

Productivity Commission  
LB2 Collins Street East  
Melbourne, Vic, 3000

Dears Sirs/Madams

**Re: Inquiry on First Home Ownership Affordability**

“Developments in financial markets” and prudential regulation of financial institutions have come up as issues in the First Home Loan Affordability Inquiry. Please find attached two submissions made by me to the Inquiry into Banking Supervision, which was an Inquiry called in mid-2001 by the House of Representatives Standing Committee on Economics, Finance and Public Administration. This Banking Inquiry received submissions but was subsequently abandoned. But the submissions, while dated, may have some relevancy in respect of the current Inquiry on First Home Ownership Affordability.

**FIRST SUBMISSION TO BANKING INQUIRY**

27 July 2001

N.J. Fitzpatrick, Vic

The Secretary  
House of Representatives  
Standing Committee on Economics,  
Finance and Public Administration  
Parliament House  
CANBERRA ACT 2600

Dear Secretary

**Re: Inquiry into Banking Supervision**  
**Australian National Audit Office Report No. 42 (2000-01)**

This letter represents my submission to the Inquiry. This submission initially discusses some developments that are of relevance to prudential supervision. This submission then analyses the Australian National Audit Office (ANAO) Bank Supervision Audit report and finds:

- inadequate levels of resourcing of bank supervision;

- inadequacies of, and gaps in, the supervision approach;
- inadequacies of, and gaps in, recommendations listed in the ANAO Audit Report;
- missing or contentious information in ANAO's Audit Report; and concludes
- supervision of banks in Australia is, in general, inadequate and requires changes.

### **The Banking System**

ANAO states in its audit report that since the establishment of Australian Prudential Regulation Authority (APRA), the financial performance of the Australian banking sector has been strong. It is difficult to see the relevance of this statement, particularly when one casts their mind back to the late 1980s when banks reported strong profits, only to subsequently suffer losses. In the early 1990s there was significant strain on the financial system, which also had adverse effects on the economy. In 2001 HIH collapsed, and this followed HIH reporting of profits over recent years.

There have been recent developments that have, taken in isolation, had the effect of either weakening banks' financial condition or artificially keeping capital adequacy ratios higher than they would otherwise be. The Prime Asset ratio, which required banks to hold 3 per cent of assets in Prime Assets, was abolished in 1998. Non-callable deposits with the Reserve Bank were also abolished in 1998. In June 1995 the value of public sector securities held by banks represented 6.5 per cent of total assets, whereas by May 2001 they represented less than 3 per cent.

During the 1990s banks improved their ability to structure loans to attract lower risk weightings (i.e. artificially reducing capital adequacy ratios). Despite this, capital adequacy ratios of Australian banks are currently not far away from the levels reported in the early 1990s.

Based on data in the Reserve Bank Bulletin, the rate of growth in the nominal value of banks' derivatives business has significantly exceeded the rate of growth in the risk weighted value of these assets (i.e. the risk weighted value included in the calculation of capital adequacy ratios). The discrepancy in relative growth may be due to better management of derivatives, use of different derivative instruments, use of lower risk weights and better management systems. But the discrepancy needs to be better explained to ensure banks are not under-reporting risk weightings.

The increase in the value of other off-balance sheet business has similarly exceeded the growth in risk weighted value of these assets, and needs explanation.

In early 2001 the RBA stated that there was a risk of some households becoming over-stretched, despite this being at a time of low unemployment and low interest rates. Lending guidelines in the housing loan industry have been relaxed over recent years. For example, loans of up to 95% of valuation can be obtained from most lenders. Some banks will accept government grants available to first homebuyers as the entire deposit on a loan (i.e. no requirement to show a history of repayment capacity). It has been reported

that people in their 50s can obtain home loans with a 25 year term (even though debt serviceability is doubtful at least beyond retirement age). Valuation reports vary in standard. Debt serviceability calculations by lenders may not take into account the possibility of a significant increase in interest rates in future. Banks are using other organisations to market and write loans, and therefore have less control over the procedures undertaken when extending loans.

