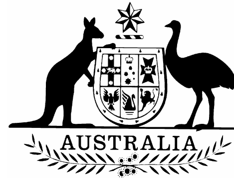

COMMONWEALTH OF AUSTRALIA

Official Committee Hansard

HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION

Reference: Review of the Australian Prudential Regulation Authority

MONDAY, 10 MAY 2004

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HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION

Monday, 10 May 2004

Members: Mr Hawker *(Chair)*, Ms Burke *(Deputy Chair)*, Mr Albanese, Mr Cox, Ms Gambaro, Mr Griffin, Mr Peter King, Mr Nairn, Mr Somlyay and Dr Southcott

Members in attendance: Ms Burke, Ms Gambaro, Mr Hawker, Mr Nairn and Mr Somlyay

Terms of reference for the inquiry:

To inquire into and report on:

The Australian Prudential Regulation Authority annual report 2003.

WITNESSES

JONES, Mr Ross, Deputy Chairman, Australian Prudential Regulation Authority 1

KHOO, Mr Brandon, Executive General Manager, Specialised Institutions, Australian Prudential Regulation Authority 1

LAKER, Dr John, Chairman, Australian Prudential Regulation Authority 1

LITTRELL, Mr Charles, Executive General Manager, Policy, Research and Consulting, Australian Prudential Regulation Authority 1

ROBERTS, Dr Darryl, General Manager, Rehabilitation and Enforcement, Australian Prudential Regulation Authority 1

SOMOGYI, Mr Stephen, Member, Australian Prudential Regulation Authority..................................... 1

Committee met at 10.04 a.m.

JONES, Mr Ross, Deputy Chairman, Australian Prudential Regulation Authority

KHOO, Mr Brandon, Executive General Manager, Specialised Institutions, Australian Prudential Regulation Authority

LAKER, Dr John, Chairman, Australian Prudential Regulation Authority

LITTRELL, Mr Charles, Executive General Manager, Policy, Research and Consulting, Australian Prudential Regulation Authority

ROBERTS, Dr Darryl, General Manager, Rehabilitation and Enforcement, Australian Prudential Regulation Authority

SOMOGYI, Mr Stephen, Member, Australian Prudential Regulation Authority

CHAIR—I hereby declare open this public hearing of the House of Representatives economics committee into the 2003 annual report of the Australian Prudential Regulation Authority. In doing so, I welcome the APRA chairman, Dr John Laker, and his colleagues—and members of the public and the media—to what I hope will be a highly informative and successful morning.

Today's public hearing is significant for a number of reasons, the foremost being that it is the first occasion that the committee has had an opportunity to publicly question APRA on its recently released report on the National Australia Bank's foreign exchange trading losses. The committee is intending to hold inquiries of this nature with APRA and other regulatory bodies on an ongoing basis, in a similar fashion to our very successful biannual hearings with the Reserve Bank.

Today we will be examining a range of matters relevant to regulation in the financial sector in Australia. In doing so, we will not only, hopefully, ensure that the authority is accountable to parliament for its actions but will also, hopefully, enhance public understanding of the role and policies of APRA.

I would like to advise all participants that, although the committee does not require you to give evidence under oath, these hearings are legal proceedings of the parliament and warrant the same respect as proceedings of the House. The giving of false or misleading evidence is a serious matter and may be regarded as a contempt of the parliament. Dr Laker, would you like to make an opening statement before we proceed to questions?

Dr Laker—We welcome the opportunity to appear before the committee today, and I thank you for the opportunity to make an opening statement. It has been some little time since the committee has met formally with APRA, and from our perspective much has happened over the intervening period to the environment in which we operate. The challenges posed to a prudential regulator by a dynamic and innovative financial system, which at times can push at the boundaries of prudent risk management, have not waned. The legislative and prudential framework for financial institutions in Australia has been further reinforced and harmonised and

international initiatives on bank capital, accounting standards, corporate governance and disclosure have continued apace.

APRA itself has a new governance structure. On 1 July last year a new three-person executive group, which is here before you today, took the place of APRA's previous board and chief executive officer. This new structure is intended to provide clearer and sharper lines of accountability. We believe it is working well, although it is ultimately for the parliament to judge whether the structure is delivering what was intended.

Two things have not changed over the recent period. One is the continued strength and resilience of the Australian financial system, which has been underpinned by the long-running expansion of the Australian economy. The other is APRA's mission. As the committee knows, APRA's purpose is to promote prudent business behaviour and risk management by authorised deposit-taking institutions, insurance companies and superannuation funds, to maximise the likelihood that they remain in sound financial condition and that they can meet their repayment obligations to depositors, policyholders and fund members—the group we call our beneficiaries. However, APRA does not and cannot guarantee that no supervised financial institution will ever fail.

As we said in the annual report last year, the new executive group is committed to restoring community confidence in APRA as a vigilant, vigorous and effective prudential regulator. We intend to build on the foundations laid by our predecessors, while ensuring that APRA fully absorbs the lessons from the HIH failure. Good intentions and battle scars will not, however, make APRA a stronger prudential regulator. An effective supervisory regime is built on much more fundamental building blocks. These are: a robust framework of legislation and prudential standards which provides the prudential regulator with appropriate powers; active early warning systems of emerging distress in financial institutions; skilled and experienced supervisory staff who understand the industries and can identify and respond to warning signals; and, as well, institutional will to take the actions necessary to promote the safety of the financial system and to protect the interests of beneficiaries.

I am pleased to report that good progress has been made in recent years on each of these building blocks. First, regulatory reforms have considerably strengthened the prudential framework in Australia and provided APRA with stronger prudential powers. In general insurance, for example, the new prudential regime, from 1 July 2002, is a more rigorous and adaptable framework for addressing insurance company risks. There are firmer and more risk based prudential requirements in relation to the financial soundness of general insurers and their risk management. And APRA has greater capacity to intervene, if necessary, in the affairs of an ailing insurer.

In superannuation, the Superannuation Safety Amendment Act, coming into effect on 1 July this year, will provide a more modern and robust regulatory framework for superannuation, built on a universal licensing regime for APRA regulated trustees as well as new regulations and operating standards. In the deposit-taking sector—banks, building societies, and credit unions—recent amendments to the banking act give APRA power to disqualify unfit or improper directors and senior managers and to remove auditors. APRA has recently released proposals for fit and proper prudential standards harmonised across the deposit-taking and insurance sectors.

Secondly, APRA has sharpened its antennae. Some 18 months ago, we introduced a more rigorous and sophisticated system for risk-rating financial institutions and determining appropriate supervisory action. This new system acts as an early warning of emerging distress and ensures that problems in high-risk institutions are escalated promptly to senior management. By the end of March this year, over 1,300 entities, accounting for close to 99 per cent of APRA-supervised assets, had been rated—and these include all 100 or so operating entities rated as high or extreme impact because of their size.

Thirdly, APRA has been building up its supervisory resources and skills. In the wake of the HIH failure, we commissioned an independent benchmarking exercise which showed that, compared with its international regulatory peers, APRA is under-resourced in its supervision of large and complex financial institutions and its supervisory teams are relatively inexperienced. As the HIH royal commissioner noted, in its formative period APRA had lost a considerable amount of industry understanding through the departure or the redeployment of experienced staff. We have been keen to turn the situation around. Since the beginning of 2003, with the support of additional budgetary resources, APRA has hired 55 additional staff into front line and supporting supervisory roles. That is a 16 per cent increase in staffing numbers in those areas. We have focused our recruiting efforts on individuals with extensive and relevant experience in industry and the professions. We have had some success in attracting a number of high-calibre new staff. For more junior staff, APRA has been changing its training and development approach in favour of narrower but deeper specialisations in industries. This is a move back from APRA's original philosophy that supervisory staff should be able to apply their skills across each and every one of the prudentially regulated industries. For the first time since our establishment, the average length of service of staff within APRA has begun to increase.

Finally, APRA has stiffened its will to intervene when it identifies a supervised entity taking undue risks. The HIH royal commission recommended that APRA develop a more sceptical, questioning and, where necessary, aggressive approach to its prudential supervision of general insurers. The community, I am certain, would expect us to apply this approach across all the prudentially regulated industries, in the interests of beneficiaries. APRA will still, where it can, seek to achieve its desired outcomes through consultation and cooperation with supervised entities, and this is usually the case. However, where persuasion needs to be backed by firm measures, APRA will have no hesitation in using the powers entrusted to it by parliament. The stronger enforcement culture is evident in the doubling of APRA's enforcement actions in 2002-03, which are outlined in the annual report.

