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Performance Audit

Bank Prudential Supervision Follow-up Audit

Australian Prudential Regulation Authority

Australian National Audit Office

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Canberra ACT
15 July 2005

Dear Mr President
Dear Mr Speaker

The Australian National Audit Office has undertaken a performance audit in the Australian Prudential Regulation Authority in accordance with the authority contained in the *Auditor-General Act 1997*. Pursuant to Senate Standing Order 166 relating to the presentation of documents when the Senate is not sitting, I present the report of this audit and the accompanying brochure. The report is titled *Bank Prudential Supervision Follow-up Audit.*

Following its presentation and receipt, the report will be placed on the Australian National Audit Office's Homepage—http://www.anao.gov.au.

Yours sincerely

Ian McPhee
Auditor-General

The Honourable the President of the Senate
The Honourable the Speaker of the House of Representatives
Parliament House
Canberra ACT

AUDITING FOR AUSTRALIA

The Auditor-General is head of the Australian National Audit Office. The ANAO assists the Auditor-General to carry out his duties under the *Auditor-General Act 1997* to undertake performance audits and financial statement audits of Commonwealth public sector bodies and to provide independent reports and advice for the Parliament, the Government and the community. The aim is to improve Commonwealth public sector administration and accountability.

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Abbreviations

ADI	Authorised Deposit-taking Institution
ANAO	Australian National Audit Office
APRA	Australian Prudential Regulation Authority
ASF	APRA Supervision Framework
MoU	Memorandum of Understanding
OECD	Organisation for Economic Co-operation and Development
PAIRS	Probability and Impact Rating System
SOARS	Supervisory Oversight and Response System
SRS	Specialist Risk Services
UK	United Kingdom
USA	United States of America

Summary and Recommendations

Summary

Background

1. The Australian Prudential Regulation Authority (APRA) was established on 1 July 1998 to promote prudent behaviour by authorised deposit-taking institutions (including banks), insurance companies, superannuation funds and other financial institutions. APRA aims to protect the interests of depositors, policy holders and members through development and enforcement of prudential standards and practices focused on the quality of an institution's systems for identifying, measuring and managing its various business risks.

2. APRA is responsible for supervising the 52 banks authorised under the *Banking Act 1959* (Banking Act) to operate in Australia. Of these, there are 14 Australian banks, 10 foreign bank subsidiaries and 28 foreign bank branches.[1]

3. In 2001, the Australian National Audit Office (ANAO) completed a performance audit on APRA's prudential supervision of banks (Audit Report No.42 2000–01 *Bank Prudential Supervision*). The audit report made one recommendation concerning the levies APRA collects from supervised financial institutions. This recommendation was not followed-up in this audit report as legislation changing the determination of these levies was introduced into Parliament on 9 December 2004. The audit report made a further four recommendations directed at improving APRA's bank prudential supervision framework and its supervision of cross-border banking operations. APRA agreed with qualification to one part of one recommendation and agreed to all parts of the other three recommendations.

Audit objective

4. The objective of this follow-up audit was to assess the extent to which APRA has implemented recommendations regarding the supervisory framework and cross-border banking made in ANAO's 2001 audit of bank prudential supervision.

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1 The Banking Act distinguishes between foreign-owned bank branches and foreign-owned bank subsidiaries. Under the Banking Act, foreign bank subsidiaries are subject to the same legislative and prudential requirements as Australian owned banks. This allows them to take retail deposits from members of the public. In comparison, foreign bank branches are subject to similar requirements but the home country prudential supervisor governs their solvency. As a consequence, they are exempt from certain prudential requirements, including capital adequacy, and are prohibited from undertaking certain types of retail deposit business.

Audit conclusion

5. The ANAO found that APRA has implemented or made progress in implementing all recommendations made in the 2001 audit report. Table 1 shows ANAO's assessment of APRA's progress in implementing each of the relevant recommendations. Also indicated in Table 1 is APRA's abbreviated response to ANAO's original recommendation and the location within this current report of supporting analysis for ANAO's 2005 assessment of action taken by APRA.

6. APRA considered recommendations concerning the supervisory framework as being of greatest importance. As a result, it has made the most progress in implementing the 2001 recommendation concerning a review of its risk rating process. In addition to introducing a new risk rating process, the implementation of a new supervision framework has led APRA to refine the basis on which it determines the frequency of on-site visits to banks.[2] The number of such visits made to banks by APRA has increased since completion of the 2001 audit. Prudential restrictions applying to large bank exposures were also reviewed by APRA in a timely manner.

7. APRA has also implemented the recommendation regarding concerns it may hold about the Australian operations of foreign banks or the international operations of Australian banks, having made efforts to contact overseas supervisors regarding these concerns. Some progress has been made in relation to the other recommendations about supervision of cross-border banking, although ANAO considers that further progress is required in relation to:

- completing implementation of the structured offshore review program that was finalised in April 2005;
- pursuing formal information sharing arrangements with overseas supervisors; and
- APRA supervisors being aware of any issues of concern relating to the parents of foreign banks and overseas operations of Australian banks.

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[2] During an on-site visit, APRA seeks to gain an understanding of a specific bank's business developments, changes to risk management systems and processes, and changes to operational controls. In addition, APRA assesses whether a bank's risk management plans are both appropriate and followed in practice.

Table 1

Progress in implementing recommendations from the 2001 audit report[a]

2001 audit report recommendation	Agency response	ANAO assessment	Reference paragraphs
Recommendation No.1 was not included in this follow-up audit as the levies APRA collects from financial institutions are subject to legislative change. For further information see paragraph 1.9.			
2. ANAO recommends that APRA reviews its risk rating process to ensure risk ratings provide sufficient basis for prioritising supervisory actions.	Agreed.	Implemented.	2.1–2.23
3. ANAO recommends that APRA:			
(a) conducts periodic on-site visits to all banks with the level of assessed risk determining the appropriate frequency and intensity of visits; and	Agreed with qualification.	Considerable progress made.	2.24–2.42
(b) considers the merits of a structured program of visits to the offshore operations of Australian banks.	Agreed.	Program recently finalised. Implementation underway.	3.1–3.14
4. ANAO recommends that APRA reviews prudential restrictions on bank exposures to single borrowers or groups of related borrowers in accordance with the Basel Committee's best practice guidelines.	Agreed.	Implemented.	2.43–2.49
5. ANAO recommends that APRA enhances its supervision of the international operations of Australian banks and the Australian operations of foreign banks by:			
(a) documenting, and regularly updating, assessments of the quality of supervision provided by overseas supervisors drawing, as appropriate, on assessments completed by internationally recognised agencies;	Agreed.	Addressed.	3.15–3.21
(b) establishing formal information sharing arrangements with relevant overseas supervisors;	Agreed.	Progress made but more is required.	3.22–3.30
(c) seeking periodic confirmation from overseas supervisors that there are no issues of concern relating to foreign parent banks and overseas operations of Australian banks that APRA needs to be made aware of; and	Agreed.	Progress made but more is required.	3.31–3.40
(d) where there are concerns about the Australian operations of foreign banks or the international operations of Australian banks, promptly informing the relevant overseas supervisor of these concerns.	Agreed.	Implemented.	3.41–3.47
Note: (a) APRA agreed with ANAO's assessment in all instances. In relation to ANAO's assessment of action taken on Recommendation Nos 5(b) and 5(c), APRA agreed with qualification. APRA's detailed comments in relation to ANAO's assessment of progress towards implementing individual recommendations are included in the body of this report.			

Source: ANAO analysis.

APRA response

8. APRA's response to the section 19 proposed audit report was as follows:

> APRA is pleased that the ANAO, in this follow-up audit, has recognised the considerable amount of effort APRA has, over recent years, devoted to improving the robustness and consistency of our supervision tools, methodologies and approaches. This has been a particular focus of the new Executive Group which was appointed to APRA in mid-2003.
>
> APRA believes that through the enhancements to our supervisory armoury—such as the PAIRS [Probability and Impact Rating System] rating system, the new APRA-wide supervision framework and our activity tracking systems—we have significantly improved APRA's capacity to deliver more vigilant, vigorous and effective prudential regulation, and in a consistent manner across regulated institutions. These enhancements cover not only banks, to which this specific audit report relates, but all institutions supervised by APRA.
>
> This improvement process must, of course, be an on-going one. APRA operates in an ever-changing legislative, financial and operational environment and our supervisory tools need to evolve with developments affecting the institutions that we regulate. They will also evolve to reflect changes in supervision practices and technology. APRA's Executive Group is committed to ensuring that our armoury remains at the forefront of supervisory best practice.
>
> We welcome the report's findings that APRA has fully implemented a number of the recommendations in the original report and is well on the way to implementing the other recommendations. Those recommendations which APRA considered most important to its supervisory effectiveness received the highest priority. Now that APRA has been able to build up staff resources, we are making good progress on the other recommendations.
>
> However, in one area—establishing formal information-sharing arrangements with our supervisor counterparts overseas—progress is not fully in APRA's hands. Progress also depends on the willingness and capacity of other supervisors, given their own legislative and confidentiality constraints, to agree to our requests. That said, we continue to build our network of contacts within the international supervisory community and, even if formal arrangements are not in place, we will, as we have for many years now, maintain an open dialogue with our counterparts and take every opportunity to discuss issues of mutual interest.
>
> APRA will report on its attention to the findings of this ANAO audit in its 2004–05 Annual Report.

