



Core Principles for Effective Banking Supervision: Self-Assessment for Australia

Information Paper
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CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION: SELF-ASSESSMENT FOR AUSTRALIA

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Australian Prudential Regulation Authority

PREAMBLE

This document outlines APRA's self-assessment of its supervisory policies and practices against the *Core Principles for Effective Banking Supervision*, issued by the Basel Committee on Banking Supervision in October 1999¹.

Although supervisory practices and processes are always evolving and, we hope, improving over time, it is nonetheless invaluable to take stock now and then; to subject our supervisory arrangements to scrutiny against internationally accepted benchmarks, and to consider where improvements can be made. To be effective, any such assessment must be undertaken with a critical eye. It is too easy for supervisors to assert that existing arrangements represent best practice when closer analysis would reveal otherwise. This document has been prepared with that thought firmly in mind.

In preparing the assessment, it should be noted that APRA is responsible for supervising all authorised deposit-taking institutions (ADIs) in Australia (including banks, building societies and credit unions). However, reflecting the objective of the Basel Committee, this document has as its focus the supervisory regime surrounding banks. In practice, the legislative framework and much of APRA's supervisory processes are applied equally to all deposit-takers. Where this is not the case, the supervisory standards applying specifically to banks have been used as the basis for assessment (with references to the approach adopted for non-bank ADIs included as a footnote).

Comments and views on the self-assessment are welcome, and should be directed to:

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¹ Details on the Core Principles can be found on the Bank for International Settlements website (www.bis.org)

1. INTRODUCTION

The development of criteria against which supervisory systems can be assessed, both in absolute terms and relative to those in other countries, has long been a goal of prudential regulators. However, practical impediments to establishing appropriate benchmarks (for example, the difficulty in adequately quantifying the “quality” of supervisory arrangements, as well as inherent differences in supervisory systems throughout the world) have made for slow progress. Nevertheless by the late 1990s work on this topic, commissioned by the Basel Committee on Banking Supervision (BCBS), had begun to take form, and the *Core Principles for Effective Banking Supervision* were issued in September 1997. The Principles were developed by the Committee (which comprises the central banks and bank supervisory agencies of the G10 countries) in co-operation with supervisors from non-G10 countries.² The Principles were endorsed by the international financial community during annual meetings of the IMF and World Bank in Hong Kong in October 1997.

Soon after release, a first attempt was made to survey a large number of countries, with a view to assessing the degree of adherence with the new Principles. This was done in the lead-up to the October 1998 International Conference of Banking Supervisors (ICBS) in Sydney. Results of the survey were mixed however, and pointed to the need for further refinement of the Principles and greater rigour both in the detail and presentation of the Principles. Because of the subjective and high-level nature of the Principles at that stage, direct comparisons of results from country to country proved to be unreliable.

The Sydney ICBS, therefore, called for more work to be done aimed at producing a more precise and useable form of guidelines. The Committee responded, and a revised Core Principles Methodology was issued in October 1999.

1.1 The New Core Principles Methodology

There are two elements to the Core Principles. The first is macroeconomic/macprudential in character and requires a broad assessment of the so-called “Preconditions for Effective Banking Supervision”. Here the focus is on those structural or other features of the economy or financial system, against which the detailed day to day microeconomic work of the supervisor takes place. In the absence of these fundamental preconditions, any system of prudential supervision is unlikely to achieve the objectives of institutional and system-wide safety and stability for which it is designed.

The preconditions include:

- sound and sustainable macroeconomic policies;
- a well-developed public infrastructure;
- effective market discipline; and
- mechanisms for providing an appropriate level of systemic protection.

The second aspect of the methodology is the 25 Core Principles. These represent the agreed set of high-level Principles against which systems of prudential supervision can be measured and assessed. To aid the assessment, detailed criteria – deemed “essential” and “additional” criteria – have been established. The essential criteria for any particular principle are defined as the elements that must be present in order to demonstrate compliance with the Principle in question. The additional criteria are requirements that, in conjunction with the essential criteria, act to strengthen supervisory systems and the prospect for financial stability.

² The Core Principles Liaison Group was set up to assist in the development of the Principles. APRA is represented on that group which comprises selected G10 and non G10 countries.

1.2 Core Principles Assessments

In practice, Core Principles assessments may be conducted in a variety of contexts:

- self-assessments of local supervisory regimes by domestic bank supervisors;
- peer reviews conducted, for instance, within regional groupings of bank supervisors;
- reviews conducted by private third parties such as ratings agencies and consulting firms; and
- reviews in the context of IMF surveillance or World Bank lending programs, or via the joint IMF-World Bank Financial Stability Assessment Program (FSAP).

Self-assessment is viewed as an informal but nonetheless valuable means of establishing the current state-of-play of bank supervisory systems, and identifying areas where improvements may be required to bring arrangements closer into line with international best practice. If an assessment is sufficiently rigorous, it will help identify deficiencies even if there is little evidence of those deficiencies having caused actual problems (ie. it is proactive rather than reactive).

1.3 Assessing Australia's Compliance with the Core Principles

Our starting point, therefore, was to look at the system of bank supervision in Australia from the position of an independent, informed, outside party. Our goal was an assessment sufficiently rigorous to stand up to any outside scrutiny. We then sought to assess the extent to which any apparent shortcomings should be addressed through changes in practice or policy (this resolves to a question of determining the relative costs and benefits of changing existing arrangements). In areas where we have identified a shortcoming against the Principles, we have also indicated the remedial action required to bring arrangements into compliance.

2. PRECONDITIONS FOR EFFECTIVE BANKING SUPERVISION

A sound system of banking supervision requires, as its foundations, a range of preconditions to be in place. As noted above, these preconditions include sound and sustainable macroeconomic policies; a well-developed public infrastructure; effective market discipline; procedures for the efficient resolution of problems in banks; and mechanisms for providing an appropriate level of systemic protection. While these are largely beyond the control of the bank supervisor, they may nevertheless significantly affect the supervisor's ability to implement the Core Principles. Hence, it is necessary to assess the extent to which these preconditions are satisfied before any assessment of compliance with the Core Principles takes place.

Our assessment is that the preconditions for effective banking supervision are satisfied fully in the case of Australia.

Australia is a modern, deregulated, open economy. The macroeconomic policy framework is generally perceived to be sound and sustainable, with monetary policy guided by an independent central bank with a clear policy objective focusing on maintenance of low inflation, and the absence of significant fiscal imbalances.

There exists a strong public infrastructure, including:

- effective supervision of markets by the Australian Securities and Investments Commission (ASIC) and of the payments system by the Reserve Bank of Australia (RBA);
- a sound legal system with strong enforcement of laws associated with contract enforcement, bankruptcy, collateral and loan recovery; and
- accounting standards which are broadly consistent with internationally accepted principles, and disclosure requirements that ensure markets remain well-informed.

As described in the detailed section on the Principles (see below) APRA has at its disposal a range of powers, equal to any system in the world, to assist with the prompt resolution of problems in a bank. Furthermore, arrangements are in place to permit the RBA, on advice from APRA, to provide a lender-of-last-resort facility to a solvent bank that has encountered liquidity constraints, if there is potential for systemic problems to emerge. These specific arrangements are in addition to the general powers of the RBA to inject liquidity into the financial system in the event of financial disruption, whatever the cause. To the extent possible, therefore, the financial system and the economy more generally are insulated from the side effects of problems in the banking sector.

It should be noted that Australia does not have any form of deposit insurance scheme to protect depositors in a failed institution. Though the absence of such a scheme is unusual by world standards, this must also be read against the background of the Australian system in which no depositor has, since the passing of the Banking Act in 1945, ever lost funds held in an authorised bank.

3. CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION – ASSESSMENT

The assessment of compliance with each of the 25 Principles, set out in detail below, is made largely on a qualitative basis. A five-part assessment system is used, outlining the extent to which Australia can be considered compliant, largely compliant, materially non-compliant, or non-compliant with each of the 25 Principles. The fifth category, “not applicable,” is for cases where a Principle is not relevant to the banking system in question.

To achieve a “compliant” assessment in relation to a Principle, all essential criteria generally must be met without any significant deficiencies. However, there may be instances where it can be demonstrated that the Principle has been achieved through different means. Where appropriate, such additional information should be taken into account in reaching an overall assessment. Conversely, satisfying the essential criteria might not always be sufficient to achieve the objective of the Principle, and therefore one or more additional criteria and/or other measures may also be deemed necessary by the assessor to judge that compliance is achieved.

A “largely compliant” assessment is given if only minor shortcomings are observed, and these are not viewed as sufficient to raise serious doubts about the authority’s ability to achieve the objective of that Principle. A “materially non-compliant” assessment is given when the shortcomings are sufficient to raise doubts about the authority’s ability to achieve compliance, but substantive progress towards compliance has been achieved. A “non-compliant” assessment is given when no substantive progress towards compliance has been achieved.

3.1 Results

Details of our assessment are set out below with identification of the respective Principles, our assessment, background to the assessment and action required where some shortfall is identified. To summarise those findings, we believe that the supervisory framework covering Australian banks can be considered:

- compliant with 11 Principles;
- largely compliant with 12 Principles; and
- materially non-compliant with the remaining 2 Principles.

For many of the key Principles, APRA regards Australia to be fully compliant. For example, there are clear responsibilities and objectives for each agency involved in the supervision of banks – primarily APRA, but other agencies as well – as required by Principle 1. The capital requirements imposed on Australian banks are consistent with those produced by the BCBS (Principle 6). APRA requires that banks establish and adhere to adequate policies and procedures for evaluating the quality of assets and the

adequacy of loan loss provisions and reserves (Principle 8), and APRA's supervisory approach includes both on-site and off-site components (Principle 16).

In other areas, we have judged the Australian supervisory framework to be "largely compliant", even though the issues identified as requiring attention are often quite minor. For example, Principle 11 requires supervisors to closely monitor banks' risk-management systems for country exposure. While APRA does receive information on the internal controls banks have in place to manage country risk, this does not receive a high priority under APRA's risk-based approach to supervision, in part because of Australian banks' relatively low exposure to country risk. However, when coupled with some minor reporting gaps that need to be filled to improve the comparability of country exposure data, we have chosen to assign a "largely compliant" rating to this Principle. This reflects our recognition that improvements to processes are possible in this area, rather than indicating a significant supervisory shortfall.

Another example is Principle 5, where we have again assigned a "largely compliant" rating, even though the deficiencies are relatively minor. In this case, the issue is the existence of clear criteria by which the supervisor assesses major acquisitions and investments by banks. While APRA would normally vet major investments by banks, this reflects a cooperative arrangement with the industry rather than any formal requirement for prior approval. Nor are there publicly available guidelines on how APRA would judge various proposals. To enhance compliance with this Principle, APRA could develop a clearer definition of a "major" acquisition (ie which acquisitions, both financial and non-financial, require prior approval) and a detailed list of the information that is required in order to be able make an adequate assessment of proposals. These requirements would be publicly available to institutions. As with Principle 11, we do not believe that the existing regime is seriously deficient in this area; rather, we believe that simple improvements could be made to improve its effectiveness and efficiency, and we will be making those changes.

The key areas of material non-compliance in the Australian supervisory framework are:

- **Principle 3** - the absence of a formal "fit and proper" test for bank directors and management. Such a test will be introduced in the near future;
- **Principle 25** - the lack of supervisory oversight given to the small number of foreign banks operating as merchant banks in Australia. This situation arises from historical circumstances, originating in the era when foreign bank entry was less open than it is today, and foreign banks wishing to conduct largely wholesale business in the Australian market were permitted to do so without a formal banking authority.

