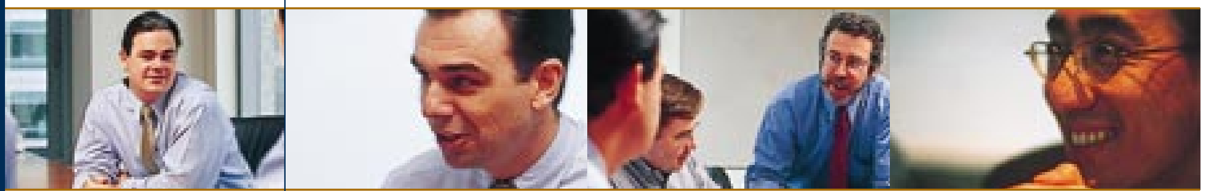
PRUDENTIAL SUPERVISION POLICY

APRA is responsible for developing prudential policies that balance financial safety and efficiency, competition, contestability and competitive neutrality.

This is achieved through:

- monitoring and analysing developments in domestic and international financial systems and keeping abreast of changes in supervisory and risk management techniques;
- researching risk measurement and capital allocation methodologies;
- designing policies in consultation with industry and other government agencies;
- effective implementation of policies; and
- developing an integrated data collection system to provide relevant and timely information about regulated institutions.

Policy work in 1998/99 covered a diverse mix of projects – input to the legislative changes associated with setting up APRA and the transfer of regulatory powers, initial work on harmonising prudential requirements across industry and improving and modernising the structure of supervision.



During the year we contributed to developing the second round of primary and subordinate Wallis legislation – including provisions to bring building societies and credit unions under the Banking Act, bringing friendly societies conducting financial business under the Life Insurance Act, facilitating transfers of business (including mergers) and giving APRA power to enter into contracts as a service provider.

We proposed and issued changes to banks' capital adequacy and solvency requirements (amendments to risk weights) and developed new provisions that permit legally effective bilateral netting for capital adequacy calculations. Guidelines were also issued on innovative equity instruments and the conditions for their inclusion in banks' Tier 1 capital. These new guidelines on equity instruments allow Australian banks to compete on equal terms in international markets and give them greater flexibility in capital management, without compromising the support which a bank and its depositors obtain from Tier 1 capital. In this sense, the arrangements strike a good balance between prudential and market efficiency considerations.

In conjunction with proposals by the Basel Committee on Banking Supervision to reform its 1988 capital accord, we did work on various aspects of banks' management of credit risk. Discussions were held with banks on the state of their internal credit risk management models, along with detailed analysis of the methods being developed by these institutions and across industry more generally. The significance of these issues will increase over time as supervisors place greater emphasis on internal models for determining regulatory capital charges.

An important initiative was the establishment of a credit risk modelling group involving staff of APRA and the major banks, to promote debate on innovations in measurement and management of credit risk and to exchange views on modelling techniques.

In March, a Discussion Paper on the prudential supervision of conglomerates was issued to the market for comment. The paper canvassed a broad framework within which supervision of financial and mixed conglomerates could be conducted. Amongst other things, the proposals would liberalise previous policy in allowing non-financial activities to coexist with deposit-taking in a conglomerate.

Specific proposals in the paper included new or upgraded prudential requirements in the area of corporate governance (including 'fit and proper' tests), controls on intra-group transactions and group-wide large exposures and proposals for group-wide capital assessment. An important feature is the emphasis on internal risk management on a group-wide basis as a potential substitute for the more traditional (and somewhat more arbitrary) prudential rules relating to risk and capital adequacy of financial groups. This is consistent with the trend to an increasing focus on institutions' internal risk assessment, discussed above in relation to credit risk, and as currently applied to traded market risks in some banks. The proposed measures are intended generally to enhance transparency, limit contagion and reinforce the idea that primary responsibility for safety and soundness rests with the conglomerate itself.

While the issues canvassed in the Discussion Paper are fully consistent with international standards for supervision of financial conglomerates, they represent one of the first attempts to design such a framework in detail. Some of the proposals have consequently been contentious and the process of assessing industry comments and revising and finalising our proposals will continue into early 2000.

Other policy discussion papers and working papers in 1998/99 dealt with credit derivatives, evaluating value-at-risk on banks' trading books and assessing the impact of prudential capital requirements on the capital management of banks and credit unions. While some of these topics sit at the more technical end of the scale, they remain important in helping to ensure that new supervisory policies and techniques are rigorous and well-tested.

Work-in-progress includes the harmonisation of prudential standards across deposit-taking and insurance institutions. While APRA is now the sole prudential regulator of these institutions, the details of prudential standards and guidelines that apply differ in significant respects. While many of the differences are justified by business characteristics, others are less easily rationalised. More broadly, we are looking into opportunities to adopt similar approaches to supervising similar risks in all financial institutions.

As part of that process we aim to create a single, consistent set of prudential rules for all deposit-takers – banks, building societies and credit unions – by mid-2000.

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In a similar vein, in the insurance area, we have an important project to reassess and modernise the prudential supervision framework for general insurers. The existing regime dates back to 1973 and has been little changed since then. Among particular issues covered in the review will be the refinement of solvency standards, valuation of outstanding claims provisions, and more general issues associated with disclosure and corporate governance.

Good prudential supervision requires high quality information about the condition of financial institutions. APRA's creation provides a unique opportunity to review the current, disparate statistical collections and to improve the quality of data available for supervision and use by industry and the general public. During 1998/99 we launched a major project to re-evaluate existing collections across all industries against criteria of relevance and materiality. As well as refining the statistics themselves, we hope to streamline collection and publication processes. This project will run over the next two years and will include extensive consultation with industry and other official agencies.