

Chapter 2

Background to the fit and proper test

Introduction

2.1 The Selection of Bills Committee recommended that the provisions of the Bill be referred to the Senate Economics Legislation Committee to allow it to clarify the design and application of the fit and proper test. Thus, although the proposed legislation seeks to amend a number of Acts, the Committee looks only at amendments to Schedule 2 of the *Banking Act 1959*. More specifically, the Committee deals with the amendment that inserts sections 17–23 to address the ‘fit and proper’ status of directors and senior managers of an ADI or NOHC.

2.2 This chapter provides background to the proposal to introduce a ‘fit and proper’ test—its growing recognition as an international standard of best practice and its acceptance in Australia.

Background—The Basel Committee on Banking Supervision

2.3 In 1997, the Basel Committee on Banking Supervision released its Core Principles for Effective Banking Supervision.¹ They comprised 25 minimum requirements that the Committee believed ‘must be in place for a supervisory system to be effective’. They were formulated by the Committee in close collaboration with the supervisory authorities in 15 emerging countries and benefited from broad consultation with many other supervisory authorities throughout the world.

2.4 The Basel Committee stated that the principles form the fundamental elements of an effective supervisory system and provide a benchmark for international agencies and groups. It encouraged supervisory authorities around the world to endorse the core principles and suggested that ‘where legislative changes were required, national legislators are requested to give urgent consideration to the changes necessary to ensure that the principles can be applied in all material respects’.²

2.5 The Reserve Bank of Australia noted soon after the release of the principles that Australia complied with almost all of them. It stated, ‘This is hardly surprising given that its regime for supervising banks has been developed in the light of

1 The Basel Committee on Banking Supervision is a Committee of banking supervisory authorities which was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, United Kingdom and the United States.

2 Basel Committee on Banking Supervision, *Basel Core Principles for Effective Banking Supervision*, 22 September 1997.

international best practice'. It noted, however, two areas where a 'literal interpretation of the principles could raise doubts about Australia's compliance'—Principle 3 and 25.³

Effective banking supervision—Principle 3

2.6 For the purposes of this inquiry, the report is concerned only with Principle 3, which sets down that bank licensing authorities must have the right to determine criteria and reject applications for establishments that do not meet such criteria. In turning specifically to the management of banks, the Basel Committee advocated a licensing process that would evaluate the competence, integrity and qualifications of proposed management, including the board of directors. It maintained that the licensing agency 'should obtain the necessary information about the proposed directors and senior managers to consider individually and collectively their banking experience, other business experience, personal integrity and relevant skill.'⁴

2.7 In essence, Principle 3 means that all directors and senior managers, whether appointed at establishment or subsequently, should be subject to a 'fit and proper test'. According to the Reserve Bank 'the aim is to ensure that these personnel have the integrity to operate a bank'.⁵

Fit and proper test

2.8 In September 1999, as part of its on-going work to promote effective banking supervision, the Basel Committee issued a paper, *Core Principles Methodology*, in which it outlined a fit and proper test to be used to evaluate proposed directors and senior management with the emphasis on expertise and integrity. The fit and proper criteria included:

- skills and experience in relevant financial operations commensurate with the intended activities of the bank; and

3 Reserve Bank of Australia, *Bulletin*, December 1997, p. 3. Principle 25 reads: 'Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision'. Basel Committee on Bank Supervision, *Core Principles for Effective Banking Supervision*, Basel Committee on Banking Supervision, September 1997, p. 40.

4 Basel Committee on Banking Supervision, *Core Principles for Effective Banking Supervision*, Basel, September 1997, pp. 17–18. The Committee went on to state that the evaluation of management 'should involve background checks on whether previous activities, including regulatory or judicial judgements, raise doubts concerning their competence, sound judgement, or honesty. It is critical that the bank's proposed management team includes a substantial number of individuals with a proven track record in banking. Supervisors should have the authority to require notification of subsequent changes in directors and senior management and to prevent such appointments if they are deemed to be detrimental to the interests of depositors.'

5 Reserve Bank of Australia, *Bulletin*, December 1997, p. 3.

- no record of criminal activities or adverse regulatory judgements that make a person unfit to uphold important positions in a bank.⁶

It added a number of additional criteria which included that:

- at least one of the directors must have a sound knowledge of the types of financial activities the bank intends to pursue; and
- the licensing authority has procedures in place to monitor the progress of new entrants in meeting their business and strategic goals, and to determine that supervisory requirements outlined in the licence approval are being met.⁷

Toward a fit and proper test for Australian ADIs

2.9 In April 2001, APRA released an information paper *Core Principles for Effective Banking Supervision: Self-Assessment for Australia*. It found, as the Reserve Bank had done so in 1997, that Australian banks could be considered compliant with 11 principles set down by the Basel Committee, largely compliant with 12 principles and materially non-compliant with 2 principles—Principle 3 and Principle 25.⁸

