



THE ART OF SUPERVISION - CULTURE, RUGBY AND REGULATION

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Introduction

Good morning all and thank you for the introduction. It's good to be able to present at your conference.

In line with good governance practice I would like to start with a declaration, disclosure and a conflict of interest.

- Firstly a declaration. I started as the new APRA member two months ago.
- Secondly a disclosure. Unlike my predecessors, Ian, John and Steve, I am not an actuary.
- Thirdly, a potential conflict of interest. I have sat where you are for the last 20 years.

An APRA Member is a very different role for me, but one that I am very energised about and so far, finding both stimulating and enjoyable. What may be of interest to you is the gap between the view I had of APRA as a supervised entity and what I have discovered and experienced. With that in mind I would like to share my new Member's view after two months.

Reflections after two months

Like many in this room I always got out of the lift at APRAs office on the 26th floor of 400 George St with some trepidation. I now do that in a more relaxed manner. It has taken some weeks to make that adjustment. On a more serious note it has surprised me how narrow my view was about what APRA does and the way it approaches its mandate. So let me give you some insights.

The most overriding impression I have had is the quality of the people. They are bright, engaged and operate in a very collaborative and collegiate culture. I am not sure what I expected but one tends to have a jaundiced view across the regulatory table.

The people and culture is aligned around APRAs Mission, purpose and values. There is a palpable sense of the 'greater good' that is less evident in corporates. The culture is aligned around the financial system stability and safety. This is what one would expect but it is reassuring to feel it in the conversations throughout the organisation.

For me there has also been a gap between my perception and the reality of what APRA does. To draw this out I wish to contrast the role of rules-based regulation verses that of risk-based supervision. It is something I hadn't previously spent time considering. I didn't appreciate the strength of focus on risk-based supervision over a rules driven approach, and the benefits it can have for the industry and the broader financial sector.

It is this theme of the ‘art of supervision’ that I would like to explore in more detail with you today.

Policy update

In recent years Ian Laughlin at this event has outlined important changes and updates to policy and frameworks, LAGIC, ICAAP, international developments and many related topics on capital. At least for the time being, much of the heavy lifting in this area has been thankfully done by my predecessors with good engagement and progress by industry.

That is not to say that the general insurance industry may not see developments over the next few years, such as in failure preparedness, but we do not see wholesale changes in rules based regulation that we have seen in past years.

It is with this in mind that I would like to promote our focus on supervision and its foundation role in APRA fulfilling its mandate.

APRA’s mandate and approach

Let me start recapping what APRA’s mandate is. Our purpose, as set out in the APRA Act and the relevant industry Acts such as the Insurance Act, is to undertake prudential oversight of regulated institutions. We currently supervise over 600 financial services entities including about 100 general insurers.

The APRA Act states that we are required to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, to promote financial system stability in Australia.

APRA’s Mission articulates how we fulfil this purpose through establishing and enforcing prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by institutions to customers are met within a stable, efficient and competitive financial system.

As highlighted, APRA uses both regulation and supervision to achieve its objectives. These two tools are used with different emphasis by regulators around the world. In APRA’s case, a minimum bar is set through regulation but primarily APRA seeks to fulfil its mandate through a supervision-led approach.

We certainly believe in sound regulation and enforcement, and as you would be aware, have over recent years introduced a more robust regulatory framework. But as I am

discovering, regulation on its own is no substitute for proactive, informed, and confident supervision.

APRA supervisors seek to ensure that regulatory requirements are met, but they also focus upon the more fundamental question: Are regulated entities operating soundly? That is with:

- a reasonable business strategy;
- robust governance and risk management arrangements; and
- adequate capital.

And this is a matter of judgement. There is no definitive definition of a reasonable business strategy – the question of reasonableness will be answered differently for different companies in different circumstances. Let me be clear, we do not see our role as setting or unduly influencing business strategy. Rather we seek to understand what it is, the risks it entails, how well it is understood across the business and whether there is appropriate capacity to effectively execute it. In fact diversity is important for an industry like general insurance, ranging from large diverse international insurers to small mono-lines.

Regulatory requirements are, by their nature, minimums: it is best for all concerned if regulated entities operate a safe distance from that minimum in the normal course of business. Prudential supervisors seek to ensure this is the case. However, if we set standards at a level that ensures a ‘minimum’ appropriate for every case – that minimum would be very high indeed. Instead, APRA takes a principles based approach where possible and deals with the variations through proactive supervision – making judgements about reasonableness for each company, seeking to identify and prevent problems. This preventative approach is preferred so that there is less need for us to deal with wrongdoers after the event.

It is worth noting here that APRA sees the whole industry and, by and large, operates behind the scenes, with a long view. Absent a particular issue, it is not generally in APRA’s or the company’s interests for APRA to undertake its supervisory activities publicly. When supervisors identify areas for improvement, this judgement reflects a view of practices across the industry and a view that has the long term health of the company in mind. While it may be uncomfortable to receive such recommendations, these are not broadly disclosed and provide an outside insight into the company. In some respects, APRA can be seen as management consultants that carry a stick! While we may sometimes disagree on the specifics of how to achieve an outcome, APRA is equally interested in having an industry with sustainable profitability and adequate returns

The under-appreciated art of supervision

I would now like to discuss in a little more detail the under-appreciated art of supervision. Let me firstly distinguish the respective roles of regulation and supervision.

‘Regulation’ is often thought of as the sum of statute, standards and associated guidance material that determine the rules by which your organizations must operate.

‘Supervision’ is the process by which regulators seek to ensure that firms stay within the rules. In this frame, the rules are the key, with supervision acting in a supporting role to police them.

