REPORT OF THE REVIEW OF FINANCIAL SECTOR LEVIES

TREASURY

AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY

JUNE 2009
THE REVIEW

Introduction

The existing levy-setting arrangements fund the vast majority of the costs of the Australian Prudential Regulation Authority (APRA) in undertaking its role of prudential supervision and regulation. The levies also cover consumer protection and market integrity functions of the Australian Securities and Investments Commission (ASIC) and the Australian Taxation Office (ATO)\(^1\) (‘the regulators’) in relation to APRA-regulated institutions\(^2\). The levy-setting arrangements were established following the 1997 Financial System Inquiry (Wallis Inquiry).

The legislative framework for levies is covered by the following arrangements:

- the Financial Institutions Supervisory Levies Collection Act 1998 prescribes the timing of payment and the collection of levies;

- a suite of imposition Acts impose levies on regulated entities, set a CPI-indexed statutory upper limit, and provide for the Treasurer to make a determination as to certain matters such as the levy percentages for the restricted and unrestricted levy component, the maximum and minimum levy amounts applicable to the restricted levy component, and the date at which the entity’s asset value (to which the levy percentage applies) is to be calculated;\(^3\)

- each year the Treasurer makes a separate determination under each of these Acts covering those matters.

In this regard, there is an annual industry consultation process for adjusting financial sector levy rates to apply in the following financial year. The levy arrangements and methodologies are also subject to regular reviews to ensure that they continue to provide effective funding for the prudential supervisory framework. This Review of Financial Sector Levies (the Review) is the latest such regular review. The previous review took place in 2004. In 2005, following the 2004 review, a change of the levy framework from a single levy component into two levy components was implemented together with other fine-tuning changes.

On 1 July 2008, the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs announced an examination of the methodologies governing the determination of the financial sector levies. This was in response to industry views on the methodologies and the fact that the methodologies had not been considered for some time.

The Assistant Treasurer subsequently agreed to the Terms of Reference for the Review and issues to be covered (Attachment A). The review team intended to report to the Minister with draft recommendations by the end of January 2009 and, subject to the Minister’s approval, to consult with relevant financial sectors during February 2009, with a view to submitting to the Minister a final report by March 2009. Given the range and complexity of the issues the Review has taken additional time beyond the proposed timetable.

The manner in which APRA is funded through the levies is described in Attachment B.

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\(^1\) For simplicity in expression, this paper refers to the prudential supervision and regulation functions (i.e. APRA) when the relevant regulatory functions of ASIC and the ATO may also be included. Whether or not they should be included in specific instances should be clear from the context.

\(^2\) These are consumer protection related regulatory and enforcement activities carried out by ASIC for prudentially regulated institutions, and the cost of administering the Lost Members Register by the ATO.

Executive Summary

As set out in the Terms of Reference, the financial services sector has generally supported the levy arrangements and the methodologies governing the calculations of the levies. However, a number of parties have raised some specific issues about the methodologies. In addition, APRA’s experience with the levy arrangements has identified some operational issues. Against that background, the Review has focussed largely on these issues, rather than on a fundamental examination of the levy system. The key guiding principle has been the need to provide stable and effective funding for the regulators on a sustainable basis into the future at a reasonable cost to the financial sector.

Also influencing the Review has been the current volatility in financial markets as a result of the Global Financial Crisis (GFC). While Australia’s financial system has performed well through the crisis, the Review has been conscious that the prudentially regulated sector is experiencing unprecedented stress. Also, it is not yet clear how the GFC will impact on the structure of the financial sector in Australia. Consequently the Review has sought to limit the extent of changes flowing from the recommendations.

The following recommendations are put forward for the consideration of the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs, the Hon Chris Bowen. These recommendations reaffirm the existing framework and involve changes which are designed to improve the operation of the levy arrangements.

Recommendations arising from the Review:

1. That (subject to the recommendations below) the current framework for setting financial sector levies be maintained. The Review has examined the effectiveness of the levy framework and considers that it is appropriate for funding the relevant costs of the regulators and it has met the funding requirements of APRA. The annual consultation process has provided the regulated industries with both the context in which the levy is set and the opportunity to comment on the parameters that set the levy for the following financial year, through annual Ministerial determinations. No industry sector is arguing for significant reform of the levy framework.

2. That the current reporting accountability of APRA in relation to the imposition and collection of levies generally should not be changed. The Review has assessed the reporting accountability for the levies imposed and collected, and considers that this is generally appropriate. However, as part of the annual consultation process, APRA will provide more detailed information on the allocation of costs and levy recovery to improve the transparency of the levy arrangements.

3. That the minimum and maximum restricted levy arrangements for each sector be maintained - there is sufficient capacity within existing caps to fine tune the amounts imposed. The statutory upper limits (which cap the maximum restricted levy amount) should continue to automatically increase annually in line with the indexation factor specified within the imposition Acts.

4. That the recommendation of the 2004 review that the notional ratio of the unrestricted component of levy to the total levy be between 10 per cent and 30 per cent be removed in relation to the 2009-10 and subsequent years. This requirement assisted with the transition to the new arrangements implemented in 2005, but now imposes an unnecessary constraint on levy setting.

5. That the valuation date for ADIs, general insurers, life insurers and friendly societies and superannuation funds not be changed.

6. a) That the levy date for new starters should be redefined and a new starter return be introduced. The current imposition Acts require APRA to charge a minimal levy for new starters even where their asset base would dictate a higher levy amount; and b) that leavers from the industries not be entitled to a pro-rata reduction in the levy, consistent with the current arrangements.
7. **Total assets should remain the base for most financial sector levies, subject to Recommendation 9.** The Review examined alternative valuation bases. While a change in the basis for levies from assets to an alterative basis may be more appropriate in some circumstances, it is not appropriate in others. Any change would result in a significant redistribution of the levy burden on industry constituents and would require extensive consultation across all industries. With limited industry feedback suggesting a need for change, the Review recommends that the current system be maintained. The Review further recommends that a more extensive review of the valuation basis be carried out at the next review.

