

## SUPERVISING FINANCIAL INSTITUTIONS

### Deposit-takers and insurers

APRA's prudential regulation aims to minimise the risk that deposit-takers and insurers are unable, as a result of financial weakness, to meet their obligations to depositors and policyholders. In the event that these institutions seem likely to be unable to meet those obligations we have powers to intervene.

We pursue our responsibilities through:

- administering licensing conditions;
- developing prudential standards and requirements for institutions to follow;
- regular consultations with senior management, external auditors and actuaries;
- collecting and analysing financial and other information to understand the condition of financial institutions and to monitor their compliance with prudential requirements;
- liaising with institutions on changes to their businesses and their associations with others and approving major changes to their structure and operations;
- on-site reviews of operations, with particular emphasis on control systems and management quality;
- encouraging institutions to correct non-compliance or unsound practices, and if necessary taking enforcement action to achieve this;
- liaising with local industry specialists and bodies and international organisations and participating in industry conferences to keep abreast of developments and communicate regulatory changes and concerns;
- liaising with overseas regulators; and
- compiling aggregate statistics to show trends in industry structure and soundness.



### Banks

During 1998/99 we held 42 annual consultations with banks' senior management to review performance and strategy. In addition, regular meetings were held with banks' external auditors to discuss the integrity of data provided to APRA and the banks' observance of statutory and regulatory requirements. These meetings also reviewed reports on their risk management systems. In 1998 the focus was on business continuity planning, while the two topics for 1999 were independence and effectiveness of internal audits and operational risk management.

Specialist asset quality staff conducted 20 on-site reviews of credit risk management practices. These focused on the management and monitoring of credit scoring models, the degree of independence of credit approval and review functions and the need to ensure that credit risk grades are regularly updated.

In addition, 21 visits were conducted by specialist market risk staff. We focused on improving risk management by enhancing integration of front and back office systems; ensuring that systems and limits appropriate to a bank's operations are in place; and enforcing adequate separation between trading and back office functions, particularly as regards independent valuation of trading positions.

Numerous meetings were held with bank management on prudential issues that arose on a day-to-day basis. New capital issues, securitisation schemes, changes to risk management systems, proposed new products or business alliances are examples of the broad range of issues on the agenda of such meetings.

Another subject of extensive discussion with banks was our review of all their liquidity management policies, as a precursor to abolishing the outdated Prime Assets Requirement. This was done in August 1999.

Banking authorities were relinquished by QIDC, whose business was absorbed into Suncorp-Metway, and ABN AMRO Finance which had completed the run-off of retail deposits that had been on the books of Lloyds NZA Bank when it was purchased by ABN AMRO.

Only one new banking authority was issued – to Toronto Dominion – but discussions are continuing with several prospective applicants. At the end of 1998/99 there were 51 institutions licensed as banks, 25 operating as branches of foreign banks and 26 locally incorporated.

The number of representative offices of foreign banks fell from 35 to 30. Despite the fall, this was again an area of responsibility that absorbed an inordinate amount of our resources. Representative offices are allowed to use their bank's name and to run a liaison office but are not authorised to conduct banking business in Australia. Some representative offices have not observed the spirit of this condition in recent years. We have also given attention to allegations about foreign banks with no status in Australia conducting business in this country.





### Credit unions and building societies

**While APRA was not responsible for supervising credit unions and building societies in 1998/99, a good deal of effort was expended on preparing for their transfer to us.**

We assisted with drafting transition legislation and settling the transfer of business rules which can be used to help resolve the situation of a deposit-taker in difficulty. We also discussed with Credit Union Services Corporation of Australia (CUSCAL) the details of its industry support scheme for credit unions. This scheme, which allows member credit unions to support each other in times of crisis, was certified by APRA on 1 July 1999. Certification gives us the power to enforce compliance by members with the terms of the scheme if necessary.

### Life insurance

**During 1998/99 our supervisors conducted 43 annual reviews and two review updates of life insurance companies. There were, in addition, 14 on-site visits.**

One particular issue of concern that arose during the year relates to the underpricing of disability income business within the life insurance sector. In our view, some of these products need to be redesigned to make them more financially viable. We had discussions with a number of leading writers of the business to understand how they are pricing the product and have strongly encouraged them to reconsider the products' pricing strategies.

We processed five applications under the *Insurance Acquisitions and Takeovers Act 1991* and another seven were processed and approved under the *Financial Sector (Shareholdings) Act 1998*. Five life companies were deregistered after transferring their existing businesses to other companies and four life business transfers were completed under Part 9 of the *Life Insurance Act 1995*, involving assets worth approximately \$1.5 billion. Acquisition and transfer activity was higher than normal due to institutions seeking strategic and cost reduction benefits as competitive pressures intensify, especially in funds management and superannuation.

Following the deregistration of the five life companies at their own request, the number of companies registered under the *Life Insurance Act 1995* at 30 June 1999, fell from 49 to 44. With the Colonial group's acquisition of Prudential Corporation of Australia Limited and Legal and General Life of Australia Limited, there has been an additional concentration of assets, as well as a reduction in foreign ownership in the life insurance industry. Further acquisitions have been announced. Following the Colonial acquisitions, the five largest life companies have over 62 per cent of the country's life insurance assets.

