

**Australia: Basel Core Principles for Effective Banking Supervision—  
Detailed Assessment of Observance**

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FINANCIAL SECTOR ASSESSMENT PROGRAM UPDATE

# AUSTRALIA

BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING  
SUPERVISION

# DETAILED ASSESSMENT OF OBSERVANCE

NOVEMBER 2012

INTERNATIONAL MONETARY FUND  
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## GLOSSARY

AASB	Australian Accounting Standards Board
ACCC	Australian Competition and Consumer Commission
ACT	Australian Competition Tribunal
ADI	Authorised Deposit-taking Institutions
A-IFRS	Australian International Financial Reporting Standards
AMA	Advanced Measurement Approaches (operational risk)
AML/CTF	Anti-Money Laundering/Counter Terrorist Financing
APRA	Australian Prudential Regulation Authority
APS	Prudential Standards for ADISs
ASIC	Australian Securities and Investments Commission
AUASB	Auditing and Assurance Standards Board
AUSTRAC	Australian Transaction Reports and Analysis Centre
BCP	Basel Core Principles
CFR	Council of Financial Regulators
CP	Core Principle
CPS	Prudential standards applying to ADIs and other regulated entities
D2A	Direct to APRA (reporting)
FATF	Financial Action Task Force
FCS	Financial Claim Scheme
FIRB	Foreign Investment Review Board
FSAP	Financial Sector Assessment Program
FSCODA	Financial Sector (Collection of Data) Act
FSBTGR	Financial Sector (Business Transfer and Group Restructure) Act
FSSA	Financial Sector (Shareholdings) Act
FTR	Financial Transaction Reporting Act
GFC	Global Financial Crisis
GRCL	General Reserve for Credit Losses
ICAAP	Internal Capital Adequacy Assessment Process
IRRBB	Interest Rate Risk in the Banking Book
KYC	Know Your Customer
MOU	Memorandum of Understanding
NOHC	Non Operating Holding Company
PAIRS	Probability and Impact Rating System
PCR	Prudential Capital Ratio
PPG	Prudential Practice Guide
QRR	Quarterly Risk Review
RAS	Risk Appetite Statement
RBA	Reserve Bank of Australia
RFC	Registered Financial Corporation
SAP	Supervisory Action Plan
SMR	Suspicious Matter Report
SOARS	Supervisory Oversight and Response System
TTBC	Trans-Tasman Council on Banking Supervision

## I. SUMMARY, KEY FINDINGS, AND RECOMMENDATIONS

1. **Australia has a very high level of compliance with the Basel Core Principles for Effective Banking Supervision (BCPs).** The Australian banking system was more sheltered than a number of other countries and weathered the Global Financial Crisis relatively well. This was in part due to relative concentration of the system on a well performing domestic economy, but also due to a material contribution from a well-developed regulatory and supervisory structure. Notable strengths of the Australian supervisory approach rest in its strong risk analysis and on the focus of the responsibility of the Board. The Australian banking system however, is still vulnerable to continuing aftershocks of the financial crisis not least as banks' funding profiles could be a conduit of instability.

2. **The assessors saw many examples of high-quality initiatives and practices in the supervisory authority (APRA).** APRA's response to the global financial crisis has been to intensify its supervisory practices and to move to an early, and conservative, adoption of key aspects of the international regulatory reform agenda, especially the Basel III capital and liquidity framework. The reform agenda presents challenges of implementation for supervisors and firms alike but continued fragilities in the global system mean that continued development of supervisory standards and firm based practices in risk management and liquidity remain at a premium and continued efforts are needed to advance depth and intensity of the supervisory approach in liquidity. There are some aspects of the legislative framework which need to be addressed to ensure that APRA will be able to act in a fully effective and efficient manner should weaknesses emerge within the banking system or within individual institutions.

### A. Introduction

3. **This assessment of the current state of the implementation of the BCPs in Australia has been completed as part of a Financial Sector Assessment Program (FSAP) undertaken by the International Monetary Fund (IMF) during 2012.** It reflects the regulatory and supervisory framework in place as of the date of the completion of the assessment. Importantly, it is not intended to assess the merits of the important policy and implementation issue regarding several aspects of the international regulatory framework that are yet to be decided in international fora and in Australia. An assessment of the effectiveness of banking supervision requires a review of the legal framework, both generally and as specifically related to the financial sector, and detailed examination of the policies and practices of the institutions responsible for banking regulation and supervision. In line with the BCP methodology, the assessment focused on the major banks and banking groups, and their regulation and supervision, given their importance to the system.

## B. Information and Methodology Used for Assessment

4. **The Australian authorities agreed to be assessed according to the Core Principles (CP) Methodology issued by the Basel Committee on Banking Supervision (Basel Committee) in October 2006.** The current assessment was thus performed according to a revised content and methodological basis as compared with the previous BCP assessment carried out in 2005. The assessment of compliance with each CP is made on a qualitative basis to allow a judgment on whether the criteria are fulfilled in practice. Effective application of relevant laws and regulations is essential to provide indication that the criteria are met.
5. **To assess compliance, the BCP Methodology uses a set of essential and additional assessment criteria for each principle.** The essential criteria (EC) are the only elements on which to gauge full compliance with a core principle. The additional criteria (AC) are suggested best practices against which the Australian authorities have agreed to be assessed. Additional criteria are commented on but are not reflected in the grading. The assessment of compliance with each principle is made on a qualitative basis. A four-part grading system is used: compliant; largely compliant; materially noncompliant; and noncompliant. This is explained below in the detailed assessment section.
6. **The assessment team reviewed the framework of laws, rules, and guidance and held extensive meetings with officials of APRA, the RBA, the Treasury and banking sector participants.** The team met the industry association representing banks in addition to a number of domestic and non-domestic institutions, as well as detailed responses to additional questionnaires and facilitated access to supervisory documents and files.
7. **The team appreciated the very high quality of cooperation received from the authorities.** The team extends its thanks to staff of the authorities who provided excellent cooperation, including extensive provision of documentation, at a time when many other initiatives related to domestic and global regulatory initiatives are in progress.
8. **The standards were evaluated in the context of the Australian financial system's sophistication and complexity.** It is important to note that Australia has been assessed against the BCP as revised in 2006. This is significant for two reasons: (i) the revised BCP have a heightened focus on risk management and its practice by supervised institutions and its assessment by the supervisory authority; and (ii) the standards are evaluated in the context of a financial system's sophistication and complexity.

9. **An assessment of compliance with the BCPs is not, and is not intended to be, an exact science.** Reaching conclusions required judgments by the assessment team.<sup>1</sup> Banking systems differ from one country to another, as do their domestic circumstances. Furthermore, banking activities are undergoing rapid change after the crisis, prompting the evolution of thinking on and practices for supervision. Nevertheless, by adhering to a common, agreed methodology, the assessment should provide the Australian authorities with an internationally consistent measure of the quality of its banking supervision in relation to the revised Core Principles, which are internationally acknowledged as minimum standards.

10. **To determine the observation of each principle, the assessment has made use of five categories: compliant; largely compliant, materially noncompliant, noncompliant, and non-applicable.** An assessment of “compliant” is given when all essential criteria are met without any significant deficiencies, including instances where the principle has been achieved by other means. A “largely compliant” assessment is given when there are only minor shortcomings, which do not raise serious concerns about the authority’s ability to achieve the objective of the principle and there is clear intent to achieve full compliance with the principle within a prescribed period of time. A principle is considered to be “materially noncompliant” in case of severe shortcomings, despite the existence of formal rules and procedures and there is evidence that supervision has clearly not been effective, the practical implementation is weak or that the shortcomings are sufficient to raise doubts about the authority’s ability to achieve compliance. A principle is assessed “noncompliant” if it is not substantially implemented, several essential criteria are not complied with, or supervision is manifestly ineffective. Finally, a category of “non applicable” is reserved (though not used) for those cases that the criteria would not relate to the Australian authorities.

11. **For completeness’ sake, it should be noted that the ratings assigned during this assessment are not directly comparable to the ones assigned in terms of an FSAP performed using the pre-2006 BCP Methodology.** Differences may stem from the fact that the bar to measure the effectiveness of a supervisory framework was raised by the 2006 update of the BCP Methodology, as well as by lessons drawn from the financial crisis that may have a bearing on supervisory practices.

### **C. Institutional and Macroeconomic Setting and Market Structure—Overview<sup>2</sup>**

12. **Australia’s financial sector is large and mature with assets totaling 330 percent of GDP.** The financial sector has grown rapidly over much of the last two decades, and two types of assets have contributed significantly to its growth, i.e., home mortgages and superannuation funds (a retirement scheme comprising mandatory contributions by

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<sup>1</sup>The assessment team comprised Michael Deasy and Katharine Seal.

<sup>2</sup>This section draws from the Financial System Stability Assessment.

employers and voluntary and tax-concessional contributions by employees). ADIs, mostly banks, are the dominant group of financial institutions with 60 percent of financial sector assets, followed by superannuation funds (including investment-linked superannuation written by life insurance companies) with 25 percent. The non-life insurance sector is relatively small with 3 percent of financial sector assets, and non-superannuation managed funds have another 6 percent. The stock market had a capitalization of 80 percent of GDP at end-2011, although this was below the peak of 150 percent in mid-2007.

13. **Australia's financial sector faces a unique set of risks.** Its concentrated banking sector dominated by four large banks with broadly similar business models and reliance on offshore funding, reflects long standing structural issues that will remain key sources of risk over the medium-term. Against a pessimistic global environment, these risks will need to be closely managed, particularly if the domestic economy slows sharply.

14. **Profitability of the Australian banking system remains strong and the banking system is well-capitalized.** The four major Australian banks reported aggregated after tax profits of \$11 billion in the year ended June 2012, up 1 percent from the previous year. The return on equity for the major banks has remained steady over the past two years at 15 percent. Australian ADIs have been increasing regulatory capital in advance of the implementation of Basel III from 2013. APRA has taken a more conservative stance in certain areas than is required by the BCBS standards, including requiring banks to maintain higher quality capital (in terms of deductions) and to meet an accelerated timetable for meeting minimum requirements for Tier 1 capital). As of June 2012, the aggregate Tier 1 capital ratio for Australian banks was 10.5 percent of risk-weighted assets, up from 8.5 percent in 2009. The total capital ratio was 11.8 percent as of June 2012.

## II. PRECONDITIONS FOR EFFECTIVE BANKING SUPERVISION

### A. Sound and Sustainable Macroeconomic Policies

15. **Five years after the U.S. sub-prime debacle triggered the global financial crisis (GFC), the Australian economy continues to thrive and the outlook remains favorable.** Australia is one of the few advanced economies to avoid a recession, in part because of strong fundamentals at the onset of the crisis. Growth dipped only briefly below trend during the crisis and rebounded quickly, supported by robust demand for commodities from China, which fueled a mining boom and pushed the terms of trade to 60-year highs. As a result, the current account deficit fell to about 2½ percent of GDP in the first half of 2011 from an average of 4½ percent for the previous 15 years. The economy and the financial sector continue to outperform most of the country's peers with the economy expected to grow close to trend at 3-3.5 percent annually in 2012 and 2013. Inflation, meanwhile, is expected to remain subdued and well within the authorities' target band of 2-3 percent over the medium term and the government has made returning to surplus by 2012/13 a major policy priority. In



addition, unlike many other advanced economies, Australia's monetary policy space is still sizable and output is close to potential.

## **B. A Well-Developed Public Infrastructure**

### **16. Policy coordination and cooperation between Australia's four main financial sector agencies is supported mainly through the Council of Financial Regulators (CFR).**

The CFR is the primary coordinating body for Australia's main financial sector agencies: the RBA (Chair), APRA, ASIC, and Treasury. The CFR's objectives are specified in its Charter and require it to promote the stability of the Australian financial system and to contribute to the efficiency and effectiveness of financial regulation. The CFR does not have a legal personality, nor does it have powers separate from its member agencies. Its members share information and views and advise the Government on Australia's financial system architecture. APRA and the RBA both have mandates for financial stability and have legal gateways to share institution-level data that is needed for them to carry out their respective duties.

**17. A significant area of regulatory cooperation is the Trans-Tasman Council on Banking Supervision (TTBC).** The TTBC comprises representatives of the Australian and New Zealand Treasuries, the RBA, the Reserve Bank of New Zealand, and APRA. Trans-Tasman cooperation has been enhanced by legislation passed in 2005 by Australian and New Zealand parliaments. These laws implement reciprocal obligations that require APRA and the Reserve Bank of New Zealand to support the other agency in meeting its statutory responsibilities for prudential regulation and financial stability. These laws also oblige the regulators to seek to avoid actions, where reasonably practicable, that are likely to be detrimental to the other country's financial stability. In 2010, the TTBC agencies, along with ASIC, signed a Memorandum of Cooperation on the management of trans-Tasman bank distress and in 2011, the TTBC started developing guidance on the joint resolution of distress in a trans-Tasman bank.

**18. The common law system, as developed in the United Kingdom, forms the basis of Australian jurisprudence.** The Australian Constitution of 1901 established a federal system of government, under which powers are distributed between the Commonwealth and the six States. It defined exclusive powers (investing the federal government with the exclusive power to make laws on matters such as trade and commerce and taxation). The states and territories have independent legislative power in all matters not specifically assigned to the federal government. Where there is any inconsistency between federal and state or territory laws, federal laws prevail. Federal laws apply to the whole of Australia. In effect, Australia has seven legal systems—the six state and territory systems and one federal system. Each of the federal and state systems incorporates three separate branches of government—legislative, executive and judicial. The Constitution grants the legislative power to Parliament. Proposed legislation must be passed by both Houses of Parliament—the Senate

and House of Representatives. Only Parliament can pass Acts to create statute law, but these Acts often confer on the Executive the power to make regulations, rules and by-laws pursuant to the particular Acts. The executive government administers the laws which the judiciary independently interprets and applies.

19. **There is a strict separation between the Judiciary and the Parliament and Executive.** Only courts can exercise the judicial power of the Commonwealth to decide whether a person has contravened a law of the Commonwealth Parliament. Dispute in Australia can be settled through the judicial system. The High Court decides disputes concerning the meaning of the Constitution and is also the final court of appeal. The Australian legal system provides for enforcement of the judgments of Australia courts, including by courts in a different state from which a judgment was made. A foreign judgment has no inherent legal force in Australia. Therefore, to enforce a foreign judgment an applicant must seek recognition and enforcement under either the common law or a statutory regime. The Foreign Judgments Act 1991 provides a statutory regime for the recognition and enforcement of certain foreign judgments. Where the Act does not apply, the common law governs the recognition and enforcement of foreign judgments. Australia has a number of options available for alternative dispute resolution. These include mediation, conciliation, conferencing, neutral evaluation and arbitration. In Australia there is generally no requirement to undertake alternative dispute resolution before seeking court resolution.

20. **Australia has implemented International Financial Reporting Standards (IFRS).** Accounting standards in Australia are made by the Australian Accounting Standards Board (AASB). The AASB's role changed following adoption of the International Financial Reporting Standards (IFRS) in Australia as it is now involved in the International Accounting Standards Board's IFRS standard-setting process. The AASB reviews IFRS text to ensure they are appropriate for Australia and issues Australian equivalent A-IFRS which apply to Australian companies with the force of law. The Financial Reporting Council, which is the body responsible for overseeing the effectiveness of the financial reporting framework in Australia, provides oversight of the AASB's activities. There is a full range of high-quality accountancy, audit, legal, and ancillary financial services available in the jurisdiction.

### **C. Effective Market Discipline.**

Australia's corporate financial reporting requirements are contained in the Corporations Act. Australian auditing standards are made by the Auditing and Assurance Standards Board (AUASB) and are based on the International Auditing and Assurance Standards Board.

21. **Australia has a well-developed capital market.** Its stock exchange, ASX, functions primarily as a trading operator, clearing house and settlements system facilitator. It oversees compliance with its listing rules, promotes standards of corporate governance among listed companies and seeks to educate retail customers. It places particular emphasis on

transparency and disclosure. Overall, capital markets corporate governance systems comply with the OECD Principles of Corporate Governance. The listed equity market is quite active with over 2,200 companies listed on the exchange. Its debts market is relatively underdeveloped and its over-the-counter market, though active, is small by international standards.

#### **D. Financial Sector Safety Net**

22. **The Reserve Bank of Australia plays a key role in managing and providing liquidity to the financial system.** It is the ultimate provider of liquidity to the financial markets. As well as fostering lower inflation and sustainable growth, it also seeks to ensure that the payment system is safe and robust. It also plays a key role in developing a framework for dealing with financial institutions in distress. It chairs the CFR. The objectives of the Council include the promotion of the stability of the Australian financial system and to contribute to the efficiency and effectiveness of financial regulation.

23. **A Financial Claim Scheme was established in October 2008 for authorized deposit-taking institutions (ADIs) and general insurers.** The FCS is a deposit protection scheme which provides for prompt access to deposits if they fail. The FSC is activated for an ADI when APRA has determined that the ADI is insolvent and has applied to the Court to be wound up. The maximum payout to a depositor is \$250,000 (it had been \$1 million between 2008 and 1 February 2012 to foster confidence in the banking system). The FCS is ex-post funded, so, , payouts will initially come from the Government but any eventual shortfall will be met by a levy on the industry.

#### **E. Main Findings**

##### **Objectives, independence, powers, transparency, and cooperation (CP1)**

24. **APRA has clear responsibility for the supervision of banks in Australia.** While Australia classifies APRA as an independent statutory authority, there are two areas where there is the potential for APRA's independence to be compromised. One relates to the fact that the Minister may give APRA a written direction about policies it should pursue, or priorities it should follow, in performing or exercising any of its functions or powers. Such a direction may only be given once the Minister has given APRA notice in writing of the proposed direction, and given the Chair of APRA an adequate opportunity to discuss with the Minister the proposed direction. Further, where a direction is given, that direction must be laid before each House of Parliament within 15 sitting days. The second relates to the fact that prudential regulations made by APRA must be tabled in each House of Parliament. After the prudential standards have been laid before each House, a notice of motion to disallow the prudential standards may be given within 15 sitting days. If the notice of motion to disallow is then passed within 15 sitting days after the giving of the notice, the regulations will cease

to have effect, APRA has said that neither of these provisions has ever been invoked and that they are not likely to be. Nonetheless, they have the potential to compromise the independence of APRA.

25. **There is no provision mandating the public disclosure of the specific reasons for the termination of the appointment of APRA Members** (i.e., its governing body).

26. **The membership of APRA’s Risk Management Committee and Audit Committee membership comprises both internal and external members.** It is recommended that a separate audit committee be established whose membership would comprise external members only.

#### **Licensing and structure (CPs 2–5)**

27. **The Australian regulatory approach regarding licensing and control are broadly appropriate and clearly articulated.** There remain, however, some areas where adjustments are needed. Australian law permits the existence of non-authorized, non-supervised financial companies who are carrying out deposit like activities. While the number of such institutions is small and the scale of their activities is mostly de minimis, there are major global institutions benefitting from this exemption and deposit like facilities are being offered to the public. At present, APRA is subject to an unnecessary reputational risk arising from this source.

28. **There is some degree of legal restriction on APRA’s powers concerning the right to object to or prevent a change of control of an ADI.** The Treasurer, rather than APRA, has the power of approval for change of control for ADIs whose asset-size exceeds one billion. The Treasurer is legally responsible for approving the holding of a stake in any ADI in excess of 15 percent. The Treasurer has delegated approval authority to APRA in cases where the ADI’s assets are less than \$1 billion, and the Treasurer takes advice from APRA in relation to ADI’s with assets are greater than \$1 billion. Although there is no indication that the Treasurer would fail to abide by advice from APRA where the supervisor had concerns, it would support the clarity of APRA’s responsibilities for it to be given a binding right of veto on prudential grounds concerning change of control of ADIs irrespective of the scale of the entity.

#### **Prudential regulation and requirements (CPs 6–18)**

29. **Australia has historically adopted a very conservative definition of capital.** This stance is being maintained with the advent of the revised Basel III capital framework as APRA intends to remain super-equivalent to the Basel standard. This means that the capital levels in Australian banks can appear low relative to their peers, so it is important for the supervisor and the industry to press for strong and comparable disclosure standards so that

the capital strength of the Australian banking sector can be accurately assessed and compared with the global community.

30. **APRA undertakes a well-structured Pillar 2 assessment.** However, while APRA reviews the firms' Pillar 2 assessments (ICAAPs) it does not use this input as the sole or main determinant of the minimum level of capital that banks must hold. Instead APRA places greater weight upon its PAIRS rating methodology as an input. This choice reflects a number of factors including the supervisor's view that the ICAAP process in banks is not sufficiently mature or robust to act as the sole determinant of the capital level. APRA continues to focus effort on the improvement of the banks' ICAAP assessments. Banks are required to hold capital above the minimum level prescribed by APRA, but the size of the buffer is at the firm's individual discretion.

31. **APRA's supervisory approach is based squarely on the premise that risk management stems from the Board's responsibilities for management and oversight.** The processes and procedures embedding good risk management within the banks are still undergoing seasoning, however, and not all firms have achieved the same level of art. Broadly, while progress is being made throughout the industry, firms need to strengthen their work on relating risk to capital. Stress testing practices need further development.

32. **Credit risk management, including impaired assets and provisioning are well developed in Australia.** APRA keeps track of emerging credit risk issues on an industry wide basis, through its risk register and this aids assessment of sectorial concentrations. There is well established policy on large exposures which is being reviewed. In the context of a highly concentrated banking system, there is a tension between cautious prudential limits for the interbank market and the practical options open to institutions which APRA must consider. Similarly appropriate limits with respect to sovereign risk must be assessed in the context of the forthcoming Basel III liquidity framework which will generate concentrations. With the exception of domestic exposure, sovereign risk is not a major feature of the banking system but, despite its low levels, APRA monitors country risk and has given direction to industry during the Global Financial Crisis.

33. **A notable feature of the Australian banking system at the time of the assessment is a significant exposure to overseas wholesale funding.** Consequently the natural focus of much of APRA's analytical work and engagement with the industry has been upon funding issues. Nevertheless, APRA must guard against too narrow a focus on the funding dimension of liquidity risk. Work undertaken in recent years to review liquidity standards, including contributing the Basel III work, and intensifying off-site data analysis needs to continue.

34. **A comprehensive regime for the oversight of money laundering and terrorism financing has only been relatively recently introduced.** Some banks, therefore, have yet to

introduce a sufficiently advanced technology system that would eliminate possible errors using less sophisticated means.

### **Methods of ongoing banking supervision (CPs 19–21)**

35. **APRA has a thorough understanding of the operation of individual banks and the banking system.** APRA operates a risk based supervisory model which is informed by a peer review process and supported by an extensive and flexible information technology system. The rating methodology used in the risk assessment itself is supported by internal guidance and ratings criteria which are subject to regular review and update. The ratings criteria provide a mix of concrete and judgmental factors, the latter of which puts a premium on the skill set of staff to ensure the exercise of sound supervisory discretion. As in other jurisdictions, continued evolution of the risk methodology to enhance its forward looking dimension will be important. Much of APRA’s activity seeks to embed a common approach to banking and insurance sectors and this is notable in the issuance of joint prudential standards where possible (e.g., corporate governance). APRA is therefore well placed to analyze the relationship of risks between these sectors and should begin to focus more on this area. The development of the “Level 3” (conglomerate) approach should be used as a platform to stimulate such work.

36. **While APRA conducts a well planned and well executed approach to on and off-site supervision the resource allocation to on-site reviews is modest.** The frequency and intensity of direct on-site supervision with the institutions has been increased since the GFC and at a minimum this heightened level needs to be maintained. As a matter of importance, APRA should consider extending the duration of its on-site reviews to ensure that it is able to fully scrutinize the institution’s own understanding and risk management practices.

### **Accounting and disclosure (CP 22)**

37. **Accounting and Auditing Standards are set to a very high standard in Australia and are based on best international practice.** They are also implemented to a high standard. On the Accounting front, IFRSs were introduced in 2005 and Australia has also adopted the audit standards promulgated by the International Auditing and Assurance Board.

### **Corrective and remedial powers of supervisors (CP 23)**

38. **APRA has a wide range of supervisory tools to deal with problems arising in banks.** These range from seeking to resolve the problem through standard supervisory actions, to appointing a person to investigate and report on financial matters, issuing directions which embrace a wide set of powers (e.g., directing banks to cease or curtail business), removing directors, senior management or auditors, effecting a compulsory transfer of business, revoking a license.

### Consolidated and cross border banking supervision (CPs 24–25)

39. **APRA meets the requirements for effective consolidated supervision.** APRA meets the standard in terms of overseeing group risk management structures, being informed of breaches of prudential standards on a group-wide basis, calculating the necessary ratios on a solo and consolidated basis, etc. APRA should consider extending the scope of its reviews to cover risks unique to non-banking activities carried on within the group, e.g valuation of assets/pricing of units in the case of fund management.

40. **Table 1 below offers a principle-by-principle summary of the assessment results.**

**Table 1. Summary Compliance with the Basel Core Principles—Detailed Assessments**

Core Principle	Grading	Comments
1. Objectives, independence, powers, transparency, and cooperation		
1.1 Responsibilities and objectives	C	
1.2 Independence, accountability and transparency	LC	APRA's independence could be compromised by the following provision: The Minister may give APRA a written direction about policies it should pursue, or priorities it should follow, in performing or exercising any of its functions or powers. There is no mandated provision for the public disclosure of the terms relating to the termination of appointment of an APRA Member (i.e., a member of its governing board). APRA has a risk management and audit committee whose membership comprises both internal and external members. Internal membership on an audit committee is contrary to good corporate governance practices.
1.3 Legal framework	LC	Prudential regulations made by APRA must be tabled in each House of Parliament and may, in certain circumstances, be disallowed by parliament.
1.4 Legal powers	C	
1.5 Legal protection	C	Staff are protected against the costs of defending their actions and/or omissions made while discharging their duties in good faith, however the provisions in the APRA Act do not explicitly detail costs.
1.6 Cooperation	C	

2. Permissible activities	LC	Australian law permits the existence of non-authorized and non-supervised deposit taking institutions. The number of such institutions is small and the scale of their activities is predominantly de minimis, however there are major global institutions benefitting from this exemption within the Australian market and deposit-like facilities are being offered to the public.
3. Licensing criteria	LC	APRA has a clearly established process for the authorization of banks. APRA has clearly stated powers to reject applications that do not meet the necessary standards and is not obliged to grant a banking authority within a prescribed timeframe. However, APRA do not routinely undertake independent checks on new directors or shareholders under the fit and proper criteria, relying instead on scrutiny of information provided by the institution.
4. Transfer of significant ownership	MNC	APRA's powers concerning the right to object to or prevent a change of control of an ADI are subject to restriction. This restriction applies to APRA in respect of all systemic banks and is thus material. APRA does not systematically check the ownership of ADIs. Typically there is a wide spread of ownership (in all but one case at present).
5. Major acquisitions	C	APRA has full powers to review major acquisitions or investments.
6. Capital adequacy	C	APRA has long adopted a conservative approach to the definition of capital; a stance that will be maintained through the transition to the Basel III framework.
7. Risk management	LC	APRA's emphasis upon Board responsibility provides a sound foundation for good risk management governance. The processes and procedures embedding good risk management within the banks are still undergoing seasoning, however, and not all firms have achieved an appropriate standard of linking capital to risk.
8. Credit risk	C	Credit risk is the predominant risk within the Australian banks' balance sheets and APRA has a well articulated, well understood and well practiced approach to assessing the level of credit risk and the quality of credit risk management within the banking system.
9. Problem assets, provisions, and reserves	C	Impaired assets are at a low level within the Australian banking system but APRA operates a prudent regime challenging banks to establish adequate policies and processes for managing problem assets and ensuring adequacy of provisioning.
10. Large exposure limits	C	APRA has a clear set of policies on large exposures and concentration risk which are due to be reviewed, an initiative that will be able to take account of work conducted by the Basel Committee.



11. Exposure to related parties	LC	APRA has clear prudential standards governing lending to related entities and APRA has powers to define a connected entity on a case by case basis, but some relevant institutions may fall outside of the definition within the current prudential standard, even though there may be effective reporting. The prudential standard does not cover lending to connected individuals and corporate law while governing some aspects of connected lending does not address all relevant individuals and applies only to public companies.
12. Country and transfer risks	C	APRA has few regulatory requirements specifically targeted at country and transfer risk though it meets compliance with the standard largely through its comprehensive approach to credit risk management. In future country and transfer risk may become a much more significant aspect of the banking system's risk profile and may merit more explicit attention within the prudential standards.
13. Market risks	C	APRA maintains and enforces clear standards and has close cooperation with the UK FSA which is valuable in the context that the major Australian institutions have market operations running out of London.
14. Liquidity risk	LC	APRA has undertaken significant work on its liquidity regime in recent years in both quantitative and risk management terms. Much progress has been made, notably in respect of data requirements from firms but more is needed both in respect of data requirements and in terms of on-site inspection by APRA. A notable feature of the Australian banking system at the time of the assessment is a significant exposure to overseas wholesale funding. Consequently the natural focus of much of APRA's analytical work and engagement with the industry has been upon funding issues. Nonetheless, it is important that APRA guards against too narrow a focus upon the funding dimension of liquidity risk.
15. Operational risk	C	
16. Interest rate risk in the banking book	C	
17. Internal control and audit	C	While all banks have a permanent compliance function, there is no explicit provision for banks to establish one.
18. Abuse of financial services	LC	Because of the relatively recent introduction of a comprehensive regime for the oversight of money laundering and terrorism financing, some banks have yet to introduce a sufficiently advanced technology system that would eliminate possible errors using less sophisticated means.
19. Supervisory approach	C	APRA supervisors possess a comprehensive understanding of banks and banking groups.

20. Supervisory techniques	C	APRA conducts a well planned and well executed approach to on and off-site supervision. The frequency and intensity of direct contact supervision with the institutions has been increased since the Global Financial Crisis.
21. Supervisory reporting	C	
22. Accounting and disclosure	C	
23. Corrective and remedial powers of supervisors	C	
24. Consolidated supervision	LC	APRA's onsite review regime does not extend to review of risks unique to non-bank activities as a matter of course.
25. Home-host relationships	C	

*Aggregate:* Compliant (C) – 20, Largely compliant (LC) – 9, Materially noncompliant (MNC) – 1, Noncompliant (NC) – None (note: CP 1 is divided into six component for this analysis.)

### III. RECOMMENDED ACTION PLAN AND AUTHORITIES' RESPONSE

#### Recommended action plan

41. **Table 2 lists the suggested steps for improving compliance. Recommendations are proposed on a prioritized basis.**

**Table 2. Recommended Action Plan to Improve Compliance with the Basel Core Principles<sup>3</sup>**

Reference Principle	Recommended Action
1.2 Independence, powers, transparency and cooperation	<p>While the difficulties are fully recognized in seeking to address the independence issue and that removing the relevant provisions go beyond APRA to other statutory authorities, operational independence is a key factor in enabling a prudential financial regulator to carry out its function in the best interests of depositors and the financial system as a whole. It is suggested that APRA explore with the Australian Government possible avenues which would ensure unambiguous independence within APRA.</p> <p>Legal provision should be made to mandate the public disclosure of the terms relating to the termination of appointment of an APRA Member.</p> <p>It is recommended that APRA's Risk Management and Audit Committee be split in two and that membership of the new audit committee is comprised solely of external members.</p>

<sup>3</sup>Please note that this table does not contain all recommendations within the report. It highlights the main recommendations only.

Reference Principle	Recommended Action
1.3 Legal framework	Provide APRA with sufficient delegated powers, clearly circumscribed to the prudential sphere, to ensure that the supervisor can issue prudential regulations without additional Parliamentary procedures.
2. Permissible activities	Revise the conditions for exemption from section 11 of the Banking Act for RFC to ensure, at a minimum, that such exemptions be limited to institutions reliant wholly on wholesale funding.
3. Licensing criteria	Evaluate proposed directors and senior management as to expertise and integrity at point of authorization, on a complete and systematic basis, independently from the information provided by the institution to ensure a sound judgment by the supervisor that is not based on information that may be at risk of bias.
4. Transfer of significant ownership	Ensure that APRA has the legal right to prevent a change of control of any ADI on prudential grounds. Ensure that requirements are in place for a bank or ADI to notify the supervisor, at a minimum, on an annual basis of major shareholders including ultimate beneficial shareholders.
7. Risk management	Put in place more guidance or regulation on APRA expectations for enterprise risk management, in particular with respect to capital planning related to risk. Continue to subject banks to regular detailed APRA assessment and feedback to achieve appropriate levels of practice in firms.
11. Exposure to related parties	Review and amend prudential standards to ensure that all lending transactions with related parties – both entities and individuals--above a threshold (whether at normal terms or not) are approved by the board.
14. Liquidity risk	Increase the frequency and duration of on-site review of liquidity risk management. Finalize the program of enhanced liquidity risk regime, including revised reporting standards to ensure that firms are capable of providing accurate, system wide, comparable data on a daily basis if required and ensuring the general principles of liquidity risk management are applied to and adhered to by all institutions.
17. Internal control and audit	It is recommended that an explicit requirement be introduced for banks to have a permanent compliance function.
18. Abuse of financial services	It is recommended that banks be given a deadline within which they must install the necessary technology to enable them to meet effectively the obligations under the AML/CTF legislation.
24. Consolidated supervision	It is recommended that APRA extends its onsite supervisory regime to include an examination of risks unique to non-banking activities carried on within the bank/group as a matter of course e.g., valuation of assets/pricing of units in the case of fund management activity.

## Authorities' response to the assessment

42. **The Australian authorities wish to express their appreciation to the IMF and its assessment teams for their assessment.** Australia is strongly committed to the FSAP process and the insights that the FSAP provides into a country's financial sector. Australia acknowledges that it is important to continually review and seek to improve the regulatory framework and supervision practices.

43. **The Australian authorities share the view expressed in the report that Australia has a very high level of compliance against the Basel Core Principles.** There are some ratings, however, with which the Australian authorities disagree.

44. **Importantly, the Australian authorities consider that any assessment of a country's supervisory framework should appropriately reflect the outcomes of that framework.** The strength of Australia's banking system—particularly in the face of the global financial crisis—demonstrates the robustness of Australia's supervisory approach.

45. **The Australian authorities consider that there are some principles for which the rating does not reflect the strengths and performance of Australia's supervisory approach or where the issues raised are more theoretical than reflective of actual deficiencies in practice or outcomes.** These include the following Core Principles:

- **CP 3 Licensing criteria.** The IMF has recommended that APRA evaluate proposed directors and senior management as to expertise and integrity at point of authorisation, on a complete and systematic basis, independently of the information provided by the institution. APRA undertakes its role as gatekeeper very seriously. It subjects licence applications, including proposed directors and senior management, to a comprehensive and thorough evaluation process, which includes independent checks (including reference to the home supervisor) as required. Licensing involves an iterative evaluation process commonly taking up to 18 months. APRA would not authorise a bank where there are unresolved concerns in any area including the fitness and propriety of an applicant's directors or senior management. The Australian authorities are not aware of the assessment finding any evidence of deficiencies in the outcomes of APRA's robust licensing process.
- **CP 7 Risk management.** The IMF has assessed Australia as 'Largely Compliant' on the basis that not all banks have achieved an appropriate standard of risk management, particularly in relating risk to capital. This is an assessment of the performance of Australian banks not of the supervisor or supervisory regime, an interpretation of CP 7 that, in the view of the Australian authorities, the IMF does not appear to have applied consistently. The Australian authorities have strong reservations about this interpretation and the resulting assessment. Achievement of

strong practice in risk management is evolutionary; it goes to the heart of the role of a prudential supervisor to raise the risk management bar. APRA will continue to push banks to better practice, and where it is not satisfied with the adequacy of a bank's risk management, it has taken and would take action.

- **CP 11 Exposure to related parties.** The assessment finds a narrow gap in the current prudential framework in this area. However, the assessment finds no evidence of issues in practice and does not recognise that APRA's supervisory framework and powers ensure that any issues that may arise in this area are identified and pursued.
- **CP 14 Liquidity.** In Australia's view, APRA's comprehensive approach to supervision of liquidity risk meets the requirements of this Core Principle. The Australian authorities are concerned, in particular, that the IMF has taken a narrow definition of 'on-site reviews' and has discounted the breadth and frequency of APRA's interactions with banks in relation to liquidity risk. These interactions ensure that APRA has a comprehensive understanding of all aspects of liquidity risk management. Further, the assessment does not recognise that banks are able to provide accurate liquidity data, on a daily basis if required. In the context of the new Basel III liquidity standards, the format of the prudential reporting requirements for liquidity—including daily reporting capacity—will be standardised.
- **CP 18 Abuse of financial services.** The IMF has stated that the need for increased technology is the basis for the 'largely compliant' rating on this principle. It is suggested that increased technology is needed to prevent the banks from being used, intentionally or unintentionally for criminal activities. The Australian authorities observe that the banks are directing significant resources to system improvements for AML/CTF and other monitoring and control purposes, for example the US FATCA requirements. Within this context, the authorities are generally comfortable with the pace of technology upgrade by the banks. Although some of these improvements are still in train, the authorities do not believe that the ongoing nature of these upgrades is impeding the ability of banks to satisfy the essential criteria of this core principle.
- **CP 24 Consolidated supervision.** The Australian authorities consider that the essential criteria are met through APRA's supervisory practices. As a matter of course, APRA evaluates the risks that non-banking group activities may pose to the bank or banking group. Consistent with its risk-based approach to supervision, APRA can, and does on a routine basis, conduct on-site reviews of such activities where they are material to the bank or banking group. In many cases, non-banking activities are either immaterial or conducted in entities that have little capacity to impact on the overall soundness of the banking group. The Australian authorities do not consider

that on-site reviews of these entities as a matter of course is necessary or required by CP 24.

46. **The Australian authorities have serious concerns about the justification for the ‘Materially Non-Compliant’ rating on CP 4 Transfer of significant ownership.** This rating is intended to apply ‘in the case of severe shortcomings, despite the existence of formal rules and procedures and where there is evidence that supervision has clearly not been effective, the practical implementation is weak or that the shortcomings are sufficient to raise doubts about the authority’s ability to achieve compliance’. The issues raised by the assessment do not appear to be consistent with this definition. Most importantly, the practical outcomes of the Australian approach in this area are acknowledged as not having led to material shortcomings. Key factors are longstanding Government policy ruling out takeovers or potential mergers among the four major banks, and the philosophy underpinning the Financial Sector (Shareholdings) Act 1998. The former reflects the structure of the Australian banking system and the prominence of the four largest banks. With respect to the latter, Australian Governments have long supported the general principle of a diversity of ownership to ensure the risks associated with a concentration of ownership are minimised. Taken together, the Australian authorities, including APRA, exercise effective control over the risks associated with the transfer of significant ownership of Australian banks. The recommendation that APRA be given the legal right to prevent a change of control of any bank on prudential grounds would amount to giving APRA a power of veto over the Government itself (rather than over another authority), which would run counter to a fundamental principle of Parliamentary sovereignty.

47. **Finally, the Australian authorities have concerns about the assessment for CP 1 Objectives, autonomy, powers and resources.** The IMF has made a number of recommendations in respect of CP 1.2 to, ‘ensure unambiguous independence within APRA.’ The Australian authorities agree with the need for an independent supervisor and are of the view that APRA is already unambiguously independent. APRA is established as a statutory authority, at arm’s length from Government and with substantial statutory and operational independence, including extensive powers to determine prudential standards. There is no evidence, past or present, of any Government or industry interference that compromises APRA’s operational independence.

48. **The IMF, under CP 1.3 has also recommended that APRA be provided with sufficient delegated powers to issue prudential regulations without additional Parliamentary procedures.** The Australian authorities disagree with this recommendation. APRA has extensive power to set legally enforceable standards. The requirement that APRA’s prudential standards be subject to the scrutiny of Parliament is an essential element of accountability in Australia’s Parliamentary framework. APRA exercises powers as a delegate of the Parliament; as such, oversight of how APRA uses Parliament’s delegation of

power is a fundamental principle of Parliamentary sovereignty. The strength of Australia’s approach is that APRA’s prudential standards are legislative instruments under the Legislative Instruments Act 2003 and are legally binding on regulated entities. This makes them a flexible but powerful supervision and enforcement tool; a breach of a prudential standard is a breach of the law. No prudential standard has ever been disallowed by Parliament.

#### IV. DETAILED ASSESSMENT

49. The Table 3 below offers the detailed Principle-by-Principle assessment. It provides a “description” of the system with regard to a particular Principle, a grading or “assessment,” and a “comments.”

**Table 3. Detailed Self-Assessment of Compliance with the Basel Core Principles**

<b>Principle 1</b>	<b>Objectives, autonomy, powers, and resources.</b> An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
Assessment	
<b>Principle 1(1)</b>	<b>Responsibilities and objectives.</b> An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks.
<b>Essential criteria</b>	
<b>EC1</b>	Laws are in place for banking, and for the authority (each of the authorities) involved in banking supervision. The responsibilities and objectives of each of the authorities are clearly defined and publicly disclosed.
Description and findings re EC1	A number of acts deal with the supervision of banks in Australia. Principal among them are the Banking Act 1959 (as amended) and the Australian Prudential Regulation Authority Act 1998 (as amended) (APRA Act). The Banking Act 1959 sets down provisions relating to the carrying on of banking business in Australia and its prudential supervision. Section 12 (1) of the Act states that it is the duty of APRA to exercise its power and functions for the protection of depositors of authorized deposit-taking institutions (ADIs) and for the promotion of the financial system in Australia. ADIs are banks, building societies, credit unions and a small number of specialized service providers to the sector. All are subject to the same supervisory regime.  The APRA Act established APRA as the body responsible for the prudential supervision of bodies in the financial sector. The APRA Act also requires APRA to

	<p>seek to avoid any action that is likely to have a detrimental effect on the financial system stability in New Zealand on the grounds that the four major Australian banks have almost a 90 percent share of the banking system assets in New Zealand. Whereas APRA is responsible for the prudential supervision of ADIs in Australia, conduct of business regulation is carried out by a separate agency –the Australian Securities and Investments Commission (ASIC). It has responsibility for consumer protection in the financial system, as well as for disclosure and market conduct of Australian companies and financial services providers including ADI's. The Reserve Bank of Australia has responsibility for monetary policy, stability of the financial system and the safety and efficiency of Australia's payments system. The Australian Transaction Reports and Analysis Centre (AUSTRAC) is Australia's anti-money laundering regulator and specialist financial intelligence unit. Its role is to oversee compliance with anti-money laundering legislation by a wide range of financial service providers including all ADIs.</p>
<b>EC 2</b>	The laws and supporting regulations provide a framework of minimum prudential standards that banks must meet.
Description and findings re EC2	<p>Section 11AF of the Banking Act gives APRA the power to make prudential standards for ADIs (as well as for their non-operating holding companies--NOHCs). Prudential standards have the force of law and an ADI or authorized NOHC is required to comply with them. APRA can take administrative or court action to require compliance. Section 11AF provides for standards to 'impose different requirements to be complied with in different situations or in respect of different activities'. It also allows for standards to be set for all ADIs, a class of ADIs or one or more specific ADIs. APRA has a comprehensive framework of minimum prudential standards applying to ADIs and banking groups. It also issues prudential practice guides (PPGs) that provide non-enforceable, non-binding guidance on certain prudential matters.</p>
<b>EC3</b>	Banking laws and regulations are updated as necessary to ensure that they remain effective and relevant to changing industry and regulatory practices.
Description and findings re EC3	<p>APRA monitors and analyses developments in domestic and international financial systems and keeps abreast of changes in supervisory practices to ensure Australia's banking laws and regulations remain effective and relevant. APRA works closely with the Treasury. The latter has responsibility for advising the Government on financial stability issues and for the legislative and regulatory framework underpinning system framework. Where proposed legislative reforms concern the objectives of more than one financial regulatory agency, or otherwise are of particular significance to Australia's financial system, such reforms will, where appropriate, be considered by the Council of Financial Regulators (CFR), the primary coordinating body for Australia's main regulatory agencies (Membership of the Council comprises the Reserve Bank, which chairs the Council, APRA, ASIC and Treasury). Changes to APRA's prudential standards and prudential practice guide which together form the basis for APRA's supervisory regime can be changed at short notice by APRA without any need to amend the enabling Act.</p>
<b>EC4</b>	The supervisor confirms that information on the financial strength and performance of the industry under its jurisdiction is publicly available.
Description and	APRA regularly publishes details of the financial strength and performance of the



findings re EC4	<p>industry it supervises. These details are available on its website. APRA also provides data to other agencies that are used in publications such as the Financial Stability Review issued by the Reserve Bank of Australia.</p> <p>Under its prudential standards, APRA has requirements (in line with the mandatory disclosure requirements of Pillar II of Basel II) for public disclosure by the ADIs themselves of information relating to certain prudential matters including information on risk management practices and capital adequacy.</p>
<b>Additional criteria</b>	
<b>AC1</b>	In determining supervisory programs and allocating resources, supervisors take into account the risks posed by individual banks and banking groups and the different approaches available to mitigate those risks.
Description and findings re AC1	APRA takes a risk-based approach to supervision and has developed various tools to assist in the efficient allocation of supervisory resources. A key building block of APRA's supervisory approach is a forward-looking supervisory action plan (SAP) for each institution (or banking group when warranted). In addition, APRA's Probability and Impact Rating System (PAIRS) and Supervisory Oversight and Response System (SOARS) provide a structure to guide supervisors in gauging risks and determining an appropriate supervisory response. Together, the PAIRS model and SOARS framework are used to determine the nature and intensity of APRA's supervisory relationship with each ADI.
<b>Assessment of Principle 1(1)</b>	<b>Compliant</b>
Comments	There is an effective system of banking supervision in Australia with clear responsibilities and objectives for each authority involved.
<b>Principle 1(2).</b>	<b>Independence, accountability and transparency.</b> Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties.
<b>Essential criteria</b>	
<b>EC1</b>	The operational independence, accountability and governance structures of each supervisory authority are prescribed by law and publicly disclosed. There is, in practice, no evidence of government or industry interference which compromises the operational independence of each authority, or in each authority's ability to obtain and deploy the resources needed to carry out its mandate. The head(s) of the supervisory authority can be removed from office during his (their) term only for reasons specified in law. The reason(s) for removal should be publicly disclosed.
Description and findings re EC1	<p>APRA was established in 1998 as an independent statutory authority charged with responsibility for prudential regulation. It is both independent from, and accountable, to the Australian Government.</p> <p>APRA is governed by a commission-style structure of a three member Executive Group, one of which is the Chairman. The three Members are appointed by the Governor-General, on the advice of the Treasurer. They serve on a full time basis.</p> <p>There is one area where APRA's independence might be compromised, namely that the Minister may issue a direction to APRA.</p> <p>Under section 12 of the APRA Act, "The Minister may give APRA a written direction</p>

	<p>about policies it should pursue, or priorities it should follow, in performing or exercising any of its functions or powers". The Minister does not have power to give a formal direction as to the approach to be adopted in respect of any given regulated entity. A direction can only be given after the Minister has notified APRA in writing that consideration is being given to making the direction and giving the Chairman of APRA an opportunity to discuss the need for the proposed direction. To date no such direction has been issued by the Minister.</p> <p>Section 25 of the APRA Act sets out the terms relating to the termination of appointment of the Members (Heads) of APRA. These are objective, e.g., bankruptcy, conflict of interest, becomes employed by a regulated company, etc. However, there is no provision for the public disclosure of the specific reasons for terminating the appointment of an APRA Member. No APRA Member has ever been dismissed.</p> <p>APRA has a risk management and audit committee. Its membership comprises an external chair (with casting vote), one external member, one member of APRA's Executive Group (i.e., one of the three Members) and one executive General Manager (on a one year rotation). In the interests of good corporate governance practice it is recommended that APRA consider splitting this committee into two separate committees, one dealing with risk management and the other dealing with audit. It is suggested that the new risk committee would retain its current membership but that membership of the new audit committee would comprise external members only in order to avoid any conflict of interest on the part of any executives if they were on the committee.</p>
<b>EC2</b>	The supervisor publishes objectives and is accountable through a transparent framework for the discharge of its duties in relation to those objectives.
Description and findings re EC2	<p>The purpose for establishing APRA is set out in section 8 of the APRA Act. "APRA is established for the purpose of regulating bodies in the financial sector in accordance with other laws of the Commonwealth that provide for prudential regulation or for retirement standards, and for developing the administrative practices and procedures to be applied in performing that regulatory role. In performing and exercising its functions and powers, APRA is to balance the objectives and procedures of financial safety and efficiency, competition, contestability and competitive neutrality"</p> <p>These objectives were confirmed in the Statement of Expectations 2007 issued by the Treasurer. It confirmed the objective that the prudential regulation regime maintains a low incidence of failures of entities while not impeding continued improvement in efficiency or hindering competition.</p> <p>Avenues through which APRA is accountable to the Parliament include appearances before Parliament's standing committees, in particular the House of Representatives Committee on Economics, Finance and Public Administration, and the Senate Economics Legislative Committee (sitting as Senate Estimates), as well as other <i>ad hoc</i> committees. Transcripts of the proceedings of these committees are publicly available and such hearings are open to the public. In addition, APRA is also subject to financial and performance audits by the Australian National Audit Office (ANAO). The reports of the ANAO are tabled in Parliament and are publicly available.</p> <p>APRA also accounts for its performance through its Annual Report, which is tabled in Parliament. APRA also has a number of other publications explaining its objectives, procedures and operations.</p>

<b>EC3</b>	The supervisory authority and its staff have credibility based on their professionalism and integrity.
Description and findings re EC3	The assessors were very impressed by the quality and caliber of APRA staff. The organization appears to have a very well-trained, experienced and professional staff who are committed to carrying out their function to the highest standards. This impression was confirmed at meetings with industry sources who commended APRA staff on their professionalism, level of knowledge and general receptiveness. It was clear that APRA staff is well respected within the industry and among service providers (e.g., accountancy/audit regulators and accountancy firms).
<b>EC4</b>	<p>The supervisor is financed in a manner that does not undermine its autonomy or independence and permits it to conduct effective supervision and oversight. This includes:</p> <ul style="list-style-type: none"> <li>• A budget that provides for staff in sufficient numbers and with skills commensurate with the size and complexity of the institutions supervised.</li> <li>• Salary scales that allow it to attract and retain qualified staff</li> <li>• The ability to commission outside experts with the necessary professional skills and independence and subject to necessary confidentiality restrictions to conduct supervisory tasks</li> <li>• A training budget and program that provides regular training opportunities for staff</li> <li>• A budget for computers and other equipment sufficient to equip its staff with the tools needed to review the banking industry and assess individual banks and banking groups; and</li> <li>• A travel budget that allows appropriate on-site work.</li> </ul>
Description and findings re EC4	<p>APRA's budget is proposed by the APRA Members and put to Government for consideration and ultimately endorsement. In this respect, it appears that Government support for APRA is strong and that to date budgets have been adequate.</p> <p>When the budget figure is agreed by Government, that figure forms the basis on which the levy from the regulated entities is calculated. Thus, APRA is self-funding. Apart from the levy, APRA also receives, from time to time, Special Appropriations from Government to deal with particular matters. For instance, in 2008 APRA received a Special Appropriation of \$45m, payable over the following four years, to assist APRA deal with the global financial crisis. Similarly, in the recently announced State budget for 2012/13, APRA was allocated a total of \$82.4m by way of Special Appropriation, payable over a four year period.</p> <p>Excluding the Special Appropriation, APRA's budgets over the last number of years has remained relatively static (\$109m in 2008/09; \$121m in 2009/10; \$120m in 2010/11; \$120m in 2011/12. For 2012/13, the budget has been fixed at \$125m which includes a first tranche (\$18.9m) of the Special Appropriation of \$82.4m referred to above.</p> <p>Like many other government agencies, APRA is subject to the general financial management policies of the Australian Government. These include:</p> <ul style="list-style-type: none"> <li>• APRA's budget is subject to scrutiny by the Department of Finance and Deregulation;</li> <li>• APRA is subject to 'whole of government' procurement and cost reduction initiatives, particularly in areas such as travel and information technology, which may not always ensure flexible and cost-effective outcomes in APRA's</li> </ul>

