LIST OF CONTENTS

Chapter 2 – The Regulation of Mutual ADIs

2. THE REGULATION OF MUTUAL ADIs

2.1 Financial Sector Reform

Overview of Financial Sector Reform

On 1 July 1999 (the Transfer Date) the responsibility for regulating credit unions and building societies transferred from the States and Territories to the Commonwealth. A regulatory environment underpinned by the Banking Act and the Corporations Act replaced the Financial Institutions Scheme.

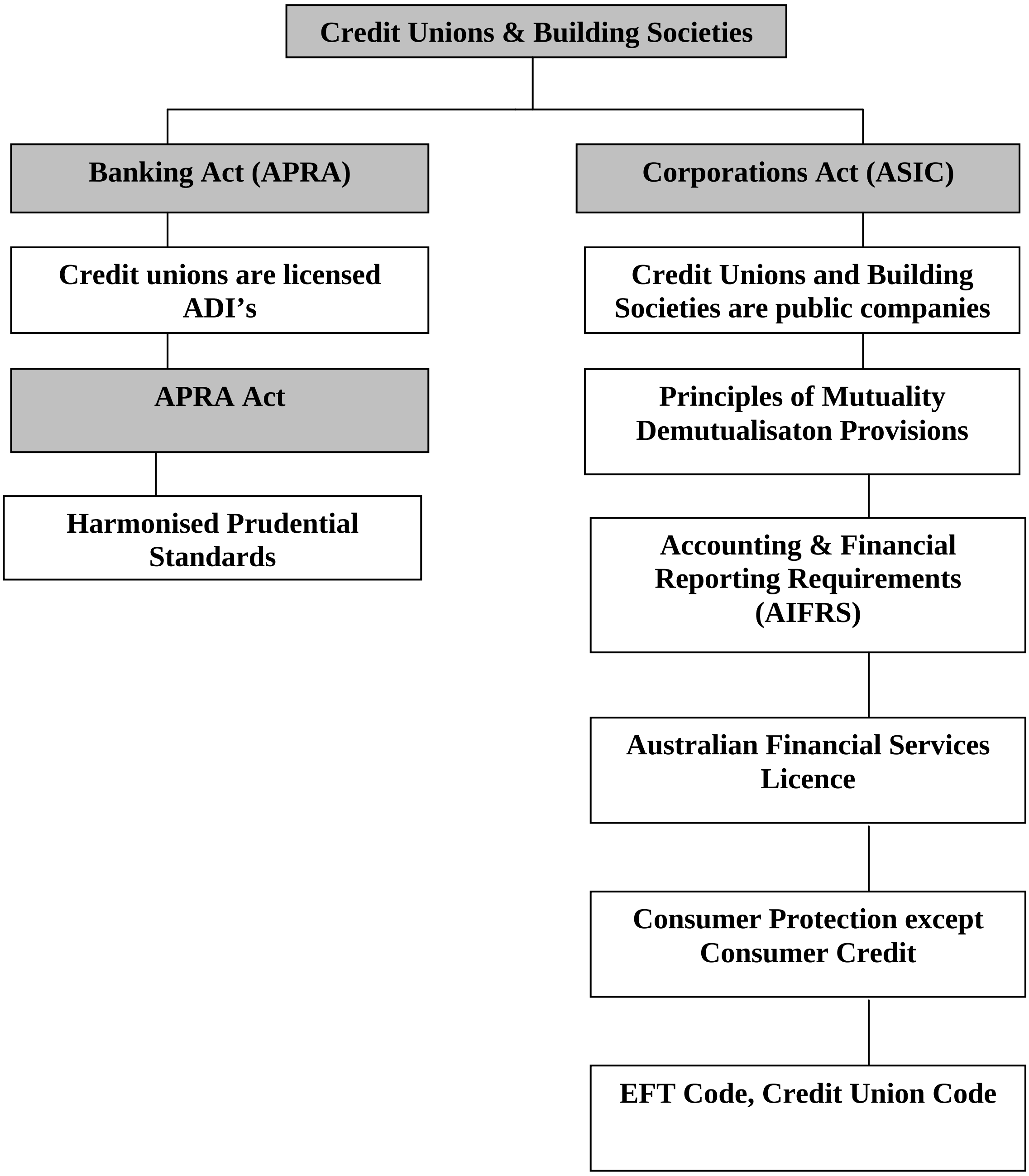
Credit unions and building societies are regulated by the Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investments Commission (ASIC).

[Detailed information on APRA and Prudential Regulation is dealt with in Section 2.6 of this booklet]

From 1 July 1999 credit unions and building societies became licensed and supervised by APRA as Authorised Deposit Taking Institutions (ADIs) under the Banking Act and the majority of credit unions became public companies limited by shares and most building societies became companies limited by shares and guarantee under the Corporations Act 2001. ASIC administers the Corporations Act and is responsible for consumer protection under the Australian Securities and Investments Commission Act 2001 (ASIC Act) for all financial services (except consumer credit, which remains a State/Territory responsibility).

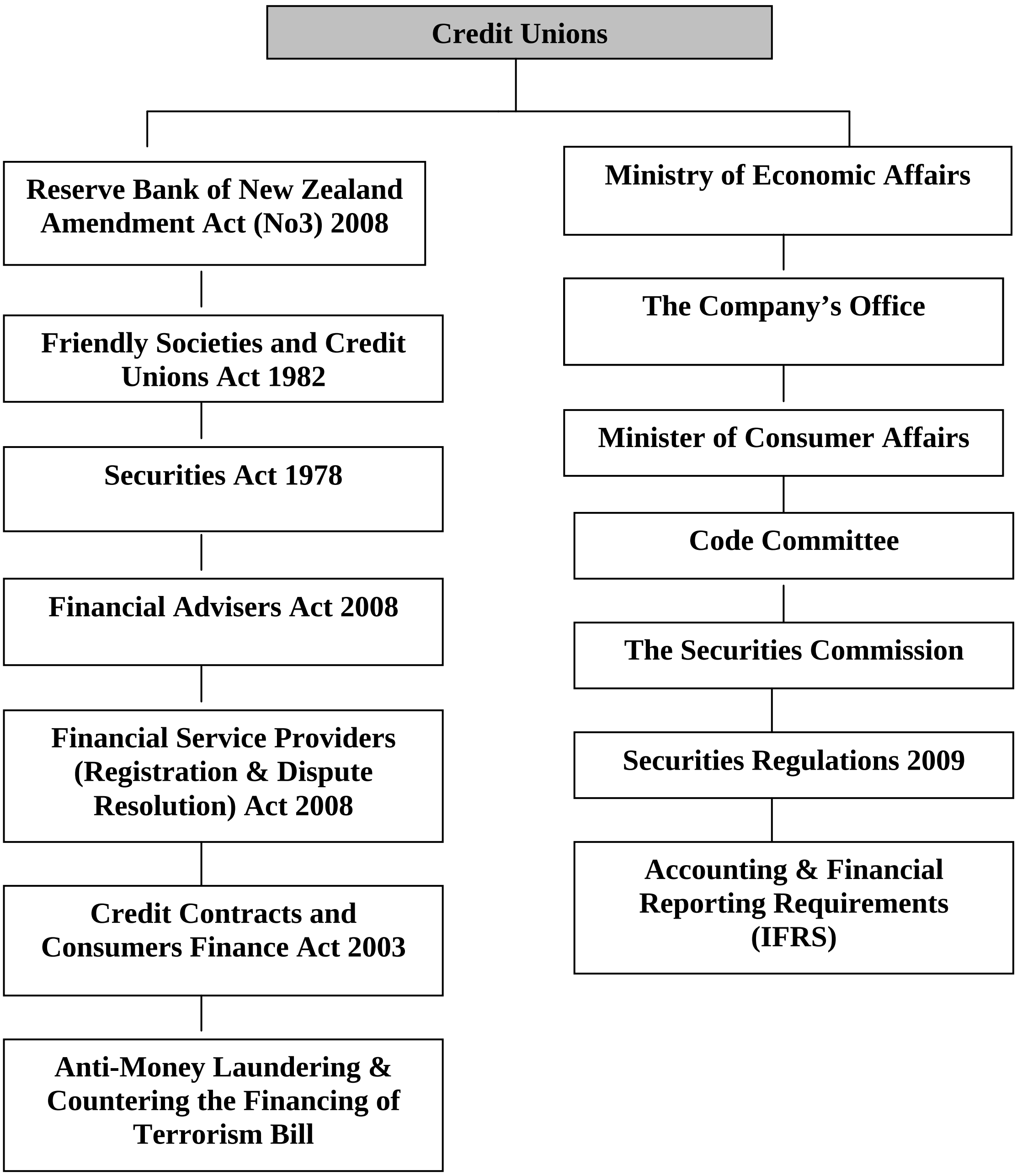
The state based Consumer Credit Code will be replaced by the Commonwealth National Consumer Credit Code from 1st July 2010 which will extend the powers of ASIC to make it the sole regulator for the new national credit framework with enhanced enforcement powers (see Section 2.10 for more detail.

Diagram of the Australian Regulatory Environment



New Zealand

Diagram of the Regulatory Environment



2.2 ASIC - Corporate Regulator

ASIC - Corporate Governance and Consumer Protection Regulator

ASIC administers the Corporations Act 2001 and consumer protection laws under the ASIC Act relating to investments, life and general insurance, superannuation and banking. ASIC also has the responsibility for the Mutual Banking Code of Practice and the EFT Code and will from 1st July 2010 have responsibility for the National Consumer Credit Code.

ASIC Structure

ASIC is established under the ASIC Act. Three full-time Commissioners lead it. It operates as a national organisation with operations in each State and Territory and Regional Commissioners in each relevant State and Territory.

Executive Directors provide coordination for matters of national significance including Enforcement, Financial Services Regulation, Policy & Markets Regulation, Consumer Protection, Public & Commercial Services, Regional Co-ordination & International Relations, and Infrastructure.

ASIC Policy

ASIC issues Regulatory Guides and Class Orders.

Regulatory Guides are formal guidance about how ASIC administers the Corporations Act and guidance on reporting and compliance matters. Class Orders are instruments providing exemptions from, or modifying, the Corporations Act or the ASIC Act for classes of persons.

2.3 Mutuality

Overview

A mutual institution is owned by individuals for their collective benefit without any one individual having the ability to control the entity. There are many variations on the concept of mutuality, but the common theme is the concept of one member one vote.

There are, of course, a number of other indicators of whether an entity is a mutual organisation. In Australia credit unions must be mutually owned and limit their activities largely to retail business in order to have the right to use the words "credit union", "credit society" or "credit co-operative" (see section 66 of the *Banking Act* and Section 2.6)

To give a clear indication when APRA and ASIC consider an entity to be a mutual organisation, ASIC issued Regulatory Guide 147 "Mutuality - Financial Institutions" (12 September 2000).

ASIC Regulatory Guide on Mutuality

Regulatory Guide 147 identifies a number of indicators of mutuality that the Guide divides into two broad tests, namely:

- the economic relationship test; and
- the governance relationship test.