SUMMARY OF SELF-ASSESSMENT

APRA assesses the Australian supervisory framework as:

Principle 1(1)	COMPLIANT
Principle 1(2)	COMPLIANT
Principle 1(3)	COMPLIANT
Principle 1(4)	COMPLIANT
Principle 1(5)	COMPLIANT
Principle 1(6)	COMPLIANT
Principle 2	LARGELY COMPLIANT
Principle 3	MATERIALLY NON-COMPLIANT
Principle 4	COMPLIANT
Principle 5	LARGELY COMPLIANT
Principle 6	COMPLIANT
Principle 7	LARGELY COMPLIANT
Principle 8	COMPLIANT
Principle 9	LARGELY COMPLIANT
Principle 10	LARGELY COMPLIANT
Principle 11	LARGELY COMPLIANT
Principle 12	COMPLIANT
Principle 13	LARGELY COMPLIANT
Principle 14	LARGELY COMPLIANT
Principle 15	COMPLIANT
Principle 16	COMPLIANT
Principle 17	LARGELY COMPLIANT
Principle 18	LARGELY COMPLIANT
Principle 19	LARGELY COMPLIANT
Principle 20	COMPLIANT
Principle 21	COMPLIANT
Principle 22	COMPLIANT
Principle 23	LARGELY COMPLIANT
Principle 24	COMPLIANT
Principle 25	MATERIALLY NON-COMPLIANT

Principle 1: An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Principle 1(1): An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks.

Essential criteria

1. Laws are in place for banking, and for (each of) the agency (agencies) involved in banking supervision. The responsibilities and objectives of each of the agencies are clearly defined.
2. The laws and/or supporting regulations provide a framework of minimum prudential standards that banks must meet.
3. There is a defined mechanism for coordinating actions between agencies responsible for banking supervision, and evidence that it is used in practice.
4. The supervisor participates in deciding when and how to effect the orderly resolution of a problem bank situation (which could include closure, or assisting in restructuring, or merger with a stronger institution).
5. Banking laws are updated as necessary to ensure that they remain effective and relevant to changing industry and regulatory practices.

Additional criteria

1. The supervisory agency sets out objectives, and is subject to regular review of its performance against its responsibilities and objectives through a transparent reporting and assessment process.
2. The supervisory agency ensures that information on the financial strength and performance of the industry under its jurisdiction is publicly available.

Assessment APRA considers Australia to be **COMPLIANT** with this Principle.

Background

In Australia, the key pieces of legislation covering agencies involved in the supervision of the banking system are the *Australian Prudential Regulation Authority Act 1998* and the *Reserve Bank Act 1959*. The respective responsibilities of APRA – prudential supervision – and the Reserve Bank of Australia (RBA) – amongst other things, financial system stability – are clearly defined in the respective Acts. A range of mechanisms have been implemented to ensure that, in fulfilling their objectives, the two agencies work in a co-ordinated manner (eg, cross-directorships, working-level liaison committees and a Memorandum of Understanding (MoU) on information sharing and crisis management). Similar arrangements exist between APRA and other financial sector supervisors, eg the Australian Securities and Investments Commission (ASIC), which has responsibility for market conduct and disclosure.

Under the Banking Act, APRA has the responsibility for setting prudential standards for all authorised deposit-taking institutions (ADIs). After its establishment, APRA began a project to harmonise the various prudential standards inherited from predecessor agencies, with a view to establishing a single set of harmonised prudential standards for all ADIs. This project was completed in October 2000. Unlike the previous supervisory arrangements, in which the prudential standards for banks were not legally binding, the new standards are supported by a range of enforcement powers.

In the event of a bank experiencing difficulties, APRA would play a lead role in the resolution of the problem. In some cases, where an otherwise solvent bank might jeopardise the stability of the financial system, the RBA may also play a role by providing liquidity. These arrangements are set out in the APRA/RBA MoU.

Banking legislation, including the Banking Act, has recently been updated to reflect the significant rearrangement of the regulatory framework in Australia. Further legislative changes are likely in the future as the new framework is bedded down and harmonised further. APRA is accountable to Parliament, and provides an annual report outlining its performance, as well as making ad hoc appearances at Parliamentary Committees as required. APRA also publishes regular statistical information about the industries under its supervision.

Action Required to Improve Compliance

None

Principle 1(2): Each such agency should possess operational independence and adequate resources.

Essential criteria

1. There is, in practice, no significant evidence of government or industry interference in the operational independence of each agency, and in each agency's ability to obtain and deploy the resources needed to carry out its mandate.
2. The supervisory agency and its staff have credibility based on their professionalism and integrity.
3. Each agency is financed in a manner that does not undermine its autonomy or independence and permits it to conduct effective supervision and oversight. This includes, inter alia:
 - salary scales that allow it to attract and retain qualified staff;
 - the ability to hire outside experts to deal with special situations;
 - a training budget and program that provides regular training opportunities for staff;
 - a budget for computers and other equipment sufficient to equip its staff with tools needed to review the banking industry; and
 - a travel budget that allows appropriate on-site work.

Additional criteria

1. The head of each agency is appointed for a minimum term and can be removed from office during such term only for reasons specified in law.
2. Where the head of an agency is removed from office, the reasons must be publicly disclosed.

Assessment APRA considers Australia to be **COMPLIANT** with this Principle.

Background

APRA's activities are overseen by a Board of Directors, the majority of whom are non-executive and independent of the Government. The Board's role is to determine APRA's policies, oversee the efficient and effective conduct of APRA's functions, and ensure that APRA's operations are consistent with its statutory objectives. The Board therefore has primary responsibility for the full range of APRA's activities, thus ensuring APRA maintains a strong degree of operational independence.

APRA is funded by industry levies, and is not dependent on the Government for its on-going financial support. Levies are ultimately set by the Treasurer, after consultation between APRA and supervised industries, so as to cover the full cost of APRA's operation.

Supervisory staff at APRA was initially sourced from predecessor agencies, but there has been extensive external recruitment. Skill and experience levels are high. In fulfilling their duties, staff have access to an adequate IT infrastructure, a training program designed to further their technical and management skills, and a travel budget that allows for on-site work as necessary. To deal with special situations, APRA has the ability to hire specialist skills or experts as required.

The Treasurer appoints the Chief Executive Officer of APRA for a fixed term (limited by the APRA Act (section 35) to a maximum of five years). Under the terms of the Act, the Treasurer may also dismiss the CEO under certain pre-defined circumstances. Although there is no specific requirement in the Act for this to be publicly announced, in practice this would occur.

Action Required to Improve Compliance

None

Principle 1(3): A suitable legal framework for banking supervision is also necessary... including provisions relating to authorisation of banking establishments and their on-going supervision.

Essential criteria

1. The law identifies the authority (or authorities) responsible for granting and withdrawing banking licenses.
2. The law empowers the supervisor to set prudential rules administratively (without changing laws).
3. The law empowers the supervisor to require information from the banks in the form and frequency it deems necessary.

Assessment APRA considers Australia to be **COMPLIANT** with this Principle.

Background

The Banking Act (section 9) gives APRA responsibility for granting institutions an authority to carry on banking business in Australia, and the authority (if necessary) to impose conditions on such authorisation. The Banking Act also gives APRA the power to make, vary or revoke prudential standards without the need for legislative changes (section 11AF), and to collect any information from banks that is necessary for its supervisory activities (section 51).

Action Required to Improve Compliance

None

Principle 1(4): A suitable legal framework for banking supervision is also necessary... including powers to address compliance with laws, as well as safety and soundness concerns.

Essential criteria

1. The law enables the supervisor to address compliance with laws and the safety and soundness of the banks under its supervision.
2. The law permits the supervisor to apply qualitative judgement in forming this opinion.
3. The supervisor has unfettered access to banks' files in order to review compliance with internal rules and limits as well as external laws and regulations.
4. When, in a supervisor's judgement, a bank is not complying with laws and regulations, or it is or is likely to be engaged in unsafe or unsound practices, the law empowers the supervisor to:
 - take (and/or require a bank to take) prompt remedial action;
 - impose a range of sanctions (including the revocation of the banking license).

Assessment APRA considers Australia to be **COMPLIANT** with this Principle.

Background

The Banking Act gives APRA various powers to address compliance with laws, as well as to address concerns on institutional safety and soundness. Under Part II, Division 1 of the Act, APRA has the authority to issue standards to which banks must comply. If necessary, APRA can direct banks to comply with these standards or to conduct, or cease, other activities; failure to comply with a direction is regarded as an offence under the Criminal Code.

Section 12 of the Banking Act states APRA's duty as the protection of bank depositors. In formulating standards, issuing directives and undertaking other supervisory activities, APRA's task is to ensure a sufficient degree of safety and soundness within banks so that depositors funds are deemed secure. Should APRA have concerns about the safety and soundness of an individual institution, it has the authority to undertake a range of actions: seek additional information (section 13), make directions to cease certain activities (section 11CA), appoint an independent inspector to review the bank's financial position (section 13B), and take control of, and/or appoint a statutory manager to, the bank (section 13C). Ultimately, APRA can choose to revoke the bank's banking authority. In deciding to exercise any of these actions, APRA is not bound by any constraints, other than it must be APRA's judgement that the actions are in the interests of depositors.

Action Required to Improve Compliance

None

Principle 1(5): A suitable legal framework for banking supervision is also necessary... including legal protection for supervisors.

Essential criteria

1. The law provides legal protection to the supervisory agency and its staff against lawsuits for actions taken while discharging their duties in good faith.

2. The supervisory agency and its staff are adequately protected against the costs of defending their actions while discharging their duties.

Assessment APRA considers Australia to be **COMPLIANT** with this Principle.

Background

The APRA Act (section 58) provides that APRA and its staff (including Board members) are not subject to any liability for anything done, or omitted to be done, in the exercise or performance of any of APRA's powers and functions (unless that act or omission is done in bad faith).

Action Required to Improve Compliance

None

Principle 1(6): Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Essential criteria

1. There is a system of cooperation and information sharing between all domestic agencies with responsibility for the soundness of the financial system.
2. There is a system of cooperation and information sharing with foreign agencies that have supervisory responsibilities for banking operations of material interest to the domestic supervisor.
3. The supervisor:
 - may provide confidential information to another financial sector supervisor;
 - is required to take reasonable steps to ensure that any confidential information released to another supervisor will be treated as confidential by the receiving party;
 - is required to take reasonable steps to ensure that any confidential information released to another supervisor will be used only for supervisory purposes.
4. The supervisor is able to deny any demand (other than a court order or mandate from a legislative body) for confidential information in its possession.

Assessment APRA considers Australia to be **COMPLIANT** with this Principle.

Background

Section 56(1) of the APRA Act contains a general requirement for APRA to maintain the confidentiality of information provided to it. However, section 56(1)(5) provides APRA with the authority to provide confidential information to financial sector supervisory agencies, or other foreign agencies, provided APRA is satisfied that the information will assist the agency to perform its function. There is no statutory requirement for APRA to take reasonable steps to ensure the confidentiality of information passed to other supervisory agencies is maintained, although Section 56(1)(9) allows APRA to impose conditions on the confidentiality of the information supplied, and in practice, the decision on whether to impose conditions would take account of any possible breach of confidentiality.

There are three bodies primarily responsible for the oversight of the Australian financial system: APRA, the RBA and the Commonwealth Treasury. In addition to the general legislative provisions above, APRA has implemented a Memorandum of Understanding (MoU) with each of the other agencies. The MoUs

provide, amongst other things, the mechanisms by which information can be exchanged. For example, the APRA/RBA MoU recognises that, when exchanging information, both agencies acknowledge the confidentiality and secrecy requirements of their respective Acts. Each organisation has the right to specify the level of confidentiality attached to the information given to the other.

Action Required to Improve Compliance

None

Principle 2: The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word bank in names should be controlled as far as possible.

Essential criteria

1. The term “bank” is clearly defined in law or regulations.
2. The permissible activities of institutions that are licensed and subject to supervision as banks are clearly defined either by supervisors, or in laws or regulations.
3. The use of the word “bank” and any derivations such as “banking” in a name are limited to licensed and supervised institutions in all circumstances where the general public otherwise might be misled.
4. The taking of proper bank deposits from the public is reserved for institutions that are licensed and subject to supervision.

Assessment APRA considers Australia to be **LARGELY COMPLIANT** with this Principle. The permissible activities of authorised banks are not clearly defined by laws or regulations; instead, proposals to undertake new activities are assessed on a case-by-case basis.

Background

The Banking Act (section 66) prohibits the use of the term “bank” (or derivations such as “banker” or “banking”) to describe a financial business, unless that business is authorised by APRA to use the term. Banks are granted an authority under the Banking Act to conduct banking business in Australia. APRA would not provide an authority to an institution that did not wish to carry out banking business, and can revoke the authority of a bank that has ceased to do so (section 9A). However, banking business is very broadly defined: “both taking money on deposit and making advances of money”. There are no statutory restrictions on the other financial activities that a bank may undertake.

