APRA

Australian Prudential Regulation Authority

APRA and the Financial System Inquiry

Working Paper 3
January 2000

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David Lewis has presented this paper at the Australian National University and Geoffrey Shuetrim has presented a version of it at Griffith University. The authors appreciate the contribution of Melissa Hope and others at the Reserve Bank of Australia.

ABSTRACT

This paper describes the institutional and functional changes that have occurred in Australia's system of prudential supervision as a result of the recommendations put forward by the final report of the Financial System Inquiry chaired by Stanley Wallis. The previous regulatory framework was organised around institution type, with separate agencies regulating different classes of institutions. The new regulatory framework distinguishes regulatory agencies by the type of market failure that they are designed to address. The decision to reform is explained as an adjustment in response to the influences of technological and demographic trends and other regulatory reforms that have been driving change in the Australian financial system. Focus is on the role of the Australian Prudential Regulation Authority (APRA), the regulatory agency responsible for prudential supervision. The objectives of APRA are analysed in detail and the powers and approach used by APRA to achieve these objectives are described.

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Table of Contents

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Brenton Goldsworthy, David Lewis and Geoffrey Shuetrim

1 INTRODUCTION

In 1981 the findings of the first comprehensive review into the financial system were presented. This review, conducted by the Australian Financial System Inquiry (the Campbell Committee), recommended substantial reform of the Australian financial system. Since then, the Australian financial system has changed considerably under pressures emanating from technological innovation, globalisation of financial markets and customers' demands for a wider variety of financial products and services. To keep pace with this evolution, other committees of inquiry have been instigated to ensure that regulation of the financial system remains efficient and effective. It was against this background that the Government decided, in 1996, that a new inquiry was warranted. The resulting Financial System Inquiry, chaired by Stanley Wallis, was given the following mission:

> *The Inquiry is charged with providing a stocktake of the results arising from the financial deregulation of the Australian financial system since the early 1980s. The forces driving further change will be analysed, in particular, technological development. Recommendations will be made on the nature of the regulatory arrangements that will best ensure an efficient, responsive, competitive and flexible financial system to underpin stronger economic performance, consistent with financial stability, prudence, integrity and fairness.*

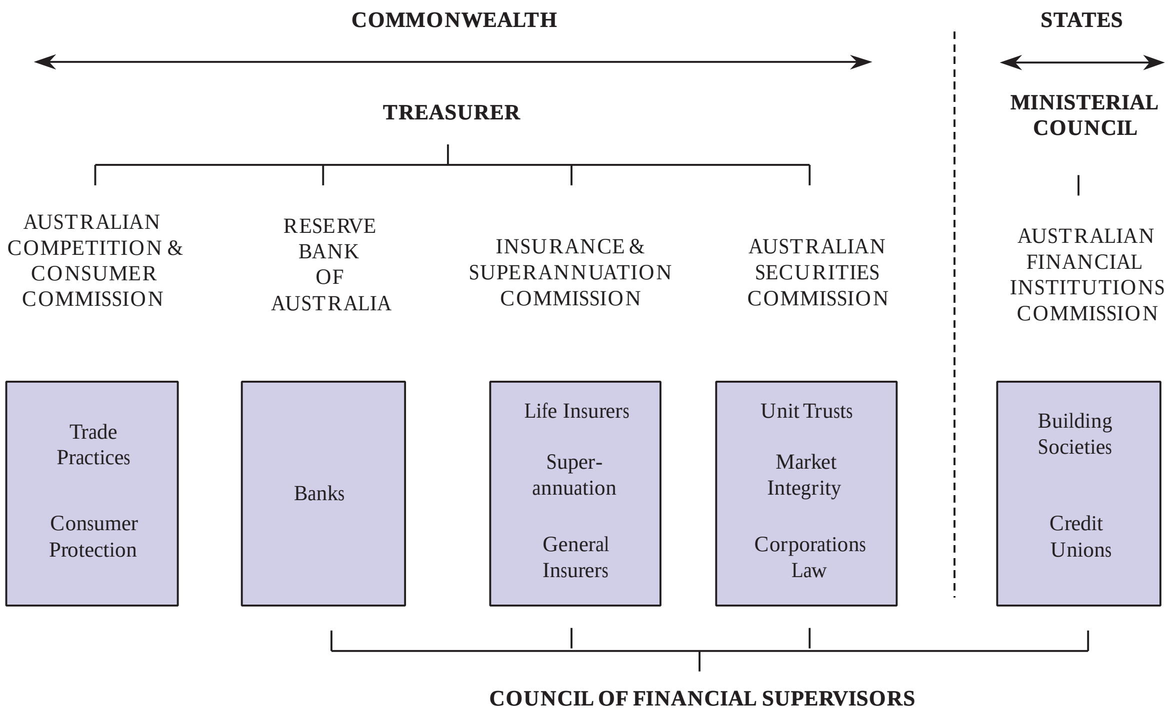
With the aid of submissions received from participants in the finance industry, and the public in general, the Financial System Inquiry (Wallis Inquiry) presented its findings in March 1997. One of the key recommendations of the Wallis Inquiry was that "a single Commonwealth agency... should be established to carry out prudential regulation in the financial system" (Recommendation 31). This recommendation led to the formation of the Australian Prudential Regulation Authority (APRA) on 1 July 1998.

This paper answers three questions: what is APRA, why was APRA created and what does APRA do? The paper proceeds as follows. Section 2 outlines the regulatory framework that was in place prior to the Wallis Inquiry. The new structure of prudential regulation is described in Section 3. Section 4 discusses the forces that have driven the reforms. APRA's objectives are examined in Section 5, while Section 6 looks at APRA's powers and approach. Concluding remarks are offered in Section 7.

2 THE PREVIOUS REGULATORY FRAMEWOK

Figure 1 summarises the regulatory framework that was in place prior to the Wallis Inquiry reforms.

Figure 1: Overview of the Previous Regulatory Framework



Preceding the reforms recommended by the Wallis Inquiry, the framework for prudential supervision was organised around institutional type, with separate agencies regulating the activities of each class of institution. The Reserve Bank of Australia (RBA) had responsibility for banks, the Insurance and Superannuation Commission (ISC) had responsibility for insurers and superannuation funds and the state and territory-based "State Supervisory Authorities" (SSAs) had responsibility for building societies, friendly societies and credit unions under the administration of the Australian Financial Institutions Commission (AFIC). This structure was largely a product of history. Under the Constitution, responsibilities for regulating Australia's financial system are divided between the Commonwealth and the States. This division of legislative power drove the separation between the Commonwealth regulatory agencies and the state- and territory-based regulatory agencies.

Prior to the reforms suggested by the Wallis Inquiry, the RBA had responsibility for a wide range of central banking functions including monetary policy, the payments system, overall financial system stability and the prudential supervision of banks.

The powers and functions of the RBA are set down in the *Reserve Bank Act 1959* and the *Banking Act 1959*. The RBA also administered the *Banks (Shareholdings) Act 1972*. The prudential supervision function of the RBA was primarily governed by the *Banking Act*. This Act placed a duty on the RBA to protect the depositors of banks that were authorised under the Act (with the exception of foreign-bank branches). That said, the RBA did not guarantee the repayment of deposits. Instead the Act conferred a number of powers on the RBA to ensure depositor protection. In particular, if the RBA became aware that a bank was unlikely to meet its obligations to depositors, it had the authority to investigate the bank's affairs and assume control of the bank for the benefit of depositors. Furthermore, the *Banking Act* provided that, if a bank became unable to meet its obligations, the Australian assets of the bank were available to meet its deposit liabilities in Australia in priority to all other liabilities.

The RBA also played a role in ensuring market integrity and financial-consumer protection by providing the Chair and the Secretariat for the Australian Payments System Council, which monitored compliance with codes of conduct for electronic funds transfer schemes, banks, building societies and credit unions. The RBA was also represented on the Board of the Australian Banking Industry Ombudsman Scheme, established to improve disclosure standards and complaints resolution in the banking industry, and chaired the Council of Financial Supervisors, established to co-ordinate financial regulation across different industries.

While the RBA had prudential responsibility for the banks, its authority did not cover the entire spectrum of deposit-taking institutions. The Financial Institutions (FI) Scheme was established on 1 July 1992 to protect depositors and to promote stability amongst the state-based financial institutions that remained outside the supervisory umbrella of the RBA. In particular, the FI Scheme created a uniform approach to the regulation of building societies, friendly societies and credit unions across Australia. AFIC set the prudential standards and co-ordinated the supervision of FI Scheme institutions while the day-to-day supervision rested with the individual SSAs. Each SSA was responsible for ensuring that those building societies and credit unions registered in its jurisdiction complied with AFIC's standards, the *Financial Institutions Code* and the *Australian Financial Institutions Commission Code.*[1] AFIC also had responsibility for the direct supervision of industry-owned organisations called "Special Services Providers" (SSPs).

