

27 July 2001

N.J. Fitzpatrick
35 Cole Street
East Hawthorn 3123

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

Dear Secretary

Re: *Inquiry into Banking Supervision*
Australian National Audit Office Report No. 42 (2000-01)

This letter represents my submission to the Inquiry. This submission initially discusses some developments that are of relevance to prudential supervision. This submission then analyses the Australian National Audit Office (ANAO) Bank Supervision Audit report and finds:

- inadequate levels of resourcing of bank supervision;
- inadequacies of, and gaps in, the supervision approach;
- inadequacies of, and gaps in, recommendations listed in the ANAO Audit Report;
- missing or contentious information in ANAO's Audit Report; and concludes
- supervision of banks in Australia is, in general, inadequate and requires changes.

The Banking System

ANAO states in its audit report that since the establishment of Australian Prudential Regulation Authority (APRA), the financial performance of the Australian banking sector has been strong. It is difficult to see the relevance of this statement, particularly when one casts their mind back to the late 1980s when banks reported strong profits, only to subsequently suffer losses. In the early 1990s there was significant strain on the financial system, which also had adverse effects on the economy. In 2001 HIH collapsed, and this followed HIH reporting of profits over recent years.

There have been recent developments that have, taken in isolation, had the effect of either weakening banks' financial condition or artificially keeping capital adequacy ratios higher than they would otherwise be. The Prime Asset ratio, which required banks to hold 3 per cent of assets in Prime Assets, was abolished in 1998. Non-callable deposits with the Reserve Bank were also abolished in 1998. In June 1995 the value of public sector securities held by banks represented 6.5 per cent of total assets, whereas by May 2001 they represented less than 3 per cent.

During the 1990s banks improved their ability to structure loans to attract lower risk weightings (i.e. artificially reducing capital adequacy ratios). Despite this, capital adequacy ratios of Australian banks are currently not far away from the levels reported in the early 1990s.

Based on data in the Reserve Bank Bulletin, the rate of growth in the nominal value of banks' derivatives business has significantly exceeded the rate of growth in the risk weighted value of these assets (i.e. the risk weighted value included in the calculation of capital adequacy ratios). The discrepancy in relative growth may be due to better management of derivatives, use of different derivative instruments, use of lower risk weights and better management systems. But the discrepancy needs to be better explained to ensure banks are not under-reporting risk weightings.

The increase in the value of other off-balance sheet business has similarly exceeded the growth in risk weighted value of these assets, and needs explanation.

In early 2001 the RBA stated that there was a risk of some households becoming over-stretched, despite this being at a time of low unemployment and low interest rates. Lending guidelines in the housing loan industry have been relaxed over recent years. For example, loans of up to 95% of valuation can be obtained from most lenders. Some banks will accept government grants available to first homebuyers as the entire deposit on a loan (i.e. no requirement to show a history of repayment capacity). It has been reported that people in their 50s can obtain home loans with a 25 year term (even though debt serviceability is doubtful at least beyond retirement age). Valuation reports vary in standard. Debt serviceability calculations by lenders may not take into account the possibility of a significant increase in interest rates in future. Banks are using other organisations to market and write loans, and therefore have less control over the procedures undertaken when extending loans.

Some banks have securitised and sold loans (mostly residential mortgages) to get them off balance sheet, and this practice is often used to reduce capital requirements. The ANAO Report did not look into APRA's processes in examining these transactions (and there may be implications for bank and financial system risks).

In recent years, banks have increasingly relied on foreign currency liabilities to finance lending. APRA should liaise closely with the RBA to determine implications for banks.

APRA Resourcing

In 1999-2000 APRA budgeted to spend \$10.4 million on direct supervision of a banking industry with assets approaching \$800 billion. Australians are reliant for their prosperity on a safe banking system.

The Basle Committee on Banking Supervision states that ‘...while the cost of banking supervision is indeed high, the cost of poor supervision has been proven to be even higher’. Since the establishment of APRA, it appears there has been a real decline in the amount spent on bank supervision. It would appear that the amount spent by APRA is significantly less than the amount spent by the previous regulator (the Reserve Bank), although ANAO’s Report does not outline the amount spent by the Reserve Bank.

APRA has between 30 to 34 staff allocated to supervision of banks – i.e. less than one staff member per bank. This is extraordinarily inadequate, and goes a long way to explaining why ANAO found so many areas where APRA could make improvements in its practices and processes. It was also apparent that ANAO was concerned with a lack of on-site visits by APRA to banks. APRA advised ANAO that there had been under-resourcing, but APRA does not go on to say what level of resourcing is required (nor is this information sought by ANAO).

‘Financial safety’ should be a paramount objective for a banking prudential supervisor. Government policy requires APRA to balance the objectives of financial safety with other objectives such as efficiency, competition, contestability and competitive neutrality. Some of these objectives appear at odds with the role of a prudential supervisor, and could provide ongoing pressure to maintain (or even reduce) the level of supervision at a level which is unacceptable to the Australian community (and potentially unacceptable to overseas financial markets). APRA actually stated that any increase in the intensity of its on-site examinations is at odds with its obligation to balance objectives.

