

**Australia: Financial Sector Assessment Program—
Detailed Assessment of Observance of Standards and Codes**

This Detailed Assessment of Observance of Standards and Codes for Australia was prepared by a staff team of the International Monetary Fund as background documentation to the Financial Sector Assessment Program with the member country. It is based on the information available at the time it was completed in October 2006. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of Australia or the Executive Board of the IMF.

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FINANCIAL SECTOR ASSESSMENT PROGRAM

AUSTRALIA

DETAILED ASSESSMENT OF
OBSERVANCE OF STANDARDS
AND CODES

OCTOBER 2006

INTERNATIONAL MONETARY FUND
MONETARY AND FINANCIAL SYSTEMS DEPARTMENT

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I. BASEL CORE PRINCIPLES

A. General

1. This assessment of the current state of Australia's implementation of the Basel Core Principles for Effective Banking Supervision has been completed as part of a Financial Sector Assessment Program undertaken in December 2005 by the International Monetary Fund. An assessment of the effectiveness of banking supervision requires a review of the legal framework, both generally and as specifically related to the financial sector, and a detailed examination of the policies and practices of the institutions responsible for banking supervision.
2. Australia has adopted a functional approach to oversight of the financial system, with the roles and responsibilities of the various agencies broadly divided by regulatory objective. The Australian Prudential Regulation Authority (APRA) is the agency responsible for the prudential supervision of banks, insurers and superannuation funds. The Australian Securities and Investments Commission (ASIC) is the market conduct regulator and also administers the provisions of company law for both listed and unlisted companies. The Reserve Bank of Australia (RBA) has responsibility for payment system oversight and overall financial stability. The federal financial intelligence unit (FIU), the Australian Transaction Reports and Analysis Centre (AUSTRAC), has a dual role as both an FIU and anti-money laundering and countering the financing of terrorism (AML/CFT) regulator. As the AML/CFT regulator, AUSTRAC is responsible for ensuring compliance with current AML/CFT legislation. With respect to banking and other financial services issues, the Treasury is responsible for the preparation of laws and regulation and provides the Treasurer with policy advice. Legislation confers on the Treasurer certain responsibilities and the Treasurer might also play a role in financial sector supervision through issuing directions to APRA and ASIC. With respect to AML/CFT, the Attorney-General's Department is responsible for the preparation of laws and regulation and provides the Minister for Justice and Customs with policy advice.

B. Information and Methodology Used for Assessment

3. The assessment team¹ reviewed the legal framework for banking supervision, held extensive discussions with the staff of the APRA, ASIC, the RBA, ASIC, the Treasury and participants in the banking and financial markets, and examined the current practice of APRA's on-site and off-site supervision. The assessment team had the benefit of working with a comprehensive self-assessment completed by the Australian authorities, enjoyed excellent cooperation with its counterparts, and received all the information it required. The team extends its thanks to the staff of the various agencies and the Treasury and in particular

¹ Michael Andrews (IMF-MFD Consultant) and Göran Lind (Sveriges Riksbank).

to the staff of APRA for their participation in the process and comprehensive self-assessment.

4. Reaching conclusions required judgments by the assessment team. Banking systems differ from one country to another, as do their domestic circumstances. Furthermore, banking activities are changing rapidly around the world, and theories, policies, and best practices for supervision are swiftly evolving. Nevertheless, by adhering to a common, agreed methodology, the assessment should provide the Australian authorities with a reliable measure of the quality of its banking supervision in relation to the Core Principles, which are internationally acknowledged as minimum standards.

5. The assessment of compliance with each principle is made on a qualitative basis. A four-part assessment system is used: compliant; largely compliant; materially non-compliant; and non-compliant. To achieve a “compliant” assessment with a principle, all essential criteria generally must be met without any significant deficiencies. A “largely compliant” assessment is given if only minor shortcomings are observed, and these are not seen as sufficient to raise serious doubts about the authority’s ability to achieve the objective of that principle. A “materially non-compliant” assessment is given when the shortcomings are sufficient to raise doubts about the authority’s ability to achieve compliance, but substantive progress had been made. A “non-compliant” assessment is given when no substantive progress toward compliance has been achieved.

C. Preconditions

6. The preconditions for effective banking supervision are well established in Australia. Over the past two decades, Australia has implemented wide-ranging structural reforms and strengthened the frameworks for monetary and fiscal policies, which have yielded rapidly rising incomes through strong job creation and high productivity growth. The economic expansion that began in 1992 is now in its fourteenth year. The unemployment rate has fallen by 6 percentage points since 1992, supported by more flexible labor markets and welfare reforms. Inflation has remained low and net public debt has been all but eliminated, all in the context of a stable and resilient economy.

7. The financial system is relatively large and diversified. Financial system assets amount to over 300 percent of GDP. Authorized deposit-taking institutions (ADIs, consisting of banks, credit unions, and building societies) account for about half of total financial system assets.² A further 23 percent of assets are held by life insurers and superannuation funds. Stock market capitalization is also relatively large, at over 100 percent of GDP.

² The terms bank and ADI are generally used interchangeably in this assessment, although in some contexts it will be clear that only banks and not other ADIs are being referenced.

8. The banking system was made up of 238 ADIs, including 14 Australian-owned banks, 11 foreign subsidiary banks, 28 branches of foreign banks, 14 building societies, 158 credit unions, 3 specialist credit card institutions, and 3 ADIs that provide services to member building societies and credit unions. Of the banks, the largest five held some 74 percent of assets, with the bulk of the remainder being held by other domestic banks, locally incorporated foreign banks, and foreign bank branches. The credit unions and building societies play a modest role, with their total assets comprising less than 2 percent of total ADI assets.

Monetary policy framework

9. The power to determine monetary policy is conferred on the Board of the RBA by the Reserve Bank Act 1959, which requires the Board to conduct monetary policy in a way that, in the RBA Board's opinion, will best contribute to the objectives of the stability of the currency of Australia, the maintenance of full employment, and the economic prosperity and welfare of the people.

10. The RBA Board conducts monetary policy independently of the Government. This is made explicit in the *Statement on the Conduct of Monetary Policy* agreed between the Treasurer and the Reserve Bank Governor in 1996 and reaffirmed and updated in 2003. The Statement includes a commitment by the RBA to hold consumer price inflation to between 2 and 3 percent, on average, over the course of the cycle. Under the Statement, the Government notes the role that disciplined fiscal policy must play in achieving the inflation objective. Monetary policy is conducted through the cash rate. Open market operations by the RBA in the money market keep the cash rate at or near an operating target decided by the RBA Board.

Currency regime

11. The Australian dollar was floated in 1983 and has become a key economic shock absorber. By moving broadly in accordance with the fluctuations in external demand and commodity prices, the exchange rate has tempered the impact of these fluctuations on Australian economic activity.

Disclosure arrangements

12. Listed companies are subject to a modern continuous disclosure regime, and ADIs (the majority by number are not listed) are subject to specific disclosure requirements which include publication of their annual reports. APRA prescribes key elements to be disclosed, including the entities' governance and risk-management arrangements, as well as audited financial statements. APRA also publishes financial statement information on the industry.

The legal system

13. The Commonwealth of Australia has a federal system of government which consists of the Commonwealth Government, six State Governments and two Territory Governments. The Australian Constitution (1901) establishes the Federal government and sets out the basis for relations between the Commonwealth and the States. It also provides the system of separation of powers, by providing for the Parliament, the Executive government, and the Judiciary. APRA operates in accordance with Commonwealth law, and the winding up of banks is carried out under Commonwealth law.

14. The Constitution gives the legislative power to Parliament. Proposed legislation must be passed by both Houses of Parliament to become law. The Houses are elected by the Australian people and have equal powers, with minor exceptions. The nominal head of state is the Queen's representative in Australia, the Governor-General, who acts on the advice of the Executive government.

15. The Executive government administers the law and carries out the business of government through such bodies as government departments, statutory authorities and the defense forces. Only Parliament can pass Acts to create statute law, but these Acts often confer on the Executive the power to make regulations, rules and by-laws in relation to matters relevant to the particular Acts.

16. Australia is subject to the rule of law. The essence of the rule is that all authority is subject to, and constrained by, the law. The rule of law also means that each citizen is equal before the law; that laws must be predictable and known to all; and that laws must be fair and apply equally to the government as well as to those it governs. This includes the openness of courts, judicial independence from government and the presumption of innocence. English common law and equitable principles are the foundation of Australian laws.

17. The Australian court system has two arms: Federal and State/Territory. The constitution provides that the judicial powers of the Commonwealth are vested in the High Court of Australia. High Court judges are appointed by the Governor-General in Council, after extensive consultation and upon the basis of merit. Australian State and Territory courts have original jurisdiction under all matters brought under State or Territory laws and in other matters where the jurisdiction has been conferred on the courts by the Commonwealth parliament. Only a court may exercise the judicial power and examine the question of whether a person has contravened a law of Parliament.

18. The provisions of the Corporations Act that deal with corporate insolvency are primarily concerned with efficient procedures for the winding up of companies, the orderly realization of available assets of those companies and the equitable distribution of the proceeds to creditors, employees and shareholders. There are also provisions governing the appointment of receivers or other persons who are entitled to assume control over particular

assets of the company; the reconstruction of companies; arrangements and compromises with creditors; and the voluntary winding up of solvent companies.

19. There are three types of external administration of insolvent companies: liquidation, receivership and voluntary administration. A company comes under external administration when its directors must relinquish direction of its affairs to a receiver, administrator, provisional liquidator or liquidator. Directors have to consider the options for external administration because they are under a legal obligation to cause an insolvent company to cease trading. If they fail to do so they may be held personally liable for the company's debts.

Accounting and auditing

20. From January 2005, Australia adopted International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board (IASB). Some Australian-specific accounting standards have been retained to deal with particular issues, such as disclosure of director and executive remuneration, and concise financial reports.

21. A listed company is required to lodge with ASIC annual and half-yearly financial reports. The financial statements must be prepared in accordance with IFRS and must provide a true and fair picture of the entity's financial position and performance. The annual accounts must be audited, with the half-yearly reports subject to either review or audit. Large non-listed companies are required to lodge annual statements with ASIC. ASIC has granted some relief to compliance with accounting standards to non-listed companies which are defined as "non-reporting companies." Exemptions from reporting requirements are also provided for small non-listed companies.

22. The accounting profession in Australia is well established and recognized as being of a high international caliber. In order to audit a listed company's financial report, the auditor must be registered under the Corporations Act. In order to be registered, ASIC must form an opinion that the applicant has the necessary qualifications, satisfies the auditing competency standard and is capable of performing the duties of an auditor. Oversight of auditors is provided by ASIC and the professional accounting bodies. Disputes over the behavior of auditors are decided by the Companies Auditors and Liquidators Disciplinary board. There are currently 6110 registered auditors. Auditing standards in Australia are established by the Auditing and Assurance Standards board (AUASB), and are based on International Standards on Auditing (ISAs). The Financial Reporting Council oversees the AUASB and the AASB.

Prudential regulation framework

23. Prudential regulation of the Australian financial system (authorized deposit-taking institutions, insurance companies, and superannuation funds) is undertaken by APRA, which aims to ensure that, under all reasonable circumstances, financial promises made by regulated entities are met within stable, efficient and competitive financial markets. Australia's

prudential framework is risk-based, and based on a consultative dialogue between supervisors and regulated entities. The risk-based approach recognizes that management and boards of supervised institutions are primarily responsible for financial soundness of their respective institution. Where difficulties arise, intervention by the regulator will be proportionate to the seriousness of the problem and the level of risk to policyholders and industry.

Mechanisms for dealing with problem banks

24. APRA has a broad range of supervisory powers which escalate from preventative, through to corrective, to failure management:

- Preventative powers include the authorization framework, the tests of fitness and propriety, and the implementation of prudential standards.
- Correction powers include court-enforceable undertakings, e.g. agreements between APRA and market participants, and issuing of directions to supervised entities. In serious and/or immediate cases APRA has the power to seek court injunctions.
- Failure management powers include the ability to apply for the transfer of business of an entity that is in financial distress to a healthy institution; to initiate external administration; and to initiate wind-up.

APRA's powers and their use in practice are addressed in more detail in the principle-by-principle assessment.

25. The Reserve Bank of Australia (RBA) is able to provide emergency liquidity (as a "lender-of-last-resort") to distressed ADIs. The stated policy of the RBA is that it would consider lending to an ADI only if it was of the view that the failure of the institution represented a systemic threat. Furthermore, the RBA would not be willing to extend liquidity support to an insolvent institution.

26. The Government has not yet decided whether to introduce some form of explicit depositor guarantees in Australia. At present, there is depositor preference in authorized deposit taking institutions (ADIs). Hence, in liquidation, depositor claims are given priority over other claims on the estate. In the HIH Insurance failure, the Government responded on a discretionary basis to compensate policy holders. In two cases of near-failures of banks owned by State governments, their respective owners ensured that all creditors' claims were met. The long history of depositors not suffering losses in bank failures, in part due to government intervention, creates the impression that there is an implicit government guarantee of deposits.

D. Detailed Assessment

27. This assessment has been completed against the Core Principles essential criteria, which is the FSAP standard. In the description and comments below references are made to the additional criteria. Australia has a high level of compliance with both the essential and additional criteria, reflecting a supervisory framework and practice which captures almost all elements of current international best practices. In many areas, such as capital adequacy and the overall approach to risk-based supervision, Australia is at the leading edge of current international practice.

Table 1. Principle by Principle Assessment of Basel Core Principles

Principle 1.	Objectives, autonomy, powers, and resources An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
Description	See the analysis under each of the six subcomponents
Assessment	Compliant.
Comments	Five of the six subcomponents of CP 1 are fully complied with. In several cases a high level of compliance with international best practices is achieved. For the sixth subcomponent, CP 1(6), the assessment is “largely compliant,” but the shortcoming is not so severe as to downgrade CP 1 overall. The overall rating of CP 1 need not be an arithmetic average but the severity of the shortcomings must be taken into account.
Principle 1(1).	An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks.
Description	<p>Australia has a system of laws in place for banking and for each of the agencies involved in banking supervision. The Banking Act 1959 (BA) provides the basis for Australia’s banking regulation. The Australian Prudential Regulation Authority (APRA) is Australia’s banking regulator. APRA was established under the Australian Prudential Regulation Authority Act 1998 (APRA Act). The responsibilities and objectives of APRA are clearly defined by the APRA Act (section 8 “Purpose for establishing APRA”, section 10 “Advice to the minister”, and section 10A “cooperation with other agencies”) with APRA’s overarching powers defined in section 11 “APRA’s powers”. In addition, specific powers, responsibilities and functions are conferred on APRA throughout the BA. In its role as Australia’s banking regulator, APRA also relies on several additional statutes.</p> <p>The Reserve Bank of Australia (RBA), established by the Reserve Bank Act 1959, regulates Australia’s payment system. The regulation of the payments system is governed by various statutes.</p> <p>The Australian Transaction Reports and Analysis Centre (AUSTRAC) is Australia’s anti-money laundering and specialist financial intelligence unit. It oversees compliance with reporting requirements of the Financial Transaction Reports Act 1988, by banks and other financial services providers.</p>

The Australian Securities and Investments Commission (ASIC) monitor's corporations registered under the Australian Securities and Investment Commission Act 2001, which include all banks.

The Treasurer and the Australian Treasury have responsibility for the legislative framework governing the financial sector and have involvement in aspects of APRA's enforcement activities and the administration for the Financial Sector (Shareholdings) Act 1998.

Sec 11AF BA empowers APRA to issue Prudential Standards for banks and bank holding companies. These standards are issued as ADI Prudential Standards (APS). They are tabled in the Parliament for 14 days and are approved on a no-objections basis. APRA has used this power to issue APSs addressing key prudential issues including capital adequacy, liquidity, credit quality, large exposures, and association with related entities. While the Prudential Standards in themselves are not legally binding (i.e. it is not a punishable offense not to comply with them) they are effective in practice since APRA may use (and in practice often uses) its overriding power to request or, ultimately, to direct ADIs to comply with any Prudential Standard. Section 11CA (1) of the BA provides APRA with the power to issue legally binding directions for a range of reasons, specifically including breach of any Prudential Standard. APRA may also take various actions, such as raising an ADI's capital requirements, against an ADI which does not comply with Prudential Standards.

APRA also issues Practice Guidance notes. These are intended to provide detailed and practical guidance to supervised entities on what APRA regards as good practices when implementing laws, regulations, standards and other prudential requirements. These are not legally enforceable by themselves, but an entity would have to explain to APRA why it took a different course from the one recommended in the Guidance notes.

In addition, Sec 11A allows prudential requirements to be prescribed by legally-binding regulations. These are based on specific provisions in the underlying legislation which is spelled out in greater detail in the regulations. Regulations can be made by the governor-general on the advice of the Treasurer. The Treasurer must have consulted with the APRA before advising that such a regulation be made. Proposals for regulations must be tabled with the Parliament for five days before being approved on a no-objections basis.

APRA and other agencies involved in banking supervision have defined mechanisms for interaction and coordination of actions. (See CP 1(6) for a more detailed description). The BA gives APRA wide ranging powers to revoke a bank license (9A), issue a direction requiring the bank to undertake specific actions (11CA), appoint an investigator (13A), an administrator (13A) or a statutory manager (13C). APRA may also take control of the ADI's (see CP 2 for a definition of an ADI) business when its ability to repay depositors could be threatened.

For the most part, the prudential framework is set down in standards and guidelines which enable APRA to respond quickly and effectively to new and emerging prudential issues without the need for legislative amendment. Notwithstanding this, the BA and other relevant legislation have been subject to a number of successive amendments to ensure it remains relevant and active.

In performing its role as a prudential regulator of financial sector institutions, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and

	<p>competitive neutrality. APRA is subject to financial and performance audits. Those audit reports are tabled in Federal Parliament and are publicly available. APRA is subject to review before Parliamentary Standing Committees. Transcripts of proceedings are publicly available. APRA is required to prepare an annual report for the minister on its operational and financial performance. This report is made public. APRA has issued publications explaining its objectives, procedures and operations. Internal oversight of APRA is monitored by the Risk Management and Audit Committee.</p> <p>APRA regularly publishes industry-based papers that detail the financial strength and performance of the industries it supervises, including the quarterly “Insight” bulletin and monthly “Banking Statistics” (which also contain individual bank information).</p>
Assessment	Compliant
Comments	APRA may issue (on a no-objection basis) Prudential Standards to supplement laws and regulations issued by the Parliament. While these Standards in themselves are not legally binding, the broad overall powers given to APRA "to protect depositors" make these Standards equally enforceable as regulatory tools, as APRA directions can be used if necessary to make them legally binding. In practice, APRA has not had to resort to its direction powers.
Principle 1(2).	Each such agency should possess operational independence and adequate resources.
Description	<p>APRA is both formally independent from and accountable to the Australian government. APRA is also accountable to the Parliament. APRA is headed by an Executive Chairman and is governed by a three member executive group, known as APRA Members. APRA Members are appointed by the Governor General, on advice of the Minister. By placing responsibility for the function of prudential regulation of financial institutions with an independent authority, the government aims to ensure both that this task receives specialized attention and that it is conducted in a politically neutral manner. In practice, there is no evidence of government interference in APRA’s operations.</p> <p>Nevertheless, APRA remains subject to a formal power of direction by the minister under Sec 12 of the APRA Act. This power is limited to policies and operational priorities and cannot apply to individual cases.</p> <p>Sec 12(1) APRA Act provides the following: “The Minister may give APRA a written direction about policies it should pursue, or priorities it should follow, in performing or exercising any of its functions or powers. Sec 12(3) The Minister must not give a direction under subsection (1) about a particular case.”</p> <p>A direction must be made in writing and can be given only after the Minister has notified APRA in writing that consideration is being given to making the direction and then has given the APRA Chairman an opportunity to discuss the need for the proposed direction. The power to issue a direction is tempered by a requirement that the minister must publish any direction in the Gazette within 21 days and must table it before Parliament within 15 sitting days after the publication. This submission is drafted by the minister but should include the relevant information, such as any comments from the APRA on the matter, in particular if different from the minister’s own conclusions. There have been no instances of APRA being directed by the minister according to this procedure.</p> <p>APRA is financed by levies imposed on the financial sector entities it supervises. These levies are determined and collected by the Australian government – as a tax on supervised entities – and are then allocated to APRA (as well as to other financial supervisory agencies) and held specifically by APRA to finance its operations. There are no specific</p>

	<p>conditions attached, by the government or others, to the use of these funds.</p> <p>APRA has a strong, albeit rather short (APRA was founded in 1998) track record of professionalism and personal integrity. APRA staff is often invited to explain APRA's requirements and approaches to industry conferences and seminars and to provide training for financial regulatory staff in other countries.</p> <p>While APRA must compete in highly competitive markets for staff. APRA has established salary scales above those of the general civil service which have been generally sufficient to allow it to attract qualified staff (note, though, the comment below on the high turnover rate), and to hire outside experts to deal with special situations, if required. The number of APRA staff has increased significantly in recent years and now stands at 612 (this includes all APRA tasks for ADIs, insurance companies and superannuation schemes). APRA's training budget has enabled the development of a comprehensive in-house training program and makes provision for regular external training opportunities for staff, including post-graduate studies. APRA is equipped with up-to-date computer equipment and other tools needed to review the banking industry and APRA has a travel budget that provides for appropriate levels of on-site work, both in Australia and overseas.</p> <p>APRA Members are appointed, by the Governor-General on the advice of the Cabinet, for a term specified in the instrument of appointment, which cannot exceed 5 years (Sec 20, APRA Act). Sec 25 of the APRA Act governs the removal of APRA Members during their term of office and specifies the reasons for termination. Such reasons include:</p> <ul style="list-style-type: none"> • If the Member becomes employed by a body regulated by APRA or other institution operating in the financial sector; • Misbehavior or physical or mental incapacity; • The Member becomes bankrupt or shows other signs of severe financial weakness; • The Member is absent from duty during a significant period; <p>There is no legal requirement to publicly disclose the reasons, in a specific case, for removing an APRA Member from office.</p>
Assessment	Compliant.
Comments	<p>Although the formal power of direction by the Minister potentially weakens the independence of the APRA, in practice the power of giving direction has not been used and the potential for ministerial interference is tempered by various restrictions and procedures. Further, the assessors have noted – and consider this to be important – that the power to issue directions does not apply to matters related to particular cases.</p> <p>The Government proposes to change APRA's financial arrangements by removing it from the Commonwealth Authorities and Companies Act (CAC) and placing it under the Financial Management and Accountability Act (FMA). The Treasurer has agreed in principle that APRA be brought under the FMA, subject to a number of exemptions being granted from the provisions of the FMA. Moving to an FMA agency could, if exemptions for APRA were not granted, limit APRA's ability to reserve for unexpected emergencies and thus limit its capacity to respond promptly. It would also limit APRA's capacity to use its own legal staff in the conduct of enforcement actions. Given that bringing APRA under the FMA without exemptions would limit its room of maneuver to govern the allocation of its spending (within the annual levies-based amount determined by the Government) the assessors would regard this as a restriction on the operational independence of APRA.</p> <p>APRA is aware, and this is supported by statements heard on assessors' interviews with</p>

	<p>supervised entities, that the high turnover rate (some 20 percent per year) of APRA staff makes it difficult to maintain a high level of “institutional memory” and continuity in the supervisory work. The assessors have also observed that the depth of analysis of individual institutions (such as in offsite and onsite reports) differs, which to some extent could be explained by the lack of long-term experience. While the overall quality of supervision is good, APRA needs to deal with its high turnover rate and we strongly support the ongoing efforts to do so. Given that APRA to a high degree is competing with the private sector for competent staff, the assessors find that it would potentially undermine APRA’s ability to attract the skilled staff required for the performance of its prudential responsibilities, if salary scales were aligned with those of the civil service.</p> <p>There should be a formal legal requirement to publicly disclose the reasons for removing an APRA Member from office. Such a requirement would provide an additional protection against such actions being taken (or perceived to be taken) with the aim to reduce APRA’s independence.</p>
Principle 1(3).	A suitable legal framework for banking supervision is also necessary, including provisions relating to the authorization of banking establishments and their ongoing supervision.
Description	Sec 9(3) and 9A BA identify APRA as the authority responsible for granting as well as revoking banking licenses and provide for the circumstances in which a license can be granted or revoked. As noted under CP 1(1), under Sec 11AF of the BA APRA is empowered to make Prudential Standards for ADIs and holding companies. APRA can, in practice, make these Standards effectively binding by using Section 11CA (1) of the BA to issue directions should Prudential Standards be breached. Several complementary pieces of legislation empower APRA to obtain from banks the information it requires to fulfill its obligations as prudential supervisor. Sec 13 of the Financial Sector (Collection of Data) Act enables APRA to determine reporting standards and to require banks to submit data. APRA has determined 43 such standards. In addition, the various Prudential Standards issued make provision for the submission of specific prudential information. APRA is also empowered to obtain any information that it requires from banks and their holding companies under Sec 62 BA. Sec 13 BA specifically enables APRA to obtain information from a bank in relation to its financial stability.
Assessment	Compliant
Comments	
Principle 1(4).	A suitable legal framework for banking supervision is also necessary, including ... powers to address compliance with laws as well as safety and soundness concerns.
Description	<p>Sec 11CA BA gives APRA wide powers of direction over banks when necessary to ensure compliance with its prudential standards or to protect the interest of depositors. Division 2 BA empowers APRA to intervene whenever a bank’s ability to repay its depositors is threatened. Sec 13(3) BA requires a bank to notify APRA immediately if it is likely to become unable to meet its obligations or suspend payment. In addition, directors of a bank must notify APRA immediately after they have become aware of any breach of a prudential standard or other requirement, or of any other circumstance which may have a material impact on the bank. Under Sec 62A BA it is an offence to fail to notify the APRA of any breach of prudential standards or other matter which adversely affect the entity’s financial soundness.</p> <p>APRA adheres to the principle of risk-based supervision which allows considerable room to exercise qualitative judgment, subject to internal procedures to ensure consistency in decision-making. The qualitative assessments are incorporated into APRA’s internal risk rating system for all its supervised entities – the Probability and Impact Rating System (PAIRS).</p>

	<p>In practice, Australian banks afford APRA full access to their records and books of account without the need for legal compulsion. Nonetheless, APRA has a number of powers under the BA to compel a bank to supply it with information. Sec 62 BA enables APRA to require a bank (or its holding company or a subsidiary) to supply any information, books, account or documents. Sec 13 BA specifically enables APRA to obtain information in relation to a bank's financial stability. This includes access to internal and external audit reports and working papers. In addition, Sec 11 of APRA Act empowers APRA "to do anything that is necessary or convenient to be done for in connection with the performance of its functions"</p> <p>Both in law and in practice, APRA has wide-ranging powers to remediate and deal with unsafe or unsound banking practices. (See CP 22) APRA is required to exercise those powers for the protection of depositors, and to promote financial safety and efficiency.</p>
Assessment	Compliant
Comments	
Principle 1(5).	A suitable legal framework for banking supervision is also necessary, including... legal protection for supervisors.
Description	<p>Sec 58(1) APRA Act states that APRA, an APRA Member or an APRA staff member is not subject to any liability to any person in respect of anything done or omitted in the exercise of powers, functions or duties of such agency or person. This does not apply for acts or omissions in bad faith.</p> <p>There is no specific legislation to indemnify APRA or its staff against the legal costs for any legal action brought against them. However, in the normal course, APRA would assist staff in defending their actions and APRA has resolved to indemnify Members and staff for their costs incurred in defending such actions, as required. Legal costs for APRA directors and officers are provided through insurance cover taken out by APRA and by the Deed of Indemnity granted by APRA to the APRA Members.</p>
Assessment	Compliant
Comments	In order to enhance transparency and to ensure equal treatment, APRA should have written policies on assisting its Members or staff in any legal action brought against them in the course of their duties.
Principle 1(6).	Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
Description	<p>APRA participates in a number of councils, committees and working groups with ASIC, RBA, the Treasury and AUSTRAC. In addition, APRA and other agencies act together on investigations and enforcement actions which cross more than one agency's mandate. The Council of Financial Regulators (CFR) is the coordinating body for Australia's main financial regulatory agencies.</p> <p>APRA has concluded Memoranda of Understanding with ASIC, the RBA and the Treasury. These promote effective cooperation and information sharing. In practice, there is cooperation among agencies and information exchange on a regular basis.</p> <p>APRA may provide information to AUSTRAC but is not permitted to receive information from AUSTRAC.</p> <p>If APRA or the RBA identify a situation which is likely to threaten the stability of the financial system, each has a responsibility to inform the other as a matter of urgency. The Treasurer will also be informed.</p>

	<p>APRA’s system of cooperation and information sharing extends to foreign agencies which have supervisory responsibility for banking operations of material interest to APRA, notably New Zealand and the UK. Operational contact with other than those countries occurs when necessary, such as pursuant to obligations as host supervisor of foreign banks, but is limited.</p> <p>MOUs have been concluded with UK/FSA, New Zealand/RBNZ, Hong Kong/HKMA, Germany/BaFin; China Banking Regulatory Committee (CBRC) and the United States Office of Thrift Supervision/OTS.</p> <p>Sec 56 APRA Act empowers APRA to release confidential information to other financial sector supervisory agencies (including foreign agencies) for the purpose of allowing that agency to carry out its duties. When such information is released APRA requires that the confidentiality of the information is maintained by the receiving agency. It is an offence under the APRA Act to disclose confidential information and this extends to persons to whom protected information has been released.</p> <p>APRA cannot be compelled by a court to release protected information. However, APRA is empowered to make available protected information for the purposes of enabling proceedings under any of the Acts it administers.</p> <p>Sec 56(11) APRA Act exempts APRA from being required to disclose protected information under the Freedom of Information Act 1982.</p>
Assessment	Largely compliant.
Comments	Essential criterion 1 requires information sharing between all agencies with a responsibility for the soundness of the financial system, but at present AUSTRAC is unable to share information with APRA. Because information gathered by AUSTRAC in certain circumstances will be relevant for APRA, e.g., indications on inadequate internal control systems in ADIs, APRA should be permitted to receive such general information from AUSTRAC.
Principle 2.	<p>Permissible activities</p> <p>The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word “bank” in names should be controlled as far as possible.</p>
Description	<p>Sec 5 BA defines the term “banking business” as a business which consists of both the taking of money and the making of advances of money, or such other financial activities that may be prescribed by regulation. All entities wishing to carry on “banking business” are required to obtain authorization by APRA under Sec 9 BA (or an exemption under Sec 11). All deposit taking institutions are required to be authorized (or exempted) under the BA.</p> <p>Beyond the definition of ‘banking business’ the permissible activities of banks are not specified in law. Authorized banks must consult, and do in practice consult, with APRA in respect of any significant new business initiatives. In this way APRA is able to review in advance all new lines of business proposed by banks to ensure that adequate risk controls are in place and that they do not pose disproportionate risks to the bank.</p> <p>Only authorized institutions which have at least \$A 50 million in Tier 1 capital or which are branches of foreign banks are able to describe themselves as banks. Authorized institutions without the required capital base or which are mutually owned are referred to as “authorized deposit-taking institutions” (ADIs). In practice, all large and systemically important deposit-taking institutions are authorized banks.</p>

	<p>Sec 11 BA empowers APRA to grant exemptions from the Act's provisions. These exemptions apply to a range of institutions, typically wholesale institutions such as investment banks or specialized finance companies but also some foreign banks. These entities are not subject to prudential supervision by APRA but may engage in fund-raising on a prospectus-basis. The short prospectus required for this activity must disclose that the issuing institution is not supervised by APRA and not covered by the depositor preference provisions of the BA. Such institutions may not advertise themselves as providing deposit facilities. There is also one Australian territory which operates a Government-owned insurance and banking organization. This is not supervised by APRA but its obligations to policyholders and depositors are government-guaranteed.</p> <p>APRA is reviewing its policy for granting Sec 11 exemptions in order to ensure that all significant deposit-taking institutions come within the prudential framework.</p>
Assessment	Largely compliant
Comments	<p>Although the group of deposit-taking institutions which are exempt from supervision is small in terms of market share, and does not presently constitute a systemically significant risk, the Sec 11 BA and/or its application should be reviewed, among other things to ensure that depositors are not misled and to ensure equal treatment among deposit-taking institutions. The assessors note that some of the exempted institutions invite deposit-like facilities for retail-size amounts and on conditions which are close to those applying for deposit accounts. For example, "at call debentures" are offered by finance companies with no minimum deposit and redemption through an on-line transaction without notice, closely paralleling the characteristic of a demand deposit. In a review, consideration should be given to update the criteria for Sec 11 exemptions to ensure that only institutions which fund themselves on a truly wholesale basis may be exempted from APRA regulation and supervision. (Similar comments are provided under CP 25 re unregulated foreign banks.)</p>
Principle 3.	<p>Licensing criteria</p> <p>The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organization's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organization is a foreign bank, the prior consent of its home country supervisor should be obtained.</p>
Description	<p>Sec 9 BA empowers APRA to grant or reject applications for an "authority to carry on banking business". APRA determines and publishes the criteria for granting banking authorizations. These criteria require an applicant to demonstrate its strategic and financial viability, an effective risk management framework and a capacity to meet all of APRA's prudential requirements on an ongoing basis. The criteria and information requirements are available in APRA's Guidelines on Authorization of ADIs. There are detailed criteria covering: capital; ownership; management; risk management and control systems; information and accounting systems; External and internal audit arrangements; Supervision by home supervisor (for foreign banks). All licensing criteria are consistent with APRA's Prudential standards for ongoing supervision. The initial licensing assessment is undertaken by the team of supervisors who will have responsibility for ongoing oversight of the potential new bank. Sec 9 BA confers on APRA the power to grant or reject applications, to impose conditions on banking authorities and to revoke existing authorities. Sec 9A(2) empowers APRA to revoke a bank's authority if the bank has provided information that was false or misleading in connection with the application.</p> <p>Ownership and managerial structures are assessed in detail as part of the licensing application.</p>

All substantial shareholders must be well-established and financially sound; and must be able to demonstrate that their commitment to the bank is long-term and that they are able to contribute additional capital should this be required. Transparency and complexity of the ownership structure is an important element in APRA's assessment. APRA requires the applicant to identify substantial shareholders, both direct and ultimate, and their respective shareholdings. APRA will investigate the sources of capital for the proposed ADI.

BA requires that 'banks' must have at least \$A 50 million in Tier 1 capital.

APRA requires an applicant to submit a three-year business plan incorporating the goals and milestones of the operations of the bank and the banking group. APS 510 - Governance sets out the minimum governance requirements banks must adhere to as part of their overall governance arrangements. The Standard states that the board and senior management have the prime responsibility for the sound and prudent management of the bank and that they should institute effective governance arrangement in the bank. The board, as a whole, must possess the requisite expertise to oversee the operations of the bank. The Chairperson of the board must be an independent non-executive director. Consideration is given to the fitness and propriety of proposed directors, including banking experience. Division 3 BA sets out a range of circumstances in which a person is disqualified from acting as a director or in a senior management position in a bank, including persons disqualified as not being fit and proper by APRA or under the Corporations Law; persons who have been disqualified in other jurisdictions or who have been convicted of offences of dishonesty. APRA Draft Prudential Standards 520 and 521 place the onus on institutions to ensure that their directors, senior managers and auditors are "fit and proper". Banks must notify APRA of any change to its responsible officers or of any adverse fit and proper determination in respect of such officers, within 28 days. APRA may determine to remove a responsible officer, even if the bank has assessed the officer to be fit and proper.

Applicants must satisfy APRA that their risk management and internal control systems are adequate and appropriate for monitoring and limiting risk exposures. In assessing whether the policies and procedures proposed for managing and controlling risks are adequate and appropriate APRA will take account of the size, nature and complexity of the operations, the volume of transactions undertaken, the proposed organizational structure, and the geographical distribution of the business. Applicants must satisfy APRA that their information and accounting systems are adequate for maintaining up-to-date records, so as to keep management continuously and accurately informed of the bank's condition and to the risks to which it is exposed.

APRA requires applicants to submit three-year projections including sensitivity analysis covering expected, upside and downside scenarios of: (i) balance sheet, cash flow and earnings; and (ii) key financial and prudential ratios for the bank and for the banking group on a consolidated basis.

Foreign bank applicants must have consent from their home supervisors. Only banks which are authorized in their home country will be granted authority to operate foreign banks in Australia. In addition, APRA must be satisfied that they are subject to adequate prudential supervision by the home supervisor. APRA will consider the home country's implementation of the Core Principles of Banking Supervision promulgated by the Basel Committee. This includes whether the home supervisor supervises the foreign bank applicant on a consolidated basis in accordance with the Basel Concordat and is prepared to cooperate (in terms of the Concordat) with APRA in the supervision of the bank in Australia.

	<p>New entrants are subject to on-going supervision in accordance with APRA’s Supervision Framework and also to an early onsite visit to ensure, e.g., that the arrangements presented in the license application are being met in practice. As a rule, higher capital requirements are set for new entrants.</p> <p>ADIs which engage in activities regulated by ASIC must also obtain a “Code of conduct” license from this agency.</p>
Assessment	Compliant
Comments	Based on interviews and samples, the assessors have concluded that APRA applies a comprehensive and well structured licensing procedure with the intent to identify and make the applicant address potential weaknesses before a license is granted.
Principle 4.	Ownership Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.
Description	<p>Individual shareholdings in “financial sector companies” (which include banks and their holding companies) are limited to 15 percent by the Financial Sector (Shareholdings) Act 1998 (FSSA) unless granted an exception (by prior approval) by the Treasurer or APRA provided that such a shareholding can be shown to be in the national interest. Such an approval will specify the permitted ownership stake, and further approval would be required if the entity wished to increase its stake above the previously approved level.</p> <p>Ownership interests are defined very broadly to include any controlling interest or position of influence or any group of associated interests. The restrictions apply equally to new banks and to changes in ownership of existing banks. Powers exist to direct a reduction in shareholding or to seek remedial or injunctive orders from the courts in order to ensure compliance with the FSSA. In addition, the Treasurer may revoke or vary an existing approval to hold a shareholding in excess of 15 percent, if in the national interest or if there has been a contravention of the existing approval.</p> <p>As mandated by Sec 44 FSSA, the Treasurer has delegated his powers under the Act to APRA so that APRA may approve or reject shareholdings (of 15 per cent or more) of banks with total assets under \$A 750 million. APRA advises the Treasurer on transactions exceeding the delegated limit, and there have been no instances of the Treasurer acting against an APRA recommendation.</p> <p>All shareholdings in an Australian bank in excess of 5 per cent must be disclosed in the bank’s annual report. APRA’s assessment of ownership interests covers both nominal and beneficial owners.</p>
Assessment	Compliant
Comments	
Principle 5.	Investment criteria Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.
Description	APRA undertakes detailed assessments of all significant acquisitions and new business lines proposed by banks. APRA expects banks to consult with them early about acquisitions and new business proposals. APRA's approval and prior notification requirements for acquisitions and investments are set out in Prudential Standard APS 222 - Associations with Related Entities. A bank is required to advise APRA in advance of any proposed change to the

	<p>operation of its group, if the group's overall risk profile will be altered to any material extent.</p> <p>Specifically:</p> <ul style="list-style-type: none"> • an ADI should consult before establishing or acquiring a subsidiary; • an ADI should consult before committing to acquire an interest of more than 10 percent in another entity engaged in the field of finance; • an ADI must obtain prior approval to establish or acquire another regulated presence; and • an ADI must obtain prior approval to exceed any of APRA's exposure concentration limits, which include equity exposures (see CP9). <p>APS 222 also contains restrictions on a bank's ability to acquire equity interests in another company arising out of the work-out of problem exposures. Acquisitions of equity in non-financial companies are generally not allowed unless resulting from such work-outs. Exposures to non-financial companies as a result of the ongoing business of the ADI will be considered in the context of large exposure limits and the reporting of large exposures.</p> <p>APRA assesses acquisitions against a number of criteria such as: strategic rationale and business plans; funding and impact on capital; integration issues; group structure and corporate governance; risk management systems; consent of home supervisor (for overseas acquisitions). When assessing new investment and acquisition proposals, APRA considers the risks to the institution and the effect on supervision. No approval will be given if the APRA does not consider the bank to have adequate financial and organizational resources or if APRA considers that supervision will be hindered.</p> <p>The thresholds above which proposed acquisitions and investments must be referred to APRA are very low; hence, most are required to be referred to APRA in advance. In addition to the prior notification requirements, all equity associations must be reported to APRA pursuant to s4a APS 222.</p>
Assessment	Compliant
Comments	
Principle 6.	<p>Capital adequacy</p> <p>Banking supervisors must set minimum capital requirements for banks that reflect the risks the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. For internationally active banks, these requirements must not be less than those established in the Basel Capital Accord.</p>
Description	<p>Prudential standard APS 110 - Capital Adequacy outlines the overall framework for assessing a bank's capital adequacy. The standard sets out detailed capital requirements consistent with the Basel Capital Accord and ensures that banks maintain adequate capital. The capital requirements apply on a stand-alone basis as well as to the consolidated banking group; s7 APS 110 requires banks to maintain a minimum risk-weighted capital ratio of 4 percent (tier 1 capital) and 8 percent (for total capital) at all times. The capital adequacy rules apply to all deposit-taking institutions in Australia, including building societies and credit unions. Typically, each Australian bank is required to meet individually specified tier 1 and total capital ratios above the minimum required by APS 110 - often between 10 and 20 percent - reflecting its risk profile or due to general economic conditions. APRA has the ability and the legal authority to set a bank's required risk-based capital ratio at any time. APRA regards its assessed capital adequacy ratio as a hard floor which implies that remedial action should be taken before the capital ratio falls to the specified minimum.</p> <p>Summary on capital adequacy:</p>

	<ul style="list-style-type: none"> • Statutory requirement: 8 percent, of which 4 percent must be tier 1 capital. • APRA assessment, taking into account the general risks and other circumstances relevant for the individual ADI. The assessment would generally lead to an expected capital ratio higher than 8 percent; for some ADIs considerably higher. This ratio is not legally enforceable in itself, but if the ADI does not reach it or maintain it, this could cause APRA to intensify its monitoring, or issue a direction to make the APRA ratio legally binding. • A "capital buffer" could be added by APRA if the ADI is judged as being vulnerable to more than normal volatility in its revenues and risks. • In addition, the ADI is required to calculate its own "economic capital." <p>The definition of eligible "capital base", and the eligible components, is set out in APS 111 - Capital Adequacy. A bank's risk-weighted exposures are determined in accordance with requirements and procedures set out in APS 112 (credit risk) and 113 (market risk). The definition of capital components and of risk-weights is in accordance with the Basel Capital Accord. In considering the required capital ratio, APRA considers all material risks, both on and off-balance sheet.</p> <p>If banks fail to comply with the standards on capital adequacy, APRA has the power to compel compliance by issuing a direction under 11CA BA. Failure to comply with a direction is a criminal offence. In addition, APRA may use its other enforcement powers under BA to ensure compliance. In practice, there have been no instances of a bank refusing to comply with APRA instructions on capital adequacy.</p> <p>The capital adequacy reporting standard (ARF 110.0 Capital Adequacy) requires banks to submit detailed information, including capital ratios and the components of capital, on a quarterly basis.</p> <p>APRA's approach to the measurement of capital applies to all deposit-taking institutions in Australia, including building societies and credit unions, and is based on the risk-based capital adequacy framework developed by the Basel Committee on Banking Supervision.</p> <p>APS 110 requires that a bank has adequate systems and procedures in place to identify, measure, monitor and manage the risks arising from its activities on a continuous basis to ensure that capital is held at a level consistent with the bank's risk profile; and maintain and implement a capital management plan. Institutions authorized to use the word "bank" must have at least \$A 50 million in tier 1 capital or be branches of foreign banks. ADIs authorized as "building societies" must have at least \$A 10 million in tier 1 capital.</p>
Assessment	Compliant
Comments	APRA applies, and should be commended for so doing, standards for capital requirements which constitute best international practices, including some which will be introduced for those countries implementing the coming Basel II framework (e.g., capital requirements on an individual and risk-based bank basis).
Principle 7.	<p>Credit policies</p> <p>An essential part of any supervisory system is the independent evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.</p>
Description	Prudential standard APS 220 establishes the responsibility of the board of directors and management of an ADI to ensure that an effective credit risk management system is in place and is appropriate to the needs of the institution, and further requires that the bank's system must be regularly reviewed. Verification of the adequacy of an institution's policies and the

	<p>effectiveness of implementation is undertaken in on-site prudential reviews. Supervisory verification is guided by APRA’s Supervision Framework, with Module 8 intended to ensure an in-depth assessment of the credit risk management framework, including among other things credit approval and underwriting standards, credit concentration, risk grading systems, and problem assets. The sample on-site reviews examined by the assessment team were thorough. On-site reports are prepared on an exception basis, but there are detailed working papers substantiating the completion of the various Modules. The specialist support group, which includes credit risk specialists, has detailed guidance to assist them in ensuring consistency in application across institutions.</p> <p>APRA’s guidance on credit risk management is highly detailed with respect to identifying asset quality (this is the main focus of APS 222 and three related guidance notes 220.1, 220.2 and 220.3) and more principle-based with respect to a sound and well-documented credit granting and investment process, and credit administration. Principles for credit risk grading systems are outlined in guidance note 220.4. As part of the on-site verification process, credit files for directors and related parties are reviewed, as is the composition and quorum of credit committees to verify that credit decisions are free of conflicts of interest and are that credit is extended on an arm’s length basis. Also, in its onsite work, APRA examines the ADI’s measures to encourage staff to be familiar with and follow the requirements of its credit policies. Section 62 of the BA empowers APRA to obtain any information it requires from banks and their holding companies.</p>
Assessment	Compliant.
Comments	
Principle 8.	<p>Loan evaluation and loan loss provisioning</p> <p>Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and reserves.</p>
Description	<p>APRA has issued detailed prudential standards for loan evaluation and loan loss provisioning (APS 222, Credit Quality, and related guidance notes 220.1, Impaired Asset Definition; 220.2, Security Valuation and Provisioning; 220.3, Prescribed Provisioning; and 220.4 Credit Risk Grading Systems). These establish the requirements for review by banks of credits, and asset classification and provisioning.</p> <p>The adequacy and implementation of the required policies and procedures is regularly verified in on-site work in addition to the required quarterly reporting to APRA. External auditors review the adequacy of banks’ policies and provisioning as part of the annual audit, with the application of Australian accounting standards (IFRS from January 2005) supplemented by specific guidance provided to auditors by APRA (Guidance Note—Forms subject to audit and application of materiality—Authorized Deposit Taking Institutions).</p> <p>The definition of impaired assets explicitly includes off-balance sheet exposures, with reporting requirements encompassing both on and off-balance sheets items (AGN 220.1, paragraphs 6-8).</p> <p>APS 222 and the related guidance notes 220.2 and 220.3 require provisioning policies that result in an accurate statement of asset values, with estimates of credit losses accounting for all significant factors that affect collectability as of the valuation date. Banks have the option of using an internal modeling approach to specific provisioning, or adopting a prescribed standardized approach.</p>

	<p>Supervisory verification of the adequacy of banks' treatment of problem assets is addressed in on-site reviews. Supervisory verification is guided by Module 8 of the APRA Supervision Framework. The sample onsite reports examined by the assessment team reflected thorough and professional completion of the various Modules. On-site reports are prepared on an exception basis, but detailed working papers substantiate the completion of the specifics required by each module undertaken in on-site reviews.</p> <p>The BA (division 1BA) provides APRA with broad authority to issue directive directions compelling banks to take or refrain from taking specific actions to comply with prudential requirements. In practice APRA has not had to use its formal powers to compel banks to meet loan evaluation and provisioning standards.</p> <p>Quarterly reporting is required on impaired assets and provisioning levels, and where banks are using internal rating systems, on the ratings of credits and provisions. (ARS 220.0, ADI Reporting Form 220.0, and AGN 220.4)</p> <p>APS 220 specifically requires policies adopted by the Board or delegated committee of the board for establishing, recording and reviewing the value of security held against exposures. There is a further requirement that the policy include provisions for regular assessments of the value of security to ensure adequate coverage (AGN 220.2)</p> <p>The definition of impaired assets in APS 220 provides objective measures, requiring among other things that an asset be classified as non-accrual when a specific provision is made, write-down is taken, or the facility is 90 days past due. In on-site reviews APRA uses statistical sampling to test whether banks have correctly classified impaired assets.</p> <p>APS 220 specifically requires that security held should be valued at net current market value, as defined in AGN 220.2.</p> <p>APRA agrees with each bank a reporting level above which valuation, classification and provisioning must be undertaken on an individual exposure basis rather than a portfolio basis.</p>
Assessment	Compliant.
Comments	
Principle 9.	<p>Large exposure limits</p> <p>Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.</p>
Description	<p>APS 221 establishes the responsibility of boards of directors to ensure banks have adequate policies and procedures to identify and manage concentrations. The criteria for determining related parties include a "catch-all" provision which provides the ability to deem relationships to be a single exposure even if not captured by the specific criteria. There is a specific provision (paragraph 12) for APRA to set limits on a case-by-case basis.</p> <p>Prudential limits are established by paragraph 9: 25 percent of capital for non-government, non-bank, unrelated parties; 50 percent of capital for unrelated banks; 50 percent of capital for foreign parents and their subsidiaries, with aggregate exposure to non-deposit-taking subsidiaries capped at 25 percent of capital. There is a provision for banks to exceed these limits with the prior approval of APRA, which is to be provided only on an exceptional basis (paragraph 13). At end-November 2005 less than five such approvals were in force, with these</p>

