Chapter 7

PRUDENTIAL SUPERVISION[1] OF BANKS

With the accelerating pace of change, it is becoming increasingly difficult for prudential supervisors worldwide to establish and supervise adherence to prescriptive prudential standards. They face two choices:

- they can increasingly extend prescriptive regulation, in the hope that they will be able to prevent any serious problems arising; or

- they can opt for a more outcomes-oriented approach, in which they lay down guidelines and some key standards, and place greater responsibility on directors and management for the prudent management of their financial institutions.

If the approach of extending prescriptive regulation is adopted, the efficiency and flexibility of the financial system in meeting customer needs will be increasingly affected. At the same time, because such regulation inevitably lags developments in the finance industry, it is unlikely to prove effective.

This chapter, therefore, proposes that the prudential framework which applies to banks and other deposit-taking institutions should adopt the second of these options.

7.1 The Level and Degree of Prudential Supervision

7.1.1 The existing approach

The Reserve Bank's approach to supervision is set down in various prudential statements. Central to this approach is the view that:

> "the prime responsibility for the prudent management of a bank's business lies with the bank itself ... (with the Reserve Bank) ... satisfying itself that individual banks are following management practices which limit risks to prudent levels; and that banks' prudential standards are being observed and kept under review to take account of changing circumstances."[2]

The Reserve Bank also noted that:

> "Existing arrangements for prudential supervision have the advantage of flexibility in administration and can be adapted quickly to meet changing financial conditions. They also provide the Bank with a measure of discretion, which can be desirable in handling special situations."[3]

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1 See footnote 1 in chapter 6
2 *Prudential Statement A1,* paragraph 3
3 *Prudential statement A1,* paragraph 5

Notwithstanding that "ultimate responsibility for prudent management of investors' funds lies with the institutions (ie. the directors and executives) themselves"[4], the approach over the past decade for supervisors worldwide - not just the RBA - has involved prescribing rules which banks should observe. The RBA's Prudential Statements, for example, prescribe in a quite detailed manner what banks may and may not do. Examples of these are:

- Prudential Statement C1 on Capital Adequacy of Banks;
- Prudential Statement C2 on Funds Management and Securitisation; and
- Prudential Statement G1 on Banks' Associations with Non-Banks.

While there have been periodic concerns about individual banks in recent years, the existing system of prudential supervision of banks has enabled these to be resolved without loss of depositor confidence in other banks or resulting liquidity problems for the system as a whole.

As suggested at the outset of this chapter, however, the rapid pace of change in financial markets means it will become increasingly difficult to ensure the effectiveness of prescriptive regulation. This underlines the need for prudential supervision to move towards an approach which places greater emphasis on directors and management for the prudent operation of banks and gives them greater flexibility to meet the challenges of the market place.

Westpac is concerned that there are some aspects of the present approach which, although not creating major problems for banks now, may well do so in future as financial markets undergo rapid and extensive change.

7.1.2 Scope for outcomes-oriented[5] prudential guidelines

There are signs of change. The Reserve Bank has recently noted the growing recognition among international bank supervisors that

> "the more 'market-oriented' our prudential supervisory framework can be, the greater the chance of striking a sensible balance between the community's need for a sound and reliable banking system and its desire for a system which is also efficient, innovative and responsive to changing customer needs".[6]

Westpac believes the Reserve Bank should begin to move towards a more outcomes-oriented approach by reassessing whether the existing Prudential Standards should be replaced in some instances. These might comprise:

- guidelines as to expected outcomes, but with discretion for banks as to how these are achieved; and
- standards which would take account of the risk profile of individual banks.

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4 *Council of Financial Supervisors, Annual Report, 1993,* page 18

5 The term 'outcomes-oriented' is intended to distinguish between prudential requirements which prescribe actions to be undertaken, standards observed, etc. and requirements which express the outcome desired by the prudential supervisor.

6 *The RBA Perspective - Self-regulation*, G.J. Thompson, July 1996, page 3

Under this approach, the Reserve Bank would retain an important supervisory role, but one which relied more on ensuring that banks have the necessary systems in place to manage various risks and that prudential guidelines are being observed. Bank management and directors would be required to confirm compliance with acceptable risk management standards and practices.[7] Bank auditors would be used more extensively to ensure that banks are operating within any guidelines and that risk management systems are in place.

Guidelines as to expected outcomes

Some practical examples of guidelines the Reserve Bank might set down include:

- a requirement that banks have disclosure arrangements in place to ensure that customers understand the limits of a bank's guarantee concerning the performance of its funds management arm, but without specifying how this should happen;

- a broad policy concerning equity investments in non-financial enterprises but with banks being permitted to make such investments without restriction, subject to these being deducted from capital; and

- the need for banks to maintain adequate liquidity to underpin their involvement in the payments system and more generally their overall banking activities, but with banks left to determine what their level of liquidity might be and the liquid assets they might hold.

In each case, the Reserve Bank would discuss a bank's policies from time to time, to satisfy itself that its guidelines were being observed.

