



10 September 2001

Ms Bev Forbes
Secretary
House of Representatives Standing Committee on
Economics, Finance and Public Administration
Parliament House
CANBERRA ACT 2600

Dear Ms Forbes

Inquiry into Bank Prudential Supervision: APRA

The International Banks and Securities Association of Australia (IBSA) represents and promotes the interests of investment banks engaged in wholesale banking, securities and financial markets business (list of members attached).

Most members are supervised by APRA as authorised deposit taking institutions (ADIs). Our members represent a substantial investment in the banking sector and they share a joint interest with APRA and the Government in the effective prudential supervision of banks. This involves sound prudential rules applied with flexibility and good judgement.

Investment banks generate healthy competition within the financial sector and provide a range of finance, advice and risk management services to business and government, with important downstream benefits to retail consumers. They also generate significant employment and tax revenue. Investment banks are typically international institutions and foreign banks have a strong presence in the Australian market, mainly through branch operations.

Investment Banks & APRA Supervision

Branches of foreign banks account for half of IBSA's 40 members. Their parent bank's regulator, which has responsibility for their solvency supervision under the Basle Accord, primarily supervises them and they are consequently subject to limited supervision by APRA. IBSA's membership covers another seven banks (mainly foreign-owned) that are locally incorporated and these are subject to full APRA supervision.

Investment banks service corporate and government clients, providing them with finance, access to the capital markets, corporate advice and risk management facilities, amongst other things. They are quite different to retail banks and typically do not conduct retail banking; indeed, regulation effectively excludes foreign branch banks from the retail market. Consequently, the consumer

protection element of regulation that is vital for retail banks is usually not relevant to investment banks.

Broad Approach to Regulation

APRA's approach has been to regulate locally incorporated investment bank ADIs in exactly the same way as retail banks, because they have the potential to accept retail deposits. Foreign branch banks are subject to less intensive regulation by APRA primarily because the home country supervisor of their parent bank already supervises them and there is no need to duplicate the process.

Members have reported that APRA operates with a high level of commitment and its approach to the supervision of their business is firm but fair. Industry acceptance of APRA's regulatory constraints on their business is predicated in large part on a shared interest in the security of the banking system and public confidence in it, along with an understanding of the methods and objectives of its prudential supervision.

There are a wide variety of individual bank circumstances to be accommodated safely within the supervisory regime. The application of harmonised prudential regulation across a range of ADIs that conduct a variety of businesses is a difficult task that requires flexibility in administration to deliver a consistent outcome. Well-balanced prudential standards are an excellent start but this must be supplemented by good judgement in their implementation. This seems to have been achieved in part because APRA adopts a pragmatic approach to supervision.

APRA's Resources

The Committee has indicated that the scope of the Inquiry includes APRA's resourcing. From our experience, APRA seems to be adequately resourced in terms of staff numbers. It seems to have successfully negotiated the distracting establishment process, though it lost some experienced staff when responsibility for banking supervision was transferred from the Reserve Bank to it.

Looking to the future, it will be necessary to maintain a good depth of technical expertise within APRA especially if, as seems likely, the new Basle Capital Accord places much greater reliance on banks' internal risk management systems. To accommodate this APRA must have the ability to attract and retain good staff that are skilled and experienced, to form the core of its operational base.

Consultation

APRA's consultation with industry on the development of policy and design of prudential standards has been good. We feel that this has improved both the quality of prudential supervision and industry's understanding of it, which is always helpful in securing acceptance of conditions that impose costs or conditions on a bank's business. The open and constructive manner in which APRA has operated has probably helped it to keep abreast of industry developments, as banks are more comfortable approaching it for advice about business issues on which supervision could have a bearing. The alternative more

rigid, legalistic approach inhibits a free and open exchange in regard to problems and issues.

