



Australian Government
The Treasury

The Financial Industry Supervisory Levy Methodology Review

Response Paper
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CONTENTS

INTRODUCTION	1
Financial Institutions Supervisory Levies	1
Summary of Conclusions.....	2
Conclusion 1	3
Conclusion 2	4
Conclusion 3	6
Conclusion 4	8
Conclusion 5	9
OTHER POINTS CONSIDERED.....	11
General Insurance	11
Conglomerates.....	11

INTRODUCTION

The design and operation of the Financial Institutions Supervisory Levies ('the levies') were previously reviewed in 2003-2004 and 2008-09. The 2008-09 Review of the levies concluded, among other things, that a further review should be carried out within four years. This report sets out conclusions following the 2013-14 Financial Institutions Supervisory Levy Methodology Review ('the Review').

On 5 April 2013 the Treasury released a discussion paper on the Financial Institutions Supervisory Levies to seek stakeholder views on the existing arrangements. The discussion paper provided an overview of levy arrangements and outlined a number of questions for stakeholders to consider.

In response to the discussion paper, 13 submissions were received¹, two of which were confidential. Stakeholders had a range of concerns including the transparency of the levy methodology, the adequacy of consultation, and the fairness of the application of the levies.

This paper presents a number of conclusions based on stakeholder feedback and analysis by Treasury and APRA. These conclusions will be put forward to the Assistant Treasurer to consider as part of the development of the annual consultation paper on the 2014-15 financial industry levies.²

FINANCIAL INSTITUTIONS SUPERVISORY LEVIES

Under the *Australian Prudential Regulation Authority (APRA) Act 1998*, the responsible Minister (the Assistant Treasurer) makes annual determinations specifying the levy to be paid to the Commonwealth to cover the cost of: providing market integrity and consumer protection functions for prudentially regulated institutions; administering the early release of superannuation on compassionate grounds; and implementing the SuperStream measures³ until 30 June 2018.

The legislative framework for the implementation of the levies is established by the *Financial Institutions Supervisory Levies Collection Act 1998*, which prescribes the timing of payments and the collection of a levy. The levy recovers the majority of APRA's costs and is used to fund specific costs for a range of other Commonwealth agencies and departments, which are:

- the Australian Taxation Office's (ATO) costs in administering the Superannuation Lost Member Register;
- the ATO's (and other agencies) costs associated with the implementation of the previous Government's SuperStream measures;

1 Public submissions can be found at:
<http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2013/Financial-Industry-Supervisory-Levy-Methodology/Submissions>.

2 Prior to the release of the determinations, a consultation paper on the application of the levies is released (usually with options) in order to seek industry views on the relevant financial year's levy allocations.

3 SuperStream is designed to deliver greater efficiency in back-office processing across the superannuation industry.

- the Australian Securities and Investments Commission's (ASIC) costs in relation to work in ensuring informed and confident consumers and financial investors, and regulatory and enforcement activities that relate to the products and services of APRA-regulated entities; and
- the Department of Human Services (DHS) costs in administering claims for the early release of superannuation benefits on compassionate grounds.

On 7 November 2013, the Australian National Audit Office (ANAO) released a report titled *Determination and Collection of Financial Industry Levies*. The report focused on how APRA administered the levies for the recovery of its own costs, as well as the costs incurred by other Government agencies. The report noted that the levy methodology was consistent with the Government's policy intent of an 'administratively simple and uniform funding scheme based on the principle of full cost recovery'. It also found that APRA's processes for applying the levy methodology were sound.

However, the ANAO did provide the following recommendations:

- to improve the effectiveness of consultation additional time and opportunities should be provided to stakeholders to participate in the annual levies consultation process. There should also be an increase in the amount of public information available about the levy methodology and how APRA's prudential regulation activities are linked to its costs; and
- to ensure levies imposed on financial entities reflect the costs of efficient prudential regulation the financial industry levy methodology review should consider: the impact on levy distribution between industry sectors of more fully allocating APRA's indirect costs; the application of the restricted and unrestricted components; and the appropriateness of applying APRA's financial levy methodology to calculate the levies collected by APRA on behalf of other Australian Government agencies.

These recommendations along with stakeholder concerns were considered in the context of this Review which forms part of the Treasury's response to the ANAO report.