1 There were eight SSAs: the New South Wales Financial Institutions Commission (FINCOM), the Victorian Financial Institutions Commission (VicFIC), the Registrar of Financial Institutions (N.T.), the Western Australian Financial Institutions Authority (WAFIA), the Queensland Office of Financial Supervision (QOFS), the South Australian Office of Financial Supervision (SAOFS), Registrar of Financial Institutions (A.C.T.) and the Tasmanian Office of Financial Supervision (TOFS).

The other prudential supervisory body in Australia, prior to the Wallis Inquiry, was the ISC, which was established in 1987 to provide prudential supervision of the insurance and superannuation industries. The ISC derived its supervisory powers from a number of Acts of Parliament. Separate legislation covered the regulation of life companies *(Life Insurance Act 1995)*, general insurers *(Insurance Act 1973)* and superannuation funds *(Superannuation Industry (Supervision) Act 1993)*.[2] The ISC was also given responsibility for market integrity and consumer protection in relation to insurance and superannuation products. Specifically, the ISC oversaw the General and Life Insurance Codes of Practice, the disclosure requirements applying to superannuation funds and the operation of the Superannuation Complaints Tribunal.

Operating in tandem with the prudential supervisors was the Australian Securities Commission (ASC), which was formed on 1 January 1991 to protect consumers of financial products from fraud and market manipulation, and to promote confidence in the integrity of the securities and futures markets. These objectives of the ASC were primarily achieved through the enforcement of the market conduct and disclosure requirements in the *Corporations Law 1990*. For example, the ASC ensured that prospectuses contained all the information necessary for an investor to make an informed assessment of the securities on offer, other than deposits offered by Authorised Deposit-taking Institutions (ADIs).

Also arching across the full gamut of institutions was the Australian Competition and Consumer Commission (ACCC) which had responsibility for ensuring compliance with the consumer protection provisions of the *Trade Practices Act 1974*. The key provision, contained in Section 52 of the Act, prohibits corporations from engaging in misleading or deceptive conduct. The ACCC also enforces the competition laws contained in the *Trade Practices Act 1974*. This includes prohibiting mergers and acquisitions that are likely to significantly lessen competition in a substantial market, unless the ACCC deems the merger or acquisition to provide net public benefits.

3 THE NEW REGULATORY FRAMEWORK

The Wallis Inquiry recommended widespread reform of the existing regulatory framework. Figure 2 illustrates the re-organisation of regulatory responsibilities recommended by the Wallis Committee.

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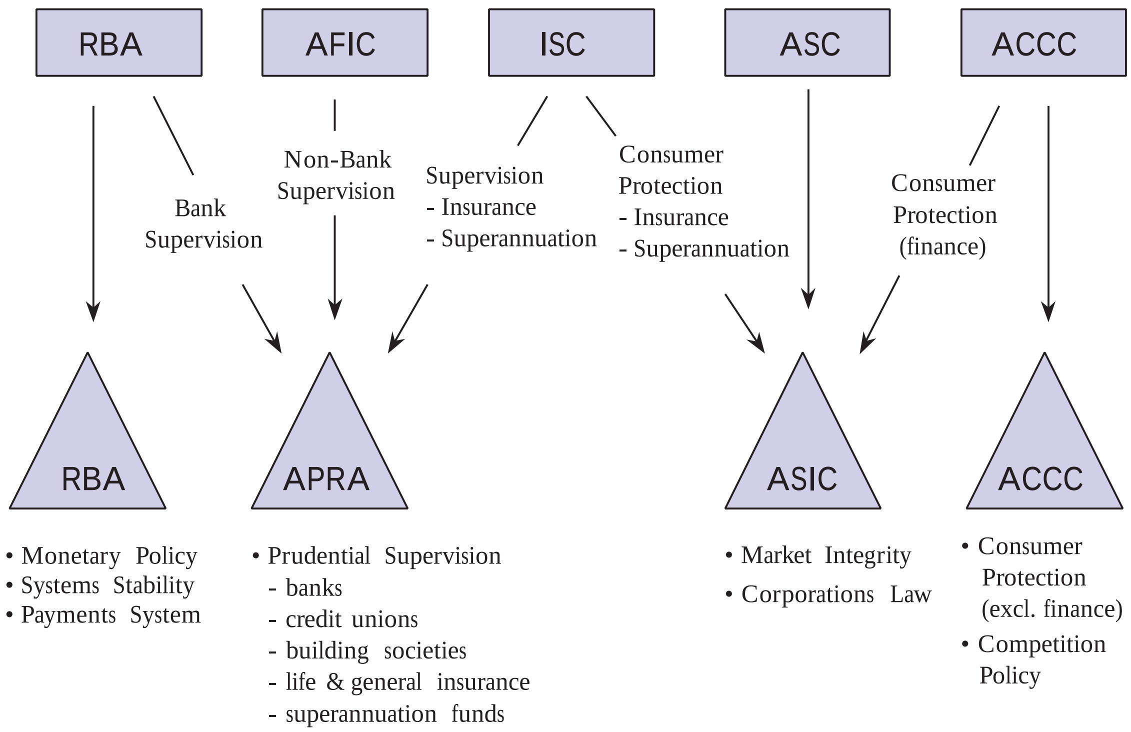
[2] Interestingly, in the context of the Wallis Inquiry recommendations, friendly societies were not under the ISC jurisdiction, instead being supervised by AFIC.

Figure 2: New Regulatory Framework

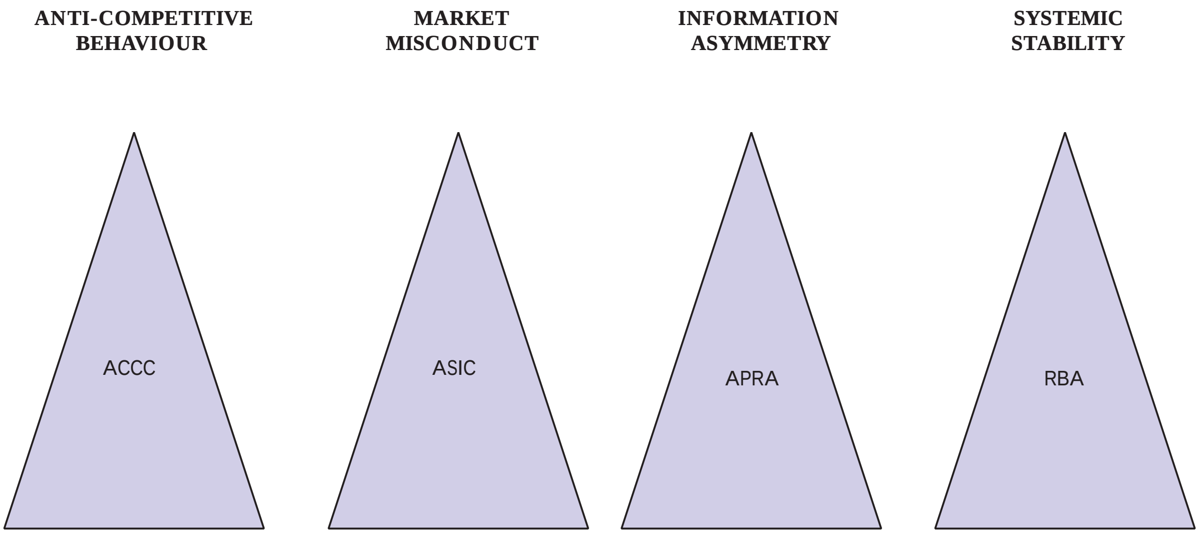


This re-organisation of financial system regulation was guided by two key principles. First, there should be a one-to-one relationship between regulatory bodies and causes of financial-market failure as opposed to the many-to-many relationship that characterised the previous regime. Second, regulation should only be imposed in situations where the risk and consequences of market failure are sufficiently large.

The application of the first principle can be seen in the allocation of regulatory responsibility to four institutions corresponding to the four major types of market failure of concern to the Wallis Committee as shown in Figure 3:

- Systemic instability ie where failure of one institution or market can have flow-on effects on others (RBA);
- Information asymmetry ie where the inherent complexities of a product or service are such that consumers are unable to make informed choices, even after full disclosure (APRA);
- Market misconduct ie market manipulation and consumer exploitation, such as fraud and insider trading (ASIC); and
- Anti-competitive behaviour ie restrictive trade practices, such as collusive conduct or the exercise of monopoly power (ACCC).