The ANAO Report Recommendations

To assist the Committee in its deliberations, we provide detailed comments on each of the five Australian National Audit Office (ANAO) recommendations in attachment 1. Some key points to note include:

1. The APRA levy for ADIs is seriously flawed and penalises small to medium sized banks in particular. The fundamental problem lies in the levy legislation, not APRA's administration of it. The levy structure should be reviewed without delay to make it fairer for individual ADIs and to provide a sustainable funding basis for APRA.
2. The issue raised by the ANAO in regard to APRA's risk rating process is minor in the overall scheme of things. The rating process pushes supervision resources to the area of greatest need and is far superior to a rigid code on supervision activity.
3. The timing of APRA's on-site visits to domestic banks should be determined by its risk rating process and not prescribed in accordance with a periodic cycle. APRA should judge the need to visit the offshore operations of domestic banks on a case-by-case basis.
4. APRA adopts a cautious approach to the supervision of banks' large exposures, which can be more demanding than the international standard. It should proceed as planned with its large exposures policy review.
5. Formalisation of APRA's information sharing arrangements with foreign supervisors is sensible. Amongst other things, it should deal with the requirement to notify the other regulator of relevant material concerns. Reliable international assessments of foreign supervision regimes are emerging and should be used if needs be, rather than taking up APRA's resources on an independent review.

Summary Comments

Although APRA is a young organization, its banking supervision operations draw off extensive experience gained over a long period in the Reserve Bank, which was recognised as a sound and effective bank supervisor. The transition to APRA has been satisfactory and it continues supervision based on good judgement and flexibility that is balanced with resolute supervisory guidance. This approach has stood the test of time and the quality of APRA's supervision has been commented on favourably by overseas bankers that have had dealings with it.

As is apparent from the ANAO report, there are no serious weaknesses in the way in which APRA approaches bank supervision. It would be a mistake to further codify the detail of its operations, as this would remove discretion that is essential to a good regulator, if it is to deal effectively with different banks' circumstances and ever changing conditions.

We are grateful for the opportunity to provide comments to the Committee and would be happy to contribute further to your work, as appropriate. Please contact me if there are any matters arising from this submission.

Yours sincerely

Duncan Fairweather
Executive Director

Attachment 1.

Comments Arising from the ANAO's Recommendations

FINANCIAL GOVERNANCE

Recommendation 1

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.

The ANAO report recommends several measures that APRA should implement to improve its administration of the APRA levy. There is merit in the ANAO recommendation, but we believe that it does not address the more substantive problems created by the levy structure. The Government has signalled that it plans to review the levy some time around 2003. We recommend that this review be brought forward to provide levy arrangements that are more secure and fairer.

1. The Levy Structure is Seriously Flawed

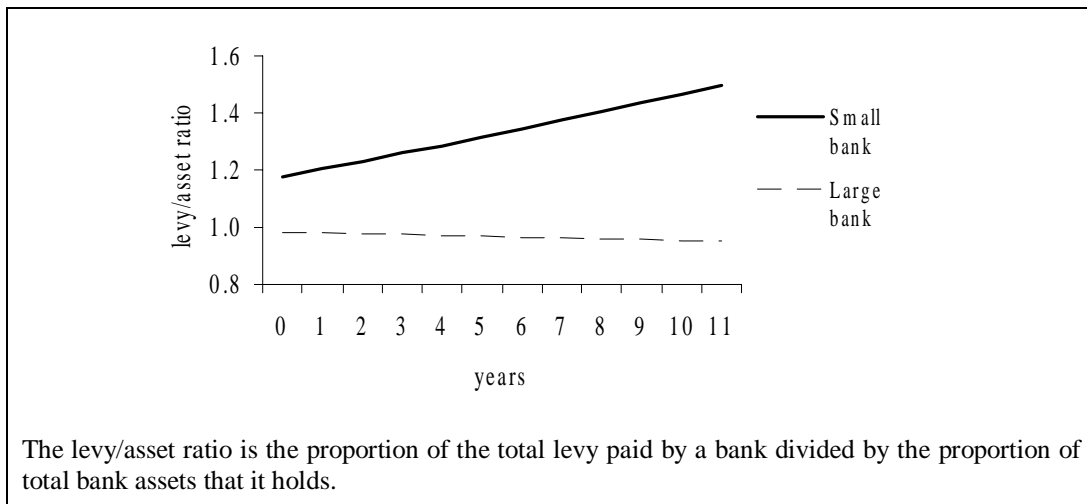
APRA must administer the levy strictly under the terms of the associated legislation. However, this legislation is flawed because it does not deliver a fair or sensible levy for individual ADIs – for example, see figures 1 and 2. APRA is not responsible for the consequent difficulties, as it is only responsible for the administration of the levy. However, it has assisted efforts to limit the problem.