SUMMARY OF CONCLUSIONS

1. There is a need to clarify when the levies are being used to recover costs in a manner consistent with the Government's Cost Recovery Guidelines and when they are not.
2. The pre-budget submission process should be used by Government to elicit industry views about the total amount collected through the levies and the related activities. The annual consultation process should be limited to the application of the levies.
3. There should be increased transparency of how the costs of an activity are recovered through the levies process.
4. The lower supervisory activity required for prudentially regulating pooled superannuation trusts (PSTs) could be recognised through lower levy rates compared to other superannuation entities.
5. In the 2014-15 annual levies consultation process consideration should be given to modelling the use of the number of superannuation fund members as the levy base (instead of asset value) for SuperStream to gain further feedback from industry.

Conclusion 1: There is a need to clarify when the levies are being used to recover costs in a manner consistent with the Government's Cost Recovery Guidelines and when they are not.

The annual consultation papers have previously discussed the levies using a cost recovery framework. Activities recovered under the cost recovery framework require appropriate transparency and consultation, and a link between the amounts raised and spent on cost recovered activities. However, it is not clear to what extent some costs funded through the levies process are consistent with the Government's cost recovery policy.

Some stakeholders raise concerns that the current consultation process falls short of that outlined in the Government's cost recovery policy. Stakeholders consider that there is insufficient detail about how the levies are formulated and about the levied activities of regulators. Feedback indicates that it is 'difficult to determine whether the principles of the cost recovery guidelines have been applied to the composition of the levy'. There is also feedback that APRA should publish an updated Cost Recovery Impact Statement as soon as possible.

The Government has had a formal cost recovery policy since December 2002. The policy requires:

- a high degree of transparency about what costs are recovered and to demonstrate that charges reflect the cost of government goods and services, including regulation, provided to specific individuals, organisations or groups;
- that there needs to be a close relationship between the amount raised and the amount spent on cost recovered activities; and
- that cost recovery charges should have a high degree of consultation to ensure only efficient costs are being recovered.

Among other considerations, cost recovery should be implemented where:

- there is an identifiable individual, organisation, or group that receives or creates the need for government activity;
- the activity can be characterised as a good, service, or regulation, or a combination of these;
- it is efficient to cost recover the activity; and
- it does not unduly impact on other policy objectives (such as competition or equity).

There are a wide range of identifiable groups that create the need for government regulation of the financial sector. The need for prudential regulation has been justified on the basis of the need to protect the depositors, policy-holders and members of regulated institutions. In addition, the Global Financial Crisis showed that inadequate prudential supervision can have adverse impacts on the broader economy. In this instance, cost recovery is applied to the regulated institutions because it is administratively simple and cheaper to administer than trying to levy all the individual customers and businesses relating to the financial sector.

Table 1 below identifies which activities could be viewed as cost recovered after applying the principles previously outlined. These cost recovered activities have an identifiable group of levy payers and the levy represents an efficient collection mechanism. The remaining activities warrant further examination as they include instances where a number of entities that give rise to the need for regulation do not contribute to the levy and/or there is not a strong link between those who pay the levy and those who create the need for the activity.

Table 1: Cost recovered activities and those requiring further consideration

Cost Recovered Activities	Activities for further consideration
APRA — prudential regulation	ASIC — financial literacy
DHS — early release of superannuation benefits [^]	ASIC — OTC derivatives*
ASIC — regulatory and enforcement activities	ATO (and other agencies) — SuperStream [^]
ASIC — Superannuation Complaints Tribunal [^]	
ATO — unclaimed and lost superannuation [^]	

*levied on ADI's only

[^]levied on APRA-regulated superannuation entities only

Some entities are not levied for the activities of regulators, which are provided to these entities directly or indirectly. Activities designed to promote financial literacy have whole-of-economy benefits but are not provided to APRA regulated entities which pay for them. Activities relating to the implementation of SuperStream are only recovered from APRA regulated superannuation funds despite all superannuation funds (including Self-Managed Superannuation Funds (SMSFs)) using SuperStream. Over the counter derivatives (OTC) are used mainly, but not exclusively, by authorised deposit taking institutions (ADIs), yet ADIs are levied for the full cost of ASIC OTC oversight.

