

REVIEW OF FINANCIAL SECTOR LEVIES

TREASURY/APRA ISSUES AND DISCUSSION PAPER

APRIL 2003

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GLOSSARY OF ACRONYMS AND ABBREVIATIONS

Acronym/Abbreviation	Full Title/Meaning
ADIs	Authorised Deposit-taking Institutions
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ATO	Australian Taxation Office
FDIC	Federal Deposit Insurance Corporation (United States)
FSA	Financial Services Authority (United Kingdom)
FSI	Financial System Inquiry (otherwise known as the 'Wallis Inquiry'). The Final Report of the FSI was published in 1997.
ISC	Insurance and Superannuation Commission
NOHCs	Non-operating Holding Companies
OCC	Office of the Comptroller of the Currency (United States)
OSFI	Office of the Superintendent for Financial Institutions (Canada)
PSTs	Pooled Superannuation Trusts
RBA	Reserve Bank of Australia
RSAs	Retirement Saving Accounts
SAFs	Small APRA Funds
SCT	Superannuation Complaints Tribunal

THE REVIEW

Why is the Review being undertaken?

The existing levy-setting arrangements fund the vast majority of the costs of the Australian Prudential Regulation Authority (APRA) in pursuing its role of prudential supervision and regulation, and certain consumer protection and market integrity functions of the Australian Securities and Investments Commission (ASIC) and the Australian Taxation Office (ATO)¹. These levy-setting arrangements were established following Government consideration of the recommendations of the 1997 Financial System Inquiry (Wallis Inquiry).

While annual review processes enable financial sector levy rates to be adjusted each year, the most recent review of the levy-setting arrangements themselves took place in 1999. The timing of the current Review is consistent with what was envisaged in 1999.

The Review is required to evaluate the arrangements for determination of the levies and make recommendations on any changes that need to be made to the current arrangements. In reaching its recommendations, it will balance accountability, efficiency, transparency and equity with simplicity of administration and collection. It will also ensure that recommended options have the capacity to provide stable and effective funding for the regulators on a sustainable basis and meet the evolving needs of prudential supervision into the future at a reasonable cost.

The Terms of Reference for the Review of Financial Sector Levies were announced by the Minister for Revenue and Assistant Treasurer, Senator Coonan, on 29 October 2002. (The text of the Minister's Press Release and the detailed Terms of Reference for the Review are at Attachment A.)

How is the Review being undertaken?

The Review is being chaired by the Treasury and undertaken jointly by Treasury and APRA in consultation with ASIC and the ATO.

Submissions were sought in November 2002 from industry groups and other interested parties to assist in the preparation of this discussion paper. Some nine submissions were received. It is intended that this paper will provide a platform for further consultation. The Review's final report will weigh the issues arising from consultations in recommending any proposed changes to the existing arrangements.

This paper is intended to stimulate discussion of the key issues relating to the determination of the financial sector levies. To that end, while advantages and disadvantages of particular approaches are considered, no particular options are recommended.

It is anticipated that any changes arising from the Review's recommendations will take effect from the beginning of the 2004-05 financial year and that levies for the 2003-04 financial year will be established on the basis of the existing levy-setting arrangements.

¹ Occasionally, for simplicity in expression, this paper refers to the prudential supervision and regulation function when the other relevant regulatory functions should also be taken to be included. Whether or not they should be included in specific instances should be clear from the context.

The Review recognises that issues relating to how much money the levies should raise and provide for prudential supervision and regulation are important to the institutions being levied (and to the regulators). Indeed, separate processes are in place for considering the appropriate level of resourcing for prudential regulation and APRA in particular.

However, it is not the purpose of the Review to consider what resources should be provided to APRA and the other regulatory and supervisory agencies through the financial sector levies. Rather, it is required to evaluate the arrangements for the determination of levies imposed on the financial services sector to support prudential regulation. The Review intends that the validity of its recommendations will not be affected by any changes in the total amount that may be sought through the levies.

Framework and principles underlying the Review

The financial sector levies provide a means of recovering, from the financial services industry, the costs of the prudential supervision and regulation of that sector and of the relevant consumer protection and market integrity functions performed by ASIC and the ATO.

As noted in the Terms of Reference, the Review takes as a given that supervision of regulated institutions in the financial services sector is to be paid for collectively by those regulated institutions. This is consistent with Recommendation 104 of the Financial System Inquiry that “As far as practicable, the regulatory agencies should charge each financial entity for direct services provided, and levy sectors of industry to meet the general costs of their regulation.”²

That recommendation followed from the Inquiry’s acceptance of the “...general principle that the costs of financial regulation should be borne by those who benefit from it.”³ The Inquiry saw the most practical way of applying this principle as being the levying of industry to meet the cost of regulation incurred by regulatory agencies, with each industry sector levied in proportion to the agency resources expended on it.

Conceptually, there is a wide range of possible arrangements for recovering from industry the costs of the prudential supervision and regulation function. At one extreme are individualised fee for service arrangements and, at the other, broad-based funding from the financial sector as a whole that takes no account of the individual costs of regulating particular industry sectors or institutions. The existing levy arrangements lie between these extremes. A key task for the Review is to consider where on this spectrum the funding arrangements for the prudential regulation and supervision undertaken by APRA and the related consumer protection and market integrity functions undertaken by ASIC and the ATO should lie.

Purpose of prudential and related supervision and regulation of the financial sector

A fundamental consideration in determining the most appropriate funding arrangements is the purpose for which the funds are required. It is a basic requirement that any industry-funding regime recommended by the Review is consistent with the purpose of prudential supervision and regulation and of the relevant consumer protection and market integrity regulation.

² Financial System Inquiry Final Report, 1997, pages 68, 532.

³ Financial System Inquiry Final Report, 1997, page 532.

In this context, the Financial System Inquiry indicated that specialised regulation of the financial system is required to ensure that market participants act with integrity and that consumers are protected. It considered specialised regulation appropriate due to the complexity of financial products, the adverse consequences of breaching financial promises and the need for low-cost means to resolve disputes. In addition, the Inquiry suggested that the intensity of prudential regulation should be at its greatest where the intensity of financial promises, and hence the risk of market failure, is greatest.

Section 8 of the *Australian Prudential Regulation Authority Act 1998* (APRA Act) states the purpose for which APRA was established. This was '...for the purpose of regulating bodies in the financial sector in accordance with other laws of the Commonwealth that provide for prudential regulation or for retirement income standards, and for developing the policy to be applied in performing that regulatory role.'

The APRA Act also requires APRA to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality. Against that background, APRA's Board has adopted the following mission statement:

APRA's mission is to establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by institutions we supervise are met within a stable, efficient and competitive financial system.

Criteria for assessing possible alternative levy arrangements

The Terms of Reference specify a number of criteria against which the existing and possible alternative arrangements are to be assessed. In particular, they note that the Review '...will balance accountability, efficiency, transparency and equity with simplicity of administration and collection.' The Review is also required to ensure that options '...have the capacity to provide stable and effective funding for the regulator on a sustainable basis and to meet the evolving needs of effective prudential supervision into the future at a reasonable cost.'

In addition, a number of submissions suggested some principles against which the levy arrangements might be considered. These principles are generally consistent with the criteria in the Terms of Reference.

In some cases, the key criteria tend to reinforce each other; in other cases, there may be a tension between them. For example, an approach that scores well against the transparency criterion may also do well when assessed against an accountability criterion, but may show limitations against a simplicity of administration and collection standard.

The meaning of some criteria in particular contexts can also be open to interpretation. For example, it is clear from submissions that different parties have different views as to what is required for greater 'fairness' and equity. There are also different understandings of what should be included in the costs of financial sector supervision and regulation, how these are accrued and, consequently, what might constitute cross subsidisation.

It is unavoidable that opinions will differ as to how particular criteria should be interpreted and what the relative weight of different criteria and principles should be in assessing the levy

arrangements. The Review will exercise its best judgement in attempting to reach an appropriate balance.

History of levies and existing arrangements

Background

The existing financial sector levy arrangements essentially represent a practical resolution of a number of recommendations in 1997 of the Financial System Inquiry, most notably Recommendation 104:

The regulatory agencies should collect from the financial entities which they regulate enough revenue to fund themselves, but not more. As far as practicable, the regulatory agencies should charge each financial entity for direct services provided, and levy sectors of industry to meet the general costs of their regulation.⁴

Previously, different regulatory and funding regimes applied to the various types of financial institutions.

Findings of the 1999 Financial Sector Levies Review

The arrangements for determining the financial sector levies were reviewed in 1999 in a similar process to that of current Review. While the 1999 Review recommended, and led to, some adjustments to the arrangements applying at that time, no legislative changes were made. The retention of key features such as the sectoral basis for the levies and the concept of minimum and maximum levy amounts was supported.

The 1999 Review also recommended that the levy-setting arrangements be reviewed again in around 2003.

Existing arrangements

Under the existing levy arrangements, industry is levied to cover the operational costs of APRA, and certain consumer protection and market integrity functions of ASIC and of the ATO.

These costs are allocated between certain sectors of the financial services industry. A levy rate per dollar of assets is set with minimum and maximum levy amounts for each of the industry sectors. The levy on each of the sectors is intended essentially to raise sufficient revenue to meet the budgeted costs of supervising that sector for that financial year. The levy rates are determined after taking into account key parameters including:

- the estimated time spent on the supervision of the industry (this is used in apportioning the cost of supervision by industry sector);
- APRA's estimated supervision costs and estimated relevant costs of the ATO and ASIC;
- the current levy rates, minimum and maximum levies; and

⁴ Financial System Inquiry Final Report, 1997, pages 68, 532.

- the asset values of entities, the expected growth of assets and any changes to the industry from mergers, takeovers and deregistration.

The industry sectors covered as part of the levy setting process include: authorised deposit-taking institutions (ADIs); foreign bank branches; superannuation funds; life insurers and friendly societies; general insurers; retirement savings account providers; and non-operating holding companies (NOHC). The Treasurer (or other Treasury Minister) determines the rates, thresholds and limits.

Under the existing arrangements, levies are raised from institutions according to the *Financial Institutions Supervisory Levies Collection Act 1998* and six supervisory levy Acts that apply to individual sectors of the financial system. These are the:

- *Authorised Deposit-taking Institutions Supervisory Levy Imposition Act 1998;*
- *Authorised Non-operating Holding Companies Supervisory Levy Imposition Act 1998;*
- *Life Insurance Supervisory Levy Imposition Act 1998;*
- *General Insurance Supervisory Levy Imposition Act 1998;*
- *Retirement Savings Account Providers Supervisory Levy Imposition Act 1998; and*
- *Superannuation Supervisory Levy Imposition Act 1998.*

In addition to the functions funded by the levies, APRA undertakes certain elective services to industry, for which it charges fees that reflect the cost of providing the services.