Audit Findings and Conclusions

1. Introduction

This chapter outlines the original audit findings and conclusion and also sets out the objective of the follow-up audit.

Background

1.1 APRA was established on 1 July 1998 as the prudential regulator of banks and other authorised deposit-taking institutions (ADIs)[3], life insurance companies (including friendly societies), general insurance companies, superannuation funds and retirement savings accounts. APRA's mission is

> to establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by institutions we supervise are met within a stable, efficient and competitive financial system.[4]

1.2 In Australia, the *Banking Act 1959* provides the legislative framework for the prudential supervision of ADIs. Prudential supervision is a form of regulatory action aimed at substantially reducing the risk of insolvency of financial institutions leading to losses for depositors and instability in the financial system. Prudential supervision aims to protect depositors by ensuring that financial institutions adopt prudent risk management practices designed to ensure their continuing solvency and liquidity.

1.3 As at 1 July 2004, APRA was responsible for the prudential supervision of the 52 banks licensed to operate in Australia,[5] listed in Appendix 1. While the majority of these banks are foreign bank subsidiaries and branches, the majority of assets supervised by APRA are those of Australian banks (see Table 1.1).

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3 ADIs are corporations granted a license under the Banking Act to carry on banking business in Australia. ADIs comprise banks, building societies and credit unions.

4 APRA, 2004, *Annual Report 2004*, p. 1.

5 Although Appendix 1 lists 52 banks as operating in Australia, some analysis in this report will refer to 51 banks rather than 52 as JPMorgan Chase Bank, National Association was created on 1 July 2004 following a merger between JPMorgan Chase and Bank One Corporation.

Table 1.1

Classification of banks operating in Australia as at 28 February 2005

	No. banks	Assets ($ billion)	% of total assets
Australian banks	14	1054.4	80.0
Foreign bank subsidiaries	10	100.3	7.6
Foreign bank branches	28	163.1	12.4
Total	**52**	**1 317.8**	**100.0**

Source: APRA.

The original audit

1.4 In May 2001, ANAO tabled an audit of APRA's prudential supervision of banks licensed to operate in Australia.[6] The objective of the 2001 audit was to assess the efficiency and effectiveness of APRA's prudential supervision of banks. Specifically, the 2001 audit objectives involved:

- examining APRA's adoption and implementation of internationally accepted banking supervisory standards and developments;
- evaluating APRA's prudential supervision of banking activities; and
- assessing APRA's financial governance arrangements.[7]

1.5 The 2001 audit methodology included assessing the extent to which APRA had implemented the 1997 Core Principles for Effective Banking Supervision issued by the Basel Committee on Banking Supervision and other guidance on supervisory practice published by the Basel Committee.[8] A detailed examination was also undertaken of the supervision of seven of the 50 banks supervised by APRA at the time of the audit. This audit sample involved two of the four major Australian banks, another large Australian bank, one subsidiary of a foreign bank and three foreign bank branches. In addition, ANAO also examined:

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6 ANAO, 30 May 2001, *Bank Prudential Supervision,* Australian Prudential Regulation Authority, Audit Report No.42 2000–01, Canberra. This report is referred to as the 'original report' in this current audit report.

7 ibid., p. 28.

8 The Basel Committee on Banking Supervision is a Committee of banking supervisory authorities that has been working to improve banking supervision at the international level. The Basel Committee on Banking Supervision was established by central bank Governors of the Group of Ten countries in 1975. It usually meets at the Bank for International Settlements in Basel, Switzerland where its permanent Secretariat is located.

- the licensing processes adopted in relation to the two most recent occasions when a banking licence had been granted; and
- the approval process for all nine banks granted permission to use their internal market risk models to calculate their capital adequacy position (three of which were included in ANAO's original sample of seven banks).[9]

Original report conclusion

1.6 The audit report concluded that APRA had successfully negotiated the transition from a system of Commonwealth and State supervisors to becoming an integrated prudential regulator of all ADIs. This included establishing a new organisational structure, adopting a risk-based supervisory methodology for sophisticated financial institutions (including most banks) and introducing harmonised Prudential Standards for all ADIs.[10]

1.7 However, ANAO also concluded that there were steps APRA could take in a number of areas to improve its supervisory practices. The 2001 report made five recommendations, each of which APRA agreed, or agreed with qualifications, to implement. The recommendations addressed the administration of the levy on authorised deposit-taking institutions; strengthening of the supervisory risk management approach; closer adherence to international standards for prudential supervision; and more active supervision of the international operations of cross-border banking operations.[11]

The follow-up audit

1.8 The objective of this follow-up audit was to assess the extent to which APRA has implemented the recommendations contained in Audit Report No.42, 2000–2001. Specifically, the audit sought to assess APRA's progress in implementing Recommendation Nos 2 to 5, which concerned APRA's supervisory framework and supervision of cross-border banking.

1.9 Recommendation No.1, which concerned APRA's administration of the levies it collects from supervised financial institutions,[12] was not included in the follow-up audit as legislation changing the determination of these levies was introduced into Parliament on 9 December 2004.[13]

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[9] ANAO, op. cit., p. 29.

[10] ibid., p. 10.

[11] ibid., p. 17.

[12] ibid., p.40.

[13] A package of seven Bills to give effect to the Government's response to the Review of Financial Sector Levies was originally introduced in August 2004 but lapsed with the dissolution of the 40th Parliament.

1.10 In using the recommendations made in the original audit as criteria to assess APRA's performance, ANAO was cognisant of the currency of the original recommendations, any changed circumstances, and any new administrative issues. The scope of the follow-up audit included an examination of APRA policy, procedures and work practices, together with an examination of APRA's prudential supervision of the banks licensed to operate in Australia.

1.11 Audit fieldwork was conducted between October and December 2004. A Discussion Paper was provided to APRA in April 2005. A draft report was provided to APRA in June 2005.

1.12 The audit was conducted in conformance with ANAO auditing standards and cost the ANAO approximately $265 000.

2. Supervisory Framework

This chapter outlines the implementation of three recommendations made by ANAO about APRA's supervisory framework. Recommendation No.2 of the 2001 audit concerned APRA's risk rating process and how this is used to prioritise supervisory actions. On-site visits by APRA to banks operating in Australia was the focus of Recommendation No.3(a). Recommendation No.4 of the 2001 audit related to APRA's prudential standards limiting exposures by banks to single borrowers or groups of related borrowers.

Using risk ratings to prioritise supervisory actions

Findings of the original audit

2.1 In July 2000, APRA adopted a risk-based supervisory methodology for sophisticated financial institutions, including most banks. ANAO found that 86 per cent of banks, representing 95 per cent of total bank assets, were rated in the bottom of the risk exposures by APRA in the category of 'low' risk. ANAO consequently concluded that the ratings provided insufficient basis for prioritising supervisory activities for entities within the banking sector.[14]

Original Recommendation No.2

ANAO recommends that APRA reviews its risk rating process to ensure risk ratings provide sufficient basis for prioritising supervisory actions.

Original APRA response: APRA **agreed** with the recommendation. APRA commented that its risk assessment process, particularly the setting of internal ratings, is relatively new and is subject to ongoing refinement and review.

Findings of the follow-up audit

2.2 In August 2004, when assessing progress against the ANAO 2001 recommendations for its Risk Management and Audit Committee, APRA stated:

> APRA staff are satisfied that our current risk modelling processes produce much improved and high quality risk assessments, and resultant guidance for supervisory stances in respect of regulated entities.
>
> APRA staff regard this as the most important of the five ANAO recommendations, and the one in which the most substantial improvement has been achieved.

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[14] ANAO, op. cit., p. 53.