The Department of Finance is finalising a whole-of-government review of the Australian Government's Cost Recovery Guidelines. The purpose of the review is to improve consistency, transparency and accountability of cost recovery of government activities.

It is proposed that following the release of the revised Cost Recovery Guidelines the activities whose costs are recovered through the levies be further examined. Following this, it should be clearly communicated in the annual consultation papers what activities recovered through the levy are considered cost recovery for the purposes of the cost recovery guidelines and which are not.

APRA will produce an updated Cost Recovery Impact Statement (CRIS) to improve transparency around APRA's costs and the linkage to the provision of prudential regulation. The CRIS should demonstrate how the levies related to APRA reflect the efficient costs of prudential regulation provided to those who pay cost recovery fees and charges. APRA has committed to completing an updated CRIS by June 2014.

Conclusion 2: The pre-budget submission process should be used by Government to elicit industry views about the total amount collected through the levies and the related activities. The annual consultation process should be limited to the application of the levies.

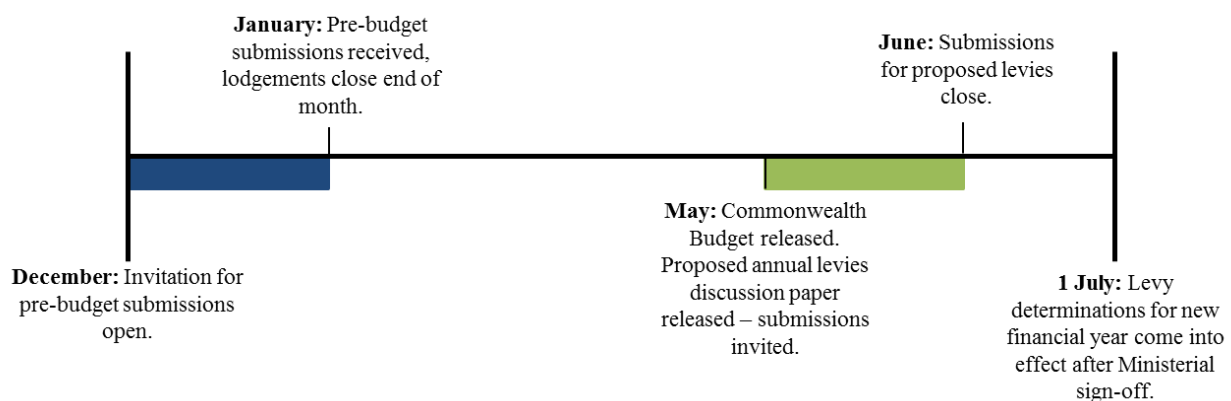
Following the publishing of the budget, the Government releases an annual consultation paper to seek stakeholder views on the application of the levies. However, some stakeholders seek to reopen the funding provided to regulators which is not the purpose of the consultation process.

Concerns about the amount regulators are funded

One stakeholder indicated that ‘it is difficult for industry stakeholders to question APRA’s overall costs when the funding decision is not open to consultation’. This reflects different expectations of the annual levies consultation process. The Government decides the amount regulators will be funded as part of the budget process, which is concluded prior to the release of the annual consultation paper.

As part of the budget process, governments have sought pre-budget submissions from the public. The pre-budget submission process provides individuals, businesses and community groups the opportunity to provide their views on budget strategies and policies.⁴ Given the timing of the pre-budget submission process, it may be the most effective way to inform Government about stakeholder views on the size of the levies collected and provides scope to influence Government decisions during the Budget process.⁵

Chart 1: Proposed consultation timeline



Future annual levy consultation papers will reiterate that the pre-budget submission process should be used to comment on how much is raised through the levies. The annual consultation process should remain focussed on how the levied amount is proposed to be raised from different levy payers.

Timing

Submissions raise concerns around the period of consultation for both the annual consultation process as well as the Review itself. Stakeholders indicated that the length of consultation for the annual process was not ‘appropriate’ in that it did not allow ‘sufficient time to provide considered responses’. Stakeholders also suggested that ‘it would be useful if the levies papers could acknowledge the issues raised by stakeholders and provide some feedback’. Stakeholders also consider that elements of the consultation process ‘signified tokenism in the approach to consultation’.

