FINCOM

FINANCIAL SYSTEM INQUIRY

SUBMISSION BY

NSW FINANCIAL INSTITUTIONS COMMISSION

Contacts: Bill Gole
Chief Executive

Karin Hawkins
Manager, Prudential Supervision

(02) 9247 2100

(02) 9247 6767 (Fax)

9 September 1996

CONTENTS

1. EXECUTIVE SUMMARY 2

2. TERMS OF REFERENCE 2

3. INTRODUCTION 2

3.1. Lead Regulator 2

3.2. Super-Regulator 2

4. FINCOM'S ROLE 2

4.1. Within the FI Scheme 2

4.2. As Supervisor of other State based Institutions 2

4.3. FINCOM's Relationship with Industry 2

5. THE NEED FOR STATE BASED SUPERVISION 2

5.1. Convergence and Competition 2

5.1.1. Convergence at the Top End of the Market 2

5.1.2. Consumer Choice and Competition 2

5.2. The Unique Nature of the Industries 2

5.3. Depositor/Investor Protection 2

5.4. Functional vs Institutional Supervision 2

6. SUCCESS OF THE FI SCHEME MODEL - KEY ATTRIBUTES 2

6.1. Administrative Gains 2

6.2. Benefits to Industry 2

6.2.1. Competitive Neutrality 2

6.2.2. Depositor Protection and Industry Stability 2

6.2.3. Cost-effective Supervision 2

6.2.4. Consultation with Industry 2

6.2.5. Increased Sophistication 2

6.3. Opportunities to Improve the FI Scheme **2**
6.3.1. Structure of the FI Scheme 2
6.3.2. Permanent Capital and Operational Restrictions 2

7. APPLICATION OF FI SCHEME MODEL **2**

7.1. Key Attributes of the FI Scheme **2**
7.1.1. Structure 2
7.1.2. Transition Period 2
7.1.3. User Pays 2
7.1.4. Separate Consumer Protection Function 2
7.1.5. Consultation 2
7.1.6. On-ground Supervision 2

7.2. FI Scheme Model is Equally Applicable to Other Industries **2**

8. EFFECTIVE ON-GROUND SUPERVISION **2**

8.1. Cost-Effective Supervision **2**

8.2. Supervisory Approach **2**

8.3. Sound Knowledge of Industries Supervised in NSW **2**

8.4. Wide Skills Base **2**

8.5. Adaptability to Industry Change **2**

APPENDIX A **2**

APPENDIX B **2**

APPENDIX C **2**

APPENDIX D **2**

APPENDIX E **2**

APPENDIX F **2**

1. EXECUTIVE SUMMARY

FINCOM's Submission

The Financial Institutions (FI) Scheme has proven to be a most effective means of supervising state based financial institutions and should be retained or its essential characteristics incorporated into any new structure of supervision. The main advantage of the Scheme is that supervisors have the autonomy and discretion required to respond quickly to changes in the business environment of institutions, which is inexorably tied to regional economic, political and market factors.

The FI Scheme has proven to be successful because its structure is both flexible and responsive. It is characterised by the following:

- an independent standard setting body;
- a separate on-ground supervisor ensuring that those standards are met through an inspection process which tests the operations of the financial institution;
- a high level of autonomy or discretionary powers for the on-ground supervisor to ensure responsiveness and flexibility;
- a consultation ethic between supervisors and industry;
- full exposure and disclosure to industry and on-ground supervisors in the standard setting process;
- transparent funding arrangements; and,
- a transition period at the commencement of the Scheme which assists in the maintenance of industry stability as institutions adjust to new prudential standards.

The FI Scheme model not only applies to deposit taking institutions but can also apply to other financial institutions. It has already been successfully applied to conglomerates such as friendly societies whose operations are wide-spread and include funds management, health insurance, and aged care facilities to name a few.

Unique Nature of Institutions

Whilst it is evident that convergence is occurring at the top end of the financial market spectrum, it cannot be said that it is occurring to the same degree with smaller financial institutions such as building societies and credit unions.

Although smaller institutions are moving into a broader range of products, the essential character of the institutions is not being altered as is increasingly the case with larger national organisations. Smaller financial institutions provide an alternative for consumers who continue to desire personalised service, regardless of the availability of technologically advanced financial products and service delivery. These financial institutions are increasingly filling the gap in regional and rural areas.

Characteristically these institutions are relatively small and lacking in the critical mass required to sustain an effective service delivery infrastructure. They are, therefore, reliant on industry bodies and the combined strength of the whole industry to remain competitive. They are also very much exposed to the risk of contagion if one member of the industry suffers commercial instability or loss.

Under a regulatory system where there is no differentiation between financial institutions, the unique nature of these institutions may not be recognised, resulting in competitive disadvantage to these institutions due to size or other factors.

These distinctions support the need for the state or regional based supervision of these industries.

Industry/Institutional Viability

An effective regulatory regime must focus on the financial integrity and on-going viability of the whole institution and "functional" or "product" issues should be addressed through standards commonly applied by all regulators.

Demand exists for consumer protection to cover financial products and their delivery. Since consumer protection does not necessarily have a bearing on prudential issues in all cases, this role should remain separate from prudential supervision.

Credit unions and building societies rely heavily for their success on the continued confidence of depositors and the stability of their industry. Such confidence and stability can only be maintained by commercially sound and viable participants. Viability can only be determined through a process of ongoing direct supervision at an institutional level, where the key risk areas of a financial institution can be assessed and monitored.

These industries are prone to contagion effects should another society fail, and as systemic risk is generally restricted to these institutions and does not extend to larger financial institutions, such as banks, there remains a need for these institutions to be supervised under a regime that is responsive to the unique risks associated with them.

A key achievement of the FI Scheme in NSW is that no depositor has lost funds through the failure of an institution to date.

Benefits to Industry

The FI Scheme has already provided significant benefits to the credit union and building society industries in NSW in terms of competitive neutrality. These include:

- removal of discriminatory legislation;

- granting of Trustee status;
- access to the payments system;
- reduced barriers to interstate trading.

FINCOM also has a strong relationship with the industries it supervises. These institutions understand the need for supervision and acknowledge the increased public confidence which supervision under the FI Scheme has provided to their industries.

Depositor Protection

There is a community perception that State Ministers have a moral responsibility to ensure the viability of regionally based financial institutions and to protect depositors. In the event of any recommended change to the current FI Scheme structure by the Inquiry, there should be a clear understanding and articulation of the accountability trail within the regulatory and supervisory structure.

State governments are unlikely to favour relinquishing prudential oversight of such institutions if it is likely that they will be held accountable in the event of failure.

Cost Effective

The cost of supervision under the FI Scheme in NSW, both in real terms and in absolute terms, has fallen steadily since the Scheme's inception. Supervision levies for credit unions have fallen (on a net basis) by over 50% since 1993. In the same period, levies for building societies have fallen by 82.5%.

Whilst costs are falling, benefits continue to be provided which improve the competitive position of the industries. These include removing discriminatory legislation (in NSW) and direct access to the Payments System. It can reasonably be expected that benefits will continue to accrue as the Scheme matures.

Opportunity for Review

Whilst the FI Scheme is a good model of supervision and has worked well to date, the Inquiry provides a timely opportunity to review some aspects of the Scheme. The operation of the Scheme could be streamlined in a number of areas:

- transferring all "prudential" and "character" provisions to the Prudential Standards from the FI Code; and,
- incorporating FI societies under the Corporations Law. The ASC would then be responsible for the corporate regulation of these institutions.