Figure 3: Functional Regulation



Under this new structure the ACCC has retained responsibility for thwarting any anti-competitive behaviour that would otherwise result in sub-optimal price and production outcomes being realised by the market. In particular, the ACCC remains responsible for competition policy and consumer protection across all sectors of the economy. The most common types of behaviour that are of concern to the ACCC are collusion and the exercise of monopoly power.

Following the reforms to the regulation of the financial system, the Australian Securities and Investments Commission (ASIC) has become the sole agency responsible for consumer and investor protection, taking the various consumer protection responsibilities in the area of financial products away from the ASC, the ISC and the ACCC. The primary objective of ASIC is to prevent market misconduct by ensuring compliance with the relevant sections of the *Corporations Law Act 1990*. The intention is to promote confidence in the efficiency and fairness of markets by ensuring that markets are sound, orderly and transparent. Without this type of regulation, financial markets would be considerably less liquid and, thus, less able to allocate financial resources efficiently. Disclosure requirements (for example, prospectus rules) and conduct rules (for example, the prohibition on insider trading) are the primary means to this end.

Another institution to emerge from the reforms to the regulatory framework is APRA, which has been created to prevent the more severe forms of market failure associated with the information asymmetries inherent to many financial contracts traded in the Australian financial system. APRA does so by supervising particular types of financial institutions from a “prudential” perspective.

The information asymmetries of concern arise when the financial products are sufficiently complex to prevent disclosure requirements, by themselves, from providing consumers with sufficient information to make an informed choice. Without direct prudential supervision, the resulting information asymmetries may result in market failure. Thus, APRA has been given the responsibility to supervise and monitor financial institutions on behalf of parties to particular types of financial contracts that have the potential to be at an informational disadvantage and that are unable to meet the costs of monitoring their counterparties.

The application of the second key principle guiding the Wallis Committee's regulatory re-organisation can perhaps be best seen in the restriction of prudential supervision to those types of financial contracts where the consequences of information asymmetries were perceived to outweigh the costs of regulation. The only financial contracts meeting these requirements were deposits raised by institutions without the issuance of prospectuses, insurance contracts and superannuation funds. In line with the first key principle guiding the recommendations of the Wallis Committee, APRA has become the comprehensive *prudential* regulator of the Australian financial system, taking over the prudential responsibilities of the ISC, the RBA and AFIC. As the sole prudential regulator, APRA is directly responsible for supervising around 85 per cent of the assets in Australia's financial system. Those groups left outside APRA's regulatory net include money market corporations, finance companies and non-superannuation investment funds.

While the prudential role of the RBA has shifted to APRA, the RBA retains its central banking functions, including responsibility for overall financial system stability and the provision of liquidity. In fulfilling these particular obligations, the RBA and APRA will need to cultivate a close liaison with each other. In recognition of this, the RBA and APRA signed a *Memorandum of Understanding*, which laid down a framework for co-operation between the two bodies. Issues addressed include the sharing of information and the handling of threats to financial system stability. To further promote this co-operation, the *Australian Prudential Regulation Authority Act 1998* provides for officers of the RBA to occupy two positions on APRA's board.

In keeping with these institutional reforms, the Council of Financial Supervisors, which used to have representatives from the RBA, ASC and AFIC, now has representatives from the RBA, ASIC and APRA.

To conclude, the reforms to prudential supervision, put forward by the Wallis Committee, have not led to a change in the range of institutions being regulated. Instead, the reforms have focused on changes to the organisational structure of the prudential-supervision framework. In particular, there has been a move away from a structure delineated by the institutions being supervised toward a structure defined by the types of products being monitored. This has been described as a move from institutional to functional supervision. To a large extent, this shift has been necessitated by three developments:

- the presence of conglomerates, which provide a broad array of financial products ranging from deposit-taking through to funds management and insurance;
- the blurring of institutional boundaries as financial intermediaries experiment with new products; and
- the increasing ability of financial institutions to dramatically alter their risk profiles using sophisticated financial products.

In a sense, the move to an integrated or "conglomerate" prudential supervisor is a reflection of similar trends amongst the institutions being supervised. Thus, the reforms to the prudential regulation system can perhaps be best understood as a response to the range of forces driving the evolution of the Australian financial system. These forces for change are the topic of the next section.

4 WHY REFORM?

Motivating the reform of the prudential regulation framework has been the view that the Australian financial system has evolved rapidly in recent years in ways that had made the existing regulatory framework inefficient. Changing customers' needs, rapid technological innovation and the evolving regulatory environment itself have been key factors driving the changes to the financial system. The reforms of the prudential system are intended to ensure that supervision is conducted efficiently and effectively in the context of the changes that these forces have already necessitated and of the changes that are likely to arise in the future.

With regard to customers' needs, demographic changes have increased the demand for financial services. In particular, the ageing of the Australian population has been a driving force behind the introduction of compulsory superannuation to support the "pay as you go" aged pension scheme. This move to a self-funded retirement-income scheme was motivated by the burden that an unfunded retirement-income scheme would otherwise have placed on society over coming decades. With participation in self-funded retirement-income schemes becoming compulsory, in the form of superannuation, there has developed a whole new type of financial service provision requiring prudential supervision. As Authorised Deposit-taking Institutions (ADI) and insurance providers tap into superannuation contributions as a source of funds, the need for co-operation between superannuation, ADI and insurer supervisors has and will continue to increase. By merging the bodies responsible for prudential supervision into APRA, it is intended that this co-operation will be made substantially easier.

Overlaid on the foundation of changing demographics, has been the steady trend towards greater job mobility which has increased the demand of employees for investment vehicles that allow them to provide for their own income protection above and beyond the compulsory savings embodied in superannuation schemes. Both these demographic and the lifestyle trends are creating the incentives for the financial sector to provide a greater range of services to customers. This increased demand for alternative investment vehicles has caused financial institutions to diversify their product ranges in an effort to maintain their supply of funds. The diversification of product ranges has and will continue to blur the boundaries between different types of financial institutions, making the organisation of prudential supervision around institutional types increasingly irrelevant.

Technological innovation has also played a major role in reshaping the financial system. An important component of technological process has been the development of systems for processing and storing information. This, combined with other advances, has enabled financial institutions to analyse, monitor and price risk more accurately. The resulting reduction in information asymmetries has begun a trend towards greater liquidity of financial institutions' balance sheets. This increasing liquidity will facilitate efficient redistributions of risk between firms in the financial sector. The increasing ability of firms to transfer risk in sophisticated ways can already be seen in the growth of securitisation schemes and the use of credit derivatives. As financial institutions become more efficient in transferring risk, the relationship between the types of activities undertaken by institutions and their risk profiles will continue to erode. The breakdown of this traditional relationship will encourage the organisation of prudential supervision to become increasingly risk-based rather than institutional.

Technology has also played an important role in driving reform because of its impact on the costs of delivering financial services. With the introduction of electronic banking services, the cost of developing distribution networks for financial services has fallen sharply.[3] This reduction in the barriers to entry for new suppliers of financial services will facilitate the movement of financial institutions into new activities as they seek new sources of and uses for funds, again reducing the distinctions between the types of financial institutions.

The third force driving the reforms of prudential supervision has been the widespread regulatory changes that have occurred in the last two decades. The liberalisation of trade and cross-border capital flows has increased the level of global competition in Australian financial markets. The additional competition has added momentum to the diversification and innovation of financial services that has already been occurring as a result of customer demands and technological capabilities.

Competitive pressures emanating from the three forces described above have transformed the financial system along a number of dimensions. Perhaps the most important transformation from a prudential supervision perspective has been the increasing need for existing institutions to reconfigure their operations in light of the increasing need to find additional sources of revenue and to reduce costs. This reconfiguration may involve large financial institutions diversifying their product ranges, enabling them

3 Evidence of this was documented in the Financial System Inquiry Final Report (Figure 2.3, page 109).

to gain competitive advantages through operational and marketing synergies.

In short, the case for amalgamating the prudential supervision functions of the RBA, ISC and AFIC into a single Commonwealth agency has been driven by the need for more effective supervision of financial conglomerates. In particular, the formation of an integrated prudential supervisor is expected to enhance regulatory neutrality in the sense that the regulatory burden applying to a financial product or service should be independent of the institution that it originated from. Instead, the regulatory burden should be a function of the risk attached to the product or service. Under the previous prudential supervision framework, entities belonging to a financial conglomerate were often supervised by different agencies. This created the potential for them to conduct as much business as possible through the subsidiaries that were subject to the most favourable regulations. Moreover, the partial jurisdictions of the individual supervisory agencies made it difficult for them to form an opinion on the overall financial strength of the supervised institutions. The benefits of the move to a single prudential supervisor are largely expected to arise from the elimination of these two problems with the previous prudential supervision model.