	<p>generally relating to underwriting by merchant banks, with the excess expected to be cleared through the subsequent sale of the issue.</p> <p>Supervisory verification of the adequacy and implementation of banks' policies is undertaken in on-site examinations. Module 8 of the APRA Supervisory Framework includes specific review of a banks' credit concentration management. Completion of the various on-site modules was thorough and professional in the sample reviewed by the assessment team.</p> <p>Banks are required to report to APRA quarterly on all exposures exceeding 10 percent of the banks capital base (ARF 221.0), with the report completed on both a solo and consolidated basis. Banks are specifically required to advise APRA immediately of any violation of the limits established under paragraph 9 of APS 221, or and specific limits established pursuant to paragraphs 12 or 13.</p> <p>In addition to the reporting requirements for large exposures, there are reporting requirements for various specific portfolio concentrations including commercial property (ARF 230.0), international exposures (ARF 231), geographic by state and territory (ARF 391.0), commercial finance (ARF 394.0), personal finance (ARF 395.0). Sectoral data is collected through AFR 395.0, Business Finance Statistics.</p> <p>APS 221 defines a large exposure as 10 percent of capital.</p>
Assessment	Compliant.
Comments	
Principle 10.	<p>Connected lending</p> <p>In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.</p>
Description	<p>APS 222, Association with Related Entities, defines entities related to the bank as those controlled directly or indirectly by a bank or its parent. There is a provision for APRA to deem other entities and their subsidiaries to be related parties to the bank. The definition of related parties does not capture individuals, such as officers and directors of the bank, its parent, subsidiaries and affiliates, with exposures to these persons being governed by the more generally applicable standards for credit risk management. As part of the on-site verification process, credit files for directors and related parties are reviewed, as is the composition and quorum of credit committees, to verify credit decisions are free of conflicts of interest and are extended on an arm's length basis. The basis of this review is established in Module 8 of the Supervision Framework, with Topic 6 specifically addressing the independence of the credit review process. On-site work reviewed by the assessment team was thoroughly completed, indicating that the appropriate supervisory verification does take place.</p> <p>Banks are specifically required to deal with related parties on an arm's length basis (APS 222 paragraph 10), and dealings with related parties inconsistent with the benchmark for unrelated parties must be approved by the board of directors (paragraph 11).</p> <p>Paragraph 27 of APS 222 establishes limits on exposures to different classes of related entities, with a further provision that APRA may impose higher minimum capital requirements in view of the risks arising from exposure to related entities (paragraph 29).</p> <p>APS 22 clearly establishes the responsibility of the board of directors to have appropriate</p>

	<p>policies and procedures to identify and manage the risks from exposures to related parties (paragraph 14), which includes a specific reference to systems.</p> <p>Banks are required to report quarterly to APRA on exposures to related parties (ARF 222.0)</p> <p>The definition of related parties includes only entities controlled or deemed to be controlled directly or indirectly by the bank. The restrictions on exposure limits to related parties are somewhat more lenient for related non-bank regulated entities (35 percent of level 1 capital) than for unrelated non-bank entities (25 percent of capital). APS 222 establishes limits of 50 percent of level 1 capital for exposure to a related ADI (including overseas equivalents to ADIs), and 150 percent of level 1 capital for the aggregate of all such exposures. Exposures to individual related unregulated entities are limited to 15 percent of level 1 capital, and exposure of individual related regulated non-ADI entities is limited to 25 percent of level 1 capital. Total exposure to all related non-ADI (or overseas equivalent) entities is limited to 35 percent of level 1 capital.</p>
Assessment	Compliant.
Comments	While the objectives of the principle are met in practice through the detailed standards and on-site review of credit risk management, it would be preferable if the definition of parties related to the bank were expanded to include individuals such as officers, directors and persons related to or closely associated with such persons.
Principle 11.	<p>Country risk</p> <p>Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.</p>
Description	There are no specific prudential standards for country risk and transfer risk. These elements are expected to be captured in the overall credit risk management framework required by APS 220, and verified through on-site examinations. Module 8 of the APRA Supervision Framework specifically addresses country and transfer risk, requiring that to meet the minimum standard banks should have a policy for determining acceptable country exposures, including geographic and size limits. Banks are specifically required when determining the quantum of country risk, to consider the country's legal system, political stability, economic climate, social stability, foreign exchange controls and bankruptcy laws. Banks are also required to have a process for monitoring the country risk of exposures and the level of exposures to individual countries, on an on-going basis. Individual banks establish provisions in accordance with their internal policies and procedures, the adequacy of which and implementation in practice, is subject to regular supervisory verification through on-site work. Provisioning is also subject to review by external auditors. Banks are required to report quarterly to APRA on international exposures (ARF 231) and international operations (ARF 325), with this data incorporated into the overall risk-assessment of the institution. The sample on-site work examined by the assessment team indicated that the various Modules are thoroughly and professionally completed, providing good verification in practice that banks meet the required minimum standard, or are required to take corrective action if material shortcomings are identified.
Assessment	Compliant.
Comments	While the intent of the principle is met through the detailed requirements for credit risk management and thorough on-site verification, it would be preferable to promulgate a prudential standard specifically addressing country and transfer risk.
Principle 12.	<p>Market risks</p> <p>Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor, and adequately control market risks; supervisors should have powers to</p>

	impose specific limits and /or a specific capital charge on market risk exposures, if warranted.
Description	<p>APS 113 clearly establishes the responsibility of the boards of directors of ADIs engaged in activities that give rise to risks associated with potential movements in market prices to adopt strategies, policies and management practices for identification, measurement and control that are commensurate with the risks involved (paragraph 4). ADIs with no trading book and no positions in foreign exchange or commodities can be exempt from the otherwise applicable prudential requirements for market risk, but must explicitly include a statement to this effect in their description of their general risk management system (paragraph 8). Prior to on-site examinations, each bank is required to provide APRA with its market risk policies and copies of board and senior management market risk reports, as well as any recent independent internal and external reviews of the effectiveness of the market risk management framework. APRA conducts inspections of both traded and non-traded market risk.</p> <p>AGN 113.3 The Standard Method prescribes the methodology for calculation of capital requirements and establishes prudential limits for specific market risks, including among other interest rate risk, foreign exchange risk, and equity risk. AGN 113.2 Internal Models, establishes the minimum criteria for banks using their own models to determine capital requirements for market risks. These are comprehensive, and require APRA approval prior to implementation (paragraph 3). Eight ADIs have received approval to use internal models for market risk, with one authorization having subsequently been revoked.</p> <p>Banks are required to hold capital against market risks, calculated using either the Standard Method or an approved internal model, or a combination of the two approaches. Paragraph 8 of APS 110, Capital Adequacy, explicitly provides that APRA may require a bank to hold capital above the minimum. In practice, APRA has made use of this power.</p> <p>The adequacy of banks' information systems, management and internal control is regularly assessed in the course of on-site examinations. In addition to the advance review of policies and reports noted above, on-site review includes analysis of front office, market risk management, information technology, accounting, back-office and internal/external auditors. During these reviews, APRA examines compliance with internal policies and limits and the effectiveness of middle and back office functions. At the conclusion of these visits, APRA will present its recommendations to each bank in relation to improving the market risk management framework. Adherence with established limit frameworks is tested along with the disciplinary approach of the bank.</p> <p>Part of the on-site review includes a review of policies and systems for deal capture, deal input, confirmation, authorization and settlement. The process for establishing revaluation rates is tested to ensure they are sourced by officers independent of the front office and are validated for accuracy.</p> <p>AGN 113.2 specifies detailed requirements for banks using internal models to conduct scenario and stress-testing on a regular basis. Back-testing is also required, with results provided regularly to APRA, which has a specialist Risk Models unit. The Risk Models unit may initiate further investigations, and should the back-testing indicate poor model specification APRA may require an adjustment in the model's capital requirement multiplier. APRA also periodically requires internal model users to calculate the capital charge on a standard portfolio specified by APRA to ensure broad consistency across internal model users. In addition to off-site review of quarterly market risk returns, the adequacy of stress testing and back-testing is tested during on-site examinations.</p>

	<p>Specialist Risk Model teams support the supervisors responsible for individual ADIs. These teams have extensive experience. On-site work is undertaken by teams involving both the frontline supervisors and risk model specialists, combining detailed knowledge of the institution being examined with expert knowledge of model validation and testing.</p> <p>The review prior to each on-site examination of market risk reports to senior management and the board provides insights into the depth of senior management understanding of market risks, and confirms that these are reviewed regularly by the board. In practice, APRA has required remedial action when it has deemed the level of oversight exercised by the board and senior management to be inadequate. The most notable incident was the 2004 revocation of National Australia Bank's authorization to use its internal model for market risk, pending completion of 84 required remedial measures.</p>
Assessment	Compliant.
Comments	APRA has developed a highly skilled specialist team for market risk supervision.
Principle 13.	<p>Other risks</p> <p>Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor, and control all other material risks and, where appropriate, to hold capital against these risks.</p>
Description	<p>APS 310 requires banks to provide annually to APRA a declaration from the CEO, endorsed by the board (or in the case of a foreign bank, by a senior officer from outside Australia with responsibility for overseeing the Australian operations) that the board and management have identified the key risks facing the bank; established systems to monitor and manage those risks including, where appropriate, by setting and requiring adherence to a series of prudent limits; satisfied themselves through adequate and timely reporting processes that these risk management systems are operating effectively and are adequate regarding the risks they are designed to control; and the risk management systems descriptions provided to APRA are accurate and current. In addition, there are a number of prudential standards and guidance notes which provide more specific requirements in key risk areas including funds management and securitization (APS 210), liquidity (APS 221), outsourcing (APS 231), and business continuity (APS 232), as well as the previously noted standards for credit risk and market risk.</p> <p>The adequacy of banks' risk management processes with respect of liquidity risk, interest rate risk and operational risk is verified through on-site and off-site review. Operational risk and liquidity risk are specifically addressed in Module 6 of APRA's Supervision Framework. For liquidity risk, banks are required pursuant to APS 210 to implement a liquidity management strategy that APRA agrees is appropriate for the operations of the bank (paragraph 4). APS 210 establishes the minimum requirements for liquidity management, which among other things include a liquidity management policy statement approved by the board of directors or a board committee, a system for measuring, assessing and reporting liquidity, procedures for managing liquidity, clearly defined managerial responsibilities and controls; and a formal contingency plan for dealing with a liquidity crisis (paragraph 5). There is also an express requirement that the policy address group-wide issues and all currencies (paragraph 6). Further guidance on scenario testing and minimum liquidity holdings are provided in AGN 210.1 and AGN 210.2 respectively.</p> <p>APRA has a specialized operational risk team which provides support to the responsible front line supervisors. Typically, on site operational risk review is undertaken by specialists from the operational risk team in conjunction with one or more of the responsible front line supervisors.</p>

	<p>The assessment team reviewed sample specialized IT on-site examination reports, which were thoroughly completed. The planning and follow-up for these specialized examinations was found by the assessment team to be well integrated into the overall supervisory plan for the institutions examined.</p> <p>APRA's liquidity guidelines establish the minimum criteria for acceptable bank liquidity management policies. Most banks determine their own limits and guidelines pursuant to the criteria in APS 210, subject to the specific concurrence of APRA (paragraph 4). Banks whose scale and complexity do not warrant sophisticated liquidity management techniques may, with APRA concurrence, comply with the requirement to maintain a minimum of 9 percent of liabilities in specified high-quality liquid assets (paragraph 10). Only credit unions and building societies are currently subject to this simplified 9 percent limit.</p> <p>Supervisory verification that banks in practice comply with limits and established procedures takes place primarily during on-site examinations. As a part of routine on-site work, APRA also verifies that compliance with limits and procedures is regularly verified by the banks' internal audit function. Assessment of risk management processes is regularly conducted as part of the PAIRS rating process, in addition to monitoring of quarterly off-site reports and on-site examinations. The sample on-site reports reviewed by the assessment team were of high quality.</p> <p>As noted in the discussion of Caps 6 and 12, APRA has the explicit power to require banks to hold additional capital beyond the minimum requirement. Annual reports of Australian banks include detailed discussion of risk management policies. AGN 210.1 specifically addresses issues of foreign currency liquidity transformation. There are requirements for banks with sophisticated operations to undertake scenario analysis on both an aggregate and individual currency basis.</p>
Assessment	Compliant.
Comments	
Principle 14.	<p>Internal control and audit</p> <p>Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.</p>
Description	<p>Each existing prudential standard clearly establishes the responsibility of the board of directors to ensure that there is effective control over risk management. As noted in the description of CP 13, APS 310 requires boards of directors to endorse the annual declaration to APRA that that the board and management have identified the key risks facing the bank; established systems to monitor and manage those risks including, where appropriate, by setting and requiring adherence to a series of prudent limits; satisfied themselves through adequate and timely reporting processes that these risk management systems are operating effectively and are adequate having regard to the risks they are designed to control; and the risk management systems descriptions provided to APRA are accurate and current. APRA draft prudential standard APS 510 would provide further specific guidance on minimum governance arrangements.</p> <p>Supervisory verification of the adequacy and implementation of internal controls is undertaken</p>

	<p>in on-site reviews. These reviews assess the appropriateness of delegations and limits, separation of duties, decision-making procedures, management information systems and reports, accounting procedures and adequacy of reporting. Topic 7 in Module 6 of APRA’s Supervision Framework provides good guidance for review of the internal audit functions, and all of the risk management topics in the Supervision Framework include specific verification of internal controls. The on-site reports reviewed by the assessment team were of high quality, indicating that in practice the supervision modules are thoroughly completed. This provides appropriate supervisory verification that banks comply with the minimum expected standard, or are subject to appropriate remedial action.</p> <p>APS 310, as well as the standards relating to specific risks, requires boards and management to understand the underlying risks, and establishes their responsibility to adequately address these risks. The composition of the board and senior management, and the quality of oversight, is explicitly addressed in Modules 1 and 2 of APRA’s supervision framework. Section 20 of the BA provides that APRA may direct a bank to remove a director or senior manager who does not meet APRA’s fit and proper requirements.</p> <p>The balance of skills, resources of the back office and adequacy of control functions are routinely reviewed by APRA in on-site examinations following detailed provisions in Module 6 of the APRA Supervision Framework.</p> <p>APS 310 requires locally incorporated banks to have a comprehensive and independent internal audit process (paragraph 11). However, if the scale of an ADI does not warrant full-time internal audit, the ADI may agree alternative arrangements with APRA (paragraph 12). These exemptions have been granted only to building societies and credit unions, and in these cases appropriately qualified accounting firms provide the internal audit service on an out-sourced basis.</p> <p>An audit committee comprised of a majority of non-executive directors is required to oversee the internal audit function (paragraph 9) as well as financial reporting and the external audit. APS 310 (paragraph 11) requires ADIs to establish a comprehensive and independent internal audit process for reviewing and testing their internal controls and risk management systems. The scope of the internal audit should include a review of the processes and controls put in place by management to ensure compliance with APRA’s prudential requirements. Currently, banks are required to have an audit committee consisting of a majority of non-executive directors, although in practice all the large banks have audit committees comprising exclusively non-executive directors. The draft of APS 510 (governance) would require all audit committee members to be non-executive, extending the current practice for large banks to all ADIs.</p> <p>Section 62 of the BA provides APRA with the legal authority to obtain any information required for supervisory purposes, although in practice it has not been necessary to rely on formal powers to obtain access to reports of the internal audit functions.</p>
Assessment	Compliant.
Comments	The essential and additional criteria of this principle are met by the current prudential standards. The changes proposed in the current draft of APS 510 would further strengthen governance practices.
Principle 15.	<p>Prevention of Use of the Bank by Criminal Elements</p> <p>Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict “know-your-customer” rules that promote high ethical and</p>

	professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.
Description	<p>Prudential requirements for prevention of the use of a bank by criminal elements focus on licensing guidelines to prevent applicants of suspicious repute from obtaining a banking license, and on the fit and proper requirements for directors and senior management. Under the functional approach adopted in Australia, AUSTRAC has a dual role as both an FIU and AML/CFT regulator. As the AML/CFT regulator, AUSTRAC is responsible for ensuring compliance with current AML/CFT legislation, which would include on-site verification.</p> <p>The FTR Act requires cash dealers (a defined term under the FTR Act, which includes ADIs) offering accounts to obtain the necessary identification verification information from all signatories to accounts. There is no specific requirement in either the prudential framework or the FTR Act to appoint a senior officer with explicit responsibility for ensuring compliant compliance with anti-money laundering requirements. AUSTRAC does recommend that a senior officer be appointed to ensure compliance with FTR legislation.</p> <p>The adequacy of banks' policies and procedures and internal functions would be considered as part of on-site activity. However, there are no specific references in the APRA Supervision Modules regarding systems and procedures for reporting of suspicious transactions. AUSTRAC is empowered to conduct on-site verification, but has focused mostly on education. AUSTRAC has conducted two compliance examinations in respect of banks during the last two years</p> <p>Section 13 of the BA requires an ADI to notify APRA of any matter which would threaten its ability to meet its obligations to depositors.</p> <p>Section 16 of the FTR Act provides legal protection of cash dealers and their employees in the submission of suspicious transaction reports.</p> <p>The FRT Act (section 27 11A) permits AUSTRAC to share information with foreign supervisory bodies and FIUs, however it is currently unable to share suspicious transaction information with APRA. The APRA Act (section 56) specifically authorizes APRA to disclose protected information to other supervisory agencies and any other agency specified in the regulations, which includes law enforcement agencies.</p> <p>There is no explicit requirement for banks to have a policy statement on ethics and professional behavior communicated to all staff.</p> <p>FATF has published its October 2005 Mutual Evaluation Report on Australia. This report documented shortcomings in the legal framework and "did not find the implementation of the AML/CFT supervisory system to be effective in terms of the standards required by the revised 40 Recommendations." A need for enhanced coordination of AML/CFT measures among the relevant authorities was noted.</p>
Assessment	Materially non-compliant.
Comments	The principal shortcomings with respect to this principle relate to the current absence of an effective regime of on-site verification. Revised legislation is in preparation to address legal shortcomings. AUSTRAC is expected to build over a two year period the capacity for on-site verification. Most of the essential criteria of this principle have a requirement for on-site verification. Achieving compliance with this principle requires on-site verification that banks have actually implemented appropriate and effective measures to address a range of issues

	<p>extending beyond anti-money laundering and countering the financing of terrorism. Verification is required of:</p> <ul style="list-style-type: none"> • Banks' policies and procedures for high ethical standards and prevention of the use of the bank by criminal elements (EC 1); • Documented and enforced procedures for the identification of customers (EC 2); • Formal procedures to recognize potentially suspicious transactions (EC 3); • Banks' appointment of a senior officer to ensure banks' policies and procedures comply with statutory requirements (EC 4); • Banks' procedures are clearly communicated to all staff for the reporting of suspicious transactions (EC 5); • Banks have established lines of communication to both management and internal security for reporting problems (EC 6); • Banks' internal processes and controls for anti-money laundering are sufficient (EC 9). <p>Because many of these requirements are not specifically limited to AUSTRAC's AML-CFT function, it will be vitally important that there is effective coordination and communication between AUSTRAC and APRA. APRA must be appropriately advised, and able to take appropriate action, to address general prudential concerns arising from the issues addressed in AUSTRAC's on-site work at ADIs that could potentially affect reputational and liquidity risk, among other things.</p>
Principle 16.	<p>On-site and off-site supervision An effective banking supervisory system should consist of some form of both on-site and off-site supervision.</p>
Description	<p>APRA uses an integrated approach to on-site and off-site supervision. Offsite analysis is conducted by responsible frontline supervisors. Onsite prudential reviews are conducted by the same frontline supervisors, who are joined as required by relevant supporting specialists (e.g., IT, operational risk, market risk and credit risk) to complete teams for the conduct of on-site work.</p> <p>Off-site work systematically monitors the condition of banks through a combination of regular quarterly analysis, annual review, PAIRS risk assessments and the assessment of various prudential issues as they arise. Off-site analysis is used to determine the frequency of application of the various Modules of APRA's Supervision Framework. In addition to off-site verification of data through review by the statistics unit and follow-up by frontline supervisors of large or material variations, external auditors are required by APS 310 to report annually on the accuracy of data submitted to APRA.</p> <p>The financial analysis routinely undertaken is based on a wide range of inputs, including prudential and statistical reports. Detailed reports are produced for individual banks and the data is also analyzed on an aggregate and peer group basis to monitor trends for the banking sector as a whole. The sample reports reviewed by the assessment team were generally of high quality, but quarterly reviews for some banks were lacking in depth and insight. Quarterly reports are also not always produced due to other demands on supervisory resources.</p> <p>Off-site analysis is a continuous process. The frequency of on-site reviews is determined by a combination of minimum review cycles and risk-based prioritization. Banks assessed as subject to additional risk, or with identified potential weaknesses, are subject to more frequent and intensive on-site reviews. The prioritization system is largely driven by the Probability and Impact Rating System (PAIRS) and the Supervisory Oversight and Response Systems (SOARS). PAIRS classifies regulated financial institutions on two dimensions: the probability that the institution may be unable to honor its financial promises; and, the potential impact</p>

	<p>should the institution fail. Based on a structured supervisory assessment of inherent risk, management and control, capital support, and the potential impact (measured by balance sheet size), each institution is assigned one of five PAIRS ratings: Low, Low Medium; High Medium; High or Extreme. SOARS is then used to transform the PAIRS assessment into a supervision strategy for the ADI. The combination of the PAIRS rating and the size of the bank results in one of four supervisory stances: Normal; Oversight; Mandated Improvement; or Restructure. Stances other than “Normal” will incorporate measures intended to ensure a bank rectifies identified shortcomings. Movement among the various stances has reflected expected transitions, with stances of “Mandated Improvement” not being sustained for extended periods. The APRA Supervision Framework outlines the methodology for prudential reviews. The scope of reviews is determined using PAIRS results, with the particular modules from the suite available in the Supervisory Framework, and breadth and depth of application of the modules, tailored to address the issues identified in off-site analysis.</p> <p>Supervisory activity is supported by the Activity and Issue Management System (AIMS), which records and tracks all prudential reviews and other activities and interventions. The system itself is well founded, and the sample on-site reviews examined by the assessment team generally had a well documented follow-up process. However, due to pressures on supervisory resources, APRA does not always meet its own established deadlines for production of supervisory reports, and on occasion outstanding on-site issues are not closed on a timely basis.</p> <p>APRA reviews the effectiveness of supervisory process and practices on an ongoing basis, although this tends to be on an informal rather than structured basis. APRA has formal legal powers to access the report of internal and external auditors, provided by both the BA and APS 310.</p>
Assessment	Compliant.
Comments	The variation in quality observed by the assessment team is likely due to high levels of turnover in supervisory staff, as well as the lack of a standardized approach to quarterly reports and ongoing fine-tuning of the PAIRS/SOARS system. While the current approach of leaving the format and details of the analysis in quarterly reports to the discretion of supervisory teams has the advantage of avoiding a check-list mentality among examiners, APRA should consider the benefits of consistency and comparability that would arise from a more standardized approach.
Principle 17.	<p>Bank management contact</p> <p>Banking supervisors must have regular contact with bank management and a thorough understanding of the institution’s operations.</p>
Description	<p>APRA has an extensive program of regular meetings with bank management at various levels, and boards of directors. APRA meets annually with CEOs and functional heads to review APRA’s assessment of the prudential condition of the bank and discuss areas of emerging concern. On an ongoing basis, APRA will meet with senior executives in connection with both on-site and off-site prudential reviews and if any issues arises in the course of ongoing oversight.</p> <p>The combination of on-site and off-site work, especially the detailed risk analysis undertaken using the PAIRS framework, provides the supervisory authority with a detailed understanding of the activity of banks. In CP 15 the assessors have noted and criticized that the AUSTRAC may share information with APRA with respect to AML/CFT issues in individual banks. However, for the purpose of CP 17 which focuses on the different supervisory approaches to gather information about a bank, we have found that APRA's supervisory work, which includes checking internal audit and control functions and corporate governance in general, should be sufficient to achieve a thorough understanding of the bank's activities</p>

	<p>As part of its ongoing risk assessment of banks, APRA expects to be notified by banks immediately if there is any material adverse development to their risk positions. Although this requirement is not expressed in any prudential standard, failure to do so would have a negative impact on APRA's risk assessment and may attract enforcement action. The case of National Australia Bank provides an illustration that this expectation is met in practice. There is an explicit requirement in APS 222 that banking groups notify APRA immediately after it becomes aware of any breach of a prudential standard requirement or a condition of a banking authority (whether by an ADI in the group or by the group) and of any circumstances that might reasonably be seen as having a material impact and potentially adverse consequences for an ADI in the group or for the overall group.</p> <p>The APRA Supervision Framework (Module 2) requires an explicit assessment of the quality of bank management as part of prudential reviews. The assessment includes management composition and structure and a fit and proper test. The PAIRS assessments involve a rating of the quality of senior management. The sample on-site work reviewed by the assessment team was of a high standard, indicating that the assessment of management is undertaken in practice.</p>
Assessment	Compliant.
Comments	
<p>Principle 18. Off-site supervision Banking supervisors must have a means of collecting, reviewing and analyzing prudential reports and statistical returns from banks on a solo and consolidated basis.</p>	
Description	<p>The legal powers provided under the BA and paragraph 13 of the Financial Sector (Collection of Data) Act, have been used to determine 43 reporting requirements, which are quarterly or annual, and apply on both a consolidated and solo basis.</p> <p>The legal powers noted above enable APRA to specify the form and content of required reporting.</p> <p>The various prudential standards all explicitly establish the responsibility of boards of directors and senior management for all aspects of risk management, including required prudential reporting. APRA is empowered under Division 3 of the Financial Sector (Collection of Data) Act to impose criminal sanctions penalties in lieu of prosecution for failure to comply with the provisions of the act.</p> <p>The 43 mandated prudential reports provide all information needed for effective supervision, including balance sheet and income statement data, as well as detail regarding on and off-balance sheet activities, the composition of capital and data on asset classification and provisioning.</p> <p>APRA's legal authority to require information does not currently extend to banks' unregulated related companies, however, in practice APRA receives full cooperation from banks with regard to information on the entire group operation. APRA could use its powers to require an institution to hold higher capital as an interim measure to enforce moral suasion, and in the extreme could use the powers of section 11AF of the BA to issue a direction requiring subsidiaries of banks to submit any required information that had not been voluntarily provided.</p> <p>The prudential data collected is a key input for the PAIRS risk-rating assessments. In addition to the routinely collected prudential reports, in preparation for on-site work banks are required</p>

	<p>to provide additional material including risk management policies for prior review.</p> <p>APRA collects data quarterly and annually in a standardized form, which among other things is used for comprehensive peer group analysis. Periodically APRA prepares industry papers drawing on this comparative analysis. The assessment team reviewed sample semi-annual reports on the smaller ADI sectors (building societies and credit unions) and found these to be a of a good standard.</p>
Assessment	Compliant.
Comments	
<p>Principle 19. Validation of supervisory information Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.</p>	
Description	<p>APRA's Supervisory Framework establishes the basis for thorough risk-focused on-site examinations, establishing clear responsibilities for supervision staff, identifying objectives and outputs. The integrated approach involves both frontline supervisors and specialists in various technical areas including market risk and operational risk. Prudential reviews are organized around a suite of Modules which address the key functional and risk areas of institutions. The frequency of application of the Modules is determined by the supervisory stance assigned to the banks through the PAIRS and SOARS framework. External auditors are used to undertake targeted reviews and to review the reliability of data reported to APRA. Regular tripartite meetings involving APRA, the external auditor and the bank are held to discuss auditors' reports and any issues arising from the auditors' work.</p> <p>APS 310 explicitly requires auditors to provide to APRA management letters in addition to audited financial statements and a range of specific reporting information about the ADI. Paragraphs 15 and 16 explicitly provide for the appointment of auditors to undertake "specific reviews," with the cost of such reviews to be borne by the institution. Paragraph 18 empowers APRA to require auditors to provide any additional information required for supervisory purposes. Division 2B of the BA empowers APRA to remove a bank's external auditor (either the responsible partner or the firm).</p> <p>The role and responsibilities of an external auditor undertaking a "specific review" is delineated in paragraph 16 of APS 310, which references Accounting Standard 904.</p> <p>The provisions of the BA and the Financial Sector (Collection of Data) Act empower APRA to obtain all information necessary for supervisory purposes.</p> <p>APS 310 specifically requires external auditors to report to APRA annually on whether the financial and statistical data provided by the ADI is accurate and reliable (paragraph 13). APRA's Statistic Unit undertakes an initial review of reported data for consistency and common errors prior to releasing data to supervisors. Supervisors as a matter of routine query large or material movements in data, and if found to be incorrect, banks are required to resubmit.</p> <p>APRA does not generally meet with boards of directors, but may do so when particularly serious issues are identified in on-site reviews. APRA meets quarterly with the major accounting firms as part of the Auditor Liaison Group in order to discuss major accounting and regulatory issues.</p>
Assessment	Compliant.
Comments	

Principle 20.	<p>Consolidated supervision</p> <p>An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.</p>
Description	<p>APRA has a detailed understanding of the structure of banking organizations and the activities of all material parts of groups. APS 222 requires banks to provide APRA with detail of group members, management structure of the group, intra-group support arrangements and intra-group exposures (paragraph 4), and the discussion by the assessment team with various APRA supervisory teams indicated that the responsible analysts have a thorough understanding of the individual banks and group structures. There are requirements that APRA be notified in advance of intended changes in the composition or operations of the group with the potential to materially alter the overall risk profile, and the major acquisition file reviewed by the assessment team indicates that this occurs in practice. Groups are also required to annually provide APRA with a description of group risk management policies and the procedures used to measure and manage overall group risk exposure (paragraph 5).</p> <p>APRA adopts a group-wide focus to its supervision of conglomerate groups. Sample quarterly analysis reports reviewed by the assessment team included specific discussion of issues on a solo and group basis where appropriate. APS 222 specifically references risks from the non-bank activities of the group.</p> <p>APRA has wide powers to supervise banks and their affiliates under the BA, and APS 222. In addition, as the prudential supervisor of insurance companies and pension funds APRA is able to ensure the prudent management of these entities within a banking group through its powers under the Insurance Act, Life Insurance Act, and the Superannuation Industry (supervision) Act. APRA staff has a good working relationship with ASIC, and while there may be some scope for improvement in the sharing of information and inter-agency cooperation, there is evidence that in practice there is a good flow of intelligence between the two supervisory authorities.</p> <p>There are no impediments to the supervision of affiliates and subsidiaries of banks. In practice, banks are subject to supervision on a solo basis, consolidated banking group basis, and conglomerate group basis. The supervision documents and processes reviewed by the assessment team provides evidence that in practice solo, group and conglomerate issues are considered as required.</p> <p>All the major prudential standards (e.g. capital adequacy, APS 110) apply on a consolidated basis as well as on a solo basis. The sample quarterly reports reviewed by the assessment team included analysis of capital adequacy on both a solo and group basis.</p> <p>APRA routinely collects consolidated financial information for locally incorporated banks and full financial information for branch operations in Australia. Prudential reporting requirements under the Financial Sector (Collection of Data) Act apply on both a solo and consolidated basis.</p> <p>Section 11CA of the BA provides APRA with broad powers to direct banks to take or refrain from taking specific actions, which in practice could be used to ring-fence a regulated entity. These powers could be used to limit the range of activities the consolidated banking group may conduct or restrict its overseas operations.</p> <p>Corporate ownership is generally prohibited by the Financial Sector (Shareholdings) Act, which limits ownership in locally owned banks to a maximum of 15 percent of voting shares, although there are provisions for this to be exceeded if in the national interest. A corporate</p>

	owner would have to be authorized as a holding company under the BA.
Assessment	Compliant.
Comments	
Principle 21.	Accounting standard Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.
Description	<p>International Financial Reporting Standards (IFRS), promulgated by the IASB, were enacted as Australian law from 1 January 2005. (Please refer also to the section on the Preconditions for the BCP assessment). There are no "carve-outs" for Australian ADIs, which thus will implement IFRS in full. (In addition there are a few insignificant additions for ADIs but these do not infringe on IFRS.)</p> <p>As stipulated by the Corporations Act, bank management is responsible for the financial record keeping systems and the reliability of data they produce. The Corporations Act requires that banks maintain proper financial records, that these are subject to appropriate independent audit, and that disclosure is adequate and in accordance with Australian Accounting Standards. Also all annual financial statements must be in accordance with Australian Accounting Standards. The Act also prescribes that the annual financial report and directors' report be audited. When there is concern that these requirements are not being met, APRA would liaise with ASIC to determine an appropriate course of action. The reports must be lodged within 3 to 4 months after the end of the financial year depending on the type of entity.</p> <p>The ADI Reporting Standards (ARS) issued by APRA require the submission of information to APRA. The Standards state that it is the responsibility of the board and senior management to ensure that an appropriate set of policies and procedures for the authorization of data submitted to APRA is in place. APS 310 requires external auditors to provide simultaneously to APRA and the audit committee a report detailing auditors' opinions as to whether the statistical and financial data provided by the bank to APRA are reliable. In addition to the external audit verification process, APRA reviews management information systems and the data they produce during on-site reviews.</p> <p>It is generally accepted practice in the Australian banking industry for APRA and auditors to interact directly or in conjunction with banks and open communication is maintained. Bank auditors report directly to APRA annually on adherence to prudential standards and statutory banking requirements by the bank; that the data provided to APRA are reliable, and any matters that may have the potential to prejudice the interests of depositors. APRA may, in consultation with a bank, request its external auditor, or other external auditors, to undertake a specific review of a particular aspect of the bank's operations or risk management system. The BA also mandates auditors to inform APRA if the auditor has reasonable ground for believing that the bank is insolvent, or is at risk of becoming insolvent, or the bank has failed to comply with a prudential requirement; or if there exists a current or proposed state of affairs that may materially prejudice the interests of depositors.</p> <p>APRA's reporting standards, and the instructions, instruct banks as to the form of presentation and of the accounting standards under which the information is to be prepared. They also specify valuation methods.</p>

	<p>APRA has the power to engage external auditors to undertake specific audits of banks' accounts. The scope of these audits is determined by APRA. APRA may require that a bank submit its annual financial report to APRA prior to its lodgment with ASIC and can require changes to be made.</p> <p>All information supplied to APRA, unless previously publicly disclosed or expressly permitted to be disclosed, is protected information under Sec 56 APRA Act. The same Section, however, allows such information to be shared with other supervisory bodies</p> <p>Sec 17 BA empowers APRA to remove a person, or, if relevant, the whole audit firm from the task of auditing a bank if APRA is satisfied that the person or firm has failed to perform the functions and duties of the position as required by the BA or prudential standards or does not meet the fit and proper criteria set out in the prudential standards.</p> <p>APRA strongly supports the principles of transparency and statutory disclosure of financial information to enhance the pursuit of its prudential objectives.</p>
Assessment	Compliant
Comments	
Principle 22.	<p>Remedial measures</p> <p>Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking license or recommend its revocation.</p>
Description	<p>As noted under CP1(4), the BA provides APRA with a wide range of powers, which can be used by APRA when it deems a bank not to be complying with laws and regulations, or it is or is likely to be engaged in unsafe practices. APRA can utilize these powers to both take prompt remedial action and impose sanctions. In practice, if APRA were to become concerned about one of its regulated entities it would increase the frequency and intensity of supervisory oversight. It might also require the bank to meet a higher capital ratio, or to discontinue certain lines of business. As an initial measure, more frequent reporting from the area of the bank causing concern would be required.</p> <p>Sec 11CA BA confers on APRA powers to issue a broad range of directions to banks, such as:</p> <ul style="list-style-type: none"> • removing or restricting the powers of a director, executive, secretary or employee; • appointing a person to act as a director, executive, secretary or employee of a bank; • replacing an internal auditor; • placing restrictions on a bank's activities and acquisitions; • restricting or suspending dividends or repayment of shares; • restricting repayments or asset transfers; and • directing anything else as to the way in which the affairs of the bank are conducted, or not conducted <p>Ultimately, if warranted, APRA may revoke the license of the bank.</p> <p>APRA could participate in arranging a take-over by or merger of a troubled bank, if warranted. It would only do this, however, if such an outcome was not a material detriment to the healthier institution.</p>

	<p>APRA's continuous off-site monitoring and its risk-based program of on-site reviews are intended to assist supervisors to take timely and proportionate remedial actions. This is supported by the PAIRS risk-rating tool, the SOARS response system and the APRA Supervision Framework (For a detailed description of these - see CP 16). For more serious breaches or where depositors' interests are clearly threatened, APRA is able respond quickly using its powers under the BA.</p> <p>APRA's senior executive group receives a monthly report on risk ratings of banks along with recent downgrades and upgrades. This provides a mechanism for querying and follow-up of cases which may not appear to be getting adequate and timely attention.</p> <p>The BA enables APRA to apply penalties and sanctions in a number of cases to the bank or an officer of the bank and/or its Board in relation to a direction given by APRA. Sec 11BA states that a bank's officers are guilty of an offence if they fail to take reasonable steps to ensure that the bank complies with a direction by APRA.</p> <p>The powers to take remedial action are not subject to "cooling off" periods. Judicial review of APRA's decisions is available, but this does not amount to a rehearing on the merits.</p> <p>APRA is able to act proactively (and is often doing so in practice) to meet increased risks or perceived weaknesses, e.g. by increasing capital requirements for individual banks.</p> <p>All requirements and instructions given to banks in relation to their operations and systems are given in writing. In almost all cases, progress on actions is reported to APRA in writing. Significant issues are addressed to the bank's board. Following all on-site reviews to banks, APRA writes to the bank setting out its findings and specifying any required, recommended or suggested actions.</p>
Assessment	Compliant
Comments	<p>It is presently being considered whether APRA decisions for remedial action might be submitted to "merit review" (whether APRA's decision was based on a correct analysis of the situation) in addition to the "judicial review" (whether APRA applied correct procedures and interpreted the law correctly) which is currently applied. While the BCP assessors see arguments, for instance in an accountability context, for "merit reviews," this must be carefully considered and structured so that APRA's ability to act forcefully and promptly, in particular in an urgent crisis situation, is not compromised.</p>
Principle 23.	<p>Globally consolidated supervision</p> <p>Banking supervisors must practice global consolidated supervision over their internationally active banking organizations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organizations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.</p>
Description	<p>All operations of locally incorporated banks and their subsidiaries, whether they are in Australia or overseas, are subject to the global consolidated banking supervision undertaken by APRA. To strengthen the scope of its consolidation, APRA has implemented a "conglomerates policy" for banks. APRA requires the board of a bank to ensure the bank establishes appropriate policies, systems and procedures to monitor compliance with APRA's prudential requirements on a group basis. APRA's on-site reviews examine banks' activities on a group-wide basis and consider the ability of the board and head office management to oversee and control overseas operations. For banks with significant offshore operations, in practice, New Zealand and the UK, APRA conducts on-site reviews of the local office and liaises with the host supervisor in the process. APRA keeps abreast of host country supervision where material</p>

	<p>to Australian banks.</p> <p>APRA's on-site reviews of credit risk, market risk and operational risk include determining that the information received from overseas entities are sufficient. When reviewing operations on-site, the APRA reviews compliance with internal controls and ensures that the head office oversight of the overseas operation is effective.</p> <p>APRA has powers to require a bank to divest itself of certain businesses or branch offices or place limits on certain activities or undertake other measures, also abroad, if necessary to ensure compliance with prudential standards or to protect the interests of depositors. This would apply, for instance, if:</p> <ul style="list-style-type: none"> • Bank management on the group level does not monitor and control the overseas entity sufficiently; • If host country supervision of the entity is deemed to be weak; • If APRA does not receive required information on the overseas' entity and its operations, e.g., for reasons of secrecy according to the host country's laws and regulations. <p>Where a bank is assessed as being subject to additional risk, or where APRA has identified a potential risk weakness, APRA will increase the frequency and intensity of its on-site reviews. This would normally include an increased level of reporting.</p>
Assessment	Compliant
Comments	
<p>Principle 24. Host country supervision</p> <p>A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.</p>	
Description	<p>APRA has close working relations with the Reserve Bank of New Zealand and the Financial Services Authority (FSA) in the UK and has an MOU with both authorities. APRA also has MOUs with several other authorities, namely the Hong Kong Monetary Authority; BaFin (Germany), China Banking Regulatory Commission and the Office of Thrift Supervision (USA). The memoranda establish a formal basis for cooperation, including the exchange of information and investigative assistance. In addition, the memoranda enable the agencies to assist APRA in obtaining information from third parties.</p> <p>APS 222 requires banks to advise APRA in advance of any proposed changes to the composition or operations of the group with the potential to materially alter the group's overall risk profile and to obtain APRA's prior approval for the establishment or acquisition of a regulated presence domestically or overseas. If APRA considers a proposed overseas operation to be too risky it can use its powers under the BA to prohibit a bank from setting up such operation. When reviewing the overseas operations on-site, APRA meets with the host supervisors to discuss the overall operations of the bank group. In addition, where APRA's assessment of the group's operations raises concerns, it will promptly contact the host supervisors and inform them. In many instances, prudential assessments and reports on bank groups are exchanged with foreign supervisors.</p> <p>In taking any action in respect of the overseas operations of an Australian bank, APRA would always liaise closely with the host supervisor.</p>
Assessment	Compliant
Comments	
<p>Principle 25. Supervision over foreign banks' establishments</p>	

	Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.
Description	<p>All local branches and subsidiaries of foreign banks authorized by APRA are subject to similar prudential, inspection and regulatory reporting requirements as domestic banks.</p> <p>However, as discussed in CP 2, Australian law (Sec 11 BA) allows foreign banks to operate in Australia without being authorized and supervised by APRA, provided they disclose to their counterparties that they are not supervised by APRA. These institutions may not accept deposits otherwise than by issuing or selling securities in accordance with the Corporations Act.</p> <p>The quality of prudential oversight by home country supervisors is an important element in APRA's assessment of any application from a foreign bank to be authorized to carry on banking business in Australia. Whether it practices consolidated global supervision is a consideration in making this assessment. APRA will not authorize a bank to conduct banking business in Australia without it having received consent from its home supervisor.</p> <p>There is no impediment for APRA to share relevant information with overseas regulators. However, this only applies to licensed foreign banks and does not extend to those foreign banks operating in Australia pursuant to an exemption under Sec 11 BA. (See above)</p> <p>APRA facilitates requests from home country supervisors to examine the Australian operations of foreign banks. APRA advises home country supervisors of any material issues that arise affecting the Australian operations of an authorized foreign bank or where APRA makes a material prudential intervention affecting a foreign bank.</p> <p>APRA obtains relevant information on the global activities of foreign banks during the licensing process and as part of its ongoing supervision. In many instances, prudential assessments and reports are exchanged between home and host supervisors.</p>
Assessment	Largely compliant
Comments	<p>The foreign deposit-taking institutions outside APRA's regulation have aggregate assets of \$A 77 billion as compared with the prudentially regulated sector's total assets of 2.1 trillion. Few of them have assets in excess of 1 billion and thus they are not regarded as systemically important. That being said, the assessors take the view that the possibility to grant "Sec 11 exemptions" (which is automatically provided if the preconditions are met) opens a wide door, which might lead to regulatory arbitrage. For instance, some institutions, while observing the formal limitations, obviously offer deposit-like instruments to retail customers. In general, while the non-regulated foreign institutions are not systemically important some of them are of significant size also within Australia and failures could ultimately affect the regulated sector, and the depositors. Also, given that the boundaries between wholesale and retail banking has blurred over recent years it seems less relevant to allow a fairly wide sector of non-regulated entities which de facto conduct quasi-banking activities. This could increasingly become a level-playing-field issue.</p> <p>Finally, this issue could also be seen in a global perspective. Even though home country supervisors may visit the unregulated entities (in Australia), globally consolidated supervision obviously becomes more difficult when there is no host country regulation and supervision available.</p> <p>The assessors' recommendation to the Australian authorities is to introduce an amended and</p>

	clearer demarcation line between authorized and exempted institutions, better reflecting today's financial market structures and instruments, between regulated and exempted entities. Clearer criteria would apply on the liabilities' (funding) side as well as to the range of permitted activities.
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Table 2. Summary of Compliance with the Basel Core Principles

Core Principle	C ^{1/}	LC ^{2/}	MNC ^{3/}	NC ^{4/}
1. Objectives, Autonomy, Powers, and Resources	X			
1.1 Objectives	X			
1.2 Independence	X			
1.3 Legal framework	X			
1.4 Enforcement powers	X			
1.5 Legal protection	X			
1.6 Information sharing		X		
2. Permissible Activities		X		
3. Licensing Criteria	X			
4. Ownership	X			
5. Investment Criteria	X			
6. Capital Adequacy	X			
7. Credit Policies	X			
8. Loan Evaluation and Loan-Loss Provisioning	X			
9. Large Exposure Limits	X			
10. Connected Lending	X			
11. Country Risk	X			
12. Market Risks	X			
13. Other Risks	X			
14. Internal Control and Audit	X			
15. Use of Banks by Criminal Elements			X	
16. On-Site and Off-Site Supervision	X			
17. Bank Management Contact	X			
18. Off-Site Supervision	X			
19. Validation of Supervisory Information	X			
20. Consolidated Supervision	X			
21. Accounting Standards	X			
22. Remedial Measures	X			
23. Globally Consolidated Supervision	X			
24. Host Country Supervision	X			
25. Supervision Over Foreign Banks' Establishments		X		

^{1/} C: Compliant.

^{2/} LC: Largely compliant.

^{3/} MNC: Materially non-compliant.

^{4/} NC: Non-compliant.

E. Recommended Action Plan and Authorities' Response to the Assessment

Recommended action plan

28. Australia has already initiated plans to address the most serious shortcomings in the implementation of the Basel Core Principles for Effective Banking Supervision, which relate to Core Principle 15. It is intended that AUSTRAC will develop the necessary skills and expertise to undertake the needed on-site verification of bank's implementation of measures to prevent abuse by criminal elements. Coordination and information sharing between AUSTRAC and APRA will be vital in this regard because many of the specific requirements of CP 15 extend beyond the narrow confines of AML/CFT issues. If AUSTRAC is unable to share information with the prudential supervisor, it will not be possible to effectively implement measures to ensure APRA is apprised on a comprehensive and timely basis of any issues that might affect soundness, for instance though reputational risk. It will also be important the APRA receives the full benefits of insights into the broader issues of internal control and compliance than can come from the detailed on-site review of the specific aspects of internal controls that will be undertaken by AUSTRAC.

29. While the provisions to ensure operational independence of APRA fall short of those of the RBA, they currently provide a generally adequate framework to meet the requirements of the Core Principles. The power of the Treasurer to give directions to APRA has not been used; however, it would provide greater certainty regarding the independence of the prudential supervisor if this provision were removed. It would appear possible that making APRA subject to the Financial Management and Accountability Act could lead to a diminution of operational independence, and it would be preferable to maintain the greater independence arising from the current status under the Commonwealth Authorities and Companies Act.

30. Consideration should be given to revising the criteria for Section 11 exemptions to ensure that only institutions which fund themselves on a truly wholesale basis may be exempted from APRA regulation and supervision. An amended and clearer demarcation line between authorized and exempted institutions, better reflecting today's financial market structures and instruments, would address the current concern that there is little difference in practice between unlicensed and unsupervised finance companies and foreign bank subsidiaries that fund themselves using instruments issued by prospectus which may be easily mistaken, especially by retail investors, as deposits. The revised criteria could be used to ensure that all subsidiaries of foreign banks undertaking bank-like activity in Australia are subject to APRA oversight.

