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Parliament of the Commonwealth of Australia

# **Review of the Australian Prudential Regulation Authority:**

**Who will guard the guardians?**

House of Representatives  
Standing Committee on Economics Finance and Public Administration

October 2000  
Canberra

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## Foreword

This is the House Economics Committee's first report on the Australian Prudential Regulation Authority's (APRA) supervision and prudential regulation of those areas of the financial services sector for which it has responsibility.

APRA is a new regulator. It was created as a result of a change in the focus of financial regulation from sector based regulation to risk based regulation following the Wallis Report. APRA was created by merging 11 regulatory organisations, including those parts of the Reserve Bank of Australia responsible for banking regulation and the Insurance and Superannuation Commission supervision department.

The Committee has been given a standing reference by the Minister for Financial Regulation, the Hon Joe Hockey MP to inquire into APRA's activities, and expects to deliver a similar report annually. The regular review of APRA's activities will dovetail with its biannual review of the Reserve Bank to form a comprehensive accountability mechanism for those organisations that safeguard Australia's financial system.

This report focuses on issues discussed in the September 2000 public hearing with APRA, and incorporates information derived from APRA's *Annual Report 2000*, and from the comprehensive documentation produced by APRA as it has been updating Australia's prudential regulations.

As APRA is a new organisation, this report deals extensively with APRA's administrative arrangements in addition to APRA's regulatory activities and the state of Australia's financial institutions. I expect that future reports will reflect a greater concentration on regulation and the regulated industries.

In a benevolent economic environment, APRA appears to have managed the transition to the new regulatory framework well, and is progressing regulatory reform in most regulated industries. Nevertheless, the Committee has made two

recommendations and has indicated it will monitor APRA's progress in a number of areas.

In undertaking this review, the Committee appreciates the excellent assistance and cooperation given by APRA's staff, especially the CEO Mr Graeme Thompson and the Secretary Ms Thea Rosenbaum. The Committee has been impressed with the level of professionalism demonstrated in APRA's approach to the inquiry.

I thank all of the members of the Economics, Finance and Public Administration Committee for their contributions to the public hearing and to this report.

**David Hawker MP**  
**Chair**



## **Membership of the Committee**

**Chair** Mr D P M Hawker MP

**Deputy Chair** Ms A E Burke MP

**Members** Mr A N Albanese MP

Ms T Gambaro MP

Mrs K E Hull MP

Mr M W Latham MP

Ms T Plibersek MP

Mr C M Pyne MP

Hon A M Somlyay MP

Dr A J Southcott MP

## **Committee Secretariat**

**Secretary** Ms B Forbes

**Inquiry Secretary** Mr K Bodel

**Administrative Officers** Ms B Zolotto

Ms S Jurcevic







## **Terms of reference**

On 29 March 1999 the Minister for Financial Services and Regulation, the Hon. J Hockey MP, provided the Economics Committee with a standing reference to review and report on the Australian Prudential Regulation Authority's supervision and prudential regulation of those areas of the financial services sector for which it has responsibility.





## List of abbreviations

ACCC	Australian Competition and Consumer Commission
ADI	Authorised Deposit-taking Institution
ANAO	Australian National Audit Office
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ATO	Australian Taxation Office
CPA	Certified Practising Accountants Australia
IMF	International Monetary Fund
ISC	Insurance and Superannuation Commission
OECD	Organisation for Economic Cooperation and Development
RBA	Reserve Bank of Australia
SIS Act	<i>Superannuation Industry (Supervision) Act 1993</i>





## List of recommendations

### Recommendation 1

That the Government review Regulation 6.21(3A) of the *Superannuation Industry (Supervision) Act 1993* to make it less onerous for working people over the age of 65 to continue to contribute to a superannuation fund. (para 3.42)

### Recommendation 2

That APRA provide yearly statistics which include the location and level of face to face banking in Australia. (para 3.58)



# INTRODUCTION

## Background to the inquiry

- 1.1 In March 1997, the Financial Systems Inquiry, commonly known as the Wallis Committee, recommended a reorganisation of the Australian financial services regulatory framework. Part of the recommended reorganisation was the formation of a single prudential regulator for the financial services sector.<sup>1</sup>
- 1.2 As part of the implementation of the Wallis Committee recommendations, the Australian Prudential Regulatory Authority (APRA) became fully operational on 1 July 1998.<sup>2</sup>
- 1.3 APRA describes its purpose as the:

... prudential regulation of Australia's financial institutions. This means we promote business behaviour by deposit takers, insurers and superannuation funds to maximise the likelihood that they will remain in a sound financial condition so that they can meet their repayment obligations to depositors, policy holders or fund members, as the case may be...<sup>3</sup>
- 1.4 APRA has been provided with comprehensive powers in its area of responsibility, including the licensing of financial institutions, and making

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1 Financial Systems Inquiry. *Financial Systems Inquiry Final Report*. 1997. Melbourne, FSI, pp 312-317.

