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The Secretary
Senate Economics Committee
Suite SG.64
Parliament House
CANBERRA ACT 2600

Dear Dr Dermody

INQUIRY INTO THE FINANCIAL SECTOR LEGISLATION BILL 2002

I refer to your letter of 14 November on behalf of the Senate Economics Legislation Committee inviting APRA to make a submission on the design and application of a "fit and proper test" to directors and senior managers of ie ADIs and authorised NOHCs.

The "fit and proper" provisions proposed to be introduced into the Banking Act 1959 by FSLAB 2 are modeled on provisions enacted last year in the Insurance Act 1973 covering the directors and senior managers of general insurers. It is intended that the application of the "fit and proper" provisions to ADIs and authorised NOHCs will follow a similar pattern to the application of those provisions to general insurers.

The starting point for the application of "fit and proper" requirements rests with the board of a licensed institution. APRA will establish a Prudential Standard requiring institutions to have policies and procedures to address fitness and propriety of their directors and senior managers. The Standard will also establish some key criteria that these should address. Prudential Standard GPS 220 - "Risk Management for General Insurers" and Guidance Note GGN 220.1 - "Governance" provide a model for those requirements. (Extracts from these documents are attached for information.)

APRA will review the policies established by institutions and monitor their compliance with those 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 required action we would invoke direction or the proposed "fit and proper" powers as appropriate.

APRA will require institutions to notify it of appointments of directors and senior managers. However, it is not our intention in the normal course to investigate or vet prospective directors or senior managers prior to their appointment. Such persons should, of course, be appointed in

accordance with the policies established by institutions governing fitness and propriety. Pre-vetting processes carry a number of problems, in particular risking a moral hazard as institutions effectively shift some of the responsibility for ascertaining the fitness and propriety of persons from themselves to the regulator. Institutions will understand, however, that APRA has the power to require the removal of a person it considers to be not fit and proper at any time, including on the day of their appointment if need be. This prospect will encourage institutions to consult with APRA prior to the appointment of any person to whom they feel APRA might have objections.

APRA does not intend to implement a program of formally examining the status of directors and senior managers each year. However, as part of its routine supervisory oversight of ADIs and authorised NOHCs 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. There may be circumstances where APRA will form the view that it should exercise immediately those formal powers - eg a director involved with inappropriate dealings exposing an ADI to excessive risk.

We note it is not a case of one test fits all as to what constitutes "fitness and propriety." 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 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 than another. Assessment of fitness and propriety will therefore involve APRA, on occasion, needing to make considered judgements. The exercise by APRA of its proposed powers will, of course, be subject to judicial review by the AAT.

The application of the proposed powers may also vary. APRA may form the view that a person should not be involved with institutions in any capacity (eg a person whose general integrity appears highly questionable) and would utilise the proposed provisions to disqualify such a person. In other instances - for example where APRA has concerns only as to the fitness and propriety of a person for a particular position in an institution (eg person may lack the necessary expertise) - APRA may simply use the proposed fit and proper direction powers to require an ADI to remove a person from that position. Such a person may appropriately be employed in another position or in another institution.

While we do not expect the proposed powers would be used frequently, we do see them as an important addition to our regulatory tool kit.

Yours sincerely



Encl.

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.

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 propriety⁵ 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;

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 responsibilities⁷ 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.

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.