31. APRA's approach to supervision is commendable, with the PAIRS/SOARS approach reflecting current best practices in risk-focused supervision. The overall approach is still quite new, and subject to ongoing refinement. One area for improvement would be the introduction of greater standardization in off-site analysis. While it is important to avoid a

check-list mentality, some of the variation in quality currently observed could be addressed by providing staff with greater guidance to shape their exercise of supervisory judgment.

32. Specific recommendations for individual principles assessed as less than fully compliant are provided below. Additional observations and suggestions are provided in the comments of a number of principles where it is possible, in the view of the assessors, to enhance the already high standard of supervision.

Table 3. Recommended Action Plan to Improve Compliance of the Basel Core Principles

Reference Principle	Recommended Action
CP 1(6): Information sharing	<ul style="list-style-type: none"> Remove the legal obstacles to AUSTRAC sharing information with APRA and implement effective coordination with respect to the information gathered by AUSTRAC that is relevant to APRA's prudential oversight of the adequacy and implementation of banks' internal policies
CP 2: Permissible activities	<ul style="list-style-type: none"> Revise the criteria for exempting institutions from regulation so that the demarcation line between regulated and non-regulated entities becomes clearer.
CP 15: Use of banks by criminal elements	<ul style="list-style-type: none"> Establish an effective supervisory verification program, ensuring that APRA is able to obtain all necessary information regarding prudential issues, including those that extend beyond AUSTRAC's narrow mandate.
CP 25: Supervision Over Foreign Banks' Establishments	<ul style="list-style-type: none"> Revise the criteria for exempting institutions from regulation so that all foreign bank subsidiaries undertaking bank-like business in Australia are subject to APRA oversight.

Authorities' response

The Australian Government considers that this has been a high quality assessment and is valuable in assisting it to consider its framework for regulating banks. It shows Australia's high level of compliance with the core principles.

The authorities are aware of the issues raised in relation to the framework for protection of depositors in the 'preconditions' section of the assessment and they have been noted in the Reserve Bank of Australia's March 2006 *Financial Stability Review*. The work that is currently being undertaken by the Council of Financial Regulators on the potential introduction of a Financial Claims Compensation Scheme recognizes such community attitudes to support in the event of a failure.

In relation to Principle 1(2) the Australia Government recognizes that, to achieve high quality outcomes in prudential regulation, it is important to have a regulator with operational independence from government. However, it is also an important element of Australia's system of ministerial accountability that governance and accountability arrangements operate in such a way that regulators follow the policy intention of the parliament when implementing legislation.

The Government considers that the power of the Treasurer to issue directions to APRA on policies and priorities (but not particular cases) strikes an appropriate balance in this regard. The conditions attached to this power, such as discussing the proposed direction with the APRA Chair and tabling the direction in parliament, provide transparency and accountability in its use, such that a direction would only be considered as a final option. To date the Treasurer has not given APRA any directions under this power.

As part of a government wide review of statutory authorities, the Treasurer has agreed to move APRA's financial framework to the *Financial Management and Accountability Act 1997* (FMA Act) from the current *Commonwealth Authorities and Companies Act 1997* (CAC Act). Prudential regulation is a core function of government, and the FMA Act is the financial framework that most appropriately applies to agencies delivering core functions. The CAC Act is most applicable to government entities that undertake commercial operations.

The Government does not consider that this change will materially affect APRA's operational independence or funding. It is APRA's enabling legislation (the *Australian Prudential Regulation Authority Act 1998*) that establishes the required level of operational independence necessary to exercise statutory powers objectively. Further, the Government has exempted APRA from a small number of conditions under the FMA Act that may affect its ability to fulfill its duties efficiently and effectively. As a result, the change to the FMA Act will not affect how APRA is funded or reduce its autonomy in deciding how it spends its funding and organizes itself (including its ability to set the employment terms and conditions of its staff) to meet its statutory obligations.

More generally, the Australian Government notes that its overall approach to fiscal policy over the last decade, in which all public sector spending is subject to robust discipline, has served Australia well, ensuring adequate funding for government services and agencies while producing a degree of sustained fiscal responsibility unmatched by many other OECD economies.

On Principle 15, as the IMF has noted, the Government is committed to updating Australia's anti-money laundering and counter-terrorist financing (AML/CTF) regime to reflect developments in financial crime and revised international standards from the Financial Action Task Force on Money Laundering (FATF).

In keeping with its commitment the Government is closely consulting with industry on a range of reforms. Legislation is expected to be introduced during 2006. The reforms when implemented will bring Australia into compliance with the FATF recommendations and will ensure that Australia's financial sector, in meeting its obligations, remains robust and internationally competitive.

Processes are currently in place to amend the existing *Financial Transaction Reports Act 1988* to allow AUSTRAC to share FTR information with APRA. This will also involve the establishment of a memorandum of understanding between the two authorities. Under the proposed AML/CFT legislation APRA will be included as a partner agency with which AUSTRAC can share FTR information. These arrangements will ensure that APRA is provided with information essential to assessing reputational and liquidity risks within APRA regulated institutions. In addition, APRA and AUSTRAC will continue to improve broader cooperation and coordination arrangements.

In relation to the comments on Principle 22, the Government is currently reviewing the application of merits review to APRA decisions following a recommendation of the HIH Royal Commission and, more recently, a recommendation of the Taskforce on Reducing the Regulatory Burden on Business. The review will take into consideration the need for APRA to be able to take timely decisions where they are necessary to protect the interests of depositors and/or other policyholders. The review will also seek to balance the objective of timeliness with the need to ensure that persons affected by decisions are treated fairly.

Merits review is a key element of Australia's system of administrative review and, where appropriate, offers the potential for a cost effective and relatively timely review of an administrative decision. In the absence of the availability of merits review, persons affected by decisions would have recourse to judicial review by the courts.

II. INSURANCE CORE PRINCIPLES AND METHODOLOGY

33. This assessment examines Australia's observance with the ICP issued by the International Association of Insurance Supervisors (IAIS) in October 2003. The assessment was conducted by Su Hoong Chang from November 30 to December 14, 2005 as part of the IMF Financial Sector Assessment Program (FSAP). The assessment is based on the assessment methodology established by the IAIS.

34. The level of observance for each ICP reflects the assessments of the essential criteria only. Assessment of advanced criteria is not included in assessing observance with ICP. An ICP will be considered observed whenever all the essential criteria are considered to be observed or when all the essential criteria are observed except for a number that are considered not applicable. For an ICP to be considered largely observed, it is necessary that only minor shortcomings exist which do not raise any concerns about the authority's ability

to achieve full observance. An ICP will be considered partly observed whenever, despite progress, the shortcomings are sufficient to raise doubts about the authority's ability to achieve observance. A Principle will be considered **not observed** whenever no substantive progress toward observance has been achieved.

35. Separate assessments are made for the life and general industries based on their respective legislation and regulatory regimes. Given the distinct legal and regulatory regimes for the two industries, different observance levels are recorded, where applicable. The assessments are based on a) a comprehensive self-assessment prepared by the authorities; b) a review of applicable laws, regulator/supervisory guidance and procedures; c) analysis regulatory and market data; d) interviews with staff of the authorities, industry participants, industry and professional associations; and e) documentation provided by various interviewees.

36. The assessments are based solely on the laws, regulations and other supervisory requirements and practices that are in place at the time of assessment. The authorities are in the process of reforming certain aspects of the supervisory framework during the FSAP mission. The progress of these initiatives, which have yet to be fully implemented, are noted in the report by way of additional comments.

37. The mission is grateful to the Treasury, APRA, ASIC and ATO for their full cooperation and assistance with the logistical arrangements and co-ordination of various meetings with industry bodies and companies. They have provided comprehensive responses to an extensive questionnaire as well as a thorough self assessment against the ICPs. Discussions with and briefings by the authorities during a series of technical meetings also facilitated a meaningful assessment of Australia's adoption of international best practices.

Table 4. Principle by Principle Assessment of IAIS Core Principles

Conditions for Effective Insurance Supervision	
Principle 1.	Conditions for effective insurance supervision Insurance supervision relies upon: - a policy, institutional and legal framework for financial sector supervision - a well developed and effective financial market infrastructure - efficient financial markets.
Description	Australia has a sophisticated macro-economic framework. Sound fiscal and monetary policies have contributed to a stable environment conducive for the development of well functioning financial markets. Australia adopts a functional approach to financial sector regulation. Prudential supervision under APRA, investment market integrity and transparency through ASIC and broader financial system stability through the Reserve Bank. In exercising its functions and powers, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality. The legal system is robust. There are various checks and balances on the power of the government and ensure the independence of the judiciary. While contract law does not lay down

	<p>a comprehensive set of rights, duties and liabilities, it sets out the parameters within which the parties' agreement must fall if it is to be enforceable. The courts provide an effective mechanism for the settlement of contractual disputes and enforcement of contractual obligations.</p> <p>Australia adopts international accounting and auditing standards. <i>International Financial Reporting Standards (IFRS)</i> was adopted as from 1 January 2005 while Australian-specific accounting standards issued by the <i>Australian Accounting Standards Board (AASB)</i> deal with issues specific to local financial reporting framework (e.g. disclosure of directors and executive remuneration). Auditing standards are set by the <i>Auditing and Assurance Standards Board (AUASB)</i>, based on International Standards on Auditing issued by the International Auditing and Assurance Standards Board. The Financial Reporting Council provides oversight of the AASB and AUASB including determining the strategic direction of these bodies.</p> <p>Oversight of auditors is by ASIC and the professional bodies. They must be registered with ASIC and meet minimum qualifications as well as fit and proper criteria. There are currently approximately 6,110 registered auditors. As from 1 July 2004, the Corporations Act requires an auditor to give the auditor's independence declaration to directors at the same time as the auditor's report. ASIC may revoke a license or deregister an auditor due to misconduct.</p> <p>The <i>Life Insurance Actuarial Standards Board (LIASB)</i> establishes actuarial standards. Compliance with the LIASB actuarial standards is obligatory for life insurers. Actuaries must complete a rigorous education program and meet a practical experience requirement to qualify as Fellows of the <i>Institute of Actuaries of Australia (IAAust)</i>.</p> <p>All the professional bodies have developed professional standards and codes of ethics that apply to their members. The standards are published on the websites of the relevant bodies. Disciplinary processes are also in place to ensure compliance by members.</p> <p>Economic, financial and statistics data are widely available in Australia. Publications by APRA and others on the insurance industry are detailed under ICP 11.</p> <p>Australia has well functioning money and securities markets. The four prescribed stock exchanges have total stock market capitalization of almost US\$500 billion. Australia has the eight largest stock market in the world and the second largest in the Asia-Pacific region behind Japan. An active money market provides an important source of liquidity for the Australian financial system.</p> <p>Advanced Criteria Substantial reforms have been undertaken in recent years to facilitate market innovation and reflect international best practices. <i>The Corporate Law Economic Reform Program (CLERP)</i>, started in 1997, is part of the Government's drive to promote business, economic development and employment in Australia. CLERP 9: the <i>Corporate Law Economic Reform Program (Audit Reform & Corporate Disclosure) Act 2004</i> became law on 30 June 2004 and introduces significant changes to the regulation of corporate governance in Australia (particularly in relation to auditor qualifications and independence, financial reporting, director and executive remuneration and disclosure).</p> <p>APRA has also undertaken major supervisory initiatives since its inception. On-going initiatives include Stage 2 Reform for general insurance industry and development of a comprehensive framework for the prudential supervision of conglomerates.</p>
Assessment	Observed
Comments	Australia has sophisticated and progressive macroeconomic and legal supervisory frameworks. It adopts international accounting and auditing standards and the professional bodies exercise effective self-regulation. Its deep, liquid and well functioning financial markets facilitate

	effective asset-liability management by insurers.
The Supervisory System	
Principle 2.	Supervisory objectives The principal objectives of insurance supervision are clearly defined.
Description	<p>The objectives of insurance supervision are clearly enunciated in both the <i>Insurance Act (IA)</i> and the <i>Life Insurance Act (LIA)</i>. The main object of insurance supervision is to protect the interests of policyholders and prospective policyholders in a manner consistent with the continued development of a viable, competitive and innovative insurance industry. An additional object under the LIA is “to protect the interests of persons entitled to other kinds of benefits provided in the course of carrying on life insurance business”.</p> <p>In line with Australia’s functional approach to financial sector supervision, APRA and ASIC adopt supervisory objectives that reflect their respective roles.</p> <p>APRA’s main objective is to minimize failures among APRA regulated financial institutions. “Failure” means failure to meet expected payments to depositors, policyholders and super fund members, who are collectively referred to as beneficiaries. However, APRA cannot guarantee that there will be no failures. While APRA’s focus is on financial soundness, the primary responsibility for financial soundness lies with the Boards and management of regulated entities. APRA takes a risk-based and consultative approach to supervision. It consults widely to ensure that the interests of all stakeholders are taken into consideration.</p> <p>ASIC’s objective is to “achieve the outcome of a fair and efficient market characterized by integrity and transparency and supporting confident and informed participation of investors and consumers”.</p> <p>APRA and ASIC do not have a mandate for financial sector development. A separate agency, Axiss Australia, has been established to position Australia as a global financial services centre in the Asian time zone.</p>
Assessment	Observed
Comments	While the supervisory objective for the insurance industry is clearly defined and transparent, APRA and ASIC need effective coordination to balance the inherent tension between prudential and conduct of business supervision.
Principle 3.	Supervisory authority The supervisory authority: <ul style="list-style-type: none"> - has adequate powers, legal protection and financial resources to exercise its functions and powers - is operationally independent and accountable in the exercise of its functions and powers - hires, trains and maintains sufficient staff with high professional standards - treats confidential information appropriately.
Description	<p>APRA is responsible for the general administration of the insurance legislations. Financial sector policy formulation and reforms are the responsibilities of the Treasury. In practice, APRA has substantial input into legislative initiatives that impact on its roles and responsibilities. Frequently, such reforms are initiated by APRA. The passage of legislation has to be accommodated within the Government’s overall policy program.</p> <p>In administering the IA and LIA, APRA has wide powers to make standards across a broad range of prudential matters within the parameters of the legislative framework. Insurers must comply with the standards. APRA is able to give directions to insurers where it is satisfied that they have breached or are likely to breach a standard. Contravention of a direction by APRA is</p>

an offence. These powers enable APRA to issue and enforce rules by administrative means.

However, APRA has to seek the Treasurer's agreement before taking actions or decisions in a number of administrative areas. These include ownership in excess of 15 percent in financial sector companies and freezing an insurer's assets. Specific areas pertaining to the general and life insurance industries are outlined under the respective sections below.

ASIC has no power to create legal obligations. In addition, the government is not legally obliged to consult ASIC in its legislative and policy formulation and there is no formal mechanism for such consultation. Nonetheless, ASIC may interpret the laws through issuance of guidelines and preferred practices. ASIC's powers to impose licensing conditions allows for adapting the legal requirements to the circumstances of the regulated entity.

The APRA Act establishes APRA as an independent statutory authority. APRA is headed by an executive Chairman and is governed by a three member executive group known as the APRA Members. The APRA Members are appointed by the Governor General, on advice of the Minister. Section 25 of the Act governs the removal of APRA members but there is no legal requirement to publicly disclose the reasons for removing an APRA member from office.

While there is no evidence of government interference in APRA's operations, APRA is subject to a formal power of direction by the Minister under section 12 of the APRA Act. This power is limited to policies and operational priorities and cannot apply to individual cases. A direction must be in writing and can be given only after the Minister has notified APRA in writing. The power is also tempered by a requirement that the Minister must table any direction before Parliament within 15 sitting days. There have been no instances of APRA being formally directed by the Minister.

APRA's decisions are subject to substantive judicial review under the *Administrative Decisions (Judicial Review) Act 1997 (ADJR Act)* and review by *Administrative Appeal Tribunal (AAT)*.

APRA is subject to review before Parliamentary Standing Committees. Its performance is also subject to review in the Senate Estimates hearings and Senate Select committees. Transcripts of the proceedings of all of these committees are publicly available. In addition, APRA is subject to financial and performance audits by the *Australian National Audit Office (ANAO)*. The reports of the ANAO are tabled in Federal Parliament and publicly available. APRA's annual reports are tabled in Parliament and made public.

APRA is financed from levies imposed on all regulated entities. Separate levy scales apply to the different industry sectors supervised by APRA. APRA has autonomy to apply levy funds allocated to it as it deems fit. APRA has discretion in setting its own organizational structure and autonomy in staffing.

The Government is considering placing APRA's financial arrangements under the *Financial Management and Accountability Act (FMA)* instead of the current *Commonwealth Authorities and Companies Act (CAC)*. This may have implications on APRA's autonomy in how its funds are being spent and may limit APRA's ability to reserve for unexpected emergencies and thus limit its capacity to respond promptly. Such a move should be carefully considered in relation to the operational independence of APRA.

Internal oversight of APRA is monitored by the Risk Management and Audit Committee. The Committee comprises an external chair (with casting vote), one external member, one member of APRA's Executive Group and one Executive General Manager (on a one-year rotation). APRA has developed *Supervisory and Technical Decision Making Procedures* to guide staff in making balanced, accountable, consistent and professional decisions. Supervisory or technical decisions are documented and recorded in APRA's record keeping systems, including the *Activity and Issue Management System (AIMS)*.

The IA requires APRA to consult extensively with insurance entities before making, modifying or varying a prudential standard. The LIASB, established under the LIA to make actuarial standards, follows a due process of exposure and consultation in developing actuarial standards.

APRA is obliged to prepare a **Regulation Impact Statement (RIS)** when proposing any new prudential standard or rule or in any review or amendment of existing prudential standards. A RIS is prepared after consultation with affected parties in the policy formulation process. It includes an assessment of the costs and benefits of options, and a recommendation supporting the most effective and efficient option.

APRA has issued a Code of Conduct to staff which includes, *inter alia*, the declaration and management of potential conflict of interests arising from their duties and their investments. APRA staff is protected from liability in the course of discharging their duties, provided they have acted with good faith. The Commonwealth Authorities and Companies Act 1997 allows APRA to indemnify staff from any liability. APRA Members have resolved to indemnify APRA staff for the costs incurred in defending such actions.

APRA may engage consultants or other people to provide advice or undertake other services.

Under the APRA Act, it is an offence for a person to disclose protected information or release any protected documents, except in specified situations. "Protected Information" includes information relating to the affairs of a licensed insurer, which comes into APRA's possession in the course of discharging its supervisory functions. Information released under section 56 retains its protected status even if it is communicated to another financial sector supervisor and such information should only be used for prudential purposes. The offence provision under section 56 of the APRA Act extends to all recipients of protected information.

General insurance

APRA is empowered to license general insurers, revoke authorization, make prudential standards and exercise monitoring and enforcement powers under Parts IIIA and V of the Act. It is able, through the **Director of Public Prosecutions (DPP)**, to pursue the prosecution of persons carrying on an insurance business in Australia without authorization. The following powers are subject to the Treasurer's agreement:

- Power to wind-up general insurer (not provided under the IA but under Corp Act)
- Direction under sections 49M and 49N to require a general insurer to make provisions in its accounts in respect of its liabilities or specified assets
- Restriction on a general insurer from issuing new, or renewing existing, policies when an investigation is underway
- Taking actions to revoke a general insurer's authority

Life insurance

APRA has the power to register and monitor insurers' compliance with conditions of registration, the solvency, capital adequacy and directions given by APRA. APRA may investigate the affairs of a life company, appoint a judicial manager or seek the winding-up a life company where warranted. The following powers are subject to the Treasurer's agreement:

- Refusal to register a life insurer
- Withdrawal of life insurer's license
- Giving directions to life insurers on the solvency and capital adequacy of statutory funds and management capital requirements
- Give notice in relation to the maintenance of statutory funds under Part 4.
- Direction to a life insurer not to issue any further policies under section 150 of the LIA if the life company is, or has been, under investigation and the company is, or is about to become, unable to meet its policy or other liabilities or it has contravened the LIA or a direction.

	<p>A failure to comply with APRA’s prudential standards is not an offence but may lead to APRA giving a life company a direction under section 230B. A contravention of such a direction is an offence under section 230F. APRA is also empowered to prescribe prudential rules. Where a life insurer failed to comply with a prudential rule, APRA may require compliance by issuing a direction under section 230B.</p>
Assessment	Largely observed
Comments	<p>In administering the IA and LIA, APRA has wide powers to establish prudential standards within the parameters of the legislative framework. ASIC has no rule making powers to issue supervisory standards and interprets the laws through issuance of guidelines and preferred practices. As APRA and ASIC have more intimate knowledge of the industry through their direct and on-going supervision, effective mechanisms should be in place to ensure that their policy inputs are addressed appropriately and in a timely manner.</p> <p>There is scope for reviewing the extent of the Treasurer’s involvement in operational decisions of APRA and ASIC. Such involvement has implications for the operational independence of APRA. APRA has to seek the Treasurer’s agreement before taking actions or decisions in a number of administrative areas under the IA and LIA. While there is no evidence of Government interference in APRA’s operations, the Minister has a power of direction over the policies APRA should follow and the priorities it should pursue under the APRA Act. The Minister must not give direction regarding individual cases. For greater clarity, it may be useful to reconcile the Minister’s role under the insurance legislation and the APRA Act on specific matters relating to specific institutions. In this regard, the circumstances under which the Minister may give directions to APRA should be clearly spelt out.</p> <p>In general, APRA has adequate powers and financial resources to carry out its duties. APRA and its staff have established their credibility based on professionalism and integrity, and assurance of legal protection against lawsuits for actions taken in good faith while discharging their duties. The current financing arrangements do not undermine APRA’s autonomy or independence. There are strong safeguards to protect confidential information.</p> <p>APRA is subject to both external and internal governance requirements. It has also established supervisory procedures to ensure consistency and accountability. APRA members are appointed for a minimum term and can only be removed from office for reasons specified in law. However, there is no requirement to publicly disclose the reasons for removing an APRA member from office.</p>
Principle 4.	<p>Supervisory process The supervisory authority conducts its functions in a transparent and accountable manner.</p>
Description	<p>APRA conducts continuous off-site analysis through annual and quarterly assessments on the prudential condition of regulated entities. The frequency of on-site reviews of insurers is determined by a combination of minimum review cycles and risk-based prioritization.</p> <p>Risk prioritization is based on APRA’s <i>Probability and Impact Rating systems (PAIRS)</i> and its <i>Supervisory Oversight and Response System (SOARS)</i>. These two key tools ensure that risks are being assessed consistently across APRA and that proportionate prudential interventions are being taken.</p> <p>PAIRS classifies regulated financial institutions according to the probability and potential impact (based on total assets) of failure. PAIRS involves supervisors considering and assessing:</p> <ol style="list-style-type: none"> inherent risks – insurance, counterparty, market, operational, liquidity, legal/regulatory, strategic and related party; the effectiveness of management and control in mitigating the inherent risks;

c) whether capital support provides a buffer to deal with unexpected issues and losses; and d) the overall risk, taking into account of all the above. Each institution is assigned one of five PAIRS ratings: Low; Low Medium; High medium; High; or Extreme.

SOARS transforms PAIRS risk assessments into a supervision strategy for an entity. It determines the qualitative nature of the supervisory relationship between APRA and the supervised entity and APRA's planned supervisory activities. There are 4 supervisory stances: Normal; Oversight; Mandated Improvement; and Restructure.

Normal supervision activities include assessment and analysis of regular data received, monitoring market intelligence on developments affecting an insurer, maintaining a good knowledge of changes occurring within an insurer, conducting on-site and off-site reviews on specific areas of an insurer's business and operations and conducting a formal PAIRS risk assessment.

APRA adopts a case-by-case approach for institutions in Oversight, Mandated Improvement and Restructure. Likely supervisory actions for entities in "Restructure" may involve: a) forced sale; and/or b) forced run-off. Entities in 'Mandated Improvement' are likely to require one or more of the following: a) imposition of license conditions or statutory directions; b) appointment of an Inspector to investigate the whole or part of the affairs of the insurer; c) giving of an Enforceable Undertaking by the insurer; d) the closure of an entity to new business and/or freezing of its assets; e) the disqualification of key personnel; f) civil litigation to impose a penalty or claim damages; and/or g) criminal prosecution brief for the Director of Public Prosecutions.

Individual institutions are informed of their PAIRS ratings and of the factors considered in determining that rating. Insurers are also informed of any supervisory action consequent upon their PAIRS rating.

PAIRS and SOARS are supported by the *APRA Supervision Framework (ASF)*, AIMS and Supervisory and Technical Decision Making Procedures (see ICP 3). The ASF outlines APRA's supervision policy and a structured approach to core supervision activities such as prudential reviews and off-site analysis. AIMS records and tracks all prudential reviews and other activities and interventions. This enables supervisory resources to be appropriately allocated and management to effectively follow up planned or outstanding supervisory activities.

An Enforcement unit supervises entities identified to be of high risk and handles functions like issuing directions or enforceable undertakings, conducting investigations or freezing of assets. APRA has also established an Enforcement Committee which meets on a timely basis to decide on corrective or enforcement actions to remedy a problem situation or to limit losses to policyholders. The Committee comprises all the frontline Executive General Managers and the Deputy Chair of APRA as chairman.

APRA's administrative decisions are subject to substantive judicial review under the ADJR Act. Review is available where, among other things, there is bad faith or improper purpose, irrelevant considerations have been taken into account, or relevant considerations have not been taken in to account, or where there is evidence of unreasonableness, denial of natural justice or inflexible application of policy. In practice, there have been few instances of judicial reviews of APRA decisions.

A person who is dissatisfied with a reviewable decision (defined under the IA and LIA) may request a review of that decision. The decision may be confirmed, revoked or varied by such a review. A person not satisfied with the outcome of the review may apply to the AAT for a further review. In reviewing the decisions, the AAT stands in the shoes of APRA or the Treasurer and makes a determination based on the evidence put before it (also see ICP 14).

	<p>All prudential standards, rules, guidelines and determinations issued by APRA are published on APRA's website, which is kept up-to-date. APRA prepares an annual report within four months after the end of the financial year. The report includes a report of APRA's operations for the year and published on its website.</p> <p>Advanced Criteria APRA publishes a quarterly publication, <i>Insight</i>, which provides prudential commentary and features articles with statistical tables and figures that focus principally on the financial and risk characteristics of supervised financial institutions. APRA also publishes a <i>Quarterly General Insurance Performance Statistics</i> on general insurance and <i>Life Insurance Trends</i> (quarterly) and <i>Life Office Market Report</i> (six-monthly) for life insurance on its website.</p> <p>APRA is in the process of designing a more comprehensive semi-annual publication that will include detailed information at both an individual insurer and aggregate industry level.</p>
Assessment	Observed
Comments	<p>APRA has instituted a risk-based supervisory approach supported by rigorous internal documentation and procedures to ensure consistency and accountability. Timely enforcement is facilitated by the use of a specialized Enforcement unit and an empowered Enforcement Committee. Supervisory decisions and activities are transparent and subject to independent judicial review. APRA publishes its role, supervisory activities and decisions as well as market analysis on its website.</p>
Principle 5.	Supervisory cooperation and information sharing The supervisory authority cooperates and shares information with other relevant supervisors subject to confidentiality requirements.
Description	<p>APRA participates in a number of councils, committees and working groups with ASIC, the Reserve Bank, the Treasury and the <i>Australian Transaction Reports and Analysis Centre (AUSTRAC)</i>, through which regulatory interventions and supervision activities are coordinated.</p> <p>APRA, ASIC, the Reserve Bank and the Treasury are members of the <i>Council of Financial Regulators (CFR)</i> which provides a high-level forum for co-operation and collaboration. Members share information and views, discuss regulatory reforms or issues where responsibilities overlap and, if the need arises, coordinate responses to potential threats to financial stability. The CFR operates as an informal body.</p> <p>ASIC and APRA entered into a <i>Memorandum of Understanding (MOU)</i> in June 2004. Under the MOU, ASIC and APRA have established a joint Coordination Committee to facilitate close cooperation. The Committee is responsible for ensuring that appropriate arrangements are in place for information sharing, joint inspections and task forces and referral of matters in relation to enforcement action or major supervisory intervention. The Committee is also responsible for coordinating operational matters to avoid duplication in the collection of information from regulated entities and the collection of statistical data. Enforcement liaison meetings are held monthly. Operational liaison meetings are held bi-monthly in Sydney and Perth and on a quarterly basis in Melbourne and Brisbane. Liaison between the agencies in respect of routine operational matters occurs on an as needed basis.</p> <p>The MOU provides that each agency will notify and consult with the other agency in relation to any proposed changes in regulatory policy or regulatory decisions where the policy or decision is likely to impact on the responsibilities of the other agency. The MOU further provides that, where appropriate, the agencies will consult with each other in relation to policy statements and media releases that may be of interest or may have an affect on the other agency. In November 2005, APRA and ASIC jointly released <i>Unit Pricing – guide to good practice</i>, for the life insurance, superannuation and fund management industries.</p>

	<p>The MOU also provides for the provision of mutual assistance and the provision of unsolicited assistance and information. In the past 12 months, ASIC has made 116 releases to APRA and APRA has made 164 releases to ASIC.</p> <p>Before ASIC suspends or cancels an <i>Australian Financial Services License (AFSL)</i> issued to an insurer regulated by APRA, ASIC must first consult APRA. However, there is no legal obligation for APRA to consult or notify ASIC in taking any action on an insurer's license.</p> <p>APRA has also entered into a number of MOUs with other domestic and overseas supervisors. The MOUs establish a formal basis for co-operation, including the exchange of information and investigative assistance. APRA cooperates fully with its overseas counterparts, with exchanges of information extending beyond home/host supervisory issues to broader issues of prudential policy development. For example, APRA works closely with its counterpart in New Zealand. APRA has also established good relationships with those host agencies which host significant operations of Australian based insurers.</p> <p>Formal agreements are not a pre-requisite for information sharing. APRA's disclosure powers under the APRA Act are not subject to any reciprocity conditions. APRA may release protected information if the disclosure is for the purposes of prudential regulation or to assist a financial sector supervision agency (including foreign agencies) to perform its functions or exercise its powers. Disclosure of protected information by the recipients is an offence under the APRA Act.</p> <p>Before APRA acts on the evidence of any information received from another supervisor, it will notify and consult that supervisor. Should APRA need to take action that would have a material effect on the insurer's overseas operations, APRA would promptly notify the relevant overseas supervisors. Before APRA takes action on the Australian branch or subsidiary of a foreign insurer, APRA would inform the home supervisor.</p>
Assessment	Observed
Comments	<p>Domestically, coordination between the regulatory agencies is facilitated through a number of councils, committees and working groups at various levels. The CFR provides a high-level forum for co-operation and collaboration. ASIC and APRA has entered into a MOU, under which a joint Coordination Committee has been established to facilitate close cooperation. Considerations should be given in ensuring that APRA consults or notifies ASIC in taking any action on an insurer's license, where appropriate.</p> <p>APRA has also entered into a number of MOUs with other domestic and overseas supervisors. APRA cooperates fully with its overseas counterparts, with exchanges of information extending beyond home/host supervisory issues to broader issues of prudential policy development.</p>
The Supervised Entity	
Principle 6.	<p>Licensing An insurer must be licensed before it can operate within a jurisdiction. The requirements for licensing are clear, objective and public.</p>
Description	<p>Insurers are required to hold two licenses – a license from APRA and an AFSL from ASIC.</p> <p>Composite insurers are not allowed under the IA and LIA. Reinsurers and captive insurers are licensed under the IA and LIA in the same manner as primary insurers and subject to the same regulatory regime.</p> <p>Private Health insurers are not licensed and regulated by APRA. The Department of Health and Ageing has the primary responsibility for oversight, policy development, information provision, the administration of the Private Health Insurance Industry. Other commonwealth agencies involved included: a) The Private Health Insurance Administration Council - responsible for the prudential regulations; b) the Private Health Insurance Ombudsman – resolution of complaints;</p>

c) the Australian Competition and Consumer Commission – anti-competitive and unfair market practices; d) ASIC – corporate governance ; e) the ATO – monitoring tax rebates and levy ; e) the Health Insurance Commission – tax rebates and identification of fraud; and e) APRA – in relation to friendly societies that also undertake private health insurance. In Australia private health insurance operates as a supplement to the Government’s Medicare scheme. Private health insurers are subject to product and pricing controls and have little scope for risk or underwriting selection; their principle function is in claims administration. As such, private health insurance will not be assessed against the ICPs.

APRA has set up a Cross-Divisional Licensing Group to ensure consistent practice and application of licensing standards across all APRA supervised industries. For a foreign applicant, APRA will require a statement from the home supervisor confirming its approval for the foreign applicant to conduct operations in Australia, that it supervises the foreign applicant and its subsidiaries on a consolidated basis and that it is willing to cooperate with APRA in the supervision of the Australian operations.

General Insurance

It is an offence to carry on general insurance business in Australia without being authorized. Insurance business is defined as “the business of undertaking liability, by way of insurance (including reinsurance), in respect of any loss or damage, including liability to pay damages or compensation, contingent upon the happening of a specified event, and includes any business incidental to insurance business as so defined”. APRA may refuse an application on prudential grounds.

APRA’s power to deal with unauthorized entities is limited. APRA must refer any prosecution for an offence under sections 9 and 10 of the IA to the DPP. Prosecution is then a matter for the DPP. APRA cannot obtain an injunction to restrain entities from carrying on insurance business without authorization.

The Guidance Note *Guidelines on Authorisation of General Insurers* sets down the minimum criteria for authorization. These include fit-and-proper criteria for substantial shareholders and key positions; ability to comply with APRA’s prudential requirements at all times, satisfactory risk management systems, including reinsurance arrangements. A 3-year business plan, details on the product offering and group structure must be submitted.

The IA allows both foreign branches or subsidiaries of a foreign insurer be licensed. The *Guidelines on Authorization of General Insurers* stipulate supervision by the home supervisor for foreign insurers seeking authorization. The authorized foreign branch or subsidiary must meet all statutory requirements under the IA.

Foreign general insurers, referred to as ***Direct Offshore Foreign Insurers (DOFIs)*** are not licensed and not subject to prudential supervision by APRA because their business functions (such as underwriting, claims and policy issues) are not conducted in Australia. However, as DOFIs market directly in Australia, they are required to hold an AFSL from ASIC. The purpose of the AFSL is to ensure that licensees comply with certain on-going obligations, including maintaining competency, ensuring their financial services are “provided efficiently, honestly and fairly” and taking responsibility for the actions of authorized representatives. Where a licensee provides services to retail clients (consumers) they must disclose that they are not APRA-authorized.

Discretionary Mutual Funds (DMFs) provides an insurance-like product that involves no legal obligation by the provider to meet the costs of an ‘insured’ event. The provider may, at its discretion, consider meeting such costs. Most discretionary schemes have grown out of mutual-type arrangements based around particular professions e.g. a group of doctors or lawyers may jointly agree to meet the costs of certain risks that members face. As the products are discretionary in nature, these mutual funds are not subject to the provisions of the IA as they do

	<p>not meet the definition of “insurance business”.</p> <p>A review of the appropriate regulation of DMFs and DOFIs commenced on 12 September 2003 with the announcement of the Review of Discretionary Mutual Funds and Direct Offshore Foreign Insurers (Potts Review). On 27 May 2004, the Government released the key findings of the Potts Review and agreed to implement its recommendations. Since then, Treasury has consulted widely with stakeholders.</p> <p>The Potts Review reported that DOFIs and DMFs accounted for approximately 2.5 percent and 0.5 percent of the Australian insurance market, based on data provided by the industry in confidence. The industry indicated to the assessors that the market share of DOFIs has been increasing, since 2003.</p> <p>The Government has yet to release its formal response to the recommendation of the Potts Review that: a) DOFIs be exempt from prudential regulation in Australia if they are domiciled in a country APRA considers to have comparable prudential regulation, subject to a market significance threshold; b) APRA to have enhanced enforcement and investigative powers against DOFIs, c) APRA to assume a data collection role in relation to offshore insurers.</p> <p>The IA currently does not directly apply to insurance activities carried on outside Australia by subsidiaries of insurers domiciled in Australia. However, APRA has the ability to regulate Australian-based companies with overseas operations via the authorization of <i>Non-operating Holding Company (NOHC)</i>. Draft proposals released in May 2005 would extend APRA’s supervisory net to include overseas operations.</p> <p>Life Insurance</p> <p>LIA prohibits companies from issuing life policies or carrying on life business without registration. Life insurance business means the issuing of life policies and the undertaking of liability under life policies.</p> <p>Applications for registration should furnish particulars including: managerial structure; business plan with sample premium rates, particulars of reinsurance and financing of new business; operational structure; investment policy; outsourcing arrangements; and details of the administrative and accounting systems. The application must be accompanied by written advice from the appointed actuary about the terms and conditions and reinsurance arrangements plus service agreements for all outsourced functions.</p> <p>Life Insurers shall establish statutory funds exclusively in respect of life insurance business carried on outside Australia. Foreign life insurers could only carry on life insurance businesses in Australia through locally incorporated subsidiaries, except for “eligible foreign life insurance company”. Under the US-Australia Free Trade Agreement concluded in 2004, life insurers incorporated and conducting life insurance business in the US are eligible to conduct life insurance business in Australia through branches. There has not been any application from an eligible foreign life insurance company.</p> <p>APRA’s refusal to register a company needs the Treasurer’s approval. In practice, registration applications are assessed against the same benchmarks as for banking and general insurance licenses.</p>
Assessment	Observed for life insurance and partly observed for general insurance
Comments	<p>APRA has limited power to deal with unauthorized persons carrying on general insurance. Timely prosecution of such persons is determined by the DPP.</p> <p>DOFIs, which provide general insurance covers in Australia, are not licensed and not subject to prudential supervision by APRA. They are required to hold an AFSL from ASIC and must</p>

	<p>disclose that they are not APRA-authorized when providing services to retail consumers. While there is no evidence that discretionary mutual funds avoided insurance regulation via a discretionary structure in form but not in substance, the potential for abuse could not be precluded. In this regard, the Government has agreed to implement the Potts Review recommendation that DMFs offer cover only as a contract of insurance under the IA unless the APRA considers that there is no contingent risk to be met by additional undefined members' contributions.</p> <p>Based on data provided by the industry to the Potts Review, DOFIs and discretionary mutual funds had insignificant roles in the insurance market. The industry, however, raised concerns that DOFIs have been increasing their market share since 2003.</p> <p>The IA currently does not provide for cross-border supervision of insurance activities carried out by subsidiaries of insurers domiciled in Australia. APRA has issued draft proposal to extend its supervisory powers in this area but there is no similar proposal for life insurance. While APRA considers that it observes EC (d) on regulation of cross-border establishments in practice, this is not supported by legal provisions and may be subject to legal interpretation and review by the AAT.</p>
<p>Principle 7.</p>	<p>Suitability of persons The significant owners, board members, senior management, auditors and actuaries of an insurer are fit and proper to fulfill their roles. This requires that they possess the appropriate integrity, competency, experience and qualifications.</p>
<p>Description</p>	<p>Significant shareholdings in, and control of, financial sector companies are governed by the <i>Financial Sector (shareholdings) Act (FSSA)</i> and the <i>Insurance Acquisitions and Takeovers Act 1991 (IATA)</i>. The FSSA requires ownership stakes in excess of 15% in a financial sector company to be approved by the Treasurer. Approval is subject to the ownership stake being in the national interest. The IATA applies to any proposal to acquire a significant portion (15% or more) of an Australian-registered insurance company. All proposals are to be notified and approved by the Treasurer, subject to public interest.</p> <p>The Treasurer has delegated his powers under the FSSA and IATA to APRA staff members, subject to size limitations (for life companies, total assets of the life company involved must not exceed \$A 5 billion and for general insurers, total assets of the insurer must not exceed \$A 1 billion). In those cases where the Treasurer's approval is still required, the Treasurer would seek APRA's advice.</p> <p>The FSSA allows the Treasurer to revoke any approval previously granted if it is in the national interest to do so. Furthermore, the Treasurer may apply to the Court to order disposal of shares to remedy any unacceptable shareholding situation.</p> <p>On 2 March 2006, APRA released new and harmonized 'fit and proper' prudential standards for all its regulated institutions, including general and life insurer. The new standards are aimed at enhancing the caliber of those charged with running APRA-regulated institutions. The standards establish a minimum benchmark for acceptable practice in the appointment of Board directors, senior management, and certain auditors and actuaries. Key elements of the new standards are:</p> <ul style="list-style-type: none"> · an insurer must implement a written fit and proper policy that meets APRA requirements; · the fitness and propriety of a responsible person must be assessed prior to taking up appointment with the insurer and re-assessed annually thereafter; · insurers must not allow anyone assessed as not fit and proper to hold a responsible person position; · additional requirements for certain auditors and actuaries; and · APRA be provided with certain information regarding the responsible persons assessed as fit and proper by an insurer.

	<p>General Insurance</p> <p>The IA defines a “disqualified person”. Fitness and propriety criteria are set out in Prudential Standard GPS 220 <i>Governance</i>, which is also applicable to the approved auditor and approved actuary.</p> <p>A general insurer must assess all new persons filling key positions and should review these assessments at least annually. APRA should be notified immediately if a key person no longer complies with the tests of fitness and propriety. APRA assesses the fitness and propriety of the Board of directors and the management team of insurers during its on-site prudential review process.</p> <p>Prudential Standard GPS 220 <i>Risk Management for General Insurers</i> stipulates that responsible persons must have no actual or potential conflicts of interest that are likely to influence their ability to carry out their role and functions with appropriate probity and competence. Further, a person is prohibited from holding the positions of both approved auditor and approved actuary simultaneously.</p> <p>Life Insurance</p> <p>LIA disqualifies bankrupts and convicted persons from serving as director, principal executive officer or appointed actuary. Approval of auditors and actuaries under the LIA is based on qualifications and experience.</p> <p>APRA may give direction to a life insurer to remove a director, executive officer, employee, the approved auditor or approved actuary. APRA has indicated it would exercise these powers to ensure compliance with the fit and proper criteria</p>
Assessment	Observed
Comments	With the formalization of fitness and probity framework in March 2006, both the life and general insurance regimes fully observe ICP 7.
Principle 8.	<p>Changes in control and portfolio transfers</p> <p>The supervisory authority approves or rejects proposals to acquire significant ownership or any other interest in an insurer that results in that person, directly or indirectly, alone or with an associate, exercising control over the insurer.</p> <p>The supervisory authority approves the portfolio transfer or merger of insurance business.</p>
Description	<p>Apart from the national interest test, the Treasurer has not set any specific assessment criteria for FSSA or IATA approvals. In practice, proposals will be assessed by APRA against the licensing criteria, which include fitness and propriety standards for the proposed owners and their financial capacity to provide capital support if needed.</p> <p>Under the FSSA and IATA, a person’s stake in a financial sector company is the aggregate of the person’s voting power and the voting power of the person’s associates. FSSA also defines “associates”, “direct control interest”, “interest in a share”, “power to appoint a director”, “voting power” and “control of the voting power”. A person may also be declared by the treasurer as having practical control of an insurer.</p> <p>Neither the FSSA nor IATA exempts overseas persons. Where relevant, the proposal may need separate approval from the Foreign Investment Review Board.</p> <p>APRA assesses proposals relating to changes in control as if they were initial license applications. Any structure that would hinder the effective supervision of the insurer would not be acceptable. With the current supervisory regime on a solo rather than consolidated basis, however, there is little emphasis on the insurance group. This will change when the current</p>

	<p>proposals to extend the supervisory framework to corporate groups involving insurers are implemented.</p> <p>Given the requirement to segregate assets and liabilities in statutory funds, life insurers are less vulnerable to risks arising from complex ownership structures. Group-wide supervision for life insurers is on APRA's reform agenda.</p> <p><i>The Financial Sector (Transfer of Business) Act 1999 (FSTB Act)</i> stipulates that, for a transfer of business to be approved, APRA must have regard to the interest of the policy owners of the transferring body and the receiving body. For the Court to confirm transfers, an actuarial report on the scheme is required.</p> <p><i>General insurance</i> APRA approves any portfolio transfer under the IA. Prudential Standard GPS 410 <i>Transfer and Amalgamation of Insurance Business for General Insurers</i> deals with the transfer or amalgamation of insurance business of a general insurer. These requirements are designed to ensure that affected policyholders and other interested members of the public are informed about any such transfer or amalgamation.</p> <p><i>Life insurance</i> LIA prohibits the transfer or amalgamation of any life insurance business except under a scheme confirmed by the Court, or where the transfer is made under the FSTB Act.</p>
Assessment	Observed
Comments	<p>Legislation sets clear ownership and control thresholds above which approval will be required. As the Treasurer has delegated approval authority to APRA (subject to quantitative limits) it is APRA's role to assess delegated applications for proposed acquisitions or changes in control. Where the authority is exercised by the Treasurer, APRA will provide input into the decision making process. In practice, APRA assesses all proposals as if they were initial license applications. Proposals that fall short of licensing criteria would be unlikely to pass the national interest test. Any impediment to effective supervision, including complex group structures, is unacceptable.</p>
Principle 9.	<p>Corporate governance The corporate governance framework recognizes and protects rights of all interested parties. The supervisory authority requires compliance with all applicable corporate governance standards.</p>
Description	<p>Assessment of the quality and effectiveness of an insurer's board and management is a routine component of APRA's on-site prudential review. Every insurer must have an approved actuary and an appointed auditor. While there is no specific requirement for a compliance officer or officers, APRA expects insurers to have a compliance function with roles and responsibilities clearly established.</p> <p>Directors of insurers are obliged, under the Corps Act, to exercise due care and diligence in the discharge of their duties. Listed insurers are subject to the Principles of Good Corporate Governance and Best Practice recommendations of the <i>Australian Stock Exchange (ASX)</i>. Companies are required to disclose in their annual report the extent to which they have followed these best practice recommendations. If a company considers that a recommendation is inappropriate to its particular circumstances, it has the flexibility not to adopt the particular recommendation but it has to explain why. However, APRA is not content with simply relying on the general provisions of the Corps Act and the "if not, why not" approach of the ASX.</p> <p>On 5 May 2006, APRA released new and harmonized prudential standards on governance to apply to all its regulated institutions, including general and life insurers. The new standards harmonize APRA's governance standards across banking and</p>

	<p>insurance and bring them into line with what has become accepted in Australia as good practice in corporate governance. The key requirements cover:</p> <ul style="list-style-type: none"> · Board size and composition; · Mandatory Audit committee; · Dedicated internal audit function; · Auditor independence; and · Board renewal and performance assessment. <p>General insurance Prudential Standard GPS 220 <i>Risk Management for General Insurers</i> and associated Guidance Notes detail the Board's responsibility to establish audit functions, actuarial functions, strong internal controls and applicable checks and balances. It also defines senior management responsibilities to include: a) high level decision making; b) implementing strategies and policies approved by the Board; c) developing processes that identify, manage and monitor risks incurred by the insurer; and d) monitoring the appropriateness, adequacy and effectiveness of the risk management system.</p> <p>The Board must provide the approved auditor and approved actuary with the opportunity to raise matters directly with the Board. The approved actuary must provide the actuarial report on liabilities to the Board within such time as to give the Board a reasonable opportunity to consider and use the report in preparing annual statutory accounts.</p> <p>Life insurance The appointed actuary has access to any information or document necessary for the proper discharge of his functions and duties. He is obliged to report to the directors any matter that comes to his attention that may prejudice the interests of policyholders.</p>
Assessment	Observed
Comments	APRA exercises effective supervision of insurers' corporate governance through on-site prudential review and off-site monitoring. The formalization of the corporate governance framework for the insurance sector in May 2006 brings the Australian regime into full observance of ICP 9.
Principle 10.	<p>Internal control The supervisory authority requires insurers to have in place internal controls that are adequate for the nature and scale of the business. The oversight and reporting systems allow the board and management to monitor and control the operations.</p>
Description	<p>APRA's prudential reviews are based around a suite of modules that address the key functional and risk areas of the supervised institutions. The modules relevant to internal controls include management, structure and relationships; risk management; and operational risk. The assessments are tailored to the nature, size and complexity of the institution under review. In reviewing reports from the actuary and auditor, APRA focuses on any comments on the strength of the insurer's internal control processes.</p> <p>The Corps Act requires the directors of a corporation to: a) use the care and diligence; and b) act in good faith in the best interests of the corporation and for a proper purpose. The duties prescribed in sections 180 and 181 ensure that the directors provide adequate supervision of a company's market conduct activities.</p> <p>Section 912A of the Corps Act also imposes obligations on directors of entities that hold AFSLs to have adequate monitoring systems in place to supervise market conduct activities. ASIC expects the AFSL holder to have appropriate systems in place to monitor its compliance with the Corps Act and the obligations and conditions attached to the license and has powers to revoke or suspend an AFSL</p>

	<p>General insurance</p> <p>Prudential Standard GPS 220 <i>Risk Management for General Insurers</i> requires the Board to “ensure that an appropriate, adequate and effective system of risk management and internal control is established and maintained” and “use its best endeavors to ensure that senior management monitors the effectiveness of the risk management and control system.” Guidance Note GGN 220.2 <i>Risk Management Systems</i> provides minimum standards relating to a) clearly defined management responsibilities; b) adequate segregation of duties; c) a risk committee or audit function; d) a system of approvals, limits, authorizations and reporting lines; e) policies to document the insurer’s procedural controls; f) activity controls for each division or department; g) verifications of activities such as underwriting, pricing and claims management, and reconciliations; h) reviews by Board, senior management and internal audit; and i) physical controls.</p> <p>APRA has released a draft prudential standard which requires an actuary to provide the Board with an FCR. The FCR provides an assessment of the key risks and issues impacting on the financial condition of an insurer and includes recommendations designed to address the issues.</p> <p>Approved auditor certifies that an insurer has adequate systems and procedures to ensure compliance with prudential standard requirements, statutory requirements, authorization conditions and any other conditions imposed by APRA</p> <p>A written Risk Management Strategy (RMS) must be approved by the Board and reviewed regularly. APRA requires annual Board declarations certifying that the insurer has complied with the RMS and the Reinsurance Management Strategy (REMS) and that both strategies are operating effectively in practice.</p> <p>GPS 220 requires periodic internal audits with results being reported promptly to the board or the board audit committee. An insurer is required to establish a board audit committee.</p> <p>Currently, outsourcing is covered under Guidance Note GGN 220.5 <i>Operational Risk</i>. In May 2005, APRA released a draft Prudential Standard GPS 221 <i>Outsourcing</i> to strengthen the requirements in relation to outsourcing arrangements. The aim is to ensure that material outsourcing arrangements are subject to appropriate due diligence, approval and ongoing monitoring.</p> <p>Life insurance</p> <p>The establishment of statutory funds helps to safeguard the investments and assets of policyholders. It sets rules on eligible investments and expenditures. The onus is on directors to take reasonable care, and use due diligence, to ensure that the interests of policyholders are given priority. Furthermore, it is mandatory to establish audit committees.</p> <p>The appointed auditor and approved actuary shall bring to the attention of the directors any contravention of the LIA or any matter that may prejudice the interests of policyholders. Should they fail to get the attention of the directors, they must take the matter to APRA in writing. They also have a responsibility to satisfy themselves that the underlying data systems are adequate and accurate enough to be relied upon.</p> <p>A draft standard on outsourcing is being developed. Internal audit function is covered under the draft standard on Governance.</p>
Assessment	Largely observed
Comments	To clarify and strengthen existing requirements, APRA recently released additional proposals on governance and risk management, including a requirement for an internal audit function.