Figure 1 - Examples of ADI Levy Anomalies

- Last year IBSA members paid for 70% of the full cost of supervising banks, even though they hold only 16% of bank assets – the previous year they paid for *more* than the total cost of APRA's supervision of bank ADIs (reflecting cross-subsidisation of non-bank ADIs).
- Citibank pays about 35% more for APRA ADI supervision than do each of the major domestic banks.
- Bank ADIs paid a levy of \$18.1 million, even though their prudential supervision cost is \$10.4 million – small to medium bank ADIs were penalised most by the overcharging.
- The effect of the cap is that small and medium sized ADIs effectively paid for *all* of APRA's start up costs – incremental costs arising from the ANAO report (eg through APRA visits to the major banks' overseas operations) will similarly have to be met by this group.
- Foreign branch banks are charged for the cost of ASIC consumer protection under the levy, even though they are not permitted to take retail deposits.
- Over time, smaller banks will pay proportionately more than the larger banks, as long as there is real growth in deposits (see figure 2) – fast growing banks will suffer most.

Note: Data are calculated using ADI asset figures published by APRA and cost of bank supervision information reported by ANAO and the Financial System Inquiry.

Figure 2 - Trend to Levy Cost for Small and Large Banks
(bank X's proportion of levy/bank X's proportion of assets)



Assumptions:

There are only two banks; a small bank and a large bank that is 10 times the size of the small bank. Small bank is well under the levy cap, large bank benefits from the levy cap; Inflation is 2.5%, real deposit growth for both banks is 3.5% (in line with economic growth).

Figure 2 illustrates that the proportionate cost of the APRA levy increases markedly over time for smaller banks if there is a cap on the charge to large banks. This hinders competition in the banking market, by penalising new and fast growing banks. The divergence in between the large and small bank in figure 2 would be more accentuated for a newly established bank, or a revitalised small bank, that records deposit growth above the average rate.

2. The Source of the Problem

The ANAO report does not address the main problem with the levy, which is its structure as determined under the legislation. This is much more harmful than the comparatively modest administrative deficiencies that have been identified.

The main structural problem is that it does not facilitate the allocation of costs across individual ADIs on a ‘user pays’ basis. This gives rise to the anomalies outlined above. A further significant problem is that the levy structure will not be sustainable if there is further consolidation within the banking sector.

This problem arises from:

- A failure to fully identify the ‘users’ of supervision;
- The arbitrary \$1 million levy cap, and
- The ‘user pays’ principle is applied at the sectoral level rather than at the individual institution level – combined with the levy cap, this gives rise to significant cross subsidisation within the sector that is largely at the expense of small to medium ADI banks.

3. How to Correct the Levy Structure

In so far as is possible, the levy structure should be transparent, so that the estimated cost of supervising each category of institution is apparent and can be compared to the levy raised from that category of institution.

Step 1 – Identify the Users of the Supervision

If the levy charge were to be allocated on a ‘user pays’ basis, then the first step would be to identify the full range of ‘users’ of APRA supervision ADI supervision. The main outputs from APRA supervision are widely recognised as¹:

1. Reduction in systemic risk arising from institutional failure
2. Depositor protection
3. Authorisation (licensing) of deposit taking institutions

Output 1 greatly reduces the risk of financial crisis that would disrupt the economy. This is a public good, which benefits all Australians, including business and consumers.