Lastly, the unification of a number of specialised prudential supervision agencies should lead to economies in the implementation of supervision. In particular, it will also lead to greater flexibility in the allocation of resources and expertise to problem areas as they emerge and it will maximise the opportunities for "cross-fertilisation of supervisors'" experiences, skills and ideas.

5 APRA'S OBJECTIVES

So far, we have discussed the reforms to the system of prudential regulation in terms of the organisational changes that have arisen from the Financial System Inquiry. We have described the previous model and the new model and have explained the rationale for the changes in the organisational structure of prudential supervision. However, nothing has been said about changes in the objectives of prudential supervision. This section describes and interprets the objectives of APRA as they are embodied in the existing legislation.

The *Australian Prudential Regulation Authority Act 1998* (parts 1 and 2, Section 8) states that:

> *"APRA is established for the purpose of regulating bodies in the financial sector in accordance with other laws of the Commonwealth that provide for prudential regulation or for retirement income standards, and for developing the policy to be applied in performing that regulatory role.*
>
> *In providing this regulation and developing this policy, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality."*

This legislated objective has now been embodied in APRA's mission statement:[4]

> *"We are committed to establishing and enforcing prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by institutions we supervise are met, within a stable, efficient and competitive financial system."*

Drawing on both statements of APRA's objectives, it is clear that prudential supervision is intended to ensure that:

- Financial promises of Financial Institutions (FIs) are met in all but extreme situations;
- The operation of the financial system is robust to most shocks;
- The financial system is efficient in the sense that it directs savings toward the most productive investments and at the lowest possible cost of doing so;
- The financial system is characterised by competition between FIs by ensuring that the costs of entry into the business of financial intermediation are kept as low as possible; and
- The above objectives are achieved by imposing a supervisory system that does not create a competitive disadvantage to particular types of FIs, relative to other types.

This raft of objectives suggests a substantial role for APRA in influencing financial market outcomes. However, the connection is not straightforward between these objectives and the overarching goal of prudential supervision, mentioned in Section 3, to ameliorate the potential for market failure arising from information asymmetries. To make the connection, it is necessary to recognise what constitutes a financial-market failure and to understand how information asymmetries can lead to a failure of this kind.

In the context of financial markets, failure can be broadly defined as an inability of the market to exhaust all gains from trade in financial services. As Akerlof (1970) first pointed out, information asymmetries between people on opposite sides of a market can prevent mutually beneficial exchanges from occurring. Information asymmetries have the potential to prevent some, or all, gains from trade because buyers are unable to gauge the value of the product on sale as precisely as sellers can. Unless there is some means of sorting the products being offered for sale by quality, all products will carry the same price, corresponding to the price buyers are prepared to pay for the average-quality product on offer. In general, this price will be too low to induce the high-quality products onto the market while continuing to attract the low-quality products. This "adverse selection" reduces the average-quality product on offer in the market. In extreme cases, this adverse-selection relationship between prices and the average quality of the products on offer may prevent trade at any price. By stopping the higher-quality products from being offered for

[4] See the September 1998 Insurance and Superannuation Bulletin.

sale, information asymmetries can prevent the realisation of all gains from trade.

By ensuring that certain financial promises are met in all reasonable circumstances, prudential supervision attempts to eliminate the potential for information asymmetries to undermine confidence in a particular financial institution's ability to fulfil certain types of promises. Without such confidence, it is quite possible that the supply of funds to all financial institutions would be reduced, eventually adversely affecting economic growth over the long term, as a fraction of the profitable investment opportunities find themselves unfundable. In this sense, the first objective of APRA, to ensure that certain financial promises of FIs can be met in all but extreme circumstances, amounts to ensuring that the supply of those financial promises is of sufficiently high quality to keep investors willing to buy those promises.

The second objective of APRA, to ensure that the operation of the financial system is robust to most shocks, can be seen as a supporting objective. Without this stability of the financial system, it would not be possible to maintain the level of safety that needs to be associated with the financial promises of concern. Likewise, it can be argued that the safety of the financial promises that APRA is responsible for, is a necessary condition for the stability of the financial system. Thus, stability of the financial system can be seen as an objective of APRA in and of itself. Certainly, without a robust financial system many gains from trade in financial services will fail to be realised. A good example of this type of market failure is the massive reductions in industrial production in south-east Asia following the currency depreciations and associated financial crises in 1997-98. (See Figures 4-6, which show the extent of the currency depreciations, the contractions in industrial production and the linking reductions in the broad-to-narrow-money ratios).[5] Without the ability to access funds to finance production and transport to market, producers in those countries were unable to exploit the competitive advantages associated with the currency depreciations.

5 The Indonesian credit aggregate only captures that credit denominated in Indonesian Rupiah to eliminate the distortions introduced by the large exchange rate movements over the period of interest.

Figure 4: Effective Exchange Rates
(January 1990=100, Month End Values)

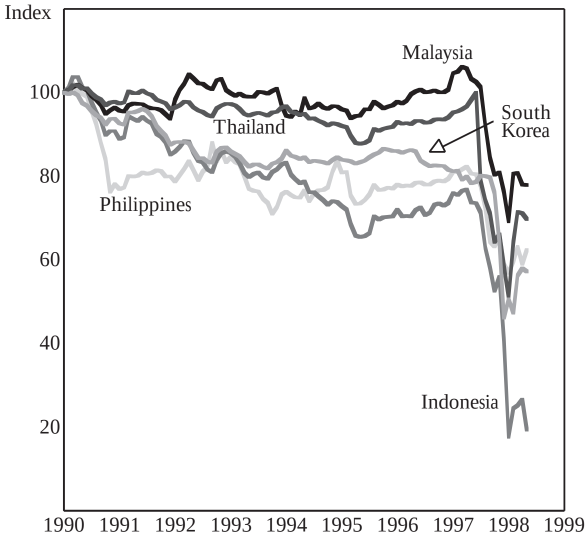


Figure 5: Credit
(Year-ended Percentage Change)

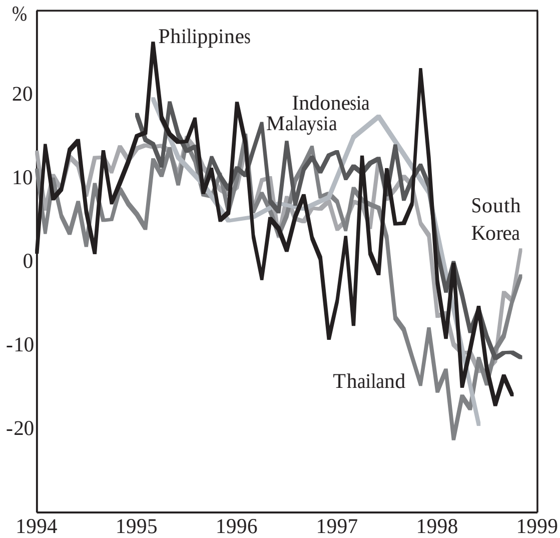
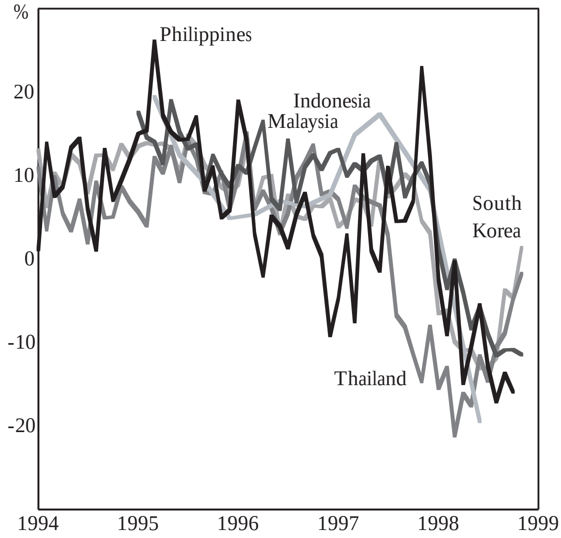


Figure 6: Industrial Production
(Year-ended Percentage Change)



What of the remaining mandates for prudential-supervision: to maintain efficiency, competition and competitive neutrality between organisational forms for financial intermediation? These can all be interpreted as constraints on the way that APRA goes about achieving the first two objectives. These constraints are needed because APRA could ensure customer safety and financial system stability in a variety of ways. For example, it would be easy to ensure that all bank deposits could be repaid, in nominal terms, by imposing a narrow banking system in which all deposits were used to invest in short-term government securities. However, this relatively draconian constraint on financial intermediation could well have substantial adverse effects on the capacity of the financial system to direct funds towards the most productive investment opportunities, thus reducing economic efficiency. By requiring that APRA work towards ensuring that the financial system is efficient, pressure is placed on APRA to find less distortionary policies to fulfil its mandate.