8. **That the Specialist Credit Card Institutions (SCCIs) and the Providers of Purchased Payment Facility (PPPFs) be levied an appropriate charge more reflective of the cost of supervision.**

9. **That the imposition legislation be amended to provide more flexibility so that a valuation basis other than assets can be used on a case by case basis in the annual determinations.** This will allow sub-classes with a differing levy base to be established within the same industry, and will ensure that timely changes to levies can be made as developments take place in the regulated sectors and products.

10. **That no change should be made to levies for foreign bank branches.** Foreign bank branches are currently paying a levy at a rate of half that paid by domestic ADIs. This remains appropriate for the amount of supervision work that they entail.

11. **That no change in levy structure should be made to the levies for regulated institutions within conglomerate groups.** The individual institutions that make up a conglomerate require supervision both jointly and individually with little reduction in the overall work of APRA.

12. **That no change should be made to the levy structure for Pooled Superannuation Trusts (PSTs).** PSTs require supervision by APRA and adequate mechanisms are in place within the imposition Acts to address any special cases where waiving of the levy is justified. APRA will make clearer the general policy that is followed in applying waivers of levies. This levy category should be re-examined at the next methodological review.

13. **That a further review of the levies framework be carried out within four years.** Sufficient time should have passed by then to assess the impact of the Global Financial Crisis on the size and structure of regulated sectors, which form a key basis of the current levy arrangements.

**How was the Review undertaken?**

The Review was chaired by the Treasury and undertaken jointly with APRA.

Issues explored in the Review, and set out in the Terms of Reference, emerged from the annual levy consultation processes in recent years, submissions by various industry groups and through administrative experience in the application of the current levy arrangements. Overall, there is broad industry support for the levy arrangements.

It is anticipated that the changes arising from the Review’s recommendations requiring legislative amendments will take effect from the beginning of the 2010-11 financial year and that levies for the 2009-10 financial year will be established on the basis of the existing levy-setting arrangements.

The Review recognises that issues relating to how much money the levies should raise to provide for regulatory supervision are important to the institutions being levied, as well as to the regulators. However, the purpose of the Review was not to consider what level of funding should be provided to the regulators through financial sector levies. Rather, the Review considered specific issues in relation to the way levies are determined to meet the required level of funding.
The issues considered

The Review concluded that in the current environment and based on the experience to date with the levies, the current arrangements are broadly appropriate. There are, however, a number of areas which warrant consideration and these are set out below.

**APRA’s Supervisory Approach and its Levy Structure**

The Review examined the framework for the levy and whether it met the needs of the prudential regulator.

_Recommendation 1:_ That (subject to the recommendations below) the current framework for setting financial sector levies be maintained. The Review has examined the effectiveness of the levy framework and considers that it is appropriate for funding the relevant costs of the regulators and it has met the funding requirements of APRA. The annual consultation process has provided the regulated industries with both the context in which the levy is set and the opportunity to comment on the parameters that set the levy to apply in the coming financial year, through annual Ministerial determinations. No industry sector is arguing for significant reform of the levy framework.

APRA’s supervisory approach is forward-looking, primarily risk-based, consultative and consistent with international best practice. APRA devotes its supervisory attention and resources to areas where regulated institutions face greater risk. APRA ensures that it recognises the complexity and diversity of its regulated entities and seeks to avoid a “one-size-fit-all” approach to supervision.

Levies under the current funding structure are not based on a “fee-for-service” model. APRA applies flexible and efficient resource allocation and the on-site supervisory effort will vary depending on institutional risk profile and emerging issues which require supervisory attention.

APRA is primarily funded through industry levies. The total funding requirement is determined by the annual Portfolio Budget Statement (PBS) submitted to, and approved by, the Government. The current levy structure has two components: a restricted levy component, which largely represents the aggregate cost of supervision; and an unrestricted levy component which reflects APRA’s cross-industry work that is not specific to a sector or an institution. A cap and a floor are embedded in the first component (hence it is known as the restricted component) to take into consideration the allocation of effort amongst institutions - i.e. there is an upper limit to the amount of supervision, and a minimum amount of supervision, that is applied to an institution. The levy structure retains an industry sector split to avoid any questions of cross-sector subsidisation.

APRA’s levy model uses a cost allocation methodology that is designed to fully recover the cost from each industry sector. The asset value of each institution is used as a basis to allocate the quantum of the sectoral levy to each regulated entity.

The Review examined the effectiveness of the framework and considers that it is appropriate for funding the relevant costs of the regulators.

**Transparency**

The Review considered the transparency of the process for setting the levy and the adequacy of communication with stakeholders.

_Recommendation 2:_ That the current reporting accountability of APRA in relation to the imposition and collection of levies generally should not be changed. The Review has assessed the reporting accountability for the levies imposed and collected and consider that this is generally appropriate. However, as part of the annual consultation process, APRA will provide more detailed information on the allocation of costs and levy recovery to improve the transparency of the levy arrangements.
APRA provides full and open disclosure of the manner in which costs are allocated to, and recovered from, industry sectors. The annual consultation on levy arrangements includes information regarding:

- **APRA’s expenditure.** This includes a high level strategic assessment of where APRA intends to place emphasis in its regulatory agenda in the year ahead. It also refers to specific programs and activities funded from sources other than levies. In addition, information is provided on APRA’s budget as agreed by the Government.

- **Summary of Supervisory levy funding requirements.** This explains how the amount to be funded by levies is derived and the amounts required to support consumer protection, regulatory and enforcement activities carried out by ASIC, and the cost to the ATO of administering the Lost Members Register.

- **Sectoral allocation of funding requirements.** This explains the amount to be collected by the restricted and unrestricted components of the levy and the time being spent on each industry sector (averaged across four years to smooth any changes). This is used to set the dollar amount to be funded by each industry sector, and includes adjustments for over and under collections in the prior period to give the overall amount to be collected from each industry sector.

- **Industry structure.** This provides a statistical breakdown of the numbers of institutions in, and assets held by, each industry sector.

- **Summary of impacts of individual sectors.** This provides commentary on each industry sector and explains the rationale for increases or decreases in the amounts to be levied.

- **Supervisory levy comparison between years.** This provides an overview of the suggested levy rates, and maximums and minimums by industry sector compared with the previous year.

- **Levy scenarios.** This provides information on scenarios that include the status quo, the change in rates and the change in maximums/minimums.

