

Financial industry supervisory levy methodology

Discussion Paper
April 2013

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CONSULTATION PROCESS

Request for feedback and comments

This paper seeks submissions on the design and operation of the Financial Institutions Supervisory Levy. The focus of the discussion paper is on the methodology used for the application of the levy.

While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please submit responses sent via email in a Word or RTF format. An additional PDF version may also be submitted.

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Closing date for submissions: 29 April 2013

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FOREWORD

In 1998, the Government introduced levy-setting arrangements to fund the activities of the then newly established Australian Prudential Regulation Authority (APRA). Since the introduction of the *Financial Institutions Supervisory Levies Collection Act 1998*, the scope of the levy imposition has expanded to include a broader range of activities relating to the APRA-regulated financial services sector. Information on how the levy is used to fund various agencies and the activities they undertake is provided in this paper.

In 2008-09¹, following a review of the design and operation of the financial industry supervisory levy, it was acknowledged that there would be merit in further reviewing the levy framework within four years on the expectation that sufficient time would have passed to assess the impact of the global financial crisis on the size and structure of the regulated sectors. An earlier review of the financial sector levy had been undertaken and a discussion paper released by Treasury in April 2005.

The purpose of this paper is to provide industry with an opportunity to comment on the design and operation of the levy framework. This discussion paper is separate to the annual 'Proposed Financial Industry Levies' paper² released in May each year. That paper generally focuses on how the levy for a particular year is calculated, whilst this discussion paper focuses on the methodology that is applied in calculating the levy.

Comments received will inform future consideration on the financial industry supervisory levy as well as future annual 'Proposed Financial Industry Levies' papers.

The Hon Bill Shorten MP
Minister for Financial Services and Superannuation

1 The 2008-09 Review of Financial Sector Levies Treasury/APRA discussion paper can be located at: http://archive.treasury.gov.au/documents/1708/PDF/Review_of_Financial_Sector_Levies.pdf

2 The 2012/13 'Proposed Financial Industry Levies' paper can be located at: <http://www.treasury.gov.au/ConsultationsandReviews/Submissions/2012/Proposed-Financial-Industry-Levies-for-2012-13>

1. OVERVIEW OF THE LEVY

The Government funds APRA and the cost of additional consumer protection functions in the financial system through a levy on the APRA-regulated financial services sector.

The legislative framework is established by the *Financial Institutions Supervisory Levies Collection Act 1998*, which prescribes the timing of payment and the collection of a levy. A suite of imposition Acts impose levies on institutions operating in the APRA-regulated financial services sector, set a CPI-indexed statutory upper limit and provide for the Minister to make a determination as to certain matters such as the levy percentages for the 'restricted' and 'unrestricted' levy component (refer to sec. 4.1), the maximum and minimum levy amounts applicable to the restricted levy component, and the date at which the regulated institutions' levy base is to be calculated.

The levy is designed to cover the majority of the costs of APRA, the prudential regulator of the Australian financial services industry, and to fund specific costs for a range of other Commonwealth agencies and departments, being:

- the Australian Taxation Office's (ATO) expenses in administering the Superannuation Lost Member Register. In addition, the ATO's costs associated with the implementation of the Government's SuperStream reforms are being collected as part of the levy on the superannuation industry;
- the Australian Securities and Investments Commission's (ASIC) expenses in relation to consumer protection, regulatory and enforcement activities that relate to the products and services of the APRA-regulated financial services sector; and
- the Department of Human Services (DHS) costs in administering claims for the early release of superannuation benefits on compassionate grounds.