Some banks have securitised and sold loans (mostly residential mortgages) to get them off balance sheet, and this practice is often used to reduce capital requirements. The ANAO Report did not look into APRA's processes in examining these transactions (and there may be implications for bank and financial system risks).

In recent years, banks have increasingly relied on foreign currency liabilities to finance lending. APRA should liaise closely with the RBA to determine implications for banks.

### **APRA Resourcing**

In 1999-2000 APRA budgeted to spend \$10.4 million on direct supervision of a banking industry with assets approaching \$800 billion. Australians are reliant for their prosperity on a safe banking system.

The Basle Committee on Banking Supervision states that '...while the cost of banking supervision is indeed high, the cost of poor supervision has been proven to be even higher'. Since the establishment of APRA, it appears there has been a real decline in the amount spent on bank supervision. It would appear that the amount spent by APRA is significantly less than the amount spent by the previous regulator (the Reserve Bank), although ANAO's Report does not outline the amount spent by the Reserve Bank.

APRA has between 30 to 34 staff allocated to supervision of banks – i.e. less than one staff member per bank. This is extraordinarily inadequate, and goes a long way to explaining why ANAO found so many areas where APRA could make improvements in its practices and processes. It was also apparent that ANAO was concerned with a lack of on-site visits by APRA to banks. APRA advised ANAO that there had been under-resourcing, but APRA does not go on to say what level of resourcing is required (nor is this information sought by ANAO).

'Financial safety' should be a paramount objective for a banking prudential supervisor. Government policy requires APRA to balance the objectives of financial safety with other objectives such as efficiency, competition, contestability and competitive neutrality. Some of these objectives appear at odds with the role of a prudential supervisor, and could provide ongoing pressure to maintain (or even reduce) the level of supervision at a level which is unacceptable to the Australian community (and potentially unacceptable to overseas financial markets). APRA actually stated that any increase in the intensity of its on-site examinations is at odds with its obligation to balance objectives.

To gain a better understanding of the adequacy of resources devoted to supervision of banks in Australia, ANAO should have compared APRA with other bank supervisors in other countries (e.g. spending as a percentage of bank assets, supervision staff/assets etc).

### **Supervision Approach**

The Basle Committee on Banking Supervision states that ‘...strong and effective banking supervision provides a public good that may not be provided by the market place...and it is critical to the financial stability in any country’. The writer believes that APRA’s reliance on the board, management and auditors of each bank is excessive. This view is based on a need for prudence and on the supervision approach adopted by bank supervisors in many other advanced countries. In Australia, the HIH situation should be a reminder that there are risks associated with over-reliance on information provided by parties close to a supervised entity. Events in the late 1980s and early 1990s provide further reminders.

The Commonwealth Treasury advised ANAO that it is ‘largely satisfied with APRA’s supervision approach’ and that it considers that APRA ‘has been developing a sound prudential framework.’ This is surprising in light of the large number of gaps found by ANAO in APRA’s supervisory processes. There is a lack of evidence presented in ANAO’s Audit Report supporting the soundness of APRA’s prudential framework.

According to the Basle Committee, the vast majority of countries have endorsed Basle Core Principals and declared an intention to implement them. Yet, the Commonwealth Treasury stated to ANAO that the risk-based approach to prudential supervision adopted by APRA does not necessarily require full compliance with the Basle Core Principals. ANAO’s report does not fully explore the basis for Treasury’s view and the Core Principals that Treasury believes do not need to be complied with. This situation is made more confusing when you consider that APRA has agreed with ANAO that it should more closely adhere to a number of Core Principals in order to enhance APRA’s supervisory effectiveness.

