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Economics Legislation Committee

Provisions of the Financial Sector Legislation Amendment Bill (No. 2) 2002

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Abbreviations and Acronyms

ABA	Australian Bankers' Association
ADI	Authorised deposit-taking institution
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
CUSCAL	Credit Union Services Corporation (Australia) Limited
NOHC	Non-operating holding company

Chapter 1

Inquiry into the Provisions of the Financial Sector Legislation Amendment Bill (No. 2) 2002

Background

1.1 The Financial Sector Legislation Amendment Bill (No. 2) 2002 was presented to the House of Representatives on 26 June 2002 by the Hon. Peter Slipper MP, Parliamentary Secretary to the Minister for Finance and Administration. The Bill was passed in the House of Representatives on 14 November 2002.

Purpose of the Bill

The Bill amends a number of financial sector Acts.

The most significant amendments are to the *Banking Act 1959* which:

- provide for the application of a 'fit and proper' test to directors and senior managers of ADIs (authorised deposit-taking institutions) and authorised NOHCs (Non-operating holding companies);
- provide the Australian Prudential Regulation Authority (APRA) with the means to remove auditors who fail to perform adequately and properly;
- require ADIs, authorised NOHCs of an ADI and their subsidiaries, to notify APRA immediately of any breaches of prudential requirements and any material adverse developments;
- allow APRA to apply prudential standards on a consolidated group basis;
- provide additional grounds for APRA to revoke the authority granted to an ADI or NOHC where the application for the authority contained false or misleading information; and
- correct a discrepancy between the indemnity provisions of the Banking Act and the APRA Act which relates to the extent of protection available to APRA officers under these acts.

The Bill also amends the *Insurance Act 1973*, the *Superannuation (Resolution of Complaints) Act 1993*, the *Superannuation Industry (Supervision) Act 1993*, the *ASIC Act 2001*, the *Corporations Act 2001* and the *Corporations (Repeals, Consequentials and Transitionals) Act 2001*.

Reference of the Bill

1.2 On 13 November, on the recommendation of the Senate Selection of Bills Committee, the Senate referred the provisions of the Bill for inquiry to the Economics

Legislation Committee. The Committee was to report by 10 December 2002.[1] The reporting date was subsequently extended to 12 December.

Submissions

1.3 The Committee advertised the inquiry in the *Australian* and the *Australian Financial Review* on 20 November and on its web site. It also wrote to banks, credit unions and building societies, relevant departments and agencies, organisations and individuals interested in the proposed legislation, alerting them to the inquiry and inviting them to make a submission. In all, the Committee contacted over 250 parties about the inquiry and received nine submissions. These are listed in Appendix 1. All but one of the submissions are public documents.

Hearing and evidence

1.4 The Committee held one public hearing on this inquiry in Parliament House, Canberra, on Thursday, 5 December. It took evidence from the APRA and the Department of the Treasury. Witnesses who presented evidence before the Committee are listed in Appendix 2.

1.5 Copies of the Hansard transcript are tabled for the information of the Senate. They are also available through the internet at http://www.aph.gov.au/hansard. Additional information provided to the Committee is also tabled with this report.

Acknowledgment

1.6 The Committee is grateful to, and wishes to thank, all those who assisted with its inquiry.

1 *Report No. 12 of 2002* of the Selection of Bills Committee, 13 November 2002.

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

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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

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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;

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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;

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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.

Chapter 3

Provisions of the Bill

3.1 Submissions clearly supported the Government's intention to introduce a fit and proper test for directors and senior managers of ADIs, with a number preferring option 3 over option 2. The International Banks and Securities Association of Australia agreed that option 3 provided the best way forward, stating:

> It places a continuing obligation on ADIs to ensure their directors and senior management meet fit and proper criteria without going to the administrative effort, cost and moral hazard of APRA having to approve every appointment as in Option 2.[1]

3.2 This chapter looks at the following proposed sections, which are based on the option 3 model, contained in the Bill:

- Section 19 which stipulates that disqualified persons must not act for ADIs or authorised NOHCs;
- Section 20 which defines a disqualified person;
- Subsection 5(1) which inserts a definition of 'senior manager';
- Sections 21, 22 and 23 which deal respectively with APRA's power:
  - to disqualify persons;
  - to determine that a person is not a disqualified person; and
  - to remove a director or senior manager of an ADI or authorised NOHC;
- Section 51 which allows for the reconsideration and review of decisions; and
- Section 62A which provides that an ADI or authorised NOHC is required to notify APRA immediately of any breaches of prudential requirements.

Most of these provisions are modelled on sections 24–27 and 63 of the *Insurance Act 1973*.[2]

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1 *Submission* 5. The Australian Stock Exchange also supported Option 3. It submitted, 'ASX supports Option 3 because it represents a sensible balance between preserving the fundamental responsibilities and accountability of the Board and senior management while reserving necessary ppowerto the supervisor to take action if required. Option 3 also provides a flexible approach, which can be more responsive to changed circumstances than the more prescriptive and interventionist approach of Option 2.' *Submission* 9.

2 Sections 24–27 of the *Insurance Act 1973* deal with disqualified persons not allowed to act for general insurers or authorised NOHCs; the definition of a disqualified person; and APRA's power to disqualify a person, to determine that a person is not a disqualified person and to remove a director or senior manager of a general insurer. Section 63 of the Insurance Act deals with the review of certain decisions.

Disqualified persons must not act for ADIs or authorised NOHCs

3.3 Section 19 of the Bill stipulates that a disqualified person commits an offence if the person is or acts as:

- a director or senior manager of an ADI (other than a foreign ADI); or
- a senior manager of the Australian operations of a foreign ADI; or
- a director or senior manger of an authorised NOHC.

3.4 This section also makes it an offence for a body corporate to allow a disqualified person to be or act as a director or senior manager of an ADI, or authorised NOHC.