In all, I believe APRA is a much stronger and more effective supervisor than it was two or three years ago. However, it is not always easy for the parliament and the community to judge this. At any given time, APRA is working behind the scenes with regulated institutions on a range of issues that may affect their ability to meet their obligations to beneficiaries. This behind the scenes approach enables us, without undermining the confidence of beneficiaries or destabilising the financial system, to pursue our prudential objectives, taking into account—but without being driven by—commercial considerations. Given our secrecy obligations, APRA cannot publicise these efforts. The institutions themselves have no incentive to do so, and, subject of course to their continuous disclosure obligations, they are encouraged to bring issues to us without fear of immediate adverse speculation. For a prudential regulator, the private workout of difficulties is generally the more effective route and highly publicised intervention, such as APRA's recent dealings with the National Australia Bank, is the exception. For each

highly publicised episode there are many more episodes where APRA has been the quiet achiever.

Looking ahead, the regulatory reform process will continue to dictate APRA's work program over the next 12 months and beyond. There are at least four major priorities to which I would draw the committee's attention. The first, obviously, is APRA's response to the HIH royal commission. The commission made 21 recommendations that were directly relevant to APRA's responsibilities. APRA responded to a number of these last November, when it released a discussion paper on a proposed second round of general insurance reforms. The new prudential framework has helped to put the general insurance industry into a stronger position than it has been in for some time, but we believe that framework could be strengthened. The discussion paper outlines proposals dealing in the main with corporate governance and disclosure matters. We are now in the consultation phase on these proposals. We are also continuing with our assessment of whether a number of individuals involved in HIH meet the standards of fitness and propriety required to remain in the industry.

The second priority is implementation of the new superannuation licensing regime, coming into effect on 1 July this year. From that date, a two-year transition period comes into effect, during which current trustees of superannuation entities regulated by APRA must either be granted a licence by APRA or exit the industry—and the superannuation entities themselves must be registered by APRA or cease operating. Currently, there are about 1,400 trustee entities that are responsible for over 10,000 superannuation entities. APRA is building up its resources for the licensing task and is establishing a dedicated licensing team. We are also working closely with Treasury to ensure that the new regulations and operating standards of trustees will be available before the licensing period begins. We are keen to encourage trustees and superannuation entities to come to us earlier rather than later for the necessary approvals. There will be nothing to be gained by stalling.

A third priority for APRA relates to international financial reporting standards—IFRS—which Australia has committed to adopting from 1 January 2005. This will be a significant exercise for APRA regulated entities, on a tight timetable, and it will demand considerable board and management attention. APRA has recently surveyed these entities to raise the level of awareness about IFRS and to assess preparedness for IFRS adoption. Our expectation is that the great majority of prudentially regulated entities will make a successful transition to IFRS, but much work lies ahead.

The adoption of IFRS also has immediate implications for APRA itself. We will need to revise our prudential standards in the deposit-taking—ADI—life and general insurance industries, as well as our statistical requirements, to take account of the new accounting standards. This is no small task. We are currently preparing a discussion paper on the prudential implications of IFRS, which we will release once the exact form of the new accounting standards in Australia has been confirmed.

A fourth priority is the new Basel capital accord or Basel II, which involves a global reform of capital adequacy requirements for banks and other deposit-taking institutions. Basel II is planned for introduction at the beginning of 2007. The final version of the accord is not due for release until the middle of this year, so the timetable is a tight one. APRA is working closely with Australian banks and other ADIs to ensure that Australia can meet that timetable.

The Basel II proposals are aimed at making regulatory capital more sensitive to the risks that ADIs undertake and are a welcome move by supervisors away from a one size fits all approach. At the same time, Basel II was never intended to allow a significant withdrawal of capital from the banking system, although our preliminary figuring suggests that ADIs in Australia, with typical risk profiles, will enjoy some modest reduction in regulatory capital requirements. As we have said elsewhere, APRA is committed to ensuring that Basel II is implemented in Australia in a fair and consistent way.

While these various reform initiatives gather momentum, APRA's day-to-day supervisory activities will continue to absorb the larger part of our resources. One could be forgiven for thinking, from recent media coverage, that the irregular currency options trading activity at the National Australia Bank, and its aftermath, is the only issue in town, so to speak. From our perspective, obviously, it is not. APRA is now monitoring the remedial program that is required of the NAB to address its governance and risk management weaknesses. APRA is also completing its review of the risk management practices of other ADIs with significant treasury operations, to ensure that the right lessons are learnt from the NAB episode.

That said, it is important to note that until this episode treasury operations have not been a major source of risk for our largest financial institutions. For the four major banks, for example, total capital requirements for market risk average only one per cent of their total regulatory capital and only about five per cent of annual profits. The major source of risk for ADIs in Australia has traditionally been, and remains, credit risk—the risk that borrowers will not meet their repayment obligations in full and on time. As this committee knows well, the continued rapid growth of credit for housing, which has been running at annual rates of well over 20 per cent, has become the subject of considerable policy attention.

APRA has been closely monitoring the housing market exposure of ADIs for some time. Late in 2002 we voiced our concerns about the emergence of some questionable housing lending practices and we asked all ADIs to review the soundness of their lending portfolios. Last year, against the backdrop of sharply rising house prices and Reserve Bank warnings that housing credit growth was not sustainable, we conducted a rigorous stress test to help gauge the resilience of ADI housing loan portfolios to a substantial housing market correction. The stress test results, which were well-publicised at the time, demonstrated that the ADI sector in Australia as a whole remains well capitalised and could withstand a housing market shock, defined to be tougher than Australia's postwar experience, without putting depositors at undue risk. This was a reassuring conclusion but, as I have emphasised, no basis for complacency. Current default rates on residential mortgages may be very low but, with tighter monetary policy and every signal now that the housing cycle has turned or is turning, our warning to ADIs to proceed with caution in housing lending stands.

APRA has also been tightening the prudential framework that applies to housing lending by ADIs. In November last year we released proposals that loans where ADIs do not verify the borrower's servicing capacity—such as so-called low doc loans—would require a higher equity contribution by the borrower before such loans would qualify for the concessional risk weight on housing lending for capital adequacy purposes. We have now completed public consultations on these proposals and will be announcing next steps shortly. In December, after public consultation, we revised the capital adequacy standard for ADIs by requiring them to treat certain types of capitalised expenses, such as loan origination fees and commissions paid to

mortgage originators and brokers, as intangible assets for prudential purposes and to deduct them from capital.

There are a range of other supervisory issues to which I could refer, but I am happy to now take the committee's questions.

CHAIR—Thank you very much, Dr Laker, for a very comprehensive introduction. It certainly lays out quite a lot of areas that I am sure the committee members will want to look at further. You talked about regulatory reforms. In the deposit-taking area, in banks and so on, you said you can move to have directors or auditors removed if they are unfit, in your opinion, for the position. Has that ever been exercised?

Dr Laker—That power was made available only at the end of last year, when the regulation was enacted. To put that particular power into context, we are also discussing with the industry at the moment our discussion paper on a fit and proper prudential standard—which would apply to deposit taking but would be harmonised to insurance. In that standard, I think it is important to emphasise that we see the responsibility for 'fit and proper' to reside in the first instance with the regulated entity. What we want our regulated institutions to have is a well-articulated policy on how they judge the fitness and propriety of what we call 'responsible persons', which are the senior members of the institution—board members, chief executives and those responsible for key business areas. We want that policy to be articulated and adhered to by the regulated entities in the first instance. We would support that policy with our own powers, but the onus is still on those entities to satisfy themselves in the first instance that they have fit and proper people in positions of responsibility.

CHAIR—But do you actually see yourself in a position where you would turn to a company and say, 'You have got to remove that director'?

Dr Laker—Those possibilities could arise. There have been occasions where we have expressed concerns to regulated entities about individuals in certain positions, based on what we know more broadly about previous experience with individuals. We traditionally—this goes back well before APRA's time—raised that with boards or chief executives and said, 'Are you aware that there are some issues here?' That has been the way in which we have proceeded, and there have been instances where we have taken concerns. I think that is the way we would continue to proceed in the first instance; that is, we would say, 'Are you aware that there are question marks here? Have you satisfied yourself?' We would also, as a result of this new framework, be able to be satisfied in our own mind about individuals who are in the business of looking after other people's life savings or deposits or protecting their assets, and we have those powers to remove them.

CHAIR—But how would you ensure natural justice?

Dr Laker—There are elaborate and very careful natural justice provisions that would be built into our exercise of that power, including the process of show cause and the process of right of review through the Administrative Appeals Tribunal. There are natural justice rights and we respect those in the way we operate. It would not be an arbitrary exercise of power, and it would not be—if these circumstances arose—one which would be done in any way to the surprise of the institution concerned. Our starting point is always to say to them, 'You have a policy on "fit

and proper". How have you rationalised the appointment of such-and-such a person within that framework or within the context of that policy?' We have a different view, and that is how that dialogue would start.