Other Industries

The FI Scheme model also allows State governments to continue to use SSAs for the supervision of co-operative housing societies as is currently the case in NSW and Queensland and other industries.

It is crucial that the Inquiry address the level of prudential supervision of superannuation funds. Given that superannuation is now compulsory and is to increase over coming years, FINCOM submits that there is a need for increased prudential supervision in this area. In short, the depositor protection argument now extends to superannuation contributions.

Conclusion

The FI Scheme provides a state based approach to supervision which is the most effective and efficient means of maintaining a high quality of prudential supervision for small, retail-based financial institutions. The unique characteristics of these institutions demands supervision of a different nature than is required for larger national institutions.

Accountability for these industries currently rests with State Governments. Changes to this accountability would have to be clearly articulated and agreed so that the community is made aware of the limits of redress through State Governments.

The FI Scheme is cost effective and has already provided a number of benefits to the industries involved although there is room for improvement in its implementation. The FI Scheme also provides a good model of supervision which is applicable to other industries and any system of prudential supervision should incorporate the essential characteristics which have contributed to the success of the FI Scheme.

2. TERMS OF REFERENCE

TERMS OF REFERENCE	FINCOM SUBMISSION
1. Results arising from the financial deregulation flowing from the "Campbell Report" in 1981. Examining and Reporting consequences for:	
1a. the choice, quality and cost of financial services available to consumers and other users.	No submission on this aspect of the Inquiry.
1b. the efficiency of the financial system including its international and domestic competitiveness.	i. In regard to international competitiveness, building societies and credit unions should not be precluded from offshore activities, provided they meet appropriate prudential requirements. ii. Remaining barriers to interstate trading for credit unions and building societies should be removed. iii. The FI Scheme is relatively new, and the full benefits of its maturation are yet to be realised. However, early benefits have resulted in removing a number of competitive disadvantages. **Principal References: Section 6.2**
1c. the economic effects of deregulation on growth, employment and savings.	No submission on this aspect of the Inquiry.

1d. the evolution of financial institutions and products offered by them and the impact on the regulatory structure of the industry.

i. There has been convergence in financial markets at an institutional and product level, and this will continue especially if access to superannuation savings is gained by deposit taking institutions. However, much of the convergence is between the larger institutions. While smaller institutions are moving into a broader range of products, it is on a smaller scale and is not changing the essential character of the institution as is increasingly the case at the larger end of the spectrum.

ii. There continues to be operational and cultural characteristics unique to smaller financial institutions that support a continuing need for institutionally based regulation of financial institutions.

Principal References: Sections 5.1 and 5.2

2. Issues driving further change:

2a. technological and marketing advances.

i. Technological advances have provided opportunities for all financial institutions, but their impact has not been as far-reaching as may have been expected, especially for smaller financial institutions.

ii. There will be a continuing niche for small, less sophisticated financial institutions focussed in regional markets.

Principal References: Section 5.1.2

2b. international competition and integration of financial markets.

International competition is covered in 1b.
Domestic convergence is covered in 1d.

2c. domestic competition in all its forms.	i. The FI Scheme has provided significant administrative gains and benefits to credit unions and building societies, and moved them closer to a position of competitive neutrality. Further benefits will accrue as the Scheme comes to maturity. ii. other discriminatory legislation throughout Australia should be removed. iii. Remaining barriers to interstate trading should be removed. **Principal References: Section 6**
2d. consumer needs and demand.	i. Consumers should have the right to choose smaller financial institutions safe in the knowledge that the institutions are viable. ii. The consumer protection role should be completely separate from prudential supervision. **Principal References: Sections 5.1.2 and 7.1.4**

3. Recommendations of Regulatory Arrangements and other matters affecting the operation of the financial system:

3a. best promote the most efficient and cost effective service for users, consistent with financial market stability, prudence, integrity and fairness.	i. The institutional approach to prudential supervision is fundamental to systemic stability and depositor protection, and must be retained. ii. The for the success of the FI Scheme should be incorporated in any key factors responsible model of prudential supervision. **Principal References: Sections 3, 5.3 and 6.**

3b. ensure that financial system providers are well placed to develop technology, services and markets and that the financial system regulatory regime is adaptable to such innovation.	The FI Scheme model is an effective supervisory structure, and is adaptable to other industries and circumstances. **Principal References: Section 7**
3c. provide the best means for funding the direct costs of regulation.	Regardless of the costing mechanism, the transparency of funding arrangements is critical. Funding of direct costs should be undertaken on a user-pays basis. This is achieved in the FI Scheme by institutions paying levies based on asset size. **Principal References: Sections 8.1 and 7.1.3**
3d. establish a consistent regulatory framework for similar financial functions, products or services which are offered by differing types of institutions.	i. There is a continuing need for institutionally-based regulation of financial institutions. ii. Several unique characteristics combine to make the FI Scheme a successful model of supervision and any regulatory structure recommended by the Committee should incorporate those key success factors. iii. An effective regulatory regime must focus on the financial integrity and ongoing viability of the whole institution with “product” and “functional” issues addressed through common standards. **Principal References: Section 5 and 7**

4. Other issues for consideration:

4a.	the objectives or procedures of the Reserve Bank in its conduct of monetary policy.	No submission on this aspect of the Inquiry.
4b.	retirement income policies.	i. All deposit-taking institutions should be able to offer retirement savings products. ii. The depositor protection principle should be extended to superannuation fund management in light of the compulsory nature of superannuation. There is scope for more rigorous prudential supervision in this area. **Principal References: Section 7.2**
4c.	the regulation of the general operation of companies through corporations law.	No submission on this aspect of the Inquiry.
4d.	policies for the taxation of financial arrangements, products or institutions.	Taxation should neither confer not take away competitive advantages of institutions.

3. INTRODUCTION

The Financial Institutions (FI) Scheme has been a successful and effective model for the prudential supervision of state based financial institutions primarily because of its focus on individual institutions which operate in a commercial environment strongly influenced by regional economic and market factors. ~~must be considered by the Inquiinfluenced by~~

There are several key factors which have contributed to the Scheme's success and which make it the most effective means of supervising state based institutions. These factors are:

- an independent standard setting body determining prudential standards;
- separate on-ground supervisors ensuring that those standards are met through an inspection process which tests the operations of the financial institution rather than relying purely on disclosure or analysis of financial statements;
- a high level of autonomy or discretionary powers for the on-ground supervisor to ensure responsiveness and flexibility;
- structured consultation between the standard setter and on-ground supervisors;
- full exposure and disclosure to industry and on-ground supervisors in the standard setting process;
- a period of transition on the introduction of the Scheme;
- industry consultation in establishing the Scheme and in its ongoing development; and
- transparent funding arrangements.

Whilst the Scheme has worked well to date, the Inquiry provides a timely opportunity to revisit some of the operational arrangements to provide greater efficiencies in the Scheme's operations. These are addressed in the body of the submission.

It is expected that the Committee will consider a number of regulatory structures, principally the "lead regulator" or "super regulator". FINCOM contends that any structure recommended by the Committee will benefit from the incorporation of the above key factors.

It is imperative that any change to the regulatory structure does not diminish the quality of prudential supervision which currently exists. Additionally, there be no legislative impediments to the free exchange of information among regulators and supervisors.

3.1. **Lead Regulator**

The "lead regulator" option for prudential supervision recognises that financial conglomerates are playing an increasingly important role in the financial system. While this is true in Australia, it is occurring among the larger and more sophisticated financial institutions.