Likewise, the requirement that APRA encourage competition and contestability in financial markets prevents policies that unnecessarily restrict entry to financial intermediation activities. Without this requirement, APRA could restrict financial intermediation licences with a view toward increasing the monopoly power and hence profitability and prudential soundness of current market participants, all in the name of achieving the two primary policy objectives. Without insisting on competitive financial markets, prudential supervision could generate situations where gains from trade in financial services are not being realised because of monopoly power rather than information asymmetries. This would undermine the original justification for prudential supervision.

Finally, the requirement that prudential supervision be competitively neutral prevents APRA from introducing distortions into the process of financial intermediation by imposing constraints on FIs that do not treat the same risks in the same manner. Such equal treatment is certainly not a necessary feature of policies that would achieve the two primary objectives of prudential supervision. However, without competitive neutrality, there is an incentive for FIs to conduct their business using certain organisational forms that may not have the most efficient forms of corporate governance and the most cost-effective means of providing the services. Thus, this last requirement, that APRA ensure competitive neutrality between FIs, is intended to ensure that the overhead costs of financial intermediation services are kept to a minimum.

The remainder of this section explores two questions. First, why might we suspect that these objectives would not be achieved without prudential supervision? Answering this question requires an exploration of specific ways in which information asymmetries affect the activities of ADIs, insurers and superannuation funds. Second, what are the consequences if APRA's objectives are not achieved? In other words, what could we expect of an unsupervised financial system? Because the answers to both of these questions differ depending upon the types of FIs, they are addressed separately for each type of institution.

5.1 Information Asymmetries and ADIs

It can be argued that ADIs are in the business of solving information-asymmetry problems.[6] Most ADIs obtain a large fraction of their funding by providing short-term deposit facilities to those with excess funds and they use these funds to make relatively long-term loans to those needing funds to exploit investment opportunities.[7] The deposits are generally short-term in nature because lenders do not know whether they will experience liquidity shocks in the near future.The loans to investors are generally long-term in nature, reflecting the time required for investment activities to yield the payoffs necessary to repay the original loan.

Both the lenders and the borrowers in these financial relationships have informational advantages over each other and over the ADIs. Lenders (depositors for the most part) have informational advantages about their needs for liquidity. Borrowers (those with investment opportunities for the most part) have informational advantages about the profitability and riskiness of the investment projects that they are in a position to exploit.

6 While this ignores the broad spectrum of financial services offered by modern ADIs, it does highlight the central role played by information asymmetries in the conduct of ADI business. See Battacharya and Thakor (1993) or Freixas and Rochet (1997) for more comprehensive discussions of the role of ADIs, and banks in particular.

7 Note that consumer durables like housing and motor vehicles are also productive investments, delivering a flow of consumption through their lifetimes.

ADIs add value by helping the borrowers and lenders engage in financial transactions that would otherwise be unavailable to them because of these uncertainties and information asymmetries. Yet, in facilitating these financial transactions, ADIs find themselves exposed to potentially severe adverse consequences of the information asymmetries that surround the parties that they deal with.

Diamond and Dybvig (1983) develop a formal model of the role that ADIs have in helping depositors to insure their liquidity risk within a model where the liquidity shocks to individuals are private information. Within their model, depositors do not know if they will need to consume in the near future or if they are able to make long-term, profitable loans and consume the returns to these loans when they are realised. By pooling this liquidity risk across depositors, ADIs are able to achieve the first-best outcome in which those individuals that discover themselves to be patient provide insurance to those individuals discovering themselves to require early consumption. The early consumers withdraw their funds from the ADI when they are needed, earning a return in excess of that possible if they had never invested in the ADI. The late consumers are prepared, *ex ante*, to contribute this extra return to the early consumers from their own investment funds because they do not know, up front, whether they will be liquidity constrained or not. Having discovered that they are able to consume later, the late consumers invest the remaining funds at the ADI in profitable investment projects and consume the proceeds at their leisure.

The feature of special interest in the Diamond and Dybvig paper, however, is that this first-best outcome is not the only possible outcome because individuals' liquidity shocks are not public knowledge. This information asymmetry makes it possible for potentially late-consuming depositors to believe that all types of depositors will withdraw early. With these beliefs, the potentially late-consuming depositors also find it best to withdraw early and receive the reduced amount of funds. This action dominates that of keeping their funds available for investment because, after both types of investors have withdrawn early, there will be no funds available at the ADI to undertake investments and to pay returns to those that have exhibited patience.

This second possible outcome is a description of a classic bank run, founded on the beliefs of the depositors. It starkly illustrates the potential for market failure to be caused by information asymmetry. The model also makes clear the role that can be played by a system of financial regulation in preventing bank-runs by providing either deposit insurance or lender-of-last-resort facilities. If an ADI has deposit insurance or lender of last resort facilities available to it, then there is no incentive for those depositors that do not suffer an adverse liquidity shock to withdraw early. With only those needing to consume withdrawing early, there is no incentive for the remaining depositors to forego the investment returns that are available to those prepared to leave their funds with the ADI.

Within the context of the new financial regulation regime in Australia, it is interesting that the lender-of-last-resort facility has remained with the RBA. If regulation is only required to avert the types of bank runs described above, then APRA's prudential supervision would only seem to have a role in distinguishing between temporary shortages of liquidity and true insolvency on behalf of the RBA. To motivate a more substantive role for APRA, it is necessary to introduce uncertainty about the returns generated by the investment projects financed by ADIs.

Diamond and Dybvig intentionally eliminate uncertainty about the returns generated by the investment projects from their model so that the potential for market-failure caused by information asymmetries about the characteristics of depositors could be examined in isolation. Unfortunately, this omission precludes examination of information asymmetries about the quality of investment projects. ADIs have a crucial role to play in resolving these types of borrower-related information asymmetries through the use of both monitoring and screening technologies and risk pooling across borrowers along the lines of Diamond (1984).

Dewatripont and Tirole (1994) reverse Diamond and Dybvig's emphasis by developing a model that demonstrates how uncertainty about the quality of investment projects that have been financed by ADIs motivates a role for prudential supervision as conducted by APRA. They begin by viewing ADIs as ordinary firms. Dewatripont and Tirole suggest that, like other firms, ADIs use capital structure to improve firm performance. Moreover, they note that capital structure affects performance by transferring control rights over management to particular groups of outside claimholders (equity holders, depositors, subordinated debt-holders etc). The threat of intervention by the various types of outside claimholders determines the incentives faced by ADI management.

Unfortunately for ADIs, there are substantial difficulties in eliciting monitoring effort from depositors (most senior outside claimholders). The classic free-rider problem arises in which the cost of monitoring for each individual depositor is prohibitive and the benefits of monitoring are shared among all of the depositors. Without some means of sharing the monitoring expense among the depositors, debt claims on ADIs are not an effective managerial control mechanism. Knowing that depositors will not act collectively, managers do not take the preferences of debtholders into account when choosing which investment projects to finance.

Assuming that the high leverage typical of most ADIs is imposed to extract certain behaviour from managers, if depositors fail to intervene in the appropriate situations, then there are gains to be had from introducing an agency that will represent the interests of depositors. The "representation hypothesis" of Dewatripont and Tirole is that the prudential supervisor provides this service, monitoring the ADIs on behalf of depositors and intervening where necessary, to ensure that the interests of depositors are taken into consideration by the managers of ADIs. This framework indicates that the objectives of the prudential supervisor should be aligned with those of depositors. Using a formal model, this intuition is pushed further to derive the types of constraints on the behaviour of ADIs that is embodied in the Basle Accord on Capital Adequacy.

So far, Dewatripont and Tirole's rationalisation of prudential supervision has had little to say about information asymmetries. However, in the background of their model, is the assumption that ADIs obtain the private information that investors have about their investment opportunities. Thus the information asymmetry between the investors and the ADI is translated into an information asymmetry between the ADI and the outsiders with claims to the income streams generated by the ADI. This information asymmetry between the ADI and depositors is what necessitates some form of monitoring to ensure that the ADI managers are acting in depositors' interests. ADI managers have the capacity to act contrary to the preferences of depositors through their choice of investment projects to finance.

Without prudential supervision of ADIs then, depositors would recognise up front that they were not in a position to intervene in the actions of ADI management. This would reduce the quantity of relatively cheap funds that they would make available to investors through ADIs. This would adversely affect the aggregate rate of investment and so economic growth. It is this market failure arising from the information asymmetry between the managers of ADIs and depositors that the prudential supervisor is resolving within the Dewatripont and Tirole framework.