The Economic Relationship Test

In basic terms the relationship between the credit union or building society and their respective members must meet the following requirements:

- Only current members, a like institution or a charity can participate in the distribution of surplus on winding-up.
- "Investor" shareholders cannot have rights to surpluses except via payment of a dividend.
- Payment of dividends to "investor" shareholders must:
  - be limited by reference to an external benchmark and payable only out of that year's profits; or
  - not more than a fixed percentage of the annual net profit in any year and in any event, not more than 50%.
- Members have to approve the method of calculating dividends on "investor" shares at a general meeting before the shares are issued.

The Governance Relationship Test

The following requirements must be met:

- Only members can participate in governance (but that doesn't prevent non-members from being directors)
- Members must have equal rights to participate in the governance on an equal footing with other members: -
  - all fully qualified members each have one vote;
  - if membership and voting is based on time period and minimum balances qualifications, they must be reasonable; and
  - if the institution has representative governance that substitutes for a direct general meeting, each member has only one vote in either electing the representative or electing those that nominate the representative.
- A membership must only allow the person who holds it to have one vote, but this doesn't prevent a person who holds a membership in more than one capacity from having one vote for each membership (eg. an individual membership and a joint membership with another person)
- No class of members has any veto or special voting rights in relation to decisions made by the members generally unless the *Corporations Law* requires it.

The above is a precis of the Regulatory Guide. It illustrates the essential elements that APRA will consider in determining if a company has the right to be considered a mutual organisation. It is also the basis for ASIC to consider whether changes to the company's Constitution will trigger the demutualisation provisions of Part 5 of Schedule 4 to the *Corporations Act*.

The manner in which mutual ADIs manifest their mutuality will not necessarily be the same. For example, credit unions affiliated with Cuscal (now Abacus – Australian Mutuals) developed the Principles of Mutuality to differentiate credit unions from non-mutual entities and other mutual organisations. Those principles are as follows:

Principles of Mutuality

Credit unions must comply with the following principles of mutuality. These principles apply to a credit union's conduct of its affairs on or after its transfer to the *Corporations Act*. They do not apply to any conduct, including the issue of shares, by a credit union before that date. The restrictions on acceptance of deposits and provision of financial accommodation do not apply during the transition period.

Customers must be Members

1. Subject to the exceptions in Principles 2 and 3, a credit union may not accept a deposit from, or grant financial accommodation to, a person who is not a member.

2. A credit union may accept deposits from, or grant financial accommodation to, a body the investment powers of which prohibit investment of the body's funds in shares.

3. A credit union may accept deposits from, or grant financial accommodation to, another ADI.

Membership and Member Shares

How to become a member

4. A person can only become a member by subscribing for a member share.

How many member shares a credit union may issue to a person

5. Subject to the exception in Principle 6, a credit union may only issue one member share to any person. *Note:*
   (i) a person can hold an interest in a member share as joint tenant with one or more persons and also hold another share in the person's own right;
   (ii) a person holding a member share as a joint tenant with one or other persons cannot exercise any of the rights of membership attaching to the jointly held member share individually and apart from the other joint holders of that member share;
   (iii) consequently, if A and B hold a member share as joint tenants, neither A nor B can open a deposit account or take out a loan in the name of A or B; A or B must hold a separate member share in order to deposit with, or obtain financial accommodation from, the credit union in their own individual right.

6. A trustee for an unincorporated association may be issued one membership share in the trustee's own right, and one membership share as trustee for the unincorporated association.

Consideration paid for membership shares

7. A credit union may issue membership shares as wholly paid or partly paid.

8. A credit union may only issue a membership share to a person in return for valuable consideration.

9. The person must provide consideration in cash or, in relation to partly paid member shares, partly or wholly in the form of an obligation to pay cash.

Voting

10. A member share must confer the right to one vote, and only one vote, at meetings of the credit union's members.

Dividends and Surplus

11. A member share may confer a right to participate in the credit union's profits through payment of dividends.

12. A member share must confer a right to participate in surplus when the credit union is wound up.

13. Any participation in profit or surplus must be on equitable terms.

Redemption and Transfer

14. A member share must confer on the member a right to redeem the member share on request, subject only to:

    (a) compliance with prudential standards or prudential regulations; and

    (b) any period of notice set out in the credit union's constitution.

15. Subject to the exceptions in Principle 16, member shares may not be transferred.

16. A trustee for an unincorporated association may transfer the member share that the trustee holds on trust for the unincorporated association.

Additional Shares

Definition

17. All shares issued by a credit union other than member shares are additional shares.

Issue of additional shares only to members

18. A credit union may only issue additional shares to a person who has been a member of the credit union continuously for the past 6 months.

Voting

19. Subject to the exceptions in Principle 20, an additional share must not confer the right to vote.

20. Additional shares may confer the right to vote, at meetings of the holders of additional shares, on questions affecting the continuing existence of the credit union.

Dividends and Surplus

21. An additional share may confer the right to participate in the credit union's profits through payment of dividends.

22. An additional share may confer a right to participate in surplus when the credit union is wound up but only to the extent of:

    (a) repayment of capital paid on the additional shares; and

    (b) payment of arrears of cumulative dividends.

23. The right to participate in profits and surplus conferred by additional shares may be preferred, equal or deferred to the rights conferred by the member shares.

Redemption and Transfer

24. An additional share may confer on the holder of the additional share a right to redeem or, subject to Principle 25, to transfer the additional share.

25. The holder of additional shares may only transfer additional shares to a person who has been a member of the credit union continuously for the past 6 months.

Accumulation of Securities

26. Accumulation of securities issued by a credit union must be restricted so that no person, or group of associated persons, may exercise a significant degree of influence over the affairs of the credit union.

Directors

27. Only a member of a credit union may be a director of the credit union.

New Zealand

Principles of mutuality applicable to New Zealand credit unions are largely enshrined in the Friendly Societies & Credit Unions Act 1982. As explained in Chapter one this legislation will change mid 2010.

2.4 Corporations Act

Mutual ADIs as Public Companies

A new Schedule 4 was added to the *Corporations Act* to provide for the transition of credit unions and building societies to a company structure. Under those provisions, on 1st July 1999, unless it elected otherwise, a credit union became a public company limited by shares. This reflects the principles of mutuality whereby the share is the primary means of membership of the credit union.

On the other hand, mutual building societies and some credit unions chose to become public companies limited by shares and guarantee, where the member guarantee is the primary means of membership.

Some complexities faced by Credit Unions transitioning to a Company Structure

Withdrawable Shares

Where the credit union had issued withdrawable shares to its members they were converted to redeemable preference shares under the Corporations Act after the transfer date. The share is redeemable on the same terms that the withdrawable share was withdrawable under the FI Code and the credit union's Rules.

Statutory Membership Shares

For any credit union members that, at the transfer date, did not hold withdrawable shares, the *Corporations Act* deemed those members to have been issued with a 'membership share'. The purpose of this provision was to provide a means of membership, and a means of limiting liability, for those that did not hold shares prior to the transfer date.

The membership share has the rights and obligations under the credit union's Constitution such as the right to attend meetings and to vote.

Membership shares have no amount paid or unpaid on them and therefore do not change the obligation of the member to contribute in the event of winding-up nor form part of the company's capital.

During the transition period the credit union was required to change its Rules and adopt a Constitution that complied with the requirements of the Corporations Act. At that point, these types of shares were recognised under the Constitution so that rights attaching to all shares were reflected in the Constitution.

2.5 Legal Structure

Constitution

The most essential document to the creation and running of a credit union or building society is its Constitution. It regulates issues such as the admission and expulsion of members; the qualifications, election and removal of directors; meetings; and the rights and liabilities of members.

The legal role of the Constitution is set out in section 140 of the *Corporations Act.* It provides:

> ***"140(1) A company's constitution (if any) and any replaceable rules that apply to the company have effect as a contract:***
> - ***(a) between the company and each member; and***
> - ***(b) between the company and each director and company secretary; and***
> - ***(c) between a member and each other member under which each person agrees to observe and perform the constitution and rules so far as they apply to that person."***

If a company does not have a Constitution, the "Replaceable Rules" set out in *section 141* of *the Corporations Act* apply. Additionally, if the Constitution is silent on one of the issues set out in the Replaceable Rules then the particular Rules will apply. It is permissible for a Constitution to displace them and the overwhelming majority of credit unions and mutual building societies have taken that course. The displacement of the replaceable rules is usually found in the "interpretation" section of a Constitution.

Altering the Constitution

The *Corporations Act* and the Constitution govern how the Constitution may be altered. A general meeting is required to pass a special resolution in order to alter the Constitution.

Alterations Permitted

A company may alter or replace its Constitution so long as the altered or adopted Constitution does not breach the *Corporations Act*. An existing member of the company is not bound by any alteration to the Constitution that:

- requires the member to take up more shares;
- increases the member's liability to contribute to the share capital of, or otherwise pay money to, the company; or
- imposes or increases restrictions on the right to transfer the shares already held by the member, unless that member agrees in writing to be bound by the modifications.

The alteration must not be oppressive, unfairly prejudicial or unfairly discriminatory against a member or members, or contrary to the interests of the members as a whole.

Demutualisation Provisions

If the proposal to alter the Constitution is a demutualisation ‘trigger,’ you will need to comply with the disclosure and procedural requirements of *Schedule 4 Part 5* of the Corporations Act or apply to ASIC for relief from complying with those requirements.

Failure to comply with Part 5 of Schedule 4 will involve a substantial penalty

Procedure for Altering Constitution

The credit union or building society can only alter the Constitution by special resolution passed at a general meeting. If the Constitution provides that a special resolution altering the Constitution does not have effect unless a further requirement is met, then this further requirement must be met to alter the Constitution.

Alterations Affecting Class Rights

If the credit union or building society issues more than one class of share (for example, additional shares), then it may only alter the Constitution in a way that affects the rights attaching to only some classes of shares by following the procedure for altering class rights:

- that is set out in your Constitution; or
- if no such procedure is set out in the credit union’s Constitution – that is set out in *Corporations Act*.

The Credit Union or building society may only modify the procedure in its Constitution for altering class rights by following the procedure itself.

Date of Effect

The alteration of the Constitution takes place when the special resolution is passed unless the special resolution specifies a later date for the alteration. If the Constitution requires something more to be done before the special resolution can take effect, then the special resolution has no effect until that further requirement is met.

Sending Copy of the Constitution to Members

The credit union or building society must send a copy of the altered or adopted Constitution to any member that gives it a written request for a copy. It must send the member a copy within 7 days of receiving the written request. You may charge the member a fee for the copy, but only up to an amount prescribed in the Corporations Regulations.

Principles of Mutuality

As set out in Section 2-3, the authority to use the name "credit union", credit society" or "credit co-operative" under the *Banking Act* is dependent on the organisation being "mutually owned".

The only way in which that can be manifested is through the credit union's Constitution. Any change to the Constitution that may have the effect of placing the credit union outside the definition of mutuality in ASIC's Regulatory Guide

147 (Mutuality - Financial Institutions) places the credit union at risk of being barred by APRA from using such protected descriptions.