Functions undertaken by ASIC for which financial sector levies are raised

The funding ASIC receives as a result of the levies is used to undertake:

- consumer protection work in relation to financial products and services;
- enforcement activities in relation to conduct involving institutions operating in the financial system and that have adversely affected consumers; and
- the operations of the Superannuation Complaints Tribunal (SCT).

Functions undertaken by the ATO for which financial sector levies are raised

Relevant ATO costs are the costs of administering the lost members function and operating the arrangements dealing with unclaimed superannuation monies.

Differences in the role of the financial sector levies for APRA, ASIC and the ATO

The financial sector levies operate a little differently in relation to ASIC and the ATO than they do in relation to APRA. The most obvious differences are that:

- the functions undertaken in the financial sector by APRA using funds from the levies are prudential supervision and regulation functions whereas the relevant ASIC and the ATO functions are the different (albeit related) consumer protection and market integrity ones;

- while the link between the funds raised through the levies and funds available to APRA is very direct, the link for the ATO, in particular, is quite circuitous;
- there are differences in the reporting and other accountability requirements and actions between the agencies; and
- the financial sector levies provide virtually all the funds available to APRA whereas they represent a relatively small proportion of ASIC's funds and an even smaller share of those of the ATO. Expenditure on the functions for which the levies are raised is limited effectively in APRA's case to the funds raised whereas the amount spent by ASIC and the ATO can exceed the amounts raised through levies by reducing the amount spent on other functions of those agencies.

Past funding and levy rates

The table below shows the levy rates charged to each sector since 1998-99.

Table 1: Financial Sector Levy Rates, Maximum and Minimum Amounts by Industry Sector

Rate (%)	1998-99	1999-00	2000-01	2001-02	2002-03
ADIs	N/A	0.013	0.012	0.012	0.010
Foreign banks	N/A	0.013	0.006	0.006	0.005
Superannuation funds	0.040	0.040	0.020	0.025	0.030
Life insurance	0.020	0.020	0.020	0.020	0.020
General insurance	0.020	0.020	0.020	0.025	0.030
Retirement savings accounts	0.040	0.020	0.020	0.020	0.020
Maximum (\$)	1998-99	1999-00	2000-01	2001-02	2002-03
ADIs	N/A	1,000,000	1,000,000	1,005,000	1,125,000
Foreign banks	N/A	500,000	500,000	500,000	562,500
Superannuation funds	39,000	41,000	46,000	53,000	66,000
Life insurance	148,000	280,000	280,000	364,000	364,000
General insurance	55,000	75,000	100,000	240,000	330,000
Retirement savings accounts	8,500	18,500	18,500	18,500	18,500
Minimum (\$)	1998-99	1999-00	2000-01	2001-02	2002-03
ADIs	N/A	500	500	500	500
Foreign banks	N/A	500	500	500	500
Superannuation funds	200	300	300	400	400
Life insurance offices	5,000	500	500	500	500
General insurance offices	5,000	5,000	5,000	5,000	5,000
Retirement savings accounts	5,000	5,000	5,000	5,000	5,000

Source: APRA

In respect of Non-operating Holding Companies there is a flat fee of \$10 000. However there are no such institutions at present.

Table 2: Amounts Raised through Financial Sector Levies (\$'000)

Funding (note 1)	1998-99	1999-00	2000-01	2001-02	2002-03
APRA prudential supervision	25,601	62,171	45,879	54,561	59,927
ASIC functions	6,600	11,600	12,567	12,316	12,316
ATO functions	2,353	2,353	2,353	2,353	2,353
Waivers and penalties	-	-	496	602	-
Total Levies	34,554	76,124	61,295	69,832	74,596
Industry Breakdown	1998-99	1999-00	2000-01	2001-02	2002-03
ADIs (note 2)	-	27,102	22,632	23,464	23,752
Life insurance offices	4,557	8,369	8,453	8,751	9,038
General insurance offices	3,995	4,608	5,147	8,757	11,259
Superannuation funds	25,944	31,867	24,473	28,150	30,473
Retirement savings accounts	58	98	94	108	74
Self managed superannuation funds	-	4,080	-	-	-
Waivers and penalties	-	-	496	602	-
Total	34,554	76,124	61,295	69,832	74,596

Source: APRA

Note 1: The 2002-03 funding figures are budget estimates.

Note 2: During 1998-99 APRA collected levies from the insurance and superannuation sectors. APRA received an appropriation for the ADI sector.

International experience

Many models around the world involve industry levy funding of financial services sector regulators. The following paragraphs briefly outline features of some of these models.

Financial Services Authority (FSA), United Kingdom

The FSA raises funding from industry through two main types of fees to cover the costs of its activities.

1. Periodic fees, which are payable annually by industry, to cover the statutory functions of the FSA.
2. Application fees that contribute to the cost of processing applications for authorisation or recognition, or requests for significant variations to the permission profile of the entity that are already authorised.

The FSA groups fee payers into fee blocks. The fee payers within each block offer similar products and services. The rationale behind this is that the FSA allocates more resources to higher risk areas and the fees charged reflect the risk attached to that class of activities relative to others. There are nineteen fee blocks and it is possible for fee payers to belong to more than one block.

The Office of the Superintendent for Financial Institutions (OSFI), Canada

OSFI is funded mainly by industry through asset-based assessments and a modified user-pay program for selected services. A small portion of OSFI's revenue is derived from the Government of Canada for actuarial services relating to the Canada Pension Plan.

Federal Deposit Insurance Corporation (FDIC), United States

The FDIC is an independent agency created by the United States Congress to insure deposits and promote safe and sound banking practices. It insures deposits, examines and supervises financial institutions and manages receiverships.

Budgeted expenditures are associated with the FDIC's three major program areas (Insurance, Supervision, and Receivership Management). The FDIC is industry-funded from risk-based premiums charged to insured deposit taking institutions. A designated reserve ratio for the Bank Insurance Fund and Savings Association Insurance Fund of 1.25 per cent must be maintained. If this is exceeded, the premiums are discontinued for well-capitalised and highly rated institutions; if the ratio declines below 1.25 per cent, the FDIC is required to develop a set of premiums to restore the reserve ratio to 1.25 per cent.

The Office of the Comptroller of the Currency (OCC), United States

The OCC charters, regulates, and supervises all national banks. It also supervises the federal branches and agencies of foreign banks.

The OCC does not receive any appropriations from Congress. Instead, its operations are funded primarily by assessments on national banks. National banks pay for their examinations, and they pay for the OCC's processing of their corporate applications. The OCC also receives revenue from its investment income, primarily from U.S. Treasury securities.

KEY FRAMEWORK ISSUES

Overview of the central issues

Within the framework of the Review, there are a number of key issues for consideration.

The first of these is whether the costs of the relevant regulation should be recovered primarily by reference to the benefits received by the regulated financial institutions or to the costs incurred by the regulators in their work in relation to those institutions. Once that question is answered satisfactorily, a number of further issues arise in attempting to translate the appropriate principle into sensible and workable practice.

Whether costs, benefits or something else should be the primary consideration is a major influence on the choice between fee for service, single universal or sectoral levy frameworks outlined below. Indeed, if the view is taken that depositors, policyholders and beneficiaries (rather than the various regulated financial institutions) benefit most from the regulatory activity funded through the levies and/or generate the costs of that activity, this will also influence preferences between these three broad levy approaches.

Fundamentally, the task of the Review is to consider how the burden of funding the relevant regulatory activities might be distributed between different parties. At a broad level, this primarily relates to the 'horizontal' distribution between different institutions or industry sectors as well as to the 'vertical' distribution between large and small regulated institutions.

The 'horizontal' design issues include the choice between fee for service, sectoral or universal single levy models and whether cross subsidisation might be appropriate (and if so how much and in what circumstances). These attract considerable attention in this paper.

The issues of the levy cap (maximum levy amount payable) and floor (minimum levy amount payable), as well as whether a stepped levy rate is possible or desirable, are the major framework design issues from a 'vertical' perspective.

Those key issues provide, in very broad terms, the outline for most of the remainder of this paper. A number of more detailed design issues that are relevant to one or more of the possible broader approaches are considered in the final major section of the paper.

How should prudential regulation be funded?

At the aggregate level, the costs of prudential supervision and regulation are to be recovered from the regulated financial services sector as a whole. Within that context, there are a number of alternative philosophical approaches to determining the model under which regulated institutions or industry sectors are to be levied. The principal alternatives relate the incidence of the levies to either:

- the benefits received by those parties; or
- the financial costs to the regulator of undertaking prudential supervisory work relating to the parties being levied.

The first view is that each of those institutions or stakeholders should pay in proportion to its share of the benefits from the system of prudential supervision and regulation that accrue to all regulated entities. A variant of this view asserts that each dollar invested through a regulated financial institution shares more or less equally (or in proportions that are very difficult to determine) in the benefits. The conclusion is that all regulated institutions should share the cost of providing these benefits in proportion to the dollar value of relevant assets. Universal levy models with single rate levies applying uniformly across all regulated institutions normally draw on this perspective. Certainly, the benefits that financial institutions derive from prudential supervision and regulation can be quite substantial.

The other view is that distribution of the levy burden should reflect the relative costs attributed by the regulator to each institution or industry sector and that these can and should vary depending on the nature of the investment and the institution. Proponents of this view tend to favour either a sectoral model or a fee for service approach.

The Financial System Inquiry⁵ effectively linked the two approaches. As noted earlier⁶, it stated the general principle that the costs of financial regulation should be borne by those who benefit from it, and then indicated that the most practical way of applying that principle is for industry to be levied to meet the cost of regulation incurred by regulatory agencies. Further, it considered that each industry should be levied in proportion to the agency resources expended on it.

Secondary factors that might impact on the levy arrangements include:

- the capacity of various regulated institutions to pay; and
- the approach institutions take to risk management.

Further, as noted earlier, in considering possible levy arrangements, the Review is required to balance equity, efficiency, transparency, accountability and administrative issues. In addition, any option must provide the capacity to provide stable and effective funding for the regulator on a sustainable basis and to meet the evolving needs of effective prudential supervision into the future at a reasonable cost. The inevitable result is that any levy model, be it based on costs, benefits or something else is unlikely to be recommended in 'pure' form.