Ongoing Supervision	
Principle 11. Market analysis	Making use of all available sources, the supervisory authority monitors and analyses all factors that may have an impact on insurers and insurance markets. It draws the conclusions and takes action as appropriate.
Description	<p>As part of APRA's risk-based approach to supervision, it conducts off-site analysis of the financial condition of individual entities and on aggregate data to identify trends and industry norms. Two industry groups, one for general insurance and one for life insurance, serve as the key forum to address emerging industry issues. One of the roles of the industry groups is to prepare industry-wide reviews. There is a dedicated Research Unit that undertakes applied research, whose work is also forward looking.</p> <p>APRA is in the process of designing a more comprehensive semi-annual publication that will include detailed information at both an individual insurer and aggregate industry level. Currently <i>Insight</i> is published quarterly.</p> <p>APRA also uses Moody's KMV, industry publications, market surveys, media releases, and government statistics as references in its quantitative and qualitative analysis.</p> <p>A number of industry bodies and statutory agencies regularly collate and publish market data that is publicly available. Examples include: a) the Insurance Council of Australia - quarterly briefing paper on general insurance; b) the IAAust - bimonthly magazine, Actuary Australia, quarterly Australian Actuarial Journal and mortality and morbidity statistics; c) Insurance Statistics Australia - management information of relevance to the pricing and profitability of selected classes of insurance business; d) Insurance Reference Services – a database to assist members to make informed risk decisions and develop competitive pricing strategies. The database contains more than 18 million insurance claims dating back 10 years; e) the Motor Accidents Authority - bulletins, information sheets, newsletters and regular comprehensive industry claims analysis on CTP insurance; f) the Motor Accident Insurance Commission - a claims register and statistical database for participating insurers; and g) the Australian Competition and Consumer Commission – studies into and findings on the insurance industry.</p> <p>Under the <i>Financial Sector (Collecting of Data) Act, 2001 (FSCD Act)</i>, APRA has flexibility to determine reporting standards, over different time periods, and from different entities. For example, APRA determined in July 2004 that all APRA-regulated general insurers, and participating State and Territory Governments, shall contribute data to the National Claims and Policies Database for public and products liability and professional indemnity insurance. Reports are produced twice a year covering data from 2003 onwards.</p> <p>APRA keeps track of international developments and contributes papers of interest through its involvement in the IAIS, the IAA, the Joint Forum and the FSF.</p> <p>General insurance APRA's <i>Quarterly General Insurance Performance Statistics</i> provides industry aggregate summaries of financial performance, financial position and key ratios.</p> <p>Life insurance APRA publishes <i>Insight</i> (quarterly), <i>Life Insurance Trends</i> (quarterly) and <i>Life Office Market Report</i> (six-monthly).</p>
Assessment	Observed
Comments	To complement APRA's risk-based approach to supervision, it conducts analysis of individual entities and aggregate market data to identify trends and industry norms. APRA published industry aggregate summaries of financial performance, financial position and key ratios of

	insurers on its website. A number of industry bodies and statutory agencies also regularly collate and publish market data which are publicly available.
Principle 12.	Reporting to supervisors and off-site monitoring The supervisory authority receives necessary information to conduct effective off-site monitoring and to evaluate the condition of each insurer as well as the insurance market.
Description	<p>APRA requires, at the licensing stage, a written undertaking that the licensed insurer will provide APRA with any information which may be required for prudential supervision. The FSCD Act provides APRA with broad powers to determine reporting standards for regulated entities.</p> <p>The FSCD Act empowers APRA to direct an entity to amend any information that is inadequate, incorrect, incomplete or misleading. It is an offence for the entity to fail to comply with this direction. Furthermore, it is an offence under the Criminal Code to provide false or misleading information or documents to APRA.</p> <p>Reporting requirements do not apply to state or territory insurers who are exempt from the LIA or IA. Currently, there is only one such exempt entity with insignificant operations.</p> <p>As part of APRA's off-site surveillance process, APRA staff checks the returns regularly for compliance with minimum prudential requirements and conduct peer analysis of the data to identify trends and anomalies. The latter are instrumental to APRA's risk-based supervisory framework. APRA has developed detailed guides that require analysis of capital, assets, liabilities, performance, premiums, and reinsurance.</p> <p>Reporting methodologies and forms are regularly reviewed taking into account changes in prudential requirements and industry developments. Reporting forms for both general insurers and life companies are under review to give effect to the adoption of IFRS.</p> <p>General insurance</p> <p>All licensed general insurers have to comply with reporting requirements under the FSCD Act. APRA has determined 28 general insurance reporting standards. Separate reports are required for the licensed entity and the consolidated group, where applicable. Generally, insurers follow the Australian accounting standards as they apply in relation to reporting periods before 1 January 2005. Where APRA methodology departs from accounting standards, the requirements are clearly spelled out (e.g. valuation of premium liabilities, deferred reinsurance expenses and deferred acquisition costs). The General Insurance Reporting Form GRF 130 series collects information on off-balance sheet exposures.</p> <p>In addition, insurers must provide APRA regularly with their: a) RMS b) REMS; c) an annual Board Declaration pursuant to section 21 of GGN 220.2; and d) actuarial reports.</p> <p>An approved auditor must submit an annual certificate to APRA which includes a confirmation that the statistical and financial data provided by the insurer are reliable. A draft prudential standard GPS 310 <i>Audit and Actuarial Reporting and Valuation</i> is under consultation which specifies that the certification must include a reference to compliance with the FSCD Act.</p> <p>Amendments proposed to prudential standard GPS 220 <i>Risk Management</i> require annual submission of a Financial Information Declaration (FID) to APRA. The FID, co-signed by the chief executive officer and the chief financial officer, must state that the financial information lodged with APRA is accurate and complete, and has been prepared in accordance with the relevant Acts and standards.</p> <p>An insurer must promptly notify APRA of: a) any changes to its Maximum Event Retention; b) any amendments to its RMS; c) if the right to conduct insurance business outside Australia has been limited or otherwise materially affected; d) an amendment to its REMS; and e) within 24</p>

	<p>hours of experiencing a major disruption that has the potential to materially impact policyholders.</p> <p>To ensure a general insurer will inform APRA of any material developments relating to its operations, APRA has strengthened notification requirements under the Stage 2 Reforms of the prudential supervision of general insurers. Draft GPS 220 requires an insurer to consult with APRA prior to implementing any changes in operations that may materially affect the risk profile of the insurer.</p> <p>Life insurance APRA has not issued any reporting standards. Currently, the broad obligations on life companies to make quarterly, half-yearly and annual reports to APRA are set out in the LIA. The formats and methods of reporting are spelt out in Prudential Rules and Actuarial Standards. APRA has powers to request information, documents and records relating to the business of the life company and its subsidiaries. The reporting requirements apply to all registered life companies without distinction.</p> <p>Prudential Rule 35 <i>Financial Statements</i> requires that financial statements comply with the requirements of Corporations Law, Accounting Standards (both Australian and International) and actuarial standards. Where a life company is a parent in an economic entity, the financial statements to be provided to APRA must comprise consolidated financial reports of the economic entity. Off-balance sheet exposures are addressed in Form H (Prudential Rule 26). A life company must provide APRA with the Financial Condition Report (FCR) by the appointed actuary within three months.</p>
Assessment	Observed
Comments	APRA collects extensive information from insurers regarding their business and activities, pursuant to prudential standards and reporting standards (for general) determined under the FSCD Act.
Principle 13.	<p>On-site inspection The supervisory authority carries out on-site inspections to examine the business of an insurer and its compliance with legislation and supervisory requirements.</p>
Description	<p>APRA is empowered to conduct on-site inspections. In practice, APRA conducts routine on-site prudential reviews without invoking any legislative powers.</p> <p>The supervisory cycle is determined by PAIRS and SOARS. Full prudential reviews mostly follow a standard supervisory cycle varying between one and four years depending on the PAIRS rating. However, APRA may choose to undertake one or more prudential reviews in the supervisory period to address specific risk issues or to enhance its understanding of certain aspects of the insurer's operations. APRA may also direct targeted investigations by an auditor or actuary chosen by APRA.</p> <p>APRA has developed prudential review modules that are designed to cover the key risk areas of supervised institutions and ensure compliance with relevant legislation. The adequacy of the external audit and actuary functions is assessed as part of the prudential review process. APRA may ask to meet with the external auditor or the appointed actuary in the course of the on-site process or separately.</p> <p>APRA holds a closing meeting after the completion of a prudential review at which the main findings would be outlined. The meeting gives the insurer an opportunity to correct factual errors. A final review report, including the findings and any required or recommended actions to be taken, is sent to the insurer after the closing meeting. The insurer must respond to the report within 4 weeks. The response should include timetables to implement the proposed actions. The timelines provided are entered into AIMS for monitoring and tracking.</p>

	<p>General insurance In consultation with an insurer, APRA may request the Approved auditor to undertake a specific review of a particular aspect of the insurer's operations or risk management system.</p> <p>In May 2005, APRA released draft Prudential Standard GPS 221. One of the proposals is to give APRA access to documentation related to the outsourcing arrangement and the right to conduct on-site visits to the service provider. The standard is expected to be finalized to take effect from 2006.</p> <p>In practice, APRA has conducted on-site visits to service providers, joint venture partners and underwriting agencies of general insurers, in conjunction with the supervised institutions.</p> <p>Life insurance APRA's powers of inspection under section 133 of the LIA extend to third parties, such as an intermediary or persons providing outsourced services. A standard on outsourcing is being drafted.</p>
Assessment	Observed
Comments	APRA conducts on-site prudential reviews as determined by the PAIRS and SOARS. The work program and regulatory decision and supervisory review processes are well documented and followed up via AIMS.
Principle 14.	Preventive and Corrective Measures The supervisory authority takes preventive and corrective measures that are timely, suitable and necessary to achieve the objectives of insurance supervision.
Description	<p>APRA maintains good rapport with regulated institutions. Minor preventive or corrective actions are normally conveyed at face-to-face meetings. These communications have been very effective to get issues addressed before they become serious concerns.</p> <p>Legislation provides APRA with a host of directions powers. For a start, APRA would seek voluntary remedial actions. In practice, if APRA is concerned with the risk profile of one of its regulated entities, it would increase the frequency and intensity of its supervisory oversight. Wherever possible, APRA seeks to make timely and preventative prudential interventions to bring the risks down to acceptable levels. APRA does this through its continuous off-site monitoring and a risk-based program of on-site reviews, supported by PAIRS, SOARS and ASF. These tools assist in timely and proportionate remedial actions.</p> <p>Cases with serious regulatory and prudential concerns are escalated to the specialized Enforcement Unit (also see ICP 4). For remedial measures that require a sequence of steps or that involve a considerable time span, APRA would seek action plans with timetables from the insurer to facilitate monitoring.</p> <p>General insurance APRA's authority to give directions to general insurers and enforce its powers is constrained by an assortment of requirements, high thresholds and narrow triggers.</p> <ol style="list-style-type: none"> While APRA may impose conditions on authorization, the conditions, however, must relate to prudential matters; A direction under sections 49M and 49N requiring an insurer to make provisions in its accounts in respect of its liabilities or specified assets is subject to the Treasurer's agreement; To freeze the insurer's assets for up to six months, APRA must seek the Treasurer's agreement; and APRA has experienced difficulties in enforcing its powers when the affairs of an

	<p>insurer are being investigated.</p> <p>APRA has no power to apply for injunction under the IA to require insurers to refrain from taking certain actions e.g. issuing new policies. While APRA may refer uncooperative persons to DPP for prosecution, the process can be untimely and not cost-effective.</p> <p>The IA enables APRA to accept an enforceable undertaking - a guarantee by regulated entities in relation to their responsibilities under the IA or the prudential standards. Where an enforceable undertaking is breached, APRA is able to seek enforcement orders from the Federal Court of Australia. APRA, however, cannot require an entity to give an enforceable undertaking and the entity cannot compel APRA to accept an enforceable undertaking: they are made and accepted purely on a voluntary basis. However, the effectiveness of the enforceable undertaking hinges on legal drafting and has yet to be tested in courts.</p> <p>Life insurance</p> <p>The LIA provides APRA with a range of powers to: a) impose conditions on the authorization at any time; b) determine standards; c) issue a wide range of directions; d) give a written notice to remedy a breach of provisions relating to the operation of the statutory funds; e) setting of solvency and capital adequacy standards for statutory funds as well as management capital requirements outside statutory funds. APRA may, with the Treasurer’s approval, give directions to insurers to increase their capital levels; f) freeze the assets for a period up to 6 months, subject to the Treasurer’s approval; g) give directions during or after an investigation; and h) apply for injunctions.</p> <p>Directions which require ministerial approval are exempt from merits review under section 236 of the LIA. These directions can only be given where a life insurer is, or is likely to become, unable to meet its policy or other liabilities as they become due.</p> <p>APRA has no power to accept an enforceable undertaking under the LIA.</p>
Assessment	Observed for Life insurance and Largely Observed in General insurance
Comments	<p>APRA continually monitors its supervised institutions and has established good communication channels with the institutions. This enables early detection of problems and facilitates the use of suasion to guide the institutions into corrective actions.</p> <p>APRA is empowered under the LIA to give a wide range of directions without having either to issue any “show cause” notice or seek Ministerial approval. In comparison, APRA’s power to give directions under the IA is more constrained, requiring threshold triggers and the Treasurer’s agreement.</p>
Principle 15.	<p>Enforcement or sanctions</p> <p>The supervisory authority enforces corrective action and, where needed, imposes sanctions based on clear and objective criteria that are publicly disclosed.</p>
Description	<p>There are various sanctions, offences and penalties interspersed throughout the LIA and IA. Failure to comply with APRA directions is an offence under the IA and LIA.</p> <p>The Enforcement Unit in APRA is responsible for dealing with problem entities. The Enforcement Committee sets priorities and review strategies for cases. Cases are classified as: Significant, Minor and No Further Action. Significant cases are reviewed by the Enforcement Committee; Minor cases are monitored by the relevant Manager; and a file-note is prepared for No Further Action cases, indicating why the Committee chose not to investigate or act.</p> <p>It is an offence to conceal, destroy, mutilate or alter a book relating to the affairs of an insurer which is being investigated.</p>

Where an insurer is, or is likely to become, unable to meet its debts as they fall due, it may be wound up under the Corps Act. Additionally, APRA has standing to bring an application earlier where it can demonstrate that the insurer has liabilities in excess of its assets within the meaning of the prudential standards. In this regard, section 462 of the Corps Act permits APRA to apply to a State Supreme Court for winding-up.

General insurance

APRA can, with the Treasurer's approval, restrict an insurer from issuing new, or renewing existing, policies under section 62 of the IA when an investigation is underway.

APRA may direct an insurer to assign its liabilities to another general insurer(s) where it is satisfied that such an assignment is in the interests of policyholders and the national interest. After such an assignment takes place the insurer's license can then be revoked.

Prudential Standard GPS 110 *Capital Adequacy for General Insurers* enables APRA to adjust an insurer's Minimum Capital Requirement where it believes that the amount determined under this Standard does not adequately reflect the risk profile of an individual insurer.⁷ Part IIIA of the IA provides that subsidiaries of a general insurer are also bound by the prudential standards.

Guidance Note GGN 110.1 *Measurement of Capital Base* restricts an insurer's ability to purchase its own shares without APRA approval.

When an insurer is under investigation by APRA, section 62 of the IA enables APRA to restrict the insurer from disposing of, or dealing with, assets without APRA's approval.

APRA may direct that a general insurer (including a foreign general insurer or an authorized NOHC) to remove a director or senior manager if APRA is satisfied that the person is a disqualified person or does not meet one or more of the criteria for fitness and propriety. In recent years, APRA has successfully disqualified various senior persons from holding key positions in general insurance companies. APRA has also accepted enforceable undertakings from individuals obliging them not to hold senior positions in insurers. However, APRA's disqualification decisions are subject to review by the AAT. Recent cases have been heard by the AAT involving time-consuming and costly legal process, which consumed significant enforcement resources.

APRA experienced difficulties in the investigation of an insurer when APRA's proceedings to wind-up the insurer was thwarted by the insurer's actions to voluntarily appoint an administrator, followed by the execution of a Deed of Company Arrangement. APRA has no power to appoint an administrator or statutory manager.

Division 3 of the IA details the procedures for dealing with insurers who are unlikely to continue to be solvent but for whom there is a reasonable prospect of arranging a compulsory transfer of business. The Treasurer's approval is required prior to APRA taking appropriate action to revoke an insurer's authority.

APRA has released a discussion paper on the prudential supervision of corporate groups. The proposed framework will allow APRA to supervise Australian authorized general insurers and their corporate groups on a consolidated basis, addressing contagion risks.

Since the general insurance reform measures were implemented in 2002, APRA has: a) exercised its disqualification powers in respect of directors, auditors, actuaries and accountants following the collapse of a major insurance group in 2001; b) accepted an increasing number of enforceable undertakings; c) used its powers to impose conditions; and d) widened the circumstances in which it is likely to investigate the affairs of insurance companies, for example in exploring financial reinsurance arrangements.

	<p><i>Life insurance</i> APRA may direct a life company not to issue any policy, collect any premium or discharge any policy or other liability of the company where to do so may prejudice the interests of policy owners.</p> <p>APRA may also, with the Treasurer’s agreement, direct a life company not to issue any further policies under section 150 of the LIA if it is, or has been, under investigation and it is, or is about to become, unable to meet its policy or other liabilities or it has contravened the LIA or a direction.</p> <p>If APRA believes that a life insurer is, or is likely to become, unable to meet its policy or other liabilities as they become due, APRA may apply to the Court for the insurer to be placed under judicial management. The judicial manager may recommend to the court that the business of the insurer be transferred to another company.</p> <p>APRA may also apply to the court to wind-up a life insurer or make a compulsory transfer determination under the FSTB Act.</p> <p>The LIA enables APRA to give solvency and capital adequacy directions. Directions powers under section 230B of the Act cover directions not to repay any amount paid on shares, not to dividend, and not to transfer any asset of a statutory fund.</p> <p>APRA has power to investigate any company associated with the insurer where it believes such an investigation is required for the purposes of investigating the business of the insurer. APRA may issue directions to the insurer regarding its ownership or dealings with an associated company.</p> <p>APRA may direct an insurer to: a) remove a director, secretary, executive officer or employee; b) ensure that the above persons do not take part in the management or conduct of the business except as permitted by APRA; or c) appoint a person as a director, secretary, executive officer or employee of the company for such terms as APRA directs. The directors of an insurer may be liable to compensate the insurer if they breach their duties under the Act.</p> <p>APRA may revoke the approval of an auditor or actuary if the person has failed to perform adequately and properly the functions and duties of an auditor or actuary.</p> <p>Proceedings to initiate the judicial management or winding-up of an insurer are not hindered by the bringing of proceedings against a life insurer for an offence under the LIA.</p> <p>All life insurers, except “eligible foreign life insurance companies”, operate as subsidiaries in Australia. Further, there is ring-fencing of assets with the establishment of statutory funds. Hence, the interests of policyholders are protected from failure in other parts of the group.</p>
Assessment	Observed for life insurance and Partly Observed under general insurance
Comments	<p><i>General insurance</i> Whilst APRA can give directions, APRA has not always been able to do so in a timely and effective manner. The IA is predicated on the assumption that a general insurer will cooperate with the regulator and appointed inspector. Should an insurer decline to cooperate, APRA has limited ability to compel co-operation other than to refer the matter to the DPP. Further, APRA’s disqualification decisions are subject to merit review by AAT. Recent cases have been heard by AAT through time-consuming and costly legal process and consumed significant enforcement resources.</p> <p>Currently, APRA can commence an application to wind-up an insurer only when it is under investigation under section 52 of the IA and APRA can demonstrate that the insurer’s liabilities</p>

	<p>exceed its assets for the purposes of the prudential standards. Insolvency under the prudential standards is difficult to prove due to the inherent uncertainty and assumptions of actuarial assessments.</p> <p>APRA currently lacks the ability to appoint an administrator to manage the affairs of a general insurer when it believes that it is necessary to protect policyholders and other policy beneficiaries. By contrast, such powers exist in relation to APRA's supervision of life insurers and banks.</p> <p>There is also tension between the IA and the Corps Act. By voluntarily appointing an administrator, a general insurer may effectively: a) forestall a winding-up application made by APRA to the Courts from being heard; b) avoid liquidation; nominate their own administrator, contrary to APRA's wishes; c) return the insurer to its shareholders after termination of a Deed of Company Arrangement; and e) materially reduce APRA's prudential supervision.</p> <p>As the legal authority of APRA could be tested by uncooperative insurers and APRA's ability to take decisive actions in relation to problem insurers is critical for effective crisis management, the current enforcement and sanctions powers of APRA are likely to be insufficient to compel compliance and to deal with emergencies.</p> <p><i>Life insurance</i> Although APRA does not have authority to withdraw a life, its wide-ranging directions powers could stop a life insurer from carrying on business. Furthermore, APRA may apply to the court to wind-up a life insurer or make a compulsory transfer determination under the <i>Financial Sector (Transfer of Business) Act 1999</i>.</p>
<p>Principle 16.</p>	<p>Winding-up and exit from the market The legal and regulatory framework defines a range of options for the orderly exit of insurers from the marketplace. It defines insolvency and establishes the criteria and procedure for dealing with insolvency. In the event of winding-up proceedings, the legal framework gives priority to the protection of policyholders.</p>
<p>Description</p>	<p><i>General insurance</i> APRA may revoke an insurer's authorization in certain circumstances, with the Treasurer's agreement. Where APRA wishes to revoke the authority of an insurer, APRA may direct the insurer to assign its liabilities to another authorized insurer, subject to the Treasurer's approval. However, it should be noted that APRA has yet to test these powers.</p> <p>Enforceable undertakings have been used to manage the exit of an insurer. Past enforceable undertakings have included an undertaking to cease underwriting of any new business or specified lines of business (e.g. if a reinsurer withdraws from a reinsurance treaty).</p> <p>Division 3 of the IA details the procedures for dealing with insurers who are unlikely to continue to be solvent but for whom there is a reasonable prospect of arranging a compulsory transfer of business. Where an insurer is, or is likely to become unable to meet its debts as they fall due, it may be wound up under the Corps Act.</p> <p>Section 17 of the IA requires that the interests of policyholders are considered in the event that the insurer's liabilities are assigned to one or more other general insurers. However, policyholders and other policy beneficiaries do not have priority of claims in the event of an insurer becoming insolvent. There is no restriction on encumbrance of insurers' assets other than higher capital charges.</p> <p>In the winding-up, a general insurer's assets in Australia must not be applied in the discharge of its liabilities other than its liabilities in Australia unless it has no liabilities in Australia. However, policyholders' claim would still rank equally with other creditors. It should also be noted that there is no restriction on encumbrance of assets so long as the general insurer</p>

	<p>provides for higher capital charge.</p> <p>Life insurance</p> <p>The LIA provides for a range of options to halt the business of a life insurer. APRA may freeze the assets of an insolvent insurer. If a life insurer has contravened the LIA, APRA may issue directions or apply for an injunction prohibiting it from issuing any policy, collecting any premium or discharging any policy or other liability.</p> <p>APRA or the life insurer can apply to the Federal Court for the insurer to be placed under judicial management. An insurer may not issue policies without the leave of the Court when it is under judicial management.</p> <p>Division 2 of Part 8 of the LIA contains winding-up provisions. There is a material level of protection for policy owners in the event of a winding-up. The assets of a statutory fund must first be applied to discharge debts and claims referred to in section 556(1) of the Corps Act including relevant expenses, administrator debts, wind-up costs, staff wages and injury compensations. Thereafter, preference is given to discharging policy liabilities of the statutory fund. Other liabilities referable to the business of the statutory fund are not to be met out of the assets of the fund unless all policy owner liabilities have first been discharged. However, the priority of claim of a policyholder of a statutory fund in deficit is unclear where one fund has a surplus while another has a deficit.</p>
Assessment	Assessment: Observed for life insurance and partly observed for general insurance
Comments	<p>While the domestication of a general insurer's assets in Australia contributes to policyholder's protection, it does not accord policyholders priority of claim above other unsecured creditors in the event of winding up. APRA currently lacks the ability to appoint an administrator to manage the affairs of a general insurer in the event that it believes that it is necessary to protect policyholders and other policy beneficiaries.</p> <p>The LIA provides a high degree of protection for policy owners in the event of insolvency. The LIA prohibits the issuing of policies while a company is under judicial management. The judicial manager or APRA can apply for an order that the life insurer be wound up. Policy owners receive priority ahead of other creditors of the life company other than in respect of expenses connected with the winding-up of the company or payments to employees for wages, injury compensation and redundancy. However, the priority of claim of a policyholder of a statutory fund in deficit is unclear where one fund has a surplus while another has a deficit.</p>
Principle 17.	Group-wide supervision
	The supervisory authority supervises its insurers on a solo and a group-wide basis.
Description	<p>General insurance</p> <p>The current regime focuses largely on regulating and supervising individual authorized insurers, with no consolidated supervision. There is also no explicit requirement with regard to insurance activities conducted by subsidiaries and associated companies in overseas jurisdictions.</p> <p>A discussion paper on <i>Prudential supervision of corporate groups involving authorised general insurers</i> was released for public consultation in May 2005.</p> <p>The IA allows APRA to authorize, and impose reporting obligations on NOHC.</p> <p>Life insurance</p> <p>There is no formal supervision of the group under the LIA. Development of a similar framework to regulate NOHC is on APRA's agenda.</p> <p>The supervisory regime is based upon a statutory fund concept. Protection of policyholders' interests is achieved by ring-fencing the assets that are backing policy liabilities in a statutory</p>

	<p>fund. Investment and management of the assets of the statutory funds is subject to stringent rules, actuarial standards for solvency and capital adequacy, an insurer's equity investment in regulated subsidiaries is treated as inadmissible assets. An insurer must not invest assets of a statutory fund in a related company that is not a subsidiary without APRA approval. All investments in subsidiary and related companies must be reported to APRA.</p> <p>In terms of reporting, APRA receives information on a group basis. The proposed consolidated supervisory framework includes provision for effective group systems and controls to ensure the availability and reliability of group statistical and financial data.</p>
Assessment	Largely Observed
Comments	<p>Although the framework for consolidated supervision of insurance is still in progress, all the financial groups in Australia are under supervision by APRA as the integrated prudential supervisor. Life companies owned by banks, account for over 50% of life company assets in Australia. Almost 90% of life company assets relate to superannuation which is subject to requirements under the <i>Superannuation Industry (Supervision) Act 1993</i>, also administered by APRA. APRA has adequate powers to restrain insurers from being involved in group operations that may prejudice policyholders.</p>
Prudential Requirements	
Principle 18. Risk assessment and management	
The supervisory authority requires insurers to recognize the range of risks that they face and to assess and manage them effectively.	
Description	<p>APRA follows a systems-based approach in supervising risk management of insurers. This approach recognizes that the primary responsibility for risk management rests with the Board and senior management. Risk management frameworks are assessed in the course of on-site prudential reviews. Currently, the only mandated Board committee is an Audit Committee.</p> <p>General insurance GPS 220 <i>Risk Management for General Insurers</i> requires that the Board and senior management develop, implement and maintain a sound and prudent RMS. An insurer's RMS must be submitted to APRA within 14 days of being approved by the Board.</p> <p>GPS 220 <i>Risk Management for General Insurers</i> expects the RMS to be appropriate to the size, business mix and complexity of operations of the insurer and must define and document the insurer's objectives and strategy for risk management and internal control. Furthermore, an insurer's minimum capital requirement (MCR) should be commensurate with the full range of risks to which the insurer is exposed. APRA considers that, at a minimum, the following risk categories must be addressed: a) balance sheet and market risk (including investment risk, insurance risk, product design and pricing risk, underwriting and liability risk, liquidity risk, risk arising from claims management and derivatives risk); b) credit risk; and c) operational risk (including legal and reputational risks). In addition, the risk management systems should also take into account the potential risks arising out of reinsurance arrangements.</p> <p>GPS 220 requires insurers to review regularly the operating circumstances that may impact on the insurer's risk profile and to amend the RMS accordingly.</p> <p>Under Stage 2 Reforms, a holistic (or enterprise-wide) risk management framework is envisaged. The existing requirement of a RMS is expanded with additional proposals to increase disclosure about the activities of general insurers to promote market discipline.</p> <p>Life insurance There is no explicit prudential standard on risk management.</p>

	<p>However, for an insurer to properly determine its solvency and capital requirements it must have in place risk identification and assessment capabilities. Through the FCR, APRA is informed of the adequacy and effectiveness of an insurer’s risk management policies and procedures. With superannuation assets making up nearly 90% of total life company assets, most, if not all, life insurers will be subject to the licensing of their subsidiary superannuation trustees and the associated superannuation funds under the SIS Act. A key requisite of the license application is a risk management plan for the Registrable Superannuation Entity (RSE).</p> <p>The actuarial standards address a wide range of risks: a) liability risks include the risk of inaccurate estimation of the mean, the risk of deterioration of the assumed mean, the risk of adverse statistical fluctuations about the mean and the risk of unexpected changes in the underlying distribution of experience; and b) asset risks include adverse asset movements, asset realization, holdings in associated entities which are prudentially regulated, asset concentration, counterparty default and liquidity.</p> <p>The actuarial standards also prescribe a resilience reserve in the computation of solvency and capital adequacy requirements. In determining the resilience reserve, consideration should be given to changes in investment markets, and in market spreads, volatility and correlation reflected in the market values of derivative assets and liabilities.</p>
Assessment	Observed for general insurance and Largely Observed for life insurance
Comments	<p>APRA has established risk management standards for general insurance, and is in the process of fine-tuning the requirements through the Stage 2 Reforms.</p> <p>Although there are no explicit requirements for risk management for life insurers, effective risk management is an implicit requirement in their compliance with the actuarial standards for solvency and capital adequacy. The appointed actuary is required to report in the FCR on the adequacy and effectiveness of risk management systems and procedures.</p> <p>The on-site review process is standard for all insurers, irrespective of whether they conduct life or general insurance business. APRA plans to issue prudential standards on risk management under the LIA, consistent with arrangements under the IA.</p>
Principle 19.	<p>Insurance activity Since insurance is a risk taking activity, the supervisory authority requires insurers to evaluate and manage the risks that they underwrite, in particular through reinsurance, and to have the tools to establish an adequate level of premiums.</p>
Description	<p>APRA’s on-site prudential review program includes Module 10 <i>Insurance Risk</i> that focuses on the assessment of product development, pricing, underwriting, claims, administration, reinsurance and distribution in an insurer. During on-site prudential reviews, APRA would check that senior underwriters are monitoring portfolio performance through tracking average premium on policies, rate movement, underlying claims costs and frequency of claims versus severity of claims.</p> <p>Verifying data quality is another key aspect of the Module 10 process. Systems should be integrated - both the underwriting and claims systems should be able to adequately capture reinsurance arrangements.</p> <p>APRA verifies the insurer’s methodology for establishing net retention and checks the reinsurance structure to ensure that there is adequate cover for the insurer’s estimated probable maximum loss (PML).</p> <p>APRA has a number of in-house specialist teams. Insurance Risk team provides expertise on key areas of insurance risk. Participation by the Insurance Risk team is mandatory for Module 10 reviews of high and extreme impact insurers. The Actuarial Services team provides actuarial</p>

	<p>advice on the interpretation of FCRs life insurers and liability valuation reports and other actuarially related matters from general insurers.</p> <p>General insurance GPS 220 <i>Risk Management for General Insurers</i> requires the Board and management to develop, implement and maintain a sound and prudent RMS and a separate REMS. In addition, an insurer must file an annual Board Declaration for assurance that it has complied with legislative and prudential requirements, and its own risk management and reinsurance arrangements.</p> <p>As part of the Stage 2 Reforms, oversight of an insurer’s reinsurance management will be strengthened. In addition to the REMS, APRA is proposing an annual Reinsurance Arrangements Statement with detailed information on the actual reinsurance arrangements they have put in place. APRA is proposing a two-stage process under which the insurer would be required to prepare two signed declarations: the first relating to the degree of documentation in place two months after the reinsurance arrangements take effect, and the second relating to the degree of documentation six months after the reinsurance arrangements take effect. Both declarations need to be signed by the CEO and the Chief Reinsurance Officer (or equivalents). Reinsurance not satisfying the two- and six-month documentation tests will not be able to be taken into account for the purposes of capital adequacy calculations. APRA also proposes to introduce a new guidance note GGN 230.3 <i>Limited Risk Transfer Arrangements</i>. Insurers will have to seek APRA’s approval before entering into limited risk transfer arrangements.</p> <p>Draft GPS 310 <i>Audit and Actuarial Reporting and Valuation</i> requires the approved actuary to assess the overall financial condition of the insurer annually and to prepare an FCR to the Board of the insurer. The FCR must list any limited risk transfer products, with comments on the extent of risk transfer.</p> <p>Life insurance Before an insurer can issue a new type of policy, the appointed actuary is required to produce a written report advising on the proposed terms and conditions, the basis of payment of any surrender values, and/or the basis on which unit values are to be determined. Furthermore, reinsurance arrangements are subject to the advice of the appointed actuary. The Board must take into account the appointed actuary’s advice in its decision.</p> <p>APRA also looks to the FCR from the appointed actuary for assurance that the life company is monitoring its expenses appropriately. Assessing an insurer’s expense experience is a top priority task on the appointed actuary’s work agenda.</p> <p>Every life company must give APRA an annual reinsurance report as prescribed by Prudential Rule 23.</p>
Assessment	Observed
Comments	APRA monitors insurers’ insurance risks through both on-site prudential reviews and off-site analysis. APRA assesses insurers’ basis for establishing net retention and their reinsurance protection. An in-house Insurance Risk team provides expertise on key areas of insurance risk while the Actuarial Services team provides advice on actuarially related matters.
Principle 20.	<p>Liabilities The supervisory authority requires insurers to comply with standards for establishing adequate technical provisions and other liabilities, and making allowance for reinsurance recoverables. The supervisory authority has both the authority and the ability to assess the adequacy of the technical provisions and to require that these provisions be increased, if necessary.</p>
Description	APRA is empowered to direct insurers to increase technical provisions, subject to Treasurer’s approval. Insurers are expected to undertake stress testing analysis as part of their business

planning process. In practice, a number of the large general insurers in Australia undertake regular scenario analysis on their own initiatives.

General insurance

GPS 210 *Liability Valuation for General Insurers* establishes principles for the consistent measurement and reporting of the insurance liabilities. GPS 210 requires the approved actuary to provide written advice to the Board of the insurer of the value of insurance liabilities in accordance with the prudential standard at least annually.

Furthermore, actuaries must follow the IAAust Professional Standard 300 *Actuarial Reports and Advice on General Insurance Technical Liabilities* and Guidance Note 353 *Evaluation Of General Insurance Technical Liabilities* in preparing estimates of the technical liabilities for general insurance activities.

GPS 210 defines insurance liabilities to include Outstanding Claims Liabilities (OCL) and Premiums Liabilities for each class of business. The value of insurance liabilities is the sum of: a) the central estimate value of the OCL; b) the central estimate value of the Premiums Liabilities; and c) risk margins that relate to the inherent uncertainty in each of these central estimate values. The risk margin is intended to secure the insurance liabilities of the insurer at 75% of sufficiency. Further, the risk margin should not be less than one half of the coefficient of variation for the insurance liabilities. Risk diversification and reinsurance across classes could be taken into account to reduce the risk margins for each class of business.

APRA's on-site review Module 10 *Insurance Risk* provides guidance on what to look for in assessing the adequacy of an insurer's liability valuation process.

Estimation of reinsurance recoveries follows the same principles as for the valuation of insurance liabilities. Insurers are required to value separately estimates of the gross liability and the recovery amounts. The approved actuary's Liability Valuation Report must consider the estimation of reinsurance recoveries. Currently, the risk that recoveries will not be received from the reinsurer is part of the investment risk. An additional capital charge for concentration may apply where the aggregate exposures to a particular reinsurer exceed the set threshold. APRA has proposed stricter rules to monitor reinsurance arrangements in insurers under Stage 2 Reforms.

General insurers using the Internal Model Based Method for determining their MCR must have in place a comprehensive stress testing program. So far, no insurer has applied to use the Internal Model Based Method. Those using the APRA prescribed methodology to determine MCR are required to calculate a **Maximum Event Retention (MER)**, which is an estimation of the largest loss that the insurer would be exposed after taking into account reinsurance arrangements.

Life insurance

Valuation of policy liabilities referable to a statutory fund must be made in accordance with actuarial standards. The LIA establishes the LIASB with the function of making actuarial standards. The LIASB has promulgated Actuarial Standard 1.03 *Valuation of Policy Liabilities* for application to life insurance. Compliance with the LIASB actuarial standards is mandatory.

Actuarial Standard 1.03 defines "Policy Liability" as the sum of the Best Estimate Liability and the value of expected future profits. The policy liability must provide for both a best estimate value of the liability under life insurance policies and a uniform emergence of profit from those policies relative to one or more appropriate Profit Carriers. All relevant expenses must be allocated both into the categories of acquisition, maintenance and investment management and into related product groups.

Treatment of reinsurance is specified in the actuarial standard. The policy liability gross of reinsurance, required to be disclosed in the financial statements of the company, should be

	determined as the sum of the net policy liability and the reinsured policy liability. Rules for the recognition of reinsurance for the purpose of determining solvency and capital adequacy requirements are also stipulated in the actuarial standards.
Assessment	Observed
Comments	<p>APRA has issued prudential principles for best estimate valuation of general insurance liabilities with a 75 percent margin of sufficiency. Risk diversification and reinsurance across classes could be taken into account to reduce the risk margins for each class of business.</p> <p>Life policy liabilities are determined based on actuarial standards that provide for both a best estimate value of the liability under life insurance policies and a uniform emergence of profit.</p>
Principle 21.	<p>Investments</p> <p>The supervisory authority requires insurers to comply with standards on investment activities. These standards include requirements on investment policy, asset mix, valuation, diversification, asset-liability matching, and risk management.</p>
Description	<p>Asset and investment risks are covered in the course of APRA's regular prudential reviews. Consistent with IFRS, AASB requires assets of insurers to be measured at fair value.</p> <p>General insurance</p> <p>APRA requires a general insurer to address investment risk in its RMS as part of the management of balance sheet and market risk. In GGN 220.3, investment risk refers to market risk, credit risk, investment concentration risk and asset and liability mismatch risk.</p> <p>Stage 2 Reform proposes enhancements to the management of investment risk. Further, the approved actuary shall prepare an annual FCR to the Board which would contain an assessment of the insurer's approach to asset and liability management and comment on any issues arising from the use of that approach, having regard to the insurer's liability profile and liquidity needs.</p> <p>Life insurance</p> <p>Safeguarding of assets and investments backing policy liabilities is achieved through statutory funds. Part 4 of the LIA provides for the investment, administration and management of the assets of a statutory fund. It prohibits encumbrance of any assets of a statutory fund, controls the movement of assets in and out of a statutory fund and defines restricted investments.</p> <p>A director, who breaches his duty resulting in a loss to a statutory fund, is liable to make good the loss pursuant to sections 48 and 50 of the LIA. Prudential Rule 35 requires a Directors' declaration to be attached to an insurer's annual financial statements. The declaration must state, amongst other matters, whether any assets of the statutory funds have been applied or invested in contravention of the LIA.</p> <p>Statutory funds are subject to solvency and capital adequacy requirements that deal with the following asset risks: a) adverse market movements; b) assets realization; c) holdings in associated entities; d) asset concentration; e) credit risks; and f) liquidity risks. An additional reserve is required to take account of any changes in the value of assets in a run-off situation. Although not specified, the appointed actuary must consider how credit and liquidity risks and the overall asset risks affect his assessment of the statutory fund's solvency and capital adequacy positions. Furthermore, the appointed actuary must assess the resilience of the statutory fund and provide for a resilience reserve. Computation of the resilience reserve must include considerations of asset and liability mismatches.</p> <p>Professional Standard 200 <i>Actuarial Reports and Advice to a Life Insurance Company</i> by the IAAust guides actuaries in checking the veracity of data, summary by type, derivatives, suitability to liabilities, valuation methods, mismatching and default risks in portfolio, and admissible assets. For investment policy, the actuary checks current policy and trend, impact on</p>

	<p>future returns and suitability to current and future liabilities.</p> <p>Advanced criteria Proposed amendments to the RMS require modeling and stress-testing of the impact of current and alternative investment strategies on the financial outcomes and asset-liability mismatch assessments of a general insurer. The resilience reserve for life insurers ensures that the statutory fund would be able to sustain shocks to the economic environment.</p>
Assessment	Observed for general insurance and Largely Observed for life insurance
Comments	<p>APRA requires a general insurer to address investment risk in its RMS.</p> <p>While there is no explicit investment rule for life insurance, the statutory funds concept safeguards the assets and investments backing policy liabilities. Part 4 of the LIA stipulates restricted investments and prohibits encumbrance of assets. The actuarial standards on solvency and capital adequacy also address asset risks, encouraging diversification in the investment portfolio and minimizing asset/liability mismatches. Another mitigating factor is that nearly 90 percent of life company assets are investment linked superannuation assets which obliges life companies to observe the investment mandate. APRA plans to issue comprehensive prudential standards on risk management under the LIA, consistent with standards proposed for general insurers.</p>
Principle 22.	<p>Derivatives and similar commitments The supervisory authority requires insurers to comply with standards on the use of derivatives and similar commitments. These standards address restrictions in their use and disclosure requirements, as well as internal controls and monitoring of the related positions.</p>
Description	<p>General insurance A circular on derivatives was put in place in 1995. Pursuant to GGN 110.4 <i>Investment Risk Capital Charge</i>, insurers must set aside capital to cover the Investment Risk arising from derivative contracts. For insurers with limited usage of derivatives, the method for computing a capital charge is prescribed. Where an insurer enters into significant derivative transactions, APRA may prescribe a method to calculate an additional capital charge against the resulting positions. GGN 220.3 stipulates the minimum requirements for derivatives control.</p> <p>Information on derivatives activities and commitments are collected through a number of forms such as GRF 140.1 <i>Investments-Direct Equity Holding and Risk Charge</i>, GRF 140.4 <i>Assets Indirectly Held by Insurer and Risk Charge</i> and GRF 310.3 <i>Investment and Operating Income and Expense</i>. In particular, GRF 160.0 <i>Derivative Activity and Risk Charge</i> requires all information on an insurer's derivative activities and exposures for the purpose of calculating an appropriate capital charge.</p> <p>Life insurance Circular No C.I.1 regulates the use, management and control of derivatives and was first issued by the Insurance and Superannuation Commission in 1995. Notwithstanding the lack of formal legal standing, the circular has worked well. Life insurers using derivatives must have satisfactory risk management practices for derivatives as evidenced by a RMS.</p> <p>Use of the following types of derivatives should be generally restricted: a) highly leveraged derivatives; b) uncovered derivatives; c) derivatives where the potential for losses is considerably higher than the initial investment or is unlimited; d) derivatives where the potential exposure cannot be reliably measured; e) derivatives where closing out is difficult considering the illiquidity of the market; and f) derivatives where the underlying asset is not admissible for solvency purposes.</p>
Assessment	Observed

Comments	APRA has a long and established history of monitoring insurers' involvement in derivatives. The circulars have been effective in ensuring insurers put in place adequate controls and necessary checks on the use of derivatives. APRA has an in-house Balance Sheet and Market Risk Team with extensive knowledge and experience in derivative use. The team monitors market developments and provides specialist advice to frontline supervisors in the conduct of prudential reviews.
Principle 23.	<p>Capital adequacy and solvency The supervisory authority requires insurers to comply with the prescribed solvency regime. This regime includes capital adequacy requirements and requires suitable forms of capital that enable the insurer to absorb significant unforeseen losses.</p>
Description	<p>As an integrated supervisor, APRA supervises many conglomerate groups that include insurers. Some of these conglomerate groups are subject to banking prudential requirements. Bank capital adequacy rules require that capital investments in insurers must be deducted from the capital base of the standalone bank as well as the consolidated banking group.</p> <p>APRA keeps up-to-date with international policy developments via strong representation on various committees of the IAIS and IAS. APRA also maintains close relationships with peer regulatory jurisdictions such as UK and Canada to ensure consistency with their solvency regimes.</p> <p>General insurance Prudential Standard GPS 110 <i>Capital Adequacy for General Insurers</i> and associated guidance notes sets out the MCR. An insurer has 2 options to determine MCR — the Internal Models Based Method or a Prescribed Method. At the minimum, both methods must provide for capital charges against: a) insurance risk – risk that the true value of net insurance liabilities may exceed the valuation under GPS 210; b) investment risk; and c) concentration risk - risk that reflects the largest loss to which an insurer will be exposed due to a concentration of policies, after netting out any reinsurance recoveries. The MCR computation allows for different risk capital factors depending on business class, asset type, counterparty grading and concentration. The policy intention is for the MCR to be established at an overall sufficiency level of 99.5%.</p> <p>The minimum MCR coverage is 1.2 times. Stage 2 Reforms proposals require insurers to set out, in their RMS, strategies for holding capital reserves above the MCR. More specifically, insurers must put in place processes and controls to monitor and ensure continual compliance with the MCR, including setting trigger ratios appropriate for each insurer.</p> <p>A general insurer must, at all times, have capital in excess of its MCR. The eligibility criteria and conditions on capital eligible to meet the MCR are prescribed in GGN 110.1 <i>Measurement of Capital</i>. Tier 1 or core capital comprises proceeds from instruments that are permanent and non-cumulative in nature. Tier 2 instruments include hybrid capital instruments that have the characteristics of both equity and debt. At least 50 per cent of an insurer's capital base must be in Tier 1 instruments.</p> <p>A general insurer's REMS, must consist of policies and procedures that set out principles for the selection of reinsurance counterparties. The investment risk capital charge is designed to cover the risk of counterparty default including where the aggregate exposures to a particular reinsurer exceed the set thresholds. Proposed GGN 230.3 will seek to ensure the robustness of risk transfer by requiring APRA approval for limited risk transfer arrangements as well as their treatment for capital adequacy purposes.</p> <p>In recognition of the inherent uncertainty in the estimate of an insurer's liabilities, GPS 210 requires the incorporation of a risk margin as a component of the value of the insurance liabilities. In addition, the MCR must include a MER to take account of catastrophic losses.</p>

GPS 110 require foreign-incorporated insurers operating branches in Australia to meet a variant of the minimum capital requirement. Specifically, the foreign insurer must maintain assets in Australia in excess of their liabilities in Australia, of an amount at least equal to the MCR.