Standards which reflect individual bank risk profiles

Westpac believes that, as deposit-taking institutions adopt different strategies to meet the changing market place, better managed ones should not be held back by the imposition of "average" or lowest common denominator regulation. This would, for example, have large strong banks required to meet the same prudential requirements as small or weak banks, and would be counter-productive to an efficient financial system.

In cases where specific quantifiable standards are required, for example Tier 1 capital or the limit on large credit exposures, the approach to supervision should vary among institutions according to their risk profile. Thus, institutions assessed as being less risky in terms of their risk management systems[8] and skills, level of capital and quality of management, would have greater flexibility and be required to meet less demanding prudential standards than weaker institutions.

Such an approach is consistent with the Reserve Bank's decision to reserve the right to apply higher prudential requirements to newly authorised banks than those applied to well-established banks[9].

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7 This is consistent with the recent decision by the Reserve Bank to require bank CEOs to provide written "personal attestations" that appropriate risk management systems are in place and in proper use.

8 Westpac's risk management systems are described in the extract (pages 35 to 45) from its 1995 Annual Report at Appendix A.

9 *Prudential Statement J1*

It is also consistent with the Reserve Bank's interest in adopting a more flexible approach to the measurement of market exposures, based on banks' own 'value-at-risk' models rather than a standard model, in determining the capital required to underpin market risk. The Reserve Bank has also recognised that there may be scope to extend this approach:

> "If similar approaches can be adopted more widely, they offer joint prospects for supervision to become more effective while also being less prescriptive and costly for banks... For instance, moves in this direction might be possible when the standards for credit risk are revised, with the possibility of recognising bank-developed systems for credit scoring and dynamic provisioning and avoiding the need for parallel internal and supervisory systems of capital allocation."[10]

7.1.3 The benefits of a less prescriptive approach

A move to a less prescriptive approach in banking supervision generally would:

- further underline the responsibility of bank directors and management for the prudent management of their banks;
- do much to ensure that the regulatory framework is more readily adaptable to change at a time when change is becoming more significant;
- provide banks with greater flexibility in the way they conduct their business at a time when customers' needs are becoming more varied and complex and the need for flexibility is becoming greater; and
- protect against moral hazard in banking[11] at a time when greater competition and rapid changes in technology and communications may lead banks to engage in riskier behaviour.

***Recommendation 7.1*: The Reserve Bank should, wherever practicable, express prudential standards in the form of guidelines as to expected outcomes, allowing banks discretion as to how they achieve these. Observance of the guidelines would be monitored by the Reserve Bank, either directly or in conjunction with bank auditors.**

***Recommendation 7.2*: Where it is necessary for the Reserve Bank to set specific standards, these should take account of the risk profile of individual banks (and other deposit-taking institutions).**

7.2 Financial and Payments System Stability

7.2.1 Systemic risk and economic efficiency

A separate issue to the protection of depositors is the potential for a loss of confidence in one bank to spread to others by virtue of the close relationships they have with each other

[10] *Regulatory Policy Issues in Australia,* G.J. Thompson, July 1996, page 15

[11] That is, the possibility that some banks may respond to increasing competition and rapid technological change by taking greater risks in the expectation that the Government will provide support or, at least, ensure depositors are protected if things go wrong.

through the payments system. This may lead to a payments gridlock, possibly a liquidity crisis, and contraction in bank lending, with major affects for the real economy. It may also lead to the integrity of the payments system being put at risk.

Economic efficiency is likely to be enhanced where there is freedom of entry and exit from the industry. To this end, banks which are not viable should be allowed to fail. The Reserve Bank's priority should then be on ensuring that they make an orderly and timely exit.

Recommendation 7.3**: The Reserve Bank should make clear in public statements, including its Annual Report, that banks which are not soundly managed and viable will be allowed to fail.**

7.2.2 The Reserve Bank as lender of last resort

The "information asymmetries" involved in intermediating deposits mean that there is a risk that a loss of confidence can occur even in soundly managed and viable banks. The failure of these banks would clearly not be consistent with depositor protection objectives or with economic efficiency, especially if there are potentially significant systemic implications. Thus, while individual banks which are not viable should be allowed to fail, those which are viable and soundly managed should not. To this end, the Reserve Bank should make clear that:

- as a matter of course, it will be prepared to act as lender of last resort to institutions where a run occurs on what is otherwise a fundamentally sound bank, that is, where liquidity rather than solvency is the issue; and

- such support would not be available to a bank which was not in this position.

With responsibility being more clearly left with bank directors and management, as proposed above, this limitation would send a clear message to banks, and their depositors, and counteract the risk of moral hazard.

At present, the Reserve Bank has no formal lender of last resort power, but relies on its power - under Section 8 of the Reserve Bank Act - "to lend money". The Act is silent on the circumstances when the Reserve Bank might do this. By not making clear the limits to the lender of last resort power, the public perception that banks are "guaranteed" may be reinforced.

The power is clearer in New Zealand, where Section 31 of the Reserve Bank of New Zealand Act provides that:

> "The Bank shall, if the Bank considers it necessary for the purpose of maintaining the soundness of the financial system, act as lender of last resort for the financial system."