Risk rating of supervised institutions

2.3 In October 2002, APRA introduced a new system to identify and address risks in the institutions it supervises. The Probability and Impact Rating System (PAIRS) and Supervisory Oversight and Response System (SOARS) require all APRA supervisors to follow the same structured approach to risk analysis. The two systems are used by APRA to determine where to focus supervisory effort and the appropriate supervisory actions to take with regard to each regulated entity.[15]

2.4 PAIRS is used by APRA to classify regulated institutions according to two categories. APRA first constructs an index based on an institution's inherent risk, balanced by its management and controls and the capital support available in the absence of APRA intervention. This index, referred to as the 'PAIRS probability rating', classifies an institution according to the probability that it may fail and therefore be unable to honour its financial promises to beneficiaries, such as depositors or policyholders. Corresponding to their index result, institutions are categorised as having a PAIRS probability rating of 'extreme', 'high', 'high medium', 'low medium' or 'low'.[16]

2.5 The second category, the 'PAIRS impact rating', is intended to reflect the impact of an institution's failure on the Australian financial system. This index is constructed according to an institution's Australian resident total assets. Depending on the level of assets, institutions are classified as having a PAIRS impact rating of 'extreme', 'high', 'medium' or 'low'.[17]

2.6 Through combining an institution's impact rating and probability rating, APRA derives a SOARS supervisory stance, as displayed in Table 2.1. This supervisory stance is used to determine the supervisory activities APRA will undertake with regard to a particular institution.[18] For the 52 banks operating within Australia, 27 are classified by APRA as requiring a 'normal' level of supervisory activity and 25 are classified as requiring an 'oversight' level.

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15 APRA, *PAIRS Explained*, [Online], Available at: <http://www.apra.gov.au/PAIRS/PAIRS-Explained.cfm>, Accessed on: 25 January 2005.

16 APRA, *How PAIRS ratings are determined*, [Online], Available at: <http://www.apra.gov.au/PAIRS/Ratings.cfm>, Accessed on: 25 January 2005.

17 ibid.

18 APRA, *Applying PAIRS*, [Online], Available at <http://www.apra.gov.au/PAIRS/Applying-PAIRS.cfm>, Accessed on: 25 January 2005.

Table 2.1

Relationship between APRA's PAIRS probability and impact ratings and SOARS supervisory stances

		PAIRS probability rating				
		Low	Low medium	High Medium	High	Extreme
PAIRS impact rating	Extreme					
	High					
	Medium					
	Low					

Note: SOARS supervisory stances are:

Normal: APRA is to collect and analyse data and make routine on-site visits.

Oversight: An increase in information collection and inspection intensity. Minimum capital requirements may be increased.

Mandated improvement: As the institution is considered to be operating in an unsustainable way, APRA is to direct the institution to present and execute a remediation plan that addresses the area of identified weakness and restores financial stability. APRA may issue directions and take other enforcement actions.

Restructure: As such institutions are considered to be in serious danger of failure, APRA is to apply its full enforcement powers, including issuing directions to replace persons and service providers and/or to restrict business activities. The paramount concern is to quarantine the institution from further deterioration and minimise losses to depositors, policy holders and fund members.

Source: APRA, *Applying PAIRS*, [Online], Available at:<http://www.apra.gov.au/PAIRS/Applying-PAIRS.cfm>, Accessed on: 25 January 2005.

2.7 In the 2001 audit report, ANAO expressed concern that the rating system used by APRA provided insufficient differentiation of risk ratings, 86 per cent of banks having had the same risk rating.[19] ANAO was concerned that this system did not provide APRA with adequate information on the relative riskiness of different banks. APRA advised ANAO that PAIRS has solved this problem with the creation of 20 possible probability/impact combinations.

2.8 An examination of PAIRS ratings as at 28 February 2005 indicated that the 52 banks are currently distributed across 10 probability/impact combinations. The maximum number of banks currently within any one combination is 11 (21 per cent).

19 ANAO, op. cit., p. 50.

Completion of PAIRS assessments

2.9 ANAO analysis indicates that most banks had several PAIRS assessments conducted from the time the PAIRS framework was introduced in October 2002 to 28 February 2005. On average, four assessments were conducted for both Australian banks and foreign bank subsidiaries and three were completed for foreign bank branches. Four banks, all of which were foreign bank branches, had only one PAIRS assessment completed during this period. However, three of these banks were authorised to commence operations in Australia after 1 July 2003.

2.10 ANAO observed that PAIRS assessments had been completed in the 12 months to 28 February 2005 for:

- all of the 14 Australian banks;
- all of the 10 foreign bank subsidiaries; and
- 22 of the 28 (79 per cent) foreign bank branches.

2.11 In August 2004, APRA specified that PAIRS risk assessments and the corresponding SOARS strategy are to be updated following the conduct of a prudential review of a bank and again following receipt of a bank's response to the findings of the prudential review.[20] Given the rate with which PAIRS assessments have been conducted in the past, APRA has acknowledged that it will need to increase the frequency of its rating process in order to meet this new benchmark.

The APRA Supervision Framework

2.12 In February 2004, APRA commenced development of a uniform, APRA-wide approach to supervisory action. The APRA Supervision Framework (ASF) seeks to:

- provide a robust supervisory framework which establishes minimum analytical requirements from a supervisory perspective;
- promote consistent, robust, effective and targeted risk-based supervision;
- enhance consistency and quality of supervising by giving supervisors more structure; and
- improve accountability that procedures are being followed.

2.13 ASF consists of a Supervision Policy statement describing APRA's approach to supervision and a set of industry-based procedures, work

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[20] APRA has observed that, in many cases, the findings of a prudential review, or the actions taken by an institution in response to these findings, will not result in a change to an institution's PAIRS rating.

instructions and resource material for core supervision activities. The initial focus of ASF development has been on material for use in the conduct of prudential reviews, including industry-specific modules for the assessment of key functional and risk areas, and practice notes to support these modules.

2.14 The modules and supporting material were developed and progressively implemented on a trial basis during the second half of 2004. APRA advised ANAO that feedback from these trials has led to some improvements and that ASF material will be subject to continual evaluation as feedback from ongoing use suggests improvements.

2.15 ASF modules essentially fall into two groups:

- 'core' modules concerning the general operating and risk environments faced by institutions (covering such issues as the institution's board, management strategy, structure and relationships, capital levels and sources, and risk management framework);[21] and
- 'risk' modules are those focussing on a specific area of risk (namely, operational risk, credit risk, balance sheet and market risk and insurance risk).[22]

2.16 Supervisory actions that have been identified for potential inclusion in the completion of the next stage of development of ASF include:

- work instructions and guidance notes for undertaking analysis in relation to financial returns and documentation received from institutions;
- enforcement procedures and guidance material;
- licensing procedures and guidance material; and
- the obtaining of technical advice through Industry Technical Services, a specialist unit within APRA's Supervisory Support Division.

2.17 APRA anticipates the supervision policy, all modules and practice notes, the main procedures, and minimum activities required within ASF, will be completed, although still in settling down mode, by 31 December 2005.

Supervisory frequency

2.18 The minimum frequency with which ASF Modules are to be completed for an individual bank is based on the SOARS stance and PAIRS impact rating

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[21] The matters covered in the completion of these modules are similar to those considered in conducting a prudential consultation. These modules may be completed simultaneously or over a period of time, depending on a particular institution's SOARS stance.

[22] Operational risk, credit risk, balance sheet and market risk are discussed in the context of on-site visits by APRA to banks, commencing at paragraph 2.26.

APRA has allocated the bank. Table 2.2 presents the minimum completion frequency for the core modules APRA requires for the 27 banks allocated a SOARS stance of normal. This frequency ranges from annually, for banks with a PAIRS impact rating of extreme, to every two years for all other banks. Subject to APRA's assessment of the bank and the supervisor's judgement, individual modules may be completed more than once during this cycle.

Table 2.2

Minimum supervision cycles for banks with a SOARS supervision stance of normal—ASF core modules

Type of bank	PAIRS impact rating	Core modules
Australian banks and foreign bank subsidiaries	Extreme	Annual
	High	2 years
	Medium and low	2 years
Foreign bank branches	All	2 years

Source: APRA, 2004, *Supervisory Oversight and Response System (SOARS) Guide.*

2.19 As can be seen in Table 2.2, APRA does not use an individual banks PAIRS impact rating to determine the minimum supervision cycle for foreign bank branches. The minimum supervision cycle for completing the core modules for foreign bank branches is two years, irrespective of an individual bank's PAIRS impact rating. APRA advised ANAO it has adopted this lower level of supervision as foreign bank branches are not allowed to take retail deposits in Australia, they are subject to a certain level of supervision by their home regulator and they are excluded from Australian capital adequacy and other supervision requirements. APRA believes this approach is appropriate on the basis of the risk presented.

