



A Stable Finance Industry Through World Class Prudential Management

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In talking to you today about world class prudential management in the finance industry which aids significantly in achieving a stable finance sector I will traverse a number of topics.

- Firstly, prudential regulation and discuss what today is regarded as world class practice in this area and comment on how we do it in Australia and how we believe we rate internationally.
- Then I will move to corporate governance, how I believe it relates to prudential management and what we believe effective governance looks like and delivers.
- I will also discuss two highly topical issues affecting the banking and finance industry, namely International Financial Reporting Standards (IFRS) and Basel II requirements for banks and how I see these affecting the prudential management of financial institutions.
- In finishing I want to talk broadly about risk management in financial institutions and how we view it.

I do not need to explain to this group why prudential regulation of financial institutions is needed or how it is important in maintaining confidence in the finance industry, but I do want to explain that it is not simply about setting some rules for institutions to comply with and then checking retrospectively if they have in fact complied.

Yes, it does involve rule setting, whether that be via laws or regulations set by parliament and the government or via standards set by the prudential regulator, but more importantly it requires active supervision by the regulator. And, now there are international benchmarks for assessing prudential regulation and much assessment of financial sector regulation has been undertaken over the past few years by international institutions such as the International Monetary Fund and the World Bank.

When prudential regulation is done well it achieves adequate financial safety for the beneficiaries of financial products without overly restricting innovation and competition in the markets, so a good balance is achieved.

The laws and standards laid down which financial institutions must comply with are essentially the “rules of the game” and they need to be comprehensive and aimed at limiting risky, or imprudent business practices.

In the jargon of financial regulators there are *core principles* for effective supervision and these have been laid down by international bodies like the Basel Committee for Banking Supervision (BCBS), the International Association of Insurance Supervisors (IAIS) and the International Organisation of Securities Commissions (IOSCO). Well what do these core principles cover?

Firstly it is recognised that there needs to be some basic conditions in place before you can have effective supervision. This includes such things as an effective legal system, adequate accounting, auditing and actuarial standards and functioning professions, and well functioning payments system and money and securities markets.

These days you also need to have clearly enunciated objectives for financial supervision and a supervisory authority which has not only adequate powers and legal protection, but is also operationally independent but accountable and has adequate financial and staff resources. There must be some entry testing or licensing requirements, along with the supervisor having to assess the fitness and propriety of the senior people running financial institutions and to vet the

major changes in ownership or control of the institutions to be satisfied that owners will not interfere with the prudent running of the entity.

The variety of financial and other risks inherent in financial institutions must be identified, understood and measured as much as possible, and there must be strategies, processes and controls to manage those risks down to acceptable levels. There must be rules or requirements around what are assets & liabilities and how they are measured. Derivatives are now very commonly used to assist in the management of financial risks, but their use can also lead to significant increases in risk so there needs to be requirements around their use, either directly or indirectly. Even if risks are well identified, measured and managed there will be some very unexpected or extreme events that may arise and threaten the safety or even survival of a financial institution. This is why capital is needed as a buffer against such unexpected risks or events.

Information disclosure assists markets to reward those which are well managed and penalise those which are not, so there needs to be disclosure requirements. Because of the money flows through financial institutions they attract perpetrators of fraud, or those who seek to launder money or find vehicles for financing terrorists, so requirements around combating these practices are now required.

With the increasing globalisation of markets generally, but financial markets in particular there is an increasing need for regulators to share information with peer regulators in other jurisdictions so there must be the legal ability to do so and the actual exchange of information.

Many people think of financial supervision as either involving the supervisor knowing everything which goes on in a financial institution, or as the policeman identifying breaches and handing out penalties. As most of you know the reality is much different and these days as well as licensing institutions to operate, the prudential supervisor needs to be actively engaged in many functions. These include:

- analysing and monitoring market developments and the individual financial institutions activities and financial performance and position;
- assessing the operations and risks in an entity both off-site but more commonly through frequent visits to see first hand the entity's operations;
- intervening pre-emptively if adverse trends or practices are identified;
- actively applying sanctions or using enforcement powers to force changes in business practices, because entities are unable or unwilling to make the corrective changes necessary if they are to meet their obligations to beneficiaries (i.e. depositors, policyholders or fund members);
- dealing with entities which can not survive such that their exit or wind-up is as clean as possible with the least amount of loss to their beneficiaries; and
- especially in Australia where we have a significant amount of convergence amongst the sectors within the finance industry carrying out supervision of the whole of a financial services group as well as each of the separate legal entities which is licensed to provide financial products.

I have previously mentioned these international bodies. The first 2 institutions are the standards setters for prudential supervision principles and practices in each of the banking and insurance sectors. Each of them has developed detailed core principles for how supervision of that sector should occur and they each have produced numerous other documents laying out practice standards or guidance on specific sector or regulatory issues or practices.