In the US, the Federal Reserve,

> "as a lender of last resort, has the responsibility for utilising the policy instruments available to it in an attempt to forestall national liquidity crises and financial panics."[12]

[12] *The Federal Reserve System,* Purposes & Functions, 1984

Westpac believes that clarifying the circumstances in which the lender of last resort power may be used is desirable, both to correct perceptions as to the extent of potential Reserve Bank support and to ensure on-going financial and payments system stability. Such clarification will also be important if the Bank takes over responsibility for supervising other DTIs.

***Recommendation 7.4*: The Reserve Bank Act should be amended to include provision of a lender of last resort power. Loans made by the Reserve Bank would be confined to soundly managed and viable banks, and where the soundness and integrity of the financial system is likely to be affected by a general loss of confidence.**

7.3 Depositor Protection

Key provisions of the Banking Act which relate to depositor protection are included in Division 2 of the Act. The main sections of interest here are:

- Section 12, which requires the Reserve Bank to exercise its powers and functions for the protection of bank depositors;
- Section 14, which provides for a range of actions which the Reserve Bank may undertake when a bank is unable to meet its obligations;
- Section 16(1), which ranks a bank's deposit liabilities in Australia ahead of all other liabilities in the event that it is unable to meet its obligations; and
- Section 16(2), which requires banks to hold assets (other than goodwill) in Australia at least equal to the amount of its Australian deposit liabilities.

The rationale for depositor protection was discussed in Chapter 5. The key element of this is the "information asymmetry" which exists, where depositors lack the information to value bank assets which are of a longer term nature than their liabilities or to assess the quality of bank liquidity management systems. A concern with all forms of depositor protection is that, in seeking to overcome this information deficiency, a public perception is created that bank deposits are "government guaranteed", when this clearly is not the case. The fact that the Reserve Bank has, on numerous occasions, indicated that neither banks or deposits held with banks are guaranteed by it or the Government appears to have had little impact on these perceptions[13].

The stability of the financial system depends critically on the community having confidence in banks. But there is a need to balance the actions taken to achieve this goal with avoiding the risk of moral hazard associated with such actions.

It is also in the interests of an efficient financial system that there be a clearer community appreciation of the extent of protection provided, as the greater the expectations about the safety of deposits with banks, the greater the pressure on the Reserve Bank to use prescriptive regulation to ensure that these expectations are fulfilled.

[13] The situation may have been further confused by the existence of a Government guarantee for the liabilities of the CBA.

Westpac recognises the difficulty of achieving a clearer community understanding of the true situation, but nevertheless makes the following recommendations:

***Recommendation 7.5*: Section 12 of the Banking Act should retain reference to depositor protection but be amended to explain clearly the limits of the Reserve Bank's responsibility, ie. that it is responsible for safeguarding, but not providing a guarantee for bank deposits.**

Section 14 of the Banking Act sets down explicitly and at length the actions the Reserve Bank **may** take if a bank is unable to meet its obligations. This includes assuming control of and carrying on the business of the bank until deposits have been repaid or it is satisfied they will be. It is important to note that this Section does not require the RBA to always assume control, irrespective of the cause. Some amendment of this Section may assist in correcting any public misconception that the RBA would always step in and that deposits are therefore guaranteed.

***Recommendation 7.6*: Section 14 of the Banking Act, which states that the RBA may assume control of and carry on the business of a bank which is unable to meet its obligations, should be retained, but with amendments to clarify the circumstances where the RBA may or may not assume control.**

Westpac also believes that Sections 16(1) and (2) should remain in place, as they provide important protection for depositors, and are explicit as to the nature of protection provided.

***Recommendation 7.7*: Section 16(1) of the Banking Act, which ranks a bank's deposit liabilities in Australia ahead of all other liabilities in the event that it is unable to meet its obligations should be retained in the Banking Act.**

***Recommendations 7.8:* Section 16(2), which requires banks to hold assets (other than goodwill) in Australia at least equal to the amount of its Australian deposit liabilities should be retained in the Banking Act.**

7.4 Entry Requirements and Ownership Restrictions

In principle, deposit-taking should be open to any institution which can meet the necessary prudential and ownership requirements. These requirements would be more stringent for banks than other DTIs, reflecting their critical position at the centre of the payments system and their access to the Reserve Bank's lender of last resort facilities. But they should not be so strict as to prevent failure (in the sense of exiting the industry without public disruption). However, even with non-bank DTIs the requirements should be sufficient to ensure confidence in these institutions on an on-going basis.

7.4.1 Banks (Shareholdings) Act

Section 10 of the Banks (Shareholdings) Act limits the proportion of voting shares in a bank which may be held by an individual shareholder (or group) to 10%, although a larger shareholding may be permitted:

- The Treasurer is required to permit a shareholding of not more than 15% of the voting shares of a bank, unless it is considered not to be in the national interest.

- The Governor-General may permit a shareholding in excess of 15%, on application by the Treasurer, if satisfied that to do so would be in the national interest.

