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Performance Audit

# Bank Prudential Supervision

## Australian Prudential Regulation Authority

Australian National Audit Office

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Australian National
Audit Office

Canberra ACT
30 May 2001

Dear Madam President
Dear Mr Speaker

The Australian National Audit Office has undertaken a performance audit in the Australian Prudential Regulation Authority in accordance with the authority contained in the *Auditor-General Act 1997.* I present this report of this audit, and the accompanying brochure, to the Parliament. The report is titled *Bank Prudential Supervision.*

Following its tabling in Parliament, the report will be placed on the Australian National Audit Office's Homepage—http://www.anao.gov.au.

Yours sincerely

P. J. Barrett
Auditor-General

The Honourable the President of the Senate
The Honourable the Speaker of the House of Representatives
Parliament House
Canberra ACT

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# Summary and Recommendations

# Summary

## Background

**1.** The *Banking Act 1959* provides the legislative framework for the prudential supervision of authorised deposit-taking institutions (ADIs). Prudential supervision aims to protect depositors by ensuring that financial institutions adopt prudent risk management practices designed to ensure their continuing solvency and liquidity.

**2.** At the commencement of ANAO's audit, there were 50 banks licensed to operate in Australia, comprising 15 Australian-owned banks, 10 subsidiaries of foreign banks and 25 branches of foreign banks.[1] As of December 2000, $760 billion in assets were on the Australian books of banks operating in Australia, with the four major banks representing $510 billion or 67 per cent of this amount, followed by other Australian owned banks (17 per cent), foreign bank branches (10 per cent) and foreign bank subsidiaries (6 per cent).

**3.** The Australian Prudential Regulation Authority (APRA) was established on 1 July 1998 as the prudential regulator of banks and other ADIs, life insurance companies (including friendly societies), general insurance companies, superannuation funds and retirement savings accounts. APRA is funded by appropriations based on levies from the institutions it regulates. In 1999–2000, some $27.1 million was collected from banks. In that year, APRA budgeted to spend $10.4 million on direct supervision of banks with the remaining funds budgeted to be spent on the development of prudential policies and standards, administrative support and the consumer protection functions of the Australian Securities and Investments Commission (ASIC).

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1 The Banking Act distinguishes between foreign-owned bank branches and foreign-owned bank subsidiaries. Under the Banking Act, foreign bank subsidiaries are subject to the same legislative and prudential requirements as Australian owned banks. In comparison, foreign branches are subject to similar requirements but their solvency is governed by the home country prudential supervisor. As a consequence, they are exempt from certain prudential requirements, including capital adequacy.

## Audit approach

**4.** ANAO's objectives for this audit were to assess the efficiency and effectiveness of APRA's prudential supervision of banks. Specifically, the audit objectives involved:

- examining APRA's adoption and implementation of internationally accepted banking supervisory standards and developments;
- evaluating APRA's prudential supervision of banking activities; and
- assessing APRA's financial governance arrangements.

**5.** The Department of the Treasury was also included within the scope of the audit as its responsibilities include providing advice on the legislative framework for APRA's prudential supervision and monitoring developments in the financial sector and advising on their policy implications. Having regard to Treasury's responsibilities, in forming the audit opinion ANAO was cognisant of Treasury advice and assurances on a number of issues including that APRA's supervisory approach is consistent with Government policy and accords with international obligations. Treasury has advised ANAO that it is largely satisfied with APRA's supervision approach and its financial governance.

**6.** Audit fieldwork was conducted between June 2000 and October 2000. Issues Papers were prepared in November 2000 followed by a Discussion Paper in December 2000 and a revised Discussion Paper in February 2001. A draft report was provided to APRA, Treasury and the Reserve Bank of Australia (APRA's predecessor supervisor of banks) for comment in March 2001.

# Overall audit conclusions

**7.** APRA is a relatively new organisation, established in July 1998 and becoming responsible for prudential supervision of all ADIs from July 1999. APRA has negotiated the transition from the previous system of Commonwealth and State supervisors to become an integrated prudential regulator of all ADIs. This has included establishing a new organisation structure with effect from August 1999, adopting from July 2000 a risk-based supervisory methodology for sophisticated financial institutions (including most banks) and the October 2000 introduction of harmonised Prudential Standards for all ADIs.

**8.** APRA's prudential supervision task is assisted by Australia's well-developed economy, robust legal system and recognised accounting and auditing standards. Furthermore, since its establishment, the financial performance of the Australian banking sector, particularly the major Australian banks, has been strong. The Department of the Treasury (Treasury) commented to ANAO that it considers APRA's supervisory approach appears consistent with Government policy to balance the objectives of financial safety with other objectives such as efficiency and competition.

**9.** ANAO concluded that there are steps APRA can take in a number of areas to improve its supervisory practices, including improving the administration of the ADI supervisory levy; strengthening its risk management approach; and maintaining closer adherence to international standards for prudential supervision issued by the Basle Committee on Banking Supervision.[2]

## Adoption of internationally accepted supervisory standards

**10.** The 1997 *Core Principles for Effective Banking Supervision* issued by the Basle Committee, and other guidance on supervisory practice published by the Basle Committee, represent the global standard for prudential supervision. APRA advised ANAO that, reflecting the fact that the Core Principles represent world best practice and not standard practice, few countries would be fully compliant at this point in time with the more detailed benchmarks laid down in the October 1999 Core Principles Methodology. Furthermore, Treasury commented to ANAO that the risk-based approach to prudential supervision adopted by APRA does not necessarily require full compliance with the Basle Core Principles as long as there is transparency to ensure that an assessment of the associated risks can be identified and managed.

**11.** ANAO found that APRA complies with most aspects of the Core Principles, including: an appropriate regulatory framework for the ***licensing*** of banking operations in Australia; ***Prudential Standards*** issued with effect from October 2000 which establish the minimum standards that banks are required to observe; and consistency of APRA's ***capital adequacy*** framework and capital adequacy requirements with international best practice, as represented by the Basle Capital Accord. ANAO also found that there are a number of areas where closer adherence to the Core Principles would assist to enhance APRA's supervisory effectiveness, as follows:

- APRA's supervisory requirements do not impose a limit on each bank's ***large exposures*** in the manner advocated by the Basle Committee[3] as

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2 The Basle Committee on Banking Supervision is a Committee of banking supervisory authorities that has been working to improve banking supervision at the international level. The Basle Committee on Banking Supervision was established by central bank Governors of the Group of Ten countries in 1975. It usually meets at the Bank for International Settlements in Basle, Switzerland where its permanent Secretariat is located.

3 The Basle Committee's guidance on measuring and controlling large credit exposures states that a sound supervisory system should include a limit of not more than 25 per cent of group capital on the exposures of a banking group combined with a reporting threshold of not more than 10 per cent of capital.

there is no prudential limit on a bank's maximum individual customer exposures, only a requirement to consult with APRA. The Basle Committee also advocates that minor deviations from large exposure limits may be acceptable, especially if explicitly temporary or related to very small or specialised banks. However, in the sample of nine banks examined by ANAO, two banks had advised of exceptionally large exposures since 1997, with the size of these exposures ranging from 31 per cent of capital up to 63 per cent for one bank and 76 per cent for the other. APRA advised ANAO that its large exposures policy for banks and other ADIs is currently subject to review as part of its wider review of ADI conglomerate policy.

- The Basle Committee considers that ***formal information sharing arrangements*** are a key component of consolidated supervision as they assist with regular exchange of information. As well, the discussions establishing these arrangements can assist the two supervisors appreciate more fully the nature of each other's supervisory process, and the comfort that can be taken from it. However, APRA has formal information sharing arrangements in place with supervisors in only two countries compared to the 36 countries in which Australian banks operate and the 13 home countries of foreign banks operating in Australia.
- APRA has not undertaken regular ***on-site visits*** to all banks and so it is unable to meet the Basle Committee best practice recommendation that it periodically verify that banks' are adhering to their risk management processes, capital requirements, credit policies and procedures and liquidity guidelines. ANAO noted that APRA has not specified a minimum visit frequency for all banks whereas the Reserve Bank of Australia (APRA's predecessor supervisor of banks) had a target of conducting visits to each bank at least once in every two years. ANAO considers that an improved risk-based approach would ensure all banks receive periodic visits in accordance with a specified minimum revisit frequency, with the level of assessed risk determining whether visits should be more frequent and/or more intense.

## Supervision of banking activities

**12.** APRA's functions involve collecting and analysing prudential information; encouraging and promoting sound prudential practices by banks; and evaluating the implementation and effectiveness of banks' prudential practices. APRA's supervisory approach is predicated on its view that the board and management of each bank is primarily responsible for the prudent management of that bank's business. In this context, APRA seeks to reduce the burden of supervisory compliance on industry by leveraging off financial institutions' internal risk management systems as far as possible. Extensive reliance is also placed by APRA on the work of banks' external and internal auditors.

**13.** APRA's enabling legislation requires it to balance financial safety with efficiency, competition, contestability and competitive neutrality. Accordingly, it is a matter for APRA to identify an appropriate supervisory approach and advise Government on the resources that are necessary to meet its objectives. APRA budgeted to spend $10.403 million on prudential supervision of banks in 1999–2000 and again in 2000–01. Only a small number of APRA officers are dedicated to the day-to-day supervision of banks with, in aggregate, 30 to 34 full-time staff equivalents allocated to the supervision of banks. APRA has advised ANAO that it accepts there has been some under-resourcing but that this is only because the audit covered a time of substantial organisation restructure in which a number of other work priorities competed for supervisory resources.

## Capital adequacy

**14.** The cornerstone of prudential supervision is the requirement for banking institutions to maintain sufficient capital to cover the risks they take. Among other things, a bank's capital provides it with a buffer for losses which, in turn, provides a cushion to protect depositors. APRA expects each bank to maintain a level of capital that is adequate for the type(s) of activities it undertakes. All locally incorporated banks are expected to maintain a risk-based capital adequacy ratio of at least 8 per cent of risk-weighted assets. They are also expected to establish their own target capital adequacy ratios in excess of the 8 per cent minimum and have capital management systems to ensure they meet their own targets. The quarterly Capital Adequacy Returns submitted to APRA by the banks in ANAO's sample indicate that each bank had maintained a capital adequacy ratio above the minimum specified by APRA.

**15.** Where a bank is considered by APRA to have an excessive concentration of credit risk exposures, inadequate provisioning or significant other risk exposures, APRA may specify a higher minimum capital ratio. The exposures of <u>two</u> of the banks whose supervision was examined by ANAO was highly concentrated in particular industry sectors. For this reason, APRA advised these banks that they were to maintain a capital adequacy ratio of at least 15 per cent and 11 per cent respectively, compared to the standard ratio of 8 per cent. Capital adequacy returns submitted by each bank indicate maintenance of the required ratio but, in neither case, has APRA made compliance with the higher ratio a legal requirement of the banks concerned.

## Risk-based supervision

**16.** In July 2000, APRA adopted a risk-based supervisory methodology for sophisticated financial institutions (including most banks). The new methodology involves a less intrusive *'consultative'* off-site supervision regime, where APRA considers it can (at a high level) verify the effectiveness of control processes through targeted on-site visits, as well as the various bank management attestation arrangements and external audit sign-offs.

**17.** The risk-based methodology is applied across all APRA supervised institutions and is to drive APRA's allocation of resources. The methodology incorporates three broad activities: risk assessment; execution of a supervisory plan; and ongoing evaluation. During the period of ANAO's audit fieldwork, initial ratings had been allocated to all bank-parented conglomerate groups and individual banks. In addition, an initial round of supervisory action plans was being documented. The vast majority of banks, representing 95 per cent of total bank assets, were rated in the bottom of the risk exposures by APRA in the category of 'low' risk. In these circumstances, the ratings provide a less than sufficient basis for prioritising supervisory activities for entities within the banking sector.

**18.** Based on its risk ratings, APRA develops supervisory action plans for each financial group as well as for the individual regulated entities. These plans generally provide for supervisory actions, such as additional off-site reviews on specific subjects, as well as on-site visits to institutions. APRA has advised ANAO that it is impractical for the agency to revoke banking licences or impose conditions on banking licences but that it has always been able to enforce appropriate prudential outcomes without resort to its formal regulatory powers and that the Banking Act equips it with substantial powers of intervention, which are capable of being applied in a wide range of circumstances.

## On-site visits

**19.** APRA has a program of high level, on-site visits to assess banks' risk management systems and methodologies in the areas of credit risk, market risk and balance sheet management, and operational risk. Following the adoption by APRA of a new risk-based visit methodology in late 2000, it is intended that banks with lower risk profiles will receive fewer, and less frequent, visits than when supervised by the Reserve Bank. The intention is that systemically important institutions and institutions with higher risk profiles, or those encountering risk management difficulties will be subject to more frequent visits. However, other work priorities associated with APRA's restructure and the absence of a complete staffing complement in the on-site review teams meant that it had not achieved the full roll-out of its risk-based on-site methodology during the ANAO review period.

**20.** On-site visits provide APRA with an increased understanding of banks' risk management systems and an insight into their risk management culture as well as enabling material issues identified through off-site supervision to be pursued. Accordingly, in a risk management context, all banks should receive periodic visits with the level of assessed risk determining the appropriate frequency and intensity of visits. Unlike a number of European and North American supervisors who visit the Australian operations of their banks, APRA does not have a structured program of visits to the offshore operations of Australian banks with none of the overseas operations of the banks in ANAO's sample having been visited since 1997.

## Cross-border banking

**21.** Financial conglomerates, particularly those that operate across national borders, raise significant supervisory issues. At the time of the ANAO audit, APRA had responsibilities as parent supervisor for the 194 overseas operations of Australian owned banks in 36 countries, as well as host country supervisor responsibilities for 25 branches and 10 subsidiaries of foreign banks operating in Australia.

**22.** APRA advised ANAO that the foreign bank population in Australia is largely drawn from members of the Basle Committee or from regimes that have transparent and well-documented supervisory frameworks. In this context, APRA places significant reliance on the supervision conducted by home country supervisors of foreign bank subsidiaries and branches operating in Australia. APRA's approach to supervising Australian banks' offshore operations also places significant reliance on the host country supervisor. However, in relying on overseas supervisors, APRA does not:

- have procedures in place to ensure overseas supervisors are apprised of the activities of Australian banks in their jurisdiction;
- document, and regularly update, assessments of the quality of supervision provided by overseas supervisors; and
- seek periodic confirmation from overseas supervisors that there are no issues of concern relating to foreign parent banks and overseas operations of Australian banks that APRA needs to be made aware of.

## Financial governance

**23.** The Basle Committee advocates that banking supervisors should be financed in a manner that does not undermine their autonomy or independence and permits them to conduct effective supervision. The ADI supervisory levy provides a suitable framework to achieve this outcome, as it enables APRA to identify the extent of supervision required, the expected costs of its supervision and then to recover these costs from the supervised industries. However, in both 1999–2000 and 2000–01, APRA did not invoice and collect the ADI levy within the timeframe set by the *Financial Institutions Supervisory Levies Collection Act 1998*. APRA has advised ANAO that it intends to bring forward invoicing in 2001–02 to meet the legislative requirements.

**24.** To provide the flexibility necessary to determine the levy on each industry according to the cost of regulating that industry, separate levy imposition acts are in place for each industry supervised by APRA. APRA has a basic process for determining the allocation of costs to regulated industries through quarterly time estimates, made by APRA management, of the time likely to be spent supervising each industry. Direct supervisory costs are allocated according to these estimates with unallocated costs apportioned pro-rata. APRA advised ANAO that its processes are aimed at simplicity, transparency, stability and low-cost in administration. However, APRA's use of staff numbers does not have regard to differences in the actual <u>costs</u> to APRA. In addition, APRA was unable to demonstrate that its approach is reliable and comprehensive.

**25.** Under current arrangements, the levy on each of the regulated industries is set annually, with the levy rates, minima and maxima, intended to raise sufficient revenue to meet the <u>budgeted</u> cost of supervising that sector for the financial year. Adjustments are made for any significant over- or under-collections from earlier years. In this context, ANAO's analysis indicates there is some imprecision in APRA's calculation of adjustments for over- or under-collections from earlier years. Although ANAO estimates that there was a shortfall of some $2 million in levy revenue against costs for 1999–2000, the 2000–01 ADI levy parameters were prepared on the basis that APRA had over-recovered in 1999–2000 by $1.7 million. This indicates that other industries may be subsidising the cost of supervising ADIs as insufficient levy revenue was budgeted to be collected in 2000–01 to cover the apparent shortfall in 1999–2000 and budgeted costs for 2000–01.

## APRA response

**26.** ANAO made five recommendations concerning administration of levies, risk-based supervision and supervision of cross-border banking. APRA agreed, or agreed with qualifications, to all recommendations, as well as agreeing with the overall audit conclusions. In this context, APRA commented that:

> *There are a few areas where supervisory practices can be improved. We note that part of the audit methodology included assessing the extent to which APRA has implemented the 1997 Core Principles for Effective Banking Supervision issued by the Basle Committee on Banking Supervision. While these Core Principles represent the international benchmark for prudential supervision, they require judgement in their practical application, taking into account the particular legal and economic infrastructure in each country and its banking system. We also note that a small number of foreign banks, which operate in Australia as "merchant banks" under the* Financial Corporation Act 1974, *are not licensed by APRA and are therefore not subject to any prudential requirements.*

# Recommendations

*Set out below are ANAO's recommendations with APRA's abbreviated responses. ANAO considers that APRA should give priority to recommendations 2, 3 4 and 5.*

**Recommendation No.1**
**Para. 2.27**

ANAO recommends that APRA improves its administration of the ADI supervisory levy by:

(a) periodically reviewing the basis of its cost estimation approaches;

(b) improving transparency and accountability by publicly reporting on the actual costs of supervision for each industry; and

(c) undertaking comprehensive analysis of levy receipts and supervisory costs against budget in order that the extent of any over- or under-collections can be taken into account when setting levy parameters for subsequent years.

***APRA response:*** Agreed with part (a) and agreed with qualification to parts (b) and (c).

**Recommendation No.2**
**Para. 3.34**

ANAO recommends that APRA reviews its risk rating process to ensure that ratings provide sufficient basis for prioritising supervisory actions.

***APRA response:*** Agreed.

**Recommendation No.3**
**Para. 3.67**

ANAO recommends that APRA:

(a) conducts periodic on-site visits to all banks with the level of assessed risk determining the appropriate frequency and intensity of visits; and

(b) considers the merits of a structured program of visits to the offshore operations of Australian banks.

***APRA response:*** Agreed with qualification with part (a) and agreed with part (b).

**Recommendation No.4**
**Para. 4.32**

ANAO recommends that APRA reviews prudential restrictions on bank exposures to single borrowers or groups of related borrowers in accordance with the Basle Committee's best practice guidelines.

***APRA response:*** Agreed.

**Recommendation No.5**
**Para. 5.32**

ANAO recommends that APRA enhances its supervision of the international operations of Australian banks and the Australian operations of foreign banks by:

(a) documenting, and regularly updating, assessments of the quality of supervision provided by overseas supervisors drawing, as appropriate, on assessments completed by internationally recognised agencies;

(b) establishing formal information sharing arrangements with relevant overseas supervisors;

(c) seeking periodic confirmation from overseas supervisors that there are no issues of concern relating to foreign parent banks and overseas operations of Australian banks that APRA needs to be made aware of; and

(d) where there are concerns about the Australian operations of foreign banks or the international operations of Australian banks, promptly informing the relevant overseas supervisor of these concerns.

***APRA response:*** Agreed.

# Audit Findings and Conclusions

# 1. Introduction

## Background

**1.1** In Australia, the *Banking Act 1959* provides the legislative framework for the prudential supervision of authorised deposit-taking institutions (ADIs).[4] Prudential supervision is a form of regulatory action aimed at substantially reducing the risk of insolvency of financial institutions leading to losses for their customers and instability in the financial system. Prudential supervision aims to protect depositors by ensuring that financial institutions adopt prudent risk management practices designed to ensure their continuing solvency and liquidity.[5] In this context, no depositor has ever lost money since the deposit protection provisions were introduced into the Banking Act in 1945.

**1.2** In recent years, the financial performance of the Australian banking sector, particularly the major Australian banks, has been strong. At the commencement of ANAO's audit, there were 50 banks licensed to operate in Australia, comprising 15 Australian-owned banks, 10 subsidiaries of foreign banks and 25 branches of foreign banks.[6] As of December 2000, $760 billion in assets were on the Australian books of banks operating in Australia, with the four major banks representing $510 billion or 67 per cent of this amount, followed by other Australian owned banks (17 per cent), foreign bank branches (10 per cent) and

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4 ADIs are corporations granted permission under the *Banking Act 1959* to carry on banking business in Australia. ADIs comprise banks, building societies and credit unions.

5 The importance of prudential supervision has been emphasised by the Basle Committee on Banking Supervision as follows:

> *Effective supervision of banking organisations is an essential component of a strong economic environment in that the banking system plays a central role in making payments and mobilising and distributing savings. The task of supervision is to ensure that banks operate in a safe and sound manner and that they hold capital and reserves sufficient to support the risks that arise in their business. Strong and effective banking supervision provides a public good that may not be fully provided in the marketplace and, along with effective macroeconomic policy, is critical to financial stability in any country. While the cost of banking supervision is indeed high, the cost of poor supervision has proved to be even higher.*

Source: Basle Committee on Banking Supervision, *Core Principles for Effective Banking Supervision*, September 1997, page 8.