To gain a better understanding of the adequacy of resources devoted to supervision of banks in Australia, ANAO should have compared APRA with other bank supervisors in other countries (e.g. spending as a percentage of bank assets, supervision staff/assets etc).

Supervision Approach

The Basle Committee on Banking Supervision states that ‘...strong and effective banking supervision provides a public good that may not be provided by the market place...and it is critical to the financial stability in any country’. The writer believes that APRA’s reliance on the board, management and auditors of each bank is excessive. This view is based on a need for prudence and on the supervision approach adopted by bank supervisors in many other advanced countries. In Australia, the HIH situation should be a reminder that there are risks associated with over-reliance on information provided by parties close to a supervised entity. Events in the late 1980s and early 1990s provide further reminders.

The Commonwealth Treasury advised ANAO that it is 'largely satisfied with APRA's supervision approach' and that it considers that APRA 'has been developing a sound prudential framework.' This is surprising in light of the large number of gaps found by ANAO in APRA's supervisory processes. There is a lack of evidence presented in ANAO's Audit Report supporting the soundness of APRA's prudential framework.

According to the Basle Committee, the vast majority of countries have endorsed Basle Core Principles and declared an intention to implement them. Yet, the Commonwealth Treasury stated to ANAO that the risk-based approach to prudential supervision adopted by APRA does not necessarily require full compliance with the Basle Core Principles. ANAO's report does not fully explore the basis for Treasury's view and the Core Principles that Treasury believes do not need to be complied with. This situation is made more confusing when you consider that APRA has agreed with ANAO that it should more closely adhere to a number of Core Principles in order to enhance APRA's supervisory effectiveness.

ANAO has stated that following the adoption of APRA of a risk-based methodology in late 2000, it is intended that banks with lower risk profiles will receive fewer, and less frequent, visits than when supervised by the Reserve Bank. It should be noted that APRA has to date made no on-site visits to 80% of banks. APRA's intention is that systematically important institutions and institutions with high-risk profiles, or those encountering risk management difficulties will be subject to more frequent visits. This raises a number of issues and questions, including:

- What systems are in place to identify systematically important institutions?
- How many banks does APRA consider as being systematically important?
- Can the failure of a bank that is not considered 'systematically important' cause contagion (e.g. run on other banks)?
- Under the Banking Act, APRA has a duty to exercise its functions and powers for the protection of depositors of all locally incorporated banks. By concentrating its resources on only a few banks, does this mean that APRA is not carrying out its duty in relation to all locally incorporated banks. In the event of a bank failure (perhaps unforeseen), could this open up APRA (and the taxpayer) to liabilities?

APRA's quarterly reviews assess, inter alia, compliance with minimum prudential ratios. APRA has advised ANAO that the submission of prudential data allows APRA to monitor key trends and convey early warning signals about emerging risks that will be investigated by analysts. However, APRA advised ANAO that, with the current resource restraints and work priorities, full quarterly reviews have been curtailed for low-risk institutions as they represent the least critical supervisory task. If APRA has made on-site visits to only 10 banks, this implies that full quarterly reviews may have been curtailed for as many as 40 of the 50 supervised banks. The curtailment of such a fundamental monitoring of supervised banks is of concern, particularly when it is possible for the financial condition of banks to change rapidly. Examples of factors that can rapidly change the risk profile of a bank include a run on deposits, derivative trading losses,

underwriting activities, the failure of counterparties, non-accruing loans and bad and doubtful debt write-offs.

The way APRA's conducts some of its activities contradicts the way APRA expects supervisors in other countries to conduct their own activities. APRA places significant reliance on the supervision conducted by home country supervisors of foreign bank subsidiaries and branches operating in Australia. Yet APRA places significant reliance on host country supervisors of Australian banks' offshore subsidiaries. According to ANAO, APRA has never visited an offshore operation of an Australian bank, even when supervisory activities have raised concerns.

Based on the ANOA Report, there appears to be inconsistencies in APRA's approach. APRA recommends, but does not require, banks to have a credit risk grading system in place. Yet, APRA advised ANAO that, where shortcomings are identified in credit risk grading systems by its supervisory work, it expects these to be corrected...' (P76).

ANAO makes no significant attempt to critically assess the veracity, consistency and viability of APRA's prudential framework or its risk-based approach. The risk-based approach is fundamental to bank supervision now being practiced in Australia. What other countries have adopted the 'risk-based approach'? Why do other major supervisors take a more hands-on approach? Have supervisors in other countries studied the relative costs and benefits of a risk-based approach/hands on approach? The APRA approach appears partly risk-based and partly hands-on – i.e. a very arbitrary situation that does not engender confidence. Is the risk-based approach based on a statistical model for predicting bank distress? What evidence is there that banks that are risk-rated by a supervisor as 'low-risk' will not encounter distress? Is the risk worth any potential loss – a loss that could far exceed the higher costs of hands-on supervision?