Output 2 protects depositors from the risk of an ADI failure (but it does not guarantee that an ADI will not fail or that depositors’ funds will not be lost). Depositors benefit directly and there is a public benefit through the consequent support for the credit intermediation and investment process that is critical to economic growth.

Output 3 provides ADIs with a license to collect deposits from the general public on an unrestricted basis (apart from APRA supervision). The value of this is predicated in part on public confidence that funds deposited with ADIs will be returned.

The current levy structure is flawed in part because it is based entirely around output 3, to the exclusion of the other two. The distribution of benefits from output 3 is a poor guide to the distribution of benefits across institutions, business and individuals from outputs 1 and 2.

Step 2 – Divide the Cost of APRA’s Supervision between the User Groups

The second step would be to divide the cost of APRA’s supervision across each set of users. This would be a subjective task, but it would not be hard to improve upon the existing situation. The approach adopted would necessarily have to be broad brush and pragmatic.

Step 3 – Allocate Individual User Charges

The third step would be to allocate costs determined under step 2 across the users of the APRA supervision, as summarised in figure 3.

Figure 3

Output	Beneficiary or ‘User’	Cost recovery from
1. Systemic risk control	Public benefit	Government
2. Depositor protection	Depositors/Public benefit	Government/depositors
3. Licence to Take Deposits	ADIs	ADIs

¹ For example, see the Wallis Financial System Inquiry Final Report.

If the costs in step 2 were identified, it would be relatively easy to allocate costs across each set of users. For example, the Government is a reasonable proxy for the beneficiaries from output 1 and output 2, while licensed ADIs are readily identifiable, so costs could be allocated accordingly to each. There are alternatives, for example, the deposit base for each ADI could be used as a proxy to allocate the charges relating to output 2.

A number of issues would need to be resolved in settling the detail of the rules, for example:

- The question of cross subsidisation across individual ADI institutions;
- The need for a levy cap to reflect the scale beneficiaries in APRA supervision (ie it costs less proportionately to supervise a big ADI than a small ADI) – logically a cap could only be applied to charges in respect of output 3;
- The need for adjustments to take account of regulatory variations that affect the outputs; for example, foreign branch bank ADIs are primarily supervised by overseas regulators, not APRA, and they do not benefit from the depositor protection provision of the Banking Act;
- APRA’s ability to accurately allocate its costs across individual ADIs for the purpose of distributing the charge relating to output 3 – this is the only issue that ANAO focussed on in its report, and
- The treatment of financial conglomerates that pay several APRA levies.

4. Concluding Comments on the Levy

The purpose of the above discussion is to demonstrate the need for a levy review and to draw out the framework that would be appropriate to it. It is not offered as a comprehensive solution, as the practical details would have to be settled through discussions involving all of the stakeholders. However, the levy is always likely to deliver anomalous outcomes in absence of a broader based approach than that currently adopted in the legislation.

A full review of the APRA levy would be necessary to deal with these issues once and for all. We believe that this is now both desirable and necessary.

SUPERVISORY FRAMEWORK

ANAO’s assessment of APRA’s supervision of banks is to a large degree based on its compliance with the Basle Committee’s *Core Principles for Effective Banking Supervision*. We agree that the Core Principles are a good benchmark for this purpose. However, good prudential supervision requires flexibility and judgement rather than prescriptive rules, so rigid application of the associated methodology is not appropriate in all cases. In fact, we believe that an important characteristic of a good supervisor is the ability to recognise situations that warrant flexibility and then effectively manage them. In this regard, we believe that APRA has adopted a sensible approach to the supervision of banks.

Recommendation No. 2:

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

The issue raised by the ANAO in its recommendation that APRA review its risk rating process is relatively minor in the overall scheme of things.