Under this model, one prudential supervisor would have primary oversight of a financial conglomerate's activities, with specific reference to other supervisors, should their functional areas overlap. This would not significantly affect the majority of institutions currently supervised under the FI Scheme.

The advantage of a lead regulator model is that regulatory authorities maintain the autonomy to deal with the institutions under their jurisdiction. This enables regulators to respond rapidly to changes in the operating environments of their specific industries and to maintain institutional and industry integrity.

The FI Scheme would be retained under this option.

3.2. **Super-Regulator**

The second option is that prudential supervision of financial institutions could be undertaken within divisions of a "super-regulator".

The "super-regulator" issue was raised by the Martin Inquiry of 1991, which recommended that all financial intermediaries with assets greater than A$1 billion be supervised by the Reserve Bank of Australia. This recommendation was not pursued either by the Federal Government of the day, or by regulatory authorities.

A super-regulator, however it may be defined, would effectively nationalise the FI Scheme, which may have the advantages of centralised decision making, uniformity and cost economies. On the other hand, a larger organisation could be viewed bureaucratic and remote, as opposed to an efficient decision-making body. The regional knowledge which is of particular relevance to the institutions supervised by FINCOM, would also be lost over time.

The Committee must determine the level and quality of supervision a "super regulator" can deliver to institutions which are small and regionally based. No regulatory regime should be responsible for the demise of institutions it supervises, especially as those institutions provide an important alternative for consumers.

FINCOM contends that:

- the key characteristics of the FI Scheme must be considered as an integral part of any supervisory structure especially under a “super regulator”; and
- that there is a strong case for the State supervision of smaller, less sophisticated institutions.

4. FINCOM’S ROLE

4.1. Within the FI Scheme

On 1 July 1992 the Financial Institutions Scheme (FI Scheme) was introduced to provide a national framework for the supervision and regulation of building societies and credit unions throughout Australia.

This framework consists of:

- a Ministerial Council (MINFIN), responsible for oversight of the Scheme;
- a national standard setting body, the Australian Financial Institutions Commission (AFIC);
- the Interstate Consultative Committee (ICC), a forum for discussion and development of policies; and
- a State Supervisory Authority (SSA) in each State responsible for on-ground supervision.

The New South Wales Financial Institutions Commission (FINCOM) is the State Supervisory Authority in NSW.

For further information on the FI Scheme and FINCOM’s role refer to Appendix A.

4.2. As Supervisor of other State based Institutions

FINCOM also supervises other state based financial institutions under State legislation. These are Friendly Societies and Co-Operative Housing Societies.

4.3. FINCOM’s Relationship with Industry

In June 1996, FINCOM commissioned an independent survey to determine the attitude of its constituents to the manner in which FINCOM fulfils its role. These constituents included both societies and key industry associations.

The key finding of the Survey is that the institutions supervised by FINCOM understand the need for supervision and acknowledge the increased public confidence which supervision under the FI Scheme has provided to their industries. Whilst supervision is seen as a necessary evil, FINCOM's constituents appreciate the professional and constructive manner in which the supervision function is performed.

Refer to Appendix B for more details.

5. THE NEED FOR STATE BASED SUPERVISION

Prudential supervision conducted under the FI Scheme is detailed and effective and gives weight to all the material areas of risk within a financial institution.

Regardless of any changes to the structure of the prudential supervision framework for financial institutions in Australia, there remains a need for state based supervision. This is especially so for smaller institutions currently supervised under the FI Scheme, which vary so much in scope and sophistication.

The arguments for state based supervision are:

5.1. Convergence and Competition

5.1.1. Convergence at the Top End of the Market

It is FINCOM's contention that convergence is occurring at the top end of the financial markets spectrum, which will accelerate if financial intermediaries gain access to superannuation savings. This is not happening to the same extent with smaller financial institutions such as building societies and credit unions.

While smaller institutions are moving into a broader range of products, the essential character of the institutions is not being affected as is increasingly the case with larger national organisations.

There continue to be operational and cultural characteristics unique to smaller financial institutions, which distinguish them from larger institutions and to some extent from each other.

The lack of critical mass of these institutions means that they are not able to compete at the individual level with banks and life offices in providing a wide range of financial services. In many cases, they rely on industry associations to supply services which they could not otherwise access, such as basic payments facilities.

Despite the convergence of financial institutions and markets, smaller institutions will continue to operate and will require on-ground supervision in order to ensure individual viability, maintain industry stability, and protect the investments of members. This can be best achieved through a state based scheme.

5.1.2. Consumer Choice and Competition

Concurrent with the convergence of institutions has been the introduction of many technological advances within the financial services industry. These technological innovations will continue to provide opportunities for those financial institutions which can harness the technology to develop new and hybrid products.

It is essential, in this climate of convergence that consumer choice and competition is ensured. Smaller financial institutions provide an alternative for consumers. The challenge for these institutions, specifically building societies and credit unions, will be to position themselves within niche markets in the changing environment.

Larger financial institutions are concentrating their operations in cities and major urban centres, leaving the regional and rural areas poorly serviced. Credit unions are increasingly filling the gap in these areas.

These institutions will have continued support, provided they are supplying a service that is relevant and useful. There are large sections of society who continue to desire personalised service, regardless of the availability of technologically advanced financial products and service delivery. Small financial institutions with local and personal knowledge of their clients will be best placed to meet these requirements.

This ongoing role for smaller financial institutions, supports the need for continuing on-ground supervision within a state based scheme.

5.2. The Unique Nature of the Industries

The nature of the industries currently supervised under the FI Scheme dictates that state based supervision is the most effective and efficient manner of addressing the key risks associated with the institutions.

Under a regulatory system where there is no differentiation between financial institutions, the unique nature of these institutions may not be recognised, resulting in competitive disadvantage to these institutions due to size or other factors.

For example, while the RBA currently adopts standards for the regulation/supervision of banks, many do not apply to building societies and/or credit unions. There is a danger that, under an alternative regulatory regime which does not discriminate between deposit taking institutions, prudential standards would be applied to small financial institutions without regard to the compliance costs or the practical applicability of those standards.

This has the potential to cause a rationalisation of those industries precipitated by the burden of the supervisory structure rather than the interaction of economic and market forces which should be the principal driver of such change.

A key characteristic of these institutions is their focus on regional issues and economies.

While banks operate in a national market, the small retail-based institutions supervised by FINCOM are either regionally based, or concentrated in specific industry groups. While some of the larger institutions are more geographically widespread, the vast majority are still subject to regional influences.

~~Therefore, the fortunes of these institutions are irrevocably tied to the regional economies in which they operate and/or industrial factors.~~

~~State-based supervision facilitates greater awareness of issues facing individual institutions, anticipates potential problems and allows supervision strategies to be planned accordingly.~~

The regional focus of financial institutions such as credit unions and building societies requires a supervision approach that is relevant, understanding of regional and local issues, and responsive to specific challenges.

State based supervision facilitates greater awareness of issues facing these institutions, anticipates potential problems and allows supervision strategies to be planned accordingly.

Much of this regional/State focus would be lost under a centralised system of prudential supervision, as would the detailed understanding of the local issues underpinning regional markets. FINCOM submits that this would be detrimental to individual institutions and to the objectives of prudential supervision.

The other key characteristics of these industries are:

- Size of institutions - ranging from a few thousand dollars up to $1.4 billion;

- Varying levels of sophistication;
- Interdependency;
- Reliance on industry bodies; and
- Risk of contagion effects.

For a detailed analysis of these other characteristics, refer Appendix C.