Who is a disqualified person?

3.5 Section 20 defines a disqualified person as one who, at any time:

- has been convicted of an offence against or arising out of this Act; or
- has been convicted of an offence against or arising out of the *Financial Sector (Collection of Data) Act 2001*; or
- has been convicted of an offence against or arising out of the *Corporations Act 2001*, the Corporations Law that was previously in force, or any law of a foreign country that corresponds to that Act or to that Corporations Law; or
- has been convicted of an offence against or arising out of a law in force in Australia, or the law of a foreign country, where the offence related or relates to dishonest conduct, or to conduct relating to a company that carries on business in the financial sector; or
- has been or becomes bankrupt; or
- has applied to take the benefit of a law for the relief of bankrupt or insolvent debtors; or
- has compounded with his or her creditors; or
- APRA has disqualified under section 21; or
- has been disqualified under the law of a foreign country from managing, or taking part in the management of, an entity that carries on the business of banking or insurance or otherwise deals in financial matters.

3.6 While the conditions set down in this section are straightforward and objective, they do not recognise degrees or shades of seriousness.

3.7 The strict application of the criteria for disqualification concerned a number of submissions. The Credit Union Services Corporation (Australia) Limited (CUSCAL) drew attention to the broad range of proposed provisions governing disqualification and submitted that they do not:

> …provide any measure of materiality to the criteria to be applied to 'disqualified persons'. It is possible that credit union employees with long

> records of distinguished service may find themselves in breach of the provisions through a minor incident extending back over a lengthy career (an example could include a relationship debt issue, or previous but unspent convictions for potential minor 'dishonesty' offences).[3]

3.8 The Australian Bankers' Association (ABA) also drew attention to the disqualification criteria, stressing in particular that the criteria apply irrespective of the gravity of the offence or the penalty incurred, including whether a custodial sentence was imposed. It underlined the same point made by CUSCAL that the provision takes no account of the magnitude of the offence or the passage of time. It stated:

> The test will apply, in a sense retrospectively, to all existing employees of an ADI as well as to future employees. Some existing employees will have had long careers with the ADI perhaps joining a bank in their early years of work and performing their duties honestly and competently. The legislation will affect career paths and promotions within the ADI.[4]

3.9 APRA indicated that it was prepared to give close consideration to the personal circumstances of a disqualified person. For example it told the Committee that 'without prejudging any decisions, APRA is likely to review sympathetically the position of persons disqualified by bankruptcies in the distant past'.[5]

Definition of senior management

3.10 Item 3 would insert the following definition of senior manager of an ADI or NOHC:

> …a person who has or exercises any of the senior management responsibilities (including those specified in prudential standards) for the ADI other NOHC or for the Australian operations of the foreign ADI, as the case may be.[6]

3.11 A number of submissions expressed reservations about the broad use of the term 'senior manager'. The International Banks and Securities Association of Australia suggested that the proposed standard would need to provide a more precise definition of senior management than is possible in the legislation so that ADIs are clear about who among their staff would be subject to the provisions of the legislation.[7] CUSCAL made a similar point that the general definition would generate uncertainty in determining the level at which the provisions for disqualification would apply. It stated:

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3 *Submission* 7, p. 3.

4 *Submission* 6, p. 2.

5 Bill Jones, opening statement, *Committee Hansard*, p. E3.

6 Clause 3 Subsection 5(1).

7 *Submission* 5, p. 2.

> A workable and clear definition is essential to enable credit unions to implement the new regime effectively. This is particularly important given the strict liability offences attached to breaches of the proposed disqualified persons provisions. Breaches will carry prison terms and significant fines.[8]

3.12 The ABA reinforced this point. It stated:

> Our members need greater clarity for compliance reasons in respect of the management positions within their organisations that are to be subject to the 'fit and proper' person test. For example, there are many positions in a bank described as 'Senior Manager' which, in fact, do not always qualify as executive positions. As a consequence, the reporting lines above these senior manager positions can be quite extensive.[9]

3.13 An amendment to the meaning of 'senior manager' agreed to by the House of Representatives will make the assessment of who is a 'senior manager' more certain by limiting it to that contained in the prudential standard issued by APRA. As noted in the Explanatory Memorandum 'it will provide APRA with sufficient flexibility in defining "senior manager" to adequately apply the fit and proper test to senior managers'.[10] APRA has advised the Committee that in developing the proposed standards covering the definition of senior managers and the imposition of fit and proper requirement it would consult extensively with relevant institutions.[11]

3.14 CUSCAL supported the government amendment and was in agreement that it 'offers a greater degree of clarity and will secure more effective implementation of the fit and proper tests for senior managers'.

APRA may disqualify a person

3.15 The Bill also allows APRA to go beyond the criteria stipulated in section 20 to disqualify a person deemed not to be a fit and proper person. Proposed section 21 states that:

> APRA may disqualify a person if it is satisfied that the person is not a fit and proper person to be or to act as a director or senior manager of an ADI; a senior manager of the Australian operations of a foreign ADI or a director or senior manager of an authorised NOHC.

3.16 Unlike section 20, this clause does not lay down the criteria against which the assessment of a person's fitness or propriety is gauged.

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8 *Submission* 7, p. 2.

9 *Submission* 6, p. 1.

10 *Supplementary Explanatory Memorandum*, p. 1. Amendment 1 proposes to amend item 3 by omitting the words 'including those specified in' and substituting 'within the meaning of', House of Representatives, Amendments Financial Sector Legislation Amendment (No. 2) Bill 2002, 8 November 2002.