4 For the most recent example see <http://jbh.ministers.treasury.gov.au/media-release/036-2013/>.

5 Treasury notes that some financial sector industry organisations already do this.

The relatively short time frame for receiving submissions on the annual consultation paper is due to the relatively small time period between the release of the Commonwealth budget in May, and the finalisation of the levy determinations before the start of the next financial year. However, there may be scope to release the annual consultation papers closer to the release of the budget.

Conclusion 3: There should be increased transparency of how an activity is recovered through the levies process.

The current levy methodology meets the cost of a range of activities, with the activities being funded through two components:

- a restricted levy component, which is structured as a percentage rate on assets subject to minimum and maximum amounts; and
- an unrestricted levy component, which is structured as a percentage rate on assets with no minimum or maximum amounts.

The rationale for the restricted and unrestricted components of levies has been that restricted costs relate to the cost of supervision, and the unrestricted component relates to systemic impact. While this framework is useful for APRA and its prudential regulation activities, it is less apparent for other activities.

The rationale for the use of a maximum and minimum amount is based on there being a minimum threshold below which the costs of regulation of an institution will not fall, while the maximum threshold is based on regulatory costs being unlikely to increase indefinitely.

There are concerns from industry that the restricted and unrestricted framework could lead to some inequitable outcomes. One submission stated there was an ‘overall lack of transparency as to what items fall into each ‘pot’ of the levy – restricted (supervisory) or unrestricted (systemic)’ and that ‘there is little or no explanation which communicates the rationale for the setting of the current parameters (for example, the percentage rate or the minimum and maximum thresholds)’. These concerns were most apparent for the funding of SuperStream.

There was some support to move towards a single uncapped levy rate, although other stakeholders support the current split between restricted and unrestricted amounts.

Use of Restricted and Unrestricted Components

This Review found that the restricted component is best placed to fund activities relating to the activities of specific institutions (for example supervisory activities), while the unrestricted component should be used to fund costs relating to a sector that are not tied to a specific institution or to cost recovered activities. Currently the allocation of the levies does not reflect these findings, particularly for agencies other than APRA. The potential revision of the allocation of levy arrangements consistent with these findings is shown at Table 2.

Table 2: Current and revised allocation of levies**Cost Recovered Activities**

Activity	Current Allocation		Revised Allocation	
	Restricted (%)	Unrestricted	Restricted	Unrestricted
APRA — prudential regulation	67	33	67	33
ASIC — financial literacy	0	100	0	100
ASIC — OTC derivatives*	0	100	0	100
ASIC — regulatory and enforcement activities	100	0	0	100
ASIC — Superannuation Complaints Tribunal^	0	100	0	100
ATO (and others) — SuperStream^	65.5	34.5	0	100
ATO — unclaimed and lost superannuation^	100	0	0	100
DHS — early release of superannuation^	67	33	0	100

*levied on ADI's only.

^levied on APRA-regulated superannuation entities only

Setting of maximum and minimum caps

The setting of the maximum and minimum caps should reflect the costs of regulation so that they do not create cross-subsidies. In the case of the supervisory activities of APRA for example, while the four major banks make up around three quarters of the assets of the banking sector they require a smaller proportion of APRA's regulatory effort per dollar supervised. In the absence of a maximum and minimum rate the four major banks would cross subsidise the regulation of smaller banks.

The Review investigated concerns raised by stakeholders around the establishment of the maximum and minimum amounts set for the restricted component of the levies. Following an examination of APRA's costed effort at an entity level, captured through APRA's time management system, the Review found the following:

- In relation to ADIs, the current minimum restricted amount was insufficient to recover direct supervisory costs related to the smallest ADIs.
 - Of 172 ADIs, eight paid the maximum cap of (\$2.3 million) while only four paid the minimum amount (\$490). The 10 largest entities paid 58 per cent of the 2013-14 restricted component for ADIs and 68 per cent of the total amount levied on ADIs. This compares to the 10 largest ADIs holding 83 per cent of gross ADI assets.
- In relation to general insurers there was some evidence of over-recovery although not significant enough to recommend any material adjustment to the maximum or minimum amount. Additionally, it was found that no life insurers were paying the minimum restricted amount (currently \$490).
 - Of the 121 general insurers only three were paying the maximum cap (\$1.1m), while 26 were paying the minimum amount (\$4,900). The ten largest general insurers contributed 50 per cent of the 2013-14 restricted components for general insurers and