CHAIR—What has been the response of financial institutions to these changes—in the whole area of your new structure and approach?

Dr Laker—That is a very broad question. I will take the 'fit and proper' part of it and extend from there. The discussion paper is still receiving responses. The closing date for submissions is not until the end of this month. I think, broadly, there is an acceptance that this is appropriate policy for APRA to have. It is one area of APRA's policies where, by international standards, we are short. We have a set of what are called core principles for prudential supervision of banks globally, and that is one area where Australia has not matched those principles. More broadly, there are proposals on corporate governance in the general insurance area that have aroused quite a degree of interest, which in the discussion paper are intended to apply to general insurance, but clearly principles that would be established there would be harmonised across all of our other regulated industries.

I have to say that those proposals provoked a fair degree of lack of support. We have not won the hearts and minds of a lot of the boards and directors on that particular issue, and we are in a very active dialogue at the moment to listen to the view being put to us that we may be over-prescriptive in that area. It is hard for me to put myself into the shoes of all the major entities in Australia that we regulate, but I think the vision of Wallis and the wish to develop an integrated approach to prudential supervision was accepted at the time. The regulatory framework has been brought into line with that view. That has been an important process and quite a time-consuming process, but it has given us more harmonised power so that we can look at the same risk in different institutions across different sectors and make sure that that risk is supervised sensibly. I think there has been good progress in that, but I am not really in a position to say that we have done that job well or completed the task at this point.

Ms BURKE—Did Wallis get it wrong? Is the whole premise of APRA wrong?

Dr Laker—No.

Ms BURKE—And you can say that now, four years down the track, after one major systemic failure and then another blip along the way with NAB?

Dr Laker—The problem at the NAB was the NAB's problem. With HIH we readily accepted that APRA had a responsibility there and could have done better. But I do not think our experience with prudential supervision has changed in any way the view within APRA—and I am new in my role, but even going back to the days when I was on the board—that it is sensible to look at the reality that financial institutions are increasingly conglomerating or merging across sectors. Some of our major deposit-taking institutions are also major funds managers. They have life insurance companies. That process, which was a little slow to get under way when Wallis first reported, is inexorable and it makes sense then not to have a silo based approach to prudential supervision but really to be able to look at risks which are common across different sectors and ensure that, firstly, they have a regulatory framework which is consistent and that, secondly, we supervise then consistently.

Ms BURKE—Isn't that one of the problems you have had, especially with your staff, where under the original APRA framework they tried to be experts in everything? The original APRA web site said it would have a 'light touch' approach to regulation and that it would rely on internal auditing of companies for its supervision as opposed to going in and doing thorough audits and spot checks, one of the problems being that you could not be all things to all the industries that you regulate. Insurance is a totally different beast to banking, and you have now recognised that by going back and saying, 'We need experts in those fields and from those industries.' Did APRA get it wrong? Did Wallis get it wrong, to go back to my original premise?

Dr Laker—No, I do not think Wallis got it wrong. I think what APRA did in its formative years was overambitious in expecting that supervisors could share their skills or apply their skills across any of the regulated entities, whatever sector they were in. I think the ambition was a noble one in that, if an insurance company is incurring a credit risk, it is not generically different from a credit risk that a bank incurs, so why would you need a separate set of skills to look at the credit risk? But I think we were overambitious at the time, and we recognised well before the new executive group was appointed that we had gone too far away from the narrow, silo approach to this very broad brush approach. The royal commissioner reminded us of that. We had lost the sense of the smell and the feel of an industry; we had lost contact with the characters of the industry. These industries are, as you say, quite separate in their histories and in their practices, and we were spreading ourselves too broadly.

Before our time, the board and the senior management of APRA started to draw back from that anyway, and we have reinforced that, but I do not want to take APRA back to those silos. I think we would lose far too much if we narrowed back to a bank silo and an insurance silo. What we do need to do, though, is to have deeper specialisations, so we now hire from industry. Those people stay with that industry and apply their skills and experience, their understanding of the language and their knowledge of the characters. We reinforce those front-line supervisors with specialist risk teams which then can go across the industries.

We were, I think, aspiring to have a light touch. It is quite clear that that was not what the community expected. We got that message loud and clear. The opposite of a light touch might be a sledgehammer, but we are not a sledgehammer. We are not moving to a highly prescriptive regime. What we want to do is to be vigorous and effective in applying the powers we have.

Mr SOMLYAY—A few moments ago, you spoke about giving a warning to institutions if information came to hand about directors or someone operating within the system who maybe should not be there. What sort of reaction did you get from these institutions? What was the outcome? Was your job finished when you informed these institutions? Did you expect them to act upon your advice? And now that you have the regulatory power to enforce, how different do you think the attitude will be on your side and on the institutions' side?

Dr Laker—Mr Somlyay, I will just be a little careful in jumping ahead to saying that we have all the regulatory powers. They are linked to establishing a prudential standard, and that is what is under discussion now: we have the residual powers but we really need the whole framework to be in place. I think it is fair to say that we get a very receptive hearing when we raise these sorts of issues with senior executives. I know of a couple of individual cases, but I do not want to go into those in any detail.

Mr SOMLYAY—No.

Dr Laker—But I think, if we raise legitimate concerns about the fitness and propriety of an individual in a particular position of responsibility, it may not necessarily be the case that that person should not be in that institution or in the industry at all; it may be that they do not have the qualifications or the aptitude for a particular role but might be better suited elsewhere. If we are strongly of the view, though, from what we have learnt, that an individual should not be in a particular position of responsibility, under this new framework and subject to the views we are getting from industry, we would certainly go back to that institution and say, 'You have a policy and you emphasise in the policy that you want certain standards to be met. How does this individual meet those standards?' That begins the dialogue. There may well be another view that we have not heard. We do consult on this process. We need to.

Mr SOMLYAY—And you are happy with the way that these consultations have worked and do work?

Dr Laker—I think it has been important to develop the powers that will come in because, in a sense, for us those powers have been absent in the development of prudential supervision. We understand that a lot of failures or weaknesses in institutions are at the personal level. They involve people. They involve mismanagement or improper behaviour. We are about influencing behaviour. So developing this extra set of powers—which I certainly hope I do not need to draw on, day in and day out—is important for the prudential framework but, as I said before, this should be something that a well-managed institution is doing anyway, and the standard would reinforce that. That is where the work would be done: within the institution.

Mr Somogyi—In the insurance sector we have had the power, as Dr Laker mentioned, since July 2002, in terms of approved auditors and actuaries. In recent times we have recruited a number of people who have expertise in that field and we have been able to advise boards when they have proposed to appoint someone who may not be appropriate for those boards. In general, in the cases I have been involved in, the institutions have said, 'Thank you; you know something that we don't.' That has added to the quality of the advice that they have received. From that point of view, it has been a good innovation but, at the end of the day, it is in their hands to take the first set of actions.

CHAIR—How often would you actually do that?

Mr Somogyi—Not often. We would exercise that very carefully but, knowing something of the industry and having people with expertise in the industry among our group, we know a lot more about the people who are being proposed to be appointed.

CHAIR—Are you talking about three or four cases?

Mr Somogyi—I think it would be no more than that. We have exercised that power very carefully.

Dr Laker—For all the natural justice reasons that you have raised.

Mr Somogyi—Yes.

Mr NAIRN—In these differing areas of expertise, it is quite true that insurance is very different to superannuation, as superannuation is different to banking. Seemingly, more and more, corporations are involving themselves in all three. You have the AMP type situation—traditionally insurance, then superannuation and now banking. Similarly, every time you get a phone call from a bank these days they try to sell you superannuation or insurance. While there are differences between these, from a risk point of view, with corporations trading across the three areas, APRA almost needs further expertise to look at that in a combined way. While you are employing expertise in, say, those three different areas, how do you bring them together when looking at an organisation?

Dr Laker—That issue has really driven the internal structure of APRA. When we moved away from the silos—we inherited a bank silo and an insurance silo—we established a group that we called the Diversified Institutions Division, where a particular entity which might be spread across all sectors is supervised as one entity. So we have a consolidated approach to the supervision of that entity. We would draw on the expertise from different sectors, but they are all in that division, all underneath one senior responsible person overlooking that institution as a whole. That is the consolidated supervision framework. We can also bring to bear to that institution the highly specialised skills that come out of our risk management areas. We now have an actuarial services area as well, where they can come in and do on-site visits to look at specific areas of risk within that conglomerate.