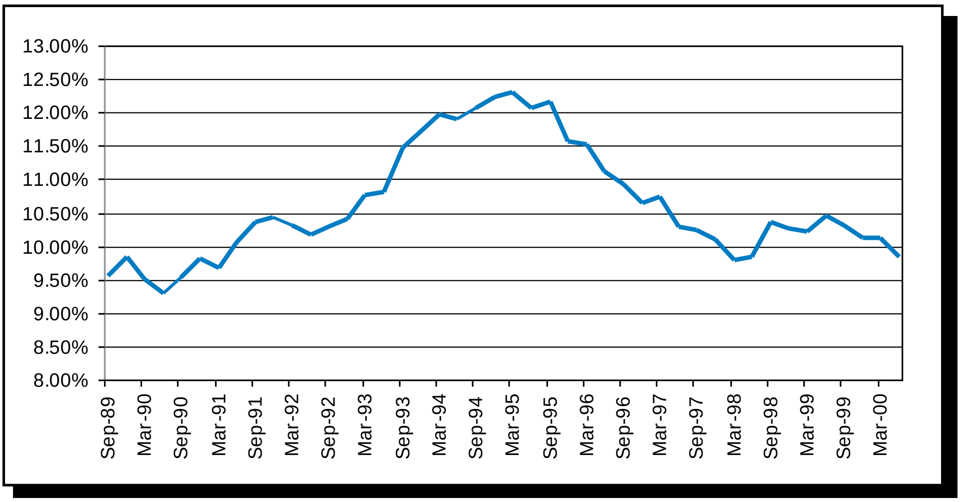
6 The Banking Act distinguishes between foreign-owned bank branches and foreign-owned bank subsidiaries. Under the Banking Act, foreign bank subsidiaries are subject to the same legislative and prudential requirements as Australian owned banks. In comparison, foreign branches are subject to similar requirements but their solvency is governed by the home country prudential supervisor. As a consequence, they are exempt from certain prudential requirements, including capital adequacy.

foreign bank subsidiaries (6 per cent).[7] Bank profitability has also increased with most banks reporting profits in the 1998 and 1999 years, with the four major Australian banks reporting a combined profit of $4.1 billion in the first half of 1999–2000, an increase of 15 per cent over the previous corresponding period.[8]

**1.3** Furthermore, banks' impaired assets[9] are low by historical standards, with the aggregate net impaired assets as a proportion of banks' capital falling to below 5 per cent as of June 2000 compared to more than 12 per cent as of June 1995. In addition, the overall capital adequacy of Australian banks, measured as the ratio of banks' capital base to their risk-weighted exposures, has stabilised at between 9.8 per cent and 10.5 per cent in the last three years (see Figure 1.1). This followed a substantial reduction in these ratios between 1995 and 1998.

### Figure 1.1

**Capital Adequacy of Locally-incorporated Banks: September 1989 to June 2000**




Source: ANAO analysis of APRA data.

7 Australian Prudential Regulation Authority, *Australian Banking Statistics*, December 2000.

8 KPMG, *2000 Financial Institutions Performance Survey*, May 2000, page 32.

9 Impaired assets are credit exposures for which the collectibility of principal and interest is compromised.

## Financial System Inquiry

**1.4** The Financial System Inquiry, the first full-scale review of the Australian financial system since the Campbell Inquiry in the late 1970s, was established in June 1996. The Inquiry's mission was to provide a stocktake of the results of the deregulation of the financial system since the early 1980s and make recommendations on future regulatory arrangements. The Inquiry reported in March 1997.

**1.5** The Inquiry concluded that prudential regulation of financial institutions should be centralised and recommended that a single Commonwealth prudential regulator be established, separate from, but cooperating closely with, the Reserve Bank of Australia (Reserve Bank). The Financial System Inquiry further recommended the prudential regulator be empowered under legislation to: issue, revoke or place conditions on authorities for deposit-taking institutions; and establish and enforce prudential regulations on any licensed financial entity; and that these regulations be consistent with standards published by the Basle Committee on Banking Supervision. The Inquiry also made recommendations on the conduct of prudential supervision including that quantitative standards on capital adequacy, liquidity and large exposure be applied and that regular on-site reviews of risk management systems form an integral part of the supervisory approach.

**1.6** The Government accepted the Inquiry's recommendations, with the Australian Prudential Regulation Authority (APRA) being established on 1 July 1998. The establishment of APRA was part of a fundamental reform to Australia's system for regulating the financial system with regulatory responsibility now divided according to the products sold and the functions performed, rather than by the description of the regulated entity.[10] Accordingly, APRA is the prudential regulator of banks and other ADIs,[11] life insurance companies (including friendly societies), general insurance companies, superannuation funds and retirement savings accounts.

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10 Under the new regulatory framework, the Reserve Bank is responsible for monetary policy and for the stability of the financial system, the Australian Securities and Investment Commission (ASIC) is responsible for market conduct, the Australian Competition and Consumer Commission (ACCC) is to prevent anti-competitive behaviour and APRA is responsible for all prudential regulation.

11 Upon its establishment, APRA assumed responsibility from the Reserve Bank for the prudential supervision of banks. Responsibility for prudential supervision of other ADIs (credit unions and building societies) was transferred from the States to APRA in July 1999.

**1.7** APRA is funded by appropriations based on levies from the institutions it regulates. In 1999–2000, some $76.1 million was collected from financial institutions, of which $62.2 million related to APRA functions.[12] In that year, APRA's operating expenses totalled $52.6 million, with abnormal costs associated with APRA's establishment of $6.2 million.[13] The resultant surplus ($5.8 million) was reduced by the brought forward deficit ($4.4 million).

**1.8** APRA is governed by a board of management that includes its Chief Executive Officer. It is subject to the *Commonwealth Authorities and Companies Act 1997*, which regulates certain aspects of the financial affairs of Commonwealth authorities including reporting, accountability, banking and investment.

**1.9** APRA's stated mission is to establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by supervised institutions are met within a stable, efficient and competitive financial system. APRA also has a duty under the Banking Act to exercise its functions and powers for the protection of depositors of all locally incorporated banks (including those controlled by foreign banks), building societies and credit unions.[14] APRA commented to ANAO that its prudential supervision task is assisted by Australia's well-developed economy, robust legal system and recognised accounting standards.

**1.10** In October 2000, the House of Representatives Standing Committee on Economics, Finance and Public Administration completed its first annual review of APRA. The Committee concluded that APRA had successfully negotiated the transitional period and that its work towards establishing a new regulatory framework for Australia's financial institutions is progressing well.[15] In this context, the Department of the Treasury (Treasury) advised ANAO that it considers APRA has been successful to date in navigating through the risks of the banking sector in developing a sound prudential framework.

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12 APRA, *Annual Report 2000*, page 63.

13 APRA, *Annual Report 2000*, page 49.

14 The depositor protection provisions of the Banking Act do not apply to branches of foreign banks.

15 House of Representatives Standing Committee on Economics, Finance and Public Administration, *Review of the Australian Prudential Regulatory Authority: Who Will Guard the Guardians?* October 2000, page 33.

**1.11** In December 2000, when commenting on a draft of this report, APRA noted to ANAO that the ANAO performance audit was undertaken against the background of the restructure of the newly created APRA as an integrated prudential regulator rather than a simple amalgamation of predecessor organisations. This restructure incorporated a review of supervisory methodologies, extensive retraining of staff and an inability to get to a fully staffed position. APRA stated that this restructure is the main reason why some activities have either fallen behind schedule or have not been completed as they might have been in the past. APRA also observed that there was a conscious decision to make structural changes to financial sector supervision and to create APRA at a time of low risk when the financial sector was in reasonably good health. APRA further commented that, as with any restructure, new processes have been implemented or existing methodologies modified to address the revised supervisory regime.

**1.12** In this context, Treasury commented to ANAO that the trend towards convergence of financial sector entities is strengthening and that the restructure undertaken by APRA in 1999 and its approach to the task of prudential supervision reflects this change. Treasury further commented that the Government's rationale for establishing APRA was to obtain more flexible, consistent and effective prudential regulation in a rapidly changing financial environment. Treasury considered greater flexibility, in practice, enables APRA to supervise institutions with a variety of structures and market presence, without being unnecessarily restricted by a formulaic approach to supervision.

## Reserve Bank role

**1.13** The Financial System Inquiry recommended that there be close coordination arrangements between the regulator and the Reserve Bank.[16] The Inquiry recommended strong mechanisms be established to ensure appropriate coordination and cooperation including: exchanges of information; joint inspection activities and establishment of bilateral coordination arrangements.

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16 *Financial System Inquiry Final Report*, March 1997, Recommendation 32, page 317.

**1.14** Consistent with the recommendations of the Financial System Inquiry, on 12 October 1998, APRA and the Reserve Bank announced that they had signed a Memorandum of Understanding covering their respective responsibilities for promoting the stability of the Australian financial system.[17] This Memorandum recognised that, although the Bank has no obligation to protect the interests of bank depositors and does not supervise any individual financial institutions, it has discretion to provide emergency liquidity support to the financial system. The Memorandum set out a framework for cooperation covering matters such as information sharing and consultation arrangements for the handling of threats to system stability. Accordingly, ANAO initially proposed to include the Reserve Bank in this performance audit. However, in May 2000, the Bank advised ANAO that it has <u>no role</u> in prudential supervision.

## Audit approach

**1.15** ANAO's objectives for this audit were to assess the efficiency and effectiveness of APRA's prudential supervision of banks. Specifically, the audit objectives involved:

- examining APRA's adoption and implementation of internationally accepted banking supervisory standards and developments;
- evaluating APRA's prudential supervision of banking activities; and
- assessing APRA's financial governance arrangements.

**1.16** Treasury was also included within the scope of the audit as its responsibilities include providing advice on the legislative framework for APRA's prudential supervision and monitoring developments in the financial sector and advising on their policy implications.[18] Having regard to Treasury's responsibilities, in forming the audit opinion ANAO was cognisant of Treasury advice and assurances on a number of issues including that APRA's supervisory approach is consistent with Government policy and accords with international obligations. Treasury has advised ANAO that it is largely satisfied with APRA's supervision approach and its financial governance.

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17 Reserve Bank of Australia, *Bulletin*, October 1998, page 28.

18 Budget Related Paper No. 1.16, *Portfolio Budget Statements 2000–01—Treasury Portfolio*, page 23.

**1.17** The audit methodology included assessing the extent to which APRA has implemented the 1997 *Core Principles for Effective Banking Supervision* issued by the Basle Committee on Banking Supervision (see Appendix 1)[19] and other guidance on supervisory practice published by the Basle Committee. The Core Principles represent the global standard for prudential supervision and, according to the Committee, the vast majority of countries have endorsed the Principles and declared an intention to implement them.

**1.18** In October 1999, the Basle Committee finalised its Core Principles Methodology, which promulgated criteria to assist with assessment of the implementation of the Core Principles. APRA advised ANAO that, reflecting the fact that the Core Principles represent world best practice and not standard practice, few countries would be fully compliant with the more detailed benchmarks laid down in the Methodology at this point. Furthermore, Treasury commented to ANAO that the risk-based approach to prudential supervision adopted by APRA does not necessarily require full compliance with the Basle Core Principles as long as there is transparency to ensure that an assessment of the associated risks can be identified and managed.

**1.19** An important part of the audit approach was to examine in detail the supervision of a sample of seven of the 50 banks supervised by APRA at the time of the audit. This audit sample involved two of the four major Australian banks, another large Australian bank, one subsidiary of a foreign bank and three foreign bank branches. ANAO also examined the licensing processes adopted in relation to the two most recent occasions when a banking licence has been granted and examined the approval process for all nine banks granted permission to use their internal market risk models to calculate their capital adequacy position (three of which were included in ANAO's original sample of seven banks).

**1.20** Audit fieldwork was conducted between June 2000 and October 2000. Issues Papers were prepared in November 2000 followed by a Discussion Paper in December 2000 and a revised Discussion Paper in February 2001. A draft report was provided to APRA, Treasury and the Reserve Bank for comment in March 2001. The audit was conducted in accordance with ANAO Auditing Standards at an estimated cost to the ANAO of $337 000.

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19 ANAO's assessment had regard to the Core Principles published in 1997 as well as an October 1999 Basle Committee publication titled the *Core Principles Methodology* that included criteria by which compliance with the Core Principles can be assessed. Relevant Core Principles and criteria are highlighted throughout the report.

# 2. Financial Governance

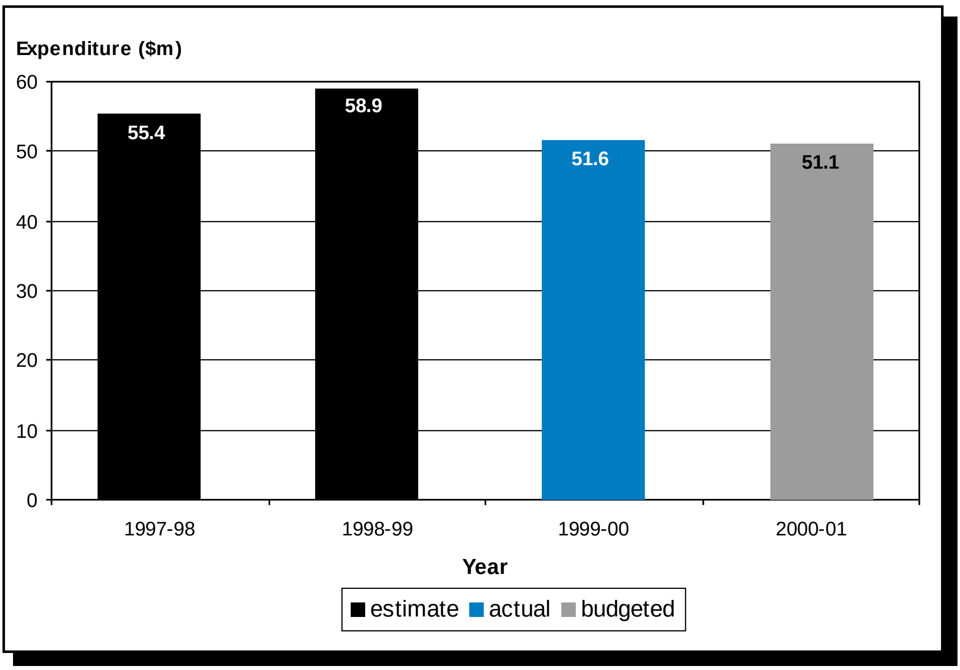
*APRA's financial governance is examined in this chapter with a focus on the administration by APRA of the ADI levy against the requirements of relevant legislation and Government policy.*

## Introduction

**2.1** The Government expected that establishing APRA as Australia's single prudential supervisor would be a more cost-effective approach than the previous system where there were eleven Commonwealth and state authorities.[20] APRA has reported that integration of facilities, more flexible work practices and investment in more efficient infrastructure have enabled it to reduce the agency's total operating expenditure related to prudential supervision in its initial four years of operation (see Figure 2.1).

### Figure 2.1

**APRA total prudential supervision operating expenditure: 1997–98 to 2000–01**




Source: APRA Annual Report 2000, page 45.

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[20] APRA, *Annual Report 2000*, page 45, adjusted for the exclusion of the Australian Government Actuary.

**2.2** Two of APRA's four divisions, comprising around 60 per cent of APRA's staff, are devoted to prudential supervision activities.[21] In addition to the two supervision divisions, another division is responsible for supervisory policies, research activities, providing specialist advice to frontline supervisors and undertaking on-site visits. The remaining division provides support and administrative functions. APRA estimates that, in 1999–2000, 49 per cent of its operating expenditure of $51.6 million was spent on supervision of ADIs, superannuation funds and insurance entities with 14 per cent of expenditure being on the development of prudential policies and standards and 9 per cent on liaison with industry. The remaining 28 per cent was incurred on administrative support and corporate governance.[22]

## Financial sector levies

**Principle 1:** Each agency involved in the supervision of banks should possess operational independence and adequate resources.

**Principle 1, Essential Criterion 3:** Each supervisory agency should be financed in a manner that does not undermine its autonomy or independence and permits it to conduct effective supervision and oversight.

***Basle Core Principles for Effective Banking Supervision***

**2.3** Prior to the establishment of APRA, there were significant differences in the nature and level of funding of the different prudential regulators. The costs of banking supervision, previously undertaken by the Reserve Bank, were recovered indirectly through the Reserve Bank's non-callable deposit (NCD) arrangements. The NCD arrangements required banks to hold 1 per cent of their total liabilities (excluding capital) in Australia in an account with the Reserve Bank with the Bank paying a below market rate of interest on these holdings. The replacement of the NCD arrangements with the ADI supervisory levy led to a significant reduction in the supervisory income received by the Commonwealth. The Reserve Bank estimated that its earnings would be around $250 million lower in 1999–2000 and thereafter as a result of the abolition of the NCD arrangements.[23] In this context, the levy charged to banks for 1999–2000 was $22.9 million,[24] an overall reduction of 91 per cent.[25] The levy charged to banks for 2000–01 was $18.1 million.

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21 APRA, *Annual Report 2000*, page 13.

22 APRA, *Annual Report 2000*, page 45.

23 Reserve Bank, *1999 Report and Financial Statements*, page 63.

24 The total levy invoiced to ADIs was $27.1 million including $4.2 million to building societies and credit unions.

25 According to Treasury analysis, the largest amount foregone by any bank through the NCD arrangements in 1998–99 was $44 million, which compares to a maximum levy of $1 million.

**2.4** The Financial System Inquiry recommended[26] that regulatory agencies levy sectors of industry to meet the general costs of their regulation and that they collect enough revenue to fund themselves, but not more. An important part of the Government's response to the recommendations of the Financial System Inquiry was the endorsement of this approach with APRA to be funded on a full cost recovery basis[27] by appropriations based on fees[28] and levies from the institutions it regulates.

**2.5** In its first year of operation, APRA was funded by an appropriation. In June 1999, legislation was enacted to provide for a levy to be imposed on those industries prudentially regulated by APRA. To provide the flexibility necessary to determine the levy on each industry according to the cost of regulating that industry,[29] separate levy imposition acts[30] are in place for each industry supervised by APRA. The financial sector levies enable the recovery of the operational costs of APRA and consumer protection functions carried out by the Australian Securities and Investments Commission (ASIC) and the Australian Taxation Office (ATO). In the initial years, the levies are also intended to recover the establishment costs associated with APRA and ASIC.

**2.6** The Basle Committee advocates that banking supervisors should be financed in a manner that does not undermine their autonomy or independence and permits them to conduct effective supervision.[31] The ADI supervisory levy provides a suitable framework to achieve this outcome as it enables APRA to identify the extent of supervision required, the expected costs of its supervision and then to recover these costs from the supervised industries.

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26 Recommendation No.104.

27 Australian Prudential Regulation Authority Bill 1998, Explanatory Memorandum, paragraph 4.39.

28 Funds can be raised from any fees and charges related to the cost of providing services or processing specific applications (such as applications for a banking authority). Fees and charges must be reasonably related to the cost incurred by APRA to provide such services. No fees or charges have been set by APRA in relation to its bank supervision activities.

29 Explanatory Memorandum for the levy imposition acts and the *Financial Institutions Supervisory Levies Collection Act 1998* circulated by authority of the Treasurer, paragraph 1.7.

30 Namely: the *Authorised Deposit-Taking Institutions Supervisory Levy Imposition Act 1998*; the *Authorised Non-operating Holding Companies Supervisory Levy Imposition Act 1998*; the *Superannuation Supervisory Levy Imposition Act 1998*; the *Retirement Savings Account Providers Supervisory Levy Imposition Act 1998*; the *Life Insurance Supervisory Levy Imposition Act 1998*; and the *General Insurance Supervisory Levy Imposition Act 1998*.

31 Basle Committee on Banking Supervision, *Core Principles for Effective Banking Supervision*, Principle 1, Essential Criterion 3.

**2.7** The levy rates are determined by the Minister for Financial Services and Regulation, based on advice from the Treasury which, in turn, relies on advice from APRA. In making its recommendations on levy rates and minimum and maximum amounts, APRA aims to avoid undue volatility between years and to move toward a point where the base levy rate is similar across industry sectors. This latter aim reflects APRA's aspiration to supervise, as far as possible, on a risk-based rather than institution-based model and APRA's expectation that it will become more difficult to accurately identify separate industry supervisory costs.[32]

**2.8** Levies on the superannuation and insurance industries commenced in 1998–99. However, the ADI levy did not commence until 1999–2000 as supervisory responsibility for building societies, credit unions and friendly societies was not transferred to APRA until 1 July 1999. With the exception of authorised non-operating holding companies, legislation requires each of the financial sector levies to be calculated according to a levy percentage of the asset value of each ADI, subject to statutory maximum and minimum amounts. The levy percentages, maxima and minima for 1999–2000 and 2000–01 are outlined in Figure 2.2.

### Figure 2.2

**Financial Sector Levies: 1999–2000 and 2000–2001**

| | *% of assets* | | *Minimum* | | *Maximum* | |
|---|---|---|---|---|---|---|
| ***Industry sector*** | ***99–00*** | ***00–01*** | ***99–00*** | ***00–01*** | ***99–00*** | ***00–01*** |
| Superannuation Funds | 0.04% | 0.02% | $300 | n.c. | $41 000 | $46 000 |
| Retirement savings account providers | 0.04% | 0.02% | $5000 | n.c. | $18 500 | n.c. |
| Life insurers | 0.02% | n.c. | $500 | n.c. | $280 000 | n.c. |
| General insurers | 0.02% | n.c. | $5000 | n.c. | $75 000 | $100 000 |
| ADIs | 0.013% | 0.012% | $500 | n.c. | $1 million | n.c. |
| Foreign bank branches[A] | 0.013% | 0.006% | $500 | n.c. | $1 million | $500 000 |
| Non-operating holding companies | Flat rate charge of $10 000 | | | | | |

Notes:

n.c. = no change from previous year

A = In 2000–01, foreign bank branches receive a concessional levy, and concessional maximum levy, that is half that of other ADIs. This concession was not given in 1999–2000.