Alternative broad frameworks for the levy arrangements

As noted previously, the Review takes as given that the supervision of regulated institutions in the financial services sector must be paid for collectively by those institutions. However, within this constraint, a central question is the level of disaggregation at which cost recovery should apply.

There are three broad options.

- The first is that fee for service cost recovery arrangements should apply at the greatest possible level of disaggregation, with each regulated institution receiving an individualised invoice for the estimated cost incurred by the regulators in relation to the supervision and regulation of

⁵ Financial System Inquiry Final Report, 1997, page 532.

⁶ See section of this paper headed 'Framework and Principles Underlying the Review'.

that institution. That is, as far as possible, the costs of regulating and supervising each individual institution would be determined and recovered from that institution.

- The second is that cost recovery need apply only at the broadest level across the regulated financial services sector as a whole. Under this option, no regard would be paid to whether the costs of supervision and regulation in relation to any particular industry sector or institution were recovered from that industry sector or institution. The distribution of the cost burden would be related to other factors such as value of assets being supervised or some other measure of perceived benefits. The standard example of this model is for a single levy rate to apply to the assets (or other levy base) of all individual institutions and groups regardless of size or of industry sector.
- The third option is a sectoral approach in which cost recovery is not required at an institutional level, but the costs of supervision and regulation for each industry sector are recovered from that sector as a whole. This option allows, *ex ante*, for cross subsidisation of costs between institutions in an industry sector, but not between industry sectors. The present levy arrangements illustrate a sectoral model, but variations could involve different levels of disaggregation with anything from two to a very large number of sectors.

Variants within these alternative frameworks

Any of these basic approaches can be varied in countless ways. For example, maximum and/or minimum levy amounts can be introduced to these models (other than the fee for service model). Indeed, the existing arrangements involve both a maximum and a minimum levy amount.

A maximum levy amount (or cap) places a limit on the amount that a levied institution will be required to pay. If a maximum levy amount is imposed, the levy rate applying below the cap will need to be adjusted if the levy is to raise the same amount in total as would be the case without the constraint of the cap. A minimum levy amount (or floor) means that each regulated institution is levied a certain minimum amount even if it substantially exceeds the amount that would result from applying the levy rate to the level of assets (or other levy base).

Fee for service

Fee for service arrangements lie at one end of the spectrum of possible approaches. Under these arrangements, each institution could receive an individualised invoice for prudential work relating to that particular institution on a strict fee for service basis. This might avoid concerns about cross subsidisation and minimise the risk of 'sound' institutions subsidising 'troubled' ones. It has been suggested that, if the amounts paid by an institution closely reflect the resources allocated to the supervision of that institution, this would encourage the adoption of sound and transparent risk management processes and assist in meeting accountability objectives.

A strict user pays/fee for service model of this type reflects the principle that those whose activities give rise to the cost of prudential supervision and regulation or who benefit from that work should pay for it. It is most readily applied where the costs and benefits of the activity are clearly identified, quantified and linked to particular parties. It can also have advantages in terms of accountability of the institution(s) it funds.

Difficulties can arise when there is not agreement as to which costs are appropriately attributable to which parties or where excessive costs arise from the record-keeping requirements needed to ensure appropriate invoicing. Such costs appear to have the potential to make this approach to the financial sector levies very expensive to administer across the regulators' activities.

In addition, a funding arrangement that is heavily weighted towards a user pays system can make budgeting/planning difficult for the regulated entities, as well as the regulatory agency, if there is significant volatility over time.

Possible adverse impact on prudential outcomes

More fundamentally, this approach would be likely to impact adversely on prudential outcomes. In particular, other things being equal, the greater the concern about a particular institution, the greater the attention it would receive from the prudential regulator. It follows that the impact of a strict 'fee for service' regime would be that those institutions considered to be in most difficulty would be required to make relatively large financial contributions to the costs of the prudential regulator. Thus, those under most financial strain would have an additional financial burden placed on them by the regulator. While this effect may be small in practice, it could lead to some increase in institutional failure and stress on the financial system at the margin.

Further, and probably more significantly in practice, if seeking assistance from the prudential regulator involved a direct cost to institutions, some might delay or avoid seeking appropriate assistance, reducing transparency and increasing the risk of more serious problems developing. Again, this would be counterproductive to the objectives underlying the function of prudential supervision and regulation.

Impact of volatility on regulators

Volatility and uncertainty in relation to funding also could be a problem for regulators. Newly recruited staff usually require significant training in order to acquire the skill levels necessary to undertake significant prudential supervision work effectively. An organisation is much more likely to make the necessary investment of time and resources in this training if it is confident that it will be in a position to retain such staff well into the future.

Timing of funding

Another difficulty for regulators in relying on fee for service arrangements for funding is that the fee normally is received only after the service is completed. This means that working capital or some other source of funds is required to finance these services prior to the receipt of fees. As APRA currently depends almost entirely on levy revenue and cannot borrow from the institutions it regulates (although it does hold some reserves), any delays in the receipt of that revenue have the potential to lead to significant cash flow problems.

If a fee for service arrangement was to be implemented in such a way that payment was required in advance, some mechanism for adjusting for initial over- and under-payments would be needed. Also, an appropriate basis for the initial fee would need to be determined.

A further funding difficulty relates to the need to meet, from somewhere, the costs of regulating and supervising firms that become insolvent.

Cost of potential disputes about amount of regulatory attention

In addition, strict user pays arrangements would be likely to result in additional questions from financial institutions and responses from the regulator as to the need/priority of particular activities for which a charge was made. This is not an ideal operating environment for a prudential regulator, which should be able to intervene to address financial difficulties and, indeed, to satisfy itself as to whether or not there are such difficulties. It should not be able to be put off by unverified assertions by an institution under question that all is well, simply because if those assertions prove to be correct it will not be able to recoup the costs of the relevant investigations.

The Government's overall cost recovery policy⁷ (outlined in more detail at Attachment B) does not require fee for service cost recovery when this would not be cost effective, nor when its implementation would be likely to lead to outcomes inconsistent with the underlying intention of the policy. It is clear that some likely outcomes of a fee for service approach to cost recovery would not sit well with this underlying policy intention of effective prudential supervision and regulation.

Sectoral and universal levy approaches

Notwithstanding the difficulties that would be involved in any attempt to fund the financial regulator through a disaggregated fee for service regime, the objective of cost recovery on an industry sector basis over time underlies the existing financial sector levy arrangements.

This approach can be seen as providing a reasonably close link between the cost of prudential activity and the recovery of those costs, without placing unnecessary financial strain on vulnerable institutions or encouraging inappropriate prudential behaviour outcomes. It involves separate levy structures for the different sectors of the industry.

The relative merits of this system and a third, 'universal single levy' or 'group' approach, which involves the same levy structure applying to each regulated entity or group regardless of which financial industry sector or sectors it may belong, are discussed below.

This discussion also received some attention during the 1999 Review, particularly in the context of the extent of convergence amongst industry sectors.

⁷ On 4 December 2002, the Government announced a formal policy on cost recovery. This policy requires that fees and charges set by government agencies reflect the costs of providing the relevant products or services. The intention is to deliver benefits to small business, industry and consumers by improving the consistency, accountability and transparency of cost recovery arrangements. While the specific application of cost recovery and accountability requirements will be a little different for prudential supervision and regulation than for most other activities undertaken by public sector agencies, the underlying policy itself will apply. The policy explicitly recognises that it may be appropriate for entities to introduce levies rather than a fee for service regime.

The cost recovery policy, which was adopted following consideration of a Productivity Commission Report, is outlined in more detail at Attachment B.

Convergence

The 1999 Review gave considerable attention to whether, in the light of convergence amongst industry sectors, the levies should continue to be imposed on an industry sector basis, rather than a group basis. It was decided at that time that the levies would continue to be set on a sectoral basis although it was anticipated that convergence was likely to continue and that the issue would need to be considered again by the time of the next (that is, the current) Review.

In the period leading up to the previous Review, financial institutions were becoming more than just mono-line providers and distinctions between different types of financial institutions were blurring. Banks, for example, were offering not only a large range of deposit and credit facilities, but also products and services such as managed funds, superannuation, insurance, financial planning advice and stock-broking.

Financial institutions continue to offer a range of products that previously would not have been available except from other financial institutions in a different sector of the financial services industry. Further, there has been increased concentration within the financial services sector, significant joint venture activity and moves by traditional institutions into wealth creation products. However, it is probably fair to say that there has not been rapid convergence of the type anticipated at the time of the Financial System Inquiry or of the 1999 Review. For example, the significant take-up that was expected of non-operating holding companies as a vehicle for managing conglomerates has not eventuated.

Institutions have closed branches and promoted one-stop shops so that it is more likely than before that a customer can walk into a branch and do banking business, take out an insurance policy and talk to a financial planner regarding his or her superannuation arrangements. However, the business undertaken is still booked into different entities depending on whether it relates to deposit taking, insurance or superannuation.

The acquisition by one type of financial institution (such as a bank) of another type of financial institution (such as an insurance company) might be seen as the first significant step towards the type of convergence that had been envisaged. However, such a takeover might not lead to a reduction in the costs of prudential supervision as both institutions would continue to require prudential oversight in their own right.

Convergence and a group or universal levy approach to the financial sector levies might overcome the possible inequity of charging two levies on the same assets because more than one financial industry sector was involved. However, so long as there is a need to supervise more than one entity in relation to these assets, there is also a case for levying the relevant assets more than once.

The second stage of convergence is selling the full range of financial products across one point of sale. This might facilitate a change in supervisory approach because the number of institutions needing examination could be reduced. The Review has found little evidence of significant steps towards this second stage.

The case for or against moving away from the current sectoral approach to the financial sector levies does not hinge on the pace (or lack of pace) of convergence over the past few years. However, recent history in relation to convergence does not provide the strength of support for a

shift to uniform levy arrangements that might have been expected at the time of the previous Review.

Uniform levy structure

Lower levy amounts for most levied institutions

A single uniform uncapped levy applying evenly to all institutions regardless of industry sector would involve significant reductions in the levy rate for most institutions (assuming no change in the total levy revenue raised), although there would be very substantial increases for a minority of institutions. This might be seen to reflect current vertical equity concerns.