That is the way in which we are trying to balance the skills that we are developing within APRA. We certainly would not want to disentangle the insurance or the superannuation entity from the bank part of it, but we accept that, while they might all be within one consolidated entity, they are still participating in these different sectors which remain quite distinct. That has driven the structure and, while we are looking at the structure, right at this moment I think that model has worked well for APRA. It is not clear that there is a better way of bringing those skills together.

Ms GAMBARO—On the two or three cases that you have spoken about, it sounds to me that you have come in at a high-risk time. Is there some formalised process? You have just spoken about going to corporations and doing an on-site risk assessment. Is there a formalised framework? If someone is appointing a director or someone to the board, can they come to you as a preventative type measure first up and ask whether that person is suitable, or does that not occur? Do you have a level of expertise where someone can come to you when they are thinking of appointing somebody and you are able to advise them, or is that out of your scope?

Dr Laker—There is an expectation for appointments at board level and at the most senior level—the chief executive level—that the institution would take APRA through their intention. But we do not see ourselves as pre-vetting or authorising individuals, but we like to know when senior appointments are made and when senior appointments are unmade, if there is a story there.

Ms GAMBARO—Does that work well?

Dr Laker—This is part of the discussion that is under way on the governance arrangements in general insurance. I think that in the main, yes, there has been a willingness among major institutions to consult with us and at senior levels.

Ms GAMBARO—So there is a flow of information?

Dr Laker—Yes.

Ms BURKE—Do you have all the legislative powers you need?

Dr Laker—To do what?

Ms BURKE—To do everything.

Ms GAMBARO—That is a very open question.

Ms BURKE—It is a very open question. I think there has been some acceptance that legislative change was needed, and you have had it, but has it gone far enough?

Dr Laker—As we supervisors said earlier, the financial system is dynamic and innovative, and no set of legislative requirements will be relevant for all time, so there is always a need to go back and look at whether or not legislation written five, 10 or 20 years ago is relevant. It is quite clear that the legislation on general insurance was well out of date. We have been pleased with the support we have had from the government and the parliament in bringing the powers up to date to cope with a very different financial system from what it was some years earlier.

There is still a challenge to harmonise these powers, and we work with Treasury and the government on areas where we think there could be more sensible harmonisation of powers, within a busy legislative framework and timetable. We look for ways that can improve our effectiveness. ‘Fit and proper’ was an important adjunct. The general insurance and super reforms are quite fundamental improvements. I think the process has delivered to APRA a much more effective regime, but it is not set in concrete, nor is the world in which we operate, so we will continually revisit and look for areas where we feel we might be caught short. Going back and refreshing the legislative framework is part of our own vigilance.

Ms BURKE—One of the things we have been exploring with the RBA is an area that is fairly unregulated—that is, the Henry Kayes of this world and property investors who are really offering credit. As you talk about in your annual report, they are deposit-taking institutions. It seems like there is a group of people that are offering credit and giving loans who are outside everybody’s regulation—yours in particular. There has been an argy-bargy with regard to whether property people are a state or federal issue. Do you see a need to have some form of regulation to cover those people, particularly those property spruikers who have not gone away even though the market is going to contract?

Dr Laker—I do not believe that APRA should suggest what policy priorities should be for the parliament. It is clearly an issue which this committee and other agencies have been looking at, but I can only work with the mandate that I have been given by parliament, which does not extend to the fringe of consumer credit, nor does it extend to risks to borrowers. It is very clear that our mandate relates to those who deposit their funds with the banks, building societies and credit unions. That is a big enough task as it is.

Mr Jones—The problem is a need for coordination with ASIC, the ACCC and someone with the mandate as well.

Dr Laker—We do not have a broad consumer mandate—

Ms BURKE—No.

Dr Laker—and that is quite tough.

Ms BURKE—But they are totally unregulated. There is nothing from you, the ACCC or ASIC saying, 'You've got to do X, Y and Z.' They seem to have escaped everybody's purview.

Dr Laker—To the extent that, for example, a deposit-taking institution has a loan referred to it by a mortgage broker, we have been looking at the quality of those loans referred and we have been looking at whether there is any suggestion that the quality is inherently poorer for mortgage or broker-introduced loans than loans introduced when the customer walks through the door. We have alerted the ADIs to the risks that might be involved if they are not carefully monitoring broker-induced loans. We are looking at how this process works its way through our deposit-taking institutions, and we have signalled to them what our concerns are but that is one step removed from taking a view about mortgage brokers as such. It is how they impact on our deposit-taking institutions that is important for us.

Ms GAMBARO—In your report—I think it is on page 17—you say that these mortgage brokers are accountable for about a quarter of total loans and that you expect the usage to grow. Do you have any figures at the moment or any indications of what that market is likely to grow to? I know that looking at the risk factors is one of your priority areas with ADIs, particularly when you are looking at these broker-originated loans—you have just touched on that. How are you going to implement some safer regimes there and subject them to the same sorts of credit standards as the other ADIs?

Dr Laker—The reason why we have taken the view there—and it is just a suggestion that we think their usage will grow—is that, from the point of view of our deposit-taking institutions, broker originated lending enables institutions to tap a much broader geographical base than they can through bricks and mortar branches. So they have been able to compete outside their traditional branch base by using the broker market. That is part of competition. It is a healthy form of competition. What we are looking at and certainly what we are requiring our institutions to look at is the nature of the lending, the quality of the loans coming on board, their reliance on particular brokers and the way they spread their risks in dealing with brokers. That is, in a sense, the limit of the ambit of our control. We will be working with the institutions to look over time at whether there is any systematic difference in the credit quality.

Ms GAMBARO—Have you found anything so far?

Dr Laker—No, we are not aware that there is any main difference at present.

Ms GAMBARO—Are there any irregularities in lending practices?

Mr Khoo—Not on a systemic basis, no. There have obviously been odd cases where we have identified practices which have not quite been at the level we would like them to be at but we have dealt with those on an individual basis.

Dr Laker—But in the proposals we have out at the moment on low doc lending, we do emphasise to these institutions that they cannot delegate the responsibility in the end for assessing credit. They may outsource some of the processing, such as bringing the material together and doing the checks on the mortgage security et cetera, but they should not be delegating the responsibility for taking a view on whether it is good credit or not. That is really at the heart of our concerns—whether they are assessing that credit rigorously.

Ms GAMBARO—And that is what you will be looking at when you are talking about the quality of the loans and the integrity of the loans?

Mr Khoo—Yes.

CHAIR—You talked about stress testing these lending institutions, particularly on housing. What sort of level of change in housing values were you looking at when you did that?

Dr Laker—We used two particular assumptions about what might happen. They are not forecasts; that was just the way we set up the test. We looked at a 30 per cent fall in property prices in one year associated with a substantial increase in mortgage defaults. We looked at how severe that test was by Australian standards. It is a tough test by Australian standards. By postwar standards, having mortgage default rates up around 3½ per cent in a year or prices falling by 30 per cent in a year is generally a tough test, although you can find elements of that in parts of Australia in the late eighties. What we then did was ask: if that were to happen, how would your loan book look, based on the age of the loan book, the original loan-to-valuation ratio and other characteristics of the book? That is the way the stress test was developed. If it were to happen, it shows what it would do to your capital. It was not an attempt to forecast but rather to test stress as any engineer would.

CHAIR—I think that 30 per cent was the figure that the *Economist* were talking about in that big report they did a few months ago or last year.

Dr Laker—That is right.

Mr SOMLYAY—The Reserve Bank gave warnings about the property market. It said that a lot of the price increases for these properties in the CBDs of Melbourne, Brisbane and Sydney et cetera were not sustainable because there was an unlikelihood of being able to gain long-term rent. Did you factor the rental situation into the risk assessment or purely the asset depreciation? Asset depreciation does not matter if you are going to keep the property. What the Reserve Bank warned about was if the property does not return an income.

Dr Laker—That would feed through into defaults.

Mr Littrell—The 30 per cent assumption applies to dwellings that were foreclosed on; it does not imply that it is a general issue across the economy. So the losses were a function of the reduction in the security value of a defaulted loan.

Mr SOMLYAY—So 30 per cent is the value and not the quantum of the property?

Mr Littrell—No. If, for example, someone bought a dwelling for $100,000 and then defaulted on their loan, we assume that the sale of the property nets $70,000. The 30 per cent assumption is not spectacularly tough, particularly since you are defining it as the defaulted property, because those tend to be the ones that have the worst property outcomes. But the 3½ per cent average default rate is very much tougher than has traditionally been the case in Australia. It normally runs at 0.15 per cent or something like that.

Ms BURKE—Did you test the knock-on effect? A lot of people have borrowed against their existing home to buy an investment property. One of the issues the RBA was concerned about is using your principal residence as the basis for borrowing. A lot of banks have started to allow people to use it as their collateral for buying their next investment home.

