

PRUDENTIAL REGULATION

3.1 Over recent years, Australian financial institutions have operated against a background of a buoyant domestic economy and a more stable international environment. Total assets of the financial sector grew by around 11% in 1999-2000 to \$1 615 billion. Rationalisation has continued to be a feature of the financial sector, and there has been increased interest in the use of internet and electronic commerce, but these areas of the financial market are still in their infancy.¹ According to Mr Thompson:

In the main, prudential supervision concerns have not been significant, although the flow on effects from natural disasters in 1999 have constrained the general insurance and domestic reinsurance sectors.²

3.2 Of the industries regulated by APRA, banking was the most profitable, experiencing growth in assets during the 1999-2000 financial year of 18%, while superannuation grew at 17%. Building societies and credit unions experienced growth of around 5% during the financial year. However, in general insurance, profits were in general flat, with a third of registered general insurers experiencing a loss over the financial year.³ The performance of each of these sectors is dealt with in greater detail below.

1 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 8. See also Evidence pp 4-5.

2 Evidence pp 4-5.

3 Evidence pp 5-6.

APRA's focus

- 3.3 APRA is a risk based prudential regulator. That is, APRA is concerned with how financial institutions control the risks in their activities in order to maximise the likelihood that financial institutions will be able to honour their obligations to their depositors and share holders.⁴
- 3.4 According to APRA, the major areas of focus in the prudential area in the last year have been:
- substantially completing a review of the prudential standards for conglomerate entities;
 - participating in the Basel Committee on Banking Supervision's review of the 1988 capital accord;
 - harmonising prudential standards for ADIs; and
 - commencing a major review of the prudential supervision of general insurers.⁵

These areas of focus are expanded on below.

Conglomerates

- 3.5 Increasingly, financial services of all kinds are offered not by single stand-alone organisations, but within conglomerates or group structures containing different types of financial institutions with different risk profiles. Typically, some of these activities are covered by regulators while others are not.⁶ These conglomerates have provided APRA with significant new challenges. Principle amongst these has been how to measure and manage risk across a diverse set of activities.⁷
- 3.6 APRA has conducted a review of the regulatory framework for conglomerates in two stages. The first stage was completed in early 2000, and dealt with: ownership of conglomerates by non-operating holding

4 Evidence pp 2 and 26.

5 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 3. See also Evidence p 4.

6 *Prudential Supervision of Conglomerates*. Australian Prudential Regulation Authority Media Release, 11 March 1999.

7 Australian Prudential Regulation Authority. *Prudential Supervision of Conglomerates*. 1999. Sydney, APRA, p 2. See also Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 4.

companies; the limits of financial activities by non ADI sections of conglomerates; and group wide risk management practices. The second stage is currently under way, and is dealing with: capital adequacy; the treatment of capital in non ADI sections of conglomerates; and intra and extra group exposures.⁸

Authorised Deposit-taking Institutions

- 3.7 Authorised Deposit-taking Institutions (ADIs) include such entities as banks, building societies, credit unions and friendly societies. During the hearing the Committee explored APRA's use of the generic term 'ADI' as a descriptor for these institutions. APRA indicated that the generic term was adopted in order to prevent any suggestion that there were first or second class deposit taking institutions in relation to prudential standards, while allowing these institutions to continue to differentiate themselves in the market place as banks, credit unions or building societies.⁹
- 3.8 In the banking sector, profits have been high, despite the continued decline in interest margins. Asset growth of about 11% and increases in non interest income have generated after tax returns to the equivalent of 18%. Bad debts remain low by historical standards. The capital ratio of the banking sector is 10%, much the same as it was two years ago. This compares with the standard minimum ratio of 8%.¹⁰
- 3.9 Banks are becoming more active in managing their capital. This is because of their efforts to maintain their returns on equity in the face of strong competition and their ability to measure their internal capital requirements more accurately than in the past. As a result, share buy-back and securitisation programs have become more common and currently an amount equivalent to around 7% of banks' collective balance sheets has been securitised and sold to investors.¹¹
- 3.10 Building societies and credit unions experienced average growth of around 5% over the past year. Consolidation remains a significant issue in these sectors, with the number of institutions continuing to trend down and being much lower than five years ago.¹² Credit Unions in Australia

8 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 24.