ANAO has stated that following the adoption of APRA of a risk-based methodology in late 2000, it is intended that banks with lower risk profiles will receive fewer, and less frequent, visits than when supervised by the Reserve Bank. It should be noted that APRA has to date made no on-site visits to 80% of banks. APRA’s intention is that systematically important institutions and institutions with high-risk profiles, or those encountering risk management difficulties will be subject to more frequent visits. This raises a number of issues and questions, including:

- What systems are in place to identify systematically important institutions?
- How many banks does APRA consider as being systematically important?
- Can the failure of a bank that is not considered ‘systematically important’ cause contagion (e.g. run on other banks)?

- Under the Banking Act, APRA has a duty to exercise its functions and powers for the protection of depositors of all locally incorporated banks. By concentrating its resources on only a few banks, does this mean that APRA is not carrying out its duty in relation to all locally incorporated banks. In the event of a bank failure (perhaps unforeseen), could this open up APRA (and the taxpayer) to liabilities?

APRA's quarterly reviews assess, inter alia, compliance with minimum prudential ratios. APRA has advised ANAO that the submission of prudential data allows APRA to monitor key trends and convey early warning signals about emerging risks that will be investigated by analysts. However, APRA advised ANAO that, with the current resource restraints and work priorities, full quarterly reviews have been curtailed for low-risk institutions as they represent the least critical supervisory task. If APRA has made on-site visits to only 10 banks, this implies that full quarterly reviews may have been curtailed for as many as 40 of the 50 supervised banks. The curtailment of such a fundamental monitoring of supervised banks is of concern, particularly when it is possible for the financial condition of banks to change rapidly. Examples of factors that can rapidly change the risk profile of a bank include a run on deposits, derivative trading losses, underwriting activities, the failure of counterparties, non-accruing loans and bad and doubtful debt write-offs.

The way APRA's conducts some of its activities contradicts the way APRA expects supervisors in other countries to conduct their own activities. APRA places significant reliance on the supervision conducted by home country supervisors of foreign bank subsidiaries and branches operating in Australia. Yet APRA places significant reliance on host country supervisors of Australian banks' offshore subsidiaries. According to ANAO, APRA has never visited an offshore operation of an Australian bank, even when supervisory activities have raised concerns.

Based on the ANOA Report, there appears to be inconsistencies in APRA's approach. APRA recommends, but does not require, banks to have a credit risk grading system in place. Yet, APRA advised ANAO that, where shortcomings are identified in credit risk grading systems by its supervisory work, it expects these to be corrected...' (P76).

ANAO makes no significant attempt to critically assess the veracity, consistency and viability of APRA's prudential framework or its risk-based approach. The risk-based approach is fundamental to bank supervision now being practiced in Australia. What other countries have adopted the 'risk-based approach'? Why do other major supervisors take a more hands-on approach? Have supervisors in other countries studied the relative costs and benefits of a risk-based approach/hands on approach? The APRA approach appears partly risk-based and partly hands-on – i.e. a very arbitrary situation that does not engender confidence. Is the risk-based approach based on a statistical model for predicting bank distress? What evidence is there that banks that are risk-rated by a supervisor as 'low-risk' will not encounter distress? Is the risk worth any potential loss – a loss that could far exceed the higher costs of hands-on supervision?

## **ANAO Recommendations**

Unfortunately, many of ANAO's recommendations do not provide a definitive way forward to enable resolution of inadequacies identified by ANAO in bank supervision. For example, the recommendations that APRA 'review' or 'consider the merits' of an action or 'periodically' conduct an action is not a positive way to promote action. The recommendations contain no timelines for action.

ANAO found that APRA conducted few on-site visits. ANAO also found inconsistencies with APRA's policy regarding on-site visits. APRA agreed to ANAO's recommendation in relation to on-site visits, yet APRA's qualification to its agreement is open-ended and can effectively be interpreted as a non-response.

ANAO recommends that APRA 'review' prudential restrictions on large exposures. ANAO appeared to express some concern about the extent of large exposures reported by 2 banks (in an audit of only 9 banks, i.e. over 20 per cent of the sample). Yet, the 'review' does not necessarily promote change.