The objective of the risk rating process is to better target APRA's supervision activities, including on-site visits to banks. This approach is appropriate and is superior to one based on strict adherence to prescriptive rules that may not always adequately recognise the particular circumstances of individual banks. Hence, judgement of the type involved in the risk rating process is an important ingredient in effective prudential supervision. The approach is also consistent with the advice of the Basle Committee on Banking Supervision.²

We are not in a position to judge the full effectiveness of the risk rating process, though members have not reported any deficiencies in its application. It is possible that finetuning of the ratings process might provide more useful indicators to help in a limited way to prioritise supervisory activity. However, this is not indicative of a material deficiency in the supervisory process or unacceptable risk. The outcome of a good regulatory process should be that the vast majority of banks are in the low risk category. That this is actually the case is no more than a fair reflection of the soundness of typical Australian banks.

It would be far more serious if the rating process were deficient in a manner that caused higher risk banks to be deemed to be low risk banks. However, there is no suggestion in the ANAO report of a deficiency like this.

Recommendation No. 3:

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.*

a) The ANAO report recommends that APRA should conduct periodic on-site visits to banks. The purpose of APRA's risk based supervision methodology is to identify material risks that warrant increased supervision, including on-site visits. Because the risk-based approach focuses on indicators of potential weakness, it results in a more efficient use of APRA's resources and less intrusion on banks than would a strict time schedule of on-site visits. Further, as noted above, APRA's approach to bank on-site visits is consistent with the Basle Committees advice on resource allocation.

b) International banks often operate with global business lines and management structures, which increases the local accessibility of their offshore operations from a domestic supervisory perspective. Nevertheless, there may be instances where APRA's risk assessment process identifies material risks that warrant a visit to the offshore operations of an Australian bank. However, a regimented cycle of visits to offshore operations is not necessary or desirable and APRA should be required to use its judgement on the need for such visits on a case-by-case basis.

² The ANAO report states that "The Basle Committee on Banking and Supervision has noted that effective banking supervision requires that the risk profile of individual banks be assessed and supervisory resources allocated accordingly."

We note that the ANAO does not propose that APRA should visit the overseas parent of a foreign bank branch operating in Australia. There would be no practical benefit to be gained from such a visit and it would cut across the role of the parent bank's supervisor, which has prudential responsibility for the global bank. Thus, there would be no justification for the expense involved.

CAPITAL ADEQUACY

Recommendation No. 4:

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.

Members report that APRA adopts a cautious approach to the supervision of banks' large exposures. The APRA rules differ in detail from those in the methodology that accompanies the Core Principles but their effect is entirely consistent with the force of the international standard.

APRA released its prudential standard on large exposures (APS 221) in September 2000. APS 221 defines a large exposure as an exposure to an individual counterparty (or group of related parties) that exceeds 10% of the bank's capital. This is consistent with the definition in the Core Principles. APRA requires a bank taking on a large exposure to any counterparty to be able to satisfy it that the proposed exposure does not pose an excessive risk to the bank.³ APRA also limits the amount of risk that foreign bank subsidiaries can shed to their parent to four times their capital base and it limits their direct exposure to their parent to one times capital. In contrast, the Core Principles place a limit on individual large exposures, but only in relation to private sector non-bank borrowers; so for example, it would not expressly limit parent bank exposures.

APRA has indicated during its regular consultations with IBSA that APS 221 does not represent its final policy on large exposures and that it is likely to be further developed.

The issues involving large exposure are complex, especially given the variety of ADIs (ranging from credit unions to large global banks) to which the standard must apply. This is an example of a circumstance where one size does not fit all and effective regulation requires an element of judgement by the regulator. In addition, changes to prudential regulation in this area can have a significant impact on investment banks' business and adjustment can be a complex and extended process.

APRA has stated that it will consult with industry on its future proposals. This is a transparent and effective way to develop policy, which is consistent with APRA's previous approach and is supported by IBSA.

³ The prior consultation limit of 30% applies to banks that had this limit before APS 221 was issued.