Fit with APRA's structure

In the past, prudential supervision activity was organised on a sectoral basis. Further, the initial financial sector levy arrangements coming out of the Financial System Inquiry replaced a wide variety of regulations and cost recovery regimes that were imposed previously on Australia's financial institutions. Both these factors tended to encourage a separate levy structure for each financial industry sector, rather than a single levy structure across all regulated financial institutions.

However, while the legislation under which it operates remains sectorally based (and its responsibilities retain an important sectoral focus), APRA's structure today does not. Rather, its structure and approach to prudential supervision is based on whether institutions are diversified or specialised.⁸

For its funding (and some of that of ASIC and the ATO) to be obtained on a different basis to that on which spending priorities are determined can be at least awkward, particularly in a context in which accountability is required to those providing the funding. Further, adoption of a uniform system could cause efficiency gains in the collection and administration of the levies to accrue because of the likely reductions in the costs of collecting and administering the levies.

Depositors, policyholders and beneficiaries as principal stakeholders

There is another, more fundamental case for moving away from a sectoral approach to the levies.

This argument takes as its starting point that the principal stakeholders in the system of prudential supervision are not the various financial institutions, but the depositors, policyholders and beneficiaries who have placed their money with these institutions. The other key propositions of this approach are that financial sector levies should be based on the protection of stakeholder value and, critically, that the view that each dollar placed by stakeholders with the various regulated financial institutions has the same stakeholder value so far as prudential supervision is concerned.

⁸ Technically, it could be argued that APRA's structure remains sectorally based, with the two sectors being diversified and specialised institutions. However, this is very different to the previous sectoral structure and to the legislative structure behind the levies.

Accepting these propositions encourages support for a single, uncapped levy rate based on the total asset value of each institution (or, possibly, some other measure of stakeholder value) rather than the various cost-based industry sector levies that operate at present. It can be argued that this is consistent with the principle of horizontal equity as applied to the interests of individual stakeholders.

Simplicity, stability and flexibility

A universal levy arrangement would be simpler than the range of different levies that currently apply (a single levy rate would apply across all regulated institutions, regardless of size or industry sector). It may also help to provide greater stability and flexibility as emerging developments in particular sectors would not automatically feed in to major changes in levy rates affecting that sector in the short term. The attraction of such stability to those paying the levies is clear, but it would also help the regulators because of the long lead times required to develop the skills of staff to perform supervisory roles.

Differences in the nature of financial promises and intensity of supervision between industry sectors

The key argument against the universal levy model is that the intensity (and therefore cost) of prudential supervision and regulation not only does, but also should, vary between industry sectors and that this should be reflected in the structure of the levy arrangements.

Sectoral levies

The sectoral levy model lies between the fee for service and the universal levy approaches. As noted earlier, the existing levy arrangements constitute an example of sectoral levies, although other models are possible, involving either a greater or a lesser degree of disaggregation than the existing arrangements.

In addition to the obvious advantage that the existing arrangements are familiar to industry and the regulators, the advantages of sectoral models are generally that they can minimise the main disadvantages of fee for service and universal levy models. In particular, the difficult volatility and cost allocation concerns associated with fee for service models can be avoided or moderated, as can the undesirable behavioural incentives for firms to delay or avoid seeking support from the prudential regulator. On the other hand, unlike the universal levy model, there is at least some capacity for the levies to reflect a different degree of supervisory intensity between industry sectors, while transparency and accountability objectives are also likely to be more readily satisfied.

Similarly, the principal disadvantages of the sectoral approach correspond to the main advantages of the other two models.

Differences in the nature of financial promises and intensity of supervision between industry sectors

The regulator's primary activity is the assessment of financial risk of financial institutions and the encouragement of sound financial governance in the protection of primary stakeholders. This is achieved through risk-based supervision, enforcement and rehabilitation, enabled by a framework of supervisory policies and standards, with full liaison with stakeholders, including government.

The process of assessing risk varies substantially in complexity with the risk being dynamically responsive to varying economic conditions. Further, the institutions being supervised are geographically dispersed, vary vastly in size and offer a wide array of products.

The different nature of financial promises made in relation to different financial transactions are associated with different regulatory intensity and different regulatory promises. It is at least arguable that the regulator should be more concerned about the financial safety of some types of entities than others (and that this varies from time to time) and that this has implications for the extent of prudential attention the various institutions should receive.

In particular, levies at a flat rate on each dollar entrusted to a regulated financial institution might be seen to over-charge those investing (deliberately) in relatively risky financial assets relative to those with more risk averse investment approaches.

That there are different levy regimes in different industry sectors is partly historical in that the current system replaced a more diverse set of regulatory and funding arrangements. However, more fundamentally, it reflects the expectation that the degree of intensity of supervision should vary depending on the nature of the financial promises typically made in individual industry sectors and on other particular features of those sectors. This includes the risk attached to these financial promises as well as reporting and other regulatory requirements.

In some cases, different regulatory treatment is required by the nature of the product. For example, holding superannuation assets within a trust structure helps isolate such assets from trading failures by an investment manager. A conventional bank deposit, a premium for an insurance policy and contributions to a superannuation fund involve different financial promises and different risks.

The principle that levies and charges should be related to the intensity of supervision and the use of services provided by the regulators appears to be broadly accepted, although there are different views as to whether, and if so to what extent, other factors should also be considered. A simple levy structure applying on a uniform basis to all types of financial institutions may be brought into question by the requirement that the levy structure should bear a close relationship to actual regulatory costs while the appropriate definition of actual regulatory costs may also need attention.

If it is accepted that the degree of intensity of prudential supervision should vary between financial industry sectors and that this should be reflected, at least to some extent, in the structure of levy arrangements, the principle-based argument presented earlier for moving away from a sectoral approach loses much of its force. It becomes an argument for a system with features broadly approximating the existing arrangements, albeit without caps.

However, practical difficulties in determining the degree of intensity of prudential supervision in each industry sector may mean that, when all the factors that need to be considered are taken into account, there may still be a case for a single levy regime across the regulated financial sector.

Incentives to inform regulator of possible concerns

If poor performance by an institution imposes costs on other institutions either in the same industry sector or more widely, there is an incentive for these other institutions to ensure that the regulator is aware of that poor performance at an early stage. This would enable the regulator to take appropriate prudential action. Of course, if action by the regulator imposes direct costs on those other institutions, there may be an incentive to delay reporting possible problems.

Flexibility of resource use

One disadvantage of cost recovery on an industry sector basis is that it may have the potential to limit the flexibility of the regulator to shift resources from one industry sector to another in response to emerging prudential concerns or other changes in strategic priorities. (This is the case *if* industry sector cost recovery is interpreted to mean that the resources allocated to any industry sector in a given year must match closely the funds raised from that industry sector for that year.) Alternatively, if priorities for prudential attention change relatively rapidly, rapid changes in industry sector levies will also be required.

The same sort of problems as those identified above in relation to a fee for service approach for each institution can arise, albeit in less severe form, in relation to industry sector levies. However, it is possible to build a substantial degree of flexibility into a sectoral cost recovery model. The existing levy structure has been criticised, in submissions received by the Review, as rigid and providing very limited scope for relieving outcomes that may be perceived as inequitable.

Volatility

As noted earlier, any levy system that attempts to measure time spent on supervising an institution and to cost the activity with a high level of overhead to absorb is inherently liable to great volatility. It may be possible to address this volatility in an industry sector context through such mechanisms as averaging the effect of short-term significant impacts on particular industry sectors so as to limit changes in levy rates. However these mechanisms have their limits.

Tinkering with the basic model to avoid what might seem to be unacceptable outcomes, such as significant cross subsidies or volatility, would add complexity to the process and encourage special pleading by other groups.

There are tensions between competing policy objectives. Predictability and stability may be in some tension with transparency, accountability and a lack of cross subsidies.

Cross subsidies

The financial sector levy arrangements were intended to provide an administratively simple and uniform scheme based on the principle of full cost recovery from the regulated institutional

categories or financial industry sectors. The anticipated cost of regulation of the relevant industry sector has always been a central consideration in establishing the levies to apply to institutions in that sector.

The Review has been asked to consider whether factors other than cost of supervision in an industry sector over time (for example, risk management and stakeholder value in the industry sector) should be taken into account in setting any industry levies

It is taken as given that, in aggregate, the funds raised through the financial sector levies should cover the relevant costs of the relevant activities of APRA, ASIC and the ATO. To then ask whether factors other than costs might be taken into account in setting industry levies is to ask whether the amounts raised through levies from particular industry sectors need to match the amounts spent on the regulation of the relevant industry sectors. That is, to accept that implies the possibility that cross subsidisation between industry sectors might be justified in some circumstances.

This implies that for some industry sectors, the amount raised through the levies would not cover costs and, in others, it would more than cover costs.

A number of submissions put to the Review have opposed cross subsidisation explicitly and most submissions raised concerns about a perceived imbalance between the amounts raised from particular industry sectors through the levies and the amounts spent on supervision of those sectors.

In addition, considerable attention has been given in submissions to a similar perceived imbalance relating, not to different industry sectors, but to different sized institutions, including within a given industry sector.

Spreading the impact of expenditure changes over time

Under the current levy-setting arrangements, the levy-determination process each year takes into account a five year moving average of actual expenditure over the previous three years and estimated expenditure for the current year and the following year. This means that, even if sectoral expenditure outcomes match exactly the estimates made for any particular year, there will be a difference between the distribution of expenditure and the distribution of levies in that year⁹. This provides greater stability in levy rates from year to year than would be the case if the levies fully reflected annual changes in expenditure.

This dampening down the of the impact of changes in the pattern of sectoral expenditure on the sectoral distribution of the levy burden means that if there is a significant sectoral shift in expenditure, the cost burden of that shift does not fall fully and immediately to the affected sector. However, that sector does meet these costs with a lag as the levies are adjusted over time.

The other side of this delay in an industry sector being required to meet increases in its regulatory costs is that each of the other industry sectors is required to meet part of those increased costs in the initial period. That is, there is some cross subsidisation in the short-run, notwithstanding that this is designed to wash out over time.

⁹ Theoretically, there are exceptions to this rule if the same pattern of distribution applies in each of the years taken into account in setting the levies or if the pattern in the relevant year matches the average pattern in the other years.

The effects of this short-run cross subsidisation will be more significant if the changes in the pattern of regulatory expenditure that it reflects are permanent or long-term, rather than simply variations from one year to the next that will return quickly to historical norms. Sometimes, it may be difficult to determine at the time which type of change is occurring.

