

kpmg

## Inquiry into the Financial System

6 September 1996

*This submission contains 20 pages*

## Contents

<b>1</b>	<b>Introduction</b>	<b>1</b>
<b>1.1</b>	<b>Scope</b>	<b>1</b>
<b>1.2</b>	<b>Experience</b>	<b>1</b>
<b>1.3</b>	<b>Information Sources</b>	<b>2</b>
<b>2</b>	<b>Executive Summary and Recommendations</b>	<b>3</b>
<b>3</b>	<b>Supervision</b>	<b>7</b>
<b>3.1</b>	<b>Why supervise?</b>	<b>7</b>
<b>3.2</b>	<b>What is prudential supervision?</b>	<b>10</b>
<b>3.3</b>	<b>Changes to the Australian framework</b>	<b>12</b>
	Introduction	12
	Mega-regulator	12
	Lead supervisor	12
	International communication	13
	Proposed structure	13
	Independent review	15

### **Appendix I : Prudential Framework**

## Introduction

### 1.1 Scope

This submission has been prepared in response to the request for public submissions by the Inquiry into the Financial System as convened by the Treasurer of Australia.

While comments have been sought on any aspect of the Inquiry's terms of reference, KPMG have concentrated their comments on aspects of prudential supervision and regulation as we believe that these are areas upon which we have direct experience and knowledge, as indicated at section 1.2.

We have not addressed issues of operational efficiency as we believe that our annual Financial Institutions Performance Survey and Insurance Survey deal with a number of issues relevant to this aspect of the Inquiry's deliberations. We have enclosed the most recent issue of our Financial Institutions Performance Survey and will provide a copy of the 1996 Insurance Survey when it is released in late September. We also understand that industry participants and associations will be making comprehensive submissions on the efficiency - allocative, operational and dynamic - of the system.

We would welcome the opportunity to provide input at a later stage on relevant matters of detail or to expand upon any observation or recommendation that we have made. In this regard, please contact Patrick Burroughs, Partner, KPMG, 161 Collins Street, Melbourne, 3000.

### 1.2 Experience

KPMG:

- are auditors of a number of supervised and regulated financial institutions and intermediaries, including 2 of the major banks, a number of other incorporated banks, bank branches, money market corporations, finance companies, building societies, insurance companies, fund managers and other non-bank financial institutions. KPMG also provides a range of specific consulting services to the industry.
- have participated in the evolution of prudential supervision in Australian through liaison with the Reserve Bank of Australia in its continuing efforts to improve prudential supervision and in particular, its relationship with the auditors of banks. KPMG were also the authors of the 1991 report to the Attorney General's Department of Victoria dealing with the Regulatory Review of Victorian Non-Bank Financial Institutions. This review was born out of the Victorian Building Societies crisis in 1990.
- have been involved in advising on a number of institution failures such as those of Farrow and Estate Mortgage. We have also been involved in the difficulties encountered by Tricontinental, Rothwells and State Bank of South Australia.

Further, the Victorian government has outsourced prudential supervision of the Treasury Corporation of Victoria and the Rural Finance Corporation to Patrick Burroughs, a senior partner of KPMG.

### 1.3 Information Sources

Our submission draws on a number of references including:

- KPMG's submission to the Inquiry into the Australian Banking Industry, dated 11 July 1991;
- Richard Dale's "Regulating the New Financial Markets"; and

- The Australian Financial System Final Report of the Committee of Inquiry, September, 1981;
- as well as other sources which have been footnoted in the submission.

## Executive Summary and Recommendations

### 2.1 Why supervise?

#### *For systemic risk*

- 2.1.1 The fundamental risk that a society and government faces in today's increasingly globalised economy with instantaneous transfer of value and information is that of systemic risk.
- 2.1.2 There is an expectation in society that government must guard against systemic risk to protect wealth and employment.