It is worth noting that Dewatripont and Tirole take as given that the majority of ADI debt funding is in the form of deposits, obtained from small depositors. They do not raise the particularly pertinent question of why, if deposits are such an inadequate corporate control mechanism, deposits are used in the first place. If ADIs were able to access alternative sources of debt finance from agencies with incentives to monitor and to intervene where necessary, the need for prudential supervision would be eliminated within the Dewatripont and Tirole model. Flannery (1994) presents a number of arguments for why banks have traditionally raised deposit funds. However, the widespread use of deposit funding remains an unresolved issue for future research.

5.2 Information Asymmetries and Insurers

There are two distinct types of insurance activities, general insurance and life insurance. The business of general insurance largely involves accepting premium income in return for promises to pay claims in certain, prespecified events that might occur during a given time interval. In contrast, life insurers now largely offer investment services, with strictly defined insurance policies forming a relatively small fraction of their business. The differences between these two types of insurance provision warrant separate discussions of the impact of information asymmetries.

5.2.1 General Insurers

In much the same way that there are information asymmetries about liquidity needs between depositors at ADIs, there are information asymmetries between general-insurance policyholders about the degree of risk attached to the events that they are insuring against. While insurers continue to develop improved screening techniques to sort policyholders into narrower risk categories, no screen is fine enough to eliminate this type of information asymmetry completely. Despite these similarities, there is one important difference between general insurance and deposit taking, which arises from the verifiability of the events that are insured against. Whereas, in deposit taking, the occurrence of a liquidity shock that forces early fund withdrawal cannot be observed by an ADI, in insurance a fundamental characteristic of all events that can be insured against is that they are observable by insurers (and more importantly, courts of law). Equally importantly, the claim is triggered by the event, not by the insured party.

This distinction between raising funds through deposit taking and raising funds through general-insurance provision is sufficient to prevent Diamond and Dybvig style runs on insurers. Verifiability is sufficient to rule out equilibrium behaviour in which policyholders decide to make claims on their policies, independent of the occurrence or not of the event being insured against. Thus, policyholders deciding to take their business away from an insurance provider only stand to redeem their unearned premiums. Even if a large fraction of policyholders withdrew their business, these redemptions would not induce insolvency because the claims could be met out of the provision for unearned premiums.[8] Thus, there is no incentive for a given policyholder to withdraw business because of the decisions of other policyholders.[9]

Thus, while the information advantages of policyholders induce the usual Akerlof-type market failures, they do not create the potential for runs on general-insurance institutions. The information asymmetries cause the level of insured risk to be sub-optimal, but they do not place the entire system of insurance at risk in the same way that the informational advantages of deposits can place the entire deposit-taking system at risk. Moreover, there is no obvious way in which the presence or activities of a prudential supervisor would assist in ameliorating the information asymmetries attached to individual policyholders. Rather, developing and using the screening techniques to minimise the effects of these information asymmetries is a large part of the business of general insurance.

Why then is there a need for prudential supervision of insurers? The answer lies in a variant on Dewatripont and Tirole's "representation hypothesis". In general insurance, however, the outside claimholders of concern are the policyholders who pay premiums to the insurer in return for long-term

8 The accounting standards require insurers to make a $1 provision for every $1 of unearned premium.

9 This statement ignores the effect that a large loss of business would have on the diversification of policy-specific risk. If a substantial fraction of policies were closed down, then the affected insurer could face an increased risk of large losses.

commitments to pay claims to the policyholders if certain prescribed events take place. The ability of insurers to fulfil these commitments depends upon the risk characteristics of the other policies written and the performance of the investments undertaken with the premium income. If anything, the asymmetry of information between insurers and policyholders about other policies and about the investment portfolios of the insurers is greater than that between depositors and the managers of ADIs. Analogously to the ADI case, the free-rider problem prevents policyholders from being able to commit to monitoring insurers and intervening in appropriate situations. Without an agency to act as the representative of policyholders, insurers may have little incentive to take the interests of policyholders into account.

Without prudential supervision of general insurance, individuals facing insurable risks would recognise in advance that they could not coordinate well enough to force general insurers to take their preferences into account. This would reduce confidence in the likelihood that insurance claims would be met as they occurred and this would reduce the overall level of insurance in the economy. More importantly, perhaps, it would reduce the willingness of individuals to take on insurable risk. To the extent that some of the risk associated with investment can often be insured against, this would adversely affect the aggregate rate of investment and so economic growth.

5.2.2 Life Insurers

The problems described above relating to information asymmetries about the riskiness of the individuals being insured also apply to life insurers. However, the potential for runs on life-insurers is even smaller because of the substantial reductions in payouts to policies that are closed down before their pre-specified expiry dates. Moreover, the reductions in the payouts to policies that are closed down early actually contribute to the ability of the life-insurer to meet the claims of the remaining policies. Thus, the Diamond and Dybvig style runs on ADIs are very unlikely to affect life insurers because the actions of one set of policyholders will not directly reduce the value of the investments held by other policyholders.

That said, the informational advantages about the capacity of life insurers to pay out policies in full are potentially greater than they are for general insurance given the extended duration over which customers are locked into the products that they purchase. Without prudential supervision, the free-rider problem will reduce the willingness of investors to lock themselves into the types of investment products offered by life insurers.

An informational asymmetry also arises from the fact that life insurers are the main writers of annuities in the Australian financial system. Given that annuities typically involve an up-front payment for a defined income stream that occurs over a potentially long period of time (sometimes with an indeterminate end date) the purchaser of such a contract is highly exposed to unpredictable future changes in the creditworthiness of the life insurer.

Thus, the prudential supervisor again has a role in representing the interests of the investors and annuity holders. Without a representative like the prudential supervisor, the supply of funds channelled through life insurers to those with investment opportunities will be reduced.

5.3 Information Asymmetries and Superannuation Funds

As mentioned in Section 3, prudential supervision of financial institutions is a policy response to information asymmetries between financial institutions and the parties that they transact with. As explained above, this is directly applicable to the ADIs and insurance institutions where information asymmetries are caused by the opaqueness of assets and the complexities involved in assessing liabilities, respectively. However, making a case for prudential supervision of superannuation providers based on information asymmetries is more difficult because other, quite similar, financial services are not deemed to require prudential supervision.

Instead, the case for prudential supervision of the superannuation industry is underpinned by broader interest of government in seeking to encourage more effective retirement income arrangements within the community. At least in part, the objective is to lessen reliance on the social welfare system as the main source of income for retirees. In this context, prudential supervision of the superannuation industry is motivated by the fact that government is a stakeholder in the performance of the retirement savings system. The prudential supervisor is the government's representative, ensuring that the superannuation system provides sufficient support to the first pillar of retirement-incomes policy.

It might be argued that, having imposed a constraint on consumption and savings behaviour, the government would be able to rely on the discipline imposed by fund members on fund managers. This argument is weakened by the historically limited fund choice available to the majority of superannuants. There are a variety of efficiency-related arguments for and against increased discretion for superannuants. However, while members of superannuation funds remain unable to impose appropriate discipline on their fund managers through choice of fund or other means, many of the control problems associated with information asymmetries in the Dewatripont and Tirole framework also apply to the superannuation industry. It is in this context that the rationale for prudential supervision of the superannuation industry can be related to the rationale for prudential supervision in the banking and insurance industries. In all three sectors, there is a need for a single agency to monitor behaviour and to have the power and incentives to act in the information gathered in a way that is aligned to the interests of the parties that they represent.

Facing these objectives, it is reasonable to ask how APRA intends to achieve them. This is the purpose of the following section, which discusses the powers available to APRA and the approach that APRA will take in applying those powers.

6 APRA'S POWERS AND APPROACH

To implement the reforms discussed in Section 3, it was necessary to pass 11 pieces of amending legislation. These changes have added considerably more depth to the legislative infrastructure that underpins Australia's financial regulation framework, particularly for the banking sector where legislation was previously quite sparse. The new legislation runs to in excess of 400 pages. It includes four new Acts - the *Australian Prudential Regulation Authority Act*, the *Payments System and Netting Act*, the *Payment Systems (Regulation) Act* and the *Financial Sector (Shareholdings) Act*. There are, as well, two omnibus Acts - *Financial Sector Reform (Amendments and Transitional Provisions) Act* and the *Financial Sector Reform (Consequential Amendments) Act* - which, between them, amended and repealed more than 70 existing Acts.

Despite this burgeoning legislation, APRA's approach will remain one in which resort to formal legal powers will generally be held in reserve; its preference will be to carry out its supervisory functions on an informal flexible basis, in co-operation with the entities it supervises. The need to maintain a flexible approach is further indicated by APRA's much broader mandate. As discussed in Section 5, APRA is required to balance the achievement of financial safety objectives against the need to promote financial efficiency, competition, contestability and competitive neutrality.