The purpose of these requirements is to ensure that “no single shareholder (or group of associated shareholders) of a bank should be in a position to exercise an undue measure of control or influence over the policies or operations of the bank”.[14]

The Reserve Bank has specified, in Prudential Statement B1, limits on the representation of directors of bank boards, with the same broad objective in mind.

The concept of “the national interest” is silent on the criteria on which decisions are based. It is thus highly subjective, and is open to the possibility that decisions will be based on political rather than prudential concerns. Westpac believes that the rules which apply to banks and their shareholders should be transparent so as to promote certainty of decision-making. Furthermore, it is anomalous that the Government should make decisions on bank ownership, with the Reserve Bank making decisions on other prudential issues, including limits on the representation of directors of bank boards. Consequently, the Government’s role should be restricted to only being able to reject proposals where they are assessed to be not in the national interests.

***Recommendation 7.9*: The Banks (Shareholdings) Act should be amended to provide for the Governor of the Reserve Bank to:**

- **permit shareholdings of between 10% and 15%; and**
- **make recommendations to the Treasurer for approval where applicants seek shareholdings in excess of 15%. The Treasurer could only reject the proposal where it was determined that this would not be in the national interest. Applications rejected by the Reserve Bank would not be subject to appeal to the Treasurer.**

7.4.2 Minimum capital requirements for new banks

Locally incorporated entities applying for a banking authority are required to meet minimum criteria set out in Prudential Statement J1. These include the requirement that applicants should have a minimum Tier 1 capital of $50 million.

Westpac sees no reason why the minimum capital should be set at such a high level, subject of course, to applicants being able to meet the various other prudential requirements laid down by the Reserve Bank. Freedom of entry is an important potential source of competition and a capital requirement as high as $50 million may act as an unwarranted restraint on new entrants. In the US, there are a number of small banks which are effective competitors and Westpac believes that the efficiency of the financial system might be enhanced if smaller banks were permitted.

***Recommendation 7.10:* The minimum capital requirement for new banks should be reduced from $50 million possibly to as low as $20 million of Tier 1 capital, subject to new entrants being able to meet other prudential requirements laid down by the Reserve Bank, including the ability to raise additional permanent capital, if required.**

[14] *Prudential Statement B1,* October 1994

7.4.3 Restrictions on ownership by supervised mutual institutions

Institutions organised on a co-operative or mutual basis do not have the capacity to raise additional external capital, if necessary, to ensure that they can maintain an adequate level of Tier 1 capital at all times. Access to additional capital might be required for purdential and stability reasons. Mutuals should not therefore be permitted to establish or own banks in their own right. While credit unions and mutual building societies are similarly constrained, banks are different in terms of their pivotal role in the payments system and financial system more generally, and hence implications for systemic stability. The fact that the Reserve Bank may be given responsibility for non-bank deposit-taking institutions does not change this.

While not being permitted to establish or own a bank, supervised mutual institutions (eg. life companies) should be allowed to establish non-bank deposit-taking institutions, on the basis that there is also a significantly lesser risk that failure of the institution, if it were to occur, would have systemic risk implications. Prerequisites for a mutual to establishing a non-bank deposit-taking institution would be that:

- the directors and senior management have a proven record of integrity, experience and competence;
- the majority of the Board are non-executive directors; and
- all prudential requirements to which other non-bank deposit-taking institutions are subject, are met.

The need for these requirements is to ensure that ownership and the way the institution operates are conducive to the preservation of confidence in the institution concerned.

***Recommendation 7.11*:** **Existing policy which prohibits mutual organisations establishing or owning banks in their own right should be preserved, but supervised mutuals should be permitted to establish a non-bank deposit-taking institution so long as all prudential requirements are met.**

7.4.4 Restrictions on ownership by non-financial enterprises

Existing Reserve Bank policy is not to permit non-financial enterprises to own banks because of the risk this creates for the safety and soundness of the financial system and depositor protection. As a result of the circumstances surrounding the collapse of Pyramid Building Society, this concern to restrict ownership by non-financial enterprises has been carried through in the Financial Institutions Scheme.

Overseas, the degree of regulation of ownership of banks by non-financial enterprises varies, in part because the focus of prudential supervisors has been “downstream”, i.e. on the activities of banks themselves. The majority of countries maintain controls on ownership linkages for two major reasons:

- concerns about undue concentration of economic power; and
- the risks associated with potential conflicts of interest and self-dealing.

Restrictions on ownership of banks may be seen as reinforcing competition policy in restricting the concentration of economic power. It prevents, for example, a major industrial or commercial company acquiring a bank and forming a conglomerate which could exercise considerable political and economic power.

At the same time, there is the risk that a bank which is owned by a major industrial or commercial company may be inclined not to treat applications for loans by its parent or other affiliated companies in the same arm's length way as it would other customers. This could add to the risks carried by the bank, with potentially adverse implications for depositors.

It follows that efficiency and stability would better be achieved by continuing to restrict ownership of banks and other deposit-taking institutions by non-financial enterprises and by allowing banks greater flexibility in the way they respond to the challenges of the market place.