Table 1: Financial industry supervisory levy funding by agency (\$'million)

Agency	FY 06/07	FY 07/08	FY 08/09	FY 09/10	FY 10/11	FY 11/12	FY 12/13
APRA	84.9	89.7	86.9	94.0	89.7	99.2	112.9
ASIC	13.1	14.7	14.6	18.5	19.3	20.7	20.7
ATO	3.8	6.9	6.4	7.3	6.8	7.2	7.1
DHS	0	0	0	0	0	0	4.2
SuperStream	0	0	0	0	0	0	121.5
Total	101.8	111.3	107.9	119.8	115.8	127.1	266.4

2. RATIONALE FOR THE LEVY

Regulators can be funded by industry, government, or a blend of the two. Most countries fund their prudential regulators through a mixture of government and industry funding.

Prudential regulation is seen as having public good characteristics. An argument could be made that the government should fund financial regulation, as a stable, well-regulated financial sector confers benefits on the entire community, not just the regulated parties. However, this needs to be balanced against the potential benefits from alternative uses for government funds, and against whether this process will ensure adequate funding for regulators in light of other government priorities. Australia's participation in the IMF Financial Stability Assessment Program reinforces the importance of adherence to global 'Core Principles' for banking and insurance, which require that a regulator be funded in a way that does not undermine its autonomy or independence from government. This is generally taken to require a high degree of industry funding. An industry levy, to meet the general costs of regulation, was also recommended by the Wallis Inquiry in 1997 that led to the creation of APRA. The use of a levy ensures that funding for regulators is determined by reference to policies for financial system regulation and supervision rather than targets for the overall budget balance.

3. SIZE AND STRUCTURE OF THE FINANCIAL SECTOR

Australian financial institutions had assets of around \$5.1 trillion as at September 2012. Since 1990, the assets of Australian financial institutions have grown by an average annual rate of around 10 per cent (considerably faster than average growth in nominal GDP), but growth has slowed since the global financial crisis. Authorised deposit-taking institutions (ADIs) account for nearly 60 per cent of financial system assets, a share that has continued to increase since 2007. ADI assets are over two times the size of nominal GDP. Australia's four major banks together hold about 75 per cent of total ADI assets.

Life insurance companies, general insurance companies and superannuation funds account for about one-quarter of Australian financial system assets. Life insurance makes up around four per cent of the assets of financial institutions. The industry has increasingly focused on wealth management rather than traditional life insurance business, with the industry's superannuation businesses continuing to account for the vast majority of its assets. The general insurance industry is fairly concentrated, with three large companies dominating the sector.

Australia's superannuation industry is relatively large by international standards, with assets of \$1.4 trillion as at 30 June 2012.

Of the \$5.1 trillion in total assets, APRA currently supervises institutions holding \$4 trillion in assets for almost 23 million Australian depositors, policyholders and superannuation fund members. The following table outlines the size and structure of the regulated sectors from June 2008.

Table 2: Number and asset base of regulated institutions

Industry	June 2008		June 2009		June 2010		June 2011		June 2012	
	No.	Total asset base (\$b)	No.	Total asset base (\$b)	No.	Total asset base (\$b)	No.	Total asset base (\$b)	No.	Total asset base (\$b)
ADIs	211	2,419.1	193	2,663.3	182	2,693.2	177	2,813.4	174	3,039.9
Representative offices of foreign banks	18		17		17		18		17	
Life insurers and Friendly societies	56	243.9	51	218.8	48	233.9	45	241.2	41	243.6
General insurers	130	91.2	132	95.2	130	99.2	127	115.0	124	118.2
Licensed trustees	292		277		251		225		209	
Non-operating holding companies	18		17		21		25		25	
APRA-regulated superannuation institutions	6,250	672.7	4,914	613.9	4,458	722.6	4,054	810.6	3,675	832.5
Excluding small funds	711	669.8	637	611.9	589	720.6	535	808.6	474	830.5
Small funds	5,539	2.9	4,277	2.0	3,869	2.0	3,519	2.0	3,201	2.0
Total	6,975	3,426.9	5,601	3,591.2	5,107	3,748.9	4,671	3,980.2	4,265	4,234.2

Note: The addition of 'excluding small funds' and 'small funds' in Table 1 gives the total of 'APRA-regulated superannuation institutions'.

