A RESER

Stephen Martin, MP, chairman of the Federal government's inquiry into the Australian banking industry, looks at the Reserve Bank's role in prudential supervision of the banks.

It is now almost nine months since my Committee's inquiry into the Australian banking industry was announced, and in that time the Committee has received a vast amount of information on banking in Australia. A range of issues has been canvassed with a wide body of representative organisations.

Throughout this inquiry, people from a variety of backgrounds have told the Committee what they think about the performance of Australian banks over the last few years. While some have focused on their personal experiences, providing the Committee with much anecdotal evidence, others have addressed broader issues relevant to the role and position of banks in Australian society.

One of the functions of the Committee during this inquiry is to assess the impact of financial deregulation on the banking sector. From the evidence which the Committee has received, it is obvious that deregulation has introduced a totally new ballgame for banks. New rules on entry of banks and new rules on how banks operate have thrust the Australian banking sector out of the sheltered environment of regulation and into the spotlight of competition.

Naturally, changing the rules of a game not only impacts on the players in the field but also on the referee, who is responsible for ensuring that the rules are followed and that the game is played in an orderly and fair fashion. Clearly, deregulation has affected the role of Australia's banking referee, the Reserve Bank of Australia, as well as the role of its various linesmen, that is accountants and auditors. I am referring here to the role of the Reserve Bank, and specifically the Reserve Bank's responsibility for prudential supervision.

Prior to deregulation, prudential supervision was not a major issue. Banks were restricted not only in their ability to lend but also in what they could pay on deposits and what they could charge on loans. As the managing director of the Commonwealth Bank, Don Sanders, recently pointed out to the Committee, the attitude in the days before deregulation was 'if you don't let them do much, they won't get into much trouble.' Supervision was often characterised as a chat in a gentlemen's club over a cup of tea and a prudential scone.

While the Reserve Bank had the power to demand information from banks relating to their stability, and to

VED

APPROACH?

make provision for the control of interest rates, generally such powers were exercised in an informal manner.

Following deregulation, a more formal supervisory procedure was considered appropriate. Banking licences issued to the new banks explicitly required them to operate within prudential standards determined by the Reserve Bank. In addition, amendments to the Banking Act in 1989 rendered the Reserve Bank responsible for the collection and analysis of information on prudential matters relating to banks. The Reserve Bank also gained responsibility for promotion of sound practices.

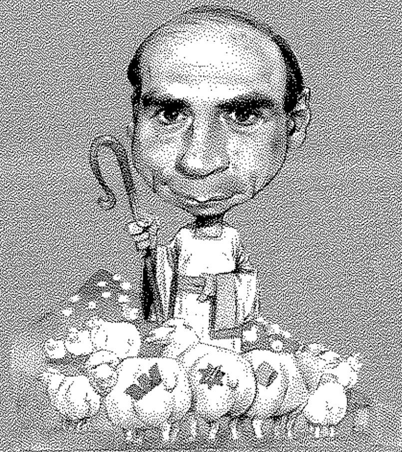
A fundamental question for the Committee is whether the existing system of prudential supervision has proved to be adequate in the new world of deregulation. Before being able to answer that question, it is necessary to be clear about what supervision is intended to achieve.

Under the Banking Act, the Reserve Bank is required to exercise its powers for the protection of depositors. It also has an overall responsibility for the stability of the financial system, but not any one intermediary. The Reserve Bank monitors developments affecting non-bank financial intermediaries and takes a close interest in the efficient working of the payments system. In exercising its responsibilities, the Reserve Bank does not have formal power over the State banks, although voluntary agreements have been entered into to meet Reserve Bank prudential requirements.

The Governor of the Reserve Bank recently told the Committee that, in his view, the system of prudential supervision is a success. He indicated that despite recent upheavals there have not been any shortfalls, depositors have not lost money, and the system has not collapsed.

It is evident, though, that the financial system has felt some strain as a result of difficulties with building societies in Victoria and the State banks of Victoria and South Australia. While the Reserve Bank may be correct in asserting that no depositors have lost money and the system has not failed, such upheavals clearly impact on an industry which relies heavily on investor confidence. It is, therefore, not surprising that suggestions have been made to the Committee about reinforcing the system in case of any future upheavals.

One such suggestion is that there should be a single regulatory authority to oversee the activities of the entire financial system, and that the Reserve Bank should



> "Bankers sometimes look on politicians as people who, when they see light at the end of the tunnel, order more tunnel."

assume such a role. This has been advocated, in particular, by some of the major banks, which have expressed concern not only about increasing regulation through consumer legislation but also about the movement of funds out of the banking sector and into what they have called the riskier environment of funds management. Such movement of funds is clearly the result of an increasing community emphasis on superannuation. In this regard, the National Australia Bank recently warned the Committee that there are some funds management companies in the community which may not place funds as prudently as one would expect.