Any alterations to the Constitution must therefore always be measured against the requirements of ASIC and APRA for an organisation to have the right to be a credit union.

There are no similar restrictions in the Banking Act on the use of the term *building society*.

Powers

Under section 124(1) of the *Corporations Act, a* company has the legal capacity and powers of an individual.

A company also has all the powers of a body corporate, including the power to:

- issue and cancel shares in the company
- issue debentures
- grant options over unissued shares in the company
- distribute any of the company's property among the members, in kind or otherwise
- give security by charging uncalled capital
- grant a floating charge over the company's property
- arrange for the company to be registered or recognised as a body corporate in any place outside Australia.

Irrespective of the powers granted under the *Corporations Act,* the Constitution may contain an express restriction on, or a prohibition of, the company's exercise of any of its powers. However, the exercise of a power by the company is not invalid merely because it is contrary to an express restriction or prohibition in the company's Constitution.

Objects

The Constitution may set out its objects. In the case of credit unions, the objects follow the International Credit Union Operating Principles developed by the World Council of Credit Unions. These are intended to declare to members and others the commitment of the credit union to act consistently with those principles. Under the *Corporations Act,* an act of the company is not invalid merely because it is contrary to or beyond any objects in the company's Constitution.

Public documents and eligible negotiable instruments

Company directors should be aware of the requirements under the Corporations Act in relation to public documents and eligible negotiable instruments.

All public documents signed, issued or published are required to show details of:

- Company Name
- Company Number (ABN, ACN, ARBN, or ARSN)
- Liability (eg Ltd or Pty Ltd)

Public documents are defined to mean “a business letter, statement of account, invoice, receipt, order for goods, order for services, official notice or publication of, or purporting to be issued, signed by or on behalf of, the company”.

All negotiable instruments signed or issued are required to show: Company Name and Company Number (ABN, ACN, ARBN or ARSN)

Negotiable instruments are defined as a bill of exchange, promissory note, cheque or other negotiable instrument, an endorsement on, or order in, such a negotiable instrument, or a letter of credit.

The Australian Company Number

While there are no specific requirements as to how an ACN should appear on a document, it should be clear, easily readable and obvious as to the company to which it relates. The ACN need only be displayed once where a company’s full name first appears on a document.

The Australian Business Number

A company can quote its Australian Business Number (ABN) instead of its ACN on public documents and negotiable instruments.

Companies that have an ABN may use that ABN with the company’s name instead of its ACN, Australian Registered Body Number (ARBN) or Australian Registered Scheme Number (ARSN) on company documents and negotiable instruments, provided that:

- the last nine digits of the ABN are the same, and in the same order, as the last nine digits of its ACN, ARBN, or ARSN; and
- the ABN is quoted wherever the ACN, ARBN or ARSN is required to be quoted under the Act (such as on the first page of every business document).

If the last nine digits of the ABN are not the same as the ACN, then the ACN must be quoted on public documents and negotiable instruments.

2.6 APRA – Prudential Regulator

The Australian Prudential Regulation Authority (APRA) is the prudential regulator.

Following the Wallis Report of July 1998, APRA was created to combine the prudential supervision functions of the Reserve Bank of Australia, the Insurance and Superannuation Commission and, in July 1999, the State-based Financial Institutions Scheme Supervisors.

APRA is responsible for the prudential supervision of credit unions, building societies, friendly societies, banks, life offices, general insurers and superannuation funds.

With respect to authorised deposit taking institutions (ADIs) five Commonwealth Acts form the basis of APRA's powers and responsibilities as they apply to credit unions and building societies:

- The APRA Act 1998
- The Banking Act 1959
- Financial Sector (Shareholdings) Act 1998
- Financial Sector (Transfers of Business) Act 1999
- Financial Sector (Collection of Data) Act 2001

The role of APRA

Amongst other things, APRA is responsible for the administration of the *Banking Act 1959.* It has taken over that role from the Reserve Bank of Australia. Credit unions and building societies are Authorised Deposit-Taking Institutions (ADIs) under the Banking Act.

The APRA Act establishes the structure and administration of APRA and the Banking Act specifies regulatory functions of APRA with respect to ADIs. APRA is accountable to the Government and the Board of APRA must advise it of APRA's policies. The Treasurer can recommend that the Governor-General issue an order determining the policy to be adopted by APRA. In this event, the Treasurer must advise the Board of APRA that the Government takes responsibility for the adoption of this policy.

Broadly, the function of APRA is to regulate bodies in the financial sector in accordance with other laws of the Commonwealth that provide for prudential regulation or for retirement income standards, and for developing policy to be applied in performing that regulatory role.

Prior to the Wallis reforms, the Banking Act provided that the granting of an authority to undertake banking business was by the Governor-General. The Governor-General could revoke an authority only if a bank was no longer undertaking banking business or applied to have its authority revoked. The functions of the Reserve Bank were specified to include undertaking the prudential supervision and monitoring of banks, and the protection of depositors.

The Banking Act provided that where a bank considered it was unable or likely to become unable to meet its obligations, or the Reserve Bank was of the opinion that a bank was likely to become unable to meet its obligations, the Reserve Bank could appoint a person to investigate the affairs of that bank and could assume control of and carry on the business of that bank. If the Reserve Bank did this it was required to carry on the business of the bank until such time as the deposits had been repaid or the Reserve Bank was satisfied that suitable provision had been made for their repayment. In addition, the Banking Act provided for depositor priority in the event that a bank was unable to meet its obligations; the assets of the bank in Australia were to be available to meet its deposit liabilities in Australia in priority to all other liabilities.

Following the Wallis reforms, responsibility for the conduct of prudential supervision and depositor protection moved from the Reserve Bank to APRA. All the references to "banks" changed to "authorised deposit-taking institutions (ADIs)". This followed Wallis Committee’s recommendation that APRA should regulate as a single class of financial institutions banks, building societies and credit unions and other entities which undertake the business of banking.

APRA's structure

APRA consists of four functional divisions:

- The *Diversified Institutions Division* has primary responsibility for the supervision of financial conglomerates and foreign banks and their operations in Australia.
- The *Specialised Institutions Division* manages those institutions whose business is concentrated mostly in one area. This division includes responsibility for credit unions, building societies, friendly societies, general insurers, small life offices and superannuation funds.
- The *Policy Research and Consulting Division* provides expert teams to resource the work of the other divisions.
- The *Supervisory Support Division*

APRA also has a regional structure and presence. Within the *Specialised Institutions Divisions* there are three regions:

Northern Region - this covers Queensland
Central Region - this covers New South Wales and the ACT
South Western Region - this covers Victoria, South Australia and Western Australia with regional managers in Adelaide and Perth

Legislative Framework - Authorised Deposit Taking Institutions

The *Banking Act* provides a definition of "banking business" as:

(a) a business that consists of banking within the meaning of paragraph 51(xiii) of the Constitution; or

(b) a business that is carried on by a corporation to which paragraph 51(xx) of the Constitution applies and that consists, to any extent, of:

(i) both taking money on deposit (otherwise than as part-payment for identified goods or services) and making advances of money; or

(ii) other financial activities prescribed by the regulations for the purposes of this definition.

Any entity that engages in any deposit taking and making of advances, unless granted an exemption by APRA under the Act, requires an authorisation to do so. Unlike the 'old' *Banking Act* provisions where an entity authorised to carry on 'banking business' could call itself a 'bank', the current Act provides that a "bank" is simply an ADI that has been granted approval to use the word "bank" in its title. APRA may place conditions on the granting of such approvals such as the requirement to have a minimum level of capital.

APRA has issued Guidelines on the use of protected words for the purposes of section 66 of the *Banking Act* and has granted certain exceptions. Under those Guidelines an ADI may use the word ***banking*** to refer to the fact that it has been granted an authority under the Banking Act. An ADI may, in its letterhead, refer to itself as being authorised under the *Banking Act 1959* to carry on banking business.

To use the word "bank" authorised deposit-taking institutions (ADIs) listed on the APRA web-site as banks have an unrestricted consent to use the words bank, banker or banking. This allows the ADI to use the word bank in any way:

- in its company name or trading names; or
- to describe, advertise, etc its business.

One of the conditions imposed is that these ADIs must have at least $50 million in Tier 1 capital or be branches of foreign banks.

Similarly, credit unions are ADIs granted approval to use the words "credit union" or "credit society". The Guidelines provide that the ADIs listed on the APRA web-site as credit unions may use ***credit union, credit society*** or ***credit co-operative*** in their name or to describe themselves or their business.

However, the consents require the ADIs to be mutually owned and to predominantly engage in retail business. They also require APRA's approval for the issue of new Tier 1 or Tier 2 capital or for the issue of securities that may convert to Tier 1 or Tier 2 capital

A critical aspect of the approval to use the name "credit union" is the requirement for it to be mutually owned. Section 2.3 deals with the mutuality requirements that APRA will look to in determining the right of an ADI to use those words. The approach by APRA is to apply Regulatory Guide 147 "Mutuality - Financial Institutions" issued by ASIC on 12 September 2000.

Building societies are ADIs granted the authority to use the words "building society". The consent of APRA to use the term requires the institution to maintain a minimum level of Tier 1 capital of $10 million.

Credit unions and building societies are permitted to use the word ***banking*** to describe specific activities and functions they provide. For example 'electronic banking', 'telephone banking' or 'banking services'.

The granting and revocation of authorities is the responsibility of APRA and it can withdraw an authority in the event that an ADI has not complied with provisions of the Act or has breached any conditions placed on its authority.

Depositor Protection

Protection of depositors is one of the central functions of APRA. The *Banking Act* sets out the powers of APRA to deal with a troubled ADI, including:

- power to appoint an administrator to act as a statutory manager and to take control of a troubled ADI. There are provisions covering the conduct of an administrator, including the obligation for an administrator to report to APRA and to comply with any directions.
- that the appointment of a statutory manager results in the directors of the ADI ceasing to hold office, and that all the powers of the board transfer to the statutory manager.

APRA has made it clear that the appointment of a statutory manager is normally a step towards winding-up. Other steps that can be taken could include finding additional capital support, arranging a merger or the sale or closure of some parts of the business.

The statutory manager has the power to dispose of the whole or part of the ADI's business on terms and conditions that the statutory manager considers appropriate.

The *Banking Act* provides for depositor protection but it does not amount to a depositor guarantee. The Act provides that if APRA considers an ADI is insolvent and is unlikely to be returned to solvency within a reasonable time APRA can apply to the courts for the ADI to be wound-up. In these circumstances depositors are preferred creditors. Such a winding-up would take place in accordance with the provisions of the *Corporations Act*.

One of the key requirements of the depositor protection regime is a carry-over from the 'old' Act as regards the requirement to hold assets sufficient to meet claims by depositors. Section 13A of the *Banking Act* provides:

> ***"(3) If an ADI becomes unable to meet its obligations or suspends payment, the assets of the ADI in Australia are to be available to meet that ADI's deposit liabilities in Australia in priority to all other liabilities of the ADI.***

(4) An ADI is guilty of an offence if:

(a) it does not hold assets (excluding goodwill) in Australia of a value that is equal to or greater than the total amount of its deposit liabilities in Australia; and

(b) APRA has not authorised the ADI to hold assets of a lesser value; and

(c) there is no order in force under section 11 determining that this subsection does not apply to the ADI.