### 2.2 What is prudential supervision?

#### *It is not functional regulation*

- 2.2.1 Prudential supervision has become an established term and function of government and this stems from deregulation of the global financial system, originally from the Basle initiative under the aegis of the Cooke Committee following the Herstatt and Franklin National Bank difficulties.
- 2.2.2 Functional regulation is concerned with a framework of rules and laws governing products, corporations and behaviour. It is not concerned with systemic risk as such or the financial prudence and integrity of an institution. These latter aspects are the focus, inter alia, of prudential supervision.
- 2.2.3 In a modern de-regulated system, one needs a matrix of both prudential supervision and functional regulation. In an analogous sense, functional regulation is the compliance officer. Prudential supervision is the risk management function.

### 2.3 Changes to the Australian framework

#### *Evolution not revolution*

- 2.3.1 Changes should be based on evolution rather than revolution with the system retaining flexibility. Supervision must be based around expertise, experience and judgement. It must be adequately funded to ensure that the right level of expertise is recruited and retained.
- 2.3.2 The framework for Australia's financial system should embrace both functional regulation and risk based prudential supervision.
- 2.3.3 The prudential supervision framework should embrace a wholly national, rather than state based, responsibility, whilst recognising the reality that Australia has a Federal, rather than unitary, system of government. It should provide for communication between regulators and supervisors and the appointment of a lead supervisor with appropriate powers vis a vis other supervisors where there are financial conglomerates.

*Proposed structure*

2.3.4 In our view, it is timely to consider a re-aligning of supervisory responsibility. We believe that the factors that should be taken into account in undertaking this re-alignment include:

- the framework that currently exists and its evolution;
- the recognition that it is institutions which fail, not functions;
- be consistent with the risks that the supervision is directed at;
- relate skill sets and expertise to the institution or function being supervised.

2.3.5 We set out below our preferred structure and a summary of the grounds on which the recommendations are made.

- Institutions most vulnerable to systemic risk

These are typically liability (deposit) based institutions, which have the privilege of accepting deposits from the public without the issue of a prospectus and have direct access to the payments system. In our view, this group would include banks, building societies, credit unions and special service providers and should come under the aegis of the Reserve Bank of Australia;

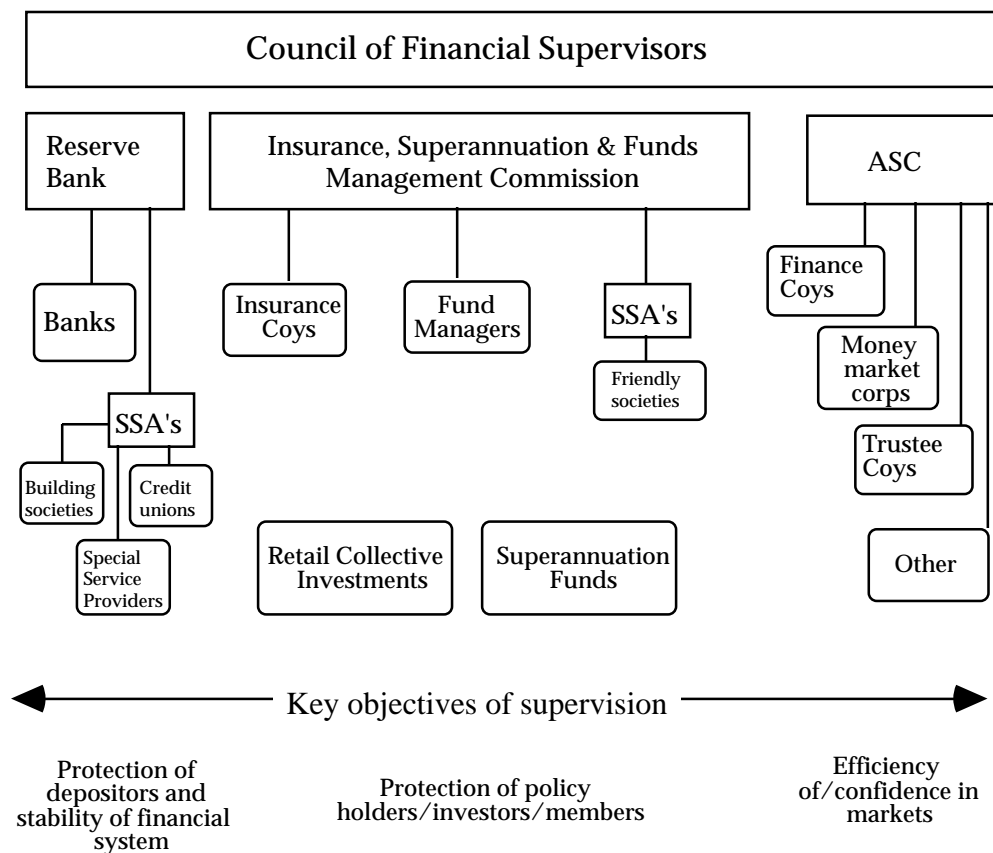
- Institutions less prone to systemic risk but where there is a need to maintain public confidence and investor protection