In the aftermath of the crisis, globally the immediate response to the failings was that we needed a stronger set of rules. There was a less emphatic reaction when it came to supervision. However, in some jurisdictions it was judged that it was not so much the rules that failed, but the people tasked with policing them. In these cases, supervision was seen as not living up to expectations, so more prescriptive rules, and less supervisory discretion, has been the response.

APRAs Chair Wayne Byres has spoken on this topic. It is his view that this downplaying of supervision has been far from ideal. He has argued that good supervision is an under-appreciated art, and it has globally lacked sufficient attention and investment in the post-crisis response.

No set of rules can adequately and efficiently deal with something as complex as a financial system with a diverse set of institutions and business models. This philosophy views supervision as the primary means by which we can promote long-term safety and soundness of financial firms, and regulation is a tool that supports and empowers supervision. Such an approach can be tailored and take account of nuances and subtleties in individual firms in a manner a rulebook cannot. This approach should be more flexible and responsive. Done well it should be one of the best countercyclical tools at our disposal.

APRA believes a supervision-led approach is ultimately in all our interests; APRA, your organizations’ board, shareholders and customers. It helps in creating a resilient, safe and stable system at the lowest cost.

What is supervision?

So what is supervision? I would like to share an articulation of supervision by Julie Dickson who was Superintendent at our peer organisation OSFI in Canada. Julie chaired the global Financial Stability Board's work on supervision post the crisis and made a series of recommendations. APRA Deputy Chair Helen Rowell and General Manager Heidi Richards also contributed to this important work.

Julie has been an effective communicator in promoting the cause of effective supervision which she simply describes as "the essential task of figuring out whether there could be a breakdown in risk management controls at an institution, and whether the culture of the institution and its appetite for risk will create dangers that could lead to insolvency."

She goes on to describe "supervisory oversight as the kind of attention financial institutions receive from supervisors on a regular basis. It is about the questions we ask, what we say to institutions, how we say it, the type of information we request, the people we ask to meet, how we deal with push back, what we do when we go on-site or otherwise deal with an institution, the extent to which we tick boxes or think about the core risks and how they are being managed."

In short, supervisors are the people on the frontlines who identify risk management problems at individual institutions. Ultimately of course, the company board is responsible for financial soundness and prudent risk management. Supervisors provide an independent check point, and at times, narrow the corridor of options where there are concerns.

In APRA, there are many more people involved in supervision than in writing the rules. That ratio is 5:1. Most of your institution's interactions with APRA will be with our supervisory teams. So why is so much attention and debate publically paid to rules, with little focus on the role of supervision? Perhaps it's because changing a rule is seen as a concrete step, as taking decisive action. It is visible to the public and can swiftly generate a reaction. Maybe post the crisis flaws in key rules were more easily identified.

In explaining the importance of supervision, perhaps a sports analogy would be most appropriate. I am a rugby fan and was fortunate last year to have some time off in between roles. My wife Henrietta (a Kiwi) and I experienced what was for rugby a memorable World Cup. It was a fabulous carnival with many great matches and we even had an each way bet in the final.

I thought one of the many highlights of RWC2015 was the high standard of refereeing. The Scots may have a different view.

In rugby there are the laws of the game, and they are complex and very technical as are rules in financial services. And while the rules are important, how the game is supervised has a lot to do with how the game is played.

Referees for example, do much more than blow whistles during games to enforce rules. They talk to players and coaches about what is expected, what is acceptable and not acceptable, and what situations they will be watching given past experience. They know the personalities of the players; they give some players the benefit of the doubt, and give others no room at all. The rules are important, but ultimately referees control the flow of the game. If referees are doing as good job as they generally did during the World Cup, they are not a feature of the game and spectators can enjoy the efforts of the players and the teams.

From what I have observed in my first two months at APRA, this analogy extends to supervision and the importance of a relationship of openness and trust with regulators, particularly if asking for the benefit of doubt.

Again I would emphasise that if there is a shared understanding of objectives, alignment of interest about financial and organisational sustainability, discussed in an environment of openness this leads to trust. As a result interactions between APRA and institutions will benefit.

My approach to industry engagement

Let me conclude with my intended approach to industry engagement. At APRA there is a huge effort put into our supervisory approach. This is described in great detail on our website. We do however acknowledge that there is room for improvement both in what we do and how we communicate that. One of the stated objectives in our published Corporate Plan is to improve our transparency and accountability. I hope what I have said today is helpful in this regard.

Like a match referee we will have our differences. But if there is an understanding of what we are each trying to achieve those should be the exception.

In the meetings I have been having with CEOs and directors of companies over recent weeks I am told that while boards don't always like what APRA might have to say they are pleased we are there and do what we do.

History has shown that a strong integrated financial regulatory system, where supervision is core strength, is essential when economies experience volatility and stress. This may come in the form of natural hazards, claims experience, pricing, market stress, a systemic

global event or paradigm shifts driven by customer, technology or climate change. We have and are experiencing all these in the insurance sector. So far we have been relatively unscathed at least in a failure sense.

We operate in a rapidly changing world where long term forecasting is difficult and uncertain. In my journey of discover during my first two months as an APRA Member I have been impressed with what I have learnt being on this side of the table. Like all organisations however, APRA needs to continue to evolve its capability and culture to remain relevant to the institutions we supervise and the Australian public we protect. A strong regulatory system not only improves customer trust but it enhances industry sustainability and in turn investor confidence.

My area of focus will be on our leadership capability and culture especially as it relates to our core function of supervision. We need to ensure we continue to question and challenge in a constructive manner that is insightful and relevant to our aligned interests of financial safety and sustainability both now and into the future.

I have been told by our supervisory teams and the people I have met that we have sound working relationships with the general insurance sector. That is important to all the stakeholders we collectively serve. I look forward to working with you and building on that base during my five-year term.

Thank you