Source: Minister for Financial Services and Regulation, Press Release No. FSR/025, 17 June 1999 and Minister for Financial Services and Regulation, Press Release No. FSR/026, 9 June 2000.

32 APRA, *Annual Report 2000*, page 46.

## Financial administration of the ADI levy

**2.9** ANAO Audit Report No.32 1999–2000, *Management of Commonwealth Non-primary Industry Levies* promulgated a better practice financial management framework for industry levies. In this context, APRA has an appropriate system of identifying ADI levy payers and a clearly defined method of assessing liability.

**2.10** The *Financial Institutions Supervisory Levies Collection Act 1998*, which provides for the collection of all levies administered by APRA, states that, for existing ADIs, the ADI levy is due and payable on 1 July of each year (or the next business day). However, ANAO's examination of APRA's invoicing and collection processes revealed that APRA does not require payment from ADIs in accordance with the legislative requirements.[33] In this context, APRA has advised ANAO that:

> *The legislation does state that the levy is due and payable on 1 July. However, we can't invoice until we have the data from the 31 March Form D returns. The net asset information is forwarded to the Finance section in spreadsheet form. We calculate the levy and forward the draft invoices, with asset details, to the APRA relationship manager for each client, as a key part of our quality control processes. The invoices are then issued and the client given 30 days to pay from the date of the invoice. The process was later than desirable this year [2000–01], partly because the data currently comes from a number of different databases. Part of the role of the [new] Statistics system is to standardise and centralise the return of data so that the process will become more streamlined and automated.*

**2.11** Other aspects of the ANAO better practice framework relate to receipting practices, debt recovery systems and records management.[34] In 1999–2000, APRA collected $27.107 million in levies from ADIs compared to $27.102 million in levies invoiced. Levies were generally paid in full on time with the small difference between the total amount collected and levied relating to penalties on some of the small number of late payments and some underpayments that APRA waived payment of because they were immaterial. In 2000–01, as of end-March 2001, APRA collected $22.6 million in levies from ADIs compared to $22.5 million in levies invoiced.

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33 Banks were not required to pay the levy for 1999–2000 until 28 July 1999 with credit unions and building societies not required to pay until between late November and mid-December 1999. ADIs were not invoiced for the 2000–01 levy until August 2000 with APRA allowing each institution 30 days to pay.

34 Other aspects of the better practice financial management framework, such as identification of costs and cost recovery, are addressed later in this paper.

**2.12** Where the ADI levy is not paid by an institution on 1 July, the Financial Institutions Supervisory Levies Collection Act states[35] that the institution is liable to pay, by way of penalty, an amount worked out at the rate of 20 per cent per year on the amount unpaid. APRA advised ANAO that it calculates late payment penalty from the date the payment was due as specified in the APRA invoice. In addition to the 30 day payment term specified in the invoice, APRA allows a further few days grace for processing of payments into its systems, which means that in practice each institution has approximately 35 calendar days to pay before any late payment penalty is applied.

**2.13** **Finding:** APRA is funded by appropriations based on levies from the institutions it regulates. The funding arrangements enable APRA to finance itself in a manner that does not undermine its autonomy or independence and permits it to conduct effective supervision. In both 1999–2000 and 2000–01 APRA did not invoice and collect the ADI levy within the timeframe set by the Financial Institutions Supervisory Levies Collection Act. APRA has advised ANAO that it intends to bring forward invoicing in 2001–02 to meet the legislative requirements.

## Cost recovery

**2.14** To provide the flexibility necessary to determine the levy on each industry according to the cost of regulating that industry, separate levy imposition acts are in place for each industry supervised by APRA. Subsequent to the passage of the levy legislation, the Government reiterated its intention that the levies collected from each industry cover the costs of supervising that industry and that there be no cross-subsidies between industries.[36]

**2.15** The classification of a levy as a tax or a fee for service has significant implications for its administration. For a levy to qualify as a tax it must be a compulsory extraction by a public authority for a specified purpose, and is not a payment for services rendered. For a levy to qualify as a fee for service as opposed to a tax, a number of criteria need to be met including: a specific service must be provided; the service is rendered to, or at the request of, the party paying the account; and the charge is proportionate to the cost of the service rendered.

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35 Section 10.

36 Minister for Financial Services and Regulation, *Financial Sector Levies Announced*, Press Release No. FSR/025, 17 June 1999. The Minister's press release also stated that, with more financial institutions becoming broad financial service providers rather than specialists, there is a question whether the sectoral approach underlying the current levy arrangements will continue to be appropriate.

**2.16** The Office of the Australian Government Solicitor (AGS) advised ANAO that there are generally no constitutional limits on the amount of a tax and, in this context, there is no requirement for the levy for each industry to be set having regard to the costs of supervising that industry. Accordingly, there are no legal implications from any cross-subsidisation in the amounts raised by levies on the various industries regulated by APRA. However, as indicated, cross-subsidisation would be contrary to Government policy that the levies collected from each industry cover the costs of supervising that industry.[37]

**2.17** Under current arrangements, the levy on each of the regulated industries is set annually, with the levy rates, minima and maxima intended to raise sufficient revenue to meet the budgeted cost of supervising that sector for the financial year. Adjustments are made for any significant over- or under-collections from earlier years and to reflect APRA's target of holding between 5 per cent and 10 per cent of its annual levy revenue as a reserve to meet unforeseen demands and reduce volatility.[38]

## Cost estimation process

**2.18** APRA has a basic process for determining the allocation of costs[39] to regulated industries through quarterly time estimates made by APRA management of the time likely to be spent supervising each industry. Direct supervisory costs are allocated according to these estimates with unallocated costs apportioned pro-rata. These estimates of industry cost ratios are averaged over a three year period to avoid sharp swings in levy rates. The moving average determined by timesheet estimates provides a continual adjustment to the estimated time, and hence cost, spent on each industry. APRA advised ANAO that its processes are aimed at simplicity, transparency, stability and low-cost in administration. Treasury advised ANAO that it supports APRA's estimation methodology as it is considered to be relatively simple and low-cost; provides stability in levy parameters; is supported by industry; and is consistent with Government policy that there be no cross-subsidisation.

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37 The Productivity Commission has commenced a review of cost recovery arrangements by Commonwealth regulatory, administrative and information agencies. The Commission is to report by 17 August 2001.

38 The levy parameters set for 2000–01 envisage that APRA's reserves will grow from $5.1 million in 1999–2000 to $9.0 million by 2000–03.

39 The Management Advisory Board Report *Beyond Bean Counting—Effective Financial Management in the APS—1998 and Beyond* outlines the development of costing systems as a three stage process. In the first or primary stage, cost information is generally only used in one-off situations, mainly in response to external accountability requirements. In the second phase, cost information is regularly obtained and monitored in order to support decision making. In the third and final stage, the demand for cost information is driven by the requirements of management, as the use of cost information is fully integrated into the organisation's reporting and decision making process.

**2.19** The primary driver of APRA's costs is staff costs, and therefore the prime indicator of cost is staff time spent on a variety of activities. To estimate supervisory costs for each industry, APRA general managers prepare periodic time estimates on the activity of their staff by industry.[40] APRA considers the accuracy of this methodology to be commensurate with the nature of the estimation used in the determination of its levies. Furthermore, APRA advised ANAO that it has made continual improvements to the timesheets since their introduction during 1999–2000. However, APRA's use of staff numbers does not have regard to differences in the actual costs to APRA. In this respect, ANAO noted that the time estimates for Diversified Institutions Division for 2000–01 (which supervises most banks):

- allocated supervisory time to each institution in each industry, which does not recognise any relative differences between the staffing costs for the different industries; and
- were based on an estimate for only one of the four branches. There was no information to indicate that this Branch was representative of the activities of the entire Division.

**2.20** Furthermore, staff time spent performing various activities and the time taken to perform different supervisory tasks has never been measured by APRA. Accordingly, although APRA considers its cost estimation process to be appropriate, it was not possible for APRA to demonstrate the accuracy of its approach. In this context, ANAO considers that there is merit in APRA periodically assuring itself as to the accuracy of its cost estimation approaches. This would also assist APRA to meet industry calls for greater transparency and accountability in determining the costs of supervision for each industry.[41]

40 Estimates are averaged over a three year period. The average is determined from the previous year's figures, the estimate for the current year and an assessment for the year ahead. This process is intended to take into account the approximate nature of each year's calculation and the desirability of avoiding sharp swings in levy rates.

41 The April 2000 report of the Financial Sector Levy Review undertaken by Treasury and APRA noted that most industry groups consulted had raised the issue of the need for greater transparency and accountability in determining the costs of supervision. They considered the information available from the regulators (including APRA) was insufficient to accurately establish the costs of supervision and therefore whether the scenarios presented to industry accurately reflected costs. The review recommended that APRA and other regulators provide more detailed specific activity cost information to assist with setting levies more reflective of the costs of supervision. However, APRA has advised ANAO that, within the role anticipated for levies, it considers its reporting of costs within both industry consultation and its financial statements information regarding its costs and the performance of levies collected according to plan to be appropriate.

## Prior year adjustments

**2.21** APRA's budgeted supervision costs are adjusted for any significant over- or under-collections from earlier years. ANAO considers that the calculation of an over- or under-collection of a levy intended to recover the costs of supervision should have regard both to: any differences between budgeted levy receipts and actual receipts; and any differences between budgeted supervisory costs and actual supervisory costs. However, APRA's approach to calculating over- and under-collections does not examine the extent of any differences between its budgeted costs of supervising each industry and the actual costs of supervising each industry. APRA's focus is on any differences between budgeted receipts and actual receipts.

**2.22** The levy parameters for the following year are set in advance of the financial year to which they relate so that full data on actual annual costs of supervision for each sector is not available. The levy parameters for 2000–01 were set in June 2000 meaning that actual cost data for most of 1999–2000 was available to inform an assessment of any significant differences between actual supervisory costs and budgeted supervisory costs (with appropriate extrapolation to the end of the financial year).

**2.23** ANAO's analysis indicates there is some imprecision in APRA's calculation of adjustments for over- or under-collections from earlier years (see Figure 2.4). In setting the ADI levy for 1999–2000, APRA budgeted to receive $25.456 million in levies from industry, $0.379 million more than the budgeted costs of supervising ADIs. In actual fact, ADI levy income for 1999–2000 was $27.107 million ($1.651 million more than budgeted). The additional levy income partially offset a $3.649 million increase in supervisory costs compared to budget but there remained a shortfall of $1.998 million. Although ANAO estimates that APRA did not recover the costs of its supervision of ADIs in 1999–2000, the 2000–01 ADI levy parameters were prepared on the basis that APRA had over-recovered by $1.7 million. This indicates that other industries may be subsidising the cost of supervising ADIs as insufficient levy revenue was budgeted to be collected in 2000–01 to cover the apparent shortfall in 1999–2000 and budgeted costs for 2000–01.

## Figure 2.4
**Cost of ADI Supervision and Levies Received: 1999–2000 ($m)**

| | Budgeted $m | Actual $m | Difference $m |
|---|---|---|---|
| **Levy Income** | **25.456** | **27.107** | **1.651** |
| Costs of Supervising ADIs: | | | |
| APRA Operating Expenses [A] | 19.313 | 22.962 | (3.649) |
| APRA Establishment Costs [B] | 3.203 | 3.203 | Nil |
| ASIC [C] | 2.560 | 2.560 | Nil |
| **Costs of Supervising ADIs** | **25.077** | **28.725** | **(3.649)** |
| **Over/(Under) Recovery of Costs** | **0.379** | **(1.618)** | **(1.998)** |

Note:

[A] ANAO estimated the actual costs of supervising ADIs in 1999–2000 by applying APRA's 2000–2001 budget estimate that 43 per cent of supervisory time is spent supervising ADIs to APRA's operating expenses and abnormal items of $53.399 million (after excluding the repayment of the establishment loans of $5.440 million for 1999–2000). These figures were sourced from APRA's audited financial statements for 1999–2000.

[B] These figures differ from the amounts specified in a Memorandum of Understanding between Treasury and the Department of Finance and Administration that required APRA to recover $1.6 million in establishment costs through the ADI levy in 1999–2000. In aggregate, APRA has budgeted to recover $7.882 million in establishment costs from ADIs which is 63 per cent greater than the $4.844 million specified in the Memorandum of Understanding for establishment costs of ADIs and friendly societies. APRA has advised ANAO that it considers the allocation of some $7.9 million in establishment costs to ADIs (39 per cent of the total) to be a fair allocation.

[C] In addition to APRA's supervisory costs, the ADI levy enables the recovery of the costs of the consumer protection functions carried out by ASIC. Analysis of the calculation of ASIC's costs was outside the scope of this ANAO performance audit. Costs are assumed to be equal to the amount determined by the Minister.

Source: Treasury and APRA data.

**2.24** Treasury advised ANAO that:

*Financial sector levies are set well in advance of the financial year to which they relate. The levies are not revised at any time through the year, even though other key variables may change. For example, the forecasting assumptions of expected supervision intensity for each sector, asset growth or the number of firms that will be levied are more than likely to change over the course of the financial year. Any changes to the assumptions will have implications not only for APRA's costs, but also for the amount of revenue generated through levies. APRA allocates its costs to each sector by timesheets, but they also need to pro rata costs from APRA's policy development and corporate services divisions across sectors in the best way possible. Financial sector levies are set with the aim of achieving minimum volatility in levy parameters from one year to the next.*

*Given the difficulties in estimating these variables in advance, Treasury considers it is not unreasonable to expect that there will be a difference* *between the estimated cost of supervision and the actual cost of supervision. This is recognised in the levy process. Positive or negative carry forwards for individual sectors are also applied to ensure sectors pay their fair share. Consistent with Government policy, there is no intention of cross subsidisation in levy payments across sectors, and in spite of the difficulties identified above, we consider there is little, if any, evidence of cross subsidisation in practice.*

**2.25** **Finding:** APRA has a basic process for determining the allocation of costs to regulated industries through quarterly time estimates made by APRA management of the time likely to be spent supervising each industry. Direct supervisory costs are allocated according to these estimates with unallocated costs apportioned pro-rata. APRA advised ANAO that its processes are aimed at simplicity, transparency, stability and low-cost in administration. However, APRA's use of staff numbers does not have regard to differences in the actual costs to APRA. APRA was unable to demonstrate that its approach is reliable and comprehensive.

**2.26** Under current arrangements, the levy on each of the regulated industries is set annually, with the levy rates, minima and maxima intended to raise sufficient revenue to meet the budgeted cost of supervising that sector for the financial year. Adjustments are made for any significant over- or under-collections from earlier years. In this context, ANAO's analysis indicates there is some imprecision in APRA's calculation of adjustments for over- or under-collections from earlier years. Although ANAO estimates that there was a shortfall of some $2 million in levy revenue against costs for 1999–2000, the 2000–01 ADI levy parameters were prepared on the basis that APRA had over-recovered by $1.7 million. This indicates that other industries may be subsidising the cost of supervising ADIs, as insufficient levy revenue was budgeted to be collected in 2000–01 to cover the apparent shortfall in 1999–2000 and budgeted costs for 2000–01.

## Recommendation No.1

**2.27** ANAO recommends that APRA improves its administration of the ADI supervisory levy by:

(a) periodically reviewing the basis of its cost estimation approaches;

(b) improving transparency and accountability by publicly reporting on the actual costs of supervision for each industry; and

(c) undertaking comprehensive analysis of levy receipts and supervisory costs against budget in order that the extent of any over- or under-collections can be taken into account when setting levy parameters for subsequent years.

### *APRA response*

**2.28** APRA **agreed** with part (a) and **agreed with qualification** to parts (b) and (c), as follows:

- In relation to part (b), APRA commented that it will continue to measure supervisory activity by industry and inform industry of those measurements as part of the levy setting process. It should be noted that as APRA continues to develop its risk-based approach to supervision on a group or conglomerate basis, rather than an institutional approach, its ability to measure activity by industry is becoming increasingly difficult.
- In relation to part (c), APRA commented that it will continue to provide comprehensive analysis of levy receipts against the plan defined by the levy model that is agreed by the Minister. APRA will also consider any significant change in supervisory activity during the modelling of the subsequent year's levies as part of the recommendation to the Minister prior to the setting of the levies determination and will, over time, take over- and under-collections into account in its levy recommendations.

# 3. Supervisory Framework

*This chapter discusses the overarching supervisory activities undertaken by APRA in its supervision of banks. It examines the procedures adopted, resources applied and the reliance placed on advice and certifications from banks and third parties.*

## Introduction

**3.1** APRA's enabling legislation requires it to balance financial safety with efficiency, competition, contestability and competitive neutrality. Accordingly, it is a matter for APRA to identify an appropriate supervisory approach and advise Government on the resources that are necessary to meet its objectives. APRA budgeted to spend $10.403 million on prudential supervision of banks in 1999–2000 and again in 2000–01.

**3.2** The Government's response to the Financial System Inquiry stated that APRA should conduct regulation so as to ensure that the risk of loss of depositors funds is remote, that regulation is consistent with international standards and that the regulator should seek to reinforce prudential standards by encouraging greater public disclosure of the risks and ratings of financial institutions. APRA is also expected to take a flexible and facilitative approach to the licensing of new entrants without undermining the safety of the financial system.

**3.3** APRA has powers under the Banking Act for licensing and registration of institutions authorised to provide banking services as well as ongoing prudential supervision of their activities. Its functions include:

- the collection and analysis of information in respect of prudential matters[42] relating to ADIs and authorised non-operating holding companies of ADIs;
- the encouragement and promotion of the carrying out by ADIs and authorised non-operating holding companies of sound practices in relation to prudential matters; and
- the evaluation of the effectiveness and carrying out of those practices.[43]

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42 Prudential matters are defined in the Banking Act as matters relating to the conduct by a body corporate of its affairs: in such a way as to keep itself in a sound financial position and not to cause or promote instability in the Australian financial system; and with integrity, prudence and professional skill.

43 Banking Act, section 11B.

**3.4** APRA is organised into four divisions, two of which (Diversified Institutions and Specialised Institutions) are responsible for the day-to-day supervision of financial entitites.[44] Specialised Institutions Division supervises institutions whose activity is mainly in one of the three traditional categories of deposit-taking, insurance or superannuation and where those activities are predominantly within Australia. Diversified Institutions Division is responsible for the supervision of functionally diversified groups that operate in more than one APRA regulated sector (for example, deposit-taking, insurance, superannuation) and those with international links.

**3.5** APRA advised ANAO in December 2000 that, at that date, there were 50 people employed in Diversified Institutions Division. On the basis that 40 per cent of the Division's time is allocated to the supervision of banks, APRA advised that there is the equivalent of 20 person years allocated to supervising banks. APRA also noted that the frontline supervision staff in Diversified Institutions Division are complemented by Consulting Services staff, with the equivalent of 10 person years allocated to banks.[45] In addition, four regional banks are supervised within APRA's Specialised Institutions Division. Each of these institutions is assigned to one analyst (who also has responsibility for other institutions) and report to a supervising manager. Accordingly, in aggregate, APRA allocates the equivalent of 30 to 34 full-time staff equivalents to the supervision of banks. In this context, APRA has advised ANAO that it accepts there has been some under-resourcing but that this is only because the audit covered a time of substantial organisation restructure in which a number of other work priorities competed for supervisory resources.

**3.6** **Finding:** APRA's enabling legislation requires it to balance financial safety with efficiency, competition, contestability and competitive neutrality. Accordingly, it is a matter for APRA to identify an appropriate supervisory approach and advise Government on the resources that are necessary to meet its objectives. APRA budgeted to spend \$10.403 million on prudential supervision of banks in 1999–2000 and again in 2000–01. Only a small number of APRA officers are dedicated to the day-to-day supervision of banks with, in aggregate, 30 to 34 full-time staff equivalents

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44 In addition, Consulting Services, a section of the Policy, Research and Consulting Division, conducts specific risk visits in the areas of credit, market and operational risk. Frontline supervisory staff participate in these visits. Frontline supervision staff also separately conduct on-site consultation visits and lead specific risk visits to banks. The remaining sections of this Division focus on policy development and risk research and analysis, while APRA's fourth division provides corporate support functions.

45 APRA advised that there are around 20 staff in Consulting Services who spend 50 per cent of their time supervising banks.

allocated to the supervision of banks. APRA has advised ANAO that it accepts there has been some under-resourcing but that this is only because the audit covered a time of substantial organisation restructure in which a number of other work priorities competed for supervisory resources.

## Bank licensing

**Principle 1(3):** A suitable legal framework for banking supervision is necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision.

**Principle 2:** The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word 'bank' in names should be controlled as far as possible.

**Principle 3:** The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organisation's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base. Where the proposed owner or parent organisation is a foreign bank, the prior consent of the home country supervisor should be obtained.

***Basle Core Principles for Effective Banking Supervision***

**3.7** Body corporates that wish to carry on banking business in Australia are required to apply in writing to APRA for an authority (the banking 'licence') under section 9 of the Banking Act.[46] APRA is empowered to grant banking licences; impose enforceable conditions on licences; and, in certain situations, revoke licences. Neither APRA or the Reserve Bank have ever revoked a licence for prudential reasons.