2.20 For banks rated as having a SOARS stance of oversight or higher, supervisors determine whether the core modules should be completed more frequently than every two years.

Completion of ASF core modules

2.21 Information supplied by APRA in February 2005 indicates that core modules have been completed, or are scheduled for completion by March 2006, for 36 of the 51 (71 per cent) banks. APRA advised ANAO that it considers this to be reasonable progress given that the first full minimum supervision cycle period will not end until the third quarter of 2006.

Conclusion

2.22 The risk rating process has been improved and enhanced by APRA. Accordingly, ANAO considers that APRA has implemented Recommendation No.2.

APRA comment

2.23 APRA agreed with ANAO's findings regarding implementation of Recommendation No.2 and commented as follows:

> APRA has devoted considerable resources and intellectual property to developing a robust supervision methodology and a quantifiable risk assessment process. Because of the dynamic nature of the Australian financial system, these tools will continue to evolve to address changing risks and supervisory needs.

On-site visits to banks

Findings of the original audit

2.24 On-site visits provide APRA with an increased understanding of banks' risk management systems and an insight into their risk management culture. They also enable material issues identified through off-site supervision to be pursued.

2.25 ANAO found that APRA did not undertake regular on-site visits to all banks. As a result, APRA was unable to meet the Basel Committee best practice recommendation that it periodically verify that banks' are adhering to their risk management processes, capital requirements, credit policies and procedures and liquidity guidelines. ANAO further noted that APRA had not specified a minimum visit frequency for all banks.[23]

Original Recommendation No.3(a)

ANAO recommends that APRA:

(a) conducts periodic on-site visits to all banks with the level of assessed risk determining the appropriate frequency and intensity of visits; ...

Original APRA response: APRA **agreed with qualification**. APRA's qualification was that, consistent with its application of a risk-based supervision methodology, a scheduled visit may be deferred if it were felt that a visit would offer no insights into a bank's risk management practices. APRA commented that it relies to some extent on annual updates to risk management system descriptions from banks to track changes in risk management processes. It also requires an annual declaration from management and the board that risk management systems are current, adequate and operating effectively.

[23] ANAO, op. cit., pp. 64, 67.

Findings of the follow-up audit

2.26 APRA considers on-site prudential reviews to be one of its key activities in assessing the risk of failure for a bank.[24] During an on-site visit, APRA focuses on a bank's business developments, changes to risk management systems and processes, and changes to operational controls.

2.27 By undertaking a program of different types of visits, APRA attempts to ensure that a supervised institution's risk management plans are both appropriate and followed in practice. Specific risk visits are undertaken by APRA to review the effectiveness of policies, procedures and controls surrounding:

- balance sheet and market risk—including trading activities, liquidity risk management, internal audit and back office procedures;
- credit risk—including portfolio management;
- operational risk—including governance and audit arrangements, outsourcing arrangements, IT systems and business continuity and disaster recovery plans.[25]

2.28 ANAO observed that, for the period 1 July 2001 to 28 February 2005, all but three of the 52 banks supervised by APRA received at least one on-site visit. APRA advised that, of these three banks,:

- one bank is the wholly-owned subsidiary of a major Australian bank and has not conducted any new business for some years; and
- two are foreign bank branches. One bank conducts only a very limited range of business in Australia. The other bank has been the subject of supervisory visits conducted by its home supervisor, with the visit team accompanied by APRA staff.

2.29 ANAO analysis indicates that, during the period 1 July 2001 to 28 February 2005, APRA conducted visits of all three risk types to 32 of the 52 (62 per cent) banks operating in Australia, as illustrated by Table 2.3. Excluding the three banks which did not receive any on-site risk visits, during this time:

- 11 banks did not receive an operational risk visit, of which nine were foreign bank branches;

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24 'Prudential review' is the terminology adopted by APRA to refer to what were previously known as 'prudential consultations' and 'on-site visits'.

25 These visit types now correspond to specific ASF modules.

- five banks did not receive a credit risk visit, of which four were foreign bank branches; and
- nine banks did not receive a balance sheet and market risk visit, of which five were foreign bank branches.

2.30 APRA advised that, in early 2003, it accompanied the relevant foreign supervisor in their review of the local operations of three foreign bank branches. For other foreign bank branches, APRA considers that the limited range of local activities means that specialist risk visits cannot always be justified across risk streams. For example, some banks do not undertake any credit intermediation activity.

Table 2.3

Number of on-site visits to banks, 1 July 2001 to 28 February 2005

Bank	Operational risk	Credit risk	Balance sheet and market risk	Total no. visits to bank
Australian banks				
Australian bank 1	2	2	2	6
Australian bank 2	1	1	3	5
Australian bank 3	1	0	0	1
Australian bank 4	1	2	1	4
Australian bank 5	2	3	4	9
Australian bank 6	1	2	2	5
Australian bank 7	6	3	3	12
Australian bank 8	1	1	1	3
Australian bank 9	1	1	2	4
Australian bank 10	0	0	0	0
Australian bank 11	2	2	2	6
Australian bank 12	1	3	3	7
Australian bank 13	1	1	1	3
Australian bank 14	2	2	1	5
Total visits to Australian banks	**22**	**23**	**25**	**70**
Foreign bank subsidiaries				
Foreign bank subsidiary 1	0	1	2	3
Foreign bank subsidiary 2	4	3	3	10
Foreign bank subsidiary 3	1	1	1	3
Foreign bank subsidiary 4	0	1	0	1
Foreign bank subsidiary 5	1	1	0	2
Foreign bank subsidiary 6	1	1	1	3
Foreign bank subsidiary 7	1	2	0	3
Foreign bank subsidiary 8	1	1	1	3
Foreign bank subsidiary 9	1	2	2	5
Foreign bank subsidiary 10	3	4	4	11
Total visits to foreign bank subsidiaries	**13**	**17**	**14**	**44**

Bank	Operational risk	Credit risk	Balance sheet and market risk	Total no. visits to bank
Foreign bank branches				
Foreign bank branch 1	1	1	1	3
Foreign bank branch 2	2	2	2	6
Foreign bank branch 3	0	1	0	1
Foreign bank branch 4	1	1	1	3
Foreign bank branch 5	0	1	0	1
Foreign bank branch 6	1	1	1	3
Foreign bank branch 7	2	2	2	6
Foreign bank branch 8	1	1	2	4
Foreign bank branch 9	1	0	1	2
Foreign bank branch 10	0	0	0	0
Foreign bank branch 11	1	1	1	3
Foreign bank branch 12	1	2	0	3
Foreign bank branch 13	1	1	1	3
Foreign bank branch 14	0	1	0	1
Foreign bank branch 15	1	1	1	3
Foreign bank branch 16	0	1	1	2
Foreign bank branch 17	0	0	0	0
Foreign bank branch 18	0	1	1	2
Foreign bank branch 19	1	1	1	3
Foreign bank branch 20	1	0	0	1
Foreign bank branch 21	0	1	1	2
Foreign bank branch 22	0	0	1	1
Foreign bank branch 23	1	1	1	3
Foreign bank branch 24	0	1	1	2
Foreign bank branch 25	1	1	1	3
Foreign bank branch 26	2	1	1	4
Foreign bank branch 27	0	0	1	1
Foreign bank branch 28	1	1	1	3
Total visits to foreign bank branches	**20**	**25**	**24**	**69**
Total visits	**55**	**65**	**63**	**183**
Note: Not all visits in this table were conducted by teams including Specialist Risk Services personnel.				

Source: ANAO analysis of on-site visits conducted by APRA.

2002 on-site visit frequency

2.31 In September 2002, APRA decided upon a schedule for the frequency of on-site visits to banks incorporating personnel from Specialist Risk Services (SRS).[26] This frequency was based on a bank's PAIRS impact rating (that is, a bank's Australian resident total assets). Visit frequency was specified for banks with a PAIRS impact rating of extreme or high, but not for those banks with a PAIRS impact rating of medium or low. APRA advised that, for these banks, frontline supervisors were responsible for the conduct of on-site visits, with the option of utilising SRS. In practice, SRS was utilised for banks where the need for specific expertise arose.