	<p>case; and</p> <ul style="list-style-type: none"> <li>APRA's staff enterprise agreement (covering remuneration and conditions) is vetted by the Australian Public Service Commission and approved by the relevant Minister.</li> </ul> <p>APRA is also subject to general 'efficiency dividend' requirements, under which agency funding is reduced to drive efficiency savings.</p> <p>APRA has said that these arrangements involve some constraints on APRA's budget have not, to date, materially affected its ability to conduct effective supervision. In broad terms, the assessors believe that this is the case.</p> <p>As indicated in EC3, APRA's staff are well regarded by all sides for their professionalism, level of knowledge and effectiveness. APRA states that its remuneration levels are reasonably competitive but acknowledge it cannot match the top end of the financial sector. At the same time, APRA believes that it can and does recruit high caliber (and expensive) specialist staff, for example, those with risk management expertise, partly on the basis that some such people actually want to work in regulation (Within the overall budgetary constraints, APRA is not constrained in what it pays individual staff but it could not pay, say, bonuses available in the private sector and it must be very mindful of internal pay relativities).</p> <p>However, APRA acknowledges, as does the industry, with greater force, the difficulties for agencies like APRA to attract and, more particularly, retain good staff. While the assessors did not detect acute staff shortages, either in number or expertise, it did form the impression that certain staff, particularly in the specialist areas referred to above, was somewhat overstretched.</p> <p>The volume of staff turnover in APRA's operational divisions, which includes bank supervisors, was nine percent in 2011. This is below APRA's longer term average of about 14 percent and significantly below a figure of about 20 percent in the mid 2000's. APRA acknowledges that retention of staff, particularly at more junior levels with three to five year service, remains problematic. About 90 percent of those who leave find new roles in the financial sector.</p> <p>APRA places heavy emphasis on training and development. In benchmark studies, it emerges that the level of expenditure in this area places APRA in the 90<sup>th</sup> quartile of private and government organizations in Australia. APRA's current priority for staff training is further developing prudential supervision skills and leadership capabilities. APRA's IT infrastructure, which is soon to undergo significant refurbishment, appears adequate and from demonstrations to the assessors ably assists supervisors in carrying out their functions.</p> <p>APRA's budget allows supervisors to undertake onsite review, both domestic and overseas.</p>
<b>Additional criteria</b>	
<b>AC1</b>	The head(s) of the supervisory authority is (are) appointed for a minimum term.
Description and findings re AC1	The APRA Members (including the Chairman) are appointed for fixed terms of up to five years, as specified in their instrument of Appointment.
<b>Assessment of Principle 1(2)</b>	<b>Largely Compliant</b>
Comments	The reason for the LC rating relates to the issue of Independence and the absence of

	<p>public disclosure of the specific terms relating to the termination of appointment of an APRA Member (EC1). The assessors are acutely aware of the difficulties posed for the Australian authorities in seeking to address the independence issue. The ability of Ministers to issue directions is common to all statutory authorities such as APRA. It is regarded as an essential feature in the checks and balances of the Australian democratic process. It is also acknowledged that in APRA's case it has never been invoked and that in normal circumstances are unlikely to be invoked.</p> <p>On the absence of mandated public disclosure of the terms relating to the termination of appointment of an APRA member, it is recommended that a legal provision be introduced to provide for such.</p> <p>On the question of APRA's Risk Management and Audit Committee, it is recommended that it be split into two committees, one dealing with the risk management aspect and the other dealing with audit issues and that membership of the latter committee be sourced externally (While this issue is not directly covered by an EC, it is addressed indirectly in the general narrative introducing Principle 1, i.e., "each such authority should possess operational independence, transparent processes, <i>sound governance</i>, and adequate resources....").</p> <p>On the question of resources, it is recommended that APRA remain mindful of the need to recruit and retain high caliber staff, both in terms of number and expertise. This is particularly relevant for the future, given the backdrop of the global financial crisis, giving rise to the need for more intensive supervision, and the level and increasing complexity of new supervisory legislation.</p>
<b>Principle 1(3)</b>	<b>Legal framework.</b> A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision.
<b>Essential criteria</b>	
<b>EC1</b>	The law identifies the authority (or authorities) responsible for granting and withdrawing banking licenses.
Description and findings re EC1	Section 9 of the Banking Act gives APRA responsibility for granting corporations the right to carry on banking business in Australia subject to whatever conditions APRA considers appropriate. Section 9A grants APRA the right to revoke licenses for stated reasons e.g., at the request of the holder; where its continuance would not be in the best interests of depositors of the holder or contrary to the national interest.
<b>EC2</b>	The law empowers the supervisor to set prudential rules (without changing laws). The supervisor consults publicly and in a timely way on proposed changes, as appropriate.
Description and findings re EC2	Under section 11AF of the Banking Act, APRA has the power to make, amend or revoke prudential standards without the need to change the underlying legislation. However, prudential standards must be tabled in Parliament and may be disallowed. Under the Legislative Instruments Act 2003, prudential standards made by APRA must be tabled in each House of Parliament. After the standards have been laid before each House, a notice of motion to disallow the standards may be given within 15 sitting days. If the notice of motion to disallow is then passed within 15 sitting days after the giving of the notice, the standards will cease to have effect. To date no standards have been disallowed under this process.
	In introducing or proposing changes to its prudential framework, APRA undertakes

	public consultation, including with relevant industry groups. APRA issues formal discussion papers and consultation packages, consults with industry and other interested parties in relation to submissions and provides response papers when finalizing proposals. APRA publishes an annual regulatory plan detailing its planned prudential policy initiatives for the coming financial year and providing a summary of changes to the prudential framework that were finalized in the preceding financial year.
<b>EC3</b>	The law or regulations empower the supervisor to obtain information from the banks and banking groups in the form and frequency it deems necessary.
Description and findings re EC3	The Financial Sector (Collection of Data) Act 2001 provides APRA with the power to collect data from ADIs and to determine the frequency of collection. In addition, section 62 of the Banking Act allows APRA to obtain information from an ADI or any member of its relevant group.
<b>Assessment of Principle 1(3)</b>	<b>Largely Compliant</b>
Comments	Placing prudential regulations before the Houses of Parliament, like the ability of Ministers to issues directions (see Principle 1 (2)), is regarded as an essential feature in the checks and balances of the Australian democratic process. It has never been invoked and its invocation is seen as a remote possibility. Nonetheless, it could result, in admittedly extreme circumstances, in the failure to introduce what are considered essential prudential standards and necessitating a new initiative.
<b>Principle 1(4)</b>	<b>Legal powers.</b> A suitable legal framework for banking supervision is also necessary, including powers to address compliance with laws as well as safety and soundness concerns.
<b>Essential criteria</b>	
<b>EC1</b>	The law and regulations enable the supervisor to address compliance with laws and the safety and soundness of the banks under its supervision. The law and regulations permit the supervisor to apply qualitative judgment in safeguarding the safety and soundness of the banks within its jurisdiction.
Description and findings re EC1	<p>Section 11CA of the Banking Act gives APRA wide powers of direction over ADIs where necessary to ensure compliance with its prudential standards or to protect the interests of depositors.</p> <p>Also, Part II of the Banking Act empowers APRA to intervene in a range of circumstances including where an ADI is considered unlikely to be able to carry on business in a manner that is consistent with the interests of depositors or the stability of the financial system. This includes powers to appoint a person to investigate the affairs of an ADI, to remove the board or officers of the ADI, to require the ADI to sell assets or raise capital, and to take control of the ADI through the appointment of a statutory manager that can assume control of the ADI and manage its business in the interests of its depositors and the stability of the financial system. In a situation where an ADI is insolvent, APRA may apply to the Federal Court of Australia to have the ADI wound up.</p> <p>Section 13(3) of the Banking Act requires an ADI to notify APRA immediately if it is likely to become unable to meet its obligations or suspend payment. In addition, individual prudential standards require an ADI to notify APRA immediately after it becomes aware of any breach of a prudential standard or other requirement, or of any circumstance that might reasonably be seen to have a material impact on the ADI. As part of its supervisory regime, APRA applies qualitative judgment to assess the</p>

	effectiveness and appropriateness of an ADI's risk management systems, its management and board, its access to additional capital and its management information systems. These qualitative assessments are incorporated into APRA's internal risk-rating system, PAIRS, which in turn drives the supervisory stance for an ADI.
<b>EC2</b>	The supervisor has full access to banks' board, management, staff and records in order to review compliance with internal rules and limits as well as external laws and regulations.
Description and findings re EC2	APRA has legal powers to access the board, senior management and records of an ADI. In addition, Prudential Standard APS 510 – Governance--requires members of the board and senior management to be available to meet with APRA on request. Section 62 of the Banking Act enables APRA to require an ADI to provide any information, books, accounts or documents as may be required by APRA. Section 13 of the Banking Act specifically enables APRA to obtain information from an ADI in relation to its financial stability.
<b>EC3</b>	When, in a supervisor's judgment, a bank is not complying with laws or regulations or it is or is likely to be engaged in unsafe and unsound practices, the supervisor has the power to: <ul style="list-style-type: none"> <li>• take (and/or require a bank to take) prompt remedial action; and</li> <li>• Impose a range of sanctions (including the revocation of the banking license).</li> </ul>
Description and findings re EC3	Section 11CA of the Banking Act enables APRA to issue a direction requiring an ADI to undertake (or not to undertake) specific actions in respect of prudential matters. Such direction could relate to complying with a prudential requirement, removing a director or senior manager, requiring an audit of the affairs of the ADI, nor to grant loans, repay deposits, etc.
<b>Assessment of Principle 1(4)</b>	<b>Compliant</b>
Comments	APRA has sufficient powers to address compliance with laws as well as safety and soundness concerns.
<b>Principle 1(5)</b>	<b>Legal protection.</b> A suitable legal framework for banking supervision is also necessary, including legal protection for supervisors.
<b>Essential criteria</b>	
<b>EC1</b>	The law provides protection to the supervisory authority and its staff against lawsuits for actions taken and/or omissions made while discharging their duties in good faith.
Description and findings re EC1	Section 58 of the APRA Act provides that APRA and its staff (including the 3 APRA Members) are not subject to any liability for any act, or any omission, in the exercise or performance of any of APRA's powers or functions, unless that act or omission is done in bad faith.
<b>EC2</b>	The supervisory authority and its staff are adequately protected against the costs of defending their actions and/or omissions made while discharging their duties in good faith.
Description and findings re EC2	While section 58 of the APRA Act protects APRA and its staff from any liability for any act or omission where they act in good faith, it does not provide for a specific indemnification for APRA or its staff for any costs of defending their actions and/or omissions made while discharging their duties in good faith. In this respect, APRA relies on the Legal Services Directions 2005(LSD) issued by the Attorney General under section 55ZF of the Judiciary Act 1903. In accordance with that Act, expenditure to cover legal costs of an employee of an agency (including APRA) should normally be

	approved to assist an employee who is a defendant in civil or criminal proceedings if (a) the proceedings arose out of an incident that relates to their employment with the employing agency and (b) the employee acted reasonably and responsibly (i.e., where the employee has not engaged in serious or willful misconduct or culpable negligence.) In addition, the terms of APRA's Directors' and Officers' Liability Cover policy provide cover where a director or officer is legally liable to pay for the consequences of a wrongful act'
<b>Assessment of Principle 1(5)</b>	<b>Compliant</b>
Comments	While acknowledging compliance with this principle ie that staff are protected against the costs of defending their actions and/or omissions made while discharging their duties in good faith, however the provisions in the APRA Act do not explicitly detail costs.
<b>Principle 1(6)</b>	<b>Cooperation.</b> Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
<b>Essential criteria</b>	
<b>EC1</b>	Arrangements, formal or informal, are in place for cooperation and information sharing between all domestic authorities with responsibility for the soundness of the financial system, and there is evidence that these arrangements work in practice, where necessary.
Description and findings re EC1	<p>Section 56 of the APRA Act enables APRA to provide confidential information to other domestic financial regulators, such as ASIC, the RBA and AUSTRAC. Confidential information can be exchanged with these agencies provided such information is required to enable them to carry out their supervisory functions.</p> <p>APRA has established MOUs with each of these agencies which provide a formal framework of cooperation between the various agencies and exchange of information is a regular feature of that cooperation. In addition, regular meetings are held with each of the agencies.</p> <p>APRA is also a member of the Council of Financial Regulators which comprises the Treasury, the RBA, APRA and ASIC. It provides advice to the Australian Government on the adequacy of Australia's financial regulatory arrangements and oversees the objectives and implementation of financial distress management in times of financial crisis. This function is facilitated by an MOU signed by the four Council members.</p>
<b>EC2</b>	Arrangements, formal or informal, are in place, where relevant, for cooperation and information sharing with foreign financial sector supervisors of banks and banking groups of material interest to the home or host supervisor, and there is evidence that these arrangements work in practice, where necessary.
Description and findings re EC2	<p>APRA has developed systems of cooperation and information sharing, normally through MOUs, with foreign financial sector regulators that have supervisory responsibility for banking operations of material interest to APRA. This is particularly with New Zealand and the UK, where the bulk of Australian banks' overseas operations are based. In the case of New Zealand, where almost all banking services are provided by Australian banks, a Trans-Tasman Council of Banking Supervision has been established to facilitate a more coordinated and effective banking supervisory regime.</p> <p>Where relevant, APRA takes part in supervisory colleges and is the home supervisor for the two Australian banks with material overseas operations.</p>



	Section 56 of the APRA Act enables APRA to share confidential information with foreign supervisors subject to the normal constraints associated with such sharing.
<b>EC3</b>	The supervisory may provide confidential information to another domestic or foreign financial sector supervisor. The supervisor is required to take reasonable steps to ensure that any confidential information released to another supervisor will be used only for supervisory purposes and will be treated as confidential by the receiving party. The supervisor receiving confidential information from other supervisors is also required to take reasonable steps to ensure that the confidential information will be used only for supervisory purposes and will be treated as confidential.
Description and findings re EC3	Under Section 56 of the APRA Act, APRA may provide confidential information to financial sector supervisory agencies, both domestic and foreign, where it is satisfied that the information will be used by those other agencies for supervisory purposes and that these agencies are subject to the same confidential constraints as APRA. Section 56 also provides that confidential information received by APRA is subject to confidential constraints.
<b>EC4</b>	The supervisor is able to deny any demand (other than a court order or mandate from a legislative body) for confidential information in its possession.
Description and findings re EC4	Under section 56 of the APRA Act, APRA may only disclose information for stated reasons, e.g., exchange of information with a fellow regulator for supervisory purposes. Section 56 also provides that APRA is exempt from being required to disclose confidential information under the Freedom of Information Act, 1982. This Act is currently being revisited by the Government but APRA expects that that it will not adversely impact on its ability to restrict disclosure of confidential information.
<b>Assessment of principle 1(6)</b>	<b>Compliant</b>
Comments	The previous BCP assessment of 2006 recommended that the legal obstacles to the exchange of information between APRA and AUSTRAC (the body responsible for the implementation of AML/CTF Law) be removed. This was achieved with the passing of the Anti-Money Laundering and Counter Terrorism Financing Act 2006.
<b>Principle 2</b>	<b>Permissible activities.</b> The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined and the use of the word “bank” in names should be controlled as far as possible.
<b>Essential criteria</b>	
<b>EC1</b>	The term “bank” is clearly defined in laws or regulations.
Description and findings re EC1	The term “bank” is not defined in legislation. However, the use of the word “bank” in relation to financial business is restricted and requires approval by APRA. APRA will only grant approval to an ADI to describe itself as a bank where it holds at least \$50m in Tier 1 Capital (see also response to EC3). Financial business means the provision of, or relates to the provision of, financial services. All banks are authorized deposit taking institutions and are subject to supervision. The term “banking business” is defined in legislation (Section 5 of the <i>Banking Act 1959</i> ) and any company wishing to carry out “banking business” must be authorized by APRA (Section 9 of the <i>Banking Act 1959</i> ). “Banking business” is defined to include ‘both taking money on deposit (otherwise than as part-payment for identified goods or services) and making advances of money’ as well as other financial activities prescribed by the Banking Regulations. The Banking Act further defines the term ‘authorized deposit-taking institution’ (ADI) to mean a body corporate that has been granted an authority to conduct banking

	<p>business in Australia. In practice, ADIs include banks, credit unions and building societies.</p> <p>All ADIs are subject to equivalent supervision.</p>
<b>EC2</b>	The permissible activities of institutions that are licensed and subject to supervision as banks are clearly defined either by supervisors, or in laws or regulations.
Description and findings re EC2	<p>Only ADIs authorized by APRA can carry on banking business in Australia and 'banking business' is defined in the Banking Act. APRA may impose conditions on an ADI's authority to undertake banking business. Please see EC1.</p> <p>Authorization as an ADI requires that the firm provides a written undertaking that it will 'consult APRA and be guided by it on prudential matters, including in respect of new business initiatives'.</p> <p>In addition, ADIs must prenotify APRA and ensure that the supervisor is satisfied that the institution is capable of managing any changes to the ADI's standalone operations or for new business activities which may materially alter the group's overall risk profile (paragraph 8(c) of <i>Prudential Standard APS 222 Associations with Related Entities</i>).</p> <p>This provision would typically apply when an institution were contemplating the establishment of a subsidiary, merger or acquisition.</p>
<b>EC3</b>	The use of the word "bank" and any derivations such as "banking" in a name is limited to licensed and supervised institutions in all circumstances where the general public might otherwise be misled.
Description and findings re EC3	<p><b>General prohibition on the use of restricted expression</b></p> <p>Section 66 of the Banking Act restricts the use of restricted words or expressions in relation to a financial business, including the terms 'bank', 'banker' and 'banking'. Furthermore, section 66A of the Banking Act restricts the use of the expressions 'authorized deposit-taking institution' and 'ADI'.</p> <p>The policy intent is to ensure that potential customers of financial businesses that are not ADIs are not misled into believing that such institutions have the same level of capital adequacy, depositor priority and other prudential requirements that apply to ADIs.</p> <p><b>Circumstances in which the use of the term 'bank' and related expressions are permitted</b></p> <p>Exemptions to the Section 66 restriction are possible. APRA may grant consent to a person to use restricted expressions or exempt such person under section 11 of the Banking Act from the prohibition against using such restricted expression. In addition, the Banking Act itself permits the use of certain restricted expressions in limited circumstances.</p> <p>The key circumstances in which the terms 'bank', 'banker' and 'banking' are permitted to be used are as follows:</p> <ul style="list-style-type: none"> <li>• ADIs that are banks may use the expressions 'bank', 'banker' and 'banking' on an unrestricted basis.</li> <li>• APRA applies a 'substance test' to an ADIs wishing to be termed a bank in Australia. The substance test, in place and unchanged since 1992, is defined as minimum Tier 1 capital of \$50 million. This test and applies equally to foreign bank subsidiaries, potential Australian-owned entrants and existing credit unions or building societies wishing to convert their status to a bank.</li> <li>• A foreign corporation, authorized as a bank in its home country, is permitted to use the expressions 'bank', 'banker' or 'banking' in relation to raising funds in the Australian wholesale capital market through issuing securities, subject to the following conditions:</li> </ul>

	<ul style="list-style-type: none"> <li>○ the securities must be offered and/or traded in parcels of not less than \$500,000; and</li> <li>○ the securities and related information memorandum must clearly state that the issuer is not authorized as a bank under the Banking Act.</li> <li>● Credit unions and building societies have been granted a class approval to use the expression 'banking' (not "bank") in relation to their banking activities, provided such term is not used in a misleading or deceptive fashion.</li> </ul> <p>APRA guidelines, 'Implementation of Section 66 of the Banking Act 1959', detail the approach APRA adopts in respect of authorizing the use of restricted expressions, including the reasons for the restrictions and a discussion of the factors APRA considers. The guidelines also outline some further (limited) circumstances in which the use of restricted expressions is permitted.</p> <p><b>Changes since 2006</b></p> <p>In 2010, the Government released its 'Competitive and Sustainable Banking System' package, a series of measures to promote competition in the Australian banking system. In response to this package, APRA reviewed its guidelines for approval to use the restricted word 'bank' and determined that they continued to be generally applicable. However, APRA revoked an existing consent for non-regulated financial businesses operating in the short-term money market to describe themselves as 'merchant banks'.</p>
<b>EC4</b>	The taking of deposits from the public is generally reserved for institutions that are licensed and subject to supervision as banks.
Description and findings re EC4	<p>Not all deposit taking institutions in Australia are licensed and subject to supervision as banks. While, deposit-taking institutions are authorized under section 9 of the Banking Act and all large and systemically important deposit-taking institutions are recognized as banks, there are exemptions permitted under section 11 of the Banking Act.</p> <p>Exempted entities are not subject to prudential supervision as ADIs.</p> <p>In addition there is a Government-owned insurance and banking organization operating in the Northern Territory which is not supervised by APRA but which is monitored by the Northern Territory Treasury. The deposits are government-guaranteed as are the obligations to policyholders. The institution is the sole remaining legacy from the period in which Australia had State owned (and guaranteed) banks, as permitted in the Constitution. State banking largely ended in the late 1980s and early 1990s due to the failure of a number of such banks (such as the State Bank of South Australia and the State Bank of Victoria) in a major property crash. A State bank must, however, operate exclusively within its state (or in this case Territory).</p> <p>The section 11 exemptions are generally made by way of class order and there are two exemptions currently in force:</p> <ul style="list-style-type: none"> <li>a) Registered entities (Registered Financial Corporations "RFCs") Registered entities (as defined by the <i>Financial Sector Collection of Data Act 2001</i>(FSCODA)) are subject to regulation as they must hold a an Australian Financial Services (AFS) license under the Corporations Act and AFS licensees are subject to regulation by ASIC. Registered entities also have some (aggregate and non-prudential) reporting requirements to APRA in APRA's capacity as Government data agency. The Banking Exemption Order 96 provides that the exempted entities are not prohibited from engaging in activities that would otherwise constitute banking business where the entity takes money on deposit:</li> </ul>

- by issuing or selling securities (within the meaning of Part 6D.2 of the Corporations Act 2001);
- by issuing or selling a financial product (within the meaning of Part 7.9 of the Corporations Act);
- or otherwise.

However, this provision is contingent on the obligation on the entity to warn the investor (“the prudential supervision warning”) that:

- i. the registered entity is not authorized under the Banking Act and is not supervised by APRA; and
- ii. the investment will not be covered by the depositor protection provisions in section 13A of the Banking Act.

RFCs are not obliged to issue the prudential supervision warning to professional investors.

RFC activity represents a relatively small part of the Australian financial sector. One sub category comprises money market funds, including many global names. The total funds taken by RFCs is estimated to be approximately AUD53 billion, and in many cases is provided by the parent entity, but less than a tenth of the funding is retail. Funds, other than parental funding, are typically raised via debentures but there is some small degree of provision of services, such as checking accounts for some of these companies.

Some RFCs will be permitted to use the term “bank” by virtue of the fact that they come under the category of a “foreign corporation, authorized as a bank in its home country, is permitted to use the expressions ‘bank’, ‘banker’ or ‘banking’ in relation to raising funds in the Australian wholesale capital market through issuing securities” and provided they meet conditions set out in EC3 above.

New RFCs can be established (i.e., the exemption is not merely for pre-existing companies). Requirements are imposed by ASIC rather than APRA and relate to prospectus, disclosure and licensing arrangements as indicated in the text above.

b) Religious charitable development funds

Case-by-case permission has been granted to religious charitable development funds to raise funds from the public in order to make loans furthering the objectives of the fund. Requirements placed on the charitable funds were tightened in 2006 to demarcate such funds more clearly from retail banking operations and include:

- i. the fund must be formed for religious and charitable purposes, and operate on a not-for-profit basis;
- ii. the fund must not offer EFTPOS or ATM facilities,
- iii. the fund must in all advertising and marketing material make clear and prominent disclosure to the effect that: (a) the fund is not prudentially supervised by APRA; (b) contributions to the Fund are not entitled to depositor protection; and (c) the Fund is designed for investors who wish to promote the charitable purposes of the Fund. Such disclosures and marketing is monitored by ASIC and there have been instances in which ASIC has considered that the charitable fund has been misleading in its presentations. Check books and ATM cards can be issued by such funds.

The size of the religious charitable development funds is approximately AUD 4.3 billion. Typically such funds have been central funds management for the

	<p>larger churches.</p> <p>The current section 11 exemption in force in respect of religious charitable development funds is expressed to expire on 27 June 2013. In conjunction with the Government, APRA is undertaking a comprehensive review of the existing exemption and will consult widely.</p> <p><b>Changes since 2006</b></p> <p>The Australian Government has recently introduced an easy-to-recognize seal that ADIs may elect to use in respect of protected accounts covered by the Financial Claim Scheme (FCS). The full set of rules that apply have not yet been finalized but use of this seal is on a voluntary basis only. However, the use of the seal is intended to contribute to the public's appreciation of the distinction between protected accounts covered by the FCS (including deposits) and other types of financial investments.</p>
<b>EC5</b>	The supervisory or licensing authority publishes, and keeps current, a list of licensed banks and branches of foreign banks operating within its jurisdiction.
Description and findings re EC5	<p>APRA publishes and maintains a list of ADIs on its website. The register of ADIs uses the following categorization:</p> <ul style="list-style-type: none"> <li>• Australian-owned banks;</li> <li>• foreign subsidiary banks;</li> <li>• branches of foreign banks;</li> <li>• building societies;</li> <li>• credit unions; and</li> <li>• other ADIs.</li> </ul> <p>APRA also maintains a list of authorized non-operating holding companies.</p>
<b>Assessment of Principle 2</b>	<b>Largely Compliant</b>
Comments	<p>Non-authorized and non-supervised deposit taking institutions operate in Australia using exemptions that exist under Australian law. The number of such institutions is small and the scale of their activities is predominantly de minimis. However, a major global institutions has until recently benefitted from this exemption within the Australian market and deposit like facilities were offered to the public and there is no certainty that other major institutions might not enter this space although it is encouraging to note that this sector appears to be in decline at present. Despite the introduction of useful developments such as the seal which an ADI may use to indicate which accounts are protected by the Financial Claim Scheme, this initiative is not mandatory, APRA does not have the power to make the scheme mandatory, and scope for confusion with respect to protected and unprotected deposits persists, notwithstanding a perceived high level of financial literacy among Australian consumers.</p> <p>It is recognized that the exemption from section 11 of the Banking Act for religious charitable funds will be reviewed and also that APRA would consider using suasion techniques, which have been successful in the past, to encourage RFCs to relinquish their status should the activity of these entities grow significantly or exhibit some other cause for concern, but in practice APRA's legal powers are limited. Moreover, the monitoring of exempted institutions with respect to the extent to which their behavior and marketing may be misleading is carried out by ASIC rather than APRA itself, thus--in practical terms--distancing APRA from active consideration of these institutions.</p>

	It is strongly recommended that the conditions for exemption from section 11 of the Banking Act for RFC be reconsidered not least as there is no bar to additional companies obtaining this status and being exempt from APRA's prudential regime. As in the 2006 review of the BCP, it is suggested that section 11 exemptions be limited to institutions reliant wholly on wholesale funding. At present APRA is subject to a reputational risk which is unnecessary.
<b>Principle 3</b>	<b>Licensing criteria.</b> The licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the ownership structure and governance of the bank and its wider group, including the fitness and propriety of Board members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition, including its capital base. Where the proposed owner or parent organization is a foreign bank, the prior consent of its home country supervisor should be obtained.
<b>Essential criteria</b>	
<b>EC1</b>	The licensing authority could be the banking supervisor or another competent authority. If the licensing authority and the supervisory authority are not the same, the supervisor has the right to have its views considered on each specific application. In addition, the licensing authority provides the supervisor with any information that may be material to the supervision of the licensed institution.
Description and findings re EC1	APRA is both the licensing authority and the supervisor of banks in Australia.
<b>EC2</b>	The licensing authority has the power to set criteria for licensing banks. These may be based on criteria set in laws or regulations.
Description and findings re EC2	APRA is empowered to grant or reject applications for an 'authority to carry on banking business' (banking authority) under Section 9 of the <i>Banking Act 1959</i> (Banking Act). APRA determines the criteria and information requirements for granting a banking authority and publishes these in the <i>ADI Authorisation Guidelines</i> available on APRA's website.
<b>EC3</b>	The criteria for issuing licenses are consistent with those applied in ongoing supervision.
Description and findings re EC3	The criteria for assessing an applicant for a license are derived from, and consistent with, APRA's ongoing supervision requirements, which are set out in the prudential standards. Broadly, the criteria require an applicant to demonstrate to APRA's satisfaction that the proposed new bank will have strategic and financial viability, will have an effective risk management framework, and will meet all their legislative obligations and APRA's prudential requirements at the point of licensing and on an ongoing basis.
<b>EC4</b>	The licensing authority has the power to reject an application if the criteria are not fulfilled or if the information provided is inadequate.
Description and findings re EC4	APRA has the power to grant or reject applications for a bank authorization under Section 9 of the Banking Act, which states that "APRA may, by legislative instrument, set criteria for the granting of an authority to carry on banking business in Australia." APRA has not chosen to make such a legislative instrument, but does not approve an authorization until its information needs have been fully satisfied. The Banking Act (Part VI) contains provisions for reconsideration and review if APRA refuses a licence application or imposes conditions or restrictions on the authorisation.

	<p>The Banking Act sets out the procedures and timelines for review and reconsideration. The reasons for a decision are always given in any review. Where a person affected by the reviewable decision is still dissatisfied with the decision after an internal review by APRA, the applicant can then make an application to the Administrative Appeals Tribunal for a review of that decision.</p> <p>In the context of the <i>Financial Sector (Shareholdings) Act 1998</i> (FSSA), noted below in EC6, one of the matters that APRA may take into account in determining whether to grant authority under section 9 of the Banking Act to carry on banking business is the suitability of the owners. An FSSA application is ordinarily submitted at the same time as an application for a Section 9 authorisation. This is because the section 9 authorisation means that the entity immediately meets the definition of "financial sector company" in section 4 of the FSSA and (in the absence of approval under section 14 FSSA) an unacceptable shareholding would exist in relation to any shareholdings greater than 15%. The FSSA approval is, in a licensing context, a formality. The question of granting any necessary FSSA approvals does not arise if APRA refuses to issue a section 9 Banking Act authority on the basis that a shareholder is unsuitable. Or to express the issue in alternative terms, the Treasurer cannot approve a person to hold a shareholding prior to the ADI being authorised by APRA, because there would be no "financial sector company" (see section 4 of the FSSA) in relation to which approval could be granted.</p> <p>Hence the provisions of the FSSA do not impinge upon APRA's powers to reject an application it does not find to be adequate.</p>
<b>EC5</b>	The licensing authority determines that the proposed legal, managerial, operational and ownership structures of the bank and its wider group will not hinder effective supervision on both a solo and a consolidated basis.
Description and findings re EC5	<p>The proposed legal, managerial, operational and ownership structures of the bank and its wider group are assessed in detail as part of the licensing application process. APRA considers each of these structures for effectiveness and risk. Where the applicant is part of a wider group, this includes an understanding of reporting lines within the group.</p> <p>To ensure that the legal, managerial, operational and ownership structures of the bank and its wider group will not hinder effective supervision on both a solo and a consolidated basis, APRA has the power to require the holding company of the conglomerate group to be authorized as a non-operating holding company (NOHC). Further comments in relation to APRA's consolidated supervision framework can be found in CP24.</p>
<b>EC6</b>	The licensing authority identifies and determines the suitability of major shareholders, including the ultimate beneficial owners, and others that may exert significant influence. It also assesses the transparency of the ownership structure and the sources of initial capital.
Description and findings re EC6	<p>APRA requires the applicant to identify the names of substantial shareholders, both direct and ultimate, and their respective shareholdings as well as the source(s) of initial capital and potential future capital requirements. APRA's expectations are set out in the ADI Guidelines, although these do not have the force of law.</p> <p>Applicants for bank authorization are required to demonstrate that all substantial shareholders of the proposed new bank are well-established and financially sound entities of standing and substance. Substantial shareholders must be able to demonstrate that their involvement with the bank will be a long-term commitment and that they will be able to contribute additional capital should this be required.</p>

	<p>Ownership in locally incorporated banks, including subsidiaries of foreign banks, is governed by the <i>Financial Sector (Shareholdings) Act 1998</i> (FSSA), which limits shareholdings of an individual shareholder, or group of associated shareholders, in a bank to 15 percent of the bank's voting shares.</p> <p>Any shareholding over 15 percent is subject to the requirements of the FSSA, which only permits shareholdings greater than 15 percent if such a shareholding is not contrary to the national interest. National interest would include such considerations as foreign ownership and impact on competition within the market. Depending on the nature of the acquisition, either the Treasurer or APRA (within delegations provided by the Treasurer) may approve shareholdings in excess of 15 percent. Under the current threshold of delegation the Treasurer has delegated approval authority to APRA in respect of ADIs with assets less than AUD 1 billion.</p> <p>For cases falling below the threshold of delegation there is no provision in the FSSA for the Treasurer to overrule APRA's decision.</p> <p>While the assessment of the suitability of a shareholder of more than 15 percent might be made ultimately by the Treasurer, the Treasurer will seek APRA's opinion on the suitability of a shareholder. Treasury guidelines provide that "APRA is consulted on all FSSA applications before any recommendations are put to the Minister as prudential issues are a primary consideration in any FSSA decision".</p> <p>Further, a decision by the Treasurer under the FSSA is subject to judicial review, including the Administrative Decisions (Judicial Review) Act 1977 (ADJR Act). Failing to take a relevant consideration into account in the exercise of a power is an 'improper exercise of power' under the ADJR Act. As prudential considerations raised by APRA would be a relevant to a decision under the FSSA, it is not open to the Treasurer to ignore such matters. APRA does not, however, have a legal veto on prudential grounds.</p> <p>Importantly, the provisions of the Banking Act 1959 provide sufficient legal grounds for APRA to withhold the authorization should they deem the overall application to be deficient.</p>
<b>EC7</b>	A minimum initial capital amount is stipulated for all banks.
Description and findings re EC7	<p>The <i>ADI Authorisation Guidelines</i> specify that proposed new banks must have at least \$50 million in Tier 1 capital unless they are a branch of a foreign bank. Australian branches of foreign banks are not required to have capital in Australia, but the foreign bank must meet capital requirements of the home regulator, which must be comparable.</p> <p>Applicants must also satisfy APRA that they are able to comply with the prudential standards on Capital Adequacy (<i>APS 110</i>) from the commencement of their banking operations. In addition, APRA has power to specify a higher minimum capital amount by placing conditions on a banking authority or by specifying an individual prudential capital ratio (PCR) under APS 110.</p> <p>An institution may, however, be authorized as an ADI without being designated as a bank and would thus not be subject to the \$50 million threshold of Tier 1 capital. There is no minimum threshold stated for such an institution, though minimum capital adequacy in accordance with APS 110 would be required.</p>
<b>EC8</b>	<p>The licensing authority, at authorization, evaluates proposed directors and senior management as to expertise and integrity (fit and proper test), and any potential for conflicts of interest. The fit and proper criteria include: (i) skills and experience in relevant financial operations commensurate with the intended activities of the bank; and (ii) no record of criminal activities or adverse regulatory judgments that make a person unfit to uphold important positions in a bank.</p>



Description and findings re EC8	<p>Directors and senior management of the proposed bank must satisfy APRA that they are fit and proper to hold the relevant position in accordance with <i>Prudential Standard APS 520 Fit and Proper</i>. APRA considers that there is an onus on the institution to satisfy itself that its directors and senior managers are fit and proper. However, should APRA determine that a responsible officer of a bank is not fit and proper, APRA may direct the bank to remove the officer, even if the bank has assessed the officer to be fit and proper. APRA may undertake its own independent checks and assessment of the directors and senior management, should they be of the view it is necessary and consistent with APRA's application of a risk based supervisory approach, but the authorities confirmed that APRA will not do so as a matter of course. APRA will more typically rely upon an assessment of information provided to it by the institution itself. The prudential standard 520 has been revised, so that from end of June 2012 a new CPS 520 (i.e., industry cross standard) will be in force. However the key requirements remain consistent between new standard and its predecessor.</p> <p>APS 520 establishes that the ultimate obligation rests with the Board of Directors (or equivalent) of a regulated institution to ensure that the responsible persons – i.e., directors, senior managers and auditors are 'fit and proper'.</p> <p>Key requirements in the standard include the obligation for a regulated institution to have a Fit and Proper Policy (which must meet APRA's requirements) for the fitness and propriety of a responsible person to be assessed prior to initial appointment and re-assessed annually, and for information regarding the responsible persons and the institution's assessment of fitness and propriety to be submitted to APRA.</p> <p>Criteria to be used in determining whether a person is 'fit and proper' include:</p> <ul style="list-style-type: none"> <li>• the person's competence, character, diligence, honesty, integrity and judgment;</li> <li>• whether or not the person has been disqualified by APRA; and</li> <li>• whether or not the person has a material conflict of interest.</li> </ul> <p>The Banking Act (Part II, Division 3) sets out a range of circumstances in which a person is disqualified from acting as a director or in a senior management position of a bank or an authorized NOHC. In particular, these include persons who have been disqualified as not being fit and proper by APRA, persons disqualified under the Corporations Law, persons who have been disqualified in other jurisdictions, or persons who have been convicted of offences of dishonesty. The names of persons disqualified as not being fit and proper under any of the legislation administered by APRA are published on APRA's website.</p>
<b>EC9</b>	<p>The licensing authority reviews the proposed strategic and operating plans of the bank. This includes determining that an appropriate system of corporate governance, risk management and internal controls, including those related to the detection and prevention of criminal activities, as well as the oversight of proposed outsourced functions, will be in place. The operational structure is required to reflect the scope and degree of sophistication of the proposed activities of the bank</p>
Description and findings re EC9	<p>The authorization process involves APRA undertaking a detailed assessment of the applicant's Board and management, the governance framework, risk management and control systems, information and accounting systems and internal and external audit arrangements. This includes an assessment of the applicant's ability to comply with all relevant prudential standards, including credit, market and operational risk standards, and covers any proposed outsourcing arrangements. All of APRA's assessment work is based on the principle of proportionality taking into account of whether the proposed plans, policies and procedures are commensurate with the nature, scale and complexity of the proposed institution.</p>

	<p><b>Business Plan</b> APRA reviews the three-year business plan covering the operations of the bank and banking group which applicants are required to submit. The plans must cover the structure of the business, including proposed activities, and provide detailed financial projections, including key financial and prudential ratios. In reviewing an applicant's business plan APRA has regard to the nature, scale and complexity of the bank.</p> <p><b>Risk management and internal control systems</b> Applicants must satisfy APRA that their risk management and internal control systems are adequate and appropriate for monitoring and limiting risk exposures in relation to their domestic and, where relevant, offshore operations. This includes, in particular, the development, implementation and maintenance of adequate and appropriate policies and procedures for monitoring and managing credit risk, market risk arising from banking business and trading activities, liquidity risk and operational risk, in accordance with the requirements in the respective prudential standards. Applicants must be able to demonstrate to APRA's satisfaction that risk control systems are relevant and proportionate to the risks inherent in the bank's proposed business strategy. Towards the end of an application process, APRA will carry out on-site reviews and perform tests and checks, such as requiring walk through demonstrations of processes and procedures.</p> <p>In assessing whether the policies and procedures proposed for managing and controlling risk are adequate and appropriate for the applicant's operations, APRA will take account of the size, nature and complexity of the operations, the volume of transactions to be undertaken, the proposed organizational structure and the geographical distribution of the business as set out in the business plan</p> <p>In addition, foreign bank applicants must demonstrate that arrangements for reporting to foreign bank parents or head offices are adequate.</p> <p><b>Compliance</b> Applicants must satisfy APRA that their compliance processes and systems are adequate and appropriate for ensuring compliance with APRA's prudential standards and other Australian regulatory and legal requirements.</p> <p><b>Information and accounting systems</b> Applicants must satisfy APRA that their information and accounting systems are adequate for maintaining up-to-date records of all transactions and commitments undertaken by the bank, so as to keep management continuously and accurately informed of the bank's condition and the risks to which it is exposed. Specifically, applicants are required to demonstrate to APRA that the proposed systems will be capable of producing all required statutory and prudential information in an accurate and timely manner from the commencement of their banking operations.</p> <p>In assessing the overall adequacy of the proposed information and accounting systems, APRA will have regard to the integrity and security of the systems and arrangements for business continuity management; as outlined in the <i>Prudential Standard APS 232 Business Continuity Management (APS 232)</i>. Outsourcing of material data processing must satisfy APRA's outsourcing requirement as set out in <i>Prudential Standard APS 231 Outsourcing (APS 231)</i>.</p> <p><b>External and internal audit arrangements</b> Applicants must be able to demonstrate that they can satisfy APRA's requirements in relation to board audit committees and internal audit set out in <i>Prudential Standard APS 510 Governance (APS 510)</i>, and that they have in place arrangements with external auditors in accordance with the requirements set out in the <i>Prudential Standard APS 310 Audit and Related Matters (APS 310)</i>. This includes, in particular, arrangements for an external auditor to report to APRA on the matters relating to</p>
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	APRA data collections, internal controls relating to prudential requirements and compliance with prudential requirements.
<b>EC10</b>	The licensing authority reviews pro forma financial statements and projections for the proposed bank. This includes an assessment of the adequacy of the financial strength to support the proposed strategic plan as well as financial information on the principal shareholder of the bank.
Description and findings re EC10	As noted in EC9, APRA requires applicants to submit detailed financial projections as part of the three-year business plan. These include balance sheet, cash flow and earnings projections and key financial and prudential ratios (for example: capital ratios, liquidity ratios) for the proposed bank and banking group. APRA expects sensitivity analysis and will require more conservative and stressed estimates if initial figures and projections are not perceived to be suitably robust or realistic. As noted under EC6, applicants for bank authorization are required to demonstrate that all substantial shareholders are well-established and financially sound entities of standing and substance. Substantial shareholders must be able to demonstrate that their involvement with the bank will be a long-term commitment and that they will be able to contribute additional capital should this be required.
<b>EC11</b>	In the case of foreign banks establishing a branch or subsidiary, before issuing a license, the host supervisor establishes that no objection (or a statement of no objection) from the home supervisor has been received. For purposes of the licensing process, as well as ongoing supervision of cross-border banking operations in its country, the host supervisor assesses whether the home supervisor practices global consolidated supervision.
Description and findings re EC11	As noted in the <i>ADI Authorisation Guidelines</i> APRA requires foreign bank applicants to have consent from their home supervisor for the establishment of a banking operation in Australia. Only applicants that are authorized banks in their home country will be granted authority to operate as a foreign bank in Australia. For foreign bank applicants, APRA must be satisfied that the home supervisor supervises the foreign bank applicant on a consolidated basis in accordance with the principles contained in the Basel Concordat, and is prepared to cooperate (in terms of the Concordat) with APRA in the supervision of the bank in Australia.
<b>EC12</b>	If the licensing, or supervisory, authority determines that the license was based on false information, the license can be revoked.
Description and findings re EC12	APRA has the power to revoke the authorization of a bank immediately if the bank has provided false or misleading information in connection with its application. Section 9A(2)(aa) of the Banking Act provides specifically that the provision of information in connection with the authorization application that was false or misleading in a material particular is grounds for revocation. While subsection 9A(3) sets out procedures to be adhered to in the revocation of an authority, subsection 9A(4) makes clear that APRA has the power to determine that the procedures do not apply if APRA is satisfied that the procedures could result in a delay that was contrary to either the national interest or the interests of depositors of the bank.
<b>EC13</b>	The board, collectively, must have a sound knowledge of each of the types of activities the bank intends to pursue and the associated risks.
Description and findings re EC13	When assessing the applicant's governance structure, APRA considers the fitness and propriety of all of the proposed directors, including banking experience.

	APRA also assesses the application to ensure that the prudential standards (APS 510) requiring the Board to ensure that directors and senior management of the bank, collectively, have the full range of skills needed for the effective and prudent operation of the bank and that each director has skills that allow them to make an effective contribution to Board deliberations and processes will be met.
<b>Additional criteria</b>	
<b>AC1</b>	The assessment of the application includes the ability of the shareholder to supply additional financial support, if needed.
Description and findings re AC1	APRA requires, as set out in the <i>ADI Authorisation Guidelines</i> , all substantial shareholders to be able to demonstrate that their involvement in the bank represents a long-term commitment and that they have the capacity to contribute additional capital, if required. Declarations to that effect are required.
<b>AC2</b>	The licensing or supervisory authority has policies and processes in place to monitor the progress of new entrants in meeting their business and strategic goals, and to determine that supervisory requirements outlined in the license approval are being met.
Description and findings re AC2	New entrants are subject to on-going supervision, in accordance with the APRA Supervision Framework discussed in CP19 and CP20. APRA's on-going supervision assesses banks against their business and strategic goals and monitors compliance with all of APRA's prudential standards and with any specific requirements imposed on an individual banking authority. However, during the first year of operation APRA indicated in discussion that it would normally place the new institution in the supervisory category of "oversight". This means that there is a more intensive level of "normal" supervisory activity directed at the institution. See BCPs 19 and 20 for more detail. However, file review by the assessors identified that in practice the "oversight" stance was not adopted in all circumstances.
<b>Assessment of Principle 3</b>	<b>Largely Compliant</b>
Comments	<p>APRA has a clearly established process for the authorization of banks. Applications are guided by the ADI Authorisation Guidelines and applicants must pay a fee (AUD 62,000) which acts as some discouragement to speculative applications. APRA adopts a policy of working with applicants through an iterative dialogue to assess whether an application is likely to be successful and is thus able to reinforce supervisory expectations upon new candidates for authorization.</p> <p>It is of concern, however, that APRA has indicated that although independent checks on directors and senior management at point of authorization may take place such checks would not take place as a matter of course. This view is in keeping with APRA's stance that the onus is on the institution to satisfy itself that its directors and senior managers are fit and proper and have requisite skills. Nevertheless, the methodology requires the licensing authority, at authorization, to evaluate proposed directors and senior management as to expertise and integrity and it is recommended that APRA adopt this approach on a complete and systematic basis.</p> <p>It is noted that, due to the provisions of the FSSA, APRA would not necessarily in all cases make the final determination on suitability of a prospective major shareholder (see EC6). However, in the case of a new licence (as opposed to a change of control), the provisions of the Banking Act 1959 provide sufficient legal grounds for APRA to withhold the authorization should they deem the overall application to be deficient. APRA has clearly stated full powers to reject applications that do not meet the necessary standards and is not obliged to grant a banking authority within a</p>

	prescribed timeframe.
<b>Principle 4</b>	<b>Transfer of significant ownership.</b> The supervisor has the power to review and reject any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.
<b>Essential criteria</b>	
<b>EC1</b>	Laws or regulations contain clear definitions of “significant” ownership and “controlling interest.”
Description and findings re EC1	<p>Australian legislation does not define thresholds for significance and control as can be found in other jurisdictions as the <i>Financial Sector (Shareholdings) Act 1998</i> (FSSA) sets limits on the control that may be held over a bank. The definition of “control” in the FSSA states “control as a result of, or by means of, trusts, agreements, arrangements, understandings and practices, whether or not having legal or equitable force and whether or not based on legal or equitable rights.”</p> <p>Under the FSSA a person’s stake in a ‘financial sector company’, which is defined to include a bank, can only exceed 15 percent if that person has received approval from the Treasurer (under section 14 of the FSSA, or where applicable, from APRA as the Treasurer’s delegate). See also CP2 EC6.</p> <p>A person’s stake in a financial sector company is assessed widely as the aggregate of the person’s voting power and the voting power of the person’s associates. Indirect ownership or control is captured through a broad definition of ‘associates’ (clause 4 of Schedule 1 to the FSSA). Voting power in a company is defined (clause 9 of Schedule 1) as a right to vote, or participate in any decision-making, concerning any of the following:</p> <ul style="list-style-type: none"> <li>a) the making of distributions of capital or profits of the company to its shareholders;</li> <li>b) the constituent document of the company;</li> <li>c) any variation of the share capital of the company;</li> <li>d) any appointment of a director of the company.</li> </ul> <p>A person whose stake in a financial sector company does not exceed 15 percent may still be declared by the Treasurer to have “practical control” of the company (section 23 of the FSSA) in which case the person must take steps to relinquish practical control of the company (section 24 of the FSSA).</p>
<b>EC2</b>	There are requirements to obtain supervisory approval or provide immediate notification of proposed changes that would result in a change in ownership, including beneficial ownership, or the exercise of voting rights over a particular threshold or change in controlling interest.
Description and findings re EC2	<p>Prior approval is required under the FSSA where a person proposes to acquire a stake in a financial sector company, (including a bank or ADI) of greater than 15 percent, and also where a person proposes to increase their stake beyond the level of an existing approval.</p> <p>With respect to notification, there is no express requirement under the FSSA for notification by a person changing their ownership stake. However, in effect, the sanction for not notifying is in section 11. A person who acquired shares where the acquisition resulted in an 'unacceptable shareholding situation' under the Act without first having obtained approval, would be guilty of an offence under section 11. The Treasurer also has power to apply to the Court for remedial action (including divestment) where an unacceptable shareholding exists: section 12. So that, if a person acquired shares in excess of the limit without notifying and seeking approval,</p>

	<p>the Treasurer could seek an order requiring divestment of those shares. The power to grant approval under the FSSA is vested in the Treasurer. However, the Treasurer has delegated power to APRA under the FSSA in respect of applications relating to banks with assets less than \$1,000 million. As a matter of practice, the Treasurer will seek APRA's advice as to whether there are any prudential concerns in relation to decisions affecting banks with assets exceeding \$1,000 million.</p> <p>Approval to hold a stake in a bank in excess of 15 percent is given only where the the applicant satisfies Treasurer or, where applicable, APRA as the Treasurer's delegate, determines that approval is in the national interest.</p> <p>As noted in EC1, a person's stake in a financial sector company is taken as the aggregate of the person's voting power and the voting power of the person's associates. The definition of 'associates' (clause 4 of Schedule 1 to the FSSA) is broad and captures any indirect ownership or controlling interests, including beneficial interests, provided control over voting has not been entirely alienated from the beneficial owner.</p> <p>The FSSA applies to both domestic and non-domestic stakeholders. Where an application is from a non-domestic person the proposal may need separate approval from the Treasurer under the <i>Foreign Acquisitions and Takeovers Act 1975</i>. The Treasurer will receive the advice of the Foreign Investment Review Board (FIRB) on whether the proposed acquisition is consistent with the government's foreign investment policy, but the Treasurer is not bound by such advice. APRA will seek information from foreign supervisors where it is material to deciding an application involving entities domiciled or regulated in a foreign jurisdiction.</p> <p>Further, if the merger or acquisition would have the effect of substantially lessening competition in a market, it is prohibited under section 50 of the <i>Competition and Consumer Act 2010</i>. The Australian Competition and Consumer Commission (ACCC) assesses acquisitions for compliance with section 50 (noting that exemptions for some particular situations are provided for in the <i>Banking Act 1959</i> (Banking Act)).</p> <p>In the event that an acquisition is likely to substantially lessen competition, authorization can be sought from the Australian Competition Tribunal if the merger parties consider there will be a net benefit to the public if the merger or acquisition proceeds.<sup>4</sup></p>
<b>EC3</b>	The supervisor has the power to reject any proposal for a change in significant ownership, including beneficial ownership, or controlling interest, or prevent the exercise of voting rights in respect of such investments, if they do not meet criteria comparable to those used for approving new banks.
Description and findings re EC3	Ownership of an ADI is governed by the FSSA rather than the Banking Act 1959. The FSSA limits shareholdings to 15 percent unless the Treasurer (or APRA acting with delegated authority) approves the holding on grounds of national interest. In other words, the restrictions set out in the FSSA apply equally to new banks and to

<sup>4</sup>The Australian Competition Tribunal hears applications for review of determinations of ACCC granting or revoking authorizations permitting conduct and arrangements that would otherwise be prohibited under the Competition and Consumer Act because of their anti-competitive effect. The Tribunal also hears applications for review of determinations of the Commission granting or refusing clearances for company mergers and acquisitions.