**3.8** APRA's *Guidelines on the Authorisation of ADIs* establish the minimum criteria to be addressed by applicants and necessary information and documents to be submitted with an application. The minimum criteria relate to: capital requirements; ownership limits and a 'fit and proper' test for substantial shareholders; requirements for directors and senior management; adequate and appropriate risk management and internal control systems; adequate information and accounting systems; external and internal audit arrangements; and, for foreign bank branches, adequate prudential supervision by the home country supervisor.[47]

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46 The Banking Act also restricts the use of words and expressions such as 'bank' and 'authorised deposit-taking institution' in an attempt to assure the public that financial businesses that describe themselves as banks, building societies or credit unions are authorised by APRA to conduct this type of business.

47 In addition, foreign bank branches are prohibited from accepting initial deposits (and other funds) from individuals and non-corporate institutions of less than $250 000 and are required to disclose to customers that they are not subject to the depositor protection provisions of the Banking Act.

**3.9** At present, APRA does not hold copies of all banking licences. In many instances, copies of licences have been retained in the records of the Reserve Bank and not provided to APRA. The Reserve Bank advised ANAO in May 2000 that:

> *Under Australia's new financial regulatory arrangements, the Bank has no role in prudential supervision. It has no responsibility for protecting the interests of depositors; it has no power to direct the affairs of a financial institution; and it does not receive confidential prudential data on individual institutions from APRA on an ongoing basis. Our responsibility for overall financial system stability involves a broader range of issues which would be outside the scope of your performance audit.*

**3.10** APRA advised ANAO that the retention of authorities by the Reserve Bank is a reflection of the dates when the authorities were granted to institutions as all but two of the institutions licensed at the time of ANAO's audit were licensed prior to APRA's establishment. In response to ANAO's concerns, APRA advised ANAO that it would obtain copies of all authorities from the Reserve Bank granted before the commencement of APRA.

## Licence conditions

**3.11** APRA may, at any time, impose conditions on a banking licence. APRA may also vary or revoke existing conditions. Conditions on banking authorities must relate to prudential matters. The Banking Act defines prudential matters as matters relating to the conduct by the body corporate of any of its affairs: in such a way as to keep itself in a sound financial position and not to cause or promote instability in the Australian financial system; and with integrity, prudence and professional skill.

**3.12** ANAO examined 50 banking licences issued to 15 Australian-owned banks, 10 subsidiaries of foreign banks and 25 branches of foreign banks. These licences had been issued between 1945 and 2000. All licences for the foreign bank subsidiaries and foreign bank branches included two conditions, namely: that the bank consult with the Reserve Bank in relation to the making or variation of arrangements for the prudential supervision of their banking business; and that conformance with prudential supervision arrangements be notified to the bank by the Reserve Bank.[48] While ten of the licences issued to Australian-owned

[48] The licences issued to foreign bank branches also included a condition prohibiting them from accepting deposits of amounts less than $250 000. This is consistent with the provisions of the Banking Act that provide that the depositor protection provisions do not apply to foreign bank branches.

banks also included these or similar conditions, five included no such conditions.[49]

**3.13** APRA advised ANAO that its policy is that conditions will only be included on bank licences in exceptional circumstances. Accordingly, since its establishment, APRA has included no new conditions on licences previously issued by the Reserve Bank and no conditions on the licences of those banks authorised after APRA's establishment. However, APRA has not examined licences issued by the Reserve Bank in the light of legislative changes and its policy on licence conditions.

**3.14** **Finding:** The Banking Act and APRA's authorisation guidelines establish an appropriate regulatory framework for the licensing of banking operations in Australia. APRA may, at any time, impose conditions on a banking licence but it has a policy that conditions will only be included on bank licences in exceptional circumstances. Implementation of this policy will require APRA to re-examine licences issued by the Reserve Bank as a number of these licences were issued with conditions attached to them.

## Prudential standards

> **Principle 9:** Laws are in place for banking, and for each of the agencies involved in banking supervision. The laws and/or supporting regulations provide a framework of minimum prudential standards that banks must meet.
>
> ***Basle Core Principles for Effective Banking Supervision***

**3.15** Under section 11AF of the Banking Act, APRA may, in writing, determine standards in relation to prudential matters (Prudential Standards) to be complied with by ADIs and non-operating holding companies. The standards-making power was expected to provide APRA with regulatory independence and assist APRA to act quickly in the event of a crisis.[50]

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49 APRA advised ANAO that the authorities granted to the four of these banks were issued before relevant amendments concerning prudential supervision were made to the Banking Act in the late 1980s. As such, APRA advised that the absence of conditions on these authorities is a reflection of history. In relation to the remaining bank, APRA advised ANAO that including such a condition on the authority would be inconsistent with the Second Reading Speech for the *Financial Sector Reform (Amendments & Transitional Provisions) Act 1998* which specifically said that prudential standards would not be directly enforceable.

50 *Financial Sector Reform (Amendments and Transitional Provisions) Act 1998*, Second Reading Speech, House of Representatives, 26 March 1998.

**3.16** At its inaugural meeting in July 1998, the APRA Board decided against the immediate promulgation of formal prudential standards under the Banking Act. Instead, the Prudential Statements previously issued by the Reserve Bank were to be applied by APRA to ADIs by way of '*policy advice*'. The Reserve Bank's Prudential Statements were formulated by the Bank after consultation with banks operating in Australia and took into account supervisory policies existing overseas, including those produced by the Basle Committee on Banking Supervision. The Prudential Statements issued by the Reserve Bank had not been the subject of regulation pursuant to the Banking Act and, as a result, were not legally binding on banks.

**3.17** In September 2000, APRA finalised a set of harmonised Prudential Standards covering all ADIs. These Standards cover capital adequacy, liquidity, credit quality, large exposures, equity associations and external audit arrangements. With effect from 1 October 2000, they replaced the Prudential Statements with APRA deeming all ADIs to be fully compliant with the Prudential Standards. Each of the Prudential Standards is broadly consistent with the former Prudential Statements. Where changes have been made, APRA has stated that it will agree on transition periods, which may be as long as five years, in order to facilitate compliance with the new regime.[51]

**3.18** The Prudential Standards establish the minimum standards which banks are required to observe. However, they are not directly enforceable,[52] which APRA advised ANAO reflects the intentions of Parliament. Instead, where an entity has contravened a Prudential Standard, APRA has the power to give a direction requiring compliance. Failure to comply with such a direction is an offence and gives APRA the power to revoke the entity's banking licence.

**3.19** **Finding:** The Basle *Core Principles for Effective Banking Supervision* include that there be a suitable legal framework for banking supervision. Consistent with this guidance, section 11AF of the Banking Act provides that APRA may, in writing, determine prudential standards. Until October 2000, there were no minimum prudential standards that banks were required to meet. The Prudential Standards issued by APRA with effect from October 2000 establish the minimum standards which banks are required to observe. However, they are not directly enforceable, which APRA advised ANAO reflects the intentions of Parliament. Instead, where an entity has contravened a Prudential Standard, APRA has the power to give a direction requiring compliance.

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51 APRA Media Release, *APRA releases harmonised ADI standards*, 11 September 2000.

52 *Financial Sector Reform (Amendments and Transitional Provisions) Act 1998*, Second Reading Speech, House of Representatives, 26 March 1998.

## Risk-based supervision

**3.20** The Basle Committee on Banking Supervision has noted that effective banking supervision requires that the risk profile of individual banks be assessed and supervisory resources allocated accordingly.[53] Such an approach has, for example, been adopted in the United Kingdom with the risk presented by each bank identified, assessed and prioritised with supervisory actions then linked to areas of material concern.[54] This approach was adopted in order to provide a more structured framework in which to exercise supervisory judgements. APRA is moving in a similar direction. APRA's Diversified Institutions Division (which supervises most banks), revised its supervision methodology in July 2000 to address risks within the financial group as a whole as well as the individual regulated entities.

**3.21** The revised methodology is predicated on two broad assumptions, namely: Diversified Institutions Division supervises sophisticated institutions that will have access to further capital or solvency support, if required, either from the market or overseas parent; and APRA expects such institutions to have well developed and documented internal controls as well as regulatory compliance systems. APRA considers that this environment enables it to adopt a less intrusive *'consultative'* off-site supervision regime, where it can (at a high level) verify the effectiveness of control processes through targeted on-site visits, the various bank management attestation arrangements and external audit sign-offs. In this context, APRA advised ANAO that:

> *an inevitable consequence of the introduction of risk-based supervision methodologies, consistent with recommendations of the Financial System Inquiry, has been the adoption of a less regimented or process-driven approach to supervision (eg such as would result in a regular visit cycle to each authorised bank). APRA is also obliged by its establishing legislation to balance financial safety with efficiency, competition, contestability and competitive neutrality. Prudential supervision involves making a concurrent assessment of a number of individual issues and acting on those that raise material concerns, rather than trying to uncover every possible risk in a bank and then pursuing every issue uncovered.*

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53 Basle Committee on Banking Supervision, *Core Principles for Effective Banking Supervision*, September 1997, page 9.

54 Bank of England, *A Risk Based Approach to the Supervision of Non-EEA Banks (the SCALE framework)*, July 1997, page 9.

**3.22** The risk-based methodology incorporates three broad activities: risk assessment; execution of a supervisory plan; and ongoing evaluation. During the period of ANAO's audit fieldwork, initial ratings had been allocated to all bank-parented conglomerate groups and individual banks, and an initial round of supervisory action plans was being documented.

## Risk assessment

**3.23** APRA's risk ratings are based on a prudential review of each institution, usually conducted annually. The content and extent of prudential reviews varies according to the size and diversity of the group. One source of information for the prudential reviews are quarterly reviews undertaken to assess compliance with minimum prudential ratios, highlight potential prudential concerns and identify significant business trends. However, APRA has advised ANAO that, with current resource constraints and work priorities, full quarterly reviews have been curtailed for low-risk institutions as they represent the least critical supervisory task.[55]

**3.24** The prudential reviews prepared by APRA analysts for the seven banks in ANAO's sample focused on prudential and statistical data submitted to APRA as well as publicly available information. APRA advised ANAO that:

> *The submission of prudential data allows APRA to monitor key prudential trends and convey early warning signals about emerging risks in a bank's operations that will be investigated by analysts. Where APRA has concerns about certain aspects of a bank's operations, we would specifically request the bank to provide more frequent and/or additional data and/or seek a regular report on developments in associated risk management infrastructure. APRA undertakes ongoing assessments of banks' risk management and internal control processes through the submission of material supporting analyst reviews of new business proposals, specific transactions, or information obtained from on-site risk visits. Included in such material could be output from internal and external auditors. Developments in, and major concerns with, risk management and internal control processes (including the findings of internal and external auditors) are also assessed as part of the annual prudential review.*

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55 In July 2000, APRA completed a project to map its supervisory processes and procedures. This project concluded that key supervisory controls revolve around the reviews performed by APRA analysts (namely, notes prepared for the annual prudential consultation with each bank and quarterly reviews of each bank) and the management overview of the planning and output from these reviews.

**3.25** APRA analysts apply a risk rating from an agreed rating regime to each regulated entity and institutional group. The rating is to reflect factors such as capital adequacy, prevalence of high risk business activities, concentrating of funding risks, large exposures and product lines and management effectiveness, structure and stability. The output of the initial round of risk assessments (see Figure 3.1) indicates to ANAO that there is insufficient differentiation in the available risk ratings as the vast majority (86 per cent) of banks representing 95 per cent of total assets were rated as 'low' risk, a small number of banks were rated 'medium' risk and only one bank was rated 'high' risk. In these circumstances, the ratings provide an insufficient basis for prioritising supervisory activities for entities within the banking sector.

**Figure 3.1**

**APRA Risk Assessment: Banks supervised by Diversified Institution Division**

| *Rating* | *Criteria* | *Banks* |
|---|---|---|
| **Low Risk** | APRA has no prudential concerns such that there are no significant issues with any aspect of the entity's operations or any apparent trend or event that would, in the medium term, be expected to have a substantial adverse impact on the entity. | 42 (86%) |
| **Medium Risk** | An operation where APRA has identified an adverse trend or developing situation and needs to closely monitor developments. | 6 (12%) |
| **High Risk** | APRA has numerous and/or significant concerns with one or more aspects of its operations that it is seeking to have recognised and addressed by the entity. | 1 (2%) |
| **Extreme Risk** | APRA has serious prudential concerns with one or more aspects of its operations and doubts about its ability or willingness to address them in a timely manner. | none |
| **Managed Exit** | APRA considers the management/ shareholders do not have the ability/capacity to address its prudential concerns. | none |
| | **Total** | **49 (100%)** |

Source: APRA advice to ANAO.

## Risk treatment

**3.26** Supervisory action plans are intended to summarise supervisory priorities and tasks. APRA envisages its supervisory action plans will provide a flexible timetable that allows for developments in the financial group and provides for supervisory actions such as additional off-site reviews on specific subjects as well as on-site visits to institutions. APRA provided ANAO with copies of the plans for four of the seven banks whose supervision was examined in detail as part of the audit. APRA advised ANAO, in February 2001, that plans for the other three banks were still being developed and would be completed ahead of the 2001 annual prudential consultation.

**3.27** APRA has emphasised to ANAO the importance of regulators applying judgement when assessing the impact of deviations from prudential standards and other requirements. APRA commented that the assessment of risk and the outcome for depositors is of prime importance, not enforced perfunctory compliance with standards. Nevertheless, the Basle Committee's *Core Principles for Effective Banking Supervision* recognise that bank licensing and prudential standards are important, as they establish a framework of minimum prudential requirements to be met. The Basle Committee also recommends that supervisors be able to impose a range of sanctions on banks that do not comply with the supervisor's requirements, including the revocation of the banking licence.[56]

**3.28** Regulators often have available to them a range of risk treatment options that vary in severity. This assists regulatory effectiveness by enabling an appropriate initial response and, where this proves unsuccessful, escalation. APRA's supervisory action plans outline the proposed consultations, reviews and visits planned to be conducted to each institution.

**3.29** As recognised in APRA's rating regime, where significant risks are present there may be a need for APRA to use its enforcement powers. In this respect, the Financial System Inquiry noted that enforcement of prudential regulations is closely linked to licensing powers. However, in relation to bank supervision, APRA has indicated to ANAO that exercising certain of its licensing powers would be impractical, as follows:

- APRA considers **revoking a banking authority** is not an effective remedial action if depositors have not been repaid as depositors get their protection from the bank being subject to the Banking Act and supervision by APRA. APRA advised that, if the authority is revoked, then the powers available to protect depositors cannot be used.
- The Banking Act permits APRA to include **conditions on banking licences** but APRA has advised ANAO that conditions would only be necessary in exceptional circumstances. Even where APRA expects banks to adhere to more stringent requirements than the generic standards applicable to all banks, it does not make this a legally binding obligation on the bank concerned by including a condition on the banking licence. APRA has advised ANAO that, if it made compliance with more stringent requirements a condition of the licence and the bank breached this condition, the authority would have to be relinquished and depositors would again lose their protection under the Banking Act.[57]

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56 Basle Committee on Banking Supervision, *Core Principles for Effective Banking Supervision*, Principle 1(4), Essential Criterion 4.

57 See paragraphs 4.12 and 4.13 for examples related to capital adequacy ratios.

**3.30** The Banking Act provides APRA with other regulatory sanctions.[58] However, other than giving directions to a bank, these sanctions would generally only be appropriate in the event of a bank crisis. APRA advised ANAO that it has never found it necessary to use its formal enforcement powers as it has always been able to enforce appropriate prudential outcomes without resort to sanctions and that the Banking Act equips APRA with substantial powers of intervention, which are capable of being applied in a wide range of circumstances.

**3.31** ANAO notes that there is evidence that APRA's approach has not been universally successful. APRA's records state that one of the banks in ANAO's sample has breached various Prudential Standards and has a culture that appears to treat ongoing compliance with the Prudential Standards as a burdensome imposition that may be dispensed with if it interferes with the bank's primary function of developing business. APRA records also indicate a reluctance on the part of this bank to advise APRA of significant changes in the bank's activities and that information that is supplied is often selective. At the time of the ANAO audit, APRA was continuing discussions with the bank about these issues and advised ANAO that:

> *Application of the prudential standards is most effective when tailored to each bank's circumstances and risk profile. Any enforcement action needs to consider the potential impact on depositors and the most effective way to remedy the breach. In the case referred to, APRA assessed the breaches individually and together to determine the impact of them on depositors and other relevant stakeholders, and found that these parties were not at risk from the non-compliance. It found no need to issue a formal direction to enforce compliance or for the bank to take other prudential actions provided for in APRA's direction powers. Rather, APRA closely monitored the bank's action to rectify its breaches. At the time of the ANAO audit, APRA was seeking specific reports on specific issues and closely monitoring developments.*

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58 These involve:

- giving directions—which APRA can do if a prudential standard is contravened, or for some other reasons;
- appointing an investigator—if APRA believed the bank was unable to meet its obligations and APRA needed experts to quickly help it decide whether the bank was solvent or not;
- appointing an administrator—if APRA believed the bank was unable to meet its obligations and the bank's management was unwilling or unable to work with APRA to try and restore the situation; or
- applying for wind-up of the bank—if APRA believed it was insolvent and solvency could not be restored in a reasonable period.

**3.32** **Finding:** In July 2000 APRA adopted a risk-based supervisory methodology for sophisticated financial institutions (including most banks). The risk-based methodology incorporates three broad activities: risk assessment; execution of a supervisory plan; and ongoing evaluation. During the period of ANAO's audit fieldwork, initial ratings had been allocated to all bank-parented conglomerate groups and individual banks, and an initial round of supervisory action plans was being documented. The vast majority (86 per cent) of banks representing 95 per cent of total bank assets were rated in the bottom of the risk exposures by APRA in the category of 'low' risk. In these circumstances, the ratings provide insufficient basis for prioritising supervisory activities for entities within the banking sector.

**3.33** Based on its risk ratings, APRA develops supervisory action plans for each financial group as well as the individual regulated entities. These plans generally provide for supervisory actions such as additional off-site reviews on specific subjects as well as on-site visits to institutions. APRA has advised ANAO that it is impractical for it to revoke banking licences or impose conditions on banking licences as provided for by the Banking Act. APRA advised ANAO that it always been able to enforce appropriate prudential outcomes without resort to its formal regulatory powers, although ANAO noted that there is evidence that APRA's approach has not been universally successful.

## Recommendation No.2

**3.34** ANAO recommends that APRA reviews its risk rating process to ensure risk ratings provide sufficient basis for prioritising supervisory actions.

### *APRA response*

**3.35** APRA **agrees** with the recommendation. APRA commented that its risk assessment process, particularly the setting of internal ratings, is relatively new and is subject to ongoing refinement and review.

## Audit and related arrangements

**3.36** Prudential Standard APS 310 *Audit & Related Arrangements for Prudential Reporting*, and the predecessor Prudential Statement H1 *Relationship Between Banks, Their External Auditors and APRA*, outlined the role played by banks' internal and external auditors in the supervisory process. These arrangements are designed to assure APRA of the accuracy and integrity of the prudential information provided to it by banks. Prudential Standard APS 310 also includes requirements relating to the responsibilities of bank management and boards of directors in relation to banks' risk management systems.

## Bank management and boards

**Principle 17:** Banking supervisors must have regular contact with bank management and a thorough understanding of the institution's operations.

**Principle 17, Essential Criterion 1:** Based on the risk profile of individual banks, the supervisor has a programme of regular meetings with senior and middle management to discuss operational matters such as strategy, group structure, corporate governance, performance, capital adequacy, liquidity, asset quality, risk management systems, etcetera.

***Basle Core Principles for Effective Banking Supervision***

**3.37** APRA's supervisory approach is predicated on the board and management of each bank being primarily responsible for the prudent management of the bank's business. This emphasis on the responsibility of bank boards and management is reflected in the following requirements:

- Annual consultations between APRA and the senior management and staff of each bank. Annual prudential consultations between APRA and the senior management and staff of each bank were an initiative of the Reserve Bank. These consultations were intended to cover past and present performance as well as the strategy and future plans of the bank. They also provide APRA with an opportunity to raise issues of concern with a particular bank. During 1999–2000, APRA held prudential consultations with 41 of the 50 entities (82 per cent) licensed to conduct banking business in Australia. Prudential consultations were not held with nine banks.[59]
- An annual declaration from the chief executive officer of each bank that: key risks facing the bank have been identified; systems have been established to manage those risks including, where appropriate, by setting and requiring adherence to a series of prudent limits and by adequate and timely reporting processes; these risk management systems are operating effectively and are adequate having regard to the risks they are designed to control; and the descriptions of risk management systems provided to APRA by each bank are accurate and current.
- Board endorsement of the chief executive declarations. A major function of the board is to bring a perspective which is independent

[59] In relation to eight of these institutions, APRA advised ANAO that the failure to hold consultations reflected other work priorities associated with the creation of Diversified Institutions Division and that consultations have occurred or are scheduled to occur by December 2000. In relation to the remaining instance (one of the four major Australian banks), APRA advised that the gap between consultations was greater than 12 months because senior personnel from both APRA and the bank were unavailable to meet on the initial date targeted by the APRA analyst/relationship manager.

of management to the bank's business. Accordingly, the declarations by each bank's chief executive officer are required[60] to be endorsed by the bank's Board. This endorsement is to be evidenced by a copy of the relevant Board minute.[61]

**3.38** ANAO sought from APRA copies of the annual chief executive officer declarations for the last three years for each of the seven banks included in the audit sample. In most instances, these declarations had been provided to APRA within the required timeframe with each declaration conforming to APRA's requirements.

**3.39** However, APRA generally does not require banks to provide evidence that the board endorses the chief executive officer's declaration.[62] By endorsing the chief executive officer's declaration, the board is essentially providing an independent confirmation of its accuracy. This is important as it reflects the responsibility and accountability of the board for ensuring good corporate governance,[63] for determining and approving corporate strategy, and providing guidance and oversight to senior management. APRA has advised ANAO that it accepts this point and that it will remind both banks and supervisory staff of the need to comply with this requirement.