11 Bill Jones, opening statement, *Committee Hansard*, p. E4..

Prudential Standard

3.17 APRA explained that the starting point for the application of 'fit and proper' requirements resides with the board of a licensed institution. It indicated that it would establish a prudential standard requiring institutions to have policies and procedures to address fitness and propriety of directors and senior managers. It then stated:

> APRA will review the policies established by institutions and monitor their compliance with these policies. In the event that APRA considers there are any deficiencies in either the policies established, or in their implementation, APRA will raise these issues with the institutions and seek action to remedy the situation. Should an institution not take the required action we would invoke direction or the proposed 'fit and proper' powers as appropriate.[12]

3.18 Similar to the development of other ADI Prudential Standards, APRA is to conduct extensive industry consultation on the draft standards prior to their implementation. According to the Explanatory Memorandum, APRA intends to review the proposed 'fit and proper' regime in consultation with industry after it has been put in place for two to three years to coincide with the review of fit and proper requirements for directors and senior managers of General Insurers (same approach has recently been adopted by APRA for General Insurers). [13]

3.19 APRA informed the Committee that the Prudential Standard to be developed will set down some key criteria that ADIs should address in formulating their policies and procedures. It indicated that Prudential Standard GPS 220 made under the *Insurance Act 1973* would provide a model. (See appendices 3 and 4) The criteria for the fit and proper test under this standard require that:

> (a) the person has not been convicted of an offence against or arising out of the Act or the *Financial Sector (Collection of Data) Act 200*1;
>
> (b) the person has not been convicted of an offence against or arising out of a law in force in Australia, or the law of a foreign country, if the offence concerns dishonest conduct or conduct relating to a financial sector company within the meaning of the *Financial Sector (Shareholdings) Act 199*8;

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12 The *Explanatory Memorandum* stated that: 'APRA will develop Prudential Standards requiring the board of an ADI (and authorised NOHC) to establish policies defining fit and proper standards for directors and senior managers and to monitor compliance with these standards on an ongoing basis. These Standards will also require ADIs (and their group members) to notify APRA promptly of any changes in directors and senior management and to provide it with details of these personnel. The standards will address APRA's expectations as to minimum fit and proper criteria, ensuring the standards by which office holders will be judged are transparent.'

13 *Explanatory Memorandum*, p. 15.

(c) the person has never been bankrupt, has not applied to take the benefit of a law for the relief of bankrupt or insolvent debtors, or has not compounded with his or her creditors;

(d) the person has no actual or potential conflicts of interest that are likely to influence their ability to carry out their role and functions with appropriate probity and competence;

(e) the person has adequate experience and demonstrated competence and integrity in the conduct of business duties;

(f) the person is not of bad repute within the business and financial community…

3.20 The Committee is pleased to learn that APRA has confirmed that:

> Prudential standards covering fit and proper requirements will include a requirement that ADIs and authorised NOHCs will need to submit to APRA a copy of its own internal policies established covering fitness and propriety of directors and senior managers.[14]

3.21 The Traditional Credit Union wanted information on the tests that could be used noting that any test would have to reflect the fact that some ADIs are mutual organisations. The National Credit Union Association submitted that:

> Credit Unions are member owned and controlled mutual organisations with a long history of sound and prudential management. The only requirement for qualification, to nominate as a director of a Credit Union, is the individual to be a member and not be disqualified under the current Corporations Law. This is considered to be a fundamental and paramount principle in relation to the operation of mutual organisations such as Credit Unions, as well as a number of Building Societies, and any proposals which would interfere with that democratic right is opposed.
>
> …
>
> given the diversity of backgrounds of Credit Union directors, we are particularly concerned to ensure that no specific qualification criteria is prescribed in relation to academic or business activities. [15]

3.22 APRA accepted that a fit and proper test should not be a 'one-size-fits-all'. It explained:

> While criteria such as honesty and diligence are applicable in all instances, other criteria such as adequacy of experience and demonstrated competence will need to be assessed in context. For example, the experience of an individual board member needs to be considered against the experience of a

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14 *Supplementary Submission* 4A.

15 *Submission* 2, p. 1.

> board collectively, and the experience/capabilities of a person acting as senior manager in a particular function may be more critical at one type of ADI then another.[16]

3.23 At the public hearing APRA explained further:

> When assessing compliance with criteria such as expertise and experience, we will look at the context in which they are being applied. We will not be setting any minimum academic or other formal requirements per se. For example, ADI directors do not need to be ex-bankers. In reaching a decision about the fitness of those persons in particular institutionS, APRA will have regard to, for example to the quality of the board as a whole, the supervision of senior managers and the structure of management and the particular qualities of individual directors and senior managers.[17]

3.24 In making its final point on this matter, APRA told the Committee that it would be 'sensitive to the issues facing particular institutions' but would not be 'sympathetic to institutions which want to follow a minimalist or lowest common denominator approach'.[18]

3.25 It should be noted that APRA may also revoke a disqualification on application by the disqualified person or on its own initiative. The Bill, however, stipulates that APRA may only make the determination if it is satisfied that the person is highly unlikely to be a prudential risk to any ADI or authorised NOHC.

Committee View

3.26 The Committee notes the concerns expressed about the need for reasonableness in applying the criteria for determining whether an individual is a disqualified person. The Committee accepts that the language is clear and forthright and does not appear to allow for minor offences or offences that may have been committed decades earlier in a person's otherwise long and unblemished career. The Committee, however, notes APRA's advice that it would look sympathetically at the circumstances that have given rise to a disqualification.

3.27 The Committee also notes the broad and uncertain definition of 'senior manager' and recognises the need for the meaning of this term to be more precise in its application. It accepts that the proposed amendment to the provision would allow sufficient scope for APRA in cooperation with industry to establish a clear understanding of the application of the term 'senior manager'.

3.28 Finally, the Committee understands that Credit Unions are member owned and controlled mutual organisations that must observe certain requirements in appointing directors. It acknowledges APRA's assurances that it would give

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16 *Submission* 4, p. 2. See also Bill Jones, APRA, opening statement, *Committee Hansard*, p. E3.