Another protection mechanism is set out in section 11Cb of the Act that allows APRA to certify an industry support contract. Such contracts are defined in the *Banking Act* to mean:

> *"a contract under which emergency financial support is to be provided by parties to the contract to any ADI that is a party to the contract if a specified event occurs. The contract may also deal with matters associated with the provision of the financial support."*

Credit unions initially affiliated with Cuscal (but now affiliated with Abacus) have entered into a certified industry support contract known as the Credit Union Financial Support System (CUFSS). The stated aim of the contract is to protect the interests of members and to promote financial stability of the sector. Such arrangements are in addition to the other aspects of depositor protection. The corner stone of depositor protection is the system of prudential regulation that all credit unions must comply with as administered by APRA.

The CUFSS Contracts were amended during 2008 moving to a more open and voluntary system aimed at encouraging all credit unions and mutual building societies to join the system.

DEPOSIT GUARANTEE

All deposits under $1 million are automatically guaranteed by the Commonwealth Government until November 2011.

Commonwealth Government released a Deed of Guarantee dated 20 November 2008 covering large deposits by approved Institutions (including approved credit unions and building societies). It came into effect on 28 November 2008.

In respect of deposits, it guarantees deposits over $1 million in "protected accounts" with approved institutions as set out in Section 5 of the Financial System Legislation Amendment (Financial Claims Scheme and Other Measures) Act 2008 and as defined in the Banking Act 1959 - Declaration of Covered Financial Products and the Banking Amendment Regulations 2008 (No. 1).

As an Australian ADI your institution is eligible to apply for the guarantee of your deposit liabilities. The application for the guarantee must be made using the prescribed ADI application form and the prescribed covering letter. If your application is accepted the Commonwealth will issue you with an eligibility certificate. Eligible Institutions are listed on the Scheme website. The application form lists the accounts you require to be guaranteed. The decision to issue an Eligibility Certificate is at the discretion of the Commonwealth.

Once the application is approved the Commonwealth will issue an Eligibility Certificate confirming the products applied for are Guaranteed Liabilities (as referred to in the Deed of Guarantee). The Eligible Institution must not issue an Eligible Scheme Liability, in respect of which an Eligibility Certificate has been issued, which differs in any material respect from the particulars of the Eligible Scheme Liability specified in the relevant Eligibility Certificate.

The Guarantee is an irrevocable undertaking by the Commonwealth of Australia in favour of persons to whom the Guaranteed Liabilities are from time to time owed (“Beneficiaries"). The Commonwealth guarantees to the Beneficiaries the payment of the Guaranteed Liabilities (as specified in the Eligibility Certificate). The Commonwealth undertakes that whenever an Eligible Institution does not pay a Guaranteed Liability on the date on which it becomes due and payable, the Commonwealth shall, following a claim made in accordance with procedures set out in the Scheme Rules and following the expiry of the applicable grace period must pay that liability in accordance with the procedures set out in the Scheme Rules.

Even though Beneficiaries are not parties to the Guarantee, they may enforce it. The Guarantee will terminate 67 calendar months after the “Final Application Date” without prejudice to the rights of a Beneficiary who has lodged a valid claim before that time.

The Commonwealth may amend the Guarantee at any time by publishing the changes on the Scheme website provided the changes don’t reduce Beneficiaries’ rights.

If your institution offers guaranteed large deposits you must pay the Eligibility Certificate Fee monthly in arrears. You must report monthly on the average daily value of guaranteed deposits (using the balance of the account at the end of each day, excluding accrued but uncredited interest). On the day the report is submitted you must also pay the fee by SWIFT or by direct credit.

2.7 Prudential Regulation - Overview

APRA has the power to establish prudential standards. Such powers allow APRA to give legal effect to the types of prudential guidelines on which supervision is based.

The central approach to prudential supervision is the identification and management of risk. The prudential supervisory regime in Australia is based on the standards established by the Basel Committee of the Bank for International Settlements.

The Basel Committee on Banking Supervision is a committee of banking supervisory authorities which was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States. Membership has since grown to 56 member central banks including the European Central bank. It usually meets at the Bank for International Settlements in Basel, where its permanent Secretariat is located.

APRA applies the same standards of supervision that are used by most countries. To date the major planks of that supervision are the maintenance of sufficient capital as measured against risk-weighted assets and the control of liquidity risk. There are other risks, such as credit risk, market risk and operations risk that complete the basis of prudential supervision.

All ADIs are subject to a uniform set of prudential standards (although a couple of the pre-existing standards remain but they will be removed with the implementation of the changes being made for the Basel II Capital Accord.
There are 22 standards covering the following areas:

- capital adequacy
- funds management and securitisation
- liquidity
- credit quality
- large exposures
- associations with related entities
- outsourcing
- business continuity management
- risk management of credit card activities
- audit and related matters
- public disclosure of prudential information
- governance
- fitness and propriety of officers
- purchased payment facilities

The standards replaced Books 3 and 4 (the previous AFIC Prudential Standards applying to credit unions and building societies under the old State-based scheme) with the exception of those provisions dealing with:

- Data risk; and
- Operations risk

The Prudential Standards released by APRA on 12 September 2000 were the first stage of a "harmonisation" process so that the basis of prudential supervision of all ADIs was the same. However, there are Preserved Transitional Prudential Standards left over from the pre-APRA supervision by ASIC. Those standards were replaced when the final implementation of the new Basel II capital accord commenced on 1 January 2008.

The regime of prudential supervision is not about achieving prescriptive targets (eg 8% capital adequacy). The Prudential Standards stress the need for the board and management to be able to demonstrate:

- that they understand their business;
- that they are capable of identifying, monitoring and managing the risks associated with that business; and
- that they can verify that these duties have been met.

The nature of the risks will differ from one ADI to another. It is not satisfactory to just achieve and maintain a prescribed level of capital adequacy or liquidity. If the risks associated with the business of the ADI require a higher level of capital adequacy or liquidity it is the obligation of the directors and management to identify that requirement and to meet it. Equally, it is not the role of APRA to undertake that task. If the framework established by the ADI for measuring, monitoring and managing their risks is considered by APRA to be inadequate then it has the power to impose greater stringency.

This emphasis is best demonstrated by the requirements in APS 310 (Audit) for the CEO to provide APRA with a "declaration", endorsed by the Board, that attests that:

- the board and management have identified key risks facing the ADI;
- the board and management have established systems to monitor and manage those risks;
- those risk 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.

Not only is there this positive requirement on the board and management, but also on the external auditor. Amongst other obligations the auditor must provide APRA with a report stating whether the ADI "has observed all the prudential standard requirements which APRA has set for the ADI". Therefore, when considering Prudential Standards, this emphasis must be borne in mind. It requires a high level of vigilance.

Non-compliance with the Prudential Standards

A breach of a standard does not carry a penalty, but it can constitute grounds for APRA to issue directions. The *Banking Act* gives APRA powers to issue directions to ADIs. The directions powers can be aimed at individual institutions and to particular aspects of their operations. The power can be used in conjunction with the depositor protection powers to resolve a crisis.

APRA can issue a direction if an authorised institution fails to comply with a prudential standard or regulation and may issue a direction if necessary in the interests of depositors. Directions may be given on a confidential basis so that corrective action can be implemented by an institution without the potential for loss of confidence.

A direction can include:

- requiring an ADI to comply with a standard or regulation;
- requiring an audit of an ADI, and/or ordering the removal of external auditors from office and their replacement by other auditors;
- removing a Director or executive officer of an ADI from office;
- causing a Director, executive officer or employee to not take part in the management or conduct of the business of the ADI;
- stopping the payment of dividends or any other payments by an ADI;
- stopping the undertaking of any financial obligation on behalf of any other person;
- requiring an ADI to stop taking deposits; and
- any other direction as to the way in which the affairs of an ADI are to be conducted or not conducted.

Failure to comply with a direction is grounds for revoking an authority and failure to ensure compliance with a direction can attract criminal proceedings.

Statistical Reporting

The reporting requirements for ADIs are set out in the ADI Reporting Standards determined under the Financial Sector (Collector of Data) Act 2001.

The method of reporting is electronic using the “D2A” software and the frequency of reporting is as follows:

Monthly reporting - due ten working days after the end of the month.

Quarterly reporting - due either 15 days, 20 days or 25 days after the end of the reporting period.

Sub - annual reporting - due either 15 days or 20 days after the end of the reporting period.

Annual reporting - due either 20 days or 40 days after the end of the reporting period.

Information on the reporting requirements are set out on the APRA website www.apra.gov.au.

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Unclaimed Money

ADIs are subject to the Banking Act requirements with respect to the obligation to account to the Commonwealth Treasury for unclaimed money. Section 69 of the Banking Act applies to all unclaimed money and the equivalent State and Territory legislation has no application.

Levies

ADIs are required to pay supervisory levies to APRA to cover the cost of supervision by APRA.

2.8 BASEL II Capital Accord

Prudential supervision is based on an ADI having sufficient capital as a buffer against risk. The capital-based prudential supervisory framework in Australia was developed from 1988 Basel Capital Accord which sought to impose a "one size fits all" regime which basically required the holding of 8% of capital against risk weighted assets. The higher the risk of an asset the greater the amount of capital required to be held.

However, the Committee on Banking Supervision has reviewed and revised that approach with the result that the major elements of the Basel II Capital Accord will commence on 1 January 2008. Other changes consistent with the new Accord have already been made and will continue to be made or refined to apply to the Australian market. Local supervisors have discretionary areas under the Accord that allow APRA to make changes to suit the requirements of the local market.

Under Basel II, rather than impose a prescriptive minimum level of capital, the new Accord aims to impose capital requirements against a more robust and relevant assessment of the risk that each institution faces. In some cases it may mean an increase in prudential capital requirements and in others a decrease.

The new approach is based on 3 pillars:

> **Pillar 1**: The basis for assessing minimum capital adequacy. Essentially, this is the 'replacement' of the existing Capital Accord.
>
> **Pillar 2**: Called the "supervisory review process", it requires ADIs to have processes and plans for assessing and maintaining their capital levels. It takes into account all risks and not just those covered by Pillar 1.
>
> **Pillar 3**: This promotes market discipline by requiring appropriate levels of disclosure so that the market can monitor and measure for itself the capital and risk profiles of ADIs.

The major changes being implemented in January 2008 relate to Pillar 1 and the commencement of new Prudential Standards on Credit Risk and Operational Risk.

Capital adequacy – credit risk

There are two permissible approaches to measuring capital requirements with respect to credit risk:

- The Standardised approach
- The Internal Ratings Based approach being either the Foundation (FIRB) or the Advanced (AIRB) approach

No credit union or building society in Australia is allowed to use the Internal Ratings Based approach. They are required to apply the standardised approaches (and that includes the standardised approach to operational risk). Any ADI adopting either of the IRB approaches to credit risk are required to apply the Advanced Measurement Approach (AMA) to operational risk (see the next section on operational risk).