At present, banks’ associations with non-banks are expected to be in the field of financial intermediation (see Prudential Statement G1). However, this policy is under review with the intention by APRA to allow authorised banks to be owned as part of conglomerate groups. These groups may contain a full range of financial and commercial activities. There are no explicit restrictions on the types of non-banking activities that banks may be involved with. Instead, proposals which involve banks and non-financial (ie commercial) activities will be assessed on a case-by-case basis.

Action Required to Improve Compliance

APRA could develop publicly available criteria for assessing the types of activities that authorised banks can undertake. Specification of the range of permissible activities that can be conducted by banks on their own balance sheets need not be seen as commercially restrictive, as in most (if not all) cases, non-

permitted activities could be conducted in subsidiaries and associates (subject, of course, to meeting the requirements of the proposed conglomerates framework). However, such a list would serve to reinforce the clear separation between banking activities and other financial (and non-financial) activities.

Principle 3: The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organisation's ownership structure, directors and senior management, its operating plan and internal controls, and its projected capital position, including its capital base; where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.

Essential criteria

1. The licensing authority has the right to set criteria for licensing banks. These may be based on criteria set in law or regulation.
2. The criteria for issuing licenses are consistent with those applied in ongoing supervision.
3. The licensing authority has the right to reject applications if the criteria are not fulfilled or if the information provided is inadequate.
4. The licensing authority determines that the proposed legal and managerial structures of the bank will not hinder effective supervision.
5. The licensing authority determines the suitability of major shareholders, transparency of ownership structure and source of initial capital.
6. A minimum initial capital amount is stipulated for all banks.
7. The licensing authority evaluates proposed directors and senior management as to expertise and integrity (fit and proper test). The fit and proper criteria include: (1) skills and experience in relevant financial operations commensurate with the intended activities of the bank and (2) no record of criminal activities or adverse regulatory judgements that make a person unfit to uphold important positions in a bank.
8. The licensing authority reviews the proposed strategic and operating plans of the bank. This includes determining that an appropriate system of corporate governance will be in place.
9. The operational structure is required to include, *inter alia*, adequate operational policies and procedures, internal control procedures and appropriate oversight of the bank's various activities. The operational structure is required to reflect the scope and degree of sophistication of the proposed activities of the bank.
10. The licensing authority reviews pro forma financial statements and projections for the proposed bank. This includes an assessment of the adequacy of the financial strength to support the proposed strategic plan as well as financial information on the principal shareholders of the bank.
11. If the licensing authority and the supervisory authority are not the same, the supervisor has the legal right to have its views considered on each specific application.
12. In the case of foreign banks establishing a branch or subsidiary, prior consent (or a statement of "no objection") of the home country supervisor is obtained.
13. If the licensing, or supervisory, authority determines that the license was knowingly based on false information, the license can be revoked.

Additional criteria

1. The assessment of the application includes the ability of the shareholders to supply additional financial support, if needed.
2. At least one of the directors must have a sound knowledge of each of the types of financial activities the bank intends to pursue.
3. 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 license approval are being met.

Assessment APRA considers Australia to be **MATERIALLY NON-COMPLIANT** with this Principle. At present, there is no formal “fit and proper” test applied to directors and senior management (either at the time of application or as part of on-going supervision – refer Principle 17). However, APRA has announced that it proposes to introduce such a test in the near future, and is currently discussing the structure of the test with Treasury.

Background

The Banking Act provides APRA with the authority to issue a banking authority, as well as the ability to impose conditions or restrictions on that authority. APRA’s general criteria, and information requirements, for assessing an application for a banking authority are publicly available (refer *Guidelines on Authorisation of ADIs* at www.apra.gov.au/ADI). These essentially involve an applicant being able to demonstrate an on-going ability to meet APRA’s prudential standards. These include a minimum capital base (\$50 million)³, suitable legal and managerial structures, shareholders of appropriate quality (including, where necessary, approval under the Financial Sector (Shareholdings) Act), comprehensive risk management strategies, and suitable multi-year strategic and financial plans. Where the applicant is foreign-owned, confirmation that the home supervisor does not object to the granting of an authority is also sought.

Although APRA assesses the overall management quality of the applicant, it does not at present have a formal “fit and proper” test for individual executives or directors. Current arrangements require banks to notify APRA in advance of proposed changes of directors and to provide details of the individual’s qualifications and associations.

Action Required to Improve Compliance

APRA will establish a process by which “fit and proper” assessments of senior management and directors can be determined, both at authorisation and on an on-going basis. APRA has announced its intention to implement a formal “fit and proper” test, and is consulting with Treasury about implementation.

As a technical matter, consideration could also be given as to whether APRA should be granted the explicit power to revoke an authority if it was granted on the basis of false information. However, this is a relatively minor matter, and not one that is likely to impact adversely on overall compliance.

³ Non-bank deposit-takers do not need to meet the \$50 million minimum capital requirement.

Principle 4: Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.

Essential criteria

1. Law or regulation contains a clear definition of “significant” ownership.
2. There are requirements to obtain supervisory approval or provide immediate notification of proposed changes that would result in a change in ownership or the exercise of voting rights over a particular threshold or change in controlling interest.
3. The supervisor has the authority to reject any proposal for a change in significant ownership or controlling interest, or prevent the exercise of voting rights in respect of such investments, if they do not meet criteria comparable to those used for approving new banks.

Additional criteria

1. Supervisors obtain from banks, either through periodic reporting or on-site examinations, the names and holdings of all significant shareholders, including, if possible, the identities of beneficial owners of shares being held by custodians.

Assessment APRA considers Australia to be **COMPLIANT** with this Principle.

Background

The *Financial Sector (Shareholdings) Act 1998* (section 10) states that an individual (or group of related individuals) cannot own more than 15 per cent of the shares of a bank without the prior approval of the Treasurer. Applications for shareholdings in excess of this level must justify why the shareholding is in the national interest.

The Treasurer may also deem an individual (or group of related individuals) to be in practical control of a bank, even if the individual (or group) does not have an aggregate shareholding in excess of 15 per cent (section 23).

If a shareholding in excess of 15 per cent is acquired without approval, the Treasurer can require the excess shareholding to be divested (section 12). Where the Treasurer has deemed *practical control* to exist, he/she can require appropriate action to ensure that the ability to control is no longer available (section 25).

The Treasurer may delegate all of his powers under the Act to the APRA CEO, or other member of APRA staff. Currently, the Treasurer has delegated approval powers to APRA, subject to certain asset limitations. APRA may approve transfers involving assets less than AUD750 million. The aim of this delegation is to give APRA the power to make these decisions for all but the largest of banks. In those cases where the Treasurer’s approval is still required, the Treasurer would consult closely with APRA; APRA would provide advice on the suitability of shareholders, and recommendations on the means by which practical control could be diminished (if this was necessary).

Action Required to Improve Compliance

None.

Principle 5: Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

Essential criteria

1. Laws or regulations clearly define what types and amounts (absolute and/or in relation to a bank's capital) of acquisitions and investments need supervisory approval.
2. Laws or regulations provide criteria by which to judge individual proposals.
3. Consistent with the licensing requirements, among the objective criteria that the supervisor uses is that any new acquisitions and investments do not expose the bank to undue risks or hinder effective supervision. The supervisor determines that the bank has, from the outset, adequate financial and organisational resources to handle the acquisition/investment.
4. Laws or regulations clearly define for which cases notification after the acquisition or investment is sufficient. Such cases should primarily refer to activities closely related to banking and the investment being small relative to the bank's capital.

Assessment APRA considers Australia to be **LARGELY COMPLIANT** with this Principle. At present, APRA has not specified clear criteria for assessing major acquisitions or investments by banks.

Background

At present, Prudential Standard APS-222 outlines APRA's restrictions on banks' investments in associates. APRA must be notified of equity investments in non-financial businesses when the investment exceeds 0.25 per cent of Tier 1 capital, or when the aggregate size of those investments accounts for more than 5 per cent of the bank's Tier 1 capital.⁴ APRA should be notified if an ADI intends to take an equity interest of more than 10 per cent in a financial entity. Where sizeable acquisitions or investments are proposed, APRA would assess, amongst other things, whether the transaction would expose the bank to undue risk or hinder effective supervision. This would include ensuring the bank has adequate financial and management resources to manage the new business activities. There are, however, no detailed criteria specified within laws or regulations, although in practice APRA has developed a high-level, internal "checklist" of issues against which a proposal are assessed.

APRA's policy on banks' associations with non-banks, corporate structures and the use of holding companies is currently under revision as its approach to supervising conglomerates is formalised. This policy framework is expected to be finalised by the end of 2001.

Action Required to Improve Compliance

More formal criteria for assessing major acquisitions or investments, building on its existing processes could be developed. This would include, amongst other things, a clearer definition of a "major" acquisition (ie which acquisitions, both financial and non-financial, require prior approval) and a detailed list of the information APRA requires in order to be able make an adequate assessment of proposals. These requirements should be publicly available to institutions. Appropriate sanctions for institutions that commit to acquisitions without the appropriate approval could also be considered.

⁴ Non-bank deposit-takers are also required to notify APRA of investments that involve more than a 10 per cent interest in an individual entity. There is no equivalent requirement specified for banks.

Principle 6: Banking supervisors must set minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. For internationally active banks, these requirements must not be less than those established in the Basel Capital Accord.

Essential criteria

1. Laws or regulations require all banks to calculate and consistently maintain a minimum capital adequacy ratio. At least for internationally active banks, the definition of capital, method of calculation and the ratio required are not lower than those established in the Basel Capital Accord.
2. The required capital ratio reflects the risk profile of individual banks, in particular credit risk and market risk. Both on-balance-sheet and off-balance-sheet risks are included.
3. Laws or regulations, or the supervisor, define the components of capital, ensuring that emphasis is given to those elements of capital available to absorb losses.
4. Capital adequacy ratios are calculated and applied on a consolidated bank basis.
5. Laws or regulations clearly give the supervisor authority to take measures should a bank fall below the minimum capital ratio.
6. Regular (at least semi-annually) reporting by banks to the supervisor is required on capital ratios and their components.

Additional criteria

1. For domestic, as well as internationally active banks, the definition of capital is broadly consistent with the Basel Capital Accord.
2. The supervisor clearly sets out the actions to be taken if capital falls below the minimum standards.
3. The supervisor determines that banks have an internal process for assessing their overall capital adequacy in relation to their risk profile.
4. Capital adequacy requirements take into account the conditions under which the banking system operates. Consequently, minimum requirements may be higher than the Basel Accord.
5. Capital adequacy ratios are calculated on both a consolidated and a solo basis for the banking entities within a banking group.
6. Laws or regulations stipulate a minimum absolute amount of capital for banks.

Assessment APRA considers Australia to be **COMPLIANT** with this Principle.

Background

APRA has applied the Basel Capital Accord to all Australian banks since 1988.⁵ The definition of capital, and the risk-weighting categories, adopted in Australia are consistent with the Basel framework in all material respects. All banks are required to maintain a minimum capital ratio of at least 8 per cent at all times, on both a solo and a consolidated basis. APRA may set a higher minimum requirement for an individual institution where it has concerns about a particular aspect of the bank's activities: examples

⁵ Similar arrangements for non-bank deposit-takers have been in place since 1992.

include the presence of geographic concentrations, or new business activities where the bank does not have a demonstrated track record of successful risk management.

In practice, all banks are expected to operate with a margin above their minimum requirements (including when this is set above 8 per cent). Should a bank's capital ratio decline towards its minimum level, APRA would expect the bank to provide it with a plan to indicate how its capital ratio will be restored. A decline in the bank's capital ratio below its minimum requirement is not a precondition, nor a formal trigger to provoke corrective action. However, as noted under Principle 1(4), the Banking Act provides APRA with the authority to undertake a range of actions if the bank is unable to demonstrate how its capital ratio will be increased. These include the power to: make directions to cease certain activities (section 11CA), appoint independent inspector to review the bank's financial position (section 13B), and take control of, and/or appoint a statutory manager to, the bank (section 13C).

Action Required to Improve Compliance

None

Principle 7: An essential part of any supervisory system is the independent evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the on-going management of the loan and investment portfolios.