2 Department of the Treasury. 'Reform Of The Australian Financial System.' *Economic Round-Up*, Winter 1998. Canberra, AGPS, p 19.

3 Evidence p 2.

standards on prudential matters in relation to Authorised Deposit Taking Institutions (ADIs), superannuation funds, and insurance companies.<sup>4</sup>

1.5 It is also useful to clarify what APRA is not responsible for. During the 4 September 2000 hearing, APRA indicated:

...We are not responsible for policing competition in financial markets, for standards of disclosure about products and services or for how banks and others handle customer complaints and disputes. We are not responsible for fees, charges or interest margins, or for the representation of financial institutions in particular regional areas.

1.6 APRA is funded by levies paid by regulated financial institutions and is accountable through an independent board. To ensure there is a close relationship between the Reserve Bank of Australia (RBA), the Australian Securities and Investments Commission (ASIC), and APRA, the RBA has two representatives and ASIC one representative on the APRA board.<sup>5</sup>

1.7 APRA is split into three divisions: the Diversified Institutions Division; the Policy, Research and Consulting Division; and the Specialised Institutions Division. APRA's head office is in Sydney, with regional offices in Adelaide, Brisbane, Canberra, Melbourne and Perth. The Diversified Institutions Division, and Policy, Research and Consulting Division, along with APRA's administration, are based in the Sydney head office. The Specialised Institutions Division has staff in the Sydney head office as well as the regional offices.<sup>6</sup>

## Scope and conduct of the inquiry

1.8 In the Committee's *Reviews of the 1995-96 Annual Reports of the Reserve Bank of Australia, Australian Securities Commission, and the Insurance and Superannuation Commission*, the Committee recommended that APRA appear before the House Economics Committee once a year to report on the prudential supervision of the financial services industry.<sup>7</sup> The

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4 Department of the Treasury. 'Reform Of The Australian Financial System.' *Economic Round-Up*, Winter 1998. Canberra, AGPS, p 20.

5 Department of the Treasury. 'Reform Of The Australian Financial System.' *Economic Round-Up*, Winter 1998. Canberra, AGPS, p 20.

6 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, pp 13-14.

7 House of Representatives Standing Committee on Economics, Finance and Public Administration. *Reviews of the 1995-96 Annual Reports of the Reserve Bank of Australia, Australian*



Committee indicated it wanted to review APRA's performance once the RBA no longer had prudential regulation responsibilities.<sup>8</sup>

- 1.9 On 29 March 1999, the Minister for Financial Services and Regulation provided the committee with a standing reference to review and report on APRA's supervision and prudential regulation of those areas of the financial services sector for which it has responsibility (see p *vii* for Terms of Reference).
- 1.10 On 4 September 2000, the Committee held its first public hearing with APRA in Canberra. Details of the hearing are set out in Appendix B. A copy of the transcript of evidence from the hearing has been published by the Committee and is available on the inquiry internet site<sup>9</sup> and from the committee secretariat.
- 1.11 Following the hearing, APRA made a submission to the Committee to follow up additional issues. A copy of that submission is at Appenix C and is also available on the inquiry internet site and from the committee secretariat.
- 1.12 APRA's *Annual Report 2000*, which was tabled in parliament on 5 September 2000, was also considered during the drafting of this report. While the *Annual Report 2000* fulfils all the necessary technical reporting requirements, the Committee believes that the annual report could be used more effectively by APRA as a regulatory and public accountability tool. APRA has a long way to go in its reporting activities before it reaches the high standards set by the RBA's *Annual Report 2000*. The Committee suggests a significant improvement by APRA in this area.
- 1.13 As the 4 September 2000 hearing was the first appearance by APRA before the Committee, the Committee addressed a wide range of issues relating to prudential regulation and APRA's administration. This report reflects the broad focus of that hearing. The report is structured into two chapters. Chapter 2 focuses on APRA's administration, including progress in the implementation of the Wallis Committee recommendations relating to

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*Securities Commission, and the Insurance and Superannuation Commission*. 1997. Canberra, AGPS, p 17.

8 House of Representatives Standing Committee on Economics, Finance and Public Administration. *Review of The Reserve Bank of Australia Annual Report 1997-98: Interim Report*. 1999. Canberra, AGPS, p 10. See also House of Representatives Standing Committee on Economics, Finance and Public Administration. *Review of The Reserve Bank of Australia Annual Report 1997-9*. 1999. Canberra, AGPS, pp 22-31, and House of Representatives Standing Committee on Economics, Finance and Public Administration. *Review of The Reserve Bank of Australia Annual Report 1998-99: Interim Report*. 2000. Canberra, AGPS, p 43.