General insurers which use the Internal Model Based Method for determining MCR must have in place a comprehensive stress testing program to supplement their capital measurement calculations. So far, no insurer has applied to use the Internal Model Based Method. For other insurers, APRA has not stipulated stress testing as a requisite but a number of the large general insurers in Australia undertake regular scenario analysis for their own purposes.

General insurers using the APRA prescribed methodology to determine MCR are required to calculate a MER which requires a consideration of: a) all relevant areas of risk concentration; and b) those perils which produce the greatest MER; c) the return period of the relevant catastrophes and the sensitivity of the MER to changes in those return periods; d) the results produced by modeling the insurer's own past experience; and e) any appropriate externally, commercially available data and modeling facilities.

Life insurance

Solvency is determined on the basis that each statutory fund has sufficient assets to fund existing liabilities in the event of the fund being wound up. This is designed to require insurers to hold reserves to a broad target level of safety of 99.5 percent.

The capital adequacy requirement for a fund is determined based on a going concern scenario. Capital adequacy requirements are generally higher than solvency requirements and act as an early warning trigger to protect against the breach of solvency levels. The policy intention is for insurers to hold reserves at a safety level of 99.75 percent—broadly equivalent to S&P A rating.

APRA encourages life companies to hold assets in excess of the regulatory requirements to minimize the risk of regulatory intervention. An insurer should have a target surplus policy commensurate with its overall risk profile. APRA expects to see a discussion of the target surplus by the appointed actuary in the FCR.

Actuarial standards 1.03, 2.03 and 3.03 establish the principles and methodologies for the valuation of policy liabilities, and solvency and capital adequacy requirements.

The solvency requirement broadly comprises the solvency liability, other liabilities, an expense reserve, a resilience reserve and an inadmissible assets reserve. The capital adequacy requirement is made up of a capital adequacy liability, other liabilities, a resilience reserve, an inadmissible assets reserve and a new business reserve. Asset risks, in respect of valuation, liquidity and credit quality, are addressed through the inadmissible asset reserve or other additional reserves while the resilience reserve deals with the matching of assets and liabilities.

With the solvency and capital requirements met by the excess of assets over liabilities, rather than issued capital, in a statutory fund, there is no definition of eligible capital. Instead, the attributes associated with capital, that is permanency and loss absorption capabilities, become important features for the assets. To this end, assets short of the requisite attributes are treated as inadmissible assets under AS2.03 and AS3.03.

To ensure that life companies are adequately capitalized outside the statutory funds, APRA has determined a Management Capital standard. A life company must hold sufficient assets in the General Fund in accordance with Actuarial Standard 6.02 *Management Capital Standard*.

Insurers are required to hold the higher of the management capital determined under Actuarial Standard 6.02 or the minimum A\$10 m under Prudential Standard No 3, *Prudential Capital Requirement* outside the statutory funds. For companies limited by shares only, prudential

	<p>capital must take the form of ordinary shares, irredeemable preference shares or APRA approved redeemable preference shares. For a life company limited both by shares and guarantee or that does not have any share capital, capital must be held in the form of eligible assets as defined in the prudential standard.</p> <p>Allowance for reinsurance is subject to the reinsurance arrangements meeting the criteria in section 3.3 of AS2.03 and AS3.03. Where the reinsurance arrangements are with “ineligible” reinsurers, the arrangements are to be ignored when calculating the liabilities in respect of the policies.</p> <p>Solvency and capital adequacy requirements are risk-based - the level of requirements will therefore depend on the size and nature of the life company’s operations. Both the solvency and capital adequacy requirements include a resilience reserve. To accurately assess a life company’s resilience requirements, the appointed actuary must undertake capital projections that consider how the value of a life company’s assets and liabilities would be affected by adverse scenarios.</p> <p>Both the solvency and capital adequacy requirements address the risk of double gearing of capital of associated entities. Holdings in an associated entity which is an institution itself subject to legislated minimum capital requirements are treated as inadmissible assets under the solvency and capital adequacy standards.</p> <p>Eligible foreign life insurance companies operating as branches will be required to operate their Australian business in a separate statutory fund subject to solvency and capital adequacy regimes.</p>
Assessment	Observed
Comments	<p>The capital adequacy regime in place for general insurance is prudent and comprehensive. Although it does not currently apply at a group level, legislative provisions are already in place.</p> <p>The solvency and capital adequacy regimes for life insurance have worked well. While capital instruments do not have a large role given the statutory fund structure, it is in APRA’s plans to harmonize the capital regime of life companies with that of banks and general insurers.</p>
Markets and consumers	
<p>Principle 24. Intermediaries The supervisory authority sets requirements, directly or through the supervision of insurers, for the conduct of intermediaries.</p>	
Description	<p>Insurance intermediaries are required to hold an AFSL under the Corps Act, except when the intermediary is acting as an authorized representative of an AFSL holder or an exemption applies under the special circumstances specified. Insurance contracts fit into the definition of “financial services business” that includes providing “financial product advice” and dealing in “a financial product” (includes the management of financial risk).</p> <p>As a principal, an insurance broker or a financial services business giving advice on an insurance product is required to hold its own AFSL. As an authorized representative of an AFSL holder, an insurance agent of the AFSL holder is exempted from the requirement to hold an AFSL</p> <p>AFSL applicants must: a) ensure that the financial services covered by the AFSL are provided efficiently, honestly and fairly; b) maintain the competence to provide the financial service; c) comply with financial services laws; and d) ensure that the AFSL holder's representatives are adequately trained and competent to provide the financial service.</p> <p>ASIC Policy Statement PS 164 <i>Licensing: Organisational Capacities</i> provides guidance on how to address competence of senior management. Training requirements are specified in Policy</p>

	<p>Statement PS 146 <i>Licensing: Training of Financial Product Adviser</i>. This includes minimum training standards where the staff or the authorized representatives of an AFSL holder are providing advice to retail clients. The onus is on the AFSL holder to ensure that the representative meets the training requirements.</p> <p>Section 913B of the Corps Act requires the AFSL holder to be of good fame and character. There is no requirement for an authorized representative to be of good fame and character; the onus is on the AFSL holder in relation to the conduct of an authorized representative that it appoints.</p> <p>ASIC has the power to suspend or cancel the AFSL, make a banning order, impose and/or vary conditions on an AFSL. If an AFSL holder is an insurer regulated by APRA, ASIC cannot make such a change to the AFSL held by an insurer without ASIC first consulting APRA. Even when ASIC is not required by law to consult with APRA before making a decision to suspend or cancel an AFSL, ASIC is still required to advise APRA of its action within a week.</p> <p>An intermediary who is an AFSL holder must pay money from a client into an account with an APRA authorized deposit-taking institution, or an account with an approved foreign bank or a cash management account. This account can only be used for client money. There is, however, no requirement to maintain separate accounts for each client; an AFSL holder can have a single account for all clients. Money paid to the AFSL holder by the client is taken to be held on trust for the client. If an AFSL holder becomes insolvent, all client money held on trust remains the property of the clients and cannot be used for the purposes of paying the AFSL holder's creditors.</p> <p>The Corps Act requires the provision of a Financial Services Guide (FSG) to assist a retail client in deciding whether to acquire a financial service (as opposed to a financial product). The obligation applies to an AFSL holder as well as the authorized representatives of an AFSL holder. Intermediaries are required to disclose fees and commissions charged</p> <p>ASIC may take enforcement action against any person who carries on a financial services business without an AFSL. Failure to comply with the requirement to hold an AFSL is an offence subject to a penalty of \$220,000 or 2 years imprisonment or both.</p>
Assessment	Observed
Comments	ASIC has issued a number of policy statements that regulate the professional conduct of intermediaries in providing financial services and advice. Intermediaries are also required to maintain separate trust accounts for clients' monies.
Principle 25.	<p>Consumer protection</p> <p>The supervisory authority sets minimum requirements for insurers and intermediaries in dealing with consumers in its jurisdiction, including foreign insurers selling products on a cross-border basis. The requirements include provision of timely, complete and relevant information to consumers both before a contract is entered into through to the point at which all obligations under a contract have been satisfied.</p>
Description	<p>To be licensed, an AFSL holder must “do all things necessary to ensure that the financial services covered by the AFSL are provided efficiently, honestly and fairly” and “maintain the competence to provide those financial services”. ASIC has the power to suspend or cancel an AFSL if the AFSL holder is unable to meet its license requirements on on-going basis.</p> <p>ASIC has approved the ICA’s General Insurance Code of Practice and the independent complaints resolution scheme, Insurance Enquiries and Complaints Ltd. The Code implements various recommendations for: a) making policy wording and information more user friendly; and b) improving training and accountability for the conduct of employees, agents, loss adjustors, assessors and debt collectors who handle insurance claims.</p>

The *Insurance Contracts Act 1984* imposes a duty on insurers to act with the utmost good faith. The Act contains provisions that prevent an insurer from denying claims where it would have been entitled to do so at common law but to do so would be unfair on the consumer.

An AFSL holder and an authorized representative must have a reasonable basis for “personal advice” provided to a “retail client”. They must determine the relevant personal circumstances of the client to establish a reasonable basis on which to give advice. If they provide “general advice”, they must notify the client that the advice has been prepared without taking account of the client's specific objectives, financial situation or needs. If the advice relates to the acquisition of a particular financial product, the client should obtain a **Product Disclosure Statement (PDS)** and consider it before making any decision.

Part 7.7 of the Corps Act contains the financial services disclosure requirements that apply to AFSL holders and their authorized representatives: a) FSG; b) **Statement of Advice (SOA)**; and c) PDS that include significant benefits and risks associated with a product and dispute resolution information.

The Corps Act requires an AFSL holder to have a dispute resolution system and membership of one or more external dispute resolution schemes. ASIC's Policy Statement PS165 stipulates that internal dispute resolution procedures must satisfy the Essential Elements of Effective Complaints Handling in *Australian Standard AS 4269 1995: Complaints Handling*. Essential elements that must be covered include: commitment, fairness, resources, visibility, access, assistance, responsiveness, charges, remedies, data collection, systemic and recurring problems, accountability and reviews.

To satisfy the Corps Act's membership requirement of an external dispute resolution scheme, membership must be of a scheme approved by ASIC. The key principles that external schemes must address are: accessibility, independence, fairness, accountability, efficiency and effectiveness.

The Insurance Ombudsman Service is a national service which also assists in resolving disputes between consumers and insurers or other financial service providers that are members of the Service. Furthermore, the industry has adopted a Code of Practice which is a self-regulatory code that aims to raise the standards of practice and service in the insurance industry. The Code is administered by the Ombudsman.

ASIC's website publishes licensed AFSL holders and lists names of people who have been banned or disqualified under the Corps Act. The ASIC publication, *Consumers and Money*, is a quick guide for consumers about consumer protection laws, insurance, fees and charges, credit cards, superannuation and scams. Segments of the website have been designed specially for the more vulnerable sectors of the population, such as retirees, young adults and indigenous people.

One of ASIC's statutory aims is “to promote the confident and informed participation of investors and consumers in the financial system”. To this end, a Consumer Education Strategy was developed, one aspect of which focused on providing financial services education in schools. ASIC publications, such as *Your Money*, *Don't kiss your money goodbye*, and *You can complain*, have proved to be popular and very effective in promoting financial awareness among the public.

Since the inception of the Financial Services Reform Act in 2002, ASIC has conducted 483 surveillances into insurers holding AFSL and/or their authorized representatives or Insurance brokers. Most of these surveillances were conducted in 2004/5. ASIC surveillance activities included special risk-based projects such as insurance broker remuneration arrangements, regional surveillance, superannuation switching surveillance project and shadow shopping project (assessment of consumers' experience of seeking and obtaining financial advice

	regarding superannuation).
Assessment	Observed
Comments	ASIC requires and monitors that AFSL holders and their representatives conduct with due care and diligence and ensure fair treatment of consumers. The industry has established codes of practice, independent complaints resolution scheme and Insurance Ombudsman Service. ASIC website provides extensive information to consumers and it has embarked on a Consumer Education Strategy.
Principle 26.	Information, disclosure & transparency towards the market The supervisory authority requires insurers to disclose relevant information on a timely basis in order to give stakeholders a clear view of their business activities and financial position and to facilitate the understanding of the risks to which they are exposed.
Description	<p>Policy owners have the right to receive the financial statements and annual returns given by a life insurer to APRA. APRA maintains a register of returns for individual life insurers for inspection by the public.</p> <p>APRA requires extensive reporting from general insurers but currently only publishes a limited amount of this data and only at an aggregate level. APRA is reviewing its disclosure regime with a view to expanding the range of published information to facilitate the assessment of the financial strength of individual insurers by stakeholders. Work is advanced in the design of a new annual publication containing company specific general insurance statistics. The proposed publication will disclose key profit and loss, balance sheet and solvency data at an individual insurer level. Consultation with industry is pending.</p> <p>A person is entitled to inspect and obtain a copy or extract of certain public documents lodged with ASIC, including financial reports and directors' reports. Periodic reports lodged pursuant to AFSL holder obligations or other Corps Act obligations are accessible by the public. ASIC has also appointed a number of information brokers that can provide a copy of these documents on behalf of ASIC.</p>
Assessment	Observed
Comments	Both APRA and ASIC published extensive market data and analysis. Selected regulatory information is easily accessible by the public through the agencies' websites or public inspection of documents.
Principle 27.	Fraud The supervisory authority requires that insurers and intermediaries take the necessary measures to prevent, detect and remedy insurance fraud.
Description	<p>The ASIC Act, the Corps Act, and the <i>Insurance Contracts Act (IC Act)</i> are the principal pieces of legislation that address insurer fraud, which may be administered and enforced by ASIC.</p> <p>ASIC has the necessary investigative powers to enforce compliance with the laws to deter, detect, record, report and remedy fraud in insurance. A range of civil and criminal remedies is available to ASIC. These include injunctive powers, ability to freeze assets and ability to wind-up companies or managed investment schemes. Furthermore, where fraud is established, ASIC may apply to Court for a declaration that there has been a breach of the civil penalty provisions. ASIC may then apply for a civil penalty order, seek compensation for damages and seek orders to ban persons who have committed fraud.</p> <p>ASIC has sufficient resources to achieve its target outcome of "a fair and efficient market". In 2003-04, ASIC jailed 28 criminals, obtained 118 civil orders against people or companies, banned 22 people from directing companies and 42 people from offering financial services, and disciplined or deregistered 13 company auditors and liquidators for misconduct.</p>

	<p>Breaches of the IC Act involving general or life insurance may be punished through the avoidance of insurance contracts; restitution if it only relates to general insurance, or varying the contract if the fraud relates to life insurance. If the fraud relates to a misstatement of age, the insurer may apply to vary the contract by either substituting or decreasing the amount payable according to the relevant formula provided for under the Insurance Contracts Act.</p> <p>There is no specific crime of insurance fraud in Australia. Persons alleged to have engaged in insurance fraud is may be charged under a number of provisions of the <i>Crimes Act 1900 (NSW)</i> and equivalent provisions in the relevant legislation in other state jurisdictions. Instance of claims fraud may be prosecuted under provisions relating to fraudulent misappropriation, obtaining money by deception and obtaining money by false and misleading statements.</p> <p>There is no explicit requirement for insurers and intermediaries to promptly report fraud to the appropriate authorities. AFSL holders are required to report to ASIC significant breaches or likely breaches of their obligations within 5 days. ASIC expects licensees to report fraud incidents under this obligation. The requirement to provide counter fraud training to management and staff is implied in the statutory requirement that an AFSL holder maintain the competence to provide financial services. APRA also checks on the adequacy of staff training and awareness in fraud in the course of its prudential review of insurers.</p> <p>Section 915F of the Corps Act requires ASIC to publish a notice of suspension, revocation of suspension or cancellation of an AFSL in the Gazette. Section 920E sets out an equivalent obligation on ASIC in respect of an authorized representative of an AFS licensee. Section 920E(2) also provides that the notice must also set out a copy of the banning order. ASIC maintains a register of persons against whom a banning order or disqualification order is made. ASIC also maintains an Enforceable Undertaking Register which includes details of persons that have undertaken not to take part in the management of a corporation, or carry on a financial services business. However, these registers would not include persons who have committed fraud but are not AFSL holders or their representatives.</p> <p>ASIC has done some work in supporting the efforts of insurance companies in mitigating the risks of electronic fraud (internet) and has promoted fraud reporting as part of the “critical infrastructure” defensive mechanisms that addresses risks such as rampant electronic crime reducing investors’ confidence in the financial system. Under this initiative, ASIC brought the Insurance Council of Australia and a number of large insurers together to discuss the ways to mitigate risks, particularly in relation to fraud.</p> <p>ASIC can also cooperate with foreign supervisory authorities through compulsorily obtaining and transmitting information, documents or evidence to a foreign regulator for the administration and enforcement of a foreign business law under the <i>Mutual Assistance in Business Regulation Act 1992</i>. For proceedings in relation to a criminal matter or in respect of a foreign serious offence, ASIC can cooperate with foreign supervisory authorities under the <i>Mutual Assistance in a Criminal Matter Act 1987</i>.</p>
Assessment	Observed
Comments	The current regulatory measures to address insurance fraud could be enhanced by clarifying the reporting requirements in respect of insurance fraud and promoting more regular exchange of information on fraud amongst insurers.

Anti-money laundering, combating the financing of terrorism	
Principle 28. Anti-money laundering, combating the financing of terrorism (AML/CFT)	
<p>The supervisory authority requires insurers and intermediaries, at a minimum those insurers and intermediaries offering life insurance products or other investment related insurance, to take effective measures to deter, detect and report money laundering and the financing of terrorism consistent with the Recommendations of the Financial Action Task Force on Money Laundering (FATF).</p>	
Description	<p>The <i>Financial Transaction Reports Act 1988</i> (FTR Act) and the <i>Financial Transaction Reports Regulations 1990</i> are largely compliant with the FATF's 40 Recommendations (1996 version). FTR Act imposes reporting, customer due diligence and document retention provisions on the broader cash dealer community. The term cash dealer includes insurers or insurance intermediaries.</p> <p>AUSTRAC supervises insurers and intermediaries only in relation to their obligations under the FTR Act. AUSTRAC has a dual role as the financial intelligence unit (FIU). AUSTRAC is responsible for administering the FTR Act. Part IVA of the FTR Act provides AUSTRAC with powers of inspection. AUSTRAC has no role in supervising ownership or control of insurers or insurance intermediaries.</p> <p>A draft exposure Bill was under preparation to bring Australia's AML/CFT regime in line with the latest FATF recommendations. It will address areas of FATF interest including customer verification and ongoing due diligence requirements, suspicious and other threshold transaction reporting obligations, recordkeeping and other requirements relevant to the financial sector.</p> <p>APRA may disclose protected information to AUSTRAC, the Australian Federal Police, the Police Force of a State or Territory, the Australian Crime Commission and the Australian Treasury, among others. AUSTRAC currently has 43 exchange agreements allowing it to share financial intelligence with other FIUs. It also maintains partner agency agreements with a broad range of law enforcement, national security, revenue collection and social justice agencies which enable the exchange of financial intelligence. However, AUSTRAC is currently unable to share suspicious transaction information with APRA.</p> <p>Currently the customer due diligence requirements are limited to identification verification of signatories of products considered to be accounts for the purposes of the FTR Act. Identification verification generally occurs when an account is opened and where a cash transaction involving \$A 10,000 or more occurs. However, the insurance industry does not normally deal in cash transactions.</p> <p>Insurers and insurance required to report significant cash transactions (\$A 10,000 or more), all international funds transfer instructions and suspicious transactions under the FTR Act.</p> <p>FATF has published its October 2005 Mutual Evaluation Report on Australia. This report documented shortcomings in the legal framework and "did not find the implementation of the AML/CFT supervisory system to be effective in terms of the standards required by the revised 40 Recommendations." A need for enhanced coordination of AML/CFT measures among the relevant authorities was noted.</p>
Assessment	Partly observed
Comments	Australia is committed to implementing a robust AML/CFT regime in line with FATF standards and is in the process of updating its legislative framework.

Table 5. Summary Observance of the IAIS Core Principles

ICP	Description	Level of Observance *			
		O	LO	PO	NO
1	Conditions for effective insurance supervision	L,G			
2	Supervisory objectives	L,G			
3	Supervisory authority		L,G		
4	Supervisory process	L,G			
5	Supervisory co-operation and information sharing	L,G			
6	Licensing	L		G	
7	Suitability of persons	L,G			
8	Changes in control and portfolio transfers	L,G			
9	Corporate governance	L,G			
10	Internal control		L,G		
11	Market analysis	L,G			
12	Reporting to supervisors and off-site monitoring	L,G			
13	On-site inspection	L,G			
14	Preventive and corrective measures	L	G		
15	Enforcement or sanctions	L		G	
16	Winding-up and exit from the market	L		G	
17	Group-wide supervision		L,G		
18	Risk assessment and management	G	L		
19	Insurance activity	L,G			
20	Liabilities	L,G			
21	Investments	G	L		
22	Derivatives and similar commitments	L,G			
23	Capital adequacy and solvency	L,G			
24	Intermediaries	L,G			
25	Consumer protection	L,G			
26	Information, disclosure and transparency towards the market	L,G			
27	Fraud	L,G			
28	AML/CFT			L,G	

* O - Observed

LO - Largely Observed

PO - Partly Observed

NO - Not Observed

G — General Insurance

L — Life Insurance

A. Recommended Action Plan and Authorities Response to the Assessment

Table 6. Recommended Action Plan to Improve Observance of the Insurance Core Principles

Insurance Core Principles (ICP)	Recommended Action
The Supervisory System (ICP2, 3, 4 and 5)	<ul style="list-style-type: none"> • In the absence of policymaking powers for ASIC, effective mechanisms should be in place to ensure that their policy inputs are addressed appropriately and in a timely manner. • The circumstances under which the Treasurer may give directions to APRA should be clearly spelt out. • Considerations should be given for a) public disclosure of the reasons for the removal of APRA Members; and b) APRA to consult or notify ASIC in taking any action on an insurer's license, where appropriate.
The Supervised Entities (ICP6 , 7, 8, 9 and 10)	<ul style="list-style-type: none"> • Implement the recommendations of the Potts Review on the regulatory status and scope for DOFIs and DMFs, as appropriate. • Consideration should be given to reviewing the requirement that APRA can only refuse registration of a life insurer with the approval of the Treasurer. • APRA should be given explicit powers for cross-border supervision of insurance activities carried out by subsidiaries of insurers domiciled in Australia.
Ongoing Supervision (ICP11, 12, 13, 14, 15,16,17)	<ul style="list-style-type: none"> • To empower APRA to deal with troubled institutions in a timely and cost-effective manner. In this regard, considerations should be given to expedite the on-going review on harmonizing the powers of the APRA across the banking, life insurance and general insurance industries.
Markets and Consumers (ICP24, 25,26, 27)	<ul style="list-style-type: none"> • To assist the industry in combating fraud more effectively, consideration should be given to: a) making claims fraud a punishable offence; b) requiring insurers to report fraud promptly; and c) promoting effective mechanisms for exchange of information between insurers with respect to fraud and those committing frauds (e.g. industry databases).
AML/CFT (ICP28)	<ul style="list-style-type: none"> • To update its legislative framework for the AML/CFT regime in line with FATF standards and enhance clarity on the regulatory scope of the various regulatory agencies in AMF/CFT supervision.

Authorities' response

The authorities appreciate the IMF's considered views and recommendations contained in the assessment, which will be taken into account in developing the policy agenda for further insurance reforms.

Supervisory Authority

In addition to APRA having the power to make Prudential Standards, APRA and ASIC provide valuable input into the policy and legislative process. However, it has to be recognized that the development and passage of legislation is subject to constraints imposed by the Government's overall policy program and the priorities accorded particular policy agendas. Accordingly, it is not possible to give any guarantee about the timing of adopting proposals put forward by APRA and ASIC.

It is recognized that to achieve high quality outcomes in prudential regulation it is important to have regulators with operational independence from government. However, it is also important that governance and accountability arrangements operate in such a way that regulators follow the policy intention of the parliament when implementing legislation. The Government considers that the power of the Treasurer to issue directions to APRA on policies and priorities (but not particular cases) strikes an appropriate balance between accountability and transparency. The conditions attached to this power, such as discussing the proposed direction with the APRA Chair and tabling the direction in parliament, provide a substantial check on its use, such that a direction would only be considered as a last resort. To date the Treasurer has not given APRA any directions under this power.

As part of a government wide review of statutory authorities, the Treasurer has agreed to move APRA's financial framework to the Financial Management and Accountability Act (FMA Act) from the current Commonwealth Authorities and Companies Act (CAC Act). The Treasurer considers prudential regulation to be a core function of government, and the FMA Act is the financial framework that most appropriately applies to agencies delivering those functions. The CAC Act is most applicable to government entities that undertake commercial operations.

The Government does not consider that this change will materially affect APRA's operational independence or funding. It is APRA's enabling legislation (the *Australian Prudential Regulation Authority Act 1998*) that establishes the required level of operational independence necessary to exercise statutory powers objectively. Further, the Government has used its powers to exempt APRA from a small number of conditions under the FMA Act that may affect its ability to fulfill its duties efficiently and effectively. As a result, the change to the FMA Act will not affect how APRA is funded or reduce its autonomy in deciding how it spends its funding and organizes itself (including its ability to set terms and conditions of its staff) to meet its statutory obligations.

In general, the Australian Government notes that its overall approach to fiscal policy over the last decade, in which all public sector spending is subject to robust discipline, has served Australia well, ensuring adequate funding for government services and agencies while producing a degree of sustained fiscal responsibility unmatched by many other OECD economies.

The Treasury does not have any involvement in the operational decisions of APRA or ASIC. Currently, the Treasurer's agreement must be sought before certain administrative actions or

decisions are taken under the Insurance Act and the Life Insurance Act. The Treasurer's agreement for APRA decisions was based on the need to ensure that APRA was able to act in a timely manner to protect the interests of depositors and/or policyholders, while ensuring that there was review of those administrative decisions to protect persons affected. The Government agreed to remove the Treasurer's involvement in operational decisions, other than in cases where broader policy issues were not involved, as part of its response to the HIH Royal Commission.

The Financial Sector (Shareholdings) Act (FSSA) which imposes controls on the ownership of financial entities is not administered by APRA as it is not an Act related to prudential supervision; however, prudential aspects are taken into account when considering applications for changes in ownership. In making decisions under the Act, the Treasurer takes account of APRA's advice. In certain instances, determined by monetary thresholds, the Treasurer has delegated his powers under the FSSA Act to senior APRA staff.

Licensing

We disagree with the rating of 'partly observed' for general insurance.

Australia's licensing regime was substantially revised in 2001 and in 2002 all existing insurers were subjected to a rigorous re-licensing process. As a consequence, we consider that Australia has demonstrated that it has in place a robust, well-tested licensing regime to ensure that only well-resourced and prudentially sound insurance companies are licensed. While it is acknowledged that DMFs and DOFIs are not prudentially supervised by APRA at this time, they are required to comply with AFSL license requirements. In view of the relatively small market share held by DMFs and DOFIs, we consider that the rating given places undue emphasis on the deficiencies identified and does not have sufficient regard to Australia's otherwise robust licensing framework. Neither does it recognize the Government's agreement to implement the key recommendations of the Potts Review.

Internal control

We consider that the 'largely observed' rating for general insurance with respect to principle 10 should be revised to 'observed' as a result of the release of the risk and financial management prudential standard and the corresponding non-binding prudential practice guide. This prudential standard will be effective from 1 October 2006 and address the concerns raised in the assessment.

Enforcement or sanctions

The Government is currently reviewing the application of merits review to APRA decisions following a recommendation of the HIH Royal Commission, and more recently, a recommendation of the Taskforce on Reducing the Regulatory Burden on Business. The review will take into consideration the need for APRA to be able to take timely decisions where they are necessary to protect the interests of depositors and/or other policyholders. The review will also seek to balance the objective of timeliness with the need to ensure that persons affected by decisions are treated fairly.

Merits review is a key element of Australia's system of administrative review and, where appropriate, offers the potential for a cost effective and relatively timely review of an administrative decision. In the absence of the availability of merits review, persons affected by decisions would have recourse to judicial review by the courts.

Anti-money laundering, combating the financing of terrorism

As the IMF has noted, the Government is committed to updating Australia's anti-money laundering and counter-terrorist financing (AML/CTF) regime to reflect developments in financial crime and revised international standards from the Financial Action Task Force on Money Laundering (FATF).

In keeping with its commitment the Australian Government is closely consulting with industry on a range of reforms. Legislation is expected to be introduced during 2006. The reforms when implemented will bring Australia into compliance with the FATF recommendations and will ensure that Australia's financial sector, in meeting its obligations, remains robust and internationally competitive.

Processes are currently in place to amend the existing *Financial Transaction Reports Act 1988* to allow AUSTRAC to share FTR information with APRA. This will also involve the establishment of a memorandum of understanding between the two authorities. Under the proposed AML/CTF legislation APRA will be included as a partner agency with which AUSTRAC can share FTR information. These arrangements will ensure that APRA is provided with information essential to assessing risks within APRA regulated institutions. In addition, APRA and AUSTRAC will continue to improve broader cooperation and coordination arrangements.

III. IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION

A. General

38. This assessment of the current state of Australia's implementation of the IOSCO Objectives and Principles of Securities Regulation has been completed as part of a Financial Sector Assessment Program undertaken in December 2005 by the International Monetary Fund. An assessment of the effectiveness of securities regulation requires a review of the legal framework, both generally and as specifically related to the financial sector, and a detailed examination of the policies and practices of the institutions responsible for securities regulation.

39. Australia has adopted a functional approach to oversight of the financial system, with the roles and responsibilities of the various agencies broadly divided by regulatory objective. The Australian Securities and Investment Commission (ASIC) is the market conduct regulator and also administers the provisions of company law for both listed and unlisted companies. The Australian Prudential Regulation Authority (APRA) is the agency responsible for the prudential supervision of banks, insurers and superannuation (pension)

funds. The Reserve Bank of Australia (RBA) has responsibility for payment system oversight and overall financial stability. The federal financial intelligence unit (FIU), the Australian Transactions Reports and Analysis Centre (AUSTRAC), is also responsible for anti-money laundering and countering the financing of terrorism (AML/CFT) regulation and on-site verification in financial institutions. Investigations are carried out by law enforcement agencies. As the AML/CFT regulator, AUSTRAC is responsible for ensuring compliance with current AML/CFT regulation. With respect to banking and other financial services issues, the Treasury is responsible for the preparation of laws and regulation, and provides the Treasurer with policy advice. Legislation confers on the Treasurer certain responsibilities and the Treasurer might play a direct role in financial sector supervision through legal powers to issue directions to APRA and ASIC. With respect to AML/CFT, the Attorney-General's department is responsible for the preparation of laws and regulations and provides the Minister for Justice and Customs with policy advice.

40. In the last four years regulators and the financial services industry have been implementing a substantial body of change mandated by the Financial Services Reform Act 2001. The introduction of compulsory superannuation (pension) contributions in 1992 has raised public interest in, and expectations of, securities markets, financial intermediaries and their regulators.

B. Information and Methodology Used for Assessment

41. The assessor³ reviewed the legal framework for securities regulation, held extensive discussions with the staff of ASIC, APRA the Treasury and participants in the banking and financial markets, and examined the current practice of ASIC's supervision of financial services providers. The assessor had the benefit of working with a comprehensive self-assessment completed by the Australian authorities, enjoyed excellent cooperation with his counterparts, and received all the information he required. The assessor extends his thanks to the staff of the various agencies and the Treasury and in particular to the staff of ASIC for their participation in the process and comprehensive self-assessment.

42. Reaching conclusions required judgments by the assessor. Securities markets differ from one country to another, as do their domestic circumstances. Furthermore, the structure of securities markets and the range of products available are changing rapidly around the world, and theories, policies, and best practices for regulation are swiftly evolving. Nevertheless, by adhering to a common, agreed methodology, the assessment should provide the Australian authorities with a reliable measure of the quality of its securities regulation in relation to the IOSCO Principles.

43. The assessment of compliance with each principle is made on a qualitative basis. A Principle will be considered to be **Implemented** whenever all assessment criteria are generally met without any significant deficiencies. **Broadly implemented** applies whenever a jurisdiction's inability to provide affirmative responses to applicable Key Questions for a particular Principle are limited to the questions excepted under the Principle's broadly implemented benchmark and, in the judgment of the assessor, such exceptions do not substantially affect the overall adequacy of the regulation that the Principle is intended to address. **Partly implemented** applies whenever the assessment criteria specified under the partly implemented benchmark for that Principle are generally met without any significant deficiencies. A Principle will be considered to be **Not implemented** whenever major shortcomings are found in adhering to the assessment criteria as specified in the not implemented benchmark. **Not applicable** will apply whenever it does not apply given the nature of the securities market in the given jurisdiction and relevant structural, legal and institutional considerations.

C. Capital Markets

44. Key facts: Australia ranks globally as the seventh biggest foreign exchange market; the \$US/\$AUS is the fourth most-traded currency pair; the Australian dollar is the sixth most-trade currency; the stock market is rated eighth largest in the world; and Australia has the tenth largest market for international debt securities.

45. The Australian Stock Exchange Limited (ASX) operates the largest equities market and clearing and settlement facilities in Australia, accounting for over 99 percent of equities trading. Average daily turnover was some \$A 3.2 billion during 2004–05, of which some

³ Richard Britton, external technical expert to the IMF

78 percent came from institutional investors. Between 1990 and 2005, the total domestic capitalization of the 1,774 companies listed on the ASX capitalization increased by more than 500 percent to \$A 975 billion at end-June 2005. The ASX in 2004 was the fourth most active globally for capital raising-US\$7.8 billion via 166 IPOs.

46. Forty-two percent of the market by value is owned by foreign institutions. It is the second largest exchange, behind Tokyo, in the Asia-Pacific region,

47. There are two main derivatives markets in Australia, the ASX and the Sydney Future Exchange (SFE). The ASX derivatives market is small compared to its equity market business and traded some 22.6 million contracts during 2004–05. The SFE, the second largest derivatives market in the Asia-Pacific region, is much larger than the ASX, with approximately 54.6 million contracts traded during 2004. Besides these exchanges, the OTC securities and derivatives markets offer liquidity across a wide range of financial products. In 2004/5, total turnover for OTC transactions exceeded \$A 58 trillion compared to total on-exchange turnover of \$A 24 trillion. Australia's share of global debt markets is around one percent, with the commonwealth government, the state/territory governments, and corporations as the three groups of issuers. The value of the commonwealth government bonds on issue has been declining since 1997, and the corporate sector is now the largest issuer of bonds in Australia, although in global terms the domestic bond market is small. As at end-March 2005, the total value of bonds on issue by domestic borrowers in Australia was approximately \$A 260 billion.

D. General Preconditions for Effective Securities Regulation

48. The preconditions for effective securities regulation are well established in Australia. Over the past two decades, Australia has implemented wide-ranging structural reforms and strengthened the frameworks for monetary and fiscal policies, which have yielded rapidly rising incomes through strong job creation and high productivity growth. The economic expansion that began in 1992 is now in its fourteenth year. The unemployment rate has fallen by 6 percentage points since 1992, supported by more flexible labor markets and welfare reforms. Inflation has remained low and net public debt has been all but eliminated, all in the context of a stable and resilient economy.

49. The financial system is relatively large and diversified. Financial system assets amount to over 300 percent of GDP. Authorized deposit-taking institutions (ADIs, consisting of banks, credit unions, and building societies) account for about half of total financial system assets. A further 23 percent of assets is held by life insurers and superannuation funds. Stock market capitalization is also relatively large, at over 100 percent of GDP.

Monetary policy framework

50. The power to determine monetary policy is conferred to the Board of the RBA by the Reserve Bank Act 1959, which requires the board to conduct monetary policy in a way that, in the RBA Board's opinion, will best contribute to the objectives of the stability of the currency of Australia, the maintenance of full employment, and the economic prosperity and welfare of the people.

51. The RBA Board conducts monetary policy independently of the Government. This is made explicit in the *Statement on the Conduct of Monetary Policy* agreed between the Treasurer and the Reserve Bank Governor in 1996 and reaffirmed and updated in 2003. The Statement includes a commitment by the RBA to hold consumer price inflation to between 2 and 3 percent, on average, over the course of the cycle. Under the Statement, the Government notes the role that disciplined fiscal policy must play in achieving the inflation objective. Monetary policy is conducted through the cash rate. Open market operations by the RBA in the money market keep the cash rate at or near an operating target decided by the RBA Board.

Currency regime

52. The Australian dollar was floated in 1983 and has become a key economic shock absorber. By moving broadly in accordance with the fluctuations in external demand and commodity prices, the exchange rate has tempered the impact of these fluctuations on Australian economic activity.

Shareholder rights

53. Listed companies are required to publish annual and half yearly audited accounts, hold annual general meetings subject to proper advice notice and are subject to a modern continuous disclosure regime. Shareholder rights are respected (5% of shareholders can call for an extraordinary general meeting) and the interests of minority shareholders are properly protected. There is a lively market in corporate control subject to oversight and intervention when necessary by ASIC and the government funded Takeovers Panel.

The legal system

54. The Commonwealth of Australia has a federal system of government which consists of the Commonwealth Government, six State Governments and two Territory Governments. The Australian Constitution (1901) establishes the Federal government and sets out the basis for relations between the Commonwealth and the States. It also provides the system of separation of powers, by providing for the Parliament, the Executive government, and the Judiciary.

55. The Constitution gives the legislative power to Parliament. Proposed legislation must be passed by both Houses of Parliament to become law. The Houses are elected by the Australian people and have equal powers, with minor exceptions. The nominal head of state is the Queen's representative in Australia, the Governor-General, who acts on the advice of the Executive government.

56. The Executive government administers the law and carries out the business of government through such bodies as government departments, statutory authorities and the defense forces. Only Parliament can pass Acts to create statute law, but these Acts often confer on the Executive the power to make regulations, rules and by-laws in relation to matters relevant to the particular Acts.

57. Australia is subject to the rule of law. The essence of the rule is that all authority is subject to, and constrained by, the law. The rule of law also means that each citizen is equal before the law; that laws must be predictable and known to all; and that laws must be fair and apply equally to the government as well as to those it governs. This includes the openness of courts, judicial independence from government and the presumption of innocence. English common law and equitable principles are the foundation of Australian laws.

58. The Australian court system has two arms: Federal and State/Territory. The constitution provides that the judicial powers of the Commonwealth are vested in the High Court of Australia. High Court judges are appointed by the Governor-General in Council, after extensive consultation and upon the basis of merit. Australian State and Territory courts have original jurisdiction under all matters brought under State or Territory laws and in other matters where the jurisdiction has been conferred on the courts by the Commonwealth parliament. Only a court may exercise the judicial power and examine the question of whether a person has contravened a law of Parliament.

The insolvency regime

59. The provisions of the Corporations Act that deal with corporate insolvency are primarily concerned with efficient procedures for the winding up of companies, the orderly realization of available assets of those companies and the equitable distribution of the proceeds to creditors, employees and shareholders. There are also provisions governing the appointment of receivers or other persons who are entitled to assume control over particular assets of the company; the reconstruction of companies; arrangements and compromises with creditors; and the voluntary winding up of solvent companies.

60. There are three types of external administration of insolvent companies: liquidation, receivership and voluntary administration. A company comes under external administration when its directors must relinquish direction of its affairs to a receiver, administrator, provisional liquidator or liquidator. Directors have to consider the options for external administration because they are under a legal obligation to cause an insolvent company to cease trading. If they fail to do so they may be held personally liable for the company's debts.

61. The ASIC Act and Corporations Act and the cooperative arrangements operated by ASIC and APRA provide a sound basis for investigating and resolving problems in financial markets and financial intermediaries.

Accounting and auditing

62. From January 2005, Australia adopted International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB). Some Australian-specific accounting standards have been retained to deal with particular issues, such as disclosure of director and executive remuneration, and concise financial reports.

63. A listed company is required to lodge with ASIC annual and half-yearly financial reports. The financial statements must be prepared in accordance with IFRS and must

provide a true and fair picture of the entity's financial position and performance. The annual accounts must be audited, with the half-yearly reports subject to either review or audit. Large non-listed companies are required to lodge annual statements with ASIC. ASIC has granted some relief to compliance with accounting standards to non-listed companies which are defined as "non-reporting companies". Exemptions from reporting requirements are also provided for small non-listed companies.

64. The accounting profession in Australia is well established and recognized as being of a high international caliber. In order to audit a listed company's financial report, the auditor must be registered under the Corporations Act. In order to be registered, ASIC must form an opinion that the applicant has the necessary qualifications, satisfies the auditing competency standard and is capable of performing the duties of an auditor. Oversight of auditors is provided by ASIC and the professional accounting bodies. Disputes over the behavior of auditors are decided by the Companies Auditors and Liquidators Disciplinary board. There are currently 6110 registered auditors. Auditing standards in Australia are established by the Auditing and Assurance Standards Board (AUASB), and are based on International Standards on Auditing (ISAs). The Financial Reporting Council oversees the AUASB and the AASB.

E. Principle-by-Principle Assessment

Principles related to the regulator

65. Although currently operationally independent and appropriately funded there are several issues concerning the independence of ASIC, which should be resolved. Consultation on new regulatory issues is presently extensive but there may be a case for the authorities and the private sector working together to improve even further its effectiveness.

Principles related to compliance and enforcement

66. Apart from the acknowledged weakness in the AML/CFT area, where Australia legislation has failed to keep pace with the latest international developments (and where change is imminent), the powers given to ASIC under the law are comprehensive and ASIC's use of them is effective and credible.

Principles related to information sharing and cooperation

67. As a signatory to the IOSCO Multilateral MOU (MMOU) for the exchange of information ASIC's commitment to the highest standards in this area is undisputed. Improvements as to timeliness have already been identified as necessary by the authorities and change is imminent. Subject to review of the effectiveness of those changes, further improvement may prove necessary.

Principles related to issuers

68. The mix of corporate law and securities regulation appears to work well. ASIC is frequently called upon to facilitate takeover bids via use of its exemptive relief powers as

well as to prevent misbehavior. It would be helpful to the market, however, if ASIC were to collate and publish the advice it has given in recent years on prospectus disclosure.

Principles related to collective investment schemes

69. Operators of collective investment schemes are subject to a comprehensive licensing system and to risk-based supervision. Greater specificity could usefully be introduced into the provisions governing the conduct of fund managers when trading on behalf of their clients. The ongoing record of the industry regarding unit pricing errors should be monitored closely to see whether the guidance recently published by ASIC and APRA has, in fact, minimized what has clearly been a major and longstanding problem.

Principles related to market intermediaries

70. Market intermediaries are subject to a comprehensive licensing system and risk-based supervision. Detailed regulations govern the firm/client relationship but ASIC's risk-based capital requirements do not fully match international best practice

Principles related to secondary markets

71. The Minister is responsible for licensing exchanges (market operators) and clearing and settlement facilities (CSFs); their rule changes must be submitted to him and are subject to a disapproval process. In practice, day-to-day supervision is carried out by ASIC, which also conducts an annual review of their compliance with their obligations. It may, therefore, be appropriate to review the original case for the Minister retaining these powers. ASIC's risk-based capital requirements for large exposures are not sophisticated enough for an OTC market of growing size and complexity.