**3.40** **Finding:** APRA's supervisory approach is predicated on its view that the board and management of each bank is primarily responsible for the prudent management of the bank's business. Accordingly, APRA conducts annual prudential consultations with banks and requires bank chief executive officers to provide risk management declarations which, in turn, are to be endorsed by the board of the bank. Annual prudential consultations were held with 82 per cent of licensed banks in 1999–2000 and most chief executive declarations for the seven banks in ANAO's sample had been provided to APRA within the required timeframe with the declaration conforming to the APRA's requirements. However, APRA has generally not required banks to comply with the requirement to provide evidence that the board endorses the chief executive officer's declaration. APRA has undertaken to rectify this deficiency.

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60 This requirement is documented in Prudential Standard H1 and Auditing Guidance Statement *AGS 1008 Audit Implications of Reserve Bank Prudential Reporting Requirements*.

61 In the case of foreign bank branches, the chief executive officer declarations are to be endorsed by a senior executive of the bank overseas with appropriate responsibilities.

62 In some instances, the chief executive officer has included in his declaration a statement that the declaration has been endorsed by the board. In many declarations, there is no mention of board endorsement.

63 This includes ensuring that an effective system of controls is in place to: manage the major risks faced by the bank; report performance to stakeholders; and comply with applicable laws and regulations.

## External auditors

> **Principle 19:** Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.
>
> ***Basle Core Principles for Effective Banking Supervision***

**3.41** APRA's supervisory processes place extensive reliance on the work of banks' external auditors,[64] as the following indicate:

- Annual tripartite discussions should be held between the bank, its external auditors and APRA. In the normal course, these meetings discuss the external auditor's reports to APRA and any matters arising from the external auditor's review. In 1999–2000, APRA held tripartite discussions with 40 of the 50 banks and their external auditors (80 per cent). In one instance, a tripartite discussion was not necessary because the bank was not licensed until June 2000. APRA advised ANAO that the failure to hold tripartite meetings with a number of banking groups reflected other work priorities associated with the creation of Diversified Institutions Division but that meetings have been undertaken or scheduled with most of these institutions. Notwithstanding the tripartite relationship, a bank's external auditor and APRA may, in exceptional circumstances as required under the Banking Act, meet on a bilateral basis. APRA advised ANAO that no such meetings have occurred.
- Within three months of the annual balance date of each bank, the bank's external auditor is required under the Prudential Standards to provide simultaneously to APRA and the bank's audit committee, a report outlining the auditor's opinions as to whether all prudential standard requirements have been met; the statistical and financial data provided to APRA are reliable; the bank has complied with statutory banking requirements and any conditions on the banking licence or other conditions imposed by APRA; and if there are any matters which may have the potential to prejudice materially the interests of depositors of the bank. For the seven banks included in ANAO's sample, external audit reports had been provided to ANAO by each bank's auditors in each year since 1997. Occasionally, the reports did not comply fully with APRA's requirements and, often, reports were provided outside the required period of within three months of the annual balance date of the bank.
- Annual reviews are commissioned by APRA of nominated aspects of

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64 Inquiries into state bank crises in Victoria and South Australia identified deficiencies in the external audits of these banks.

banks' risk management systems. At the time of ANAO's audit fieldwork, reviews had been commissioned of information flows to management (1997); business continuity planning (1998); operational risk management (1999); and outsourcing (2000). Most of the seven banks in ANAO's sample commissioned the targeted reviews when requested by APRA and the reviews were generally completed and a copy provided to APRA.

**3.42** Neither the annual external audit report to APRA and the audit committee or the targeted reviews are conducted as audits and, as a result, neither can provide APRA with a high level of assurance, illustrated as follows:[65]

- The annual external audit reports are conducted as reviews, which provides APRA with only a moderate level of assurance that prudential standards and statutory requirements are being complied with and that data provided to APRA is reliable. There are no other steps taken by APRA to increase the level of assurance it obtains in relation to compliance with prudential standards and statutory requirements or that the data provided to APRA is reliable.
- The targeted reviews are conducted as agreed-upon-procedures engagements which means that no assurance is provided to APRA by the external auditor. APRA advised ANAO that its analysts examine these reports and assess the findings of the auditor and comment on the approach taken to the task.

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[65] There are three forms of audit and audit-related services, each of which provides a different level of assurance:

- ***Audits*** provide the highest level of assurance as they involve the positive expression of an opinion. An audit requires the accumulation of audit evidence necessary for the auditor to conclude whether there are any material misstatements in the subject matter taken as a whole.
- ***Reviews*** involve the auditor providing a moderate level of assurance, being a lower level of assurance than that provided by an audit. The auditor states whether anything has come to the auditor's attention that the information is not presented fairly in accordance with identified criteria.
- ***Agreed-upon Procedures*** involves the auditor providing a report of the factual findings of procedures agreed with management with no assurance provided. Instead, users of the report assess for themselves the procedures and findings reported by the auditor and draw their own conclusions from the auditor's work. The report is restricted to those parties that have agreed to the procedures to be performed since others, unaware of the reasons for the procedures, may misinterpret the results.

**3.43** APRA advised ANAO that the Reserve Bank conducted an extensive review of the tripartite arrangements with banks' external auditors in 1996 and 1997, and these were subject to further re-assessment as part of APRA's recent prudential supervision harmonisation exercise. This led to revisions of the tripartite arrangements such that APRA considers it receives effective levels of comfort on risk management systems and adherence to them by banks, and bank compliance with prudential standards from banks' management and external auditors respectively. APRA further advised ANAO that provisions in Division 2A of the Banking Act also enable it to leverage off the output of external auditors where they identify material concerns with a bank (which has not occurred since APRA's establishment).

**3.44** APRA acknowledged to ANAO that it cannot rely upon external auditors to detect all deficiencies in bank's risk management and compliance with Prudential Standards but that it considers the existing arrangements and the provisions of the Banking Act enable the detection of material concerns in this area. Furthermore, APRA advised ANAO that any increase in the intensity of its on-site examinations would require a substantial change in its supervisory methodology and resources that would be at odds with APRA's obligations to balance financial safety with efficiency, competition, contestability and competitive neutrality. APRA's on-site review methodology does not entail conducting an audit of a bank but focuses on gaining both an understanding of the operations of an entity's risk management systems, and an insight into its risk management culture. An on-site review also enables APRA to act upon material issues identified through its off-site supervision and in background material supplied by a bank prior to the visit.

**3.45** **Finding:** In relation to APRA's supervisory processes, APRA places extensive reliance on the work of banks' external auditors. APRA acknowledged to ANAO that it cannot rely upon external auditors to detect all deficiencies in bank's risk management and compliance with Prudential Standards but that it considers the existing arrangements and the provisions of the Banking Act enable the detection of material concerns in this area.

## Internal audit

> **Principle 14, Essential Criterion 5:** The supervisor determines that banks have an appropriate audit function charged with (a) ensuring that policies and procedures are complied with and (b) reviewing whether the existing policies, practices and controls remain sufficient and appropriate for the bank's business. The supervisor determines that the audit function:
>
> - has unfettered access to all the bank's business lines and support departments;
> - has appropriate independence, including reporting lines to the board of directors and status within the bank to ensure that senior management reacts to and acts upon its recommendations;
> - has sufficient resources, and staff that are suitably trained and have relevant experience to understand and evaluate the business they are auditing; and
> - employs a methodology that identifies the key risks run by the bank and allocates its resources accordingly.
>
> ***Basle Core Principles for Effective Banking Supervision***

**3.46** APRA requires that the scope of each bank's internal audit function include the processes and controls implemented by management so as to ensure compliance with APRA's prudential requirements. The work of internal auditors is considered and relied upon by APRA in its prudential supervision activities. For example, APRA's on-site visits to banks consider internal audit reports and action the bank advises has been taken to rectify any deficiencies identified. In addition, as part of the process by which some banks are permitted to use their internal market risk models to calculate their capital adequacy position, Prudential Standard APS 113 *Capital Adequacy: Market Risk* requires an independent review of the market risk measurement system to be carried out regularly (at least once a year) as part of the internal audit process.

**3.47** The role and operational independence of each bank's internal audit function is determined by each bank's management. The Basle Committee's *Core Principles for Effective Banking Supervision* require supervisors to assess the scope and effectiveness of each bank's internal audit unit's operations, policies and procedures. In this context, ANAO noted that, when the Reserve Bank held responsibility for prudential supervision of banks, the Bank reviewed banks' internal audit functions.[66] In comparison, APRA does not periodically review banks' internal audit functions to assess what (if any) reliance can be placed upon this work. APRA also does not seek advice from banks' external auditors on the extent to which they rely on the work of internal audit and, where the external auditors rely on internal audit, details of the external auditor's assessment of the internal audit function.

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66 *Implications of the Barings Collapse for Bank Supervision*, Reserve Bank of Australia Bulletin, November 1995, page 5.

**3.48** APRA advised ANAO that the quality, output and independence of internal audit is specifically addressed as part of its new methodology; that there is scope to review internal audit as part of an on-site operational risk review; and that it would investigate the use of internal audit by external auditors during tripartite meetings (that are usually convened on an annual basis). APRA further advised ANAO that its procedures require analysts to review the internal audit function with a focus on: any lack of independence and/or accountability; ineffective policies, procedures and practices; and an inappropriate/lack of segregation of duties. However, such assessments were often not documented and ANAO considers explicit regard should also be had to: the nature and extent of the assignments undertaken by the internal auditors; the technical training and proficiency of the internal auditors; and whether internal audits are properly planned, supervised, reviewed and documented.[67]

**3.49** **Finding:** APRA's Prudential Standards require a comprehensive and independent internal audit process within each bank in order that APRA may rely upon the work of internal auditors. APRA advised ANAO that the quality, output and independence of internal audit is specifically addressed as part of its new methodology; that there is scope to review internal audit as part of an on-site operational risk review; that it would investigate the use of internal audit by external auditors during tripartite meetings; and existing procedures require analysts to review the internal audit function. However, such assessments were often not documented. ANAO considers explicit regard should also be had to: the nature and extent of the assignments undertaken by the internal auditors; the technical training and proficiency of the internal auditors; and whether internal audits are properly planned, supervised, reviewed and documented.

## On-site supervision

**Principle 16:** An effective banking supervisory system should consist of some form of both on-site and off-site supervision.

***Basle Core Principles for Effective Banking Supervision***

[67] Australian Auditing Standard *AUS 604 Considering the Work of Internal Auditing*.

**3.50** The Basle Committee advocates a mixture of on-site and off-site supervision for bank supervisors. Off-site supervision enables banking sector trends and developments to be monitored as well as analysis of the financial condition of individual banks. Off-site supervision involves analysis of statistical returns and other information obtained from each bank by supervisors as well as publicly available information. On-site work assists supervisors to verify that risk management systems and internal controls are in place; assess the reliability of information provided by banks to the supervisor; and obtain additional information needed to assess the condition of each bank.

**3.51** The Basle Committee recommends that on-site visits be scheduled based on an assessment of the nature, importance and scope of the risks to which individual banks are exposed, including the business focus, the risk profile and the internal control environment.[68] Within the context of these risk assessments, better practice[69] is for all supervised entities to be visited on a regular basis, with higher risk entities visited more often and/or subject to more intensive visits. In this context, the Final Report of the Financial System Inquiry recommended that <u>regular</u> on-site reviews of risk management systems form an integral part of the approach to prudential regulation of deposit-taking institutions.[70]

**3.52** The Reserve Bank commenced on-site supervision of banks in October 1992 when it introduced a program of visits to assess banks' processes for managing credit risk. Visits to assess banks' management of market risk commenced in December 1994. In August 1999, APRA established a function to examine financial institutions' management of operational risk, with an initial focus on Year 2000 preparations and examination of institutions considered to be at the forefront of new developments regarding operational risk management methodologies.[71] Although on-site reviews of operational risk commenced in August 1999, on-site reviews of credit risk and market risk functions in banks involved the assessment of related operational risks. APRA advised ANAO that, when the operational risk on-site function was established, it drew upon staff with extensive operational risk review experience.

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68 Basle Committee on Banking Supervision, *Core Principles for Effective Banking Supervision*, Principle 16, Additional Criterion 3.

69 Audit Report No.12 1995–96, *Risk Management by Commonwealth Consumer Product Safety Regulators*, pages 50–60 discusses the application of these principles in regulatory environments.

70 *Financial System Inquiry Final Report*, March 1997, Recommendation 35, pages 321–322.

71 In addition to its on-site visits, APRA also relies upon the on-site work of external auditors.

**3.53** A number of overseas prudential supervisors conduct in-depth examinations of the financial institutions which they supervise. In comparison, APRA has adopted a 'light touch' regulatory approach and does not conduct in-depth bank examinations.[72] APRA's reviews are intended to be targeted, high level visits to assess (and develop benchmarks for) risk management systems and methodologies. The visit program comprises: routine reviews of eleven institutions regarded as key players in the Australian financial system; visits undertaken at the request of frontline supervisors; and benchmarking visits. The scope and duration of each visit varies. However, as a general rule, credit risk visits are conducted over a three day period and market and operational risk visits three to four days. APRA commented to ANAO that, in addition to the on-site visits conducted by Consulting Services, annual prudential consultations are conducted on-site with banks and Diversified Institutions Division staff also lead specific risk visits to institutions.

## Resourcing

**3.54** In August 1999, APRA established a separate group (the Consulting Services Group) that provides specialist advice to supervisory staff and undertakes the on-site visits that were formerly undertaken by the Reserve Bank, the ISC and state supervisory authorities.[73] Following the establishment of APRA and the adoption by APRA of a new risk-based visit methodology, it is intended that banks with lower risk profiles will receive fewer and less frequent visits than when supervised by the Reserve Bank.

**3.55** A further factor that has limited APRA's on-site visits to banks is that the on-site visit teams have yet to be fully staffed. Staffing is intended to be 28 officers, comprising nine officers in each of the three visit teams and a senior manager in charge of all teams. At the time of ANAO's audit fieldwork, the three visit teams were understaffed by 25 per cent. The credit risk team was understaffed by one officer, the market risk team by two officers and the operational risk team by four officers. APRA advised ANAO that the shortage in staff was limiting the number of visits that can be conducted but that it is actively recruiting staff externally and appointing experienced staff from frontline supervision areas to fill positions.

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72 APRA advised ANAO that its approach is substantially the same as that of the Reserve Bank when it had responsibility for bank prudential supervision.

73 Staff with primary supervisory responsibility for each institution also attend the on-site visits.

## Scheduling

**3.56** APRA initially adopted the Reserve Bank's targets of conducting a market risk visit and a credit risk visit to each Australian incorporated bank at least once in every two years (except where there were overriding circumstances). The Reserve Bank aimed to visit branches of foreign banks less frequently.[74] More recently, APRA has adopted a target of visiting each of the eleven largest Australian financial groups (including eight banks) on an 18 month to two year cycle.[75] APRA's procedures also require that more frequent visits be conducted when there are problems or substantial changes in the structure of a bank's business.

**3.57** APRA advised ANAO its view is that a regular cycle of visits by its Consulting Services team to all institutions is not consistent with a risk-based methodology nor the Basle Core Principles. APRA commented that, under its risk-based supervisory methodology, some institutions may be visited more frequently, for example those which are systematically important or operate in higher risk activities whereas only key aspects of the operation of low risk institutions will be subject to more frequent review. APRA advised ANAO that it is of the view that it is applying its risk-based on-site methodology but acknowledged that other work priorities associated with APRA's restructure and the absence of a complete staffing complement in the on-site review teams meant that it had not achieved the full roll-out of its risk-based on-site methodology during the ANAO review period.

**3.58** Of the 50 banks licensed to operate in Australia in 1999–2000, APRA conducted a total of 15 on-site visits[76] to 10 of these banks (20 per cent). More specifically, since its establishment on 1 July 1998, APRA has not undertaken regular market and credit risk visits to the nine banks in ANAO's audit sample, as the following demonstrate:

- A credit risk visit to one of the eight largest Australian banks is planned for the first half of 2001, almost three years since the last visit in June 1998. This bank also has not received a market risk during the three years since the last visit in October 1997. No market risk visit is currently planned. APRA advised ANAO that an operational risk visit was conducted in November 2000. These delays have occurred in circumstances where the bank has significantly expanded its operations and APRA has held concerns about the bank's risk management

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74 APRA, *Market Risk Visit Procedures*, March 1999, page 13.

75 No target was set for other institutions.

76 Comprising five credit risk visits, five market risk visits, three operational risk visits and two pre-authorisation visits.

systems. Accordingly, the delays are inconsistent with APRA's stated policy of undertaking more frequent visits when there are problems or substantial changes in the structure of a bank's business.

- Another of the eight largest Australian banks included in ANAO's sample group received regular credit risk visits every two years but has not been subject to regular market risk visits. For this bank, the most recent market risk visit was conducted some two and a half years after the previous visit.
- Two foreign bank branches received credit risk visits in November 1997 and May 1998 respectively as part of the licensing process. For the first of these banks, no subsequent visits have been conducted and none is planned for 2000 or 2001. This represents a gap of between two and a half and four years between visits. Market risk visits were also conducted in March 1998 and May 1998 respectively as part of the licensing processes. There have been no further market risk visits for either bank since that time. None is planned for either bank in the remainder of 2000 resulting in a gap between market risk visits for each bank of more than two and a half years.
- Another foreign bank branch has not received a credit risk visit since February 1997. APRA advised ANAO that a visit has been scheduled for July 2001, which represents a gap of almost five years since the previous credit risk visit. The last market risk visit was conducted in March 1999, three and a half years after the previous visit by the Reserve Bank in October 1995.
- The remaining foreign bank branch included in ANAO's audit sample has received a credit risk visit every two to two and a half years but has not received a market risk visit in the four years since the last visit in October 1996.

**3.59** On-site visits provide APRA with an increased understanding of banks' risk management systems and an insight into their risk management culture as well as enabling material issues identified through off-site supervision to be pursued. Accordingly, in a risk management context, ANAO considers all banks should received periodic visits with the level of assessed risk determining the appropriate frequency and intensity of visits. In this context, the prolonged gap between visits to some banks in ANAO's sample is inconsistent with a sound risk-based approach having regard to the pace of change in the financial services industry. APRA advised ANAO that, while a regular risk visit cycle to all banks is not a feature of its on-site methodology, the need to undertake on-site visits will be regularly considered as part of APRA's prudential review cycle.

**3.60** One consequence of APRA's decision not to undertake periodic visits to all banks with the level of assessed risk determining the appropriate frequency and intensity of visits is that APRA is unable to meet some of the Basle best practice recommendations, namely that it periodically verify that:

- prudent credit-granting and investment criteria, policies, practices, and procedures are approved and implemented by banks;[77]
- credit policies, practices and procedures include the establishment of an appropriate and properly controlled credit risk environment;[78]
- banks' have management information systems that enable management to identify on a timely basis concentrations within their portfolios (including large individual exposures);[79]
- banks' are adhering to their risk management processes, capital requirements, liquidity guidelines and qualitative standards;[80] and
- banks' money laundering controls and systems for preventing, identifying and reporting fraud are sufficient.[81]

## Visits to overseas operations

**3.61** The Basle Committee advocates[82] that supervisors should visit offshore locations periodically, with the frequency determined by the size and risk profile of the overseas operation. It is also recommended that the home country supervisor meet with the local supervisor during these visits. However, APRA does not have a structured program of visits to the offshore operations of Australian banks. In this context, APRA advised ANAO that:

> *This fails to acknowledge the adoption by Australian banks of global business line frameworks, and global risk management structures. As such, through our on-site inspections of Australian banks' head offices, we can gain an understanding of what business is being undertaken, and how such activity is being managed in authorised banking entities offshore. In addition, as part of our credit risk visits to banks that maintain banking operations offshore, we can request a sample of credit*

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77 Basle Committee on Banking Supervision, *Core Principles for Effective Banking Supervision*, Principle 7, Essential Criterion 1.

78 *ibid*, Principle 7, Essential Criterion 2.

79 *ibid*, Principle 9, Essential Criterion 3.

80 *ibid*, Principle 13, Essential Criterion 6.

81 *ibid*, Principle 15, Essential Criterion 9.

82 *ibid*, Principle 23, Additional Criteria 1 and 3.

*files to gain an understanding of how globally based credit risk management systems operate in individual domiciles. Further, if our ongoing supervision of, or our on-site visit to, this category of bank identified a need to review individual offshore operations we could undertake a visit to, or seek a targeted review of, such entities.*

**3.62** ANAO noted that a number of overseas supervisors have a practice of regularly visiting the Australian operations of banks for which they are the home country supervisor. APRA has occasionally visited supervisors in the United Kingdom, the United States and New Zealand. However, for ANAO's audit sample of three Australian-owned banks with overseas operations, APRA had not undertaken any overseas visits since it was established in July 1998, although each of these three banks has significant offshore operations. This is despite APRA advising one of the United States supervisory authorities in November 1998 that it would seek to supervise Australian banks through a regular schedule of visits.

**3.63** APRA advised ANAO that its policy is to conduct an on-site visit to banks' offshore operations where it has material concerns with an operation's risk profile or gaps in its risk management systems. However, the last on-site visit of any overseas operations of the three internationally active banks in ANAO's sample was conducted by the Reserve Bank in 1997 when it conducted a one week visit to London that included visits to the United Kingdom regulator and the London branches of two of these banks.