	<p>changes in ownership of existing banks.</p> <p>APRA has full determination, i.e., delegated authority where size of the entity is below the one billion dollar asset threshold, but the determination rests with the Treasurer when the value of the entity's assets` is above the threshold.</p> <p>Where APRA exercises its delegated authority, it assesses all significant new shareholders of an existing institution on the same basis as it assesses initial shareholders in new banks.</p> <p>Approval is given under section 14 of the FSSA to the holding of a stake exceeding 15 percent if the transaction is considered to be in the national interest. No definition of 'national interest' exists in the FSSA. Judgments commonly consider the proposed transaction in terms of prudential issues, unsuitable influential person(s), undue economic power and whether it is considered contrary to the national interest. However, the focus of APRA's supervision centers on the prudential issues as they apply in the circumstances. Input of other agencies (for example, ACCC) may be sought in relation to other criteria. Proposals not considered to be in the national interest are rejected.</p> <p>In addition, the Treasurer or, where applicable, APRA as the Treasurer's delegate, may revoke or vary an existing approval to hold a shareholding in excess of 15 percent if satisfied that it is in the national interest to do so, of if there has been a contravention of the existing approval.</p> <p>Powers also exist to obtain orders of the Federal Court of Australia, including orders directing disposal of shares and orders restraining or disregarding the exercise of any rights associated with shares. In the circumstance where APRA considered that voting power had been exceeded without approval it may turn to the Federal Court on the grounds that an offence had been committed.</p> <p>As noted above, where value of the entity's assets is above the one billion dollar asset threshold, the determination rests with the Treasurer. In these circumstances should the Treasurer make a determination with which the supervisor did not agree, APRA does not have the direct legal power to itself reject the proposed change of control. In such a scenario, however, APRA's legal recourse in terms of preventing the exercise of control would include powers such as seeking to compulsorily transfer the business of the bank to another bank under the FSBTGR Act and revoking the license of the bank. The action would need to be proportionate to the risk posed by the inappropriate shareholding. Were APRA able to demonstrate that, consequent upon the circumstances of the particular shareholding, whether through pressure exerted upon the bank or otherwise, either:</p> <p>(i) it is likely that the ADI will be unable to carry on banking business in Australia consistently with the interests of its depositors; or</p> <p>(ii) it is likely that the ADI will be unable to carry on banking business in Australia consistently with the stability of the financial system in Australia,</p> <p>APRA could take control of the ADI's business or appoint a statutory manager to take control of the ADI's business (section 13AA(1)(b)(iii) and (iv) and section 13(2) Banking Act). In such circumstances the shareholders would not be able to exercise any control over the bank.</p>
<b>EC4</b>	<p>The supervisor obtains from banks, through periodic reporting or on-site examinations, the names and holdings of all significant shareholders or those that exert controlling influence, including the identities of beneficial owners of shares being held by nominees, custodians and through vehicles which might be used to disguise ownership.</p>
Description and findings re EC4	<p>As noted in EC1, FSSA approval involves assessing a person's stake in a financial sector company, which is the aggregate of the person's voting power and the voting</p>

	<p>power of the person's associates. This process of investigation over the shareholder and associates provides a basis for obtaining and understanding the ultimate ownership and/or control of a bank.</p> <p>APRA does not routinely collect information on names and holdings of significant shareholders. Should APRA have doubts about whether undue influence is being exerted by owners of a bank, APRA can ask the bank to provide the full details of its owners under section 62 of the Banking Act.</p> <p>Some information will be routinely available due to disclosure provisions of company law although the disclosures are not made specifically to APRA. Under section 671B of the <i>Corporations Act 2001</i> (Corporations Act), where a person acquires or ceases to have a substantial holding in a listed company, or has a substantial holding in the bank and there is a movement of at least one percent in their holding, that person must lodge a substantial shareholding notice with ASIC and the relevant stock exchange within two business days. A substantial holding is defined as five percent or more of total votes attached to voting shares in the bank.</p> <p>ASIC has powers to issue a disclosure notice to persons for their ownership and/or interests in a publicly listed corporation or a company with more than 50 members for the purposes of the Corporations Act.</p>
<b>EC5</b>	The supervisor has the power to take appropriate action to modify, reverse or otherwise address a change of control that has taken place without the necessary notification to or approval from the supervisor.
Description and findings re EC5	<p>Where a person holds a stake in a financial sector company in excess of 15 percent and the holding of that stake or a higher percentage stake has not been approved by the Treasurer, an unacceptable shareholding situation exists. The Treasurer may apply to the Federal Court for orders to remedy this situation, including the making by the Court of a divestment order. Section 11 of the FSSA makes it an offence for a person to acquire shares where the person knows or is reckless as to whether the acquisition will result in an unacceptable shareholding situation coming into being in relation to that person or a third party.</p> <p>Indeed, APRA has delegation from the Treasurer to make application to the Federal Court. There is no limit on this particular delegation, so APRA could make application regardless of the size of the entity. APRA may initiate proceedings under section 12 (through an enduring delegation the Treasurer has provided under section 44) without needing to involve the Treasurer, other than a requirement that he/she be informed. In short, the ability to bring an action for breach of the Act does not line up with the delegations limits. APRA may initiate action to remedy all breaches of the Act.</p> <p>In addition, ASIC has divestiture powers in the Corporations Act that enable the unwinding of structures facilitating voting power that is unauthorized.</p> <p>Further, if a merger or acquisition proceeds in breach of section 50 of the Competition and Consumer Act (i.e., it would substantially lessen competition), the Federal Court of Australia can order divestiture of assets or declare the acquisition void on the application of the ACCC or any person.</p>
<b>Additional criteria</b>	
<b>AC1</b>	Laws and regulations provide, or the supervisor ensures, that banks must notify the supervisor as soon as they become aware of any material information which may negatively affect the suitability of a major shareholder.



Description and findings re AC1	<p>There is no specific requirement for a bank to notify APRA if it becomes aware of material information that raises questions as to the suitability of a major shareholder. In discussion with the assessors, APRA explained that their expectation is that a bank's Board or management would alert APRA in a timely manner, to matters considered to have the potential to adversely impact on the bank or its reputation. This would include situations where the shareholder's influence was exercised through board representation and doubts were raised about governance standards or the fitness and propriety of directors (matters specifically addressed in prudential standards). No specific example was relevant to the suitability of shareholders, but APRA described instances in which institutions had delayed notification of adverse developments and the supervisor had made it plain that the lateness of information was unacceptable.</p> <p>Overall, given its supervisory approach involving regular close contact with banks, boards and management, APRA is effectively alerted to material issues in a timely manner.</p>
<b>Assessment of Principle 4</b>	<b>Materially Non Compliant</b>
Comments	<p>APRA's powers concerning the right to object to or prevent a change of control of an ADI are subject to restriction. The restriction itself arises from the provisions of the FSSA and applies in respect of entities with assets over a \$1,000 million threshold where decision making powers have not been delegated to APRA by the Treasurer. In other words, the restriction placed on APRA is in respect of the systemic institutions. It is important to stress that in practical terms there is no evidence or history to suggest that the Treasurer would fail to abide by advice from APRA where the supervisor had concerns regarding a potential change of control. Moreover there is no history of prudential issues arising from change of control despite lack of legal power for APRA. Although it is wholly legitimate for a jurisdiction to nominate the approval powers to a finance ministry in recognition of national interests being fully and completely taken into consideration, the methodology requires that the supervisor has power to reject a change of control, meaning that approval powers granted to a different authority cannot override prudential considerations.</p> <p>Nevertheless, the remedies open to APRA should a change of control be approved by the Treasurer against the advice of the supervisory authority are cumbersome and lengthy. It would be preferable to ensure that APRA be given a clear and binding right of veto on prudential grounds concerning change of control of ADIs irrespective of the scale of the entity.</p> <p>APRA does not require an ADI to provide regular notifications of its major shareholders, including ultimate beneficial shareholders. It is accepted that there is information available in respect of listed entities and it is recognized that any change to "significant control" above 15 percent could not occur without APRA being aware (due to the FSSA), but it is recommended that such a requirement, at a minimum on an annual basis, be introduced for all institutions. One reason for the criterion, and a motivation behind other jurisdictions setting a significance threshold to be reported of 5 percent, is to ensure the authority is able to identify the identities of beneficial owners of shares being held by nominees, custodians and through vehicles which might be used to disguise ownership. The discipline would support the existing APRA culture that an institution ensures that its supervisor is kept fully updated in a timely manner on its corporate affairs.</p>

	It is recommended that APRA introduce requirements in order to ensure that a bank or ADI must notify the supervisor as soon as they become aware of any material adverse development concerning the suitability of a major shareholder.
<b>Principle 5</b>	<b>Major acquisitions.</b> The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and confirming that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.
<b>Essential criteria</b>	
<b>EC1</b>	Laws or regulations clearly define what types and amounts (absolute and/or in relation to a bank's capital) of acquisitions and investments need prior supervisory approval.
Description and findings re EC1	<p>Australian laws and regulations clearly define the acquisitions and investments that need prior supervisory approval.</p> <p>Requirements for prior notification to APRA and for APRA's approval of acquisitions and investments are set out in <i>Prudential Standard APS 222--Associations with Related Entities</i>. Foreign bank branches are only subject to paragraph 20 to 31 of APS 222.</p> <p>The standard (subparagraph 8(c)) requires banks to advise APRA in advance of any proposed change to its operations or the operations of its group that has the potential to materially alter the group's overall risk profile. APS 222 specifically requires that a bank must consult with APRA before:</p> <ul style="list-style-type: none"> <li>• establishing or acquiring a subsidiary (other than an entity that is to be used purely as a special purpose financing vehicle for the bank) (paragraph 35(a));</li> <li>• committing to any proposal to acquire an interest of more than 20 percent in another entity (paragraph 35(b)); and</li> <li>• taking up an interest in an entity arising from the work-out of a problem exposure where the interest exceeds certain specified thresholds (paragraph 35(c)).</li> </ul> <p>The assessors discussed with APRA whether there was a formal approval process in place or whether the obligation was for the institution to consult. APRA confirmed that it is not a formal approval but that the institution was expected to take APRA through its due diligence. Examples were discussed of cases where APRA had been satisfied by the banks' plans and of instances where APRA had not obtained sufficient comfort and the acquisition had not proceeded. APRA undertakes detailed assessments of all significant acquisitions, investments and new business lines proposed by banks. APRA expects banks to consult with it at an early stage of any such proposed activities.</p> <p>A bank must obtain APRA's prior consent to the establishment or acquisition of a regulated presence domestically or overseas (paragraph 8(d) of APS 222).</p> <p>In addition according to APS 222 (paragraph 37) an ADI must report any equity investments that are not subject to the prior consultation requirements set out in paragraph 35, in writing, to APRA within three months of undertaking the investment</p> <p>On a related note, paragraph 32 of APS 222 requires that a bank must at all times ensure that its exposures to related entities, both regulated and non-regulated, comply with certain thresholds calculated by reference to the bank's capital base (see also CP10, EC2). A bank is required to obtain prior approval from APRA for any proposed exposures in excess of the prescribed limits (Paragraph 32 of APS 222). Paragraph 34 of APS 222 notes that such approval will only be given on an exceptional basis where APRA is satisfied that the proposed exposure may reasonably be expected not to expose the bank to excessive risk and, even in such a</p>

	<p>case, APRA may impose higher prudential capital ratios on the bank to compensate for the additional risk.</p> <p>Separately from APS 222, if a bank proposes to acquire a stake in an Australian financial sector company (including an ADI, general insurer or life insurer) in excess of 15 percent, the bank requires the prior approval of the Australian Treasurer (or, where applicable, APRA as the Treasurer's delegate) under the <i>Financial Sector (Shareholdings) Act 1998</i> (FSSA). Section 14 of that Act endows the Australian Treasurer with broad discretion to grant or refuse such approval on national interest grounds (See CP4 for more information).</p>
<b>EC2</b>	Laws or regulations provide criteria by which to judge individual proposals.
Description and findings re EC2	<p>Laws and prudential standards provide criteria by which to judge individual proposals. Paragraph 4 of APS 222 provides that in assessing the risk associated with a bank's exposure to a related party, APRA will have regard to the following factors:</p> <ul style="list-style-type: none"> <li>• the financial strength of the group;</li> <li>• the nature of business conducted in group entities;</li> <li>• the quality of management and systems and, particularly, risk management across the group;</li> <li>• the level of financial and operational interdependence across the group, particularly between regulated and unregulated entities;</li> <li>• whether other members of the group are regulated entities (i.e., any entity directly regulated by APRA or by an equivalent banking or insurance prudential regulator overseas) and the quality of regulation;</li> <li>• the ratings (where applicable) of unregulated entities in the group;</li> <li>• badging and product distribution arrangements that might link the bank to the fortunes of other entities in the group; and</li> <li>• other relevant factors to be considered on a case-by-case basis.</li> </ul> <p>In addition, under APRA's internal guidelines, APRA would take into account the following matters when considering whether to grant consent in respect of a bank's proposal to proceed with an acquisition or investment:</p> <ul style="list-style-type: none"> <li>• the strategic rationale of, and future business plans for, the acquisition/investment;</li> <li>• how the acquisition/investment is to be funded and the expected impact on capital and profitability;</li> <li>• the quality and effectiveness of the due diligence process undertaken by the bank;</li> <li>• the bank's capacity to manage integration issues (including compatibility of IT systems, staffing, reporting to board and management);</li> <li>• group organisational structure and corporate governance;</li> <li>• risk management systems and controls to be applied to the new business;</li> <li>• the bank's expectations around trading activity, banking book position, funding and risk appetite for the new business;</li> <li>• the bank's expected exchange rate hedging policy for the new business; and</li> <li>• the position of the home supervisor, where relevant.</li> </ul> <p>As noted above, where a bank proposes to acquire a stake in an Australian financial sector company (including an ADI, general insurer or life insurer) in excess of 15 percent, the prior approval of the Treasurer (or, where applicable, APRA as the Treasurer's delegate) is required under section 14 of the FSSA. Section 14 of that</p>

	<p>Act endows the Treasurer with broad discretion to grant or refuse such approval on national grounds (Please see CP4).</p> <p>Where an acquisition has the potential to materially alter a bank's risk profile, APRA adopts an interactive process APRA expects banks to consult it informally prior to the submission of the formal acquisition proposal. APRA's initial feedback would typically iterate any concerns it might have, its expectations in relation to the documents the bank should submit in support of its application and any other issues, such as how the bank would ensure compliance with APRA's prudential requirements post-acquisition. Further meetings and submission of information including management's internal submission to its Board and work on due diligence might also be required. Furthermore, APRA's internal supervision methodology guidelines may require supervisors to consult with the risk specialists and/or legal specialists within APRA. As noted under EC1, the assessors discussed examples of situations that APRA had had to consider.</p>
<b>EC3</b>	<p>Consistent with licensing requirements, among the objective criteria that the supervisor uses is that any new acquisitions and investments do not expose the bank to undue risks or hinder effective supervision. The supervisor can prohibit banks from making major acquisitions / investments (including the establishment of foreign branches or subsidiaries) in countries with secrecy laws or other regulations prohibiting information flows deemed necessary for adequate consolidated supervision</p>
Description and findings re EC3	<p>In accordance with APS 222 APRA considers a wide range of matters pertaining to the risks and prudential implications associated with proposed acquisitions or investments. In practice, APRA will engage with the bank to ascertain how the bank proposes to comply with APRA's prudential requirements post-acquisition. Key areas of focus include:</p> <ul style="list-style-type: none"> <li>• what impact the proposed acquisition or investment might have on the capital position of the bank and how the bank would ensure that it can maintain its capital above APRA's minimum requirements post-acquisition;</li> <li>• how the bank's risk management framework would extend to the new entity including the adequacy of the Board and/or management reporting of the new entity;</li> <li>• the existing level of the bank's exposures to related entities; and</li> <li>• whether there will be any adverse reputational impact on the bank and how the bank proposes to manage and mitigate such impact.</li> </ul> <p>Were APRA not satisfied that a bank could comply with reporting obligations or with any other prudential or reporting requirements in respect of a foreign acquisition or investment (for example, due to secrecy regulations of the foreign jurisdiction), APRA would not consent to the bank proceeding with a proposed acquisition. Banks must comply with applicable reporting standards made by APRA under the <i>Financial Sector (Collection of Data) Act 2001</i>(FSCODA) on an entity and group basis and must also provide information that APRA may require to effectively supervise the group (subparagraph 8(a) of APS 222).</p> <p>In addition, under certain circumstances, APRA has powers under section 11CA of the Banking Act to direct a bank or authorized NOHC not to proceed with a proposed acquisition or investment, or otherwise divest itself the relevant interest. Examples of relevant circumstances include the bank or NOHC having contravened a condition of its license, the Banking Act 1959, or its financial condition is materially impaired or unsound.</p>
<b>EC4</b>	<p>The supervisor determines that the bank has, from the outset, adequate financial and organizational resources to handle the acquisition/investment.</p>

Description and findings re EC4	<p>APRA has a comprehensive and structured process for assessing acquisitions/investments. Assessments require consideration of a wide spectrum of prudential and other relevant issues including with respect to the adequacy of financial and organizational resources. Factors considered, and which are set out in the internal guidelines, include but are not limited to:</p> <ul style="list-style-type: none"> <li>• the quality and completeness of the due diligence process undertaken in relation to the acquisition/investment;</li> <li>• the size, nature and strategic intent and rationale for the acquisition or investment;</li> <li>• capital adequacy following acquisition/investment;</li> <li>• funding and liquidity considerations;</li> <li>• impact of the acquisition/investment on risk management systems and capabilities including proposed credit limits and delegation authorities; and</li> <li>• governance and oversight arrangements including an ability to meet financial and prudential reporting needs as well as apply sound project management practices associated with major acquisitions/investments.</li> </ul> <p>In the case of major acquisitions APRA's practice has been to review relevant Board or committee meeting minutes and associated papers as well as key policy and strategic documentation. Examples of documentation reviewed include:</p> <ul style="list-style-type: none"> <li>• due diligence reports;</li> <li>• capital management plans typically covering a period of three years and reflective of outcomes under different scenarios (for example, low growth, higher non-performing loans);</li> <li>• revised organizational structures and associated material of roles and responsibilities and how the revised delegation structure work operate;</li> <li>• business plans;</li> <li>• the policy framework for credit and operational risks, including aspects such as IT platforms, systems integration, customer-facing systems, etc.;</li> <li>• project management plans and details of how the transition and integration process would be managed;</li> <li>• revised funding plans incorporating varied scenarios and different time horizons; and</li> <li>• plans by financial control staff detailing how financial and prudential reporting requirements would be satisfied from the outset and on an ongoing basis.</li> </ul>
<b>EC5</b>	<p>Laws and regulations clearly define for which cases notification after the acquisition or investment is sufficient. Such cases should primarily refer to activities closely related to banking and the investment being small relative to the bank's capital.</p>
Description and findings re EC5	<p>APS 222 imposes a very low threshold for notification: the key requirement is that any proposal that has the potential to materially alter the group's overall risk profile requires prior notification (paragraph 8(c)). Notification after the event would only be acceptable where:</p> <ul style="list-style-type: none"> <li>• the acquisition or investment does not have the potential to materially alter the group's overall risk profile;</li> <li>• the acquisition or investment did not involve the establishment or acquisition of a subsidiary (other than a SPV financing vehicle);</li> <li>• the acquisition or investment does not involve regulated business (i.e., banking or insurance); and</li> <li>• the acquisition or investment did not represent an ownership stake of 20 percent or greater in an entity.</li> </ul> <p>As noted above, further notification requirements apply in discrete circumstances.</p>

	In the limited circumstances in which prior notification is not required, paragraph 37 of APS 222 requires banks to notify APRA of all equity investments in writing within three months of the investment.
<b>EC6</b>	The supervisor is aware of the risks that non-banking activities can pose to a banking group, and has the means to take action to mitigate those risks.
Description and findings re EC6	<p>Recognition, management and monitoring of potential contagion risk between a bank and other members of a conglomerate group is a key requirement of APS 222. Under APS 222, potential contagion risk is defined as the possibility that problems arising in other group members may compromise the financial and operational position of the bank. Factors that APRA will consider in assessing the level of risk of such associations are detailed in response to EC2 above. APS 222 empowers APRA to request any group information needed for the effective supervision of the group and permits APRA, in response to potential risks, to require a bank to establish additional internal controls and a more robust reporting mechanism and to maintain a higher prudential capital ratio if it is not satisfied with the adequacy of bank's systems and controls.</p> <p>The supervisors routinely monitor the level of the bank's exposures to its related entities and request further information from the bank where appropriate.</p> <p>A wide range of options, including requiring more capital, are available to APRA to address any prudential concerns arising from potential contagion risks.</p>
<b>Additional criteria</b>	
<b>AC1</b>	When a bank wishes to acquire a significant holding in a financial institution in another country, the supervisor should take into consideration the quality of supervision in that country and its own ability to exercise supervision on a consolidated basis.
Description and findings re AC1	<p>Where a bank wishes to acquire a significant holding in a financial institution in another country, APRA considers the quality of prudential supervision in that country and would seek to discuss significant acquisitions/investments with the relevant authorities/agencies. To date the majority of relevant overseas supervisors has been a relatively limited group with whom APRA is already familiar and well placed to make any necessary assessment.</p> <p>Specific assurances are sought from the acquiring bank that any significant acquisition would not jeopardize APRA's ability to exercise consolidated supervision. In discussion with the supervisors APRA confirmed that the bank would be reminded of APRA's expectations and requirements with respect to access to and availability of information.</p> <p>If there are concerns that effective consolidated supervision may be hindered, APRA may refuse to approve the transaction. Where APRA has reservations, it would respond in a manner appropriate to the circumstances. This may involve more intensive oversight of the operations of the foreign entity through the parent bank, requiring additional capital to be held or imposing specific risk management requirements. Alternatively, APRA might impose strict limits on the bank's exposure to the foreign entity or require other measures designed to limit the risk taken on by the foreign entity and/or limit the risk of contagion to the parent bank.</p>
<b>Assessment re Principle 5</b>	<b>Compliant</b>
Comments	
<b>Principle 6</b>	<b>Capital adequacy.</b> Supervisors must set prudent and appropriate minimum capital

	adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the applicable Basel requirement.
<b>Essential criteria</b>	
<b>EC1</b>	Laws and regulations require all banks to calculate and consistently maintain a minimum capital adequacy ratio. Laws, regulations or the supervisor define the components of capital, ensuring that emphasis is given to those elements of capital available to absorb losses.
Description and findings re EC1	<p>Capital Adequacy requirements are set out in a number of prudential standards, notably APS 110 and APS 111.</p> <p>APS 110 requires banks to maintain adequate capital on both a standalone and consolidated banking group basis to support the risks associated with their activities. The standard requires banks to maintain a prudential capital ratio (PCR) of at least eight percent (total capital) of which four percent must be Tier 1 capital at all times. In other words APRA expects banks to hold a buffer about their PCR (paragraph 14). The standard also permits APRA to increase a bank's PCR where APRA believes there are prudential reasons for doing so. When APRA increases the PCR, at least half of the higher ratio must be held as Tier 1 unless APRA explicitly states otherwise. APRA may increase PCRs on a standalone and consolidated basis. In practice, APRA has exercised this power and all banks currently have PCRs above the minimum Basel requirements.</p> <p>The components of capital are set out in APS111: i.e., the essential characteristics that an instrument must have to qualify as Tier 1 or Tier 2 capital for inclusion in the capital base for assessing individual and group capital adequacy. The definition is not weaker than the current applicable Basel standard (Basel II.5) and Tier 3 capital is not recognized.</p> <p>The capital base for the risk-based capital ratio is defined (paragraph 7, APS 111) as the sum of Tier 1 and Tier 2 capital, net of all specified deductions and amortization, subject to the limits that apply under the standard. APS 111 further emphasizes that regulatory capital components must have the ability to absorb losses.</p>
<b>EC2</b>	At least for internationally active bank, the definition of capital, the method of calculation and the ratio required are not lower than those established in the applicable Basel requirement.
Description and findings re EC2	<p>APRA's capital adequacy standards apply to all banks and the definition of capital, calculation methodologies and capital ratios accord with applicable Basel minimum requirements. APRA has, however, adopted a more conservative stance to regulatory capital in a number of areas, notably in relation to deductions (the majority of which are made from Tier 1 rather than 50 percent Tier 1 and 50 percent Tier 2) as well as the non-recognition of Tier 3 capital instruments as regulatory capital.</p> <p>At the time of the assessment in 2012, Basel 2.5 rules were in effect and draft prudential standards covering the Basel 3 framework were issued in March 2012. APRA intends to be an "early adopter" of the Basel 3 framework. A number of major banks were announcing, as of 2011, plans to increase their target levels of Tier 1 capital to higher levels than required by Basel 3.</p> <p>As of December 2011, the aggregate Tier 1 capital ratio for locally-incorporated banks was 10.3 percent of risk-weighted assets, up from 7.4 percent in 2007. The total</p>

	capital ratio was 11.8 percent.
<b>EC3</b>	The supervisor has the power to impose a specific capital charge and/or limits on all material risk exposures.
Description and findings re EC3	<p>In respect of a specific capital charge and/or limit on an exposure, APRA has broad powers granted by the Banking Act 1959 to set prudential standards (section 11AF). Examples of areas where APRA has made its ability to set or adjust capital requirements or set prudential limits include:</p> <ul style="list-style-type: none"> <li>• increase the multiplication factor above the usual minimum of three when relevant prudential requirements are not fully addressed but deficiencies fall short of necessitating the withdrawal of model approval for those banks using the internal model approach to market risk (<i>Prudential Standard APS 116 Capital Adequacy: Market Risk</i> (APS 116), Attachment C, paragraph 3);</li> <li>• require 'advanced' banks' to reduce the level of interest rate risk in the banking book (IRRBB) or increase capital if APRA considers the bank's capital is not commensurate with its risk profile (<i>Prudential Standard APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book (Advanced ADIs)</i>, paragraph 13);</li> <li>• raise a bank's capital requirement by a specified amount if APRA considers that implicit support is provided to a securitization including by increasing the capital charge on all the bank's securitization business (<i>Prudential Standard APS 120 Securitisation</i>), paragraph 21);</li> <li>• use its powers to increase provisions for credit loss or hold higher levels of capital where APRA considers that a bank's approach to the recognition and valuation of collateral may lead to the misstatement of provisions or regulatory capital or otherwise may reflect adversely on the safety and soundness of the bank (<i>Prudential Standard APS 220 Credit Quality</i>), paragraph 35);</li> <li>• require a bank (at solo or group level, i.e., Level 1 and/or Level 2) to maintain a higher capital ratio or otherwise direct a bank to reduce its level of risk concentration should APRA consider a bank is exposed to excessive concentration risk (<i>Prudential Standard APS 221 Large Exposures</i>), paragraphs 16, 21 and 22); and</li> <li>• require a bank to establish additional internal controls or more robust reporting mechanisms or to maintain higher capital levels if APRA is not satisfied that existing systems and controls are adequate to identify, review, monitor and manage exposures arising from dealings with related entities (<i>Prudential Standard APS 222 Associations with Related Entities</i>), paragraph 18).</li> </ul>
<b>EC4</b>	The required capital ratio reflects the risk profile of individual banks. Both on-balance sheet and off-balance sheet risks are included.
Description and findings re EC4	<p>As noted under EC 1, APRA has the power to set PCRs for Tier 1 and total capital for banks above the minimum levels established by the Basel Committee, and it has generally exercised this power. Institutions are not permitted to disclose their PCR publicly although their public documents indicate that APRA has set a PCR. The assessors reviewed APRA management reports which confirmed that PCRs have been set for all institutions (at solo and consolidated level) and that no PCR is in breach of the minimum Basel requirements.</p> <p>The PCR for an individual bank will reflect a number of inputs which are designed to capture the risk profile of the institution. The PAIRS analysis and rating (see CP19) provides a substantial input and the supervisory review process applied to an</p>



	<p>institution's own internal capital adequacy assessment is another main component. APRA conducts, at a minimum, an annual process to review the PCR. APRA uses its normal supervisory powers to intervene where it has concerns relating to the risk exposures of a bank. As part of this response, APRA may increase the PCR of a bank, issue directions to the bank to undertake specific actions or impose conditions on a banking authority if there are appropriate prudential reasons to do so. In APS 110, Attachment D, paragraph 6, the definition of total risk-weighted assets specifically includes both on-balance sheet and off-balance sheet assets.</p>
<b>EC5</b>	<p>Capital adequacy requirements take into account the conditions under which the banking system operates. Consequently, laws and regulations in a particular jurisdiction may set higher capital adequacy standards than the applicable Basel requirements.</p>
Description and findings re EC5	<p>As noted under EC1 and EC4, APRA has the power to set PCRs that are higher than the minimum levels established by the Basel Committee (and where at least half of the PCR must be met by Tier 1 capital). In practice, APRA exercises this power and sets PCRs above the minimum requirement in APS 110. All banks are currently operating above the minimum Basel requirements.</p>
<b>EC6</b>	<p>Laws or regulations clearly give the supervisor authority to take measures should a bank fall below the minimum capital ratio.</p>
Description and findings re EC6	<p>All banks are required to operate at levels that are higher than the PCR set by APRA, although APRA does not prescribe the degree of buffer required. Hence breach of the PCR is a breach of the minimum capital ratio. APRA has strong powers under the Banking Act 1959 to compel compliance by issuing a direction under section 11CA. Failure to comply with a direction from APRA is a criminal offence under the Banking Act. In addition, APRA may use its other enforcement powers under the Banking Act to ensure compliance. These include imposing a condition on a banking authority, issuing directions to the bank's Board and management, and taking control of the bank's business or appointing an administrator to take control of the bank's business if the bank appears likely to become, or becomes, unable to meet its obligations or suspends payments.</p> <p>Should APRA consider that a bank is at risk of breaching its PCR, APRA would use its normal supervisory powers to make an early intervention. If a bank's capital ratio declines below its PCR and towards the Basel minimum level, APRA would significantly increase its supervisory intensity and require the bank to develop and implement a plan to restore its capital ratio.</p>
<b>EC7</b>	<p>Where the supervisor permits banks to use internal assessments of risk as inputs to the calculation of regulatory capital, such assessments must adhere to rigorous qualifying standards and be subject to the approval of the supervisor. If banks do not continue to meet these qualifying standards on an ongoing basis, the supervisor may revoke its approval of the internal assessments.</p>
Description and findings re EC7	<p>Banks are permitted to use internal models to calculate regulatory capital subject to supervisory approval from APRA. Standards and requirements are set out in the prudential standards: the internal ratings-based (IRB) approach to credit risk (APS 113) ; the Advanced Measurement Approach (AMA) for operational risk (APS 115); interest rate risk in the banking book (APS 117) and for market risk (APS 116). The standards have been updated to incorporate the changes brought in by Basel 2.5. APRA's framework for ensuring ongoing compliance with the relevant prudential</p>

	<p>standards, includes onsite reviews.</p> <p>APRA adopts a policy of requiring a bank to take a full modeling approach, so that if it wishes to apply for internal ratings based approach for credit risk, the institution will be required to migrate to advanced approaches for operational risk and interest rate in the banking book also (APS 113 paragraph 25). This is part of a conscious policy to discourage IRB applications from entities who are mainly motivated by potential capital savings under the internal ratings approaches. APRA has rejected/discouraged model applications and did not take the policy approach of approving models with non-material deficiencies. APRA has not had a policy of requiring its major banks to use advanced approaches.</p> <p>Where APRA considers that the bank is not compliant with material aspects of the respective standards and that the capital calculation does not properly reflect the underlying risk, it may vary or revoke an approval or impose additional conditions on the approval if it determines that such conditions are appropriate. If considered necessary, the bank would be required to adopt the 'standardized' Basel II approaches. Revocation of IRB approval has not happened though variations of approval are on record and revocation of market risk model approval has occurred, as well as increase of required multipliers. The assessors noted that supervisory action plans have included targeted reviews addressing re-validation of IRB models consistent with recommendations from the IMF review of Basel II implementation in 2009. Discussion with firms confirmed close scrutiny and conservatism paid by APRA to models, their data inputs and surrounding governance. Firms noted however that the models teams, while skilled, appeared to be stretched in their resources.</p>
<b>Additional criteria</b>	
<b>AC1</b>	For non-internationally active banks, the definition of capital, the method of calculation and the capital required are broadly consistent with the principles of applicable Basel requirements relevant to internationally active banks.
Description and findings re AC1	APRA does not draw any distinction between internationally active and internationally non-active banks in relation to the application of capital standards: all banks must comply with the same prudential standards, which are consistent with, and in places more conservative than, applicable Basel requirements.
<b>AC2</b>	For non-internationally active banks and their holding companies, capital adequacy ratios are calculated and applied in a manner generally consistent with the applicable Basel requirement, as set forth in the footnote to the Principle.
Description and findings re AC2	APRA does not draw any distinction between internationally active and internationally non-active banks in relation to the application of capital standards: all banks must comply with the same prudential standards.
<b>AC3</b>	The supervisor has the power to require banks to adopt a forward-looking approach to capital management and set capital levels in anticipation of possible events or changes in market conditions that could have an adverse effect.
Description and findings re AC3	APRA requires banks to adopt a forward-looking approach to capital management. APS 110 outlines APRA's requirements in relation to capital management. Paragraph 6(b) requires banks to have a capital management plan that is consistent with the bank's overall business plan on an ongoing basis. This is an integral component of a bank's Internal Capital Adequacy Assessment Process (ICAAP), itself a requirement detailed in APS 110.

	<p>A key element of the ICAAP is the documentation of a bank's strategy for maintaining appropriate capital resources over time, and in the face of changing circumstances, as well as the means available for sourcing additional capital where required. A bank's ICAAP is one input into APRA's process of setting a PCR for each bank. Determining PCRs for individual banks allows APRA to set capital requirements in anticipation of possible events or changes in business plans or market conditions. The assessors observed that the supervisory analyses for banks include an assessment of the entity's outlook emphasizing the forward looking dimension of APRA's perspective. During 2008 and 2009 in particular APRA sought to give more feedback to firms on stress, scenario testing. Currently there is an overall review of the ICAAP processes.</p>
<b>AC4</b>	The supervisor requires adequate distribution of capital within different entities of the banking group according to the allocation of risks.
Description and findings re AC4	<p>APS 110 outlines the overall framework for assessing capital adequacy. It requires banks to maintain adequate capital, on both an individual and group basis, to act as a buffer against the risks associated with their activities (paragraph 6, which applies to banks on a solo and consolidated basis).</p> <p>Additionally, a bank that heads a conglomerate group (incorporating insurance entities), in addition to maintaining adequate capital in the bank, must satisfy APRA that the group as a whole has a level of capital consistent with the group's risk profile. To this end, the Board of a bank that heads a conglomerate group must establish policies on group capital adequacy (which have regard to the type and distribution of risks and capital resources held by the group) and implement a group capital management plan to ensure that the group overall is adequately capitalized to cover its risks and to meet regulatory, market and strategic needs (paragraph 9).</p> <p>APS 110 requires that the Board of a bank that is a member of a conglomerate group have regard to the ability to readily extract capital from another member in the group should the need arise to recapitalize the bank or other group member. This includes consideration of the integration of the business within the group, the importance of subsidiaries to the group and the impact of taxation, regulatory requirements and other factors on the ability to realize investments in, or transfer surplus capital from, subsidiaries.</p>
<b>AC5</b>	The supervisor may require an individual bank or banking group to maintain capital above the minimum to ensure that individual banks or banking groups are operating with the appropriate level of capital.
Description and findings re AC5	As noted under EC1, APRA has and exercises its power to set Tier 1 and total capital ratios (namely PCRs) and for individual banks or banking groups above the minimum levels established by the Basel Committee.
<b>Assessment re principle 6</b>	<b>Compliant</b>
Comments	<p>APRA has long adopted a conservative approach to the definition of capital; a stance that it is maintaining through the transition to the Basel 3 framework. Because the definition of capital used in Australia is conservative, relative to the applicable Basel standard, capital ratios are lower than they would be if calculated in other jurisdictions. APRA has made a comparison of calculations based on its methodology and some European methodologies, for example. Some banks routinely publish their ratios calculated under more than one standard to illustrate this point. It is possible that the strength of the capital ratios calculated according to the APRA framework may not be</p>

	fully understood without such illustrative comparisons of calculations. A more comprehensive disclosure regime would support the financial community in being able to make valid comparisons between the strength of capital available in the Australian banking system and other jurisdictions.
<b>Principle 7</b>	<b>Risk management process.</b> Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including Board and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.
<b>Essential criteria</b>	
<b>EC1</b>	Individual banks and banking groups are required to have in place comprehensive risk management policies and processes to identify, evaluate, monitor and control or mitigate material risks. The supervisor determines that these processes are adequate for the size and nature of the activities of the bank and the banking group and are periodically adjusted in the light of the changing risk profile of the bank or banking group and external market developments. If the supervisor determines that the risk management processes are inadequate, it has the power to require a bank or banking group to strengthen them.
Description and findings re EC1	<p>APRA's risk management requirements are detailed in its prudential standards. In particular, <i>Prudential Standard APS 310 Audit and Related Matters</i> requires the Board and management to ensure that the bank meets prudential and statutory requirements and has management practices to limit risks to prudent levels. <i>Prudential Standard APS 222 Associations with Related Entities</i> requires banks to establish appropriate policies, systems and procedures to monitor compliance with APRA's prudential requirements on a group basis. Various prudential standards detail specific risk management requirements for material risks including credit, liquidity, market and operational risk.</p> <p>A bank's risk profile and risk management framework are assessed in the 'Inherent Risk' and 'Management and Controls' components within the Probability and Impact Rating System (PAIRS). The outcome of the assessment feeds through to the Supervisory Oversight and Response System (SOARS) and supervisory action plans (SAPs) (See CP 19 for more detail on the supervisory systems). There is supporting guidance in the PAIRS framework to assist the supervisors in assessing and rating the quality of risk governance and management.</p> <p>APS 222 requires the Board or a board committee to review and adjust Board-approved policies and the relevant controls regularly (at least annually) to take account of changing risk profiles of group entities to ensure that these policies and controls remain adequate and appropriate for managing and monitoring overall group risk. Onsite reviews assess bank management processes and require "demonstrated applications".</p> <p>Following an onsite review, APRA issues a report to the Board of the bank that will typically include recommendations and requirements regarding, as appropriate, aspects of the risk management framework and risk management processes. The assessors observed, through file review, that APRA can send highly detailed recommendations and requirements and that it expects remedial action to be carried out in a timely manner. APRA might (based on file evidence) ask the bank to specify a timetable the assessors also saw examples where APRA indicated that it was dissatisfied with either the slow timing of remedial action or slow progress and slipped</p>

	<p>timetables. APRA would be entitled to use its formal powers if necessary to ensure compliance (See CP 23 for details on corrective actions).</p> <p>APRA plans to draw together many of the existing risk management requirements into an overarching risk management standard for banks as part of its ongoing policy development program. Although certain requirements related to specific risk topics will remain in other standards, the initiative will harmonise the ADI prudential framework for risk management (in common with other behavioural standards such as outsourcing and business continuity management and fit and proper assessments) with that of the insurance industry.</p>
<b>EC2</b>	<p>The supervisor confirms that banks and banking groups have appropriate risk management strategies that have been approved by the board. The supervisor also confirms that the board ensures that policies and processes for risk-taking are developed, appropriate limits are established, and senior management takes steps necessary to monitor and control all material risks consistent with the approved strategies.</p>
Description and findings re EC2	<p>Under APS 310, the Board and Chief Executive Officer must attest annually that they have identified the key risks of the bank or banking group and established systems to monitor and manage those key risks – see further details below.</p> <p>APRA has requested banks to formally develop risk appetite statements (RAS). Apart from consideration during regular onsite prudential reviews, APRA undertook a thematic offsite review of RAS for a cross-section of APRA-supervised entities during 2010/11. This work has been used to benchmark RAS and provide feedback to entities as part of prudential review findings, as appropriate. The assessors noted that the early RAS submissions (in 2009) have been subsequently revised and discussions with firms indicated that the RAS process is taken very seriously and firms are attempting to cascade and embed the risk approach articulated in the RAS throughout their business lines. It is an area of continuing evolution.</p> <p><i>Prudential Standard APS 510 Governance (APS 510)</i> contains requirements for a board committee to assist the Board by providing an objective non-executive review of the effectiveness of the regulated institution's risk management framework (paragraph 55).</p> <p>As part of the APS 310 annual declaration, the Board and Chief Executive Officer must attest that:</p> <ul style="list-style-type: none"> <li>• they have identified the key risks of the bank or (Level 2) group;</li> <li>• they have established systems to monitor and manage the key risks including, where appropriate, by setting and requiring adherence to a series of prudent limits, and by adequate and timely reporting processes;</li> <li>• the risk management systems are operating effectively and are adequate having regard to the risks they are designed to control; and</li> <li>• the descriptions of risk management systems provided to APRA are accurate and current.</li> </ul> <p>Banks are required to ensure that the Chief Executive Officer provides an explanation, endorsed by the Board, of any qualifications made to the Chief Executive Officer's declaration, including plans for corrective actions to address any deficiencies identified in the risk management systems. APRA noted that supervisory activity routinely looks at the existence and robustness of processes within the bank to support the provision of these attestations. The PAIRS guidance module on risk governance supports supervisory assessment of the quality of the risk management framework and draws attention to the need for banks to have robust risk management policies in place and are being implemented and reviewed on a regular basis.</p>

	<p>Specific prudential standards on key risks, such as liquidity management, require the Board or a board committee to approve a strategy in relation to the management of that risk.</p> <p>In addition, banks must have a Board Audit Committee and an internal audit function. The appointed auditor also reviews bank compliance with APRA's prudential standards, including the adequacy of risk management systems. Management is expected to respond to any findings from these reviews.</p>
<b>EC3</b>	<p>The supervisor determines that risk management strategies, policies, processes and limits are properly documented, reviewed and updated, communicated within the bank and banking group, and adhered to in practice. The supervisor determines that exceptions to established policies, processes and limits receive the prompt attention of and authorization by the appropriate level of management and the Board where necessary.</p>
Description and findings re EC3	<p>APS 310 requires banks' risk management practices to be detailed in descriptions of risk management systems that must be regularly reviewed and updated, at least annually, to take account of changing circumstances (APS 310, paragraph 23). Banks are required to provide APRA with high-level descriptions of their key risk management systems covering all major areas of risk, and to inform APRA of all material changes (APS 310, paragraph 24). Among other things, the annual declaration required of a Bank's Chief Executive Officer, endorsed by the Board, is a confirmation that the description of risk management systems provided to APRA is accurate and current. Any qualification triggers prompt supervisory attention.</p> <p>APRA requires banks to have robust management information systems that readily allow management and the Board to identify, monitor and manage exceptions. Standard information requests for onsite prudential reviews include copies of relevant risk management documentation and of reports used by management and the Board to gauge compliance and exercise oversight.</p> <p>In discussion APRA staff noted that documentation is routinely reviewed and the PAIRS guidance draws attention to the need for policy exceptions and limit excesses to be carefully managed. Supervisors pay particular attention to the management of policy exceptions and limit excesses through review of internal documentation, accompanying processes and assessments of the level of staff understanding of such exception and excess reporting.</p> <p>APRA assesses how readily accessible of relevant policies and procedural documentation is to staff during onsite prudential reviews, noting that increasingly banks are using intranet sites to communicate policies to staff. The assessors saw examples of pre-review documentation requests to firms.</p> <p>Reviews of risk management systems include consideration of the adequacy, quality and implications of risk management information presented to Board and management. Again, the PAIRS guidance module on risk governance provides support to supervisors in conducting this assessment.</p> <p>In addition to APRA's own supervisory oversight of risk management, APRA may appoint an auditor to assess the adequacy of a specific aspect of a bank's risk management through a special purpose engagement under APS 310. These types of reviews are typically undertaken on an annual basis for larger banks.</p>
<b>EC4</b>	<p>The supervisor determines that senior management and the board understand the nature and level of risk being taken by the bank and how this risk relates to adequate capital levels. The supervisor also determines that senior management ensure that the risk management policies and processes are appropriate in the light of the bank's risk profile and business plan and that they are implemented effectively. This includes a requirement that senior management regularly reviews and understand the</p>

	<p>implications (and limitations) of the risk management information that it receives. The same requirement applies to the board in relation to risk management information presented to it in a format suitable for board oversight.</p>
<p>Description and findings re EC4</p>	<p>APRA frequently meets or interacts with senior management and the Board of banks and banking groups through its prudential supervisory cycle. The Chairman of APRA will meet with the Boards of the major banks on an annual basis.</p> <p>The individual prudential standards focused on individual risks, as well as the prudential standards relating risk profile to capital (i.e., APS 110) underpin the requirement for the bank to manage risk and relate its risks to capital (See EC5 for further discussion of banks' standards in this area). The requirement for senior management/Board to have an understanding of the risks is within the over-arching context of the Board and senior management having responsibility for the direction and management of the entity. APRA requires the delegation of authority to be clearly set out and documented.</p> <p>Supervisors seek to ensure that onsite prudential reviews or other prudential meetings are highly interactive in order to assess the actual knowledge of business and risk management staff, the strength of the bank's risk management culture and the degree to which Board-approved policies and procedures are embedded in the bank. Supplementary checks, such as loan file reviews, may also take place to allow supervisors to assess the application of policies in practice. Presentations to the supervisors are generally limited to no more than half the allocated time of the reviews or meetings. The Assessors were able to review supervisory letters following on-site reviews provide details to credit institutions of supervisory expectations. Supervisory review processes in relation to risk governance of the Board is supported by internal guidance which points to consideration of:</p> <ul style="list-style-type: none"> <li>• how the Board sets the risk management framework;</li> <li>• the role of the Board in approving the Risk Management Systems Description (RMSD) required by APS 310;</li> <li>• how risk appetite and risk tolerance are expressed;</li> <li>• how risks are defined, understood and managed as distinct risk classes; and</li> <li>• the alignment of RMSD to strategic and business plans.</li> </ul> <p>Reviewing Board meeting minutes and relevant supporting reports as well as equivalents for key risk and audit committees is a core element of APRA's supervisory review activities.</p> <p>APS 510 requires the Board Audit Committee (unless there is another board committee that carries out this function with respect to risk management--paragraph 55 of APS 510) to review the effectiveness of the financial reporting and risk management framework of the bank. The Board must enforce clear lines of responsibility and accountability throughout the bank or group for all aspects of the risk management framework. The Board must also ensure that management implements and monitors the effectiveness of the risk management system.</p> <p>APS 222 requires the Board or a board committee to review and adjust Board-approved policies and the relevant controls regularly (at least annually) to take account of changing risk profiles of group entities to ensure they remain adequate and appropriate for managing and monitoring overall group risk.</p> <p>The Assessors discussed senior management and board involvement in risk matters with a range of institutions as well as APRA. The discussions indicated that there was variation of practice within the industry but that there was an evolutionary process taking place. A number of institutions reported fairly recent changes to their management structure, while other firms were further down the path of embedding the</p>

	<p>board involvement in the oversight of strategic matters.</p> <p>The assessors also reviewed the supervisory guidance being used to support the analysis and rating of risk governance within the PAIRS framework as well as examples of PAIRS assessments. The guidance provided strong input with respect to issues surrounding structures and processes. This guidance also expresses the clear expectation that a Board should understand the risks of the group/institution. One useful area, also supported by the guidance, relates to the need for clear articulation of risk appetite statements, which is an area in which APRA has been requiring firms to improve their standards and staff considers that notable improvements have been seen, not least through the “cascading” of the statements through the architecture of the firms/groups.</p> <p>Discussions with APRA staff indicated strong commitment to the need for continued improvements in risk governance within firms. APRA staff considered that there was evidence that some risks were now being thought through in a more integrated manner leaving behind the silo based approach to risk management, strongly evident before the global financial crisis.</p>
<b>EC5</b>	<p>The supervisor determines that the banks have an internal process for assessing their overall capital adequacy in relation to their risk profile, and reviews and evaluates bank’s internal capital adequacy assessments and strategies. The nature of the specific methodology used for this assessment will depend on the size, complexity and business strategy of a bank. Non-complex banks may opt for a more qualitative approach to capital planning.</p>
Description and findings re EC5	<p>APS 110 provides the overarching framework for APRA’s capital adequacy requirements, including capital management. All banks are required by APS 110 to have an ICAAP in place. This requirement reflects the Board’s duty to ensure that the bank maintains an appropriate level and quality of capital commensurate with the level and extent of risks to which the bank is exposed from its activities. It also recognizes that capital serves as a benchmark against which the financial condition of a bank can be measured.</p> <p>Under the terms of APS110 the ICAAP must include, as a minimum:</p> <ul style="list-style-type: none"> <li>• adequate systems and procedures to identify, measure, monitor and manage the risks arising from the bank’s activities on a continuous basis to ensure that capital is held at a level consistent with the banks’ risk profile; and</li> <li>• a capital management plan, consistent with the bank’s overall business plan, for managing the bank’s capital levels on an ongoing basis. Essentially, the plan must set out: <ul style="list-style-type: none"> <li>○ the bank’s strategy for maintaining adequate capital over time, including outlining its capital target for providing a buffer against the risks involved in the bank’s activities, how the target level of capital is to be met and the means available for sourcing additional capital where required; and</li> <li>○ actions and procedures for monitoring the bank’s compliance with minimum regulatory capital adequacy requirements, including the setting of trigger ratios to alert management to, and to avert, potential breaches of these requirements.</li> </ul> </li> </ul> <p>Furthermore, a bank’s ICAAP is required to be subject to effective and comprehensive review. The frequency and scope of review must be appropriate to the bank having regard to the size, business mix and complexity of the bank’s operations and the nature and extent of any change to its business profile and risk appetite. Supervisors commented in discussion with the assessors that while some institutions had made considerable progress not all ICAAP documents which they examined were</p>