In general terms, the major difference between the two approaches is that the IRB allows the institution to use its own assessment of the risks. It is driven by the sophistication of the bank's own data and is likely to result in lowering the levels of prudential capital required to be held. The IRB approaches necessarily imposed large cost obligations on banks because of resource requirements to capture and analyse a significant amount of data.

The standardised approach saw a small reduction in the capital requirements for some non-IRB institutions.

In basic terms, the standardised approach applies an external ratings approach to assessing the risk weighting of assets. This is the case with respect to exposure to governments, corporates and other ADIs. Exposures to unrated corporates retained the 100% weighting. It is the case that some exposures can require some assets to be risk weighted up to 400% of the minimum capital adequacy ratio.

The important issue for mutual ADIs involved predominantly in the retail lending were the changes to the risk weighting of mortgage secured loans.

Loans secured by eligible mortgages over residential property were risk weighted at 50%. That changes to 35% where the loan to valuation ratio (LVR) is less than 80%. The following table was prepared by APRA to show the changes and includes the impact of lenders mortgage insurance (LMI) on the required level of capital.

LVR	**Risk Weighting (no LMI) %**	**Risk Weighting (LMI) %**	**Current %**
< 60%	35	35	50
60% - 80%	35	35	50
80% - 90%	50	35	100 (50 with LMI)
90% -100%	75	50	100 (50 with LMI)
> 100%	100	75	100 (50 with LMI)

Mortgages on commercial property are risk weighted at 100%.

In addition, specific capital requirements for past due claims of more than 90 days are up to 150% on loans not secured by eligible residential mortgages where the specific provision is less than 20% of the outstanding amount or 100% where the specific provision exceeds 20%. All past due loans of more than 90 days where the loan is secured by eligible residential mortgages are be 100%.

Operational risk

This was a significant change because Basel II imposed a specific capital charge for operational risk. Operational risk means the risk of loss as a result of inadequate or failed internal processes, people and systems or from external events. It encompasses legal risk which includes, but is not limited to, exposure to fines, penalties or punitive damages resulting from supervisory actions as well as private settlements. However, it excludes reputational and strategic risk.

The standardised approach is divided into three areas of business:

- **Retail**
- **Commercial banking**
- **All other activity**

The method of calculation of the capital charge is different for each area of business.

Retail/commercial banking
The capital requirement for the operational risk in your retail/commercial banking is calculated using a proportion (3.5 %) of the **total gross outstanding loans and advances** over the previous six half-yearly periods and multiplying each proportion by a factor of 15%. The resultant capital charge is the average result of those six observations.

The term "total gross outstanding loans and advances" means the total loans in the following portfolios:

- Cash holdings of notes and coins
- Loans to households
- All deposits and amounts due from financial institutions
- Securities held in the banking book
- Commercial lending

All other activity
The capital requirement for the operational risk arising from all other activity is calculated by multiplying each of the last 6 consecutive half-yearly observations of **adjusted gross income** by a factor of 18%. The resultant capital charge is the average result of those six observations.

The term "adjusted gross income" means gross income adjusted to exclude income primarily relating to retail and commercial banking.

All ADIs will be required to have a comprehensive risk management framework for operational risk.

2.9 The Harmonised Prudential Standards

Overview

The Prudential Standards are divided into:

- Australian Prudential Standards (APS); and
- Guidance Notes (AGN) on each Standard.
- Prudential Practice Guides (PPG or APG)

Over time the AGNs will disappear as they are replaced by PPGs or APGs. Basically, the mandatory requirements are set out in the Prudential Standard while PPGs set out APRA's expectations with respect to practice and although not mandatory departures from the PPG will have to be justified to APRA.

There are five "series" in the Prudential Standards:
"100" (Capital)
"200" (Risk Management)
"300" (Accounting & Prudential Reporting Issues)
"500" (Governance)
"600" (Payment facilities)

For credit unions and building societies there were still Preserved Transitional Prudential Standards covering Data Risk, Operations Risk and Quarterly Reporting that terminated on 1st January 2008 when the Basel II provisions commenced.

100 – CAPITAL

APS 110 Capital Adequacy

APS 111 Capital Adequacy: Measurement of Capital

APS 112 Capital Adequacy: Standardised Approach to Credit Risk
APG 112 Standardised Approach to Credit Risk

APS 113 Capital Adequacy: Internal Ratings Approach to Credit Risk
APG 113 Internal Ratings Approach to Credit Risk

APS 114 Capital Adequacy: Standardised Approach to Operational Risk
APG 114 Standardised Approach to Operational Risk

APS 115 Capital Adequacy: Advanced Measurement Approaches to Operational Risk
APG 115Advanced Measurement Approaches to Operational Risk

APS 116 Capital Adequacy: Market Risk
APG116 Market Risk

APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book (Advanced ADIs)

APG 117 Interest Rate Risk in the Banking Book

APS 120 Securitisation

APG 120 Securisation

200 – RISK MANAGEMENT

APS 210 Liquidity

AGN 210.1 Liquidity Management Strategy
AGN 210.2 Scenario Analysis
AGN 210.3 Minimum Liquidity Holdings

APS 220 Credit Quality

AGN 220.1 Impaired Assets Definitions
AGN 220.2 Impairment, Provisioning & the General Reserve for Credit Losses
AGN 220.3 Prescribed Provisioning
AGN 220.4 Credit Risk Grading Systems

APS 221 Large Exposures

APS 222 Associations with Related Entities

APS 231 Outsourcing

PPG 231 Outsourcing

APS 232 Business Continuity Management

AGN 232.1 Risk Management and Business Continuity
PPG 233 Pandemic Planning and Risk Management

APS 240 Risk Management of Credit Card Activities

300 – ACCOUNTING & PRUDENTIAL REPORTING

APS 310 Audit & Related Matters

APS 330 Capital Adequacy – Public Disclosure of prudential Information

500 – GOVERNANCE

APS 510 Governance

APG 510 Governance
PPG 511 Remuneration

APS 520 Fit and Proper

APG 520 Fit & Proper

600 – PAYMENT FACILITIES

APS 610 Prudential Requirements for Providers of Purchased Payment Facilities

2.10 National Consumer Credit Code

Introduction

The Consumer Credit Code commenced on 1 November 1996. This State based legislation will be replaced by the Commonwealth *National Consumer Credit Code* from 1 July 2010. At the date of preparing this revision, the National Consumer Credit Protection Bill 2009 has been passed by Parliament and awaits Royal Assent.

Two phases

There will be two phases to the reforms.

Phase 1 will involve:

- Enacting the existing State based legislation, the Consumer Credit Code, into Commonwealth legislation with a few changes.
- Establishing a national licensing regime which will require providers of consumer credit and credit related broking and advisory services to obtain a license from ASIC.
- Extending the powers of ASIC to make it the sole regulator of the new national credit framework with enhanced enforcement powers.
- Requiring licensees to observe a number of general conduct requirements including responsible lending practices.
- Requiring mandatory membership of an external dispute resolution body by all providers of consumer credit and credit related broking and advisory services.
- Extending the scope of credit products covered by the Consumer Credit Code to regulate the provision of consumer mortgages over residential investment properties.
- Extending the operation of the Corporations Act and to regulate margin lending.
- Regulation of trustee corporations.

Phase 2, which will come later, will involve:

- Enhancements to specific conduct obligations to stem unfavorable lending practices, such as a review of credit card limit extension offers, an examination of State approaches to interest rate caps, and other fringe lending issues as they arise.
- Regulation of the provision of credit for small businesses.

- Regulation of investment loans other than margin loans and mortgages for residential investment properties.

- Reform of mandatory rate comparison rate and default provisions.

- Enhancements to the regulation of, and tailored disclosure obligations applying to, reverse mortgages.

- Examination of remaining credit related State and Territory reform projects.

Like the current Code, the National Consumer Credit Code regulates all consumer credit provided by all credit providers in Australia — credit unions, building societies, banks, finance companies, money lenders and any other person who is in the business of providing credit to consumers, including the provision of credit for investment properties. It regulates these credit providers regardless of size, location or institutional type.

Timetable

As at December 2009 the timetable is as follows:

- Anyone who engages in regulated credit activities will need to register with ASIC between 1 April and 30 June 2010.

- Those who have registered will then have six months to apply for an Australian Credit License (ACL) – i.e. between 1 July and 31 December 2010.

- Those engaging in regulated credit activities must have a license, or be registered and have applied for a license, by 1 January 2011.

- Those engaging in regulated credit activities must have a license from 1 July 2011.

- The National Credit Code (NCC), which will replace the “uniform” Consumer Credit Code (UCCC) will come into effect on 1 July 2010.

- New responsible lending obligations will apply to authorized deposit taking institutions (ADIs) and registered finance companies (RFCs) from 1 January 2011.

- The new responsible lending obligations will apply to all other regulated entities from 1 July 2010.

Risk

The provision of credit poses one of the most significant systemic risks for any ADI. If there is failure to comply with the form and substance requirements of the Code the risk is the loss of all interest charges on each affected loan contract and under the new licensing regime the possibility of losing the right to provide credit. For all mutual ADIs, the loan portfolio is the largest single asset in the balance sheet and the risk potential losses from non-compliance must be the subject of continuous monitoring and management.

Licensing

A very important feature of the new legislation is that it will put in place a national licensing regime. Consumer lenders and providers of consumer credit broking services will need to obtain an Australian Credit License (ACL) from ASIC. To do so they will need to meet certain standards. As issuer of the licenses, ASIC will have significant regulatory, investigative and enforcement powers.

The licensing regime is modeled upon the “Australian Financial Services License” licensing regime that currently applies to those who provide financial services (excluding most credit related financial services) regulated by the Corporations Act 2001 – ie what is commonly referred to as the “FSR” licensing regime. As with the FSR regime, there will be licensees and authorized representatives (known as “credit representatives” in this case).

Credit Representatives

A credit representative will be a person (or company) who has received a written notice from a licensee authorizing the person to engage in specified credit activities on behalf of the licensee. The provisions dealing with the appointment and regulation of credit representatives are very similar to those applying to authorized representatives under the FSR licensing regime.

Important points to note are that licensees will be responsible for the activities of their credit representatives and that the activities of credit representatives must be subject to an approved external dispute resolution (EDR) scheme.

Registration

For those that are existing participants in the consumer credit industry there will be a transitional registration process to go through before they become licensed. They will need to apply to ASIC for registration between 1 April and 30 June 2010. If an existing participant is not registered by 30 June 2010 then they will not be able to carry out regulated credit activities until they are registered.

Assuming that existing participants are registered by 30 June 2010, they will then need to apply for an Australian Credit License between 1 July 2010 and 30 December 2010.

By 1 January 2011 they will need to have a license or to have applied for a license. From 1 July 2011 all those carrying out regulated credit activities will need to be licensed (unless an exemption applies).

ASIC will be able to impose conditions upon registration, and the registration will specify which classes of credit activities a registered person is authorized to engage in. A hearing process will be available if there are disputes about conditions and authorizations. In the case of ADIs which are regulated by APRA, the Minister (rather than ASIC) will exercise the relevant powers and must consult with APRA about any new or varied conditions. However, ASIC will still conduct any relevant hearings.