**3.64** Despite APRA's stated policy, it has not visited offshore operations even where supervisory activities have raised concerns.[83] In response, APRA advised ANAO that, rather than conduct on-site visits to offshore operations, it has relied on confirmations from relevant senior management in Head Office that adequate risk management infrastructure is in place and such entities are subject to a frequent update regime so that APRA remains apprised of key developments. In the light of international experience such as the Barings crisis, ANAO considers that APRA should visit banks' offshore operations to assure itself that risks are being effectively managed on a global consolidated basis.

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83 For example, APRA's 1999 on-site visit to one internationally active Australian bank found that the bank had inadequate risk management resources internationally. In response, APRA advised ANAO that the locations involved had substantially reduced their trading activities and while there was an indication of higher trading levels going forward, APRA had received acknowledgment from the bank's senior management that they were comfortable with this infrastructure. APRA also noted that it receives regular updates on market risk management that enables it to review business and risk management developments.

**3.65** **Finding:** APRA has a program of high level, on-site visits to assess banks' risk management systems and methodologies in the areas of credit risk, market risk and balance sheet management, and operational risk. APRA's on-site review capabilities build on the infrastructure of the Reserve Bank and other APRA predecessor entities. However, following the establishment of APRA and the adoption by APRA of a new risk-based visit methodology, it is intended that banks with lower risk profiles will receive fewer and less frequent visits than when supervised by the Reserve Bank. The intention is that systemically important institutions and institutions with higher risk profiles or encountering risk management difficulties will be subject to more frequent visits. However, other work priorities associated with APRA's restructure and the absence of a complete staffing complement in the on-site review teams meant that it had not achieved the full roll-out of its risk-based on-site methodology during the ANAO review period.

**3.66** APRA has not undertaken regular on-site visits to all banks and so it is unable to meet the Basle Committee best practice recommendation that it periodically verify that banks' are adhering to their risk management processes, capital requirements, credit policies and procedures and liquidity guidelines. ANAO noted that APRA has not specified a minimum visit frequency for all banks, whereas the Reserve Bank of Australia (APRA's predecessor supervisor of banks) had a target of conducting visits to each bank at least once in every two years. ANAO considers that an improved risk-based approach would be for all banks to receive periodic visits in accordance with a specified minimum revisit frequency with the level of assessed risk determining whether visits should be more frequent and/or more intense. Unlike a number of European and North American supervisors who visit the Australian operations of their banks, APRA does not have a structured program of visits to the offshore operations of Australian banks with none of the banks in ANAO's sample having been visited since 1997.

## Recommendation No.3

**3.67** ANAO recommends that APRA:

(a) conducts periodic on-site visits to all banks with the level of assessed risk determining the appropriate frequency and intensity of visits; and

(b) considers the merits of a structured program of visits to the offshore operations of Australian banks.

### *APRA response*

**3.68** APRA **agrees with qualification** to part (a) and **agrees** with part (b). In relation to part (a), APRA's qualification was that, consistent with its application of a risk-based supervision methodology, a scheduled visit may be deferred if it were felt that a visit would offer no insights into a bank's risk management practices. APRA commented that it relies to some extent on annual updates to risk management system descriptions from banks to track changes in risk management processes. It also requires an annual declaration from management and the board that risk management systems are current, adequate and operating effectively.

# 4. Capital Adequacy

*The cornerstone of prudential supervision is the requirement for banking institutions to maintain sufficient capital to cover the risks they take. Among other things, capital provides banks with a buffer for losses which, in turn, provides a cushion to protect depositors. This chapter outlines APRA's capital adequacy requirements and examines how it monitors and enforces compliance with these requirements.*

## Background

**4.1** In 1988, the central banks of the Group of Ten countries agreed to apply minimum capital standards to their banking industries, to be achieved by the end of 1992. This agreement, which became known as the Basle Capital Accord,[84] provided definitions for bank capital together with a methodology for identifying and measuring exposures to credit risk[85] which was, at that time, the largest risk faced by banks. The Accord also specified that internationally active banks should be required by their supervisors to maintain a ratio of capital to risk-weighted assets (the capital adequacy ratio) of at least 8 per cent. In Australia, the Reserve Bank issued Prudential Statement C1 *Capital Adequacy of Banks* in August 1988 which was consistent with the Basle Capital Accord.

**4.2** In January 1996, the Basle Committee issued an *Amendment to the Capital Accord to Incorporate Market Risks* which for the first time placed requirements on banks to hold capital against their market risk.[86] A key aspect of the amendment is the "internal model option" which allows banks to use their own risk management systems for generating a regulatory capital charge (subject to satisfying a number of qualitative and quantitative requirements). In January 1997, the Reserve Bank issued the Prudential Statement C3 *Market Risk* which became effective on 1 January 1998.[87] This Statement, in all material respects, was consistent with the Basle Committee's amendment to the Capital Accord.

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84 Basle Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards*, July 1988, paragraph 44.

85 Credit risk is the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms. Banks face credit risk as a result of their lending activities as well as from trading and investing activities. The Basle Committee has noted that the major causes of serious banking problems have been credit-risk related including lax credit standards for borrowers and counterparties, poor risk management and a lack of attention to changes in economic or other circumstances that can lead to a deterioration in the credit standing of a bank's counterparties.

86 Market risk represents exposure to the possibility of financial loss resulting from unfavourable movements in market prices such as interest and exchange rates.

87 A further capital adequacy prudential statement (Prudential Statement C2 *Funds Management and Securitisation*) had been issued in October 1995. This statement did not involve any additional capital charge but established parameters within which banking groups were permitted to undertake funds management and securitisation activities.

**4.3** The credit risk and market risk components represent two different aspects of a bank's business, namely traditional banking activities and market trading activities. Before the introduction of Prudential Statement C3 *Market Risk*, banks applied Prudential Statement C1 *Capital Adequacy of Banks* to both their banking and trading activities. Prudential Statement C3 introduced the idea of separate banking and trading books,[88] and banks were required to allocate all of their financial instruments to one of these books. Where banks are permitted to use their internal models for capital adequacy purposes, the application of Prudential Statement C3 reduces the capital adequacy requirements of banks that have large trading books as the capital charge applied under this Statement is significantly less than the capital charge applied under Prudential Statement C1.

**4.4** With effect from 1 October 2000, Prudential Statements C1 and C3 were replaced by the following Prudential Standards, which include substantially the same requirements as the former Prudential Statements, as follows:

- APS 110 *Capital Adequacy* which outlines the <u>overall framework</u> adopted by APRA to assess the capital adequacy of locally incorporated banks;
- APS 111 *Capital Adequacy: <u>Measurement of Capital</u>* which stipulates the qualifying criteria for various types of capital elements for inclusion in a bank's capital base for capital adequacy purposes;
- APS 112 *Capital Adequacy: <u>Credit Risk</u>* which prescribes the manner in which on- and off-balance sheet credit exposures are risk-weighted for capital adequacy purposes; and
- APS 113 *Capital Adequacy: <u>Market Risk</u>* which details the alternative approaches for banks to manage and measure risks associated with their market trading activities.

**4.5** In addition, a number of further Prudential Standards were also issued to replace Prudential Statements that addressed other factors relevant to the overall capital adequacy of a bank, including the quality of its credit assets and credit risk concentrations.

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88 A bank's trading book contains all of its positions that: are held for short-term resale; are taken on by the bank with the intention of benefiting in the short-term from actual and/or expected differences between their buying and selling prices; arise from brokering and market making; or are taken in order to hedge other elements of the trading book.

**4.6** Recognising developments in financial markets and some deficiencies in the Capital Accord,[89] the Basle Committee has announced its intention to introduce a new capital adequacy framework to replace the Capital Accord. The objectives of the review include the adoption of a more comprehensive approach to addressing risks and that the new framework should, at least, maintain the current level of overall capital in the system.[90] In this context, the proposed new framework[91] consists of:

- minimum capital requirements that continue to consist of a definition of regulatory capital, measures of risk exposure and rules specifying the level of capital to be held in relation to these risks. The Committee proposes that the new framework cover more explicitly each of the major risk categories[92] including the development of an explicit capital charge for all risk categories and that, whilst there would remain a standardised approach, some banks may be permitted to make greater use of their internal models in calculating capital charges;
- a supervisory review process that aims to ensure each bank's capital position is consistent with its overall risk profile and strategy and that enables early supervisory intervention if the capital does not provide a sufficient buffer against risk; and
- effective use of market discipline through enhanced public disclosure of banks' financial condition and performance, business activities, risk profile and risk management activities.

**4.7** APRA has contributed to the Basle Committee's review of the Capital Accord, responding to the Committee's consultative papers.[93] APRA commented that the Australian banking system is relatively well capitalised and that APRA does not see the need for an increase in the overall minimum capital requirements. In this context, APRA indicated its support for the introduction of a capital adequacy framework that is

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89 For example, the current Accord does not address interest rate risk in the banking book and operational, liquidity, legal and reputations risks are not explicitly addressed although the minimum ratio of 8 per cent includes a buffer to cover unquantified risks.

90 Basle Committee on banking Supervision, *A New Capital Adequacy Framework*, June 1999 issued for comment by 31 March 2000, pages 4–5.

91 Basle Committee on Banking Supervision, *A New Capital Adequacy Framework*, June 1999 issued for comment by 31 March 2000.

92 Namely: credit risk (particularly from loans in the banking book); market risk; and other risks (including interest rate risk in the banking book and operational, liquidity, legal and reputational risks).

93 APRA, *Submission to the Basel Committee on Banking Supervision—A New Capital Adequacy Framework*, 13 March 2000.

more sensitive to institutions' individual risk profiles, including by placing greater reliance on banks' internal risk models to calculate regulatory capital charges. APRA's response also supported the Committee's view that supervisory scrutiny and enhanced public disclosure can provide incentives for prudent behaviour.

**4.8** **Finding:** Australia's capital adequacy framework is consistent with international best practice, as represented by the Basle Capital Accord. APRA has contributed to the Basle Committee's current review of the Capital Accord and has indicated its support for the introduction of a capital adequacy framework that is more sensitive to institutions' individual risk profiles, including by placing greater reliance on banks' internal risk models to calculate regulatory capital charges.

## Capital adequacy ratios

**Principle 6:** Banking supervisors must set minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. For internationally active banks, these requirements must not be less than those established in the Basle Capital Accord.

***Basle Core Principles for Effective Banking Supervision***

**4.9** Consistent with the Basle Capital Accord, APRA has adopted a target standard minimum ratio of capital to risk-weighted assets of 8 per cent, calculated by dividing the bank's eligible capital base by its total risk-weighted exposures.[94] In addition to the requirement for each bank to meet a minimum capital adequacy ratio, APRA requires that at least half the ratio take the form of Tier 1 capital.[95] Furthermore, since 1992, all new authorised locally incorporated banks have been required to have Tier 1 capital of at least $50 million.

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94 Comprising the credit risk associated with each bank's on-balance sheet and off-balance sheet exposures and the market risk arising from each bank's trading activities.

95 For capital adequacy purposes, a bank's capital base is divided into two tiers:

- Tier 1 (or core) capital which comprises the highest quality elements which fully meet the essential requirements that capital: provide a permanent and unrestricted commitment of funds; be freely available to absorb losses; not impose any unavoidable servicing charge against earnings; and rank behind the claims of depositors and other creditors in the event of winding-up; and
- Tier 2 (or supplementary) capital which includes other elements which, to varying degrees, fall short of the quality of Tier 1 capital but nonetheless contributes to the overall strength of a bank as a going concern.

**4.10** APRA expects each bank to maintain a level of capital that is adequate for the types of activities it undertakes. All locally incorporated banks are expected to maintain a risk-based capital ratio of at least 8 per cent on both an individual bank and consolidated group basis. They are also expected to establish their own target capital adequacy ratios in excess of the 8 per cent minimum and have capital management systems to ensure they meet their own targets. Where a bank is considered by APRA to have an excessive concentration of credit risk exposures, inadequate provisioning or significant other risk exposures, APRA may specify a higher minimum capital ratio. In addition, APRA has a policy of specifying a higher minimum capital adequacy ratio during the formative years of newly established banks.[96]

**4.11** The 25 foreign bank branches operating in Australia at the time of ANAO's audit are not subject to APRA's capital adequacy requirements but are expected to meet equivalent standards in their home country. Of the nine banks included in ANAO's sample, five were subject to APRA's capital adequacy requirements comprising four Australian-owned banks and one Australian subsidiary of a foreign bank.[97] Of these five banks, three were expected to maintain the standard minimum capital adequacy ratio of at least 8 per cent. The quarterly Capital Adequacy Returns submitted by these banks between December 1997 and June 2000[98] indicated that, at each reporting date, each bank had maintained a capital adequacy ratio above the minimum of 8 per cent on both an individual bank and consolidated group basis.

**4.12** Of the remaining two banks in ANAO's sample, the loan book of one was considered to be very concentrated with a large proportion of capital tied up in a small number of transactions with one group of clients in a particular industry sector. For this reason, APRA asked this bank to maintain a capital adequacy ratio of 15 per cent, compared to the standard ratio of 8 per cent. However, APRA has not included the higher minimum ratio as a condition on the banking licence but advised ANAO that it relies upon a standard licence condition that requires the bank to conform with prudential supervision arrangements notified to the bank. ANAO sought advice from the Office of General Counsel of the Australian Government Solicitor (AGS) about the effectiveness of this approach. AGS advised that the approach taken does not appear to impose a legal

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96 Guidance Note AGN 110.3—*Minimum Capital Adequacy Requirements*, September 2000, paragraph 2.

97 The remaining four banks in ANAO's sample were foreign bank branches.

98 The September 2000 capital adequacy returns were not due to be submitted by locally incorporated banks until 31 October 2000, after ANAO fieldwork was completed.

obligation on the bank to maintain a minimum capital ratio of 15 per cent. AGS suggested that an effective approach would be to make the minimum capital ratio of 15 per cent subject to a specific condition on the banking licence.[99] This bank's capital adequacy returns indicate it has always maintained a ratio above 15 per cent. Furthermore, APRA advised ANAO that APRA's minimum capital requirement of $50 million resulted in this bank maintaining a capital ratio with a significant buffer above the 15 per cent such that, if a large exposure was deducted from capital, the bank would still meet the minimum ratio of 15 per cent.

**4.13** For the remaining bank in ANAO's sample, an important consideration in the decision to grant a banking licence was that the applicant maintain a minimum capital adequacy ratio of 11 per cent. This was because APRA was concerned that all of this bank's loans would be made to one industry sector.[100] Although the bank agreed to maintain a higher minimum capital adequacy ratio, the banking licence does not require a higher minium capital adequacy ratio. Since its licence was granted, this bank's capital adequacy returns indicate it has always maintained a ratio above 11 per cent. In response, APRA advised ANAO that if it had made compliance with the higher minimum capital ratio a condition of the licence and the bank breached this, the authority would have to be relinquished and depositors would lose their protection.

**4.14** **Finding:** Australia's capital adequacy requirements are consistent with international best practice standards as outlined by the Basle Committee on Banking Supervision. APRA expects each bank to maintain a level of capital that is adequate for the type of activities it undertakes. All locally incorporated banks are expected to maintain a risk-based capital ratio of at least 8 per cent on both an individual bank and consolidated group basis. They are also expected to establish their own target capital adequacy ratios in excess of the 8 per cent minimum and have capital management systems to ensure they meet their own targets. The quarterly Capital Adequacy Returns submitted to APRA by the banks in ANAO's sample indicate that each bank had maintained a capital adequacy ratio above the minimum specified by APRA.

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99 In this respect, ANAO noted that APRA's internal legal counsel has advised its supervisory staff that, if a licence condition is not expressed to prevail over a prudential standard, then the standard will prevail in the event of any conflict. Accordingly, to make higher minimum capital ratios legally binding, APRA would need to either make this requirement an explicit licence condition that is stated to prevail over the general requirement to maintain a capital adequacy ratio of 8 per cent, or APRA would need to issue a prudential standard that is binding solely on the institution(s) concerned.

100 APRA also has a policy that newly established banks will generally be subject to a higher minimum capital adequacy requirement in their formative years. Source: APRA, Guidance Note AGN 110.3 *Minimum Capital Adequacy Requirements*, September 2000, paragraph 2.

**4.15** The exposures of two of the banks whose supervision was examined by ANAO was highly concentrated in particular industry sectors. For this reason, APRA advised these banks that they were to maintain a capital adequacy ratio of at least 15 per cent and 11 per cent respectively, compared to the standard ratio of 8 per cent. Capital adequacy returns submitted by each bank indicate that each bank is maintaining the required ratio but in neither case has APRA made compliance a legal requirement of the bank concerned.

## Banks' internal risk management systems

**4.16** A tenet of APRA's supervisory approach is that the board and management of banks have primary responsibility for managing the bank in a prudent and sound manner. For this reason, before granting a banking licence, APRA reviews a bank's internal risk management systems. Moreover, APRA has stated that it will seek to reduce the burden of supervisory compliance on industry by leveraging off financial institutions' internal risk management systems as far as possible. In this context, reliance on banks' internal risk management systems has been emphasised by APRA in the following three areas:

- Each bank is required to have in place a **liquidity management** strategy that meets APRA's criteria. This approach was adopted in April 1998 to replace the Prime Assets Ratio, which required that 3 per cent of each bank's total liabilities (excluding shareholders' funds) be held in prime assets. Nevertheless, where APRA is not satisfied with the adequacy of a bank's strategy, or where APRA has particular concerns about a bank's liquidity, it may direct the bank to hold specified amounts of high quality liquid assets. APRA has approved the liquidity management strategy for each of the nine banks included in ANAO's audit sample and in no case has APRA found it necessary to require one of these banks to hold specified amounts of high quality liquid assets. However, APRA advised ANAO that all liquidity management strategies/systems assessed must include provisions for holdings of highly liquid assets, as this is a component of any suitable liquidity management strategy. APRA stated that it will only require banks to hold specified amounts of highly liquid assets if the liquidity management strategy is assessed as not suitable.
- Subject to APRA approval, banks are permitted to use an internal model to measure some or all of their **market risk** for capital adequacy purposes. The internal model approach allows banks to use risk measures derived from their own measurement models to calculate the capital charge required for prudential supervision purposes. APRA

does not prescribe any particular type of internal model so long as the model used captures all the material risks run by the bank and any empirical correlations within and across the bank's risk categories. Approval of its internal model for capital adequacy purposes benefits a bank that is involved in significant market trading activities as the internal model generally reduces the level of capital that a bank is required to hold compared to the standard model approach that must otherwise be adopted.[101] Nine of the 25 locally-incorporated banks have been granted approval to use their internal market risk models.

- APRA recommends, but does not require, banks to have a **credit risk** grading system in place.[102] Credit risk grading systems categorise credit exposures into various classes designed to take into account graduations in risk. This data can then be used to provide summary indicators of the degree of risk inherent in a bank's individual credit exposures in order to improve credit risk management at the transaction, customer and portfolio levels. The Basle Committee anticipates that, in the future, banks' internal credit risk grading systems will be used as a basis for calculating their regulatory capital requirements. In ANAO's sample of nine banks, seven had a grading system in place but two did not. APRA advised that, where shortcomings are identified in credit risk grading systems by its supervisory work, it would expect these to be corrected like any other deficiency identified in a bank's credit risk management systems.

## Market risk models

**Principle 12:** Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

***Basle Core Principles for Effective Banking Supervision***

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[101] In comparison, the standard model is a simplified approach where banks apply a specified capital charge to the instruments and commodities contained in their trading book.

[102] Former Prudential Statement L1 *Asset Quality* advocated that banks have in place appropriate credit risk grading systems to help assess asset quality and credit exposures, including both performing and impaired facilities. Prudential Standard APS 220 *Credit Quality*, issued in September 2000 to replace the Prudential Statement, goes further in stating that banks should have a well-structured credit risk grading system and should risk-grade all credit exposures. However, APRA is able to exempt banks from having a credit risk grading system if, after grouping its exposures, the bank has a negligible number of exposures to risk grade.

**4.17** Banks' internal models are to be used to measure the Value-at-Risk (aggregate exposure)[103] from all market risks over a period of ten trading days.[104] To derive the regulatory capital required to cover these risks, the model's measure of Value-at-Risk is required to be multiplied by a multiplication factor set by APRA in the range of three to five according to the quality of each bank's risk management system. The multiplication factor was designed to provide a sufficient buffer for cumulative losses arising from adverse market conditions over an extended period of time and account for potential weaknesses in the modelling process.[105] At the time of ANAO's audit, the multiplication factor for each of the nine banks was set at the minimum of three.[106]

**4.18** Consistent with the recommendations of the Basle Committee, APRA's policy is that it will only grant a bank permission to use its internal model where the bank has met specified general criteria[107] as well as:

- quantitative standards intended to ensure the mathematics of the model are robust and comprehensive; and
- qualitative standards intended to ensure that banks using internal models have market risk management systems that are conceptually sound and implemented with integrity.[108]

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103 Value-at-Risk models are designed to estimate, for a given trading portfolio, the maximum amount that may be lost over a specific time period with a given probability. In this way, they provide a summary measure of the risk exposure generated by a given portfolio.

104 Where a bank's internal model does not readily fit the value-at-risk framework, the bank is permitted to use an alternative approach provided APRA is satisfied that the model adequately captures the risks involved and identifies the capital needed to support those risks in a comparable manner.

105 Basle Committee on Banking Supervision, *Overview of the Amendment to the Capital Accord to Incorporate Market Risks*, January 1996, page 3.

106 APRA advised ANAO that the purpose of the multiplication factor is to distinguish only those banks that had not fully addressed all issues to receive internal model status rather than to discriminate between the quality of banks' risk management systems.

107 Namely, APRA must be satisfied that: the bank's risk management system is conceptually sound and is implemented with integrity; the bank has sufficient numbers of staff in the trading area, risk control, audit and back office that are skilled in the use of sophisticated models; the bank's models have a proven track record of reasonable accuracy in measuring risk; and the bank regularly conducts specified stress tests.