9 <http://www.aph.gov.au/house/committee/efpa/apra9899/index.htm>.

prudential regulation, and the administration of levies. Chapter 3 addresses APRA's prudential regulatory activities across all regulated sectors.

- 1.14 As the Committee has a standing reference from the Minister for Financial Services to inquire into APRA's prudential regulation activities, this report is the first of a regular series. The Committee expects to review APRA's performance annually as it does biannually with the RBA.

## ADMINISTRATION

- 2.1 APRA has been supervising banks, insurance firms and superannuation funds for just over two years, and credit unions and building societies for just over 12 months. APRA is the single prudential supervisor of financial institutions in Australia. It brought together the prudential supervisory responsibilities of 11 separate agencies.<sup>1</sup>

### Wallis Committee recommendations

- 2.2 The Wallis Committee recommended the establishment of a new regulatory entity to undertake prudential regulation of the financial system, and made a number of further recommendations establishing the scope of the proposed regulator.<sup>2</sup> The specific aims of the new prudential regulator were to:
- reduce supervisory costs for regulated industries through administrative economies;
  - develop a harmonised approach to supervising similar risks and activities whenever they occur in the financial system;
  - apply a more flexible approach to dealing with structural change in the financial system; and
  - develop more effective supervision of financial conglomerates.<sup>3</sup>

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1 Evidence p 17.

2 Financial Systems Inquiry. *Financial Systems Inquiry Final Report*. 1997. Melbourne, FSI, pp 297-319. See also Australian Prudential Regulation Authority. *Annual Report 99*. 1999. Sydney, APRA, p 5.

3 Evidence p 3.

## Early indicators of APRA's performance

- 2.3 Gauging how well APRA has implemented the aims of the Wallis Committee is an important early indication of how effectively the organisation is operating. It is easier to assess APRA's progress in some of these aims than others.
- 2.4 According to APRA, in relation to administrative economies, the operating cost of its prudential regulation has dropped from \$56 million in 1997-98 to an estimated \$51 million in the 2000-01 financial year. This has been achieved at a time when financial institutions have grown in complexity and increased in size by about 35%.<sup>4</sup> APRA believes this is a reasonable administrative saving, and will be seeking to keep its costs steady in real terms in the future.<sup>5</sup>
- 2.5 Some advances have been made in the harmonisation of prudential regulation. These are dealt with in more detail in Chapter 3. However, the regulation of mutual institutions, such as credit unions, has exposed some difficulties in reconciling a more flexible approach to prudential regulation with the aim of developing a harmonised approach to regulation.
- 2.6 Recommendation 54 of the Wallis Committee report states that restrictions on the classes of debt and equity that may be issued by a mutual institution should be removed to the greatest extent possible on the basis that protection for depositors is enhanced by increasing funding from non-depositor sources, such as shareholders.<sup>6</sup> According to APRA, mutual institutions face some difficulties in retaining their mutual status when they issue these forms of debt. ASIC has issued a set of principles detailing how a mutual can raise capital from its members and preserve mutuality, and work is continuing in this area.<sup>7</sup>
- 2.7 Another concern for mutual organisations is the new capital standard, which restricts the portion of tier 1 capital<sup>8</sup> based on the issue of preference shares to 25%. Apart from capital raised through retail banking, mutual institutions are restricted to raising capital through preference shares, as other forms of capital raising threaten their

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4 Evidence p 3.

5 Evidence p 8.

6 Financial Systems Inquiry. *Financial Systems Inquiry Final Report*. 1997. Melbourne, FSI, pp 357-358.

7 Evidence p 12.

8 Tier 1 capital is the highest quality capital for the purposes of meeting capital adequacy standards.

mutuality. In relation to this issue, APRA recognises that within the harmonised approach there needs to be some flexibility.<sup>9</sup>