4. CALCULATION OF THE LEVY

4.1 APRA'S COMPONENT OF THE LEVY

The current levy methodology used to recoup APRA's costs is based on the time APRA estimates that it spends on the supervision of each industry sector. The levy has two components:

- the restricted levy component, which has a cost of supervision rationale, is structured as a percentage rate on assets subject to minimum and maximum amounts. Activities covered by this component include costs associated with APRA's onsite and offsite supervision of individual institutions and its legal and enforcement activities; and
- the unrestricted levy component, which has a system impact and vertical equity rationale, is structured as a low percentage rate on assets with no minimum or maximum amounts. Activities covered by this component include costs associated with the development of APRA's prudential framework for the industries it supervises, as well as its statistical data collection and publications.

The levy allocation methodology is designed to fully recover the costs from each industry sector and minimise cross-subsidies across sectors.

The estimated asset value of each institution is used as a basis for allocating the quantum of the sectoral levy to each regulated institution.

To maintain the integrity of the levy funding mechanism, the levy model is adjusted by over-and under-collection of the levy in prior periods by sector. Over-or under-collection occurs from time to time, mainly from either a difference in the actual asset values of institutions or from a change in the population of regulated institutions to that estimated at the time of calculating the levy rates.

Table 3: APRA’s levy requirement by industry for 2012-13 (\$’million)

Industry	2012-13		2012-13
	Restricted component	Unrestricted component	Total
ADIs	30.3	16.6	46.9
Life insurance/ friendly societies	6.2	4.4	10.6
General insurance	11.2	8.2	19.4
Superannuation	23.5	12.5	36.0
Total	71.2	41.7	112.9

4.2 OTHER COMPONENTS OF THE LEVY

As indicated in section 1, the levy is also designed to fund specific costs for the ATO (including the Government’s SuperStream reforms), ASIC and the DHS.

The specific costs to be recovered are included in the determined levy rates by industry sector and the estimated asset value is used as the basis for the calculation of the quantum of the levy component.

Table 4: Other Commonwealth agency levy requirements by industry for 2012-13 (\$’million)

Industry	ATO	ASIC	DHS	Super Stream	Total 2012-13 levy
ADIs	0	3.4	0	0	3.4
Life insurance/ friendly societies	0	2.3	0	0	2.3
General insurance	0	2.9	0	0	2.9
Superannuation	7.1	12.1	4.2	121.5	144.9
Total	7.1	20.7	4.2	121.5	153.5

5. RECENT DEVELOPMENTS IN THE FINANCIAL INDUSTRY SUPERVISORY LEVY

Funding for Commonwealth agencies and departments through the financial industry supervisory levy is considered in the Government’s annual budget process. As part of this process, agencies may bring forward new spending proposals and identify how they will be funded. While most APRA proposals are funded through the levy, other agencies may also propose to fund activities through the levy arrangements. In these instances, the Expenditure Review Committee of Cabinet gives consideration to whether it is appropriate to fund these proposals through the levy.

During the global financial crisis, the Government provided \$45.5 million over four years in additional funding to APRA to meet a range of additional prudential regulation and supervisory activities including stress-testing, reviews of ADI funding plans and monitoring industry impacts. This was funded directly through the budget and was not recovered by a supervisory levy. This was to enable APRA to react as required through the crisis, rather than wait until appropriate funding could be established through the annual levy setting process. This budget funding expired in 2011-12. To allow APRA to continue with these activities, they are funded from 2012-13 onwards through the financial industry supervisory levy.

Additionally, some functions undertaken by APRA are not recovered through a levy but instead through direct user charges or fee for service arrangements. This includes accreditation of ADIs and general insurers to adopt 'advanced' internal model approaches to determining capital adequacy, licensing of new entrants and provision of statistics to the Reserve Bank of Australia and the Australian Bureau of Statistics.