17 Bill Jones, opening statement, *Committee Hansard*, p. E3.

18 Bill Jones, opening statement, *Committee Hansard,* p. E4.

consideration to the qualification criteria for certain institutions particularly in applying strict academic or business requirements. It further notes APRA's assertion that while honesty and diligence would be required in all instances, other criteria such as adequacy of experience and demonstrated competence would 'need to be assessed in context'.

3.29 The Committee agrees with APRA that the fit and proper test should not be one that is made to fit all. It is the Committee's view that the prudential standards to be developed by APRA hold the key to resolving the matters raised above. The Committee believes that matters such as refining the definition of senior manager and having the prudential standards accommodate the particular circumstances of institutions such Credit Unions could be addressed and settled during the consultation process that APRA is to undertake.

3.30 The authority of APRA to determine that a person is not disqualified provides another avenue for APRA to make allowances for particular circumstances. The resolution of some of these concerns could also rest with an effective appeals process which is discussed below.

Removal of a disqualified person and appeal process

3.31 Having set down the conditions under which a person is a disqualified person, new section 23 then allows APRA to remove a director or senior manager of an ADI or authorised NOHC if it is satisfied that the person:

- is a disqualified person; or
- does not meet one or more of the criteria for fitness and propriety set out in the prudential standards.

3.32 Section 51B allows a person dissatisfied with a reviewable decision by APRA to have the decision reconsidered.[19] Under this provision APRA must reconsider the decision and may confirm or revoke the decision or vary it in such manner as it thinks fit.[20] A person may also apply to the Administrative Appeals Tribunal for the review of decisions. This applies to a decision reached by APRA after it has been requested to reconsider a decision.[21]

3.33 There were no objections raised about the provisions allowing a disqualified person the opportunity to appeal. The matter of privacy and confidentiality, however, was raised. The ABA noted that inevitably, applications for relief against disqualification would be made to APRA and it asked that 'the interests of affected

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19 Section 51B—Reconsideration of decisions. A decision made by APRA to disqualify a person or to revoke a disqualification is a reviewable decision under section 51B. The refusal of APRA to make a determination that a person is not a qualified person is also a reviewable decision under section 51B.

20 Section 51B(3).

21 Section 51C—Review of decisions.

employees should be protected with effective confidentiality requirements for these processes and the final outcome irrespective of the ultimate decision by APRA'.[22]

3.34 CUSCAL echoed this concern. It submitted:

> Applications for relief from disqualification provided for under the Bill will require a process that ensures confidentiality, privacy and procedural fairness are observed. CUSCAL considers a transition period important to enable APRA to develop a robust and sound process for such processes, and communicate its intention and processes in these new powers to ADIs.[23]

3.35 APRA advised the Committee that during the process of considering whether a person should be deemed not fit and proper and/or should be disqualified it would 'note that such consideration is governed by the secrecy provisions contained in section 56 of the APRA Act 1998 and by provisions of the Privacy Act'.

Notification of appointments

3.36 As mentioned earlier, under the proposed legislation, ADIs are to apply their own fit and proper standards in the appointment of directors and senior management and are expected to monitor compliance with these standards. They are, however, required to provide APRA with details of their directors and senior management and to notify it promptly of any changes in those personnel.[24]

3.37 This requirement is not set down in the legislation although APRA indicated that it would be a requirement in the Prudential Standards. According to APRA, while ADIs must notify it of the appointments of directors and senior managers, it is not APRA's intention to investigate or vet prospective directors or senior managers prior to their appointment.[25] Nor does APRA intend to examine formally the status of directors and senior managers each year. It informed the Committee that:

> …as part of its routine supervisory oversight of ADIs, APRA will observe the appointment and conduct of directors and senior management. Should APRA come to a view there are questions about the fitness and propriety of persons then, in the normal course, we will raise those concerns and seek to have them resolved (eg by an ADI obtaining the removal of a senior manager from a position). In the event that our concerns were not satisfactorily addressed we would make use of the 'fit and proper' powers to be introduced into the Banking Act.[26]

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22 *Submission* 6, p. 3.

23 *Submission* 7, p. 3.

24 *Explanatory Memorandum*, p. 8.

25 *Submission* 4, p. 2.

26 *Submission* 4, p. 2.

Transition Period

3.38 In light of the self-reporting obligation and the strict liability applying to the provision that a disqualified person must not be a director or senior manager, a number of submissions referred to the need for a suitable transition period. CUSCAL stated:

> Credit Unions will be required to review employment screening, promotion and vetting procedures. The new provisions are likely to require revisions and potentially investigations into the backgrounds of current and prospective senior staff. Issues of confidentiality and privacy must also be considered.
>
> Credit unions directors are drawn primarily from the general membership of credit unions, reflecting the principles of democratic participation in corporate governance in the credit union sector. A transition period is necessary to ensure credit unions procedures are consistent with the requirements in the Bill, and credit unions have time to develop appropriate policies.[27]

3.39 It endorsed the amendment proposed to the Bill to secure a three-month transition period.[28] It suggested that at least three months would be required to enable the necessary paperwork to be completed. The Committee supports this amendment.

Duplication of the supervision function

3.40 The matter of duplication by regulatory bodies in the supervision of ADIs was also raised. The National Credit Union Association was concerned at the supervisory authority duplication with ASIC requiring notification of changes in directors and the demonstration competency of senior management.

3.41 In response to the matter of duplication of functions, APRA stated that it was aware that regulated institutions are also required to notify ASIC of changes in the composition of boards of directors. Further it noted that both ASIC and APRA seek to review the competency and other qualities of directors and senior management when authorising new ADIs. APRA assured the Committee that it is 'working closely with ASIC to address any overlap in licensing processes'. ASIC also acknowledged that

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27 *Submission* 7, p. 3.