	<p>sufficiently well developed or necessarily fit for their purpose. The assessors were able to note a number of ICAAP submissions which supported the supervisors' assessment. It may be noted (see also CP 20) that APRA, unlike some other supervisory authorities, takes an independent approach (i.e., PAIRS) in establishing what it deems to be an appropriate capital to risk relationship for the institutions. ICAAPs are reviewed as part of routine supervisory activity on an annual basis. Reviews take into account institutional features and are periodically undertaken on a peer and cross-sectorial basis in keeping with the strong peer group approach that APRA adopts. As APRA takes a proportionate approach, the creation of an economic capital model is not obligatory for firms.</p>
<b>EC6</b>	<p>Where banks and banking groups use models to measure components of risk, the supervisor determines that banks perform periodic and independent validation and testing of the models and systems.</p>
Description and findings re EC6	<p>All banks wishing to use the advanced methodologies for regulatory capital adequacy purposes require approval from APRA. Implementation of the Basel II Capital Framework, including reliance on advanced approaches, was subject to an IMF assessment in 2009. The IMF broadly found that APRA had effectively implemented Basel II in accordance with the principles set out in the Basel II Capital Framework. APRA's prudential standards relating to credit, market, operational risk and interest rate risk in the banking book (IRRBB) (APS 113, 115, 116 and 117) require banks accredited to use internal models for regulatory capital adequacy purposes to have an independent, robust and documented system in place to validate the accuracy and consistency of underlying models. Validation efforts should be capable of assessing the performance of relevant models in a meaningful and consistent manner. Models should also be subject to periodic re-validation.</p> <p>These prudential standards incorporate a requirement for an independent review of the risk measurement system and overall risk management process. In addition, APRA looks to the appointed auditor's report in terms of APS 310 to provide assurance on compliance with all prudential standards, including capital adequacy when based on advanced approaches reliant upon a bank's internal risk models. Such assurance is provided on a 'limited assurance' basis.</p> <p>With the assistance of specialist internal resources, APRA periodically undertakes targeted onsite prudential reviews to facilitate its assessment of banks' internal models and the robustness of their validation efforts. Modification of internal models for capital purposes requires APRA's prior approval.</p>
<b>EC7</b>	<p>The supervisor determines that bank and banking groups have adequate information systems for measuring, assessing and reporting on the size, composition and quality of exposures. It is satisfied that these reports are provided on a timely basis to the board or senior management and reflect the bank's risk profile and capital needs.</p>
Description and findings re EC7	<p>APRA seeks to determine that banks and banking groups have adequate information systems for measuring, assessing and reporting on the size, composition and quality of exposures through the full program of supervisory activities. In some areas (e.g., liquidity risk) APRA will regularly receive MIS reporting. There is also a focus on technology risk in the present supervisory cycle which supports the continued work by firms on robust MIS systems.</p> <p>Internal supervisory guidance outlines factors to be considered by supervisors when assessing banks' management information systems (MIS) generally and in the context of particular material risks. Routine supervisory activity incorporates various opportunities to make and refine assessments about the quality and timeliness of MIS and management/Board reporting. Periodic reviews of Board and committee papers,</p>

	<p>insights provided by a bank's track record with respect to prudential reporting, reports from compliance and audit functions, and firsthand assessments from onsite reviews all contribute to an overall picture of MIS capability.</p> <p>APRA's review activity considers reporting across the breadth of the bank and the broader group as well as the hierarchy of reporting reflective of different users' needs. Reporting to the Board and key committees is reviewed regularly to ensure risk governance is appropriate and risk culture reinforced. Reports are expected to readily convey an up-to-date perspective of the risk profile for each material risk and on an enterprise-wide (or group-wide) basis. Day-to-day management reports addressing particular functions, sub-portfolios and exposure types are assessed as deemed appropriate. In recognition of the importance of information technology (IT) systems and the potential impact of an IT failure on a bank's inherent risk profile, APRA employs a team of IT risk specialists capable of assisting supervisors in their assessments of banks' MIS. It is common for IT operational risk reviews to incorporate assessments of Board reporting to facilitate their oversight responsibilities as well as the robustness of MIS.</p> <p>As noted in EC 5, all banks are required to have an ICAAP as an integral part of effective capital management. ICAAPs must be subject to effective and comprehensive review. It is the Board's responsibility to ensure that the bank maintains an appropriate level of quality of capital. In practice, banks incorporate regular reports on capital adequacy as part of routine reporting packs provided to relevant committees and/or the Board. Capital management is also an important component of banks' annual budget and strategic planning efforts. Reports, plans and supporting material are reviewed by APRA routinely as part of regular supervisory activities, including offsite and onsite prudential reviews and reviews of Board meeting minutes and supporting material.</p> <p>The annual declaration from banks' Chief Executive Officers, endorsed by the Board, provides an additional control. Among other things, this declaration must include a specific attestation as to the establishment of systems to monitor and manage risks including through adequate and timely reporting processes (APS 310, paragraph 26).</p>
<b>EC8</b>	<p>The supervisor determines that banks have policies and processes in place to ensure that new products and major risk management initiatives are approved by the board or a specific committee of the board.</p>
Description and findings re EC8	<p>Under the prudential standards Boards are required at all times to have a clear and comprehensive understanding of the inherent risks in their business and have a risk management framework in place to manage these risks, including where a bank proposes to undertake new business activities or products. In such cases the bank must consider from the outset the type and level of risk to which such activities or products may give rise, the impact upon the inherent risks in the bank's business and whether risk management processes require change (for example para 52 of APS 220 in relation to credit risk, or para 24 of APS 117 in relation to interest rate risk in the banking book). Likewise, major risk management initiatives must be thoroughly evaluated. APS 222 requires the Board of a bank to approve all material changes to group risk management policies.</p> <p>APRA's supervisory activities include assessing material new product and risk management initiatives. APRA expects banks to have robust product approval processes that subject new products to risk management assessments, as underpinned by the PAIRS supervisory guidance. Where the product exposes the entity to significant risks or is in a new and unfamiliar area of business, the bank would be expected to consult with APRA.</p> <p>APRA's focus on risk governance routinely incorporates an assessment of Board and</p>

	<p>senior management understanding and oversight of risks associated with new products and business initiatives. For example, market risk reviews would include a focus on new trading initiatives as would a credit review for a bank intending to enter particular lending segments for the first time and APRA would discuss these issues with the banks.</p>
<b>EC9</b>	<p>The supervisor determines that banks and banking groups have risk evaluation, monitoring and control or mitigation functions with duties clearly segregated from risk-taking functions in the bank, and which report on risk exposures directly to senior management and the board.</p>
Description and findings re EC9	<p>A fundamental premise of APRA's prudential supervision is that the ultimate responsibility for the sound and prudent management of a bank or banking group rests with its Board (see EC1 above). The supervisory expectation is articulated and reinforced through a broad range of prudential standards, not least APS 510, as well as other internal and external guidance, including:</p> <ul style="list-style-type: none"> <li>○ internal supervisory guidance--various modules such as Board, Management, Risk Governance and Operational Risk;</li> <li>○ the language that has been used in relevant prudential review reports (especially seeking to reinforce the linkage between good governance and the operation of robust risk management framework); and</li> <li>○ relevant external guidance such as AS/NZS ISO 31000:2009 Risk Management--Principles and Guidelines (which, among other things, discusses risk in the context of achieving organisational objectives) and Stock Exchange Listing Rules as they apply to listed entities.</li> </ul> <p>The adequacy of a bank's or banking group's risk evaluation, monitoring and control functions as well as the robustness of risk exposure reporting are subject to prudential requirements and routine supervisory review. Specific requirements regarding the reporting line of risk management functions are detailed in relation to specific risk issues in individual prudential standards. Examples include trading book valuation practices and the sourcing and verification of market prices or model inputs in relation to market risk management (e.g., APS 116 Attachment A, paragraph 18 and Attachment C, paragraph 8) and the independence of the separate risk control function required for Pillar 1 risks for advanced banks.</p> <p>APRA considers the robustness of internal controls, including separation of duties, as well as the risk function's contribution to organizational risk culture as part of its onsite prudential reviews. Among other things, reporting lines, roles and responsibilities, and systems support are taken into consideration. In addition, APRA places reliance on the work done by external and internal auditors in reviewing and assessing the appropriateness of risk control, monitoring and reporting systems and reporting. APRA periodically reviews these assessments and reports, before and during onsite prudential reviews.</p> <p>APRA considers how a bank's organizational structure facilitates appropriate risk management outcomes as a routine part of supervisory activity. This occurs irrespective of the risk focus of a particular onsite review and is considered an important input to APRA's overall assessment of management and controls within PAIRS.</p> <p>Increasingly, for larger banks, APRA noted that it encounters structures built around the 'three lines of defence' philosophy, a view strongly supported by all the banks with whom the assessors met. This approach rests on a clear distinction being drawn between those who manage risks within the business, those that monitor risks at a framework level and the oversight role of assurance provided at the third line (i.e.,</p>

	<p>internal audit).</p> <p>APRA pays attention to whether risk management functions have enough status and resources to satisfy their roles and responsibilities and achieve outcomes consistent with the Board-approved risk management framework. This includes the skills and experience of relevant staff, the independence of the function and evidence that material issues are escalated to the relevant management or board committees. To support its assessment, APRA obtains and examines “role statements” (i.e., statements of the role, responsibility, reporting, accountability and remuneration), key performance indicators and the appropriateness of remuneration incentives to ensure these are consistent with the intended outcomes for the risk functions. Reporting lines and access of internal and external audit to senior management and Boards/committees are also considered to ensure these functions can support risk functions.</p>
<b>EC10</b>	The supervisor issues standards related to, in particular, credit risk, market risk, liquidity risk, interest rate risk in the banking book and operational risk.
Description and findings re EC10	APRA has detailed prudential standards relating to all major risks. In particular these cover credit risk, large exposures, associations with related entities (although with limitations that are considered in CP11), liquidity risk, interest rate risk in the banking book, various operational risks (outsourcing, business continuity management), governance and fit and proper requirements.
<b>Additional criteria</b>	
<b>AC1</b>	The supervisor requires larger and more complex banks to have a dedicated unit(s) responsible for risk evaluation, monitoring and control or mitigation for material risk areas. The supervisor confirms that this unit (these units) is (are) subject to periodic review by the internal audit function.
Description and findings re AC1	<p>Banks are required to have risk management frameworks in place commensurate with their size, complexity and nature of business undertaken. For banks accredited to use the ‘advanced’ Basel II methodologies, specific operational requirements in relation to the need for independent risk management functions and ongoing independent review are outlined in individual prudential standards addressing different major risks.</p> <p>APS 310 requires banks to ensure that internal audit covers compliance with APRA prudential standards. As part of APRA’s offsite activities, supervisors routinely review banks’ annual internal audit plans to ensure adequate coverage and that key risk management areas are periodically reviewed. Further, as part of APRA’s onsite prudential reviews, supervisors typically meet with internal auditors without the presence of management to allow open discussions between supervisors and internal auditors. Such discussions enable APRA to assess the quality and competence of the bank’s internal audit function and to understand any issues faced by the internal auditors. Where APRA identifies any deficiencies in relation to the coverage of the internal audit function, APRA may require or recommend that the internal auditors conduct a review on the relevant unit(s).</p>
<b>AC2</b>	The supervisor requires banks to conduct rigorous, forward-looking testing that identifies possible events or changes in market conditions that could adversely impact on the bank.
Description and findings re AC2	Banks are required to undertake stress tests covering various types of risk (for example, the prudential requirements for stress testing market and liquidity risks have

	<p>been in place since September 2000, through standards APS 116 and APS 210 while those for credit risk (APS 112 &amp; APS 113) were formalized as part of Basel II implementation in January 2008). APRA's expectations as regards banks' ICAAPs also include reasonably frequent simulations of a range of unlikely but plausible adverse scenarios. Internal guidance provides supervisors with potential questions to consider when assessing stress/scenario adjustments made by banks in their ICAAPs.</p> <p>Expectations regarding stress testing are higher for banks using their own internal models for regulatory capital adequacy purposes. For example, a bank that uses the internal model approach to meet market risk capital requirements must have a comprehensive stress testing program to evaluate its capacity to absorb potential large losses and identify steps it can take to reduce risk and conserve capital (APS 116, Attachment C). These banks are required to publicly disclose the types of stress testing and value-at-risk (VaR) values that they apply for their trading portfolios (APS 330, Attachment A).</p> <p>APRA expects stress testing to be a routine element of banks' risk management systems. To this end, APRA required all advanced banks to conduct a self-assessment of their capabilities and approach to stress testing against the Basel Committee on Banking Supervision paper <i>Principles for sound stress testing practices and supervision</i> released in May 2009. Responses were reviewed and discussed with relevant banks. APRA has also communicated and reinforced its views and expectations on good practice through speeches of its own senior management. Subject to review scoping, an individual bank's approach to stress testing is discussed during onsite prudential reviews and other supervisory interactions. APRA has been developing its internal resourcing to support its stress testing capabilities and frontline supervisory effort. Other initiatives include the recent development of a proof-of-concept stress testing tool that uses data from prudential returns, combined with judgment-based risk estimates to project financial and regulatory capital outcomes. Plans to expand and deepen this capacity are in train.</p> <p>APRA uses stress testing as part of its supervisory activities to understand the vulnerabilities facing individual institutions and industries, as well as the potential for systemic threats.</p>
<b>AC3</b>	<p>The supervisor requires banks and banking groups to have in place appropriate policies and processes for assessing other material risks not directly addressed in the subsequent BCPs, such as reputational and strategic risks.</p>
Description and findings re AC3	<p>APRA expects reputational and strategic risk to be captured and addressed as part of the ICAAP, details of which are set out in APRA's Information Paper <i>Implementation of the Basel II Capital Framework Supervisory Review Process</i>. Supervisors would also expect to see strategic and operational risk captured in the operational risk management frameworks of all banks, whether standardized or advanced. Strategic risk is a specific component of APRA's PAIRS assessment.</p> <p>APS 222 requires a bank to have adequate systems, policies and procedures in place to manage, monitor and control contagion risk to ensure that it is kept at a modest level.</p> <p>Whether reputation risk is by way of group contagion or the result of the bank's own actions, its potential impact needs to be taken into account by banks in assessing overall capital adequacy. In quantifying the impact of a damaging operational failure, for example, the cost of the resulting damage to the bank's franchise may far exceed the direct cost of the operational risk event itself. In the context of its supervisory review APRA makes a judgment as to whether the capital allocated to the Pillar 1 risks is adequate to cover the reputational consequences of credit, market and</p>

	operational risk events. Finally, as part of its supervisory review, APRA will ascertain whether the bank believes there are any other risks to which it is materially exposed and the impact these risks may have on overall capital adequacy.
<b>Assessment of Principle 7</b>	<b>Largely Compliant</b>
Comments	<p>Compliance with this CP requires performance by both banks and supervisors, necessitating appropriate standards, policies and effective practice. This is underlined both in the overarching principle, which is the “lens” through which the individual criteria must be understood, but also in the individual criteria which clarify that it is necessary for the supervisor not merely to check but to be satisfied with the adequacy of banks’ performance. The supervisor is required to be active in making an assessment and it is necessary for the banks to have reached a standard that is adequate, i.e., proportional to the level of complexity/advancement. Globally the standards for and expectations surrounding risk management and the processes for relating capital to risk are rising.</p> <p>APRA’s long held emphasis upon Board responsibility provides a sound foundation for good risk management governance. Risk management governance structures within firms are typically well constructed, utilizing the “three lines of defence” model and ultimate Board oversight and responsibility is very clear.</p> <p>While the Australian banking system is mature, it is not highly complex and therefore on a proportionate basis appropriate risk management practices within banks are less difficult to achieve than in some jurisdictions that were more badly affected by the Global Financial Crisis. Nonetheless, the processes and procedures embedding good risk management within the banks is still undergoing seasoning, and not all firms have achieved an appropriate standard and this is the basis for the grading (ECs 4, 5 and 7). . Broadly, while progress is being made throughout the industry, and which APRA is actively encouraging, there is work still to do most of all with respect to firms’ work in relating risk to capital (i.e., which is central for ECs 4, 5 and 7).</p> <p>APRA’s requirement that firms develop risk appetite statements has stimulated increasingly integrated, firm wide, risk management approaches and this approach can be expected to continue to yield benefits. Looking forward APRA’s focus on firms’ ICAAPs will be an important catalyst to further improvements in this area. Stress testing practices, by banks, need further development. This issue does not feed into the rating as stress testing forms an additional criteria in the current set of principles.</p>
<b>Principle 8</b>	<b>Credit risk.</b> Supervisors must be satisfied that banks have a credit risk management process that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control credit risk (including counterparty risk). This would include the granting of loans and making of investments, the evaluation of the quality of such loans and investments, and the ongoing management of the loan and investment portfolios.
<b>Essential criteria</b>	
<b>EC1</b>	The supervisor determines, and periodically confirms, that a bank’s Board approves, and periodically reviews, the credit risk management strategy and significant policies and processes for assuming, identifying, measuring, controlling and reporting on credit risk (including counterparty risk). The supervisor also determines, and periodically confirms, that senior management implements the credit risk strategy approved by the Board and develops the aforementioned policies and processes.

Description and findings re EC1	<p><i>Prudential Standard APS 220 Credit Quality (APS 220)</i> emphasizes that it is the responsibility of the Board and management of a bank to ensure that an effective credit risk management system is in place, commensurate with the risk appetite of the bank. Among other things, APS 220 requires a bank to have in place credit risk management policies, procedures and controls appropriate to the complexity, scope and scale of its business. In addition, APS 220 requires that the credit risk management system be regularly reviewed to take account of changing operating circumstances, activities and risks encountered by the bank.</p> <p>Apart from this overarching responsibility, APS 220 specifically requires Board approval and oversight for:</p> <ul style="list-style-type: none"> <li>• the criteria established to identify and report credit exposures deemed to be a source of concern (paragraph 18);</li> <li>• a bank's credit-risk grading system (paragraph 21);</li> <li>• policies directed at ensuring the timely and reliable recognition of impaired facilities (paragraphs 22 and 28);</li> <li>• the basis for collateral valuations, especially where the value of collateral materially underpins estimates of future cash flows (paragraph 32); and</li> <li>• the prudent and reasonable assessments of the level of impaired facilities, estimated future credit losses, specific provisions and the General Reserve for Credit Losses (GRCL) (paragraph 37).</li> </ul> <p>Consistent with management's responsibilities discussed in relation to CP7, bank senior management are expected to implement policies, processes, practices and other systems designed to deliver outcomes consistent with Board-approved strategies and frameworks.</p> <p>Assessments of banks' credit risk management frameworks are regularly made as part of routine supervisory activity, including the undertaking of onsite prudential reviews, typically with the assistance of APRA's Credit Risk specialists. Specialists may also assist with certain offsite analysis. Given the predominance of credit risk in the risk profiles of a typical bank, the majority of the specialist Credit Risk team's time is devoted to the review of ADIs' credit risk management frameworks.</p> <p>There is internal supervisory guidance to supervisors on Credit Risk which covers a wide range of credit risk issues including the role of board and senior management. APRA noted that supervisory activities commonly undertaken include the review of Board and risk committees' charters or terms of reference, an assessment of the adequacy of reporting to the Board and relevant committees, perusal of meeting minutes, consideration of issues identified by the bank's own credit control processes and internal audit, and ensuring that policy and other breaches are appropriately escalated and addressed. Other topics would include governance structures, quality of credit risk management systems, credit policy, credit approval and underwriting standards, credit portfolio and concentration management, credit risk grading systems, scorecards and independent credit review processes. The documentation requested by APRA before on-site reviews targeted at credit risk provides the supervisors with a comprehensive range of material and firms confirm that strategy, business plans and risk appetite statements that are approved by the Board are also routinely requested by APRA.</p>
<b>EC2</b>	<p>The supervisor requires, and periodically confirms, that such policies and processes establish an appropriate and properly controlled credit risk environment, including:</p> <ul style="list-style-type: none"> <li>• a well documented strategy and sound policies and processes for assuming credit risk;</li> <li>• well defined criteria and policies and processes for approving new exposures</li> </ul>

	<p>as well as renewing and refinancing existing exposures, identifying the appropriate approval authority for the size and complexity of the exposures;</p> <ul style="list-style-type: none"> <li>• effective credit administration policies and processes, including continued analysis of a borrower’s ability and willingness to repay under the terms of the debt, monitoring of documentation, legal covenants, contractual requirements and collateral, and a classification system that is consistent with the nature, size and complexity of the bank’s activities or, at the least, with the asset grading system prescribed by the supervisor;</li> <li>• comprehensive policies and processes for reporting exposures on an ongoing basis;</li> <li>• comprehensive policies and processes for identifying problem assets; and</li> <li>• prudent lending controls and limits, including policies and processes for monitoring exposures in relation to limits, approvals and exceptions to limits.</li> </ul>
Description and findings re EC2	<p>In the case of credit risk, APRA’s prudential requirements are outlined in a prudential standard (APS 220). A key objective of APS 220 is to ensure that an ADI has “a robust system for the prompt identification, monitoring, and accurate and complete measurement of its credit risk. This includes recognition and reporting of impaired facilities and estimated future losses on the credit portfolio.”</p> <p>APS 220 further requires documented policies and procedures for addressing specific aspects of credit risk management. These include, but are not limited to:</p> <ul style="list-style-type: none"> <li>• estimation of inherent credit risk in the bank’s business;</li> <li>• monitoring of credit quality;</li> <li>• identification and appropriate measurement of impaired facilities;</li> <li>• recognition of collateral (including the sound and prudent valuation of collateral);</li> <li>• write-down or write-off of uncollectable facilities;</li> <li>• validation of credit assessment and provisioning and reserve processes;</li> <li>• adequacy of provisions and reserves covering existing and estimated future credit losses and the timely establishment of such provisions and reserves; and</li> <li>• production of data and other information required for adequately assessing the credit risk exposure of the bank.</li> </ul> <p>The internal guidance to supervisors addresses APRA’s expectations with respect to credit policies. The guidance emphasizes the importance of credit culture, risk appetite, credit methodologies and delegation authorities. The guidance provides support on issues such as risk appetite, separation of duties in the credit area and notes that among other things, policies should cover:</p> <ul style="list-style-type: none"> <li>• the bank’s Code of Conduct (for example, what to do if there is a conflict of interest; lending for illegal activity);</li> <li>• lending principles around appropriateness of products in certain situations and what transactions, activities, industries, etc are not considered acceptable;</li> <li>• serviceability regimes and what constitutes sustainable and regular ‘income;’</li> <li>• how to approach financial analysis for complex business (for example, commercial and institutional lending), including key industry benchmarks and critical financial ratios to be satisfied;</li> <li>• a full list of acceptable security types and arrangements and associated valuation processes;</li> <li>• requirements for third-party security;</li> <li>• prudential limits aimed at constraining risk within acceptable tolerances;</li> </ul>



	<ul style="list-style-type: none"> <li>• the approach and controls applying to credit risk grading and the application of scorecards, as appropriate;</li> <li>• processes around environmentally sensitive borrowers and security types;</li> <li>• guidance for support functions such as the preparation of security documentation, loan drawdown and settlement processes;</li> <li>• monitoring and review processes (including in relation to the current financial condition of the borrower, compliance with existing covenants and an assessment of value of collateral held); and</li> <li>• roles and responsibilities for management and staff for all stages of the credit process, including credit origination, evaluation, approval, funding, ongoing administration and monitoring as well as problem management.</li> </ul> <p>The guidance also discusses the appropriateness of delegation structures including approval, provisioning and write-off. APRA reviews seek to ensure that credit approval delegations are assigned based on credit experience and expertise rather than being role-based.</p> <p>Onsite credit risk reviews provide regular opportunities for APRA to assess a bank's credit risk control environment. While APRA conducts a multi-year program to address a range of credit areas for the major banks, as noted below, and therefore not all elements would necessarily be reviewed every year, the assessors saw that APRA has adopted assiduous practices in examining the credit risk control environment. Internal supervisory guidance provides a structured basis for supervisors to form judgments about a bank's credit risk management framework. The onsite review process includes a comprehensive review of relevant documentation, with individual bank's policies and procedures assessed against the requirements in APRA prudential standards and against those of the bank's peer group. The onsite reviews will also typically include a review of a selection of credit files in order to assess how well the credit control framework operates in practice. Where a deficiency in policies or procedures is identified, the review findings include requirements and recommendations to address the deficiency in a timely manner. Where there are material issues, a copy of the report is provided to the Board. Review reports commonly follow the basic structure of topics outlined in supervisory guidance facilitating a structured and consistent approach to making assessments. Reports from onsite credit reviews incorporate quantitatively and qualitatively expressed opinions about inherent credit risk as well as the quality of credit risk management.</p> <p>Over recent years, APRA has required a series of targeted reviews – mainly credit risk reviews of the major banks – to be carried out by external auditors on an industry wide basis. In 2010/11 the subject was collateral management and foreclosure management and in 2011/12 it will be housing loan approval standards, focusing on loan serviceability criteria.</p> <p>Risk issues may be identified through a variety of mechanisms including routine offsite analysis and as a consequence of emerging issues being identified at an industry level. Recent examples of areas of particular focus during credit risk reviews which the assessors saw some examples of include banks' commercial property exposures, small-to-medium enterprise lending portfolios, provisions for credit losses and structured finance business. In other words, although the major banks can expect (and confirmed this was actual practice) to have an on-site review addressing credit risk at least annually, the review will not cover all areas of the credit business. In addition, APRA noted that it made efforts to keep abreast of emerging credit issues which it might, as appropriate, raise with the industry. Issues that APRA has raised or</p>
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	<p>on which it might seek industry views have recently included:</p> <ul style="list-style-type: none"> <li>• the impact of Responsible Lending provisions under the <i>National Consumer Credit Protection Act 2009</i>;</li> <li>• intentions to adopt alternative benchmarks for household expenditure when assessing retail loan serviceability;</li> <li>• reliance on salary credits as a form of income verification;</li> <li>• issues relating to property valuation methodologies;</li> <li>• market developments in the non-ADI lending market;</li> <li>• confirmation of regulatory capital treatment for specific products;</li> <li>• likely impacts from recent court decisions;</li> <li>• recognition of social security payments as a source of sustainable income for loan assessment purposes;</li> <li>• changes in the demand for particular products (for example trade finance);</li> <li>• hedging patterns for particular customers (for example commodity producers); and</li> <li>• changes in capitalization rates and property values for various types of commercial properties.</li> </ul> <p>Compliance with the requirements of prudential standards is incorporated within the annual assurance and declaration process outlined in APS 310. Appointed auditors are required to provide a 'limited assurance' opinion on compliance with all applicable prudential requirements annually. In addition, residential mortgage lending practices as well as collateral and foreclosure management have been the subject of specific reviews by appointed auditors with respect to the reviews taken subject to APS 310.</p>
<b>EC3</b>	The supervisor requires, and periodically confirms, that banks make credit decisions free of conflicts of interest and on an arm's length basis.
Description and findings re EC3	<p>APRA expects banks to have in place procedures to prevent conflicts of interest and to ensure that credit is extended on an arm's-length basis. Internal guidance to supervisors specifically indicates that an ADI should have a code of conduct that will address the issue of how to deal with a conflict of interest. The guidance to industry (APG510) reminds firms that the Corporations Act contains provisions governing the treatment of conflict of interests.</p> <p>APRA further noted that conflict of interest issues would be considered as part of routine onsite reviews. Reviews of a sample of credit files will commonly incorporate exposures deemed most likely to be susceptible to such a risk, for example lending to related entities. Organizational structure and governance arrangements supporting credit decisions are also routinely assessed and where conflicts of interest are highlighted by auditors, or other credit review staff, APRA would seek to be assured that appropriate action is taken in a timely manner and subject to adequate oversight. For banks accredited to use the advanced Basel II methodologies, part of the accreditation process employed by APRA included a work stream specifically addressing operational integrity and governance arrangements as they applied to credit risk. APRA noted that lessons from this experience were applied across the sector and led to a general improvement of standards.</p> <p>More broadly, APRA's behavioral standards such as APS 510 and APS 520 seek to foster sound risk governance practices within a strong risk management environment. The adequacy of segregation of duties in an overall organizational sense is also periodically assessed as part of regular operational risk reviews.</p>
<b>EC4</b>	The supervisor has full access to information in the credit and investment portfolios and to the bank officers involved in assuming, managing, controlling and reporting on

	credit risk.
Description and findings re EC4	The <i>Banking Act 1959</i> (Banking Act) provides APRA with power to require banks to supply any information, including books, accounts or documents, to enable APRA to discharge its functions. In practice, APRA has full access to information in the bank's credit and investment portfolios and to all relevant staff. APRA commonly meets relevant senior management during onsite reviews and, as required, as part of other supervisory discussions. Onsite reviews also provide an opportunity to meet directly with lending officers and other personnel involved in the credit process as required.
<b>Additional criteria</b>	
<b>AC1</b>	The supervisor requires that the credit policy prescribes that major credit risk exposures exceeding a certain amount or percentage of the bank's capital are to be decided by the bank's senior management. The same applies to credit risk exposures that are especially risky or otherwise not in line with the mainstream of the bank's activities.
Description and findings re AC1	APRA seeks to ensure, through its onsite reviews and review of board minutes that credits above certain size, risk or capital thresholds are reviewed or approved at senior levels in the banks. Please see EC2 above and CP10, EC3. For banks accredited to use the advanced Basel II methodologies, APRA expects that one manifestation of the 'use test' outlined in the Basel II Framework is the use of risk estimates to inform decisions about the structure of the delegated approval authority framework. An integral part of these arrangements is that exposures deemed riskier should be subject to a higher level of scrutiny and be decided by more experienced senior management.
<b>AC2</b>	The supervisor determines that banks have in place policies and processes to identify, measure, monitor and control counterparty credit risk exposure, including potential future exposure sufficient to capture the material risks inherent in individual products or transactions. These processes should be commensurate with the size or complexity of the individual bank.
Description and findings re AC2	APRA's prudential standards require banks to have detailed policies and processes to adequately address all aspects of credit risk exposure, including counterparty exposures arising from treasury operations and derivatives trading. These are assessed through operational processes set out in the supervision framework, including onsite reviews and offsite analysis. APRA noted that it has increasingly called upon credit risk specialists to accompany frontline supervisory staff and market risk specialists when undertaking reviews of banks' traded market and treasury operations. The assessors were able to review files which confirmed that risk specialists are typically involved in on-site reviews targeted at particular risk areas. APRA also noted that it continues to refine the existing baseline agenda and discussion points that are routinely incorporated into such reviews. Methodologies, processes and systems used for credit risk management (measurement, aggregation, monitoring and reporting), mitigation of counterparty credit risk (CCR) and CCR stress testing framework, are assessed at such onsite reviews. The frequency, coverage and duration of these reviews are greater for the larger banks (e.g., up to five days). The assessors were able to review follow up correspondence with the institution that confirmed supervisors had examined the processes and systems and were consequently making suggestions, recommendations and requirements (these are formal terms of art and represent an increasing scale of severity) for remedial action by the institution.

<b>AC3</b>	The supervisor determines that banks have policies and processes to monitor the total indebtedness of entities to which they extend credit.
Description and findings re AC3	<p>In reviewing a bank's credit policy, APRA checks to ensure that there is clear articulation of a serviceability policy; APRA does not condone lending based exclusively on collateral. Paragraph 34 of APS 220 specifically indicates that reliance on collateral must not be a substitute for an appropriate assessment of a party to a facility or that party's ability to meet its contractual obligations. Accordingly, the bank must consider a client's total indebtedness and servicing obligations before granting any credit. It is typical for banks to require prospective borrowers to provide full details of their financial position and of other borrowings, commensurate with the requirements of the product on offer. Independent verification of information provided is required, a matter recently reinforced by 'responsible lending' obligations outlined in association with the National Consumer Credit legislative framework.</p> <p>APRA noted that onsite prudential reviews will routinely consider a bank's credit evaluation and approval policies and processes as well as the robustness of the associated risk management framework and internal guidance to supervisors directs attention to these areas. In addition, an assessment will routinely be made about a bank's management information system for capturing and managing credit exposures on an aggregated group basis. The latter was an area where deficiencies were exposed by the global financial crisis and where APRA has devoted particular attention, including undertaking targeted reviews.</p>
<b>Assessment of Principle 8</b>	<b>Compliant</b>
Comments	<p>Credit risk is the predominant risk within the Australian banks' balance sheets and APRA has a well articulated, well understood and well practiced approach to assessing the level of credit risk and the quality of credit risk management within the banking system.</p> <p>However, while credit monitoring and assessment of credit risk is sound, and well supported by internal and external guidance, the emphasis appears more to be upon the time after the loan decision has been made, and verified ex post by supervision. Requirements or guidance on the quality of the lending process, as required by this CP is less developed. APRA are invited to consider specific regulation/guidance on credit decision processes.</p>
<b>Principle 9</b>	<b>Problem assets, provisions and reserves.</b> Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves.
<b>Essential criteria</b>	
<b>EC1</b>	Laws, regulations or the supervisor require banks to formulate specific policies and processes for identifying and managing problem assets. In addition, laws, regulations or the supervisor require periodic review by banks of their problem assets (at an individual level or at a portfolio level for credits with homogenous characteristics) and asset classification, provisioning and write-offs.
Description and findings re EC1	The prudential standard for Credit Quality (APS 220) and the associated guidance notes (covering Impaired Facility Definitions, Impairment, Provisioning and the General Reserve for Credit Losses, Prescribed Provisioning, and Credit Risk Grading Systems) aim to ensure that a bank recognizes impaired exposures on a timely basis and subjects problematic exposures to close and ongoing scrutiny.

	<p>Impaired exposures for APRA purposes include any facilities (on- and off-balance sheet) where there is doubt over the timely collection of the full amount of cash flows contracted to be received by the bank (paragraph 23 of APS 220). Objective evidence of impairment is required. Impairment is recognized when estimated cash flows fall short of the full amount of the cash flows contractually due to be received (paragraph 24 of APS 220). More specifically, APRA's prudential requirements reinforce the need for banks to have adequate policies and procedures to cover a number of facets of the management of impaired exposures, including:</p> <ul style="list-style-type: none"> <li>• timely and reliable recognition of impaired facilities incorporating, as appropriate, the exercise of experienced credit judgment (paragraph 28 of APS 220);</li> <li>• reliable, consistent and prudent estimates of future cash flows, including income and principal payments, used in determining the level of impairment of facilities (paragraph 30 of APS 220);</li> <li>• determination of impairment of facilities and associated provisions based on the bank's own methodologies, supported by robust internal controls and having regard to accounting practices, unless APRA agrees otherwise in writing (paragraph 43 of APS 220);</li> <li>• consideration to be given to whether it would be prudent to classify all facilities as impaired if one facility is assessed as impaired and the bank has multiple facilities to a single entity or group of related entities (paragraph 11 of AGN 220.1);</li> <li>• the identification, monitoring and management of (distressed) restructured facilities, defined in terms of APS 220 (paragraph 28 of AGN 220.1);</li> <li>• the validation of credit risk models and other statistical techniques used to determine levels of credit risk, estimated impairment of facilities, specific provisions and the General Reserve for Credit Losses (GRCL) (paragraph 31 of AGN 220.2); and</li> <li>• the determination of facilities managed on an individual or portfolio basis, the criteria for provisioning on an individual or portfolio basis and the prudent oversight of credit risk associated with material individual facilities (paragraph 37 of AGN 220.2).</li> </ul>
<b>EC2</b>	<p>The supervisor confirms the adequacy of the classification and provisioning policies and processes of a bank and their implementation; the reviews supporting this opinion may be conducted by external experts.</p>
Description and findings re EC2	<p>APRA regularly reviews a bank's credit risk grading, impairment and provisioning policies during routine onsite credit risk prudential reviews. During 2009, APRA also undertook a series of targeted prudential reviews to assess the adequacy of several banks' provisioning policies and processes in response to challenging market conditions and pressure on banks to maintain profitability at the time. Provisioning levels and classification of problem credits as well as movements in provisioning are reported quarterly to APRA (<i>ARF 220.0 Impaired Facilities and ARF 220.5 Movements in Provisions for Impairment</i>). Data are subject to external audit testing in terms of the standard on <i>Audit and Related Matters</i> (APS 310). Supervisors review information on banks' portfolios and credit quality using a suite of standard reports that are automatically generated from quarterly data, and which indicate key financial ratios as well as outlining trends. Peer group analysis is also undertaken and may result in a targeted onsite review with the credit risk specialists to review processes in more detail.</p>

	<p>Following identification of misreporting, APRA has provided industry wide feedback, for example the letter to the ADI industry of 18 May 2007 (available on APRA's website), to clarify reporting requirements, on the topic of impaired assets and provisions.</p> <p>In addition, APS 310 requires appointed auditors to inform APRA promptly where they form the view that there is a material misstatement of provisions and impaired assets thus providing a further level of oversight.</p>
<b>EC3</b>	The system for classification and provisioning takes into account off-balance sheet exposures
Description and findings re EC3	<p>The definition of impaired assets under APS 220 includes off-balance sheet exposures. The inclusion of off-balance sheet items in impaired assets, and the reporting of provisions in respect of off-balance sheet exposures, are detailed in paragraphs 12 – 15 of Guidance Note AGN 220.1.</p> <p>Instructions to ARF 220.0 use the definition of impaired assets in APS 220 as the basis of regular reporting to APRA but provide specific instructions regarding the measurement of off-balance sheet credit exposures (see paragraphs 1--3 under the heading of 'scope').</p>
<b>EC4</b>	The supervisor determines that banks have appropriate policies and processes to ensure that provisions and write-offs reflect realistic repayment and recovery expectations.
Description and findings re EC 4	<p>Banks are required to have sound provisioning policies so that asset values, earnings and capital adequacy are accurately stated. APS 220 (paragraph 36) requires a bank to report specific provisions and GRCL that, together, are adequate at all times to absorb credit losses given the facts and circumstances applicable at the time. Losses include those identified as being incurred and incurred-but-not-yet-reported as well as credit losses estimated but not certain to arise in the future. APRA requires provisions and reserves to cover the inherent credit risk in the bank's business extending over the life of all individual facilities making up its credit portfolio. In that sense, APRA's requirements would typically result in a higher level of losses than would be the case under the 'incurred loss' approach inherent in IFRS accounting.</p> <p>The guidance notes associated with APS 220 (Paragraph 31 of AGN 220.2) set out elements that a bank's provisioning and reserving policies and procedures must cover. APRA expects that provisions reflect realistic repayment and recovery expectations. APRA, however, acknowledges that there is a high degree of professional judgment involved and looks to the bank's Board and senior management to ensure that adequate provisioning is an integral part of the credit risk management framework.</p> <p>APS 220 (Paragraph 7) requires banks' documented credit policies and procedures to address, among other things, write-down or write-off of uncollectable facilities. Write-offs are reported to APRA each quarter in ARF 220.5. As noted previously, prudential returns are subject to routine supervisory offsite review and are also reviewed by the appointed auditors as required by APS 310. System-generated standard reports include details of bad debts written off and bad debts recovered through time, and routinely provide an insight into whether write-offs were taken directly from the profit and loss account or from specific provisions. Supervisors also routinely consider respective banks' bad debt experience relative to peers as well as compare outcomes relative to perceptions of the state of the credit cycle and other information to hand. Assessors saw examples of relevant dashboard reports.</p> <p>In February 2008 APRA wrote to a large number of selected banks emphasizing the</p>

	<p>need for prudence, particularly for assets held in trading portfolios. In cases where market prices were not readily available, APRA noted that it expected robust analysis to be undertaken to ascertain a 'best estimate' of current value. APRA also noted that where it was not satisfied with the approach a bank had taken to its valuations and provisioning, it would consider requiring an increase in the bank's GRCL to compensate for any shortcomings. The same letter emphasized that APRA would not hesitate to issue directions to banks that entered into transactions whose primary aim was to avoid the need for banks to make write-downs on traded asset positions. Preparatory work ahead of on-site reviews routinely requests information on policies and data with respect to credit impairment and provisioning.</p>
<b>EC5</b>	<p>The supervisor determines that banks have appropriate policies and processes, and organizational resources for the early identification of deteriorating assets, for ongoing oversight of problem assets, and for collecting on past due obligations.</p>
Description and findings re EC5	<p>In line with its internal supervisory guidance, APRA's regular onsite prudential reviews of banks include a thorough assessment of banks' problem asset management. Topics routinely assessed include (and on which APRA seeks pre-review documentation):</p> <ul style="list-style-type: none"> <li>• credit quality;</li> <li>• quality of systems;</li> <li>• adequacy of collection and other problem asset policies and procedures;</li> <li>• collection strategies;</li> <li>• structure and resources;</li> <li>• delegated credit authority framework;</li> <li>• problem asset recognition; and</li> <li>• provisioning methodologies.</li> </ul> <p>APRA indicated in discussion with the assessors that the adequacy of and flexibility in resourcing of collection and problem asset management areas are routine points of discussion during onsite credit reviews. APRA expects banks to have robust resource management and contingency plans. How banks' management of resources responds to adverse stress scenarios, determined by the bank or APRA, has also been a discussion point at prudential meetings.</p> <p>APRA seeks to ensure that banks have the policies, processes and resources to foster early identification of deteriorating assets and to collect on past due obligations. Actions taken have included the collection of larger banks' watch list credit reports, undertaking onsite reviews targeted at assessing the practical effectiveness of processes for particular portfolios (for example: commercial property, corporate and SME) and heightening the attention given to credit risk issues as part of the regular discussions with the chief risk officers of the major banks. The frequency of discussions with banks was also increased. Moreover, the upsurge in properties subject to mortgagee in possession (similar to foreclosure) is a topic that has been raised in prudential meetings and also tripartite contact involving banks, their external auditors and APRA.</p> <p>Trends in banks' asset quality data are routinely tracked by supervisors from both an institutional and industry perspective. Dashboard reports (see CP19) highlight outliers. Various publically available sources of delinquency data supplement information in prudential returns and obtained from banks' management reports.</p>
<b>EC6</b>	<p>The supervisor is informed on a periodic basis, and in relevant detail, or has access to information concerning the classification of credits and assets and provisioning.</p>

Description and findings re EC6	<p>As noted above, banks submit prudential returns detailing their impaired assets and the level and movements in provisioning each quarter (ARF 220.0 and ARF 220.5, respectively). Those banks that have credit risk grading systems but are not accredited to use the advanced internal ratings-based (IRB) methodologies for regulatory capital adequacy purposes are required by AGN 220.4 (paragraph 5) to include APRA among the recipients of information on their graded portfolio. Banks accredited to use the IRB approaches for regulatory capital adequacy purposes must regularly submit a comprehensive suite of prudential reports split predominantly by Basel II asset categories.</p> <p>APRA has the right to require further information as needed and does so, for example, copies of management reports addressing issues in asset quality.</p>
<b>EC7</b>	<p>The supervisor has the power to require a bank to increase its levels of provisions and reserves and/or overall financial strength if it deems the level of problem assets to be of concern.</p>
Description and findings re EC7	<p>The Banking Act empowers APRA to direct banks to comply with its prudential standards (including those relating to credit quality, problem asset recognition and provisioning). APRA also has a general power to issue directions to banks as to the way their business affairs are conducted, provided a relevant statutory 'trigger' exists. In practice, however, banks generally accept APRA's specific requirements as to appropriate provisioning levels and problem credit categorization without APRA having to invoke its formal powers.</p> <p>APS 220 specifically provides for APRA to require a bank to increase the level of its provisions, reserves or capital or to otherwise change its policies and practices. For example, paragraph 35 provides for APRA to require a bank to:</p> <ul style="list-style-type: none"> <li>• adjust its valuation methodologies or practices;</li> <li>• increase levels of provisioning reported to APRA; or</li> <li>• hold higher levels of capital.</li> </ul> <p>APRA may require (paragraph 40) a bank to adopt amended or alternate policies and procedures; to increase the amount of impaired assets specific provisions and GRCL; or to otherwise increase its capital.</p>
<b>EC8</b>	<p>The supervisor assesses whether the classification of the credits and assets and the provisioning is adequate for prudential purposes. If provisions are deemed to be inadequate, the supervisor has the power to require additional provisions or to impose other remedial measures.</p>
Description and findings re EC8	<p>Supervisory activities enable APRA to assess the adequacy of banks' credit risk grading, asset recognition and provisioning methodologies. The off-site supervision and risk assessment system explicitly includes assessment of the adequacy of provisioning based on ratio analysis. APRA on-site inspectors are in charge of checking adequacy of provisions in credit risk reviews. Guidance to supervisors draws attention to the need to come to a view on the quality and adequacy of banks' methodologies and provides some assistance to supervisors in differentiating between good and less good practices.</p> <p>APRA has the power to require change to achieve prudential outcomes. See EC2, EC6 and EC7.</p>
<b>EC9</b>	<p>The supervisor requires banks to have appropriate mechanisms in place for periodically assessing the value of risk mitigants, including guarantees and collateral. The valuation of collateral is required to reflect the net realizable value.</p>
Description and	<p>Prudential standards, in line with the Basel II framework, outline extensive</p>



findings re EC9	<p>requirements for the recognition of risk mitigants and collateral support for prudential purposes (<i>APS 112 Capital Adequacy: Standardised Approach to Credit Risk</i> and <i>APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk</i>). APS 220 and associated guidance outline APRA's expectations regarding banks' policies and procedures for establishing, recording and reviewing the value of collateral held and supporting security valuation practices. Robust valuation practices are required to deliver assessments that reflect net realizable value (i.e., that take account of any costs involved in taking possession of and realizing the value of collateral). A range of possible collateral support, including secured interests in assets, mortgage insurance, cash collateral, guarantees, put options and interest servicing arrangements is recognized. For prudential purposes, however, banks must be able to demonstrate to APRA that any value ascribed to collateral is reliable in a recovery situation (refer AGN 220.2).</p> <p>Onsite prudential reviews routinely involve assessments about banks' collateral management systems. Additional attention was paid to any banks with significant exposures to structured credit products at the time of the global financial crisis, including a focus on appropriate collateral management practices.</p> <p>The collateral management systems of the largest banks were the topic of the targeted review by external auditors in respect of APS 310 for 2010/11.</p>
<b>EC10</b>	<p>Laws, regulations or the supervisor establish criteria for assets to be identified as impaired, e.g., loans are identified as impaired when there is reason to believe that all amounts due (including principal and interest) will not be collected in accordance with the contractual terms of the loan agreement.</p>
Description and findings re EC10	<p>Please see EC 1.</p> <p>The definition of impairment outlined in APS 220 aligns with the approach detailed in AASB 139 (Australian equivalent to <i>IAS 39 Financial Instruments: Recognition and Measurement</i>). APRA's approach is, wherever feasible, to use information produced in accordance with accounting standards unless there is a prudential reason for a different approach. In practice, decisions about impairment require the exercise of sound professional judgment. APRA acknowledges this. Hence, while prudential requirements take an accounting view as a starting point, APRA is not limited to that view; it may require the recognition of assets as impaired notwithstanding their treatment under accounting standards.</p> <p>AGN 220.1 outlines various matters to be considered in gauging impairment. Paragraph 4 lists factors that affect the collectability of facilities. These include, but are not limited to:</p> <ul style="list-style-type: none"> <li>• indications of significant financial difficulty of a party to a facility;</li> <li>• breach of contract, such as a default or delinquency in interest or principal;</li> <li>• likelihood of bankruptcy or other financial reorganisation of a party to a facility;</li> <li>• concessions in terms of a facility (for example: interest or principal payments) granted to a party to a facility relating to such a party's financial difficulties;</li> <li>• changes or trends in default rates on categories of facilities which might be assessed for impairment on a collective basis;</li> <li>• any identified changes in the value of collateral or other sources of security which might bear on the collectability of facilities;</li> <li>• disappearance of an active market in assets (including derivatives) held by a bank relating to a given counterparty;</li> <li>• any other matter that might reasonably suggest to a bank that a party to a facility may be unlikely to meet its contractual obligations.</li> </ul> <p>Notwithstanding the need for sound management, APRA expects that the scope for</p>

	the exercise of discretion in assessing impairment to be prudently limited. Documentation must facilitate an understanding of the procedures and judgments that are exercised by management.
<b>EC11</b>	The supervisor determines that the Board receives timely and appropriate information on the condition of the bank's asset portfolio, including classification of credits, the level of provisioning and major problem assets.
Description and findings re EC11	The quality and frequency of board reporting in relation to asset quality is assessed at onsite credit risk prudential reviews. Copies of regular Board reporting packs, papers discussing emerging and other issues, relevant audit and internal credit risk review reports routinely feature in pre-review information requests. Internal APRA guidance outlines matters to be considered by supervisors in forming judgments about Board awareness of credit issues. Particular attention is given to: <ul style="list-style-type: none"> <li>• the types of information that are being captured in credit risk reports and which information is being escalated;</li> <li>• the trigger points by which senior management and the Board will be informed about emerging credit risk issues; and</li> <li>• examples where the management/Board have had to act in relation to credit risk issues.</li> </ul>
<b>EC12</b>	The supervisor requires that valuation, classification and provisioning for large exposures are conducted on an individual item basis.
Description and findings re EC12	Consistent with the provisions of the Australian equivalents to International Financial Reporting Standards (AIFRS), APS 220 allows banks to manage facilities on an individual or portfolio basis. Provisioning may be assessed in a similar manner (paragraph 10). APRA expects that facilities representing more significant levels of potential credit losses will be managed on an individual basis (paragraph 11). No specific level is prescribed, reflective of the variations in size and operations of ADIs to which the standard applies and the principles-based approach to supervision that APRA seeks to pursue. However, in practice, APRA agrees the size of credit that must be managed on an individual basis with each bank. File reviews undertaken in association with onsite credit reviews will include examples of exposures on both an individual and portfolio-managed basis. For the larger banks, reviews will typically be heavily oriented to larger individually managed facilities.
<b>Additional criteria</b>	
<b>AC1</b>	Loans are required to be classified when payments are contractually a minimum number of days in arrears (e.g., 30, 60, 90 days). Refinancing of loans that would otherwise fall into arrears does not lead to improved classification for such loans.
Description and findings re AC1	For the purpose of assessing impairment, APS 220 requires banks to consider, among other things, whether a facility is 90 days past due. This requirement excludes facilities that are regarded as well-secured (paragraph 25). A well-secured facility is defined in AGN 220.1 (paragraph 18: "the value of collateral (including the fair value of associated security) is sufficient to ensure that the ADI will recover the outstanding principal <sup>5</sup> and other previously unpaid amounts, and any estimated shortfall in all remaining cash flows (.g., payments) due over the life of the facility,"). Requirements for restoring facilities to non-impaired status are outlined in AGN 220.1 (paragraphs 20 – 23). In the case of a facility classified as impaired as a result of write-offs, the facility has to be fully performing for six months (or three payment cycles, whichever is the longer) before restoration to non-impaired status.