Table 7. Principle-by-Principle Assessment of Observance of the IOSCO Objectives and Principles

Principles Relating to the Regulator	
Principle 1.	The responsibilities of the regulator should be clear and objectively stated.
Description	<p>The Australian Securities and Investments Commission (ASIC) regulates the provision of financial services. The ASIC Act 2001 (the Act) sets out the functions and powers conferred upon ASIC by other legislation:</p> <ul style="list-style-type: none"> • Corporations Act 2001 • Insurance Contracts Act 1984 • Superannuation (Resolution of Complaints) Act 1993 • Life Insurance Act 1995 • Retirement Savings Accounts Act 1997, • Superannuation Industry (Supervision) Act 1993. <p>The Corporations Act (CA) is the most important Act with respect to the regulation of financial intermediaries. The Financial Services Reform Act 2001, (FSRA), which came into effect in 2002 made numerous fundamental changes to the CA, including the introduction of a new licensing system, and financial intermediaries have had to adapt their compliance to substantial regulatory change. Further changes or refinements to the FSRA are (at the time of writing) in the process of being introduced, which will continue to impose transitional costs and other pressures on intermediaries</p>

	<p>The responsibilities of ASIC are clearly defined and transparently set out.</p> <p>The Australian Prudential Regulation Authority (APRA) is the prudential regulator of banks, building societies, credit unions, insurance companies, and friendly societies. Financial services providers that do not fall within those categories of firms such as financial advisers, and non-bank securities and derivatives brokers and dealers are subject to capital requirements and other prudential-type regulation by ASIC. These requirements are targeted at seeking to ensure that a financial services provider:</p> <ul style="list-style-type: none"> • has sufficient financial resources to conduct its affairs in accordance with its statutory obligations • has a financial buffer sufficient to limit the risk of a disorderly or non-compliant wind-up if the business fails • is structured so as to incentivise its owners to comply through fear of financial loss <p>Section 1(2) of the Act requires ASIC to <i>'strive to maintain, facilitate and improve the performance of the financial system and entities within that systemreducing business costs...'</i> and to <i>'promote the confident and informed participation of investors. Section 12a(2) describes one of ASIC's functions as '... monitoring and promoting market integrity and consumer protection in relation to the Australian financial system.'</i></p> <p>ASIC does not have the power to issue legally enforceable rules or regulations on financial services providers or corporations. The Minister issues regulations. They do not require Parliamentary approval although Parliament has the right to disapprove them. The function of ASIC is to implement those regulations and the accompanying legislation. ASIC can and does issue Policy Statements that provide guidance on how ASIC will interpret the regulations and the legislation that it administers. ASIC also has the statutory power to grant exemptive relief from some parts of the CA. The power is broad. ASIC can exempt a person or a class of person from certain provisions of the CA. It can declare that a chapter of the CA applies as if a specified provision were omitted, modified or varied. A class order relief, with a Regulatory Impact Statement where required, must be tabled in each House of Parliament and can be disallowed by negative resolution. ASIC has published a Policy Statement in which it sets out the guidelines it imposes upon itself to ensure that it exercises the power consistently. It relies to a great extent on precedent. All policy statements, practice notes, individual relief instruments and class orders must be published in the ASIC Gazette and are posted on the ASIC web site.</p> <p>Cooperation and the exchange of information between ASIC and APRA is seen by both parties as essential for the success of the functional regulation approach. An MOU was signed between ASIC and APRA in June 2004 which provides a framework for cooperation at all levels by utilizing appropriate gateways for the exchange of information for which the agencies otherwise have an obligation to keep confidential. The obligations are expressed as a set of positive obligations of 'will notify', sometimes modified by use of 'best endeavors' terminology.</p> <p>There is an agreement to seek to preserve the confidentiality of shared information although if the receiving agency is permitted by law to disclose the information, the MOU does not appear to prevent it from so doing. Since signing the MOU the number of occasions when information has been exchanged has increased significantly.</p>
Assessment	Implemented
Comments	<p>ASIC's lack of rule making powers is not unique among IOSCO members, though the extent of the separation between ASIC's advisory role and the Minister's power to make decisions on new regulations places it towards one end of the spectrum among advanced economies. Domestically, ASIC has less rulemaking power than APRA.</p> <p>ASIC's power to grant exemptive relief is, therefore, an important tool that enables ASIC to</p>

	address unintended consequences of the law or circumstances where the objectives of the law would be defeated by strict adherence to the legislation. In practice it appears to have become fully embedded in business decision-making. For example, almost all corporate takeovers require ASIC to use the power to facilitate the transaction.
Principle 2.	The regulator should be operationally independent and accountable in the exercise of its functions and powers.
Description	<p>ASIC is part of the executive branch of government and is responsible to the Treasurer ('the Minister') who in turn is answerable to Parliament for the actions of ASIC. The level of operational independence today appears high.</p> <p>However, ASIC operates in an environment in which several powers granted the Minister, while individually of limited significance, cumulatively can be said to have a direct impact on ASIC's operational independence.</p> <p>First, the Minister may give ASIC a written direction about policies it should pursue, or priorities it should follow in performing or exercising any of its functions or powers under the corporations legislation (s12(1) ASIC Act). The Minister has used these powers only once, in 1992. ASIC must comply with such a direction. Although such a direction must be public, and is therefore subject to scrutiny, depending on the terms of such a direction it could require ASIC to deploy its human and financial resources in ways contrary to those it would itself have chosen to do.</p> <p>Second, although the Act states that the Minister must not give a direction under subsection (1) about a particular case, the effect of that constraint is diluted by a further power of the Minister to direct ASIC to carry out an investigation into certain defined matters if he believes it is in the public interest for such an investigation to be carried out (s14 ASIC Act). ASIC must comply with the direction and prepare a report, which must be given to the Minister who may publish it whole or in part. The matters on which a direction to investigate can be made are wide ranging and include the affairs of a corporation and dealing in financial products.</p> <p>Third, ASIC is funded out of the Government's budget as approved by Parliament. There is a formal 'outcomes and outputs' framework for setting ASIC's budget with the objective being to provide sufficient funds to obtain 'a fair and efficient market characterized by integrity and transparency and supporting confident and informed participation of investors and consumers'. Although this is subject to inter-ministerial negotiations within the constraint of the overall budget there are no indications that currently the funding is not stable or reliable. Revenues from corporations fees and charges exceeds the funding provided to ASIC, as the revenues are intended to cover other costs including compensation payments to the States and notional allocations to other bodies involved in the corporate regulatory scheme. While the scheme ran at a cumulative loss for many years, that trend is now beginning to reverse. This cost recovery regime is scheduled for review in 2007/8 as part of a broader program of reviewing cost recovery by the Government. The composition of ASIC's funding is also changing. While ASIC's funding has increased in recent years, much of this is related to expansions of ASIC's regulatory role and funding for high-cost enforcement actions (for example the HIH investigation). As such these increases may not assist ASIC in meeting an increasing demand for and complexity of core functions. Any change to the financial management structure of ASIC arising out of the Uhrig review should be carefully assessed to avoid any unintentional impacts on ASIC's operational capacity or independence</p> <p>The appointment process of members of the Commission is fully compliant with the Principle. The members are appointed by the Minister (technically by the Governor-General on the advice of the Minister). The Minister is obliged to appoint only persons with relevant knowledge or experience in relevant fields. Members are appointed for terms of up to 5 years but may be reappointed. There are appropriate constraints in the Act on the Minister's (technically the Governor-General's) powers to dismiss a member.</p>

	<p>The Act provides that ASIC, the Commissioners and its staff are protected from legal liability in relation to an act done or omitted in good faith in performance of their functions and exercise of powers under the law (s246 ASIC Act).</p> <p>As to accountability, ASIC operates within a highly transparent framework and is publicly accountable for the discharge of its obligations. It is required to publish a comprehensive annual report, including audited accounts, which is tabled in Parliament. The Joint Parliamentary Committee on Corporations and Financial Services has oversight of ASIC (and the Takeovers Panel); the Senate Estimates Committee enquires into ASIC's use of its budget allocation; other ad hoc Parliamentary committees can review ASIC's activities. Class order reliefs must be tabled in each House of Parliament and can be disallowed by negative resolution. The Freedom of Information Act provides individuals with the right to see any document held by ASIC, subject to certain exceptions. Persons subject to a decision by ASIC are entitled to a hearing before that decision is made. Reasons for a decision must be provided in writing. All ASIC decisions are subject to judicial review. In addition a person can have his case referred to the Administrative Appeals Tribunal (AAT), which is empowered to conduct a review on the merits and remake the decision. The Minister consults publicly on new regulations as does ASIC on new policy initiatives. Generally, such consultation is accompanied by a Regulation Impact Statement.</p>
Assessment	Broadly implemented
Comments	<p>The official position on the Ministerial direction and investigation powers is that they are a necessary fallback provision for use if the regulator should prove unresponsive to proper public concern about a matter. This seems unlikely as is demonstrated by the fact that the direction power has been used only once, 17 years ago, and the investigation power has never been used.</p> <p>Although there is no current evidence that ASIC is not fully funded for the work it seeks to undertake, the method of funding raises two issues. The first is that ASIC's reliance on the government for its entire income is a source of vulnerability should the economic situation require a cut in the governments budget (as happened during the period 1995 to 1997 when ASIC had to make more than 300 staff redundant and close down a major program). ASIC today still employs the same number of staff that it did in 1994 despite having assumed substantially increased responsibilities. The Wallis enquiry recommended that ASIC be funded by a levy as is APRA. That may be inappropriate given that only a small proportion of ASIC's income and expenditure derives from the securities industry. Consideration should, however, be given to developing alternative sources of funding for a proportion of ASIC's work. The second issue arises from the growing proportion of ASIC's funding that is tied to specific purposes and of limited duration. Over time, if this trend continues, the practice will increasingly limit ASIC's operational independence.</p> <p>The Government's decision in principle to implement the recommendation of the Uhrig Review that ministers should issue Statements of Expectation to statutory authorities including ASIC will also need careful nuancing to avoid creating the impression that the Minister is seeking to fetter ASIC's powers to determine and implement its own agenda under the law.</p>
Principle 3.	The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.
Description	<p>ASIC has an appropriate range of powers and other regulatory tools that fully reflect the fact that it has civil and criminal jurisdiction and extensive and diverse responsibilities as regulator of the corporate sector, markets regulator and regulator of financial services providers. In the case of financial services providers ASIC has comprehensive powers of licensing (including the imposition of conditions on a license), supervision, inspection, investigation and enforcement. Funding is currently adequate and ASIC is able to allocate funds as it thinks appropriate except for special purpose funds. See Principle 2 for forward-looking comments on funding issues.</p> <p>With regard to staffing ASIC has found it relatively easy to attract a high quality graduate intake but more difficult to retain them for longer than three years—that is beyond the point at which they became fully productive. Nevertheless, ASIC has been able to maintain a reasonable level of</p>

	turnover within the normal constraints experienced by government agencies. Both practices are in the process of change and the turnover rate has reduced from over 20 percent to around 12 percent. The additional costs related to recent salary increases have been funded out of the existing budget allocation. ASIC provides extensive funded opportunities for professional training. Secondees from industry, currently primarily from insolvency practitioners, are also used.
Assessment	Implemented
Comments	For detailed discussions on powers see the following Principles, particularly Principles 8 and 9.
Principle 4.	The regulator should adopt clear and consistent regulatory processes.
Description	<p>To ensure that ASIC consistently operates within its procedural rules and regulations, ASIC has developed policy statements that set out how it administers certain aspects of the CA and the ASIC Act. Practice notes have been issued by ASIC that guide staff on compliance and reporting matters. These policy statements and practice notes are publicly available on the ASIC website.</p> <p>Neither the Minister in framing regulations, nor ASIC, in deciding how it will enforce regulations, or when and why to grant exemptive relief has an obligation under the law to consult with those who may be affected by the decision or the public more generally. But there is a strong tradition, and public presumption, that consultation will take place and in practice that is what happens. The Minister and ASIC will generally provide a Regulation Impact Statement alongside any consultation document.</p> <p>ASIC consults extensively on new policy proposals with the public, with industry bodies and where appropriate with other regulators. The consultation period is normally three months and is usually accompanied by a Regulation Impact Statement (RIS). The Minister has adopted the same policy with regulations for which he and not ASIC has sole responsibility.</p> <p>The Freedom of Information Act provides individuals with the right to see any document held by ASIC, subject to certain exceptions. Persons subject to a decision by ASIC are entitled to a hearing before that decision is made. Reasons for a decision must be provided in writing. General criteria, for example governing the revoking of a license, are set out in the CA. The ASIC Act imposes appropriate confidentiality constraints on ASIC. In addition a person can have his case referred to the Administrative Appeals Tribunal (AAT) that is empowered to conduct a review on the merits and remake the decision. All ASIC decisions are subject to judicial review.</p> <p>ASIC plays an active role in promoting investor education through means such as the FIDO consumer protection website and its international award winning 'Your Money' publication. In June 2005 the Treasury established and funded the Financial Literacy Foundation to raise awareness of financial matters, to incorporate financial literacy programs in schools, to set up a financial literacy web portal, to carry out research into public attitudes to money management and to develop best practice in raising financial awareness. This is a significant commitment to investor education.</p>
Assessment	Implemented
Comments	There might be room for improvement in the consultation process, though that may require at least as much change from the private sector as from the authorities. For the authorities, subject to any constraints imposed by law, consultation might start earlier in the policy formulation process and be less formal at that stage, with more use of discussion papers setting out the perceived problem, the various options and an attempt to evaluate their various likely economic impacts even at that early stage. For the private sector there would need to be an enhanced commitment to involve front line operational, compliance and IT staff at this early stage to get realistic feedback to the various options that might be for discussion.
Principle 5.	The staff of the regulator should observe the highest professional standards including appropriate standards of confidentiality.
Description	All staff is required to adhere to Australian Public Service Values and the Australian Public

	Service Code of Conduct which set out the highest standards of behavior including requirements to behave honestly and with integrity, to disclose or avoid conflict of interest, not to make improper use of inside information. As regards holding and trading in financial instruments ASIC operates on the basis of full disclosure rather than restrictions. ASIC and its staff are also subject to the requirements of the Privacy Act in handling personal information. The obligation on ASIC to provide procedural fairness applies to staff when making decision that may adversely affect a person's rights, etc. The Public Service Act provides for a range of sanctions for breach of its requirements (including breaches of the Code of Conduct) from reprimand to termination of employment. All staff are subject to these sanctions
Assessment	Implemented
Comments	There has been only one instance of a member of staff abusing his position of trust for personal gain and that occurred some fifteen years ago. There are from time to time complaints about staff, generally from persons under investigation. These complaints are examined internally and none have to date been assessed as well founded.
Principles of Self-Regulation	
Principle 6.	The regulatory regime should make appropriate use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, and to the extent appropriate to the size and complexity of the markets.
Description	ASIC considers that there are no SROs in Australia since ASIC is the sole licensing authority for financial services providers. Although they do not have formal SRO status under Australian law, entities licensed as markets (AMLs) and clearing and settlement faculties (CSFLs) conduct certain self-regulatory functions such as imposing eligibility rules on participants, trading rules and disciplinary rules and sanctions.
Assessment	Implemented
Comments	IOSCO has indicated that there are no criteria for this Principle
Principle 7.	SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.
Description	The regulatory functions carried out by Australia's exchanges and their regulation by ASIC are described in Principles 25 and 26
Assessment	Implemented
Comments	
Principles for the Enforcement of Securities Regulation	
Principle 8.	The regulator should have comprehensive inspection, investigation and surveillance powers.
Description	<p>ASIC has a comprehensive range of powers that can be exercised for cause or on a routine basis.</p> <p>It is a criminal offence to carry on a business of providing financial services without having first obtained an Australian Financial Services License (AFSL) except as a representative of a person who holds an AFSL (s911A CA). Sanctions are a fine of A\$ 22,000 or 2 years in prison or both.</p> <p>Under s29 ASIC Act ASIC has the power to inspect books that an entity is required to keep as required by the corporations legislation without prior notice. Failure by a person to provide access to such records in their possession is a strict liability offence.</p> <p>ASIC may also, without prior warning serve a notice requiring production of books upon all corporations including exchanges and clearing houses in relation to a broad range of reasons, including the affairs of the corporation, securities and derivatives traded on an exchange and the provision of financial products and financial services generally. 11,000 notices were issued in 2004. (Sections 31,32A, 33 ASIC Act).</p> <p>If ASIC is satisfied that a person has, without reasonable cause, failed to comply with these sections of the Act it may refer the failure to the court, which may enquire into the case and order the person to comply. Failure to do so may result in the person being found guilty of contempt of</p>

	<p>court for which the punishment can include a fine or imprisonment.</p> <p>If books are not produced, ASIC may apply for and execute a search warrant (s35,36 ASIC Act and other legislative Acts). ASIC can also apply for a search warrant under the provisions of the Crimes Act, which will be executed with the police in attendance. It does not require an initial serving of a notice by ASIC, thereby facilitating seizure of articles that might otherwise be removed or destroyed.</p> <p>The Corporations Act 2001 (CA) gives ASIC further powers to carry out surveillance. For example, ASIC has the power to require persons, whether or not carrying on a financial service business to provide certain information concerning the acquisition or disposal of financial products, such as the identity of the person for whom the acquisition or disposal was effected (where relevant) and the identity of the counterparty. Financial services license holders and operators of exchanges and clearing houses are required by law to provide ASIC with assistance to perform its functions including but not limited to assessment of their compliance with financial services laws.</p> <p>The CA also imposes extensive record keeping requirements on all corporations and financial services licensees. Records must be retained for seven years.</p> <p><u>AML/CFT</u></p> <p>With the exception described below, there are no obvious gaps in ASIC's powers. With regard to anti-money laundering and combating the financing of terrorism, Australia has enforced anti-money laundering legislation since 1988, (Financial Transaction Reports Act 1988 (FTR)) but the requirements are limited (largely to suspicious transaction reporting) and it applied only to 'cash dealers' (for example, financial institutions, insurance companies, securities dealers and the gambling sector). The October 2005 FATF Mutual Evaluation Report on Australia highlighted these and other significant limitations in the governing legislation and in its enforcement, which under the functional approach to regulation adopted by Australia is carried out by the Australian Transaction Reports and Analysis Centre (AUSTRAC). ASIC has no power to impose comprehensive customer due diligence requirements for the purposes of combating money laundering or funding of terrorism on AFSL holders as required by the FATF 40+9 Recommendations. Neither ASIC (nor AUSTRAC) has an explicit power to revoke an AFSL or to remove an individual from the management of a license holder for breach of the FTR. It is possible that ASIC could achieve this indirectly, based on a breach of obligations imposed on AFSL holders to comply with financial services laws, including the FTR. This has not been tested. ASIC has not imposed any sanctions for AML/CFT failings. Under the IOSCO methodology this requires a 'not implemented' assessment</p>
Assessment	Not implemented
Comments	The Australian Government is currently reviewing its anti-money laundering regime in the light of the FATF Report and publication of a draft bill was released on 16 December 2005 for public consultation. Elsewhere, there are certain restrictions in the uses ASIC can make of material obtained following the execution of a search warrant under the Crimes Act. ASIC is seeking an amendment to the law in this respect.
Principle 9.	The regulator should have comprehensive enforcement powers.
Description	<p>ASIC has the necessary powers to enforce compliance with the laws and regulations relating to securities activities.</p> <p>ASIC has a general power to commence investigations where there is a suspicion of a contravention of the CA or any other law of the Commonwealth of Australia or a State or Territory within the Commonwealth which concerns the management or affairs of a corporation or collective investment scheme (known in Australia as managed investment schemes) or involves fraud or dishonesty in regard to the above or to financial products.</p>

	<p>ASIC has the power to commence civil proceedings for a wide range of offences. Civil penalty orders may be sought for a declaration, disqualification or compensation. ASIC can also apply for various restraining or directing orders and can seek a fine of up to \$A 200,000 for an individual and up to \$A 1 million for a corporation.</p> <p>ASIC may also bring criminal proceedings, though in compliance with the prosecution policy of the Commonwealth Government ASIC undertakes only minor summary prosecutions. Other cases are referred to the Commonwealth Director of Public Prosecutions (CDPP). ASIC also has administrative powers such as banning a person from providing financial services and issuing infringement notices (which impose a financial penalty) for contravention of the continuous disclosure obligations under the CA. It can issue stop orders where defective disclosure is made to retail investors through mandatory product disclosure statements (PDS) and on the sale of securities where the offer document is non-compliant.</p> <p>ASIC can order the suspension of trading on an exchange of a security or derivative.</p> <p>ASIC can negotiate and accept an ‘enforceable undertaking’ from a person which, in the event of a breach, permits ASIC to obtain a court order to compel on-going compliance without having to establish a contravention of the legislation originally the subject of the enforceable undertaking.</p>
Assessment	Implemented
Comments	<p>ASIC lacks the power to impose an administrative fine except through the use of recently introduced infringement notices for breaches of the continuous disclosure requirements by listed entities. In these cases payment is not mandatory but failure to pay may trigger civil penalty action. This power can be exercised against individuals as well as corporations. The lack of a more extensive power to fine under administrative processes is not significant given the range of alternative powers available.</p> <p>Although the CDPP can choose whether or not to prosecute, the preparation of a brief by ASIC usually includes discussion with the CDPP, which limits the risk of the CDPP declining to act on a case ASIC has referred to him.</p> <p>When ASIC takes civil penalty proceedings seeking management banning orders, judges impose rigorous procedural burdens on ASIC. The courts have taken the view that banning a person from managing a corporation is a penalty (as well as a protection for the public). Unlike in a purely civil case a defendant is not required by the courts to put on evidence and is not compelled to give discovery to ASIC, prior to ASIC putting its case before the court. In addition, courts have held that in these proceedings ASIC must establish its case to a standard of proof slightly higher than the balance of probabilities (but below that of beyond reasonable doubt). This can also create difficulties for ASIC.</p> <p>Enforceable undertakings on the Australian model have demonstrated their effectiveness in a number of high profile cases. In particular they focus the attention of senior management in corporations that have agreed to such an undertaking on the need to ensure ongoing compliance and have provided an effective basis for obtaining compensation for clients.</p>
Principle 10.	The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.
Description	<p>Judged on the public results of its enforcement activities ASIC appears to use its powers in an effective way. Its 2004/5 annual report notes that in that year it had 27 criminals jailed for a total of 96 years and 23 others convicted; obtained \$A 119 million in recoveries, costs, compensation and fines with more than \$A 5 million frozen; banned 58 people from managing corporations or offering financial services; disciplined 12 company auditors and liquidators for misconduct and wound up 60 companies. Within those numbers it jailed two superannuation (pension) scheme promoters, halted 5 suspect schemes involving at least \$A 14 million and closed down 76 other</p>

	<p>illegal schemes involving 2150 investors and A\$220 million. It also secured five criminal convictions and 2 civil penalty orders for insider trading and market manipulation.</p> <p>As of April 2005 there were 4091 AFSL license holders and over 45,000 ASIC registered authorized representatives, or persons authorized to provide financial services for the license holder. As to inspections, ASIC favors risk-based inspection programs over periodic inspections although it carries out some of the latter. It has developed an entity-based risk scoring system, STIRS, to assist the licensing process which includes risk factors such as information from the license application, the regulatory history of the entity and industry or product specific risks. The surveillance department has developed a similar risk based process for focusing resources and thought is being given to combining the best features of the two systems. Factors relevant to targeting include the frequency of complaints against the licensee, notification by the licensee of significant breaches of the financial services laws and ASIC's use of campaigns aimed at areas of emerging risk which ASIC believes merit proactive analysis.</p> <p>In practice, in the year 2004/5 ASIC conducted 938 compliance or compliance related visits and 865 campaign-based visits which, even allowing for some repeat visits, amounts to more than 40 percent of licensees. Although most visits have a targeted agenda they provide an opportunity for inspectors to observe the operations of a licensee and to form a view, albeit largely subjective, of its capacity to meet its obligations. Compliance visits may result from complaints by clients, for example alleging churning of a client's account. Campaign-based visits may arise from broader concerns such as the 2003 campaign to assess the independence of research analysts following the 'dotcom' problems in the US.</p> <p>As regards on-exchange market surveillance, primary responsibility, and a licensing condition, for monitoring day to day security and derivative market activity lies with the market operators, principally the Australian Stock Exchange (ASX) and the Sydney Futures Exchange (SFE). Both apply a range of automated techniques to this function. Unusual transactions are referred to ASIC. ASIC also monitors the equity market using electronic systems, with different parameters to ASX, to supplement the work of the exchanges.</p> <p>ASIC received almost 10,000 investor complaints from the public in 2004/5, an increase of 7 percent over the previous year They are dealt with in ASIC by a dedicated team numbering 100. Increasingly, ASIC will seek a resolution with the licensee or company although some may result in significant regulatory action. Additionally licensees providing financial services to retail clients must have an internal dispute resolution mechanism, which meets the requirements of the CA, and be a member of an ASIC approved external dispute mechanism.</p>
Assessment	Implemented
Comments	<p>ASIC's status among the general public appears to be growing judging by newspaper articles and references in the specialized and even popular mass-audience TV programs, which may account for the rise in complaints received. ASIC believes its staff is well regarded in the industry and no negative comments were received during the assessment. There is some criticism of some of ASIC's methodologies such as 'shadow shopping', and some concerns expressed that ASIC places too much emphasis on procedural matters under the law, but these criticisms are not fundamental.</p> <p>Most of ASIC's powers in this area have been in force since 1990 and are well tested. Notices requiring the production of books and records are rarely if ever challenged.</p> <p>Although the risk based approach to surveillance has been developed with a view to being the primary mechanism by which the activities of licensees are monitored, a clearer articulation of objectives and the identification and adoption of a comprehensive suite of tools for identifying and prioritizing risk would be helpful in maximizing its implementation.</p>
Principles for Cooperation in Regulation	

Principle 11.	The regulator should have authority to share both public and non-public information with domestic and foreign counterparts.
Description	<p>Australia is signatory of the IOSCO Multi-lateral Memorandum of Understanding (MMOU), which implies that IOSCO's screening committee considered that Australia's legal and regulatory framework provides for effective cooperation and coordination with foreign regulators.</p> <p>Section 127 ASIC Act authorizes ASIC to share public and non-public information with other domestic authorities responsible for financial sector supervision. The information may be related to matters of investigation and enforcement, licensing, approvals and surveillance activity.</p> <p>ASIC can also provide public and non-public information to foreign regulatory authorities under the Act if the Chairman is satisfied that it will assist the foreign authority to perform its powers or functions conferred by a law in that country s127(4)(c). The Chairman may, and as a matter of practice does, impose conditions to be complied with in relation to disclosure under this latter process.</p> <p>ASIC may release information in its possession to a foreign regulator without the need for external approval. If ASIC needs to use compulsory powers to obtain information, documents or evidence for transmission to a foreign regulator the foreign regulator must make a request under the Mutual Assistance in Business Regulation Act 1992 (MABRA) and ASIC must first obtain the consent of the Attorney General. If the request concerns criminal matters the foreign regulator must apply directly to the Attorney General under the Mutual Assistance in Criminal Matters Act 1987 (MACMA). In order for a request for assistance under MABRA to be granted it is normally necessary for foreign regulator to be required to state that the information is not sought for the purpose of a criminal investigation. If at some point after the information has been transmitted the requesting authority has to pass the information on to a criminal authority it is sufficient for the requesting authority to notify ASIC of that fact and request ASIC to confirm that the Attorney-General consents to the on-release of information to the criminal authorities.</p> <p>The standard conditions that ASIC imposes on confidential information released to foreign regulators (pursuant to section 127 of the Australian Securities and Investments Commission Act) are as follows:</p> <ul style="list-style-type: none"> • A requirement that the foreign regulator takes reasonable steps to maintain the confidentiality of the information released; • If the foreign regulator propose to release it to any other parties, such as another regulator or law enforcement agency, that ASIC's consent be sought prior to doing so; • The information may only be used or further disclosed by the foreign regulator for the purpose of enabling or assisting it to perform or exercise one or more of its functions or powers and for no other purpose. <p>Where the confidential information is released pursuant to the IOSCO MMOU, the first two conditions are not imposed; rather ASIC refers in the release to the specific requirements in the MMOU that address these issues.</p> <p>The confidentiality condition is imposed given that the confidential information that is released to the foreign regulator is information that ASIC itself is under an obligation to take reasonable measures to protect from unauthorized use or disclosure (section 127(1) ASIC Act). In addition, it may also be information that ASIC has obtained in the course of conducting a concurrent investigation for example, and it may prejudice ASIC's own investigation if this information was inadvertently disclosed.</p> <p>The condition requiring ASIC's consent for the confidential information to be released to another regulator, is in recognition that section 127 of the ASIC Act, provides for the release of information to a particular foreign regulator. In the event that it is intended for the information to</p>

	<p>be shared with another regulator, then this should be disclosed by the foreign regulator in the initial request or consent sought at a latter stage. There has not been a recent case where ASIC has refused its consent to the provision of the confidential information to another foreign regulator, where this consent has been sought.</p> <p>In the case of requests for assistance under the MMOU, the MMOU contemplates that a foreign regulator should be able to release information to a criminal authority with jurisdiction in relation to securities offences or a Self Regulatory Organisation. As a consequence, ASIC treats requests for assistance from foreign regulators from jurisdictions where criminal authorities and/ or SROs have a role in securities regulator, as being a request for the provision of confidential information from the foreign regulator and the criminal authority and the SRO. As a consequence, it is not necessary for ASIC to impose this standard condition.</p> <p>The final standard condition merely specifies that the foreign regulator can only use the confidential information in furtherance of its statutory functions or in exercising its statutory powers. Again, this condition recognizes that the confidential information is released to the foreign regulator on the basis that it will enable or assist the regulator to perform a function or exercise a power conferred by a law that it is administering (section 127(4)(c) ASIC Act).</p>
Assessment	Implemented
Comments	For commentary on an outstanding issue concerning responding to requests for overseas regulators see Principle 13.
Principle 12.	Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.
Description	ASIC has the power to enter into information sharing agreements with any domestic or foreign securities regulator. To date, ASIC has entered into MOUs with a number of domestic regulators (including APRA, RBA, the competition authority (ACCC) and the taxation office) government departments and non-government co-regulatory bodies such as the stock and derivatives exchanges, ASX and SFE. ASIC has also entered into about 35 bilateral MOUs with foreign regulatory authorities. It is also a signatory of the IOSCO Multilateral MOU, which facilitates the detection and deterrence of cross-border misconduct and assists ASIC to enforce, monitor and administer licensing and surveillance activities across borders. ASIC is also able to assist domestic or foreign regulators in accordance with the ASIC Act even if there is no formal MOU in place between ASIC and the relevant regulator.
Assessment	Implemented
Comments	
Principle 13.	The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers.
Description	<p>If ASIC holds information, which is publicly available, ASIC can provide this information to a foreign regulator as a matter of course.</p> <p>Otherwise, ASIC can share confidential information it has in its possession with foreign regulators under s127(4)(c) ASIC Act. Subject to the approval of the Attorney General, ASIC can also compel the production of information, documents or evidence to assist a foreign regulator administer or enforce a foreign business law under MABRA; and take evidence require the production of documents, have things seized, forfeited or confiscated, recover pecuniary penalties or restrain dealings in property in respect of foreign serious offences under MACMA.</p> <p>It can take some time to provide assistance, even for a relatively simple request such as for copies of a stockbroker's books and records. Delays of up to 12 months have been known in the past although the current average is 2-3 months. A request for assistance under MABRA has to be made according to a detailed checklist required by the legislation. Resource constraints in the AGs department and perhaps a natural inclination to priorities major criminal investigations can add to the problem.</p>

Assessment	Implemented
Comments	<p>The problem of timeliness can limit the effectiveness of the assistance given. The Australian authorities appear to have recognized that this is not conducive to the efficient conduct of cross border investigations and will shortly transfer responsibility for operating MABRA from the Attorney General's department to the Treasury. It is hoped that the assignment of dedicated staff will reduce the response time to about two weeks. In certain circumstances, for example where a foreign regulator needs the information in order to freeze a bank account as part of a civil enforcement action, two weeks may still be too slow. The efficiency and effectiveness of the arrangements should be kept under review and consider be given in due course whether to take the further step of adopting international best practice and giving ASIC the authority to acquire the information and transmit it directly to its counterparts overseas without first having to seek the Minister's permission.</p> <p><i>Information Sharing–MABRA</i></p> <p>As to the conditions that are generally imposed by Attorney General, when authorizing the exercise of powers under the MABRA, the MABRA Act provides that ASIC can make recommendations to the Attorney General as to what conditions ought to be imposed. Section 7(2) of MABRA provides guidance regarding the subject matters that such conditions can address:</p> <ul style="list-style-type: none"> • Confidentiality of the information provided; • The storage of, use of, or access to, the information provided; • Copying, returning or disposing of copies of documents provided in compliance with the request. <p>It should be noted that the conditions that can be imposed are not limited to those referred to in section 7(2) of MABRA, nor is there a requirement for these suggested conditions or any other conditions to be imposed at all.</p> <p>A review of the conditions imposed by the Attorney General in respect of the MABRA request considered in the last 5 years, indicates that if conditions are imposed they tend to require that the:</p> <ul style="list-style-type: none"> • Foreign regulator not pass the information provided to a criminal authority without notifying the Attorney General or his delegate; or • The information provided is not to be used as evidence in criminal proceedings without the prior consent of the Attorney General or his delegate. <p>The rationale for these conditions is the recognition that, while there is some scope for information obtained under MABRA to be used for criminal investigative purposes, that MABRA primarily governs assistance to regulators exercising civil jurisdiction. Where a request for assistance concerns a criminal matter then it is more appropriate for that request to be dealt with under the MACMA Act. The conditions that are generally imposed, therefore, ensure the integrity of the MABRA/ MACMA procedures.</p> <p><i>Information Sharing–MACMA</i></p> <p>The MACMA Act provides that the Attorney General may impose conditions on the assistance provided under the Act.</p> <p>The conditions that the Attorney General generally imposes are:</p> <ul style="list-style-type: none"> • Information, documents or evidence provided to the foreign criminal authority will only be used for the purpose for which it was provided; • The information, documents or evidence provided to the foreign criminal authority will not

	<p>be released to another authority without the consent of the Attorney General.</p> <p>There may be additional conditions imposed, depending on the circumstances of the case.</p>
Principles for Issuers	
Principle 14.	There should be full, accurate and timely disclosure of financial results and other information that is material to investors' decisions.
Description	<p><u>Offers of securities</u></p> <p>There is a general provision in the CA that states that an offer of securities requires disclosure to investors (s706). The required disclosure may, depending on the legislative requirements, take the form of a prospectus, short form prospectus, profile statement or offer information statement. In relation to derivatives, which fall within the broad definition of 'financial product' a separate disclosure regime applies. An issue of derivatives is to be accompanied by a product disclosure statement (PDS), similar to the requirements for collective investment schemes. A short form prospectus may be used for any offer. ASIC publishes a list of prospectuses filed with it and where copies can be obtained. Instead of setting out material that has been lodged with ASIC the short form prospectus may refer to this material and inform the reader of their right to obtain a copy free of charge. With the approval ASIC a profile statement may be sent out with offers without a prospectus. A prospectus must still be lodged with ASIC and provided to investors on request without charge. An offer information statement may be used instead of a prospectus if the amount of money to be raised by the issue plus amounts previously raised by the entity under an information statement is A\$5 million or less. Exempt offerings include offers to less than 20 investors or for less than A\$2 million in a 12 month period and offers to sophisticated investors (defined as an offer where the minimum amount payable by an investor is A\$500,000).</p> <p>Section 710 of the CA imposes a general test that the contents of a prospectus are to contain all information that investors and their advisers would reasonably require to make an informed assessment of matters set out in the section, which includes, for offerings of shares bonds and collective investment schemes, the rights and liabilities attaching to the securities and the assets, liabilities, financial position and performance, profits, losses and prospects of the issuer. There are also specific disclosure requirements such as fees and benefits to directors. The CA requires that disclosure documents must be worded and presented in a clear concise and effective manner.</p> <p><u>Offences and liability</u></p> <p>It is an offence to continue with an offer after the offer has become aware of a misleading or deceptive statement, omission or new circumstance unless the deficiency is corrected by lodging a supplementary document with ASIC. The offer has several options regarding the investor including supplying the supplementary document and giving the investor one month to withdraw the application and be refunded (s724(2) CA). There is civil liability exposure for misleading or deceptive statements or omissions on directors, and underwriters and professional advisers named with consent. Apart from several narrowly defined exceptions, such as press reports or an independent research report it is an offence to advertise a public offer outside of a prospectus.</p> <p><u>Periodic reporting</u></p> <p>A financial report and directors report must be prepared for each financial year by disclosing entities, a group that includes public companies, large proprietary companies and all collective investment schemes. In some circumstances the same obligations apply to small proprietary companies. Unlike its treatment of prospectuses, the CA contains general and extensive specific content requirements for the annual financial report and directors' report, with special rules for public and listed companies. There is an obligation that annual financial reports comply with accounting standards (At the beginning of January 2005 Australia moved to a modified version of International Financial Reporting Standards (IFRS)). A disclosing entity must also prepare half-year financial and directors reports. The contents are specified in the CA. They must comply with accounting standards and present a true and fair view. Disclosing entities are required to send</p>

	<p>copies of the annual financial report, directors' report and auditors report on the financial report to members or, alternatively, a concise report with a statement that the member can get the full reports on request, free of charge. Disclosing entities (except collective investment schemes) must report to members by the earlier of 21 days before the next AGM or 4 months after the end of the financial year. The deadline for most collective investment schemes is 3 months after the end of the financial year. All public companies must file annual and half yearly reports with ASIC.</p> <p>Collective investment scheme reports must be filed three months after the end of the financial year. All public companies must file annual and half yearly audited reports with ASIC. In addition exchange listed entities, and some unlisted entities are subject to requirements of continuous (and immediate) disclosure to the market of events material to the price of their securities. There is an exemption for certain categories of information such as significant but partly completed transactions. There are sanctions for non-compliance.</p> <p>The CA has various provisions relating to shareholder voting decisions. These provisions cover a wide range of issues from members' rights to call meetings, notice periods for meetings (28 days in the case of a listed company) through to the dissemination and recording of meeting particulars and resolution outcomes.</p> <p><u>Listed securities</u></p> <p>Regulations under the CA specify various matters concerning exchange-listed securities which must be included in a licensed market's operating rules including admission of an entity to the official list, the activities and conduct of listed entities and the disciplinary action which an exchange can take against an entity for breach of the operating rules. Each of the exchanges has CA compliant rules and additional, more comprehensive, rules including the grounds on which an exchange can suspend trading in a particular security and a requirement to produce information to correct or prevent a false market even if that information had not been disclosed because of an exception relating to confidential information. Conversely, listed entities can, and are encouraged to, request a trading halt for up to two days to prevent trading taking place in an uninformed market.</p> <p><u>Derivatives</u></p> <p>Australia has two dominant financial markets in which derivative are traded, the SFE and ASX. Regulations under the CA set out various disclosure requirements that apply to derivatives contracts traded on an exchange. In addition to complying with these obligations the rules of the derivatives markets contain provisions related to the disclosure of the terms of the contracts traded, mechanics of trading and the risks related to gearing and leverage.</p>
Assessment	Broadly implemented
Comments	<p>The prospectus legislation is unusual compared to international norms in that it does not set out a detailed and extensive list of items that must be contained in a prospectus beyond those described above. This is, however, consistent with the government's decision to legislate on a principles basis. Issuers and their advisors must interpret their obligations in light of the general obligations and subject to the judgment of ASIC, which must receive copies of all prospectuses. The government and ASIC believe that, in the case of disclosure documents, this approach, combined with civil liability sanctions on directors and others responsible for making the disclosures secures more effective disclosure than complying with a list of requirements. ASIC reviews the contents of prospectuses and can, and frequently does, issue 'stop orders' if it takes the view that the disclosure does not meet the reasonable needs of investors and their advisers or is lacking in clarity, as required by the CA. Stop orders are public documents and attract the attention in particular of lawyers and accountants who specialize in prospectus preparation. Hence, ASIC's views on what is acceptable and what is not, become well understood in the specialist advisory community quickly. In addition ASIC staff has frequent meetings, bilaterally and collectively with professional advisers to discuss emerging issues. All of this is not inconsistent with how ASIC approaches its work generally, except that unlike, for example in dealing with licensing</p>

	<p>applications, there has been no Policy Statement for several years that brings together in one or more documents, the many expressions of view that ASIC staff have made. Press releases that discuss specific issues are insufficient. There is, therefore, an unusual lack of public clarity as to ASIC's interpretation of the legislation, which may inhibit informed debate outside the relatively tight circle of specialist professional advisers on the quality of regulation. In the view of the assessor, this does not substantially affect the adequacy of implementation from a negative response to Question 1a. ASIC has recognized this problem and intends to issue, for consultation, a policy statement to achieve this and other goals very early in 2006</p>
<p>Principle 15. Holders of securities in a company should be treated in a fair and equitable manner.</p>	
<p>Description</p>	<p>The company may appoint a new director by resolution passed in a general meeting (s201G) or by other direction (s201H). If the directors appoint a director to a public company, then this appointment is to be confirmed at the next AGM of the company. These requirements are incorporated into the replaceable rules of the company and may therefore be modified by the company's constitution (s135). However, the CA does provide for members (and others) to apply to the court if the company's conduct, actual or proposed act or omission or resolution is contrary to the interests of the members as a whole or oppressive, unfairly prejudicial or unfairly discriminatory against members. Similar issues and remedies arise in relation to the variation of rights attached to securities or other fundamental corporate changes. The position with regard to, registration and transfer of shares, and the right to receive dividends and other distributions appear straightforward. As regards proxy voting the government announced in December 2005 its intention to proceed with reforms to require proxy holders to vote in accordance with the shareholders instructions and other reforms to facilitate electronic circulation of resolutions and members' statements.</p> <p>In a bankruptcy or insolvency all members are generally treated equally under the CA and are given certain rights such as</p> <ul style="list-style-type: none"> • the right to apply to the court for a review of a liquidators remuneration • the right to apply to the court to stay the court winding up • the right to apply to the court to, have questions determined in a creditors voluntary winding up • the right to require the liquidator to convene a meeting in certain circumstances. <p>Exchange listing rules impose additional obligations on companies. For example, ASX requires that a decision to acquire or dispose of an asset worth more than 20 percent of the business requires the vote of shareholders.</p> <p>Disclosure has an important role to play here as elsewhere in this regulatory system. Changes in directors holdings must be disclosed within two days Persons with a significant holding in a company must make their first public declaration at five percent and subsequently for every one percent move up or down. Twenty percent is the takeovers threshold.</p> <p>Section 671B(6) of the Corporations Act provides the deadline for disclosure of a substantial shareholding (or change in that substantial shareholding) in a listed company or listed managed investment scheme (i.e.: a collective investment scheme). The information is to be disclosed:</p> <ul style="list-style-type: none"> • Within two business days after the person becomes aware of the substantial shareholding or change in their holding; • By 9:30 am on the next trading day of the relevant market, once the person becomes aware of the substantial shareholding or change in their holding, and this occurs during a takeover bid for the voting shares of the company or managed investment scheme. <p><u>Takeovers and other changes of control transaction</u></p>

Chapter 6 of the CA relates to takeovers and is underpinned by four principles, known as the Eggleston Principles, which seek to ensure that:

- the acquisition of control takes place in an efficient, competitive and informed market
- shareholders and directors know the identify of any person who proposes to acquire a substantial interest in the company and are given enough time and sufficient information to enable them to assess the merits of the proposal
- as far as practicable the holders of the relevant class of voting shares or interest all have a reasonable and equal opportunity to participate in any benefits accruing to the holders through any proposal under which a person would acquire a substantial interest in the company
- an appropriate procedure is followed as a preliminary to compulsory acquisition of voting shares or interest in any other kind of securities

Chapter 6 of the CA contains detailed provisions that implement the Principles. Contravention carries a range of sanctions. In addition the Takeovers Panel will consider the Eggleston Principles when determining whether to make a declaration of 'unacceptable circumstance'. To do so the Panel does not need to have found an actual contravention of the CA. For example frustrating actions by directors will generally be found to have created unacceptable circumstances and will be overturned by the Panel. The Treasury funds the Panel and its orders are enforceable in the courts. The Panel is the main forum for resolving disputes about a takeover bid during the bid period. However, ASIC is the front line regulator as regards reviewing documents and deciding whether or not to use its exemptive relief powers in the circumstances of a particular takeover. The Panel has a particular problem, common to most jurisdictions, of identifying concert parties, where two or more persons have agreed, in secret, to secure control of a company. This is where the practitioner experience of the Panel's part time members is invaluable.

Three of the panels 47 members are appointed to make decision on a particular case and in the case of an initial review a second group of three will review the case on its merits.

A takeover offer must last for at least one month, which will be extended by 14 days if within the last 7 days the terms of an off-market offer are varied or the bidder's voting power in the target increases to more than 50 percent.

A bidders statement must be prepared and sent to ASIC, the target, its shareholders and the market (if applicable). If the bidder is a director of the company or holds 30 percent voting power in the target, the statement must be accompanied by an independent expert's report as to whether the offer is fair and reasonable. The CA sets out the information which must be included in the statement which includes the identity of the bidder, the offeror's intentions regarding the business of the target, details of the cash or securities offered, details of any benefits offered during the four months prior to the bid to a person that was likely to induce that person to accept an offer under the bid or to disposed of bid class securities, and any other information material to the making of decisions by holders of bid class securities. There are sanctions for either the bidder or the target failing to correct statements they know to be misleading or deceptive.

A conventional takeover bid must be for all the securities in the bid class. In an off-market bid several provisions ensure that members are treated equally:

- The bid must be for all the securities in the bid class or a specified proportion which must be the same for all holders.
- Unless a particular benefit is offered to all holders of securities in the bid class, a bidder or associate must not give the benefit to a person in order to induce them to accept the bid or dispose of their securities.
- A condition of the offer that allows the bidder to acquire securities from some but not all of the people who accepted the offer is prohibited.
- In an off market bid for cash only if the bidder purchases securities in the bid class outside the bid and during the bid for a price higher than the bid price the considerations payable under the bid price increases to that higher amount. If the bid does not only consist of a cash offer a holder

	<p>is entitled to accept the offer on a cash only basis for an amount equivalent to the highest paid outside of the bid during the bid period.</p> <p>For off-market and on-market bids:</p> <ul style="list-style-type: none"> • If a proportionate off market bid leaves a holder with an unmarketable parcel of shares the bid extends to those shares on the same terms. • If the bidder purchased securities in the bid class in the four months prior to the bid the consideration under the bid must be equal to or exceed the maximum price paid in those four months. • All telephone calls between the bidder or target and a holder of securities to discuss the bid must be recorded, indexed and stored. ASIC has the power to listen to the recordings in certain circumstances. <p>In certain instances members may be treated differently. An offer to foreign holders need not be in securities in certain circumstances (for example when the shareholder is in a jurisdiction in which only locally registered shares can be offered). If a bidder and its associates have interests in 90 percent and have acquired at least 75 percent of the bid class securities he will be able to buy the balance compulsorily on the same terms. Conversely, in these circumstances, a minority shareholder can require the bidder to buy out his holding.</p> <p>In addition to rights conferred on shareholders in a takeover, the CA also contains specific safeguards for shareholders when a company enters into a scheme of arrangement since these can be used to effect a change of control. Schemes of arrangements are overseen by the courts and among the safeguards incorporated into the process, ASIC is given time to examine the proposal and make submissions to the court which shall consider any objections raised by ASIC.</p>
Assessment	Implemented
Comments	
Principle 16. Accounting and auditing standards should be of a high and internationally acceptable quality.	
Description	<p><u>Accounting standards</u></p> <p>There are two bodies that have responsibility for accounting standards, the Australian Accounting Standards Board (AASB) and the Financial Reporting Council (FRC). Both are established under the ASIC Act. The AASB has responsibility for standard setting and the FRC has responsibility for oversight of the AASB's activities. From January 1, 2005 Australian accounting standards have used a modified version of International Financial Reporting Standards (IFRS), an approach adopted by many countries including the European Union. AASB 101 requires an entity to prepare the information in its financial report in a manner which is relevant, reliable, comparable and understandable. Information is required to be presented consistently and to ensure comparability across periods and between entities. Australia's accounting profession is widely recognized as meeting a high international standard.</p> <p><u>Auditing standards</u></p> <p>There are two bodies in Australia that are responsible for auditing standards, the FRC and the Australian Auditing Standards Board (AUASB). The AUASB is established under the ASIC Act and is responsible for standard setting while the FRC has an oversight role over the AUASB. Australian auditing standards are based on International Standards on Auditing that are regarded as being comprehensive. Auditors must register with ASIC. In order to be registered, ASIC must form an opinion that the applicant has the necessary qualifications, satisfies the auditing competency standard and is capable of performing the duties of an auditor. Oversight of auditors is provided by ASIC and the professional accounting bodies. Disputes over the behavior of auditors are decided by the Companies Auditors and Liquidators Disciplinary Board. The CA contains extensive provisions on auditor independence and contains numerous offences for breaches by auditors, audit firms, their members and directors.</p>

	The regulatory requirements imposed on auditors in Australia were significantly enhanced by the coming into force of the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act (which amended the Corporations Act) in 1 July 2004. In implementing those reforms, ASIC has introduced an ongoing surveillance for auditors. This surveillance program includes on-site visits to firms, with the initial focus on the 'Big 4'. Second tier audit firms are the focus of the current year's surveillance program. In the first year of its auditor inspection program, (to 1 November 2005), ASIC's initial focus was on auditor independence. The program has since been expanded to include a focus on audit methodology and the application of Australian Audit Standards.
Assessment	Implemented
Comments	Early indications of the effect of the move to IFRS focus on earnings volatility, valuations and systems. The need to value defined benefit pension plans, financial instruments, etc is increasing compliance costs, as most companies do not have adequate internal expertise to carry out these valuations. Earnings volatility seems likely to rise due to external factors outside of the control of the company, such as accounting for investment properties and financial instruments. Internal accounting systems have to be upgraded -in some cases significantly.
Principles for Collective Investment Schemes	
Principle 17.	The regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme.
Description	<p>The Australian regulatory system of collective investment schemes (cis) differs from most jurisdictions. In 1998, following the pattern established earlier for superannuation (pension) schemes, the dual structure with an investment manager and a trustee was replaced with a single responsible entity that has sole responsibility to investors for the operation of the scheme. The responsible entity is legally responsible and accountable for the entire operation of the cis. There are currently about 600 responsible entities licensed to operate 4500 schemes.</p> <p>The differences between the regulatory treatment of superannuation schemes and cis arise in areas such as tax concessions, the compulsory nature of the investment in superannuation funds and the severe restrictions on withdrawal of funds until retirement age (although switches between funds is permitted) and the more limited range of products that superannuation funds can invest in. The cis regime has no limits subject to adequate disclosure having been made. However, unlike cis, superannuation schemes are prudentially regulated by APRA as superannuation supports government objectives in retirement incomes policy. There is also a provision for the Minister to grant financial assistance in the event of fraud in a superannuation fund. To date grants have been made totaling A\$60 million. ASIC regulates marketing and disclosure of superannuation funds.</p> <p>The CA is the primary Australian legislation that sets standards for those who wish to market or operate a collective investment scheme, known in Australia as managed investment schemes. Operators and marketers of managed investment schemes are required to hold an Australian Financial Services License (AFSL) and an application for a license would be considered by ASIC by reference to the financial service, which the applicant proposes to carry on. All licensees must (amongst other things) :</p> <ul style="list-style-type: none"> • Do all things necessary to ensure that the financial services covered by the license are provided efficient, honestly and fairly • Have available adequate human financial and technological resources • Maintain the competence to provide those financial services • Ensure that its representatives are adequately trained and are competent to provide those financial services. <p>In addition ASIC has published several Policy Statements setting out in detail how it will assess those requirements for all licensees and for the operators of collective investment schemes specifically.</p> <p>ASIC has a range of sanctions available to it for breach of AFS license provisions.</p>