APRA also provides additional information to the industry in its Annual Report, including information on the total levies collected, the Treasurer’s Determination for ASIC and the ATO, waivers and details of the levies collected for each industry sector compared to the prior year.

Last year one industry body queried whether APRA was providing sufficient transparency in reporting, although it raised no specific issues.

Given that there appears to be little overall concern from industry in this area the Review concludes that disclosure of APRA costs by industry sectors is already sufficient. However, as a way of promoting transparency, APRA will provide further information on significant areas of APRA focus in the coming year. APRA will also provide more detailed information on the allocation of costs and levy recovery.

Treasury will continue to work with ASIC and the ATO to aim to increase the amount of information relating to the costs of ASIC work on consumer protection and market integrity in relation to APRA-regulated institutions and the costs of the ATO work in relation to the Lost Members Register.

**Minimum and maximum restricted levy amounts imposed**

The Review considered the adequacy of the minimum levies compared with the minimum amount of work performed to prudentially regulate an institution and the maximum levies compared with the maximum amount of work to prudentially regulate an institution.
Recommendation 3: That the minimum and maximum restricted levy arrangements for each sector be maintained - there is sufficient capacity within existing arrangements to fine tune the amounts imposed. The statutory upper limits (which cap the maximum restricted levy amount) should continue to automatically increase annually in line with the indexation factor as specified within the imposition Acts.

The 2004 review considered in detail the adequacy of the minimum and maximum restricted levy amounts relative to the amount of supervisory efforts that might be applied to an institution. The introduction, following that review, of the second (unrestricted) levy resolved the most serious issues regarding vertical equity. The question still remains whether the minimum and the maximum remain broadly equitable to an industry sector. Ideally, the band width between the minimum and maximum should be such that few institutions pay the minimum and few pay the maximum. In this manner, increases in funding requirements fall evenly across those paying the marginal levy rate. The minimum levy typically applies to either a new entrant or a comparatively dormant institution. Since the 2004 review, the number of institutions paying the minimum rate has declined and little overall levy is collected from this group. Therefore, the Review concludes there is no need to change the minimum levy.

The maximum levy typically applies to the largest organisations and, with the unrestricted component, this ensures that the levy arrangements are equitable and that the levy on larger entities reflects the level of supervisory intensity.

The percentage of institutions in each industry sector paying the maximum levy has increased over the last four years as shown in the following table:

<table>
<thead>
<tr>
<th>Number of institutions as a % of total number of institutions</th>
<th>ADIs</th>
<th>Foreign ADIs</th>
<th>Life Insurance</th>
<th>General Insurance</th>
<th>Super (Non-SAFs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005-06</td>
<td>3.8</td>
<td>0.0</td>
<td>13.5</td>
<td>4.4</td>
<td>15.1</td>
</tr>
<tr>
<td>2006-07</td>
<td>4.1</td>
<td>0.0</td>
<td>14.7</td>
<td>5.4</td>
<td>19.3</td>
</tr>
<tr>
<td>2007-08</td>
<td>4.8</td>
<td>0.0</td>
<td>14.3</td>
<td>4.7</td>
<td>16.9</td>
</tr>
<tr>
<td>2008-09</td>
<td>5.1</td>
<td>9.4</td>
<td>15.6</td>
<td>5.5</td>
<td>18.3</td>
</tr>
<tr>
<td>Current maximum actually used</td>
<td>$1.4m</td>
<td>$0.7m</td>
<td>$0.7m</td>
<td>$0.7m</td>
<td>$0.2m</td>
</tr>
<tr>
<td>Original statutory upper limit (as at April 2009)</td>
<td>$1.5m</td>
<td>$1.5m</td>
<td>$1.5m</td>
<td>$1.5m</td>
<td>$1.5m</td>
</tr>
<tr>
<td>Indexed statutory upper limit (as at April 2009)</td>
<td>$1.9m</td>
<td>$1.9m</td>
<td>$1.9m</td>
<td>$1.9m</td>
<td>$1.9m</td>
</tr>
</tbody>
</table>

This suggests there is a need to address the distributional effects of the levies as any increases in levies would not impact on those already on the maximum but would impact on those below the maximum. This can be addressed by increasing statutory upper limit thereby increasing the number of institutions paying levies between the minimum and maximum limits. Without such a change, any future increase in levies resulting from an under collection in the prior year, or an increase in funding requirements for the regulators, would have a disproportional impact on small to medium sized entities.

The imposition Acts already provide for indexation of the statutory upper limits at CPI plus 0.03 - as noted above this would allow the maximum to be actually used to be set at $1.9m. Increasing the maximum levy amount to $1.9m would significantly address any distributional concerns that are arising as a result of an increasing number of institutions sitting at the maximum levy rate.

The Review recommends that it is timely to increase the maximum levies within the existing statutory upper limit contained in the imposition Acts.
Constraint on the unrestricted component of the levy

The Review considered the recommendation from the 2004 review that there be a cap on the proportion of the unrestricted component of the levy to the total amount of levy required.

**Recommendation 4:** That the recommendation of the 2004 review that the notional ratio of the unrestricted component of levy to the total levy be between 10 per cent and 30 per cent be removed in relation to the 2009-10 and subsequent years. This requirement assisted with the transition to the then new arrangements implemented in 2005, but now imposes an unnecessary constraint on levy setting.

The 2004 review introduced the concept of restricted and unrestricted components of the levy. There was a decision that the proportion of the unrestricted component to the total levy be between 10 per cent and 30 per cent. This was not, however, structured into the legislation and was intended to be a transitional provision to assist in bedding down the new system.

Consultations during that review indicated a clear industry view that the cost of supervision should be the single most important consideration in setting the levies, but not the only one. In addition to cost, some industry representatives suggested that system risk should be taken into account in setting the levies and that the levy arrangements should be consistent with vertical equity.

The 2004 review concluded that:

• cost should be the principal, but not sole, determinant of levy amounts;

• system risk and vertical equity considerations are consistent with a component of the total levy being determined as a single levy rate on assets held by an institution, unconstrained by minimum or maximum amounts;

• there should be a reasonable limit to the total amount that could be raised through this component of the levy. In particular, it should be set each year such that it is expected to raise between 10 per cent and 30 per cent of APRA’s levy funding requirement, which on the basis of existing figures would amount to a maximum of around one-quarter of the total levies; and

• a cap should be retained for the separate, cost-based (i.e. restricted) component of the levy as it is clear that the cost of regulation does not increase continually and at a constant rate as the value of assets held increases.