	Banks are required to report (distressed) restructured facilities as defined in APS 220 and AGN 220.1 in ARF 220.0 quarterly. Supervisory activity also seeks to identify situations where practices and outcomes may be inconsistent with the true underlying situation. For example, as a result of onsite reviews, APRA has on occasion required banks to revise their policies and procedures with respect to classification of restructured facilities. APRA noted that considerable effort has been devoted over recent times to ensuring the robustness of processes supporting banks' practices for re-ageing facilities, particularly in cases where customers are considered eligible for relief under hardship provisions of consumer credit law or in terms of the Code of Banking Practice.
<b>Assessment of Principle 9</b>	<b>Compliant</b>
Comments	<p>Impaired assets are at a low level within the Australian banking system and discussions with APRA and firms confirmed that strong management attention is paid to identification and management of delinquency.</p> <p>The assessors noted that internal APRA guidance emphasizes the importance of loan serviceability rather than the presence of collateral or security. Discussions with APRA staff also confirmed supervisory caution with respect to potential over-reliance on asset based metrics (such as loan to value ratios) as this could discourage a full assessment of the loan and create a bias towards lending against security. This is a prudent approach particularly in the context of the environment where market participants comment on the lengthy and costly process of foreclosure. Where security is in place there is guidance on the valuation of such collateral.</p> <p>In the context of this general good practice, it is therefore surprising to find that APRA's prudential standards permits an ADI to exclude a facility from impairment when it is regarded as "well secured". It is noted that APRA requires data regarding such facilities to be separately reported to APRA (pursuant to ARF 220.0), and supervisors would typically consider such facilities to be non-performing. It is also noted that the definition of default for capital standards (as opposed to the credit quality standards) would include any exposure that was more than 90 days past due. It is recommended that APRA review its prudential standards in respect of impairment.</p>
<b>Principle 10</b>	<b>Large exposure limits.</b> Supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.
<b>Essential criteria</b>	
<b>EC1</b>	Laws or regulations explicitly define, or the supervisor has the power to define, a "group of connected counterparties" to reflect actual risk exposure. The supervisor may exercise discretion in applying this definition on a case by case basis.
Description and findings re EC1	<p>The prudential standard governing large exposures (APS 221) addresses both standalone and group (connected) exposures. The definition for connected counterparties (paragraph 11) establishes that a group of related counterparties should be deemed to exist where two or more individual counterparties are linked by:</p> <ul style="list-style-type: none"> <li>• cross guarantees;</li> <li>• common ownership;</li> <li>• the ability to exercise control over the other(s), whether direct or indirect;</li> <li>• financial interdependency such that the financial soundness of any of them may affect the financial soundness of the other(s); or</li> <li>• other connections or relationships which, according to a bank's assessment,</li> </ul>

	<p>identify the counterparties as constituting a single risk.</p> <p>However that family members are generally not treated as connected where they have independent retail relationships with the bank, although the bank may treat such parties as connected if considered appropriate.</p> <p>APRA provides internal guidance to supervisors to draw attention to the following dimensions of concentration risk when assessing firms:</p> <ul style="list-style-type: none"> <li>• ‘ADIs should be able to quickly group large exposures and understand how repayment structures between them might be correlated’;</li> <li>• ‘Large exposure and grouping policy, as well as largest single obligors and major risk concentrations, should be well known by lending staff’;</li> <li>• ‘All ADIs should have an appropriate process/system to be able to “group” facilities which depend on the same cash flow (e.g., loans to members of the one corporate group)’;</li> <li>• ‘ADIs are required to meet the provisions in APS 221. In assessing compliance supervisors should consider how the ADI groups related exposures and sets limits for: direct relationships (such as cross-guarantees or common directors); ...; and</li> <li>• ‘within the file reviews supervisors should consider the following:...the accuracy of large exposure reporting to APRA including grouping of related risks.</li> </ul> <p>The internal guidance, more broadly, draws supervisors’ attention to the need to consider the role and involvement of the Board, the quality of policies, processes, and procedures and the importance of sound judgment and independence in the credit function.</p> <p>The treatment of aggregated exposures and related processes and procedures was the subject of targeted reviews in several banks during the global financial crisis, primarily in 2008/9. As a result, APRA recommended that some bank policies provide more detailed guidance in relation to situations that had proven to be problematic when market conditions deteriorated and less obvious forms of connectedness became evident, and it encouraged banks to provide greater clarity when documenting the basis of an aggregation decision in the credit file.</p> <p>APRA noted that it has also, when necessary, required aggregation when the previous treatment was to disaggregate. There are records on file of discussions with institutions confirming that APRA explores potential aggregation issues with institutions and will challenge firms’ practices and assumptions.</p>
<b>EC2</b>	<p>Laws, regulations or the supervisor set prudent limits on large exposures to a single counterparty or a group of connected counterparties. “Exposures” include all claims and transactions, on-balance sheet as well as off-balance sheet. The supervisor confirms that senior management monitors these limits and that they are not exceeded on a solo or consolidated basis.</p>
Description and findings re EC2	<p>The definition of a large exposure to a counterparty or a group of related counterparties (Paragraph 9 of APS 221 ) is an exposure greater than or equal to 10 percent of a bank’s capital base. The 10 percent threshold applies to a bank’s exposure at Level 1 (solo bank) and Level 2 (banking group). The capital base is measured in accordance with the prudential standard governing <i>Capital Adequacy: Measurement of Capital</i> (APS 111).</p> <p>An exposure to a counterparty or group of related counterparties is defined as the aggregate of all claims, commitments and contingent liabilities arising from on- and off-balance sheet transactions (in both the banking and trading books) with the counterparty or group of related counterparties (paragraph 10). Paragraph 10 further specifies elements to be included and excluded from the definition. The definition is</p>

	<p>deliberately broad and non-exhaustive.</p> <p>The aggregate exposure of a bank to a single counterparty or group of related counterparties (except governments) is also subject to limits (Paragraph 9 of APS 221):</p> <ul style="list-style-type: none"> <li>• 25 percent of capital base for non-government, non-bank, unrelated parties;</li> <li>• 50 percent of capital base for unrelated banks; and</li> <li>• 50 percent of capital base for foreign parents and their subsidiaries, with aggregate exposure to non-deposit-taking subsidiaries capped at 25 percent of capital base.</li> </ul> <p>Although certain types of exposure (e.g., settlement risk, exposure secured by eligible collateral) and certain counterparties such as governments and central banks are excluded from the above prescribed limits.</p> <p>Prudential limits are 'hard' limits and only able to be exceeded with APRA's prior approval and in exceptional circumstances. With any excessive exposure APRA would follow up with the bank. ADI's are required to pre-consult with APRA in respect of any proposed exposures to non-government, non-bank counterparties in excess of 10 percent of capital base (paragraph 19 APS 221).</p> <p>Large exposures are reported to APRA quarterly (ARF 221.0) and routinely assessed through offsite supervisory activity. Under <i>APS 310 Audit and Related Matters</i>, appointed auditors are also required to verify such reporting. Copies of relevant Board and management reporting concerning risk concentrations are a standard part of pre-review material requests and are often provided for other prudential meetings.</p> <p>In addition to the requirements of APS 221, the prudential standard governing <i>Associations with Related Entities</i> (APS 222) imposes prudential limits and approval requirements on exposures to related entities of the bank.</p> <p>Exposures to related entities are subject to limits set out in Paragraph 32 of APS 222. There are limits for individual related entities:</p> <ul style="list-style-type: none"> <li>• 50 percent of capital base to an individual related bank;</li> <li>• 25 percent of capital base to other individual regulated related entity;</li> <li>• 15 percent of capital base to individual unregulated related entity; and</li> </ul> <p>There are limits for aggregate exposures to related entities:</p> <ul style="list-style-type: none"> <li>• 150 percent of capital base for aggregate exposure to all related banks;</li> <li>• 35 percent of capital base aggregate exposure to all related entities (other than related banks and related overseas-based equivalents).</li> </ul> <p>A 'related entity' is defined (paragraph 12 of APS 222) as all entities controlled, whether directly or indirectly, by a bank, other than subsidiaries that form part of the 'Extended Licensed Entity' (ELE – see CP 11 for definition) or by the ultimate domestic parent of a bank. Where appropriate, APRA may deem that other entities, and their subsidiaries, represent a related entity of a bank.</p> <p>A bank's exposures to related entities are reported to APRA quarterly (ARF 222.0), which is also verified by the appointed auditor of the bank.</p>
<b>EC3</b>	The supervisor determines that a bank's management information systems identify and aggregate on a timely basis exposure to individual counterparties and groups of connected counterparties.
Description and findings re EC3	A bank's Board is responsible for establishing, and monitoring compliance with, policies governing large exposures and risk concentrations of the bank (paragraph 5 of APS 221). The Board and senior management should also ensure that the bank has adequate systems and controls to identify, measure, monitor and report large exposures and risk concentrations of the bank in a timely manner (paragraph 7).

	<p>Concentration risk management is reviewed through APRA's onsite program. APRA's practice is to undertake a sampling of credit files for review, including a selection of the largest customer credit files as well as files from sectors representing particular risk concentrations (for example, commercial property exposures). APRA staff noted that commentary would often be found on the bank's files with respect to why an exposure had or had not been aggregated and it was typical practice for APRA to raise the issue with the Chief Risk Officer. The assessors were able to review a number of APRA file notes covering a span of six years recording the feedback provided to the entity. Several major banks have recently commissioned reviews by external consultancy firms to ascertain current good market practice with respect to management of concentration risk.</p> <p>In response to a number of national governments guaranteeing various bank debt instruments, APRA wrote to all banks in November 2008 expressing a view that it would be imprudent for banks' internal counterparty credit limits and monitoring processes to follow strictly the regulatory capital treatment (treating these as government exposures) due to the temporary nature of the guarantee programs.</p>
<b>EC4</b>	The supervisor confirms that a bank's risk management policies and processes establish thresholds for acceptable concentrations of credit and require that all material concentrations be reviewed and reported periodically to the Board.
Description and findings re EC4	<p>Banks are required to keep large exposures and risk concentrations under regular review according to Paragraph 7 of APS 221. This is a responsibility specifically attributed to a bank's Board and senior management under APS 221 and commonly incorporated into APRA's regular assessments of banks' credit risk management systems.</p> <p>APRA's regular onsite prudential reviews routinely incorporate an assessment of the thresholds, policies and processes used by a bank to manage its risk concentrations.</p>
<b>EC5</b>	The supervisor regularly obtains information that enables concentrations within a bank's portfolio, including sectorial, geographical and currency exposures, to be reviewed. The supervisor has the power to require banks to take remedial actions in cases where concentrations appear to present significant risks.
Description and findings re EC5	<p>APS 221 emphasizes that safeguarding against risk concentrations to particular counterparties, industries, countries and asset classes is an essential component of banks' risk management strategies. As outlined in APS 221, APRA expects the Board to have the primary responsibility for ensuring that adequate and prudent policies and practices cover risk concentrations.</p> <p>Quarterly reporting to APRA on large exposures includes a breakdown of information by counterparty classification type (ARF 221.0).</p> <p>Other information on risk concentrations is available through the following reporting forms:</p> <ul style="list-style-type: none"> <li>• <i>Exposures to Related Entities</i> (ARF 222.0);</li> <li>• <i>Commercial Property</i> (ARF 230.0);</li> <li>• <i>Immediate and Ultimate Risk Exposures</i> (ARF 231.3a);</li> <li>• <i>Immediate and Ultimate Risk Exposures – Foreign Entity</i> (ARF 231.3b); and</li> <li>• <i>Locational Data Part 1a: Assets</i> (ARF 231.1a).</li> </ul> <p>Sectorial information on banks' portfolios can be obtained from reporting forms covering <i>Deposits and Loans Classified by State and Territory</i> (ARF 320.7); <i>Commercial Finance</i> (ARF 391.0); <i>Housing Finance</i> (ARF 392.0); <i>Lease Finance</i> (ARF 393.0); <i>Personal Finance</i> (ARF 394.0); <i>Business Finance Statistics</i> (ARF 395.0); and <i>Housing Loan Reconciliation</i> (ARS 320.8). Standard and dashboard reports available to supervisors also facilitate entity comparisons and trend analysis. The</p>

	<p>assessors were able to review the APRA data systems (including “baseline” and “micro strategy dash boards”) which enable front line supervisors to interrogate such data on an institution specific and peer group basis (see also CP 19)</p> <p>Together with other prudential reports, reporting forms (ARF 221.0, ARF 222.0 and ARF 230.0) are subject to verification by external auditors in terms of APS 310 (see Principle 7 inter alia). APRA has the power to impose additional reporting requirements or any further information deemed necessary.</p> <p>Supervisory guidance requires supervisors to consider a variety of sources of risk concentrations including industry, country, and asset class (including securitization activity), as well as indirect concentrations related to collateral type.</p> <p>Exposures to the household sector and to commercial real estate (including developers of residential property) represent a large share of Australian bank assets and a potential source of risk. As such, APRA continues to closely monitor related risks, especially given high household debt and the inherent cyclicity of property development businesses. Past supervisory efforts have included targeted and thematic onsite reviews (for example, reviews of commercial property portfolios, aggregation processes and mortgage lending portfolios) as well as stress testing. Particular attention has also been directed at advanced IRB banks’ income producing real estate portfolios, which APRA largely requires to be ‘slotted’, and these banks’ commercial property exposures to be reported.</p> <p>Relatively lower sources of concentration risk, for example those arising in relation to currency exposures, are considered as part of routine supervisory monitoring activities such as quarterly analysis and in formulating agendas for prudential discussions.</p> <p>Major concentrations commonly feature in APRA’s annual ADI Industry Review and are discussed at the ADI Industry Group.</p> <p>APRA may also (APS 221 paragraph 21) provides for APRA to impose a higher capital ratio in circumstances where APRA is of an opinion that the bank is exposed to a significant level of risk concentration. APRA may also direct a bank to take measures to reduce its level of risk concentration (paragraph 22).</p>
<b>Additional criteria</b>	
<b>AC1</b>	<p>Banks are required to adhere to the following definitions:</p> <ul style="list-style-type: none"> <li>• 10 percent or more of a bank’s capital is defined as a large exposure; and</li> <li>• 25 percent of a bank’s capital is the limit for an individual large exposure to a private sector non-bank counterparty or a group of connected counterparties.</li> </ul> <p>Minor deviations from these limits may be acceptable, especially if explicitly temporary or related to very small or specialized banks.</p>
Description and findings re AC1	<p>Refer to EC 2 above.</p> <p>APS 221 defines a ‘large exposure’ on a basis consistent with these definitions and provides that banks cannot have individual exposures to private sector non-bank borrowers or a group of borrowers in excess of 25 percent of a bank’s capital base, without prior APRA approval.</p>
<b>Assessment of Principle 10</b>	<b>Compliant</b>
Comments	<p>APRA has a clear set of policies on large exposures and concentration risk. Industry confirmed that APRA has questioned their standards and capacities to ensure that they are capturing risk aggregation, both direct and indirect, effectively. Similarly industry confirmed that APRA Failures of risk management in this area led to some high profile issues in the 1990s and a number of institutions consider that this discipline retains a beneficial impact on credit culture. If the lessons of the 1990s</p>

	<p>property crash are not, in fact, embedded in banks' business culture it is very likely that institutions will very shortly lose "corporate memory" through the retirement of seasoned and senior credit risk and risk management professionals.</p> <p>It is recommended that APRA pursue a review of its large exposures policy and ensure that its prudential standards are fully informed by the good practices that it wishes to foster. APRA are particularly recommended to consider the exemptions currently permitted for interbank and sovereign lending.</p>
<b>Principle 11</b>	<p><b>Exposures to related parties.</b> In order to prevent abuses arising from exposures (both on balance sheet and off balance sheet) to related parties and to address conflict of interest, supervisors must have in place requirements that banks extend exposures to related companies and individuals on an arm's length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes.</p>
<b>Essential criteria</b>	
<b>EC 1</b>	<p>Laws or regulations explicitly provide, or the supervisor has the power to provide, a comprehensive definition of "related parties". This should consider the parties identified in the footnote to the Principle. The supervisor may exercise discretion in applying this definition on a case by case basis.</p>
Description and findings re EC1	<p>The Prudential Standard Associations with Related Entities (APS 222, paragraph 12) defines related entities as all entities controlled (whether directly or indirectly) by (a) an ADI (other than subsidiaries that form part of the Extended Licensed Entity (ELE – i.e., where the ADI and all subsidiaries of the ADI that have been approved under Prudential Standard APS 110 Capital Adequacy for the purposes of Prudential Standard APS 222 Associations with Related Entities to be taken together and treated as if they formed a single entity for the purposes of measuring the ADI's exposures to related entities); or (b) the ultimate domestic parent of an ADI (including the parent entity itself). However, a "related entity" excludes the foreign parent(s) of an ADI, the foreign parent's overseas-based subsidiaries and their directly owned non-ADI entities operating in Australia. Where appropriate, APRA may deem that other entities (and their subsidiaries) represent a "related entity" of an ADI.</p> <p>In exercising its power to deem parties to be related, APRA may draw on the definition of 'group of related counterparties' under paragraph 11 of <i>Prudential Standard APS 221 Large Exposures</i> (APS 221) as a guide (Refer to EC1 of CP10.) Discretion is exercised on a case-by-case basis.</p> <p>APRA's definition of related parties does not capture individuals/natural persons such as directors or staff in the bank. Although supervisory guidance notes that an ADI is expected to have policies to address potential conflict of interest, there are no direct requirements (i.e., in the prudential standards) relating to individuals to ensure that transactions with connected individuals would be handled at arms' length and on equivalent terms to a third party. The reference to conflict of interest policies in APS 222 (paragraph 14(c)) refers to an institution needing a policy to resolve potential conflicts of interest in relation to lending to a related entity rather than an individual. Separately from APRA's prudential standards, there is relevant corporate law in this area applying to public companies. At the time of the assessment all but two ADIs were public companies.</p> <p>The Corporations Act 2001 (section 208) provides that a public company, or an entity controlled by a public company, may not give a financial benefit to a related party without shareholders approval, except in limited circumstance, most importantly where</p>



	<p>the transaction is conducted on arm's lengths terms. In this context, the definition of 'related parties' includes:</p> <ul style="list-style-type: none"> <li>- directors and family members;</li> <li>- an entity that controls a public company;</li> <li>- an entity controlled by any person being a related party;</li> <li>- an entity which was otherwise a related party within the last six months;</li> <li>- an entity which has reasonable grounds to believe that it will become a related-party on some other ground in the future; and</li> <li>- an entity that acts in concert with a related-party in anticipation of a financial benefit.</li> </ul> <p>Onsite reviews provide APRA with the opportunity to examine any credit files associated with directors and staff to verify that the relevant credit decisions are free of conflicts of interest and are on an arm's length basis. The assessors noted some file reviews were requested.</p>
<b>EC2</b>	Laws, regulations or the supervisor require that exposures to related parties may not be granted on more favorable terms (i.e., for credit assessment, tenor, interest rates, amortization schedules, requirement for collateral) than corresponding exposures to non-related counterparties.
Description and findings re EC2	<p>The prudential standard on related entities (APS222 Paragraph 14(a)) requires a bank to address risks arising from dealing with related entities on an arm's-length basis as strictly as it would address its risk exposures to unrelated entities.</p> <p>Furthermore there is an explicit requirement for the Board to approve the terms and conditions for dealings with related entities where such terms are inconsistent with the benchmark for unrelated entities. The justifications must be fully documented and made available to APRA for inspection upon request (APS 222 Paragraph 15).</p>
<b>EC3</b>	The supervisor requires that transactions with related parties and the write-off of related-party exposures exceeding specified amounts or otherwise posing special risks are subject to prior approval by the bank's Board. The supervisor requires that Board members with conflicts of interest are excluded from the approval process.
Description and findings re EC3	<p>As noted under EC2, the provisions of APS 222 (Paragraph 15) oblige the Board to approve transactions with related entities where the terms are inconsistent with those for non-related entities. The justifications must be fully documented and made available to APRA for inspection upon request. Procedures for resolving any conflict of interest arising from any related-entity dealings must be established by the Board (Paragraph 14(c)).</p> <p>APRA's current requirements do not prescribe that Board approval is specifically required for a given level of write-off of related-party (or other) exposures. However, the Board is expected to set acceptable limits for exposures to related entities (Paragraph 17) and in doing so have regard to limits which would be appropriate for non-related counterparties of comparable credit quality as well as the impact on the bank (including its capital and liquidity) should the related counterparty fail.</p> <p>Additionally, the bank must satisfy APRA (Paragraph 18) that it has adequate systems and controls in place for identifying, reviewing, monitoring and managing exposures arising from dealings with related entities.</p> <p>However, there are weaknesses in the regime. APS 222 (as noted above) does not apply to individuals who may be connected to the bank. Nor are there explicit or specific requirements to ensure that Board members with conflicts of interest are excluded from the approval process.</p> <p><i>Prudential Practice Guide APG 510 Governance</i> (paragraphs 6 to 9 (inclusive))also</p>

	discusses various provisions of the <i>Corporations Act 2001</i> (Corporations Act) as it relates to conflicts of interest in a prudential context. Specifically APG 510 indicates that under section 195(1) of the Corporations Act, a director of a public company with a material personal interest in a matter that is being considered at a directors' meeting should not be present while the matter is being considered at the meeting; or vote on the matter, although exceptions are permitted and the provision does not apply to apply to the directors of proprietary companies or foreign bank branches. However APG510 makes it clear that APRA would expect this general stance to apply and that directors would recuse themselves. APRA also notes that the same supervisory standards would thus be expected of banks constituted as proprietary companies as those which are public companies.
<b>EC4</b>	The supervisor requires that banks have policies and processes in place to prevent persons benefiting from the exposure and/or persons related to such a person from being part of the process of granting and managing the exposure.
Description and findings re EC4	Although banks are required to establish policies and procedures to deal with "resolving" any conflict of interest that may arise from related party dealings there are no requirements that would directly exclude individuals from the process of approving and managing the exposure where conflict of interest might arise. APS222 requires that the Board of a bank must establish and monitor compliance with policies governing all dealings with related entities and ensure that a bank has in place appropriate credit risk management policies, procedures and controls, although there are no specific requirements related to connected individuals. Supervisory reviews that are focused on credit risk can incorporate consideration of the adequacy of separation of duties and appropriateness of reporting lines relevant to areas of a bank dealing with credit provision and exposure management. Supervisory guidance indicates that supervisors should typically expect a credit policy to incorporate the institution's code of conduct and policy on how to address conflict of interest. Banks are expected to have a Code of Conduct which describes how conflicts of interest are to be resolved in respect to lending to related entities (APS 222 Paragraph 14(c)).
<b>EC5</b>	Laws or regulations set, or the supervisor has the power to set on a general or case by case basis, limits for exposures to related parties, to deduct such exposures from capital when assessing capital adequacy, or to require collateralization of such exposures. When limits are set on aggregate exposures to related parties those are at least as strict as those for single counterparties, or groups of connected counterparties.
Description and findings re EC5	APRA does not impose a requirement for capital deduction or collateralization of related party exposures but there are prudential requirements limiting counterparty exposures (as noted in CP10 above). Exposures that exceed the limits set out in APS 221 would require APRA's prior approval. This treatment is the same as for any exposure exceeding large exposures limits. APRA may impose higher capital charges as set out in APS 110. APRA has prudential powers to impose limits available through the Banking Act 1959 should it have prudential concern about related party exposures. For example, APRA may, if necessary, impose specific limits on a bank's exposures to particular counterparties, groups of counterparties, industry sectors, countries or asset classes on a case-by-case basis (Paragraph 15 of APS 221). APS 222 requires the Board-approved policies on related-entity dealings to detail prudent limits on exposures to related entities at both an individual and aggregate

	<p>level (paragraph 14 (b)). In determining limits on acceptable levels of exposure to related parties a bank's Board must have regard to:</p> <ul style="list-style-type: none"> <li>• the level of exposures that are approved for unrelated entities of broadly equivalent credit status; and</li> <li>• the impact on a bank's standalone capital and liquidity positions, as well as its ability to continue operating, in the event of failure of any related entity to which the bank is exposed (paragraph 17, APS 222).</li> </ul> <p>In addition, paragraph 21 of APS 221 provides for APRA to require a bank to maintain a higher Prudential Capital Ratio (PCR) at solo or consolidated level (Level 1 and/or Level 2) if, in APRA's opinion, the bank is exposed to a significant level of risk concentration. APRA may also direct a bank to take measures to reduce its level of risk concentration.</p> <p>APRA may determine an amount to be deducted from a bank's consolidated (Level 2) capital should APRA consider(s) that a non-consolidated subsidiary (or subsidiaries) is (are) undercapitalized. In judging the extent of undercapitalization of a non-consolidated subsidiary APRA would consider, amongst other things, the:</p> <ul style="list-style-type: none"> <li>• size and scale of the operations of the non-consolidated subsidiary;</li> <li>• materiality of the subsidiary's operations to group income and strategic outlook;</li> <li>• level of net tangible assets of the subsidiary;</li> <li>• risk profile of the subsidiary;</li> <li>• level of exposure of the consolidated (Level 2) group to the subsidiary; and</li> <li>• size of any identified capital shortfall and the likelihood of such a shortfall being remedied in the near future (Prudential Standard APS 111 Capital Adequacy: Measurement of Capital, paragraph 47).</li> </ul> <p>Finally, should APRA have concerns not be satisfied that a bank has adequate systems and controls to address the risks arising from dealings with related entities, APRA may require the bank to put in place additional internal controls, a more robust reporting mechanism and impose a PCR on the bank (APS 222, paragraph 18).</p>
<b>EC6</b>	<p>The supervisor requires banks to have policies and processes to identify individual exposures to related parties as well as the total amount of such exposures, and to monitor and report on them through an independent credit review process. The supervisor confirms that exceptions to policies, processes and limits are reported to the appropriate level of senior management and, if necessary, to the Board, for timely action. The supervisor also confirms that senior management monitors related party transactions on an ongoing basis, and that the Board also provides oversight of these transactions.</p>
Description and findings re EC6	<p>APRA requires firms to have in place adequate policies, procedures, systems and controls in place to identify, review, monitor and manage risk large exposures pursuant to APS 221 (paragraph 7). Exposures to related parties (other than to individuals as discussed in EC1) are subject to the terms of APS 221.</p> <p>APS 222 on related parties requires an ADI's Board policy, at a minimum, to set prudent limits on exposures to related entities at both an individual and aggregate level (paragraph 14 (b)). Furthermore APS 222 (paragraph 18) requires an ADI to satisfy APRA that it has adequate systems and controls in place for identifying, reviewing, monitoring and managing exposures arising from dealings with related entities. An independent credit review process is not explicitly specified in the prudential standard but there is supervisory guidance that draws supervisors' attention to the need for an ADIT to have a process for independent review of its credit decision-making.</p>

	<p>APRA has standards for requiring banks to monitor and report any breaches of prudential limits or of the bank's own internal limits in relation to related parties (APS 222 paragraph 13).</p> <p>APRA has included processes and practices aimed at identifying, managing, monitoring and controlling related-party exposures into the scoping of onsite prudential reviews when requesting pre-review material and the topic may be a discussion point during prudential consultations or other prudential meetings.</p> <p>Banks associations' with related entities was the subject of targeted reviews in 2006/07 under the predecessor to <i>Prudential Standard APS 310 Audit and Related Matters</i>. The review sought to deliver an independent assessment of the adequacy of risk management policies, systems and procedures to ensure compliance with APS 222 requirements. Findings and general themes were widely shared amongst supervisors, discussed within the ADI Industry Group and referenced in the annual ADI Industry Review.</p> <p>Internal guidance directs supervisory attention to the need for adequate separation of duties as well as sound reporting. However, such guidance is generic and does not draw specific attention to the need to assess processes around connected lending.</p>
<b>EC7</b>	The supervisor obtains and reviews information on aggregate exposures to related parties.
Description and findings re EC7	<p>Banks report quarterly to APRA using <i>Reporting Form Exposures to Related Entities</i> (ARF 222.0) but foreign banks (i.e., branches) are only required to submit details in terms of Part C of the return. The quarterly reporting form requires banks to list their ten largest exposures to related entities, their ten largest exposures to Extended Licensed Entity (ELE)-eligible subsidiaries. For the foreign bank branches Part C requires reporting of exposures to head office, overseas branches or Australian and overseas subsidiaries.</p> <p>When APRA identifies risk concentrations to related entities in the course of its offsite analysis this may prompt supervisory investigation including examination.</p> <p>APRA issued a letter to banks in December 2006 reinforcing APRA's expectation regarding ELEs and the materiality of liabilities in assessing eligibility.</p>
<b>Assessment of Principle 11</b>	<b>Largely Compliant</b>
Comments	<p>The principle requires there to be a comprehensive definition of related parties, which encompasses lending to connected individuals as well as entities.</p> <p>The definition of related party entities set out in APS 222 does not cover exposures to connected individuals hence any governance of lending to an executive or director of an ADI falls under corporate law. The Corporations Act 2001 establishes disclosure obligations for directors of a company in relation to conflict of interest and APS 510 highlights the provisions that require a director to absent him or herself from discussion or decision making on issues that could present a conflict of interest. The Corporations Act also addresses lending to connected individuals under various provisions. It provides that public companies can only engage in related party transactions with directors on arms' length terms (or with shareholder approval following full disclosure). Currently all locally-incorporated banks are subject to these provisions except for two banks which are proprietary companies. For both public companies and proprietary companies, the general directors' duties oblige directors not to use their position improperly to: gain an advantage for themselves or someone else; or cause detriment to the corporation.</p> <p>While abuses of connected lending to individuals have not, to date, arisen in Australia</p>

	<p>and may in any case be unlikely for major entities, it is not impossible, and for smaller scale entities risks stemming from connected lending that is not taking place at arms' length or on too significant a scale can be very damaging to the viability of the institution. In either case there is a reputational risk that may arise for the regulatory system should problems emerge. Given that APRA has broad powers to establish prudential standards it is recommended that it amend APS 222 to ensure that clear principles govern any potential connected lending to individuals. The definition of a related or connected individual should capture all elements included in the footnote to this core principle, not least as corporate law does not remedy all deficiencies (i.e., only applies to public companies, thus not applying to any mutually held ADI that might be established, and does not address lending to the senior executive).</p> <p>In terms of exposures to related entities, the definition in APS 222 excludes the foreign parent(s) of an ADI, the foreign parent's overseas-based subsidiaries and their directly owned non-ADI entities operating in Australia, albeit that APRA has case by case discretion to define a related party entity. It is some mitigation that foreign bank (branches) are required to supply information on their related party lending to APRA but such lending essentially falls outside of any articulated policy by APRA.</p> <p>While supervisory processes may identify weaknesses in policies, processes and procedures concerning conflict of interest, there is limited reference and guidance to supervisors on this topic. APRA has made use of its powers to request that appointed auditors to examine related party lending but this was not within the last five years and the assessors review of contact with institutions revealed inconsistencies with respect to whether the issue of connected lending was addressed.</p> <p>It is strongly recommended that APRA widen its definition of related parties and enhance its supervisory guidance to ensure that connected lending practices and the inherent risk of such practices is clearly highlighted.</p>
<b>Principle 12</b>	<b>Country and transfer risks.</b> Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate provisions and reserves against such risks.
<b>Essential criteria</b>	
<b>EC1</b>	The supervisor determines that a bank's policies and processes give due regard to the identification, measurement, monitoring and control of country risk and transfer risk. Exposures are identified and monitored on an individual country basis (in addition to the end-borrower/end-counterparty basis). Banks are required to monitor and evaluate developments in country risk and in transfer risk and apply appropriate countermeasures.
Description and findings re EC1	<p>The need for Boards and management to ensure that banks have adequate policies and processes to identify, measure, monitor and control all risks to which they are exposed is outlined in various APRA prudential standards and the requirement for supervisors to assess this facet of a bank is underlined in guidance to supervisors. A bank must have adequate processes to identify, monitor, report, manage and control counterparty exposures irrespective of their source.</p> <p>Other than LE is there are no specific requirements addressing country risk or transfer risk but the Large Exposures Prudential Standard (APS 221) requires banks to implement appropriate measures and prudent limits to monitor and control risk concentrations. This extends to exposure limits for individual countries, where applicable (paragraph 6 [iv]).</p> <p>Banks must report to APRA quarterly their foreign country claims, off-balance sheet</p>

	<p>commitments and risk transfers (<i>Reporting Form ARF 231.3 International Exposures</i>). Claims are reported on an immediate borrower basis by maturity and on an ultimate risk basis by country and categorized by counterparty sector (for example banks, public sector or non-bank private sector). A distinction is also drawn between cross-border and local claims. Off-balance sheet information is split into derivative contracts, guarantees and credit commitments.</p> <p>Information on risk transfers and country exposures is considered as part of regular analysis of a bank's quarterly prudential returns. APRA's Industry Analysis team also provides analysis of industry-wide country exposure data.</p> <p>A bank's policies and processes for addressing country and transfer risk can be considered as part of onsite credit risk reviews.</p> <p>Offshore exposures represented 22 percent of the industry's total assets as at June 2011. Advanced banks that report more significant exposures are subject to more intensive supervision. The major Australian banks account for approximately 78 percent of the banking system's international exposures.</p>
<b>EC2</b>	The supervisor confirms that banks have information systems, risk management systems and internal control systems that accurately monitor and report country exposures and ensure adherence to established country exposure limits.
Description and findings re EC2	<p>Onsite credit risk reviews provide regular opportunities for APRA to confirm that banks have information, risk management and internal control systems to accurately monitor and report country exposures, including adherence to relevant limits. The frequency of the risk reviews will however be determined on a risk based approach and country risk would not be a routine part of every credit risk assessment, which for larger banks, would be more targeted.</p> <p>However, portfolio risk management capabilities would more routinely be considered in the context of a credit risk prudential reviews. Targeted operational and Information Technology (IT) related risk reviews may also provide support to views about the overall integrity of risk management information systems.</p> <p>For those banks where country exposures are more significant, supervisory discussions include instances of limit breaches and associated remedial action. The largest exposures are to New Zealand, the United Kingdom and the United States (approximately 60 percent of international claims reside in New Zealand and the United Kingdom). These exposures reflect important subsidiary operations in these countries.</p>
<b>EC3</b>	<p>There is supervisory oversight of the setting of appropriate provisions against country risk and transfer risk. There are different international practices which are all acceptable as long as they lead to risk-based results. These include:</p> <ul style="list-style-type: none"> <li>• The supervisor (or some other official authority) decides on appropriate minimum provisioning by setting fixed percentages for exposures to each country.</li> <li>• The supervisor (or some other official authority) sets percentage ranges for each country, and the banks may decide, within these ranges, which provisioning to apply for the individual exposures.</li> <li>• The bank itself (or some other body such as the national bankers' association) sets percentages or guidelines or even decides for each individual loan on the appropriate provisioning. The provisioning will then be judged by the external auditor and/or by the supervisor.</li> </ul>
Description and findings re EC3	APRA expects banks themselves to set provisioning levels for all exposures, including international exposures, in accordance with the requirements of <i>Prudential Standard</i>

	<p><i>APS 220 Credit Quality (APS 220)</i>. APRA requires the level of provisions and the General Reserve for Credit Losses to be reviewed regularly to ensure that provisions and reserves are consistent with current expectations of credit losses. APRA's offsite analysis incorporates financial, trend and peer group analysis. Provisioning outcomes and methodologies, process and practices are reviewed on site. In addition, prudential returns applicable to asset quality and provisioning are subject to review by the appointed auditor in terms of <i>Prudential Standard APS 310 Audit and Related Matters (APS 310)</i>. A bank's external auditors will also consider provisioning levels as part of their annual audit of their financial accounts.</p>
<b>EC4</b>	The supervisor obtains and reviews sufficient information on a timely basis on the country risk and transfer risk of individual banks.
Description and findings re EC4	<p>APRA receives quarterly reporting international exposures (<i>Reporting Form ARF 231.3 International Exposures</i>). In addition, APRA's Industry Analysis unit takes an industry-wide perspective in tracking trends in country and transfer risks and provides an independent source of questions to supplement frontline analysis. Additional quarterly reporting from banks, pursuant to APRA's own need to report to the Bank of International Settlements (BIS) is also obtained to provide aggregate international banking statistics for Australia. Relevant reporting standards are:</p> <ul style="list-style-type: none"> <li>• <i>ARS 231.1.a International Exposures: Locational (Assets) Part 1;</i></li> <li>• <i>ARS 231.1b International Exposures: Locational (Liabilities) Part 1;</i></li> <li>• <i>ARS 231.2 International Exposures: Locational Part 2;</i></li> <li>• <i>ARS 231.3a International Exposures: Consolidated (Domestic Entity);</i></li> <li>• <i>ARS 231.3b International Exposures: Consolidated (Foreign Entity);</i></li> <li>• <i>ARS 325.0 International Operations;</i> and</li> <li>• <i>ARS 326.0 Offshore Banking Units.</i></li> </ul>
<b>Assessment of Principle 12</b>	<b>Compliant</b>
Comment	<p>Australia has few regulatory requirements specifically targeted at country and transfer risk. A sound credit risk environment is required through the prudential standard governing credit risk (APS 220) and is verified through on-site reviews. Greater supervisory attention is devoted to those few larger banks that have more significant international exposures. Material exposures to New Zealand, the United Kingdom and the United States and the small, but increasing, exposure to Asia have been subject to targeted supervisory activity.</p> <p>In a climate in which sovereign risk and country risk has acquired renewed prominence and concern in the international community, it is recommended that APRA reconsider the need for prudential requirements directed specifically at country risk and transfer risk. Given that 22% of exposures are non-domestic, the scale of this risk is not immaterial. The guidance given to firms in 2008 in relation to counterparty credit limits following the sovereign guarantees applied to a range of bank exposures in areas affected by the Global Financial Crisis (see CP10) was a prudent response to a potentially volatile situation and a review of sovereign and country risk exposure could build on such initiatives.</p> <p>In response to a number of national governments guaranteeing various bank debt instruments, APRA wrote to all banks in November 2008 expressing a view that it would be imprudent for banks' internal counterparty credit limits and monitoring processes to follow strictly the regulatory capital treatment (treating these as government exposures) due to the temporary nature of the guarantee programs. APRA's prudential standards require banks to have risk management systems that</p>

	incorporate prudent and transparent exposure limits commensurate with their risk appetite, and robust reporting frameworks to provide for adequate information on their international operations for reporting to APRA. This framework includes country risk, although country risk is not specifically identified.
<b>Principle 13</b>	<b>Market risk.</b> Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor and control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.
<b>Essential criteria</b>	
<b>EC1</b>	The supervisor determines that a bank has suitable policies and processes that clearly articulate roles and responsibilities related to the identification, measuring, monitoring and control of market risk. The supervisor is satisfied that policies and processes are adhered to in practice and are subject to appropriate Board and senior management oversight.
Description and findings re EC1	<p>All locally incorporated banks are subject to the requirements in <i>Prudential Standard APS 116 Capital Adequacy: Market Risk</i> (APS 116) which has been updated to include the Basel 2.5 amendments supported by <i>Prudential Practice Guide APG 116 Market Risk</i> which cover traded market risk. Attachment A of APS 116 sets out governance, trading book policy and valuation requirements. While APS 116, as a capital standard, does not technically apply to local branches of foreign banks, APRA applies similar qualitative standards and supervisory processes to foreign bank branches. The assessors reviewed files of on-site market risk reviews that followed the same principles, processes and procedures (including scoping, specification, analysis, reports and follow up) as for the major domestically incorporated banks.</p> <p>As part of the supervisory processes for traded market risk, APRA conducts onsite reviews (at least every three years) for banks with trading exposures (including locally incorporated banks, subsidiaries and local branches of foreign banks) but more often for banks large trading operations and internal model approval. Targeted reviews are also undertaken where warranted. The need for such reviews is identified in the context of the supervisory action plan for each institution.</p> <p>Market risk specialists can also support frontline supervisors in assessing models and providing opinions on banks' traded and non-traded market risk management policies and systems.</p> <p>Reviews will include discussions with a cross-section of relevant management including representatives from front office, risk management and other support function staff (i.e., back office, IT, accounting/product control, internal audit etc.). The onsite reviews and assessments are made within the broader context of the bank's operations and governance processes, an assessment articulated in APRA's main supervisory tools of PAIRS, SOARS and SAPs (refer to CP19, EC3).</p> <p>Internal supervisory guidance requires supervisors to consider how well the Board and management articulate how they are kept informed of issues and how they satisfy themselves that market risks – as well as the other relevant risk areas for the bank-- are well understood and monitored. Board and relevant committee papers, management reports and relevant reports from assurance functions like internal and external auditors are routinely reviewed as part of the supervisory assessment process.</p> <p>For the locally incorporated banks with large trading operations and internal model approval, there are also regular discussions (usually on a quarterly basis) between market risk executives at the bank, frontline supervisors and APRA's market risk</p>



	<p>specialists. It may be noted that none of the domestic ADIs has a heavy proportion of business exposed to market risk and the majority of the market risk profile is relatively straightforward. The major institutions, however, are accredited for internal models for market risk. The agenda of these discussions is tailored to the institution, and typically cover topics such as:</p> <ul style="list-style-type: none"> <li>• market conditions;</li> <li>• structural and personnel changes;</li> <li>• changes to systems, risk framework and risk models;</li> <li>• recent trading performance and risk metrics; and</li> <li>• changes in strategy, new products and markets.</li> </ul> <p>The assessors reviewed a number of reports of on-site reviews focuses on market risk.</p> <p>Supplementing this, under APS 116, all banks are required to inform APRA of any changes to their Trading Book Policy statement and of any material changes to their risk measurement/management systems and market risk profile.</p>
<b>EC2</b>	<p>The supervisor determines that the bank has set market risk limits that are commensurate with the institution's size and complexity and that reflect all material market risks. Limits should be approved by the Board or senior management. The supervisor confirms that any limits (either internal or imposed by the supervisor) are adhered to.</p>
Description and findings re EC2	<p>Paragraph 1 of APS 116, Attachment A, states:          'An ADI's Board of directors (Board) is responsible for approving strategies and policies with respect to market risk and ensuring that senior management takes the steps necessary to monitor and control these risks.'</p> <p>Policies for the management and control of market risk must be approved by the Board (including the limit framework), and APRA expects all banks with trading operations to have a clearly articulated Board risk appetite that would set clear Board-approved limits around market risk.</p> <p>Onsite prudential reviews include an assessment of the market risk limit framework against the size, complexity and risk profile of the bank and the nature and frequency of limit breaches. The review will also assess reporting to management and Board and the escalation of material breaches to the Board. Banks must also inform APRA if there are any material changes to the limit framework and the Board-approved risk appetite statement (which would include limits for traded market risk) at least annually. In addition, for locally incorporated banks with large trading operations and internal model approval, limit breaches must be reported to APRA on a quarterly basis. Paragraph 21 of APS 116 allows APRA to require a bank to reduce its market risk or increase its capital if APRA considers that the bank's capital for market risk is not commensurate with its market risk profile. APRA has in practice exercised this power.</p>
<b>EC3</b>	<p>The supervisor is satisfied that there are systems and controls in place to ensure that all transactions are captured on a timely basis, and that the banks' marked to market positions are revalued frequently, using reliable and prudent market data (or, in the absence of market prices, internal or industry-accepted models). The supervisor requires banks to establish and maintain policies and processes for considering valuation adjustments/reserves for positions that otherwise cannot be prudently valued, including concentrated, less liquid, and stale positions.</p>
Description and findings re EC3	<p>The systems, procedures and controls around deal capture, collection of market rate data and valuation methodologies/reserves are assessed by APRA as part of its market risk onsite reviews. These items are generally discussed in the sessions on</p>

	<p>valuation and back/middle office, and also with internal audit (where relevant--for banks with internal model approval, most of these items are subject to independent review on a regular basis (see APS 116 Attachment C paragraph 16 (b), (c), (d), (f)). The valuation policy, recent revaluation committee minutes/packs, relevant internal audit reports and reports on valuation adjustments/reserves also form part of the typical pre-review information request for the onsite reviews. The assessors' review of files confirmed the typical pre-review requests for information and also that the following set of points is representative of the agenda for onsite reviews:</p> <ul style="list-style-type: none"> <li>• organisational structure, roles and responsibilities;</li> <li>• valuation policies and fair value methodology; provisioning, reserving and other valuation adjustments;</li> <li>• rates testing thresholds;</li> <li>• unobservable prices and use of mark-to-model;</li> <li>• reporting frequency;</li> <li>• daily position reconciliations; and</li> <li>• daily profit and loss (P&amp;L) production process, rates sources and identification of where these differ from those used by risk management, P&amp;L confirmation and dispute resolution procedures.</li> </ul> <p>Policies governing the trading book must cover the treatment of illiquid instruments, reserves or provisions held against mark-to-market P&amp;L (APG 116 paragraph 5(b)) and must also cover the valuation methodologies used (APS 116 Attachment A paragraph 11(d))</p> <p>Banks are also required to have policies (paragraph 4 of APS 116 Attachment A) to actively monitor the market liquidity of trading positions, and this would include assessments of the quality and availability of market inputs to the valuation process, level of market turnover and sizes of positions traded in the market.</p> <p>Banks have also been encouraged – through direct contact by the supervisor--to consider experience gained from other globally publicized instances of control breakdown in trading rooms and to assess how well their processes and controls would do in managing the relevant risks.</p>
<b>EC4</b>	<p>The supervisor determines that banks perform scenario analysis, stress testing and contingency planning, as appropriate, and periodic validation or testing of the systems used to measure market risk. The supervisor confirms that the approaches are integrated into risk management policies and processes, and results are taken into account in the bank's risk-taking strategy.</p>
Description and findings re EC4	<p>With respect for banks with internal modeling approval (Stress testing qualitative requirements in APS 116 (Attachment C paragraph 14) state that:</p> <p>'An ADI must have a routine and robust program of stress testing as a supplement to the risk analysis based on the day-to-day output of the risk measurement model. The results of stress testing exercises must be used in the internal assessment of capital adequacy and reflected in the policies and limits set by management and the Board, or Board committee. The results of stress testing must be routinely communicated to senior management and, periodically, to the ADI's Board, or a Board committee.'</p> <p>The use of scenario analysis and stress testing and its integration with the risk management practices are assessed as part of the onsite reviews, with information requests incorporating examples of market risk stress testing reports to management and board committees. Apart from internal stress testing and reporting, banks with internal model approval must, on a quarterly basis, also conduct stress testing in a specified format for APRA. The APRA-defined stress tests are split by asset class or risk factor and generally shock a matrix of price/volatility movements.</p>

	<p>Under APS 116 (Attachment C paragraph 16), banks with internal model approval must conduct an independent review and validation of the risk measurement system and overall risk management process to independently test and validate systems and controls. The scope of the review, outlined in paragraph 16 of Attachment C, is extensive. It is to be undertaken when the risk measurement model is accredited by APRA, and once every three years or when there is a material change made to the framework.</p> <p>While the qualitative requirements in Attachment C apply to banks with internal model approval, similar principles are applied to other banks with trading operations and these principles are raised in the onsite reviews of these banks. The expectations around the extent and use of stress testing for market risk would differ by institution and be commensurate with the size, nature and complexity of their trading exposures. For banks without models approval, on-site reviews will be sequenced according to a longer time horizon, proportionate to the scale of risk for the institution. The market risk prudential standard (APS 116) does not however express specific provisions with respect to stress or scenario testing for institutions using the standard approach to market risk.</p>
<b>Additional criteria</b>	
<b>AC1</b>	The supervisor requires that market data used to value trading book positions are verified by a function independent of the lines of business. To the extent that the bank relies on modeling for the purposes of valuation, the bank is required to ensure that the model is independently tested.
Description and findings re AC1	<p>APS 116 Attachment A paragraph 11(d) requires that the policies governing the trading book cover the valuation methodologies used; this includes the extent to which valuations for the exposure can be validated externally in a consistent manner. This covers the source of rates and independent verification of those rates, and the independent validation of valuation models used for financial reporting and within risk measurement models.</p> <p>In addition, APS 111 requires that institutions have robust independent price verification processes and that all valuation and risk models be independently validated (see especially APS 111, Attachment E: Use of Fair Values). Actual practices are reviewed by APRA as part of its market risk onsite reviews.</p> <p>Furthermore, for banks with internal model approval, the independent review of the market risk measurement system and management process (Attachment C paragraph 16(d), (f) and (h)) specifically addresses these points.</p>
<b>Assessment of Principle 13</b>	<b>Compliant</b>
Comments	The requirements and level of supervisory oversight is generally higher for locally incorporated banks with internal model approval as these banks tend to have larger and more complex traded market risk exposures, albeit that the level of market risk within the Australian banking system is relatively low. One potential avenue of risk is the trading desks located in the major firms' London offices. However, to date, APRA's supervisory work in cooperation with the host supervisor (UK FSA) has been able to confirm a group wide consistency of approach adopted by the banks.
<b>Principle 14</b>	<b>Liquidity risk.</b> Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control liquidity risk, and to manage liquidity on a day-to-day basis. Supervisors require banks to have contingency plans

	for handling liquidity problems.
<b>Essential criteria</b>	
<b>EC1</b>	The supervisor sets liquidity guidelines for banks. These guidelines take into consideration undrawn commitments and other off-balance sheet liabilities, as well as existing on-balance sheet liabilities.
Description and findings re EC1	<p>APRA sets liquidity requirements and guidelines for banks in Australia which take into account on- and off-balance sheet obligations in all currencies as they fall due, across a range of operating circumstances. These requirements are set out in <i>Prudential Standard APS 210 Liquidity</i> and <i>Guidance Notes on Liquidity Management Strategy</i> (AGN 210.1), <i>Scenario Analysis</i> (AGN 210.2) and <i>Minimum Liquidity Holdings</i> (AGN 210.3).</p> <p>Banks are required to undertake either a 'scenario analysis' approach, or a 'minimum liquidity holding' approach, to liquidity management.</p> <p>The majority of banks are required to apply the 'scenario analysis' approach. The scenario analysis regime (incorporating a worst case idiosyncratic name crisis) specifically requires banks to consider adverse contractual and behavioral cash flows including undrawn commitments and other off-balance sheet liabilities (refer to paragraphs 7 and 8 of APS 210 and AGN 210.2)</p> <p>For other banks with relatively straightforward business models, a Minimum Liquidity Holding ('MLH') regime is applied (paragraph 9 of APS 210 and AGN 210.3). The MLH regime specifies a level of eligible liquid assets (as a percentage of liabilities) that must be held. That level is determined on a case-by-case basis and any off-balance sheet commitments must be factored into that judgment. In practice, the MLH regime is not applied to banks that have significant non-retail off-balance sheet commitments.</p>
<b>EC2</b>	The supervisor confirms that banks have a liquidity management strategy, as well as policies and processes for managing liquidity risk, which have been approved by the Board. The supervisor also confirms that the Board has an oversight role in ensuring that policies and processes for risk-taking are developed to monitor, control and limit liquidity risk, and that management effectively implements such policies and processes.
Description and findings re EC2	<p>APRA requires (APS 210) the Board and management of a bank to implement and maintain a liquidity management strategy that is appropriate for the operations of the bank to ensure that it has sufficient liquidity to meet its obligations as they fall due (paragraph 1). Banks must regularly review their liquidity management strategy (at least annually) and adhere to the approved liquidity management strategy at all times. Should concerns arise, the bank must immediately inform APRA and outline plans to address these concerns.</p> <p>Banks' liquidity management strategies are subject to review and approval by APRA (paragraph 4 of APS 210). APRA assesses banks' liquidity strategies, including the assumptions on which the strategies are based and the key elements of the strategies. APRA has powers to require a bank to modify its strategy to address supervisory concerns where APRA is not satisfied with the adequacy of the strategy. The strategy must include various elements including: a board-approved liquidity management policy statement (although liquidity management policy statement may be approved by a Board committee rather than the principal Board); a system for measuring, assessing and reporting liquidity; procedures for managing liquidity; clearly defined managerial responsibilities and controls; and a formal contingency</p>

	<p>plan for dealing with a liquidity crisis (paragraph 5). In short, the strategy is required to set out how the bank measures, manages and assesses its liquidity position and how it is able to respond to a liquidity crisis.</p> <p>APRA is able to determine the adequacy of banks' implementation of their liquidity management strategy through routine supervisory activity, including onsite prudential review meetings with the firms. Responsibility for liquidity supervision rests with the front line supervisors, though the specialist risk team is available for support and to carry out targeted on-site reviews. The assessors discussed the frequency of the more in depth targeted onsite reviews on liquidity risk with APRA. The resources of the specialist team are, naturally, finite and the majority of on-site work that is carried out is planned in the context of the supervisory action plan (see CPs 19 and 20). Hence the frequency of a specialist onsite risk review will depend on the risk based analysis of the individual bank's profile. On site reviews (typically between one to three days' duration) have taken place for some but not all of the largest banks over the past year. However, the liquidity risk specialist team has had much higher frequency of contact with firms through meetings, discussions and queries, as individual issues have arisen, not least due to preparations for the Basel III liquidity framework.</p> <p>The PAIRS framework and supporting guidance indicates that attention should be paid to the role of the Board, both in terms of overall risk governance but also in the specific context of liquidity risk management and controls. Although the assessors were not able to review a range of records of on-site prudential reviews relating to liquidity for systemic banks, APRA indicated that actions supervisors might take to confirm the role of the Board would typically include of the quality of associated reporting through the onsite review process, discussion with relevant personnel, reviews of Board and committee papers and related reports as well as reports issued by internal or external auditors. In addition, and as for other risk areas, supervisors use peer-group comparisons to better inform their assessments of individual banks' liquidity strategies.</p> <p>Supervisors periodically update their assessment of the appropriateness of a bank's liquidity management strategy through the PAIRS architecture. There is no set frequency for liquidity risk to be reviewed but the overall PAIRS rating should be reviewed at least annually.</p> <p>At present the prudential standard for liquidity (APS 210) is being revised to incorporate the Basel Committee on Banking Supervision's 2008 Principles for Sound Liquidity Risk Management and Supervision' and the Basel III liquidity reform proposals.</p> <p>Ahead of the finalization of new liquidity requirements in mid 2012, APRA wrote to all ADIs in November 2010 encouraging them to apply the Basel Committee Principles of Liquidity Risk management and asking all banks currently subject to scenario analysis to undertake a self-assessment against the Principles. APRA commented that there had been a range of findings from this exercise. Front line supervisors are responsible for follow up with respect to remedial action that might be necessary as the result of this exercise although these actions typically benefit from input from risk specialists. .</p>
<b>EC3</b>	The supervisor determines that a bank's senior management has defined (or established) appropriate policies and processes to monitor, control and limit liquidity risk; implements effectively such policies and processes; and understands the nature and level of liquidity risk being taken by the bank.
Description and findings re EC3	APS 210 establishes requirements for banks to set internal limits and procedures consistent with their liquidity management strategy and have appropriate control mechanisms in place to ensure that these internal limits and procedures are adhered

	<p>to at all times. The internal supervisory guidance draws the supervisor's attention to the need for a bank to put in place a well-defined management responsibility and control structure for monitoring, reporting and responding to the bank's liquidity position in a timely and effective manner.</p> <p>APRA requires banks to clearly document the full range of policies and processes used to manage liquidity. These are reviewed during periodic onsite prudential reviews. The June 2008 Guidance Note AGN 210.1 indicates APRA's expectations with regard to a range of issues, including:</p> <ul style="list-style-type: none"> <li>• whether any mismatch limits established are realistic and commensurate with the bank's funding capacity;</li> <li>• the quality and adequacy of the bank's holdings of liquid assets and how readily liquefiable these might be under different operating conditions;</li> <li>• how diversified and stable the bank's liability base might be, including the potential to avoid excessive reliance on a single counterparty (or related counterparties), products or market;</li> <li>• the bank's ability to access interbank and wholesale markets for funds under both normal and crisis conditions;</li> <li>• a bank's capacity to manage its liquidity position if it is actively involved in multiple currencies and/or has significant positions in specific foreign currencies;</li> <li>• any regulatory or legal impediments to the access of liquidity sourced from related parties;</li> <li>• the potential for less liquid assets (for example, mortgages or other loans) to generate additional funding when required;</li> <li>• a bank's ability to access committed standby facilities; and</li> <li>• reliance on any industry liquidity support arrangements and the capacity of participants to provide support when needed.</li> </ul> <p>Offsite review activity will involve ongoing monitoring of information regularly provided to APRA and information gained by other means, including from the bank's external auditor. The assessors were able to review quarterly risk analyses, notes from prudential reviews and PAIRS assessments. APRA noted that it is usual practice that relevant audit reports are obtained regularly, especially when preparing for an onsite review. APRA further noted that on occasion, it may request copies of management letters from external auditors with a view to checking if any issues have been identified and highlighted to the Board.</p>
<b>EC4</b>	<p>The supervisor requires banks to establish policies and processes for the ongoing measurement and monitoring of net funding requirements. The policies and processes include considering how other risks (e.g., credit, market and operational risk) may impact the bank's overall liquidity strategy, and require an analysis of funding requirements under alternative scenarios, diversification of funding sources, a review of concentration limits, stress testing, and a frequent review of underlying assumptions to determine that they continue to be valid.</p>
Description and findings re EC4	<p>APRA requires banks to have the capacity to construct maturity profiles of cash flows to identify cumulative net funding positions at selected maturity dates (paragraph 6(b) of AGN 210.1). The assumptions underpinning the maturity profiles must be documented in the bank's liquidity management policy statement and be reviewed regularly to take account of available statistical evidence and/or changing business profile (paragraphs 7 and 8 of AGN 210.1). Procedures required to support the management of liquidity risk must be determined taking into account other risks including changing market prices and access to markets, the impact on liquidity of</p>

collateral requirements (refer to response to EC5), the prospect of declining credit quality and other shifts in operational conditions or the external environment. Banks are also expected to have established policies limiting concentrations in funding sources.