9 Evidence pp 15-16.

10 Evidence p 5.

11 Evidence p 5.

12 Evidence p 5.

have \$21.5 billion in assets compared to \$759 billion for all ADIs,¹³ or about 2.8%. In contrast, in the United States, in 1999, credit union share of total assets was at 5.8%.¹⁴

- 3.11 Building societies' and credit unions' share of household deposits has increased over recent years. However, household deposits are only growing in line with the economy. These entities have not participated in the growth in superannuation or share ownership, so have only grown at 7-8% rather than 18% for banks.¹⁵

APRA's activities

- 3.12 In APRA's view, the significant issues in relation to ADIs have been: the review of capital adequacy requirements; the harmonisation of prudential standards; the regulation of purchased payment facilities; and the regulation of credit derivatives.¹⁶

Capital adequacy

- 3.13 Capital adequacy refers to the amount of capital held by ADIs to cover losses. Capital adequacy requirements for Australian ADIs are currently based on the Basel Committee on Banking Supervision's 1988 *International Convergence of Capital Measurement and Capital Standards*, commonly known as the Basel Accord.¹⁷
- 3.14 In June 1999, the Basel Committee released a draft replacement for the Basel Accord called *A New Capital Adequacy Framework*. The Basel Committee's proposed new Accord consists of three pillars: minimum capital requirements; a supervisory review process; and effective use of market discipline.¹⁸
- 3.15 APRA supports the general thrust of the new Accord. However, APRA believes some areas of the Accord should be reconsidered, including the

13 Reserve Bank of Australia. *Bulletin*. September 2000. Sydney, RBA, p S3.

14 Credit Union National Association. *Depository Institutions Historical Profile: United States Totals*. Madison, CUNA, p 1.

15 Evidence pp 14-15.

16 Submissions p S2.

17 *Risk and Capital Management – An Overview*. Matten, Chris. *Risk and Capital Management: Conference Papers*. 2000. Sydney, APRA, p 9.

18 Basel Committee On Banking Supervision. *A New Capital Adequacy Framework*. 1999. Basel, Basel Committee on Banking Supervision, pp 1-2.

50% risk weight attached to housing loans, which it believes should be reduced.¹⁹

- 3.16 In addition, APRA welcomes the Basel Committee's recognition that the Accord ought to be suitable for application to ADIs of varying levels of complexity.²⁰ There is no indication at this stage when the new Accord will be finalised.

Harmonisation

- 3.17 APRA's major activity in the area of ADI regulation has been the harmonisation of prudential standards across ADIs:

...we aim to create a single, consistent set of prudential rules for all deposit-takers – banks, building societies and credit unions – by mid 2000.²¹

- 3.18 The new standards came into effect on 1 October 2000.²²
- 3.19 APRA intends to undertake a second stage of investigation, involving a more thorough reassessment of the harmonised standards, to ensure they address all significant risks facing ADIs.²³

Purchased payment facilities

- 3.20 Purchased payment facilities are facilities that a consumer pays for in advance and then uses to make various types of payments. A good example is a smart card. APRA believes that if a customer is entitled to demand repayment in Australian currency for the balance of the stored currency, then the purchased payment facility is akin to a deposit. On this basis, APRA and the RBA have determined that the holder of the stored value is carrying on the business of a bank, and should be regulated as such.²⁴ The Committee believes more work needs to be done to differentiate between larger and smaller amounts of repayment before smart card operators are required to obtain a banking licence.

19 *Review Of Capital Adequacy Requirements*. Australian Prudential Regulation Authority Media Release, 15 March 2000. See also Australian Prudential Regulation Authority. *Review Of Capital Adequacy Requirements*. 2000. Sydney, APRA, p 2.

20 Australian Prudential Regulation Authority. *Review Of Capital Adequacy Requirements*. 2000. Sydney, APRA, p 3.

21 Australian Prudential Regulation Authority. *Annual Report 99*. 1999. Sydney, APRA, p 25.

22 *APRA releases ADI standards*. Australian Prudential Regulation Authority Media Release, 11 September 2000.