These are typically asset based institutions or intermediaries, which attract funds through prospectus or other disclosure documents or agency/adviser arrangements and do not have access to the payments system. This group would include insurance companies, fund managers and friendly societies. In our view, this group should come under the responsibility of a separate regulator and this would seem most appropriately the current Insurance and Superannuation Commission (appropriately re-badged). Its focus would be the protection of policy holders and retail investors/members;

- Other

For those financial institutions which do not raise funds from the retail markets or otherwise manage savings of the public, such as certain money market corporations, finance companies and finance development companies, we do not believe that there is a compelling need for a prudential supervisor. The possible query is with trustee companies which, it is arguable, should be supervised by the Insurance and Superannuation Commission, though if their principal activity is the management of estates then this would not be as compelling. For other financial institutions, as currently defined by the Financial Corporations Act, we believe the Australian Securities Commission has the appropriate skills and expertise to regulate them.

Diagram 1



- 2.3.6 The Council of Financial Supervisors has an important role and should be retained, although there may be benefit in funding a small secretariat function to assist it in achieving its objectives.

*Independent review*

- 2.3.7 Following re-alignment of the new supervisory structure, there should be an independent review of the detailed supervisory function of the Reserve Bank of Australia and the Insurance, Superannuation & Funds Management Commission similar to that of the recent independent review of the Bank of England's Supervisory and Surveillance function. This review was extensive and took some nine months. Similarly, our proposed review in Australia would be extensive, with the aim of the review being to critically assess the objectives, processes and procedures, resources and technology of the function - particularly in view of the dynamic changes in the market - and the funding arrangements necessary to support them. We assume the Wallis Inquiry is not funding such a detailed review and we are not aware of such a review having been undertaken although it is now ten years since prudential supervision of banks first commenced.

*International communication*

- 2.3.8 Australia must play its role in the evolution towards a more global, integrated, supervisory approach. Ultimately, we believe that supervision will be supra-national, with supervisors having to be as integrated as the institutions they are supervising. In this regard, we support the active participation of our supervisors and regulators in current international initiatives being led by the G7 nations.

*Other*

- 2.3.9 Whilst we appreciate that bank accounts debits tax and financial institutions duty will be subject to debate as part of the program of wider tax reform and that recommendations in respect of tax policy are not to be addressed by the Inquiry, in our opinion, these taxes are a major contributor to the perception that fees and charges charged by financial institutions are too high. In the interests of fairness, we believe it is appropriate to re-consider the levying of these taxes.



## Supervision

### 3.1 Why supervise?

3.1.1 The stability of the financial system depends on the public's confidence in the safety and soundness of individual institutions. A loss of confidence usually manifests itself in a withdrawal of deposits. This has the effect of a self-fulfilling prophecy; in the extreme, a sustained run on deposits has the capacity to bring any financial institution to its knees, no matter how irrational the concerns of depositors. Maintenance of confidence depends on public perceptions as to the:

- financial strength of individual institutions;
- judgement of those directing and managing the institutions;
- effectiveness of the regulatory and supervisory system.

A loss of confidence can impact well run institutions just as much as those that led to the loss of confidence in the first place. This is known as contagion or systemic risk.