Banks with a PAIRS impact rating of extreme

2.32 For banks with a PAIRS impact rating of extreme, APRA decided that on-site visits, incorporating SRS personnel, would be made to individual banks at least every two years. It was proposed that these visits would be on a staggered basis so that a bank would be visited by at least one SRS team each year. In practice, a bank would therefore be visited by the SRS credit risk team one year and by the SRS balance sheet and market risk team the following year. If considered necessary, the other SRS risk teams would conduct additional separate visits to review their risk area. Alternatively, they may, if considered practical, participate in visits focused on a different risk area to their speciality.

2.33 ANAO found that APRA conducted credit risk and balance sheet and market risk visits, incorporating SRS personnel, to four of the eight (50 per cent) banks with a PAIRS impact rating of extreme at least every two years. Six of these eight banks (75 per cent) were visited by a team incorporating SRS personnel at least once a year.

Banks with a PAIRS impact rating of high

2.34 APRA decided that, for banks with a PAIRS impact rating of high, on-site visits by a team incorporating SRS personnel would occur at least every three years. The proposed approach was for a two year cycle for credit risk visits and a three year cycle for balance sheet and market risk visits and operational risk visits. It was also proposed that individual banks would be visited by a team incorporating SRS personnel at least once a year.

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[26] Specialist Risk Services consists of five specialist risk groups: Credit Risk; Balance Sheet and Market Risk; Operational Risk; Insurance Risk; and Risk Models. The role of these groups is to work with the frontline supervisors to assess whether institutions have in place appropriate policies and control processes to manage the risks to which they are exposed. A major focus of SRS is to monitor developments in risk management methodology and maintain knowledge in the five risk areas across all institutions regulated by APRA.

2.35 ANAO found that APRA's performance in applying this approach was variable. Credit risk visits by a team including SRS personnel were made every two years to 19 of the 25 (76 per cent) banks with a PAIRS impact rating of high. Teams incorporating SRS personnel also made balance sheet and market risk visits every three years to 16 of the 25 (64 per cent) banks with a PAIRS impact rating of high. Twelve of the 25 banks (48 per cent) received operational risk visits by a team incorporating SRS personnel on a three yearly cycle. These visit cycles were applied to different banks with this PAIRS impact rating. In addition, only four of the 25 banks (16 per cent) were recipients of at least one visit a year by a team incorporating SRS personnel.

ASF minimum supervision cycle

2.36 In December 2004, as part of the adoption of ASF, APRA introduced a refined on-site visit cycle specifying the minimum level of monitoring to be undertaken. This new supervisory cycle incorporates the following modifications:

- visit frequency is determined by a combination of an institution's SOARS supervision stance and PAIRS impact rating;
- a visit cycle has been explicitly established for the conduct of operational risk visits; and
- a visit cycle has been established for banks APRA rates as having a PAIRS impact rating of medium or low.

Banks with a SOARS stance of normal

2.37 Table 2.4 presents the minimum supervision cycle for the completion of ASF risk modules for the 27 banks rated by APRA as having a normal SOARS stance. This cycle now requires APRA to conduct:

- credit risk and balance sheet and market risk visits, with SRS personnel involved in visits to banks with a higher PAIRS impact rating, every two years; and
- operational risk visits every two years to banks with a higher PAIRS impact rating and every four years to other banks.

2.38 For banks with a normal SOARS stance and a High, Medium or Low PAIRS impact rating, this supervision cycle increases the frequency with which APRA intends to undertake specific credit, operational and balance sheet and market risk visits.

Table 2.4

Minimum supervision cycles for banks with a SOARS supervision stance of normal—ASF risk modules

Type of Bank	PAIRS impact rating	Risk modules
Australian banks and foreign bank subsidiaries	Extreme	2 years
	High	2 years
	Medium and low	2–4 years
Foreign bank branches	All	2–4 years
Note: It is optional for supervisors to include Specialist Risk Services personnel in the visit team in certain circumstances.		

Source: APRA, 2004, *Supervisory Oversight and Response System (SOARS) Guide*.

2.39 Analysis of data provided by APRA indicates that the focus for on-site visits in 2005, the first year of operation of the ASF minimum supervision cycle, will be on visits to Australian banks and foreign bank subsidiaries operating in Australia. The majority of visits to these banks will be for credit risk and balance sheet and market risk, which are the primary risk modules for banks.

Banks with a SOARS stance of oversight

2.40 For the 25 banks rated by APRA as being in oversight, individual supervisors are to decide the frequency of completion of ASF risk modules and conduct of on-site visits. That is, APRA considers that visits should be completed more frequently than the two–four year cycle outlined in Table 2.4 for banks with a SOARS supervision stance of normal. The focus of APRA's supervisory actions for banks in oversight, or higher, is to reflect APRA's prime area of concern for the bank or the area that prompted the bank to be moved from normal to oversight. For example, if credit risk was the area of concern, credit risk visits may be completed annually, or more frequently, for the bank. Alternatively, or in addition, such banks may be subject to more frequent information and data collection.

Conclusion

2.41 ANAO considers that APRA has made considerable progress in implementing Recommendation No.3(a). The key issue going forward will be APRA's performance in undertaking visits in accordance with the specified frequency. In this regard, APRA advised ANAO in May 2005 that its operating divisions are in the process of implementing key performance indicators to measure compliance with ASF.

APRA comment

2.42 APRA agreed with ANAO's findings regarding implementation of Recommendation No.3(a) and commented as follows:

> APRA agrees generally with the ANAO that the key issue going forward will be APRA's performance in undertaking visits in accordance with the specified frequency. We would note, however, that review cycles and requirements for reviews under the APRA Supervision Framework may not always be met because APRA may, on occasion, need to redirect resources to deal with pressing risk issues with particular institutions. Importantly though, we are also building the infrastructure—for example, our Activity & Issues Management System (AIMS)—to ensure that any deviations from agreed timetables and cycles are promptly brought to management attention.

Large exposures

Findings of the original audit

2.43 The original audit report concluded that APRA's supervisory requirements did not impose a limit on each bank's large exposures in the manner advocated by the Basel Committee's Core Principles[27] as there was no prudential limit on a bank's maximum individual borrower exposures, only a requirement to consult with APRA.[28]

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.

Basel Core Principles for Effective Banking Supervision

Large exposure limits

Principle 9, Additional Criterion 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.

Basel Core Principles Methodology

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[27] Basel Committee on Bank Supervision, *Core Principles for Effective Banking Supervision* issued in 1997 and associated *Core Principles Methodology* issued in October 1999.

[28] ANAO, op. cit., p. 82.

2.44 While the Basel Committee advocated that minor deviations from large exposure limits may be acceptable, in the original sample of nine banks examined by ANAO, two banks had advised of exceptionally large exposures (greater than 30 percent of each bank's capital) since 1997.[29]

Original Recommendation No.4

ANAO recommends that APRA reviews prudential restrictions on bank exposures to single borrowers or groups of related borrowers in accordance with the Basel Committee's best practice guidelines.

Original APRA response: APRA **agreed** with the recommendation. APRA advised that it was reviewing the current large exposures 'limit' with a view to aligning more closely with the Basel Core Principles criteria.

Findings of the follow-up audit

2.45 In October 2001, APRA released a discussion paper on capital adequacy and exposure limits.[30] Following industry consultation, in November 2002 APRA issued four revised prudential standards on capital adequacy, large exposures and associations with related entities. The revised standards came into effect on 1 July 2003.

2.46 In moving to the revised requirements for large exposures, APRA advised banks that:

- all banks should make all efforts to bring existing exposures within the new limits set out in the revised standard at the earliest opportunity;
- transitional provision was made for grandfathering of existing exposures with terms expiring post 1 July 2003 but would not apply to new exposures in the lead up to 1 July 2003 that would exceed the new limits after that date; and
- for smaller banks, which may have difficulty in complying with the new limits due to smaller capital bases, the revised standard provided for APRA to approve any proposed exposures in excess of the prescribed limits or agree other limits with individual banks on a case by case basis, having regard to the circumstances of the particular bank.

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[29] ibid.

[30] APRA, 2001, *Capital Adequacy and Exposure Limits for Conglomerate Groups including ADIs: Discussion Paper October 2001.*

2.47 Australian Prudential Standard 221—Large Exposures aims to ensure that ADIs implement proper measures and prudent limits to monitor and control their large exposures on both a standalone and group basis.[31] The Standard specifies limits for different types of exposures; when ADIs are to seek approval from, notify and consult with APRA; and reporting requirements. The requirements established by Australian Prudential Standard 221—Large Exposures are in accordance with Basle Core Principle 9.