5.3. Depositor/Investor Protection

The underlying rationale of prudential supervision is to prevent the loss of investors' funds. Under the State based supervisory regime, there is a duty of care placed upon State governments to ensure the viability depositors of regionally based financial institutions and to protect their depositors. This has been demonstrated by the Pyramid and Tricontinental collapses and the consequent legal fall-out ensnaring the Victorian government.

Currently, the State Ministers' responsibilities in this regard are addressed by SSAs, which act independently from government, much in the same way as the RBA fulfils the Federal Government's responsibilities in respect of banks.

Should the Inquiry recommend change, there needs to be a clear understanding within the community of the regulatory and supervisory structure, and the ministerial responsibility for these financial institutions. In short, there is a need for a clear accountability trail.

State governments are unlikely to favour relinquishing prudential oversight of such institutions if it is likely that they will be held accountable in the event of failure.

5.4. Functional vs Institutional Supervision

FINCOM uses and endorses an institutional approach to the supervision of financial institutions. Depositor protection is the primary focus of prudential supervision and this cannot be achieved through a "functional" or "product" approach.

There is a danger under a "functional" approach that only selected aspects of the institution's operations will be reviewed. Failure in other functions (which are not product aligned) may have a compounding effect and jeopardise the entire organisation.

It is FINCOM's contention that an effective regulatory regime must focus on the financial integrity and on-going viability of the whole institution and that "functional" or "product" issues should be addressed through standards commonly applied by all regulators.

The industries supervised by FINCOM rely heavily for their success on the continued confidence of depositors and the stability of their industry. Such confidence and stability can only be maintained by commercially sound and viable participants. Viability can only be determined through a process of on-ground supervision at an institutional level, where the key risk areas of a financial institution can be assessed and managed.

Furthermore, the move to trustee status for credit unions and building societies increases the need for this type of supervision, in order to ensure the protection of trust funds.

The institutional approach to supervision requires an overall assessment of the institution which is best achieved through effective on-ground supervision within a state based scheme.

6. SUCCESS OF THE FI SCHEME MODEL - KEY ATTRIBUTES

6.1. Administrative Gains

The FI Scheme combined a number of state based regulatory structures under one national umbrella. To maintain consistency and uniformity of approach, a number of initiatives have been implemented:

- **Common Approach to Inspection Process**

  A uniform operational inspection programme has been agreed and implemented by the SSAs. This provides consistency of inspection and supervision methodologies among SSAs ensuring that financial institutions are not disadvantaged as a result of the jurisdiction within which they are supervised.

- **Co-operation Across States**

  SSAs meet together on a regular basis as the Interstate Consultative Committee. This provides opportunity to discuss and develop policy in relation to the FI Scheme; exchange information and to liaise effectively to ensure the consistent interpretation and application of the Prudential Standards and the FI Code.

  In addition, inspector exchange programs between SSAs facilitate the cross-fertilisation of ideas within the FI Scheme, and promote the co-operative nature of the Scheme.

- **Common Database and Co-Operative Computer Systems**

  SSAs and AFIC are currently working co-operatively in developing common systems for database and other computer software systems used in data manipulation. The result will be a more powerful and comprehensive information system which will strengthen the foundation for decision making in the Scheme.

6.2. Benefits to Industry

6.2.1. Competitive Neutrality

Competitive neutrality has been one of the key issues addressed by the FI Scheme.

The following benefits are the direct result of the improved prudential standing of building societies and credit unions in NSW brought about by the FI Scheme:

- **Removal of Discriminatory Legislation**

  A number of Acts in NSW specified that certain organisations and persons could transact their financial business through a bank, thereby discriminating against credit unions and building societies. On 10 July 1996 an Act was proclaimed in NSW effectively removing those provisions and allowing these institutions to compete on an equal footing for this business. FINCOM submits that discriminatory provisions should be removed from legislation throughout Australia.

- **Trustee Status**

  Credit unions and building societies in NSW were granted ”trustee status” in March 1995, which put them on equal footing with other deposit taking institutions in this respect. FINCOM submits that these institutions should be granted “trustee status” throughout Australia.

- **Access to Payments Systems**

  Changes to the Cheques and Payments Orders Act are expected to proceed in 1997, which will grant individual credit unions and building societies the ability to issue their own cheques.

- **Interstate Trading**

  Barriers to interstate trading for building societies and credit unions have reduced significantly. However there are still advances to be made in this area, such as the removal of “foreign” registration.

  Given that building societies and credit unions are now supervised under uniform national standards and SSAs apply the same operational inspection programme and work co-operatively, further barriers to interstate trading are superfluous. FINCOM submits that any remaining barriers to interstate trading should be removed.

The registration of FI Scheme societies under the Corporations Law would remove these barriers efficiently. Corporate regulation would be undertaken by the ASC.

6.2.2. **Depositor Protection and Industry Stability**

A key achievement of the FI Scheme in NSW to date is that no depositor has lost funds through the failure of an institution.

Any serious problems within individual institutions have been addressed and remedied in an appropriate manner, to minimise effects within the industry, and maintain public confidence.

A further indicator of credit union industry stability within NSW is that no recent claim has been made against the Credit Unions' Contingency Fund. The Fund has been reassessed and downsized from $50 million to $25 million, reflecting the improved financial standing of the industry under FINCOM's supervision. These funds are being returned to credit unions.

6.2.3. **Cost-effective Supervision**

One criticism levelled against the FI Scheme in its infancy was the cost burden to industry imposed through AFIC and SSA levies. Over the past four years, levies in NSW have fallen in real and absolute terms, while the benefits to industry continue to accrue.

The efficient and cost-effective provision of prudential supervision is of prime importance under any regime, and FINCOM has made demonstrable achievements in this area. For further information of net levies charged refer Appendix D.

6.2.4. **Consultation with Industry**

Prudential standards are a key element of the FI Scheme. They determine the parameters within which building societies and credit unions must operate. Industry is invited to comment on all standards prior to their release so that the views of industry may be into account and any problems corrected prior to issue.

Industry specific advisory committees have been established as part of FINCOM's commitment to open and productive communication with the industries we supervise.

These committees provide excellent forums for discussion of issues affecting individual industries and feedback on policy issues.

A number of avenues are also provided for institutions to approach FINCOM as issues arise. This process has been enhanced by encouraging communication with FINCOM and maintaining regular contact with external auditors.

6.2.5. **Increased Sophistication**

The application of comprehensive prudential standards by building societies and credit unions has compelled these institutions to improve the quality of their risk management techniques and line management.

6.3. **Opportunities to Improve the FI Scheme**

Criticisms of the FI Scheme have mainly been directed at the structure of the Scheme. Other criticisms relate to regulatory restrictions imposed at the request of industry at the Scheme's commencement in order to preserve the unique character of the organisations. These are now seen as inappropriate.

As the FI Scheme matures, these and other issues are being addressed and the full benefits of the FI Scheme are yet to be realised.

Whilst the FI Scheme is a good model, the Inquiry provides an ideal opportunity to address some of the deficiencies evident in its current application.

6.3.1. **Structure of the FI Scheme**

Some industry groups have voiced concerns that the structure of the FI Scheme and its collaborative nature has led to slow response times, and difficulty in obtaining changes to prudential standards and legislation.

The structure of the FI Scheme was outlined in section 4.1.

FINCOM submits that the FI Scheme is working well in its current form. However, the structure could be streamlined and made more effective, particularly in regard to the process of changing FI Legislation. This could be achieved by:

- Removing all "prudential" and "character" provisions from the FI Code to the Prudential Standards. These have the force of law without the need for Parliamentary involvement. This would enable the body responsible to promulgation new Prudential Standards or change existing standards to respond quickly and flexibly to the needs of the industries under supervision.