To achieve these objectives, APRA recognises the importance of detecting any problems early. In this regard, APRA has in place an extensive off-site and on-site supervision program. At this stage, these programs vary according to the type of institution supervised, however, in line with the move to a functional supervisor, this is likely to change in the near future.

6.1 Supervision of Authorised Deposit-Taking Institutions

As alluded to earlier, the bulk of the substantive legislative amendments have impacted upon the *Banking Act,* which has been in place since 1945. The core elements have been retained in the amended *Banking Act*, but have been elaborated on to accommodate all deposit-taking institutions, including those that were formerly the responsibility of AFIC. The essence of the *Banking Act* is that only institutions that are financially sound are authorised to take deposits. Once authorised, an ADI becomes subject to the prudential supervision of APRA.

In the case of banks, this supervision has always been undertaken by way of non-statutory *prudential statements* rather than through the enforcement of black letter law. These statements adopt a preventative focus and are written in the form of principles rather than rules. In part, this approach has been possible because of the relatively small number of authorised banks in Australia. It is also a product of a market environment in which financial institutions see it as very much in their commercial best interest to be seen to be complying with internationally recognised standards of supervision.

The key requirement is that ADIs must hold a minimum of 8 per cent of capital to risk-weighted assets, to allow for a margin of error between the book value of assets and what would be realised in a situation where assets had to be sold to repay depositors. The capital requirements, outlined in Prudential Statement C1, are consistent with the 1988 Basle Accord on Capital Adequacy. In 1997 the Accord was amended to incorporate a capital charge for market risk, set out in Prudential Statement C3.

Whilst these statements are non-statutory, a banking authority may be granted conditionally. To date, banking authorities have been granted on the condition that the body corporate, to which the authority is granted, conforms to the requirements embodied in these statements. APRA may revoke a banking authority if a body corporate fails to comply with such a condition of its authority. The capacity of APRA to revoke a banking authority for non-compliance with the prudential statements has never been tested.

In the amended *Banking Act*, APRA has been granted a number of additional formal powers. In particular, APRA is now able to establish *prudential standards* for ADIs and can issue directions to ADIs. The effect of the establishment of a prudential standard will be declaratory only; breach of a standard does not of itself carry a penalty. It will, however, constitute grounds on which APRA would be able to issue a direction to institutions that failed to comply with the standard. The ability to make prudential standards was inserted to ensure that APRA had the power to enforce a standard if suasion proved to be inadequate. At this stage, no standards have been issued; however, it is expected that this power, which previously existed in the Financial Institutions Code, will become more important now that APRA is also responsible for the supervision of non-bank ADIs.

Directions can also be issued by APRA whenever it considers that a direction is necessary to protect the interests of depositors. The range of directions that can be made include:

- requiring an authorised institution to comply with a standard or regulation;
- requiring an audit of an authorised institution, and/or ordering the removal of external auditors from office and their replacement by other auditors;
- removing a director or executive officer of an authorised institution from office;
- causing a director, executive officer or employee to not take part in the management or conduct of the business of the institution;
- stopping the payment of dividends or any other payments by an institution;
- stopping the undertaking of any financial obligation on behalf of any other person;

- requiring an institution to stop taking deposits, or not to repay any money held on deposit; and
- any other direction as to the way in which the affairs of an authorised institution are to be conducted or not conducted.

Failure to comply with a direction constitutes grounds for revocation of an authority (Section 9A(2)) and, for individuals concerned, failure to ensure compliance with a direction can attract a criminal penalty (Section 11CG). In addition to these new powers over ADIs, the power to issue and revoke banking authorities has been transferred from the Governor-General to APRA. The circumstances in which an ADI's authority can be revoked have been broadened significantly. Section 9A now enables APRA to withdraw an authority in the event that an ADI has not complied with provisions of the Act or has breached any conditions placed on its authority. This change is consistent with practice in many other countries governing the licensing of financial institutions and strengthens APRA's ability to control the entry and exit of regulated institutions.

The Act also confers powers on APRA over an ADI's external auditor. Section 16B(1) empowers APRA to require an ADI's auditor to supply it with any information that it considers will assist in carrying out its functions under the Act. There is also a "whistle-blowing" provision: an ADI's auditors are under a duty to inform APRA should they have reasonable grounds to believe that an ADI:

- is insolvent (or that there is a significant risk of it becoming insolvent);
- has failed to comply with requirements in the *Banking Act* (such as standards or directions); or
- has existing or proposed activities that may materially prejudice the interests of depositors of the ADI.

Again, these provisions are designed to improve APRA's capacity to detect problems early and to take preventative action to correct them.

Notwithstanding the incorporation of this substantial set of new powers into the *Banking Act*, it is APRA's expectation that they will be utilised rarely. Generally, APRA's day-to-day supervision of ADIs will be conducted with the co-operation of the supervised institutions on the basis of non-statutory guidelines. Prudential supervision of banks in Australia has traditionally favoured market-based solutions over the use of legal sanctions. This approach will continue, and is likely to spread to other institutions supervised by APRA. The direction and standard-making powers will give APRA the legal authority to ensure that an ADI takes actions to address significant problems when more direct or immediate action is warranted.

While the depositor protection provisions of the *Banking Act* have been redrafted, Australia's existing (and unique) scheme of depositor protection has been retained. These provisions consist of three elements: a power to obtain information about an ADI's financial condition; a power to intervene when depositors' interests are threatened; and affording depositors in Australia a statutory priority over other claims on an ADI's assets in the event of a liquidation. Unlike many other countries, Australia has not opted to implement any system of deposit insurance, Government guarantees or industry-funded support. Despite the existence of widespread myths to the contrary, the *Banking Act* does not provide depositors with a guarantee that their deposits will be repaid. While APRA's responsibility is to protect depositors, in most cases this will require early action to prevent financial distress and, where distress still occurs, early action to find a buyer.

As mentioned earlier, APRA undertakes both off-site and on-site supervision in order to prevent financial distress. The off-site work includes regular analysis of key prudential and statistical data - capital, profit, large exposures, country exposures, liquidity, impaired assets, balance sheet composition, off-balance sheet activity and strategic developments. The on-site visit program is centred on market-risk and credit-risk visits. These visits, which are conducted on a two-year cycle, are focused on evaluating the systems and controls employed by banks to manage these risks. In the near future, APRA will also undertake liquidity-risk and operational-risk visits.

6.1.1 Conglomerates

The amended *Banking Act* contains a new Division dealing with Non-Operating Holding Companies (NOHCs).[10] Prior to these amendments, Government policy dictated that, where a financial conglomerate included a bank, the bank was required to be the holding company.[11] The Act now allows for the adoption of different types of conglomerate structures by setting up a parallel regime for the authorisation and supervision of NOHCs.

Section 11AA confers power on APRA to authorise NOHCs which own ADIs. Once authorised, all the supervisory powers that apply to ADIs with respect to regulations, conditions, standards, directions, auditors and the supply of information, also apply to an NOHC. Authorities issued to NOHCs are separate from those granted their ADI subsidiaries; the issue of an NOHC authority does not relieve ADIs within the same group from the need to obtain authorisation in their own right. Note that, unlike ADI authorisation, the authorisation of NOHCs is not compulsory. However, APRA may refuse to authorise an ADI on the grounds that its parent is unauthorised.

There are also more direct powers that can be exercised over the operations of an ADI's subsidiaries, which previously could only be affected by taking action against the ADI itself. The information and statistical collection powers in Sections 51 and 62 have been expanded to encompass subsidiaries. Section 61 now also allows APRA to appoint a person to investigate the prudential condition of an ADI's

10 Division 1AA of Part II of the *Banking Act 1959*. A Non-Operating Holding Company is defined as a company that conducts no business other than owning shares in another company.

11 This was not the case for insurance companies – they were allowed to have non-financial entities in the group.

subsidiary. It would also be possible for APRA to use its directions power to require that an ADI divest itself of a subsidiary in the interests of the safety of its depositors.

These changes provide for a wider range of organisational structures than were previously available to financial conglomerates containing an ADI, and should more readily accommodate the inclusion of non-financial activities alongside banking than was possible in the past. They will allow for a shift away from the previous policy of prohibiting non-bank ownership of banks in favour of a policy based on exposure containment and firewalls.

6.2. Supervision of Insurance Companies

As you would expect, there are quite a few similarities between the supervision of general and life insurance (and, for that matter, ADIs). The first step in protecting policy holders is to ensure that only companies with sufficient capital backing and management expertise are authorised to carry on insurance business in Australia. Following authorisation, the operations of the insurance companies are then constrained by the need to comply with a number of requirements, some of which will be discussed shortly.