28 The *Supplementary Explanatory Memorandum* states: this amendment introduces a short transitional period of three months during which the operation of new section 19, which states that disqualified persons under the new fit and proper regime must not act for ADIs or authorised NOHCs, will be suspended. It is considered that some regulated entities…may require time in which to assess which persons may be disqualified under the new provisions and for any application to be made to APRA to have them 'undisqualified'.

there is the potential for duplication but indicated that it is looking at ways to minimise such duplication.[29]

Reporting breaches of prudential standards

3.42 Witnesses had no difficulty in accepting the statutory obligation to report breaches in prudential standards. They did, however, express concerns at the blanket terms used in the provision. CUSCAL raised concerns about the wording of proposed section 62A and its requirement for 'immediate' reporting of all breaches of prudential standards to APRA.[30] It informed the Committee:

> This requirement may exceed current reporting requirements and does not, as drafted, provide APRA with flexibility in requiring reporting of minor or technical breaches. The drafting of this provision appears to exceed the policy outlined in the Explanatory Memorandum for the Bill, which sought to establish a clear legislative requirement for ADIs to report material breaches of prudential standards to APRA.[31]

3.43 Similarly, the ABA questioned the language used in the proposed section suggesting that this was not the intention and that it should be amended to make it clear that the matters to be referred would not extend to trivial, non-material breaches.[32]

3.44 At the public hearing, APRA indicated that it was prepared to take a firm but sensible and practical approach to reporting breaches. It stated:

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29 Parliamentary Joint Committee on Corporations and Financial Services, *Hansard*, Scrutiny of ASIC's annual report, 2 December 2002, pp. 32, 68. ASIC informed the Committee that 'it is part of a bigger project we have under way to try to make sure we make it as easy as possible for people to obtain their licence from a process point of view while still protecting the integrity of a proper licensing system'.

30 Item 24 inserts new section 62A which states that a member of a relevant group of bodies corporate commits an offence if:

- a) it becomes aware of any of the following matters:
  - i) it, or another member of the group, has committed a breach of a prudential standard applying to it or to the other member, as the case may be;
  - ii) it, or another member of the group, or the group as a whole, may not be in a sound financial position;
  - iii) …and
- b) it fails to notify APRA of the matter immediately after it becomes aware of the matter.

31 *Submission* 7, p. 4. The *Explanatory Memorandum* stated under item 24 'This amendment provides that an ADI, authorised NOHC or a subsidiary of such institutions is required to promptly notify APRA of any breaches of prudential requirements (for example, licensing conditions or the Prudential Standards) or any information with a material bearing on the safety and soundness of an ADI or a group to which an ADI is a member.' p. 27.

32 *Submission* 6, p. 3.

> We have carefully considered the issue of defining material breaches in legislation but came to the conclusion that this would produce complicated drafting and give rise to potential loopholes which may serve to undermine the purpose of this measure. Materiality is, of course, both a subjective issue and a relative issue insofar as the significance of a breach of standard may vary according to the circumstances…
>
> We appreciate that there are issues with timing and the mechanism by which any breaches are notified. We will seek to work with ADIs and regulated institutions to implement appropriate notification procedures…in this context we would expect a more immediate notification of breaches of prudential standards where they related to the immediate safety and soundness of an institution than we would for matters with less immediate effect. For example, we would expect immediate notification of matters affecting liquidity and solvency while we could accept a prompt but less immediate notification of matters such as breaches of requirements to notify APRA of changes in senior managers.[33]

3.45 In summing up its approach to the notification requirement, APRA told the Committee that it is better for institutions 'to err in favour of notifying APRA of potential problems rather than to err in favour of silence as might have been the practice in the past for some institutions'.[34]

3.46 In a supplementary submission, APRA provide further assurances that it was looking at ways to tighten the compliance regime particularly in regard to reporting breaches of its prudential standards. (see Appendix 5) It informed the Committee that APRA has commenced a comprehensive stocktake of its present supervisory and enforcement powers. It explained:

> The aim is to identify all significant gaps and inconsistencies in supervisory arrangements in all sectors, with a particular focus on those that restrict APRA's effectiveness. This review is giving some detailed attention to the application of fit and proper powers. The review includes application of fit and proper powers across all APRA regulated institutions, establishing and maintaining a register of persons deemed not fit and proper; specifying that where a person provided false or misleading information to APRA in the course of APRA discharging its function or powers then a person may be deemed not fit and proper and/or disqualified; a requirement to be included in legislation for a regulated institution to notify APRA of appointments of directors and senior managers; a requirement for regulated institutions to notify APRA of the removal of directors and senior mangers (whether by way of dismissal, resignation or retirement) and the reasons for such changes, and a requirement for a regulated institution to provide APRA with information in relation to a director or senior manager of which the ADI may be aware and that APRA should be reasonably be made aware of in order to form a judgement as to the fitness and propriety of those persons on

33 Bill Jones, opening statement, *Committee Hansard*, p. E5.

34 ibid.

> a continuing basis. The outcome of the review may include the request for further legislative measures.[35]

Committee view

3.47 The Committee agrees with the view that a practical approach should be taken to the reporting requirements for ADIs and NOHCs. Clearly the legislation intends for serious breaches to be reported immediately and the Committee welcomes the firm approach being taken by APRA toward reporting breaches. It notes that APRA is reviewing its current supervisory and enforcement powers giving particular emphasis to the application of fit and proper powers. It further notes that this review may suggest that additional legislative measures are needed to strengthen the disclosure requirements on people deemed not to be fit and proper.

Conclusion

3.48 The Committee believes that the proposed legislation would provide a sturdy framework upon which to build a robust supervisory regime for ADIs and NOHCs. Clearly most of the concerns raised about the application of the fit and proper test and the disqualification and removal of directors and senior managers of ADIs could be resolved in the prudential standards to be developed by APRA.