Essential criteria

1. The supervisor requires, and periodically verifies, that prudent credit-granting and investment criteria, policies, practices, and procedures are approved, implemented, and periodically reviewed by bank management and boards of directors.
2. The supervisor requires, and periodically verifies, that such policies, practices and procedures include the establishment of an appropriate and properly controlled credit-risk environment, including:
 - a sound and well-documented credit-granting and investment process;
 - the maintenance of an appropriate credit-administration, measurement and ongoing monitoring/reporting process (including asset grading/classification); and
 - ensuring adequate controls over credit risk.
3. The supervisor requires, and periodically verifies, that banks make credit decisions free of conflicting interests, on an arm's-length basis, and free from inappropriate pressure from outside parties.
4. The supervisor requires that a bank's credit assessment and granting standards are communicated to, at a minimum, all personnel involved in credit granting activities.
5. The supervisor has full access to information in the credit and investment portfolios and to the lending officers of the bank.

Additional criteria

1. The supervisor requires that the credit policy prescribes that major credits or investments, exceeding a certain amount or percentage of the bank's capital, are to be decided at a high managerial level of the bank. The same applies to credits or investments that are especially risky or otherwise not in line with the mainstream of the bank's activities.
2. The supervisor requires that banks have management information systems that provide essential details on the condition of the loan and investment portfolios.

3. The supervisor verifies that bank management monitors the total indebtedness of entities to which they extend credit.

Assessment APRA considers Australia to be **LARGELY COMPLIANT** with this Principle. Although APRA expects banks to make credit decisions free of conflicting interests and on an arm's-length basis, it does not have a formal process for periodically verifying that this is occurring.

Background

Banks are required to submit to APRA details of their management control systems, including policies and procedures for the identification, measurement, monitoring and control of credit risk. This includes banks' key risk management policies, and procedures for credit approval, on-going monitoring, problem-loan review, and provisioning.

APRA has a specialist credit risk team that, in conjunction with operational supervisors for individual institutions, conducts on-site work in banks. This on-site work includes detailed discussions with senior management, as well as those with lending authority, credit-risk review personnel and administrative staff. Although APRA's on-site work does not involve transaction testing, a key component is an assessment of the work done by bank's own credit review and/or internal audit functions in ensuring the integrity of the credit management process.

In both its on-site and off-site activities, APRA seeks to ensure that:

- policies, practices and procedures are approved, implemented and periodically reviewed by senior management and, as appropriate, the Board of the bank;
- credit approvals and investment decisions are made in accordance with a sound and well-documented policy;
- credit administration, measurement, monitoring and reporting processes are maintained;
- the policies and procedures are communicated to all appropriate personnel; and
- the overall control environment is commensurate with the business activities being undertaken.

APRA generally requires that banks have policies in place to ensure its dealings are conducted on an arm's-length basis; it does not, as part of its regular on-site review work, ensure that this is occurring.⁶ Instead, APRA relies on the bank's own internal control mechanisms, including the internal audit and compliance functions, to ensure policy is adhered to.

Action Required to Improve Compliance

APRA will include, as part of its off-site and on-site processes, more formal consideration of connected lending. This will include, for example, requesting more detail on this issue within banks' management systems descriptions, and reviews of loan files of related parties during on-site reviews.

⁶ The review of intra-group and related-party lending to ensure that loans are entered into in an arm's-length manner is a standard component of the on-site review processes for non-bank deposit-takers.

Principle 8: Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and reserves.

Essential criteria

1. Either laws or regulations, or the supervisor, set rules for the periodic review by banks of their individual credits, asset classification and provisioning, or the laws/regulations establish a general framework and require banks to formulate specific policies for dealing with problem credits.
2. The classification and provisioning policies of a bank and their implementation are regularly reviewed by the supervisor or external auditors.
3. The system for classification and provisioning includes off-balance-sheet exposures.
4. The supervisor determines that banks have appropriate policies and procedures to ensure that loan-loss provisions and write-offs reflect realistic repayment expectations.
5. The supervisor determines that banks have appropriate procedures and organisational resources for the ongoing oversight of problem credits and for collecting past-due loans.
6. The supervisor has the authority to require a bank to strengthen its lending practices, credit-granting standards, level of provisions and reserves, and overall financial strength if it deems the level of problem assets to be of concern.
7. The supervisor is informed on a periodic basis, and in relevant detail, concerning the classification of credits and assets and of provisioning.
8. The supervisor requires banks to have mechanisms in place for continually assessing the strength of guarantees and appraising the worth of collateral.
9. Loans are required to be identified as impaired when there is reason to believe that all amounts due (both principal and interest) will not be collected in accordance with the contractual terms of the loan agreement.
10. The valuation of collateral is required to reflect the net realisable value.

Additional criteria

1. Loans are required to be classified when payments are contractually a minimum number of days in arrears (eg, 30, 60, 90 days). Refinancing of loans that would otherwise fall into arrears does not lead to improved classifications for such loans.
2. The supervisor requires that valuation, classification and provisioning for large credits are conducted on an individual item basis.

Assessment APRA considers Australia to be **COMPLIANT** with this Principle.

Background

APRA's Prudential Standard APS-220, *Credit Quality*, governs the Australian requirements for the recognition, measurement and disclosure of impaired assets. APS-220 is based on Prudential Standard L1, which was developed by the RBA in consultation with Australian banks and the accounting profession, and was introduced in January 1995. APS-220 requires banks to develop appropriate systems and controls for the recognition of impaired assets, subject to an overall framework set out by APRA. The essence of the Standard is that all items (including loans, off-balance-sheet products and all other credit exposures)

for which there is reasonable doubt about collectability should be regarded as impaired. This includes items against which a provision has been made, or other items that are more than 90 days in arrears and not well-secured.

APS-220 also contains standards for the valuation of collateral (particularly real estate). In assessing the adequacy of provisions, banks are expected to provide fully for any shortfall between the outstanding balance of the loan and the current realisable value of collateral. In general, provisioning assessments are expected to be made on a case-by-case basis, although there is scope within APS-220 for provisioning to be made on a portfolio basis for small exposures (eg personal loans and credit card receivables). Information on the value of impaired items, and associated provisions and collateral, is provided to APRA on a quarterly basis.

APS-220 is the cornerstone of APRA's attempts to ensure all banks have in place systems and controls that are commensurate with their lending activities. The Standard is complemented by:

- off-site supervision – banks are required to submit to APRA details of their management control systems, including policies and procedures for the identification, measurement, monitoring and control of credit risk. This includes banks' key risk management policies, and procedures for credit approval, on-going monitoring, problem-loan review, and provisioning.
- on-site supervision – APRA has a specialist credit risk team that, in conjunction with operational supervisors for individual institutions, conducts on-site work in banks. This on-site work includes detailed discussions with senior management, as well as those with lending authority, credit-risk-review personnel and administrative staff. Although APRA's on-site work does not involve transaction testing, a key component is an assessment of the work done by bank's own credit-review and/or internal-audit functions in ensuring the integrity of the credit-management process.
- arrangements with internal/external auditors – in certain circumstances, such as where there are particular concerns about the quality of an institution's risk-control systems, or where the area of review is beyond APRA's capabilities to perform itself, APRA can request a review to be performed by the bank's internal or external auditors.

The Basel Committee's July 1999 paper, *Sound Practices for Loan Accounting and Disclosure*, is largely consistent with APS-220.

Action Required to Improve Compliance

None

Principle 9: Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.

Essential criteria

1. A "closely related group" is explicitly defined to reflect actual risk exposure. The supervisor has discretion, which may be prescribed by law, in interpreting this definition on a case-by-case basis.
2. Laws or regulations, or the supervisor, set prudent limits on large exposures to a single borrower or closely related group of borrowers. "Exposures" include all claims and transactions, on-balance sheet as well as off-balance sheet.
3. The supervisor verifies that banks have management information systems that enable management to identify on a timely basis concentrations (including large individual exposures) within the portfolio on a solo and consolidated basis.

4. The supervisor verifies that bank management monitors these limits and that they are not exceeded on a solo and consolidated basis.
5. The supervisor regularly obtains information that enables concentrations within a bank's credit portfolio, including sectoral and geographic exposures, to be reviewed.

Additional criteria

1. Banks are required to adhere to the following definitions:
 - 10 per cent or more of a bank's capital is defined as a large exposure;
 - 25 per cent of a bank's capital is the limit for an individual large exposure to a private-sector non-bank borrower or a closely related group of borrowers.

Minor deviations from these limits may be acceptable, especially if explicitly temporary or related to very small or specialised banks.

Assessment APRA considers Australia to be **LARGELY COMPLIANT** with this Principle. APRA does not collect, in a systematic fashion, comprehensive information on sectoral and geographic concentrations within banks' credit portfolios. Also, APRA does not have large-exposure limits for all types of counterparties, although this will be remedied once the new proposals for conglomerate supervision are finalised.

Background

APRA's Prudential Standard APS-221, *Large Exposures*, requires that banks report their large credit exposures to APRA. Large exposures are defined as being greater than 10 per cent⁷ of a bank's capital base, and are measured on a consolidated basis (ie by aggregating exposures in the bank and its associated entities to the same counterparties). Individual counterparties are defined to include groups of related parties.

Banks may not have an exposure to a non-bank, non-government counterparty in excess of 30 per cent⁸ of capital without the prior approval of APRA. Such approval is usually only granted in exceptional circumstances, and where the exposure will only be short-term in nature. Foreign-owned banks also have limits placed on exposures to their parent; these are comprised of 100 per cent capital for direct exposures (eg direct lending, trading lines) and (in addition) 400 per cent of capital under risk participation arrangements. There are no limits imposed by APRA on exposures to governments or other banks, although APRA expects banks to impose their own internal limits. The banks' ability to monitor these limits, along with other industry and geographic limits, would be assessed during APRA's on-site supervision work.

APRA receives quarterly information on certain sectoral (eg commercial property) and geographic (country) exposures via its statistical collections. These cover many important areas of banks' exposures, however, they are not comprehensive, and do not cover all industry sectors, nor are comprehensive in their geographic coverage.

Action Required to Improve Compliance

APRA is in the process of developing revised large-exposure limits as part of its conglomerate supervision proposals. These should fully satisfy the criteria. APRA will also review, as part of the broader review of statistical returns currently occurring, the merits of collecting more systematic information on credit concentrations (industry, geographic).

⁷ Non-bank deposit-takers operate with a limit of 5 per cent.

⁸ Non-bank deposit-takers operate with a limit of 10 per cent.

Principle 10: In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.

Essential criteria

1. A comprehensive definition of “connected or related parties” exists in law and/or regulation. The supervisor has discretion, which may be prescribed in law, to make judgements about the existence of connections between the bank and other parties.
2. Laws and regulations exist that exposures to connected or related parties may not be extended on more favourable terms (i.e., for credit assessment, tenor, interest rates, amortisation schedules, requirement for collateral) than corresponding loans to non-related counterparties⁹.
3. The supervisor requires that transactions with connected or related parties exceeding specified amounts or otherwise posing special risks are subject to approval by the bank's board of directors.
4. The supervisor requires that banks have procedures in place to prevent persons benefiting from the loan being part of the preparation of the loan assessment or of the decision itself.
5. Laws or regulations set, or the supervisor has the mandate to set on a general or case-by-case basis, limits for loans to connected and related parties, to deduct such lending from capital when assessing capital adequacy or to require collateralisation of such loans.
6. The supervisor requires banks to have information systems to identify individual loans to connected and related parties, as well as the total amount of such loans, and to monitor them through an independent credit administration process.
7. The supervisor obtains and reviews information on aggregate lending to connected and related parties.

Additional criteria

1. The definition of “connected or related parties” established in law and/or regulation is broad and, generally, includes affiliated companies, significant shareholders, board members, senior management, key staff as well as close family members, corresponding persons in affiliated companies, and companies controlled by insiders and shareholders.
2. There are limits on aggregate exposures to connected and related parties that are at least as strict as those for single borrowers, groups or related borrowers.

Assessment APRA considers Australia to be **LARGELY COMPLIANT** with this Principle. While APRA generally expects intra-group transactions to occur on an arm's-length basis, there are no formal standards that require this to occur.

Background

APRA's general approach to supervision requires that banks' dealings with related parties be conducted on an arm's-length basis so as to ensure there is no implicit or explicit suggestion that the resources of the bank can be inappropriately used to support the activities of associates.