However, where no institutional guarantee is involved, there should be no restriction on entry, subject to complying with rules and protocols.

***Recommendation 7.12*: Non-financial enterprises should not be permitted to establish deposit-taking institutions, and their participation in bank ownership should continue to be limited under the Banks (Shareholdings) Act.**

***Recommendation 7.13*: Where there is no institutional guarantee, there should be no restriction on entry to the financial sector, subject to compliance with rules and protocols.**

7.4.5 Foreign ownership of banks

Despite the importance of banks to the Australian economy, the issue of foreign ownership of banks is not one which appears to raise any major concerns relating to competition or efficiency.

There is likely, however, to be some community sensitivity if a foreign bank were to acquire an Australian bank of any size. This sensitivity is shared throughout OECD countries. As a result, most countries have maintained restrictions on foreign ownership of domestic banks, while having liberalised the establishment of direct branches or subsidiaries of non-resident banks.

In Australia, the ability of a foreign bank to acquire a domestic bank is restricted under the Banks (Shareholdings) Act and under the Foreign Takeovers Act. That is, the Government has the ability to assess any such proposal both from a prudential and a national interest perspective through its control over bank shareholdings and its foreign investment powers.

***Recommendation 7.14*: Foreign ownership of banks should continue to be subject to control under the Banks (Shareholdings) Act and under the Government's foreign investment policy.**

7.5 Equity Investment in Non-Financial Companies

Prudential Statement G1 on Banks' Associations with Non-Banks (December 1995) expresses the Reserve Bank's view that "a bank's equity associations with other institutions should normally be in the field of finance". Such associations are required to be financed from shareholders' funds and, where they exceed 10%, are required to be referred to the Reserve Bank for comment before a firm commitment is made.

Banks are permitted to make equity investments in *non-financial businesses* up to a maximum of 5% of Tier 1 capital without prior reference to the Reserve Bank. Individual investments are generally subject to a limit of 0.25%.

This requirement has its origins in the regulatory concern to ensure the adequate separation of the financial and non-financial sectors. In addition to the rationale discussed in that Section, the specific concerns in this area are threefold[15]:

- large equity investments can result in heavy losses;
- the use of depositors funds to make equity investments could have an adverse impact on the bank's solvency and hence the bank's primary function as an intermediary of loanable funds; and
- the financial position and credit standing of a bank can be adversely affected if an affiliated non-financial (or financial) company has difficulty.

Potential conflicts of interest also arise, for example, when a bank extends credit to a corporation in which it simultaneously has a major equity investment.

It is not surprising therefore to find that participation by banks in non-financial enterprises is the most strictly controlled area of ownership regulation in OECD countries. Most countries have strict controls that severely limit such equity investments by banks.

While this approach has not represented a major constraint for banks in Australia, it may do so as the financial system evolves. For example, it is likely that, in future, banks may look to strengthen their competitive position by forming links with companies involved in activities which are increasingly integrated with banking. These may include technology companies, telecommunications companies, data processing companies, and so on.

Banks will need the flexibility to determine the best way to pursue their strategic objectives in these circumstances - through joint ventures, less formal alliances or in-house development. This would best be achieved by ensuring that a broad definition of what comprises "the field of finance" is observed by the Reserve Bank, having regard for the changing market place. This would mean that proposed investments in such companies would be subject to the pre-commitment notification requirement where they exceed 10%, with the Reserve Bank having the right to approve investments above this level.

[15] *Banks under Stress*, OECD 1992, page 90

***Recommendation 7.15*: Prudential Statement G1 on banks' associations with non-banks should be retained, but the Reserve Bank should adopt a flexible approach to determining what activities fall within "the field of finance", having regard for the changing market place. It should be willing to approve investments by bank holding companies which exceed 10% where these fall within "the field of finance", and do not pose a threat to the stability of a bank.**

7.6 Supervision of Diversified Financial Organisations[16]

The approach to the supervision of diversified financial organisations was discussed in Chapter 6, where it was recommended that:

- banks should be permitted to establish non-operating holding companies;
- lead regulators should be used in supervision; and
- the powers and responsibilities of the Council of Financial Supervisors should be strengthened.

This section looks at specific requirements which affect the efficient operation of diversified financial organisations.

7.6.1 Capital adequacy for diversified financial organisations

The issue of how capital is treated within a group, having regard to the need to avoid double counting, was considered in 1995 by the Tripartite Group of Securities, Insurance and Bank Regulators. This group concluded that a group-wide capital perspective could be achieved in either of two ways:

- a 'consolidation' approach, in which assets and liabilities of individual companies within a group are consolidated, with capital requirements being applied to the consolidated entity at the holding company level; or
- a 'solo-plus' approach, in which capital requirements are determined for individual entities within a group by their respective regulators. The solo supervision of these entities would be complemented by a general qualitative assessment at the holding company level. In theory, the capital requirement at the holding company level would be less, unless the risks associated with the subsidiaries were perfectly correlated.