Conclusion

2.48 ANAO considers that APRA has implemented Recommendation No.4 in a timely manner.

APRA comment

2.49 APRA agreed with ANAO's findings regarding implementation of Recommendation No.4 and commented as follows:

> As indicated in the report, APRA has revised the prudential standard on large exposures (APS 221—Large Exposures) to bring it into compliance with Basel Core Principle 9. ADIs are required to consult with APRA on exposures greater than 10 per cent of their capital base and seek approval for exposures greater than 25 per cent. APRA also actively monitors the large exposures of ADIs through analysis of quarterly data.

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[31] A large exposure is defined in Australian Prudential Standard 221—Large Exposures as an exposure to a counterparty or a group of related counterparties which is greater than or equal to 10 per cent of an ADI's capital base.

3. Supervision of Cross-Border Banking

This chapter outlines APRA's implementation of Recommendation No.3(b) of the original audit, which concerned visits by APRA to the offshore operations of Australian banks, and Recommendation No.5, which related to APRA's supervision of Australian banks' international operations and foreign banks' operations in Australia.

Visits to the offshore operations of Australian banks

Findings of the original audit

3.1 In the 2001 audit report, ANAO noted that the Basel Committee advocates that supervisors periodically visit the offshore locations of banks they supervise, with visit frequency determined by the size and risk profile of the overseas operation. The Committee also recommended that the home country supervisor meet with the local supervisor during these visits.[32]

3.2 ANAO found that a number of overseas supervisors had a practice of regularly visiting the Australian operations of banks for which they were the home country supervisor. APRA advised ANAO that its policy was to conduct an on-site visit to banks' offshore operations where it had material concerns with an operation's risk profile or gaps in its risk management systems.

3.3 Despite APRA's stated policy, ANAO found it had not visited offshore operations even where supervisory activities had raised concerns. In response, APRA advised ANAO that, rather than conduct on-site visits to offshore operations, it relied on confirmations from relevant senior management in Head Office that adequate risk management infrastructure was in place. APRA considered that it was kept appraised of key relevant developments as such entities were subject to a frequent update regime.

3.4 In the light of international experience such as the Barings crisis, ANAO considered that APRA should visit banks' offshore operations to assure itself that risks were being effectively managed on a global consolidated basis. The original audit report concluded that APRA did not have a structured program of visits to the offshore operations of Australian banks.[33]

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[32] ANAO, op. cit., p. 65.

[33] ibid., p. 67.

Original Recommendation No.3(b)

ANAO recommends that APRA:

(b) considers the merits of a structured program of visits to the offshore operations of Australian banks.

Original APRA response: APRA **agreed** with the recommendation.

Findings of the follow-up audit

3.5 APRA advised its Risk Management and Audit Committee as follows in August 2004:

> It would be fair to say that little progress has been made in this area as APRA regarded it as less important than the other recommendations made in the original audit report.

3.6 APRA advised ANAO in May 2005 that this lack of progress reflects both resourcing considerations and the relatively high domestic concentrations within the Australian banking system. At December 2004, the Australian banking system had $1700 billion in assets, of which 70 per cent were domiciled in Australia and 30 per cent offshore. Of the offshore assets, 75 per cent were located in two locations—New Zealand and the United Kingdom (UK). The United States of America (USA) is the only other country to account for more than two per cent of system assets.

3.7 APRA further advised ANAO in May 2005 that examination of Australian banking system assets by ultimate ownership indicates that 85 per cent are owned by Australian-owned banks, with banks from the UK, USA and Netherlands each controlling around three per cent. The largest share of system assets by banks from any non-Organisation for Economic Co-operation and Development (OECD) country is 0.1 per cent.

3.8 Since the original audit in 2001, APRA has completed the following visits to the offshore operations of specific Australian banks:

- A visit to New Zealand in 2002 to review the operational risk framework of the New Zealand operations of one Australian bank.
- The New Zealand operations of two different Australian banks were visited by APRA in 2003. These visits were essentially consultations to better understand local operations and management of the two banks; the linkages between each bank's New Zealand operations and their Australian head offices; and how risk management frameworks integrated with overall bank frameworks.

- A 2004 visit to the UK consisted of three components:
  - (a) visits to a specific risk area of the UK operations of four Australian banks;
  - (b) a visit to form an impression of the business, operations and management of a specific Australian bank. Credit, operational and IT risk were also examined briefly; and
  - (c) a more detailed balance sheet and market risk visit of the UK operations of the same bank.
- A visit to New Zealand in 2005 to review the governance, credit and operational risk management of a New Zealand banking subsidiary.

3.9 However, these visits do not encompass all of the Australian banks with offshore operations or the countries in which these operations are based.

3.10 In 2004–05, APRA received additional funding to increase the intensity of its supervision of large and complex entities, including banks. Following recruitment of additional staff, in April 2005 APRA management approved a structured offshore review program. This program will involve conducting reviews of all significant offshore operations on a two to three year cycle. As a guide, APRA management has decided that a significant offshore operation is one that accounts for more than 10 per cent of assets. Discretion has also been provided to cover offshore entities which may be small but otherwise troublesome or of unknown quality.

3.11 The offshore program also provides scope to conduct reviews, where warranted, on Australian regulated-entities which are part of a large international group, and which outsource an important part of their Australian functions to an overseas location. For example, APRA may seek to undertake a series of IT reviews of a number of entities that outsource processing functions to regional hubs such as Singapore.

3.12 APRA intends that this program will be used as a basis to further improve interactions with overseas regulators. This issue is discussed further below.

Conclusion

3.13 Following the adoption in April 2005 of a structured offshore review program, ANAO considers that APRA has made progress in implementing Recommendation No.3(b). The key issue going forward for APRA will be its ability to undertake the reviews required by the program.

APRA comment

3.14 APRA agreed with ANAO's findings regarding implementation of Recommendation No.3(b) and commented as follows:

> APRA has put in place a structured review program of visits to Australian banks (and other regulated institutions) with material activities in offshore locations. APRA agrees with the ANAO that the key issue going forward will be APRA's ability to undertake these reviews. APRA has committed funds in its 2005–06 budget for these reviews and, with the increase in our staff resources, we are confident of achieving the desired visit coverage. Progress on the visit program will be closely monitored.

Assessing the quality of supervision by overseas supervisors

Findings of the original audit

3.15 APRA places significant reliance on the supervision conducted by home country supervisors of foreign bank subsidiaries and branches operating in Australia. An important prerequisite for effective supervision of cross-border banking operations is a rigorous assessment of the quality of supervision undertaken in the home country of foreign banks. However, APRA was not assessing foreign supervisors' statutory powers, past experience in their relations, or the scope of their supervisory practices.[34]

Original Recommendation No.5(a)

ANAO recommends that APRA enhances its supervision of the international operations of Australian banks and the Australian operations of foreign banks by:

(a) documenting, and regularly updating, assessments of the quality of supervision provided by overseas supervisors drawing, as appropriate, on assessments completed by internationally recognised agencies; …

Original APRA response: APRA **agreed** with the recommendation.

Findings of the follow-up audit

3.16 As part of a program to develop Memoranda of Understanding (MoU) with overseas supervisors, APRA has found it necessary to obtain an accurate picture of the legislative and legal operational environment in target jurisdictions. In order to do so, in early 2004 APRA developed a questionnaire on information sharing and related arrangements for completion by targeted

34 ibid., p. 98.

regulators. ANAO notes that this information would be a useful starting point in assessing the quality of supervision provided by overseas supervisors.

3.17 However, at the time of the audit APRA still did not formally assess the quality of offshore supervision.

3.18 APRA advised ANAO that it has adopted the view that, for the most part, material Australian banking subsidiaries, as well as most foreign banks with material activities in Australia, are subject to supervisory oversight by well-regarded supervisory agencies in OECD countries.[35] Consequently, APRA believes that there would be limited value in dedicating resources to the assessment of the supervisors concerned, particularly as existing reviews are available for many of these countries as part of the joint International Monetary Fund—World Bank Financial Sector Assessment Program.[36]

3.19 APRA further advised ANAO that, to the extent that offshore linkages exist to non-OECD countries, the exposure is relatively minor, with non-OECD banks controlling only 0.3 per cent of Australian banking system assets. To further mitigate any reliance on supervisors of unknown quality, APRA has also adopted a different supervisory approach since mid-2004, designed to limit the extent to which parental support is relied upon when undertaking some supervisory assessments. This has seen the responsibility for the supervision of a number of foreign bank subsidiaries transferred from Diversified Institutions Division, which had traditionally supervised all foreign-owned entities, to Specialised Institutions Division (SID). APRA advises that SID's natural approach to supervision focuses on domestic entities and their capacity to operate on a stand-alone basis, and hence the need to understand the parental strength (or its associated supervision) is not substantial.