Mr Littrell—The way we have described the stress test so far has been a bit simplified. The assumptions underlying investment property loans were slightly different from the assumptions underlying primary residences. We did not do the calculation you suggested, but the difference in the default assumption was based on that sort of outcome.

Ms BURKE—The other thing we do not seem to be able to get a handle on is that, while we know that credit card debt is soaring, when we get a bank in front of us and ask them, 'What exposure do you have to credit card debt,' they do not seem to be able to answer us. I would be fascinated if anybody could answer that question. Is it also about people not only have housing debt but being way over their heads with existing credit card debt, and the effect that it would have on banks if people were suddenly to turn around and say: 'We can't meet either payment. We can't meet the house or the credit card payment'?

Dr Laker—We did not formally model that particular outcome. When we released the results, we said this was a test of how an institution's capital would be able to withstand a specific event—that is, a fall in house prices and an increase in defaults. But we did not, at the time, model what you might call the 'macroeconomic drag'—if you had a housing market correction of that size, what it do would to consumption and confidence. That would be a second round effect. It was not part of the purpose of the exercise. There was a more specific purpose in it.

Mr NAIRN—You said in your report on NAB:

> The taking of risk is an inherent part of banking. A bank's viability is dependent upon having in place a strong network of risk management controls to manage and contain risks. But no risk management system is bullet-proof; some losses are inevitable. In this case, the bank's customers were not affected by the losses.

Isn't it a fairly big call to say that the bank's customers were not affected by the losses? At the moment, we can see that the shareholders of NAB have certainly been affected, because the share price has gone down a fair bit. When a bank makes decisions with respect to the services it provides—NAB reduced their number of branches by six per cent last year—that affects its customers. When they assess their future fees, I would have thought the fact that they have lost $350 million or so would have a significant effect on customers.

Dr Laker—I accept those points. When a prudential regulator writes a report like that, I think he is really talking about depositors. I made the point publicly before a Senate estimates committee that while the amount lost through irregular foreign currency trading is large in absolute terms—$360 million is a large figure—it did not at any time, in our view, threaten the depositors of the institution. That was the judgment we made, because that amount, in the totality of the operations of NAB, was not, relatively speaking, a large amount.

Mr NAIRN—You are talking about the security of the depositors' money rather than the effect on the customers, because the effect on the customers is a much broader issue.

Dr Laker—It is a broader term. I am sure if we were sitting down, writing it with the luxury of time, which we did not have at that point, we would have clarified that what we were talking about there, from a prudential regulator's point of view, were depositors. It did not threaten depositors' money.

Mr NAIRN—You talked before about advice you have given to companies regarding the appointment of directors. Did you have any opportunity to provide any advice, or were you asked about any advice, with respect to the promotion of directors in the NAB subsequent to the problems—for instance, regarding directors who were on the audit committee and who have now found their way into other senior positions in the NAB?

Dr Laker—I will answer that question perhaps unhelpfully by saying that I am not really in a position to be able to comment on the detail of how we deal with any of the regulated entities—and certainly not down at the level of what we might have said. That report was released by the National Australia Bank. It was not released by APRA, and we could not have released that report, because I am subject to very strict secrecy obligations. I really cannot answer on the public record how we responded and what we did in the case of individuals with individual institutions. Our broad policy is that we are always keen to know who is going to go into senior positions. Under this 'fit and proper' policy, the institution would clearly need to assess that themselves. Major institutions do this anyway.

CHAIR—We have your executive summary, which has been released. How would you approach this whole question of risk assessment with an institution? Presumably you write to them first and say, 'We want to know what your risk assessment is.' Then what happens—say, with the risk management and audit committee that has been in the news a bit?

Dr Laker—There is a very elaborate process in our assessing risk. Of course, I can only talk very generally here. I could talk quite specifically as well, but I suspect we would be here for most of the afternoon. Broadly speaking, we require a supervised financial institution to have a clearly articulated policy on risk, endorsed by the board, which identifies what the major risks are for that institution, sets out a system for controlling those risks and identifies how these risks and any breaches of them would be reported to senior representatives, escalated up the institution.

If it came to a credit risk, we would have a look at the policy that was put in place and endorsed by the board. We would want to send in a specialist team on a regular basis to the institutions we deem as having a significant impact on the financial system to see how these policies are working in practice. We call that our on-site visit process. Our front-line supervisors

are looking at this as well. We want to satisfy ourselves that there is a rigorous policy, that they know the risks they are getting into, that they have thought them through and that they have a framework for controlling them. If, in the process of our front-line supervision or the on-site visits which go together with our front-line supervision, we identify concerns, we provide a report to the institution. If there are serious concerns, we provide that report to the board—or certainly to the chairman in the expectation it would go to the board—to look for necessary follow-up to tighten up where we see weaknesses.

That is really at the heart of what APRA does, day in, day out. Prudential supervision is about looking at how these institutions themselves manage risk, making sure they are on the job and that they have the staff and the expertise to stay on the job. We do not go in and manage the risk for them. We do not tell them what risks they should be taking, unless they are excessive. We are not making judgment calls; we are making sure that the institution knows what it has got itself into.

CHAIR—In the case of the National, how was that put in place?

Dr Laker—The chronology, or at least parts of the chronology, is in the report. The whole report, not just the executive summary, was published by the ASX. Starting at a point in time, in mid-2002 there was an on-site visit by our market risk team. That was the information gathering stage of what is quite a complex review. There was follow-up discussion and dialogue with the risk management personnel in the NAB to add to the information, to add to our understanding and to make sure we got it right. In the normal course of events, we would provide a draft copy of the report to an institution to get the facts ticked, but it is our judgment and our call. That is not for negotiation. We then provide that, as we did for NAB, to the head of risk, to the chairman of the board, in the following January. From the report—and it is no secret—we met a fair degree of resistance to the views that we had about their risk management systems. We wanted to see the follow-up discussion deliver the results, so we went back a few months later to see how the NAB were travelling in their remedial programs. We felt they needed to do more and we required them to meet the particular requirement of having a review of their risk limit system to a particular timetable. The irregular events, or the fictitious trading, took place some months after that, but within that time we were expecting the NAB to address the major issues.

CHAIR—You say you were expecting them to, but it took some months and it is claimed that a risk committee of the board was set up only at the end of August last year, which is the following year from when you said you first went in there. What processes do you have in place to see that your initial assessment is actually being followed through? Was it actually given to the chairman at the time?

Dr Laker—The letter that we wrote in early 2003 went to the head of risk and a copy of that letter was also sent to the chairman. As I said before, for reasons that APRA is still not entirely sure of, he chose not to show that to the board. The lesson that we have taken from this is: while it is our expectation that a chairman would share with the board a visit's finding or a letter like this—a letter which suggests that substantial work needs to be done—and that the board would then follow up with management to make sure that our requirements were met, we need to look at whether or not we can strengthen that process with more face-to-face dealings with the boards rather than with an exchange of correspondence. The new executive group is meeting much more with boards than we might have in the past. I think it is important that boards hear from us

across the table as to what our concerns are. We can then probe the boards as to how they are following up on the particular requirements.

CHAIR—One of the other issues that seems to have come out of this is the difficulty in finding independent auditors or accounting firms amongst the majors to do the inquiries. There has been some criticism of PricewaterhouseCoopers about the fact that no criticism was made by them as to why the risk committee and the board met only once between its establishment and the discovery of the losses earlier this year. Do you get involved at that level to look at what the accounting firms are doing and their possible conflicts of interest?

Dr Laker—Broadly. We are aware that with a limited number of major firms this is an issue that will raise its head, perhaps more often than now. In the first instance, it is for the institutions to identify what the conflicts of interest are for them. We are not involved that closely with each institution that we know the sort of work that is being done by different accounting firms for them. We would need to make sure that the entity itself has identified conflicts of interest and has addressed them. So we are certainly aware of it. We would look ourselves if there were any obvious conflicts, but we are not privy to the day-to-day dealings that institutions have with a whole range of legal, accounting and actuarial advices. We are involved in major issues about the appointment of the auditor and the actuary—that is our concern.

CHAIR—As a broader principle, a corporation as big as the National has dealings with all of the major accounting firms—

Mr Somogyi—As do the other banks.

CHAIR—Yes. How do you set in place a way of ensuring the independence of auditing?

Dr Laker—It is an important issue that you have identified. As I say, we have the residual powers to express a view about the appointment of an auditor. We would go back to the institution and say, ‘Explain to us why you don’t feel that there is a major conflict and how, if there were, you would be addressing that conflict?’ Some of the proposals that are currently out in the general insurance discussion paper are about auditor rotation and rotation of actuaries, for that very reason. We wanted to ensure a process which gives greater independence to the auditor and to the actuary. That is that the heart of our corporate governance proposals, and they are generally in line with the CLERP 9 approach as well.