	<p>The operation of an unlicensed scheme is subject to significant penalties. Natural persons can be fined up to \$A 22,000 or imprisoned for 5 years and corporations can be fined up to A\$ 110,000. The CA enables ASIC or others to apply to the court for a winding up order which places the scheme and its assets in the hands of a liquidator. During 2003/4 ASIC took action against 60 illegal schemes involving around 5000 investors and \$A 110 million.</p> <p>Where managed investment schemes are marketed across jurisdictions or promoters, managers or custodians are located in several different jurisdictions, ASIC relies on its cooperative arrangements with overseas regulators as set out in Principles 11-13 and on the legal position whereby the entity that outsources functions remains accountable for the actions of its agents.</p>
Description	<p>A managed investment scheme that is offered to retail investors must be registered by ASIC. There are exemptions available for certain small-scale managed investment schemes, e.g. schemes with less than 20 members that were not promoted by a person (or associate) in the business of promoting managed investment schemes. A registered scheme must be operated by a responsible entity. The responsible entity must be a public company that holds an AFSL authorizing it to operate the scheme. The scheme must file an audited financial report and directors report with ASIC annually and send copies to members. ASIC has extensive inspection power over books and records of directors, employees, agents, bankers, lawyers and auditors of the responsible entity and their predecessors. It monitors responsible entities proactively and reactively through a combination of on-site and desk based surveillance.</p> <p>For example, in 2004 ASIC conducted a review of investment practices of the Australian managed funds industry in light of the late trading abuses involving US mutual funds.</p> <p>ASIC has a range of remedial powers in the event of a breach of the AFSL obligations or a default. A responsible entity is subject to extensive record keeping requirements under the CA, notably concerning transaction records and monies received and paid. It is also subject to the requirements of the CA as regards related party transactions and the management of conflicts of interest as expanded upon by ASIC in PS 181.</p> <p>The regulations governing outsourcing are broadly phrased. S601FB2 of the CA provides that while the responsible entity has the power to appoint an agent to do anything authorized in relation to the scheme, for the purpose of determining whether there is a liability to members, the responsible entity is taken to have done or failed to do anything that is done, or not done, by the agent, even if the agent has acted fraudulently or outside the scope of the agent's authority. The strength of this obligation has persuaded ASIC that an AFSL holder that outsources functions will need to put in place more intensive compliance measures than if it undertook the functions itself. In PS 164 it states that it expects that the licensee will be able to demonstrate that it:</p> <ul style="list-style-type: none"> • Has measures, processes and procedures in place to ensure that due skill and care has been made in choosing suitable providers • Can and will monitor their ongoing performance • Will deal effectively with any breaches of the service agreement or actions that lead, or might lead, to a breach of the license obligations <p>In licensing an applicant to manage a scheme in circumstances where the applicant proposes to use an agent to perform core functions, ASIC requires the applicant to demonstrate that the provider has appropriate levels of insurance to protect the scheme from fraud and that it has the expertise to assess the ability of all its agents and to monitor their performance.</p>
Assessment	Broadly implemented
Comments	As regards the management of the assets of the scheme, IOSCO has concluded that dealing activities should be subject to a limited number of explicit obligations, notably as regards achieving best execution, appropriate trading and timely allocation of trades, the prevention of

	<p>churning, related party transactions and underwriting agreements. Under the CA only related party transactions are subject to specific controls (s601LB CA). The general statutory obligations on a responsible entity by s601FC of the CA, namely to act honestly, with due care and diligence, in the best interests of the members etc., are likely to exercise an influence in securing appropriate behavior in these areas. Nonetheless, there is clear scope for ASIC to issue a Policy Statement setting out its expectations of behavior by the responsible entity in these areas although in the view of the assessor this does not substantially affect the adequacy of implementation from a negative response to Question 14a-e.</p>
Principle 18.	The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.
Description	<p>A managed investment scheme must have a governing document (the constitution) that is legally binding on members and the responsible entity. The constitution must cover matters such as the consideration to be paid to acquire an interest in the scheme, the powers of the responsible entity relating to making investments or otherwise dealing with scheme property, scheme borrowings, handling of complaints fees and indemnities in favor of the responsible entity, members withdrawal right and how the scheme may be wound up. In addition, the CA sets out various duties of a responsible entity including duties about the holding and use of scheme assets. The responsible entity is also required to act in the best interests of members and if there is a conflict between the responsible entity and the members, to act in the best interests of the latter.</p> <p>A retail client who wishes to invest in a managed investment scheme must be provided with information about the scheme in a Product Disclosure Statement (PDS) as required by the CA. ASIC has issued guidance on the form and content of a PDS which sets out the details of specific matters such as significant benefits and risks, and other important features of the scheme.</p> <p>In addition to ASIC's surveillance and enforcement powers over the responsible entity, further protections for investors are provided by the requirement that the responsible entity have either a majority of external directors or a compliance committee with a majority of external members. Secondly, an independent auditor must audit the compliance plan each year and the report must be lodged with ASIC. The auditor is also required to notify ASIC of any serious contraventions, with penalties for non-compliance.</p> <p><u>Scheme property</u></p> <p>The CA provides that a responsible entity must ensure that scheme property is clearly identified as scheme property and held separately from property of the responsible entity and property of any other scheme. Property must be held on trust for scheme members. A responsible entity that wishes to act as its own custodian must have at least \$A 5 million in net tangible assets; otherwise it must appoint a custodian.</p> <p>ASIC has issued PS 133 in which it sets out guidance on the standards a custodian should meet and what should be included in a compliance plan. ASIC has also issued guidance concerning the management of conflicts of interest which is applicable when a responsible entity uses a related entity as custodian PS 181.</p> <p>There are various ways in which a scheme can be wound up, including by ASIC seeking an order from the court. In all cases the responsible entity must ensure that the scheme is wound up in accordance with its constitution and any orders of the court.</p>
Assessment	Implemented
Comments	
Principle 19.	Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.
Description	The CA requires that a PDS be provided when units in a managed investment scheme are offered

	<p>to a retail client. There is a requirement that the PDS is dated, current and must be worded and presented in a clear, concise and effective manner, mirroring the requirement for prospectuses and contains the information that might reasonably be expected to have a material influence on a reasonable retail client. The content requirements as set out in the CA include</p> <ul style="list-style-type: none"> • Name and contact details of the issuer • Information about significant benefits and the timing of those benefits • Information about significant risks • Information about costs and any other amounts payable • Information about any commissions or other payments that may impact on returns • Information about any other significant characteristics or features • Information about the rights, terms, conditions and obligations attaching to the product • Information about the disputes resolution system • General information about any significant tax implications • Information about any cooling off period <p>In addition ASIC has issued PS 168 that contains detailed guidance on how ASIC approaches PDS disclosure issues.</p> <p>These specific and general obligations are sufficient to require information to be provided on matters such as the constitution, further information on the operator and its principals, the methodology of asset valuation, purchase redemption and pricing of units, the custodian, the investment policy and external administrators or fund managers or advisers.</p> <p>From 15 December 2005 a responsible entity can choose to provide a retail client with a Short-Form PDS, instead of the PDS. A Short-Form PDS essentially summarizes the key information contained in the PDS. Where a retail client receives a Short-Form PDS, the retail client must be informed that a PDS is available and how to access it.</p> <p>ASIC has powers to intervene in an offering by, for example, issuing a stop order where the PDS or a related advertisement is defective or where the operator does not have an appropriate dispute resolution mechanism.</p>
Assessment	Implemented
Comments	<p>From discussions with financial services practitioners and investor groups there appears to be considerable agreement that the statutory requirement that a PDS be ‘clear, concise and effective’ has not been achieved in practice. The refinements to the original FSRA amendments to the CA in this area may result in improvement through a significant reduction in the length of PDSs driven by a lessened concern on the part of financial services providers to minimize their exposure to enforcement action by ASIC and civil suit from customers.</p>
Principle 20.	Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme.
Description	<p>Assets of a managed investment scheme must be valued at regular intervals appropriate to the nature of the scheme property. A compliance plan must be lodged with ASIC that sets out arrangements to ensure that the duty is complied with. ASIC has issued PS 132 that addresses these valuation issues. In addition there are a number of applicable accounting standards that provide guidance in relation to some of the more difficult assets to value such as property. This is particularly important in the Australian context as investment in a very broad range of assets can be offered to the public via managed investment schemes.</p> <p>The constitution of a managed investment scheme must set out fair procedures for dealing with withdrawals. ASIC has published its view that fairness will normally require that withdrawal and acquisition prices be ‘independently verifiable’. The responsible entity is responsible for the conduct of persons it engages in connection with the operation of the scheme including valuers. It</p>

	<p>must treat members equally, act with the care and diligence reasonably expected of a person in their position and act in the best interests of the members. The responsible entity will be liable to members if a valuer it engages fails to meet these standards.</p> <p>The constitution of a scheme must make adequate provision for the pricing and redemption of units to be independently verifiable.</p>
Assessment	Broadly implemented
Comments	<p>In recent years there have been a series of high profile and very large cases of unit pricing errors which have totaled over \$A 240 million and involved some very large scheme managers and tens of thousands of investors. Although when errors are discovered it appears that operators admit to the problem and investors are compensated there must be doubts that all errors have or will be discovered. It is claimed by the industry that the problems have arisen in old legacy pricing systems and not in modern systems but that is an untested assertion. ASIC has taken steps to address what is clearly a serious problem. It has in some cases accepted enforceable undertakings (see Principle 9) from the responsible entity concerned which will encourage those managers to make a serious attempt to ensure that similar problems do not recur. Following consultation with the industry, ASIC and APRA recently issued a guide to good practice in unit trust pricing, which has been well received and will monitor performance against its recommendations. It remains to be seen whether this resolves the problem. Some in APRA are said to believe that the problem will never be solved. ASIC appears to have done all that could reasonably be expected in this regard. But currently it is not possible to say with confidence that in all cases the basis for asset valuation and the pricing and redemption of units' is fully compliant with this Principle. In light of the action ASIC has taken in this area, in the view of the assessor this does not substantially affect the adequacy of implementation from a negative response to Question 6 which, in any case, sets an unattainably high standard. Regulation can never 'ensure' a particular outcome.</p>
Principles for Market Intermediaries	
Principle 21.	Regulation should provide for minimum entry standards for market intermediaries.
Description	<p>All persons who carry on a financial services business in Australia are required to hold an Australian Financial Services Licence (AFSL). It is an offence punishable to carry on financial services without a license; the penalty is a fine of up to \$A 220,000 or 2 years jail or both. A person is taken to be providing a financial service if they:</p> <ul style="list-style-type: none"> • provide advice on financial products • deal in a financial product • make a market in a financial product • operate a registered managed investment scheme • provide a custodial or depository service <p>The CA (s912A) sets out the requirements that have to be met by an applicant. Consistent with Australia's commitment to principles based regulation the requirements are described at a fairly high level of generality in the legislation (s912A) but are comprehensive and include provisions requiring a licensee to:</p> <ul style="list-style-type: none"> • Ensure that the financial services it provides are provided efficiently, honestly and fairly • Implement arrangements to manage conflicts of interest • Comply with the conditions on the license (ASIC has the power to impose conditions) • Comply with the financial services laws • Take reasonable steps to ensure that its representatives comply with the financial services law • Have adequate financial, technological and human resources to provide the financial services set out in the license (disapplied to licensees also supervised by APRA, the prudential regulator) • Maintain its competence to provide those financial services • Have adequate risk management procedures in place (similarly disapplied for licensees also supervised by APRA) • Provide a dispute resolution process for retail clients

	<p>These high level obligations are supplemented where necessary by more detailed provisions of the CA such as requirements concerning the holding and segregation of client money and assets (s981B and s984A).</p> <p>Through several public Policy Statements, ASIC provides extensive guidance on what it considers is required for a licensee to meet its obligations under the CA intended to assist applicants and to assist ASIC in applying the law in a consistent way in equivalent circumstances. ASIC has also developed an internal licensing guide ‘the Licensing Analysts Roadmap to AFSLs’ (LARA) to ensure that applications are processed efficiently, effectively, comprehensively and consistently.</p> <p>ASIC is required under the CA to grant a license if:</p> <ul style="list-style-type: none"> • The application was made correctly and the applicant has provided ASIC with any additional information ASIC has request that is relevant to the consideration of the application (such as certified copies of criminal history and bankruptcy checks on responsible officers) • ASIC has no reason to believe that the applicant would not comply with the statutory requirements • ASIC has no reason to believe that the applicant (or its responsible officers (a defined term in the CA) if the applicant is a body corporate) is not of good fame or character. <p>Although the AFSL regime is a single licensing regime, each license will set out the activities which the holder is entitle to carry out, namely those for which an application has been and which ASIC considers the applicant is competent to provide. It is a breach of the license conditions to carry on an activity not permitted by the license.</p> <p>There are two key mechanisms for enforcing the licensing regime. The first is the obligation imposed by the CA (s912D) on a licensee to notify ASIC when it has breached or is likely to breach its license obligations and such breach would be significant. ASIC’s public policy is to take more rigorous enforcement action against a licensee if ASIC itself uncovers a breach rather than the licensee admitting to the breach or likely breach first. The second is ASIC’s power to impose or vary conditions on an AFSL, such as limiting the financial services a licensee can provide, and to suspend or cancel a license. ASIC can also issue banning orders against individuals whether or not they are currently employed in the financial services industry.</p> <p>Special conditions apply when ASIC wishes to suspend or cancel the license of an entity prudentially supervised by APRA. Generally, if the suspension or cancellation would prevent the entity from carrying on all or any of its usual activities, (for which APRA is the prudential supervisor) it must first consult APRA. In the case of banks the decision to suspend or cancel (or to revoke such a decision) is reserved for the Minister after having taken the advice of ASIC.</p>
Assessment	Implemented
Comments	<p>ASIC is coming to the end of a comprehensive relicensing program required under the FSRA 2001 and 100 staff have processed approximately 4000 license applications in the last 18 months. The operation appears to have been carried out efficiently and comprehensively. To validate that, ASIC carried out 284 license verification inspections of license holders to check if unreported or undiscovered breaches have been occurring during the transition period.</p> <p>The constraints to suspend or cancel the license of an APRA supervised entity are consistent with the functional regulation approach. The constraints are not reciprocal however—they do not require APRA to consult, and although in practice consultation will almost certainly take place, this is an area which could usefully be dealt with when a suitable opportunity arises.</p>
Principle 22.	There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.
Description	Capital requirements for licensees are required by the CA and imposed via conditions attached to the AFSL. ASIC PS 166 ‘Licensing: Financial Requirements’ specifies the initial and ongoing

	<p>requirements which vary according to the financial services offered by the licensee. These requirements do not apply to AFSL holders that are also regulated by APRA as these entities have to comply with APRA's prudential requirements. Additionally, if a licensee is a participant in a licensed market such as ASX or SFE, and ASIC is satisfied that the financial requirements of the market operator are an adequate substitute for the ASIC requirements, ASIC permits a licensee to operate under those requirements instead of ASIC's.</p> <p>All licensees are subject to base level financial requirements and, where a licensee's business requires it, additional, but limited risk based capital requirements. Members of ASX are subject to comprehensive risk-based capital requirements; most SFE members are banks and so supervised by APRA. APRA supervised entities are subject to the Basel trading book requirements for securities trading. Seven banks have been authorized to use internal models for market risk calculation.</p>
Assessment	Partly implemented
Comments	<p>The base level requirements are consistent with international best practice and in some respects exceed them. For example, small-scale financial advisers require capital (sufficient cash to cover the next three months expenses) and all licensees are required to monitor anticipated cash inflows and outflows and to engage in forward thinking to determine whether there is a real risk of a shortfall over at least the next three months and preferably longer.</p> <p>On the other hand, ASIC's risk-based requirements are not set at a level that matches international norms. The risk element is limited and there are no provisions covering risks from unlicensed affiliates or off-balance sheet risk. This is clearly set out in PS 166 along with the rationale (paragraphs 122, 123, 150) and appears to be based on a determination to ensure that the functional approach to regulation is preserved and ASIC is not seen as a prudential regulator. But the result is that a large entity that takes on substantial risk in markets, such as OTC dealing as principal in equities, bonds, derivatives or complex structured products, but which does not require a banking license, can operate in Australia with less regulatory capital than in most other developed financial markets. Its regulatory capital requirement may not properly reflect the risk of its business to itself or its counterparties. Trading volume by value in the OTC markets substantially exceeds trading in on-exchange markets—\$A 58 trillion versus \$A 24 trillion in 2004/5. In the view of the assessor, the issue is not whether securities regulation in Australia is in breach of questions 2 and 3 but that this is an area where improvements should be made.</p>
Principle 23.	Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters.
Description	<p>ASIC has made public its position that without appropriate management and organizational structures a licensee would not be able to meet its obligations in this regard. ASIC's expectations are set out in PS 164 'Licensing: Organisational Capacities'. These cover:</p> <ul style="list-style-type: none"> • the adequacy of internal controls • measure to identify, properly manage and where necessary avoid conflicts of interest (including where appropriate segregation of individuals and departments) • the obligations on senior management to bear responsibility • independent audit including of key systems and controls (the auditor must report breaches to ASIC) • safeguarding of firm and client assets • maintenance of proper accounting and other records <p>• an efficient and effective mechanism for the resolution of retail investor complaints (which requires an internal and an external independent, ASIC approved mechanism.)</p> <p>Unusually for a principles-based approach to legislation, the CA sets out detailed requirements</p>

	<p>governing the firm/retail client relationship. In particular it sets out detailed specifications for three documents that must be given to retail clients (as defined in the CA). These are:</p> <ul style="list-style-type: none"> • Financial Services Guide: which provides information on the licensee and the financial services it provides • Statement of Advice: which provides the advice and the basis on which it is provided (the CA sets out detailed ‘know your customer’ and ‘suitability requirements’) and information on fees, charges, any relevant conflicts of interest, etc. • Product Disclosure Statement: (except for securities) which provides product details relevant to a well-informed investment decision <p>Providing these documents is a statutory obligation subject to sanction for breach. They must be current and there are further sanctions that may be applied if the documents are misleading or deceptive. There is also a statutory obligation to provide post-transaction confirmations.</p> <p>Licensees are required under the CA to maintain comprehensive books and records and although not an explicit requirement under the law, ASIC has interpreted compliance with the law as requiring a licensee to have a person or group of persons responsible for monitoring compliance with legal and regulatory requirements, while the statutory obligation to notify ASIC of breaches or likely breaches of the license require that person or persons, or similar to monitor internal policies and procedures.</p> <p>There is an interesting ‘catch all’ provision in the CA prohibiting a licensee from engaging in ‘unconscionable conduct’ (s991A) that provides an additional basis for action for loss or damage to be recovered by a client.</p>
Assessment	Implemented
Comments	<p>The detailed disclosure requirements in the CA, much of which has arisen from implementation of the FSRA in 2002, seems to have resulted in a significantly increased weight of expensive documentation which must be provided to retail clients. This may have arisen as protective action by the financial services industry’s uncertainty as to what the law required and ASIC would expect in its enforcement. Interestingly, at least some consumer groups have concluded that the present position is unhelpful to investors and that the current length of some documentation may serve to ‘camouflage’ essential details. The government has recognized the strengths of the concern and at the time of writing has introduced numerous ‘refinements’ to the FSRA terms that seem to be well regarded by industry and investors.</p>
Principle 24.	There should be a procedure for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.
Description	<p>ASIC has established the necessary contacts and procedures to be followed to achieve a coordinated response to major market disruptions. In particular ASX and SFE carry out on a regular basis a process of taking a ‘snapshot’ of open positions for a participant at a certain time and assuming default. In the event of failure the process is as follows.</p> <p>The insolvency of a licensee gives ASIC grounds to suspend or cancel the AFSL. This power can be exercised immediately, without ASIC being required to hold a hearing or consider submissions from the AFSL holder (s915B CA). ASIC is then able to apply to the court for an order to freeze or restrict the accounts of a person (i.e. not just the AFSL holder) with financial institutions within or outside Australia (s983A(3) CA). At that point ASIC, or a person affected by the order, can apply to the court for an order directing that specific amounts in the frozen account be paid to ASIC or its nominee (s983D CA). This order can also set out a scheme by which ASIC will distribute moneys to claimants and deal with any shortfall (s983E).</p> <p>If the licensee is a corporation then ASIC can apply to the court for an order to wind up the corporation on the grounds of insolvency (s459P CA). In addition ASIC can seek an order from the court to appoint a receiver (s1323 CA).</p>

	<p>As soon as practicable ASIC must publish a notice of the action in the Gazette (in practice on its web site) and if the licensee is a participant in a licensed market or licensed clearing and settlement facility give written notice to the operators s915F(2) CA). Operators of exchanges and clearing and settlement systems also have the necessary powers under their rules to suspend or terminate a participant in the event of a default.</p> <p>See description of Principle 21 on the special provisions that apply to APRA supervised entities.</p> <p>ASIC has powers to exchange confidential information with a range of domestic and foreign entities including licensed market operators in Australia, APRA, the RBA and domestic and foreign government agencies. For a full description of ASIC's powers and the arrangements in place to facilitate the sharing of information see Principles 11-13. SFE has recently experienced a default of a U.S. based broker (not a clearing member) which also tested the effectiveness of international cooperation arrangements.</p>
Assessment	Broadly implemented
Comments	<p>There is one gap in the procedures to deal with the failure of an intermediary. That concerns the absence of a general customer compensation scheme. Licensed market operators are required as a condition of their license to have such a scheme for the protection of retail clients of their participants for business transacted on the exchange. The Minister is required to approve each scheme and to be satisfied that it provides adequate coverage for losses. However there is no comprehensive scheme to cover retail clients of all AFSL holders (although securities dealers are required to post a bond for A\$20,000 with ASIC). That position is expected to change in July 2006 with the introduction of new regulations, although options as to the precise terms of the scheme, which will probably be insurance based, are, at the time of writing, out for public consultation. In the view of the assessor this does not substantially affect the adequacy of implementation from a negative response to Question 3.e.</p>
Principles for the Secondary Market	
Principle 25.	The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight.
Description	<p>An Australian Markets License (AML) is required in order to operate a market. Similarly, the operation of a clearing and settlement facility requires an Australian Clearing and Settlement Facility License (CSFL). Under the CA the power to grant a license resides with the Minister. ASIC is required to give advice to the Minister on an application. The key operational condition attached to a license is that the entity must have rules and procedures to ensure that the market is 'fair, orderly and transparent'. Other requirements include the obligation to have adequate investor compensation arrangements that no disqualified person is involved in the applicant and no unacceptable control situation would result if the license were granted.</p> <p>The legislative definition of a financial market that requires a license is generic as set out in the CA. By public Policy Statement PS 172 ASIC provides guidance about those statutory obligations and what is expected of an AML holder in order to comply with those obligations including the information expected to be provided by a license applicant including details of its technological resources, its financial resources, which must be sufficient, its proposed clearing and settlement arrangements, procedures for supervising the market and its employees and investor compensation arrangements. An equity exchange must have appropriate rules for admission or de-listing and the conduct of issuers whose securities are admitted.</p> <p>At any time the Minister may impose conditions on a license or vary or revoke existing conditions. All rule changes must be submitted to the Minister via ASIC, which will provide advice. The Minister has 28 days to disallow the rule change. In practice the terms of a rule change are agreed with ASIC before submission to the Minister.</p> <p>There are 14 licensed markets and 4 clearing and settlement facilities (CSF); each of the two largest exchanges, the Australian Stock Exchange (ASX) and the Sydney Futures Exchange</p>

	(SFE), own two of the CSFs. ASX has 99 percent of on-exchange equity trading and SFE has a similar proportion of on-exchange derivatives trading, heavily weighted in interest rate futures and options.
Assessment	Implemented
Comments	<p>The division of responsibility between the Minister and ASIC was intended to ensure that a proper balance is struck between appropriate regulation of markets and the need to encourage innovation and product development. Since the exchanges have developed the practice of negotiating rule changes with ASIC, and securing its approval, before they are submitted to the Minister, in practice it is not clear that the public policy interest is still served by the present arrangements and it may be appropriate to review them with a view to simplifying the licensing process so that ASIC is the licensing body as it is with financial services providers.</p> <p>ASIC keeps under review the growing use of technological systems to facilitate trading between dealers, particularly in the wholesale over the counter (OTC) markets for bonds and non-standardized derivatives contracts. It has not interpreted the broad scope of the definition of financial market to include such systems and currently relies on the conditions of the AFSL license to govern the behavior of operators. A trade association aggregates and publishes limited end of day price information for some markets. ASIC consults with users and operators and may change that decision if evidence appears of growing retail involvement in these markets, which is increasingly possible with the growth of self-administered superannuation (pension) funds.</p>
Principle 26.	There should be ongoing regulatory supervision of exchanges and trading systems, which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.
Description	<p>An AML licensee is required to comply with the conditions of its license on an on-going basis. ASIC conducts an annual assessment of the compliance of an exchange's compliance with the terms of its license. The assessment involves on-site and off-site examinations and interviews with key staff. The assessments are published. The assessments are both historical and forward-looking and make recommendations for action that are followed up during the year and at the subsequent assessment. Failure to have responded adequately to previous recommendations is subject to particular criticism as in the June 2005 report that repeated earlier calls for substantial improvement in the supervision of the warrants market. Other recommendations in that report include the need to address inconsistencies in the monitoring and enforcement of the disclosure provisions in the listing rules; further improvement in the management of conflicts of interest (between ASX's supervisory and commercial functions) and improved monitoring of ASX's derivatives market, particularly where the derivatives relate to underlying assets not listed on an ASX market.</p> <p>ASIC's supervision of the exchanges is supported by its entitlement under the CA to access an exchange's electronic trading platform and associated records, and a general power to require an exchange to provide assistance when ASIC reasonably requests it. Operationally these powers are reflected in MOUs between ASIC and the ASX and SFE but the MOUs also recognize the complimentary roles of ASIC and the exchanges and aim to promote cooperation, effective communication and mutual assistance. Consistent with the presumption of transparency in regulatory matters, the MOUs are public documents.</p> <p>The Minister and ASIC have powers to secure compliance with license conditions when necessary. The Minister can give directions to AML holders; in case of non-compliance with a ministerial direction ASIC can obtain a court order to compel compliance. ASIC can direct an AML to suspend dealings in a financial product or class of financial products; the direction can be referred at the AML's request to the Minister who can instruct ASIC to revoke or suspend the direction.</p>
Assessment	Implemented
Comments	The new management of ASX is undertaking a modernization of its organizational arrangements

	<p>for managing its supervisory and regulatory functions. It is also working on achieving a relationship with ASIC which better reflects their mutuality of roles. One aim is to ensure that in future annual reviews, ASIC has no grounds for critical comment and to eliminate complaints that the exchange has failed to take proper account of the views of ASIC.</p> <p>ASX is currently implementing a changeover for its SEATS trading platform to one provided by the Sweden-based OM Group (which currently provides the trading platform of the SFE. This a major project and ASIC is monitoring progress to ensure that ASX complies with its license obligations, notably as regards outsourcing.</p> <p>As regards clearing and settlement facilities, including those operated by exchanges, ASIC shares oversight responsibility with the Reserve Bank of Australia (RBA). The RBA has issued a financial stability standard for CFSL holders which act as a central counterparty and one for CSFL holders acting as a settlement facility. RBA is focused on payment systems facing issues with an emphasis on the CPSS-IOSCO standards. ASIC is focused on the customer facing issues and maintaining investor confidence in the system. The co-responsibility arrangements appear to work well.</p>
Principle 27. Regulation should promote transparency of trading.	
Description	<p>The regulations to the CA impose an obligation on an exchange to have operating rules that address the execution of orders and the recording and effective disclosure of transactions. The rules are approved by the Minister at the time of licensing and he can disallow any subsequent rule change. There is a strong regulatory presumption in favor of high levels of transparency that is reflected in the exchange's rules. Equality of access to trading information is considered by the Minister as part of the licensing process.</p> <p>The ASX operate a central limit order electronic trading platforms which display bids and offers and executed trades in real time subject to delays for block trades, as is typical on most exchanges. The ASX has recently introduced a so-called iceberg facility for trading large blocks on its SEATS system. This is intended to encourage the use of SEATS for block trades which are otherwise arranged off-market because of the risk of excessive market impact if the full order is exposed.</p>
Assessment	Implemented
Comments	<p>An extensive debate has recently concluded on whether or not published real-time trade reports should continue to include the identity of the broker-dealer that carried out the trade. Knowledge as to the identity of the broker has been seen by some as useful and profitable due to the closeness of corporate broking relationships. When a broker known to be close to a particular corporate investor with a known appetite for acquisitions was seen to be buying a particular stock some would also purchase the stock as a speculation on a possible takeover bid. Of course, this presumption can be exploited by other short term speculators who will acquire stock with a view to selling it before price increases, based on hopes of a possible takeover bid, have evaporated. The final decision appears to have been finely balanced but was ultimately decided in favor of removing the broker IDs on real time transaction reports for a twelve-month trail period. ASIC did not dissent.</p>
Principle 28. Regulation should be designed to detect and deter manipulation and other unfair trading practices.	
Description	<p>Market manipulation, market cornering, insider trading, misleading statements, front running and other fraudulent or deceptive conduct are prohibited under Part 7.10 of the CA. With the exception of misleading or deceptive conduct, which attracts only civil liability, breaches of these provisions attract both civil liability and criminal prosecution.</p> <p>The exchanges have an obligation under CA to notify ASIC if they have reason to believe that a person has or is about to commit a significant contravention of the CA. The MOU requires ASX to notify ASIC as soon as practicable and not to defer making the notification while it conducts enforcement action. Based on its systems designed to meet the obligation to effectively record and</p>

	<p>disclose transactions ASX conducts surveillance on trading on SEATS through the computerized SMARTS system.</p> <p>For breach of their rules the exchanges have a range of sanctions that can be imposed upon members including censure, fining, suspension of membership and expulsion.</p> <p>ASIC is empowered to share confidential information with the exchanges</p> <p>Inter-market issues are dealt with by a mix of informal arrangements between ASX and SFE to consult each other on cases of suspected market misconduct that may affect the other market, and formal arrangements for the exchange of information between them to facilitate those SFE products based, for example, on ASX indices.</p> <p>In addition specific continuous disclosure obligations are imposed on listed companies by the CA and the listing rules of the exchange. These obligations include the publication of cautionary announcements and price sensitive information and are designed to ensure that there is always a fully informed market.</p>
Assessment	Implemented
Comments	<p>The continuous disclosure regime is of long-standing and compliance with it by listed companies appears to have been improving. In many companies it appears to have become a routine matter but there are still unexplained variations via the regional offices of the ASX and more generally it seems that ASX and ASIC need to maintain a degree of pressure on issuers to ensure a proper level of compliance.</p> <p>ASIC's has a very good record in securing convictions for insider trading and market manipulation. In 2004/5 it secured 5 criminal convictions and 2 civil penalty orders for insider trading and market manipulation.</p>
Principle 29.	Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.
Description	<p>In as much as the management of large exposures, default risk and market disruption can be dealt with through the regulation of clearing and settlement facilities then Australia appears to have implemented the principle. While it is not mandatory for all market operators to have clearing and settlement facilities, ASIC has advised the Minister that a licensee should be required to have such arrangements if concluded contracts are entered into on-market and the parties to the contract do not know in advance the identify of the persons with whom they contract, as is typical of electronic trading platforms of ASX and SFE. Arrangements could be provided under an AFSL or a CSFL but in either case a condition of the license is that the licensee will have to have in place operating rules that deal with default as well as risk management procedures and processes. A licensee must have procedures to identify and monitor risks to the facility and develop rules and procedures to address those risks.</p> <p>In relation to addressing risk posed by large exposures s827D of the CA provides that the RBA may issue standards for the purpose of ensuring that CSFL holders conduct their affairs in a way that promotes overall stability in the Australian financial system. Standards have been developed in consultation with ASIC and CSFL holders and ensure that settlements, once completed, are final and irrevocable. CSFLs are also subject to an extensive list of requirements to report to the RBA to ensure that the RBA is advised of circumstances which may be indicative of unacceptable risks arising on the CS facility.</p> <p>Subject to an obligation to consult the RBA, ASIC has the power to give a CSFL holder a direction if it believes that the licensee has not done all things practicable to reduce systemic risk in the provision of the facilities services. The direction can be to adopt specific measures to comply with the RBA standards or any other action ASIC considers will reduce systemic risk. ASIC can also give the licensee directions if it considers that it is necessary, or in the public</p>

	<p>interest, to protect persons dealing in financial products or that the licensee has not done all things reasonably practical to ensure the facilities are provided in a fair and effective way (s823D CA).</p> <p>Arrangements to exchange information between regulators and CSFL holders appear comprehensive, with licensees under positive obligations under the CA to notify the regulators with the appropriate gateways to share information with licensees. ASIC is able to use the powers set out in Principles 11-13 to exchange information with a range of domestic and overseas bodies and CSFLs are, by regulation, permitted to exchange appropriate information with other clearing and settlement facilities.</p>
Assessment	Partially implemented
Comments	<p>It has not been possible to review the default rules of the CSFLs but from the examples provided by ASIC in its Self-Assessment, (from the rules of the Australian Clearing House (ACH), which is the central counterparty and clearing house for the ASX) it appears that the rules concerning the suspension or cancellation of a participant from the facility default of a participant and the power to transfer derivatives CCP contracts in a client account to another clearing participant meet international norms.</p> <p>However, as is the case with ASIC's capital requirements as they apply to AFSL holders that are not members of an exchange or clearing facility, there are no regulations or other provisions that aim to ensure the proper management of large exposures, default risk and market disruption that arise in the course of bilateral transactions involving AFSL holders not supervised by APRA. Such bilateral transactions may include new issue underwriting (where a negative change in market circumstances can leave a firm commitment underwriter heavily overexposed), or other OTC trading in equities, long term derivatives or complex structured products. Some comfort might be gained from the presumption that much of this business is transacted according to international accepted global master agreements such as those promulgated by the International Swaps and Derivatives Association (ISDA) but the issues here are presumably not beyond doubt. In the view of the assessor the issue is not whether securities regulation in Australia is in breach of questions 2 and 3 but that this is an area where improvements to regulation should be made.</p>
Principle 30.	Systems for clearing and settlement of securities transactions should be subject to regulatory oversight, and designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.
Description	
Assessment	This Principle has not been assessed
Comments	

Table 8. Summary Implementation of the IOSCO Objectives and Principles

Assessment Grade		Principles Grouped by Assessment Grade
	Count	List
Implemented	21	1,3,4,5,6,7,9,10,11,12,13,15,16,18,19,21,23,25,26,27,28
Broadly Implemented	5	2,14,17,20,24
Partly Implemented	2	22,29
Non-implemented	1	8
Not applicable	0	0

Recommended actions and authorities' response to the assessment

Table 9. Recommended Plan of Actions to Improve Implementation of the IOSCO Objectives and Principles

Reference Principle	Recommended Action
Principles Relating to the Regulator (P 1–5)	<ul style="list-style-type: none"> Consider amending the ASIC Act to remove the power of the Minister to give directions and the power to instruct ASIC to carry out an investigation. Consider reversing the growing dependence of ASIC on special purpose funding Consider whether it would be possible to fund a proportion of ASIC's work directly from a levy on the financial services industry Consider measures to improve the consultation process with the private sector
Principles of Self-Regulation (P 6–7)	
Principles for the Enforcement of Securities Regulation (P 8–10)	<ul style="list-style-type: none"> Consider removing the ambiguities in ASIC's use of evidence obtained from use of a search warrant ASIC should satisfy itself that it has adopted a comprehensive suite of tools for identifying and prioritizing risk in the surveillance function.
Principles for Cooperation in Regulation (P 11–13)	<ul style="list-style-type: none"> Consider in due course whether to give ASIC the authority to acquire information and transmit it directly to its counterparts overseas without first having to seek the Attorney General's permission.
Principles for Issuers (P 14–16)	<ul style="list-style-type: none"> ASIC should issue, as planned, a comprehensive Policy Statement on guidance on prospectus disclosure.
Principles for Collective Investment Schemes (P 17–20)	<ul style="list-style-type: none"> ASIC should issue a Policy Statement setting out its expectations of behavior by the responsible entity for a managed investment scheme in the areas of best execution, appropriate trading and timely allocation of trades, the prevention of churning, and underwriting agreements.

Principles for Market Intermediaries (P 21–24)	<ul style="list-style-type: none"> • Consider making reciprocal the constraints on ASIC when seeking to suspend or cancel the license of an APRA supervised entity • ASIC should take steps to ensure that Australia’s risk-based capital requirements meet international norms.
Principles for the Secondary Market (P 25–30)	<ul style="list-style-type: none"> • Consider transferring the power to license market operators and clearing and settlement facilities to ASIC. ASIC should take steps to ensure that Australia’s risk based capital requirements take proper account of the systemic risks of large exposures in OTC markets.

Authorities’ response

Introduction

The authorities welcome the comprehensive assessment of Australian securities regulation as part of the IMF’s Financial Sector Assessment Program. The authorities consider that the assessment reflects a high degree of compliance with the IOSCO objectives and principles of securities regulation. Australia is already taking steps to implement some of the recommendations and is carefully considering the others to ensure optimal compliance with the IOSCO objectives and principles.

Independence of the regulator

ASIC has complete independence in relation to the performance of its functions and exercise of its powers under the corporations legislation. While the IOSCO principles require an additional degree of autonomy in relation to regulatory policies and funding, it is difficult to reconcile the IOSCO approach to independence with notions of ministerial accountability. The Australian Government considers that IOSCO should reconsider its approach to this principle. The principle should focus on independence in the administration of the regulatory framework as it relates to specific cases, rather than requiring absolute strategic and financial autonomy from the executive arm of Government.

In relation to the specific issues raised in the assessment, the Minister’s power to issue a direction to ASIC with respect to policies and priorities is limited. There are prerequisites to such a direction to ensure transparency and accountability. A direction may not relate to a specific matter. While the Minister may direct ASIC to investigate a matter, the conduct of the investigation is a matter for ASIC. ASIC has a high degree of flexibility in regard to the allocation of its funding across priorities. The cost recovery arrangements that fund ASIC and other elements of the corporations regulation scheme are scheduled for review in 2007. There is no intent to introduce new levies on corporations.

Funding of the regulator

In general, the Australian Government notes that its overall approach to fiscal policy over the last decade, in which all public sector spending is subject to robust discipline, has served Australia well, ensuring adequate funding for government services and agencies while producing a degree of sustained fiscal responsibility unmatched by many other OECD economies.

The Australian Government has supported ASIC's regulatory role with significant funding increases over recent years. In the 2006-07 Budget, ASIC's funding was increased by approximately 25 per cent, or \$234.6 million over four years. The additional funding will ensure that ASIC has sufficient funding to maintain its current regulatory focus, develop its presence in relation to non-exchange based market trading (over-the-counter trading), and provide greater flexibility in funding enforcement activities.

Improving industry consultation

ASIC is endeavoring to improve the effectiveness of its consultation processes with industry and other stakeholders. To this end, ASIC released its *Better Regulation ASIC Initiatives* project in May 2006. It contains a number of initiatives to improve engagement with stakeholders and ensure stakeholders are effectively and efficiently consulted. Initiatives to date include establishing a Business Consultative Panel in Sydney and Melbourne and designing a standard liaison strategy that it will apply across all the regulated population.

Information sharing and cooperation

The Australian Government is addressing concerns with the timeliness in responding to requests for information from overseas regulators by transferring responsibility for the Mutual Assistance in Business Regulation Act 1992 (MABRA) to the Treasury. This will bring the operation of MABRA into the same portfolio as the regulatory agencies involved with the administration of the legislation. The transfer of responsibility is expected to be completed shortly. The Australian Government will review the new arrangements in due course.

Enforcement

The Australian Government is considering changes to ASIC's search warrant powers, consistent with recent changes proposed for the Australian Competition and Consumer Commission.

The Australian Government emphasizes that ASIC is not the regulator of the anti-money laundering/counter terrorist financing regulation in Australia and the legislation that it administers does not give it responsibility in this area. The definition and regulation of AFSL holders is quite distinct and not relevant to the way classes of persons are, or are intended to be, regulated under the Australian anti-money laundering/counter terrorist financing (AML/CFT) regulations. The Australian Government nevertheless is committed to ensuring that the proposed enhanced AML/CFT regulatory arrangements is supported by

effective co-operation as appropriate between the AML/CFT regulator, AUSTRAC, and both ASIC and APRA.

Issues

ASIC is in the process of finalising guidance on prospectus disclosure based on the draft policy statement *Better prospectus disclosure* released for public consultation in February 2006. It is expected that the policy statement will be finalised and released in the near future.

Collective investment schemes

There has been no identification of problems with the current regulatory arrangements relating to the conduct of managers when trading on behalf of their clients. Accordingly the need to impose further detailed requirements is not justified in terms of a regulatory impact assessment.

The authorities agree that monitoring by the regulators of compliance with accurate unit pricing obligations is important. It is also important for continuing work to be done with industry in tackling the root causes of unit pricing error which often relate to reliance on ageing computer software platforms. Policy work is currently under way to determine the most effective method to tackle impediments to the transfer to modern systems that permit timely and accurate unit price calculations.

Compensation arrangements

A mandatory requirement for Australian financial services licensees to have appropriate compensation arrangements to meet their obligations under the Corporations Act takes effect on 1 July 2006.

Reciprocal arrangements between ASIC and APRA

The Australian Government considers the current arrangement that requires ASIC to consult APRA on the impact of the imposition, variation or revocation of an AFSL is satisfactory as it relates to consultation by ASIC on the effect on an existing authorisation of an ADI by APRA. ADI authorisation will necessarily precede an application to ASIC for an AFSL which would make a reciprocal consultation obligation on APRA unnecessary.

Risk-based capital requirements

The Australian Government will consider imposing risk based capital requirements in relation to the systemic risks arising from OTC derivatives trading, as part of ongoing policy oversight of market regulation.

Secondary market regulation

Under the *Corporations Act 2001*, the Minister has the power to licence financial markets in Australia. Before making any decision to grant a financial market or clearing and settlement

facility licence the Minister is required to consider the advice of ASIC and as a matter of practice will also consider departmental advice. The Minister's involvement in the decision making process ensures that market and clearing and settlement facility licences are considered from a broad public policy position taking into account the overall benefits and impact on the economy. The Australian Government will examine in greater detail the merits of transferring all regulatory powers in relation to financial markets and clearing and settlement facilities to ASIC before making any decision to change the current arrangements.

IV. CPSS CORE PRINCIPLES FOR SYSTEMICALLY IMPORTANT PAYMENT SYSTEMS

A. General

72. This assessment of the payment systems in Australia was undertaken in the context of the IMF Financial Sector Assessment Program (FSAP) exercise for Australia in December 2005. It covers the Reserve Bank Information and Transfer System (RITS) that settles transactions on a real time gross settlement (RTGS) basis.

73. The Reserve Bank of Australia (RBA) conducted a comprehensive self-assessment of RITS' observance of the Core Principles for Systemically Important Payment Systems (CPSIPS). It was professionally done and was made available to the mission in advance. The Australian authorities were fully cooperative, and all relevant documentation to fulfill the assessment of RITS was provided on time and without difficulties. The logistical support and warm hospitality of the officials of RBA are greatly appreciated.

B. Information and Methodology Used for Assessment

74. The methodology for the assessments was derived from the Guidance Note for Assessing Observance of Core Principles for Systemically Important Payment Systems of the IMF and the World Bank of August 2001. Prior to the mission, the RBA prepared the self-assessment and filled in the Questionnaire on Payment and Securities Settlement Systems. Much of the material in RBA's self-assessment has been incorporated into this assessment. Furthermore, the assessor studied laws, articles, brochures, guidelines, data, and attended presentations provided by RBA and the different private sector institutions. Moreover, the assessor had regular and thorough discussions with relevant public authorities and met representatives from the private and commercial sector.

C. Institutional and Market Structure—Overview

75. The RBA is the central bank in Australia. It operates under the *Reserve Bank Act 1959*, and most of its powers and functions in the payments system derive from that Act and the *Payment Systems (Regulation) Act 1998*. The power to determine the RBA's payments system policy and oversight resides with the Payments System Board (PSB), one of the two boards of the RBA established under the Reserve Bank Act. The Governor of the RBA chairs the PSB. The PSB is composed of one RBA appointee, an appointee from the Australian

Prudential Regulation Authority and up to five other members. The PSB's mandate is set out in the Reserve Bank Act. It is responsible for determining the RBA's payments system policy in a way that will best contribute to controlling risk in the financial system and promoting efficiency and competition in the market for payment services, consistent with overall stability of the financial system. The PSB's policies are implemented by the RBA's Payments Policy Department, which also acts as advisor to the PSB.

76. The Australian Prudential Regulation Authority (APRA) is responsible for supervising deposit-taking institutions such as banks, credit unions, and specialist credit card institutions, which are participants in the payments system and offer payment services.

77. The Australian Securities and Investments Commission (ASIC) is responsible for market integrity and consumer protection across the financial system, including payments transactions. It administers the *Corporations Act 2001* and regulates Australian corporations, financial markets, clearing and settlement facilities (in conjunction with the RBA), and financial service providers.

78. The RBA also sets Financial Stability Standards that are to be complied with by clearing and settlement systems. Accordingly, the RBA and ASIC have agreed on a Memorandum of Understanding in relation to clearing and settlement facilities that sets out a framework for their cooperation.

79. The Australian Competition and Consumer Commission (ACCC) is responsible for ensuring that payments system arrangements comply with the competition and access provisions of the *Trade Practices Act 1974*. This authority can exempt the conduct of organizations and arrangements from the competition provisions if it judges it to be in the public interest. The ACCC and the RBA have also signed a Memorandum of Understanding to ensure a coordinated policy approach.

80. The Australian Payments Clearing Association (APCA) administers SWIFT payments and is responsible for coordinating the clearing of most retail payment instruments such as checks, direct entry, ATMs, and some card payments. APCA is a limited company owned by its shareholders such as banks, some building societies, credit unions and the RBA. Other payments clearing systems independent of APCA include MasterCard, Visa and Bankcard, and the BPAY system for payment of bills.

D. Payment Systems Infrastructure

81. RITS is the only systemically important payment system that operates in Australia. It was introduced as a real-time gross settlement system in June 1998 and is owned and operated by the RBA. Transactions are processed and settled continuously and irrevocably in real-time. It accepts payment instructions for interbank payments and for the settlement of net clearing arrangements. Low value transactions can also be processed through RITS. Final settlement of obligations between RITS participants is executed by entries to their exchange

settlement accounts (ESA) at the RBA. The bulk of large value interbank transfers is channeled through the SWIFT network,⁴ and a smaller number of transactions are transmitted via the proprietary network infrastructure.

82. RITS accepts payment instructions for interbank payments and for the settlement of interbank obligations arising from net clearing arrangements, such as the net balances of interbank obligations arising from low-value payments transactions (on a next day basis) and those transactions arising from equities settlement in the ASX's Clearing House Electronic Sub-register System (CHESS). RITS also settles on a real-time gross basis the cash leg of the securities transactions of the Austraclear settlement system.

83. There is no minimum amount for a payment to be made through RITS, so it handles time-critical low-value payments as well as large-value transfers. In 2005, RITS had 60 participants and on average settled 24,000 transactions daily with an average daily value of \$A 150 billion. The flows of payments in RITS are concentrated in a relatively small number of banks, so that the four major banks have 67 percent of the volume and value of the total RTGS transactions. However, no bank acts as a major settlement agent for other banks. In total, agency arrangements account for less than 1 percent by value of transactions.

84. Cash transactions are still the most important payment instrument for small retail transactions and for transfers of value between individuals. The ready availability of cash through automated teller machines (ATM) has sustained its use. As an indication, withdrawals from ATM average \$A 10.9 billion a month in 2004-2005, which equates to around \$A 540 per person. Non-cash payments account for most of the value of payments in the Australian Economy. On average, non-cash payments worth more than \$A 170 billion are made each business day, equivalent to about 20 percent of GDP. Check payments are still widely in use; they account for around 5 percent of the value of non-cash payments. However, the use of checks is much lower in Australia than the United States and continental Europe, but it is still much higher than the Scandinavian countries. As a consequence of the declining importance of checks, the use of electronic payment instruments at the retail level has been growing rapidly. In 2004-2005, credit and debit cards transactions averaged 112 per person. After a period of reluctance on the part of the consumers, the use of direct entry payments is growing strongly, and accounts for about 15 percent of the value of non-cash payments. The payment infrastructure for electronic retail payment is highly developed and seems to be efficient for its users, although it is relatively costly. Most banks charge their customers a so-called "foreign fee" averaging \$A 1.50 per transaction when using another bank's ATM. However, the transaction fees for using payment cards for EFTPOS transactions have fallen in recent years.

⁴ The Australian Payments Clearing Association (APCA) administers the closed user group and contractual arrangements governing access. These arrangements are set out in the form of regulations referred to as the High Value Clearing System (HVCS).

85. At present, 25 locally-owned banks, 28 branches of foreign banks, and more than 150 credit unions are active in Australia, of which 53 banks and branches are participants in RITS.⁵ The RBA preferred to have a broad participation in RTGS in order to reduce risk concentration in a few banks and, as a matter of policy, all banks were required to make their own high value payments in the RTGS system using their own account at the central bank. This policy was relaxed in March 2003 to allow very small central bank account holders (less than 0.25 percent of total payments) to enter into agency relationships with other participants.

E. Legal and Regulatory Framework

86. The Reserve Bank Act and the Payment Systems (Regulation) Act empower the RBA to oversee payment systems operated in Australia as well as fulfilling several payments related tasks. The power to determine and carry out the policy of the RBA in the field of payment systems resides with the Payments System Board (PSB) and its mandate is defined in the Act. The PSB is responsible for determining the RBA's payments system policy in a way that "will best contribute to controlling risk in the financial system; promoting the efficiency of the payments system; and promoting competition in the market for payment services, consistent with overall stability of the financial system."