Mechanisms exist to ensure value for money for the APRA-regulated financial services sector and to drive productivity and efficiencies within regulators. One such mechanism is the Government's efficiency dividend that limits the growth in regulators' costs. This flows through to the financial industry supervisory levy by making it lower than what it would otherwise have been.

The composition of the financial industry supervisory levy has changed. In 2006-07, 83 per cent of funding from the levy went to APRA. This compares to 42 per cent in 2012-13. SuperStream, which was only established in the 2012-13 Budget, currently accounts for 46 per cent of the value of the levy (although its value and proportion is expected to decline over time). Announced as part of the Government's Stronger Super Reforms, SuperStream is designed to deliver greater efficiency in back-office processing across the superannuation industry. As shown in Table 1, the funding of SuperStream through the levy has also resulted in a significant change to the amount collected through the levy. Once implemented, SuperStream is expected to save the superannuation industry \$1 billion each year in processing costs.

The cost to Government of implementing SuperStream reforms identified in the 2012-13 Budget was \$467 million over seven years with the full cost to be recovered through a temporary levy on APRA-regulated superannuation funds from 2012-13 to 2017-18 inclusive.

Further changes in 2012-13 included a levy for DHS costs for the first time. This reflected DHS assuming responsibility for the early release of superannuation benefits on compassionate grounds in November 2011. This function was previously carried out by APRA. As a result, the levy for DHS activities does not represent an increase in costs but rather a transfer of function.

The increase in funding for APRA in 2012-13 primarily reflects the cessation of non-levied funding provided by Government for additional supervisory activities, as noted above. These activities are now funded through a supervisory levy.

6. CONSULTATION ISSUES

6.1 *'IS THE CURRENT SETTING FOR RESTRICTED (SUPERVISORY) AND UNRESTRICTED (SYSTEMIC) LEVY AMOUNTS APPROPRIATE? ARE THE CURRENT MINIMUM AND MAXIMUM RESTRICTED LEVY PARAMETERS APPROPRIATE?'*

Section 4.1 of this paper outlines the methodology used to calculate the levy to recoup APRA's costs. In considering the levy model there may be merit in considering:

- the benefits;
- the financial costs APRA incurs in undertaking supervisory work relating to the institutions being levied;
- the administration cost of any levy arrangements; and
- the extent activities can be traced to individual institutions.

Any changes to the existing levy model would have distributional consequences, potentially with different effects on different industries and different sized institutions.

As explained above, APRA's activities and the time spent on them are broadly broken down into the cost of supervision (the restricted component) and the systemic impact (the unrestricted component). Each component is then apportioned across the different industries based on the total resources APRA expects to dedicate to each industry.

The 2008-09 review of the financial industry supervisory levy had concluded: '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'.

To ensure continued vertical equity in the levy applied to individual institutions within a sector, adjustments to the minimum and maximum parameters for the restricted levy component are made annually following industry consultation. These adjustments are designed to support an equitable sharing of the levy burden within each industry sector.

The introduction of the unrestricted levy component in 2005-06 sought to resolve issues regarding vertical equity. With no cap on the unrestricted levy component larger institutions are subject to a higher levy amount.

A question may still remain as to whether the minimum and maximum caps are broadly equitable to entities within each 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. The maximum levy typically applies to the largest institutions.

6.2 *'IS THE CURRENT LEVY BASE APPROPRIATE FOR EACH INDUSTRY SECTOR?'*

The current base used for the calculation of a levy is the asset value, as at 30th June and 31st March, of the regulated superannuation funds and non-superannuation institutions respectively. To date, there has been minimal industry concern regarding this issue and a case has not been presented to change the basis of the levy calculation.

During the 2008-09 financial industry supervisory levy review, the appropriateness of the asset base for general insurance institutions was considered. An analysis was undertaken comparing assets, the gross written premium and the minimum capital ratio. The result of that analysis indicated that, with the use of a different levy base:

- there would be a significant re-distribution of the levy amongst general insurance institutions;
- there would be significant winners and losers; and
- there is no clear evidence that one method of allocation was better than the others.