⁹ An exception may be appropriate for beneficial terms that are part of overall remuneration packages (eg employees receive credit at favourable rates).

Related parties are defined under APRA's large exposure requirements as including not just entities for which there is a majority ownership interest, but also other entities over which control can be exercised. APRA collects information on banks' aggregate exposures to related parties on a quarterly basis (along with other information on large exposure to other counterparties). It also imposes limits on certain intra-group exposures.

However, although there is no formal requirement within APRA's Prudential Standards, increasing attention has been paid to this issue within its on-site and off-site supervision processes.¹⁰ This has included requests for banks to provide more information as part of the details of their risk management systems provided to APRA, and incorporating specific issues associated with related-party lending within on-site supervisory processes.

Action Required to Improve Compliance

APRA will include a clear requirement within its Prudential Standards for intra-group and related-party transactions to occur on an arm's-length basis.

Principle 11: Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.

Essential criteria

1. The supervisor determines that a bank's policies and procedures give due regard to the identification, monitoring and control of country risk and transfer risk. Exposures are identified and monitored on an individual country basis (in addition to the end-borrower/end-counterparty basis). Banks are required to monitor and evaluate developments in country risk and in transfer risk and apply appropriate countermeasures.
2. The supervisor verifies that banks have information systems, risk-management systems and internal-control systems to comply with those policies.
3. There is supervisory oversight of the setting of appropriate provisions against country risk and transfer risk. There are different international practices which are all acceptable as long as they lead to reasonable, risk-related, results. These include, *inter alia*:
 - The supervisor (or some other official authority) decides on appropriate minimum provisioning by setting fixed percentages for exposures to each country.
 - The supervisor (or some other official authority) sets percentage intervals for each country and the banks may decide, within these intervals, which provisioning to apply for the individual exposures.
 - The bank itself (or some other body such as the national bankers' association) sets percentages or guidelines or even decides for each individual loan on the appropriate provisioning. The provisioning will then be judged by the external auditor and/or by the supervisor.
4. The supervisor obtains and reviews sufficient information on a timely basis on the country risk/transfer risk of individual banks.

¹⁰ Review of intra-group and related-party lending has been a standard component of the on-site review processes for non-bank deposit-takers for some time.

Assessment APRA considers Australia to be **LARGELY COMPLIANT** with this Principle. Work is required to better define country exposure for the purposes of data collection, and formalise its review processes for country-exposure risk-management systems.

Background

APRA's off-site analysis includes a limited review of banks' procedures for identifying, monitoring and controlling country risk. Banks are expected to evaluate developments in countries to which they are exposed, and impose (and adjust) limits on these exposures as necessary. However, within APRA's risk-based approach to supervision, country-exposure information, and related management-information processes, are rarely reviewed as part of APRA's on-site supervision process.

APRA does not impose standard provisioning requirements for country risk. Instead, it expects each bank to review its own country exposures, and to provide accordingly. It is assumed that the provisioning decisions will be reviewed by the banks' external auditors in the normal course of their work. APRA collects information on banks' country exposures via a quarterly statistical collection. The turmoil in financial markets in 1998-99, particularly in the Asian region, has highlighted some ambiguities in the manner in which these data are being collected.

Action Required to Improve Compliance

APRA will reassess its data collection on country exposures as part of the broader statistical review currently occurring. APRA will also ensure that, where relevant, systems descriptions and other policy documentation covers country risk management, so that this area is subject to more frequent and detailed review.

Principle 12: Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

Essential criteria

1. The supervisor determines that a bank has suitable policies and procedures related to the identification, measuring, monitoring and control of market risk.
2. The supervisor determines that the bank has set appropriate limits for various market risks, including their foreign-exchange business.
3. The supervisor has the power to impose a specific capital charge and/or specific limits on market-risk exposures, including their foreign-exchange business.
4. The supervisor verifies that banks have information systems, risk-management systems and internal-control systems to comply with those policies, and verifies that any limits (either internal or imposed by the supervisor) are adhered to.
5. The supervisor satisfies itself that there are systems and controls in place to ensure that all transactions are captured on a timely basis, and that the banks' positions are revalued frequently, using reliable and prudent market data.
6. The supervisor determines that banks perform scenario analysis, stress testing and contingency planning, as appropriate, and periodic validation or testing of the systems used to measure market risk.
7. The supervisor has the expertise needed to monitor the actual level of complexity in the market activities of banks.

Additional criteria

1. Either through on-site work, or through internal or independent external experts, the supervisor determines that senior management understands the market risks inherent in the business lines/products traded and that it regularly reviews and understands the implications (and limitations) of the risk-management information that they receive.
2. The supervisor reviews the quality of management information and forms an opinion on whether the management information is sufficient to reflect properly the banks' position and exposure to market risk. In particular, the supervisor reviews the assumptions management has used in their stress-testing scenarios, and the banks' contingency plans for dealing with such conditions.
3. The supervisor who does not have access to the adequate skills and capacity does not allow banks to determine their regulatory capital requirements based on sophisticated models, such as VaR.

Assessment APRA considers Australia to be **COMPLIANT** with this Principle.

Background

As part of its supervisory activities, APRA attempts to ensure all banks have in place systems and controls that are commensurate with the activities they are undertaking, including in the area of market risk. This is achieved via:

- off-site supervision – banks are required to submit to APRA details of their management-control systems for market risk, including policies and procedures for the identification, measurement, monitoring and control of market risk. This includes banks' key risk-management policies, specification of individual business line and product limits, procedures for monitoring those limits and reporting breaches, and
- on-site supervision – APRA has a specialist balance sheet and market risk team that, in conjunction with operational supervisors for individual institutions, conducts on-site work in banks. This on-site work includes detailed discussions with senior management, as well as traders, risk-management personnel and back-office staff. Although APRA's on-site work does not involve transaction testing, a key component is an assessment of the work done by bank's own internal-audit functions in ensuring that all genuine (and only genuine) transactions are processed on a timely basis, and that independent revaluations are occurring using appropriate data.
- arrangements with internal/external auditors – in certain circumstances, such as where there are particular concerns about the quality of an institution's risk-control systems, or where the area of review is beyond APRA's capabilities to perform itself, APRA can request a review to be performed by the bank's internal or external auditors.

APRA also applies the Basel Committee's market-risk capital requirements to all banks with trading-book activities and/or foreign-exchange or commodity exposures. Consistent with the Basel framework, banks have a choice of using a standard prescribed methodology or, subject to APRA's prior approval, an internal model-based methodology for determining their market-risk capital charge. The only major deviation from the Basel framework is that APRA does not allow the use of Tier 3 capital (this makes the Australian requirements more stringent than those imposed elsewhere).

APRA does not, at present, impose direct limits on market-risk exposures (eg net-open-positions limits for foreign exchange). Instead, APRA relies on institutions implementing, and adhering to, their own appropriate internal limits as the primary means of control, supplemented by the market-risk capital charge. However, APRA has the authority to impose such limits if it was deemed necessary.

Action Required to Improve Compliance

None

Principle 13: Banking supervisors must be satisfied that banks have in place a comprehensive risk-management process (including appropriate board and senior management oversight) to identify, monitor and control all other material risks and, where appropriate, to hold capital against these risks.

Essential criteria

1. The supervisor requires individual banks to have in place comprehensive risk-management processes to identify, measure, monitor and control material risks. These processes are adequate for the size and nature of the activities of the bank and are periodically adjusted in light of the changing risk profile of the bank and external market developments. These processes include appropriate board and senior-management oversight.
2. The supervisor determines that the risk-management processes address liquidity risk, interest-rate risk, and operational risk as well as all other risks, including those risks covered in other Principles (eg, credit and market risk). These would include:
 - Liquidity: good management-information systems, central liquidity control, analysis of net-funding requirements under alternative scenarios, diversification of funding sources, stress testing and contingency planning. Liquidity management should separately address domestic and foreign currencies.
 - Interest-rate risk: good management-information systems and stress testing.
 - Operational risk: internal audit, procedures to counter fraud, sound business-resumption plans, procedures covering major system modifications and preparation for significant changes in the business environment.
3. The supervisor issues standards related to such topics as liquidity risk, interest-rate risk, foreign-exchange risk and operational risk.
4. The supervisor sets liquidity guidelines for banks, which include allowing only truly liquid assets to be treated as such, and takes into consideration undrawn commitments and other off-balance-sheet liabilities, as well as existing on-balance-sheet liabilities.
5. The supervisor determines that limits and procedures are communicated to the appropriate personnel and primary responsibility for adhering to limits and procedures is placed with the relevant business units.
6. The supervisor periodically verifies that these risk management processes, capital requirements, liquidity guidelines and qualitative standards are being adhered to in practice.

Additional criteria

1. The supervisor has the authority to require a bank to hold capital against risks in addition to credit and market risk.
2. The supervisor encourages banks to include a statement on their risk-management policies and procedures in their publicly available accounts.
3. Supervisors obtain sufficient information to enable them to identify those institutions carrying out significant foreign-currency liquidity transformation.

4. The supervisor determines that, where a bank conducts its business in multiple currencies, management understands and addresses the particular issues this involves. Foreign-currency liquidity strategy is separately stress tested and the results of such tests are a factor in determining the appropriateness of mismatches.

Assessment APRA considers Australia to be **LARGELY COMPLIANT** with this Principle. It is deficient in that it does not have in place specific standards for balance-sheet or operational risk (although work is under way in these areas).

Background

Banks are required to submit to APRA details of their management-control systems for market risk, including policies and procedures for the identification, measurement, monitoring and control of credit market, balance sheet, liquidity and operational risk. In addition, the Chief Executive of the bank is required to provide APRA with an annual attestation that the management control systems are in place, adequate for the bank's needs and operating effectively.¹¹ Compliance with these systems can be subject to a targeted review by the bank's external auditor, at APRA's request, or APRA's own on-site review processes.

APRA has issued a prudential standard on liquidity, which requires banks to consider their liquidity needs in the light of various scenarios (including a name crisis).¹² This standard – APS-210 – requires banks to not only consider balance-sheet items, but also undrawn commitments, and other off-balance-sheet liabilities. There are no specific standards on balance-sheet or operational risk, although APRA is working to develop these. Despite the absence of formal standards, the review of balance-sheet and operational risk-management systems remains a key component of APRA's supervisory assessment processes.

Where APRA believes a bank has excessive or poorly managed levels of risk in a particular area of activity, it can require that bank to hold additional capital. In practice, this would be achieved by imposing a minimum capital requirement above 8 per cent, rather than by determining an additional capital requirement related specifically to the area of concern. APRA does not formally require banks to include details on their risk-management practices in their annual financial accounts, but many do so in response to market demands for this type of information.

Action Required to Improve Compliance

APRA will continue its work on balance-sheet and operational risk management, with a view to converting existing internal guidance on good practice into published standards. This work has recently been given added impetus with the release of the New Basel Capital Accord.

¹¹ This process is not currently applied to non-bank deposit-takers.

¹² Most non-bank institutions, while encouraged to assess their liquidity needs along the lines used by banks, will still be subject to a minimum "stock" liquidity requirement (ie a requirement to hold a proportion of their liabilities in defined liquid assets).

Principle 14: Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

Essential criteria

1. Corporate or banking laws identify the responsibilities of the board of directors with respect to corporate governance principles to ensure that there is effective control over every aspect of risk management.
2. The supervisor determines that banks have in place internal controls that are adequate for the nature and scale of their business. These controls are the responsibility of the board of directors and deal with organisational structure, accounting procedures, checks and balances and the safeguarding of assets and investments. More specifically, these address:
 - Organisational structure: definitions of duties and responsibilities including clear delegation of authority (for example, clear loan-approval limits), decision-making procedures, separation of critical functions (for example, business origination, payments, reconciliation, risk management, accounting, audit and compliance).
 - Accounting procedures: reconciliation of accounts, control lists, information for management.
 - Checks and balances (or “four-eyes principles”): segregation of duties, cross-checking, dual control of assets, double signatures.
 - Safeguarding assets and investments: including physical control.
3. To achieve a strong control environment, the supervisor requires that the board of directors and senior management of a bank understand the underlying risks in their business and are both committed to, and legally responsible for, the control environment. Consequently, the supervisor evaluates the composition of the board of directors and senior management to determine that they have the necessary skills for the size and nature of the activities of the bank and can address the changing risk profile of the bank and external market developments. The supervisor has the legal authority to require changes in the composition of the board and management in order to satisfy these criteria.
4. The supervisor determines that there is an appropriate balance in the skills and resources of the back office and control functions relative to the front office/business origination.
5. The supervisor determines that banks have an appropriate audit function charged with (a) ensuring that policies and procedures are complied with and (b) reviewing whether the existing policies, practices and controls remain sufficient and appropriate for the bank’s business. The supervisor determines that the audit function:
 - has unfettered access to all the bank’s business lines and support departments;
 - has appropriate independence, including reporting lines to the board of directors and status within the bank to ensure that senior management reacts to and acts upon its recommendations;
 - has sufficient resources, and staff that are suitably trained and have relevant experience to understand and evaluate the business they are auditing;

- employs a methodology that identifies the key risks run by the bank and allocates its resources accordingly.
6. The supervisor has access to the reports of the audit function.