Table 10. Assessment of RITS Observance of the CPSIPS and the RBA Responsibilities

<i>CP I-The system should have a well-founded legal basis under all relevant jurisdictions.</i>	
<i>Description</i>	<p><i>a. Completeness and reliability of framework legislation</i></p> <p>The legal basis for RITS and payment transfers executed in this system is defined by a consistent and reliable set of laws, regulations, and contractual arrangements. The acts, regulations, and contractual arrangements that are important for the payment system's legal basis are:</p> <ul style="list-style-type: none"> - The <i>Reserve Bank Act 1959</i> establishes the Payments System Board of the RBA, which is responsible for determining the RBA's payments system policy in a way that will best contribute to, inter alia, controlling risk and promoting efficiency and competition; - The <i>Payment Systems (Regulation) Act 1998</i> gives the RBA powers to regulate the payments systems operating in Australia. This act allows the RBA to designate a payment system, to obtain information from payment system participants and to set access regimes and determine risk control and efficiency standards for a designated payment system. Under this act, the RBA may consider the efficiency and competitiveness of the system in addition to safety and stability in determining the public interest; - The <i>Payment Systems and Netting Act 1998</i> allows the RBA to provide legal certainty (in approved RTGS payment systems) for transactions carried out on the day of appointment of an external administrator. It also gives legal certainty to multilateral netting arrangements which are approved by the RBA. This act provides certainty to netting

⁵ Non-bank deposit-taking payment service providers are eligible to hold ESAs and participate in RITS, but historically have participated indirectly through special service providers that are RITS participants. Other RITS participants include CLS Bank and entities associated with the Australian Stock Exchange and the Sydney Futures Exchange.

arrangements in the financial markets, such as those undertaken by the Australian Stock Exchange (ASX) and the Sydney Futures Exchange (SFE). It also provides the legal certainty required in multilateral netting schemes aimed at reducing foreign exchange settlement risk.

- The *RITS Regulations and Conditions of Operation (RITS Regulations)* and associated *contractual agreements* set out the rules for the operation of RITS and the rights and obligations of participants and the RBA. The legal basis for the operations of RITS is established by contract. Standard agreements are executed to bind each party to the RITS Regulations. Part 24.10 of the RITS Regulations explicitly submits each party to the non exclusive jurisdiction of the courts of New South Wales and courts of appeal from them.
- The *Cheques Act 1986* is the principal piece of legislation dealing with paper payment instruments in Australia. It establishes the framework under which checks are drawn, accepted and paid. This act was amended in 1998 to allow nonbank authorized deposit-taking institutions to issue checks in their own right. This act also allows for the turn-back, or presumed dishonor, of checks for which a failed drawee institution has not settled.
- The *Trade Practices Act 1974* has some provisions dealing with restrictive trade practices and consumer protection that are relevant to the operation of the payments system. The act prohibits conduct such as price agreements, boycotts, and exclusive dealing with the purpose or effect of substantially lessening competition. The Australian Competition and Consumer Commission (ACCC) may, however, authorize such conduct if it judges it to be in the public interest. The regulations and procedures for the five clearing streams operated by the Australian Payments Clearing Association (APCA) have been authorized by the ACCC. There are also provisions in the Trade Practices Act giving the Australian Securities and Investments Commission (ASIC) consumer protection powers in relation to the finance sector.

b. Enforceability of laws and contracts

All relevant laws, as well as contractual arrangements within the framework of RITS between the different parties involved are fully enforceable. In particular, each member of RITS signs a contract with the RBA, which binds the participant to the RITS Regulations. The RITS Regulations can be enforced through legal action. Contract law is predominantly determined by case law.

c. Definition of timing and legal protection of irrevocability and finality

The Payment Systems and Netting Act allows the RBA to provide legal certainty (in approved real time gross settlement (RTGS) payment systems) for transactions carried out on the day of appointment of an external administrator. Payments instructions that are sent to RITS and placed in the queue can be revoked by the participant itself until the settlement is executed. From that moment on, the payment is irrevocable and cannot be reversed by any party. Legal provisions recognize that finality occurs at the moment the account of the payee bank is debited, and as defined by the system, the account of the receiving bank is simultaneously credited. Final payments cannot be challenged.

d. Netting arrangements

RITS is an RTGS system and netting does not occur. However, Part 3 of the Payment Systems and Netting Act protects approved netting arrangements and Part 4 protects close out netting.

e. Zero hour rules or any similar rules

The Payment Systems and Netting Act allows the protection of transactions in approved systems which settle on an RTGS basis from the potential application of the zero-hour rule. RITS is an approved RTGS system in terms of Part 2 of this act.

	<p><i>f. Enforceability of collateral arrangements for intraday and overnight credit</i> The RBA accepts only repurchase agreements (repos) as a mechanism to provide intraday liquidity to the system. These repos are recognized and protected by laws and governed by the international standard, the <i>Public Securities Association (PSA)/International Securities Market Association (ISMA) Global Master Repurchase Agreement</i> (1995 version) as amended in exhibits under the RITS Regulations.</p> <p><i>g. Legal support of electronic processing</i> The <i>Electronic Transactions Act 1999</i> provides a legal framework for, among other things, electronic signatures, electronic record maintenance and giving information electronically. It also regulates when the settlement, valid electronic authorization and the allocation of rights and obligations occurs.</p> <p><i>h. Relevant provisions of banking and central banking law</i> In addition to the laws and regulations mentioned above, the <i>Banking Act 1959</i> covers the legal requirements necessary to be an authorized deposit-taking institution. Only authorized deposit-taking institutions can carry out banking business.</p> <p>The <i>Corporations Act 2001</i> includes provisions dealing with insolvency. The <i>Payment Systems and Netting Act 1998</i> addresses the problems of the “zero-hour rule” for insolvency. Corporations law has been substantially amended in the last decade. One of the reforms was to establish a licensing regime for clearing and settlement facilities and to empower the RBA to act as an overseer in relation to the financial stability aspects of these facilities.</p> <p><i>i. Relevance of laws outside the domestic jurisdiction</i> RITS is regulated according to the Australian laws and, hence, an overseas court order is not enforceable in Australia. However, RITS provides access to deposit-taking institutions and other supervised financial institutions established outside Australia. These institutions can participate in the system either via a branch located in Australia or on a remote basis. The foreign participation in RITS might lead to conflict of laws in the case of insolvency proceedings. In particular, the finality of settlement in RITS might be challenged by relevant regulations in the home country in the case of insolvency of an institution.</p> <p>However, to facilitate insolvency proceedings by overseas courts, the Corporations Act sets out a cooperative approach to be taken by Australian courts. Australian courts must act in aid of other courts of prescribed foreign countries. Prescribed countries include Canada, Malaysia, Papua New Guinea, Singapore, Switzerland, the U.K. and U.S.A. However, ‘aid’ only allows a foreign liquidator to exercise the powers available under the Corporations Act. Hence, transactions in RITS could not be unwound, as the powers in the Corporations Act do not allow it. There are provisions in the Corporations Act dealing with the insolvency of a foreign company. Nonresident participants agree (as part of their contractual obligations under RITS) to be subject to the laws of New South Wales in the event of a dispute or insolvency. Hence, nonresident participants must abide by the Corporations Act and their contractual obligations arising from the RITS Regulations.</p>
<i>Assessment</i>	Observed
<i>Comments</i>	<p>The operations of RITS, as well as payment transfers through the system, have a sound and solid legal basis.</p> <p><i>Recommendations:</i> In order to increase legal certainty, it is recommended that entities located outside the Australian jurisdiction that apply for participation in RITS either as a branch or on a remote basis, be required to provide a legal opinion that analyzes possible conflict of laws and potential legal risk to RITS and its participants.</p>

CP II – The system’s rules and procedures should enable participants to have a clear understanding of the system’s impact on each of the financial risks they incur through participation in it.

<p><i>Description</i></p>	<p><i>Rules and procedures:</i></p> <p>The RBA uses a variety of channels to ensure that participants understand the features and characteristics of RITS, the ways to process their transactions, and the risks they incur by using the system. The RITS Regulations and Conditions of Operation (“the Regulations”) identify the obligations and rights of the members and the system operator and set out how the system operates, including arrangements for settlement, and its operating hours. User Guides issued to all members contain detailed information on the features of RITS and use of its functions. When changes are made to the RITS Regulations, updated documents are circulated to all RITS members. Details of amendments are also generally notified electronically through email.</p> <p>The RITS Regulations and associated contractual agreements between the RBA and RITS members provide the legal structure for RITS. They set out the rules for the operation of RITS and the rights and obligations of members and the RBA. The legal basis of RITS is established by contract. Standard agreements are executed to bind each party to the RITS Regulations.</p> <p>A description of the main features of the system is provided in the Information Paper preceding the RITS Regulations. In particular, it covers the queuing mechanism used in RITS, the auto-offset facility and the transaction statuses. Descriptions of the daily settlement session, evening, morning, interim, and close settlement sessions are given in Conditions of Operation of RITS (associated with the Regulations).</p> <p>Furthermore, the RBA provides training to all new RITS members and training is available to other members on request. New members are given access to the test environment from their own offices prior to going live to enable them to perform more testing and familiarization activities. A general round of refresher training is offered to all members periodically, to allow them to send new staff for training.</p> <p><i>Risk management and procedures:</i></p> <p>RITS regulations and agreements with the participants clearly provide information on risk management and procedures. Insolvency of a participant would result in the ESA and RITS membership of that participant being suspended and transactions between that party and other participants would immediately cease to settle. Transactions previously settled are protected from application of the zero-hour rule by an approval under the Payment Systems and Netting Act. Settlement funds used by RITS are funds held in Exchange Settlement Accounts (ESA) at the RBA. These accounts cannot be overdrawn. Liquidity risk is mitigated by the design of the system queue, which uses a liquidity efficient algorithm, a bilateral offset mechanism, and provision of intraday liquidity. Intraday liquidity is provided to ESA holders by the RBA through intraday repurchase agreements. There is no cap on the amount of intraday liquidity that an institution can access, other than the value of eligible securities they hold or can obtain for repurchase agreements. Furthermore, the RBA offers an Overnight Repurchase Agreement Facility to enable holders of ESAs to have liquidity overnight from the RBA if they are unable to receive sufficient liquidity from the market to meet their settlement obligations. The facility is designed to avoid dislocations in the payments system that can arise from liquidity pressures emerging at the end of the day. Any change to the RBA’s policy on provision of liquidity or range of eligible securities is announced by media release and made available on its website.</p>
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	<p><i>Understanding of Risk:</i> Participants in RITS are clearly in a position to understand the procedures for the settlement of payments when they enter them into the system. They are also in a position to understand the procedure to handle abnormal situations such as lack of liquidity. Furthermore, the RBA publishes on a regular basis reports, articles, and other publications on various risks associated with payment and settlement activities in the RITS.</p>
<p><i>Assessment Comments</i></p>	<p>Observed The contractual arrangements, the available documentation, and the publications of the RBA enable participants to understand the system's impact on each of the financial risks they bear through participation in RITS.</p>
<p><i>CP III-The system should have clearly defined procedures for the management of credit risks and liquidity risks, which specify the respective responsibilities of the system operator and the participants and which provide appropriate incentives to manage and contain those risks.</i></p>	
<p><i>Description</i></p>	<p>Management of Credit Risks RITS is an RTGS system with queuing facilities. It settles in central bank money with finality (irrevocable and unconditional) and allows access to intraday liquidity from the RBA. The participants in RITS are protected against credit risk as funds transfer is settled by funds held in settlement accounts at the RBA with immediate finality. The RBA is also protected against credit risk. ESAs cannot be overdrawn.</p> <p>The bulk of payment orders is based on Y-copy message flow structure in SWIFT. This allows a receiver to be notified of a payment that it is due to receive, but is still held in the sending bank's queue. However, a credit risk arising from customers of the participants in RITS could arise when one participant makes irrevocable out-payments on the basis of payments intended for its account which are blocked in the queues of other participants. This could have some implication if the payments are still pending and, at the end of the day, cancelled by the system creating a liquidity shortfall. Under normal circumstances, this risk is negligible due to the fact that "active" payments tend to be settled immediately (or queued only for a short period of time). Secondly, initiating a payment to a counterparty without receiving the related payment with finality implies a provision of credit and such a decision needs to be taken by the credit manager of the bank. However, so far, very few payments in the queue would have been rejected at the end of the day due to a liquidity problem. A liquidity shortage can easily be solved by a repo transaction with the RBA.</p> <p><i>Queuing mechanism for management of liquidity risks:</i> RITS minimizes the risk of liquidity shortage that could cause payments to be blocked in the system through a number of mechanisms and instruments such as a centralized queuing mechanism and provision of intraday liquidity by the RBA. The design of the queuing mechanism allows the use of a liquidity efficient "next-down looping" algorithm that helps prevent gridlock and incorporates a bilateral offset mechanism. This means that the queue processor tests payments for settlement in order of receipt by the queue, settling or leaving each payment as it continues down to the end of the queue before looping back to the top of the queue. However, participants are able to reprioritize their payments. They can determine the way in which individual transactions draw upon liquidity by setting a status of 'deferred', 'active' or 'priority'. Queued payment instructions with a status active or priority are tested for settlement by the system queue. An active payment instruction will be processed unless it would cause the level of the paying institution's ESA balance to fall below an amount (sub-limit) specified by each member. Furthermore, a bilateral auto-offset simultaneously settles offsetting transactions that have been queued for over a minute. If a payment in the queue is not settled at the end of the day, it is automatically rejected by the system.</p> <p>Central bank intraday liquidity is provided by intraday repurchase agreements. All eligible securities taken under repurchase agreements are of a very high credit quality, such as</p>

governmental debt securities and discount instruments, securities guaranteed by the government, selected issues by supranational organizations and select bank bills and certificates of deposit (issued by third parties). These securities are subject to rigorous risk management procedures managed by the Domestic Markets Department. There is no limit on the amount of liquidity the RBA may supply by repo other than the value of eligible securities held by the participants. In unusual circumstances where a participant is unable to reverse an intraday repo with the RBA by the end of the day, the transaction can be converted to an overnight repo by agreement with the RBA. The interest rate is 25 basis points above the cash rate. This provides an incentive for participants to find funds in the money markets. So far, lack of liquidity has not been an issue in RITS. As an indicator, the daily settlement value in RITS averaged \$A 150 billion in 2005, and the total liquidity need was around AUD 8 billion.

Information systems:

The participants have access to real-time information on payments in the queue, settled incoming and outgoing payments and their settlement account balances. This information is available to all ESA holders via manual entries on their RITS terminals. It is also provided via SWIFT messages, which allows participants to automate use of these functions in their own systems. This Automated Information Facility (AIF) allows participants to submit commands, including a command to change a payment status or sub-limit (see above), make enquiries, and receive advice about payments (when specified types of payments arrive on the system queue and when payments settle) in SWIFT FIN messages. The AIF is also used for client credit management, and is mainly used by the banks whose clients undertake relatively large volumes of Austraclear settlements. ESA holders can also use their payment management functions to create the conditions for the auto-offset feature to settle a particular payment. This is more frequently used for client credit reasons, but could also be used to assist in liquidity management.

Timely monitoring by the system provider:

Liquidity is monitored both by the Domestic Markets Department and by the RITS operational staff in Payments Settlements Department. In Domestic Markets Department, staff monitor the settlement of transactions initiated at the morning's open market operations and the level of total liquidity (including intraday repurchase agreements) throughout the day. Projected end-of-day liquidity is also monitored throughout the day. Payments Settlements Department operations staff continuously monitor RITS in real-time for any functional problems, including those that may have an impact on liquidity. Monitoring includes checks as to whether a participant's payments are consistent with previously observed patterns and viewing queued payments information to ensure bottlenecks are not occurring. The staff of the Payments Settlements Department and the Domestic Markets Department are in contact with each other throughout the day.

Throughput guidelines and other incentives:

The RBA does not use throughput guidelines and price incentives to ensure that a backlog of payments on the system queue, or gridlock, does not occur. Gridlock has not been an issue for RITS. By number, over half of each day's settlements generally occur before noon. The RBA does not believe it is necessary to impose throughput guidelines. However, throughput is monitored continuously throughout the day and on occasion individual participants have been advised that the pattern of their payments behavior may cause problems.

Procedures for crisis management:

Potential settlement problems during the day may come to light within the RBA via Domestic Markets Department, which monitors conditions in the domestic money and bond markets or via Payments Settlements Department, which operates RITS and can identify unusual situations developing in the "payments queue" and in the ES account balances of individual participants. Where the settlement problems reflect a temporary shortage of ES funds or technical difficulties within RTGS, there are well-established procedures to follow. For

	<p>instance, in the event the Head of Domestic Markets Department or the Head of Payments Settlements Department has reason to believe that a participant in RTGS has, or is likely to experience liquidity problems that are neither temporary nor readily attributable to operational problems, he/she will inform the relevant assistant governors. The assistant governors for Financial Markets, Business Services or Financial System have the right to convene a meeting of the Crisis Management Group (CMG), which is responsible for coordinating the RBA's response to a crisis situation. The CMG consists of the governor, deputy governor and the assistant governors. The immediate task of the CMG is to diagnose the source, scope and dimension of any liquidity problem. It will also ensure effective coordination with APRA as required under the agreed Memorandum of Understanding. The Commonwealth Treasury and the Treasurer's Office will be informed of the development.</p>
<p><i>Assessment</i></p>	<p>Observed</p>
<p><i>Comments</i></p>	<p>The design and the functionalities provided by RITS protect the participants against credit risk and enable them to manage their liquidity risk appropriately.</p>
<p><i>CP IV - The system should provide prompt final settlement on the day of value, preferably during the day and at a minimum at the end of the day.</i></p>	
<p><i>Description</i></p>	<p><i>Irrevocability:</i> As an RTGS system, RITS provides real time an immediate settlement finality. As has been described above, transactions are entered into RITS where they proceed to the system queue. Participants can determine the way in which individual transactions draw upon liquidity. Once a payment is settled—simultaneous debit and credit of the paying and receiving participants' ESA at the RBA—it is irrevocable, unconditional, and cannot be reversed by the sender or a third party. Until a payment has been settled, the sending bank can recall the transaction.</p> <p><i>Clearly defined and legally effective moment of final settlement:</i> The finality of payments in RITS is effectively enforced and protected under the Payment Systems and Netting Act. The finality cannot be challenged in the event that the sending bank might be declared bankrupt or placed under public administration.</p> <p><i>Interval between acceptance and final settlement:</i> As an RTGS system, payments are settled during the course of the day in real time. Payments which are unsettled at the end of the day are removed from the queue. To be settled, they must be resubmitted the following day.</p> <p><i>Rejection of payments:</i> Before a payment is accepted into the system queue, it is validated to ensure the message/entry fields are valid and the payment is eligible for settlement. If the payment is valid and eligible for settlement, it is placed on the system queue for settlement testing. It is queued until the paying bank has sufficient funds in its ESA. Once a payment is settled, it is irrevocable. Until a payment has been settled, the sending bank can recall the transaction. RITS regulations permit the RBA to reverse any erroneous entry in an ESA.</p> <p><i>Enforcement of settlement processes and opening times:</i> The operating timetable of RITS is established by the RITS Regulations. RITS standard settlement hours are 07:30 to 18:30 in Australian standard time (April to October) and from 07:30 to 20:30 in Australian summer time (November to March). For a further 30 minutes after the close of settlement, members can download relevant reports for reconciliation. The RBA has the discretion to vary the operating hours under Regulations 5.6 and 5.7 of the RITS Regulations. The Guidelines for Session Extensions outlines the procedures for participants requesting extensions to session times. Requests are judged against objective criteria. Senior Management or the duty managers in the Operations and Projects Section can approve extensions. If the extension is required for a system problem, an incident report is prepared. If</p>

	a participant were to repeatedly require extensions, this would be noted and steps taken to address it. The RBA can also extend operating times if required by Domestic Markets Department. Records of extensions are kept to ensure that the frequency and length of extensions are minimized.
<i>Assessment</i>	Observed
<i>Comments</i>	As an RTGS system, RITS provides prompt final settlement during the day. Operating times are clearly defined and monitored.
<i>CP V – A system in which multilateral netting takes place should, at a minimum, be capable of ensuring the timely completion of daily settlements in the event of an inability to settle by the participant with the largest single settlement obligation.</i>	
<i>Description</i>	RITS is an RTGS system that settles on a continuous basis during the day with intraday finality.
<i>Assessment</i>	Not applicable
<i>Comments</i>	
<i>CP VI – Assets used for settlement should preferably be a claim on the central bank; where other assets are used, they should carry little or no credit risk and little or no liquidity risk.</i>	
<i>Description</i>	<p>RITS settles in central bank money, i.e., the settlement assets in RITS are claims on the RBA. Settlement is executed by debiting the sending participant's ESA with the RBA and crediting the beneficiary participant's ESA.</p> <p>The RBA was concerned that allowing indirect participation in RTGS might lead to a high degree of concentration of payments through a few direct participants. The RBA was also concerned that indirect participants could be at a competitive disadvantage in offering payments services in Australia. Consequently, the RBA formed a view that broad participation in RTGS was preferable and as a matter of policy, all banks were required to make their own high value payments in RTGS using their own ESA. This policy was relaxed in March 2003 to allow very small ESA holders (less than 0.25 percent of total payments) to enter into agency relationships with other ESA holders. At present, very few banks use other banks as settlement agents. Banks using an agent must have an ESA for use in contingencies.</p>
<i>Assessment</i>	Observed
<i>Comments</i>	Settlement takes place in central bank money, and no settlement bank or deposit risk occurs in RITS. Furthermore, it is deemed that credit risk of using settlement agents is negligible due to the lack of concentration of payments through a few direct participants.
<i>CP VII – The system should ensure a high degree of security and operational reliability and should have contingency arrangements for timely completion of daily processing.</i>	
<i>Description</i>	<p><i>Security policy and objectives:</i> The RBA defines the security policies, reliability requirements and operational service level. The overall objective is to ensure efficient, stable, and secure settlement of interbank payments transfers. RITS is a separate stand-alone module with a specified exchange of information between the subsystems. It is currently being redeveloped from an Oracle Forms-based interface to a modern, web-style GUI format. The RBA has taken advantage of the opportunity offered to review longstanding security protocols, objectives, and business requirements. The RBA benchmarks its operation and quality services against the international and national industry-level standards such as BSI 7799:1999 for information security requirement and ISO 9364 for banking communications messages.</p> <p><i>Security risk analysis and monitoring:</i> The system is subject to regular analyses of security risks. A key activity of the RITS</p>

Helpdesk is monitoring system activity and performance throughout the processing day, at a minimum every 15 minutes, using a variety of automated tools, graphs, and manual checks. Incidents and disruptions are logged adequately, and rules and routines are in place for operational follow-up. The RBA produces a Security Audit Report daily, which is examined by analysts of Security Group. This report addresses login failures, security modifications, and security audit administration. Quarterly internal reports that cover performance against service level and other operational matters are sent to senior management for review.

Documentation:

The reliability of the systems, as well as of the system's participants, are recorded in the system incidents database. The ability of participants to efficiently settle their transactions is also recorded in the database. The information recorded includes the following: source, description, and solution to problem; downtime; and impact on RITS sessions. RITS, as a system, has not so far experienced any major incident, and the number of total incidents is relatively low.

Operational reliability and contingency:

The system owner and business operator, Payments Settlements Department, and the technical service provider, Systems and Technology Department, have agreed on service level expectations for support of the production and test environments at both the primary and backup sites. The RBA has developed a contingency plan to cope with a wide range of technological problems. It deals with different levels of software and hardware defects and disruption in the various communication networks. Various scenarios and staff roles are analyzed, including but not exclusively the inability of the staff to reach the primary site, disruptions in telecommunication and electrical power, and disruptions in contact with important external parties. In the contingency plan, rules and procedures for decision-making processes are worked out and there is a clear division of responsibility in the various emergency situations and follow-up responsibilities.

In order to ensure business continuity, the RBA has set up backup facilities. The backup site has the same capacity and components as the primary site. The primary site configuration is required to have full redundancy through the duplication of equipment or by the use of high availability processing facilities for all computer and major network components. The backup site is located over 20 kilometers from the primary site, has its power supplied from a different electricity grid to the primary site, and has its telecommunications services supplied from a different exchange to that of the primary site. However, the secondary site will be moved to another location, which is 25 kilometers away from the primary site. It has sufficient capacity to continue the operation without a major deterioration in performance. It is a 'hot backup', and all transactions in the production environment are mirrored to the backup site in real time and loss of transaction data cannot occur. The backup site has the ability to continue operations for a longer term. To this end, the RBA has established dual equipment to prevent equipment failure during long term operation from the backup site. In the event of a component failure at the primary site, recovery should be within 15 minutes. In the event of a failure at the primary site which cannot be recovered at that site the benchmark time for full recovery at the backup site is within 40 minutes from the time the decision is taken. In an extreme circumstance, where it is necessary to relocate staff to the backup site, full recovery should take no more than 60 minutes. The average annual availability of RITS (all components) was 99.98 percent for 2002, 99.91 percent for 2003, and 99.94 percent for 2004. At no time during recent years was the entire RITS facility unavailable for its participants.

The RBA conducts an extensive range of contingency exercises to test the operational reliability of RITS under different circumstances. The RBA aims at conducting a minimum of four weekend tests each year, simulating a range of hardware or communication failures. Contingency tests are designed to address recovery arrangements in a number of areas including the RITS computers, the CSI computers, and the communication network. These

are extensive tests performed on weekends so that the production environment can be used.

New ESA holders joining RITS must satisfy the RBA of their operational capacity to conduct their ESA and use RITS. Payments Settlements Department undertakes an operational readiness assessment prior to the applicant being allowed to 'go live'. This assessment covers a range of areas including the participant's backup capacity.

Protection of data communication:

Two communication networks are in place to transmit payment orders to the RTGS system: SWIFT network and RITS network. The bulk of the transactions (about 65 percent) is transmitted to the RTGS system using the SWIFT Y-copy services. The use of the SWIFT network for payments is administered by the Australian Payments Clearing Association (APCA), while the centralized technical infrastructure is located at the RBA.

The second communication network is the Austraclear National Network Infrastructure (ANNI). At present, there is no network encryption, although it is a closed network. As part of the Public Key Infrastructure (PKI) project, there will be a new RITS Security Policy which will address this issue. The RITS user interface enhancements (providing online user benefits) and a move to digital certificates provide higher levels of system security. As part of the UI project, Secure Sockets Layer (SSL) technology is being implemented to provide 'end-to-end' encryption of online traffic.

Australia does not use the IBAN system for bank account numbering.

Audit trails:

All transactions in RITS can be traced back from the recipient to the sender (end-to-end). RITS logs the progress of transactions at each status change in the transaction life cycle. All transactions have a unique transaction ID number which provides an audit trail for future enquiry. The system log, which is updated in real time, includes, but is not necessarily limited to, information on when the transaction is entered into the system, whenever the details or status of the transaction changes, if it is rejected by the system, queue status information and settlement details (or removal from the queue at end-of-day, if appropriate). RITS provides extensive enquiry audit trails for online enquiry of transaction activity for the last five business days. This is supported by an extensive range of reports which, according to their nature, are either available in real-time or as an output from overnight batch processing.

Development and procurement:

Rigorous measures and procedures are in place to ensure the quality of the development of new software and testing of new updates and releases. The RBA employs a comprehensive change management program to protect the integrity and quality of the application software, hardware and communication network configuration that is made available to members. All changes to the system require user testing and signoff. To ensure RITS achieves the necessary levels of availability and stability, stringent change management processes have been established and maintained over all aspects of the system and its supporting environment. Any changes to the RITS environment must be assessed in terms of effort, impact, risk, complexity, testing requirements and back-out options, prior to approval being granted. All changes must be approved by authorized senior officers before they can occur. Changes pass through a variety of test environments before they are approved for production implementation. The RBA has a general guideline that there should be no more than four major change windows each year for RITS. All RITS specific changes are discussed and endorsed at a monthly meeting. The RBA has implemented software as the management system to support changes to RITS application components. This product tracks changes to the RITS-specific components. A weekly change management meeting involving all RBA stakeholders is held to review the scheduled and planned system changes to ensure all parties are forewarned and aware of proposed changes to all environments across the RBA. Within the procedures, there also exist exception rules catering for emergency changes.

	<p><i>Availability and scalability:</i> RITS has sufficient capacity to handle significant increases in volumes/activity. Required capacity is set out in a Capacity Plan. Capacity and performance tests are conducted prior to any system upgrade.</p> <p>The system has sufficient capacity to handle high volumes during peak times. Currently, the system uses around 35 percent of its capacity.</p> <p><i>Audits:</i> Regular internal audit reviews are conducted. The RBA's internal audit procedures review conformity to commercially reasonable standards for confidentiality, integrity, authentication, non-repudiability, availability and auditability through a comprehensive program comprising, but not limited to, technical reviews and regular operational inspections. The RBA recently established a Risk Management Unit with the primary objective of ensuring a consistent framework for the definition, assessment and monitoring of risks. Both Audit Department and the Risk Management Unit receive copies of Incident Reports generated following interruptions to RITS service. Regular updates of action items flowing from the Incident Reports are provided to Audit Department and the Risk Management Unit. In addition, external security reviews of both internal systems and network are conducted annually. The last independent external audit concluded in January 2005, and focused on the security of the new user interface infrastructure. Prior to that there was an audit of the firewall infrastructure, which concluded in October 2004. According to the RBA, all major issues raised (with the exception of the network encryption) have been adequately addressed. Network encryption is being introduced with the GUI interface.</p>
<p><i>Assessment Comments</i></p>	<p>Observed The RBA has rigorous and comprehensive security policy measures and procedures in place in order to ensure a high degree of operational reliability.</p> <p><i>Recommendation:</i> The RBA should require security enhancement of this proprietary network to meet international standards with regards confidentiality, integrity and authenticity of the transmitted information and data.</p> <p>The RBA should consider allowing external review of the RBA's current business continuity plan and future major changes introduced to the systems. Reviews should cover the assessment of the hardware, software and internal procedures.</p>
<p><i>CP VIII - The system should provide a means of making payments, which is practical for its users and efficient for the economy.</i></p>	
<p><i>Description</i></p>	<p><i>Crucial functions of RITS:</i> The primary objective of any payment system is to offer services which are sound and cost-efficient to its participants and advantageous for the economy. For a central bank, a payment system should also allow smooth execution of monetary policy. The primary objective in establishing RITS, as an RTGS system, was to reduce systemic risk and increase efficiency. As an RTGS system, RITS addresses the problem of accumulating obligations until the end of the day, typical of a deferred system, and prevents the build-up of unsettled obligations. Under earlier deferred net settlement arrangements, there was a risk that a failure of a participant could cause systemic disruption for the entire financial sector. Furthermore, individual participants had no capacity to manage their exposures against each other or their customers, nor, due to uncertainty about payment flows, could they manage their liquidity needs efficiently. Under RTGS, settlement risk is eliminated and both banks and their customers can manage their payments and associated credit risks. A further objective is that payment transactions should be legally robust. The Payment Systems and Netting Act provides the requisite protection. Under previous arrangements, there was considerable doubt</p>

	<p>that multilateral netting arrangements were legally certain.</p> <p><i>Available functionalities in the system:</i> All the usual facilities in an RTGS system for sending, queuing, and inquiry are in place. In addition, an offsetting mechanism promotes the throughput in the system and solves imminent gridlocks.</p> <p><i>Liquidity management and availability of intraday credit:</i> Based on repo transactions, there is no restriction or limitation with regards the liquidity provided by the RBA. Provision of intraday liquidity by the RBA is not subject to any charge or fee.</p> <p><i>Opening time and practicality of the settlement cycle:</i> RITS standard settlement hours are 07:30 to 18:30 in Australian standard time (April to October) and from 07:30 to 20:30 in Australian summer time (November to March). The Guidelines for Session Extensions outline the procedures for participants requesting extensions to session times. Requests are judged against objective criteria — the outstanding transactions must have an aggregate value of at least \$A 100 million. The RBA may also extend operating times if required by Domestic Markets Department. (See Core Principle IV for further information).</p> <p><i>Processing speed:</i> The time taken for a payment to settle is monitored by the Payments Settlements Department. Currently, settlement time is not a constraint for participants or the system. Capacity is not a restraint on the speed of processing in RITS. The main contributor to the time to settle is a participant's management of liquidity. One indicator of processing times is the volume of payments processed during the first fifteen minutes of the daily settlement session when the queue is at its peak. In 2005, around six payments per second were settled each day in the first 15 minutes. The highest volume settled in this time slot in 2005 was nearly double, at 11 payments per second. In addition, RITS has not encountered any capacity constraints. A range of performance tests are conducted following significant upgrades to ensure that the throughput continues to meet requirements. Accordingly, throughput guidelines are considered unnecessary.</p> <p><i>Cost recovery and pricing:</i> The RBA objective is operational cost recovery, which is currently met by a flat transaction fee. The RBA charges a flat fee per transaction, but no joining or annual fee. RITS participants pay \$A 0.88 for each debit and credit to their ESA (i.e. each transaction incurs a fee for the sender and the receiver). According to the RBA, the reason for charging both the sender and the receiver of the payment is that both receive a benefit (e.g. securities transactions, foreign exchange transactions, payments between customers) as the sender discharges its payment obligation and the receiver gets the funds by a timely and low risk method.</p>
<i>Assessment</i>	Observed
<i>Comments</i>	<p>RITS provides a reliable service to its participants that appears to fit the needs of its users and fulfils the public interests by reducing systemic risks and offering an efficient channel for the execution of monetary policy.</p> <p><i>Recommendations:</i> The price structure has not been amended since the launch of RITS in 1998 while the number of transactions has almost doubled. The RBA has undertaken various studies of RITS costs and pricing structure, analyzing the total costs associated with RITS such as operating, development and overhead costs. However there have not been formal consultations with users about these. The RBA should consider following up its studies of RITS costs and pricing structure by consulting RITS users. The RBA should consider a review of the pricing</p>

	structure to ensure that it promotes efficient functioning of the system.
<i>CP IX - The system should have objective and publicly disclosed criteria for participation, which permit fair and open access.</i>	
<i>Description</i>	<p><i>Access criteria:</i> To participate in RITS, a participant must be qualified and have an account (ESA) at the RBA for settling in RITS. There are two broad criteria for eligibility for an ESA:</p> <ul style="list-style-type: none"> • the applicant must be a provider of payment services with a need to clear obligations with other providers; and • to protect the payment system, the applicant must demonstrate that they have the liquidity to meet settlement obligations under routine conditions, during seasonal peaks and periods of stress. <p>Institutions that are authorized and supervised by Australian Prudential Regulation Authority (APRA) are eligible for an ESA without special conditions, though they must still demonstrate that they have the necessary operational, capacity and adequate liquidity to operate in RITS. The RBA offers a wider access to ESA. Entities that are not authorized and supervised by APRA have to demonstrate that they have the necessary operational capacity and adequate liquidity and may be subject to ongoing collateral requirements. All ESA holders are required to be a member of RITS and meet all of its operating conditions and charges. The details concerning access requirements can be found on the RBA's external website.</p> <p>All non-bank ESA holders and most banks are direct participants. However, ESA holders with relatively small RTGS transaction values may apply to use an agent to settle their RTGS transactions. Non-bank deposit taking institutions are eligible to apply for their own ESA, but historically have participated indirectly through special service providers that have an ESA. For a bank to be eligible to use an agent bank for the settlement of any or all of its RTGS transactions, its RTGS transactions must, on a consistent basis, account for less than 0.25 percent of the total value of all RTGS transactions. Banks that elect to settle their RTGS transactions through an agent must still maintain an ESA, for use in a contingency. A prior approval from the RBA and APRA is needed to use an agent or act as an agent for RTGS payments.</p> <p><i>Technical requirements for participants:</i> To access the system, participants must have RITS terminal access. This allows participants to monitor their settled payments and ESA balance, view and manage their queued payments and enter cash transfers.</p> <p><i>Cost of access for low volume participants:</i> The network used for RITS terminal access provides for dial-up modem or leased line connections. Dial-up access is cheaper and more suited to low volume users. In the future, dial up access will be replaced by internet connection. Furthermore, there are no membership fees and the cost to settle is flat and does not differentiate between low or high volume participants.</p> <p><i>Exit rules:</i> Rules relating to suspension, termination and resignation from RITS are found in the RITS Regulations. A member may resign by giving the RBA one month's notice in writing or, if the RBA agrees, a shorter period of notice. The RBA may at any time terminate or vary the terms of the membership of any member.</p>
<i>Assessment Comments</i>	<p>Observed The access rules for RITS are clear, publicly disclosed, fair and objective. The access criteria do not have a restrictive impact on competition.</p>

CP X – The system’s governance arrangements should be effective, accountable and transparent.	
<i>Description</i>	<p><i>Ownership structure and accountability of the management:</i> RITS is owned and operated by Payments Settlements Department as a functional area of the RBA. Decisions affecting the day-to-day operations and customer relations as well as the system’s enhancement are the responsibility of Payments Settlements Department which reports to the Assistant Governor (Business Services). Major decisions that require significant expenditure, or have policy implications, are considered by the RBA’s Executive Committee—an advisory committee designed to allow discussions among the Governor, Deputy Governor and Assistant Governors. Decisions concerning the operation of RITS and ESAs are considered to be consistent with the policy determined by the Payments System Board.</p> <p><i>Financial targets and other objectives:</i> When RTGS was introduced the RBA advised participants that fees would be capped for five years. The RBA’s goal for cost recovery in the first five years of RTGS was to recover external development costs of RTGS and on-going operational costs. Internal development costs of RTGS were not to be recovered by RTGS transactions fees.</p> <p><i>Availability of information on the system:</i> The RBA’s website provides a description of RITS and the RBA’s payment policy objectives and initiatives. The RBA’s annual report includes more detail on payment system developments. The RITS terminal can also be used to alert members to operational changes, generally as an adjunct to other notification. It can also be used to alert users to due dates for invoice payments and changes to session times for daylight saving.</p> <p><i>Consultation with all relevant users on major decisions:</i> Major decisions are made by the RBA and implemented in consultation with participants to ensure the smooth introduction of any changes. Participants are not formally involved in decision making. Liaison and consultation with them is typically informal. Consultation with RITS members, feeder system operators and other parties is the responsibility of the Planning & Client Relations Section of Payments Settlements Department. For specific projects, operational and/or technical working groups are formed to facilitate feedback from users. Issues can be raised concerning SWIFT payments and discussed within APCA Management Committee 4. Participants’ voting rights within this forum are based on volumes transacted. The RBA has a seat at this committee.</p> <p><i>Fulfillment of the Basel Core Principles:</i> As has been demonstrated in this assessment, RITS fulfils the other nine Core Principles.</p>
<i>Assessment Comments</i>	<p>Observed RITS’ governance arrangements are effective, accountable, and transparent:</p> <p>In order to ensure RITS’ continues to meet users’ needs in terms of efficiency, practicality and service level, the RBA may wish to consider re-establishing a consultative framework with the users. An advisory user group could be set up, representing different categories of RITS participants to discuss issues related to technical and business features of RITS.</p>
Central Bank Responsibilities in Applying the CPSIPS	
Responsibility A – The central bank should define clearly its payment system objectives and should disclose publicly its role and major policies with respect to systemically important payment systems.	
<i>Description</i>	The Reserve Bank Act 1959 defines the mandate, policy and role of the RBA in the field of

	<p>payment systems. The Act makes efficiency of payment systems, competition in the market for payment services and controlling risk in the financial system statutory objectives of the RBA. The power to determine the RBA's payments system policy resides with the Payments System Board (PSB). Based on the Act, the PSB is set up with a specific mandate. Within the limits of its powers, it is responsible for ensuring that:</p> <ul style="list-style-type: none"> (a) the RBA's payments system policy is directed to the greatest advantage of the people of Australia; and (b) the powers of the RBA under the Payment Systems (Regulation) Act and the Payment Systems and Netting Act are exercised in a way that, in the PSB's opinion, will best contribute to: <ul style="list-style-type: none"> (i) controlling risk in the financial system; (ii) promoting the efficiency of the payments system; and (iii) promoting competition in the market for payment services, consistent with the overall stability of the financial system. <p>In addition, the Payment Systems (Regulation) Act allows the RBA to obtain information from payment system participants, designate payment systems, and to set access regimes and determine risk control and efficiency standards for designated payment systems.</p> <p><i>Public Disclosure of role and objectives:</i></p> <p>The RBA uses various channels to inform the public on its role and policy in the field of payment systems. The activities and decisions taken by the PSB are regularly published in its Annual Report. On its website, the RBA provides a comprehensive description of the payments infrastructure in Australia. Furthermore, it also carries out studies and publishes articles on topics such as efficiency and competition in retail payments. Issues related to the impact of payment systems on the stability of the financial sector are also analyzed in the Financial Stability Review. Interested parties are also adequately informed on any policy change in the field of payments.</p>
<p><i>Assessment Comments</i></p>	<p>Observed</p> <p>Australia has been a pioneer in establishing a separate Board responsible for defining the RBA's payments system policy and oversight. An appropriate separation exists between the payments policy function and payments system operations. This separation is enforced at the departmental level; the Payments Policy Department is responsible for preparing and implementing the policy and the Payments Settlements Department is responsible for operating RITS. However, while the Payments Policy Department reports directly to the PSB, issues to be presented to the PSB are first discussed by a committee of RBA executives, which is chaired by the PSB chairman. This raises the potential for a conflict of interest given that the Assistant Governor responsible for payments system operations is present.</p> <p><i>Recommendation:</i></p> <p>The RBA should consider whether current arrangements avoid potential conflicts of interest between the policy and oversight functions (that fall under the jurisdiction of the PSB) and the Bank's role as an operator of the RITS system. Major changes introduced to RITS need, of course, to be discussed by the PSB in its capacity as an overseer.</p>
<p>Responsibility B—The central bank should ensure that the systems it operates comply with the core principles.</p>	
<p><i>Description</i></p>	<p>The Payments System Board is responsible for the oversight of the payment systems operating in Australia, including the RBA's RTGS system. As a part of its task, the Board, via the Payments Policy Department, ensures that the operations of RITS as well as changes to the system comply with the Core Principles.</p>

	<p>The Payments Policy Department undertakes ongoing oversight by monitoring RITS, including associated risks, market behavior, costs and fees, etc. The department is also informed of any operational problem and, where appropriate, discusses with the Payments Settlements Department the measures that are necessary to avoid spill-over. (Not clear what “spill-over” refers to here-maybe some elaboration?)</p> <p>The Payments Policy Department has conducted a comprehensive detailed assessment of RITS. This assessment was presented to and discussed by the PSB.</p>
<i>Assessment Comments</i>	Observed
Responsibility C—The central bank should oversee observance with the core principles by systems it does not operate and it should have the ability to carry out this oversight.	
<i>Description</i>	<p>The Payment Systems (Regulation) Act gives the RBA extensive regulatory power to regulate and oversee payment systems, including interbank and retail payment systems operating in Australia. This task is the responsibility of the PSB. The Act allows the PSB to set access regimes and determine risk control and efficiency standards for designated payment systems, and to obtain information from payment system participants. As an overseer, the PSB assesses the appropriateness of rules and regulations and changes in system design and operations. The objectives of the PSB are implemented by the Payments Policy Department which has about 30 staff members with a diversified and well qualified professional background. To a larger degree, the PSB fulfills its oversight role by monitoring payment services providers and collecting information.</p> <p>With regards the observance of the Core Principles, at present, there are no privately operated systems in Australia considered systemically important by the RBA, and for this reason there is no need for the RBA to carry out an assessment against the Core Principles.</p>
<i>Assessment Comments</i>	Observed
	The RBA should consider further strengthening the implementation of its oversight responsibility by developing formal methods and procedures, including regular monitoring and reporting, on-site inspections of important systems and arranging regular meetings with payment systems providers and other stakeholders.
Responsibility D—The central bank, in promoting payment system safety and efficiency through the core principles, should cooperate with other central banks and with any other relevant domestic or foreign authorities.	
<i>Description</i>	<p><i>Domestic cooperation:</i></p> <p>The RBA cooperates with other relevant authorities which have interests in various aspects of the payments system. In particular, the RBA cooperates with Australia’s prudential regulator (APRA), which is responsible for supervising financial institutions. A Memorandum of Understanding (MOU) is signed with APRA that sets out a framework for cooperation between the two institutions aimed at promoting the stability of the Australian financial system, including the payments system. In addition to exchange of information, both the RBA and the APRA have regular meetings to discuss issues that bear upon their responsibilities.</p> <p>The RBA has also signed a MOU with the securities regulator (ASIC) that sets out a framework for cooperation between ASIC and the RBA in respect of regulatory responsibilities for clearing and settlement facilities. The cooperation includes regular meetings and information exchange.</p> <p>Another MOU is also signed with the ACCC to ensure a coordinated policy approach to</p>

	<p>promoting competition in the market for payment services.</p> <p><i>International cooperation:</i> The RBA participates actively in a number of international fora to promote the stability of financial markets and sound and legally robust payment systems. For instance, the RBA was a member of the Committee on Payment and Settlement Systems task force on Payment Systems Principles and Practices that drafted the Core Principles.</p>
<i>Assessment</i>	Observed
<i>Comments</i>	

Table 11. Summary Observance of CPSS Core Principles and Central Bank Responsibilities in applying the CPSIPS—RITS

<i>Assessment grade</i>	<i>Principles grouped by assessment grade</i>	
	<i>Count</i>	<i>List</i>
Observed	9 + 4	I, II, III, IV, VI, VII, VIII, IX and X; A, B, C and D
Broadly observed		None
Partly observed		None
Non-observed		None
Not applicable	1	V

F. Recommended actions and authorities' response to the assessment

Recommended actions

Table 12. Recommended Actions to Improve Observance of CPSS Core Principles and Central Bank Responsibilities in applying the CPSIPS—RITS

<i>Reference principle</i>	<i>Recommended action</i>
Legal foundation (CPI)	Require entities, located outside the Australian jurisdiction, that apply for participation in RITS either as a branch or on a remote basis to provide a legal opinion that analyzes possible conflict of laws and potential legal risk for RITS and its participants.
Security and operational reliability, and contingency arrangements (CPVII)	<p>Require security enhancement of the proprietary communication network to meet international standards with regards confidentiality, integrity and authenticity of the transmitted information and data.</p> <p>Consider an external review of the RBA's business continuity plan that would include the assessment of the hardware, software and internal procedures.</p>

<i>Reference principle</i>	<i>Recommended action</i>
Efficiency and practicality of the system (CPVIII)	Consider following up its studies of RITS costs and pricing structure by consulting RITS users. The RBA should consider a review of the pricing structure to ensure that it promotes efficient functioning of the system.
Governance of the payment system (CPX)	Consider establishing a consultative framework with the users in order to ensure RITS continues to meet users' needs in terms of efficiency, practicality and service level. The RBA may wish to re-establish its advisory user groups, representing different categories of RITS participants to discuss issues related to technical and business features of RITS.
Central Bank Responsibilities in Applying the CPSIPS	<p>Consider whether current arrangements avoid potential conflicts of interest between the policy and oversight functions (that fall under the jurisdiction of the PSB) and the Bank's role as an operator of the RITS system.</p> <p>Strengthen the implementation of the PSB's oversight responsibility by developing formal methods and procedures, including regular monitoring and reporting, on-site inspections of important payment systems and arranging regular meetings with payment systems providers and other stakeholders.</p>

Authorities' response

The authorities are grateful to have had Australia's only systemically important payment system, the Reserve Bank Information and Transfer System (RITS), reviewed by the IMF. The review was conducted professionally and cooperatively and the authorities found the process useful. The authorities concur with the IMF's assessment that RITS complies with all of the *Core Principles for Systemically Important Payment Systems* and that oversight arrangements comply with the responsibilities of the central bank in applying the *Core Principles*.

With regard to the specific recommendations arising from the assessment, an upgrade to the RITS user interface was well advanced at the time of the assessment and is due for implementation during 2006. This upgrade will bring confidentiality, integrity and authenticity of transmitted information up to best practice. Also during 2006, the Reserve Bank will finalize a review of pricing. In determining any changes to fees, the Bank will take into account cost recovery, system efficiency and appropriate incentives for participants, along with industry feedback on proposed changes. The Bank will continue to ensure that the appropriate delineations are maintained between the oversight functions carried out under the responsibility of the Payments System Board and operational payments functions. It will ensure that any conflicts of interest that may arise in the oversight process are properly addressed.

The Reserve Bank will give careful consideration to the IMF's recommendations in relation to legal risk from branch participation in RITS, external review of the RITS business continuity plan, and arrangements for consultation with RITS users. The Bank will also consider how best to perform its oversight function.