23 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 23.

24 *Regulation of Purchased Payment Facilities*. Australian Prudential Regulation Authority Media Release, 15 June 2000.

- 3.21 Purchased payment facilities are one of a number of means by which non ADIs can participate in the payments system. APRA indicates that it has received approximately ten inquiries from non ADIs seeking to become payment services providers. These proposals involve internet based payment services as well as purchased payment facilities. According to APRA, it is difficult to say at this stage whether these proposals will require an ADI licence.²⁵

Credit derivatives

- 3.22 Credit derivatives (also called securitised loans) are contractual arrangements that allow ADIs to hedge their exposures to particular borrowers and write large volumes of loans without breaching internal credit limits by allowing a third party to adopt the credit risk.²⁶ Since credit derivatives facilitate the transformation of credit risk profiles, concentrations of credit exposure may be hidden. Consequently, APRA has issued guidelines that require ADIs to inform APRA of any concentration in exposures. The guidelines also deal with the capital adequacy requirements relating to the risks involved in this sort of activity.²⁷

Fit and proper

- 3.23 An ADI must ensure that its directors and senior management are fit and proper to hold their positions. According to APRA's guidelines, this involves being able to demonstrate expertise in the field; and competence, integrity and a good reputation in business.²⁸ During a recent Senate Estimates hearing, APRA revealed that it had not determined precisely how it would define whether an individual was fit and proper.²⁹
- 3.24 At the Committee's hearing, APRA pointed out that as a result of the harmonisation process, a fit and proper requirement has only recently been applied to ADIs. It said, rather than APRA imposing a prescriptive approach, institutions are required to have good systems in place so they
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25 Submissions pp S3-S4.

26 *APRA Draft Guidelines Get Cool Reception*. Hogan, Roger. *Australian Financial Review*, 20 December 1999.

27 Australian Prudential Regulation Authority. *Guidance Note To Prudential Statement C1, Capital Adequacy of Banks: Capital Adequacy Treatment of Credit Derivatives in the Banking Book*. 1999. Sydney, APRA. See also Australian Prudential Regulation Authority. *Guidance Note To Prudential Statement C3, Capital Adequacy of Banks: Capital Adequacy Treatment of Credit Derivatives in the Trading Book*. Sydney, APRA, pp 2-3.

28 Australian Prudential Regulation Authority. *Guidelines on Authorisation of ADIs*. 2000. Sydney, APRA, pp 4-5.

29 Senate Economics Legislation Committee. *Estimates Hansard*. 31 May 2000. p E325.

are sure the directors and senior management they are getting are fit and proper.³⁰ The Committee feels this response is less than adequate and looks to APRA to further justify its approach in the coming year.

Credit card debt

- 3.25 During the hearing, the Committee inquired whether APRA had any concerns about the level of credit card and household debt. In November 1999, the RBA estimated that the ratio of household debt to disposable income in Australia had reached the level of 94%.³¹
- 3.26 APRA indicated that household debt has been an area of focus for the organisation in its consultation with ADIs to ensure they had systems in place to monitor the debt. APRA also indicated that it does not monitor household debt directly, but rather monitors ADIs to ensure they are effectively monitoring household debt.³² This is a matter that does concern the Committee and we will continue to monitor it.

Superannuation

- 3.27 In 1999-2000, the superannuation sector continued to grow rapidly. Growth in the past year was about 17%, and there are now just over \$450 billion worth of savings in superannuation funds. Polarisation is the key to the superannuation market currently, with superannuation business moving out of mid range funds to either the largest 360 funds or down to small funds of less than five members.³³

APRA's activities

- 3.28 A number of issues have arisen in relation to APRA's supervision of the superannuation industry. These are: APRA's approach to supervision; the responsibilities of auditors to superannuation funds; the quality of super fund trustees; and the regulatory approach to people who are over 65 years of age and still working. Staffing in this area is also an issue, see paragraphs 2.38-2.44.