- 51 per cent of the total amount levied on general insurers. This compares to the 10 largest general insurers holding 54 per cent of total general insurance assets.
- Of the 41 life and friendlies insurers only three entities were paying the current maximum cap of \$1.3 million, while the ten largest entities were paying around 85 per cent of the restricted component for life insurers and 87 per cent of the total amount levied on life insurers. This compares to the 10 largest general insurers holding 92 per cent of total life insurance assets.
 - In relation to superannuation entities, if the proposed changes to the collection of the SuperStream levy were adopted there would be merit in reducing the maximum cap; potentially to as low as the 2011-12 level (\$260,000).
 - Of 429 APRA regulated superannuation entities⁶ (excluding Small APRA Funds⁷ (SAFs)), twenty-nine paid the maximum cap (\$1.8 million in 2013-14) while twenty-seven paid the minimum amount (\$590). The 10 largest entities paid 16 per cent of the 2013-14 restricted component and 24 per cent of the total amount levied on non-SAFs. This compares to the 10 largest entities holding 41 per cent of gross assets.
 - The superannuation industry experienced a large variation in its maximum cap (up from \$260,000 in 2011-12 to \$2 million in 2012-13) as a result of the introduction of SuperStream.

Changes to minimum and maximum caps will be considered as part of the levies annual consultation process. Also, as mentioned under Conclusion 1, APRA will be producing a revised CRIS by June 2014. The CRIS will provide industry with more transparency around the direct supervisory costs of different sized entities.

Conclusion 4: The lower supervisory activity required for prudentially regulating pooled superannuation trusts (PSTs) could be recognised through lower levy rates compared to other superannuation entities.

Pooled superannuation trusts (PSTs) provide a mechanism for superannuation entities to pool their assets so that they can be managed more efficiently. All APRA regulated superannuation entities, including PSTs, are subject to the Financial Institutions Supervisory Levies. This results in some members being levied twice – once on the assets at the fund level and again on the same assets within the PST.

Stakeholders raise concerns that ‘where PSTs are in operation there is a regulatory fee attached to the same funds twice’ and that ‘levies should be adjusted accordingly’. Another stakeholder notes that ‘there is a level of supervision that applies to PSTs and there are different models in operation in the market that in turn require different levels of regulatory supervision. It is reasonable that the methodology should apportion a fair cost ... However, it is not in the best interests of beneficiaries that grouped assets of members be levied twice’. It was also commented that the need for change was ‘pronounced in the case where the levy is used to fund costs other than those of APRA ... a PST is not likely to have retail investors (ASIC) and does not necessitate the involvement of the ATO (Lost Members Register and SuperStream) or the DHS’.

6 Includes 61 Pooled Superannuation Trusts

7 A Superannuation Fund that has fewer than 5 members and is regulated by APRA

PSTs can generally be classified into two groups: those that are 'captive' vehicles (that is single registrable superannuation entity (RSE) trustee, single fund) and those with a broader investor base (single trustee/multi funds or multi trustees/multi funds). Of the 61 active PSTs (as at 30 June 2013) regulated by APRA, the majority have a broader investor base.

The Review revisited the supervisory effort required to regulate PSTs compared to other regulated superannuation entities, particularly public offer superannuation funds. In contrast with public offer funds, PSTs can conduct fewer transactions (captives) and unit holders are more likely sophisticated investors (as opposed to other RSE funds that have individual members).

APRA has historically recognised that certain PSTs are captive vehicles involving limited additional supervisory activity and has provided case by case relief through the waiver powers conferred through section 12 of the *Financial Institutions Supervisory Levy Collections Act 1998*. On balance, the Review concluded that in general PSTs required reduced supervisory effort relative to public offer superannuation funds. As such, a separate levy regime would be appropriate, commensurate with the manner in which PSTs are typically operated and supervised.