The banks, of course, are keen to play a role in this superannuation drive. The issue of having one regulatory authority for all financial system activity indicates that the superannuation industry is very much in the banks' minds.

An important question which needs to be addressed in this context is the extent to which funds which are identified with banks can impact on the operations of the bank and, flowing on from that, on the financial system as a whole. Would a bank which has identified its name with a fund be obliged to bail that fund out if it gets into trouble, and what would that mean in terms of confidence in the bank? Who then should have the responsibility for supervision where banks are involved in funds management? Should it be the Insurance and Superannuation Commission or the Reserve Bank, or both. Clearly, these are matters which need to be addressed in considering the supervisory responsibilities of the Reserve Bank.

Alongside some of the major banks, the State Bank of New South Wales has joined the calls for extending the supervisory responsibilities of the Reserve Bank, suggesting that they include supervision of State banks. At a recent public hearing, the State Bank indicated to the Committee that it could become licensed under the Banking Act upon a referral of powers by the New South Wales government to the Federal government. In fact, the State Bank advised that an exchange of letters to this effect has already taken place.

This procedure would enable the Reserve Bank to impose standards rather than rely on voluntary compliance. While such a move would mean that State banks would be obliged to hold non-callable deposits with the Reserve Bank at a below market interest rate, this price appears acceptable to all three State banks. The managing director of the R & I Bank, in a similar vein to his counterpart in New South Wales, told the Committee that the bank would be happy to come completely within the prudential requirements or controls of the Reserve Bank. The chief executive of the State Bank of South Australia also indicated that he would be happy to participate in a more formal scheme.

The opportunity to further explore the issue of prudential supervision of State banks became available to the Committee in July and August this year when it was addressed by State government representatives. At that time, the Committee also considered the question of the supervision of building societies and credit unions, currently the responsibility of State governments.

At the present time, moves are under way to introduce uniform legislation and a national regulatory authority for building societies and credit unions. These moves were initiated following the 1990 Premier's Conference. The authority is to be called the Australian Financial Institutions Commission.

In this context, some building societies and credit unions have expressed a preference to be supervised by the Reserve Bank. This has been supported by members of the consumer movement, who recently told the Committee that it should be made very clear that any deposit-taking organisation should be under an acceptable level of prudential supervision. They indicated that as the Reserve Bank has been the most successful of prudential regulators, it should adopt a greater role in this regard.

"In response to the question "what is a bank?", The Times newspaper once commented that it is "... an institution which issues twice-yearly a misleading statement of its position."

The Reserve Bank, though, does not share the enthusiasm of other participants in the financial system for the expansion of its supervisory role. The Governor advised the Committee that, in the Reserve Bank's view, it is neither appropriate nor necessary to have a national Reserve Bank supervisory arrangement for all financial institutions. He did not see much sense in trying to force all financial institutions into the mould of a bank. Instead, the Governor indicated that there should be a diversity of financial institutions offering different degrees of protection and different degrees of reward in terms of interest rates for running greater risks.

The issue of how far the Reserve Bank's supervisory responsibilities should reach will continue to be examined by the Committee. At the same time, the Committee will be considering suggestions that the bank should improve its supervisory procedures, particularly in terms of information gathering.

In response to the question "what is a bank?", *The Times* newspaper once commented that it is "... an institution which issues twice-yearly a misleading statement of its position". Recent experiences suggest that in some cases there may be more than a little truth in that statement. The point is, how is the Reserve Bank, which is the supervisory body responsible for the stability of the financial system, able to ensure that information on prudential matters provided to it by banks is accurate?

A former bank internal auditor and trainer, Ms Carolyn Currie, warned the Committee at a recent public hearing that "you cannot rely on prudential supervision whereby the Reserve Bank collects information and assesses it, because if you have bad internal controls within the bank, if you had fraud perpetrated from within the bank, or if you just simply have some mismanagement, that information may be unreliable".

A similar concern has been expressed by the con-

PATTS – Q1554

Superannuation Services from AMP

"I run a number of super funds. When I need help I can't talk to a software program, but I can talk to my consultant at AMP."

"COMPUTER PROGRAMS are fine, I couldn't do without them, but there are times I need advice, and the computer can't help. That's when I talk to my AMP Superannuation Consultant.

"It's just like having another expert on hand to help with all the tricky legislation, and any changes which might mean benefits to my clients.

"I'm still in control, but with AMP's expertise on hand I know I'm keeping up to date with all the changes, as well as getting help with the documented information for my clients ...that can be such a problem!

"I'm glad I've got AMP on my team, they'll always be there for me."

If you want the super fund expertise that only the experienced professionals at AMP can provide, then talk to the experts at AMP today.