ANAO's Audit Report identified a number of problems but failed to follow through with recommendations. For example:

- There is no recommendation in relation to overseas on-site visits.
- There is no recommendation in regards to APRA carrying out its quarterly reviews of banks (which APRA states it has curtailed for 'low-risk institutions').
- There is no recommendation in relation to how to deal with banks that are reluctant to, or refuse to, comply with Prudential Standards (or to provide information). If banks are aware that they can breach Standards or withhold information with impunity, it is possible that such breaches could conceal and/or promote a dangerous occurrence. APRA should give timeframes for compliance and apply sanctions if compliance continues beyond a specified date. If existing sanctions cannot be enforced without risk to depositors, then the Government should legislate to introduce new sanctions that do not affect depositors (e.g. fines on directors).
- There is no recommendation in regard to processes for supervisory actions when a bank is rated as 'high risk'.
- APRA could only provide ANAO with copies of the supervisory action plans (SAPs) for 4 of the 7 banks whose supervision was examined in detail as part of the audit. Should there not be a recommendation in relation to completing SAPs?

Upon the instigation of ANAO, APRA stated that it will obtain and examine copies of all banking licenses (although this was not made a recommendation by ANAO). Consideration should be given to the legal implications of having licenses issued by a past regulator and whether licenses should be reissued in the name of APRA.

Particularly in view of ANAO finding that bank licenses were not passed on from the Reserve Bank to APRA, is there any other documentation or records that APRA needs to obtain from the Reserve Bank? Should there not be a recommendation to this effect.

## Missing Information or Contentious Information

APRA's risk rating process has produced a 'high-risk' rating for one bank. It is not evident from ANAO's Report whether this bank was one of the banks examined as part of the audit. It is considered important that ANAO should have established the reasons for the bank being rated 'high-risk', when APRA arrived at this rating, whether action could have been taken before the adverse rating to avert the high-risk rating and what action APRA is currently taking. ANAO should have also ensured there are procedures in place to deal with 'high-risk' banks.

ANAO found out of its audit sample of 7 banks, 'most' chief executive declarations had been provided to APRA within the required timeframe with the declaration conforming to APRA's requirements (P55). What systems does APRA have in place to ensure compliance and are there carrots and/or sticks in place to promote compliance? What does 'most' mean?

ANAO found that occasionally external auditor reports did not comply fully with APRA's requirements and, often, reports were provided outside the required period (P56). What systems does APRA have in place to ensure compliance and are there carrots and/or sticks in place to promote compliance? What does 'occasionally' mean?

APRA states 'as part of our credit risk visits to banks that maintain banking operations offshore, we can request a sample of credit files to gain an understanding of how globally based credit risk management systems operate in individual domiciles' (P65). The question is when is this done and by whom?

APRA advised ANAO that '...In some instances, internal model users may not have completely addressed all criteria. Where this is the case, APRA would have '...(my emphasis) ...' undertaken a documented assessment of the materiality of outstandings...' (P78). The use of 'would have' rather than 'did' is intriguing.

APRA advised ANAO that 'None of the Australian banks operating offshore could be regarded'... (my emphasis)...' as undertaking significant trading activities in these locations' (P86). The use of 'could be regarded' does not imbue confidence (on what basis does APRA reach this conclusion?).

It is difficult to come to terms with APRA's belief that if the overseas operations of an Australian bank were impacted by major credit events, this would not have a major impact on the banking group's consolidated capital base and Australian depositors (P86). It would be interesting to see how APRA has developed this belief.

## **Conclusion**

The Basle Committee on Banking Supervision says that ‘strong and effective banking supervision provides a public good that may not be provided by the market place...and it is critical to the financial stability in any country’. The Committee goes on to say that ‘while the cost of banking supervision is indeed high, the cost of poor supervision has been proven to be even higher’.