While it is essentially a decision for each country to decide if they follow these international benchmarks or not, in practice there is little choice because over the past 4 years or so the IMF and the World Bank, as part of their visits to member countries to assess a country's economy and financial system they are now also assessing the quality of the financial supervision system of a country. This is part of what is called the Financial Sector Assessment Program (FSAP) by

the IMF and the World Bank and it is aimed at improving the financial supervision requirements and practices in a country in order to achieve better financial stability.

A large number of countries (around 80) have now been assessed and that includes almost all of the developed economies. Australia has not been assessed yet, but we are likely to be assessed in the near future.

If prudential regulation is done well what are the broad outcomes or characteristics that we would see?

Firstly, it would be risk-based. By that I mean the regulatory requirements are not a blunt one size fits all set of requirements, but take into account the types of risk involved and provide the right incentives for institutions to conduct their business prudently, and provide harsh disincentives for institutions which want to engage in significantly imprudent or risky behaviour. But I also mean that the regulator in applying the requirements and conducting its supervision takes a risk-based approach by assessing the risk in individual entities, concentrating on those with more risk to their beneficiaries or the system overall, and then having the power to, and actually putting extra requirements or constraints on the riskier entities.

Secondly, the supervision should be forward looking. While it is a given that supervisors get returns from institutions and check that they are meeting the laid down requirements, that is a smaller part of the job these days. So it is more about supervising out of the front windscreen than out of the rear view mirror. It is a reality in today's fast moving world that entities which have been financially healthy can very quickly become unhealthy through bad management or complacency. The quality of an entity's board and management and the way they go about managing their risks are often more important than the entity's current level of financial strength.

Next, the supervisor should be pre-emptive in identifying imprudent practices or concerns and moving quickly to encourage, coerce, or if necessary out rightly force entities to take corrective action before the situation has deteriorated such that rehabilitation is not possible. Regulators are essentially paid to be pessimists, worry about the undesirable possibilities and work to have them dealt with so that others need not worry as much.

Finally, but very importantly, the regulator does not, and should not, manage the entity. That is unambiguously the responsibility of the board and senior management of the entity. In the free market economy we have, entities should be able to take on some risk in their business in order to provide a return to their owners, and if they do not do that successfully they need to be allowed to fail and the board and senior management be accountable. The prudential regulator should not be unduly interfering unless the interests of the entity's beneficiaries are threatened.

Essentially as we see it corporate governance is about how the directors and senior management oversee the running of a financial institutions business. The board must be the focal point of the governance system and in fact approve the governance system for the institution. Clearly boards are not able to, nor should they, be actively involved in making day to day business decisions, so they need to delegate appropriate authorities to various levels of management and this is how the governance system is implemented. However, they are ultimately responsible for the compliance with, and the effectiveness of the governance system, so they need to ensure they have in place mechanisms to satisfy themselves about this. It can not be a "set and forget" approach.

For all types of corporations boards should set the overall strategic direction of the entity and effectively monitor that management is delivering as much as possible in line with that strategy. They need to be accountable to the entity's shareholders and the market in general firstly, by if necessary changing the management if it is not performing as desired according to the desired strategy, and secondly, by being personally accountable if they fail to effectively monitor management or get the strategy badly wrong.

For prudentially regulated entities corporate governance needs to encompass more than this because there are a very important group of stakeholders, namely the beneficiaries, whose interest has been decided by the community and government needs special protection in the form of prudential supervision. So boards and senior management of financial entities also need to manage their businesses prudently taking particular notice of beneficiaries interests and of course they must ensure that their business meets the laid down prudential requirements.

So what does an effective corporate governance structure in a financial entity look like?

We expect that boards actively review the business strategies put to them by management and they approve the final strategy and own it. Similarly, we expect boards to critically review any significant policies for the entity which are put to them by the management, and the approve the final policies and own them.

Because risk management is so critical in a financial entity we expect that it is the board which must determine and approve the level of risk the entity is prepared to take on and retain and in some detail how the entity identifies, measures and manages its major risks. For a bank that clearly means the credit risk policy, loan approval delegations, volumes and mix of different types of loans and the system for tracking the performance of loans, provisioning for them and dealing with problem loans. Similarly for the policy and detail of market risk and operational risk. For insurers it means insurance risk underwriting policy, delegations, claims management and payment, and reinsurance. Similarly for the policy and detail of investment risk.

Any breaches or exceptions to these policies need to be reported up to appropriate levels, and at least summaries or aggregates and major exceptions being reported to the audit committee. Boards need to be satisfied such control mechanisms exist and work.

There needs to be a clear distinction between and a statement of the roles and responsibilities of each of the board as a whole, the Chairman, the CEO and the senior management. Without this there can not be effective checks and balances and proper accountability for major shortcomings.