As a consequence, following the 2004 review two distinct elements to the financial sector levies were identified:

• one component to relate to the cost of supervision and involve a single levy rate on assets subject to a maximum (as well as a minimum) levy amount along the lines of the previously existing levy arrangements; and

• the other component to relate to potential system impact and vertical equity considerations and be a low rate levy on assets, without any maximum levy amount. It is this component that is subject to the 10-30 per cent proportionate restriction.

Over the last four years, the total proportion of the unrestricted levy has risen from 27% to 30% and certain industry sectors are exceeding the 30% level. APRA has found that there is an increasing need to undertake more systemic work across industries and this will continue. In light of this, the Review considers the ceiling is no longer appropriate. It recommends that the portion of the total levy based on system impact and vertical equity considerations (the unrestricted component) be set without the restriction arising from the prior Review. The focus of policy and analysis of risk varies both by industry and by period causing temporary spikes in the workload, and levies should not be restrained artificially by a notional ceiling. For example, in 2006/7 additional work was done on General Insurance due to policy and licensing work with
the unrestricted portion for that industry rising to 36 per cent. A similar occurrence is now being experienced in 2008/9 with Life Insurance and Friendly Societies with significant policy work driving a 38 per cent allocation to the unrestricted component.

The Review concludes that the upper restriction on relationship between the unrestricted component of the levy and the total levy is no longer appropriate and should be removed.

**Valuation days - the valuation date upon which the levy is determined**

The Review considered the measurement date that is established in the imposition Acts and whether this is optimal.

**Recommendation 5:** That the valuation date for ADIs, general insurers, life insurers and friendly societies and superannuation funds not be changed.

Under the current arrangements, the valuation date is determined each year by the Minister and traditionally this has been chosen to be 31 March for all industries except for Superannuation, for which 30 June has been chosen. The reason for this is that the imposition Acts generally require the valuation date to be between 17 March and 14 April, except in relation to superannuation. Using the 31 March valuation date can create anomalies where institutions wind up in the last quarter of a financial year but they had been considered in the levy model. This will result in a shortfall in levy for the following financial year.

The Review considered whether a consistent valuation date of 30 June should be applied across all regulated sectors. There are a number of reasons why 30 June would make a better universal valuation date. As well as the winding up of an institution mentioned above, the use of audited accounts at 30 June provides greater accuracy. However, this is offset by two disadvantages: a reduction in APRA’s cash flow due to a one time delay in billing arrangements; and, given the short timeframe to advise the Minister for the issuing of the annual determinations, a greater risk of incorrectly forecasting assets, leading to possibly larger over and under collections.

On balance, the Review recommends that the valuation date for ADIs, General Insurers and Life and Friendly Societies, (including RSAs, NOHCs and FHSAs) not be changed from the end of March to the end of June.

**Starters and leavers**

The Review considered the possible anomalies in the amount of levy payable associated with new entrants to an industry sector and those departing.

**Recommendation 6:**

a) That the levy date for new starters should be redefined and a new starter return should be introduced. The current imposition Acts require APRA to charge a minimal levy for new starters even where their asset base would dictate a higher levy amount; and

b) that leavers from the industries should not be entitled to a pro-rata reduction in the levy, consistent with the current arrangements.

The current arrangements are generous to new entrants because of the manner in which the current legislation describes both who and when a new entrant come into existence for the purposes of the imposition Acts. For example, impediments in administering the levy legislation for superannuation effectively reduce the levy on new starters to the minimum levy. This often falls well short of the actual costs of supervising a new entrant in their first year. Application fees are now charged to all new applicants in each industry sector. While this attempts to cover the costs of assessing a new applicant it does not include the first year (or part year) of supervision.

As a result, the Review recommends that a new starter should be required to complete a new starter return to allow an appropriate determination of the valuation basis and thereby their levy for the first year (or part thereof) of supervision. APRA already has a power to require a new starter return under the Financial Sector Collection of Data Act (FSCOD). The Review further recommends that the imposition Acts be modified so that the relevant start date is the date the institution becomes regulated by APRA and that the valuation basis is the starting assets at that time rather than defaulting to zero.
In relation to regulated entities leaving industries, APRA’s experience is that ‘leavers’ do not warrant a reduced levy. There is often significant supervisory work required to manage a ‘departure’. The imposition Acts do not prorate the levy for leavers. The Review recommends that no prorating on exits continues.

**Assets remain the primary valuation basis**

The Review considered whether assets remain the best basis for the allocation of levies to an institution.

**Recommendation 7:** Total assets should remain the base for most financial sector levies, subject to recommendation 9. The Review examined alternative valuation bases. While a change in the basis for levies from assets to an alternative basis may be more appropriate in some circumstances, it is not appropriate in others. Any change would result in a significant redistribution of the levy burden on industry constituents and would require extensive consultation across all industries. With limited industry feedback suggesting a need for change, the Review recommends that the current system be maintained. The Review further recommends that a more extensive review of the valuation basis be carried out at the next review.

The Review has considered whether a valuation basis other than assets should be used to calculate levies. There have been suggestions that a different basis may better reflect the nature of both inter- and intra-sectoral differences, and provide a closer match to the intensity of APRA supervision for individual regulated entities.

The Review’s analysis indicated that while an alternative basis could be more appropriate in some circumstances, it was not more appropriate in others. In addition, any change of valuation basis from the current asset measure would inevitably result in a significant re-distribution of the levy among institutions. It is considered that there is no overwhelming benefit in changing the basis of determining levies at this stage. Anomalies may arise from the use of assets but it is not apparent that, on a systemic basis, changing to other bases would produce a better distribution of levy charges.

It is recognised that while assets may not be a good measure for all sectors, to date there has been minimal industry concern on this issue and there appears to be no strong imperative to change the basis of levy calculation.