APRA does not itself set ex ante limits (for example relating to geography, product, tenor or market sector). The assessors discussed with APRA staff the current internal debate with respect to how forceful APRA should be in delivering its expectations for diversification of funding. APRA has not set limits on or targets for domestic banks in relation to the proportion of funding that is drawn from the wholesale market but at the same time it was possible to maintain an active dialogue with firms in terms of longer term supervisory expectations. APRA noted that it also routinely benchmarks the large banks against one another and banks that are outliers with respect to a more aggressive funding or liquidity profile are drawn to the relevant board's attention. It was noted that the reliance on short term wholesale funding in the Australian market has notably decreased. Another potential source of concentrated funding could be intra-group. APRA indicated that foreign bank subsidiaries may rely on committed funding from their parent although restrictions are placed on the timing of its recognition for modelling purposes. In short, they must be able to demonstrate that they are able to meet in full the five-day name crisis scenario requirement without recognition of any committed group funding.

The assumptions underlying the construction of maturity profiles of cash flows and the reasoning behind them need to be clearly documented and regularly reviewed (paragraph 8 of AGN 210.1). For scenario analysis banks, the AGN confirms that APRA will assess and agree the suitability of the assumptions made for the going-concern and the name crisis scenarios. APRA looks to banks to provide analysis and evidence to justify the assumptions underlying these two scenarios but pays particular attention to a bank's policies to address a name crisis. Banks must assess, among other things, the effect of pressure on them to support their paper in the market, requests to redeem term liabilities before due dates as well as evaluating the marketability of their assets and the values likely to be generated from a fire sale. If inflows from industry liquidity support schemes, standby facilities and intra-group funding are to be included, the arrangements must either be fully committed and irrevocable or clearly demonstrable to an acceptable level of certainty (paragraph 3 of AGN 210.2).

Since late 2007, APRA has required banks to prepare and submit an annual funding plan. Supervisors assess these plans from an individual bank and industry-wide perspective. Entity-focused assessments take into account the nature and complexity of the bank's operations and place particular attention on unrealistic assumptions, over-reliance on short-term funding sources, and funding concentration risk.

Throughout the year supervisors monitor funding performance against the plans. Banks are expected to continuously review the applicability of assumptions and use scenario analysis and conduct stress tests of their baseline funding plans as well as reflect any adverse outcomes in their contingency plans.

APR indicated that banks were expected to demonstrate the capacity to manage unplanned changes in funding sources. Banks with significant funding risk exposures would be expected to be the subject of targeted supervisory action. The assessors' review of files showed that funding issues were a very high priority in terms of off-site analysis and communication with firms.

APRA also performs industry analysis of the funding plans from banks to identify potential systemic issues.

In the draft APS 210 currently subject to public consultation, it is proposed that

	APRA's existing practice to require banks to submit annual funding plans will be formally required under the prudential standard.
<b>EC5</b>	The supervisor obtains sufficient information to identify those institutions carrying out significant foreign currency liquidity transformation. Where a bank or banking group's foreign currency business, either directly, or indirectly through lending in foreign exchange to domestic borrowers, is significant, or where a particular currency in which the bank has material exposure is experiencing problems, the supervisor requires the bank to undertake separate analysis of its strategy for each currency individually and, where appropriate, set and regularly review limits on the size of its cash flow mismatches for foreign currencies in aggregate and for each significant individual currency.
Description and findings re EC5	<p>Due to the reliance of the larger Australian banks on offshore wholesale funding sources, APRA has instituted a range of reporting requirements for banks with significant exposure to foreign borrowing risk. In practice, non-Australian dollar wholesale debt issuance is routinely swapped into Australian dollars by banks and any residual mismatch risk (net open positions) will be measured and monitored by the bank. Regular reports provided to APRA include details of unhedged foreign currency funding denominated in major foreign currencies (USD, GBP, EUR, JPY, NZD ).</p> <p>In addition, APRA monitors collateral flows required under the International Swaps and Derivatives Association (ISDA) Credit Support Annex (CSA) for over-the-counter (OTC) derivatives predominantly undertaken for hedging non-Australian dollar debt issues. These collateral flows are materially influenced by fluctuations in the value of the Australian dollar against the United States dollar, Japanese yen and Euro. Furthermore, any material open currency positions in both banking and trading books will be visible to APRA through the APS 116 Market Risk reporting regime. This includes details for each material currency individually.</p> <p>APRA confirmed that currency risk was a factor that supervisors and specialists would examine through discussions and targeted reviews of those banks viewed as most at risk.</p>
<b>EC6</b>	The supervisor determines that banks have contingency plans in place for handling liquidity problems, including informing the supervisor.
Description and findings re EC6	<p>Banks are required to incorporate a liquidity contingency plan within their liquidity management strategies and APRA's requirements and expectations are set out in APS 210 and associated guidance (paragraph 5(e) of APS 210 and paragraphs 13-15 of AGN 210.1). Contingency plans should be approved by the bank's Board or relevant Board committee for locally incorporated banks or an appropriate senior officer outside Australia in the case of foreign bank branches. It is also APRA's expectation that the plans will be updated periodically (at least annually – paragraph 15 AGN 210.1) to ensure that they remain appropriate, sound and relevant to the bank's circumstances and the environment in which it operates.</p> <p>APRA noted that banks' liquidity contingency plans are reviewed as part of APRA's regular supervisory activities and expectations are set out in the guidance notes (e.g., paragraph 14 of AGN 210.1), namely that banks' plans should address a range of issues that would be relevant in a crisis. This includes: designation of who would be responsible for identifying crises; specification of the early warning signals; reporting procedures; procedures for making up cash flow shortfalls in crisis situation; an assessment of the cost of alternative funding strategies and the impact on the ADI's capital; outline courses of action for altering asset and liability behavior (e.g., selling marketable assets, raising deposits) plans to market assets more aggressively, raise</p>



	<p>deposits, etc; procedures to determine priority of customer relationships (e.g., regarding withdrawal of lines of credit); plans for dealing with public, market and media.</p> <p>For those banks that form part of a larger group or overseas entity it is common for APRA to obtain and consider copies of group contingency plans.</p> <p>As part of their routine supervisory review activity, supervisors consider indicators of potential liquidity concerns such as breaches of limits, volatility in deposits, deterioration of cash flow, material reductions in liquid assets, changes in the composition of liquid assets, use of central bank repo facilities (paragraph 12 of AGN 210.1). Moreover, banks are required to inform APRA of any concerns held about current and future liquidity, as well as their plans to address these concerns (paragraph 3 of APS 210).</p> <p>Proposed changes to APS 210 currently subject to public consultation will require banks to have a formal standalone contingency funding plan that clearly sets out strategies for addressing liquidity shortfalls in emergency situations. APRA's expectations are detailed in the draft standard and cover a variety of areas including clarity of lines of responsibility, invocation and escalation procedures as well the need for the plan to be regularly tested and updated to remain operationally robust.</p>
<b>Additional criteria</b>	
<b>AC1</b>	The supervisor determines that, where a bank conducts its business in multiple currencies, foreign currency liquidity strategy is separately stress-tested, and the results of such tests are a factor in determining the appropriateness of mismatches.
Description and findings re AC1	APRA expects banks to identify the material sources of liquidity risk relevant to their situation and to incorporate assumptions in relation to such risks into their liquidity name-crisis modeling. To the extent that a bank conducts significant business in multiple currencies, APRA requires this to be captured in the bank's liquidity crisis modeling (which is a stress test). Particular attention is directed to the assumptions around the convertibility (or lack of convertibility) of foreign currencies and the robustness of any associated contingency plans. APRA agrees the assumptions employed by the banks under both the going concern and name crisis scenarios for scenario analysis (AGN 210.2, paragraph 1). APRA indicated that supervisory reviews will also focus on currency mismatch exposures for banks with significant foreign currency dealings, how the bank measures and manages the risk, and how it controls or otherwise mitigates the risk. The majority of banking activity for the Australian banking system is domestic or exposed to New Zealand, but the assessors noted (through file review) that APRA pressed institutions for more information on their management of currency mismatches following on-site reviews.
<b>AC2</b>	The supervisor confirms that banks periodically review their efforts to establish and maintain relationships with liability holders, maintain the diversification of liabilities, and aim to ensure their capacity to sell assets.
Description and findings re AC2	Under paragraph 9(c) of AGN 210.1, APRA expects banks to maintain a diversified funding base with limited concentrations and to avoid excessive reliance on single counterparties (or related counterparties), products or markets. Bank liquidity risk management policies and procedures should formalize limits on funding concentrations. Likewise, AGN 210.1 provides for banks to ensure that they have a ready capacity to realize assets identified as potentially providing back-up liquidity, preferably without major discounts in value and within acceptable timeframes. As part of APRA's periodic updating of the PAIRS rating process, supervisors

	<p>consider the bank's funding strategy, funding mix, concentration mix and contingent cash outflows (as indicated by the guidance supporting PAIRS analysis and consistent with the assessors' review of PAIRS ratings analysis). Particular attention is given to the bank's funding profile with regard to sources (for example: retail vs wholesale, onshore vs offshore and intra-group vs third party), concentration and capacity.</p> <p>While retail deposit raising strategies are important, and the retail deposit base has been increasing in the major firms, in practice APRA observed to the assessors that ADIs, particularly large banks, will maintain relationships with wholesale investors either directly or indirectly through their program lead managers and dealer panels. More generally, banks will search out potential new investor segments in order to broaden their investor universe for future debt issues. The extent of a bank's debt investor relationship management activities and new wholesale funding initiatives is discussed as part of normal reviews on liquidity and funding, including as a result of reviews of banks' funding plans.</p>
<b>Assessment of Principle 14</b>	<b>Largely Compliant</b>
Comments	<p>APRA has undertaken significant work in recent years to revise its liquidity standards, and effort is continuing. The current prudential standard on liquidity was released in 2011.</p> <p>Overall there are many strengths in the approach taken by APRA not least as witnessed by a good response to liquidity pressures in the global financial crisis and its steady progress towards the new Basel standards for liquidity risk. The rating reflects two specific areas where it is recommended that APRA focus attention, namely the frequency of on-site review with respect to liquidity risk and the accuracy of reporting of liquidity data.</p> <p>Assessors recognize that there is frequent contact with institutions and also note the clear communication of supervisory expectations to firms that they must define and manage their liquidity risk appetite. However, APRA is not yet at a position where it is delivering a system wide proactive programme of in-depth reviews of risk measurement, management and related governance of liquidity risk. On-site reviews targeted at liquidity are of shorter duration and lesser frequency than those directed at credit risk (i.e., less than one week in the case of liquidity) and that onsite reviews would not necessarily be conducted annually with respect to the major institutions. For the supervisor to have comfort that an institution has in place the policies, practices and governance necessary to ensure effective liquidity risk management the amount of time allocated to on-site review of this risk is insufficient. While review of strategy is important (such as the review of annual funding plans), as is the supplementary monitoring of liquidity metrics (such as through the APRA dashboard report), it is essential for the supervisors to be able to assess the quality of the management and control culture on which the policies, and indeed the accuracy of the reporting depends. While some activity in support of these objectives can be and is already carried out off-site it is unlikely that the appropriate depth of understanding can be obtained without insights obtained from a thorough on-site process. Therefore, issues to be considered for on-site review could include, though not be limited to: review of robust strategies, policies, processes and systems that enable the ADI to identify measure, manage and monitor liquidity risk over an appropriate set of time horizons, including intra-day, confirming that risk tolerances are appropriate, examining internal pricing of risk, management of collateral, funding diversification and overall group-wide liquidity management.</p> <p>APRA can be commended for enhancing its liquidity reporting requirement and</p>

monitoring over the period of the crisis, which included daily monitoring at the absolute peak, but more remains to be done as deficiencies remain. APRA has powers to require daily reporting as necessary but it must be fully satisfied that all major banks (not only the four largest) are fully able to report reliable and consistent (i.e., comparable system wide) liquidity data to the supervisor on a daily basis should crisis conditions re-emerge. At the time of the assessment this was not the case. It is noted and accepted that APRA undertakes a review of annual funding plans (required by APRA) and has been receiving standardized information on a monthly basis since the onset of the crisis and on a fortnightly basis since late 2011. The potential to use the CLF is a valuable advantage for the stability of the Australian system, particularly if liquidity pressures re-emerge. APRA can be commended for adopting an attitude that should avoid over-reliance on this Facility. Equally, however, the provision of back-stop liquidity by the central bank for the system does not take away the importance of ensuring that liquidity risk management standards are imposed, reviewed on-site and that the timely reporting capabilities of the full range of ADIs is ensured.

Minor issue. A notable feature of the Australian banking system at the time of the assessment is a significant exposure to overseas wholesale funding. Consequently it is understandable that much of the focus of APRA's analytical work and engagement with the industry has been upon funding issues. Nonetheless, while key, funding is not the only element of liquidity risk it is important that APRA guards against too narrow a focus upon the funding dimension of liquidity risk. Documentation reviewed by the assessors indicates that this is a risk that could develop.

In terms of looking to the future and preparing for the Basel III framework (which is not reflected in the rating as this is a future standard), further revisions to the liquidity regime, on which APRA has already consulted, will incorporate the Basel III liquidity reforms.

In order to achieve a comprehensive and effective oversight of liquidity risk APRA will finalize its work on liquidity risk management standards. The work of the Basel Committee (Principles for Sound Liquidity Risk Management and Supervision published in 2008) will act as a foundation for this. APRA has drawn the industry's attention to this standard – requiring self assessment against the principles--and has worked with individual firms, APRA lags a number of other jurisdictions in confirming enhanced standards of liquidity risk management to the industry as a whole.

Finalize the program of enhanced liquidity risk regime, including revised reporting standards to ensure that firms are capable of providing accurate; system wide comparable data on a daily basis if required and ensuring the general principles of liquidity risk management are applied to and adhered to by all institutions.

APRA currently proposes that new qualitative requirements of the Basel III package will become effective when the revised APS 210 is implemented (planned for mid-2012), and the Basel III metrics for the Liquidity Coverage Ratio and the Net Stable Funding Ratio will follow the planned Basel implementation timetable of 2015 and 2018 respectively. APRA has had consistent and extensive contact with firms in the course of working on the introduction of the new standards. Reporting standards can only be finalized when the Basel framework itself is fully final. The introduction of the Committed Liquidity Facility (CLF) available from the Reserve Bank of Australia to enable ADIs to meet their Liquidity Coverage Ratio requirements (from 2015) will be an important development as APRA intends that ADIs must demonstrate that they have taken all reasonable steps towards meeting their LCR requirements through their own balance sheet management, before relying on the Facility.

<b>Principle 15</b>	<b>Operational risk.</b> Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.
<b>Essential criteria</b>	
<b>EC1</b>	The supervisor requires individual banks to have in place risk management policies and processes to identify, assess, monitor and mitigate operational risk. These policies and processes are adequate for the size and complexity of the bank's operations, and the supervisor confirms that they are periodically adjusted in the light of the bank's changing risk profile and external market developments.
Description and findings re EC1	<p>Prudential Standard APS 310- Audit and Related Matters--places broad requirements on the Boards and management of banks in relation to the risk management policies and processes to identify, assess, monitor and mitigate all major areas of risks, which include operational risk. Banks must regularly review and update their risk management systems, at least annually, to take account of changing circumstances and the Board and Chief Executive Officer provide annual declarations to APRA on these systems (refer to CP19, EC4).</p> <p>In addition to the broad requirements in respect of risk management, there are other prudential standards that address specific operational risks. These include Prudential Standard APS 231- Outsourcing – and Prudential Standard APS 232 – Business Continuity Management. For standardized banks, Prudential Standard APS 114-Capital Adequacy: Standardized Approach to Operational Risk--details requirements for holding sufficient regulatory capital against operational risk exposures.</p> <p>For AMA banks, APRA requires clearly documented policies and processes in accordance with Prudential Standard APS115--Capital Adequacy: Advanced Measurement Approaches to Operational Risk. Specifically, documentation must:</p> <ul style="list-style-type: none"> <li>• outline a robust operational risk management framework (Attachment A, paragraph 7);</li> <li>• describe the operational risk measurement system and data requirements (Attachment B, paragraph 10);</li> <li>• provide an assessment of the relevance of historical loss data (Attachment B, paragraph 17);</li> <li>• detail the approach for classification and regulatory treatment of operational risk-related credit risk and market risk losses (Attachment B, paragraph 26);</li> <li>• incorporate into the policy the process used to determine the effect of insurance on operational risk, as well as credit and market risk (Attachment B, paragraph 45); and</li> <li>• outline a comprehensive and rigorous program of sensitivity analysis of the bank's operational risk measurement model (Attachment B, paragraphs 50 and 51).</li> </ul> <p>Attachment B of APS 115 requires AMA banks to incorporate business environment and internal control factors into their operational risk measurement systems.</p> <p>APRA's supervision framework provides detailed internal guidance for the supervisory assessment of risk management policies and processes that identify, assess, monitor and mitigate operational risk. APRA applies the framework to all banks and uses operational risk guidance to assist in undertaking regular quarterly assessments and ongoing supervision activities. Frontline supervisors can also seek assistance from</p>

	operational risk specialists as required. There are three specialist operational risk teams--Operational Risk Governance, Operational Risk Analytics and Information Technology Risk – reflective of the need to address different sources of operational risk.
<b>EC2</b>	The supervisor requires that banks' strategies, policies and processes for the management of operational risk have been approved and are periodically reviewed by the Board. The supervisor also requires that the Board oversees management in ensuring that these policies and processes are implemented effectively.
Description and findings re EC2	<p>Paragraphs 23 and 26 of APS 310 – Audit and Related Matters--outline the responsibilities of the Board (and management) for banks with respect to the management practices and systems in place to limit risk to prudent levels and APRA's requirements regarding review and annual declarations.</p> <p>In addition, for AMA banks, APS 115 – Capital Adequacy: Advanced Measurement approaches to Operational Risk--specifically requires the Board of a bank to:</p> <ul style="list-style-type: none"> <li>• actively oversee the bank's approach to managing and measuring operational risk;</li> <li>• approve the operational risk management framework;</li> <li>• ensure that the framework is subject to periodic validation and review; and</li> <li>• review operational risk management on a regular basis and confirm they are satisfied this risk is appropriately managed (Attachment A, paragraphs 1-4.)</li> </ul> <p>As part of its ongoing supervisory activities, APRA routinely assesses the Board's involvement in and oversight of the bank's operational risk management as a component of its assessment of risk governance and banks' operational risk management framework. The Board's role in setting risk management strategies and policies, responsibilities of Board committees and the quality of reporting to Board and board committees are incorporated into such assessments. In forming their judgments, supervisors also take into consideration such factors as the escalation triggers and processes and the communication and reporting channels from the senior management to the Board and/or Board Committees. Supervisors' assessments of the operational risk management and controls influence supervisory activities as they are incorporated into the bank's Probability and Impact Rating System (PAIRS) and Supervisory Action Plan (SAP).</p> <p>APRA supervisors form, and periodically, refine their assessment of banks' operational risk profiles and management systems through on-going supervisory activity.</p>
<b>EC3</b>	The supervisor is satisfied that the approved strategy and significant policies and processes for operational risk are implemented effectively by management.
Description and findings re EC3	<p>APRA's supervisory framework provides for an assessment of a bank's inherent operational risks and the management and controls around these risks when determining the PAIRS rating. Ongoing supervisory activity, including onsite prudential inspections, undertaken with the support of risk specialists, assists in the update of these assessments on a regular basis.</p> <p>Also, under APS 310 – Audit and Related Matters – the Board and Chief Executive Officer are required to attest that the risk management systems are operating effectively.</p> <p>The external auditor is also required to bring to APRA's attention any material deficiencies in risk management that are identified in the performance of its audit activities.</p>
<b>EC4</b>	The supervisor reviews the quality and comprehensiveness of the bank's business resumption and contingency plans to satisfy itself that the bank is able to operate as a

	going concern and minimize losses, including those that may arise from disturbances to payment and settlement systems, in the event of severe business disruption.
Description and findings re EC4	<p>APRA's prudential requirements with respect to business resumption and contingency plans are set out in APS 232--Business Continuity Management. Guidance Note AGN 232.1--Risk Assessment and Business Continuity Management--also addresses the issues.</p> <p>In addition, Prudential Practice Guide PPG 233--Pandemic Planning and Risk Management- and Prudential Practice Guide PPG 234- Management of Security Risk in Information and Information Technology--provide guidance with respect to particular aspects of banks' operations where sound continuity planning is a prerequisite. Business continuity assessment forms an integral part of the PAIRS rating process as well as ongoing supervision activities. Frontline supervisors, often with the support of operational risk specialists, periodically review the quality and comprehensiveness of banks' business continuity during onsite prudential inspection.</p> <p>In the case of outsourced business activities, APS 231 requires banks to ensure that service providers have business resumption and contingency plans in place and conduct due diligence to assess the provider's ability to provide ongoing and stable services (paragraph 25(h)). APRA reviews material outsourcing agreements to ensure business disruption and continuity plans are covered in the arrangement. The standard also requires that the outsourcing agreement allows APRA to undertake onsite reviews of external service providers.</p> <p>The Payments System Board of the Reserve Bank of Australia (RBA) oversees the payments system in Australia and is responsible for promoting the safety and efficiency of the payments system. APRA collaborates with the RBA in monitoring the operational incidents in Australia's high-value payments system – the Reserve Bank Information and Transfer System (RITS). Quarterly meetings are held between the RBA and APRA to discuss trends in incident data and the nature of incidents. Insights gained provide useful contextual information for supervisors that may be taken into account when making assessments about individual banks or in allowing for targeted supervisory action.</p>
<b>EC5</b>	The supervisor determines that banks have established appropriate information technology policies and processes that address areas such as information security and system development, and have made investments in information technology commensurate with the size and complexity of operations.
Description and findings re EC5	<p>APRA has a specialist IT risk team that provides support to frontline supervisors in undertaking onsite and offsite reviews of banks' information security and system development capabilities. As part of routine supervisory activity, supervisors assess the adequacy and appropriateness of banks' policies and processes as well as the robustness of a bank's IT systems relative to the scale and complexity of its operations.</p> <p>An internally developed methodological framework based on the internationally recognized Control Objects in IT (COBIT) framework is commonly used when undertaking onsite IT risk inspections. The framework covers all aspects of IT and is updated annually.</p> <p>APRA has also issued PPG 234, which addresses a wide range of IT and associated security issues. The aim of PPG 234 is to assist regulated institutions in the management of security risk in information and IT. It is designed to provide guidance to senior management, risk management and IT security specialists and highlights areas of weakness identified as part of APRA's supervisory activities.</p>

<b>EC6</b>	The supervisor requires that appropriate reporting mechanisms are in place to keep the supervisor apprised of developments affecting operational risk at banks in their jurisdictions.
Description and findings re EC6	<p>APRA requires banks to inform it of any material changes in their risk profile and operations, including but not limited to:</p> <ul style="list-style-type: none"> <li>• proposed changes to the composition or operations of the banking group (Prudential Standard APS 222--Association with Related Entities, paragraph 8);</li> <li>• establishing or acquiring a subsidiary or otherwise committing to acquire more than 20 percent of an equity interest in an entity (APS 222, paragraph 35);</li> <li>• material changes in the bank's risk management systems (APS 310, paragraph 24);</li> <li>• entering into agreements to outsource material business activities and (for prior consultation with APRA) to outsource material business activities to service providers outside Australia (APS 231, paragraphs 28 and 29); and</li> <li>• changes to internal capital models for operational risk measurement for AMA banks (APS 115, paragraph 9).</li> </ul> <p>Routine supervisory discussions and separate technical meetings supplement these formal notification arrangements. Technical meetings will typically be organized to discuss any material changes to individual banks' operational risk management framework, or when it has been triggered by particular events such as merger and acquisition activities. It is common for frontline supervisors to invite APRA's risk specialists to participate in technical meetings.</p> <p>In addition, APRA receives standard prudential reports relating to the operational risk charge for capital adequacy purposes. Reporting requirements are reflective of the size and complexity of the banks. For AMA banks, information is collected regarding the number, size and business line generating operational loss and the associated calculation of a capital charge determined under internal models. For banks reporting in terms of the standardized approach, information is provided in relation to the operational risk regulatory capital charge for retail and commercial banking as well as other activity undertaken. Supervisors use the information provided by prudential returns to gain insights into operational risk drivers for individual banks. Larger banks also submit internal operational loss data on a voluntary basis every six months to keep APRA notified of any major incidents that have occurred.</p>
<b>EC7</b>	The supervisor confirms that legal risk is incorporated into the operational risk management processes of the bank.
Description and findings re EC7	<p>The definition of operational risk adopted by APRA and outlined in APS 114 (paragraph 5(d)) – Standardized Approach to Operational Risk--and APS 115 (paragraph 5(c))--Capital Adequacy: Advanced Measurement Approach to Operational Risk--specifically includes legal risk. Legal risk is defined as including, but not limited to, exposure to fines, penalties or punitive damages resulting from supervisory actions as well as ordinary damages in civil litigation, related legal costs and private settlements.</p> <p>APRA's supervisory activities ensure that legal risk is incorporated into banks' operational risk management frameworks. As with other elements of operational risk, supervisors incorporate consideration of legal risk into their PAIRS assessments and ratings. When warranted, issues will be pursued as part of routine supervisory actions.</p>
<b>EC8</b>	The supervisor determines that banks have established appropriate policies and processes to assess, manage and monitor outsourced activities. The outsourcing risk

	<p>management program should cover:</p> <ul style="list-style-type: none"> <li>• conducting appropriate due diligence for selecting potential service providers;</li> <li>• structuring the outsourcing arrangement;</li> <li>• managing and monitoring the risks associated with the outsourcing arrangement;</li> <li>• ensuring an effective control environment; and</li> <li>• establishing viable contingency planning.</li> </ul> <p>Outsourcing policies and processes should require the institution to have comprehensive contracts and/or service level agreements with a clear allocation of responsibilities between the outsourcing provider and the bank.</p>
Description and findings re EC8	<p>The requirements for outsourcing arrangements are set out in APS 231 – Outsourcing- with additional guidance provided by Prudential Practice Guide PPG 231 –Outsourcing. The broad objective of APS 231 is to ensure that all outsourcing arrangements involving material business activities entered into by a bank are subject to appropriate due diligence, approval and ongoing monitoring. All risks arising from outsourcing material business activities must be appropriately managed to ensure that the bank is able to meet both its financial and service obligations to its depositors.</p> <p>Banks that are considering outsourcing material business activities must demonstrate to APRA that they have conducted a thorough analysis, followed sound practice and established and maintained adequate risk management processes.</p> <p>Specific requirements apply to situations involving the outsourcing of business activities to related body corporates (Paragraph 18 of APS 231).</p> <p>A bank must consult with APRA prior to entering into any offshoring agreement involving a material business activity so that APRA may satisfy itself that the impact of the offshoring arrangement has been adequately addressed as part of the bank’s risk management framework. Where, in APRA’s view, the offshoring agreement involves risks that the bank is not managing appropriately, APRA may require the bank to make other arrangements for the outsourced activity as soon as practicable (paragraphs 29 and 30 of APS 231).</p> <p>APRA routinely undertakes onsite prudential inspections to assess banks’ outsourcing risk management frameworks and to supplement the offsite review of individual arrangements and descriptions of risk management systems.</p>
<b>Additional criteria</b>	
<b>AC1</b>	<p>The supervisor determines that the risk management policies and processes address the major aspects of operational risk, including an appropriate operational risk framework that is applied on a group-wide basis. The policies and processes should include additional risks prevalent in certain operationally intensive businesses, such as custody and correspondent banking, and should cover periods when operational risk could increase.</p>
Description and findings re AC1	<p>As outlined in EC1, APRA requires all banks to have an operational risk management framework in place commensurate with the size, nature and complexity of the bank’s business operations. APRA also expects periodic review of the framework to ensure its continued integrity and this forms part of the requirements placed on appointed auditors in terms of APS 310-Audit and Related Matters.</p> <p>For a conglomerate group headed by a bank, APS 222 – Association with Related Entities--requires the Board to ensure that comprehensive policies and procedures are in place to measure, manage, monitor and report overall risk at a group level (paragraph 7). To ensure that existing Board-approved policies and the relevant</p>



	<p>controls remain adequate and appropriate for managing and monitoring overall group risk, the Board or a Board committee must review them regularly (at least annually) to take account of changing risk profiles of group entities. Any material changes to group risk management policies must be approved by the Board.</p> <p>In conducting regular onsite prudential inspections, APRA will consider the implementation of the operational risk framework, its ongoing development and the adequacy of any material changes since the previous review in an overall group context. For those elements of operational risk likely to have group-wide consequences, internal supervisory guidance requires supervisors to incorporate these considerations into their assessments. Examples include the application of Business Continuity arrangements on a whole-of-business coverage basis including any subsidiaries that provide services to the group and the implications of banks employing centralized group risk management functions.</p> <p>APRA will also take into account the operational risk associated with specialized business, including those relating to custodial business and corresponding business.</p>
<b>Assessment of Principle 15</b>	<b>Compliant</b>
Comments	APRA places a high level of importance to the need for banks to identify, assess, monitor and control operational risk across the board, particularly in relation to IT, business continuity and outsourcing.
<b>Principle 16</b>	<b>Interest rate risk in the banking book.</b> Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor and control interest rate risk in the banking book, including a well-defined strategy that has been approved by the Board and implemented by senior management; these should be appropriate to the size and complexity of such risk.
<b>Essential criteria</b>	
<b>EC1</b>	The supervisor determines that a bank's Board approves, and periodically reviews, the interest rate risk strategy and policies and processes for the identification, measuring, monitoring and control of interest rate risk. The supervisor also determines that management ensures that the interest rate risk strategy, policies and processes are developed and implemented.
Description and findings re EC1	<p>APRA requires Board approval of all major risk policies and active Board oversight of associated risk management systems, processes and risk being assumed. In the event that interest rate risk in the banking book (IRRBB) constitutes a major risk for a bank, APRA would expect Board approval and oversight of strategy, policies and processes for risk identification, measurement, monitoring and control of that risk.</p> <p>'Advanced' banks are subject to Prudential Standard APS 117--Capital Adequacy: Interest Rate Risk in the Banking Book (Currently the five largest domestic banks are subject to APS 117).</p> <p>APRA approaches IRRBB as a Pillar 1 risk under the Basel II framework and therefore requires advanced banks to hold capital against IRRBB. Attachment A of APS 117 outlines APRA's requirements in relation to governance and the IRRBB management framework. It specifically addresses the responsibilities of the Board and senior management. Attachment A emphasizes that the Board must make clear its appetite for IRRBB, including determining IRRBB limits. The Board or a Board committee must also be actively involved in the oversight of the bank's approach to managing and measuring IRRBB.</p> <p>For 'standardized' banks, paragraph 6(a) of Prudential Standard APS 110--Capital</p>

	<p>Adequacy--requires that a bank must have 'adequate systems and procedures to identify, measure, monitor and manage the risks arising from the bank's activities on a continuous basis to ensure that capital is held at a level consistent with the bank's risk profile'.</p> <p>Banks are required to complete Reporting Forms ARF 117 Re-pricing Analysis on a quarterly basis. These reporting forms contain a range of information on IRRBB for both advanced and standardized banks. Supervisors periodically use these data to make assessments about banks' IRRBB's frameworks using the qualitative and quantitative (if applicable) requirements of APS 117.</p> <p>Internal supervisory guidance details the areas that supervisors examine when assessing IRRBB, particularly when undertaking onsite prudential inspections. Areas of focus include seeking evidence that the Board approves, and periodically reviews, the interest rate risk strategy and policies and processes for the identification, measurement, monitoring and control of interest rate risk. The supervisor also seeks evidence that management ensures that the interest rate risk strategy, policies and processes are developed and implemented.</p>
<b>EC2</b>	<p>The supervisor determines that banks have in place comprehensive and appropriate interest rate risk measurement systems and that any models and assumptions are validated on a regular basis. It confirms that banks' limits reflect the risk strategy of the institution and are understood by and regularly communicated to relevant staff. The supervisor also confirms that exceptions to established policies, processes and limits should receive the prompt attention of senior management, and the Board where necessary.</p>
Description and findings re EC2	<p>For advanced banks, APS 117 covers all aspects of this criterion. In particular, Attachment B of APS 117 outlines requirements with respect to quantitative standards for measuring capital. Topics addressed include: IRRBB measurement system track record, modeling re-pricing and yield curve risks, IRRBB capital requirement, stress and validation.</p> <p>For standardized banks, supervisors expect a bank to have adequate systems and procedures to identify, measure, monitor and manage the risks arising from the bank's activities on a continuous basis, commensurate with the size and complexity of the risks faced by the bank. Routine supervisory activity, including onsite prudential inspections, provide opportunities to assess the robustness of measurement and control processes.</p>
<b>EC3</b>	<p>The supervisor requires that banks periodically perform appropriate stress tests to measure their vulnerability to loss under adverse interest rate movements.</p>
Description and findings re EC3	<p>APRA's requirements with respect to stress testing are outlined in paragraphs 26 and 27 of Attachment B of APS 117. APS 117 requires an advanced bank to have a comprehensive and rigorous program of stress testing of its internal model in place. Stress testing must include consideration of a breakdown in the bank's key modeling assumptions and scenarios based on sudden changes in the level of interest rates and the shape and slope of the yield curve. For standardized banks there is no specified requirement. However, all banks are required to complete ARF 117.0 which includes, among other things, the impact of a <math>\pm 200</math>bp parallel move in interest rates across the yield curve.</p>
<b>Additional criteria</b>	

<b>AC1</b>	The supervisor has the power to obtain from banks the results of their internal interest rate risk measurement systems, expressed in terms of the threat to economic value, including using a standardized interest rate shock on the banking book.
Description and findings re AC1	<p>Section 62 of the Banking Act allows APRA to obtain information from a bank and its subsidiaries, including the results of a bank's internal interest rate risk measurement systems.</p> <p>APS 117 requires that the internal model used by advanced banks for the purpose of determining the IRRBB capital requirement measures the maximum potential change in the economic value of the banking book as a consequence of changes in interest rates, for a 99 percent confidence level and over a one-year holding period.</p> <p>All banks report the impact of a standard <math>\pm 200</math>bp parallel move in interest rates in their quarterly submissions of ARF 117.0. ARF 117.0 also provides a breakdown of the re-pricing gap into 14 different time buckets and 35 different categories of assets and liabilities, separately for each currency. This analysis includes the impact of a 200bp parallel shock to the interest curves for each currency.</p>
<b>AC2</b>	The supervisor assesses whether the internal capital measurement systems of banks adequately capture the interest rate risk in the banking book.
Description and findings re AC2	<p>APS 110 requires banks to have an Internal Capital Adequacy Assessment Process (ICAAP) that, among other things, ensures that capital is held against all risks and at a level consistent with the bank's risk profile. IRRBB is intended to be covered by banks' ICAAPs.</p> <p>APRA regularly reviews banks' ICAAPs. This occurs as an integral part of APRA's supervisory activity, and is essential input into the setting of a bank's prudential capital ratio (PCR) and into its PAIRS rating.</p>
<b>AC3</b>	The supervisor requires stress tests to be based on reasonable worst case scenarios and to capture all material sources of risk, including a breakdown of critical assumptions. Senior management is required to consider these results when establishing and reviewing a bank's policies, processes and limits for interest rate risk.
Description and findings re AC3	<p>APS 117 requires that, for advanced banks, stress testing must include consideration of a breakdown of the bank's key modeling assumptions. Results of stress testing must also be communicated to senior management and the Board or Board committee on a regular basis. Apart from the standard <math>\pm 200</math>bp shift incorporated into prudential reporting, APRA requires consideration of reasonable but plausible stress scenarios to be incorporated into banks' stress testing frameworks.</p> <p>For standardized banks, APRA applies the principles outlined in APS 117, although there is no specified requirement. APRA's internal guidelines require supervisors to assess the quality of a bank's stress testing</p>
<b>AC4</b>	The supervisor requires banks to assign responsibility for interest rate risk management to individuals independent of and with reporting lines separate from those responsible for trading and/or other risk-taking activities. In the absence of an independent risk management function that covers interest rate risk, the supervisor requires the bank to ensure that there is a mechanism in place to mitigate a possible conflict of interest for managers with both risk management and risk-taking responsibilities.
Description and findings re AC4	<p>APS 117 requires advanced banks to have an independent IRRBB management function (paragraph 9 of Attachment A). This function must:</p> <ul style="list-style-type: none"> <li>• have reporting lines and responsibilities that are independent of the activities that contribute to the bank's IRRBB profile;</li> <li>• have all roles and responsibilities of people and functions involved in the</li> </ul>

	<p>management of IRRBB clearly defined and documented;</p> <ul style="list-style-type: none"> <li>• have responsibility for the design and maintenance of a bank's IRRBB management framework, and for ensuring its implementation; and</li> <li>• continuously monitor the bank's compliance with the framework and produce and analyze regular reports on the output of the internal model.</li> </ul> <p>For standardized banks, APRA's internal guidance material reinforces the fundamentals of internal control associated with proper segregation of responsibilities between individuals who measure and report risk usage and individuals who manage IRRBB.</p>
<b>Assessment of Principle 16</b>	<b>Compliant</b>
Comments	In general, most of the assets and liabilities in the banking book of Australian banks carry variable interest rates.
<b>Principle 17</b>	<b>Internal control and audit.</b> Supervisors must be satisfied that banks have in place internal controls that are adequate for the size and complexity of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.
<b>Essential criteria</b>	
<b>EC1</b>	Laws, regulations or the supervisor establish the responsibilities of the Board and senior management with respect to corporate governance to ensure that there is effective control over a bank's entire business.
Description and findings re EC1	<p>APRA imposes governance requirements under Prudential Standard APS 510 – Governance- which applies to all authorized banks and non-operating holding companies (NOHCs) authorized under the Banking Act 1959. APS 510 explicitly states that the Board bears ultimate responsibility for governance of the bank</p> <p>APS 510 requires the Board and senior management to institute effective governance arrangements within the bank, and specifies governance principles covering board and management, board composition requirements, independence, board committees, internal audit, board renewal policy and remuneration requirements.</p> <p>In addition, the Board's responsibility for specific risks and functions is set out in detail in specific prudential standards. For example, Prudential Standard APS 220 – Credit Quality--covering credit risk requires the Board to establish and maintain a well-functioning credit risk management system. It also requires the Board to approve and exercise oversight over a wide range of risk management-related issues.</p>
<b>EC2</b>	<p>The supervisor determines that banks have in place internal controls that are adequate for the nature and scale of their business. These controls are the responsibility of the Board and/or senior management and deal with organizational structure, accounting policies and processes, checks and balances, and the safeguarding of assets and investments. More specifically, these controls address:</p> <ul style="list-style-type: none"> <li>• Organizational structure: definitions of duties and responsibilities, including clear delegation of authority (for example, clear loan approval limits), decision-making policies and processes, separation of critical functions (for example, business origination, payments, reconciliation, risk management, accounting, audit and compliance).</li> <li>• Accounting policies and processes: reconciliation of accounts, control lists,</li> </ul>

	<p>information for management.</p> <ul style="list-style-type: none"> <li>• Checks and balances (or “four eyes principle”): segregation of duties, cross-checking, dual control of assets, double signatures.</li> <li>• Safeguarding assets and investments: including physical control.</li> </ul>
Description and findings re EC2	<p>APS 222 – Associations and related entities –and APS 510 – Governance –state that it is the Board’s responsibility to ensure that there is a group risk management system in place which includes policies and procedures to measure, manage, monitor and report the overall risk of a group. APRA requires the Board to sign off on the adequacy of risk management systems annually.</p> <p>APRA assesses the adequacy of a bank’s internal control system as part of its ongoing supervisory activities including off and on-site regulation.</p> <p>APRA places considerable reliance on the work done by external and internal auditors to review and assess the appropriateness of accounting systems and reporting.</p> <p>On-site inspections also assess the effectiveness of such controls as segregation of duties, dual control frameworks, reconciliation processes, escalation processes and the adequacy of resourcing in areas such as the back-office, accounting and audit functions.</p>
<b>EC3</b>	<p>Laws, regulations or the supervisor place the responsibility for the control environment on the Board and senior management of the bank. The supervisor requires that the Board and senior management understand the underlying risks in their business and are committed to a strong control environment.</p>
Description and findings re EC3	<p>APS 510 – Governance- states that ‘...the Board must ensure that directors and senior managers have the full range of skills needed for the effective and prudent operation of the bank’. This includes the requirement for directors, collectively, to have the necessary skills, knowledge and experience to understand the risks of the bank, including its legal and prudential obligations, and to ensure that the bank is managed in an appropriate way taking account of these risks. APS 222 – Associate and related entities--imposes similar responsibility on the Board and senior management in relation to the overall risk at a group level.</p> <p>Under APS 510 and other standards, the Board and senior management of a bank are required to fully understand the risks the organization faces and be in a position to ensure that all such risks are identified, monitored and managed, so as to limit the risks arising from the bank’s business activities and operations to prudent levels. Both the onsite and offsite review processes allow APRA’s frontline supervisors and specialist risk units to assess the Board’s and senior management’s understanding of the risks facing the bank. This includes, amongst other activities, discussions with senior management as part of the onsite risk reviews, reviewing the minutes of the various risk committees, undertaking a prudential consultation with the bank’s executive team, as well as meetings with the Board.</p> <p>The requirement under APS 310 for the Board and Chief Executive Officer to annually attest that the risk management system is operating effectively further promotes a close oversight of the control environment by the Board and senior management.</p>
<b>EC4</b>	<p>The supervisor has the power to require changes in the composition of the Board and senior management to address any prudential concerns related to the satisfaction of these criteria.</p>
Description and findings re EC4	<p>Under section 23 of the banking Act, APRA may remove a director or senior manager where the person in question:</p> <ul style="list-style-type: none"> <li>• Does not meet one or more of the criteria for fitness and propriety as set out in the relevant prudential standards, principally Prudential Standard APS 520--Fit and Proper.</li> </ul>

	<ul style="list-style-type: none"> <li>• Is a disqualified person by virtue of section 21 of the Banking Act.</li> <li>• Is otherwise a disqualified person (as defined in section 20 of the Banking Act).</li> </ul> <p>Should APRA determine that a responsible officer of a bank is not fit and proper, it may direct the bank to remove the officer, even if the bank has assess the officer to be fit and proper.</p>
<b>EC5</b>	The supervisor determines that there is an appropriate balance in the skills and resources of the back office and control functions relative to the front office/business origination.
Description and findings re EC5	On site inspections, APRA supervisors and specialist risk units assess both the adequacy and appropriateness of staff resources in key areas of the bank. This assessment incorporates consideration of skills and resourcing, organization structure and evidence of communication and working relationship amongst staff in back, middle and front office functions. An assessment of mitigating controls relative to the risks arising from front office/business origination activities is also routinely made.
<b>EC6</b>	The supervisor determines that banks have a permanent compliance function that assists senior management in managing effectively the compliance risks faced by the bank. The compliance function must be independent of the business activities of the bank. The supervisor determines that the Board exercises oversight of the management of the compliance function.
Description and findings re EC6	<p>There is no explicit requirement (unlike the case of the internal audit function) for banks to have a permanent compliance function. In practice, all domestically owned banks have such functions while foreign branch operations either have local or regionally based compliance units.</p> <ul style="list-style-type: none"> <li>• During on-site inspections APRA assesses the effectiveness and contribution that the compliance function makes to the overall risk management framework of the bank. This assessment includes determining the function's independence and the mechanisms through which it is maintained, including reporting lines independent of the business, oversight and support provided by the Board and senior management to the achievement of the function's aims and objectives and whether sufficient information is provided to the Board to satisfy its needs.</li> </ul>
<b>EC7</b>	The supervisor determines that banks have an independent, permanent and effective internal function charged with (i) ensuring that policies and processes are complied with and (ii) reviewing whether the existing policies, processes and controls remain sufficient and appropriate for the bank's business.
Description and findings re EC7	<p>APS 510 – Governance--requires a bank to have an independent and adequately resourced internal audit function. APRA is able to exempt a bank from the need to have an internal audit function. However, in order to do so, APRA needs to be satisfied that the alternative arrangements achieve the same objectives (For example, in the case of foreign branches, APRA may rely on the internal audit of the head office).</p> <p>The objectives of the internal audit function must include evaluation of the adequacy and effectiveness of both the financial and risk management framework of the bank. Paragraph 69 of APS 510 provides that in order to assist the internal auditor to fulfill its functions, the internal auditor must at all times have unfettered access to all the business lines and support functions of the bank.</p>
<b>EC8</b>	<p>The supervisor determines that the internal audit function:</p> <ul style="list-style-type: none"> <li>• has sufficient resources, and staff that are suitably trained and have relevant</li> </ul>

	<p>experience to understand and evaluate the business they are auditing;</p> <ul style="list-style-type: none"> <li>• has appropriate independence, including reporting lines to the Board and status within the bank to ensure that senior management reacts to and acts upon its recommendations;</li> <li>• has full access to and communication with any member of staff as well as full access to records, files or data of the bank and its affiliates, whenever relevant to the performance of its duties;</li> <li>• employs a methodology that identifies the material risks run by the bank;</li> <li>• prepares an audit plan based on its own risk assessment and allocates its resources accordingly; and</li> <li>• has the authority to assess any outsourced functions.</li> </ul>
Description and findings re EC8	Supervisors routinely review the internal audit function to ensure that the function meets the requirements set out in APS 510. These include being independent and adequately resourced, the evaluation of the adequacy and effectiveness of the financial and risk management framework, having full access to all the bank's business lines and support functions.
<b>Additional criteria</b>	
<b>AC1</b>	In those countries with a unicameral Board structure (as opposed to a bicameral structure with a Supervisory Board and a Management Board), the supervisor requires the Board to include a number of experienced non-executive directors.
Description and findings re AC1	Under APS 510 a board of a bank is required to have a minimum of five directors of which a majority must be independent directors at all times. The Chairman must also be an independent director. Also, a majority of directors present and eligible to vote at a Board meeting must be non-executives. Prudential Standard APS 520 – Fit and Proper – requires that each director is fit and proper for the position he/she holds.
<b>AC2</b>	The supervisor requires the internal audit function to report to an audit committee, or an equivalent structure.
Description and findings re AC2	Under APS 510 – Governance –the internal is required to have a reporting line and unfettered access to the Board Audit Committee.
<b>AC3</b>	In those countries with a unicameral Board structure, the supervisor requires the audit committee to include experienced non-executive directors.
Description and findings re AC3	Paragraph 56 of APS 510 – Governance – states that “The Board Audit Committee must have at least three members. All members of the Committee must be non-executive directors of the regulated institution. A majority of the members of the Committee must be independent”
<b>AC4</b>	Laws or regulations provide, or the supervisor ensures, that banks must notify the supervisor as soon as they become aware of any material information which may negatively affect the fitness and propriety of a Board member or a member of the senior management.
Description and findings re AC4	APS 520 – Fit and Proper – requires a bank to notify APRA, within 10 business days, if it becomes aware that a responsible person, which includes a Board member or a member of senior management, is considered not fit and proper.
<b>Assessment of Principle 17</b>	<b>Compliant</b>
Comments	Re EC 6. APRA has determined that banks have a permanent compliance function. However, it does not have a specific requirement to this effect. In the interests of consistency and certainty, it is recommended that APRA introduce a specific requirement in this area, similar to that that exists for the internal function.