### Friendly societies

**Friendly societies did not come under our supervision during 1998/99, but a good deal of preparation was required for their transfer on 1 July 1999.**

In conjunction with Treasury, we were involved in the changes to the *Life Insurance Act 1995* that would bring these societies under APRA's umbrella. Amendments were also incorporated into the *Financial Sector Reform (Amendments and Transitional Provisions) Act 1999* and the *Financial Sector (Transfers of Business) Act 1999*. To support these legislative amendments, changes were made to numerous subsidiary instruments, particularly prudential rules and standards.

APRA provides the secretariat for the Life Insurance Actuarial Standards Board that during the year developed, issued for comment and promulgated a set of actuarial standards that now apply specifically to friendly societies. The Board will be looking to harmonise these standards, where possible, with those applying to life companies that are not friendly societies.



## General insurance

**During the year we held 60 meetings with company representatives and conducted 142 company visits compared with 70 the previous year. This significant increase was achieved through the streamlining of company returns and the implementation of a new computer system to input, check and analyse return information.**

The year saw APRA using its formal enforcement powers in a number of cases to protect the interest of policyholders. In one case a direction was issued to freeze the assets of an insurance company, while in another, following investigations into the activities of Greatlands General Insurance Company Limited, the company went into liquidation. No loss is expected for the majority of policyholders and only limited losses for the minority.

In the latter part of the year we devoted a good deal of attention to a small number of reinsurance companies that suffered losses as a result of natural disasters overseas and in Australia.

One of these was New Cap Reinsurance which, with significant exposures to the United States insurance market, had difficulties determining its liabilities and finalising its annual accounts. We had a number of consultations to help us understand the extent of its worsening claims experience and the impact on the company's financial position. While this was occurring the company decided to go into voluntary administration. The administrator has produced a report to creditors recommending the company be liquidated. It is expected that the creditors, mostly overseas insurance companies, will incur sizeable losses.

Fifteen applications were processed and approved under the *Financial Sector (Shareholdings) Act 1998* as the industry experienced an increase in merger and acquisition activity.

At the end of 1998/99 we supervised 171 general insurers, of which 25 operated as branches of foreign companies and the remainder were locally incorporated.

## Superannuation

**In prudential supervision of the superannuation industry, our objectives are to ensure, to the extent practicable, that fund trustees manage superannuation money prudently and in the long-term interests of members and that superannuation money is used for genuine retirement purposes. This is achieved through:**

- licensing operators of public offer funds;
- requiring trustees to meet appropriate governance standards;
- requiring trustees to have a properly thought out and documented investment management strategy;
- conducting periodic on-site reviews of funds and consultations with trustees;
- encouraging trustees to correct non-compliance or unsound practices and, if necessary, taking enforcement action to achieve this; and
- liaising with industry organisations and specialists to keep abreast of market developments and communicate regulatory changes and concerns.

We made significant enhancements to the way we review superannuation entities during the year. Our new arrangements are intended to provide more effective

## Our main concern during the year was that service provider contracts do not provide trustees with adequate protection

Another was GIO Insurance Ltd which conducted reinsurance and corporate business, but not personal lines business. It had significant international exposures and has had substantial adverse claims experience in its marine, aviation and property classes. Due to usually long claims notification periods for reinsurance business, it has taken many months for the adverse experience and its extent to become evident. We had many consultations with the company throughout the year about its claims provisioning. The company has stopped writing reinsurance business, is currently running off its existing reinsurance business and is working to raise extra capital to meet statutory requirements.

During the year three new captive mortgage insurers were registered, as lenders sought to extract some return from the mortgage insurance function and obtain better access to reinsurance rates for this business.

supervision without adding to the compliance burden for funds – in fact, the compliance burden in most cases will be reduced. The primary focus of our review methodology is the key risk areas of particular funds, rather than pursuing a range of questions indiscriminately across all funds.

The larger funds are required to provide more frequent information and will receive more ongoing contact through prudential consultations. Smaller funds will be subject to prudential reviews on a regular basis via a review cycle.

In 1998/99 we conducted reviews of 1091 Corporate Funds and 56 Approved Trustees. This entailed gathering information about the funds, on-site visits, making judgements about the adequacy of control systems and compliance with requirements and encouraging the funds to improve their practices in relation to any shortcomings that we found.

Our main concern during the year was that service provider contracts do not provide trustees with adequate protection. This, together with insufficient monitoring of service providers, remains the most common deficiency in superannuation management. Inadequate record keeping of trustee discussions and decisions is another core concern. Without good records trustees are unable to demonstrate that they are following proper processes and may be without protection in the event of member claims for losses. Prudential Management Certificates, a mandatory requirement for Approved Trustees, are too frequently being prepared and signed without accompanying investigation and due diligence processes. This raises concerns about the competence of these trustees.

While the use of hedge funds by the superannuation industry appears isolated, we will continue to monitor this and insist that the trustees fully consider all the attendant risks in investing in such funds.

After consultation with the industry, we used our power to modify the Superannuation Industry (Supervision) Regulations to ensure that superannuation funds that pay pensions are subject to appropriate prudential standards. Significant changes were also made to the Audit Report requirements with respect to Risk Management Statements, enhancing the rigour of the audit requirements.

Legislation to give effect to the Government's decision to transfer regulatory supervision of most of the excluded funds from APRA to the Australian Taxation Office is expected to be passed shortly. We are working with the Australian Taxation Office to ensure a smooth transition.