There is no international consensus at this time as to the best approach. The Tripartite Group noted that, in general, supervisors of banks and securities companies tend to take more of a 'consolidation' view than their counterparts in the insurance sector. [17]

[16] These are called **financial conglomerates** by the Reserve Bank, as well as supervisory authorities in all OECD countries. Those involving banks can take several forms: a bank holding company, where a bank acts as a holding company as well as an operating entity; or a non-operating holding company, where the bank and other operating entities are subsidiaries. Supervision relates specifically to the bank, but also in varying degrees can involve the activities of the related entities within the group.

[17] In the UK, US and Canada capital standards apply to the consolidated entity, although supervision in the UK is on a solo basis.

Recommendation 7.16: **When regulating diversified financial organisations, a 'consolidation' approach should be adopted, where the assets and liabilities of individual companies in a group are consolidated for assessing capital adequacy requirements.**

7.6.2 Separation of functions within diversified financial organisations

The remaining issue with diversified financial organisations is whether there is a need for prescriptive regulation to minimise the risk of contagion. Prudential Statement C2 on Funds Management and Securitisation rightly emphasises the importance of disclosure so that investors are aware that their investments are subject to investment risk and do not represent deposits of the parent bank. This minimises the possibility of investors assuming they have a right of recourse beyond the bank's legal obligations.

However, the annex to the Prudential Standard, which sets out the detailed guidelines to be followed with both funds management and securitisation, comprises 100 sections and is very complex. This is despite the view in the covering statement that

> "the prime responsibility for the prudent participation of a banking group in funds management and securitisation activities rests with the board and management of the bank and the board and management of any other members of the banking group involved in these activities". (paragraph 9)

Westpac believes that this approach is unnecessarily prescriptive and complex and conflicts with the Reserve Bank's desire to shift increased responsibility to directors and management. There is also no evidence that customers of Australian banks' funds management arms have ever viewed the parent bank as guaranteeing capital or performance of these entities.

Detailed intervention as exists also increases the risk of moral hazard and is excessive relative to the outcome it seeks to achieve. It should be enough for the Reserve Bank to require banks to have appropriately strong disclosure arrangements in place without 100 sections of detailed guidelines. (The same principles should apply to securitisation, where investors are more experienced and do not require the same type of protection.)

Finally, as competition increases and financial markets evolve, banks will need greater flexibility in the way they approach the market. Thus, US banks are already integrating their funds management offerings with other bank products so as to provide a full service package to their customers. This provides opportunities to derive economies of scope, delivering product packages through newly emerging delivery channels.

***Recommendation 7.17*:** **Prudential Standard C2 on Funds Management and Securitisation should be simplified, replacing the existing prescriptive approach with a requirement that banks should be required to disclose the nature and limitation of the bank's obligations to investors.**

7.7 Regulatory Capital

7.7.1 Credit risk and capital adequacy

As noted in section 7.1.2, the Reserve Bank has already acknowledged the possibility of adopting a more flexible approach in determining the capital required to underpin credit risk, one which recognises bank-developed systems for credit scoring and dynamic provisioning and avoids the need for parallel internal and supervisory systems of capital allocation. Such an approach would be consistent with the approach proposed to determine the capital required to support market risk (See section 7.9.2).

Westpac believes that an efficient financial system is most likely to be achieved where the degree of supervision reflects the risk profile of the institution concerned. This is also consistent with reducing moral hazard, by encouraging directors and management to accept responsibility for the prudent management of their own institutions. Tailoring capital requirements to the risk profile of banks and other institutions will provide an incentive to ensure adoption of international best practice in such systems.

With the disaggregation of banking and, in particular, the credit function, it is increasingly practical for other providers of funds which do not have to carry so much capital to lend to companies at more competitive rates. Thus the gap between the regulatory and economic cost of capital will encourage the diversion of loan funding away from banks. To the extent that such unregulated lenders target and capture high quality customers, the overall risk profile of banks may be adversely affected.

However, it is recognised that any move to adopt a more flexible approach to capital adequacy must be in line with international prudential standards, as determined by the Basle capital adequacy guidelines.

***Recommendation 7.18*: The Reserve Bank should seek to persuade the Basle Committee for banking to adopt an approach to capital adequacy which recognises superior bank-developed systems for credit risk management, subject to these systems being of a standard acceptable to the Reserve Bank.**

7.7.2 Risk asset ratios

A second issue relates to the clear gap which exists between the regulatory cost of capital (under the Basle capital adequacy guidelines) and the level of capital which banks' loss experience and riskiness of their loan portfolio suggests is required. Improvements are possible in this area. For example, a 50% risk weighting on loans secured by housing bears little relationship to the loan loss experience. Or to take another example, the risk of lending to BHP is considered to be equal to lending to a small business, with a 100% risk weighting attaching to both. Capital requirements such as these affect bank pricing, distort financial flows and are not compatible with efficiency.

In measuring market risk, the Reserve Bank has indicated that it proposes to apply concessional risk weightings to debt issues of certain high quality corporates - "these weightings being significantly lower than applied to loans to the same counterparty".[18] Such an approach should equally apply to measuring credit risk.