The board should also take the lead in establishing the entity's culture, its ethical values and its business behaviour. The tone should be set from the top so it is clear what is expected and senior management and the board must act when behaviour outside of acceptable limits occurs to reinforce that they are serious about this.

If this is done well what we would expect to see as outcomes are:

- a board and senior management which understands well the business of the entity, they have a clear strategy and business plans to operationalise this and they are in control because they have good monitoring systems and they are able to adjust the business plans as needed;
- the entity complies with all the legal and regulatory requirements applying to it and it complies with established codes of practice for its industry
- the entity has an effective risk management strategy and controls and is behaving prudently within that;
- the entity is meeting and is highly likely to be able to continue to meet its obligations to its beneficiaries, even in situations involving stress; and
- the entity is regarded as a good corporate citizen, which balances the interests of its owners, employees, beneficiaries and the community generally.

Looking more specifically at the attributes of a good and well functioning board, we expect:

- directors to act with a substantial degree of independence, but this is more independence of mind and acting free of constraints that other parties may impose, rather than not having financial or other ties with organisations or people;

- directors individually to bring relevant expertise to the business and the board to have collectively the range of skills it needs for its business, and crucially the wisdom to know when to seek outside specialist advice as a proper check or to obtain greater comfort;
- directors individually need to have the time and willingness to apply to the business, learn more about it where they need to and be prepared to probe and test what is put to them by management;
- the board and directors individually need to act prudently recognising that they are fulfilling a stewardship role not just for shareholders, but crucially also for beneficiaries and they need to ensure the entities promises can be met; and
- the board and senior management make decisions, report on outcomes and shortcomings and escalate issues when necessary in a transparent way as agreed they should when their respective roles and responsibilities were agreed.

Also if things are working as we believe they should be then we would expect that:

- the board works to ensure that the supervisor has full and cooperative access to all the information needed to make a proper assessment of the risks of the entity, and there is not simply a minimalist approach to providing information to the supervisor; and
- the directors are personally aware of material issues which the supervisor has raised with the entity and they have critically assessed senior management's proposed response to the supervisor and their proposed actions.

Australian reporting entities will have to adopt the Australian equivalents of International Financial Reporting Standards (IFRS) for reporting periods commencing on or after 1 January 2005. Clearly these accounting changes will impact on APRA's prudential and reporting standards for authorised deposit-takers (ADIs), general insurers, life insurers and friendly societies. While Approved Trustees and Superannuation Entities may also be affected, superannuation funds will not be subject to accounting changes on the initial adoption of IFRS in Australia.

I want briefly touch on the key issues arising for APRA-regulated entities and APRA's approach to the adoption of IFRS.

AASB 132 'Financial Instruments: Disclosure and Presentation' introduces a stricter definition of equity and, on initial adoption of IFRS, could result in certain preference shares and hybrid instruments currently classified as equity being reclassified as liabilities. APRA's standards for a financial instrument to classify as Tier 1 capital for an ADI or a general insurer are clearly impacted because currently they require, amongst other things, that the instrument be classified as equity under Australian generally accepted accounting principles.

AASB 139 'Financial Instruments: Recognition and Measurement' will introduce more stringent requirements on when financial assets which are sold to securitisation Special Purpose Vehicles (SPVs) can be removed from an entity's balance sheet. Existing securitisation structures, such as those involving mortgages, are at risk of failing APRA's clean sale and separation requirements which would result in APRA-regulated entities needing to hold capital in relation to such assets which remain on their balance sheet.

Also under AASB 139 all derivative instruments will be measured at fair value and be recognised on balance sheet. So derivatives used to hedge non-trading positions of ADIs, such as loan portfolios will be recognised on-balance sheet instead of off-balance sheet. It will also be harder for derivatives to qualify as hedges under AASB 139 so cash flow hedges will do not qualify for hedge accounting will expose an entity's reported profit and loss to fair value movements of the derivatives with no offsetting fair value adjustment for the asset or liability being hedged. There are also changes in AASB 139 which allow institutions to select how financial assets are measured, which may be different to how they are measured for prudential purposes.

AASB 118 'Revenue' and AASB 139 will limit the amount of acquisition costs which can be capitalised.

Currently AASB 1038 'Life Insurance Business' requires all assets of a life company to be measured at market value, with changes flowing through profit and loss. Under IFRS the Excess of Market Value over Net Assets (EMVONA) for subsidiaries will no longer be a tangible asset, so it will have to be written off against retained earnings to the extent that it is internally generated.

Provisions for impairment of assets will be made under AASB 139 instead of AASB 1044 and they will only be based on losses where the loss event has already occurred.

AASB 119 'Employee Benefits' which will apply from 1 Jan 06 will require surpluses and deficits in a defined benefit superannuation fund to be recognised on the balance sheet of the employer sponsor.