30 Evidence p 33.

31 Reserve Bank of Australia. *Semi-Annual Statement on Monetary Policy, November, 1999*. RBA, Sydney, p 17.

32 Evidence pp 22-23.

33 Evidence p 6.

- 3.29 Amendments to the *Superannuation Industry (Supervision) Act 1993* (SIS Act) transferred the regulation of excluded superannuation funds with fewer than five members from APRA to the ATO on the basis that all members are fund trustees and should be able to protect their own interests.³⁴

APRA's approach

- 3.30 As the regulation of a large number of the smaller funds has now moved to the ATO, APRA is considering how to regulate the remaining funds.³⁵ APRA's approach is risk based, involving assessing which funds are riskier than others (for a description of APRA's methodology, see paragraphs 3.6-3.10).³⁶
- 3.31 From the perspective of the superannuation funds, the new approach is considered intrusive, and they believe APRA:

... needs to embark on a campaign to explain its role...³⁷

APRA's response has been that:

We believe that we are not a black letter law regulator. Our approach is to be consultative and flexible, but to draw a firm line when we need to, and I think we have the resources, the talent, the experience to supervise in that mode.³⁸

- 3.32 It is the view of the Committee that new regulatory bodies have a responsibility to educate both the organisations being regulated and the general public about the relative benefits of the adopted regulatory approach. Such education cultivates an understanding about the regulator's role. From the Committee's investigations there appears to be a need for APRA to take on a more educative role with the regulated industries. APRA should ensure that it commits adequate resources to that task. The Committee will follow this up at the next hearing.

34 *APRA passes small super fund administration to ATO*. Australian Prudential Regulation Authority Media Release, 19 October 1999.

35 Evidence p 19. See also Australian Prudential Regulation Authority. *Annual Report 99*. 1999. Sydney, APRA, p 19. See also *The Energetic Enforcer*. Hely, Susan. *Superfunds*, No 227, July 1999, p 19.

36 Evidence pp 19-20.

37 *Sizing Up APRA: Friend or Foe*. McIlwraith, John. *Superfunds*, No 227, July 1999, p 15.

38 Evidence p 17.

Superannuation auditors

- 3.33 At the hearing, APRA said its reviews of superannuation funds have revealed a number of instances in which auditors are not fulfilling their responsibilities.³⁹ Many auditors are continuing to sign audit reports without completing the required audit work or without the required level of knowledge and skill.⁴⁰ CPA (Certified Practising Accountants) Australia has also raised the quality of superannuation fund auditors, indicating they are working with APRA to raise the standard of superannuation auditing.⁴¹
- 3.34 APRA does not believe that poor auditing quality is a system wide problem, although it admits there are certain cases where governance has not been as strong as it should have been.⁴² The activities of nine auditors of superannuation funds were reviewed during the year 1999-2000, resulting in three auditors being disqualified and two being referred to their professional association for disciplinary action.⁴³

Trustees

- 3.35 The *Australian Financial Review* reported on comments by Deloitte Touche Tohmatsu national partner, Mr Richard Rassi, concerning the level of neglect by super fund trustees. According to Mr Rassi, three out of four super funds have prudential and compliance issues of some description. The major areas of concern are the irregular reconciliation of assets, important profit and loss items, and membership rolls. According to Mr Rassi, trustees are not adequately trained, and lack accounting or business backgrounds.⁴⁴
- 3.36 In evidence, APRA said it does not agree with this assessment, arguing that only a minority of funds suffer from these problems and that the situation is improving.⁴⁵ There are fewer super funds than there used to be, so there is an increasing pool of people with experience available to perform the role of trustees. In addition, it is now common for trustees of medium to larger funds to develop, with the help of professionals,

39 APRA. Coulthard, Murray. *Charter*, No 11, December 1998, p 63.

40 *Auditors don't always add up*. Adams, Wayne. *The Australian*, 9 December 1998.

41 Senate Superannuation and Financial Services Select Committee. *Hansard*. 15 June 2000. p SFS437.

42 Evidence p 20.

43 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 16.

44 *Super fund trustees accused of neglect*. Dunstan, Barrie. *Australian Financial Review*, 5 April 2000.