Additional criteria

1. In those countries with a unicameral board structure (as opposed to a bicameral structure with a supervisory board and a management board), the supervisor requires the board of directors to include a number of experienced non-executive directors.
2. The supervisor requires the internal audit function to report to an Audit Committee.
3. In those countries with a unicameral board structure, the supervisor requires the Audit Committee to include experienced non-executive directors.

Assessment APRA considers Australia to be **LARGELY COMPLIANT** with this Principle. Given APRA's approach to supervision, it does not attempt to act as another layer of internal audit for supervised institutions. As a result, while it undertakes high-level, risk-based reviews, APRA does not have its own systematic process in place for ensuring appropriate systems and controls are present in all cases.

Background

APRA relies on the Corporations Law to define the responsibilities of the board of directors with respect to the principles of corporate governance and the effective control over every aspect of a bank's activities. There are no bank-specific requirements on directors.

APRA's general approach to supervision is that it is primarily the responsibility of the board and senior management to ensure the prudent management of the bank's activities. APRA does not itself audit banks' management systems and controls. Instead, in forming a view on the adequacy of these processes, APRA relies upon:

- the documented systems provided to it by the bank, and the annual management attestation as to the adequacy and application of these systems;
- the bank's own internal and external audit arrangements (APRA can access the working papers of the internal audit function if required);
- any targeted reviews APRA requests of the bank's external auditor¹³; and
- its own on-site supervision work, which provides a high-level review of the internal control structure of the bank.

Through these processes, APRA is provided with a sound overview of the application of the management systems and controls within banks. It does not, therefore, conduct its own detailed testing of processes for reconciliation, reporting and safeguarding of assets. While APRA would expect banks to report significant problems in these areas as they arise, there is no specific requirement for this to occur.

Action Required to Improve Compliance

Some modifications to existing practices that could be implemented to strengthen APRA's supervisory processes, without reproducing the detailed audit function that, as a policy matter, it has decided not to

¹³ This process is not currently applied to non-bank deposit-takers.

introduce. For example, APRA might also seek from external auditors their management letters at the conclusion of each audit; currently, this only occurs if the letter raises issues that specifically relate to regulatory matters. Over the longer term, APRA could investigate the possibility of modifying the existing tripartite arrangements to specifically incorporate audit review of all the issues raised under this Principle (although this would impose significant additional cost on banks). APRA would also need to review the mechanisms by which banks would be required to report significant problems to it.

Principle 15: Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict “know-your-customer” rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.

Essential criteria

1. The supervisor determines that banks have in place adequate policies, practices and procedures that promote high ethical and professional standards and prevent the bank from being used, intentionally or unintentionally, by criminal elements. This includes the prevention and detection of criminal activity or fraud, and reporting of such suspected activities to the appropriate authorities.
2. The supervisor determines that banks have documented and enforced policies for identification of customers and those acting on their behalf as part of their anti-money-laundering program. There are clear rules on what records must be kept on customer identification and individual transactions and the retention period.
3. The supervisor determines that banks have formal procedures to recognise potentially suspicious transactions. These might include additional authorisation for large cash (or similar) deposits or withdrawals and special procedures for unusual transactions.
4. The supervisor determines that banks appoint a senior officer with explicit responsibility for ensuring that the bank’s policies and procedures are, at a minimum, in accordance with local statutory and regulatory anti-money-laundering requirements.
5. The supervisor determines that banks have clear procedures, communicated to all personnel, for staff to report suspicious transactions to the dedicated senior officer responsible for anti-money-laundering compliance.
6. The supervisor determines that banks have established lines of communication both to management and to an internal security (guardian) function for reporting problems.
7. In addition to reporting to the appropriate criminal authorities, banks report to the supervisor suspicious activities and incidents of fraud material to the safety, soundness or reputation of the bank.
8. Laws, regulations and/or banks’ policies ensure that a member of staff who reports suspicious transactions in good faith to the dedicated senior officer, internal security function, or directly to the relevant authority cannot be held liable.
9. The supervisor periodically checks that banks’ money-laundering controls and their systems for preventing, identifying and reporting fraud are sufficient. The supervisor has adequate enforcement powers (regulatory and/or criminal prosecution) to take action against a bank that does not comply with its anti-money-laundering obligations.
10. The supervisor is able, directly or indirectly, to share with domestic and foreign financial sector supervisory authorities information related to suspected or actual criminal activities.
11. The supervisor determines that banks have a policy statement on ethics and professional behaviour that is clearly communicated to all staff.

Additional criteria

1. The laws and/or regulations embody international sound practices, such as compliance with the relevant 40 Financial Action Task Force Recommendations issued in 1990 (revised 1996).
2. The supervisor determines that bank staff is adequately trained on money-laundering detection and prevention.
3. The supervisor has the legal obligation to inform the relevant criminal authorities of any suspicious transactions.
4. The supervisor is able, directly or indirectly, to share with relevant judicial authorities information related to suspected or actual criminal activities.
5. If not performed by another agency, the supervisor has in-house resources with specialist expertise on financial fraud and anti-money-laundering obligations.

Assessment APRA considers Australia to be **COMPLIANT** with this Principle.

Background

The Australian Transactions Reports and Analysis Centre (AUSTRAC) has responsibility for the detection of criminal activities within the banking sector. In doing this, AUSTRAC requires banks and other financial institutions to have in place robust systems and procedures for the detection and reporting of suspicious transactions. These include:

- the development of appropriate policies, practices and procedures that have been communicated to all relevant staff;
- customer identification requirements;
- reporting requirements for large cash transactions (involving greater than \$10,000);
- reporting requirements for transactions which might possibly be used to otherwise avoid detection; and
- protection for staff reporting suspicious transactions.

AUSTRAC has authority to share information with other supervisory agencies, including overseas law enforcement authorities, where appropriate.

APRA's supervisory activities have little day-to-day interaction with those of AUSTRAC, and there is no legal requirement for APRA to inform AUSTRAC of suspicious transactions. However, APRA is a member of the Heads of Commonwealth Law Enforcement Agencies (HOCOLEA) group, which meets regularly to co-ordinate law enforcement activities associated with money laundering.

Action Required to Improve Compliance

None, although as a technical matter, APRA could consider the development of more formal reporting arrangement with AUSTRAC, perhaps via an MoU, to cover the exchange of information between agencies.

Principle 16: An effective banking supervisory system should consist of some form of both on-site and off-site supervision.

Essential criteria

1. Banking supervision requires an in-depth understanding, periodic analysis and evaluation of individual banks, focusing on safety and soundness, based on meetings with management and a combination of both on-site and off-site supervision. The supervisor has a framework that: (1) uses on-site work (conducted either by own staff or through the work of external auditors) as a primary tool to:
 - provide independent verification that adequate corporate governance (including risk management and internal control systems) exists at individual banks;
 - determine that information provided by banks is reliable;
 - obtain additional information needed to assess the condition of the bank;
2. and (2) uses off-site work as a primary tool to:
 - review and analyse the financial condition of individual banks using prudential reports, statistical returns and other appropriate information, including publicly available information;
 - monitor trends and developments for the banking sector as a whole.
3. The supervisor checks for compliance with prudential regulations and other legal requirements through on-site and off-site work.
4. The appropriate mix of on-site and off-site supervision is determined by the particular conditions and circumstances of the country. In any event, the framework integrates the two functions so as to maximise the synergy and avoid supervisory gaps.

Additional criteria

1. The supervisor has procedures in place to assess the effectiveness of on-site and off-site functions, and to address any weaknesses that are identified.
2. The supervisor has the right to access copies of reports submitted to the board by both internal and external auditors.
3. The supervisor has a methodology for determining and assessing the nature, importance and scope of the risks to which individual banks are exposed, including the business focus, the risk profile and the internal-control environment. Off-site and on-site work is prioritised based on the results of that assessment.
4. The supervisor is legally required to treat as confidential information received as part of the supervisory process. However, the supervisor is given powers under the law to disclose information in certain defined circumstances. The law prevents disclosure of confidential information unless the supervisor is satisfied that it will be held confidential by the recipient, or unless disclosure is otherwise required by law.
5. The supervisor is able to reasonably place reliance on internal audit work that has been competently and independently performed.

Assessment APRA considers Australia to be **COMPLIANT** with this Principle.

Background

As part of its supervisory activities, APRA attempts to ensure all banks have in place systems and controls that are commensurate with the activities they are undertaking. This is achieved via a combination of:

- off-site supervision – all banks are subject to on-going off-site supervision by dedicated supervisory analysts.¹⁴ These analysts review all activities associated with each bank's operations, and provide senior APRA management with a supervisory assessment and action plan. Off-site supervision includes the assessment of banks' financial condition through the analysis of periodic statistical returns, regular contact with bank management to discuss the bank's activities and strategies, and the review of reports provided on an annual basis by the bank's external auditors. Supervisory analysts also ensure APRA's prudential requirements are continually being met.
- on-site supervision – APRA has a specialist consulting services group within its Policy Division. The group comprises three risk-based teams: credit risk, balance sheet and market risk, and operational risk. Each of these teams assists the operational supervisors to conduct on-site work in banks by providing detailed knowledge of industry practices and standards. The on-site work conducted by these teams includes detailed discussions with senior management, as well as front-line-business teams, risk-management personnel and back-office staff.

The work of the off-site analysts and on-site teams is highly integrated. The program of on-site work is largely determined by the assessment of individual institutions by the off-site analysts, ensuring attention is directed to those institutions that require the most intense monitoring.

Action Required to Improve Compliance

None

Principle 17: Banking supervisors must have regular contact with bank management and a thorough understanding of the institution's operations.

Essential criteria

1. Based on the risk profile of individual banks, the supervisor has a program of regular meetings with senior and middle management (including the board, non-executive directors and heads of individual units) to discuss operational matters such as strategy, group structure, corporate governance, performance, capital adequacy, liquidity, asset quality, risk management systems etc.
2. The supervisor has a thorough understanding of the activities of its banks. This is accomplished through a combination of off-site surveillance, on-site reviews and regular meetings.
3. The supervisor requires banks to notify it of any substantive changes in their activities or any material adverse developments, including breach of legal and prudential requirements.
4. As part of the licensing process, and on an on-going basis during routine supervision, the supervisor considers the quality of management.

Assessment APRA considers Australia to be **LARGELY COMPLIANT** with this Principle. APRA lacks a formal fit and proper test for bank management (as discussed in Principle 3); nor is there any formal requirement for banks to notify it of breaches of legal or prudential requirements.

¹⁴ For small non-bank deposit-takers, supervisory analysts are responsible for a larger portfolio of institutions.

Background

APRA's off-site and on-site activities bring it into regular contact with the executive, senior and middle management of banks. The centrepiece of these activities is an annual prudential consultation held between senior APRA staff and the executive management of each bank. In these consultations, a full range of issues – including strategy, profitability, corporate governance, asset quality, liquidity, risk management, and subsidiary operations – are discussed. Between consultations, APRA staff have regular contact with bank management via other meetings, either as part of a regular program (eg regular on-site visits) or on an ad hoc basis as the need arises.

While APRA meets regularly with all levels of banks' management, it does not, in the normal course of events, meet with the boards and non-executive directors of banks.¹⁵ Legal duties imposed on directors of Australian companies, together with banks' commitment to high standards of corporate governance, have made this unnecessary in most instances. However, APRA has recently implemented processes to ensure important communication between APRA and the bank are brought to the board's attention and, if the need arises, APRA has the authority to raise issues of prudential concern directly with the board members.