[18] *Supervision of Market Risk: The State of Play, May 1996,* L. Austin, page 3

***Recommendation 7.19*: The Reserve Bank should apply its national discretion under the Basle accord and adopt risk asset ratios for credit risk which better reflect the true underlying risk for each category of lending.**

7.8 Liquidity

Since May 1985, banks have been required to hold a minimum proportion of their liabilities in specified prime assets, primarily cash and government securities. The predecessor of the Prime Asset Ratio (PAR) was the LGS ratio, which had a monetary policy objective. However, PAR is viewed primarily as having a prudential objective. Prudential Statement A1 (PS A1) states that:

> "The Reserve Bank believes that the holding by a bank of a substantial tranche of high quality liquefiable assets is fundamental to engendering public confidence in banks."

However, the precise value of PAR is confused by two - apparently conflicting - statements in Prudential Statement D1 on "Supervision of the Adequacy of Liquidity of Banks" in February 1990:

> "4. (PAR) provides a stock of cashable, undoubted assets which, with the Bank's approval, can be *quickly* converted into cash in extreme circumstances. Such stock is additional to the liquid assets which each bank needs for management of its day-to-day liquidity needs."

> "8. The PAR ratio is a fixed minimum which each bank is required to meet at *all* times."

It is now more than 11 years since PS A1 was issued, during which time there have been major advances in bank liquidity management. Not only has the quality of bank systems for managing liquidity improved considerably, but technological developments, financial market innovation and the globalisation of financial markets mean that banks have far greater access to liquidity, including through the liquefaction of existing assets. It is also more broadly understood and accepted that liquidity is much more determined by the composition and stability of deposits, than by the holding of certain liquid assets. If these assets are funded by unstable borrowings, they really provide no true liquidity.

The existence of PAR may make it easier for banks to borrow to meet sudden liquidity needs, as the existence of a sizeable chunk of high quality assets and thus lower credit risk would provide a comfort to lenders. But this does not mean that banks must hold PAR for prudential purposes. Any well-managed bank will maintain ample liquidity as part of prudent balance sheet management.

***Recommendation 7.20*: The Prime Asset Ratio should be abolished as an instrument of prudential regulation. In the case of individual banks or other deposit-taking institutions, this should be conditional on satisfying the Reserve Bank as to their liquidity management policies, programs and expertise.**

The Reserve Bank has indicated that, with the introduction of Real Time Gross Settlement for large value transactions, banks which carry out settlement will be able to make intraday borrowings against PAR. If PAR is abolished, alternative high quality liquid assets could be identified for similar intraday borrowing or rediscounting purposes with the RBA.

7.9 Regulation of Derivatives

The Australian financial derivatives market is quite large by international standards, and has become increasingly sophisticated. Much of this innovation has occurred within the banking system, which also dominates in terms of trading activity. For example, roughly 80% of interest rate derivatives dealing is accounted for by banks. The market is highly competitive, with foreign banks particularly active. Margins on mature products are thin.

Well publicised events, such as the collapse of Barings Bank, however, have brought new focus to initiatives by industry participants and regulators to upgrade the supervisory and legal framework relating to the conduct of both the OTC (over-the-counter) and on-exchange derivative markets. It is the OTC market that is of particular relevance to this Inquiry and the following discussion is restricted to that market.

7.9.1. Self regulation

The release of the Australian Financial Markets Association (AFMA) Manual in July 1996 marked a major development in the role of self-regulation in the governance of Australia's financial markets. The OTC derivatives market is one where players are sophisticated and knowledgeable, and as a professional market, it is well suited to self-regulatory arrangements and "market-friendly" supervision[19]. While there remains a case for some form of official regulation to limit systemic risk and to promote market integrity, the challenge is to get the right balance.

The AFMA Manual establishes comprehensive standards for the OTC market relating to market conventions, documentation, disclosure, code of conduct, dealer accreditation, compliance and alternative dispute resolution. It has been welcomed by the RBA as an important step forward in the regulation and conduct of Australia's financial markets.

Of particular importance are AFMA's initiatives regarding public disclosure, which are at the forefront of international best practice. These will continue the initiatives of the leading banks, which have made major advances in recent years in public disclosure of derivatives activity[20].

Recommendation 7.21: **Self regulation should continue to be the core approach for the governance of wholesale financial markets.**

7.9.2. Supervisory developments

As banks are the most important market-makers in derivatives in Australia, the RBA has major responsibility for assessing the adequacy of financial institutions' procedures for managing market and related operational risk. In line with a more market-oriented approach, the RBA has focused on ensuring banks have controls in place to address market risk and encourage self-regulation.

The RBA has also played its role in international initiatives by the Bank Committee on Banking Supervision to introduce a "Capital Accord to Cover Market Risk". The Basle Capital Accord, which will be formally implemented in Australia from the end of 1997,

[19] Supervision which, as far as possible, builds on the disciplinary processes of the market instead of imposing separate, parallel sets of rules.

[20] See Westpac's 1995 Annual Report, pages 39 - 45

recognises Banks' own internal models for the calculation of market capital changes, subject to the models meeting a range of quantitative and qualitative criteria.