<b>Principle 18</b>	<b>Abuse of financial services.</b> Supervisors must be satisfied that banks have adequate policies and processes in place, including strict “know-your-customer” rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.
<b>Essential criteria</b>	
<b>EC1</b>	Laws or regulations clarify the duties, responsibilities and powers of the banking supervisor and other competent authorities, if any, related to the supervision of banks’ internal controls and enforcement of the relevant laws and regulations regarding criminal activities.
Description and findings re EC1	<p>The Australian Transaction Reports and Analysis Centre (AUSTRAC) is Australia’s anti-money laundering and counter-terrorism financing regulator (AML/CTF) and specialist financial intelligence unit (FIU). AUSTRAC was established in 1989 under the Financial Transactions Reports Act 1988 (FTR Act), initially as a financial intelligence unit. Its role was expanded under the Anti-Money Laundering and Counter-Terrorism Financing Act 2006 (AML/CTF Act).</p> <p>In its role as AML/CTF regulator, AUSTRAC supervises regulated entities’ compliance with customer identification, reporting, record keeping and other requirements under the AML/CTF Act and FTR Act. The Legislative framework is supported by more prescriptive rules (which are statutorily enforceable) and detailed guidance. As the prudential supervisor, APRA is responsible for ensuring the banks have adequate systems and procedures in place to identify, manage, monitor and control all risks, including risks arising from criminal activities that can jeopardize the safety and soundness of banks and the banking system.</p>
<b>EC2</b>	The supervisor must be satisfied that banks have in place adequate policies and processes that promote high ethical and professional standards and prevent the bank from being used, intentionally or unintentionally, for criminal activities. This includes the prevention and detection of criminal activity, and reporting of such suspected activities to the appropriate authorities.
Description and findings re EC2	<p>In accordance with the AML/CTF Act, banks must have in place AML/CTF programs including appropriate risk-based systems and controls that help the banks to identify, manage and mitigate the risk they face that provision of their services might involve or facilitate money laundering or terrorism financing. The programs must include risk awareness and due diligence training for staff.</p> <p>As part of its oversight of banks, AUSTRAC undertakes assessments, both off and on-site, to review the adequacy and robustness of money laundering/terrorism financing risk assessment by banks; systems and governance implemented by banks to manage their money laundering/terrorism financing risks; banks’ customer identification processes, etc.</p> <p>Banks are required to provide reports to AUSTRAC on suspicious matters, cash transactions, at or above a \$ 10,000 threshold and instructions for international funds transfers.</p> <p>AUSTRAC carries out its review regime on a risk assessment basis. It will also pay particular attention to situations where fewer reports are lodged by banks compare to what would be expected based on the volume submitted by their peers.</p>
<b>EC3</b>	In addition to reporting to the financial intelligence unit or other designated authorities, banks report to the banking supervisor suspicious activities and incidents of fraud when they are material to the safety, soundness or reputation of the bank.
Description and	Section 62A of the Banking Act obliges banks to notify APRA immediately if a bank



findings re EC3	considers that it may not be in a sound financial position or as soon as is practicable if it has or is likely to breach a prudential standard.
<b>EC4</b>	<p>The supervisor is satisfied that banks establish “know-your-customer” (KYC) policies and processes which are well documented and communicated to all relevant staff. Such policies and processes must also be integrated into the bank’s overall risk management. The KYC management program, on a group-wide basis, has as its essential elements:</p> <ul style="list-style-type: none"> <li>• a customer acceptance policy that identifies business relationships that the bank will not accept;</li> <li>• a customer identification, verification and due diligence program; this encompasses verification of beneficial ownership and includes risk-based reviews to ensure that records are updated and relevant;</li> <li>• policies and processes to monitor and recognize unusual or potentially suspicious transactions, particularly of high-risk accounts;</li> <li>• escalation to the senior management level of decisions on entering into business relationships with high-risk accounts, such as those for politically exposed persons, or maintaining such relationships when an existing relationship becomes high-risk; and</li> <li>• clear rules on what records must be kept on consumer identification and individual transactions and their retention period. Such records should have at least a five year retention period.</li> </ul>
Description and findings re EC4	<p>The AML/CTF Act imposes obligations on banks regarding customer identification and verification of identity, record keeping, ongoing customer due diligence and reporting and monitoring of transactions. AML/CTF Rules, which are legislative instruments and therefore binding, outline specific requirements in relevant areas, including customer identification, transaction reporting, ongoing customer due diligence, record keeping, etc. As regards the latter, the AML/CTF Act requires that records must be retained for seven years after the end of the bank’s relationship with the relevant customer.</p>
<b>EC5</b>	<p>The supervisor is satisfied that banks have enhanced due diligence policies and processes regarding correspondent banking. Such policies and processes encompass:</p> <ul style="list-style-type: none"> <li>• gathering sufficient information about their respondent banks to understand fully the nature of their business and customer base, and how they are supervised; and</li> <li>• not establishing or continuing correspondent relationships with foreign banks that do not have adequate controls against criminal activities or that are not effectively supervised by the relevant authorities, or with those banks that are considered to be shell banks.</li> </ul>
Description and findings re EC5	<p>Section 97 of the AML/CTF Act provides that before a financial institution enters into a correspondent banking relationship with another financial institution, the first financial institution must carry out a preliminary risk assessment and, where warranted, a more extensive due diligence assessment. Senior officer approval is required for any new relationship.</p> <p>Section 98 of the AML/CTF Act provides that correspondent banking relationships must be subject to regular risk assessments and, where warranted, due diligence assessments. Responsibilities under correspondent banking relationships must be documented.</p> <p>Chapter 3 of AML/CTF Rules addresses correspondent banking. These Rules clarify:</p> <ul style="list-style-type: none"> <li>• what matters must be addressed when conducting a due diligence assessment before entering into a correspondent relationship;</li> </ul>

	<ul style="list-style-type: none"> <li>• what matters must be addressed when conducting regular due diligence assessments on existing relationships; and</li> <li>• other issues about correspondent banking relationships.</li> </ul> <p>Sections 95 and 96 of the AML/CTF Act prohibit banks entering into corresponding relationships with shell banks. The legislation requires termination of any existing relationship within 20 days of becoming aware that the other party is a shell bank.</p>
<b>EC6</b>	The supervisor periodically confirms that banks have sufficient controls and systems in place for preventing, identifying and reporting potential abuses of financial services, including money laundering.
Description and findings re EC6	<p>AUSTRAC carries out inspections of banks (and other entities providing designated services) on a risk assessment basis to monitor compliance with the provision of the AML/CTF Act and the AML/CTF Rules.</p> <p>APRA, in its inspections of banks, seeks to assess the robustness of banks' systems for the recognition and prevention of fraud risk, both internally and externally generated.</p>
<b>EC7</b>	The supervisor has adequate enforcement powers (regulatory and/or criminal prosecution) to take action against a bank that does not comply with its obligations related to criminal activities.
Description and findings re EC7	<ul style="list-style-type: none"> <li>• AUSTRAC has a range of enforcement powers available to it under the AML/CTF Act and AML/CTF Rules ranging from administrative to civil and criminal action. To date, there has been no civil or criminal action against banks. The highest sanction imposed was the acceptance of an Enforceable Undertaking (This is a written undertaking given by a person in connection with a matter in which AUSTRAC has a function or power. If the undertaking is breached, a Court may make orders including directing compliance, directing payment of compensation or other monies).</li> </ul>
<b>EC8</b>	<p>The supervisor must be satisfied that banks have:</p> <ul style="list-style-type: none"> <li>• requirements for internal audit and/or external experts to independently evaluate the relevant risk management policies, processes and controls. The supervisor must have access to their reports;</li> <li>• established policies and processes to designate compliance officers at the management level, and appointed a relevant dedicated officer to whom potential abuses of the bank's financial services (including suspicious transactions) shall be reported;</li> <li>• adequate screening policies and processes to ensure high ethical and professional standards when hiring staff; and</li> <li>• ongoing training program for their staff on KYC and methods to detect criminal and suspicious activities.</li> </ul>
Description and findings re EC8	<p>APRA's APS 510 – Governance –requires a bank to have an independent and adequately resourced internal audit function. Additionally, each year external auditors are required to provide assurance on banks' risk management systems. Audit reports are readily available to APRA and routinely obtained.</p> <p>Part 8.5 of the AML/CTF Rules requires reporting entities to designate a person as the AML/CFT compliance officer at management level whose function would include the receipt of reports of potential abuses of the bank's financial services.</p> <p>The robustness and appropriateness of banks' recruitment processes are assessed by APRA during the course of on-site operational risk reviews. These reviews incorporate a discussion point along the lines of recruitment processes inclusive of background checks undertaken for staff in key positions.</p>

	Part 8.2 of the AML/CTF Rules specifies that banks' AML/CTF programs must include a money laundering/terrorism financing risk awareness training program for employees that meets the requirements set out in the AML/CTF Rules. The training program should be designed to give appropriate training at reasonable intervals to keep staff up to date on the risks in question.
<b>EC9</b>	The supervisor determines that banks have clear policies and processes for staff to report any problems related to the abuse of the banks' financial services to either local management or the relevant dedicated officer or to both. The supervisor also confirms that banks have adequate management information systems to provide managers and the dedicated officers with timely information on such activities.
Description and findings re EC9	Section 41 of the AML/CTF Act requires banks to report suspicious matters to AUSTRAC in a Suspicious Matter Report (SMR). The obligation to lodge an SMR arises when a bank provides or proposes to provide a designated service to a customer and because of the circumstances the bank suspects on reasonable grounds that information that the bank has may be relevant to investigation of, or a prosecution of a person, for an offence against the law (In this respect, the obligation on an Australian bank to report goes beyond AML/CTF offences and could include bribery, for instance. In 2010/11, AUSTRAC received a total of 44,775 reports of suspicious matters and transactions). AML/CTF Rules require banks to provide AML/CTF risk awareness training. This training must be designed to enable employees to understand the obligations of the bank, including timely reporting of suspicious matters. As part of its supervisory activities, APRA looks to ensure that banks have sound risk management frameworks including adequate employee screening mechanisms, codes of conduct as well as an adequately maintained awareness and training capability.
<b>EC10</b>	Laws and regulations ensure that a member of a bank's staff who reports suspicious activity in good faith either internally or directly to the relevant authority cannot be held liable.
Description and findings re EC10	Under section 235 of AML/CTF Act, banks (together with bank officers, employees and agents) enjoy statutory immunity from any action, suit or proceeding (whether criminal or civil) in relation to anything done, or omitted to be done, in good faith: <ul style="list-style-type: none"> <li>a) in carrying out applicable customer identification procedures under the AML/CTF Act;</li> <li>b) in fulfilment, or purported fulfilment, or a requirement under the AML/CTF Act not to provide a designated service, or not to continue to provide a designated service; or</li> <li>c) in compliance, or in purported compliance, with any other requirement of the AML/CTF Act (and any associated regulations and rules).</li> </ul>
<b>EC11</b>	The supervisor is able to inform the financial intelligence unit and, if applicable, other designated authority of any suspicious transactions. In addition, it is able, directly or indirectly, to share with relevant judicial authorities information related to suspected or actual criminal activities.
Description and findings re EC11	Section 56(5) of the APRA Act together with section 5(j) of the Australian Prudential Regulation Authority Regulations provides for the exchange of information between APRA and AUSTRAC. APRA may also exchange information with the Australian Federal Police, the Police Forces of all states and territories and the Australian Crime Commission.
<b>EC12</b>	The supervisor is able, directly or indirectly, to cooperate with the relevant domestic and foreign financial sector supervisory authorities or share with them information

	related to suspected or actual criminal activities where this information is for supervisory purposes.
Description and findings re EC12	<p>APRA has entered into an MOU with AUSTRAC which provides for the exchange of information, among other things. Both agencies meet twice yearly as part of the AUSTRAC-APRA Coordination Committee to discuss common findings in assessments, policy issues and updates on regulatory matters.</p> <p>Under section 132 of the AML/CTF Act, AUSTRAC is permitted to share information with the governments of foreign jurisdictions. In practice, this generally comprises AUSTRAC's FIU counterparts following the establishment of a formal exchange instrument.</p>
<b>Additional criteria</b>	
<b>AC1</b>	If not done by another authority, the supervisor has in-house resources with specialist expertise for addressing criminal activities.
Description and findings re AC1	Neither APRA nor AUSTRAC have the power to conduct criminal investigations. Such cases are referred to law enforcement agencies.
<b>Assessment of Principle 18</b>	<b>Largely Compliant</b>
Comments	<p>The detailed regulation of the anti-money laundering and counter-terrorism financing legislative framework is of relatively recent origin in Australia. The Anti-Money Laundering and Counter-Terrorism Financing Act 2006 introduced a detailed framework for the oversight and monitoring of anti-money laundering and counter-terrorism financing measures, incorporating, for example, the FATF Principles (Prior to that, AUSTRAC was primarily a financial intelligence unit with only limited supervisory powers).</p> <p>The full suite of provisions of the 2006 Act did not become fully operational until 2009, to give banks and other relevant entities time to introduce/amend AML/CTF systems.</p> <p>AUSTRAC, through the 2006 Act and related Rules, has introduced a very solid base for the regulation of money laundering and counter terrorism financing activities. It has a risk-based approach to supervision and appears to be very pro-active in carrying out its role. It carries out regular bank reviews. For example, the four largest banks which account for the vast majority of reported suspicious matters by banks are inspected twice yearly. These reviews are theme based and would focus on, for example, KYC, correspondent banking, transaction reporting and employee training programs.</p> <p>AUSTRAC believes that while all banks have introduced the necessary processes and procedures (see EC2), there is still room for improvement in certain banks. AUSTRAC identified the need for some banks to introduce more advanced technology to help in the identification and transaction reporting processes as an example (Some of the requirements are being dealt with manually). The need for advanced technology in certain banks was confirmed by a number of banks visited.</p> <p>The need for increased technology is the basis for the 'largely compliant' rating. This is in order to comply adequately with EC2 which states "The supervisor must be satisfied that banks have in place adequate policies and processes that promote high ethical and professional standards and prevent the bank from being used, intentionally or unintentionally, for criminal activities. This includes the prevention and detection of criminal activity, and reporting of such suspected activities to the appropriate</p>

	<p>authorities.”</p> <p>The first mutual evaluation report for Australia was completed in October 2005. Because of shortcomings identified in that report, particularly in relation to Recommendation 5 (verifying beneficial ownership information for private companies, identifying and verifying beneficial ownership for other companies, verifying the beneficial ownership of trusts, etc), eight follow-up reports were prepared, the latest in May 2012. Since 2005, Australia has been addressing these shortcomings and has committed to fully addressing them by August/September 2012. and will seek removal from the regular follow-up process in October 2012. Accordingly, it is believed that an overall rating of LC for this Principle as a whole is appropriate. (Since the introduction of the 2006 Act, the weakness identified in the previous FSAP mission whereby there were difficulties for APRA in exchanging information with AUSTRAC has been addressed –see Principle 1(6) Cooperation).</p>
<b>Principle 19</b>	<b>Supervisory approach.</b> An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole, focusing on safety and soundness, and the stability of the banking system.
<b>Essential criteria</b>	
<b>EC1</b>	The supervisor has policies and processes in place to develop and maintain a thorough understanding of the risk profile of individual banks and banking groups.
Description and findings re EC1	<p>APRA has a number of policies and processes to support its risk-based approach to prudential supervision. As noted in APRA’s public document, ‘Supervision Blueprint’, APRA’s approach is to be forward looking, risk based but not seeking a zero failure regime.</p> <p>Supervisors conduct a range of offsite and onsite assessments, supported by comprehensive internal guidance material, to develop and maintain an overall risk profile for each regulated entity. These risk profiles are summarised in a PAIRS (Probability and Impact Rating System) assessment and rating. The PAIRS rating feeds through into a Supervisory Oversight and Response System (SOARS) stance that determines the level of supervisory intensity. APRA’s supervisory framework prescribes a ‘baseline’ level of supervisory activities according to the categorisation under SOARS. The PAIRS assessment also feeds into the Supervisory Action Plans (SAPs) and ultimately the results of the actions in the SAP feeds into future revisions of the entity’s PAIRS assessment and SAP (see EC3).</p> <p>PAIRS assessments and supervisory action plans are always determined at an entity level but group wide assessments and plans are also generated when this is deemed to be appropriate.</p> <p>Supervisory activities include onsite review, prudential consultations to discuss strategy, performance and capital management as well as regular offsite analysis. APRA may also call ad hoc meetings with Boards/senior management. For major firms there will be at least an annual meeting with the Board.</p>
<b>EC2</b>	The supervisor monitors and assesses trends, developments and risks for the banking system as a whole. The supervisor also takes into account developments in non-bank financial institutions through frequent contact with their regulators.
Description and findings re EC2	<p>APRA has developed a number of approaches and techniques to assess an industry-wide, or systemic, perspective.</p> <p><b>Industry Analysis team</b> The Industry Analysis team is embedded within APRA’s supervisory divisions and conducts analysis and research on current and emerging</p>

	<p>industry risks. The unit contributes to a variety of tools including:</p> <ul style="list-style-type: none"> <li>• comprehensive reviews (at least annually) of the banking industry incorporating a discussion of industry developments, commentary on trends and examination of topical issues;</li> <li>• ongoing development and refinement of industry dashboards (i.e., tools to represent data such as in graphs, tables, ratios);</li> <li>• managing and maintaining the industry risk register (see below); and</li> <li>• coordinating industry-focused stress testing.</li> </ul> <p><b>Industry risk registers</b> Industry risk registers record identified industry risks that represent an emerging concern or business practice usually common to more than one institution in the industry that, over the risk assessment horizon which is determined on a case by case basis and has a heightened possibility of threatening significant adverse prudential consequences for the industry. Thus the risks are thematic with the potential to crystallise over the short to medium term, consistent with the planning horizon of the institutions, typically a one to two year horizon. The risk register is used as an input into the PAIRS assessment. The assessors reviewed a number of the registers, from different time periods. The key ADI risks that had been identified were fully relevant for the ADI sector. Recommended responses and potential actions were typically closer monitoring or deeper analysis though more direct interaction, or change to the capital approach might be suggested on occasion.</p> <p><b>Industry groups</b> APRA has established an internal industry group for each sector it regulates. The industry group is the key forum for addressing and seeking APRA-wide consensus on emerging issues. Each industry group is a cross-divisional forum with senior representatives from supervision, industry technical services, industry analysis, policy, statistics and legal. The ADI Industry Group is used in a consultative capacity and is intended to assist in identifying emerging industry issues and reviewing risk registers. The governance and review of the industry risk register is the primary function and output of the Industry Group.</p> <p><b>Industry risk management framework</b> APRA has developed an industry risk management framework to assist it in identifying and acting on significant emerging thematic or macroprudential industry-wide risks. The framework focuses in particular how risks should be identified and incorporated into the Industry risk registers.</p> <p><b>Regulatory cooperation</b> APRA works collaboratively with the Reserve Bank of Australia (RBA) and Australian Securities and Investment Commission (ASIC) to identify trends and assess build-up of risks at both an entity level and system level. The RBA, has a mandate to promote financial stability and monitors the health of the financial system and provides warning about potential risks and vulnerabilities. The RBA/APRA Coordination Committee provides a regular high-level forum to air financial stability concerns. APRA comments on the RBA's half-yearly Financial Stability Review (FSR).</p> <p>Furthermore as APRA supervises both banking and insurance sectors and adopts an integrated approach to such supervision (supervisory departments are not segregated according to industry sector) there is a strong structural support for common understanding of banking and insurance risks. APRA and RBA staff noted that the collapse of an insurance entity in 2001 had been a positive catalyst to both institutions to become as mission focused as possible in their respective roles and this had supported cooperative working between them.</p> <p><b>Supervisors' awareness and communication</b> Information to the supervisors and APRA senior management are based on reporting from the ADI Industry Group and peer analysis reporting (for example, liquidity and</p>
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	<p>funding). Wider awareness of issues is promoted through supervisors' peer-based discussions. Peer discussions will take place on a frequent basis (e.g., 6 weeks). Supervisors also have ready access to a range of financial, industry and economic information and data through a research resources portal on APRA's intranet.</p> <p><b>Reporting within APRA</b> APRA's Management Group and Executive Group meetings discuss a range of regular reports including the annual update ADI industry group on its findings or proposed changes, to risk registers. Monthly PAIRS reports, a more comprehensive semi-annual PAIRS report and the SAPs of major entities are also reported to and discussed by the Executive Group.</p>
<b>EC3</b>	<p>The supervisor uses a methodology for determining and assessing on an ongoing basis the nature, importance and scope of the risks to which individual banks or banking groups are exposed. The methodology should cover, inter alia, the business focus, the risk profile and the internal control environment, and should permit relevant comparisons between banks. Supervisory work is prioritized based on the results of these assessments.</p>
Description and findings re EC3	<p>APRA assesses the nature, importance and scope of the risks to which individual banks or banking groups are exposed on an on-going basis, primarily through the Probability And Impact Rating System (PAIRS) methodology. APRA then transforms the PAIRS rating into a Supervisory Oversight and Response System (SOARS) stance for the entity as well as its Supervisory Action Plan (SAP).</p> <p>The foundation of APRA's risk analysis of banks is the PAIRS methodology – the Probability And Impact Rating System. PAIRS is the tool used to assess the probability that an entity may fail to honour its obligations to depositors and on the potential impact should the entity fail. Impact of failure is measured by an entity's balance sheet size, although supervisors have discretion to adjust the impact assessment if, in their analysis, the impact of an institution's failure would be disproportionate to its asset size. Probability of failure is determined by assessing the inherent risks of the business, the management and controls in the entity and the capital support available to the entity. The categories of risk assessed include:</p> <ul style="list-style-type: none"> <li>• Board;</li> <li>• Management;</li> <li>• Risk Governance;</li> <li>• Strategy And Planning;</li> <li>• Liquidity Risk;</li> <li>• Operational Risk;</li> <li>• Credit Risk;</li> <li>• Market And Investment Risk;</li> <li>• Insurance Risk; and</li> <li>• Capital Support – including assessments of capital surplus, earnings and access to additional capital.</li> </ul> <p>Of these risk dimensions six elements (strategy and planning, liquidity, operational, credit, market and insurance risk) are assessed both for inherent risk and for management and control risk. The ratings are highly granular (it is a 41 point scale) and the scale is logarithmic not linear. A net risk is assessed for all the risk categories and there is a significance weight attached to the risk for the individual institution. Supervisory judgement and discretion is an important feature of the PAIRS system. Substantial guidance is available to supervisors in assisting them in analysing the individual risk modules and there are reference points provided for each of the 23 peer groups of firms. However, although the guidance includes criteria to assist in the analysis it does not promote an automatic process driven approach to the supervisory</p>

	<p>assessment. It will (for example) include discussions and descriptions of good and/or acceptable practices surrounding a particular risk so that the supervisor has to obtain information and then determine whether or not the individual institution meets the described standard. This approach means that there is a premium on the guidance to supervisors remaining current in terms of good market and supervisory practice. The risk specialists within APRA contribute to the continual updating of such guidance. Each entity is assigned one of five PAIRS ratings: Low, Lower Medium, Upper Medium, High, or Extreme. APRA has increased the frequency of its reviews of PAIRS ratings since the global financial crisis began. Systems reports to management will identify whether any PAIRS assessment has not been updated according to the minimum timescale. APRA uses the “transition matrices” of institutions under the SOARS/PAIRS framework as a key measure of supervisory performance. The PAIRS assessment also generates an indicative prudential capital ratio (PCR). The PCR will typically be reviewed annually in recognition of the fact that an institution’s capital planning takes place over a longer time horizon, and the PAIRS assessment is expected to be updated continuously but the PAIRS assessment is given primacy over APRA’s Pillar 2 approach (the supervisory review of the institution’s ICAAP) in generating the actual PCR. The PAIRS methodology is intended to be a continuous process, such that any supervisory activity or piece of relevant information should be fed into the PAIRS assessment. APRA is currently undergoing a major project to launch new more integrated IT system that will support supervisors in updating their continuous PAIRS assessment.</p> <p>Consistency is promoted through a number of processes.</p> <p>Reference points – the PAIRS methodology provides reference points which represent the indicative significant weights of a risk for a “typical” entity in any given peer group. An entity can vary from the reference point and the reference points themselves are reviewed annually, but the supervisor is required to be able to articulate the reason for departing from the reference point.</p> <p>Internal benchmarking--promotes consistent PAIRS assessment and rating practices, identifies key risk areas and discussion of responses to risks to be included in SAPs. Benchmarking sessions also take place – typically every 4 to 6 weeks. Approximately 20 staff, including relevant risk specialists, would attend a benchmarking session which would cover one given topic and 6-8 entities. APRA favours the creation of processes that require peer review, debate, questioning and justification. This is an evolution from an earlier period when a supervisory team had to present or justify its approach and analysis to a panel. The peer group debates have proved to be more fruitful in the exchange of experience, ideas and challenge process. Finally, and again to promote consistency, the sign off protocol is that there will be two reviewers for all PAIRS assessments and SAPs. The seniority of the sign-off protocol depends on the PAIRS/SOARS rating.</p> <p>Overall, the process is intended to ensure that the analytical approach taken is a conscious one.</p> <p>Supervisory activities are detailed in an entity’s Supervisory Action Plan (SAP) and ultimately the results of these actions/activities will feed into future revisions to an entity’s PAIRS assessment and SAP. The SAP will include risk remediation, monitoring and follow up of any requirements, recommendations, suggestions or requests for information that may have been sought from the institution.</p> <p>There are four supervisory stances: ‘Normal’, ‘Oversight’, ‘Mandated Improvement’ or ‘Restructure’. The SOARS stance determines the nature and intensity of supervisory activities for the supervised entity. Of these categories, entities under “Normal” and</p>
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	<p>“Oversight” are not considered likely to fail though firms in “Oversight” would be subject to more frequent and targeted/specialist onsite reviews. Frequency and depth of analysis would be more intense. Firms are not expected to remain for extended periods of time in the “Mandated Improvement” category. Remedial action would be taken and might include imposing directions on the institution, increasing its capital requirements, prohibiting acquisitions, requiring revision to business plan, appointing specialist investigators. When an entity is in the “Restructure” category it is under the most severe of supervisory approaches. Full enforcement powers may be used and withdrawal of authorisation is likely.</p>
<b>EC4</b>	The supervisor confirms banks’ and banking groups’ compliance with prudential regulations and other legal requirements.
Description and findings re EC4	<p>APRA receives regular prudential reporting from the supervised institutions. Under the baseline supervisory approach, all institutions must submit information mandated by prudential standards and at a minimum there will be a quarterly risk analysis. Depending on the PAIRS impact rating an institution will have – at a minimum – an annual review of its PAIRS assessment and supervisory action plan. The full prudential review (onsite) and prudential consultation has a minimum three year cycle. There is a small degree of tolerance (3 months) to permit the timely completion of these supervisory activities according to the minimum timetable prescribed by the impact rating.</p> <p>However, the submission of returns and financial analysis is not subject to an extended tolerance. Extensions will only be granted for exceptional circumstances, for example business continuity problems generated by local disaster (e.g., flooding). Additionally, banks are required to submit annual declarations from the Chief Executive Officer, endorsed by the Board, attesting, amongst other things, that risk management systems established to ensure that the bank meets prudential and statutory requirements are operating effectively and are adequate (refer to APS 310). Appointed auditors submit an annual report on the matters relating to APRA’s data collections and internal controls at both the entity and consolidated banking group levels.</p>
<b>EC5</b>	The supervisor requires banks to notify it of any substantive changes in their activities, structure and overall condition, or as soon as they become aware of any material adverse developments, including breach of legal or prudential requirements.
Description and findings re EC5	<p>Section 62A of the <i>Banking Act 1959</i> (Banking Act) requires a bank to provide immediate notice to APRA if it or any member of its group may not be in a sound financial position. The same section also requires a bank to report any significant breaches of prudential standards to APRA as soon as practicable (The section defines ‘significant’ taking into account both impact and frequency).</p> <p>The <i>Financial Sector (Shareholdings) Act 1998</i> (FSSA) requires the Australian Treasurer’s approval of an acquisition that gives rise to a person holding a stake of greater than 15 percent of a bank. Section 63 of the Banking Act requires the Australian Treasurer’s consent for any significant restructuring of a bank, which would include the sale or disposal of business.</p> <p>Paragraph 8 of <i>Prudential Standard APS 222 Associations with Related Entities</i> (APS 222) requires a bank to advise APRA in advance of any proposed changes to the composition or operations of the group with the potential to materially alter the group’s overall risk profile, including any proposed changes to the bank’s standalone operations.</p>

<b>EC6</b>	The supervisor has an adequate information system which facilitates the processing, monitoring and analysis of prudential information. The system aids the identification of areas requiring follow-up action.
Description and findings re EC6	<p>APRA's information systems provides an extensive range of tools to support the supervisory work. There are some major initiatives underway to further enhance and integrate a number of these systems (noted below) but the major sources of material include the following:</p> <ul style="list-style-type: none"> <li>• Entity based information derived from reported data <ul style="list-style-type: none"> <li>○ Baseline reports – providing data for all reporting institutions which can be manipulated by supervisors to provide peer group data sets and ratios. Supervisors can interrogate more granular information from supplementary reports that underpin the baseline reports. The data is available on both consolidated and individual entity basis.</li> <li>○ Micro strategy reports – similar to the baseline reports but presented through charts and graphics. Again supervisors are able to choose data sets to examine specific features of an institution or group of institutions.</li> <li>○ Exception reports</li> </ul> </li> <li>• Industry reports</li> <li>• Industry Risk Register</li> <li>• APRA ADI Industry Group updates</li> </ul> <p>The analysts toolkit also provides links to relevant public information including</p> <ul style="list-style-type: none"> <li>• RBA quarterly statistics</li> <li>• RBA Financial Stability Report</li> <li>• Broker Reports</li> </ul> <p>APRA uses an in-house built system to capture the high-level risk assessments and ratings scores for an entity. The system also calculates the overall risk of failure score and derives the appropriate PAIRS ratings and determines a SOARS supervisory stance.</p> <p>The Activity and Issues Management System (AIMS) records prudential reviews and consultations as well as key dates to assist follow-up scheduling and to ensure key supervisory Key Performance Indicators (KPI) are met. AIMS forms the basis for various management reports produced regularly to assist ongoing monitoring of supervisory performance.</p> <p>Contacts@APRA is an in-house built customer relationship management system that maintains all the entity-related information. This includes details of key persons, contact details and the assigned supervisors.</p> <p>APRA is currently upgrading its systems to provide greater integration between its systems, notably to facilitate the updating of PAIRS and Supervisory Action Plans and to facilitate the capture and management of information in a more efficient manner. Proposed changes are intended to deliver better integration of supervisory tools and greater ease of access to and manipulation of underlying data.</p> <p>Banks and banking groups report to APRA electronically via a secure system called Direct to APRA (D2A). The system has a number of built-in pre-submission data quality checks. These checks not only search for basic calculation errors but also require explanations of significant movements of key data items. Additional data quality checks are completed after submission by APRA's Statistics Unit. These checks (including responses) are undertaken within the first two weeks of the submission date.</p> <p>A secure online breach reporting system provides another means for entities to provide details of breaches of prudential standards to APRA. While APRA's stated</p>

	<p>preference is for regulated entities to use the online breach reporting system, regulated entities may also comply with their breach reporting obligations using other methods. This information is connected to the AIMS system and provides supervisors with information of any details submitted through the application.</p>
<b>Additional criteria</b>	
<b>AC1</b>	<p>The supervisor employs a well defined methodology designed to establish a forward-looking view on the risk profile of banks, positioning the supervisor better to address proactively any serious threat to the stability of the banking system from any current or emerging risks.</p>
Description and findings re AC1	<p>Forward-looking PAIRS assessments and ratings are the cornerstone of APRA's ability to monitor banks' changing risk profiles and identify emerging risks. PAIRS assessments are required to consider all information available relevant to the bank. This includes assessments of the risk profile of the bank, its peer entities, the industry and the broader economy. Common and emerging themes are identified. Where a matter is considered material and to have potential industry-wide implications, it will be added to the industry risk register (refer to EC2). Among other things, this triggers assignment to a risk owner who is responsible to APRA's Executive Group for an action plan aimed at outlining how the risk will be assessed and addressed.</p> <p>At an entity level, the development and refinement of SAPs allows supervisors to outline, in a strategic sense, the supervisory activities to address risks and issues highlighted in the PAIRS assessment.</p> <p>The Assessors noted a number of analyses (both PAIRS and QRR) which indicated that supervisors were very alert to emerging issues within banks and were identifying indicators to monitor the situation as well as clear timelines to explore or challenge issues with the institutions.</p>
<b>Assessment of Principle 19</b>	<b>Compliant</b>
Comments	<p>APRA supervisors possess a commanding and comprehensive understanding of banks and banking groups, a view supported by the banks and other market professionals the Assessors met. The quality of off-site work reviewed by Assessors was excellent and on occasion outstanding. APRA's analytical framework (PAIRS) drives APRA's risk based approach and separates the assessment of inherent risk from the quality of management control of the risk, which is best, although not universal, practice among supervisory authorities.</p> <p>The establishment of the Supervisory Framework Team reinforces a culture in which there is a premium on identifying, refreshing and evolving good supervisory practices. The PAIRS framework itself was fundamentally refreshed in 2008, and the oversight processes for supervisory judgements moved from a potentially adversarial challenge process to a more collaborative peer group and benchmarking approach which is a keynote of the APRA approach. Staff observed to the Assessors that the focused, group sharing of experience through peer group and benchmarking has not only delivered consistency of approach but has frequently prompted innovation and fresh analytical insight.</p> <p>APRA enjoys an excellent suite of data tools that can be easily accessed, interrogated and manipulated by supervisors wishing to analyse institutions on a solo or peer group basis and from multiple angles. Further IT development is planned in order to create greater integration between PAIRS, SOARS and the SAPs to underpin a more continuous updating and conscious analytical reflection.</p>

	<p>The internal organisational structure of APRA does not segregate banking from insurance or superannuation entities and this view is reflected in the fact that few management reports that the Assessors saw are drawn up on a sectoral basis. Moreover APRA is conscious of the benefits from setting as many standards on a cross sectoral basis as possible and has made considerable progress in issuing common behavioural standards (e.g., governance) to banking and insurance sectors. APRA is therefore well placed to develop in a strong position to analyse the relationship of risks between these sectors and should begin to focus more on this area. The development of the “Level 3” (conglomerate) approach should be used as a platform to stimulate such work.</p>
<b>Principle 20</b>	<b>Supervisory techniques.</b> An effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management.
<b>Essential criteria</b>	
<b>EC1</b>	<p>The supervisor employs an appropriate mix of on-site and off-site supervision to evaluate the condition of banks, their inherent risks, and the corrective measures necessary to address supervisory concerns. The specific mix may be determined by the particular conditions and circumstances of the country. The supervisor has policies and processes in place to assess the quality, effectiveness and integration of on-site and off-site functions, and to address any weaknesses that are identified.</p>
Description and findings re EC1	<p>APRA’s supervisory framework includes a range of onsite and offsite supervisory activities. The on-site and off-site functions are not separate but are performed by integrated teams of front line supervisors, supported where necessary by specialist risk staff.</p> <p>Supervisory activity includes offsite analysis of submitted prudential returns and other relevant information, detailed onsite reviews of specific risks (for example: credit, market and operational risk) by dedicated risk teams and meetings with auditors, senior management and Boards. To ensure a minimum level of coverage, the framework includes a ‘baseline’ level for onsite and offsite activities. The frequency of prudential activities is driven by the PAIRS impact rating. For example, prudential review would be at least annual for an “extreme” bank but a three year cycle might be agreed for a bank in the “medium” or “low” category. All firms are subject to quarterly financial analysis and annual review of PAIRS and Supervisory Action Plans (SAPs). Supervisory Action Plans (SAPs) require supervisors to prioritise key risks and determine the most appropriate activities to address these risks. The intensity of supervision is influenced by the Supervisory Oversight and Response System (SOARS) stance derived from the Probability and Impact Rating System (PAIRS) ratings system (refer to CP19, EC1 and EC3). SAPs might include requirements for increased reporting by the bank or meetings with senior management or the Board. Supervisors are required to consider the implications for PAIRS and SAPs after the completion of each key onsite or offsite supervisory activity.</p> <p>The written assessments from onsite and offsite reviews, PAIRS assessments and SAPs are all subject to sign-off protocols that ensure that an appropriate level of management review is undertaken in terms of delegated authority (see also CP19 EC3). A higher level of management sign-off is required for work associated with larger entities, entities with issues and where a change in the PAIRS rating is involved. Monthly reports of the PAIRS ratings are produced for APRA’s Executive Group, containing portfolio data of the ratings and details of movements in ratings. The SAPs for peer groups of banks are also presented to the Executive Group on a periodic basis, ensuring management oversight of on and offsite work.</p>

	<p>In addition, APRA conducts in-house benchmarking exercises to promote consistency of PAIRS ratings and supervisory actions listed in SAPs. The benchmarking exercises typically focus on a group of similar banks and involve the supervisory teams supporting decisions taken in ratings and developing action plans. The meetings are facilitated by the Supervision Framework Team (SFT), a central unit responsible for oversight of the supervisory framework. The intention is to provide a forum for supervisors to review common issues, compare and contrast outliers and ensure a degree of consistency of decisions, ratings and actions across like institutions (See also CP19, EC3).</p>
<b>EC2</b>	<p>The supervisor has in place a coherent process for planning and executing on-site and off-site activities. There are policies and processes in place to ensure that such activities are conducted on a thorough and consistent basis with clear responsibilities, objectives and outputs, and that there is effective coordination and information sharing between the on-site and off-site functions.</p>
Description and findings re EC2	<p>Under APRA's system supervisors have integrated onsite and offsite responsibilities and APRA has developed a framework covering both the onsite and offsite supervision processes.</p> <p>The results of key findings from all supervisory activities contribute to a continuous process of feedback into the PAIRS rating and the SAP.</p> <p>The APRA framework includes detailed procedures documents covering all major activities (such as prudential reviews, prudential consultations and Quarterly Risk Reviews (QRR)), assessment and reporting templates and guidance material. Detailed guidance is available to supervisors for all the topic areas to be addressed in completing the PAIRS assessment – covering specific risks, management and controls and governance frameworks. Supervisors have the discretion to determine which of these topics are to be addressed through onsite or offsite supervision. The framework also includes systems for tracking supervisory activities.</p> <p>The onsite processes are supported by procedural documentation, including guidance on matters for consideration, covering pre to post review phases, such as:</p> <ul style="list-style-type: none"> <li>• scoping the review (meetings and scoping documents);</li> <li>• considering how best to undertake the review to achieve the desired outcome, often in association with the relevant specialist risk unit;</li> <li>• detailing responsibilities for those participating in the review;</li> <li>• ensuring APRA has the appropriate material available prior to going on site;</li> <li>• assisting supervisors' preparation of necessary correspondence relating to the review by incorporating pro-forma examples;</li> <li>• conducting the review (discussion with relevant personnel, examination of systems and review of materials while on site);</li> <li>• closing meeting;</li> <li>• completing documentation of the review including internal assessments, impacts on PAIRS ratings and the SAP and sending a formal report to the bank;</li> <li>• depending on the findings, ensuring the review report is sent to either the Chief Executive Officer or the Chair of the Board with the report to be formally tabled to the Board; and</li> <li>• recording key issues for follow up in APRA's internal activities and issues management system (AIMS).</li> </ul> <p>The offsite analysis is also supported by documented guidance outlining the information that needs to be considered when undertaking a QRR and the objective of</p>

	<p>creating an outlook (i.e., whether stable or positive over the coming quarter) for the bank.</p> <p>A template outlines suggested areas for consideration when completing the QRR and it is emphasized that supervisors must consider data submitted to APRA and all other relevant information (both institution specific and wider context). The assessors reviewed this material, which is updated periodically to maintain good standards. Prudential consultation is also supported by procedural guidance and refers specifically to the formal regular meetings with management of banks and, in need, with the Board/ Chairperson. Issues for discussion will include strategy, performance, capital management and any other key risk issues. The Prudential Consultation Procedure offers guidance to supervisors on:</p> <ul style="list-style-type: none"> <li>• objectives of the prudential consultation;</li> <li>• information gathering, (firm specific and wider context); and</li> <li>• logistics including: <ul style="list-style-type: none"> <li>○ initial planning meeting;</li> <li>○ scoping and agenda;</li> <li>○ setting the date and securing attendance from key representative of the bank;</li> <li>○ determining attendance of relevant APRA personnel/management;</li> <li>○ requesting information; confirming arrangements; related groundwork;</li> <li>○ preparing and circulating briefing note and associated information pack;</li> <li>○ conducting a pre-prudential consultation session;</li> <li>○ conducting the prudential consultation;</li> <li>○ facilitating a post prudential consultation wrap up;</li> <li>○ preparing a prudential consultation note;</li> <li>○ updating PAIRS and SAP; and</li> <li>○ drafting and sending the prudential consultation report.</li> </ul> </li> </ul>
<b>EC3</b>	<p>On-site work, conducted either by the supervisor's own staff or through the work of external experts, is used as a tool to:</p> <ul style="list-style-type: none"> <li>• provide independent verification that adequate corporate governance (including risk management and internal control systems) exists at individual banks;</li> <li>• determine that information provided by banks is reliable;</li> <li>• obtain additional information on the bank and its related companies needed for the assessment of the condition of the bank, the evaluation of material risks, and the identification of necessary remedial actions and supervisory actions, including enhanced off-site monitoring; and</li> <li>• monitor the bank's follow-up on supervisory concerns.</li> </ul>
Description and findings re EC3	<p>Onsite prudential reviews are scheduled in accordance with a bank's SAP and often involve APRA's risk specialists. The scope of the review is determined by the supervisor, directed at the key risks and issues identified in the PAIRS assessment and rating.</p> <p>Onsite reviews enable APRA to assess the role of Board and management of the bank, through examination of the entity's governance procedures, review of documentation received by the Board and senior management, and minutes of meetings. The supervisory standards (e.g., APS 510) and internal supervisory guidance supporting the analysis of Board and risk governance put great emphasis on the effectiveness of corporate governance and can be used to guide the on-site processes.</p>

	<p>The reliability of information provided to APRA may feature as part of APRA's onsite prudential reviews although this is not typically their primary purpose. Rather, APRA requires that, as part of their audit work, banks' external auditors provide assurance on the reliability of the data provided to APRA. This is covered in <i>Prudential Standard APS 310 Audit and Related Matters (APS 310)</i>. APRA may, nonetheless, choose to conduct its own reviews of the accuracy of information provided or have the bank commission a targeted review by external experts should the risk/issues be sufficiently significant (See, for example, CP8 for some recent topics of these reviews). Findings from prudential onsite reviews are followed up by supervisors. Findings will typically be characterized as requirements, recommendations, suggestions or requests for further information. Supervisors are responsible for ensuring that the requirements and requests are complied with and that the recommendations are addressed in a timely manner. For material risk issues, supervisors will often schedule follow-up onsite prudential reviews to ensure that all significant issues have been adequately addressed. In the assessors review of files it was clear that there are clear processes and procedures that are followed for communicating follow up actions to banks and requiring responses and confirmation of remedial action. Follow up letters reviewed by the assessors were very clear that banks were required to provide timelines for the remedial action and the supervisor monitored the completion of tasks according to these timetables. Departures from the agreed timetables were noted and pursued with senior management.</p>
<b>EC4</b>	<p>Off-site work is used as a tool to:</p> <ul style="list-style-type: none"> <li>• regularly review and analyze the financial condition of individual banks using prudential reports, statistical returns and other appropriate information, including publicly available information;</li> <li>• follow up on matters requiring further attention, evaluate developing risks and help identify the priorities and scope of further work; and</li> <li>• help determine the priorities and scope of on-site work.</li> </ul>
Description and findings re EC4	<p>The cornerstone of APRA's offsite analysis process is the quarterly risk review (QRR) which uses financial information reported by banks as well as information gained from other public sources concerning the entity, industry and the broader economy. These analyses feed into the PAIRS assessment and SAP which, in turn, will influence the timing, scope and nature of onsite reviews undertaken. The depth and breadth of the analysis is commensurate with the nature and scale of the bank's operations and risk profile. Offsite analysis also contributes to an assessment of emerging trends or potential issues that need to be monitored or require supervisory action and can be captured either through the individual entity action plan or inform developments in the ADI Risk Register.</p> <p>APRA also has a range of standard reports ('dashboards') that enable supervisors to undertake peer-group analysis, which assists in identifying outliers. APRA is currently working to increase the coverage of these reports. APRA also has an Industry Analysis unit that looks at emerging trends and issues impacting the banking sector more broadly (See also CP19). As a result of this process, banking supervisors may be given specific guidance on issues that should be addressed in their SAPs, which may involve thematic onsite reviews across a number of banks.</p>
<b>EC5</b>	<p>Based on the risk profile of individual banks, the supervisor maintains sufficiently frequent contacts as appropriate with the bank's Board, non-executive directors, Audit Committee and senior and middle management (including heads of individual business units and control functions) to develop an understanding of and assess such matters as strategy, group structure, corporate governance, performance, capital</p>

	adequacy, liquidity, asset quality and risk management systems.
Description and findings re EC5	The baseline supervision requirements ensure that supervisors maintain a minimum level of contact with a bank. As noted above, these requirements are intended to be proportionate to PAIRS impact. These requirements ensure that there are both prudential on site reviews and prudential consultations (meetings). As noted in EC2 above, the latter is a discussion with the Board/senior management that specifically focuses on strategy, performance, capital and any key issues with the bank. Should any onsite or offsite work raise material prudential concerns, these would be raised in a meeting with the relevant senior management (in addition to a written report to the Chief Executive Officer or Board). If warranted, issues will also be raised directly in a meeting with a bank's Board. The assessors were able to review reports which confirmed this to be standard practice.
<b>EC6</b>	On an ongoing basis during on-site and off-site supervisory activities, the supervisor considers the quality of the Board and management.
Description and findings re EC6	The PAIRS assessment includes a requirement to rate the quality and effectiveness of a bank's Board and management. Supervisory guidance supporting the PAIRS analysis requires specific consideration of Board composition, management structure and the fitness and propriety of both. The assessors noted a number of PAIRS reviews and discussed findings and views of the Board and management with senior APRA staff who demonstrated a nuanced understanding of and insight into the major institutions. These matters are considered routinely as part of the onsite prudential review process. Onsite reviews also involve discussing risk and control issues with senior bank staff, which enables APRA to make an assessment of their understanding of risk management issues and oversight of their respective areas. Reviews of Board minutes also enable APRA to assess the role of the Board. Prudential consultations also enable APRA to assess the senior management team. In addition, banks are required to lodge details of responsible persons, including the Board and key senior executives when there are changes to persons in those roles. These are reviewed by supervisors to ensure compliance with APRA's requirements and considered for possible implications for PAIRS assessments. Outcomes of other offsite supervisory activities, including prudential consultations, will potentially influence APRA's assessment of a bank's Board and management and be incorporated into the PAIRS assessment.
<b>EC7</b>	The supervisor evaluates the work of the bank's internal audit function, and determines whether, and to what extent, it may rely on the internal auditors' work to identify areas of potential risk.
Description and findings re EC7	The risk governance category and associated supervisory guidance material within the PAIRS assessment framework require supervisors to assess the quality of the internal audit function and its willingness to challenge management. Supervisors typically examine the structure and resources of the audit team, its independence from management, the Audit Committee's oversight of the function, the approach used by internal audit, its upcoming plan and the reporting of findings. Supervisors will also review internal audit findings and meet with internal auditors when conducting prudential reviews into specific risk categories (e.g., market, credit or operational risk). While audit findings are taken into account in refining APRA's view of a bank's inherent risk and management and controls, APRA primarily relies on its supervisory processes to develop and refine its assessment for prudential supervision purposes.



<b>EC8</b>	The supervisor communicates to the bank the findings of its on- and off-site supervisory analyses by means of written reports or through discussions or meetings with management.
Description and findings re EC8	APRA's supervisory framework specifically requires that a letter/report outlining its review findings and required remedial actions is sent following an onsite review. The letter also sets out the bank's updated PAIRS rating and SOARS stance and is sent to the Chief Executive Officer or Chair of the Board depending on the nature of the findings. A similar process is followed subsequent to a prudential consultation. It is also standard practice, supported by internal guidance, for a closing meeting to be held at the conclusion of an onsite review to provide an opportunity for APRA to discuss its findings with the relevant bank management. Where material prudential concerns are identified through offsite analysis, these will be promptly raised with the relevant bank management and, if warranted, a letter/report would be sent to the Chief Executive Officer/Board similar to that for an onsite review.
<b>Additional criteria</b>	
<b>AC1</b>	The supervisor meets periodically with senior management and the Board to discuss the results of supervisory examinations and the external audit. The supervisor should also meet separately with the independent Board members, as necessary.
Description and findings re AC1	Baseline (i.e., minimum standard) supervision requires supervisors to hold a prudential consultation with the Board/senior management on a periodic basis (typically each year for the largest banks). For the major Australian banks, APRA will meet separately with their Boards on, at a minimum, an annual basis. Meetings with Boards and prudential consultations provide opportunities to discuss a range of strategic and risk management issues including those arising from APRA's supervisory activities/onsite reviews as well as issues identified by external auditors. They are also used to discuss the bank's PAIRS assessment, SOARS stance and planned supervisory activities outlined in the SAP. There is no impediment to APRA meeting separately with the independent directors, if deemed necessary. However, the common practice is to meet with the full Board. APRA will however, on occasion, meet with a bank's Board Audit Committee, which must comprise non-executive directors only.
<b>Assessment of Principle 20</b>	<b>Compliant</b>
Comments	APRA conducts a well planned and well executed approach to on and off-site supervision. The quality of on and off-site review, preparation and follow up that the Assessors reviewed was of very high quality. In addition the Assessors were able to confirm that the frequency and intensity of direct contact supervision with the institutions has been increased since the Global Financial Crisis. Senior management has instituted a sound system of internal reporting to monitor the achievement of baseline targets and is made aware of deviations from planning. Institutions are informed annually of their assessment under the PAIRS and SOARS framework and at the same time are given the indicative timetable for the onsite reviews that will take place over the coming year. The Assessors confirmed that for substantial aspects of major firms' business such as credit risk, there would be a multi year risk based program to examine key elements, rather than seeking to cover all aspects of credit risk in one compressed reviews. On-site reviews for liquidity risk, even for the major institutions, are typically less than annual. A credit risk themed on-site review might take 5 days whereas a liquidity risk review would typically be shorter,

	i.e., 2-3 days. Firms confirm that the on-site reviews are seen as challenging, not least to the pre-review preparation required by the supervisor and entity. While it is not possible to identify the ideal balance of on and offsite resourcing, and all resource issues are finely balanced, it is recommended that APRA consider a greater proportion of resources be allocated to some longer and deeper on-site reviews. This would give greater assurance that the supervisors were able to conduct serious checks on-site and probe the institution's own understanding and risk management practices to an extent that document review, however sophisticated, cannot achieve.
<b>Principle 21</b>	<b>Supervisory reporting.</b> Supervisors must have a means of collecting, reviewing and analyzing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external experts.
<b>Essential criteria</b>	
<b>EC1</b>	The supervisor has the power to require banks to submit information, on both a solo and a consolidated basis, on their financial condition, performance, and risks, at regular intervals. These reports provide information on such matters as on- and off-balance sheet assets and liabilities, profit and loss, capital adequacy, liquidity, large exposures, asset concentrations (including by economic sector, geography and currency), asset quality, loan loss provisioning, related party transactions, interest rate risk and market risk.
Description and findings re EC1	Section 62 of the Banking Act confers on APRA the right to obtain information from banks (as well from authorized non-operating holding companies (NOHCS) in respect of the bank, the NOHC or the group of which the bank or the NOHC is a member. In addition, under section 13 of the Financial Sector (Collection of Data) Act 2001 (FSCODA), APRA is empowered to collect from banks any information which it considers necessary to carry out its statutory function. Information received includes detailed profit and loss accounts and balance sheets, capital adequacy, liquidity, large exposures, etc., calculations, asset quality/impairment data, exposures to related parties, details on market risk, interest rate risk, etc.  The information is received on a solo and consolidated basis as required.
<b>EC2</b>	The supervisor provides report instructions that clearly describe the accounting standards to be used in preparing supervisory reports. Such standards are based on accounting principles and rules that are widely accepted internationally.
Description and findings re EC2	Reporting standards and the instructions accompanying the reporting forms specify the information that APRA requires, the form in which it is to be presented and the accounting standards under which the information is to be prepared. Australian Accounting Standards are based on International Financial Reporting Standards (IFRS) and were adopted in January 2005 (There are no differences in substance between both).
<b>EC3</b>	The supervisor requires banks to utilize valuation rules that are consistent, realistic and prudent, taking account of current values where relevant.
Description and findings re EC3	In its reporting standards, APRA specifies the valuation method to be applied. In general, valuation practices adopted are consistent with requirements outlined in Australian Accounting Standards. Accordingly, financial assets and liabilities can be measured using fair value or at cost or amortized cost, as appropriate. Where it believes that it is warranted, APRA may require banks to adopt a more conservative approach to valuation rules. For example, for the purposes of calculating capital

	adequacy ratios, banks may be required to hold additional amounts of provision as a general reserve for credit losses.
<b>EC4</b>	The supervisor collects and analyses information from banks at a frequency (e.g., monthly, quarterly and annually) commensurate with the nature of the information requested, and the size, activities and risk profile of the individual bank.
Description and findings re EC4	The majority of reporting standards require quarterly reporting, although monthly, half-yearly and annual reports are also specified for certain standards. APRA may, by notice in writing, change the reporting periods for a particular bank, to require it to provide the information required by a reporting standard more frequently, or less frequently when it considers this necessary.
<b>EC5</b>	In order to make meaningful comparisons between banks and banking groups, the supervisor collects data from all banks and all relevant entities covered by consolidated supervision on a comparable basis and related to the same dates (stock data) and periods (flow data).
Description and findings re EC5	The regular quarterly and annual information APRA collects from all banks and banking groups is in a standardized form and is required to be submitted for specified periods. This enables peer-group comparisons for the same dates and periods.
<b>EC6</b>	The supervisor has the power to request and receive any relevant information from banks, as well as any of their related companies, irrespective of their activities, where the supervisor believes that it is material to the financial situation of the bank or banking group, or to the assessment of the risks of the bank or banking group. This includes internal management information.
Description and findings re EC6	Section 62 of the Banking Act confers on APRA the right to obtain from banks, (as well as from authorized non-operating holding companies (NOHCs)), on both a solo and consolidated basis, any information it believes is necessary for it to carry out its statutory duties.
<b>EC7</b>	The supervisor has the power of full access to all bank records for the furtherance of supervisory work. The supervisor also has similar access to the bank's Board, management and staff, when required.
Description and findings re EC7	Under section 62 of the Banking Act APRA has full access to all bank records and is able to request information from, and meet with, all relevant officers (directors, management and staff) as required.  Also, section 16B of the Banking Act empowers APRA to require an auditor of a bank to provide information or produce books, accounts or documents about a bank that APRA considers will assist it in performing its prudential supervisory role. Paragraph 9 of Prudential Standard APS 510 – Governance- also explicitly states that members of the Board and senior management must be available to meet with APRA on request.
<b>EC8</b>	The supervisor has a means of enforcing compliance with the requirement that the information be submitted on a timely and accurate basis. The supervisor determines that the appropriate level of senior management is responsible for the accuracy of supervisory returns, can impose penalties for misreporting and persistent errors, and can require that inaccurate information be amended.
Description and findings re EC8	Reporting standards require the submission of data for specific reporting periods and timeframes. Failure to abide by the requirements of a reporting standard is potentially subject to a criminal sanction. In addition, section 14 of the Financial Sector (Collection of Data) Act 2001 (FSCODA) requires the Principal Executive Officer of a bank to notify the Board of the bank, as soon as practicable, if there has been a failure to meet a reporting requirement. Failure or refusal to notify is an offence under the Act.