I believe that bank supervision in Australia does not currently meet the standard of being ‘strong and effective’. The Commonwealth Government must amend APRA’s objectives to make financial safety the paramount objective. Based on the information contained in ANAO’s Audit Report, APRA needs to change its approach, increase its resources (i.e. by increasing levies) and adopt a far more hands-on approach to supervision. The Commonwealth Government may also need to legislate to provide APRA with more ‘carrot and stick’ powers to facilitate banks’ compliance with Prudential Standards and APRA information requirements.

Yours faithfully

Nigel Fitzpatrick



## **SECOND SUBMISSION TO BANKING INQUIRY**

20 August 2001

N.J. Fitzpatrick  
Vic

The Secretary  
House of Representatives  
Standing Committee on Economics,  
Finance and Public Administration  
Parliament House  
CANBERRA ACT 2600

Dear Secretary

### **Re: Inquiry into Banking Supervision**

This letter represents my second submission to the Inquiry, and follows up on a submission that focussed on the Australian National Audit Office (ANAO) Report.

This submission focuses on an issue not raised by ANAO, but I believe should be considered by the Inquiry. This issue relates the 'lowering of the bar' in supervision. In particular, it relates to a submission made by Australian Prudential Regulation Authority (APRA) to the Basle Committee on Banking Supervision (BCBS) on *The New Basle Capital Accord*.

### **Lack of a Balanced Input**

In 2001 APRA made a submission to the Basle Committee on Banking Supervision (BCBS) on *The New Basle Capital Accord* ('Accord'). The Accord, which is being finalised, is expected to be a foundation stone of bank supervision in Australia and globally.

In preparing its submission, APRA held discussions with a number of institutions and received written submissions from a large number of institutions (although, notably National Australia Bank did not make a written submission).

What is of concern to the writer is APRA's overarching emphasis on 'watering down' the proposed *New Basle Capital Accord* (Accord). The writer does recognise that in some areas the Accord (as it currently stands) may be restrictive to Australian banks, but the

emphasis should be on depositors. There may also be substantive areas that may require tightening and which may not overly restrict Australian banks.

The written submissions received by APRA on the Accord were all from financial institutions and, without other substantive external input, it is possible that these institutions had excessive influence over APRA in preparing its own submission on the Accord.

### **Specific Concerns Raised by APRA**

A corner stone in bank supervision is the requirement on banks to maintain minimum levels of capital. The *New Basle Capital Accord* provides new ways to calculate the minimum level of capital, and introduces two methods (a standard approach and, for advanced institutions, an internal ratings based approach).

In its submission to BCBS, APRA expressed a range of concerns on specific areas of the Accord. Indeed APRA stated that ‘while APRA’s preference is to operate as much as possible within an internationally agreed framework we would find it difficult to implement both the standardised and IRB approach as they currently stand’.

APRA’s submission to BCBS requested a number of modifications to, or made views on, the Accord. The writer believes that some of APRA’s proposed modifications or views were not adequately supported in its submission (e.g. by way of analysis). Also, the proposed modifications focus mainly on a watering down of the Accord (e.g. reducing proposed risk weightings and capital requirements). It should, however, be stated that APRA did propose some tightening in a few less significant areas.

The following points are made in relation to APRA’s submission to BCBS:

- APRA states that overall minimum capital requirements for Australian institutions will rise substantially under the standardised approach for credit risk and are likely to fall substantially under a more sophisticated advanced internal ratings based (IRB) approach. Yet, while APRA argues to reduce risk weights for housing and possibly other retail exposures under the standardised approach, it does not argue to increase risk weights under the IRB approach.
- APRA argues that institutions who are unable to move to the more sophisticated IRB approach face a substantial increase in their minimum capital requirements in the order of 20 per cent to over 30 per cent (which would produce a competitive disadvantage in funding costs). However, institutions that adopt the IRB approach will presumably have a lower risk profile and hence lower capital requirements may be justified. The question is what should the difference in capital requirements be?
- BCBS is aiming to produce, on average, neither a net increase nor net decrease in minimum regulatory capital, after accounting for operational risk. APRA states that as the proposals currently stand, however, overall minimum capital requirements will

increase substantially for virtually all institutions on the proposed standardised approach in Australia. However, it is not clear whether this will be the case in other jurisdictions.