Registered persons will be subject to general conduct obligations which reflect those which apply to AFS licensees. Their obligations will be to:

- Do all things necessary to ensure that credit activities authorized by the registration are engaged in efficiently, honestly and fairly.

- Comply with the conditions of registration.

- Comply with the credit legislation.

- Take reasonable steps to ensure that representatives comply with the credit legislation.

- Take reasonable steps to ensure the clients are not disadvantaged by any conflict of interest that arises wholly or partly in relation to credit activities engaged in by the registered person or its representatives.

- Comply with any other obligations prescribed by regulations.

General conduct obligations of licensees

The general conduct obligations imposed upon licensees are broadly similar to those applying to AFS licensees, except that there is no obligation to report significant breaches.

Annual Compliance Certificate

Although there is no obligation to report significant breaches of the legislation to ASIC (as there is for AFS licensees), a licensee must lodge an Annual Compliance Certificate with ASIC within 45 days of each anniversary of its licensing date. This will need to be in an approved form to be provided by ASIC or to be provided for by regulation.

Key requirements for disclosure

Non-compliance with specific key requirements invokes a civil penalty. Risk minimisation is relatively straight forward if you have proper procedures in place.

The first key disclosure requirement is the amount of credit. It is the operator who will load the amount of credit into the software. Therefore, the point of due diligence is the checking of the loan contract after it has been processed to make sure that it is correct.

The next key disclosure requirement is the annual percentage rate or rates. Each credit provider will set its annual percentage rate per loan type in the software parameters. Therefore, the point of due diligence is to ensure that the percentage rates have been correctly loaded per loan type in the first place. The second point of due diligence is to ensure that the operator, by selecting the correct loan type, has selected the relevant interest rate.

The next key disclosure requirement is the method of calculation of interest charges. The method of calculation of interest charges is set out in the pre-printed terms and conditions of the contract. The only way in which a credit provider could fail to comply would be if:

- the printer makes an error — if the credit union prints the terms and conditions of the contract itself; or
- someone deletes the appropriate clause in the standard terms and conditions.

The next key disclosure requirement is the total amount of interest charges payable. This is calculated by the software. Any software used should be certified by an actuary.

The next key disclosure requirement is the default rate of interest. The earlier comments about the due diligence on the annual percentage rate disclosure apply here.

The last key requirement relates to disclosure of insurance financed under the contract. This information only has to be accurate as at the date the loan contract is prepared, in practical terms. To the extent that the credit provider has information available, this will be checked by a loans officer after the loan contract has been prepared.

The main thing is that a continuing due diligence process is easy to construct, easy to implement and easy to manage. The important thing to remember is to have the policy in place and to carry the policy out.

2.11 Anti Money Laundering & Counter – Terrorism Financing

Introduction

The Financial Transaction Reports Act 1988 (Commonwealth) and associated legislation was designed to assist in the detection of offences against Australia's corporate laws and money laundering from drug trafficking and organised crime. Information in reports provided by "cash dealers" such as ADIs are analysed by AUSTRAC (the Australian Transaction Reports and Analysis Centre). AUSTRAC then disseminates the information to Australian law enforcement agencies and the Australian Taxation Office.

On 12 December 2006 the Anti-Money Laundering and Counter-Terrorism Financing Act 2006 ("AML Act") came into force although the commencement of various provisions was staggered over 2 years from 12 December 2006. Although the FTRA continues to apply, its application to the activities of credit unions and mutual building societies ceased after the end of the implementation period in December 2008. The AML Act is aimed at bringing Australia into line with international best practice to deter money laundering and terrorism financing. AUSTRAC is still the main regulator.

Commencement

The AML Act had a staggered commencement over a two year period from 12 December 2006. In addition, the Minister announced that there would be a moratorium on prosecution for breaches of the Act for a period of 15 months from the date of commencement to allow reporting entities enough time to implement all of the new requirements.

The following tables set out the timetable for the commencement for various parts of the AML Act

Commenced on 12 December 2006
Part 1 – Introduction
Part 4 – Reports about cross-border movements of physical currency & bearer negotiable instruments
Part 5 – Electronic Funds Transfer instructions
Part 6 – Register of providers of designated services
Part 9 – Countermeasures
Part 10 – Record keeping requirements:

Division 1 (Introduction) Division 2 (Records of transactions etc) Division 4 (Records about electronic funds transfer instructions) Division 7 (General provisions) Part 11 – Secrecy and access Part 12 – Offences Part 13 – Audit Part 14 – Information gathering powers Part 15 – Enforcement Part 16 – Administration Part 17 – Vicarious liability Part 18 – Miscellaneous Schedule 1 – Alternative Constitutional basis
Commencing on 12 June 2007 Part 3 – Reporting obligations Division 5 – AML/CTF compliance reports Part 8 – Correspondent banking Part 10 – Record keeping requirements Division 7 – records about dues diligence assessments of correspondent banking
Commencing on 12 December 2007 Part 2 – Identification procedures – except for Division 6 - on-going customer due diligence Part 7 – Anti-money laundering and counter terrorism financing programs Part 10 – Record keeping requirements Division 3 – Records of identification procedures Division 5 – Records about anti-money laundering and counter terrorism financing programs

Commencing on 12 December 2008

Part 2 – Identification procedures
Division 6 – On-going customer due diligence

Part 3 – Reporting obligations
Division 1 – Introduction
Division 2 – Suspicious matters
Division 4 – International funds transfer instructions
Division 6 – General provisions

Designated services and reporting entities

The main difference between the FTRA and the AML Act is that the former regulated types of institutions whereas the latter regulates the activity. The Act regulates "designated services", which goes beyond the FTRA concept of handling "cash" and includes a much broader range of financial products and services, including electronic transactions.

Any person who has a specified geographical link with Australia who provides a designated service is a "reporting entity" and, as a consequence, the number of institutions covered by the regime is much broader than the FTRA. Due to the current list of "designated services" all ADIs are reporting entities.

The FTRA does not apply to a designated service provided by a reporting entity. However, it is possible for the FTRA to apply to your ADI's activities if the service is not a "designated service". The current list of "designated services" is very broad and covers the vast majority of an ADI's daily activities. Therefore, the FTRA is not likely to apply to your ADI's activities.

The AML Act lists 71 "designated services". Those relevant to ADIs are the following:

- Opening an account
- Allowing a person to become a signatory to an account
- Allowing a transaction to be conducted on an account
- Accepting money on deposit
- Allowing a transaction on a deposit account
- Making a loan and allowing a transaction in relation to the loan
- Factoring
- Providing a cheque facility
- Forfeiting a bill of exchange or promissory note
- Issuing bills of exchange, promissory notes and letters of credit
- Issuing a debit card
- Issuing a stored value card
- Issuing travellers cheques
- Accepting electronic funds transfer instructions

- Making money available to the payee as a result of an electronic funds transfer instruction
- Exchanging one currency for another
- Preparing a pay-roll
- Collecting physical currency
- As the holder of an Australian Financial Services Licence, arranging for a person to receive a designated service.

The core obligations of a reporting entity

There are four core requirements of the AML Act

- Verifying customers' identity
- Reporting "suspicious matters" and high value transactions
- Maintaining an internal AML/CTF program
- Producing and retaining appropriate records.

2.12 Mutual Banking Code of Practice

Introduction

The Credit Union Code of Practice commenced on 1 November 1996 but has now been updated and replaced by the Mutual Banking Code of Practice, which commenced on 1 July 2009.

The Code of Practice is applied by most credit unions and mutual building societies in Australia.

Objectives of the Mutual Banking Code of Practice

The Code of Practice seeks to establish higher standards than the law requires and addresses issues not covered by the law.

The centrepiece of the Code of Practice is the 10 Key Promises which reflect the values that credit unions and mutual building societies apply when dealing with their members and customers. Those 10 Key Promises are:

- To be fair and ethical in dealings with members and customers
- To focus on members
- Clear information will be provided about products
- Lending will be done responsibly
- Products and services will be useful, reliable and of value to members and customers
- Complaints will be dealt with fairly
- Mutuality will be respected and members will receive relevant information about any proposal to change that mutual structure
- Mutuals will comply with their legal obligations
- Mutuals will recognise their impact on the wider community
- To support and promote the Mutual Banking Code of Practice

Application

The Code of Practice applies to individual and small business members and customers, anyone who guarantees those members or customers, and prospective members or customers.

The Code of Practice covers:

- Deposit accounts, personal loans, home loans, credit and debit cards, cheques and other financial products issued by the credit union or mutual building society
- Third party products and facilities introduced, arranged or distributed but only in relation to the choice of which third party products and facilities are supplied to members and customers
- Employees, agents and representative when acting on behalf of the credit union or mutual building society.

Interaction between the Mutual Banking Code of Practice & other law

If a provision of the Code of Practice is inconsistent with Commonwealth, State or Territory legislation, the legislation prevails. If a provision of the Code of Practice is inconsistent with the EFT Code of Conduct, the EFT Code of Conduct prevails.

The Code of Practice applies to the provision of credit, however consumer lending is regulated by the Consumer Credit Code (and from 1 July 2010 by the National Consumer Credit Code). Broadly speaking, compliance with the Consumer Credit Code will be compliance with the Code of Practice. If the Code of Practice imposes a requirement which is additional to a requirement of the (National) Consumer Credit Code, then that additional requirement has to be met.

Disclosure to members

Terms and conditions relating to products and services must be provided to the member in written plain language and be clear, concise and up to date.

The terms and conditions applying to products must be fair. They have to be:

- Clear, unambiguous and not misleading;
- Distinct from advertising and promotional material; and
- Written in plain language style and legibly presented.

Terms and conditions must strike a fair balance between the legitimate interests of members and customers and the interests of the credit union or mutual building society.

Principles of conduct

The Code sets out principles of conduct which credit unions must meet when dealing with members in these areas:

- Fair Terms and Conditions
- Regular review of fees and charges
- Responsible lending practices
- Safeguards for co-borrowers
- Safeguards for loan guarantors
- Ensuring that third party products are useful, reliable and value to members and customers
- Communication must be timely, clear and effective
- Providing copies of documents
- Stopping direct debits
- Seeking charge backs
- Account closure
- Assisting when a member has financial difficulties

Dispute resolution

The Code of Practice deals with internal and external dispute resolution procedures.

For the purposes of the Code of Practice, a dispute arises if a member does not accept the response to a complaint.

Credit unions and mutual building societies must have internal dispute resolution procedures. These must be:

- readily accessible to members; and
- free of charge to members.

Directors will need to ensure management has established and maintained appropriate internal dispute resolution procedures. All staff should be fully aware of these procedures and that the persons carrying out the internal dispute resolution procedures are appropriately trained.

Subscribers to the Code of Practice must also participate in an external dispute resolution scheme as a forum of appeal from the internal dispute resolution scheme. Again, the external scheme must be:

- readily accessible to members; and
- free of charge.