This effect has occurred in the context of the existing levy-setting arrangements.

Whether, and if so to what extent, averaging over time is appropriate depends on the value placed on stability of levies in each sector relative to the avoidance of inter-sectoral cross subsidisation.

‘Vertical’ cross subsidisation and the rationale for a cap

One perspective in what might loosely be called the ‘vertical cross subsidisation debate’ argues that levy ceilings are necessary to prevent the costs to large institutions greatly exceeding the costs incurred by regulators in supervising those institutions. It also claims that minimum levy amounts should be set at a sufficiently high level to cover the costs of supervising small institutions. A theme is that the cost of supervision does not rise proportionately with the value of assets held by an institution.

An alternative perspective in this debate suggests that maximum levy amounts are set far too low. It emphasises that effective levy rates for large institutions are much less than the nominal rates attaching to entities in their industry sectors and that relatively small institutions can be required to pay almost as much as much larger ones. In addition, it points to a risk that, because of the cap, mergers or takeovers involving large institutions will lead to reductions in total levy revenue or to increased levy burdens on smaller entities.

The rationale for a cap is that, beyond a certain level, the costs to the regulator of prudentially supervising a large institution do not grow proportionately with assets and, indeed, the increase in these costs with assets can be considered to be negligible. However, taking a broader approach to the purpose of prudential regulation and supervision activity, the failure of a large financial institution could be expected to have a larger systemic impact than the failure of a smaller institution. Larger institutions might also be seen to have a greater interest in system stability as well as a greater capacity to pay. This suggests that the case for relaxing or removing any cap on the levy amounts paid by large financial institutions is stronger the greater the weight given to these factors.

Maximum levy amount

Existing cap arrangements

The supervision levy payable by a regulated financial institution is subject to a maximum determined by the Minister that must not exceed an indexed cap specified in the relevant legislation. For example, the maximum supervision levy payable by an ADI must not exceed an indexed cap specified in the *Authorised Deposit-taking Institutions Supervisory Levy Imposition Act 1998*.

Table 1 showed the nominal levy rate, and maximum and minimum levy amounts payable for each financial industry sector for the 1998-99 to 2002-03 financial years.

Impact of levy caps

While the rationale for levy caps is relatively clear, the extent to which they impact on the overall levy regime depends on the facts of the case.

Table 3, below, illustrates some of those facts in relation to the existing arrangements in Australia for the principal industry sectors.

Table 3: Share of Institutions, Assets at or above Cap, Nominal and Effective Levy Rates

Industry sector	ADIs	Superannuation	General insurance	Life insurance
Number of institutions in sector	276	10 300	140	79
Percentage of institutions in sector at or above cap	3.6	2.3	10.0	22.8
Percentage of assets held by institutions at or above cap	89	89	69	94
Nominal percentage levy rate	0.010	0.030	0.030	0.020
Estimated average effective percentage levy rate	0.0029	0.0082	0.017	0.0046

The life insurance industry sector has the largest percentage of entities at or above the cap, followed by general insurance, while only a relatively small proportion of ADI and superannuation entities are at or above the cap. However, the share of assets held by those institutions above the cap is 89 per cent of the total for both the ADI and superannuation sectors.

Because the marginal levy rate falls to zero once the cap is reached, the effective (average) levy paid by large institutions that are at or (sometimes significantly) above the cap, can be much less than the nominal rate.

The effective overall levy contribution rate for the general insurance sector is barely over half the 0.030 per cent nominal levy rate. However, for the ADI, superannuation and life insurance sectors the effective rate is substantially less again, at more like a quarter of the relevant nominal rate. Effective overall contribution rates for institutions above the cap are even smaller compared with nominal rates, while for the largest institutions the differences would be even more pronounced.

The basic effect of a cap is to redistribute the burden of additional costs away from those entities for which the cap is an effective constraint on the levy amounts paid towards those entities for which it is not a binding constraint. This will normally be the 'medium-sized' institutions large enough to be able to pay for increased levies, but not large enough to have reached the cap.

For the 2002-03 financial year, the maximum levy on an ADI was \$1,125,000, and this was the amount that the large banks were required to pay. However, much smaller ADIs were required to pay amounts that were only slightly less.

An alternative approach would be to abolish the maximum, with the result that the amount of levy payments would be proportional to total assets of the institution (or other levy base if something other than total assets is used). Another option would be to increase the cap if it was considered that current cap levels were leading to under-charging of large institutions.

Potential impact of cap on levy revenue

A cap on the levy amount for an institution risks the total funds to be raised from the levies being reduced through mergers or takeovers involving institutions that have their contributions affected by the cap. That is, if the total assets of two institutions that merge exceed the level at which the cap becomes effective, the total levy revenue raised is lower than would be the case if the institutions remained separate. Where at least one of these institutions has assets in excess of the cap amount before the merger or takeover, this effect is even more pronounced. Consolidation would lead to reduced levy revenues or, if there is not to be a reduction in these revenues, to higher rates and to greater amounts being paid by smaller institutions.

The lower the level of any cap, the more likely is such an effect and the more severe its impact. Retaining the cap at close to its existing level, without making other changes to the levy arrangements, would effectively redistribute the relative burden of the levies from the large institutions for which the cap is effective (or would be in the event of merger or takeover) towards the smaller institutions. There could also be a significant reduction in funds available to APRA, ASIC and the ATO from the levies, a point highlighted in views put to the Review, particularly by representatives of smaller entities.

Alternatively, removing or substantially increasing the cap could result in the large institutions contributing a significantly increased share of the financial sector levies.

At least one submission has proposed that the legislation governing the levies provide for APRA to recover any shortfall from financial institutions involved in any merger, and that this apply for a year or two to enable APRA to monitor the merger and smooth the impact on other institutions.

While there may be some economies in prudential supervision from a reduction in the number of entities that are to be supervised, cost-shifting to small and medium-sized institutions appears to run counter to both equity and efficiency considerations.

Potential implications of any increase in total resources to be raised through the levies

In the absence of an increase in, or abolition of, the cap, any requirement to raise increased resources through levies would have to be met from those institutions not already paying the maximum amount. This would exacerbate any concerns about a disproportionate burden falling to those institutions.

Stepped levy rates

The existing arrangements for each industry sector involve each regulated institution in the sector being levied at percentage rate on the value of its assets, subject to minimum and maximum levy amounts.

These arrangements imply that the cost of prudential supervision can be represented as comprising:

- (i) a fixed cost that is constant for each institution in a particular industry sector; and

- (ii) a variable cost that increases in proportion with the value of assets up to a certain point, beyond which there is no increase in the prudential supervision costs associated with the institution.

In other words, the current arrangements treat the costs of prudential supervision as a function of the number of institutions, the value of the assets of those institutions and the industry sector in which the institutions operate.

The rationale for a cap is to account for the fact that the costs of supervising a financial institution do not grow continually in proportion to the assets it holds. It is seen as necessary to prevent the larger institutions funding the costs of prudential regulation and supervision to a far greater extent than would be justified by the share of expenditure on those institutions.

However, a cap may be a flawed means of achieving this aim because the costs of supervising a larger financial institution, in reality, may not cease to grow as assets expand beyond the point at which a levy cap is effective.

A middle way might be a stepped levy rate model. This would involve a certain levy rate up to a particular level and a lower levy rate above that level. In principle, it would be possible to have as many different levy rates as one wished although the greater the number of rates, the greater the complexity. It would also be possible to incorporate an absolute cap (and a floor, or minimum levy amount) into this model. The rationale for this approach would be that, while the cost of prudential supervision does not increase at the same rate for every dollar by which assets increase for a larger institution, it does increase.

At present, the average effective levy rates paid by institutions with asset levels in excess of those at which the cap becomes effective is below the nominal rate, but above the (zero) marginal effective rate. An efficient outcome is achieved where the marginal effective rate matches the incremental cost of prudential supervision associated with additional assets of a regulated institution.

Minimum levy amount

The rationale for the minimum levy amounts that form part of the existing arrangements is that, regardless of how small an institution may be, it costs a certain minimum amount for the regulator to prudentially supervise that institution.

While it is important to ensure that the minimum levy amount is not set so high as to discriminate against smaller financial services institutions, more concern has been expressed in submissions that the minimum levies may have been set at too low a level.

It has been suggested that the current levy minimum for entities in at least some industry sectors appears to be lower than the actual costs applicable to the smallest entities in these sectors, especially if the frequency of on-site visits increases. The implication of this suggestion is that minimum levy rates in at least some industry sectors should be increased.

Again, the efficient outcome is achieved where the minimum levy matches the minimum expenditure by regulators, regardless of size.

Small APRA funds and approved trustees

Superannuation was one of the industry sectors for which increases in minimum levy rates were suggested. However, under the current legislated levy structure, any increase in the minimum levy amount for superannuation funds would apply to all APRA regulated funds, including some thousands of Small APRA Funds (SAFs) with an Approved Trustee. It is common for a single Approved Trustee to be trustee of a large number of SAFs.

It has also been suggested by some that a concessional rate should apply for SAFs that are managed by the same Approved Trustee. In particular, it has been proposed that SAFs with an Approved Trustee pay a flat rate levy falling between the minimum charged for regulated superannuation funds and that applying to self managed funds under the supervision of the Australian Taxation Office. The alternative of levying Approved Trustees in a way related to the number of SAFs for which they are responsible has also been suggested.

Either of these approaches would require legislative change.

Charging SAFs the same rate as other small superannuation funds has the advantage of uniform treatment. However, SAFs are subject to prudential supervision under the APRA framework, including the requirement to have an Approved Trustee.

Risk management

A system of prudential supervision and regulation aims to provide an appropriate degree of safety to users of the system, or an appropriate and justified level of confidence that financial promises and implied undertakings given will be met. It aims to facilitate stability of the financial system and of the institutions operating in that system.

Given this broader objective, it can be argued that there is a *prima facie* case for giving financial encouragement to those operating risk management systems that reduce the risk of failure to an appropriate level relative to those who are not, even if the direct costs to the prudential supervisor are unaffected.

It is clearly not practical to obtain detailed, sophisticated and reliable information on the risk management strategies of individual institutions and to reflect this information in a levy regime. The most that might be feasible might be to assess the overall quality/effectiveness of institutions' risk management systems and for this to impact on the levy rates/amounts charged in a fairly simple way. For example, a surcharge could be applied to those institutions considered to lack sufficiently good approaches to risk management.