3.1.2 We are conscious of the academic arguments as to whether systemic risk is still appropriate as a basis for financial market supervision. The difficulty in proving or disproving the argument is that, typically, action taken by prudential supervisors to guard against systemic risk has to be confidential and discreet. Indeed, this is an area where transparency would be totally inappropriate. Japan's discreet handling of their current banking crisis is a case in point.

In the last ten years, there have been sufficient instances in Australia, such as minor runs on the smaller authorised banks, and around the world, such as with the Bank of New Zealand, Credit Lyonnais in France and the Scandinavian bank crises, to demonstrate that government and authorities under-estimate systemic risk at their peril. In our opinion, the fundamental risk that a society and government faces in today's increasingly globalised economy with instantaneous transfer of value and information is that of systemic risk.

3.1.3 Deposit taking institutions, banks in particular, play, and for the foreseeable future will continue to play, a key role in the Australian financial system, whilst at the same time operating as commercial enterprises, seeking to achieve goals such as maximising profits. As a group, the decisions and policies of banks and other financial institutions made in pursuit of corporate objectives have a significant impact on the economic prospects of other commercial enterprises.

Banks provide the primary mechanism for the exchange of money and are an important conduit through which the Government implements its monetary policy. We are all impacted by banks and other deposit taking institutions to some degree; regardless of whether we are borrowers or lenders, employees, shareholders or service providers.

Given the role that banks and other institutions fulfil, the need for confidence and security in the financial system is vital. Failure of these institutions may have very real implications for the economy, and in political terms, the longevity of an incumbent government. The Victorian Labour Government's experience in the early 1990's is a case in point.

3.1.4 The potential for a systemic risk crisis is not equal for all financial institutions or intermediaries. For example,

- banks, building societies and credit unions use liquid deposits, or other short term liabilities that are often withdrawable on demand, to build an asset base that principally comprises highly illiquid loans, which normally can not be sold quickly without a loss in value.

Contrast this to securities houses and investment trusts which typically have highly liquid assets, where liquidation value is not substantially different from going concern value. In addition, arrangements such as the existence of trust accounts and market conventions of delivery against settlement minimise the risk in this area;

- institutions and intermediaries such as insurance companies and finance companies typically have longer term liabilities - not withdrawable on demand;
- access to the payments system is limited, principally to banks, and thus not all financial institutions have the capacity to disrupt the system if they find themselves in difficulty; and
- not all institutions have a lender of last resort, so problems of moral hazard are minimised in the event of their failure.

It is therefore inappropriate to supervise all financial institutions and intermediaries as if they each had the same potential to engender systemic risk.

3.1.6 However, deposit takers are diversifying such that they have investments in insurance companies, fund managers and other non-bank financial areas (or vice versa) or in certain circumstances, undertake similar activities directly. The failure of a related entity has ramifications for the deposit taker - if only to its reputation. This needs to be taken into account in determining the appropriate regulatory and supervisory framework to counter systemic risk.

3.1.7 Systemic risk can arise as a result of events related entirely to the financial system or to economic events or a combination thereof. Over time, factors influencing the source, likelihood and intensity of systemic risk have changed. Such factors include:

- the speed at which transactions occur and the magnitude of both individual transactions and the total funds flow;
- the globalisation of markets, which can mean exposure to markets over which the supervisor may have no control;
- more intense competition which alone or combined with other factors, such as deposit insurance, may encourage less prudent risk management practices; and
- the increased connections (whether as counterparties, investors etc) amongst financial institutions and intermediaries and the growing complexity of these.

In today's technological and increasingly complex world, supervising against systemic risk is arguably more onerous than it has ever been, notwithstanding the benefits that may flow from:

- the timely push for increased capital standards;
- the development of more sophisticated risk management techniques - covering not only credit, liquidity and market risks but also operational risk;