- APRA argues that the existing risk weighting for housing loans under the standardised approach is high when compared to actual loan credit history in many countries, including Australia. It must be said that historical comparisons can be dangerous as periods of significant losses can occur on relatively few occasions over a long period. For example, in the 1980s there were a large number of failures of home lenders in the USA; and claims on US mortgage insurers for loans extended in the early 1980s significantly exceeded premiums. Home loan losses are currently relatively low. In the late 1980s/early 1990s, UK-based lenders suffered significant losses on home loans.

One thing is certain though, and that is a continual reduction in risk weights for housing loans will see a greater emphasis placed on this market by institutions (at the expense of, for example, small business loans). Easier and cheaper access to home loans will see more marginal credits written, and possibly cause an unsustainable rise in real estate values. We have already seen a significant rise in loan to valuation ratios and, it appears, a reduction in requirements on borrowers (e.g. low debt service requirements, acceptance of government grants as full deposit, new 25-year loans for persons in their 50s year olds).

In the 6 years to June 2001, housing finance extended by Australian finance intermediaries exploded (note this excludes growth in securitised loans that grew at a much faster rate). During this 6 year period, housing finance grew by 70% in real terms to reach about \$300 billion, while the economy grew by around 28% overall.

The issue is what will happen if interest rates increase significantly, or the economy turns down? In February 2001, the Reserve Bank expressed concerns about some households being over-extended, and this was at a time of low interest rates and low unemployment. In the event of a decline in housing prices, will APRA require banks to revalue their security, potentially resulting in an increase in capital requirements?

It can be argued that housing loan risks have increased since housing loan risk weights were reduced from 100% to 50%. In addition to factors mentioned above, the home loan insurance market has changed. There are fewer home loan insurers. They are insuring loans with high loan to valuation ratios, and their risk levels have grown significantly. In 1997 the Government owned insurer, Housing Loan Insurance Company, was sold.

- APRA has a view that the risk weight for housing loans should be reduced from 50% to 20% under the standardised approach. APRA goes on to say that BCBS may prefer to permit discretion at the lower than 50% housing risk weight where justified by historical loss rates and market characteristics. As outlined above, historical loss rates do not necessarily translate to future loss rates. Also, a market-based approach

appears at odds with APRA's concerns about complexity and subjectivity and with APRA's statement that 'we also strongly endorse the Committee's intention to set up a framework to facilitate consistent application of the new Accord globally'.

- APRA states that formal professional revaluation of security every 3 years 'seems excessive if strictly applied to all exposures'. This may be the case in some situations, but APRA does not provide adequate details of where this is excessive (for example, amortising loans with an initial high loan to valuation ratio, say 80%), and this appears a simplistic argument. It appears more thought also needs to go into situations (e.g. economic or market shocks) where the supervisor would require revaluations.
- APRA's submission stated a view, contrary to the Accord, that borrower credit analysis may not be necessary in some limited circumstances, such as where a bank is engaged in margin lending and has in place a sound operational risk control framework commensurate with the bank's margin lending activities. Currently, it is possible to borrow from margin lenders without providing any credit details (e.g. personal income or assets). The writer believes that this is dangerous, and could cause significant bank losses in the event of a major stock market downturn.
- APRA argues in a number of areas that compliance with the Accord will result in banks incurring a 'heavy burden' or 'excessive costs'. How it reached this conclusion, without for example arriving at dollar values, is difficult to ascertain.
- APRA argues that an explicit charge for interest rate risk should be applied to all institutions, and not just to those institutions with excessive levels of risk (as proposed by the Accord). The writer believes, however, that where excessive risks are identified the prudential supervisor should, in the interim, require additional capital. (i.e. prior to the implementation of a broadly applied standard). This is an area where excessive risks, which are measurable, can be addressed.

Yours faithfully

Nigel Fitzpatrick