- Incorporating FI societies under the Corporations Law. The FI Code is based on the Corporations Law adjusted for the inherent differences of credit unions and building societies. Changes to the Corporations Law often requires changes to the FI Code which is time consuming under the current structure.

  To facilitate changes to the legislation regulating credit unions and building societies, it is proposed that they should be incorporated under the Corporations Law. Specific provisions would need to be included in that Law for those societies that wish to retain their mutual status.

  The ASC would then be responsible for the corporate regulation of FI Scheme societies and a separate body would exist for their prudential supervision.

  The benefits are:

  - a separation of regulator and supervisor, consistent with the current practice for banks and insurance companies;

  - the elimination of the requirement to register foreign societies and barriers to interstate operations;

  - a reduction in the duplication of functions such as registration in each State.

6.3.2. **Permanent Capital and Operational Restrictions**

The inability of credit unions to issue permanent capital, and the qualitative lending controls imposed through Primary Objects requirements have also been raised. FINCOM submits that these requirements should be reviewed.

However, with particular reference to the Commercial Loans Primary Objects requirement for credit unions, it should be noted that FINCOM's inspections indicate that very few of these institutions have sufficient specialist knowledge to prudently undertake commercial lending. In short, this is a measure of the level of sophistication and lack of critical mass in the industry. Therefore, these provisions should remain intact within the Prudential Standards.

FINCOM submits that Prudential Standards should restrict the general operations of financial institutions, with SSAs having the power to vary those on a case-by-case basis.

7. APPLICATION OF FI SCHEME MODEL

There are several key factors which have contributed to the success of the FI Scheme and any supervisory structure recommended by the Committee would benefit from the incorporation of those key success factors. These characteristics also make the FI Scheme model an appropriate one to be applied to other industries.

7.1. Key Attributes of the FI Scheme

The following key attributes of the FI Scheme could be incorporated in supervisory arrangements for other industries. These attributes are:

7.1.1. Structure

The basic structure of the FI Scheme consisting of a prudential standard setting body: AFIC, and on-ground supervision bodies in each State and Territory: SSAs. FINCOM submits that the separation of the "law-maker" and "policeman" roles is the optimal way of ensuring proper accountability and due process. This concept could be applied to other financial institutions.

The use of comprehensive standards (rather than black letter law) provides flexibility and allows the regulatory environment to adapt quickly to innovation and the changing risk profiles of institutions and industries.

7.1.2. Transition Period

A transition period is seen as crucial to the ultimate success of any prudential regime because it maintains stability in the industry and allows institutions to spread the costs and resources.

Under the FI Scheme, building societies and credit unions were allowed a period of adjustment of up to two years in which to comply with the higher level of prudential requirements.

FINCOM submits that any changes to prudential regulation and supervision must be phased in over an appropriate period of time.

7.1.3. User Pays

Regardless of the costing mechanism, the transparency of funding arrangements is critical. Payment for supervision should be on a user-pays basis. This is achieved in the FI Scheme by institutions paying levies based on asset size.

Transparency of funding is essential to the accountability of supervisory bodies and in ensuring that cross-subsidies from other areas of a regulator's activities do not unduly distort the costs of supervision.

7.1.4. **Separate Consumer Protection Function**

Prudential supervision should be separate from consumer protection. Depositor/Investor protection should be the prime focus of prudential supervision. This has been successfully achieved in the FI Scheme, and is an attribute which should be central to the regulatory structure of financial institutions in Australia.

Demand exists for the consumer protection function to cover financial products and their delivery. Consumer protection does not necessarily have a bearing on prudential issues in all cases, and given that they may be in competition in some instances, the consumer protection role should remain separate from prudential supervision.

7.1.5. **Consultation**

Industry Advisory Committees have functioned well in the FI Scheme as forums for discussing issues affecting individual industries, as well as providing feedback on policy issues. Such consultative bodies should be considered as part of any supervisory structure.

Advisory Committees have functioned well in NSW, and FINCOM is of the view that such focus groups are useful in providing industry with an interface to their supervisors.

7.1.6. **On-ground Supervision**

Refer to Section 8 for further information.

7.2. **FI Scheme Model is Equally Applicable to Other Industries**

It is crucial that the Inquiry address the level of prudential supervision of superannuation funds. Given that superannuation is now compulsory, and is to increase over coming years, FINCOM submits that there is a need for increased prudential supervision in this area. In short, the depositor protection argument now extends to superannuation contributions.

The FI Scheme model not only applies to deposit taking institutions but can also apply to other financial institutions. It has already been successfully applied to conglomerates such as friendly societies whose operations are wide spread and include funds management, health insurance, and aged care facilities to name a few.

The FI Scheme allows State governments to continue to use SSAs for the supervision of co-operative housing societies.

8. EFFECTIVE ON-GROUND SUPERVISION

The key requirements for an effective on-ground supervisor are:

- Cost effective supervision.
- An efficient and effective supervisory approach.
- Knowledge of regional issues and challenges faced by institutions.
- A diverse range of skills among supervision staff drawn from a wide cross section of functional areas. These skills enable the supervisor to effectively assess the nature and gravity of the risks facing a financial institution.
- On-site inspection teams constructed to reflect the operations of the institution subject to review to ensure all aspects are properly covered.
- Extensive experience in the supervision/regulation of financial institutions.

It is FINCOM's experience that individual credit unions and building societies are supportive of on-ground prudential supervision and the consultative manner in which it is currently conducted. The value which is added by the inspection process provides additional comfort to institutions, and their members as to the ongoing viability of the organisation. This process maintains the integrity of individual institutions which forms the basis of a stronger, more stable industry. In addition, industry efficiency is improved, through the promotion of operational and managerial best practice.

The following factors demonstrate FINCOM’s ability to provide effective on-ground supervision of financial institutions in NSW:

8.1. Cost-Effective Supervision

The cost of FINCOM’s supervision has fallen steadily, since the commencement of the FI Scheme, both in real terms and in dollar terms. Supervision levies for credit unions have fallen (on a net basis) by over 50% since 1993. In the same period, levies for building societies have fallen by 82.5%. Costs for non-FI Scheme societies have also fallen.

For further information of levies charged refer to Appendix D.

8.2. **Supervisory Approach**

FINCOM has developed a supervisory structure that focuses on risk and institutional viability. The following key functions are submitted as being essential to effective and efficient prudential supervision:

- Prudential Monitoring - identifies trends and potential problems early;
- On-Site Inspection - assesses of viability and risk profile of each institution;
- Risk Grading System - determines the level and frequency of review based on the risk profile of each institution; and
- Rehabilitation - assists institutions experiencing difficulties in restoring viable operations or exiting from industry.

For further information regarding FINCOM's supervisory approach refer to Appendix E.

8.3. **Sound Knowledge of Industries Supervised in NSW**

The composition of the industries supervised by State Supervisory Authorities varies from state to state. FINCOM is responsible for the on-ground supervision of 50.2% of the national credit union industry and 30.8% of the national building society industry, by number.

FINCOM is also responsible in NSW for the supervision of friendly societies which have diverse business operations and co-operative housing societies which are principally one purpose institutions.

Appendix F provides a breakdown of the industries supervised by FINCOM.

FINCOM's knowledge of the regional issues facing these institutions enables it to respond quickly, and exercise flexibility in dealing with issues as they arise. These benefits will be lost under a more centralised (and likely more bureaucratic) framework because smaller institutions may be viewed as not material and state supervisors may not enjoy the same degree of autonomy.