Most importantly, under the national discretion in the Basle guidelines, and as noted above in section 7.7.2, the RBA has decided to apply concessional risk weights to debt issues for certain high quality corporates, with the specific risk weightings being significantly lower than those applied to loans to the same counterparty. Basically, debt securities rated investment grade by at least two approved credit ratings agencies will be regarded as qualifying for concessional risks weights.

In other supervisory developments, the Companies and Securities Advisory Committee (CASAC) issued a discussion paper in August 1995 on "Regulation of the OTC Derivatives Market" which suggested that the ASC be given a supervisory role, including assessing risk management systems. Intermediaries adequately supervised by other regulatory agencies (eg. banks) would be exempted. A detailed response to the discussion paper by the Australian Financial Markets Association (AFMA) in November 1995, raises several concerns which have Westpac's endorsement. AFMA will also be making a Submission to this Inquiry, which will cover relevant aspects relating to the CASAC initiatives.

7.9.3. Netting

The netting of exposures is an extremely important mechanism for reducing counterparty credit and settlement risk. Netting can take several forms, and in its simplest form involves counterparties agreeing to settle their obligations to each other by deducting gross payments from gross receipts and simply making the net payment. The most important form is 'close-out' netting, where an institution can legally net their obligations to a failed entity and hence minimise potential financial loss to the net amount[21].

Australia was one of the first countries to recognise the benefits of netting but is now well behind the rest of the world in establishing adequate netting provisions. The problem is that netting of financial transactions, particularly 'close-out' netting, lacks legal certainty. CASAC is preparing a report on the issue but concern exists within the industry as to whether this extremely important work, and any subsequent legislative changes required, are being given high enough priority.

Without netting, the risks for international counterparties in dealing with Australian domiciled counterparties is increased and hence the amount of business they are willing to do with Australian counterparties is reduced. Consequently, the international competitiveness of Australian institutions is in danger of being impacted.

Recommendation 7.22: **Legislative change, if required, to ensure legal certainty for netting is an immediate priority and the ASC should accelerate the process of presenting legislative proposals to the Government.**

[21] Without legally enforceable close-out netting, a firm would be required to settle all gross payments due to the failed entity, but then only rank equally with other creditors in recovering gross obligations due from the failed entity.

7.10 Asset Quality

Prudential Statement L1 provides guidelines covering various aspects of banks' asset quality, including:

- the recognition and measurement of impaired assets;
- security valuation and provisioning; and
- credit risk grading systems.

The statement is largely concerned with establishing a set of minimum standards, with common language and methodology. In Westpac's view, this enhances the prudential management of banks generally, as it standardises industry data and enables banks to ensure their standards are appropriate.

In the final part of the Statement, the Reserve Bank acknowledges that banks generally have developed grading systems that best fit their individual product mix. It therefore "recommends" the implementation or upgrading of credit risk grading systems and provides guidelines as to points which should be considered when doing so.

This approach is non-prescriptive, represents good practice and is useful. It is also consistent with the more market-oriented approach to setting prudential guidelines proposed in section 7.1.3 of this Submission.

***Recommendation 7.23*: The Prudential Statement L1 on asset quality should be retained without amendment.**

7.11 Funding the Cost of Prudential Supervision

Other deposit-taking institutions, life offices and superannuation funds are currently required to meet some or all of their costs of supervision. It would be consistent with the principle of competitive neutrality for banks also to be required to meet those costs incurred by the Reserve Bank in the context of their supervisory responsibilities. However, any costs borne by banks in acting as agent for Government (see chapter 12) should be credited against this fee. If necessary, an assessment of such costs could be determined by an annual audit of several banks.

***Recommendation 7.24*: Banks should meet the costs incurred by the Reserve Bank in the discharge of its responsibilities for prudential supervision.**

***Recommendation 7.25*: Any costs borne by banks in acting as agent for government should be offset against this fee, or separately reimbursed by government.**

7.12 Payment of Interest on Non-Callable Deposits

Banks are required to keep with the Reserve Bank non-callable deposits equivalent to 1% of their liabilities (excluding capital) in Australia. Since 1 July 1995, the rate paid on these deposits has been set at 5% below the average yield at tender in the previous month on 13-week Treasury notes. The cost to banks was expected to amount to $185 million in 1995/96[22].

While the Reserve Bank has previously indicated that payment of a below-market rate on NCDs was a payment for the benefits accruing to banks from being authorised and subject to Reserve Bank prudential supervision, the Governor of the Reserve Bank has recently acknowledged that "it is essentially a budget revenue raising measure" and that customers bear the cost[22].

There is clearly no case for this impost on prudential, monetary or tax policy grounds. In particular, there is no case on efficiency or equity grounds for a special tax on banks. The NCD tax should immediately be abolished.

***Recommendation 7.26*: The requirement for banks to maintain Non-Callable Deposits with the Reserve Bank at a penalty rate represents a special tax on banks and should be abolished.**

[22] *Financial Regulation and the Financial System Inquiry,* Reserve Bank Bulletin, July 1996