Certainly, simplicity is an important attribute in this context. The more complex the levy arrangements, the greater, other things being equal, will be the compliance, enforcement and administration costs.

A disadvantage of a dual rate or other multi-rate approach is the potential for disputes as to whether a higher or lower rate should apply to any particular institution and constant pressure to reassess any institution that considered it now satisfied criteria that would entitle it to a lower rate.

Other factors relevant to the nature of the prudential attention that a regulator might apply to an institution include the number and characteristics of counterparties to the financial arrangements with the regulated institutions. If there are relatively few counterparties to provide a check to undesirable performance by the financial institutions the need for the regulator to take a more intensive role may be greater than if the number of counterparties is greater.

Probability and Impact Risk Rating System

APRA is currently developing a new Probability and Impact Risk Rating System ('PAIRS'). The PAIRS system has been designed to integrate formally the risk of a regulated institution's failure and the potential impact of such a failure into a single measure. The PAIRS Supervisory Attention Index rises as the probability of failure and the potential impact of failure increase, with ratings moving from 'Low' at one end of the spectrum to 'Extreme' at the other.

The intention is to ensure the appropriate level of supervision is applied according to each entity's risk profile. PAIRS builds on APRA's current risk-based approach and will be applied to all supervised institutions over the next twelve to eighteen months.

The ratings APRA derives from the PAIRS system will not be available publicly, although individual institutions will be advised of their ratings as PAIRS is implemented, tested and introduced progressively over the next two years.

Conceptually, it might be possible to use PAIRS (or something like it) to help determine whether a particular financial institution should be levied at a 'high' or 'low' rate. However, any such use certainly would need to await further development and refinement of PAIRS and ensure that the integrity of the ratings system was not at risk of being affected by any link to levy amounts payable by regulated institutions. Assuming these matters could be addressed satisfactorily, the more general concerns flagged above in relation to complex levy arrangements would need attention.

DESIGN ISSUES

Regardless of the decisions that may be taken on the broad framework options considered in the first part of this paper and summarised against key assessment criteria at Attachment C, a number of important design issues also require attention and are considered below. Some of these issues will require attention regardless of whether fee for service, sectoral or uniform levy arrangements are implemented, while others may be relevant only to one or two of them.

Overheads

Distribution of overheads can be difficult. Submissions from small ADIs have argued that the proportionate distribution of APRA overheads over all ADIs is inappropriate and that there is no justification for significant elements to be applied to smaller and less complicated ADIs. These submissions also suggest that larger institutions should bear a significantly greater proportion of the APRA overheads in recognition of their complex and conglomerate activities and the particular personnel and skill requirements this imposes on the regulator.

In contrast, representatives of larger institutions have indicated that smaller institutions need to bear their share of total regulatory costs, including through higher minimum levy charges.

Overheads necessarily account for a significant proportion of the costs of prudential supervision. Much of what the prudential regulator does, it does behind the scenes. For example, information technology assists it to retrieve and handle large quantities of financial information, check market reports, more easily monitor the position of a relatively large number of smaller institutions and undertake policy and other research to assist it in its regulatory task without this activity being seen by the regulated institutions. Decisions on the allocation of these overheads can have a substantial impact on the total costs charged.

If a sectoral approach is retained, should the existing sectoral splits be changed?

As outlined earlier, the current industry sector model of cost recovery considers seven financial industry sectors. The costs of supervision and regulation associated with each industry sector are recovered from that industry sector.

In principle, significant changes could be made to the current sectoral regime while retaining a sectoral approach to the levies. For example, two or more existing industry sectors could be combined, part of one or more industry sectors separated out or other changes to the sectoral definitions made.

Industry sector model with high degree of disaggregation

One option would be to increase the number of recognised industry sectors and have a greater degree of homogeneity between institutions in each. This might make it easier, within each sector, to set appropriate levy regimes, although it would also add some complexity to the overall arrangements and increase concerns about the relativities between the levy arrangements for each sector. Having fewer players in each sector would also mean that if a particular entity required

close prudential attention for any reason, the impact on other entities in the same sector would be relatively substantial unless inter-sector cross subsidies were accepted.

In order to address these concerns it might be necessary to introduce levy accounts for each sector with over- and under-spends in each year relative to levy funds raised from each sector being taken formally into account on an ongoing basis in setting levy rates in succeeding years.

The FSA in the United Kingdom operates an industry cost recovery model with a relatively large number of industry sectors. This model requires costs of supervision and regulation of each relatively small industry sector to be recovered from that industry sector.

Industry sector model with relatively low degree of disaggregation

Another alternative (and one that was considered at the time of the 1999 Review of Financial Sector Levies) is the Specialised and Diversified Group Model. It can be seen either as a type of industry sector model with only two industry sectors or as a variant of the group model in which there are two types of groups, each of which has different levy arrangements.

Regulated financial institutions would be classified as either diversified or specialised institutions. The costs of supervising and regulating the diversified institutions would be recovered from those institutions collectively and the costs of supervising and regulating the specialised institutions would be recovered from the specialised institutions.

If a sectoral approach is retained, should there be scope to adjust the sectoral splits over time?

Given the dynamic nature of the financial sector, it is quite possible that its structure will look quite different in three, five or ten years' time. Accordingly, it might be desirable at some point in the future to change the structure of the financial sector levies to reflect such changes.

While all of the financial sector levies are considered and announced together, each is imposed under a separate piece of legislation. This legislative framework enables different levies to be struck for different industry sectors.

While some relatively minor adjustments may be possible in some circumstances under the existing legislation, changing the number of financial industry sectors recognised for the purposes of the levies is likely to require legislative change. This can be a slow and involved process. If it is considered that non-trivial changes to the sectoral structure of the levies may be desirable in the future and that there would be advantages in not requiring the statutory amendments to effect such changes, it may be appropriate to introduce some flexibility to the existing arrangements.

The argument against such an approach is that the Parliamentary legislative processes, while often slow, do ensure clear accountability in relation to any changes.

Levy base options

At present, the base on which the financial sector levies are imposed is the total assets of regulated institutions in each financial industry sector, subject to maximum and minimum levy amounts. The levy rates differ between the various industry sectors.

However, at least conceptually, a number of different bases for a levy can be considered, and within this range, a number of different models are possible.

Most discussion of possible changes to the existing arrangements (for example, a flat rate across all industry sectors) assumes that total assets would continue to be the levy base.

Total assets are generally considered to be correlated with the cost of prudential supervision activity by the regulator, an institution's capacity to pay, the impact of its possible failure on the system and its interests in a stable financial system.

However, an alternative would be to use total liabilities (or some subset of total liabilities) as the levy base. Total liabilities would have the same advantages listed above for total assets and might even be considered more appropriate because the interests of the various stakeholders that prudential regulation is intended to protect are represented by the liabilities of the various financial institutions.

However, to move towards a liabilities base for the levies would be a significant change from the existing arrangements and the likelihood of unanticipated practical difficulties might be greater than for a levies regime based on assets.

Other options could involve more industry or product specific charges or direct estimates of the cost of supervision by class of institution. However, these do not appear attractive given the difficulties that have been identified with fee for service arrangements at a disaggregated level in the financial services sector.

Another possible variant might be to separate out directly attributable supervisory costs that could be levied on an industry specific basis and overhead costs that might be attributed at a low single rate to all regulated institutions. That is, there might be a base levy across the board together with a specific levy.

Finally, it has been suggested that, particularly in the light of the development of securitisation arrangements, consideration could be given to basing the levy on total funds under management. However, this option has not attracted much support at this time.

Regulatory costs are not strictly linearly related to total assets and, even within one class of financial institution, there will be differences in risk and regulatory costs. However, a relatively simple base and levy system has the advantage of simplicity. Any additional benefits in terms of equity and efficiency that might flow from more tailored levies could be outweighed by the additional costs of running such a system.

Accountability and transparency

The financial sector levies are raised for particular purposes and the funds raised should be spent in clear accordance with those purposes. That there should be appropriate accountability and transparency in the expenditure of the funds raised through the levies is uncontroversial and part of the purpose of the Government's cost recovery policy. The issue is how extensive these accountability and transparency requirements should be given the trade-offs that may exist between these objectives and others such as simplicity and the flexibility of the regulators to move resources quickly and freely to emerging areas of prudential and other concern.

In the interests of greater transparency and accountability, it has been suggested that regulated institutions should have access to the detailed costs involved in running the various departments in APRA and, implicitly, the relevant areas of ASIC and the ATO. The suggestion is that this should be built into the levy structure itself and that details of specific factors (such as head count and time allocation) that are used to allocate costs to individual institutions should be available to those institutions.

One suggestion put to the Review extended this proposal further by asserting the desirability of a concise listing of each industry member and the financial sector levies it pays. It was suggested that this should be clearly set out in each agency's Annual Report. It was also suggested that a separate report should be distributed to all industry participants detailing every contributor and the contribution of each. The logistics of this suggestion, should it be pursued, would require some attention as some 11,000 institutions are levied, of which about 3,000 are subject to variable levies.

While fee for service arrangements impose a form of accountability on the regulator, other forms of funding arrangements also can (and do) have strict accountability requirements. In particular, APRA (and ASIC) expenditure is subject to similar scrutiny to that of other agencies in the Commonwealth Government Budget process and other Parliamentary processes. Although the majority of the funds raised through the financial sector levies go (albeit with a lag) to APRA and provide the overwhelming majority of its funding, this does not imply less accountability or transparency than other public expenditure that is financed from general taxation revenue.

The regulated institutions required to pay the levies contribute to a further level of accountability under the existing arrangements through the feedback they are able to provide. The consultations being undertaken as part of the current review of the levy arrangements, as well as the annual consultations with industry prior to the establishment of the financial sector levies each year are important components of that accountability process.

One possible disadvantage of increased transparency arises from the fact that different industry players have different views as to the appropriate distribution of prudential regulation activity and the costs of that activity and the associated support services. The outcome might be an increase in disputes concerning the fairness of the levy burden on different parties and the level of prudential supervision activity in each industry sector, which potentially could divert resources from the task of that prudential supervision itself.

If increased transparency is associated with an increase in disputes about the allocation of resources, it is possible that the regulator might consider its ability to move resources quickly to areas of emerging prudential concern unduly constrained, with consequent impacts on the quality of the financial sector-wide prudential supervision function. However, the other perspective is that any short-term cross subsidies in a system of industry funded levies should be highly transparent. This perspective is that the higher resource costs that may be associated with the process of justifying resource allocation decisions are preferable to assuming simply that the regulator will always make the right decisions.