- diversification of markets, products, customers so that the issue of concentration becomes less of a concern;
  - increased financial literacy of consumers (consider that following the Pyramid building society failure, the main concerns of consumers were of banks who had previously been building societies rather than all banks) and their own diversification into transaction and investment/saving products other than at call deposit accounts;
  - the reduced dependency of banks on retail deposits to fund their activities; and
  - the development of real time gross settlement systems and other payment and settlement system developments such as multi-lateral netting, T+3 for equities, the proposed global clearing house for foreign exchange etc.
- 3.1.8 Regulation and supervision is also necessary to protect investors and policy holders, to the extent that they cannot reasonably be expected to protect their own interests. This does not require the same intensity and pervasiveness of supervision as that required to deal with systemic risk.
- 3.1.9 We recently conducted an international survey of regulation. Countries surveyed included the USA, UK, France, Germany, Spain, Italy, South Africa, Hong Kong, Japan, Malaysia, Singapore, New Zealand and Australia. One of the questions asked was what was the perceived objective of regulators. Minimising systemic risk was the number one response with maintaining reputation and integrity of the markets being the second ranked response. High standards among professionals and protection against fraud were ranked equally as third and compliance with international requirements ranked fifth.

### **3.2 What is prudential supervision?**

- 3.2.1 The terms regulation and supervision are often used interchangeably. Functional regulation is not prudential supervision.

"Regulation involves the establishment of rules of behaviour and formal business requirements. On the other hand, supervision is about enforcing regulation, monitoring behaviour of regulated firms, developing early warning systems in an industry, and generally monitoring the standards of business conduct."<sup>1</sup>

Regulation sets a framework within which supervision operates and the extent of regulation imposed has implications for the degree of discretion and flexibility that a supervisor is able to exercise.

- 3.2.2 Some argue that prudential supervision is back-door re-regulation of the financial system. This is incorrect. In a regulated financial system, governments guard against systemic risk through a myriad of very prescriptive regulation. The best example of such systems today are those in developing economies such as India or Indonesia. In a de-regulated system, prudential supervision is the key process by which systemic risk is guarded against. The majority of the industrialised economies now have de-regulated systems.
- 3.2.3 There is no common preferred or "best practice" model of regulation and prudential supervision. Each country's system is a function of economic, political and social evolution, although through globalisation of markets, a framework of common standards is starting to emerge in certain areas. The key example to date is capital and that standard, first commenced in 1988 after a number of years of study, is still evolving. Every system is a mix of prudential supervision and functional and institutional regulation. The "mix", however, is different for every jurisdiction.
- 3.2.4 What is recognised in each, however, is that it is institutions which fail and not functions. Consequently, in considering issues of systemic risk, where the risk profile of the group as a whole is important, an institutional focus is arguably the more important, but recognising that it is the function (deposit-taking and investing in longer term assets) which gives rise to systemic risk. In issues of consumer protection, functional regulation would seem the more appropriate approach. The Government's recent announcements in relation to Retirement Savings Accounts ("RSAs") whereby the prudential supervision of the institution that issues RSAs will lie with the Reserve Bank of Australia or the Australian Financial Institutions Commission but where the Insurance and Superannuation Commission will be responsible for regulatory compliance with retirement income and other superannuation standards, is an example of this. The first is concerned with financial soundness and integrity, the other with legal compliance.
- 3.2.5 In a diverse, dynamic market flexibility in any supervisory framework is going to be important. If the framework is excessively rule based, supervisors will be unable to respond quickly to changing market conditions. On the other hand, if the framework is too nebulous, confusion as to the role and responsibilities of the supervisor is bound to occur. In balancing regulation and supervision, what has become clear is that prudential supervision needs to be increasingly risk-focussed.

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<sup>1</sup> Llewellyn, David T      Regulation of Retail Investment Services : A Background Report  
 Pages 36 & 37

In making its recommendations on the Bank of England's supervision and surveillance function, the recent independent review<sup>2</sup> came out heavily in support of a risk based approach rather than an approach predicated on compliance with rules and routine inspections. The risk profile and strategies of institutions, and the environment in which they operate, are too dynamic for transaction test checking and quantitative reporting to be wholly effective. Balance sheets can change overnight, indeed even more quickly. Further, the failure of a major institution is more likely to have serious systemic ramifications than that of say, a small, localised credit union.

We note that the trend towards a risk based approach is consistent with the change in direction taken by internal and external auditors and in very recent times, by Australian supervisors. As an illustration, the Reserve Bank of Australia is currently in the process of changing its tri-partite arrangements with external auditors so as to reflect the change in their approach to a more risk based one. The Reserve Bank of Australia will, in conjunction with the external auditors, determine particular areas of risk where audit resources need to be directed.