The Review considers that any change to the levy base will result in a fundamental change to the levy arrangements and, in particular, to their distribution across entities. The Review considers that it would be more desirable to consider such changes once the financial sector landscape has settled following the unwinding of the Global Financial Crisis. Consequently, the Review recommends that more detailed consideration of this issue should take place in a future review and that broader consultation with industry be undertaken as substantial changes can be anticipated if the basis of the levy is changed.

Notwithstanding this recommendation, the Review considers that an element of flexibility should be introduced into relevant legislation to allow levies to be calculated on a basis other than assets where particular circumstances require such an approach. This issue is dealt with in Recommendation 9.

**Levy Structure for Specialist Credit Card Institutions (SCCIs) and Providers of Purchased Payment Facility (PPPFs)**

The Review considered the adequacy of the levy being applied to two specialist classes of ADIs.
**Recommendation 8:** That SCCIs and PPPFs be levied an appropriate charge more reflective of the cost of supervision.

It is considered that SCCIs and PPPFs are not being appropriately levied. Such businesses hold very little in assets and, as noted above, the current levy arrangements use asset size as the measurement basis for levy imposition. These entities are currently levied at the minimum rate which does not adequately reflect the level of supervision actually undertaken by APRA. The estimated time effort to supervise such institutions is comparable to the effort for a medium sized credit union with an asset size around $100 - $300 million. The Review concluded that these new forms of ADIs, given their operations and risk profile, and the resulting supervision undertaken by APRA, should be levied an appropriate charge more reflective of the cost of supervision.

The Review recommends SCCIs and PPPFs be subject to a minimum of $10,000 for the restricted component.

**Valuation basis**

The Review considered the lack of flexibility in the current imposition Acts in relation to the inability to introduce new classes of levy for new entrants or products that better align with the potential cost of supervision.

**Recommendation 9:** That the imposition legislation be amended to provide more flexibility so that a valuation basis other than assets can be used on a case by case basis in the annual determinations. This will allow sub-classes with a differing levy base to be established within the same industry which have a differing levy base, and will ensure that timely changes to levies can be made as developments take place in the regulated sectors and products.

From inception, gross assets have been used as the primary measure for determining levies. This has generally proved to be a reasonable measure, but from time to time it has generated particular anomalies. For example, as noted above, assets as a valuation basis are not appropriate for an SCCI which has a large volume of transactions but holds minimum assets and consequently enjoys a very small amount of levy. If the legislation is changed to refer to the ‘valuation basis’ rather than to a specific financial element such as assets, the valuation basis can be flexibly defined in the annual determination by the Minister. This would allow a basis of valuation other than assets to be used, where it is considered appropriate to do so, on a case by case basis.

The Review recommends that the legislation be amended to refer to “valuation basis” rather than gross assets. This would more flexibly accommodate changing market circumstances and regulatory developments. In particular, it would accommodate special cases where new levies are required for new entrants or where it may not be appropriate to levy all institutions within the one industry on the same basis (for example where a participant does not conform to the general characteristics of other entities within the industry).

The National Claims and Policy Database (NCPD) is an example of where greater flexibility in the imposition Act would have been useful. The NCPD was introduced to report on product liability and professional indemnity insurance. The costs of APRA’s regulatory supervision could not be applied to the general industry as a whole as only a subset of the industry provided this form of insurance. When looking at the basis of the levy, APRA considered that gross earned premiums was a more appropriate basis than assets as, for some insurers, this line of insurance only represented a small part of their total business yet their asset base was quite large. Conversely, other insurers had a significant business in product liability and professional indemnity insurance yet only had a relatively small asset base. A levy on the basis of assets would have not have truly reflected the costs to APRA of collecting the data. In this case, the relevant imposition act had to be amended which took approximately 12 months and in the meantime APRA relied on

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4 A separate section above discusses a proposed levy arrangement for SCCIs and PPPFs
voluntary contributions from affected insurers. Changing the imposition Acts as proposed by referring to the ‘valuation basis’ would accommodate the introduction of such as levy.

The Review recommends that respective imposition Acts be modified so that they allow different valuation bases. This will permit the Minister to flexibly determine the valuation basis on a case by case basis where necessary.

Foreign bank branches

The Review considered the levy on foreign bank branches in terms of its adequacy and fairness.

**Recommendation 10:** That no change should be made to levies for foreign bank branches. Foreign bank branches are currently paying a levy at a rate of half that paid by domestic ADIs. This remains appropriate for the amount of supervision work that they entail.

Under the current levy arrangements, foreign bank branches are charged at half of the restricted rate and capped at half of the maximum rate applicable to domestic ADIs. They are, however, charged the full amount for the unrestricted rate. The Review has considered the concessionary arrangement from the perspective of APRA’s supervisory work on foreign bank branches in contrast to domestic ADIs. The analysis indicates foreign bank branches require a reduced supervision effort compared to their domestic ADI counterparts.

The Review recommends no change to be made to the current arrangements for foreign bank branches.

Conglomerate groups

The Review considered whether conglomerate groups were paying a disproportionate total amount of levies.

**Recommendation 11:** That no change in levy structure should be made to the levies for regulated institutions within conglomerate groups. The individual institutions that make up a conglomerate require supervision both jointly and individually with little reduction in the overall work of APRA.

Some APRA-regulated institutions within a group structure have expressed concerns that the current levy structure puts a disproportionate share of the levies on them. They argue that levies are imposed on each of the separate entities within the same group but often APRA’s supervision assessment is performed at the group level. They conclude that it is inequitable for each institution within a conglomerate to pay the same levies as a stand-alone entity of the same kind and some form of exemption or discount is warranted.

The current levy structure, which operates under a cost allocation methodology, has taken into consideration both systemic impact (vertical) and sectoral (horizontal) equity issues. APRA has found that, while there are some synergies which can be gained from making assessments at group level, in many cases there is additional work required to ensure that group wide risk management practices (for example) are actually operational and embedded in individual regulated institutions within the group. Although prudential supervision is the most direct and visible interaction with regulated entities, it only represents one part of the supervisory framework. APRA’s supervisory effort consists of prudential reviews and consultations, entity specific analysis and other ongoing interactions. Large conglomerates may pose systemic risk due to structural complexity and this is likely to require greater supervisory effort. The counter argument considered by the 2004 review was that large entities and conglomerates were consuming a disproportionate amount of APRA’s resources. However, being limited by the maximum cap, they were paying proportionally less than simpler mid-sized institutions. This was substantially addressed through the unrestricted levy.