Banks are expected to advise APRA of material changes in their activities and any material adverse developments. Banks are also expected to advise APRA of any breach of legal and/or prudential requirements. However, at present, there are no statutory provisions in the Banking Act that require banks to notify APRA of breaches.

As discussed in Principle 3, in deciding whether to grant an authority, and in its on-going supervision, APRA assesses the overall quality of management. It does not currently apply a formal fit and proper test to individual members of the bank's management, although such a test will be introduced in the near future. In addition, the Banking Act provides APRA with the authority to direct a bank to suspend or remove any director or employee from office.

Action Required to Improve Compliance

The absence of a fit and proper test has been noted previously, and is currently being discussed between APRA and Treasury. On a more technical matter, APRA will need to consider whether it should place a statutory obligation on banks to report to APRA any breaches of prudential standards.

Principle 18: Banking supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on a solo and consolidated basis.

Essential criteria

1. The supervisor has the legal authority to require banking organisations to submit information, on both a solo and consolidated basis, on their financial condition and performance, at regular intervals. These reports provide data on matters such as on- and off-balance sheet assets and liabilities, profit and loss, capital adequacy, liquidity, large exposures, loan loss provisioning, market risk and deposit sources.
2. Laws and regulations establish, or the supervisor has the authority to establish, the principles and norms regarding the consolidation of accounts, as well as the accounting techniques to be used.
3. The supervisor has a means of enforcing compliance with the requirements that the information be submitted on a timely and accurate basis. The supervisor determines that the appropriate level of senior management is responsible for the accuracy of supervisory returns, can impose penalties for

¹⁵ APRA does, however, do this for smaller non-bank deposit-taking institutions wherever possible.

deliberate mis-reporting and persistent errors, and can require that inaccurate information be amended.

4. The information that is required to be submitted includes standardised prudential and statistical reports, and detailed balance sheets and income statements, as well as supporting schedules that provide details concerning on- and off-balance-sheet activities and on reserves included in capital. Inclusion of data on loan classification and provisioning is also required.
5. The supervisor has the authority to request and receive any relevant information from banks, as well as any of their related companies, irrespective of their activities, where the supervisor believes that it is material to the financial situation of the bank or the assessment of the risks of the bank.
6. The supervisor has an analytical framework that uses the statistical and prudential information for the ongoing monitoring of the condition and performance of individual banks. The results are also used as a component of on-site supervision planning. This requires that the supervisor has an adequate information system.
7. In order to make meaningful comparisons between banking organisations, the supervisor collects data from all banks and all other relevant entities within a banking organisation on a comparable basis and related to the same dates (stock data) and periods (flow data).
8. The supervisor collects data from banks at a frequency (eg, monthly, quarterly and annually) commensurate with the nature of the information requested, and the size, activities and risk profile of the individual bank.

Assessment APRA considers Australia to be **LARGELY COMPLIANT** with this Principle. APRA does not currently collect income statements from banks, other than those that the bank itself publicly discloses, as part of its normal statistical collections (although it is proposed that income statements will be collected from banks in the future).

Background

The Banking Act provides APRA with the power to collect information from a bank (and, via the bank, any of its associates), and to specify the form and manner in which that information is to be submitted. APRA requires banks to provide a range of information on a solo and a consolidated basis at regular intervals. The accounting standards and consolidation techniques used in the compilation of these reports are generally in accordance with Australian Accounting Standards.

APRA's supervisory framework relies to a great extent on the statistical and other information received from banks. At present, the data collection includes information on the composition of on- and off-balance sheet business, large and country exposures, capital adequacy, and liquidity. APRA does not at present collect information on banks' profit and loss (other than that which is disclosed to the market) in a systematic fashion, although this will change with the introduction of new statistical returns over the next two years.¹⁶ The new returns will collect information from all deposit-takers (and other relevant entities) in a consistent manner. Where APRA has concerns about a particular bank, it can request information to be provided more frequently, or that additional information be collected (section 13 of the Banking Act).

APRA does not have the power to impose penalties on banks for deliberate misreporting and/or persistent errors in their statistical returns. Where APRA makes a request for specific information, either as part of an investigation or other special request, it is a criminal offence to provide false information.

¹⁶ Such a collection already exists for non-bank deposit-takers.

Action Required to Improve Compliance

APRA will need to develop a statistical collection on profitability. A draft return has already been devised as part of the broader review of APRA's statistical collections, and is currently being considered by industry.

As a technical matter, APRA needs to consider whether it should have the ability to fine/sanction banks that regularly provide incorrect data. This is not seen as an issue which will affect overall compliance.

Principle 19: Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.

Essential criteria

1. The supervisor has in place a coherent process for planning and executing on-site visits, using either in-house examiners, or making use of the work of external auditors, as appropriate. There are policies and procedures in place to ensure that examinations are conducted on a thorough and consistent basis with clear responsibilities, objectives and outputs. The supervisor holds meetings with banks and their auditors to discuss the results of work by the external auditors and to agree on the responsibilities for corrective work.
2. The supervisor has the authority to monitor the quality of work done by external auditors for supervisory purposes. The supervisor has the authority to directly appoint external auditors for conducting supervisory tasks or oppose the appointment of an external auditor that is deemed to have inappropriate expertise and/or independence.
3. The supervisor can also make use of external auditors to examine specific aspects of banks' operations, provided there is a well developed, professionally independent auditing and accounting profession with skills to undertake the work required. The respective roles and responsibilities for the supervisor and the auditors in these circumstances are clearly defined by the supervisor.
4. The supervisor has the legal right of full access to all bank records for the furtherance of supervisory work. The supervisor also has similar access to the board, senior management and staff, when required.
5. The supervisor has a program for the periodic examination of supervisory returns by examiners or through the work of external auditors. There is a requirement that certain key supervisory returns such as that for capital adequacy be examined at least annually by the auditors and a report submitted to the supervisor.

Additional criteria

1. The supervisor meets with management and the board of directors each year to discuss the results of the supervisory examination or the external audit. Such visits should allow for the supervisor to meet separately with the independent board members.
2. The supervisor meets periodically with external audit firms to discuss issues of common interest relating to bank operations.

Assessment APRA considers Australia to be **LARGELY COMPLIANT** with this Principle. Although APRA requires external auditors to provide a broad assurance as to the accuracy and reliability of statistical information provided to it by banks, APRA does not specify minimum requirements for providing this assurance, leaving it instead to the judgement of the auditor.

Background

To validate supervisory information, APRA primarily relies on the work of banks' external auditors. Auditors are required to provide an annual report to APRA that confirms the accuracy and reliability of statistical information provided to it.¹⁷ As part of this process, APRA meets with external auditors to discuss their proposed audit plan and to highlight, if necessary, any particular aspects or concerns that the auditor should be aware of. In the normal course of events, however, APRA would not specify the range or number of statistical returns to be reviewed, leaving it to the judgement of the external auditor to determine what work needs to be done to provide the necessary assurance to APRA.

In addition to the report on the accuracy and reliability of statistical information, APRA requires external auditors to perform a targeted review annually. APRA selects an aspect of each bank's activities, and requires auditors to conduct an in-depth review of the bank's processes and controls in that area. The output of the review is discussed by APRA with the auditors and the management of the bank (although generally not its directors). Topics for these targeted reviews include areas such as the quality of Management information systems and the adequacy of the internal audit function.

APRA has the power under section 11 of the Banking Act to require the removal of an external auditor, which could be used if the auditor is deemed to have insufficient independence and/or expertise.

Action Required to Improve Compliance

APRA will need to consider the need for further guidance to external auditors on its minimum requirements for the assessment of the accuracy and reliability of statistical information. This might include, for example, that a minimum number of returns, or a certain range of returns, are specifically reviewed each year.

Principle 20: An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.

Essential criteria

1. The supervisor is aware of the overall structure of banking organisations (ie, the bank and its subsidiaries) or groups and has an understanding of the activities of all material parts of these groups, including those that are supervised directly by other agencies.
2. The supervisor has a supervisory framework that evaluates the risks that non-banking activities conducted by a bank or banking group may pose to the bank or banking group.
3. The supervisor has the legal authority to review the overall activities of a bank, whether the activities are conducted directly (including those conducted at overseas offices), or indirectly, through subsidiaries and affiliates of the bank.
4. There are no impediments to the direct or indirect supervision of all affiliates and subsidiaries of a banking organisation.
5. Laws or regulations establish, or the supervisor has the authority to impose, prudential standards on a consolidated basis for the banking organisation. The supervisor uses its authority to establish prudential standards on a consolidated basis to cover such areas as capital adequacy, large exposures and lending limits.
6. The supervisor collects consolidated financial information for each banking organisation.

¹⁷ This requirement is not applied to the auditors of non-bank deposit-takers at present.

7. The supervisor has arrangements with functional regulators of individual business vehicles within the banking organisation group, if material, to receive information on the financial condition and adequacy of risk management and controls of such business vehicles.
8. The supervisor has the authority to limit or circumscribe the range of activities the consolidated banking group may conduct and the overseas locations in which activities can be conducted; the supervisor uses this authority to determine that the activities are properly supervised and that the safety and soundness of the banking organisation is not compromised.

Additional criteria

1. For those countries that allow corporate ownership of banking companies:
 - the supervisor has the authority to review the activities of parent companies and of companies affiliated with the parent companies, and utilises the authority in practice to determine the safety and soundness of the bank;
 - the supervisor has the authority to take remedial actions, including ring-fencing, regarding parent companies and non-bank affiliates concerning matters that could impact the safety and soundness of the bank; and
 - the supervisor has the authority to establish and enforce fit and proper standards for owners and senior management of parent companies.

Assessment APRA considers Australia to be **COMPLIANT** with this Principle.

Background

All banks are required to inform APRA of changes to their corporate structures as they occur. Where banks are associated with non-bank activities, the latter have typically been assessed either as part of the banking group by consolidating them into the overall assessment of the bank (eg finance companies), or excluding the associates from the assessment entirely (eg life insurance companies and securitisation vehicles). To date, banking policy has prohibited banks from having a substantial association with non-financial activities.

Going forward, APRA is developing a supervisory framework focusing on conglomerate groups, including those involving both financial and commercial activities. As part of this process, a more formal process for assessing each entity's contribution to the overall risk profile of the group will be developed.

APRA has the necessary powers to ensure it is able to adequately review the overall activities of a bank, regardless of which entity or which jurisdiction the activity occurs. The Banking Act provides APRA with sufficient authority to examine the activities of all associated entities, even when these are conducted in a separate arm of a conglomerate group headed by a non-bank holding company. APRA's prudential standards are applied on a solo and consolidated basis where appropriate (eg capital adequacy).

APRA can, if necessary, use its powers to direct a bank to limit, circumscribe or cease any activities. While it cannot directly issue directions to a non-bank associate of the bank, it can require additional measures to be taken to protect the bank (eg additional capital, rearrangement of the corporate structure) if necessary.

Action Required to Improve Compliance

None

As a technical matter, APRA could consider whether it would be helpful to have legislative authority in the Banking Act to apply its prudential standards on a consolidated basis.

Principle 21: Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of the business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.

Essential criteria

1. The supervisor has the authority to hold management responsible for ensuring that financial record keeping systems and the data they produce are reliable, and that supervisor-required reports are submitted on a timely and accurate basis.
2. The supervisor has the authority to hold management responsible for ensuring that the management report and financial statements issued annually to the public receive proper external verification and bear an external auditor's opinion.
3. The supervisor ensures that information from bank records is verified periodically through on-site examinations and/or external audits.
4. The supervisor ensures that there are open communication lines with the external auditors.
5. The supervisor provides report instructions that clearly establish the accounting standards to be used in preparing supervisory reports. Such standards are based on accounting principles and rules that command wide international acceptance and are aimed specifically at banking institutions.
6. The supervisor requires banks to utilise valuation rules that are consistent, realistic and prudent, taking account of current values where relevant, and that profits are net of appropriate provisions.
7. Laws or regulations set, or the supervisor has the authority, in appropriate circumstances, to establish, the scope and standards to be achieved in external audits of individual banks, and to make public issuance of individual bank financial statements subject to its prior approval.
8. The supervisor has the ability to treat as confidential certain types of sensitive information.
9. The supervisor requires banks to produce annual audited financial statements based on accounting principles and rules that command wide international acceptance and have been audited in accordance with internationally accepted auditing practices and standards.
10. The supervisor has the right to revoke the appointment of a bank's auditors.
11. Where supervisors rely primarily on the work of external auditors (rather than on their own examination staff), banks are required to appoint auditors who are recognised by the supervisor as having the necessary professional skills and independence to perform the work.