Two acts which have repercussions for both groups of insurers are the *Financial Sector (Shareholdings) Act 1998* and the *Insurance Acquisitions and Takeovers Act 1991*. These Acts are designed to ensure the capacity of the owners to protect the rights of policy holders by requiring that any changes in the ownership structure be approved by APRA.

6.2.1 General Insurance

The *Insurance Act 1973* has, and continues to be, the primary method for supervising general insurers in Australia. This Act sets out all of the constraints imposed on general insurers, including:

- if the body corporate has share capital - its share capital must be greater than $2 million at all times;
- where the body corporate is incorporated in Australia - the value of its assets must at all times exceed the amount of its liabilities by not less than: $2 million; 20 per cent of its premium income; or 15 per cent of its outstanding claims provision, which ever is the greatest;
- have reinsurance arrangements approved by APRA in place at all times (or an exception from this requirement); and
- any such further conditions as imposed by APRA or the Treasurer.

APRA is not able to make statutory standards for general insurers. It does, however, issue General Insurance Circulars, which act as a guide to insurance companies about how particular provisions of the Insurance Act will be administered in practice and to provide guidance on reporting requirements and disclosure.

The majority of supervision work occurs off-site with the examination of reinsurance arrangements, quarterly and annual returns. A large amount of time is also devoted to the administration of the *Insurance Act*, including authorisation and revocations of insurers and the processing of applications under the *Financial Sector (Shareholdings) Act 1998* and the *Insurance Acquisitions and Takeovers Act 1991*.

There is an on-site visit program in place, the purpose of which is to gain an understanding of the current and future direction of the insurer and to investigate and discuss with management, risks that have been identified from the examination of statutory returns or through market intelligence. Although there is no generic format for visits, they can generally be categorised as either a general update visit or a specific issues inspection. General update visits are used to discuss with the senior management of the general insurer its current performance and to gain an understanding of its future directions. As the name suggests, specific-issues inspections focus on specific issues that have become apparent to APRA. After the visit has taken place, APRA may require the insurer to take remedial action.

Generally, regulation of the industry has occurred in a co-operative manner with the use of suasion to ensure that companies act in accordance with the spirit of the law. However, there have been times where the General Insurance Group has needed to apply the law to its fullest effect in order to protect the interests of policy holders. Breaches of the *Insurance Act* that constitute a serious crime or serious contravention go before an enforcement committee, which agrees on the strategy to rectify or prosecute the breach. In this regard, the *Insurance Act* includes formal powers of inspection and powers to direct a company to revalue its assets and liabilities.

6.2.2 Life Insurance

The principal supervisory instrument in life insurance is the *Life Insurance Act 1995* (Life Act). The Life Act sets out the requirements that a company must meet in order to be registered to carry on life insurance business in Australia. APRA may only refuse to register a life company if it does not meet these requirements, which are designed to ensure that the company starts with a sound financial footing.

APRA is able to impose conditions on the registration of a life company. Aside from compliance with the Life Act and other regulatory requirements, the appraisal of an application for registration would also include an assessment of the capacity of the company and its officers to meet “fit and proper” principles. This considers financial standing, ethics and expertise of management.

In contrast to the situation for general insurers, the Life Act provides for the establishment of a Life Insurance Actuarial Standards Board that publishes standards of actuarial practice required under the Act. There are two actuarial standards established under the Life Act, the Solvency Standard and the Capital Adequacy Standard. Together, these standards form a two-tier capital requirement, with each tier considering the capital requirements in a different set of circumstances. The first tier, the Solvency Standard, is to ensure that under a range of adverse circumstances the life company would be expected to be in a position to meet the guaranteed obligations to policy owners and other creditors. The second tier, the Capital Adequacy Standard, is to ensure that the obligations to, and reasonable expectations of, policy owners and creditors can be met under a range of adverse circumstances, in the context of a viable ongoing operation.

In addition to a comprehensive off-site supervision program, APRA aims to visit each life company at least every three years; companies presenting a greater risk are subject to more frequent visits with a focus on the specific issues of concern. Reviews tend to include an inspection of documents, an update on the strategic direction and business performance from the CEO and senior management and then move on to more specific issues.

The main enforcement tools contained within the Life Act are the capacity to undertake a formal investigation and the capacity to seek the appointment of a judicial manager to a life company, or part of a life company's business. In practice, the enforcement provisions of the Life Act are rarely used. In most cases, suasion and negotiation are sufficient to ensure compliance with the supervisory regime.

6.3 Supervision of Superannuation Funds

Superannuation funds are prudentially regulated under the *Superannuation Industry (Supervision) Act 1993* (SIS Act). As superannuation originally arose in the employer/employee context, it has traditionally been offered under a trust structure. The trust structure allows for the separation of the assets of an employer from the superannuation assets of its employees (the beneficiaries of the fund) and for the management of these latter assets for the best interest of the beneficiaries. As a result, the rules applying to trusts have become the main legislative backbone for the prudential regulation of superannuation funds. The regime applying under the SIS Act has maintained and enhanced the use of trust law as a prudential system. It largely codifies the relevant trust law rules applying to superannuation. The SIS Act and Regulations also prescribe various retirement income and superannuation standards that recognise the unique nature of superannuation and the concessional tax treatment afforded to it by the Government.

There are four types of superannuation funds recognised under the SIS Act: "excluded (or self-managed)" funds; "public offer" funds; "standard employer-sponsored" superannuation funds; and "public sector" superannuation funds. Excluded funds have fewer than five members and are exempted from some of the checks and balances of the SIS Act, since the members are usually not at arm's length.

The SIS Act allows for four types of instruments with similar characteristics to standards - that is, they are made by APRA and have statutory force. These instruments are approvals, determinations, exemptions and modifications. The SIS Act requires APRA to approve various activities undertaken by superannuation funds. Determinations are used to set out the specific requirements of a more general provision. Exemptions are a formal mechanism for exempting specific funds and trustees from various requirements of the Act. Modifications are a mechanism for amending the primary legislation and can be either permanent or temporary.

Superannuation funds are not subject to any system of pre-approval or authorisation to carry on business since it is not compulsory for superannuation funds to be regulated under the SIS Act. This is because under the Constitution, the Commonwealth has no direct power to legislate in respect of superannuation. However, to encourage funds to be regulated under the SIS Act, only regulated funds are eligible for tax concessions or are able to accept Superannuation Guarantee contributions.

The large number of regulated superannuation funds makes it impossible for APRA to continually monitor funds on an individual basis. As a result, APRA's approach to off-site supervision is more concerned with flagging superannuation funds for on-site visitation programs. For example, inconsistencies in statistical returns may provide a flag for overview.

In addition to funds flagged for review through off-site supervision, the largest 360 superannuation funds are visited each year. Supervision is fundamentally concerned with the ability of trustees to identify, measure and appropriately manage risks that have the potential to lead to losses due to mismanagement or fraud.

7 CONCLUSION

The recommendations put forward by the Wallis Inquiry led to a dramatic overhaul of the regulatory framework in Australia. The reforms, which focused on the organisational framework rather than on the range of institutions being regulated, were motivated by the desire to have a separate agency being responsible for each of the four major types of market failure. The previous regulatory framework, in contrast, was organised around institutional type, with separate agencies regulating different classes of institutions.

This paper focused on the role of APRA, the regulatory agency responsible for preventing information asymmetry leading to market failure. In keeping with the principle that regulation should be restricted to those types of financial contracts where the consequences of information asymmetry are perceived to outweigh the costs, regulation is restricted to deposits raised by institutions without the issuance of prospectuses, insurance contracts and superannuation funds. To achieve this goal, APRA supervises the relevant institutions from a prudential perspective.

Embodied in APRA's mission statement, and more formally in the *Australian Prudential Regulation Authority Act 1998*, is the requirement that APRA must balance the objectives of financial safety, stability, efficiency, competition and competitive neutrality. The first objective, which can be alternatively expressed as the assurance that financial promises will be met in all but extreme circumstances, amounts to ensuring that information asymmetry does not cause market failure along the lines discussed in Akerlof. The second objective can be thought of as a supporting objective, while the final three objectives can be interpreted as constraints. To ensure that these objectives are met, APRA has been given significant legislative backing.

Although the previous regulatory regime worked well, the financial system has changed in ways that made reforms to the framework desirable. The most notable changes have been the emergence of conglomerates and the erosion of the traditional distinctions between financial institutions. In this new environment, prudential supervision can be more efficiently and effectively conducted under a structure based on the types of products being supervised, rather than on the type of institution. Furthermore, it is felt that a single prudential regulator will have an enhanced ability to adjust prudential regulation to suit the evolving financial system and will achieve economies of regulation. The task ahead is to ensure that these perceived benefits become reality.

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