8.4. **Wide Skills Base**

FINCOM employs supervisory staff with a wide range of skills in the prudential supervision of financial institutions. Prudential Supervisors are drawn from a variety of backgrounds, including banking, treasury, institutional surveillance, financial analysis, legal, audit, credit and management. The construction of on-site inspection teams from this knowledge base allows specialists in a number of areas to combine to accurately assess the overall risks facing a financial institution.

8.5. **Adaptability to Industry Change**

FINCOM's supervision methodology is aimed at preventing problems rather than crisis management. The risk-based approach to prudential supervision and the supervisory processes adopted by FINCOM result in a system that is responsive to the changing nature of the industries under supervision.

The structure of FI Scheme itself is also responsive to changes in industry conditions as has been demonstrated by the development of standards in relation to Funds Management and Securitisation, Demutualisation, and the lowering of Operational Liquidity requirements in line with those applicable to banks.

FINCOM'S Role

A.1 Position in the FI Scheme

On 1 July 1992 the Financial Institutions Scheme was introduced to provide a national framework for the supervision and regulation of Building Societies and Credit Unions throughout Australia. The prime objective of this framework is to protect (but not guarantee) the interests of depositors whilst emphasising the responsibility of directors and management for the sound management and performance of their financial institutions.

The FI Scheme was structured to encourage market diversity, competition and growth within the context of a responsible supervisory regime to enhance market stability and community confidence in these institutions.

To ensure the national applicability and benefits of the regulatory framework, each State and Territory was required to adopt uniform legislation and establish a single independent State Supervisory Authority to undertake the day-to-day prudential supervision of Building Societies and Credit Unions in their respective jurisdictions.

A national body was also established, the Australian Financial Institutions Commission (AFIC), to act as the central co-ordinator, to promote the integrity of the FI Scheme, and to develop and issue standards.

The New South Wales Financial Institutions Commission (FINCOM) being the State Supervisory Authority for New South Wales was established on 1 July 1992 under the Financial Institutions Commission Act 1992. FINCOM is funded by statutory levies on the industries supervised.

FINCOM is a key participant in the FI Scheme providing the day to day supervision of financial institutions whose operations are primarily focussed in NSW, which is necessary to ensure the FI Scheme's success.

FINCOM also administers the legislative framework which provides for the effective supervision of friendly societies and co-operative housing societies in New South Wales. Friendly societies are expected to be brought under the FI Scheme by 1 January 1997.

A.2 Framework for Supervision

Under the Financial Institutions Commission Act 1992 FINCOM's key functions include:

- Registration, regulation and supervision of financial institutions;
- Administration and enforcement of the FI Scheme in NSW; and
- Facilitating or directing orderly transfer, merger or liquidation of institutions where necessary.

The Act also charges FINCOM with the responsibility of applying an effective and efficient system of prudential supervision to societies and the protection of the interests of members and depositors of societies.

To perform these functions and discharge these responsibilities FINCOM has developed the necessary resources, skills and systems appropriate to the sophistication of the industries supervised.

APPENDIX B

Constituents Survey

1. Background

In June 1996 FINCOM commissioned BIS Shrapnel to conduct a survey to determine the attitude of its constituents to the manner by which FINCOM fulfils its role.

The constituents involved were representative entities of:

- Credit Unions;
- Building Societies;
- Friendly Societies; and
- Co–operative Housing Societies.

The survey included the opinion and views of key industry associations, representing the four industries that FINCOM supervises.

The **OBJECTIVES** of the survey included the need to determine:

a) How much constituents **know** about the various roles performed by FINCOM;

b) If **value** is added by FINCOM in performing each of the identified roles; and

c) If FINCOM's existence and activities **strengthen the mechanics and increase public confidence of each financial sector.**

2. Satisfaction with guidance

As part of assessing FINCOM's ability to add value we asked constituents to rate their level of satisfaction with guidance provided by FINCOM.

Friendly Societies found FINCOM's advice very satisfactory and gained a lot of benefit, 75% of respondents felt *'extremely satisfied'* and 25% *'quite satisfied'*, none felt neutral or dissatisfied. This was followed by Co-operative Housing with 100% indicating that they were *'quite satisfied'*.

Overall the level of satisfaction was very high, with only 16% indicating they were neutral about FINCOM's guidance, while none indicated they were dissatisfied.

Level of satisfaction with guidance from FINCOM

Constituents	*Base*	*Extremely Satisfied*	*Quite Satisfied*	*Neither Satisfied Or Dissatisfied*	*Quite Dissatisfied*	*Extremely Dissatisfied*	*Have Not Contacted*	*Rating Score*
Credit Union	17	4 24%	8 47%	3 18%	0 0%	0 0%	2 12%	94.1
Building Societies	6	0 0%	3 50%	2 33%	0 0%	0 0%	1 17%	50.0
Friendly Societies	4	3 75%	1 25%	0 0%	0 0%	0 0%	0 0%	175.0
Co–operatives	4	0 0%	4 100%	0 0%	0 0%	0 0%	0 0%	100.0
Total	31	7 23%	16 52%	5 16%	0 0%	0 0%	3 10%	96.8

3. FINCOM’s Knowledge Base

FINCOM’s level of knowledge on the industry

Constituents were asked to describe the level of knowledge displayed by FINCOM supervisors at on site inspections.

Most comments were very positive, indicating that the supervisors had a high level of knowledge of the industry and their organisation. Comments included:

> *“Quite good understanding of us and industry generally.”* Friendly Society

> *"FINCOM have a sound understanding of both individual organisations and industry"* Building Society

> "*Very good level of knowledge and understanding about industry and organisation. Deal with a group within FINCOM, we have an excellent relationship with those responsible."* Building Society

> *"Very good, aware of how we operate, our strengths and weaknesses, inspector did his homework prior to the visit"* Credit Union

> *"100% understanding of our society and industry"* Co-operative Housing

The only negative comments were minor:

> "*Industry knowledge is good, but FINCOM is not comfortable with some of our loans*" Building Societies

Overall, most organisations were very satisfied with FINCOM's level of knowledge and understanding of the industry and the individual organisations they supervised. The level of criticism was relatively low and related to personal experiences with the supervisors conducting the on site inspection. However, none of the negative comments indicated that FINCOM's level of knowledge or understanding was compromised as a result, but rather that FINCOM conducted these on site inspections by the rule book and lacked flexibility.

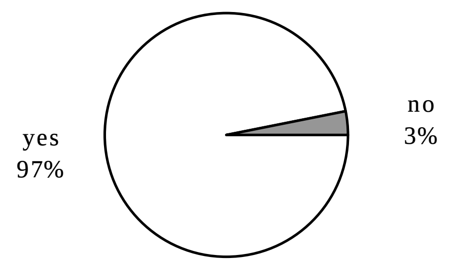
4. FINCOM's On Site Inspections

A very high percentage of organisations indicated that they found the conduct of FINCOM supervisors at on site inspections very professional with 97% responding positively. This is an exceptionally good result. In all the contact and on site inspections carried out by FINCOM only a small proportion of respondents had anything to complain about.

If we compare this with the results from the previous questions we are able to conclude that FINCOM as a supervisory body is able to conduct its business in a very effective manner and obtain a large level of satisfaction.

There was only one complaint from a Credit Union about FINCOM's conduct, representing 3% of the total sample.

Was FINCOM's conduct at on site inspections professional?