3.49 In the Committee's view, the proposed legislation provides a flexible and cost-effective means to determine the fit and proper status of directors and managers of ADIs. It also provides APRA with both the scope and power to ensure that directors and senior managers have the degree of probity and competence commensurate with their responsibilities. The success of the legislation rests, in the main, on the prudential standards set by APRA and its commitment, determination and ability to see them upheld.

3.50 The Committee agrees with APRA's approach that the implementation stage of the fit and proper test should undergo close monitoring, analysis and evaluation with a view to assessing its effectiveness and whether legislative changes are required to improve the supervisory regime of ADIs and NOHCs.

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35 *Supplementary Submission* 4A.

Recommendation

The Committee reports to the Senate that it has considered the provisions of the Financial Sector Legislation Amendment Bill (No. 2) 2002 and recommends that the Bill proceed.

SENATOR GEORGE BRANDIS
CHAIRMAN

MINORITY REPORT

REVIEW OF FINANCIAL SECTOR LEGISLATION AMENDMENT BILL

Labor and the Democrats support the amendments to the Banking Act to introduce a "fit and proper person" standard for directors and senior managers. However, we are concerned that the proposed amendments do not set out the minimum criteria by which the fitness and integrity of directors and senior manager's will be assessed.

Instead APRA would devise a standard under the Banking Act, which would set out the minimum criteria against which fitness and integrity will be assessed. However, APRA was unable to tell the Committee, other than in very general terms, what minimum criteria would be included within the fit and proper standard.

A standard is not a disallowable instrument and so there would be no opportunity for parliamentary review of the minimum criteria. Labor and the Democrats therefore propose to introduce an amendment by which the minimum criteria for the fit and proper standard are defined by a regulation and hence subject to disallowance (Attachment 1).

The Government's proposed self-regulatory approach to the application of a fit and proper person test is based on the principles of the Basle Accord, which were framed prior to recent financial scandals. If the Accord were drafted in the wake of these scandals it is likely to have favoured a more prescriptive approach to regulation.

SENATOR JACINTA COLLINS
Labor Senator for Victoria

SENATOR RUTH WEBBER
Labor Senator for Western Australia

SENATOR ANDREW MURRAY
Australian Democrats

2002

The Parliament of the
Commonwealth of Australia

THE SENATE

DRAFT-IN-CONFIDENCE
This draft is supplied in confidence and should be given appropriate protection.

Financial Sector Legislation Amendment Bill (No. 2) 2002

(Amendment to be moved by Senator Conroy on behalf of the Opposition in committee of the whole)

(1) Schedule 2, item 17, page 18 (after line 9), at the end of section 21, add:

(7) For the purposes of subsection (1), the regulations must prescribe a standard of a fit and proper person to be a director or a senior manager which must include but not be limited to consideration of whether a director or senior manager has:

(a) been subject to an adverse settlement in civil proceedings;
(b) been subject to disciplinary proceedings by the regulator;
(c) contravened any regulatory requirement;
(d) been subject to a justified complaint relating to regulated activities;
(e) been involved in a business which has been refused a license or had a license revoked;
(f) refused the right to carry on business requiring a license;
(g) been investigated, disciplined, suspended or criticised by the regulator or professional body;
(h) been dismissed or asked to resign from a position of trust;
(i) been disqualified as a director or manager;
(j) failed to be candid and truthful in dealing with a regulatory body.

[fit and proper person]

Appendix 1

List of Public Submissions and Additional Information

Submission No 1: Traditional Credit Union Limited

Submission No 2: National Credit Union Association Inc.

Submission No 3: Hibis Corporation Pty Limited

Submission No 4: Australian Prudential Regulation Authority

Submission No 5: International Banks and Securities Association of Australia

Submission No 6: Australian Bankers' Association

Submission No 7: Credit Union Services Corporation

Submission No 8: Mr Bruce Hamilton JP (CONFIDENTIAL)

Submission No 9: Australian Stock Exchange

Additional Information

Australian Prudential Regulation Authority: Opening Remarks

Appendix 2

Public Hearing and Witnesses

Thursday, 5 December 2002

Australian Prudential Regulation Authority

Jones, Mr William Robert, Senior Policy Adviser, Policy Development, Policy, Research and Consulting

Lau, Mrs Judy, Senior Policy Manager

Department of the Treasury

Ray, Mr Nigel, General Manager, Financial System Division

Rosser, Mr Michael John, Manager, Consumer Protection Unit, Financial System Division

Stylianou, Ms Vicki, Policy Analyst, Prudential Policy—Banking Unit

White, Mr Damien William, Manager, Prudential Policy—Banking Unit

Appendix 3

Extract from Prudential Standards and Guidance Notes Applied to General Insurers

ATTACHMENT

EXTRACTS FROM PRUDENTIAL STANDARDS AND GUIDANCE NOTES APPLIED TO GENERAL INSURERS

Prudential Standard GPS 220

Risk Management for General Insurers

Prudential Standard

1. This Prudential Standard, made under section 32 of the *Insurance Act 1973* (the Act), applies to all general insurers authorised under the Act.

Governance

Fitness and Propriety

2. Insurers must ensure that persons occupying key positions within the insurer have the degree of probity and competence commensurate with their responsibilities.

3. For this purpose, insurers should have in place policies and procedures to address fitness and propriety. These policies and procedures should at a minimum address the criteria for fitness and propriety that APRA uses to assess fitness and propriety set out in paragraph 0.

4. For locally-incorporated insurers, persons occupying key positions means:

   (a) directors;

   (b) senior managers;[1]

   (c) the insurer's auditor appointed under the Act and approved by APRA (Approved Auditor);[2] and

   (d) the insurer's actuary appointed under the Act and approved by APRA (Approved Actuary),[3] where relevant.