It is currently envisaged that, similar to ADI foreign branches, all PSTs could be subject to reduced restricted amounts (to reflect lower supervisory intensity). It is also envisaged that they could be subject to a lower unrestricted rate, particularly if PSTs were exempted from being levied for the activities of ASIC, the ATO (including SuperStream) and DHS. This would reflect that these activities relate to individual fund members, which PSTs do not engage with.

Conclusion 5: In the 2014-15 annual levies consultation process consideration should be given to modelling the use of the number of superannuation fund members as the levy base (instead of asset value) for SuperStream to gain further feedback from industry.

The SuperStream measures are designed to 'improve the efficiency and effectiveness of the superannuation system through the better use of technology and by standardising data and payment requirements for member related superannuation transactions'. Currently the SuperStream measures are collected as a percentage of a superannuation entity's assets (consistent with the other levies). This can result in superannuation entities paying different sized levies despite having the same number of members in their fund.

As noted in the ANAO audit there were major differences in the cost of the levy per member on superannuation funds of various sizes. Preliminary analysis indicated smaller superannuation funds paid around \$30 to \$40 per member (including SuperStream) in 2012-13, while larger funds paid around \$1.90 per member.⁸

Feedback from the superannuation industry has advocated a shift to member-based modelling to better distribute costs. This argument was based on SuperStream producing efficiency improvements that would provide the most benefit to funds with large member bases. While superannuation entities with a large number of members would be expected to benefit the behaviour of a superannuation entity's members also needs to be taken into account.

8 Australian National Audit Office, *Determination and Collection of Financial Industry Levies*, page 68 refers.

The argument to use members rather than assets as the levy base for collecting SuperStream assumes that larger member bases generate greater transactional activity over a fund's lifecycle. However, it could be argued that wealthier fund members are more active in managing their superannuation affairs than those with smaller holdings; the latter relying on passive, default fund choices. As a result the behaviour of fund members could be just as relevant as the number of members in the generation of transactions.

Under a SuperStream levy model based on the number of members, eligible rollover funds that have relatively large member bases through small individual asset balances would see potentially substantial increases, while PSTs (lacking members), would secure nearly full relief from this levy component when compared to current arrangements. The distributional outcomes of a new levy arrangement would be partially determined through any corresponding change to the maximum and minimum amounts of the restricted component.

There would be merit in the 2014-15 annual consultation paper presenting, for illustrative purposes, modelling for the collection of SuperStream using superannuation fund members as the levy base. This would allow stakeholders to compare it to the cost of moving the SuperStream levy costs to the unrestricted component. If there was a desire by stakeholders to use members as the levy base it could be adopted in 2015-16. It would not be possible to collect SuperStream using members as the levy base in 2014-15 due to the lead time in making changes to APRA's billing infrastructure.

OTHER POINTS CONSIDERED

GENERAL INSURANCE

The general insurance industry raised concerns during the consultation process regarding natural catastrophe incidents and the impact these had on the amount levied. The insurance industry noted the asset value on which the levy is based may be inflated due to the inclusion of abnormal reinsurance recovery assets following natural catastrophe incidents.

The existing methodology treats reinsurance recoveries as part of a general insurer's 'normal' business. Given that reinsurance recoveries are an integral part of general insurers' core operations, there is merit in reinsurance recoveries continuing to be included in the levy model. This is consistent with APRA's existing approach to consideration of requests for partial levy waivers.⁹

CONGLOMERATES

No special considerations are currently applied to the application of the levy to conglomerates. The conclusion of the 2008-09 Review of levies 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'.

Stakeholders had a near unanimous view that there was no case for change to the levy arrangements for conglomerates. However, one stakeholder did raise concerns that 'the current arrangements resulted in a conglomerate's life company being levied twice due to a proportion of its asset base relating to superannuation funds being levied in its own right'.

The Review considered whether conglomerate groups were paying a disproportionate total amount of levies. It was found that while there are some benefits which could be gained from making assessments at a group level, in many cases there is additional work required to ensure that group wide risk management practices are operational and embedded in individually regulated institutions within the group.

Consistent with the majority of stakeholder feedback it was concluded there should be no change to the levy structure for regulated institutions within conglomerate groups.

⁹ Any waivers provided historically, have been restricted to captive insurers that demonstrated an abnormal levy outcome associated with one-off or special purpose business activities.