Constituents	*Base*	*Yes*	*No*
Credit Union	17	16 94%	1 6%
Building Societies	6	6 100%	0 0%
Friendly Societies	4	4 100%	0 0%
Co-operatives	4	4 100%	0 0%
Total	31	30 97%	1 3%

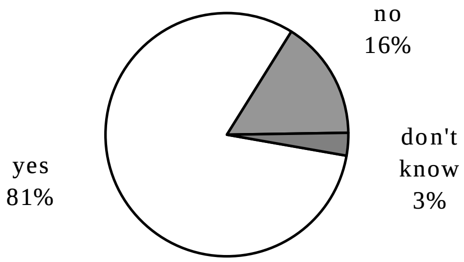
Reports from on site inspections

Organisations were asked if they found the reports issued by FINCOM following an on site inspection useful. A high percentage of respondents, 81%, indicated that they did. Those in the *'don't know'* category, 3%, were unable to answer this question because they had not been visited by FINCOM.

Of the constituents, Credit Unions had the highest proportion of respondents indicating that they found the reports useful (88%). Friendly Societies and Co-operative Housing Societies had the highest *'no'* response with 25% of those organisations indicating they did not find the reports helpful. But if we look at this result as a proportion of total respondents for this constituent, we see that this result represents one organisation out of the 4 interviewed.

Overall, most organisations found the feedback from on site inspections very useful and appreciated FINCOM's high level of knowledge of the organisation and industry.

Do you find reports from on site inspections useful ?



Constituents	*Base*	*Yes*	*No*	*Don't Know*
Credit Union	17	15 88%	2 12%	0 0%
Building Societies	6	4 67%	1 17%	1 17%
Friendly Societies	4	3 75%	1 25%	0 0%
Co-operatives	4	3 75%	1 25%	0 0%
Total	31	25 81%	5 16%	1 3%

Organisations were asked to explain why they felt that FINCOM conducted its business in a professional or in an unprofessional way. Most responses were as follows:

> *"They are very competent"* Credit Union
>
> *"They did homework prior to attending. Have reviewed our reports in advance. Efficient use of time while on site"* Credit Union
>
> *"Good notice given prior to visits. Visits are confined to 3 to 4 days. Don't impinge on day to day running. They conduct reasonable entry and exit interviews"* Credit Union
>
> *"They know what they are doing and what they are looking for and advise accordingly. Very professional"* Credit Union
>
> *"Do work in a professional manner"* Co-operative Housing

5. Constituents Comments Relating to Need for Prudential Supervision

Many of the constituents had a lot of positive comments to make about FINCOM in its role as supervisor of NBFI's. Many of the organisations surveyed felt that there was a need for prudential supervision since this improved market perception and added security to the industry.

"If you don't have supervision, the industry can fail. FINCOM provides checks and balances in government legislation." Co-operative Housing

"Preserves safety and security of members' deposits and the Credit Union industry in NSW and in general." Credit Union

"Provides security and information for Credit Union in areas of compliance. I'm happy with them." Credit Union

"Supervisory function, public perception of prudential control. Much better than what we had before, more professional and commercial." Building Society

"Improved public perception. Good individuals doing a good job. Have achieved a lot in the last 2 years." Building Society

"Public perception gives more confidence, that FINCOM is there looking over us. I'm quite happy with them." Friendly Society

Many organisations expressed a great deal of respect for FINCOM in the way it handled recent changes and pressures, in its efforts to understand organisations and the industry, and in the way it tried to enhance the industry.

"By assisting us to develop professionally in our business. Handled changes in the last 12 months without putting pressure on the industry. Hopefully, it will continue throughout the next 2 years. FINCOM doesn't transmit the pressure they are under to the industry." Friendly Society

"By us being able to tell people we're under government supervision, by providing statistical information for industry comparisons. Everything is great as far as we're concerned." Credit Union

"FINCOM adds value by ensuring depositor confidence. It fulfils a necessary good. Its role is very important, that is to protect large Credit Union from hearing about small Credit Union going down. I like them and want them to keep going." Credit Union

The Nature of the Industries that FINCOM Supervises

C.1 Degree of Sophistication

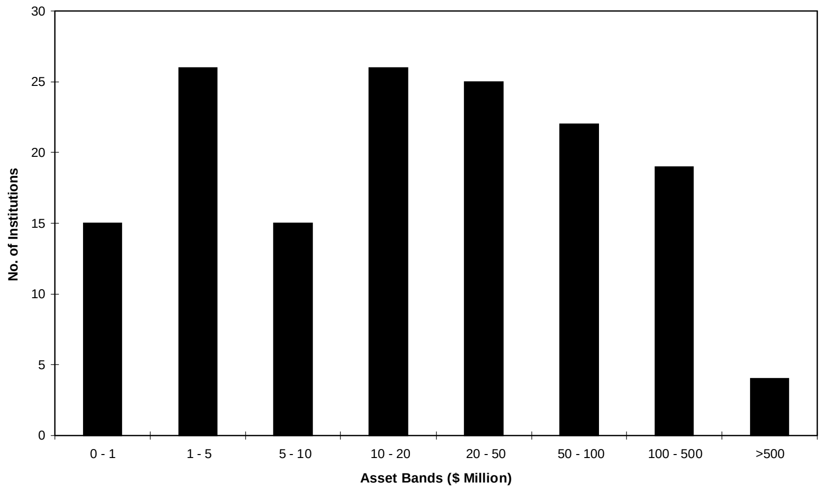
FINCOM supervises institutions ranging in asset size from a few thousand dollars to $1.4 billion. A significant number of those institutions are very small (over a third of FI Scheme societies in NSW under $10 million in assets) and are narrowly focussed in their customer base, products and services. See Table C.1 and Graph C.1 below for specific details.

ASSET DISTRIBUTION OF NSW BASED FI SCHEME INSTITUTIONS

TABLE C.1

Assets ($m)	No. of Institutions	Cumulative %
0 - 1	15	9.9
1 - 5	26	27.0
5 - 10	15	36.8
10 - 20	26	53.9
20 - 50	25	70.4
50 - 100	22	84.9
100 - 500	19	97.4
> 500	4	100.0
Total	152	

GRAPH C.1:



It is FINCOM's experience that small institutions are unsophisticated in their management practices, business acumen and strategic capabilities relative to banks, life offices or even some of the larger institutions that we supervise.

In the increasingly complex regulatory and business environment these institutions could inadvertently incur regulatory and financial risk because they do not have sufficient resources or skills to address those risks.

The introduction of the FI Scheme, prudential standards and on ground supervision has seen an increase in the awareness by institutions of risk and risk management. However, smaller institutions will remain relatively unsophisticated and narrowly focused and will continue to require active on-ground supervision.

Owing to their lack of size and sophistication, FINCOM devotes significant resources to ensuring that smaller institutions are prudently managed.

C.2 Interdependence

<u>Co-operative ethic</u>

A feature of the industries supervised by FINCOM is the co-operative ethic and pooling of resources. This is seen as a key strength of those industries. Institutions are able to access technology and expertise which would be otherwise too costly on an individual basis. The benefits are improved service delivery and product availability at reasonable cost.

This co-operative ethic also contributes to a relative lack of inter-institutional competition.

<u>Industry stability</u>

Credit unions in particular rely on their collective ability to achieve critical mass. This enables them to be recognised by the public as an appropriate alternative to banks or other financial institutions.

Therefore these institutions are very much dependent on the prudential health of their peers for the maintenance of public confidence (particularly within regional areas).

It was the recognition of interdependency factors that saw credit unions implement self-regulation in NSW with the establishment of the Credit Union Savings Reserve Board. This Board was responsible for maintaining a stable and viable credit union industry in New South Wales and the protection of members' deposits.