Conclusion

3.20 ANAO considers that APRA has satisfactorily addressed Recommendation No.5(a).

APRA comment

3.21 APRA agreed with ANAO's findings regarding implementation of Recommendation No.5(a).

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[35] Of the 38 foreign bank subsidiaries and foreign bank branches operating in Australia, the parent banks of 28 are domiciled in OECD countries. The assets of these banks account for 96 per cent of the total assets managed by foreign banks in the Australian banking system.

[36] The Financial Sector Assessment Program was introduced in May 1999 with the aim of increasing the effectiveness of efforts to promote the soundness of financial systems in member countries. Work under the program seeks to identify the strengths and vulnerabilities of a country's financial system; to determine how key sources of risk are being managed; to ascertain the sector's developmental and technical assistance needs; and to help prioritise policy responses.

Formal information sharing arrangements with overseas supervisors

Findings of the original audit

3.22 APRA's enabling legislation allows for the exchange of information between APRA and other regulators including foreign regulators. At the time of the original audit, APRA had information sharing arrangements with only two of the 18 supervisors of foreign banks operating in Australia.[37]

Original Recommendation No.5(b)

ANAO recommends that APRA enhances its supervision of the international operations of Australian banks and the Australian operations of foreign banks by:

(b) establishing formal information sharing arrangements with relevant overseas supervisors; …

Original APRA response: APRA **agreed** with the recommendation.

3.23 The Palmer report[38] on the regulatory background to the HIH collapse also considered the issue of formal cooperation arrangements between APRA and overseas supervisors. In particular, the Palmer report recommended that

> … APRA should review its relationships with foreign regulators in the light of the activities of Australian institutions and groups in foreign jurisdictions, and foreign entities in Australia. Where there are high levels of activity involving a foreign jurisdiction, consideration should be given to entering into a MOU [Memorandum of Understanding] with the jurisdiction to establish a formal basis for cooperation between home and host regulator.[39]

3.24 APRA agreed with the Palmer recommendation, noting that it intended to formalise arrangements for cooperation and information sharing with relevant foreign regulators. Formalising arrangements in respect of general insurance with the UK, USA, Switzerland, France, Japan and Singapore was identified in the Diversified Institutions Division's Business Plan for 2002–03.

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37 ANAO, op. cit., p. 99.

38 APRA commissioned Mr John Palmer, a former head of Canada's Office of Superintendent of Financial Institutions, to review it's role in its formative years in relation to the collapse of HIH and to advise on improvements in its regulatory and supervisory regime. The subsequent report was provided to the HIH Royal Commission in July 2002.

39 Palmer, J., 15 July 2002, *Review of the Role Played by the Australian Prudential Regulation Authority and the Insurance and Superannuation Commission in the collapse of the HIH Group of Companies*, p. 151.

Findings of the follow-up audit

3.25 Negotiation and final execution of MoUs in relation to cross-border regulation and information sharing takes considerable time and effort. Accordingly, timely action in relation to the 2001 audit recommendation was warranted. However, it took APRA until April 2003, some two years after the 2001 audit was completed, to develop a target list of 18 jurisdictions with which it wished to enter into a MoU.

3.26 At the time of the 2001 audit, formal information sharing arrangements existed with two regulators, the Deutsche Bundesbank and the UK Financial Services Authority (UK FSA).[40] A MoU was signed with the Reserve Bank of New Zealand in July 2003.[41] In addition, a new MoU had been signed with the Financial Services Authority in December 2003. APRA has advised that it considers these two organisations to be the most relevant overseas regulators to Australia. This assessment is based on APRA analysis indicating that New Zealand hosts 43 per cent of the total offshore assets of the Australian banking system and the UK is home to 31 per cent of total offshore assets.

3.27 Table 3.1 provides an indication of the progress APRA is making towards executing further MoUs. APRA advised ANAO that while it is working hard on trying to progress MoUs with overseas regulators, such initiatives require an equal level of interest on their part, with some regulators not interested in entering into such arrangements.

Table 3.1

Progress in making MoUs with targeted jurisdictions as of 30 June 2005

Jurisdiction	Progress to date
UK	• MoU signed.
New Zealand	• MoU signed.
China	• MoU signed.
Germany	• MoU signed.
OECD countries	• Eight countries have been investigated regarding potential MoUs, covering around 10 per cent of banking system assets. • MoUs are at various stages of discussion with three countries.
Non-OECD countries	• Preliminary investigations underway with eight countries.

Source: ANAO analysis of APRA data.

40 Germany now has an integrated regulator the BaFin, meaning the former MoU with the Bundesbank was no longer applicable.

41 Also in relation to New Zealand, APRA announced in March 2005 that it had agreed a Terms of Engagement with the Reserve Bank of New Zealand establishing high-level principles for the cross-border implementation of the Basel II Capital Framework.

3.28 No MoUs were signed during 2004. At the time of audit fieldwork, APRA anticipated a number of MoUs would be signed during 2005. MoUs were subsequently signed with the China Banking Regulatory Commission (CBRC) in May 2005 and with the Bundesanstalt fűr Finanzdienstleistungsaufsicht (BaFin) in June 2005.

Conclusion

3.29 ANAO considers that further progress from APRA is required to implement Recommendation No.5(b). ANAO recognises that APRA requires the co-operation of overseas supervisors if further progress is to be made in establishing formal information sharing arrangements.

APRA comment

3.30 APRA agreed with qualification to ANAO's findings regarding implementation of Recommendation No.5(b) and commented as follows:

> APRA notes the comment and will continue to search for opportunities to build robust international information-sharing arrangements. With the establishment and staffing of an International Relations Office, we have stepped up our efforts in this area and have recently signed MoUs with Bundesanstalt fűr Finanzdienstleistungsaufsicht (BaFin, Germany's integrated regulator) and with China Banking Regulatory Commission. However, as noted above, progress in this area can be diffcult for a number of reasons, including:
>
> - the (in)ability of other regulators to enter into such arrangements due to their own legislative provisions;
> - the priority given by other regulators to information-sharing arrangements with Australia (which may not accord with our own); and
> - the preference in some jurisdictions for more informal arrangements.

Periodic confirmations from overseas supervisors

Findings of the original audit

3.31 The APRA Act enables the exchange of information between APRA and other regulators, including foreign regulators.[42] ANAO's examination of APRA's supervisory records revealed that there was minimal formal communication between APRA and home country supervisors. ANAO found that, to provide added assurance regarding APRA's reliance on home country supervisors, there was merit in APRA seeking periodic confirmation from

[42] ANAO, op. cit., p. 98.

home country supervisors that there were no issues of concern APRA needed to be made aware of.[43]

Original Recommendation No.5(c)

ANAO recommends that APRA enhances its supervision of the international operations of Australian banks and the Australian operations of foreign banks by:

(c) seeking periodic confirmation from overseas supervisors that there are no issues of concern relating to foreign parent banks and overseas operations of Australian banks that APRA needs to be made aware of; …

Original APRA response: APRA **agreed** with the recommendation. In relation to part (c), APRA commented that the use of periodic confirmation from home country supervisors regarding any issues of concern about the parents of foreign bank branches would enhance its home country supervision framework. APRA advised that a project has been scoped to address generally the use of formal information-sharing mechanisms with offshore supervisors and receipt of periodic confirmations from home country supervisors about the operations of foreign and Australian banks.

Findings of the follow-up audit

3.32 The development and execution of MoUs can provide APRA with a formal means to obtain periodic confirmation from overseas supervisors about bank operations. For example, the MoU with the Reserve Bank of New Zealand arranges for the provision of information by the Bank to APRA where there are 'material supervisory concerns'[44] in respect of:

- an Australian authorised bank or any of its New Zealand branches, agencies, representative offices or subsidiaries; and
- the Australian branches, agencies representative offices or subsidiaries of a New Zealand registered bank.

3.33 Similarly, APRA's MoU with the UK's Financial Services Authority permits the latter to provide APRA with information on a voluntary basis or where a specific request for assistance has been made.

3.34 In addition, APRA advised ANAO in October 2004 that common obligations for inclusion in MoUs under development, and still to be developed, include making reasonable efforts to:

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43 ibid., p. 99.

44 'Material supervisory concerns' have been defined in the MoU as encompassing any matter relating to:

- whether the operations of a bank are conducted in a safe and sound manner and in conformance with applicable prudential standards;
- whether there has been evidence of a material violation of laws; or
- events that would have a material adverse effect on the financial stability of banks in the country of the authority.