Additional criteria

1. The supervisor promotes periodic public disclosures of information that are timely, accurate, and sufficiently comprehensive to provide a basis for effective market discipline.
2. The supervisor has guidelines covering the scope and conduct of audit programs that ensure that audits cover such areas as the loan portfolio, loan-loss reserves, non-performing assets, asset valuations, trading and other securities activities, derivatives, asset securitisations, and the adequacy of internal controls over financial reporting.
3. Auditors have the legal duty to report to the supervisor matters of material significance, for example, failure to maintain the licensing criteria, or breaches of banking or other laws. The law protects auditors from breach of confidentiality when information is communicated in good faith.

4. Auditors also have the legal duty to report matters to the supervisor, in situations where they become aware of matters which, in the context of the available information, they believe is likely to be of material significance to the functions of the supervisor.

Assessment APRA considers Australia to be **COMPLIANT** with this Principle.

Background

APRA primarily relies on the general requirements of the Corporations Law, which is overseen by the Australian Securities and Investments Commission (ASIC), to ensure that the management reports and financial statements issued by a bank receive proper external audit scrutiny and verification. The Corporations Law requires that banks (and all other corporations) maintain proper financial records, that these are subject to appropriate independent audit, and that disclosure is adequate and in accordance with Australian Accounting Standards. Where there was concern that these requirements were not being met, APRA would liaise with ASIC to determine an appropriate course of action.

APRA nevertheless maintains open communications with the external auditors of banks, meeting regularly with them to discuss the outcome of their work, as well as future audit plans. Where necessary, APRA can direct the auditor to perform particular audit tasks in addition to the normal audit process.

Action Required to Improve Compliance

None, although as a technical matter, APRA could consider the need for a clear policy statement that accounting and other financial information needs to be prepared in accordance with Australian accounting standards.

Principle 22: Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital-adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking license or recommend its revocation.

Essential criteria

1. The supervisor has the authority, backed by legal sanctions, to take an appropriate range of remedial actions against, and impose penalties on, banks, depending on the severity of a situation. These remedial actions are used to address such problems as failure to meet prudential requirements and violations of regulations. They range from informal written communication with bank management to actions that involve the revocation of the banking license.
2. The range of possible actions available is broad, including, in addition to the others mentioned, restricting the current activities of the bank, withholding approval of new activities or acquisitions, restricting or suspending payments to shareholders or share repurchases, restricting asset transfers, barring individuals from banking, replacing or restricting the powers of managers, directors, or controlling owners, arranging a takeover by or merger with a healthier institution, and imposing conservatorship.
3. The supervisor ensures that remedial actions are taken in a timely manner.
4. The supervisor applies penalties and sanctions not only to the bank but, when and if necessary, also to management and/or the board of directors.

Additional criteria

1. Laws and regulations mitigate against the supervisor unduly delaying corrective action.
2. The supervisor addresses all significant remedial actions in a written document to the board of directors and requires that progress reports are submitted in writing as well.

Assessment APRA considers Australia to be **COMPLIANT** with this Principle.

Background

As described under Principle 1(4), the Banking Act provides APRA with a range of powers should it have concerns about the safety and soundness of an individual institution. These include the authority to: seek additional information (section 13), make directions to cease certain activities or to remove directors or managers (section 11CA), appoint an independent inspector to review the bank's financial position (section 13B), and take control of, and/or appoint a statutory manager to, the bank (section 13C). Ultimately, APRA can choose to revoke the bank's banking authority. In deciding to exercise any of these actions, APRA is not bound by any constraints, other than it must be APRA's judgement that the actions are in the interests of depositors.

Action Required to Improve Compliance

None

Principle 23: Banking supervisors must practice global consolidated supervision over their internationally active banking organisations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organisations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.

Essential criteria

1. The supervisor has the authority to supervise the overseas activities of locally incorporated banks.
2. The supervisor satisfies itself that management is maintaining proper oversight of the bank's foreign branches, joint ventures, and subsidiaries. It also satisfies itself that the local management of any overseas offices has the necessary expertise to manage those operations in a safe and sound manner.
3. The supervisor determines that bank management's oversight includes: a) information reporting on its overseas operations that is adequate in scope and frequency and is periodically verified; b) assessing in an appropriate manner compliance with internal controls; and c) ensuring effective local oversight of foreign operations.
4. The home-country supervisor has the authority to require closing of overseas offices, or imposing limitations on their activities, if it determines that the supervision of a local operation by the bank and/or by the host country supervisor is not adequate relative to the risks the office presents.

Additional criteria

1. The supervisor has a policy for assessing whether it needs to conduct on-site examinations or require additional reporting, and it has the legal authority and resources to take those steps as and when appropriate.
2. The supervisor ensures that management's local oversight of foreign operations is particularly close

when the foreign activities have a higher risk profile and/or when they differ fundamentally from those conducted in the home country, or are conducted at locations that are especially remote from the principal locations at which the bank conducts comparable activities.

3. The supervisor arranges to visit the offshore locations periodically, the frequency determined by the size and risk profile of the overseas operation. The supervisor meets the local supervisors during these visits.
4. The home-country supervisor assesses the quality of supervision conducted in the countries in which its banks have material operations.

Assessment APRA considers Australia to be **LARGELY COMPLIANT** with this Principle. It is deficient in that it does not routinely conduct any in-depth review or assessment of banks' overseas activities, instead relying on the activities of host country supervisors, the effectiveness of internal risk-management arrangements, and assurances from local management that overseas operations are being managed in an appropriate manner.

Background

APRA expects banks to demonstrate that they have effective processes in place and are operating effectively to maintain adequate oversight and control their overseas branches, joint ventures and subsidiaries. This includes ensuring head office management has sufficiently timely and comprehensive information on overseas activities, and methods for ensuring internal controls and policies are being adhered to. APRA applies consolidated supervision to all authorised banks, including for activities that are conducted outside Australia. Capital adequacy, large exposure and other statistical reports are prepared on a consolidated basis, while information on the balance-sheet composition of individual offices is also collected (generally this is in the form of the statistical returns provided to the local supervisor). Arrangements with external auditors can also be used to assess the management control of overseas activities.

In practice, however, the degree of direct contact with banks' overseas activities is minimal, with APRA relying heavily on the work of the host-country supervisor. However, where APRA has doubts about the quality of the oversight of activities being conducted overseas, it may seek a range of actions, including conducting its own on-site supervisory visit to the overseas office(s) concerned (in practice, however, this rarely occurs). Where serious concerns exist as to the management of the overseas activities, APRA has the authority to direct the bank to limit or cease the activities in question.

Action Required to Improve Compliance

APRA will assess the need for more detailed assessment procedures for overseas activities, including for the quality of management, the adequacy of controls, and the ability of head office management to oversee offshore activities. At present, this occurs solely through discussions with the head-office management – this has been no on-site review of overseas operations conducted for some years. APRA will need to review whether this is adequate given the increasing growth in bank's offshore assets.

Principle 24: A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host-country supervisory authorities.

Essential criteria

1. For significant overseas operations of its banks, the home-country supervisor establishes informal or formal arrangements (such as memoranda of understanding) with host-country supervisors for appropriate information-sharing on the financial condition and performance of such operations in the host country. Information sharing arrangements with host-country supervisors include being advised of adverse assessments of such qualitative aspects of a bank's operations as the quality of risk management and controls at the offices in the host country.
2. The supervisor can prohibit banks or their affiliates from establishing operations in countries with secrecy laws or other regulations prohibiting flows of information deemed necessary for adequate supervision.
3. The home supervisor provides information to host-country supervisors concerning the specific offices in the host country, concerning the overall framework of supervision in which the banking group operates, and, to the extent appropriate, concerning significant problems arising in the head office or in the group as a whole.

Additional criteria

1. A supervisor who takes consequential action on the basis of information received from another supervisor, consults with that supervisor, to the extent possible, beforehand.
2. Even for less than significant overseas operations of its banks, the home-country supervisor exchanges appropriate information with host country supervisors.

Assessment APRA considers Australia to be **COMPLIANT** with this Principle.

Background

APRA has established informal arrangements for information sharing with host supervisors in those countries in which Australian banks have significant overseas operations (eg the US, UK and New Zealand). These arrangements allow for a two-way exchange of information on issues of interest to either supervisor as required, and allow for host country supervisors to pass on to APRA any concerns they have about the operation of Australian banks in their jurisdiction.

APRA can prevent a bank from establishing operations, or direct a bank to cease operations, in countries where there are secrecy laws or other restrictions that prevent APRA from being able to properly conduct consolidated supervision.

APRA would generally provide host-country supervisors with any information requested on Australian supervisory arrangements. However, APRA does not have in place a formal set of arrangements that require it to inform host-country supervisors of problems within the Australian head office or group as a whole. The need to provide such information would be assessed on a case-by-case basis.

Action Required to Improve Compliance

None, although as a matter of good practice, a more formal set of arrangements could be established to ensure that APRA informs host-country supervisors of problems within the Australian head office or group as a whole.

Principle 25: 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 purposes of carrying out consolidated supervision.

Essential criteria

1. Local branches and subsidiaries of foreign banks are subject to similar prudential, inspection, and regulatory reporting requirements as domestic banks.
2. For purposes of the licensing process, as well as ongoing supervision, the host-country supervisor assesses whether the home-country supervisor practices consolidated global supervision.
3. The host supervisor, before issuing a license, determines that approval (or no objection) from the home supervisor has been received.
4. The host-country supervisor can share with home-country supervisors information about the local operations of foreign banks provided its confidentiality is protected.
5. Home-country supervisors are given on-site access to local offices and subsidiaries for safety and soundness purposes.
6. The host-country supervisor advises home-country supervisors on a timely basis of any material remedial action it takes regarding the operations of a bank from that country.

Additional criteria

1. The host country supervisor obtains from home country supervisors sufficient information on the banking group to allow it to put into proper perspective the activities conducted within its borders.

Assessment APRA considers Australia to be **MATERIALLY NON-COMPLIANT** with this Principle. It is deficient in that foreign banks can choose to operate in Australia outside of APRA's supervisory purview. As a result, APRA is unable to make any assessment of their activities, or to pass information on their Australian business to their home-country supervisor.

Background

Current Australian Government policy allows foreign banks operating in Australia to do so under one of two guises. Foreign banks can choose to be authorised banks under the Banking Act, in which case they are subject to APRA's licensing process and on-going supervisory oversight.¹⁸ Foreign banks can also choose to operate as "merchant banks" under the *Financial Corporations Act 1974*. Merchant banks are not supervised by APRA, and as a result are subject to normal fund-raising provisions of the Corporations Law (ie they cannot take deposits without a prospectus.) There are no prudential requirements imposed on merchant banks by any other supervisory agency.

When licensing a foreign bank under the Banking Act, APRA considers the quality of home-country supervision. It also confirms that the home-country supervisor has no objection to the granting of an authority to operate in Australia. As noted under Principle 1(6), section 56(1)(5) of the Banking Act

¹⁸ Under the Banking Act, foreign banks can elect to operate as a locally incorporated subsidiary, in which case their activities are supervised in a manner identical to local banks. Alternatively, foreign banks can also elect to operate as a branch, in which case they are limited in their deposit-taking activities (branches cannot take initial deposits from the public of amounts less than \$250,000). APRA does not impose capital requirements on branches, but still collects a range of statistical information, conducts on-site reviews, and requires reports from the bank's external auditor as it would require from a local bank.

provides APRA with the authority to provide confidential information to the home supervisor provided APRA is satisfied that the information will assist the agency to perform its function. APRA places no restrictions on the ability of home-country supervisors to gain access to the Australian offices of foreign banks to perform their supervisory duties. APRA would also inform the home supervisor if it felt material remedial action was necessary to maintain the soundness of the local operations of the foreign bank.

Action Required to Improve Compliance

APRA will discuss this issue with Treasury, with a view to considering whether foreign banks operating as merchant banks should be brought within the prudentially regulated sector.