2.10 At the time, APRA acknowledged that although it assessed the overall management quality of the applicant, it did not have a formal ‘fit and proper’ test for individual executives or directors. Current arrangements required banks to notify APRA in advance of proposed changes of directors and to provide details of the individual’s qualifications and associations.⁹

2.11 In this paper, APRA announced its intention to implement a formal ‘fit and proper’ test. It stated that it would establish a process by which ‘fit and proper’ assessments of senior management and directors could be determined, both at authorisation and on an on-going basis and that it was consulting with Treasury about implementation.¹⁰

2.12 The proposed legislation now before this Committee recognises the deficiencies in the present supervisory framework for directors and senior managers of ADIs and NOHCs and seeks to redress them. In doing so, the Government identified three clear objectives which were:

- to establish a flexible and cost-effective process by which the fit and proper status of directors and senior managers of ADIs can be determined;

6 Basel Committee on Banking Supervision, *Core Principles Methodology*, Basel, October 1999, p. 16.

7 Basel Committee on Banking Supervision, *Core Principles Methodology*, Basel, October 1999, p. 17.

8 See paragraph 2.5 and footnote 3.

9 APRA, *Core Principles for Effective Banking Supervision: Self-Assessment for Australia*, April 2001, p. 14.

10 APRA, *Core Principles for Effective Banking Supervision: Self-Assessment for Australia*, April 2001, p. 14.

- to ensure directors and senior managers of ADIs have the degree of probity and competence commensurate with their responsibilities; and
- to improve current arrangements and bring them in line with international standards.

The Explanatory Memorandum states:

Since the fit and proper standards applied by ADIs vary across individual institutions, there is a risk that those occupying key roles within an ADI may not have the degree of probity and competence commensurate with their responsibilities. Without specifying any minimum fit and proper criteria for ADI directors and senior management (either in the Banking Act or in the ADI Prudential Standards), there is no explicit process by which APRA (and ADIs) can determine whether a person has met the required level of probity and competence for occupying the relevant position in an ADI. The absence of such requirements would also limit APRA's ability to disqualify certain persons (for example, those who have been convicted of an offence in respect of dishonest conduct or who have been bankrupt) from acting as directors or senior managers of ADIs and to remove any ADI directors and senior management from their duties should APRA have doubt about the fit and proper status of these personnel. The lack of a rigorous approach to 'fit and proper' assessments of ADI directors and senior management may expose depositors to greater risk of mismanagement in an ADI.¹¹

According to the Explanatory Memorandum, the Government considered the following three options:

- to maintain the status quo of self assessment;
- to establish a statutory fit and proper regime; and
- to implement a self-assessment regime supplemented by legislative power to disqualify unfit persons.

Option 1—Maintain status quo

2.13 The Government decided that option 1, which as noted earlier was found to be deficient, would not achieve the stated objectives of the proposed remedial action.

Option 2—A fit and proper regime

2.14 Under option 2, the Banking Act would be amended to establish a statutory fit and proper regime for directors and senior managers which would:

- specify minimum fit and proper requirements;
- provide APRA with the statutory power to require a person to provide information as to his or her proper status;

11 *Explanatory Memorandum*, p. 8.

- require APRA to approve appointment of directors and senior managers of ADIs; and
- provide APRA with the statutory power to remove directors and senior managers using ‘fit and proper’ tests.

2.15 The Government recognised that this more formal process for assessing the fit and proper status of directors and senior managers would provide greater incentive for ADIs to comply with the minimum fit and proper requirements. It would enable APRA to ensure that directors and senior managers have the degree of probity and competence commensurate with their responsibilities.

2.16 Nevertheless, the Government recognised that the requirement for APRA to conduct background checks and approve every appointment of directors and senior managers in ADIs would be highly resource-intensive and result in substantial administrative costs to APRA.

Option 3—Self-assessment supplemented by legislative power to disqualify unfit persons

2.17 Option 3 would allow ADIs to apply their own fit and proper test in the appointment of directors and senior managers. New prudential standards would require ADIs:

- to monitor compliance with these standards on an on-going basis;
- to notify APRA promptly of any changes in directors and senior management; and
- to provide APRA with details of these personnel.

2.18 The Banking Act would be amended:

- to specify that disqualified persons are not allowed to act as directors or senior managers of ADIs unless APRA revoked the disqualification;
- to provide APRA with the statutory power to direct an ADI to remove a director or senior manager from office if it were satisfied that the person was a disqualified person or failed to meet fit and proper criteria set out in prudential standards; and
- provide for an external mechanism by which the person and the ADI could appeal against APRA’s decision to revoke a disqualification or to remove a director or senior manager from his or her office in an ADI.

2.19 The Government preferred option 3 which it regarded as offering a more balanced approach. According to the Explanatory Memorandum it would:

Achieve all the stated objectives of the proposed remedial action. In particular it would provide a more flexible and cost-effective process for assessing the fit and proper status of directors and senior management of ADIs.

Further, the Explanatory Memorandum found that compliance costs would not be significant for authorised institutions.