	<p>FSCODA provides that where APRA considers a reporting document provided to be incorrect, incomplete or misleading, does not comply with an applicable reporting standard or does not contain adequate information about a matter, it may give the entity a written notice requesting it to give APRA a written explanation or information as specified in the notice. Should an entity fail to provide an adequate response to the notice (including failure to provide correct or complete information), APRA may give an entity a written direction for the variation of the document supplied by the bank in question to rectify any problems or for the bank to give it the required information. Failure to comply with a direction constitutes a criminal offense. APRA require inaccurate information to be resubmitted.</p>
<b>EC9</b>	<p>The supervisor utilizes policies and processes to confirm the validity and integrity of supervisory information. This includes a program for the periodic verification of supervisory returns by means either of the supervisor's own staff or of external experts.</p>
Description and findings re EC9	<p>'Direct to APRA (D2A)' is the electronic data submission system for prudential returns. When submitting data using D2A, an officer of the bank must digitally sign, authorize and encrypt the relevant data. For this purpose, APRA issues 'digital security certificates', for use with the software, to officers of the bank who have authority from the bank to transmit the data to APRA.</p> <p>APRA uses validation rules within D2A to validate the data prior to submission by reporting entities. This prevents banks from submitting the data until these errors have been corrected.</p> <p>APRA also validates data after they are submitted by entities. These post-submission data quality checks identify further data inconsistencies. Entities are expected to promptly correct (via D2A) or explain data identified by these checks.</p> <p>As part of its Quarterly Risk Review (QRR) process, supervisors routinely compare information submitted from D2A to other sources for consistencies.</p> <p>In addition to APRA's own verification, Prudential Standard APS 310 – Audit and related Matters – sets out the requirements for a bank to ensure that its appointed auditors (invariably its statutory external auditor) report to APRA annually--based on the bank's financial year end --on the reliability of data submitted to APRA.</p> <p>Furthermore, in the case of certain reports that a bank must submit to APRA the appointed auditor must provide reasonable or limited assurance that the information in those reports is reliable and in accordance with the relevant prudential standards.</p>
<b>EC10</b>	<p>The supervisor clearly defines and documents the roles and responsibilities of external experts, including the scope of the work, when they are appointed to conduct supervisory tasks and monitors the quality of the work. External experts may be utilized for routine validation or to examine specific aspects of banks' operations.</p>
Description and findings re EC10	<p>APS 310 – Audit and Related Matters – provides for the appointment of appointed auditors to banks. This is in addition to the appointment of statutory auditors, although invariably the statutory auditor will also be the appointed auditor.</p> <p>The appointed auditor will provide on a yearly basis – to coincide with the date of the annual accounts- the following:</p> <ul style="list-style-type: none"> <li>• reasonable or limited assurance on statistical and financial data provided to APRA;</li> <li>• limited assurance that there are control policies and procedures in place designed to address compliance with prudential requirements and to provide reliable data to APRA; and</li> <li>• limited assurance that prudential and reporting standards have been complied with.</li> </ul>

	<p>The appointed auditor may also be required to prepare a special purpose engagement. This is typically targeted at a particular area of prudential interest to APRA.</p> <p>For both types of engagement, annual and special, APRA specifies the scope and form of the report required.</p>
<b>EC11</b>	The supervisor requires that external experts bring to its attention promptly any material shortcomings identified during the course of any work undertaken by them for supervisory purposes.
Description and findings re EC11	<p>Section 16BA of the Banking Act requires an auditor to notify APRA immediately if it has reasonable grounds for believing that a bank is or may become insolvent; or that the interest of depositors may be or are about to be materially prejudiced. If an auditor has reasonable grounds for believing that a bank will or has failed to comply with the Banking Act, the Financial Sector (Collection of Data) Act 2001 or a prudential standard, it must write a report to APRA setting out the details of the anticipated or actual failure within 10 business days.</p> <p>Annual reports by appointed auditors must be provided to APRA within three months of the annual balance date. The agreed format for routine reports intentionally highlights areas of concern and weakness. Progress in addressing previously identified weaknesses also needs to be reported.</p>
<b>Assessment of Principle 21</b>	<b>Compliant</b>
Comments	APRA has the means to collect, review and analyze prudential reports and statistical returns on both a solo and consolidated basis.
<b>Principle 22</b>	<b>Accounting and disclosure.</b> Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability.
<b>Essential criteria</b>	
<b>EC1</b>	The supervisor has the power to hold bank management and the bank's Board responsible for ensuring that financial record-keeping systems and the data they produce are reliable.
Description and findings re EC1	<p>Bank management in Australia (and all other corporate management in Australia) is responsible for the financial record-keeping systems and the reliability of data they produce, primarily under the Corporation Act 2001 (Corporations Act) and through regulation by the Australian Securities and Investment Commission (ASIC), which regulates company and financial services laws. As such, APRA primarily relies on the general requirements of the Corporations Act and ASIC to ensure that the management reports and financial statements issued by a bank are reliable and receive proper external audit scrutiny and verification.</p> <p>The Corporations Act requires that reporting entities (which includes all ADIs) maintain proper financial records that would enable the preparation of true and fair financial statements. Should ASIC have specific concerns, it would discuss the matter with APRA and a suitable course of action agreed.</p> <p>The Corporations Act states that a financial report and directors' report must be prepared for each financial year by disclosing entities, public companies, large proprietary companies and registered schemes (section 292) and the financial report must be audited (section 301).</p>

<b>EC2</b>	The supervisor has the power to hold bank management and the bank's Board responsible for ensuring that the financial statements issued annually to the public receive proper external verification and bear an external auditor's opinion.
Description and findings re EC2	The obligation for bank's financial accounts to be audited is set out in the Corporation Act 2001 administered by ASIC. Under Chapter 2M of the Corporations Act, all Australian-incorporated banks are required to issue financial reports to the public on an annual and half-yearly basis. The annual financial report must be audited (section 301) and the half yearly accounts must be reviewed by the external auditor. Should ASIC have specific concerns it would raise the matter with APRA.
<b>EC3</b>	The supervisor requires banks to utilize valuation rules that are consistent, realistic and prudent, taking account of current values where relevant, and to show profits net of appropriate provisions.
Description and findings re EC3	For published financial statements, banks must adopt valuation practices consistent with requirements outlined in Australian accounting standards, which are Australian implementation of International Financial Reporting Standards (IFRS). AASB 101 Presentation of Financial Statements (AASB 101) and AASB 139 Financial instruments: Recognition & Measurement (AASB 139) – issued by the Australian Accounting Standard Board--provide for provisions for credit losses or changes in provisions to be charged immediately to the income statement as separate items of expenses. For prudential reporting purposes, APRA may require banks to hold an additional amount of provisions as a General Reserve for Credit Losses (a more conservative treatment than required under accounting standards).
<b>EC4</b>	Laws or regulations set, or the supervisor has the power, in appropriate circumstances, to establish, the scope of external audits of individual banks and the standards to be followed in performing such audits.
Description and findings re EC4	The audits of financial statements and the engagement of external auditors are based on standards issued by the Auditing and Assurance Standards Board (AUASB) which generally conform to auditing standards issued by the International Auditing and Assurance Standards Board. In addition to the statutory audit as referred to in the above paragraph, APRA in accordance with its Prudential Standard APS 310 – Audit and Related Matters – requires appointed auditors (which will almost invariably be the statutory auditor) to provide to it reasonable or limited assurance on statistical and financial data provided to it by ADI's, limited assurance that there are controls policies and procedures in place designed to address compliance with prudential requirements and to provide reliable data to APRA, and limited assurance that prudential and reporting standards have been complied with. Additionally, APRA can engage the appointed auditor to carry out a special purpose assignment typically targeted towards a particular area of prudential interest to APRA.
<b>EC5</b>	Supervisory guidelines or local auditing standards determine that audits cover such areas as the loan portfolio, loan loss reserves, non-performing assets, asset valuations, trading and other securities activities, derivatives, asset securitizations, and the adequacy of internal controls over financial reporting.
Description and findings re EC5	Audit standards provide that audits cover these areas. In addition, the Australian Auditing and Assurance Standards Board has developed, in conjunction with APRA, Guidance Statement GS 012 – Prudential Reporting Requirements for Authorized Deposit-taking Institutions to provide guidance to the appointed auditor in fulfilling his obligations (See EC 4 above).
<b>EC6</b>	The supervisor has the power to reject and rescind the appointment of an external

	auditor that is deemed to have inadequate expertise or independence, or not to be subject to or not to follow established professional standards.
Description and findings re EC6	Section 17 of the Banking Act empowers APRA to remove a person from the position of an auditor of a bank if APRA is satisfied that the person has failed to perform the functions and duties of the position as required by the Banking Act or prudential standards or does not meet the fit and proper criteria set out in the prudential standards. ASIC can apply to the Companies' Auditors and Liquidators Disciplinary Board for auditors to be disqualified if they fail to meet their duties or are not fit and proper (section 1292 of the Corporations Act).
<b>EC7</b>	The supervisor requires banks to produce annual audited financial statements based on accounting principles and rules that are widely accepted internationally and have been audited in accordance with internationally accepted auditing practices and standards.
Description and findings re EC7	The Corporations Act requires reporting entities (which includes all ADIs) to prepare financial statements in accordance with Australian Accounting Standards which are based on International Financial Reporting Standards. The audits of financial statements required under the Corporations Act are conducted in accordance with AUASB standards, which generally conform to auditing standards issued by the International Auditing and Assurance Standards Board.
<b>EC8</b>	Laws, regulations or the supervisor require periodic public disclosures of information by banks that adequately reflect the bank's true financial condition. The requirements imposed should promote the comparability, relevance, reliability and timeliness of the information disclosed.
Description and findings re EC8	The Corporations Act 2001 requires banks (and other reporting entities) publish annual and half yearly accounts. Each set of accounts must comply with accounting standards and regulations. The annual accounts must be audited and the half yearly accounts reviewed by the auditor.
<b>EC9</b>	The required disclosures include both qualitative and quantitative information on a bank's financial performance, financial position, risk management strategies and practices, risk exposures, transactions with related parties, accounting policies, and basic business, management and governance. The scope and content of information provided and the level of disaggregation and detail should be commensurate with the size and complexity of a bank's operations.
Description and findings re EC9	The Corporations Act 2001 disclosure requirements relate to a bank's financial performance and financial position as determined in accordance with Australian Accounting Standards. Mandatory disclosures required by Australian Accounting Standards include quantitative and qualitative information on the items presented in the financial statements or in the notes, disclosure of Accounting Policies, quantitative and qualitative information on the entity's capital management policies and the type of capital and quantitative and qualitative disclosures for each type of risk and disclosure of related party relationships, transactions and outstanding balances. Apart from the above, all banks with the exception of those established in Australia on a branch basis, are required to make the necessary disclosures under Pillar 3 of Basel 11.
<b>EC10</b>	Laws, regulations or the supervisor provide effective review and enforcement mechanisms designed to confirm compliance with disclosure standards.
Description and findings re EC10	Disclosure requirements outlined in the Corporations Act 2001, which apply to banks, are subject to review as part of ASIC's financial reporting surveillance program. Under this program, ASIC reviews annual and interim financial reports of a selection of listed

	<p>companies and other significant entities (which would include banks), to monitor compliance with the Corporations Act and Australian Accounting Standards. Remedial action will be required when concerns arise.</p> <p>APRA also has the power under section 65 of the Banking Act to direct a bank to comply with the disclosure requirements of its Prudential Standard 330--Capital Adequacy: Public Disclosure of Prudential Information.</p>
<b>EC11</b>	The supervisor or other relevant bodies publish aggregate information on the banking system to facilitate public understanding of the banking system and the exercise of market discipline. Such information includes aggregate data on balance sheet indicators and statistical parameters that reflect the principal aspects of banks' operations (balance sheet structure, capital ratios, income earning capacity, and risk profiles).
Description and findings re EC11	APRA publishes the accounts of individual banks on a monthly basis and aggregate data on a quarterly basis. This information covers assets and liabilities, loans and advances, capital adequacy, financial performance and impaired asset information. The Reserve Bank of Australia also provides extensive aggregate information on the banking system in its six-monthly Financial Stability review and makes available extensive data on the banking sector on its website.
<b>Additional criteria</b>	
<b>AC1</b>	The supervisor meets periodically with external audit firms to discuss issues of common interest relating to bank operations.
Description and findings re AC1	APRA's Prudential Standard APS 310 – Audit and Related Matters – provides that APRA can hold bi-lateral meetings (involving APRA and auditors) and tripartite meetings (APRA, bank, auditors). The frequency of such meetings depends on the nature, size and complexity of bank. APRA also meets on a periodic basis (at least twice a year) with the major auditing firms as a group to discuss emerging issues and provide clarification where necessary on compliance and reporting obligations.
<b>AC2</b>	External auditors, whether or not utilized by the supervisor for supervisory purposes, have the duty to report to the supervisor matters of material significance, for example failure to comply with the licensing criteria or breaches of banking or other laws, or other matters which they believe are likely to be of material significance to the functions of the supervisor. Laws or regulations ensure that auditors who make any such reports in good faith cannot be held liable for breach of a duty of confidentiality.
Description and findings re AC2	Section 16BA of the Banking Act sets out the requirements for auditors to provide information to APRA. These include: <ul style="list-style-type: none"> <li>a) immediately, if the auditor has reasonable grounds for believing that, for example: <ul style="list-style-type: none"> <li>i. the bank is insolvent, or there is a significant risk that the bank will become insolvent; or</li> <li>ii. an existing or proposed state of affairs may prejudice materially the interests of depositors of the bank; and</li> </ul> </li> <li>b) as soon as is practicable, if the auditor has reasonable grounds for believing that a bank has failed to comply with a provision of: <ul style="list-style-type: none"> <li>i. the Banking Act or other regulatory acts, or</li> <li>ii. a Prudential Standard; or</li> <li>iii. a Direction under Division 1BA of Part II of the Banking Act (APRA's power to issue directions); or</li> <li>iv. a condition of its authority; and</li> </ul> </li> </ul>



	v. the failure to comply is or will be significant. <sup>5</sup> Section 70A of the Banking Act requires that auditors providing information to APRA in good faith and without negligence in the performance of their duties are protected from any liability to any person.
<b>AC3</b>	Laws, regulations or the supervisor require banks to rotate their external auditors (either the firm or individuals within the firm) from time to time.
Description and findings re AC3	Division 3 of the Corporations Act 2001 provides that an individual (but not an audit firm) who has played a significant role in the audit of a particular bank for five successive financial years is not eligible to continue to play a significant role unless the individual has not played such a role for at least two successive years. The '5/7 rule' provides that an individual may not play a significant role for more than five out of seven successive financial years.
<b>AC4</b>	The supervisor requires banks to have a formal disclosure policy.
Description and findings re AC4	Banks are required to disclose information in accordance with the provisions of Pillar 3 of Basel 11.
<b>AC5</b>	The supervisor has the power to access external auditors' working papers, where necessary.
Description and findings re AC5	Under section 16B of the Banking Act, APRA may give written notice to the auditor to provide information, or to provide books, accounts or documents, about such entities to APRA if the latter considers that the provision of such information will assist it its functions under the Banking Act.
<b>Assessment of Principle 22</b>	<b>Compliant</b>
Comments	Australia has a well-developed accounting and auditing regime.
<b>Principle 23</b>	<b>Corrective and remedial powers of supervisors.</b> Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking license or to recommend its revocation.
<b>Essential criteria</b>	
<b>EC1</b>	The supervisor raises supervisory concerns with management or, where appropriate, the Board, at an early stage, and requires that these concerns are addressed in a timely manner. Where the supervisor requires the bank to take significant remedial actions, these are addressed in a written document to the Board. The supervisor requires the bank to submit regular written progress reports and checks that remedial actions are completed satisfactorily.
Description and findings re EC1	A bank's senior management will be informed in writing when prudential concerns are identified, highlighting the areas APRA wants addressed and the timeframe for responding to the issues. These letters include 'requirements' for more significant issues that APRA wants addressed in a timely manner. Any letter than contains requirements is also sent to the bank's Board. Bank management must respond with proposed remedial actions and timeframes. Where APRA is not satisfied with the response, it will continue to follow up with the bank, including further written responses outlining APRA's stance.

<sup>5</sup>Refer to paragraph 210 of AAUSB's 'Guidance Statement GS 012 Prudential Reporting Requirements for Auditors of Authorised Deposit-taking Institutions'.

	In situations where a bank is either unable or unwilling to address adequately APRA's concerns, APRA may resort to the exercise of formal powers under the Banking Act. In these cases APRA may direct the bank to undertake specific actions. The type of direction that may be issued include a direction to the bank to comply with any requirement of the Banking Act and other relevant acts, to remove a director or senior manager, to remove an auditor, nor to accept further deposits or grant future loans or pay a dividend.
<b>EC2</b>	The supervisor participates in deciding when and how to effect the orderly resolution of a problem bank situation (which could include closure, or assisting in restructuring, or merger with a stronger institution).
Description and findings re EC2	<p>In cases where a bank is in serious distress, APRA would activate its internal Financial Crisis Management Plan. This would occur when</p> <ul style="list-style-type: none"> <li>• there is a material or immediate threat to a bank's capital position or solvency ;or</li> <li>• the bank's ability to meet its obligations to depositors as and when they fall due is subject to doubt; or</li> <li>• there is a risk of financial system instability arising from the financial condition of the bank in question.</li> </ul> <p>Under section 10 of the APRA Act, APRA is obliged to inform the Minister if it considers that a regulated body is in financial difficulty. APRA, in deciding on an appropriate course of action to resolve the situation, would consult with the Council of Financial Regulators (comprising the Ministry, Reserve Bank of Australia, APRA and ASIC). Where the bank is considered to be systemically important, the Council would be the vehicle through which a coordination response to the situation is prepared, with each agency performing its respective functions. APRA has the lead responsibility for the exercise of resolution powers under the Banking Act, including the giving of a direction to a bank, the appointment of a statutory manager (who would assume responsibility for running of the bank), the application to a Court for a winding up, and the exercise of business transfer under the Financial Sector (Business Transfer and Group Restructure) Act 1991.</p>
<b>EC3</b>	The supervisor has available an appropriate range of supervisory tools for use when, in the supervisor's judgment, a bank is not complying with laws, regulations or supervisory decisions, or is engaged in unsafe or unsound practices, or when the interests of depositors are otherwise threatened. These tools include the ability to require a bank to take prompt remedial action and to impose penalties. In practice, the range of tools is applied in accordance with the gravity of a situation.
Description and findings re EC3	<p>APRA will seek in the first instance to resolve the problem through standard supervisory actions. Where these are regarded as inadequate, it can invoke a number of statutory powers including:</p> <ul style="list-style-type: none"> <li>• the appointment of a person to investigate and report on prudential matters (Section 61 of the Banking Act);</li> <li>• powers to issue directions as described in EC1;</li> <li>• power to accept an Enforceable Undertaking (This is a written undertaking by a person in connection to a matter in which APRA has a function or power. If the undertaking is breached, a court may make orders including directing compliance, directing payment of compensation or other monies);</li> <li>• power to remove a director or senior manager;</li> <li>• power to remove an auditor;</li> <li>• power to effect a compulsory transfer of business of a bank;</li> <li>• power to revoke a license.</li> </ul>

<b>EC4</b>	The supervisor has available a broad range of possible measures to address such scenarios as described in EC 3 above and provides clear prudential objectives or sets out the actions to be taken, which may include restricting the current activities of the bank, withholding approval of new activities or acquisitions, restricting or suspending payments to shareholders or share repurchases, restricting asset transfers, barring individuals from banking, replacing or restricting the powers of managers, Board directors or controlling owners, facilitating a takeover by or merger with a healthier institution, providing for the interim management of the bank, and revoking or recommending the revocation of the banking license.
Description and findings re EC4	As described in EC1 and EC3, APRA has a wide range of tools to address serious deficiencies in a bank. In particular, the power to issue a direction, to appoint a statutory manager, to effect a compulsory transfer of business cover the action referred to in this EC.
<b>EC5</b>	The supervisor has the power to take measures should a bank fall below the minimum capital ratio, and seeks to intervene at an early stage to prevent capital from falling below the minimum. The supervisor has a range of options to address such scenarios.
Description and findings re EC5	<p>APRA sets out the minimum capital requirements a bank is required to satisfy in Prudential Standard APS 110 – Capital Adequacy. APS 110 requires the Board of a bank to ensure that the bank maintains an appropriate level and quality of capital commensurate with the level and extent of risks to which it is exposed from its activities. This includes a requirement for the bank to have an Internal Capital Adequacy Assessment Process (ICAAP) and to maintain minimum levels of capital, at both sol and group level, as appropriate.</p> <p>In addition, at a minimum APRA requires a bank to hold capital equivalent to the Prudential Capital Ratio (PCR) determined for it by APRA. A bank’s PCR is eight percent of risk-weighted assets unless APRA indicates that a higher percentage is required. It is common practice for APRA to require a higher percentage where this is warranted by prudential issues (See CP6, EC1).</p> <p>Under section 62A a bank must notify APRA of any breach or prospective breach of the minimum capital adequacy requirements. This notification must also outline the actions the bank is taking and/or plans to take to rectify the breach.</p> <p>APRA has a number of powers to require banks to take steps to implement recovery plans to take other measures to ensure that their capital is restored to its appropriate level. These include powers to issue directions, including directions to take specified measures to recapitalize.</p>
<b>EC6</b>	The supervisor applies penalties and sanctions not only to the bank but, when and if necessary, also to management and/or the Board, or individuals therein.
Description and findings re EC6	<p>Section 11 of the Banking Act allows APRA to issue directions requiring banks to undertake certain actions or to refrain from taking certain actions (See EC1 above). Non –compliance with such a direction is an offence. An officer of a bank can also be guilty of the offence if the officer fails to ensure that the bank complies with the direction.</p> <p>Also, under sections 137.1 and 137.2 of the Criminal Code Act 1995, a person is guilty of an offence punishable on conviction by imprisonment for 12 months if the person gives false or misleading information or documents to a Commonwealth entity, which includes APRA, provided that such person has been notified that provision of false or misleading information constitutes an offence.</p> <p>Under the Financial Sector (Collection of Data) Act 2001, it is an offense for a bank not to provide APRA with information within a specified period or by a particular time. Also, the principle executive officer must notify the board of the bank if the bank has</p>

	failed to provide the information. A penalty applies for breaching this requirement.
<b>Additional criteria</b>	
<b>AC1</b>	Laws or regulations guard against the supervisor unduly delaying appropriate corrective actions.
Description and findings re AC1	<p>Relevant laws do not stipulate the time in which APRA must take action or whether it must act if a trigger is met that allows for action to be taken. This, APRA contends, is intended to allow it necessary supervisory discretion to take measure corrective action as it deems appropriate.</p> <p>At the same time, APRA's supervisory regime (in particular PAIRS, SOARS, SAPs) does facilitate early identification and rectification of potential problems.</p>
<b>AC2</b>	The supervisor has the power to take remedial actions, including ring-fencing of the bank from the actions of parent companies, subsidiaries, parallel-owned banking structures and other related companies in matters that could impair the safety and soundness of the bank.
Description and findings re AC2	<p>APRA has a consolidated supervision framework and has various powers available to it to limit the risk to a bank from the actions of related entities. Relevant prudential standards include:</p> <ul style="list-style-type: none"> <li>• APS 110 – Capital Adequacy--which, in addition to detailing capital requirements on a standalone basis, requires the maintenance of minimum levels of capital for a banking group commensurate with the risks assumed; and</li> <li>• Prudential Standard APS 222--Associations with Related Entities--which imposes limits on exposures of a bank to related counterparties.</li> </ul> <p>The latter is intended to reduce the risk of contagion should there be a problem in a related entity. In addition, APS 222 requires a bank to have in place systems, policies and procedures to manage, monitor and control all forms of risks arising from its associations with other members of a group, beyond those arising from direct financial dealings with group members. These risks can include reputational and legal risk arising from the use of common brands or cross-selling and operational risk from shared services.</p> <p>The direction powers outlined in EC1 allow APRA to effectively ring-fence the bank from other group entities. This includes stopping payments to external parties and preventing the bank from engaging in transactions that could adversely impact on the bank and its depositors.</p>
<b>AC3</b>	When taking formal remedial action in relation to a bank, the supervisor ensures that the regulators of non-bank related financial entities are aware of its actions and, where appropriate, coordinates its actions with them.
Description and findings re AC3	<p>APRA's role as an integrated regulator across the banking, insurance and superannuation industries means that many coordination issues are internalized. In the event that another regulator is involved, APRA would actively engage with that agency to ensure coordination of action.</p> <p>In addition, the Council of Financial Regulators (Ministry, Reserve Bank of Australia, APRA, ASIC) provides a forum for discussion and coordination among domestic regulatory agencies. In this respect, a formal MOU exists between members of the Council which, inter alia, details respective roles and responsibilities in the event that formal remedial action is required in a crisis situation.</p>
<b>Assessment of Principle 23</b>	<b>Compliant</b>
<b>Comments</b>	The supervisor has sufficient corrective and remedial powers at its disposal to bring

	about timely corrective actions.
<b>Principle 24</b>	<b>Consolidated supervision.</b> An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.
<b>Essential criteria</b>	
<b>EC1</b>	The supervisor is familiar with the overall structure of banking groups and has an understanding of the activities of all material parts of these groups, domestic and cross-border.
Description and findings re EC1	<p>Prudential Standard APS 222--Associations with Related Entities- sets out APRA's requirements for banks to monitor and limit their risks as a result of their associations and dealings with related entities in a consolidated group. Consolidation covers the bank's global operations and related entities include all entities controlled (whether directly or indirectly) by the bank or its ultimate domestic parent (paragraph 12 of APS 222).</p> <p>Paragraph 8 of APS 222 requires a bank to provide APRA with the following group information:</p> <ul style="list-style-type: none"> <li>• details of group members (for example: name, place of incorporation, board composition, nature of business and any other additional information required by APRA for a better understanding of the risk profiles of individual group members);</li> <li>• management structure of the group (including key risk management reporting lines);</li> <li>• intra-group support arrangements (for example, a specific guarantee of the obligations of an entity in the group);</li> <li>• intra-group exposures (paragraph 17);</li> <li>• other information as required by APRA from time to time for the effective supervision of the group; and</li> <li>• prior advice of any proposed changes to the composition or operations of the group with the potential to materially alter the group's overall risk profile.</li> </ul> <p>Paragraph 9 of APS 222 requires the bank to provide APRA with descriptions of its group risk management policies and the procedures used to measure and control overall group risk (including any material changes thereto).</p>
<b>EC2</b>	The supervisor has the power to review the overall activities of a banking group, both domestic and cross-border. The supervisor has the power to supervise the foreign activities of banks incorporated within its jurisdiction.
Description and findings re EC2	<p>APRA conducts supervision of banks at two levels – as a standalone bank (Level 1) and at the consolidated banking group (Level 2). Consolidation at Level 2 covers the global operations of a bank and its subsidiary entities, as well as any other controlled banking entities, securities entities and other financial entities, except for insurers (which are deducted from capital for the purposes of calculating the capital adequacy ratio), responsible entities related to funds management, non-financial operations and certain securitisation Special Purpose Vehicles (SPV) (Attachment C of APS 110). APRA's prudential requirements apply to banks at both Level 1 and Level 2, where relevant.</p> <p>Banks must obtain APRA's prior approval for the establishment or acquisition of a regulated presence domestically or overseas. Approval will be subject to APRA having the ability to access information on the overseas operations and the agreement of relevant host supervisors to cooperate and share information with APRA (refer to</p>

	<p>CP25). APRA regularly undertakes onsite inspections of material offshore operations of Australian-incorporated banks.</p> <p>Sections 61 and 62 of the <i>Banking Act 1959</i> (Banking Act) also provide APRA with powers to obtain information from, and conduct investigations into, subsidiaries within the banking group, both in Australia and overseas.</p> <p>APRA is currently consulting on a prudential and reporting framework for Level 3 groups. A 'level 3 group' refers to a conglomerate group that has material operations in more than one APRA-regulated industry and/or has one or more material unregulated entities. The Level 3 proposals seek to apply a group-wide approach to risk and capital management to ensure adequate protection for APRA-regulated entities from potential contagion and other risks associated with their membership of the group.</p> <p>As noted in AC1 below, bank conglomerate groups must be headed by a bank or an authorised non-operating holding company (NOHC) to facilitate group supervision by APRA.</p>
<b>EC3</b>	The supervisor has a supervisory framework that evaluates the risks that non-banking activities conducted by a bank or banking group may pose to the bank or banking group.
Description and findings re EC3	<p>As outline in EC 1, APRA's supervision framework applies to banking groups on a consolidated basis. Supervisors routinely assess the level of risk posed by non-banking activities as part of their supervisory activities, both onsite and offsite. In assessing the level of risk of such associations, APRA will have regard to certain factors, including:</p> <ul style="list-style-type: none"> <li>• the financial strength of the group;</li> <li>• the nature of business conducted in group entities;</li> <li>• the quality of management and systems and, particularly, risk management across the group;</li> <li>• the level of financial and operational interdependence across the group, particularly between regulated and unregulated entities;</li> <li>• whether other members of the group are regulated entities (i.e., any entity directly regulated by APRA or by an equivalent banking or insurance prudential regulator overseas) and the quality of that regulation;</li> <li>• other relevant factors to be considered on a case-by-case basis.</li> </ul> <p>Under paragraph 18 of APS 222, where it is not satisfied that a bank has adequate systems and controls in place for identifying, reviewing, monitoring and managing exposures arising from dealings with related entities, APRA may require a bank to put in place additional internal controls, more robust reporting mechanisms and/or to maintain a higher prudential capital ratio.</p>
<b>EC4</b>	The supervisor has the power to impose prudential standards on a consolidated basis for the banking group. The supervisor uses its power to establish prudential standards on a consolidated basis to cover such areas as capital adequacy, large exposures, exposures to related parties and lending limits. The supervisor collects consolidated financial information for each banking group.
Description and findings re EC4	<p>Under section 11AF of the Banking Act, APRA may make prudential standards apply to banks, authorized NOHCs and their subsidiaries.</p> <p>APRA's prudential and reporting standards apply on a standalone and consolidated basis, where relevant. The standards cover capital adequacy, credit quality, large exposures and exposures to relate parties.</p>

<b>EC5</b>	The supervisor has arrangements with other relevant supervisors, domestic and cross-border, to receive information on the financial condition and adequacy of risk management and controls of the different entities of the banking group.
Description and findings re EC5	<p>In assessing the financial condition and risk management of the consolidated banking groups, APRA has developed working relationships with relevant domestic and foreign regulators (for example: the Reserve Bank of New Zealand and the UK Financial Services Authority) and has formalised these relationships in Memoranda of Understanding (MOUs). The memoranda establish a formal basis for cooperation, including the exchange of information and investigative assistance. In addition, the memoranda enable the agencies to assist APRA in obtaining information from third parties.</p> <p>APRA regularly conducts onsite prudential inspections of banks' foreign operations where these are considered material.</p> <p>APRA is an active participant in supervisory colleges and crisis management groups hosted by foreign banks with significant Australian operations. APRA has hosted supervisory colleges in Australia for Australian with significant cross-border operations.</p>
<b>EC6</b>	The supervisor has the power to limit the range of activities the consolidated group may conduct and the locations in which activities can be conducted; the supervisor uses this power to determine that the activities are properly supervised and that the safety and soundness of the bank are not compromised.
Description and findings re EC6	Paragraph 8 of APS 222 requires banks to advise APRA in advance of any proposed changes to the composition of operations of the group that have the potential to alter materially the group's overall risk profile, and to obtain APRA's prior approval for the establishment or acquisition of a regulated presence domestically or overseas. If APRA sees excessive risks or foresees impediments in the conduct of consolidated supervision, it can use its powers under the Banking Act to prohibit a bank from undertaking the activities.
<b>EC7</b>	The supervisor determines that management is maintaining proper oversight of the bank's foreign operations, including branches, joint ventures and subsidiaries. The supervisor also determines that banks' policies and processes ensure that the local management of any cross-border operations has the necessary expertise to manage those operations in a safe and sound manner and in compliance with supervisory and regulatory requirements.
Description and findings re EC7	APRA's onsite prudential inspections examine banks' activities on a group-wide basis and consider the ability of the Board and head office management to oversee and control regional operations. APRA conducts onsite inspections to assess foreign operations where these are considered to be material (e.g., New Zealand).
<b>EC8</b>	<p>The supervisor determines that oversight of a bank's foreign operations by management (of the parent bank or head office and, where relevant, the holding company) includes: (i) information reporting on its foreign operations that is adequate in scope and frequency to manage their overall risk profile and is periodically verified; (ii) assessing in an appropriate manner compliance with internal controls; and (iii) ensuring effective local oversight of foreign operations.</p> <p>For the purposes of consolidated risk management and supervision, there should be no hindrance in host countries for the parent bank to have access to all the material information from their foreign branches and subsidiaries. Transmission of such information is on the understanding that the parent bank itself undertakes to maintain the confidentiality of the data submitted and to make them available only to the parent</p>

	supervisory authority.
Description and findings re EC8	APRA's onsite inspections include the oversight of material foreign operations. In these inspections, APRA would typically request copies of Board and/or management reports, relevant risk management policies, relevant internal audit reports and reporting lines to head office as part of the pre-inspection information request. The offsite review of these documents together with the onsite discussions and interaction with local management assist APRA in determining whether the information received by the parent bank/head office on foreign operations is sufficient in terms of scope and frequency. When inspecting operations onsite at overseas centres, APRA reviews compliance with internal controls and assesses whether head office oversight of the overseas operations is effective. APRA will also discuss with the host supervisor its assessment of the effectiveness of the management and activities of the foreign operations.
<b>EC9</b>	The home supervisor has the power to require the closing of foreign offices, or to impose limitations on their activities, if: <ul style="list-style-type: none"> <li>• it determines that oversight by the bank and/or supervision by the host supervisor is not adequate relative to the risks the office presents; and/or</li> <li>• it cannot gain access to the information required for the exercise of supervision on a consolidated basis.</li> </ul>
Description and findings re EC9	APRA has broad powers under the Banking Act (Division 1 BA) to issue directions to banks where necessary to ensure compliance with its prudential standards. These include directing the bank to divest of certain businesses or branch offices, or placing limits on certain business activities.
<b>EC10</b>	The supervisor confirms that oversight of a bank's foreign operations by management (of the parent bank or head office and, where relevant, the holding company) is particularly close when the foreign activities have a higher risk profile or when the operations are conducted in jurisdictions or under supervisory regimes differing fundamentally from those of the bank's home country.
Description and findings re EC10	Paragraph 7 of APS 220 requires the Board to ensure that detailed policies and procedures are in place to measure, manage, monitor and report all risk at a group level, including all foreign operations. APRA expects the intensity of the bank's management oversight to be commensurate with the risk profile of its operations. That is, Apra expects closer management oversight when the bank's foreign activities have a higher risk profile or when the operations are conducted in jurisdictions or under supervisory regimes that are fundamentally different from Australia. The effectiveness of a bank's management oversight of foreign operations is an area of focus during prudential discussions and considered as part of relevant onsite inspections. When APRA is not satisfied with the adequacy of a bank's management oversight, it may require the bank to put in place additional internal controls, a more robust reporting mechanism and/or maintain a higher prudential ratio.
<b>Additional criteria</b>	
<b>AC1</b>	For those countries that allow corporate ownership of banking companies: <ul style="list-style-type: none"> <li>- the supervisor has the power to review the activities of parent companies and of companies affiliated with the parent companies, and uses the power in practice to determine the safety and soundness of the bank; and</li> <li>- the supervisor has the power to establish and enforce fit and proper standards for owners and senior management of parent companies.</li> </ul>
Description and	Corporate ownership of banks is permitted in Australia and is in fact the norm.



findings re AC1	Currently, there are no banks in conglomerate groups with substantial non-financial companies in the group. As banking groups must be headed by a bank or an authorized non-operating holding company, the bank has the power to establish and enforce fit and proper standards for owners and senior management of parent companies.
<b>AC2</b>	The home supervisor assesses the quality of supervision conducted in the countries in which its banks have material operations.
Description and findings re AC2	APRA's supervisory approach involves regular liaison with host supervisors in countries where Australian banks have material operations. Currently, banks have significant operations only in the New Zealand and the UK and APRA has a close working relationship with the supervisors in each of those jurisdictions.
<b>AC3</b>	The supervisor arranges to review the foreign locations periodically, the frequency being determined by the size and risk profile of the foreign operation. The supervisor meets the host supervisors during these reviews. The supervisor has a policy for assessing whether it needs to conduct on-site examinations of a bank's foreign operations, or require additional reporting, and has the power and resources to take those steps as and when appropriate.
Description and findings re AC3	The frequency of onsite inspections of banks' offsite operations is determined by APRA's assessment of the materiality and risk profile of these operations. Where these operations are assessed as being material or high risk, or where it has identified a potential control weakness, APRA will increase the frequency and intensity of its onsite inspections and require an increased level of reporting regardless of whether a bank's operations are conducted in Australia or overseas. When APRA conducts a review of a bank's foreign operations it typically liaises with the host-country supervisor to discuss any prudential issues.
<b>Assessment of Principle 24</b>	<b>Largely compliant</b>
Comment	<p>APRA meets the requirements for effective consolidated supervision in terms of overseeing group risk management structures, being informed of breaches of prudential standards on a group-wide basis, calculating the necessary ratios on a solo and consolidated basis, etc.</p> <p>APRA should consider extending its onsite inspection of banking groups as a matter of course to cover risks unique to non-banking activities (often carried out by subsidiaries). Typical of these activities would be funds management. APRA has the right to inspect these activities and will do so if it becomes aware of issues arising with them, but it does not do so as a matter of course. Such companies are licensed by ASIC but it is understood that it does not carry out in-depth prudential inspections of them.</p> <p>While issues relating to group risk will be made known to APRA, there are certain risks which be unique to these other activities, e.g., valuation of assets and pricing of units. Such activities are generally only carried out by the very large banks and constitute only a very small part of group overall business. Nonetheless, the possibility of problems arising in these areas and going undetected by APRA through the absence of onsite inspections exists and could lead to, for example, contagion or reputational risk. It is recommended that APRA's onsite inspection regime be extended to cover these activities.</p>
<b>Principle 25</b>	<b>Home-host relationships.</b> Cross-border consolidated supervision requires cooperation and information exchange between home supervisors and the various

	other supervisors involved, primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards as those required of domestic institutions.
<b>Essential criteria</b>	
<b>EC1</b>	Information to be exchanged by home and host supervisors should be adequate for their respective roles and responsibilities.
Description and findings re EC1	<p>Section 56 of the APRA Act provides for the exchange of information with other supervisors subject to protection of confidential information provisions. It is APRA's policy to establish formal cooperation arrangements, mostly in the form of MOU's, with jurisdictions which have banking connections with Australia, either Australian banks having a presence in those other jurisdictions or foreign banks having a presence in Australia.</p> <p>Various mechanisms are used to foster the effective exchange of information, including face-to-face meetings, teleconferencing and participation in supervisory colleges. In recognition of the substantial presence of Australian banks in New Zealand, a Trans-Tasman Council on Banking Supervision was established in 2005. The aim of the Council is to enhance information sharing, promote a coordinated response to financial crises and guide policy advice to the respective governments on banking supervision issues. Similarly, given that some Australian banks have significant subsidiary operations in the UK, there are special arrangements with the UK FSA, which involve quarterly telephone conferences, periodic interactions between supervisors on operational issues, possible joint banks inspections and participation in relevant supervisory colleges.</p> <p>In addition to the normal degree of regular contact on supervisory matters, the frequency of interaction between Australian and overseas regulators increased during the global financial crisis.</p>
<b>EC2</b>	For material cross-border operations of its banks, the supervisor identifies all other relevant supervisors and establishes informal or formal arrangements (such as memoranda of understanding) for appropriate information sharing, on a confidential basis, on the financial condition and performance of such operations in the home or host country. Where formal cooperation arrangements are agreed, their existence should be communicated to the banks and banking groups affected.
Description and findings re EC2	APRA's policy is to establish MOU's, or equivalent, with all prudential agencies where material cross-border operations exist. Accordingly, APRA has established formal cooperation arrangements, mostly in the form of MOU's, with 22 overseas financial regulators. These formal cooperation arrangements cover sharing of confidential information, on-going supervision, and other issues such as policy development. All banks/banking groups are made aware of the existence of formal cooperation arrangements and, in general, MOUs are published on the APRA Website.
<b>EC3</b>	<p>The home supervisor provides information to host supervisors, on a timely basis, concerning:</p> <ul style="list-style-type: none"> <li>• the overall framework of supervision in which the banking group operates;</li> <li>• the bank or banking group, to allow a proper perspective of the activities conducted within the host country's borders;</li> <li>• the specific operations in the host country; and</li> <li>• where possible and appropriate, significant problems arising in the head office or other parts of the banking group if these are likely to have a material effect on the safety and soundness of subsidiaries or branches in host countries.</li> </ul>

	<p>A minimum level of information on the bank or banking group will be needed in most circumstances, but the overall frequency and scope of this information will vary depending on the materiality of a bank's or banking group's activities to the financial sector of the host country. In this context, the host supervisor will inform the home supervisor when a local operation is material to the financial sector of the host country.</p>
Description and findings re EC3	<p>APRA's overall approach to supervision is documented on its Website. In the case of host supervisors visiting Australia, presentations are made by APRA detailing its supervisory approach, particularly in relation to the Australian banks with operations in those host jurisdictions. These presentations cover, inter alia, APRA's risk based approach to supervision and its off and on-site supervisory regimes. Where supervisory colleges exist, a summary of recent prudential findings is included in agendas.</p> <p>APRA organizes conference calls with all relevant host supervisors at least annually but more typically every three to six months. APRA will provide host supervisors of subsidiaries incorporated in overseas jurisdictions with its assessment of the parent, if requested. It is also APRA's practice to invite a representative from the host supervisor to accompany APRA when undertaking an inspection of Australian banks operating in the host supervisor's jurisdiction.</p>
<b>EC4</b>	<p>The host supervisor provides information to home supervisors, on a timely basis, concerning:</p> <ul style="list-style-type: none"> <li>• material or persistent non-compliance with relevant supervisory requirements, such as capital ratios or operational limits, specifically applied to a bank's operations in the host country;</li> <li>• adverse or potentially adverse developments in the local operations of a bank or banking group regulated by the home supervisor;</li> <li>• adverse assessments of such qualitative aspects of a bank's operations as risk management and controls at the offices in the host country; and</li> <li>• any material remedial action it takes regarding the operations of a bank regulated by the home supervisor.</li> </ul> <p>A minimum level of information on the bank or banking group, including the overall supervisory framework in which they operate, will be needed in most circumstances, but the overall frequency and scope of this information will vary depending on the materiality of the cross-border operations to the bank or banking group and financial sector of the home country. In this context, the home supervisor will inform the host supervisor when the cross-border operation is material to the bank or banking group and financial sector of the home country.</p>
Description and findings re EC4	<p>Where it is the host supervisor, APRA advises the home supervisor of any material issues in its dealings with the local operations of a foreign bank and, upon request, shares its assessment of risk management systems, including the basis to set the prudential capital ratio for a foreign bank subsidiary.</p> <p>Some instances where APRA has engaged with home supervisors are: its perception of undue concentration risk on the books of a foreign bank branch operating in Australia, when viewed on a standalone basis, to ensure that the home supervisor was cognizant of APRA's views when considering concentration risk on a global basis: sharing its intention not to accredit the local operations of a foreign bank for the advanced methodologies for the calculation of regulatory capital adequacy notwithstanding the home's supervisors accreditation of the bank under the Basel II framework on a global basis.</p>
<b>EC5</b>	<p>A host supervisor's national laws or regulations require that the cross-border operations of foreign banks are subject to prudential, inspection and regulatory</p>

	reporting requirements similar to those for domestic banks.
Description and findings re EC5	<p>Foreign banks wishing to undertake banking business in Australia, must be authorized to do so by APRA, subject to meeting the requisite authorization requirements. They can establish as an incorporated subsidiary in Australia or on a branch basis. A foreign bank subsidiary is subject to the same regulatory, supervisory and reporting regime as Australian-owned banks. Foreign bank branches are, of necessity, not subject to certain prudential requirements, e.g., capital adequacy requirements but are subject to the same supervisory approach as applies to locally incorporated banks, e.g., off and on-site supervision. They are also rated under APRA's risk rating regime (PAIRS and SOARS). The foreign bank branches in Australia are prohibited from taking retail deposits (defined as an initial deposit amount of less than A\$250,000).</p> <p>Two current exemptions allow foreign banks to conduct business in Australia without being authorized and therefore subject to the APRA's prudential regime:</p> <ul style="list-style-type: none"> <li>• a foreign bank can raise funds in Australian wholesale capital markets by issuing securities subject to certain conditions (see EC3 of CP2) and under the terms of the Corporations Act which is administered by ASIC.</li> <li>• A foreign bank can operate as a "registered entity" and take money on deposit subject to certain conditions (see EC4 of CP2)</li> </ul>
<b>EC6</b>	Before issuing a license, the host supervisor establishes that no objection (or a statement of no objection) from the home supervisor has been received. For purposes of the licensing process, as well as ongoing supervision of cross-border banking operations in its country, the host supervisor assesses whether the home supervisor practices global consolidated supervision.
Description and findings re EC6	APRA will not issue an authorization to a foreign bank without consent from the bank's home supervisor. Under APRA's Authorization Guidelines, a statement need to be issued by the applicant's parent's home supervisor consenting to the application to establish a banking presence in Australia. The statement must confirm that the home supervisor supervises the parent bank and its subsidiaries on a consolidated basis in accordance with the principles set out in the Basel Concordat and that the home supervisor is willing to co-operate in the supervision of the proposed subsidiary in terms of the Concordat. In its periodic contacts with the home supervisor, APRA confirms that the latter continues to apply global consolidated supervision.
<b>EC7</b>	Home country supervisors are given on-site access to local offices and subsidiaries of a banking group in order to facilitate their assessment of the group's safety and soundness and compliance with KYC requirements. Home supervisors should inform host supervisors of intended visits to local offices and subsidiaries of banking groups.
Description and findings re EC7	APRA pursues a program of onsite prudential inspections of the overseas operations of Australian banks based on its assessment of risks, controls, etc. Over the three year period 2008/2011, an average of 10 inspections of foreign operations of Australian banks was undertaken per year. In all such cases, APRA informs the host supervisor of the intended review and ensures that host authority staff have the opportunity to accompany the inspection team and/or to take part in subsequent debriefing discussions.
<b>EC8</b>	The host supervisor supervises shell banks, where they still exist, and booking offices in a manner consistent with internationally agreed standards.
Description and findings re EC8	Australia does not allow shell companies or booking offices to operate in Australia.
<b>EC9</b>	A supervisor that takes consequential action on the basis of information received from

	another supervisor consults with that supervisor, to the extent possible, before taking such action.
Description and findings re EC9	Where a supervisory action is based on information received from another supervisor, APRA will generally consult with the relevant supervisor prior to taking action. Where prior consultation may not be appropriate, APRA will inform the relevant supervisor after the event.
<b>Additional criteria</b>	
<b>AC1</b>	Where necessary, the home supervisor develops an agreed communication strategy with the relevant host supervisors. The scope and nature of the strategy should reflect the size and complexity of the cross-border operations of the bank or banking group.
Description and findings re AC1	APRA's approach is that all communications with relevant overseas supervisors will be timely and relevant to that supervisor. This is particularly the case with the New Zealand authorities given the interdependence between the banking regimes of both jurisdictions.
<b>Assessment of Principle 25</b>	<b>Compliant</b>
Comments	APRA operates a strong cross-border consolidated supervisory regime.