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5 Foreign bank branches are foreign ADIs and must obtain an authority and licence to carry on banking business (s9 Banking Act 1959). This is in contrast to Foreign Representative Offices, which merely provide information and do not carry out banking business. Foreign Representative Offices are charged fees set under s51 of the APRA Act.
There is little evidence that the levy structure has produced an unintended outcome which disadvantages conglomerates.

Based on the above conclusions, the Review recommends no change to the levy structure for regulated institutions within conglomerate groups.

Pooled Superannuation Trusts (PSTs)

The Review considered the special case of PSTs within the superannuation industry sector and whether any special arrangement for them could be justified.

Recommendation 12: That no change should be made to the levy structure for Pooled Superannuation Trusts. PSTs require supervision by APRA and adequate mechanisms are in place within the imposition Acts to address any special cases where waiving of the levy is justified. APRA will make clearer the general policy that is followed in applying waivers of levies. This levy category should be re-examined at the next methodological review.

The Review has considered the current levy structure in place for PSTs. Under section 6 of Superannuation Supervisory Levy Imposition Act 1998 (Imposition Act), levies are imposed on a superannuation entity and a PST is defined as a superannuation entity.

A number of trustees of PSTs have argued over time that the assets used in calculating the levy for each of the underlying funds are used again in calculating PSTs’ levies and this is inappropriate. They also contend that there is no material additional supervisory effort in supervising PSTs and APRA should consider waiving levies on PSTs since the law has produced an unintended outcome. APRA considers there is some merit in the assertion that some PSTs are very simple structures and there is little additional work to supervise them. However, it is difficult to adequately distinguish this sub-class in law.

PSTs consolidate investments from other superannuation entities - in particular, superannuation funds - and thus levies are applied separately to both the PSTs and other superannuation entities that invest in them. PSTs can generally be classified into two groups: those that are purely captive and those with a broader investor base (non-captive). Captive PSTs are used more for administrative convenience by a single trustee of a number of funds. The latter make up the majority of PSTs and provide an investment vehicle for unrelated superannuation funds. The amount of work APRA performs is higher for non-captive PSTs. However, the distinction between captives and others is blurred and there is no convenient way to adequately define their intended purpose sufficiently to clearly distinguish a sub-class of PST and thereby differentiate the levy.

More significantly, the charging of levies on assets which are ‘double-counted’ in different institutions is a practice that exists throughout the levy system. Levies are first calculated for the industry sector on the basis of the work that is required to supervise the industry sector. Levies are then allocated to each of the institutions that make up the industry sector on the basis of the proportionate size of the institution’s assets relative to the size of the industry sector’s assets as a whole.

Thus, the levy imposed on each institution within an industry sector reflects the asset base of the institution relative to the overall asset base of the sector as a whole. The levy does not target the asset of the institution as such. Rather, the levy uses institutions’ assets as an allocation device: how much each institution should contribute to meet the amount that the industry sector is required to pay for the costs of prudential supervision. The same assets may be used more than once in allocating costs in different industry sectors. For example, the costs of supervising life insurance are allocated on the basis of the assets of life companies. Because life companies also provide superannuation services, these assets are also used in allocating the costs of supervising the superannuation industry sector.

Double counting, as discussed, therefore is not in itself an argument supporting consideration of a change for PSTs. It is a broader issue about the structure of the levy arrangements which goes beyond PSTs. Any change in relation to PSTs because of this issue would necessitate reconsideration of all areas where there is some double counting.
APRA has previously waived levies for a few PSTs but only in specific circumstances. If a broad exemption for the levy was to be put in place, one option would be to apply the exemption to captive PSTs. It is difficult however to precisely define a captive PST as even superannuation funds under the same trustee may have external investors.

As a result, the Review believes it is appropriate to continue with the current practice of APRA discretion which allows a case-by-case consideration to be made of any applications for waivers. APRA needs to be cautious in setting policy with regard to the interpretation and practical implementation of applying waivers which is set out in Financial Institutions Supervisory Levies Collection Act 1998 and be mindful of the requirements of the Administrative Decisions (Judicial Review) Act 1977. APRA will make clearer the general policy that is followed in applying waivers of levies.

Based on the above conclusions, the Review recommends no change to the levy arrangements for PSTs, which includes consideration for waiving the levies.

Due to the complexity of this issue and the broader implications that it has for double counting more generally across the regulated sectors, the Review recommends that this issue be further considered as part of a future review. It would be appropriate to consider any changes to address double counting at the same time more fundamental issues are advanced such as the appropriate levy base as suggested in Recommendation 7.
Terms of Reference for Review of Financial Sector Levies 2009

Background
On 1 July 2008, the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs (the Minister) announced an examination of the methodologies governing the determination of the financial sector levies, in light of industry views on the methodologies and the fact that the methodologies have not been changed for some time.

The last time the methodologies were subject to a major review was in 2004. At that time, it was announced that the methodologies would be reviewed during 2008.

It should be stated at the outset that the financial services sector collectively supports the levy arrangements that raise revenue to fund the operations of the Australian Prudential Regulation Authority (APRA) and related activities of the Australian Securities and Investments Commission and the Australian Taxation Office. Overall, the financial services sector has considered that the methodologies have worked satisfactorily and have merited overall support. However, a number of financial organisations have raised specific issues about the methodologies. In addition, APRA’s experience with the levy arrangements has also identified some operational issues.

Scope
Against that background, there is no apparent need to undertake a broad and far-reaching review of the levy framework. Rather, there are benefits in a focussed examination of these specific issues, with a view to improving the efficacy of the system.

The review process and timeframe
The review is to be chaired by the Treasury and assisted by APRA as a member of the review team. Treasury will provide a preliminary paper with draft recommendations/proposals at the end of January 2009 to the Minister. Subject to the Minister’s approval, the review team will discuss the recommendations with relevant sectors of the industry. A final report of the review is to be provided to the Minister by 6 March 2009. Within the scope of the review noted above, this report will review the principal issues in administering the existing arrangements, the merits of any proposal for change to existing arrangements, and make recommendations on any necessary legislative amendments. Any changes to the existing levy arrangements which would require legislative amendment would not take effect before the 2010-11 financial year.