Accountability of ASIC and ATO

Some submissions have argued that, while the material made available on APRA's supervision costs has been less comprehensive than some would have preferred, less information again has

been made available on the relevant costs of the ATO and ASIC. Concern has been expressed that the nature of those activities funded by the levies and undertaken by ASIC and the ATO is not well understood within the financial sector. Similarly, the nature of the link between the amounts raised through the levies for these ASIC and ATO functions is not well understood.

Understanding of the nature of this link is complicated by the fact that it is significantly less direct for the functions undertaken by ASIC and the ATO than for those undertaken by APRA. In particular, the relevant levy funds go into Consolidated Revenue and are taken into account in determining the appropriations for ASIC and the ATO. Unlike APRA, which depends almost entirely on revenue from the financial sector levies, both ASIC and the ATO undertake activities far beyond the scope of those funded by these levies. Accordingly, the levy funds allocated to activities they undertake constitute only small proportions of their total funding.

It has been proposed explicitly to the Review that there should be earlier and more complete disclosure of relevant information, in particular the basis for estimating the relevant costs of ASIC and the ATO along with provision of objective supporting material. The strong claim is that a clearer connection is needed between the relevant activities of ASIC and the ATO and the levy amounts that are set for these activities. In short, the claim is that, if a proportion of the funds raised through the levies is to go to those activities in the future, greater transparency and accountability will be required of both ASIC and the ATO.

The Government's cost recovery policy requires appropriate accountability. It explicitly requires that cost recovered revenue should be clearly identified in agency financial statements in both annual reporting and portfolio budget documentation. All significant existing cost recovery arrangements are to be reviewed over a five-year period, according to an agreed schedule announced by the Government.

Scope of activities funded through the financial sector levies

Under the current arrangements, the financial sector levies are set annually to cover the operational costs of APRA and certain market integrity and consumer protection functions of ASIC and the ATO. These levies provide the overwhelming majority of APRA's funding and relatively small proportions of the funds available to ASIC and the ATO.

The fact that the funds raised through the levies contribute to the funding of more than one regulator is not, in itself, a significant problem. The Government's cost recovery policy is activity-based, not agency-based. Under existing arrangements, APRA has primary, but not exclusive, responsibility for the activities funded through the levies.

One potential difficulty with activities undertaken by more than one agency being funded through the levies is the possible perception that the 'APRA levies' go entirely to APRA when APRA does not have any access to those funds allocated to ASIC and the ATO. However, while this may cause a degree of irritation and confusion, it is probably primarily an issue of presentation.

Fundamentally, any case for adjusting the coverage of the activities funded through the financial sector levies rests on the closeness of the relationship of those activities to the function justifying the levies. It might be argued that, for example, the consumer protection and market integrity activities undertaken by ASIC and the ATO are sufficiently different to the prudential supervision

work undertaken by APRA that alternative funding arrangements (for example a different form of separately identified levy) would be appropriate. Alternatively, some activities not currently undertaken from levy funding might be considered sufficiently closely related to that function as to merit levy funding.

Regardless of whether any changes are made to the scope of functions funded through the financial sector levies, the functions funded in that way in the future will need to satisfy the requirements of the Government's cost recovery policy. In particular, the costs recovered will need to be clearly identified in the relevant agency financial statements.

Is there scope for greater use of fee for service arrangements for some activities by APRA, ASIC or the ATO?

Section 51 of the APRA Act 1998 provides a capacity for APRA to charge directly for services and this is used. The role of user pays fees is recognised and accepted.

As noted earlier, fee for service arrangements for a regulator's core activities may be counterproductive in relation to prudential policy, notably because of the potential for institutions in some difficulty to face additional charges and the disincentive for institutions to seek prudential assistance.

However, for non-core and elective activities that a regulator might undertake for regulated entities, fee for service arrangements may be attractive. Indeed, a number of fee for service arrangements operate already.

Nevertheless, submissions make clear that linking a substantial part of the recovery of regulatory costs to specific interactions between financial entities and the regulator could involve some difficulties. Some have claimed that any such charges could have a potentially disproportionate impact on smaller bodies and should be applied, if at all, in a framework that recognises that.

The Review has received a specific comment to the effect that user charges should not be introduced for services such as the complaints mechanism provided by the Superannuation Complaints Tribunal (SCT). Much of the business of the SCT is establishing whether the decision by a trustee as to whether a complainant is totally and permanently incapacitated is fair and reasonable and whether a trustee was fair and reasonable in balancing the relative claims of dependants after the death of a member. It was argued that applying user charges to superannuation funds alone in regard to the resolution of such complaints was not desirable and could encourage inappropriate offers of settlement.

In general, except on a very limited basis, fee for service arrangements for dispute resolution schemes are not supported by existing Government policy.

The Review notes that a number of issues relating to the SCT were considered in a Productivity Commission inquiry report, *Review of the Superannuation Industry (Supervision) Act 1993 and Certain Other Superannuation Legislation*, released on 16 April 2002.

Licence fees and financial assistance funding levies

As part of the package of reforms to strengthen the prudential regulation of superannuation, in October 2002 the Minister for Revenue and Assistant Treasurer, Senator Coonan, announced that

all trustees of APRA-regulated superannuation funds would be required to obtain a superannuation trustee licence. She also announced that all superannuation funds would be required to register with APRA prior to accepting contributions.

The licence fees to be associated with this process, as well as uncertainty in relation to the relative coverage of licence fees and financial sector levies, have attracted some criticism from parties arguing that the licensing procedures for existing funds should be regarded as part of APRA's ongoing activities. The suggestion is that they should be funded out of the general levy proceeds instead of being regarded as a fee for service. The argument made in these criticisms is that the service being provided is part of the core function of determining the continuing suitability of an entity to provide superannuation services.

However, there seems to be wider acceptance that trustees seeking to establish a new superannuation fund should face a licence fee rather than impose the costs on the rest of the industry sector.

The concern about licence fees in the context of the current review of the financial sector levies is primarily that both impact on the superannuation sector and there may be a degree of uncertainty as to which functions are covered by each. However, the financial sector levies and the functions they fund are well established and the licence fees are intended to cover the costs associated with the new licensing process. Further, the licence fee will apply to the trustee itself, not to each superannuation fund, and will be a one-off rather than an ongoing, annual charge. The underlying principle is that, while the relevant costs incurred must be recovered from industry, it is clear that any 'double-dipping' by the regulator is ruled out in the sense that what is subject to fees is not to be funded again through levies.

In addition, levies have been imposed in the past financial year to fund financial assistance for beneficiaries of superannuation funds that have suffered losses as a result of fraudulent conduct or theft. These levies have a quite different purpose, in that they fund the costs of actual losses incurred under certain conditions, whereas both licence fees and the financial sector levies fund the activities of the regulator.

Time-frames

Under existing arrangements, new levy rates are set every year. The levies are reviewed each year within certain parameters.

Given that the levies for each industry sector are linked to the resources allocated to prudential supervision and regulation in that industry sector, the flexibility to adjust resource allocation in response to changing prudential priorities and developments suggests that the rates should be revisited and adjusted relatively frequently.

However, stability — or, at least, predicability — in levy payment requirements helps with the planning processes of the institutions required to pay the levies (particularly where the levy amounts are significant in relation to the size of the institutions). Stability and predicability in levy revenue also help the regulator plan and develop prudential supervision strategies in a systematic manner.

Essentially, it is desirable for changes to the way resources are spent to be able to be made relatively quickly, but it is also desirable for the way these resources are raised to be relatively stable.

Maintaining relatively stable levy rates for the various industry sectors while giving the regulator the flexibility to respond to developments that impact on priorities for the allocation of prudential supervision resources would require a change in the nature of accountability requirements. In particular, a degree of cross subsidisation, at least in the short- to medium-term, would have to be accepted.

Timing of collection of levy payments

Under the current legislation, the levies are calculated and payable by all industries at the same date, apart from the superannuation industry. The levy on the superannuation sector is based on assets as at 30 June while the levies on other sectors are based on assets as at 31 March.

In practice, all industries other than superannuation pay their levies in advance while the majority of levies from the superannuation sector are received in the second half of the financial year.

Maintaining the existing timing of collection of levy payments has the advantage that expectations are well set and funding is required at the beginning of the period. However, calculating the levy based on assets at the same date and requiring the levy to be payable from all sectors at the same date might improve equity between sectors and enable groups to be sent a single invoice rather than separate invoices for separate sectors of their business.

Merger of providers of RSAs with ADIs

A levy is currently imposed on the industry of providers of retirement savings accounts. As each of the current providers is an ADI, it would be possible to recoup this revenue from within the ADI sector. Merging these groups would require legislative change, but appears to be supported by industry and ADIs could easily absorb the small numbers involved. Some administrative efficiency gains could be expected from merging the assets of these institutions with the associated ADI for the purposes of calculating the levy.

PRESS RELEASE AND TERMS OF REFERENCE FOR REVIEW OF FINANCIAL SECTOR LEVIES

C115/02

29 October 2002

Review of Financial Sector Levies

The Minister for Revenue and Assistant Treasurer, Senator Helen Coonan, today announced the terms of reference for the Review of the Financial Sector Levies.

Under current arrangements, the financial sector levies are set annually to cover the operational costs of the Australian Prudential Regulation Authority (APRA), and market integrity and consumer protection functions of the Australian Securities and Investments Commission (ASIC) and the Australian Taxation Office (ATO). They are paid by regulated financial institutions and generally levied as a percentage of assets held by each entity, subject to minimum and maximum levy amounts.

The Review will be chaired by the Treasury and undertaken jointly by Treasury and the APRA in consultation with ASIC and the ATO.

The Review's terms of reference are attached.

"The Review is required to evaluate the arrangements for the determination of levies that are imposed on the financial services sector to support the prudential regulation undertaken by APRA, ASIC and the ATO," Senator Coonan said.

'The Review will make recommendations on any changes that need to be made to the current arrangements.'

'In reaching its recommendations, it will balance accountability, efficiency, transparency and equity with simplicity of administration and collection.'

'It will also ensure that recommended options 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.'

The Treasury and APRA will seek submissions from relevant industry groups shortly. These submissions will be used to help prepare a discussion paper that will form the basis for further extensive consultation.