AMP
CORPORATE SUPERANNUATION SERVICES

WE'LL ALWAYS BE THERE

SYDNEY: (02) 257 1904 Colin Saultry • ACT: (062) 75 4241 Gil Le • MELBOURNE: (03) 895 5866 Tony Hills • BRISBANE: (07) 347 0260 Gary Keily
ADELAIDE: (08) 210 1514 Kevin Cooper • DARWIN: (089) 46 4211 Stephen Trenorden • PERTH: (09) 426 2002 Mike O'Donnell • HOBART: (002) 35 5470 Wayne Gates

sumer movement. A representative of the Australian Consumers' Association commented that "the Tricontinental inquiry and part of the Westpac letters have shown us very clearly how senior management of a bank and the auditors often do not know what is happening in their own bank".

Currently, the Reserve Bank relies on banks' external auditors to verify that banks are reporting correct information and complying with prudential requirements. It has been suggested, though, that these auditors see their duty as being to the shareholders of the bank alone and not to the Reserve Bank. The concern is that some auditors may be reluctant to offend those who appoint them and may therefore be in conflict of interest.

"The Committee will also be directing its attention to the adequacy of existing accounting standards in relation to prudential supervision."

One way of overcoming such difficulties, according to Ms Currie, would be to adopt the United States approach and establish Reserve Bank audit squads which would make surprise visits to banks to check their books. Audit teams would swoop in, check security packages, look at the calibre of credit assessment, and check non-accrual loans to ensure that adequate provisions have been made.

In considering such a proposal, it is important to remember that a balance needs to be maintained between, on the one hand, an efficient and profitable banking system, and, on the other hand, the depth and intrusiveness of supervisory arrangements designed to maintain the stability of the financial system. It is also important to draw a distinction between having accurate information on bad loans and actually preventing them.

In rejecting the proposal for audit squads, the Reserve Bank argued that apart from the numbing effect such a move would have on the banking system, it also would not stop banks from writing bad loans and making losses.

Equally though, the Reserve Bank has acknowledged that it does have doubts about too great a reliance on external auditors. The governor told the Committee that when the arrangements which the Reserve Bank relies upon were put in place, auditors were held in higher esteem than they are now. He noted that "... there have been occasions when [the Reserve Bank has] not been able to, or there might well be occasions where [the Reserve Bank] cannot, rely entirely upon what management and/or the auditors are telling [it]."

In response, the Reserve Bank has expressed an interest in developing its in-house capacity to assess information provided to it, as a supplement to the external auditor process utilised by banks. The aim would be to enable the Reserve Bank to get an independent feel for the seriousness of potential problems and to assist it in identifying any inadequacies in the systems of particular institutions about which there are concerns or suspicions. Clearly, the Committee will be exploring this development in its consideration of an expanded supervisory role for the Reserve Bank.

In this context, the Committee will also be directing its attention to the adequacy of existing accounting standards in relation to prudential supervision. If the Reserve Bank is to improve its capacity for assessing information from banks, then it must be able to ensure that the information which it receives from banks' auditors is not only accurate but also consistent.

In December 1987, the Australian Accounting Research Foundation issued an Auditing Guidance Release on the audit implications of Reserve Bank prudential reporting requirements. That release remains the official source of guidance issued to auditors on their responsibilities to the Reserve Bank and to their client banks. In light of recent experience in the banking industry, the Committee is interested in exploring with the Reserve Bank and representative accounting bodies the extent to which the standards outlined in that release are being adhered to and are adequate.

As I indicated I have concentrated here on one aspect of my Committee's inquiry into the Australian banking industry, that of prudential supervision. As one can see, in this one area alone there are a number of complex issues for consideration by the Committee. We must weigh up whether the scope of the Reserve Bank's responsibilities for prudential supervision is adequate in the changed and changing environment of deregulation. We must also consider whether the approach to prudential supervision, which has placed much emphasis on the role of external auditors, is appropriate in light of recent experiences.

Beyond the supervision issue, there are, of course, a myriad of matters to be examined, ranging from issues of competition to profitability and the impact of deregulation on consumers.

When this inquiry commenced, there was much concern about it being a political exercise. Critics were quick to dismiss the Committee and presumed that it could not achieve very much at all. In fact, my Committee is addressing the substantive issues in relation to banking in this country. We are taking a serious and comprehensive look at the banking sector and how deregulation has impacted on one of Australia's most important industries.

I once read that "bankers sometimes look on politicians as people who, when they see light at the end of the tunnel, order more tunnel". Through this inquiry, I believe that my Committee has burrowed into Australia's banking tunnel and has let in the light so that everyone – bankers, politicians and the general public – can see where the financial train is heading.

At the end of the day, the recommendations which my Committee makes will not be about adding to the tunnel, but rather ensuring that the track to the future is clear and safe, and that no-one is taken for a ride. ●

The above address was delivered by the chairman of the House of Representatives Standing Committee on Finance and Public Administration to the Chartered Accountants in Business Committee of the Institute's NSW branch on 19 July, 1991.