INDUSTRY OVERVIEW **Industries supervised by APRA at the end of 1998/99 were in generally sound condition. They had weathered well the effects of the Asian crisis, other stresses in the global financial system and the distraction of preparations for the Year 2000 date change. The one exception was some sectors of general insurance where a costly spate of natural disasters overseas and in Australia put stress on the reinsurance market. But for the most part, the health of financial institutions was underpinned by the ongoing strength of the domestic economy – with steady growth, low inflation and falling unemployment. Competition was strong and, together with the high cost of new technology, created pressure for rationalisation through acquisitions and alliances.**

A major and growing challenge for the entire financial services sector is tracking and responding to developments in electronic commerce and the concomitant shifts in customer preferences

Profitability in banking and life insurance remains healthy, but is under some pressure in general insurance and this will need to be watched closely over the year ahead. Financial soundness in superannuation is particularly associated with sound corporate governance. Standards of governance have been progressively improving since the current statutory regime started in 1994, and this trend is expected to continue.

The banking industry ended the year with an average capital ratio well above the regulatory minimum. The industry has now been strongly capitalised above the 10 per cent level for the past seven or so years, except for a brief dip in mid 1998. Similarly, banks' impaired assets were relatively low at year-end at around $6 billion in total, or 0.7 per cent of total assets on average – this is near the low point for the past decade, and in contrast to the peak of 6 per cent in 1992.

Effects of the recent strong growth in household debt – lifting the ratio of debt to household disposable income almost 40 percentage points over the past seven years to around 90 per cent – need to be monitored. This is, however, unlikely to be problematic while inflation remains under control (interest rates are low) and unemployment is steady or falling. Another pertinent fact is that the financial assets of Australian households have also been growing strongly.

Australian banks have some exposure to Asia, commensurate with their role of financing the participation of Australian industry in the region and with efforts to forge long-term commercial relationships with Asian counterparties. While there have been losses on lending to Asia, these have been readily absorbed, and by year's end Asian exposures amounted to less than four per cent of banks' total assets. Financial disruption in Russia, Brazil and some other economies had even less impact on Australian banks.

Bank exposures to highly leveraged hedge funds were topical in the aftermath of the rescue of Long Term Capital Management (LTCM) in the United States. This episode highlighted the risks such borrowers can pose to inattentive lenders and to financial markets. Australian banks' exposures to highly leveraged funds are, however, immaterial in the context of their capital resources. And while there are entities in Australia which describe themselves as hedge funds, their activities are not on a scale that is potentially disruptive to Australian intermediaries.

Profitability in banking remained high, with many banks reporting a return on equity of 16 per cent or more, similar to their average performance over the past four years, and comparable to the returns made by Australian banks in the mid 1980s.

Profits of the major banks have been maintained despite the downward trend in their Australian interest margins. This has been offset partly by growth in non-interest income from financial services activity (as banks have diversified into funds management, life insurance and other fee based business lines to reduce their dependence on interest income). In addition, banks have been steadily cutting costs. The average cost to income ratio of the four major banks has fallen from 60 per cent to 55 per cent the over past four years.

On 1 July 1999, APRA was given responsibility for prudential supervision of credit unions, building societies and those friendly societies that conduct financial business. As one might expect with a group of around 300 financial institutions that are diverse in nature – but mainly small – a number had been under close supervision by their State-based regulators, and this oversight will need to be maintained by APRA. However, consistent with the high quality of the State supervisory systems, these transferring institutions were in generally sound condition. Credit unions and building societies were, on average, well capitalised at just below 15 per cent and just above 12 per cent of risk weighted assets, respectively. Friendly societies are still in transition to uniform, national standards, and their condition will need to be assessed and monitored.

In the general insurance sector, the penetration of Asian markets has been slow, with the result that even the most developed of Australian-owned Asian insurance portfolios are still only a minor proportion of local revenue accounts. As a consequence, the Asian crisis had little adverse effect on the local industry. Natural disasters, on the other hand, increased in number and severity during the year, putting pressure on the world and local reinsurance markets.

Several internationally active Australian-based reinsurers were hit by an unusually heavy series of disasters, including hurricanes, ice storms, satellite failures and aviation losses in various countries. The Sydney hailstorm – Australia's largest natural disaster in terms of dollar losses – adversely affected all our major reinsurers, although the full impact will not be known until all claims have been lodged and worked their way through the various reinsurance channels.

The life insurance industry continued to grow during the year on the back of the compulsory superannuation system; over 80 per cent of life insurance business is superannuation, particularly in market-linked superannuation where member balances are subject to changes in asset values. Like the other regulated industries, life insurers were relatively unscathed by the Asian fallout.

The general and life insurance industries finished the year, with one or two exceptions mentioned later in the Report, in a sound state, ie. solvent, liquid and profitable. For example, at December 1998, solvency reserves were in aggregate 1.8 times the statutory minimum for life insurance, and 3.2 times the statutory minimum for general insurance (inside Australia).

Aggregate after-tax profit for 1998 was $3.0 billion for life insurance (compared with $4.4 billion the previous year) and $0.5 billion for general insurance (compared with $2.1 billion the previous year). The drop in general insurance profits reflected falls in both the underwriting and investment components. However, it should be noted particularly in the insurance sectors that there is some natural year-to-year volatility in reported insurance profits because assets are marked to market.

While the structure of the banking industry was quite stable in 1998/99, the pace of structural change in the insurance sector quickened with the number of entries, exits, mergers and acquisitions running rather higher than usual. However, contrary to predictions that the market would polarise into a few majors at the big end, and specialised niche players at the small end, the year saw the mid-sized insurers continue to hold a significant market share. There was some consolidation in life insurance, partly due to acquisitions by the Colonial group.

In superannuation, on the other hand, polarisation is more marked with assets continuing to move out of mid-range corporate funds into either the 360 large funds at the top end of the market, or new family and small business funds at the 'under five members' end. The compulsory superannuation system is still relatively young, and the market is ceaselessly restructuring and rearranging itself as service providers struggle to identify new and creative (ie, profit generating) ways of adding value to the basic trustee functions of administering and investing member entitlements.

Total superannuation assets continued to grow at the average annual growth rate of recent years of 11 per cent. They were $387 billion at March 1999, with the increase of $38 billion over the previous 12 months attributable to net contributions of $15 billion – partly due to the increase in the Superannuation Guarantee from six per cent to seven per cent from July 1998 – and to net earnings of $23 billion.

As in recent years, the corporate and public sector segments of the superannuation market grew more slowly than the self-managed, industry and retail segments.

The insurance and superannuation industries continued to invest significant proportions of their portfolios in overseas markets as part of their asset diversification strategies, viz.: 17 per cent for superannuation, 14 per cent for life insurance and 12 per cent for general insurance, as at March 1999

A major and growing challenge for the entire financial services sector is tracking and responding to developments in electronic commerce and the concomitant shifts in customer preferences. These market developments can be hard to read, and the rapid pace of technological change and shifting consumer loyalties will inevitably create winners and losers. For example, in the banking sector, there are some quite diverse approaches being taken in the strategic alliances different banks are forming with supermarket chains, pharmacy groups and other commercial partners to exploit lower cost distribution systems. APRA's prudential supervision will need to be alert to the risks in whichever strategies are pursued.

INDUSTRY OVERVIEW (continued)