In taking a risk-based approach, one needs to recognise, however, that while there are economic attractions because of resource allocation, issues of fairness may arise. Inevitably, smaller institutions will not receive the same degree of monitoring that they might have received under a different approach. Should that institution fail, there may be political ramifications for the incumbent government to deal with. Therefore, the economic resource argument may have to be tempered by a degree of political reality.

- 3.2.6 The Bank of England independent review recognised that for a risk-based approach to be successful, relying as it does on subjective judgments, it requires resources of the highest standard. Just as a financial institution's attitude to risk and supervision, and its ability to undertake its multi-faceted responsibilities, is shaped largely by the attitudes, calibre and expertise of its senior management, so it is with prudential supervisors.

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<sup>2</sup> Arthur Andersen Findings and recommendations of the review of Supervision and Surveillance of the Bank of England July 1996

### 3.3 Changes to the Australian framework

#### *Introduction*

- 3.3.1 Prudential supervision in Australia is still evolving. There are opportunities to improve supervisory arrangements, which will always be the case given the dynamic nature of the industry.

Such changes, though, should be evolutionary in nature, rather than revolutionary. One can not ignore:

- the extensive cost of dismantling existing systems;
- the “cultural” confusion of significant, wholesale change;
- the risk of potential under regulation during any transition phase; and
- the risk that “new” systems may be “out of date” by the time they are implemented.

Further, we note that for the banking sector (which we have argued is most obviously exposed to systemic risk and where the Reserve Bank of Australia has an explicit duty to exercise its powers and functions for the protection of depositors) that no depositor has lost any principal, notwithstanding the large loan losses which have in recent times been incurred by Australian Banks.

#### *Mega-regulator*

- 3.3.2 However, changes in financial markets do require some adjustment of the Australian system of prudential supervision. We do not believe that such change should include the establishment of a "mega-regulator".

While the concept has intuitive appeal given the globalisation of financial activities and the blurring of services between institutions and between products, we have serious reservations about its ability to work in practice. Large bureaucratic entities generally suffer from a lack of focus and an inability to respond quickly. Further, we note that none of the major jurisdictions has developed a successful mega-regulator model. These factors, and consistent with our belief that an evolutionary approach to change should be adopted, we prefer a "lead supervisor" model.

#### *Lead supervisor*

- 3.3.3 Where financial conglomerates operate, a lead supervisor should be appointed at the holding entity level, responsible for co-ordinating the consolidated supervisory effort. Where the conglomerate includes a deposit taking institution and that institution undertakes the dominant activity of the group, we believe the lead supervisor should be that responsible for that institution (most likely the Reserve Bank of Australia), notwithstanding that this may not be the parent entity. This is on the basis that it is the deposit-taking institution which is most exposed to systemic risk, which is, we argue, the core reason for prudential supervision.

The existence of financial conglomerates also means that communication between supervisors is key. In this regard, the establishment of the Council of Financial Supervisors was timely and important and its aims to "enhance the quality of financial supervision and regulation in Australia by:

- facilitating exchanges of information bearing on the efficiency and health of the financial system;
- assisting each supervisory agency to be aware of, and to understand, developments in parts of the financial system outside its particular area of responsibility;
- identifying important issues and trends in the development of the financial system as a whole; and
- avoiding unintended gaps, duplication or inconsistencies in regulation",<sup>3</sup>

are both relevant and appropriate.

Yet we note it has no formal infrastructure and resources and we query whether this inhibits its ability to progress certain issues such as development of policy on financial conglomerates. It may be appropriate to fund a small secretariat to assist it in achieving its objectives. We would not, however, like to see this expand such that the Council becomes, in substance if not in law, a mega-regulator.

*International communication*

- 3.3.4 The supervisory framework should embrace a wholly national responsibility and move towards a more global, integrated approach.

