostly Australian listed institutions is a big help in this regard. This discipline can only be for the benefit of all stakeholders, including APRA and our beneficiaries.

The key to the future, in an industry notorious for cycles, will be the extent to which the strong management disciplines currently being imposed are able to withstand the strong competitive pressures that also exist at present. It may be unpopular in the short-term with the market analysts and alike if it leads to a fall in market share, but the insurer that does not succumb to price cutting, or a weakening of terms in the current environment, is undoubtedly well-positioned to ride out the tougher times that will inevitably emerge at some stage in the future. APRA's governance reforms are designed to help bolster the resolve of management to maintain their focus on building businesses that are sustainable in the long-term.

I also hope that the increased focus on risk management, again supported by APRA's requirements, will not be seen as a regulatory compliance issue, but will be recognised by all as a genuine value-adding proposition. The signs for this are positive. Many who expressed concern about APRA's 2002 general insurance reforms, for example, have now recognised the value of things like well-documented risk management strategies.

Finally, it would be remiss of me not to mention APRA's evolution. Over the past few years, we have developed a prudential supervision framework that leaves APRA as well placed as it has ever been to meet the community expectations of our role. We have recruited well, and now possess a strong team of people, blending supervisory expertise with commercial experience. From my own perspective, half my direct reports are long-term supervisors, while the other half are recent recruits from industry. For each of them, a similar result applies. All of this means that APRA is well-equipped for the task ahead. Our task now is to hopefully minimise the need for further radical reform, and to bed down what we have introduced in recent years.

In doing that, we will be aiming to apply what I call 'the 3 R's of prudential supervision'. That is, we will be aiming to be:

- *rigorous* in what we do - people should expect an APRA review to be a professional and comprehensive exercise;
- *robust* in defending what we think is right - if we find unacceptable practice, we will be clearer about our expectations to have it rectified, and not reluctant to use our powers if we need to; and
- *reasonable* in our actions - that is, we aim to be risk-based, proportionate in our response to issues, and ensure we focus our attention on the matters that are really important for the well-being of our beneficiaries.

If we can do these things, then I believe we will have met the community's expectations of us, while at the same time not only minimising the burden to industry, but adding significant value as well.

Concluding Remarks

I came across this quote recently, and undoubtedly many people working to implement the current raft of regulatory reforms will share its sentiments:

“We may not imagine how our lives could be more frustrating and complex - but Congress can.”⁹

For those of you who are feeling the strain from all of the current regulatory initiatives, I can offer you some respite, at least from APRA's perspective. Our Chairman, Dr John Laker, recently said that:

“APRA would this year set down the prudential framework for the next 10 years for banks, insurers and superannuation funds.”¹⁰

In other words, we see the current reform program, while far from complete, as setting out the foundations for a strong system of prudential regulation for the foreseeable future. We can reasonably expect evolutionary, rather than revolutionary, changes in years ahead. And as we focus more on raising the standards of governance and individual behaviour, we would hope firms that are currently well-run would have little problem demonstrating compliance.

As I have said many times, we are definitely increasing our focus on the individual, as against the entity. This is because, to put it simply, a strong capital position cannot protect an entity from weak management, but strong management can protect an entity from a weak capital position. We cannot simply rely on tough capital requirements if we want to adequately protect our beneficiaries.

Our common interest - and by that I mean the Government, APRA and all those with a part to play in the finance industry - is to achieve clear and sensible regulation, promoting and not stifling good commercial practices,

⁹ Cullen Hightower, American writer.

¹⁰ Australian Financial Review, February 9, 2005.

coupled with a supervisory agency that possesses a strong industry knowledge and an appreciation of commercial realities. If we can achieve such a position, and have well-educated and well-intentioned directors and executives overseeing the public's funds, then we are well on the way to meeting community expectations in regard to the safety and soundness of the financial system.

Thank you.