Additionally, credit unions in NSW established a contingency fund to assist member credit unions who experienced financial difficulties. The contingency fund was funded by contributions from member credit unions.

Critical mass

Credit unions are largely reliant on industry groups to provide the critical mass to access certain services (for example settlements). This enables credit unions to provide a wider range of services to customers than they otherwise would have been able as a stand-alone institution. For such reliance to be effective all credit unions must be viable and the industry stable. Any industry instability will put pressure on the remaining credit unions.

Contagion effects

The disadvantage of interdependence is the contagion effects should an industry participant fail. This contagion effect could exert pressure on commercially viable and sound institutions. Adverse publicity may reflect upon the entire industry due to the failure of one participant.

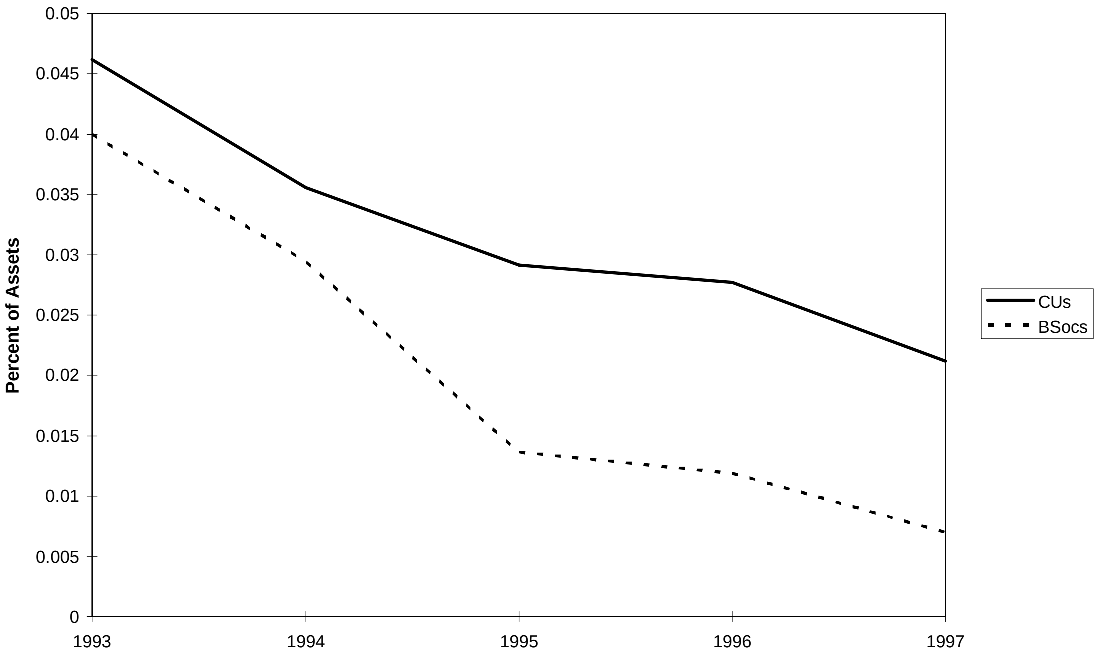
Contagion may also have an effect at the local and social level.

However, it should be noted that this systemic failure, or contagion, would most likely be restricted to building societies, credit unions and friendly societies. A credit union failure is not likely to materially affect the banking sector, for example. It is therefore important for these institutions to be supervised under a regime that is responsive to the unique risks associated with them.

APPENDIX D

GRAPH D.1:

NET SUPERVISION LEVIES
(% of Total Assets)



Supervisory Approach

FINCOM's approach to on ground supervision consists of the following key functions:

<u>Prudential Monitoring</u>

Prudential monitoring identifies the level of risk associated with each institution, trends and potential problems. This is achieved by the collection and analysis of information from quarterly returns submitted by each institution.

Early identification of potential problems allows quick action to be taken and allows the allocation of scarce resources to effectively deal with those institutions experiencing difficulty.

Information on an industry basis is analysed to identify common trends and provide feedback to each institution.

<u>On-Site Inspection</u>

On-site inspections of each institution are undertaken on a cyclical basis to ensure that institutions are operating in a commercially sound and viable manner, and are complying with governing legislation.

This is achieved through the application of a risk based inspection methodology against which the operations of each institution are tested. This inspection assesses viability, risk levels and adequacy of risk management systems, and the level of compliance with prudential standards. This methodology has been developed in conjunction with other SSAs.

On site inspections provide valuable information which is used on the assessment of that institution's viability. They also provide an informal opportunity for the institutions to discuss issues of concern about the institution's operations, compliance with the legislation and prudential standards.

Feedback to institutions on performance against industry benchmarks and against Prudential Standards is essential so that institutions can assess matters raised and implement appropriate corrective action. Feedback is given through meetings with senior management and inspection reports.

FINCOM strongly believes in adding value to institutions by providing constructive advice to assist managers and boards in exercising their functions. This is particularly important given the diversity of sophistication and size within the industries we supervise.

Risk Grading System

FINCOM has implemented a system of risk grading based on the results of prudential monitoring, on-site inspections and knowledge of industry issues.

Each institution's grading reflects the perceived riskiness of that institution's operations and management's ability to control risk.

The aim of the risk grading system is to clearly identify those institutions requiring more intensive supervision either through increased reporting requirements or more frequent on site inspections. The risk grading system also identifies those institutions who are operating well and do not require intensive supervision. This allows resources to be directed to those institutions which are experiencing difficulties.

Rehabilitation

Institutions identified as experiencing difficulty are segregated to enable a program of more intensive monitoring to be implemented.

All possible efforts are made to restore these institutions to a viable operating position quickly with minimal disruption to the industry and the public.

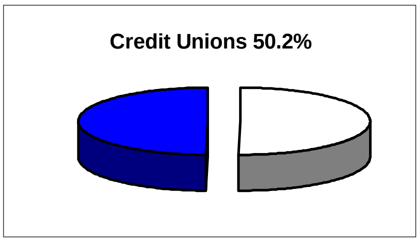
If this is not possible FINCOM will assist the orderly exit of the institution from the industry with the aim of ensuring that there is no disadvantage to the members of the exiting institution. Exits are normally achieved by transferring engagements to an appropriate institution.

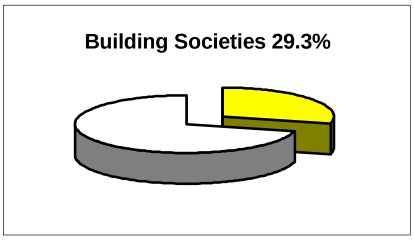
APPENDIX F

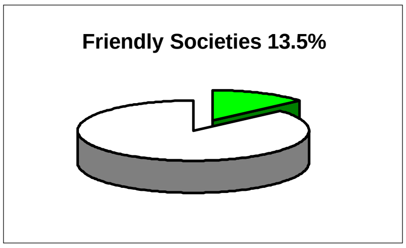
Institutions supervised fall in the following categories

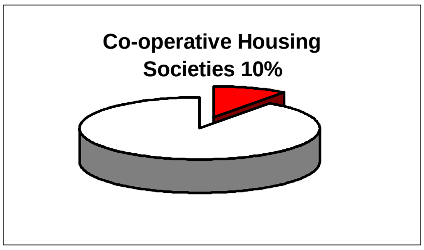
As at 30 June 1996:

NSW share of National Industry Assets as at 30 June 1996









NSW share of Number of Institutions Nationally as at 30 June 1996