The reputation of our financial institutions in offshore markets will increasingly be influenced by the reputation of Australia's prudential supervisory system. Australia must be active in participating in the international debate on regulatory and supervisory developments, including those in connection with payment and settlement systems, and be swift to adopt those with international endorsement. In this regard, we support the recent initiatives of the Reserve Bank of Australia in promoting an Asia Pacific equivalent to Basle.

*Proposed structure*

- 3.3.5 In our view, it is timely to consider a re-aligning of supervisory responsibility. We believe that the factors that should be taken into account in undertaking this re-alignment include:

- the framework that currently exists and its evolution;
- the recognition that it is institutions which fail, not functions;
- be consistent with the risks that the supervision is directed at; that is, with supervisory objectives;
- relate skill sets and expertise to the institution or function being supervised.

- 3.3.6 We set out below our preferred structure and the basis on which we have formed our view.

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<sup>3</sup> Council of Financial Supervisors Annual Report 1995

i) Institutions most vulnerable to systemic risk

For those institutions which most pose a systemic threat, a robust, risk based approach. In our view, this group would come under the aegis of the Reserve Bank of Australia. It would include banks, building societies and credit unions. This would require the State Governments entering into a memorandum of understanding or some other legal arrangement to give their State Supervisory Authorities direct reporting lines to the Reserve Bank of Australia (similar to the arrangement which existed between the State Governments and the Reserve Bank of Australia in respect of State Banks). It effectively means the Australian Financial Institutions Commission is subsumed into the Reserve Bank but the resources supervising building societies and credit unions remain physically in their States and become State branches of the Reserve Bank's supervision division.

ii) Institutions less prone to systemic risk but where there is a need to maintain public confidence and investor protection

For those institutions or intermediaries whose systemic profile is different to deposit takers by virtue of the nature of their balance sheet and/or their management activities, the focus would be on issues of solvency and customer protection - protecting the interests of policy holders, members and investors - though the basic principle of "caveat emptor" must continue to apply to users of these financial services.

In our view, the regulatory responsibility for these institutions should probably rest with the current Insurance & Superannuation Commission, which would be appropriately re-named. The style of regulation in this area would be more compliance based, though recognising that major institutions in this sector may require a more robust, risk based approach by virtue of their size.

This group would include insurance companies, fund management companies, and the like. It would also include friendly societies which, as for building societies and credit unions, would mean the State Governments entering into a memorandum of understanding or other legal arrangement to give their State Supervisory Authorities direct reporting lines to the Insurance and Superannuation Commission. In reality, friendly societies are not numerous in Australia and tend to be largely a Victorian phenomenon at present.



iii) Other

For those financial institutions which do not raise funds from the retail market or otherwise manage savings of the public, such as certain money market corporations, certain finance companies and finance development companies, we do not believe that there is a compelling need for a prudential supervisor. For finance companies raising funds through the issuance of debentures, the current arrangements with respect to trustee and other "protection" arrangements would appear adequate and for practical purposes, do not seem to demand a change in regulator. The possible query is with trustee companies which, it is arguable, should be supervised by the Insurance and Superannuation Commission, though if their principal activity is the management of estates then this would not be as compelling. For other financial institutions, as currently defined by the Financial Corporations Act, we believe the Australian Securities Commission has the appropriate skills and expertise to regulate them.

3.3.6 The proposed re-alignment would result in the following changes to the current system:

- Those institutions currently under the regulation and supervision of the Australian Financial Institutions Commission would be re-assigned to other supervisors, leading to the demise of the Australian Financial Institutions Commission. Nonetheless, the Australian Financial Institutions Commission, like the NCSC, has played an important role in the evolutionary cycle.
- The Reserve Bank of Australia would add building societies and credit unions to its responsibilities.
- The Insurance & Superannuation Commission would add to its institutional focus fund managers and friendly societies.
- The Australian Securities Commission would devolve its responsibilities for fund managers.

The changes to the current system are summarised in table form at Appendix I.

*Independent review*

3.3.7 Irrespective of whether the Inquiry decides to amend the regulatory or supervisory framework, we believe it is timely to follow the lead of the Bank of England in commissioning an independent review of the supervision and surveillance function of regulators<sup>4</sup>, most particularly of the Reserve Bank of Australia and the Insurance & Superannuation Commission upon whom so much depends.