New Zealand Credit Union Movement

Code of Conduct for New Zealand Credit Unions

- Agreed Core Values of the New Zealand Credit Union Movement
- Duties to Stakeholders
- NZACU to Member Credit Unions
- Credit Union to their Association
- Credit Unions to their Members
- Credit Unions to Credit Unions

The NZACU Code of Conduct contains procedures for settling disputes and adjudicating complaints.

Credit Union Institute of New Zealand (CUINZ)
Code of Ethics

The formation of CUINZ in September 2006 in response to new regulatory pressures around quality of governance applies specifically to credit union directors and managers. The Code of Ethics is expressed under 12 headings:

- High ethical standards and personal integrity
- Legal compliance
- Avoidance of conflicts of interest
- Confidentiality
- Responsibility to shareholders
- Non-participation with gifts, facilitation payments, bribes

- Community well-being
- Proper use of property and information
- Objectivity and independence
- Competence and quality performance
- Duty to report violations
- Non-waiver of the provisions of the code

CUINZ is empowered to enforce disciplinary provisions for breaches of the code of ethics.

Financial Service Providers (Registration and Dispute Resolution) Act 2008

- Provides a comprehensive consumer dispute resolution and redress mechanism.
- Director and senior management vetting
- Provides assistance with anti-money laundering obligations

2.13 Financial Services Reform

Background

Wallis Report

The Financial Services Reform amendments to the *Corporations Act* originated from the recommendations of the Financial System Inquiry (FSI) (The "Wallis Report") into Australia's financial system structure and regulation, which handed down its recommendations to the Commonwealth Government in March 1997.

The Wallis Report considered that financial system regulation in Australia was piecemeal and varied, and was determined by the particular industry and product being provided. This was seen as giving rise to regulatory confusion. The major proposals in the Wallis Report were:

- a single licensing regime for financial sales, advice and dealings in relation to financial products;
- standard competencies for sales, advice and dealings;
- consistent and comparable financial product disclosure; and
- a single authorisation procedure for financial exchanges and clearing and settlement facilities

Corporate Law Economic Reform (CLERP)

The Commonwealth Government undertook a major review of corporate regulation in Australia under the "Corporate Law Economic Reform" (CLERP) program. Responding to the findings and recommendations of the Wallis Report, the review of the regulation of the provision of financial products and services in Australia was outlined in the CLERP 6 discussion paper entitled "Financial Markets and Investment Products".

Financial Services Reform (FSR)

The Acts to amend the Corporations Act to implement these broad policy objectives of the CLERP 6 paper were assented to on 27 September 2001 and commenced from 11 March 2002 with a 2 year transition period from that date.

Overview of FSR

The regulatory framework of financial services regulation covers a wide range of financial products and services including securities, derivatives, general and life insurance, superannuation, deposit accounts and non-cash payment facilities.

The requirements apply to the activities of existing financial intermediaries such as insurance agents and brokers, securities advisers and dealers, and futures brokers, as well as any other person carrying on a financial services business.

The main objectives of the new regime is to promote:-

(a) confident and informed decision making by consumers of financial products and services while facilitating efficiency, flexibility and innovation in the provision of those products and services.
(b) fairness, honesty and professionalism by those who provide financial services.
(c) fair, orderly and transparent markets for financial products.
(d) the reduction of systemic risk and the provision of fair and effective services by clearing and settlement facilities.

Underpinning these objectives is:-

- a single licensing regime for financial sales, advice and dealings in relation to financial products;
- standard competencies for sales, advice and dealings;
- consistent and comparable financial product disclosure; and
- a single authorisation procedure for financial exchanges and clearing and settlement facilities

Chapter 7 of the *Corporations Act* covers a diverse range of financial service providers and financial products. As providers of deposit products and/or non-cash payment facilities (ie cheques, direct payments), credit unions and building societies fall within the FSR requirements.

The broad areas that ADIs need to be familiar with include:-

- **Licensing** of your credit union or building society as an Australian Financial Services Licensee;
- **Training** of staff and representatives;
- **Dispute Resolution -** both internal and external;
- **Disclosure and Conduct** requirements at different levels depending on the activity and the type of client;
- **Authorised Representatives** who act on behalf of the mutual ADI or the mutual ADI acting as the authorised representative of an insurer under a binder.

The Acts

The Financial Services Reform Act 2001 gives effect to the amendments to Chapter 7 of the Corporations Act.

The Financial Services Reform (Consequential Provisions) Act 2001 contains the transitional provisions and amendments to the ASIC Act

ASIC information

ASIC's website www.asic.gov.au contains a dedicated section for Financial Services. The Financial Services Section provides comprehensive information about compliance with your AFS Licence and the law, FSR Publications, a "Frequently Asked Questions" section, and a "What's New" Section. This page contains information about the release of FSR policy documents including licensing information.

Information about FSR Policy Guides, Class Orders, Media Releases and other publications can be found under the heading "FSR Publications" on the Financial Services Homepage.

ASIC provides an email update service for FSR issues. You can register for ASIC's FSR news service by going to the Financial Services Homepage and clicking on "Subscribe to our e-newsletter".

What does FSR look like?

The FSR regime consists of: -

- Corporations Act 2001 (Chapter 7 and Part 10.2)
- Corporations Regulations 2001 (Chapter 7 and Part 10.2)
- ASIC Regulatory Guides
- ASIC Licensing Kit
- ASIC Class Orders

The General Concepts

To understand Financial Services Reform you need to consider the following general FSR concepts:-

- Financial Service
- Financial Product
- Dealing
- Financial product advice
- Personal advice
- General advice
- Retail client
- Basic deposit product

Financial service

An ADI provides a financial service when it, or its authorised representative;

- Deals in a financial product; or
- Gives advice about a financial product

Financial Products

The FSR regime applies to a variety of financial products from securities to superannuation and stock exchanges. Of relevance to ADIs is that it includes deposit products, non-cash payment facilities (such as cheques and Bpay) and insurance. Special concessions have been given with respect to “basic deposit products” and related non-cash payment facilities as well as general insurance products.

Dealing

Dealing includes:

- Issuing a financial product, for example, opening a 3 year term deposit account for a member; and
- Arranging for someone else to issue a financial product, for example when the credit union or building society arranges for a member to buy an insurance product issued by an insurer.

Financial product advice

This is a recommendation or statement of opinion that:

- Is intended to influence a person to make a decision in relation to a particular financial product or class of financial products; or
- Could reasonably be regarded as being intended to have such an influence (unless an exemption applies)

There are a number of exemptions from the definition of financial product advice:

- Referrals
- Inquiries about insurance premiums
- Inquiries about product price or return
- Giving exempt documents and statements.

Personal advice

The FSR regime distinguishes between two types of advice: personal advice and general advice. Personal advice is advice that is prepared taking into account one or more of the objectives, financial situation and needs of the person, or where a reasonable person might expect that these factors were taken into account.

General advice

General advice is all advice that does not fall within the definition of personal advice.

In deciding whether advice is personal or general, ASIC's Policy Statement PS 175 states that ASIC will consider all of the circumstances including the following:

- Whether the adviser offered to give personal advice in a Financial Services Guide (see later in this Chapter concerning the FSG) or other material given to the person before giving the advice.
- Whether the adviser had an existing relationship with the member where the adviser regularly gave the member personal advice.
- Whether the person requested personal advice, including asking for advice about what decision to make.
- Whether the adviser requested information about the person's personal circumstances.
- Whether advice was directed to a particular client.
- Whether a general advice warning was given – although this will not be determinative.
- Whether the advice appeared on its face to be tailored to the client's personal circumstances.

Retail client

For financial products except general insurance, a person is a retail client unless one of the following four exceptions applies:

- The price of the financial product or service is more than $500,000.
- The client is a business that does not fall within the definition of small business.

  Small business means: -

  - A manufacturing business that employs less than 100 people: or
  - Otherwise, a business that employs less than 20 people.

- The person is an individual with assets of at least $2.5 million or gross income for each of the last 2 financial years of $250,000.
- The person is a professional investor.

For general insurance products, a person is a retail client if they are an individual or a small business.

Basic Deposit Products

This is defined to mean a product with all of the following characteristics:-

- The amount can only be reduced by withdrawals, transfers and debits by the member, account keeping fees, paying charges and duties payable by law, other payments required by law or court order, combining accounts and correcting errors.
- Entry fees, exit fees and funds management fees are not permitted.

- The return on the account is set out in or calculated using a rate set out in the terms and conditions.
- If there is no penalty (ie. reduction in return) for early withdrawal, and the funds are available at call or within seven days, then it is a basic deposit product.
- If there is a penalty (ie. reduction in return) for early withdrawal, then it depends upon the period within which the penalty operates:
  - If the penalty operates up to the end of two years, it is a basic deposit product and you can impose restrictions on withdrawal, and the funds needn't be at call or available within 7 days.
  - If the penalty operates for more than two years but less than five years, it will be a basic deposit product only if the funds are available at call or within 7 days.
  - If the penalty operates for five years or more, it will not be a basic deposit product.

The definition is quite complex, and you should review individual products carefully against the requirements of section 761A of the Corporations Act.

Licensing

A person who carries on a "**financial services business"** must hold **an Australian Financial Services Licence** covering the provision of the financial services. The requirement to be licensed will apply irrespective of whether the person provides services to retail or wholesale clients. Additional requirements will apply where the licensee provides services to retail clients.

Determining whether a licence is required, and the extent of the obligations placed on your credit union or building society is dependent on some critical definitions in Part 7.1 of the Corporations Act.

NOTE: All ADIs are required to have an Australian Financial Services Licence. The level of training and the degree of disclosure will depend on the nature of the financial products and services your ADI offers and to whom you offer them.

Obligations of licensees

As a financial services licensee, the ADI must:

- ensure that the financial services are provided efficiently, honestly and fairly; and
- comply with any conditions imposed on the licence; and
- comply with the financial service law; and
- take reasonable steps to ensure that its representatives comply with the financial services laws; and
- maintain the competence to provide those financial services; and
- ensure that its representatives are adequately trained, and are competent, to provide those services; and

- if those financial services are provided to persons as retail clients - have a dispute resolution system complying with the Corporations Act; and
- comply with any other obligations imposed by the Regulations.

There are two broad licensing requirements that **do not** apply to bodies regulated by APRA:-

(a) the requirement to have adequate resources (including financial, technological and human resources) to provide the financial services covered by the licence and to carry out supervisory arrangements; and
(b) have adequate risk management systems.

Training and Competency

These are three of the major issues for all ADIs with respect to training and competence.

1. **Training staff and representatives.** Licensees are obliged to ensure that their representatives are adequately trained and competent to provide financial services [see s 912A(1)(ca)]. If directors are providing "financial product advice" to members then these competency requirements will also apply to directors.
2. **The competence of managers.** Licensees must maintain the competence to provide the services covered by the licence [see s912A(1)(e)]. This applies to those who manage the licensees business who must ensure that the quality of services the licensee provides is adequate and that the licensee complies with the licence obligations.
3. **"Key person"**. There are special obligations imposed on licensees that are dependent on the expertise of a small number of individuals called "Key Persons". This is particularly relevant to small credit unions [Regulatory Guide 164].