45 Evidence p 11.

training packages for themselves so that new trustees go through a training regime.⁴⁶

Over 65s

- 3.37 Under Regulation 6.21(3A) of the SIS Act, superannuation funds are required to check on a monthly basis whether contributors over the age of 65 years are still eligible to make superannuation contributions. In order to continue contributing, contributors must work over ten hours a week.
- 3.38 APRA has recommended that the employment status of people who fit this criteria be checked every month. One problem with this approach is that people who fit this criteria will have to respond to superannuation fund correspondence every month in order to remain a member. If they miss a correspondence, the fund will be required to pay out their benefit.
- 3.39 When this happens, two further problems emerge. The first is that because the fund is unable to communicate with the member, the member may not be able to instruct the fund on the preferred method of receiving their benefit. The second is that, if the member is still properly employed, they will have to pay to reinvest their benefit.⁴⁷
- 3.40 Unfortunately, the legislative requirements in this area are quite prescriptive and APRA's view is that there is no scope for an alternative approach.⁴⁸
- 3.41 The Committee believes that, given the greater flexibility in work patterns, there should also be a more flexible approach to the superannuation treatment of employees over the age of 65.

Recommendation 1

- 3.42 **That the Government review Regulation 6.21(3A) of the *Superannuation Industry (Supervision) Act 1993* to make it less onerous for working people over the age of 65 to continue to contribute to a superannuation fund.**

46 Evidence p 22.

47 Investment and Financial Services Association. *Submission to the Senate Superannuation and Financial Services Select Committee*. 2000. Sydney, IFSA, p 396.

48 Submission pp S8-S9.

Insurance

- 3.43 The year 1999-2000 was one of continuing difficulties for general insurance sector. This is a similar picture to that of the previous financial year and partly reflects the continued effect of natural disasters experienced over the previous few years. Problems generally focussed on the reinsurance sector of the market. This small segment of the market recorded losses of \$3 billion in 1999-2000. Overall solvency levels within the industry remained well above statutory minimums and Australian policy holders were not affected by the disruptions to this sector.⁴⁹
- 3.44 The life insurance industry saw some further restructuring during the financial year, with mergers amongst some of the larger players encouraged by increasing competitive pressure in the international and domestic market.⁵⁰

APRA's activities

- 3.45 APRA points out that the performance of the insurance sector underscores the need for prudent underwriting and a strong, risk focussed management, particularly in high-risk areas such as reinsurance. The experience also strengthens the need for reform of the supervisory framework for the general insurance sector.⁵¹

Reform of prudential regulation for general insurers

- 3.46 In April 2000, APRA released a policy discussion paper on the reform of the prudential supervision of general insurance companies.⁵²
- 3.47 The purpose of this paper was to set out detailed proposals on a new prudential regulation regime for general insurance companies. The scope of the proposals cover all insurance companies authorised to conduct business in Australia with the exception of Lloyd's underwriters.⁵³
- 3.48 The paper sets out a series of principles for the proposed supervisory regime:

49 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 10. See also Evidence p 5.

50 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 11.

51 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 11.

52 Australian Prudential Regulation Authority. *Proposed Reforms to the Prudential Supervision of General Insurance Companies in Australia*. 1999. Sydney, APRA, 36 p.

53 Australian Prudential Regulation Authority. *Proposed Reforms to the Prudential Supervision of General Insurance Companies in Australia*. 1999. Sydney, APRA, p 4.

- it will be targeted at the protection of policy holders;
- it will be more responsive to the risk profiles of individual insurance companies;
- it will enhance the transparency of the general insurance industry;
- it will reflect international best practice;
- it will minimise restrictions on competition;
- it will reflect APRA's supervisory objective of regulating like risks in a like manner across industries; and
- it will respond appropriately to risks that may affect the ability of a general insurer to meet its policy holder liabilities.⁵⁴

3.49 APRA is proposing to make new prudential standards for: capital adequacy; liability valuation; qualitative requirements for reinsurance arrangements; and operational risk.⁵⁵