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1 For the purpose of subsection 3(1) of the Act, a senior manager is a person who has or exercises any of the senior management responsibilities set out in paragraph 0 of this Standard.

2 An insurer must appoint an auditor under section 39 of the Act and have that appointment approved by APRA in accordance with section 40.

5. For foreign-incorporated insurers operating in Australia as branches (foreign insurers), persons occupying key positions means:

   (a) senior managers of the Australian operations;

   (b) the foreign insurer's agent in Australia appointed under the Act;[4]

   (c) the foreign insurer's Approved Auditor; and

   (d) the foreign insurer's Approved Actuary, where relevant.

6. The criteria for fitness and propriety[5] are as follows:

   (a) the person has not been convicted of an offence against or arising out of the Act or the *Financial Sector (Collection of Data) Act 2001*;

   (b) the person has not been convicted of an offence against or arising out of a law in force in Australia, or the law of a foreign country, if the offence concerns dishonest conduct or conduct relating to a financial sector company within the meaning of the *Financial Sector (Shareholdings) Act 1998*;

   (c) the person has never been bankrupt, has not applied to take the benefit of a law for the relief of bankrupt or insolvent debtors, or has not compounded with his or her creditors;

   (d) the person has no actual or potential conflicts of interest that are likely to influence their ability to carry out their role and functions with appropriate probity and competence;

   (e) the person has adequate experience and demonstrated competence and integrity in the conduct of business duties;[6]

   (f) the person is not of bad repute within the business and financial community;

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3 An insurer must appoint an actuary under section 39 of the Act and have that appointment approved by APRA in accordance with section 40, unless exempted from the requirement in accordance with section 47.

4 A foreign insurer must appoint an agent in accordance with section 118 of the Act.

5 Specified for the purposes of paragraphs 27(2)(b), 42(1)(b), 44 (2)(b) and 45(3)(b) of the Act.

6 Approved Auditors and Approved Actuaries are subject to particular experience requirements as set out in paragraph **Error! Reference source not found.** of this Standard.

19. Insurers must provide APRA with details of all newly appointed directors, including their name, principal business associations and curriculum vitae, within 14 days of their appointment. In addition, insurers must provide APRA with an updated annual statement listing all of its directors (including details of any changes to business associations) no later than at the time which the insurer lodges its yearly statutory accounts.

(ii) Senior Management

21. Senior managers comprise persons employed by an insurer who exercise senior management responsibilities. Senior management responsibilities[7] means having primary responsibility for one or more of the following:

(a) high level decision making;

(b) implementing strategies and policies approved by the Board;

(c) developing processes that identify, manage and monitor risks incurred by the insurer; and

(d) monitoring the appropriateness, adequacy and effectiveness of the risk management system.

22. Insurers must provide APRA with a list of senior management positions and the responsibilities of those positions. Details of the individuals who occupy these positions, including their name and curriculum vitae, must also be submitted within 14 days of their appointment. In addition, insurers must provide APRA with an updated annual statement listing all senior management positions, and names of persons occupying those positions, no later than at the time which the insurer lodges its yearly statutory accounts.

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7 Specified for the purpose of subsection 3(1) of the Act.

Guidance Note GGN 220.1

Governance

1. The internal governance structure of an insurer is critical to ensuring that the interests of policyholders are protected. For an internal governance structure to be effective, the Board, senior management and appointed experts of an insurer must have the probity and competence necessary to develop, monitor and review sound systems for managing risk.

2. In addition, risk management and control systems should be supported by a strong and fully informed Board, the use of Board Audit Committees and independent experts.

Fitness and Propriety

3. In accordance with paragraphs 2-3 of GPS 220 *Risk Management*, insurers must ensure that persons occupying key positions within the insurer have the degree of probity and competence commensurate with their responsibilities. For this purpose, insurers should have in place policies and procedures to address fitness and propriety. Accordingly, insurers must assess all new persons filling key positions, and those of existing staff, and should review these assessments at least annually.

4. An insurer should notify APRA immediately if a key person no longer complies with the tests of fitness and propriety established by the insurer.

5. APRA may conduct a review of the fitness and propriety of an individual. Where APRA conducts such a review, APRA will allow access to the information collected as part of the review where the provider of the information has granted permission for the information to be released. APRA will not release information where it is prohibited from doing so under any agreement with the provider of the information or under any law.

Roles and Obligations of Key Positions

(i) Boards

6. Paragraphs 17-18 of GPS 220 set out the requirements for the composition of an insurer's Board. The Board of an insurer must collectively possess appropriate skills and experience to understand the risks of that insurer's business. This could include (but is not limited to) actuarial, accounting, finance, insurance business and legal expertise.

Appendix 4

Draft Prudential Standards and Guidance Note: Authorised Deposit-Taking Institutions[1]

DRAFT

Prudential Standard

Board Composition (August 2001)

Objective

This standard aims to ensure that locally incorporated ADIs are soundly and prudently managed by a competent board of directors, capable of making reasonable and impartial business judgements in the best interests of the ADI.

Principles

Overview

1. Depositors' confidence is critical for ADIs to whom the public has entrusted their monies. To maintain this confidence, it is essential that ADIs conduct their affairs with a high degree of integrity.

2. The ultimate responsibility for the sound and prudent conduct of an ADI rests with its board of directors (Board). When setting policies and making decisions for the ADI, the Board should have regard to the interests of depositors. Effective corporate governance is more likely to be achieved when the Board of an ADI is made up of directors who are:

(a) 'fit and proper' to hold the position;

(b) capable of exercising judgement independent of the management of the ADI and the group to which the ADI belongs; and

(c) widely representative of the shareholders. No single shareholder (or group of associated shareholders) should be in a position to exercise undue control or influence over the Board.