2.14 Governance

The implementation of APS510 – Governance from 1st October, 2006 saw the arrival of APRA into the regulatory space which has traditionally been the preserve of ASIC. APRA's explanation about this centred around an authority derived from Basel Committee for Bank of International Settlements which specifically encourages prudential regulators to set a higher level of governance standards in the banking, insurance and superannuation sectors.

The governance framework required by APS – 510 is fundamental and should not be seen as the ultimate requirements of governance.

Directors should also consider the requirements of the Australian Standards. The governance series (AS 8000 series) comprises six standards.

- Good Governance Principles (AS 8000 – 2003)
- Fraud and Corruption Control (AS 8001 – 2003)
- Organisational Codes of Conduct (AS 8002 – 2003)
- Corporate Social Responsibility (AS 8003 – 2003)
- Whistleblower Protection Programs for Entities (AS 8004 – 2003)
- Corporate Governance of Information and Communication Technology (AS 8015 – 2006)

AMInstitute has also available *The Mutual ADI Corporate Governance Manual* which is a model framework for documenting decisions on corporate governance.

The governance framework adopted by your ADI is the basis for all legal compliance by your ADI. From it stems the moral and legal values that your company will adhere to and is the core issue for all directors. Directors should consider not just APS 510 but all other sources of governance standards with the aim of achieving best practice.

Ambit

APS 510 covers the following broad issues: -

- Board composition and size
- Independence of the Chairman
- The requirement to have a Board Audit Committee
- The requirement to have an internal audit function
- Independence of the external auditor
- Policy on Board renewal and Board performance
- Board must have a Remuneration Policy that aligns remuneration and risk management
- Must establish a Board Remuneration Committee

Board Charter

Every ADI is required to have a Board Charter. The sorts of matters your ADI could consider including in the charter are:

- Composition
- Knowledge and Experience
- Independence
- Membership
- Committees
- Delegations
- Strategy
- Risk Management
- Audit
- Review of Performance
- Education and Training
- Code of Conduct
- Whistle blowing
- Succession Planning & Renewal
- Remuneration

There are many examples of Board Charters freely available on the internet if you wish to review your charter against your peers.

Knowledge and skills of directors

It is appreciated that, as mutual entities, credit unions and building societies foster a democratic approach to the eligibility to participate in the governance of the organisation. There have been concerns expressed by mutual ADIs about the possibility of minimum skill levels being mandated for ADI Directors. However, that is not the approach that APRA has taken in the Standard. Rather than look at individual capacities, the approach is to consider the collective skills.

APS 510 requires that the board and senior management "collectively" to have the range of skills needed for the effective and prudent operation of the ADI. Collectively, the board needs to have the skills, knowledge and experience necessary to understand the risks facing prudentially regulated entities and that includes the legal and prudential obligations imposed on ADIs.

When considering the competencies required of directors and the possibility of imposing those requirements as part of the fit and proper assessment of candidates for election or appointment to the board, mutual ADIs have a careful balancing act between developing and maintaining competency standards while, at the same time, not disenfranchising the broader membership from participating in the governance of the organisation.

It is probably more appropriate for boards of mutual ADIs to consider the need for enhancing the collective skills of the board by allowing under the Constitution for the board to appoint directors to supplement the skills of the member elected directors and implementing a training regime for member elected directors. AMInstitute provides a comprehensive education and professional development program featuring the ***Mutual ADI Directors' Diploma Course*** that will assist all directors to enhance their knowledge and skills.

The Standard also recognises that the skills can be enhanced by the use of external consultants and experts. Therefore, mutual ADIs should approach the requirements of the Standard as an opportunity to further director training and development which will benefit individual directors as well as the institution and the interests of the members.

Board composition

The Standard requires a minimum of 5 directors. The Corporations Act requires a minimum of 3 (at least 2 of which must ordinarily reside in Australia).

Director independence

The Standard requires that the board must consist of a majority of "independent directors at all times". The definition of independence is taken from the ASX Corporate Governance Council's "*Principles of Good Corporate Governance and Best Practice Recommendations*" as in force in March 2003. That definition is set out in Attachment A to the Standard. You should also refer to the replacement "*Corporate Governance Principles and Recommendations"* Second edition issued by the ASX in August 2007 and applying to the first financial year commencing after January 2008.

While the majority of the requirements of that definition are matters of common sense, but item 6 of that definition has caused concern because it requires consideration of whether the length of holding office could, or could be perceived to, materially interfere with the director's ability to act in the best interests of the company. This provision does not mandate any maximum period of directorship. The requirement is twofold, namely the period (which could be 2 years or 2 decades) **and** that it is materially interfering with the ability to act in the interests of the company.

The ASX Corporate Governance Council "Review of the Principles of Good Corporate Governance and Best Practice Recommendations" Second Edition removed the tenure element from the definition of "independence". As the first edition definition of independence had been adopted in the form of Annexure A to APS 510 this then led APRA to revise annexure A to bring it into line with the second edition definitions and then move the tenure considerations to the section relating to Board renewal.

It will also be appreciated that such a decision is a very serious one. Section 203E of the Corporations Act renders void any resolution, request or notice of any or all of the directors of a public company that purports to remove a director from office or to require the director to vacate. If there is a concern that a director may not be independent that must be reported to APRA.

The other aspect of the requirement for independence is that the director has to be a non-executive director to be considered independent.

Independent chairman

All credit unions and building societies have been used to the requirement that the chairman of the board must be an independent director. Until 2006, the Preserved Transitional Prudential Standards continued to apply section 237(2) of the Financial Institutions Code, which imposed that same obligation. APS 510 has taken over the requirement and the previous Preserved Standard has been revoked.

Also the chairman cannot have been the CEO in the previous 3 years. The chairman must be available to meet with APRA on request

Board audit committee

An ADI must have an Audit Committee. The purpose of the Committee is to review the effectiveness of the ADI's financial reporting and risk management framework.

Composition

There must be at least 3 members of the committee, all of whom must be non-executive directors and the majority must be independent. The chairman of the committee must be an independent director and the chairman of the board cannot also be the chairman of the committee.

Audit committee charter

There must be a charter for the committee. Amongst other things, the charter must state that the committee is responsible for the oversight of APRA statutory reporting obligations as well as other statutory reporting. That necessarily includes reporting on matters such as:

- Reporting to ASIC as a corporation and as an Australian Financial Services Licensee.
- Reporting and accounting to the ATO on tax matters

The charter must also cover financial reporting and professional accounting requirements as well as internal and external audit and the appointment of the external auditor.

There are many examples of audit committee charters freely available on the internet if you wish to review your charter against your peers.

Review appointment of the external auditor

The committee must review, at least annually, the external auditor's engagement. Amongst other things, the committee must review the auditor's independence and whether the auditor meets the requirements of Professional Statement F1 on auditor independence.

Review audit plans and findings

The committee must review the internal and external audit plans to ensure that they cover all of the material risks and financial reporting requirements of the ADI. Also, the committee must review audit findings and oversee any remedial action.

Access to the committee

The internal auditor must have free access to the committee and a clear unfettered reporting line to it. There must be 'whistleblower' access to the committee.

The committee must have free and unfettered access to senior management, the internal auditor, heads of risk management and the external auditor and vice versa.

The external auditor must be invited to the meetings of the committee, but it is clearly not mandatory for the auditor to attend every meeting.

Audit – internal, external and independence

There must be an internal audit function, but smaller institutions can apply to APRA for an exemption from the requirement that the auditor be a dedicated internal resource. Many smaller ADI's have appointed independent third parties to perform the internal audit function. In those cases, the requirement of APS 231 (Outsourcing) must be complied with.

Auditor independence required by the Standard largely reflects the requirements of the Corporations Act. It is required that the board must assess the independence of the auditor and part of that process is to require the auditor to provide a declaration as to independence, including that the auditor has no conflict of interest that could compromise that independence.

An auditor involved in the audit of an ADI cannot be appointed to the board or as a senior manager of the ADI for at least 2 years after they were involved in the audit.

The more significant issue for all ADIs is the requirement for auditor rotation. Any person who has played a significant role in the audit of an ADI for 5 successive years or 5 years over the previous 7 years cannot continue in that role until at least 2 years have passed. APRA can provide an exemption and this is particularly relevant for regionally based mutual ADIs where alternative auditing services may not be readily available.

Board performance and renewal

There must be procedures for the assessment of the board's performance and the performance of individual directors, which must be undertaken at least annually.

AMInstitute is able to assist you with the establishment of peer review frameworks to assess the effectiveness of your board.

Of importance to smaller mutual ADIs that may have difficulty in attracting interest in directorship, the Standard does require a policy on board renewal. ADIs take a number of different approaches to achieving renewal, such as the appointment of 'associate' directors and the use of board appointed directors. The Standard does not mandate a maximum period of directorship. It is up to each mutual ADI to adopt a policy on renewal that is relevant to their institution and realistic given the demographic of their membership.

Whistleblower Protection

You must have in policies and procedures to ensure that no employee is constrained from providing information to APRA. You are referred to Australia Standard AS 8005 – 2003 which sets out the requirements for an effective whistleblower protection program.

Some care need to be taken with the protection requirements because there are also similar requirements with respect to Financial Services Licensees, but there are some inconsistencies between the requirements.

Remuneration Policy

Effective from 1st April 2010 APS510 was amended to include new requirements relating to remuneration.

An ADI must establish and maintain a written Remuneration Policy that outlines the remuneration objectives and the structure of the remuneration arrangements including but not limited to the performance based remuneration components.

In addition to any other objectives, the Remuneration Policy's performance-based components of remuneration must be designed to encourage behaviour that supports:

(a) the regulated institution's long-term financial soundness; and

(b) the risk management framework of the regulated institution.

37. The performance-based components of remuneration must be designed to align remuneration with prudent risk-taking and must incorporate adjustments to reflect:

(a) the outcomes of business activities;

(b) the risks related to the business activities taking account, where relevant, of the cost of the associated capital; and

(c) the time necessary for the outcomes of those business activities to be reliably measured.

Board Remuneration Committee

An ADI must establish a Board Remuneration Committee consisting of at least three members all of which must be non-executive directors with the majority also independent including the Chairman with a written charter and terms of reference.

Committee responsibilities must include:

(a) conducting regular reviews of, and making recommendations to the Board on, the Remuneration Policy including an assessment of the Policy's effectiveness and compliance with the requirements of this Prudential Standard;

(b) making annual recommendations to the Board on the remuneration of the Chief Executive Officer (CEO), direct reports of the CEO, other persons whose activities may in the Board Remuneration Committee's opinion affect the financial soundness of the institution, and any other person specified by APRA; and

(c) making annual recommendations to the Board on the remuneration of the categories of persons covered by the Remuneration Policy.

The Board Remuneration Committee must:

(a) have free and unfettered access to risk and financial control personnel and other parties (internal and external) in carrying out its duties; and

(b) if choosing to engage third-party experts, have power to do so in a manner that ensures that the engagement, including any advice received, is independent.

Members of the Board Remuneration Committee must be available to meet with APRA on request.