# Benny BM Popoitai: Prudential supervision of the financial system in Papua New Guinea

Speech by Mr Benny BM Popoitai, MBE, Acting Governor of the Bank of Papua New Guinea, at the seminar for external auditors of regulated financial institutions to CPA - PNG, Port Moresby, 7 April 2005.

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My dear auditors, good morning. It gives me great pleasure to address your association once again.

The purpose of this seminar is to enhance the Bank of Papua New Guinea's relationship with important players in the financial system, with respect to compliance with the Bank's reporting requirements to ensure stability of the financial system in Papua New Guinea. BPNG, as a corporate statutory body established by the Central Banking Act 2000 (CBA), is empowered to supervise the operations of the licensed financial institutions, including commercial banks, licensed financial institutions, savings & loan societies, superannuation funds and life insurance companies.

The primary function of Bank, as the prudential supervisor, is to foster efficiency, maintain confidence and stability in the financial system. Effective prudential supervision of financial system is an essential component of a strong economic environment because the financial sector plays a central role in mobilizing the necessary capital for private sector participation in the economy to stimulate economic growth.

Prudential supervision, however, cannot, and should not, provide an assurance that financial institutions will not fail. In a market economy, failures are a part of risk-taking and the objective of the Bank, as the prudential supervisor, is to ensure that the number of failures and the resulting financial losses to depositors, policyholders and contributors, is minimized. Financial crises are a serious concern and can be extremely costly – not only in terms of the direct cost to the government and taxpayers, but also in terms of foregone growth. The NPF saga is a classical example.

Perhaps, the challenging part of prudential supervision and threat to stability in the financial sector in Papua New Guinea is the potential for corruption and blatant dishonesty creeping into our financial institutions, and the Bank will have to ensure that there is zero tolerance to such behaviors.

This is the reason why the Bank requires individuals holding or intending to hold Board, Trustee and Management positions to go through a vigorous 'fit and proper person' test before occupying responsible position in any financial institution regulated by the Bank. The primary responsibility for the overall conduct of the financial institution is vested in the board of directors and management and they have a fiduciary duty to manage the institution in a honest and prudent manner. An unfit board and management will run the institution down for sure.

The Bank has developed and issued prudential standards and guidelines, and directives to allow the licensed financial institutions to develop appropriate risk management tools and practices that limit risks to prudent levels. It is the responsibility of boards, trustees and management of each individual institutions to adhere to these prudential and statutory requirements.

The Bank also conducts on-site inspections and off-site surveillance based on information provided by the licensed financial institutions. Even the most successful supervisory agencies must rely, to some degree, on the information provided by individual financial institutions that it regulates, so that corrective measures can be taken – including placing them on statutory management and initiating liquidation of financial institutions.

This brings us to the important issue of corporate governance, which has gained increased attention all around the world, including Papua New Guinea.

Although the Companies Act does not specifically emphasize corporate governance, the Bank expects all the financial institutions that it supervises to adopt and implement good corporate governance practices.

The issue of strong corporate governance cannot be overly emphasized because the roll-on effect of a financial institution collapsing, particularly in the case of a bank or life insurer, can be very dramatic for both individuals, and can severely affect the stability of the financial system. Recent experiences in the Asia, US, Australia, and even Papua New Guinea, particularly in the superannuation industry, indicate that the risk of such collapses are heightened where poor corporate governance prevail.

The Bank, however, is aware that each financial institution is unique, in terms of its structure, objectives and operating environment, and circumstances change over time, particularly in regard to globalization, technology and innovation. It is, therefore, impractical to “prescribe” how an institution should structure its corporate governance practices.

The Bank, therefore, places the onus on the financial institutions, the need to embrace effective internal control measures, good accounting and strong corporate governance practices, and thorough risk-management procedures. These are fundamental to the institution’s management in achieving its objectives of ensuring proper conduct of business, so that the assets of institutions are safeguarded, fraud is detected and prevented, and accounting records are accurate and completed on time to prepare reliable financial information.

External auditors, thus play a very important role in this game because their primary role is to test and certify, based on internationally-accepted accounting standards, that the financial statements of the entities are accurate – that is, it is a “true and fair view” of the institution’s financial position for the period in which such statements are prepared.

Although the auditor’s report is normally intended for the shareholders, the Acts that the Bank administers, including the Banks and Financial Institutions Act, Superannuation (General Provisions) Act, Life Insurance Act and Savings and Loans Societies Act, require the Auditor to report to Bank on any matters where the auditor has reasonable grounds for believing that the institution is insolvent, at significant risk or the state of affairs of the financial institution will materially affect depositors, policyholders, and contributors. The auditor’s opinion helps to establish the credibility of the financial statements, and the Bank, as the supervisor, would normally rely on this opinion and use the accounts to verify and complement the periodic financial reports received from the financial institutions.

The Bank, as the prudential supervisor of licensed financial institutions, also wants to see the role of external auditor extended to include conducting compliance auditing. The Bank would like to see licensed financial institutions attest their internal control systems, conduct checks and balances on the governance structures, and issue comprehensive disclosure statements, including disclosures along a number of risk dimensions, and be approved by the external auditors. This should assist license holders to comply with the prudential requirements of the Acts.

In summary, the Bank would like to have a tri-partite approach in the supervision of the licensed financial institution, which is important for fostering closer working relationships, particularly with the external auditors. Consequently, auditors will require better understanding of the supervisory concerns in order to help them perform their audit functions and thus report adequately on those requirements.

An example of such arrangement is the tri-partite meeting arrangements between the Bank, financial institutions licensed under the Banks and Financial Institutions Act and their external auditors, where the licensed financial institutions are required to provide a statement on compliance on all prudential standards and FX limits, a declaration by the CEO, endorsed by the board on whether the board and senior management have identified key risks facing the bank, established systems to monitor those risks and whether those systems are operating effectively and are adequate having regard to the risks they are designed to control. The external auditor shall provide to the BPNG a report on their opinion whether the bank has complied with all specified prudential standards and FX limits, conditions imposed on a bank’s license, and any other relevant BPNG instructions

While financial stability is the supervisor’s primary concern and monitors the present and future viability of the institution through the use of financial statements the auditor provides, the auditor, on the other hand is concerned with the institution as a “going concern” and expresses professional view on the “true and fairness” of the institution’s condition expressed in its account.

At the end of the day, both the supervisor and the auditor is looking at the same coin but from different sides. This commonality therefore justifies the position for closer understanding and knowing of each other’s concerns, and the need to maintain good working relationship and liaison between supervisor and external auditors in order to promote a sound and stable financial system.

It is in this light that I feel the need for Auditors and Accounting Associations of PNG to come down hard on members who do not properly carry out their tasks, be it deliberate or otherwise. Sanctions for such behaviour be punitive and must be enforced and not for show only.

Our experiences with some of your members in their roles as external auditors leave a lot to be desired.

At the very least annual public advertisement of registered auditors is a necessity. How will anyone know if a firm or an individual is a registered member of the PNG Auditors Charter? Is this information readily available?