In reaching its recommendations, the review team will balance accountability, efficiency, transparency and equity with simplicity of administration and collection. It will ensure that arrangements have the capacity to provide stable and effective funding for the regulator on a sustainable basis and to meet the evolving needs of prudential supervision into the future at a reasonable cost.

Matters to be reviewed
The review will examine specific issues arising from previous consultations and from operational experience with the existing arrangements. It will address the following matters:

• providing more choice than ‘total assets’ as the more appropriate basis for determining relative levy shares amongst prudentially regulated institutions where sub-classes of industry sectors may need special consideration;

• the appropriateness of the current levy framework for particular sectors such as conglomerates, Pooled Superannuation Trustees and foreign banks;

• the relationship between the levies raised under current arrangements and the cost of supervision of particular sectors;
• the appropriateness of the existing levy minimum and maximum caps for the restricted component;
• the appropriateness of confining the unrestricted component of the levy between 10 per cent and 30 per cent of the total levies;
• measures to improve the disclosure of the methodology for determining expenses funded by levies; and
• whether any legislative changes might be desirable or necessary to implement the recommended changes, including possible consideration of:
  – the value date upon which the levy is determined;
  – the value basis upon which the levy is determined;
  – new entrants to, and departures from, the financial sectors affecting the work load of the prudential regulator; and
  – the suitability of the current business rules regarding ‘starters’ and ‘leavers’ to the financial sector.
APRA’s levies, costs and performance

APRA is funded primarily from levies collected from supervised financial institutions, with a contribution from fees for services and miscellaneous cost offsets. Included within Revenue from Government for the current period is: an annual special appropriation in lieu of the equivalent interest\(^6\) on the Special Account; a special appropriation for participation in the Standard Business Reporting program; and a special appropriation to assist with the Global Financial Crisis.

Levies are raised according to the *Financial Institutions Supervisory Levies Collection Act 1998* and six other Acts applying to the main industry sectors (imposition acts). Prior to the beginning of each financial year, the Minister announces the levy determinations for each industry sector with a rate to be applied on assets, subject to a minimum and maximum amount per institution, except for non-operating holding companies that are levied at a flat rate. The levies collected by APRA also cover some costs\(^7\) of ASIC and the ATO. The process includes detailed consultation with the main industry groups and the Treasury. Levies are based on industry sectors. In addition, levies are collected to cover the costs of the National Claims and Policies Database with a rate applied to the gross earned premiums of contributors. The total levies collected by APRA for all three agencies in 2007/08 were $103.6 million.

APRA’s total revenue from ordinary activities in 2007/08 was $88.0 million. After adjusting for HIH Royal Commission funding and additional revenue from direct cost recoveries, and including interest earnings (though a special appropriation), net revenue was $86.0 million. APRA returned $14.7 million to industry sectors in 2007/08 by way of reduced levies, comprising $8.5 million in previous over-collections of levies and $6.2 million of excess reserves.

The amount to levy an institution, which is derived from a financial model of the industry sector, starts with an attribution of costs by sector from time recorded by staff and allocates to institutions within each sector by the valuation basis (in most cases assets) as at a valuation date, which currently varies by sector. The levy is compromised of two components:

- The restricted component that is imposed at a rate sufficient to recover the cost of direct institutional supervision bounded by a minimum and a maximum level; and
- The unrestricted component that is imposed at a rate sufficient to recover the costs associated with industry wide activity that is not bounded by minimum or maximum amounts.

The parameters are suggested to industry via an annual consultation process along with a full explanation on their derivation. Minor variations to the mix of rate, minimum and maximum to the parameters may be suggested by industry. From this process, the Treasury Minister is advised, and the Minister’s approval is subsequently sought to enact the levy determinations. Once in place, APRA sets about billing the institutions and collects into APRA’s Special Account according to section 50 of the APRA Act, leaving the ASIC and ATO components in the Consolidated Revenue Fund.

Reserves

Since inception, APRA has been predominantly funded by levies, supplemented where appropriate by direct fees for specific work for a small sub-group eg Basel New Capital Accord,

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\(^6\) When APRA was a CAC agency, it invested the money pre-paid by institutions for their levies in Government securities. In addition, APRA earned interest on reserves that have been accumulated from levies paid by institutions. In return, industry has received the benefit of lower levies. On becoming a FMA, it is agreed with DoFaD to be appropriated an equivalent amount.

\(^7\) On the formation of APRA, some of the functions of the predecessor agency, the Insurance and Superannuation Commission, were transferred to ASIC being for consumer protection related activity and to ATO for the management of the Lost Members Register for superannuation.
cost recovery for work done for a special group of government eg RBA and ABS and for licensing of new entities. The process of levying is dependent on the estimated value of assets, which may subsequently be more or less than modelled. This gives rise to over and under collection of levies on an annual basis and results in operating surpluses and deficits that flow through to financial reserves.

Table 1 explains the occurrence of annual surpluses and deficits between the levies and fees collected and the costs of running APRA. APRA maintains a policy of retaining reserves at a reasonable level. This has been set to be at a level between five and ten per cent of the annual levies. It is intended to ensure that a significant shortfall in funding due to mergers or the need to take swift action on enforcement and other matters is not jeopardised through lack of adequate funds. This has been a critical feature in providing APRA with flexibility and responsiveness. The Annual Financial Statements provide a full reconciliation of the disposition of funds and the accumulation of reserves. As APRA staff do not fall under the Public Sector Act, APRA must provide fully for staff entitlements. Consequently, APRA holds (through the Department of Finance and Deregulation) significant amounts of cash particularly at the early part of the annual billing cycle. It is important for APRA to demonstrate solvency as any significant shortcoming in the availability of funds would present some reputation risk in the management of its financial affairs.