108 The qualitative standards address: the independence of the risk control unit; regular comparison of the model's risk measure against actual daily changes in portfolio value (back-testing); the active involvement of the board and senior management in the risk control process; integration of the model into the day-to-day risk management process; the use of internal trading and exposure limits; routine and rigorous stress testing; documentation of the risk management system and a routine for ensuring compliance; and an annual internal audit review of the risk measurement system.

**4.19** Use of a bank's internal model for supervisory capital purposes requires the explicit approval of APRA. On this point, APRA observed that the Reserve Bank had invested considerable amounts in the training of staff so as to build sufficient expertise in the assessment of internal model users. APRA also noted that the Reserve Bank made use of market risk visits to foreign bank branches and foreign bank subsidiaries represented in Australia to develop an understanding of internal models being accepted by peer supervisors. APRA comment that the Reserve Bank's processes were designed to be consistent with that used by its supervisory peers.

**4.20** In giving approval to a bank to use its internal model, compliance with the criteria is assessed through meetings with bank employees, documentation provided by the bank, and on-site model review visits. ANAO examined the model recognition process for each of the nine banks granted approval to use their internal models to measure market risk for capital adequacy purposes. Of these banks, only two (both of which were Australian subsidiaries of foreign banks) were assessed at the time to comply with all general, quantitative and qualitative criteria. In this context, APRA advised ANAO that:

> *The assessment of internal model users requires the assessment of an extensive range of general, quantitative and qualitative criteria. The process may entail a number of visits as well as additional follow-up meetings. In some instances, internal model users may have not completely addressed all criteria. Where this was the case, APRA would have undertaken a documented assessment of the materiality of outstandings before determining whether the institution should be granted internal model user status and, if so, whether such deficiencies required an institution to maintain a higher multiplication factor.*[109]

**4.21** ANAO considers that the multiplication factor for each bank and continuing approval of the model should be subject to ongoing review according to APRA's assessment of the quality of each bank's risk management system. APRA advised ANAO that the issue of a higher multiplication factor will be individually addressed for all internal model users if its ongoing supervision or on-site visit highlights problems with a model. However, despite significant and/or ongoing non-compliances by some banks, APRA has never withdrawn its approval of a bank's model or increased the multiplication factor for any bank. In this regard, APRA commented that:

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[109] As a general rule, a higher multiplication factor has a small impact on the capital adequacy ratio.

> *Removal of model recognition is not a decision that can be taken lightly given that it would act as a disincentive for institutions to invest in more sophisticated risk management resources at the expense of both the bank and the financial system. APRA is also wary of the time and costs entailed in setting up the systems to apply the standard model for an interim period when it is not fully satisfied with a bank's internal model compliance. The threat of an increase in a multiplication factor or the inability to reduce the multiplication factor to the minimum of three has proven to be a major incentive for banks to improve their risk management infrastructure. This reflects that the maintenance of a multiplication factor higher than the minimum can reflect poorly on a bank's risk management function.*

**4.22 Finding:** Nine Australian banks were subject to model assessment during 1997 by the Reserve Bank and this led to the acceptance of all banks as internal model users. However, acceptance did not mean that all banks fully complied with all criteria, with only two banks assessed to comply with all criteria at the time their model was approved. APRA advised ANAO that this course of action was taken rather than reject outright non-complying internal models because of the benefits to both individual banks and the financial system of implementing more sophisticated risk management systems rather than relying on the default standard market risk model. Institutions that received a higher multiplication factor were required to rectify outstanding issues to an agreed action plan before a reduction to the minimum level could be achieved.

## Credit concentration

**Principle 9:** Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.

***Basle Core Principles for Effective Banking Supervision***

**4.23** A bank's exposure to credit risk is intensified where it is concentrated with a small number of counterparties. The Basle Committee has noted that a significant proportion of major bank failures have been due to credit risk concentration.[110] At the time of ANAO's audit fieldwork, APRA's guidelines for the supervision of large credit exposures was outlined in Prudential Statement E1 *Supervision of Banks' Large Credit Exposures*. This Statement required each bank to:

- provide (and update as necessary) a statement of its policy in respect of large exposures to individual clients or groups of related clients;

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[110] Basle Committee on Banking Supervision, *Measuring and Controlling Large Credit Exposures*, January 1991, paragraph 1.

- report quarterly to APRA all exposures of the bank and its subsidiaries to individual clients, or groups of related clients, above 10 per cent of the Tier 1 and Tier 2 capital base;
- keep large exposures under review and to place a limit on their size relative to the capital base of the bank and its subsidiaries; and
- give prior notification to APRA of its intention to enter into an exceptionally large exposure to an individual client or group of related clients.

**4.24** In September 2000, APRA issued Prudential Standard *APS 221—Large Exposures*. This Standard aims to ensure that banks and other ADIs monitor and control the risk of credit concentration by limiting their exposures to individual counterparties or groups of related counterparties. The Prudential Standard includes similar obligations to the Prudential Statement as well as some new or revised requirements. In this context, APRA advised ANAO that its large exposures policy for banks and other ADIs is currently subject to review as part of its wider review of the ADI conglomerate policy.

## Large exposure limits

**Principle 9, Additional Criterion 1:** Banks are required to adhere to the following definitions:

- 10 per cent or more of a bank's capital is defined as a large exposure;
- 25 per cent of a bank's capital is the limit for an individual large exposure to a private sector non-bank borrower or a closely related group of borrowers. Minor deviations from these limits may be acceptable, especially if explicitly temporary or related to very small or specialised banks.

***Basle Core Principles for Effective Banking Supervision***

**4.25** The Basle Committee's best practice guidance on measuring and controlling large credit exposures[111] states that a sound supervisory system should include a limit of not more than 25 per cent of group capital on the consolidated private sector non-bank exposures of a banking group combined with a lower reporting threshold of not more than 10 per cent of capital. The rationale for imposing both a 10 per cent reporting threshold and a 25 per cent maximum limit is that the supervisor can devote particular attention to exposures above the 10 per cent reporting threshold and approaching the 25 per cent maximum limit and may, if judged desirable, require banks to take preventative action before the exposure becomes excessively risky (that is, greater than 25 per cent of group capital).[112]

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[111] Basle Committee on Bank Supervision, *Measuring and Controlling Large Credit Exposures*, January 1991, paragraph 25.

[112] Basle Committee on Bank Supervision, *Measuring and Controlling Large Credit Exposures*, January 1991, paragraph 20.

**4.26** What constituted an exceptionally large exposure was not defined in Prudential Statement E1. Instead, all locally incorporated banks were formally advised in writing that an exceptionally large exposure was an exposure to non-bank, non-government clients that exceeded more than 30 per cent of capital. The draft of Prudential Standard APS 221 issued in June 2000 proposed to formalise the definition of exceptionally large exposures as those that exceed 20 per cent of a bank's consolidated capital base with a requirement to seek APRA's permission before any bank proceeds with the exceptionally large exposure. This would have been consistent with the Basle Committee's Core Principles for Effective Banking Supervison. However, this requirement was excluded from Prudential Standard APS 221 issued in September 2000. APRA advised ANAO that the requirement was excluded to acknowledge that there was a need for further industry consultation on the subject and how the new requirement would be implemented. APRA advised ANAO that it considers that its large exposure prior notification requirement sets a clear and effective limit on such exposures.

**4.27** Instead of placing a limit on exceptionally large exposures, Prudential Standard APS 221 requires banks to <u>consult</u> with APRA before committing to the exposure and that the bank <u>be able to</u> satisfy APRA that the proposed exposure does not constitute an excessive risk. ANAO has been advised by AGS that consultation requires a genuine invitation to give advice and proper consideration of the advice given. However, a requirement to consult does not automatically carry with it an obligation to follow advice that is given. Thus, strictly, Prudential Standard APS 221 does not impose a limit on each bank's large exposures in the manner advocated by the Basle Committee. On this point, APRA advised ANAO that other Basle Committee members maintain large exposure policies that provide for discretion to deal with proposed exposures on an individual basis.

**4.28** The Basle Committee has noted that a bank with a relatively high proportion of large exposures is more exposed to potential credit risk and that too great an exposure to particular economic or geographic sectors increases a bank's vulnerability. For these reasons, the Committee advocates that minor deviations from large exposure limits may be acceptable, particularly if the deviations are explicitly temporary or related to very small or specialised banks.

**4.29** In the sample of nine banks examined by ANAO, two banks had advised of exceptionally large exposures since 1997, that is, exposures greater than 30 per cent of capital. The size of these exposures has ranged from 31 per cent of capital up to 63 per cent for one bank and 76 per cent for the other. In this context, APRA advised ANAO that:

*When assessing such exposures [that is, exposures greater than 30 per cent of consolidated capital], APRA would review any proposed arrangements in place to reduce the exposure to 30 per cent of consolidated capital. We usually expect this to involve the sell-down of an exposure to other parties or, in the case of locally incorporated banks controlled by foreign banks, risk shedding of the exposure in excess of 30 per cent of capital to the foreign parent bank. That is, the foreign parent bank assumes the credit risk for the excess of the exposure above thirty per cent of capital. The total amount of risk shedding to foreign banks is limited to four times the locally incorporated bank's capital so as to ensure that it is not unduly exposed to its own parent bank. Also, in the case of exposures that are only slightly above the 30 per cent of consolidated capital limit, we may also take into account other risk mitigants such as conservative loan-to-valuation ratios on the proposed facility.*

**4.30** APRA further noted that a simple capital base limit on large exposures does not fully acknowledge the variety of exposures that a bank can enter into, or the differences in how exposures can be measured. These considerations need to be taken into account when assessing individual transactions to determine the full risk and credit exposure of the institution. Further, the capital based limit for large exposures also does not take into account the capital ratio maintained by a bank at the time it seeks to enter into an exceptionally large exposure.

**4.31** **Finding:** APRA's supervisory requirements do not impose a limit on each bank's ***large exposures*** in the manner advocated by the Basle Committee as there is no prudential limit on a bank's maximum individual customer exposures, only a requirement to consult with APRA. The Basle Committee also advocates that <u>minor</u> deviations from large exposure limits may be acceptable, especially if explicitly temporary or related to very small or specialised banks. However, in the sample of nine banks examined by ANAO, two banks had advised of exceptionally large exposures since 1997, with the size of these exposures ranging from 31 per cent of capital up to 63 per cent for one bank and 76 per cent for the other. APRA advised ANAO that its large exposures policy for banks and other ADIs is currently subject to review as part of its wider review of ADI conglomerate policy.

## Recommendation No.4

**4.32** ANAO recommends that APRA reviews prudential restrictions on bank exposures to single borrowers or groups of related borrowers in accordance with the Basle Committee's best practice guidelines.

### *APRA response*

**4.33** APRA **agrees** with the recommendation. APRA advised that it is reviewing the current large exposures 'limit' with a view to aligning more closely with the Core Principles criteria.

# 5. Supervision of Cross-Border Banking

*APRA aims to adopt a supervisory approach that is in line with international best practice. Using authoritative guidance on international best practice, this chapter examines APRA's supervision of foreign banks operating in Australia as well as the international operations of Australian banks.*

## Introduction

**5.1** Financial conglomerates, particularly those that operate across national borders, raise significant supervisory issues. In particular, there is the risk of contagion due to intragroup exposures. Supervisory responsibility for cross-border banking operations is allocated between host and parent authorities according to whether the cross-border banking operation is in the form of a branch, subsidiary or joint venture (See Figure 5.1).[113] In this context, at the time of the audit APRA had responsibilities as parent supervisor for the overseas operations of Australian owned banks, including 47 branch and 23 subsidiary/joint venture bank operations in 31 countries as well as host country supervisor responsibilities for 25 branches and 10 subsidiaries of foreign banks operating in Australia. Accordingly, the supervision of cross-border banking operations is a significant issue for APRA.

### Figure 5.1
**Supervisory Responsibilities**

| *Responsibility* | *Branches* | *Subsidiaries* |
|---|---|---|
| **Home country supervisor** | • Solvency (Capital adequacy) | • Solvency of entire group |
| **Joint supervision** | • Foreign Exchange | • Foreign Exchange |
| **Host country supervisor** | • Monitor Financial Soundness<br>• Solvency of the subsidiary only | • Liquidity<br>• Liquidity |

Source: ANAO analysis of Basle publications.

113 A branch is defined as an operating entity that does not have a separate legal status and is thus an integral part of the foreign parent bank. Subsidiaries are legally independent institutions, wholly-owned or majority-owned, by a bank that is incorporated in a country other than that of the subsidiary. Joint ventures or consortia are defined as legally independent institutions incorporated in the country where their principal operations are conducted and controlled by two or more parent institutions, most of which are usually foreign and not all of which are necessarily banks.

**5.2** In 1975, the Basle Committee on Banking Supervision produced a report on the supervision of banks' foreign establishments (the Basle Concordat). In May 1983, the Concordat was updated to reflect the need to take a consolidated approach to cross-border supervision. The updated Concordat reflects the principle that bank supervisors cannot be fully satisfied about the soundness of individual banks unless they examine the totality of each banks worldwide business.[114] This principle is also espoused in the Committee's *Core Principles for Effective Banking Supervision*.[115]

**5.3** The Concordat, and subsequent revisions, is intended to ensure that no foreign banking establishment escapes supervision and that supervision is adequate.[116] It was designed to '*encourage more regular and structured collaboration between supervisors with a view to improving the quality and completeness of the supervision of cross-border banking*.'[117] To this end, the Concordat advocates a free flow of information between supervisory authorities and the facilitation of inspections, by either parent or host authorities or both.

**5.4** As a result of the July 1991 closure of the Bank of Credit and Commerce International, the Basle Committee sought to close loopholes and raise standards of supervision and cooperation internationally. Consequently, in July 1992 the Committee promulgated the Basle Minimum Standards for the supervision of international banking groups and their cross-border establishments. The Minimum Standards established the following four main principles:

- all international banks should be supervised by a home country authority that capably performs consolidated supervision;

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114 According to the Basle Committee, consolidated supervision involves:

> *a group-wide approach to supervision whereby all the risks run by a banking group are taken into account, wherever they are booked. In other words, it is a process whereby a supervisor can satisfy himself about the totality of a banking group's activities, which may include non-banking companies and financial affiliates, as well as direct branches and subsidiaries.*

Source: Balse Committee on Banking Supervision, 1996, *The Supervision of Cross-Border Banking*, page 22.

115 Principle 23 states that banking supervisors must practice global consolidated supervision over their internationally active banking organisations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organisations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.

116 The Right Honourable Lord Justice Bingham, *Inquiry into the Supervision of The Bank of Credit and Commerce International*, 1992, page 4.

117 Basle Committee on Banking Supervision, *Information Flows Between Banking Supervisory Authorities*, 1990 page 2.

- the creation of a cross-border banking establishment should receive the prior consent of both the host country and the home country authority;
- home country authorities should possess the right to gather information from their cross-border banking establishments; and
- if the host country authority determines that any of these three standards is not being met, it could impose restrictive measures or prohibit the establishment of banking offices.

**5.5** The publication of the Basle Minimum Standards was followed in October 1996 with the publication of a report[118] by a working group established to consider a number of issues relating to the implementation of the Minimum Standards with a view to overcoming the impediments to effective cross-border supervision. The Basle Committee's September 1997 *Core Principles for Effective Banking Supervision* also includes a number of principles relating to the supervision of cross-border banking.

## Supervision of Australian banks' overseas operations

**5.6** At the time of ANAO's audit fieldwork, APRA had responsibilities as home country supervisor for the operations of Australian banks in 36 different countries (see Figure 5.2) 31 of which have authorised bank operations of Australian banks in their country. In relation to its supervision of Australian banks' overseas operations, APRA advised ANAO that:

> *None of the Australian banks operating offshore could be regarded as undertaking significant trading activities in these locations. On the contrary, the material operations offshore tend to be focussed on retail financial services and domestic commercial business conducted in subsidiaries that are subject to the deposit protection frameworks of their local jurisdictions. As such, even if these operations were impacted by major credit events, we believe that this would not have a major impost on the banking group's consolidated capital base and Australian depositors.*

[118] Report by a working group comprised of members of the Basle Committee on Banking Supervision and the Offshore Group of Banking Supervisors, *The Supervision of Cross-Border Banking*, October 1996.

**5.7** The Basle Committee's *Core Principles for Effective Banking Supervision*[119] require APRA to adequately monitor and apply appropriate prudential norms to all aspects of the business conducted by Australian banks in other countries. According to the Committee, this involves:

- ensuring that the parent bank adequately oversights its overseas operations;[120]
- establishing contract and information exchange with host country supervisors of Australian banks' overseas operations; and
- assessing the nature and extent of supervision conducted by the host country of the local operations of Australian banks.

## Figure 5.2

**Offshore Operations of Australian Banks: August 2000**

| ***Country*** | ***Australian Bank Representation*** | | ***Other Subsidiary Offshore Operations***[121] |
|---|---|---|---|
| | ***Branches*** | ***Subsidiaries & Joint Venture Banks*** | |
| American Samoa | 0 | 1 | 0 |
| Brazil | 0 | 0 | 1 |
| Canada | 0 | 0 | 1 |
| China | 1 | 0 | 1 |
| Cook Islands | 2 | 0 | 1 |
| Fiji | 2 | 1[122] | 0 |
| France | 1 | 0 | 0 |
| Germany | 1 | 0 | 0 |
| Grand Cayman | 1 | 0 | 0 |
| Guernsey | 0 | 1 | 0 |
| Hong Kong | 4 | 0 | 13 |
| India | 0 | 0 | 1 |
| Indonesia | 0 | 2[123] | 1 |
| Japan | 4 | 0 | 1 |
| Jersey | 1 | 1 | 0 |
| Kiribati | 0 | 1[124] | 0 |

*continued next page*

119 Principle 23.

120 APRA's on-site visits to offshore operations of Australian banks is discussed in Chapter 3 of this report.

121 These non bank subsidiary operations include Holding entities, Investment entities, Finance companies, Property entities, Mortgage Finance entities, Funding entities, and Futures entities.

122 Comprises one 51 per cent controlled subsidiary.

123 Includes one 99 per cent controlled subsidiary and one 85 per cent controlled subsidiary.

124 Comprises one 51 per cent controlled subsidiary.

| Country | Australian Bank Representation | | Other Subsidiary Offshore Operations |
|---|---|---|---|
| | **Branches** | **Subsidiaries & Joint Venture Banks** | |
| Malaysia | 1 | 0 | 3 |
| Netherlands | 0 | 0 | 1 |
| Netherlands Antilles | 0 | 0 | 1 |
| New Zealand | 3 | 4[125] | 49 |
| Nuie | 1 | 0 | 0 |
| Papua New Guinea | 0 | 2[126] | 1 |
| Philippines | 1 | 0 | 0 |
| Republic of Ireland | 0 | 1 | 1 |
| Singapore | 4 | 0 | 8 |
| Solomon Islands | 2 | 0 | 1 |
| South Korea | 2 | 0 | 1 |
| Switzerland | 0 | 1 | 0 |
| Taiwan | 2 | 0 | 0 |
| Thailand | 1 | 0 | 0 |
| Tonga | 1 | 1[127] | 0 |
| United Kingdom | 6 | 3 | 18 |
| United States | 4 | 1 | 20 |
| Vanuatu | 1 | 1 | 0 |
| Vietnam | 1 | 0 | 0 |
| Western Samoa | 0 | 2[128] | 0 |
| **Total Countries 36** | **47 in 23 Countries** | **23 in 15 Countries** | **124 in 19 Countries** |

Source: APRA advice to ANAO.

## Ensuring adequate parent bank oversight

**Principle 23:** Banking supervisors must practice global consolidated supervision over their internationally active banking organisations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organisations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.

***Basle Core Principles for Effective Banking Supervision***

**Standard 3:** Supervisory authorities should possess the right to gather information from the cross-border banking establishments of the banks or banking groups for which they are the home country supervisor.

***Basle Minimum Standards***

[125] Includes one 75 per cent controlled subsidiary.

[126] Includes one 90 per cent controlled subsidiary.

[127] Comprises 30 per cent owned representation, joint venture bank.

[128] Includes one 43 per cent owned representation, joint venture bank.

**5.8** APRA's Prudential Standards and Guidance Notes apply to the global operations of Australian banks. For example, APRA Guidance Note AGN110.1—Consolidated Group states[129] that APRA prefers to supervise the capital adequacy of banks and their subsidiaries on a fully consolidated basis but that exceptions to this approach will be considered where consolidation is not judged appropriate for accounting reasons and/or where the non-consolidated subsidiary is subject to effective supervision by another authority. Market risk capital requirements apply to both the bank as a stand alone entity and its global consolidated operations.[130] Banks are also required to report large exposures in terms of the consolidated group[131] and banks' policies, systems and controls for managing liquidity are to apply both to the Australian bank and the group as a whole.[132]

**5.9** In addition to consolidated information received from banks on their capital adequacy, large exposures and liquidity management policies, APRA requires banks to submit quarterly returns that identify the assets, risk-weighted assets, liabilities, off-balance sheet business and impaired assets in each country in which the bank is operating. The activities of overseas operations of Australian banks may also be discussed in the annual prudential consultations held with bank management or by requesting reports from internal and/or external auditors.