The review undertaken of the Bank of England made a number of recommendations dealing with the approach of supervision and also with the level of skill, experience and resources. An upgrading of skills and experience, increased staffing and pay rates and an increasing technology budget, were all factors which resulted in estimates of the cost of these changes being in the order of 20 - 25% of the total costs attributed to supervision. Obviously, in undertaking such a review, a cost-benefit analysis

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<sup>4</sup> Arthur Andersen Findings and recommendations of the review of Supervision and Surveillance of the Bank of England July 1996.

would need to be made so as to ensure that supervision is both effective and efficient. In this regard, the objectives of each aspect of supervision would need to be clear.

The review should also particularly look at the supervisory challenges associated with technology and payments and settlements systems. The changes in this area are perhaps the most pronounced of all changes that have impacted the financial sector - smart cards, internet and PC banking to name but a few. It should also include a review of funding arrangements, including the recognition of any recommendations which might add to the cost structures.

Typically, such independent reviews only occur after a major institution failure or other serious disruption to the system. To our knowledge, an independent review of the kind proposed has not been undertaken of the Reserve Bank of Australia or the Insurance & Superannuation Commission and it is now some 10 years since de-regulation of the markets. We think such a review would be timely and would aid in ensuring that resources are appropriate to ensure a world class system.

**Appendix I : Prudential Framework †**

<b>Type of Financial Institution</b>	<b>Current Regulatory Authority</b>	<b>Current Main Aspects of Supervision</b>	<b>Proposed Regulatory Authority</b>
Banks	Reserve Bank	Entry, ownership, capital, liquidity, large exposures, impaired assets, open overnight foreign exchange positions, associations with subsidiaries and funds, management systems, directors	Reserve Bank
	Australian Securities Commission	Prospectus requirements, Corporate Governance	Australian Securities Commission
	ASX	Listing requirements, if applicable	ASX
Building Societies / Credit Unions	AFIC/State Supervisory Authorities	Entry , capital, liquidity, risk management, provisioning, large exposures, ownership, associations, prohibited investments	Reserve Bank/State Supervisory Authorities
	ASX	Listing requirements, if applicable	ASX
Insurance companies  Super related unit trusts/funds	Insurance and Superannuation Commissioner	Entry, solvency of statutory funds, investments in related companies, trusts, types of policies written, management structure, transfers and amalgamation and information disclosure.	Insurance, Superannuation and Funds Management Commission
Investment Trusts (non-super related)	Australian Securities Commission (regulates - does not supervise)	Prospectus and trust deed, role of funds manager and trustee, redemption procedures, liquidity (unit trusts), borrowings and capital/reserves.	Insurance, Superannuation and Funds Management Commission
	ASX	Listing requirements, if applicable	ASX

APPENDIX I

<b>Type of Financial Institution</b>	<b>Current Regulatory Authority</b>	<b>Current Main Aspects of Supervision</b>	<b>Proposed Regulatory Authority</b>
Friendly Societies	State Supervisory Authorities	Entry , capital, liquidity, risk management, provisioning, large exposures, ownership, associations, prohibited investments	Insurance, Superannuation and Funds Management Commission
Money Market Corps.	Australian Securities Commission (regulates - does not supervise)	For securities and futures dealing: capital, liquidity, dealing practices; and for borrowing: prospectus requirements	Insurance, Superannuation and Funds Management Commission, otherwise ASC
	Reserve Bank	For Forex dealing: capital, overnight exposure limits and management/ dealer expertise	Reserve Bank
Trustee Companies	State Supervisory Authorities	Qualifications and licensing, investments, borrowings	ASC, provided the dominant activity does not evolve to funds management
Finance Companies	Australian Securities Commission (regulates - does not supervise)	As for money market corps, although additional "borrowing corporation" provisions may also apply	Australian Securities Commission
	Trustees	Compliance with provision of Trust Deeds - put in place to protect the rights of debenture holders	Trustees

† Reserve Bank of Australia Bulletin - November 1990, amended