Table 1: Accumulated surpluses since inception $’000

<table>
<thead>
<tr>
<th>Year</th>
<th>Annual Surplus/(deficit)</th>
<th>Accumulated surpluses</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999-2000</td>
<td>6,071</td>
<td>1,692</td>
</tr>
<tr>
<td>2000-2001</td>
<td>(1,140)</td>
<td>552</td>
</tr>
<tr>
<td>2001-2002</td>
<td>2,965</td>
<td>3,517</td>
</tr>
<tr>
<td>2002-2003</td>
<td>(168)</td>
<td>3,349</td>
</tr>
<tr>
<td>2003-2004</td>
<td>2,067</td>
<td>5,416</td>
</tr>
<tr>
<td>2004-2005</td>
<td>4,054</td>
<td>9,470</td>
</tr>
<tr>
<td>2005-2006</td>
<td>2,944</td>
<td>12,181(^{8})</td>
</tr>
<tr>
<td>2006-2007</td>
<td>17,099</td>
<td>23,280(^{9})</td>
</tr>
<tr>
<td>2007-2008</td>
<td>(13,263)</td>
<td>10,017</td>
</tr>
<tr>
<td>2008-2009 (B)</td>
<td>533</td>
<td>10,550</td>
</tr>
<tr>
<td>2008-2009 (F)</td>
<td>(2,570)</td>
<td>7,447</td>
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</tbody>
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From above table, the accumulation of reserves is seen over the period from 1998 to 2005. In 2005/6 the reserves became more than required and by 2006/07 the reserves were well in

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\(^{8}\) A prior year adjustment reduced reserves by $233k.

\(^{9}\) In 2006-07 a contingency enforcement fund of $6 million was set up.
excess of that required by APRA. This was brought about by rapid asset growth in excess of that modelled and a shortfall in expenditure. This was rectified in 2007/08 with the return of $13 million to industry through reduced levies. APRA took the opportunity in this year to set up a Contingency Enforcement Fund (CEF) of $6 million to provide further confidence in taking on major enforcement actions promptly. APRA’s reserves have now been returned to the five to ten per cent range.

**Levies imposed versus actual costs**

With regard to the manner in which the levy is set, APRA has used a model that has been consistently applied each financial year since inception. The model is based on the factors defined within the imposition acts and supplies the recommended parameters needed for the recommendation to the Minister. The model starts with the valuation basis (in most cases assets) collected through periodic returns by the Statistics Group at the valuation date. A funding rate is set to recover the cost estimated for each industry sector in the levy year constrained by minimums and maximums. The levy methodology has been modified from 2005/06 to include a levy designed to recover industry wide costs (i.e. not institutionally specific) concerned with systemic risk. This is not bounded by a minimum nor a maximum and is aimed at providing vertical equity in funding those costs incurred within APRA for industry wide activity eg policy development, research, statistics etc. Subsequently, it is considered that the introduction of the unrestricted levy has addressed many of the vertical equity issues encountered pre 2005/06 eg mid-range banks such as Bendigo were paying nearly as much as the large four banks because of the impact of the caps in levy in restricting their contribution.

The levy model is subject to a number of assumptions. In retrospect, each assumption could be tested for validity. Firstly, what if APRA assumes either too little asset growth or uses a consolidation factor to target more levy than is strictly needed to fund operations. During the levy modelling process care is taken to refer to the most recent returns from institutions to ascertain asset values. Generally the longer the period from the last return, the greater the potential is for error. Consequently, Superannuation is the least accurate having to rely on many returns from the prior June year-end. Even with best estimates, the precise number of entities and asset values may fall short or exceed that modelled. Should this happen, then the excess or shortfall in levy collected will be adjusted in the subsequent year.

Secondly, APRA may collect more or less fees than modelled. Fees are used to reduce the amount of the levy. This is justifiable in that less activity is spent on direct supervision and should be funded by a user based cost recovery. However, they have been notoriously difficult to estimate with accuracy. The volume of licensing, the negotiation with the banks on the costs regarding Basel and certain state based activities have been other variable factors in levy setting. However, should the fees be too low or high the resulting deficit/surplus will be taken into account in setting the levy for the following year.

Thirdly, an error can occur from the overall cost of APRA being higher or lower than that modelled. APRA attempts to manage within its budget as set within the Portfolio Budget Statements. However, should a deficit or surplus occur reserves will be changed. APRA will then consider whether this should be subsequently adjusted by increasing or decreasing the levy in the following period.

Fourthly, the amount of cost allocated to each industry sector may be higher or lower than the actual activity during the year incurred. This potentially could cause a distortion and horizontal equity issues whereby one industry sector appears to be getting less supervisory attention than planned for. To reduce this possibility, APRA uses a four year averaging process. The average is determined by taking the recorded time by APRA staff against industry sectors for the prior two years plus the actual for the first two quarters of the year in which the model is run. Estimates are then made for the last two quarters of the current year and for the following year. Should the estimates be in error then the model for the subsequent year will start the process of unwinding the error. This means that errors are subsequently corrected. Furthermore, the averaging process reduces the volatility of supervisory time and associated levy with major policy initiatives and spikes in risk based work such as superannuation and general insurance
licensing. Four years has proven to be the best period to perform the averaging; both three and five having been used in earlier periods and found to be inadequate.
<table>
<thead>
<tr>
<th>Acronym/Abbreviation</th>
<th>Full Title/Meaning</th>
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<tbody>
<tr>
<td>ADIs</td>
<td>Authorised Deposit-taking Institutions</td>
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<tr>
<td>APRA</td>
<td>Australian Prudential Regulation Authority</td>
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<tr>
<td>ASIC</td>
<td>Australian Securities and Investments Commission</td>
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<td>ATO</td>
<td>Australian Taxation Office</td>
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<tr>
<td>FISCLA</td>
<td>The Financial Institutions Supervisory Levies Collection Act 1998</td>
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<tr>
<td>FHSA</td>
<td>First Home Saving Account</td>
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<tr>
<td>Imposition Acts</td>
<td>This includes various industry sector imposition Acts and FISCLA (see above).</td>
</tr>
<tr>
<td>Imposition legislation</td>
<td>This includes various industry sector imposition Acts, FISCLA (see above) and imposition Determinations set annually.</td>
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<td>NOHCs</td>
<td>Non-operating Holding Companies</td>
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<td>Providers of Purchased Payment Facilities</td>
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<td>Pooled Superannuation Trusts</td>
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<td>Reserve Bank of Australia</td>
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<td>Retirement Saving Accounts</td>
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<td>Special Credit Card Institutions</td>
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