Capital adequacy

3.50 APRA's policy discussion paper points out that the current minimum capital adequacy requirements for general insurers, set at \$2 million, is too low in comparison with the other institutions regulated by APRA. However, 40 of the 160 authorised general insurers are currently subject to the \$2 million minimum capital adequacy rule, so any change to this rule will have a substantial impact on a number of players in the industry.⁵⁶

3.51 APRA is proposing to increase the minimum capital adequacy requirement to \$5 million. Current market participants will have up to five years to reach this level of capital adequacy.⁵⁷

3.52 APRA indicates that many of these smaller insurers are a part of larger conglomerates, which may minimise the level of restructuring in the industry. In addition, APRA believes that any restructuring should impact minimally on service levels to particular areas or in particular sectors of the general insurance market. APRA intends to test the proposed capital adequacy standards using actual company data to assess

54 Australian Prudential Regulation Authority. *Proposed Reforms to the Prudential Supervision of General Insurance Companies in Australia*. 1999. Sydney, APRA, p 5.

55 Australian Prudential Regulation Authority. *Proposed Reforms to the Prudential Supervision of General Insurance Companies in Australia*. 1999. Sydney, APRA, p 6.

56 Submissions p S6.

57 Australian Prudential Regulation Authority. *Proposed Reforms to the Prudential Supervision of General Insurance Companies in Australia*. 1999. Sydney, APRA, pp 8-9.

the precise impact of the proposal.⁵⁸ It said this test will be under way by the end of 2000. The Committee will monitor this process closely.

- 3.53 APRA said these proposals are unlikely to have an effect on the competitiveness of the industry because the top 20% of the industry write about 90% of the business.⁵⁹

Collection of statistics

- 3.54 APRA is currently undertaking a review of its statistics collection that it expects to take up to two years to complete. Its aim is to remove the old collections that are not much use and install new collection that are. APRA says it is interested in the collection of quantitative rather than qualitative data, so the new collections will cover the quantitative aspects of the financial services sector, but will not cover a lot of the qualitative aspects.⁶⁰ Overall, APRA says it will move towards a comprehensive, integrated and modernised set of data collections. The key problems currently identified by the review are:

- the presence of disparate data collection systems from predecessor agencies;
- the complex data structures that have built up over time, making frontline supervisors dependent on the handful of people who understand the system;
- the extensive resources required to support and maintain the inherited systems;
- problems with the design and content of the statistical returns; and
- the labour intensive nature of the data collection systems.⁶¹

- 3.55 APRA says it has devised a two stage process for dealing with these problems. The first is to improve the performance of the existing systems. The second is to completely re-engineer the processes and practices associated with the collection and storage of statistics.⁶²

58 Submissions p S6.

59 Australian Prudential Regulation Authority. *Proposed Reforms to the Prudential Supervision of General Insurance Companies in Australia*. 1999. Sydney, APRA, pp 8-9.

60 Evidence p 24.

61 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 29.

62 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 30.

- 3.56 Ultimately, this change will require the replacement of the current fragmented legislative framework for the collection of statistics with a single piece of legislation to govern the collection of all information for regulated entities. Another objective will be to collect data electronically, using encryption mechanisms to ensure confidentiality, and to provide a single collection system to institutions to facilitate data entry of all important types of forms.⁶³
- 3.57 The *Commonwealth Government Response to the Committee's Regional Banking Services: Money too far away* inquiry indicates that the government has advised APRA to take into account Recommendation 2 of that inquiry, which recommends the collection of comprehensive data on the access communities have to financial services, as part of APRA's review of statistics collection.⁶⁴ The breadth of means of access to banking services has increased significantly over the last five years, so APRA is looking at ways it can capture and measure that breadth of access in order to adequately respond to that recommendation.⁶⁵

Recommendation 2

- 3.58 **That APRA provide yearly statistics which include the location and level of face to face banking in Australia.**

Cross-sectoral issues

- 3.59 APRA has been exploring a number of cross-sectoral issues. One of these is operational risk. APRA was one of the first agencies to put in place an operational risk team, which examines the methods in place to prevent operational risk. The driving force behind establishing this team is the number of institutional failures that have occurred as a result of operational risk. APRA hopes the team will be able to undertake some benchmarking studies across the regulated industries to determine how these issues are dealt with. After that, APRA will release a discussion paper on the issue.⁶⁶

63 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 27.