The overall conclusion of the 2008-09 review was that: '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 participants and would require extensive consultation across all industries'.

6.3 *'IS THE LEVY STRUCTURE APPROPRIATE FOR REGULATED INSTITUTIONS WITHIN CONGLOMERATES?'*

No special considerations are currently applied to the application of the levy to conglomerates. In some instances, there may be some supervision efficiencies in making assessments of regulated institutions at a group level. However, conglomerates also require additional work, such as ensuring that group-wide risk management practices are operational and embedded in individual regulated institutions within the group. Furthermore, conglomerates may pose systemic risks due to their size or structural complexity and hence require greater supervisory effort.

The conclusion of the 2008-09 financial industry supervisory levy review was that: 'the individual institutions that make up a conglomerate require supervision both jointly and individually with little reduction in the overall work of APRA'.

6.4 *'DOES THE CURRENT LEVY METHODOLOGY PROVIDE ADEQUATE TRANSPARENCY AND IS IT APPROPRIATE FOR INDUSTRY SUB SECTORS?'*

Information concerning APRA costs is provided in the annual 'Proposed Financial Industry Levies' paper and in APRA's annual report. Further transparency of the process is achieved by:

- a Cost Recovery Impact Statement (CRIS), prepared following the outcome of this levy methodology review. The CRIS contains further expenditure information where appropriate; and

- the performance audit relating to APRA's supervisory levy, currently being conducted by the Australian National Audit Office (ANAO). The report is expected to be tabled in the Winter 2013 Parliamentary sittings.

Friendly societies, which are included within the life insurance sector for levy purposes, have raised concerns about the application of the current levy methodology as it relates to them (specifically in respect to vertical equity). No other industry sub-sectors have raised any specific concerns regarding the current methodology.

If a differential levy by industry sub-group were considered, it would likely add a further level of complexity to the existing processes and could potentially increase the cost of administering levy arrangements. A change to industry sub-group arrangements would also be likely to result in some institutions in the sub-group paying more and others paying less.

6.5 'SHOULD THE CURRENT LEVY METHODOLOGY TAKE INTO ACCOUNT REINSURANCE RECOVERIES AND THE RESULTANT IMPACT ON THE LEVY CALCULATION [BASED ON ASSET VALUE] FOR GENERAL INSURERS?'

The Insurance Council of Australia provided feedback during the 2012-13 'Proposed Financial Industry Levies' paper consultation period that the levy methodology does not account for the impact on general insurer asset values of reinsurance recoveries relating to natural disasters. The timing of when reinsurance recoveries occur can have a significant impact on the amount a general insurer may be levied.

Under the current methodology, changes to asset values that occur as a result of reinsurance recoveries are treated as part of the general insurer's 'normal' business.

In cases where the amount of the general insurance levy collected is higher than modelled (which may occur as a result of reinsurance recoveries lifting asset values of general insurers), there will be a proportional levy reduction (totalling the excess collected) for general insurers in the following year.

6.6 'IS THE CURRENT LEVY METHODOLOGY APPROPRIATE FOR POOLED SUPERANNUATION TRUSTS?'

Pooled superannuation trusts (PSTs) are regulated superannuation funds in which only superannuation funds are allowed to invest.

Some trustees of PSTs have noted that the assets used in calculating the levy for each of the underlying funds are used again in calculating the PSTs' levy and this in effect results in members of the PSTs paying the levy twice.

The issue arising where the investment structure of a PST entails 100 per cent of the assets being invested in the head fund has been raised by some PSTs with APRA. The distinction between captive PSTs (100 per cent investment) and other PSTs is determined on a case-by-case basis by APRA.

The conclusion of the 2008-09 financial industry supervisory levy review was that: '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'.