Mr Somogyi—They are built on top of the CLERP 9 proposals, which are going through parliament at the moment, which will strengthen the Corporations Act and will give the regulators, not just us but also ASIC, some greater oversight of some of these issues, particularly the rotation of audit partners and the requirement, as is proposed, that auditors and actuaries do not come from the same firm when they are providing these types of advices to regulated entities.

CHAIR—You would have been aware of this before; you did not need the legislation to see that in the case of PricewaterhouseCoopers there was already an established problem. What did APRA do about that at the time?

Dr Laker—When you say ‘an established problem’, what do you mean?

CHAIR—A conflict. Clearly, PricewaterhouseCoopers were being brought in to do an assessment when you would have been aware that they may have not been seen to be totally independent.

Dr Laker—The decision to hire PwC was the NAB board's decision; that was the way they wished to proceed. We were conducting a separate inquiry. We used the forensic work of PwC to avoid double handling of the same factual data. Our report was quite independent of that PwC report. It did not rely on any of the judgments or the views expressed in that report. The way we had to proceed was to ensure we could justify our own views on the basis of the information and the assessments we were making.

Ms BURKE—But there has been criticism that APRA relied too heavily on the factual information from the PricewaterhouseCoopers report. There have been press statements to that effect.

Dr Laker—I have not heard criticism that we relied too heavily on it, but I am sure it has been made. In the investigation team, we needed to get on top of the transactional data which explained where the weaknesses in the risk management system were, which involved going through thousands of transactions, document after document. PwC were doing that work; they had been asked to that by the NAB board. We were satisfied that PwC were doing that forensic work quite thoroughly. Given the pressure of time and the pressure of resourcing, it would not have made a lot of sense for us to then take the whole, large series of documents aside, sit down and work out that a given deal was done at that price on a given day. That kind of forensic work normally does not raise doubts about the facts. The question is: what led to the circumstances and what were the series of weaknesses? That is where we formed our own view.

Ms BURKE—There are also some concerns that have been raised about your approach in that you showed marginal interest in the NAB risk management committee—I think there is only a half-page reference to it in the report. There are other concerns that you did not interview senior executive Ian Scholes, who was the executive general manager of corporate and institutional banking, and that that has had a detrimental impact on your formal report. Would you like to comment on those statements?

Dr Laker—Regarding Ian Scholes, I cannot give you any answer as to the particular set of interviews. I would have to check who was interviewed. I think we listed those we interviewed at the back of the executive summary. Reading it, I do not think he was interviewed by either party.

Ms BURKE—No. I suppose that is what everybody is asking: why not, seeing that he was general manager of corporate and institutional banking, which would have overseen the area where the transaction was happening?

Dr Laker—I do not know why the decision was taken, but I do know that APRA was able to put together, in its view, a quite comprehensive understanding of how the structure of risk management was set up in the first place, how it operated and what the escalation procedures were. We really needed to look at the system as a whole before getting into individual personalities in the system. I think the point we made in our executive summary was that it was

not as if the NAB did not have an elaborate structure of risk management controls and committees; it was that they did not work under pressure.

Ms BURKE—Given that this NAB fiasco comes on the back of Homeside in America and that you would have thought that they should have learned from previous mistakes—there are other instances but, again, risk management was part of it—were you a bit surprised at the failure of internal processes to be observed?

Dr Laker—I do not have the detailed background on Homeside; it happened before the executive group arrived in a full-time capacity. In the case of the market risk area, which had gotten our attention from the middle of 2002, having done the structural engineer's assessment we had warned that their system had stress cracks. We could not have foretold how that stress would manifest itself, but our warnings that there were stresses that needed to be addressed were in our view quite straightforward and quite clear. I am not in a position to draw a line between that and Homeside; that would have been a different part of the NAB. Can I also look forward rather than just looking back: we have quite a comprehensive remedial program that we have required of the NAB. In the market risk area we have been working with them on a timetable. Some actions we have required prompt attention to; some will take a little more time. We have a very strong commitment from the board and the CEO of NAB to get on with this job. We are getting on with it as well, so at this point we are busy just trying to make sure that this does not happen again.

Ms BURKE—Given that most people indicated that the losses were small in the grand overall scale of NAB, why have you increased the capital levels of NAB by $2 billion? Is this one of the looking forward things to ensure that we do not see a systemic risk problem actually having an effect?

Dr Laker—Let me explain very broadly the role of those internal capital targets. We form an assessment about the capital that is needed by an institution over and above the minimum Basel requirements, which are minimum, taking into account the range of activities in which it is involved and taking into account in particular the views of the board about the capital that they need, because it is their call in the first instance. There had been a judgment made about what was necessary for the NAB, as there is for every one of our regulated institutions.

What was clearly manifested in the case of the irregular trading and its aftermath was that the risk profile of the NAB was not the same as what it was when we had formed that original judgment. In particular, a number of senior executives in the risk management area were no longer in position; they needed to fill positions. They themselves admitted that they had weaknesses in their risk management controls and more broadly in the culture and governance that needed to be addressed, so the risk profile for the institution was different from the one that had been the basis of our original judgment.

Raising a capital requirement in that case is not unprecedented. It is part of the supervisory armoury, and we have used that on more than one occasion to deal with a change in our assessment of the risk profile of an institution. Equally, when that risk assessment is changed because institutions address our concerns we can move the capital ratios down. This is part and parcel of what we do. What is unique about the NAB case is that it is all under the full glare of publicity because the report was released. That particular step is not one that I am anxious to see

repeated publicly, because it is just part of what we do as a prudential regulator to satisfy ourselves on behalf of depositors that there is adequate capital for the risk. These levels will go up and down as part of that process.

Ms BURKE—Going back to that Homeside analogy, NAB and now most of our banks—fundamentally, the big four—have more deposits offshore than they have onshore. Particularly the NAB would have more assets under book offshore than onshore at this point in time. What sort of regulatory regime do we have to ensure that those offshore banks throughout the UK, US and New Zealand are also being regulated? The previous ANAO report some time ago—I think it was two years ago—showed that they were concerned about the lack of offshore regulation of Australian banks. Has APRA got some more money to ensure that people are going offshore and looking at our offshore institutions and how they are going? I suppose what happened with AMP recently is a good case in point.

Dr Laker—We were given more budgetary support for that and we are doing that. It is important to emphasise that in the UK and other regimes there is a very powerful regulator in place in any event. Our starting point is to look at the organisation as a whole, because we are ultimately the home supervisor and we look at the operations of any of our banks who are offshore as part of that consolidated assessment. Also, though, in the other jurisdictions there is a regulator, a host, who looks after the interests of the depositors in their regime. We have MOUs with some of these regulators. If we have not, we still interact with them quite a lot. But in many cases the important ones are governed by MOUs. We work quite productively and constructively and we share information. We need to do that because we need to make a judgment in the end of confidence in the other regulators.

So there are already many pairs of eyes looking at these offshore operations. We will be stepping up an on-site visit program to satisfy ourselves and to bring the broader perspective that we have from looking at the whole group to the supervision of the offshore operations. The dialogue between, for example, APRA and the FSA was very active in the AMP demerger. We shared information with them on the NAB, obviously enough. Ironically, it was the fact that we shared our initial assessments with the FSA that provoked people in NAB to be a bit offended, and that is what brought the matter to the attention of the audit committee. But it is a standard practice that we share information with the regulators, and it is a good two-way dialogue.

CHAIR—You alerted the National Australia Bank to the problem with their risk management back in 2002. A risk committee was set up in August 2003 and a problem was discovered in January 2004. There seems to be an awfully long delay between your identifying something and the process of response. If you were to find a similar situation now, what would be different in your response from saying, ‘We think there is a structural weakness. Right, what is happening?’

Dr Laker—I would be a little careful in saying that the delay, as you described it, involved our sending a signal to the NAB. The delay or the absence of the principal risk management committee’s involvement was really about the board’s involvement in this process. We sent the signal to the head of risk. We had a commitment from the institution in response to our first letter. We went back to see how they were delivering on that particular commitment.

Mr SOMLYAY—What level did that response come from?

Dr Laker—That was from the head of risk. We followed up with the head of risk.

CHAIR—How quickly?

Dr Laker—That was quite a prompt response. We had no indication at that point that the institution was not committed to getting on with what we had asked it to do. We went back a few months later to review that, because we knew that there had been quite strong views about the approach we had taken. We felt that it needed to get on with the job, and we said that we wanted a firm timetable to meet our concerns. That was happening at the coalface level in the NAB. At that point we had a commitment from the institution to get on with the job. We had not been involved in what was happening behind the scenes through the governance processes. This all came to light of course when the unauthorised trading was identified. But at the time our front-line people had a commitment from the institution, and one which we sought to push harder through a timetable.