SUPERVISION OF CROSSBORDER BANKING

The senior management of an international bank is primarily responsible for its global business and safety. To meet this obligation, the management must rely on sound corporate governance procedures and risk management systems that extend across their global operations, amongst other things.

Similarly, a prudential supervisor must be satisfied about the soundness of an international bank's global business, wherever conducted, to meet its depositor protection and other objectives. Consequently, there is an agreed international approach to the supervision of international banks that raise special regulatory issues because they have operations in two or more jurisdictions, as summarised in the ANAO report. This incorporates any special conditions that might be placed on foreign banks by host countries. We believe that it is important to preserve this coordinated international approach to avoid creating a multiplicity of requirements for foreign branch ADIs.

Recommendation No.5:

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.*

a) We agree that some assessment of overseas supervisory regimes may be necessary and that third party assessments by recognised international agencies should suffice. However, this is not a priority issue given the origins of Australian foreign branch banks.

We note that the IMF and World Bank are jointly conducting a program, the Financial Sector Assessment Program (FSAP), to assess countries' observance of financial sector standards and codes, including the Core Principles. The Basle Committee has stated that the IMF/World Bank work on the Core Principles is being conducted on a case-by-case and priority basis, so we expect that it should more immediately cover potential problem jurisdictions.

APRA should implement this recommendation by drawing on the output of the FSAP and conduct its own independent analysis only in exceptional circumstances.

b) We agree that there is merit in formal information sharing arrangements with relevant overseas supervisors. This is an appropriate response to the expansive development of international banks' operations.

The Basle Committee on Banking Supervision has recently addressed this issue and set out the essential elements of a Memorandum of Understanding (MOU) between bank supervisors in different countries.⁴ This should provide a structure that could be useful to APRA in its design of any MOUs.

c) We disagree with the recommendation that foreign supervisors should regularly confirm to APRA that there are no issues of concern to it from banks in their jurisdictions. Instead, we suggest that the same approach as in ANAO's recommendation (d) should be adopted. We cannot see that periodic confirmation of the non-existence of issues would serve any purpose, if instead there were a requirement to notify APRA of issues of concern to it as they arise.

d) We agree that there should be prompt notification of any concerns about the relevant operations of international banks. This item should form part of a memorandum of understanding under recommendation (b).

⁴ Basle Committee on Banking Supervision, Essential Elements of a Statement of Cooperation Between Banking Supervisors, May 2001.

LIST OF MEMBERS

September 2001 - 40 Members

ABN AMRO Australia Limited
Bank of America NA
Bank of China
Bank of Tokyo-Mitsubishi Australia Limited
Barclays Bank PLC
BBL Australia Limited
BNP Paribas
BOS International (Australia) Limited
Citigroup
Credit Agricole Indosuez Australia Limited
Credit Suisse First Boston Australia Securities Limited
Deutsche Bank Group - Australia
Dresdner Bank AG
Fortis Bank (Nederland) N.V. Representative Office
Fuji International Finance (Australia) Limited
Goldman Sachs Australia Pty Limited
HSBC Bank Australia Limited
ING Bank (Australia) Ltd
IntesaBci Spa
Investec Australia Limited
JPMorgan
Macquarie Bank Limited
Merrill Lynch Australasia
Morgan Stanley Dean Witter Australia Limited
N M Rothschild & Sons (Australia) Limited
Overseas Union Bank Limited
Rabo Australia Limited
RMB Australia Limited
Royal Bank of Canada
SG Australia Limited
Standard Chartered Bank Australia Limited
State Street Bank & Trust Company - Sydney Branch
Sumitomo Mitsui Finance Australia Limited
The Dai-Ichi Kangyo Bank Limited
UBS Warburg Australia Limited
UFJ Australia Limited
United Overseas Bank Limited
WestLB - Sydney Branch
Westpac Institutional Bank
Zurich Capital Markets Australia Limited

..oOo..