64 Minister for Financial Services and Regulation. *Commonwealth Government response to the recommendations of the House of Representatives Standing Committee on Economics, Finance and Public Administration inquiry into Regional Banking Services*. 2000. Canberra, pp 6-7.

65 Evidence p 25.

66 Evidence p 27.

- 3.60 Another cross-sectoral issue for APRA has been the growth in electronic commerce. APRA has initiated a project to examine the prudential aspects of the rapid development of electronic commerce. The objectives are to ensure that financial institutions have adequate processes to identify, assess and manage the risks associated with electronic commerce. A consultative document will be produced in late 2000.⁶⁷
- 3.61 The new cross-sectoral initiatives, along with APRA's proposed approach to levy restructuring discussed in Chapter 2, indicate that APRA is increasingly focussed on delivering regulation on a cross-sectoral basis where this is appropriate. The Committee will investigate these developments at future hearings.
- 3.62 Another example of APRA's cross-sectoral approach is its supervisory methodology. APRA's supervisory methodology is risk based, and differs between specialised institutions and diversified institutions, rather than between industry sectors.
- 3.63 In August 1999, the Specialised Institutions Division introduced a risk assessment system in which a single rating is assigned to each institution based on a risk assessment process.⁶⁸
- 3.64 Supervisory staff are required to form an opinion on the capacity of an institution to manage the risks to which the institution is exposed. These opinions form an overall assessment of an institution's risk profile, which drives the development of an appropriate supervisory strategy and actions. The frequency and intensity of supervision varies based on the institution's overall risk profile as assessed by the supervisory staff. In this environment the supervisory review timetable for an institution that is considered low risk will span two to three years, while institutions regarded as high risk will have a review timetable of 6 months or less.⁶⁹
- 3.65 Conglomerate entities require the oversight of individual regulated entities as well as oversight of the health of the whole group. This incorporates three broad activities:
- risk assessment;
 - execution of a supervision plan; and
 - ongoing evaluation.⁷⁰

67 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 27.

68 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 21.

69 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 20.

70 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 21.

- 3.66 The supervision of conglomerates comprises a cycle of work that is coordinated on an annual or longer basis, premised on continuous supervision or on-going monitoring. This involves:
- quarterly prudential reviews;
 - the application of an institutional risk rating;
 - a supervisory action plan;
 - a prudential consultation; and
 - site visits.⁷¹
- 3.67 Considering the number of institutions APRA is responsible for, the number of incidents of serious problems during 1999-2000 was relatively small. Most of APRA's actions relate to suggestions for improvements to risk management processes rather than observed lapses.⁷²
- 3.68 The Rehabilitation and Enforcement area within the Specialised Institutions Division in APRA deals with those institutions where a significant impairment issue has been identified that will threaten the institution's viability. In these circumstances the supervision process is more intensive, involving high levels of interaction with the individual institutions, incorporating additional reporting requirements, monthly monitoring of performance, regular contact with institutional representatives and more on site visits. During the 1999-2000 financial year such intensive supervision successfully rehabilitated 22 institutions and was also involved in the smooth exit of 16 institutions from the market. Currently, 65 institutions remain under intensive supervision.⁷³

Overall conclusion

- 3.69 The Committee is satisfied with APRA's progress in the area of prudential regulation. Work in the area of conglomerate and ADI regulation appears to be progressing, while APRA has indicated that it will be focusing on insurance regulation in the near future. Performance by the regulated industries has on the whole been good.

71 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 21.

72 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 17.

73 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, pp 15-16.

- 3.70 The general view of the industries being supervised is that the transition to the new regulatory framework has been smooth, with a number of modest achievements. The Committee concurs with this view. APRA has successfully navigated the transitional period and its work towards establishing a new regulatory framework for Australia's financial institutions is progressing well.
- 3.71 However, it should be added that APRA has been fortunate to be born in a benign economic climate. The Committee will continue in its hearings to test these conclusions to determine whether APRA can cater for a less benign economic situation.

David Hawker MP
Chairman
12 October 2000