CHAIR—You say you had a commitment from the institution—that is, the head of the risk department. Is that right?

Dr Laker—The head of risk management.

CHAIR—So you would take the authority of that to be sufficient?

Dr Laker—We would have presumed that he was responding to us with the support of senior management and the board. The presumption would have been that this kind of issue had been taken to the board—we believed it had been—by writing to the chairman and that he was clearing his responses with the board before they came back to us. In a subsequent event what would we do? We would make it very clear when we required information that the board was aware of it, was overseeing management's response and was able to, if necessary, critically challenge management's response.

Mr SOMLYAY—Did Catherine Walter play a part in the APRA inquiry?

Dr Laker—She was interviewed as part of that inquiry.

CHAIR—I want to turn to a couple of other things in your report. You talk about rising premiums in general insurance on page 19 and you make reference to one of the obvious problems there being the question of tort law reform. There is a Commonwealth-state working party implementing that. How involved is APRA in that question of tort law reform?

Mr Somogyi—We have been assisting Treasury and the minister in some of those discussions. We have had people actively involved at the workplace level with the ministerial committee that has been looking at it. So we have had quite a deal of involvement in getting some of those important changes made to torts law. Fortunately, so far the progress has been fairly good and positive.

Ms BURKE—Have we got anywhere with ensuring that insurance companies price their policies appropriately so that we do not have to have the systemic failure that we did at HIH and

so that, if you have an actuarial account of what it costs to provide a product, you are charging the appropriate amount?

Mr Somogyi—One of the good outcomes of now having approved actuaries involved in insurance companies is that the principles of pricing and the professional work that goes behind it have been introduced to quite a large number of companies. All of the larger insurance companies now heavily rely on actuarial advice, both internal and external. Some of those pricing principles have given them a great deal more strength and resilience, and we have seen that in the marketplace in that more appropriate pricing has come to pass.

Ms BURKE—One flow-on, though, is that we still have a lot of small community groups who cannot get indemnity.

Mr Somogyi—Yes.

Ms BURKE—But we have seen every insurance company post record profits. So there is a bit of a dichotomy that we deal with on a face-to-face level with our constituents who come in and say, 'We want to run the local fete,' or that they want to do X, Y and Z, or a small business wanting to continue—like in my neck of the woods—a rock-climbing business but now going broke because they cannot get indemnity who say, 'X, Y and Z companies just posted nice record profits.' I am not sure you can answer this, but there does seem to be a bit of a dichotomy out there where one group were underpricing and now they seem to have said, 'We've got carte blanche to overprice.'

Mr Somogyi—I think you have pretty effectively answered the question. It is important that we ensure that, with the risks these insurance companies undertake, they are now going to be capable of meeting genuine claims when they are due to be made. Our key role is to ensure that the insurance companies, to the maximum extent possible, are there when their policyholders need them most. What risk they underwrite is, I guess, a market issue as opposed to a prudential regulatory issue. I understand the question and I understand the frustration.

Ms BURKE—I want to change tack, if that is all right, to one of the criticisms with respect to APRA and staffing concerning the move to Sydney with the loss of senior staff and a whole lot of people who saw going from RBA to APRA as being—and no offence intended in this—a bit of a downward step at the time.

Dr Laker—I'm going to plead the fifth on that one!

Ms BURKE—I did preface it. Certainly at the time, going from RBA to APRA was seen as something you were not going to do as a career move, and a lot of very good staff were lost to the organisation.

Mr Somogyi—From Canberra?

Ms BURKE—Yes, the Canberra to Sydney move. A lot of people said that they could not afford the cost of the translocation. There was also some criticism at the time of trying to move staff off an award and an enterprise agreement that they had been happy with onto individual contracts, with the subsequent loss of certain conditions and the arguments about the transfer. I

am wondering whether you have managed to bed down the staffing structure and whether you have a happier staff than you had two years ago. What sort of employment conditions are you now offering staff? Are you going back to an EA or are you still trying to do individual contracts?

Dr Laker—The transition period for APRA was a difficult one. The Reserve Bank staff you referred to were not really offered the choice at the time, given the bipartisan commitment to getting APRA up and running. The bank took the view that the prudential supervision function needed to transfer en masse on day one for continuity of coverage, and we could not allow the regulated sector to be weakened by the loss of staff. The staff were given the option within a year of whether they really wanted to make that a permanent home. I cannot remember the exact numbers, but about a quarter of our staff are from the predecessor bodies.

Broadly speaking, I think we have addressed those transitional issues. It is very hard for us to say whether they are happy. They are very motivated. They work very hard and all of them—both the new and the old—are very committed. Looking at how we are recruiting to make up for the loss of experience, we are now able to blend the hard-nosed supervisors who have stayed with us from the bank, the ISC and AFIC and other agencies with people who have 15 years, 20 years and 30 years of hands-on experience. We are able to bring this blend of experience to bear on our supervision, and we would like to do more of that. That is the way in which APRA will grow in the future—hard-nosed supervisors and hard-nosed experienced industry people. We normally recruit from the marketplace on a contractual basis. That is the way we bring people in. Ross, Steve and I obviously get involved in some of the staffing issues, but I am not aware that there are any longstanding major problems. It was a difficult transition period but it was well negotiated.

Mr Jones—There is also a positive element in the move to Sydney as well, in the sense that, to some degree, it is now actually easier to attract quality, experienced staff. You are quite right: there were many people who did not want to move from Canberra to Sydney. But there is also the reverse element to that as well. We have also been able to improve the pay scale for some of the people we want to get, which has helped us.

Dr Laker—We also have a big operation in Melbourne, and we are in all of the state capitals as well. Sydney is the hardest market to recruit in. We have been able to recruit a good team in Melbourne, many of whom have been long-term supervisors and some who are new. So it is not just a Sydney focus; this is an Australia-wide institution. We recruit Australia wide and we staff offices Australia wide. But it is true to say that our biggest branch or the biggest part of our activity is in Sydney. It is our toughest market.

Mr Jones—In response to the question with respect to staff attitudes, we may be able to tell you next visit, because we will be doing our next survey of staff attitudes—so they will be able to respond with their views on us as well.

Dr Laker—It will be the first time they get asked what they think of the new executive group, without fear or favour.

CHAIR—To come back to the insurance questions, there have been some concerns raised, as you would be well aware, about financial regulation as it applies to fit and proper people for

responsible roles, particularly in insurance. A report in the *Financial Review* on 3 March said that in the case of HIH the criteria may not have been entirely effective in preventing the ultimate problems with its senior management. Is that a reasonable assessment?

Dr Laker—From a burden of proof point of view, I can see what that argument was saying. We put in our proposals in general insurance—this is the discussion paper—a range of what we call objective criteria for satisfying ourselves that a board is independent. I think the weight of the criticism—and that is probably reflected in that article—is that you can tick the objective criteria but you do not necessarily get independence. That has been a view put quite strongly to us in the consultation process and it is one that we hear loud and clear. We are not looking for a prescriptive approach for the sake of it; we have said to industry, 'That is one option of objective criteria. How can you satisfy a prudential regulator that you do have an active independent board without these criteria?' That is the dialogue we have under way at the moment with industry. The question about the way in which APRA will engage itself with boards has some way to run and it will be something that we can come back to the next time we appear before the committee.

CHAIR—What about the concern that I am hearing in some circles that it has now become rather difficult to find suitably qualified and willing individuals to go onto boards?

Dr Laker—It is certainly an issue that has been put to us in the regulated sector, but I think you are also raising a more general point—that the combined effect of CLERP 9 and the ASX listing rules et al is in a sense discouraging good people from going onto boards. It is hard to know how much weight to put on that, because we do have very strong boards across most of our regulated entities. The issue of how all these boards refresh themselves over time and remain vibrant and motivated is a question that we need to look at. It is hard for us to say yes or no to that particular view. Good directors do come forward. Stephen, what is your view?

Mr Somogyi—Dr Laker's answer is with respect to not only boards of the prudentially regulated sector but also boards of all kinds. It has to be remembered that the vast majority of our prudentially regulated entities are not listed organisations. By number, they are largely medium size or smaller. They find it just as difficult, if not more difficult, to attract appropriately qualified people who are well-educated in the risk area to sit on the boards and who will not necessarily tick the box but will act independently inside a boardroom to ask appropriate questions of management and of each other to ensure that everything that should be investigated has been investigated in looking at various proposals.