Composition of Board

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1 http://www.apra.gov.au/Policy/Draft-Prudential-Standards-and-Guidance-Notes-for-A… 9 December 2002

3. The Board of an ADI should comprise at least five directors at all times.

4. The Board should be broadly representative of the ADI's shareholders or members as a whole. Individual shareholders (or any group of associated shareholders) should have broadly proportionate representation on the Board based on their shareholdings. As a guide, holdings under 15 per cent of an ADI's voting shares should have a representation of no more than one on a board of six or less, and no more than two on a board of seven or more. Holdings over 15 per cent (as approved under the provisions of the Financial Sector (Shareholdings) Act 1998) may have greater representation but not more than is broadly proportionate to the relevant shareholding.

5. The Chairman, and a majority of an ADI's board of directors, including those present and eligible to vote at all board meetings, should be non-executives i.e. they are not part of the management of the ADI nor executives of any member of the group to which the ADI belongs.

6. For the purposes of paragraph 5, non-executives of a foreign owned locally incorporated ADI may include executives of the foreign parent (including banking subsidiaries of the foreign parent). APRA will also accept an executive of the foreign parent to be Chairman of the Australian ADI provided the Chairman is available to consult with APRA if required.

7. In the case of mixed conglomerates (a group consisting of both financial and non-financial business) containing an ADI, at least two non-executive directors of the ADI should be independent of the non-financial operations of the group.

8. APRA may, on a case-by-case basis, require an ADI to appoint additional non-executive directors if it is not satisfied with the presence of independence on the Board.

9. At least two directors of an ADI must be Australian residents, one of whom should be a non-executive.

10. An ADI must notify APRA in advance of any proposed changes in its Board composition (including any new appointment, resignation, retirement or removal of directors). Notifications of proposed appointments should include details of the individual's qualifications, history and business associations. A resigning director should supply APRA with a written statement of reasons for resignation.

11. An ADI should provide to APRA annually:

(a) an update on all its directors and their business associations; and

(b) information in respect of the functions and membership of all its board committees.

Quality of Directors

12. Individual directors must be 'fit and proper' to hold the position. In defining 'fit and proper' standards, an ADI should have regard to factors such as:

(a) the person's integrity in the conduct of business activities and reputation within the business and financial community;

(b) the person's competence and experience relative to the duties involved; and

(c) the person's business record and other business interests, as well as financial soundness and strength.

13. Directors of an ADI should be familiar with APRA's prudential requirements and with their responsibilities (including to depositors).

Appendix 5

APRA—Supplementary Submission 4A

Dr Dermody'

We would request the opportunity to make a supplementary submission to the Senate Economic Legislation Committee for the purposes of its deliberations on the Financial Sector Legislation Amendment Bill No 2, 2002.

We would wish to inform the Committee that APRA has commenced a comprehensive stocktake of its present supervisory and enforcement powers. The aim is to identify all significant gaps and inconsistencies in supervisory arrangements in all sectors, with a particular focus on those that restrict APRA's effectiveness. This review is giving some detailed attention to the application of fit and proper powers. The review includes application of fit and proper powers across all APRA regulated institutions, establishing and maintaining a register of persons deemed not fit and proper; specifying that where a person provided false or misleading information to APRA in the course of APRA discharging its function or powers then a person may be deemed not fit and proper and/or disqualified; a requirement to be included in legislation for a regulated institution to notify APRA of appointments of directors and senior managers; a requirement for regulated institutions to notify APRA of the removal of directors and senior mangers (whether by way of dismissal, resignation or retirement) and the reasons for such changes, and a requirement for a regulated institution to provide APRA with information in relation to a director or senior manager of which the ADI may be aware and that APRA should be reasonably be made aware of in order to form a judgement as to the fitness and propriety of those persons on a continuing basis. The outcome of the review may include the request for further legislative measures.

This development of new regulatory requirements affecting fit and proper provisions will have regard to legal issues (eg need for any protection for people providing information and privacy issues), the practicalities and effectiveness of measures, the burden it may place on institutions and the cost of such measures vis a vis the desired benefits which they may bring. This review is on-going but we would seek the implementation of the proposed fit and proper powers contained in the Bill to give the vital addition to APRA's prudential tools which they represent.

We can confirm that Prudential Standards covering fit and proper requirements will include a requirement that ADIs and authorised NOHCs will need to submit to APRA a copy of its own internal policies established covering fitness and proprietary of directors and senior managers. As part of its supervisory oversight of these institutions APRA will review these policies.

In due course once appropriate policies have been established APRA will include the application of these policies as part of the matters subject to examination by APRA review teams, or subject to targeted reviews which may be commissioned from ADI's external auditors from time to time.

We accept the need to offer guidance to regulated institutions in forming judgements about fitness and propriety and this matter will be taken up in our proposed Prudential Standard. We would see this as being undertaken in consultation with affected institutions to provide guidance in a manner which assist them but is effective and appropriately flexible. This process will likely involve a combination of key principles and some prescriptive elements underpinning those elements. In constructing this Prudential Standard we will obviously look at overseas practice but would note that such practice is not always the best approach in the Australian context. We believe the approach we will adopt with our proposed "fit and proper" Prudential Standard will stand favourably in comparison to the approaches adopted in many overseas countries, a number of whom provide minimal guidance on this subject to their regulated institutions. This approach adopted overseas reflects the difficulties perceived in those countries in defining precisely across all persons and institutions through time the features of fitness and is, of course, captured in the appeals processes which are typically established around the judgements exercised by regulators over what constitutes fit and proper.

We would note that APRA and regulated institutions will, of course, only ever be able to reach the on-balance judgements about the fitness and propriety of persons based on information available to them at any given point in time. As such we will always be hostage to the information which is available.

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