**5.10** ANAO's audit sample of eight banks included three Australian-owned banks that have overseas operations. ANAO noted that two of these banks have on different occasions refused to provide APRA with access to data that had been sought for supervisory purposes as follows:

- APRA's on-site credit risk visits procedures include reviewing individual credit files which, for some banks, involves loans written in offshore locations. During a 1999 credit risk visit to the Australian head office of one bank, APRA was denied access to credit files sought in relation to two of the bank's United Kingdom subsidiaries. APRA chose not to exercise its powers to obtain the information it had sought during the visit, instead preferring to advise the bank that, in future, it should be willing to provide any files requested in conformity with section 62 of the Banking Act. APRA advised ANAO that its decision not to pursue the bank in this instance was based on its assessment of the credit file involved.

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129 Paragraphs 1 and 2.

130 Prudential Standard APS 113—Capital Adequacy: Market Risk, paragraph 3.

131 Prudential Standard APS 221—Large Exposures, paragraph 4.

132 Prudential Standard APS 210—Liquidity, paragraph 6.

- Another bank has declined on several occasions to provide the Reserve Bank and, more recently, APRA with information on certain of the bank's offshore operations. In one instance, the offshore subsidiary was not being supervised by the host country authority as the bank had not met its undertaking to APRA to establish an authorised branch operation and, until mid 2000, neither APRA nor the bank had informed the relevant host country supervisor.[133] APRA advised ANAO that it did not advise the host country supervisor of the bank's activities earlier because APRA expected the bank to re-organise its activities so as to put itself under the host country supervisor's supervision. APRA also noted that it has set a deadline for the institution to provide a report on its representational options in this domicile and is closely monitoring developments on this issue.

**5.11 Finding:** APRA's Prudential Standards and Guidance Notes enable APRA to practice global consolidated supervision of Australian banks' internationally active banking organisations. At the time of ANAO's audit, Australian banks had 194 operations in 36 countries. APRA collects a range of information concerning Australian banks' offshore operations but there have been occasions where supervised entities have denied APRA access to information concerning their offshore operations, although APRA has advised ANAO that it will pursue such information where it considers it material.

## APRA's relationship with host country supervisors

**Principle 1:** Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

**Principle 24:** A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.

***Basle Core Principles for Effective Banking Supervision***

**Standard 2:** The creation of a cross-border banking establishment should receive the prior consent of both the host country supervisory authority and the bank's and, if different, banking group's home country supervisory authority.

***Basle Minimum Standards***

[133] APRA has advised ANAO that the offshore subsidiary was conducting business which APRA considered was unlikely to be required to be supervised by the host country authority and, subsequent to notification from APRA, the host supervisor has raised no concerns about the activity.

**5.12** APRA's approach to supervising Australian banking operations overseas is to place significant reliance on the host country supervisor. In this context, the Basle Committee advocates a number of principles to govern an effective relationship between home and host country supervisors. Among other things, these principles require APRA to:

- inform host supervisors about matters affecting Australian banks with an office in the host territory;[134]
- not authorise Australian banks to establish or acquire offices in any host jurisdiction without satisfying itself in advance that such offices will be subject to appropriate supervision;[135] and
- establish arrangements with host country supervisors for appropriate information sharing in relation to the overseas operations of Australian banks.[136]

### *Informing host supervisors*

**5.13** The Basle Concordat states that when domestic banks plan to establish cross-border operations in another territory, parent authorities should consult with host authorities to ensure that the host authorities are aware of the overall systems within which the foreign establishments are operating.[137] It is also a requirement of the Basle Minimum Standards[138] that cross-border expansion of banking operations not be permitted unless both the parent and host country supervisory authorities have given their consent.

**5.14** At present, APRA does not have procedures in place to ensure overseas supervisors are apprised of the activities of Australian banks in their jurisdiction and APRA does not, as a matter of course, seek host country supervisor consent before permitting Australian banks to establish an offshore banking operation. For example, in July 1999, one Australian bank in ANAO's sample advised APRA that it planned to establish a single purpose banking subsidiary in New York, pending the establishment of a branch within nine to twelve months. During this time, neither APRA nor the bank advised the host country regulator of the bank's activities or future plans, with the bank subsequently indicating to APRA that it

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[134] Basle Committee on Banking Supervision, *Information Flows Between Banking Supervisory Authorities*, 1990, pages 3–4.

[135] Basle Committee on Banking Supervision, *The Supervision of Cross-Border Banking*, 1996, page 6.

[136] Basle Committee Core Principle 24, Essential Criterion 1 and Additional Criterion 2

[137] Basle Committee on Banking Supervision, *Principles for the Supervision of Banks' Foreign Establishments*, 1983, page 7.

[138] Standard 2.

did not wish to be subject to host country supervision for these operations. Following an approach from the bank, in July 2000, APRA extended its approval for the 'temporary' arrangements to continue until January 2001 on the basis that they will then be replaced by a structure that satisfied APRA. In August 2000, APRA advised the host country supervisor of the bank's activities.

### *APRA authorisation*

**5.15** The Prudential Standards do not explicitly permit APRA to prohibit an Australian bank from establishing, or continuing to operate, in a host jurisdiction where APRA considers prudential supervision is inadequate. All that is required is that banks consult[139] APRA before commencing any significant new overseas operations.[140] Accordingly, the only avenue through which APRA could prohibit the establishment of an overseas operation is by issuing a direction under the Banking Act or by imposing a condition on the banking licence.

**5.16** When considering banks' proposals to operate in foreign jurisdictions, APRA does not assess the host country supervisor against the Basle Core Principles or otherwise seek to satisfy itself that host supervision is adequate. This is despite the reliance placed by APRA on host supervisors and the Basle guidance that APRA not authorise Australian banks to establish or acquire offices in any host jurisdiction without satisfying itself in advance that such offices will be subject to appropriate supervision.

### *Information sharing arrangements*

**5.17** Under the Basle Core Principles, Australian banks conducting banking business in foreign jurisdictions should be subject to a licensing (or authorisation) process in the host country. The authorisation process is considered by the Basle Committee to offer an ideal opportunity for parent authorities to create the basis for cooperation, collaboration and information sharing.[141] This is because authorisation of the overseas office of an Australian bank provides the first opportunity to establish an understanding between home and host supervisors as to what information is required by each party and how it can be provided.

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139 Licences of some banks also require them to consult with the Reserve Bank, which was the prudential supervisor when these licences were issued. In this context, the Australian Government Solicitor advised ANAO that, although consultation requires a genuine invitation to give advice, there is no automatic requirement to follow the advice that is given.

140 Prudential Standard APS222, *Equity Associations*, paragraph 6.

141 Basle Committee on Banking Supervision, *Information Flows Between Banking Supervisory Authorities*, 1990, page 2.

**5.18** The Basle Committee advocates that a key component of consolidated supervision is establishing contact and information exchange with host country supervisors. Information sharing arrangements are to include being advised of the financial performance, operations and any adverse assessments of qualitative aspects of a bank's overseas operations such as the quality of risk management and controls. The Basle Committee considers that the discussions establishing these understandings can also assist the two supervisors appreciate more fully the nature of each other's supervisory process, and the comfort that can be taken from it.[142]

**5.19** Information sharing arrangements can take the form of bilateral memoranda of understanding (MOU) or exchanges of letters that outline what each party expects from the relationship. At the time of the audit, APRA had formal information sharing arrangements in place with supervisors in only two countries, being the United Kingdom and Germany. APRA records indicate that it also has informal information sharing arrangements in place with supervisors in the United States and New Zealand. However, no such arrangements exist in relation to supervisors in the other 32 countries in which Australian banks are operating. APRA advised ANAO that its legislation, and that of a number of overseas supervisors, allows information to be provided to overseas supervisors without the need for a formal information sharing arrangement and that information is shared without formal arrangements in place.

**5.20** **Finding:** APRA's approach to supervising Australian banking operations overseas is to place significant reliance on the host country supervisor. However, in relying on host supervisors, APRA: does not have procedures in place to ensure overseas supervisors are apprised of the activities of Australian banks in their jurisdiction; does not assess host country supervision against the Basle Core Principles or otherwise seek to satisfy itself that host supervision is adequate; has formal information sharing arrangements in place with supervisors in only two countries; and has informal arrangements in another two countries out of the 36 countries in which Australian banks are operating.

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142 Basle Committee on Banking Supervision, *The Supervision of Cross-Border Banking*, 1996, page 8.

## Supervision of foreign banks' operations in Australia

**Principle 25:** Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.

***Basle Core Principles for Effective Banking Supervision***

**Standard 1:** All international banking groups and international banks should be supervised by a home country authority that capably performs consolidated supervision.

***Basle Minimum Standards***

**5.21** Up until the 1980s, with very few exceptions,[143] foreign banks had not been permitted to operate in Australia. The 1981 final report of the Campbell Inquiry recommended the existing embargo on non-resident participation in Australian banking be removed.[144] As a result, in 1985 fifteen foreign banks accepted the invitation to establish a subsidiary in Australia.[145] In February 1992, the then Prime Minister announced that, subject to compliance with Reserve Bank prudential guidelines, foreign banks would be permitted to operate in Australia as branches, as well as subsidiaries.[146]

**5.22** In evidence to the 1991 House of Representatives Standing Committee on Finance and Public Administration Inquiry into Banking and Deregulation, the Reserve Bank suggested that the development of appropriate supervisory arrangements for the branches of foreign banks depended on the adequacy of supervision in the banks' home country. On balance, the Committee supported the proposal to allow foreign banks to operate in Australia as branches, subject to the establishment of appropriate supervisory arrangements including examination of branch operations by Australian supervisors.[147] At the time of the audit (see Figure 5.3), there were 35 foreign branches and subsidiaries operating in Australia representing 13 countries with a total of 18 parent supervisors (some overseas banks are supervised by more than one agency).

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143 Namely the Bank of New Zealand and the Banque Nationale de Paris which had established branch operations in Australia prior to the introduction of a policy in 1945 that precluded foreign interests from carrying on banking business in Australia.

144 *Australian Financial System*, Final Report of the Committee of Inquiry, September 1981, paragraph 25.24. Other recommendations included: that the rate of entry of foreign banks be carefully managed (paragraph 25.26); that foreign bank participation in domestic banking only be restricted through the number of licences granted (paragraph 25.50); and banking licences issued to non-residents carry no encumbrances additional to those attached to licences held by residents such that identical privileges and responsibilities would be applied.

145 Reserve Bank of Australia, *Bulletin*, July 1989, page 21.

146 Reserve Bank of Australia, *Bulletin*, January 1994, page 23.

147 The House of Representatives Standing Committee on Finance and Public Administration, *A Pocket Full of Change*, 1991, paragraphs 10.40, 10.45 and 10.46.

**Figure 5.3**

**Foreign Banks Operating in Australia**

| *Country* | *Parent Supervisory Authority* | *Branches* | *Subsidiaries* | *MOU* |
|---|---|---|---|---|
| Canada | Superintendent of Financial Institutions | 2 | 0 | No |
| China | Peoples Bank of China | 1 | 0 | No |
| France | Commission Bancaire | 1 | 0 | No |
| | Banque De France | | | No |
| Germany | Deutsche Bundesbank | 3 | 0 | Yes |
| | Federal Banking Supervisory Office | | | No |
| Hong Kong | Hong Kong Monetary Authority | 0 | 1 | No |
| Netherlands | De Nederlandsche Bank | 3 | 2 | No |
| Japan | Financial Services Agency | 2 | 2 | No |
| Jordan | Central Bank of Jordan | 0 | 1 | No |
| Singapore | Monetary Authority of Singapore | 3 | 0 | No |
| Switzerland | Swiss Federal Banking Commission | 1 | 0 | No |
| Taiwan | The Central Bank of China (Taipei, Taiwan) | 1 | 0 | No |
| United Kingdom | Financial Services Authority | 2 | 3 | Yes |
| United States | Federal Reserve Bank | 6 | 1 | No |
| | State of New York Banking Department | | | No |
| | Massachusetts Commissioner of Banks | | | No |
| | Office of the Comptroller of Currency | | | No |
| **Total Countries** | **Total Parent Supervisory Authorities** | **Total Branches** | **Total Subsidiaries** | **Total MOU's** |
| **13** | **18** | **25** | **10** | **2** |

Source: APRA data.

## Assessment of parent authority supervision

**Standard 4:** If a host country authority determines that any one of the Basle Minimum Standards is not met to its satisfaction, that authority should impose restrictive measures necessary to satisfy its prudential concerns consistent with these Minimum Standards, including the prohibition of the creation of banking establishments.

***Basle Minimum Standards***

**5.23** According to the Basle Committee, if the parent supervisory authorities do not meet the Basle Minimum Standards for cross-border banking supervision, or APRA is unable to obtain a satisfactory response from the parent authorities concerning these Standards, APRA may:[148]

- deny the granting of an authority to carry on banking business in its territory;
- grant the authority subject to specific prudential restrictions;[149] or
- accept full responsibility for, or increase the intensity of, supervision of the new establishment.

**5.24** APRA places significant reliance on the supervision conducted by home country supervisors of foreign bank subsidiaries and branches operating in Australia. APRA implicitly accepts that supervision by each of the 18 parent country supervisors for the 35 foreign bank operations in Australia complies with the Basle Minimum Standards and the Basle Core Principles. Currently, APRA has not placed specified prudential restrictions on any foreign banks or increased the intensity of its supervision because of unsatisfactory home country supervision. In this context, APRA advised ANAO that:

> *APRA would generally not grant an authority for a foreign bank branch or bank subsidiary if unsatisfactory home country supervision existed in the first instance. While this has not involved us making a detailed assessment of home country supervision against the Basle Core Principles, it has involved us making an assessment of whether a foreign supervisor uses the Basle Capital Accord framework. Where APRA has authorised an entity in which we are relatively unfamiliar with its home country supervision, and where we have not had a long history of performance to observe, we have imposed high capital adequacy ratios.*

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148 *Minimum Standards for the Supervision of International Banking Groups and their Cross-Border Establishments (*July 1992 page 5–6*), Information Flows Between Banking Authorities (*1990 page 6*)* and *Principles for the Supervision of Banks' Foreign Establishments (*also known as the Concordat page 3*).*

149 In this case, the Committee recommends that the conditions (and any subsequent changes in the conditions) be communicated to the parent supervisory authority.

**5.25** Before granting a banking authority to the foreign applicant, under the Basle Committee's principle of consolidated supervision, APRA should assess whether the home country supervisors of foreign bank subsidiaries and branches operating in Australia capably perform consolidated supervision and are meeting the Basle Minimum Standards for cross-border supervision.[150] ANAO examined the two most recent licensing processes for foreign banking operations and found no evidence that an independent assessment was conducted or that any previous assessment of the supervisor was reviewed prior to the licences being granted. There was no documented analysis of: the statutory powers of the relevant supervisors; past experience with these supervisors in relation to other banks; and the supervisory practices of the home country supervisor. In these circumstances, there was no basis for the high level of reliance placed by APRA on home country supervisors of foreign branches and subsidiaries.

**5.26** APRA advised ANAO that:

- where the subject home supervisor has previously been accepted, it has not been usual practice to undertake a further review of its supervisory framework;
- it seeks signed undertakings from home supervisors to confirm if applicants' home country supervisors apply the Basle supervisory framework;
- where it is unfamiliar with home country supervision and there is not a long history of performance to observe, APRA would impose a higher minimum capital requirement on the applicant;
- it is not practical for APRA itself to conduct extensive reviews of banking supervisors in other jurisdictions against the Basle Core Principles, however detailed assessments are being conducted by the World Bank and these will form a solid basis for future decisions about offshore supervisors;
- Australia's foreign bank community is essentially drawn from Basle Committee countries or internationally recognised jurisdictions, with supervisory regimes that are transparent and well documented. APRA also keeps up-to-date with developments in such frameworks through its regular attendance at meetings of international supervisors; and

[150] This assessment is to incorporate an examination of the parent supervisor's statutory powers, past experience in their relations, and the scope of its supervisory practices. Source: Basle Committee on Banking Supervision, *Minimum Standards for the Supervision of International Banking Groups and their Cross-Border Establishments*, 1992, page 2.

- in the mid 1990s at a time of expected high application activity, the Reserve Bank commissioned a series of country papers on key domiciles from which potential applicants were expected to be drawn.

**5.27** **Finding:** APRA places significant reliance on the supervision conducted by home country supervisor of foreign bank subsidiaries and branches operating in Australia. An important prerequisite for effective supervision of cross-border banking operations is a rigorous assessment of the quality of supervision undertaken in the home country of foreign banks. However, APRA does not assess foreign supervisors' statutory powers, past experience in their relations, or the scope of their supervisory practices. Counteracting this, APRA advised ANAO that it has adopted other procedures to address the quality of supervision provided by home country supervisors.

## Contact and information sharing arrangements

**Principle 1:** Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

**Principle 24:** A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.

***Basle Core Principles for Effective Banking Supervision***

**5.28** It is necessary for banking supervisors to have the legal power to gather and share information for the purpose of carrying out consolidated supervision.[151] In this context, the APRA Act enables exchange of information between APRA and other regulators including foreign regulators.[152] At the time of this audit, APRA had formalised contact and information sharing arrangements with only two of the 18 supervisors of foreign banks operating in Australia. APRA advised ANAO that, while there are no formal procedures in place to escalate concerns to a parent supervisor, its desire to communicate with these will be a function of materiality such that issues need to be assessed on their individual merits and cannot be simply handled by generic operating procedures.

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[151] Basle Committee on Banking Supervision, *Core Principles for Effective Banking Supervision*, 1997, Principles 1, 24 and 25.

[152] Australian Prudential Regulation Authority Bill 1998, Explanatory Memorandum, paragraph 4.49.

**5.29** The importance of liaison and coordination between supervisors has also been stressed by the Joint Forum of the Balse Committee, the International Organization of Securities Commissions and the International Association of Insurance Supervisors. These agencies advocate that supervisors liaise closely with one another to ascertain each other's concerns and coordinate, as deemed appropriate, any supervisory action relevant to risk concentrations and intra-group transactions and exposures.[153]

**5.30** ANAO's examination of APRA's supervisory records revealed that there is minimal formal communication between APRA and home country supervisors. To provide added assurance regarding APRA's reliance on home country supervisors, ANAO considers there is merit in APRA establishing formal information sharing arrangements and seeking periodic confirmation from home country supervisors that there are no issues of concern that APRA needs to be made aware of.

**5.31** **Finding:** The APRA Act enables exchange of information between APRA and other regulators including foreign regulators. APRA has formalised contact and information sharing arrangements with only two of the 18 supervisors of foreign banks operating in Australia. Furthermore, where APRA has identified concerns with the Australian operations of foreign banks, procedures are not in place to inform the home country supervisor of APRA's concerns, or to seek advice from the parent supervisor on whether the Australian operation's relationship with its parent bank might mitigate APRA's concerns. On this point, APRA observed that its desire to communicate such matters will be a function of the materiality of the issue, and thus each decision will need to be assessed individually. APRA also does not seek periodic confirmation from home country supervisors that there are no issues of concern that APRA needs to be made aware of. APRA advised ANAO that the lack of formal information sharing arrangements with individual home country supervisors has not impeded its ability to inform home country supervisors of material concerns.

[153] The Joint Forum, *Intra-Group Transactions and Exposures Principles*, December 1999, Principle IV and The Joint Forum, *Risk Concentrations Principles*, December 1999, Principle IV.

## Recommendation No.5

**5.32** ANAO recommends that APRA enhances its supervision of the international operations of Australian banks and the Australian operations of foreign banks by:

(a) documenting, and regularly updating, assessments of the quality of supervision provided by overseas supervisors drawing, as appropriate, on assessments completed by internationally recognised agencies;

(b) establishing formal information sharing arrangements with relevant overseas supervisors;

(c) seeking periodic confirmation from overseas supervisors that there are no issues of concern relating to foreign parent banks and overseas operations of Australian banks that APRA needs to be made aware of; and

(d) where there are concerns about the Australian operations of foreign banks or the international operations of Australian banks, promptly informing the relevant overseas supervisor of these concerns.

### *APRA response*

**5.33** APRA **agrees** with the recommendation. In relation to part (c), APRA commented that the use of periodic confirmation from home country supervisors regarding any issues of concern about the parents of foreign bank branches would enhance its home country supervision framework. APRA advised that a project has been scoped to address generally the use of formal information-sharing mechanisms with offshore supervisors and receipt of periodic confirmations from home country supervisors about the operations of foreign and Australian banks.

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Canberra ACT
30 May 2001

P. J. Barrett
Auditor-General

# Appendix

## Appendix 1

# 1997 Basle Core Principles for Effective Banking Supervision

### Preconditions for Effective Banking Supervision

**1.** An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banking organisations. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking organisations and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

### Licensing and Structure

**2.** The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word 'bank' in names should be controlled as far as possible.

**3.** The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organisation's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.

**4.** Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.

**5.** Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

## Prudential Regulations and Requirements

**6.** Banking supervisors must set prudent and appropriate minimum capital adequacy requirements for all banks. Such requirements should reflect the risks that the banks undertake, and must define the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the Basle Capital Accord and its amendments.

**7.** An essential part of any supervisory system is the evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.

**8.** Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and loan loss reserves.

**9.** Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.

**10.** In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, such that extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.

**11.** Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.

**12**. Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

**13.** Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks.

**14.** Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

**15.** Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict 'know-your-customer' rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.

## Methods of Ongoing Banking Supervision

**16.** An effective banking supervisory system should consist of some form of both on-site and off-site supervision.

**17.** Banking supervisors must have regular contact with bank management and thorough understanding of the institution's operations.

**18.** Banking supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on a solo and consolidated basis.

**19.** Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.

**20.** An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.

## Information Requirements

**21.** Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.

## Formal Powers of Supervisors

**22.** Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking licence or recommend its revocation.

## Cross-border Banking

**23.** Banking supervisors must practise global consolidated supervision over their internationally-active banking organisations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organisations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.

**24.** A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.

**25.** Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.

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