That challenge applies to a broad spectrum of organisations. I think everyone is struggling with how to measure that appropriately, including professional organisations like the Australian Institute of Company Directors. They are struggling as much as everyone else. I think everyone—not just the prudentially regulated—is trying very hard to come up with broad pragmatic solutions to these issues.

Ms BURKE—One of the other areas that you are obviously concentrating on with respect to fit and proper is in the superannuation sector and fund trustees. There has been a concern raised that trustees have recently had to get licensed under ASIC and now they are having to get licences under APRA. The concern goes to (a) the conflicting nature of this and (b) the cost in responding to different regulators under two different systems. Also, a lot of super funds are not-for-profit entities, so any cost borne by the trustee may come out of members' funds. Is this a

great impost on these entities? Have you ironed out what may be seen as some conflict in having to answer to two different regulators?

Mr Jones—There are a couple of points on that. First of all, on the issues with regard to ASIC, our preliminary investigation suggests that, of the people we expect to go through this super licensing—we are expecting probably around 800 entities—we have about 120 or 130 that have gone through the ASIC AFSL process. We have been in dialogue with ASIC to see whether we can get some sort of advantage in using some of their material. If it is only around 15 per cent or so, it may well be that there is not much in it in trying to find some sort of simple system. With regard to the other part of your question, our approach is that they need to prepare a risk management plan for the trustee that complies with the legislation. That is really all there is. There is a fee of course.

Ms BURKE—Do you see that there will be a contraction in the super sector? There are literally thousands of funds out there and literally thousands of tiny funds. Do you think that this process might mean that some of those will either amalgamate or close up?

Mr Jones—I think that will probably be the case—but that has been the trend anyway.

Dr Laker—It is already happening.

Mr Jones—It has been a longer term trend. The system may accelerate the trend, but I would think that it would also have the advantage of improving the quality of what remains.

Ms BURKE—One of the big concerns that the super industry are expressing is that their fit and proper test is actually greater than what you are putting forward for banks and insurance companies, and they are asking why the proposed tests for superannuation fund trustees appear to be higher and more subjective. With respect to that, they refer to the words ‘oppressive or otherwise improper business practices’. Given that a lot of these funds are industry funds that are run by trade unionists, some officials are thinking that the test may have implications for them as a body. Whether or not that is true is another thing entirely but, having read through the literature you have given to banks and insurance companies and the literature you are giving out to super, it does seem that you are recommending different tests for trustees going on to super funds. Can anyone answer that question?

Mr Jones—Oppressive? Sorry, I missed the context—

Ms BURKE—‘Oppressive or otherwise improper business practices’ are the words you have used for the super trustees, but you have not used them with respect to anything else.

Mr Littrell—To clarify one point: in superannuation, we have operating standards which are not, strictly speaking, in APRA’s control. Were we drafting prudential standards in super, we would harmonise those with what we do in banking and insurance. But we had one chance to get our views—

Ms BURKE—Can’t we revisit that?

Mr Littrell—That was a recommendation of the super working group when the government elected a different approach, as is their right. We have striven to make the fit and proper rules for super and all our other industries as identical as possible. But, due to the sheer fact that you are talking a year or so difference in time and everything else, you are going to get slight differences in words.

I would point out that, with respect to the issue of the word 'oppressive', it is not the case that an APRA supervisor can say, 'Joe Bloggs has been oppressive and he is out of the industry.' There has to be a fact pattern that is defensible in front of the AAT and possibly the courts—not to mention defensible inside APRA. We have a great number of sceptical people who have to be convinced that someone really is unfit.

In both sets we have what might be described as catch-all language that essentially says that if we think you should not be here and we are confident that we can win that case if you challenge us, we will do it. The way we achieve that is not described in super by language identical to everything else but, at the end of the day, the effect is very similar. I should also note that trustee duties in super are different. The obligation of a trustee to a super member is more demanding than the obligation of a bank director to a bank depositor, for example. So there is a sense there for possibly a higher standard, but not materially higher.

Ms BURKE—One of the difficulties with that is that we try to encourage onto super boards trustees who are actually members of the fund. We try to have people on those boards who are not people who are going to become bank directors. My previous experience was in banking. The people we usually got on were bank tellers. We tried desperately to try to make sure that people who were on the ANZ or NAB super fund board came off the floor—because, at the end of the day, it is your money, Ralph, and you should have some sense. The person you are looking at as a trustee to go on a super fund is different kettle of fish from the person who you are looking at to go on a board—in some respects, you do not want them to have had that life experience. They may be a fitter and turner or a hairdresser. Do you want them on their fund too? So there is some concern that these tests are actually going to eliminate that really good grassroots view going on those trustee boards. They might not know anything about finance, but they know the industry that they representing and they know the people in their industry. There is a concern coming through that that is going to have an impact.

Mr Littrell—We need to separate the concept of fitness from the concept of propriety. If you are a crook or a shonk, we want you out. If we can prove you are a crook and a shonk, we are going to get you out. The fitness standard for super trustees is different than it is for other people. If you are a bank chief executive or a head of risk, we have pretty firm views about what your background would be. Our fitness standard for super trustees as drafted is essentially that you are an honest, sensible person. Part of the risk management of the trustee is that, to understand your duties, you will receive sufficient education and training, which can be as little as a day or two of education. You need a certain minimum education as to what your duties are. We have no expectation that people coming off a shop floor or from behind a desk—which is increasingly the case nowadays—are not going to be as good as people coming from anywhere else. We have been cognisant of the fact that, for super trustees, fitness is very much a matter of mindset as well as formal training and experience. I do not see that as being a big problem in practice.

Mr Jones—I think it is for that very reason that we deliberately avoided the use of language that said you are required to have certain types of qualifications, a degree or anything else. That runs the risk of excluding the very subset of people that you are mentioning who may make an extremely worthwhile contribution to their fund. As you say it is their money—it is compulsory.

Dr Laker—The education focus will be on understanding what their obligations are as a minimum under the SI(S) Act. I think they do need to have that understanding.

Ms BURKE—Yes, I think that is reasonable.

Mr Somogyi—Not just for their sake but also for the sake of their fellow contributors.

Mr SOMLYAY—I have one question—a bit of unfinished business with respect to recruitment and staffing. You said that it was easier to recruit in Sydney. Do you find that the private sector is poaching some of your staff because of perhaps better salaries in the private sector? Is that a problem?

Dr Laker—Yes. It is a problem for APRA. It is a problem for all of the agencies, as I am sure you will find if you ask the governor the same question. It was an issue when I was in the Reserve Bank. We are still able to attract very good industry people. We also bring in good graduates. We rely on the graduate program to provide the young talent that we train and develop. They are at risk within a couple of years. We do lose good staff—people we have put time and a lot of training into when we have seen the potential—but so do other employers. We do lose more staff than I would like. That is life in the financial sector.

Mr SOMLYAY—In a way, that is not a bad thing, if the APRA culture is getting out into the private sector through those people.

Dr Laker—I accept that. In time we will be pleased to see a familiar face on the other side of a negotiating table. At least they will understand where we have come from and what our concerns are. But, at the same time, I do not want to be overly generous to industry. I really want to have good supervisors on the job. We have been able to build a very strong team, and I would like to hold them. It is not just salary and another employer putting a tempting offer; I think generally our younger people want to have a broad career and a wide spread of experience before they finally settle in a particular career. I would be pleased to see them come back to APRA after they have tested the waters elsewhere. But that is life.

Ms BURKE—There has been some ongoing discussion of the levies you charge the institutions and there was a review of the levy structure. Has that finally settled down? We see in the paper that there is still criticism from various institutions that they are paying too much or other institutions are not paying enough and the maximum was never sufficient and the work that goes into a small super fund might be even greater than a big bank. Is that finally bedded down, or are we still—

Dr Laker—On Friday, the minister released the levies review paper, and the government said that it has accepted the recommendations of the paper, subject to further consultation with industry on detail. The framework that was put out—which would apply not in the next 12 months but the following period—goes a long way to addressing concerns that there was not

what we call vertical equity between the smaller institutions and the larger institutions. There is a framework that has been proposed in which a major part of our revenue from levies will be specifically cost focused but there will be a separate levy which will apply to deal with system risk and what is called 'vertical equity' in the paper—that is, fairness between small and large—which would provide a more equitable distribution of the levies. That framework was out on Friday. A lot of the earlier concerns that were put to the review team—I could see the strengths of those arguments—have been taken on board and the paper came out on Friday.

CHAIR—I thank you all very much for coming along today.

Resolved (on motion by **Mr Somlyay**, seconded by **Ms Burke**):

That this committee authorises publication, including publication on the parliamentary database, of the proof transcript of the evidence given before it at public hearing this day.

Committee adjourned at 11.53 a.m.