Essentially APRA's objective in how we are approaching the implementation of IFRS is to align our prudential and reporting standards with Australian accounting standards and principles to the greatest extent practicable.

However, in certain circumstances APRA's prudential framework will depart from accounting standards, as it does in some cases now.

APRA's prudential framework and supervisory approach are primarily risk-based and forward-looking, while accounting standards primarily focus on verification and reporting of past transactions and events. Also, prudential requirements are aimed at protecting beneficiaries' interests, even in adverse circumstances, while general purposes financial reporting focuses on evaluating the interests of an entity's economic owners on a going concern basis.

Our approach to IFRS is to be measured in considering the implications of changes on APRA-regulated industries and to consider the concurrent developments such as general insurance reform and the introduction of Basel II.

We will be aiming to make only the necessary changes to prudential standards and reporting to achieve the current position as far as possible, and we will not be making any changes before 1 July 05, at the earliest.

We issued an overview paper about our approach to IFRS adoption on 8 November 2004 and this will be followed by position papers covering the key issues.

Basel I, which was introduced in 1998, is a very blunt approach to setting capital according to risk. In the intervening years banks own approaches to determining capital have become more advanced and the regulators needed to catch up. Basel II is that catching up and it will align regulatory capital more closely to underlying risks. With a more granular approach to setting capital it will provide more finely tuned incentives for sound risk management in banks.

Basel I initially covered only credit risk, although it was accepted that other risks were implicitly allowed for. This changed when a specific market risk capital adjustment was made to Basel I, but now Basel II will also explicitly allow for operational risk.

In Australia we will be applying Basel II to all deposit-takers from the major banks through to the credit unions, so we need to implement it in a way which is equitable for this diverse range of institutions.

The Basel Committee does not intend that the overall level of capital within the banking system should be altered, but clearly there will be changes for individual banks.

The Basel II framework is built around 3 Pillars.

Pillar 1 is for the minimum regulatory capital and it includes both standardised and forms of advanced methods for determining the minimum regulatory capital for each of credit risk, market risk and operational risk.

Pillar 2 requires the individual banks and the supervisor to carry out their own risk assessments of the individual bank and to adjust the needed capital to reflect the specific risks of that bank, either because they vary from the underlying assumptions of Pillar 1 or because there are substantial risks which Pillar 1 does not allow for.

Pillar 3 requires that banks disclose information about their risks, how they manage them, and their level and form of capital. In my experience as a financial supervisor it is amazing how an institution's behaviour can change when they know certain information has to be disclosed.

The Basel Committee has made all but the most sophisticated approaches available for implementation from year-end 2006 and the most sophisticated approaches from year-end 2007. But actual starting dates have been left to the discretion of regulatory authorities in each country.

Following consultation with industry participants APRA has decided on a common implementation date from year-end 2007 for all approaches. So all deposit-takers will commence at the same time and thus be treated equitably.

Banking supervision is conducted internationally on a basis whereby the home supervisor not only supervises the bank's operation in the home country but also supervises on a consolidated basis the total global operations of a bank. The host supervisor in each country offshore where the bank operates specifically supervises that local operation only and needs to cooperate closely with the home supervisor. For Basel II implementation this cooperation is crucial because it also extends to whether the bank and its operations in each country use the standardised or one of the advanced methods available under Basel II.

The major Australian banks each have spends for Basel II measured in tens of millions of dollars, so it is a very large exercise and it should deliver them improved risk management capabilities.

It is also a major task for APRA with about 8 people full time in our Basel II project team as well as the individual responsible bank supervisors.

We expect all financial institutions the have risk management strategies and systems. Obviously we expect these to be more extensive and sophisticated in the major institutions to match the range and complexity of risks they have.

While it takes people who know how the business operates to understand the risks and how well they are managed there also needs to be at least a mental separation from the business by those who are actually doing the risk management function. We see risk managers within business lines as well as sitting outside them, but it must be clear that it is their responsibility to do their job in an objective way and not be subsumed by the business's market share and profit objectives.

Clearly the risk management function needs to be adequately resourced with enough and quality people to monitor the risks against limits, to understand the underlying changes in the risk profile and to do this in a timely way. They must also be empowered to not only report up the line when breaches occur or risk taking is becoming excessive, but in some cases also have the power to stop practices which are clearly outside of the stated risk policies.

Australia's economic conditions have been very favourable for many years now and both institutions and the people in them, especially in banks, have not seen major corrections or downturns. So there is a risk that complacency is setting in and corners will be cut as the

pressure to meet internal targets is applied. Institutions need to resist this approach for the short term gain which may well sow the seed for long term pain.

I will conclude with a quote from a modern day financial oracle, Warren Buffett, which I believe states succinctly how risk management should be considered.

“Predicting rain does not count, building arks does”.

Thank you.