It is envisaged that any changes arising from the Review's recommendations will take effect from the beginning of the 2004-05 financial year and that levies for the 2003-04 financial year will be established on the basis of the existing levy-setting arrangements.

Terms of Reference for the 2002-03 Review of Financial Sector Levies

Mission

The Review is required to evaluate the arrangements for the determination of levies that are imposed on the financial services sector to support the operations of the Australian Prudential Regulation Authority (APRA), and certain operations of the Australian Securities and Investments Commission (ASIC) and the Australian Taxation Office (ATO).

The Review is to be chaired by the Treasury and undertaken jointly by the Treasury and APRA in consultation with ASIC and the ATO. It is to include a programme of consultation with industry and to ensure that all industry concerns are fully canvassed.

A written report of the Review is to be provided to the Minister for Revenue and Assistant Treasurer by 1 April 2003. This report will outline the principal advantages and disadvantages of the existing arrangements, identify other options and make recommendations with a view to any changes being implemented to take effect from the 2004-05 financial year.

Specifics

1. Supervision of regulated institutions in the financial services sector is to be paid for collectively by those institutions. In reaching its recommendations, the Review will balance accountability, efficiency, transparency and equity with simplicity of administration and collection. It will ensure that options have the capacity to provide stable and effective funding for the regulator on a sustainable basis and to meet the evolving needs of effective prudential supervision into the future at a reasonable cost.
2. The Review will examine concerns expressed by institutions and industry bodies arising from operational experience with the existing arrangements.
3. General matters that will need to be considered include:
 - whether factors other than cost of supervision in an industry sector over time (for example, risk management and stakeholder value in the industry sector) should be taken into account in setting any industry levies;
 - the most appropriate basis for such a levy; and
 - the relative merits of alternative systems for levying regulated bodies, such as:
 - the current system;
 - other industry specific systems;
 - a uniform levy arrangement;
 - separate arrangements for diversified and specialised institutions; and
 - arrangements specific to each institution (such as direct cost recovery).
4. Specific matters that will need to be considered include:

- whether total assets continue to be the most appropriate basis for determining relative levy shares amongst prudentially regulated institutions and what other options there may be;
- the experience on fees for service and their role in future funding, including consideration of any relevant recommendations arising from the Productivity Commission's Review of Cost Recovery Principles to Government Agencies;
- the relationship between the levies raised under current arrangements and the cost of supervision of particular sectors;
- appropriate arrangements for reporting the costs of supervision on an ongoing basis;
- the desirability of levies being set annually, as at present, or for a longer period;
- the desirability of a maximum cap on the levy for particular institutions and, if a cap is deemed appropriate, how it should be set;
- the appropriateness of the existing levy minima; and
- what legislative change might be desirable or necessary to implement different options and what transitional arrangements might be needed.

COMMONWEALTH GOVERNMENT POLICY ON COST RECOVERY BY GOVERNMENT AGENCIES

The Productivity Commission (PC) Report No 15, *Cost Recovery by Government Agencies*, was tabled in Parliament on 14 March 2002. The report made 23 recommendations. The Commission's recommendations aimed to promote economic efficiency and improve the accountability and transparency of cost recovery arrangements and proposed cost recovery guidelines for agencies.

Following an interim response to this report, in which the Government agreed that all cost recovery arrangements should have clear legal authority and that revenue from cost recovery should be transparently identified, on 4 December 2002 it announced a formal policy on cost recovery. The policy's intention is to deliver benefits to small business, industry and consumers by improving the consistency, accountability and transparency of cost recovery arrangements.

This policy is based largely on the recommendations of the Productivity Commission and requires that fees and charges set by government agencies reflect the costs of providing the relevant products or service. According to the new policy, certain overhead and infrastructure costs that are not directly linked or integral to the product or service will not be recovered.

- Agencies with significant cost recovery arrangements will be required to have adequate mechanisms for stakeholder consultation, which may include consultative committees with stakeholder representation.
- The policy applies immediately to new cost recovery proposals and will be progressively phased in for existing government cost recovery arrangements. All significant existing cost recovery arrangements will be reviewed over a five-year period, according to an agreed schedule.

Among the specific requirements of the Government's cost recovery policy are the following:

- cost recovery arrangements should have clear legal authority;
- cost recovered revenue should be clearly identified in agency financial statements in both annual reporting and portfolio budget documentation;
- cost recovery arrangements should have sound economic underpinnings and should not be undertaken solely to raise revenue for Government activities;
- cost recovery arrangements should, as a matter of principle, be considered on an activity basis rather than as broadly applying to the agency as a whole;
- where functions undertaken for Government are directly linked to service and product delivery, they are validly considered to be integral to the costs of the activity and should be included in agency charging; and
- in some instances it may be appropriate for entities to introduce levies rather than a fee for service;

- significant cost recovery arrangements should have appropriate mechanisms to promote consultation with stakeholders.

While the specific application of cost recovery and accountability requirements will likely be a little different in the case of prudential supervision and regulation than for other activities undertaken by public sector agencies, the underlying policy itself will apply. The policy explicitly recognises that it may be appropriate for entities to introduce levies rather than a fee for service regime.

All significant existing cost recovery arrangements are to be reviewed over a five-year period, according to an agreed schedule announced by the Government.

MAJOR ALTERNATIVE MODEL OPTIONS AND ASSESSMENT CRITERIA

Model	Key Features	Accountability and Transparency	Efficiency	Equity	Capacity to provide stable and effective funding	Simplicity (administration/ collection)
Fee for Service	Each institution is invoiced for the cost of prudential work attributed to that particular institution.	<p>Each institution has access to details of regulatory actions undertaken by the regulator in relation to that institution.</p> <p>Direct costs associated with those regulatory actions are available to the institution.</p>	<p>Cost volatility and uncertainty for institutions.</p> <p>Funds normally not paid or received until after the service is completed.</p> <p>Uncertainty of funding for regulators may impact on planning and staff training and retention.</p> <p>Institutions in difficulty discouraged from seeking assistance from the regulator.</p> <p>May delay ability of regulator to respond quickly to sector specific difficulties.</p>	<p>Avoids cross subsidisation and minimises risk of 'good' institutions subsidising 'bad' institutions.</p> <p>May impose greatest relative cost on those in relatively greatest financial difficulty.</p>	<p>Uncertain flow of revenue to regulators.</p> <p>Revenue flows normally occur only after completion of the relevant service, leading to cash-flow concerns for regulators.</p> <p>Source of funding for supervision of failing institutions unclear.</p> <p>Institutions most in need of supervision are unlikely to be in a favourable position to pay for this supervision.</p>	<p>Extensive record keeping required.</p> <p>Administratively expensive.</p> <p>Potential for increased cost of disputes as to appropriateness of services, charges for them.</p>

<p>Current Sectoral Model</p>	<p>Costs are allocated between sectors of the financial services industry. A levy rate per dollar of assets is set for each of the industry sectors. Current model incorporates minimum and maximum amounts for each sector.</p> <p>The cost of supervising each sector is budgeted each financial year.</p>	<p>Does not allow for identification of costs incurred by APRA on individual institutions.</p> <p>No disclosure of the levy charged to each institution.</p> <p>Audited annual report is prepared each year.</p> <p>Budget estimates are prepared for each financial year.</p> <p>APRA, through its board, must keep the Treasurer (and Finance Minister) informed of its operations and give the Ministers such reports, documents and information in relation to its operations as requested. (This would apply to any model.)</p>	<p>Relatively little volatility from year to year.</p> <p>Possibly limits the ability to move funds from one sector to another to respond to urgent concerns (if spending in any particular sector constrained to funds raised from that sector in a given year).</p> <p>Institutions have the incentive to 'whistleblow' poorly performing institutions.</p>	<p>Some cross subsidisation, (both vertical and horizontal)</p> <p>Relatively close link between cost of regulatory activity and cost recoveries.</p>	<p>Limited financial strain placed on vulnerable institutions.</p>	<p>Some administrative complexity.</p> <p>Trade-off exists between administrative complexity and other assessment criteria.</p>
<p>Universal Levy Model</p>	<p>Cost recovery on an aggregate basis only.</p> <p>A single levy rate on assets is set across all industry sectors.</p>	<p>Need to impose strong accountability and transparency requirements on such a design.</p> <p>Cross subsidisation likely.</p>	<p>Allows the quick movement of resources to emerging areas of concern.</p> <p>Does not allow for differing intensity of prudential supervision between industry sectors (and institutions).</p>	<p>Substantial vertical and horizontal cross subsidisation can occur.</p>	<p>Substantial cross subsidisation may put pressure on sustainability.</p> <p>Limited financial strain placed on vulnerable institutions</p>	<p>Administratively simple.</p>

<p>Maximum Levy Amount</p>	<p>A maximum levy amount is set for each industry sector.</p> <p>Beyond a certain size the increase in size of assets of an institution does not add to the cost of prudential supervision.</p>	<p>Maximum levy amounts are disclosed.</p> <p>Further justification of the level of the maximum amount may be needed.</p> <p>Can result in substantial differences between effective and nominal levy rates, especially for very large institutions.</p>	<p>Avoids larger entities having to pay more as their assets grow when the incremental supervision costs to the regulator are negligible.</p> <p>Places burden of increased costs of the sector on those institutions large enough to be able to bear increased costs, but that are below the cap.</p>	<p>Considerably smaller sized institutions can pay levies close to the maximum amount imposed on larger institutions.</p> <p>Systemic risk associated with larger entities may need to be taken into account when setting the maximum levy amount.</p> <p>Larger entities may be subsidising smaller institutions if the maximum is set too high, but otherwise medium-sized institutions bear the burden of overall cost increases.</p>	<p>Mergers and takeovers involving firms at or close to the cap may lead to reductions in total levy revenue.</p>	<p>Cap adds complexity to any basic model.</p> <p>Relatively simple to administer when compared with implementing a step based approach</p>
<p>Stepped Levy Rates</p>	<p>A single levy rate applies up to a certain threshold level. Above that threshold, a different (lower) rate applies. Can involve a number of different thresholds and levy rates.</p>	<p>Differences between effective and nominal levy rates minimised.</p>	<p>Differences between effective and nominal levy rates minimised.</p> <p>Understanding of cost structure of regulation may be less sophisticated than stepped levy rates assume.</p>	<p>Recognises that supervisory costs increase with size of regulated institution, but not at same rate as for smaller institutions.</p>	<p>Mergers and takeovers involving shift to higher category might lead to reductions in total levy revenue.</p>	<p>More complex than a single cap approach.</p>