ANAO Recommendations

Unfortunately, many of ANAO's recommendations do not provide a definitive way forward to enable resolution of inadequacies identified by ANAO in bank supervision. For example, the recommendations that APRA 'review' or 'consider the merits' of an action or 'periodically' conduct an action is not a positive way to promote action. The recommendations contain no timelines for action.

ANAO found that APRA conducted few on-site visits. ANAO also found inconsistencies with APRA's policy regarding on-site visits. APRA agreed to ANAO's recommendation in relation to on-site visits, yet APRA's qualification to its agreement is open-ended and can effectively be interpreted as a non-response.

ANAO recommends that APRA 'review' prudential restrictions on large exposures. ANAO appeared to express some concern about the extent of large exposures reported by 2 banks (in an audit of only 9 banks, i.e. over 20 per cent of the sample). Yet, the 'review' does not necessarily promote change.

ANAO's Audit Report identified a number of problems but failed to follow through with recommendations. For example:

- There is no recommendation in relation to overseas on-site visits.
- There is no recommendation in regards to APRA carrying out its quarterly reviews of banks (which APRA states it has curtailed for 'low-risk institutions').
- There is no recommendation in relation to how to deal with banks that are reluctant to, or refuse to, comply with Prudential Standards (or to provide information). If banks are aware that they can breach Standards or withhold information with impunity, it is possible that such breaches could conceal and/or promote a dangerous occurrence. APRA should give timeframes for compliance and apply sanctions if compliance continues beyond a specified date. If existing sanctions cannot be enforced without risk to depositors, then the Government should legislate to introduce new sanctions that do not affect depositors (e.g. fines on directors).
- There is no recommendation in regard to processes for supervisory actions when a bank is rated as 'high risk'.
- APRA could only provide ANAO with copies of the supervisory action plans (SAPs) for 4 of the 7 banks whose supervision was examined in detail as part of the audit. Should there not be a recommendation in relation to completing SAPs?

Upon the instigation of ANAO, APRA stated that it will obtain and examine copies of all banking licenses (although this was not made a recommendation by ANAO). Consideration should be given to the legal implications of having licenses issued by a past regulator and whether licenses should be reissued in the name of APRA.

Particularly in view of ANAO finding that bank licenses were not passed on from the Reserve Bank to APRA, is there any other documentation or records that APRA needs to obtain from the Reserve Bank? Should there not be a recommendation to this effect.

Missing Information or Contentious Information

APRA's risk rating process has produced a 'high-risk' rating for one bank. It is not evident from ANAO's Report whether this bank was one of the banks examined as part of the audit. It is considered important that ANAO should have established the reasons for the bank being rated 'high-risk', when APRA arrived at this rating, whether action could have been taken before the adverse rating to avert the high-risk rating and what action APRA is currently taking. ANAO should have also ensured there are procedures in place to deal with 'high-risk' banks.

ANAO found out of its audit sample of 7 banks, 'most' chief executive declarations had been provided to APRA within the required timeframe with the declaration conforming to APRA's requirements (P55). What systems does APRA have in place to ensure compliance and are there carrots and/or sticks in place to promote compliance? What does 'most' mean?

ANAO found that occasionally external auditor reports did not comply fully with APRA's requirements and, often, reports were provided outside the required period (P56). What systems does APRA have in place to ensure compliance and are there carrots and/or sticks in place to promote compliance? What does 'occasionally' mean?

APRA states 'as part of our credit risk visits to banks that maintain banking operations offshore, we can request a sample of credit files to gain an understanding of how globally based credit risk management systems operate in individual domiciles' (P65). The question is when is this done and by whom?

APRA advised ANAO that '...In some instances, internal model users may not have completely addressed all criteria. Where this is the case, APRA would have '(my emphasis) ...'undertaken a documented assessment of the materiality of outstandings...' (P78). The use of 'would have' rather than 'did' is intriguing.

APRA advised ANAO that 'None of the Australian banks operating offshore could be regarded'... (my emphasis)... 'as undertaking significant trading activities in these locations' (P86). The use of 'could be regarded' does not imbue confidence (on what basis does APRA reach this conclusion?).

It is difficult to come to terms with APRA's belief that if the overseas operations of an Australian bank were impacted by major credit events, this would not have a major impact on the banking group's consolidated capital base and Australian depositors (P86). It would be interesting to see how APRA has developed this belief.

Conclusion

The Basle Committee on Banking Supervision says that ‘strong and effective banking supervision provides a public good that may not be provided by the market place...and it is critical to the financial stability in any country’. The Committee goes on to say that ‘while the cost of banking supervision is indeed high, the cost of poor supervision has been proven to be even higher’.

I believe that bank supervision in Australia does not currently meet the standard of being ‘strong and effective’. The Commonwealth Government must amend APRA’s objectives to make financial safety the paramount objective. Based on the information contained in ANAO’s Audit Report, APRA needs to change its approach, increase its resources (i.e. by increasing levies) and adopt a far more hands-on approach to supervision. The Commonwealth Government may also need to legislate to provide APRA with more ‘carrot and stick’ powers to facilitate banks’ compliance with Prudential Standards and APRA information requirements.

Yours faithfully

Nigel Fitzpatrick