- provide relevant information in an Authority's possession upon request by the other Authority;
- assist in obtaining information not in the immediate possession of a respective Authority but within that Authority's jurisdiction;
- confirm/verify particular information, for example, on the fitness and propriety of responsible officers of authorised institutions;
- assist each other with any inspections in their respective jurisdictions; and
- proactively supply, to the other Authority, confidential information that may be material from a supervisory perspective.

3.35 APRA advised ANAO in May 2005 that, as a result of its efforts to obtain MoUs, it has found that many offshore supervisors are unable to formally exchange information due to legislative or other restrictions.

3.36 To supplement its efforts to establish formal MoUs, APRA engages in regular communication with overseas supervisors when staff are travelling overseas to various international supervisory fora, or undertaking supervisory review work. For example, APRA is active on various sub-committees of the Basel Committee on Banking Supervision, providing an opportunity to discuss matters of mutual concern with a range of supervisors from around the world. APRA also has a prominent role in the International Association of Insurance Supervisors, which provides similar opportunities for information sharing amongst supervisors.

3.37 Requirements for supervisors to contact home regulators were introduced by APRA with the implementation of ASF in 2004, although modules are yet to be completed for the majority of banks. APRA advised ANAO in December 2004 that ASF Modules advise bank supervisors to contact home regulators in the following instances.

- When assessing the fitness and propriety of the Board of Directors of foreign ADIs or locally incorporated foreign subsidiary ADIs, supervisors should consult with the home supervisor or regulator regarding the suitability of personnel of the ADI if there is insufficient information obtainable domestically.
- It is prudent to contact the home country regulator at least once a year for foreign owned ADIs, including branches, where:
  - issues with the Australian subsidiary or branch exist;
  - there is a possibility of the parent having to provide capital; or

  - the Australian subsidiary or branch is high or extreme impact under SOARS.

- It is prudent to contact the home country regulator once a year for foreign owned conglomerates, where:
  - issues with the Australian group or any regulated entity within it exist;
  - there is a possibility of the overseas parent having to provide capital; or
  - the Australian group is high or extreme impact under SOARS.

3.38 However, when completing an ASF module, APRA does not require supervisors to complete all points within a module topic. As such, it is not compulsory for supervisors to complete the above points. APRA advised ANAO in December 2004 that contact with home supervisors could be reinforced in the ASF Modules.

Conclusion

3.39 ANAO considers that APRA has made progress in implementing Recommendation No.5(c). However, further work is required for APRA supervisors to ensure that, in practice, they are aware of any issues of concern relating to foreign parent banks and the overseas operations of Australian banks.

APRA comment

3.40 APRA agreed with qualification to ANAO's findings regarding implementation of Recommendation No.5(c) and commented as follows:

> APRA agrees that more information from overseas supervisors relating to foreign parent banks and the overseas operations of Australian banks would always be helpful. At the same time, through its schedule of overseas visits, formal and informal discussions and arrangements with other regulators (both overseas and in Australia), APRA mitigates the risks that may arise from any inadequacies in information exchanges. The review programs and supervisory processes relating to branches and subsidiaries of foreign banks and the prudential standards with which they are required to comply in Australia are also strong mitigants. The same point applies to those Australian banks with overseas exposures, which are required to have appropriate risk management processes and sufficient capital to address such exposures; APRA take these factors into consideration when assessing and risk-rating the institution.
>
> Processes have been established with the PAIRS ratings system and the APRA Supervision Framework to ensure that the risk arising from overseas exposures are actively considered and assessed.

Communication by APRA of supervisory concerns

Findings of the original audit

3.41 As well as a general lack of confirmation from overseas supervisors to APRA, the original audit also found that APRA had taken insufficient steps to communicate any concerns it held to relevant overseas supervisors. In particular, the original audit found that, where APRA had identified concerns with the Australian operations of foreign banks, procedures were not in place to inform the home country supervisor of APRA's concerns, or to seek advice from the parent supervisor on whether the Australian operation's relationship with its parent bank might mitigate APRA's concerns.[45]

3.42 On this issue, APRA observed that its desire to communicate such matters would be a function of the materiality of the issue, and thus each decision would need to be assessed individually. APRA also advised ANAO that the lack of formal information sharing arrangements with individual home country supervisors had not impeded its ability to inform home country supervisors of material concerns.[46]

Original Recommendation No.5(d)

ANAO recommends that APRA enhances its supervision of the international operations of Australian banks and the Australian operations of foreign banks by:

(d) where there are concerns about the Australian operations of foreign banks or the international operations of Australian banks, promptly informing the relevant overseas supervisor of these concerns.

Original APRA response: APRA **agreed** with the recommendation.

Findings of the follow-up audit

3.43 Since the 2001 audit, ANAO is aware of one occasion where APRA formally sought information from an overseas supervisor about the operations of foreign banks and one occasion where APRA formally supplied information to overseas supervisors about the operations of an Australian bank.

3.44 Although still largely reliant on informal communication channels, APRA advised the ANAO that there are no instances where prudential concerns relating to the solvency or on-going viability of an Australian-authorised bank have not been brought to the attention of relevant overseas supervisors.

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45 ANAO, op. cit., p. 99.

46 ibid., p. 99.

3.45 As previously outlined, through the development and execution of MoUs, APRA is establishing formal means by which to alert overseas supervisors of concerns about the Australian operations of foreign banks or the international operations of Australian banks. The MoUs APRA has executed with the Reserve Bank of New Zealand and the UK Financial Services Authority allow for APRA to provide information to these authorities in the circumstances outlined in paragraphs 3.32–3.33. In addition, the common obligations for inclusion in MoUs under development also allow for the provision of such information.

Conclusion

3.46 ANAO considers that APRA has implemented Recommendation No.5(d).

APRA comment

3.47 APRA agreed with ANAO’s findings regarding implementation of Recommendation No.5(d).

Ian McPhee
Auditor-General

Canberra ACT
15 July 2005

Appendices

Appendix 1: Banks licensed to operate in Australia

At the time the audit commenced, the banks listed below were regulated by APRA in terms of the Banking Act. Changes since this time have been noted.

Australian-owned banks

- Adelaide Bank Limited
- AMP Bank Limited
- Australia and New Zealand Banking Group Limited
- Bank of Queensland Limited
- Bendigo Bank Limited
- Commonwealth Bank of Australia
- Commonwealth Development Bank of Australia Limited
- Elders Rural Bank Limited
- Macquarie Bank Limited
- Members Equity Pty Limited
- National Australia Bank Limited
- St George Bank Limited
- Suncorp-Metway Limited
- Westpac Banking Corporation

The Commonwealth Development Bank is in the process of winding down its banking operations in Australia. As part of this process, the bank no longer has any deposit liabilities and has not conducted any new lending business for a number of years. As such, APRA advised ANAO that its supervision of the bank is focused on ensuring that the bank exits the industry in accordance with its departure plan. Quarterly returns, rather than on-site risk visits or prudential consultations, are therefore the focal point of supervisory activity.

Foreign bank subsidiaries

- Arab Bank Australia Limited
- Bank of Cyprus Australia Pty Limited
- Bank of Western Australia Limited
- Citibank PtyLimited
- HSBC Bank Australia Limited
- ING Bank (Australia) Limited
- Investec Bank (Australia) Limited
- Laiki Bank (Australia) Limited
- NM Rothschild & Sons (Australia) Limited
- RabobankAustralia Limited

Foreign bank branches

- ABN AMRO Bank N.V.
- Bank of America, National Association
- Bank of China
- Bank of Tokyo-Mitsubishi, Ltd
- Bank One, National Association
- Barclays Capital
- BNP Paribas
- Citibank N.A.
- Credit Suisse First Boston
- Deutsche Bank AG
- HSBC Bank plc
- ING Bank NV
- JPMorgan Chase Bank
- Mizuho Corporate Bank, Ltd
- Oversea-Chinese Banking Corporation Limited
- Rabobank Nederland
- Royal Bank of Canada
- Société Générale
- Standard Chartered Bank
- State Bank of India
- State Street Bank and Trust Company
- The International Commercial Bank of China
- The Royal Bank of Scotland Plc
- The Toronto-Dominion Bank
- Taiwan Business Bank
- UBS AG
- United Overseas Bank Limited
- WestLB AG

Since commencement of the audit, the number of foreign bank branches has reduced by one. JPMorgan Chase Bank, National Association was created on 1 July 2004 following a merger between JPMorgan Chase and Bank One Corporation, of which Bank One, National Association was a member.

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