- 2.8 Credit unions have sought to have their members' shares recognised as tier 1 capital for the purposes of capital adequacy. On this question, APRA states it will look at the situation on a case by case basis. The issue is one of the permanence of the shares. The international definition of shares as tier 1 capital requires that the shares be permanent and that the people holding the capital should not have the right to withdraw it. According to APRA, a mutual institution needs to show that it remains in control of its members' shares in order for these shares to be considered as tier 1 capital.<sup>10</sup>
- 2.9 Overall, in relation to the difficulties faced in reconciling harmonisation and flexibility, APRA states:
- Harmonisation means a single look and feel to the prudential standard guidelines...But different parts and different approaches within those standards will be relevant to smaller, less sophisticated institutions than the parts that are relevant to the larger banks. We are talking about harmonisation rather than an identical set of requirements across the board.<sup>11</sup>
- 2.10 Reconciling flexibility and harmonisation will require further work by APRA before a sensitive and prudent solution is found to the problems posed by mutual institutions. The Committee will monitor this area of APRA's work in the future and looks forward to seeing progress in the current financial year.
- 2.11 With regard to dealing with structural change in the financial system, such as the growth in the number and complexity of conglomerate institutions, APRA indicates that the process of change is a continuing one, so it may never be possible to say that APRA's job is complete.<sup>12</sup> However, APRA has created a Diversified Institutions Division to regulate conglomerates and is in the process of developing a regulatory framework for conglomerates (see Chapter 3).<sup>13</sup>
- 2.12 Overall, in the opinion of Mr Graeme Thompson, APRA's CEO:

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9 Evidence p 11.

10 Evidence p 13.

11 Evidence p 14.

12 Evidence pp 6-7.

13 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p24.

...the task of establishing the new institution...is just about complete...<sup>14</sup>

- 2.13 Notwithstanding this APRA has commenced a project to see what useful indicators can be developed in measuring the implementation of the aims proposed by the Wallis Committee.<sup>15</sup> The Committee looks forward to the outcome of this investigation.

## Relations with other regulatory bodies

### National regulatory bodies

- 2.14 In order to effectively perform its regulatory functions, APRA must have close contact with the other organisations in the financial regulatory framework. To facilitate this, APRA has negotiated Memoranda of Understanding delineating lines of responsibility and methods of cooperation with: the RBA;<sup>16</sup> ASIC;<sup>17</sup> the Australian Taxation Office (ATO);<sup>18</sup> and the Australian Competition and Consumer Commission (ACCC).<sup>19</sup> APRA's Chair, Dr Jeffrey Carmichael, recognised that:

While APRA's role is, in principle, distinct, in practice it continues to overlap – or at least abut – the roles of the other financial regulatory agencies...<sup>20</sup>

- 2.15 Evidence from some of regulated industries indicates that the separation of responsibilities still requires some work. The Corporate Super Association has indicated that APRA and ASIC have applied different interpretations of the regulations concerning pooled superannuation

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14 Evidence p 6.

15 Evidence p 3.

16 *Memorandum of Understanding: The Reserve Bank of Australia and the Australian Prudential Regulation Authority*. Australian Prudential Regulation Authority Media Release, 12 October 1998. See also House of Representatives Standing Committee on Economics, Finance and Public Administration. *Review of the Reserve Bank of Australia Annual Report 1997-98: Interim Report*. 1999. Canberra, AGPS, p 30.

17 *Memorandum of Understanding: The Australian Securities and Investment Commission and the Australian Prudential Regulation Authority*. Australian Prudential Regulation Authority Media Release, 12 October 1998.

18 *Memorandum of Understanding between the Australian Prudential Regulation Authority and the Australian Taxation Office*. Australian Prudential Regulation Authority Media Release, 16 April 1999.

19 *ACCC/APRA Sign Memorandum of Understanding*. Australian Prudential Regulation Authority Media Release, 2 December 1999.

20 Australian Prudential Regulation Authority. *Annual Report 99*. 1999. Sydney, APRA, p 2.

trusts, and these differing interpretations are constraining the activities of superannuation funds.<sup>21</sup>

- 2.16 APRA indicates that part of the problem for the superannuation and insurance industries is that previously, the Insurance and Superannuation Commission (ISC) handled all regulatory activities in their sector. Under the current, functional, division of responsibility, prudential supervision resides with APRA, disclosure and market conduct is with ASIC, and the development of new legislation is the responsibility of the Department of the Treasury. Regulated industries are still coming to terms with this arrangement, and this may be the source of much of the frustration being expressed.<sup>22</sup>
- 2.17 APRA recognises the need to work closely with other regulatory agencies, especially ASIC, to minimise the duplication and inconsistencies and to share information and cooperate in taking action wherever necessary.<sup>23</sup>
- 2.18 APRA states that over the past year it has expended a large amount of time developing liaison and consultation processes with ASIC, and the two regulators meet often. Special focus groups discuss issues such as the consistency of legislative interpretations, identifying enforcement options, and surveillance programs and techniques.<sup>24</sup>
- 2.19 Effective relations between APRA and other national financial regulatory bodies is clearly a key to the success of the current regulatory structure. The Committee will monitor these relationships to ensure they remain sound.

## International regulatory bodies

- 2.20 APRA has an active international presence providing technical assistance and training to supervisors in emerging economies, particularly in the Asian region. Supervisors from agencies in Fiji, India, Korea, Malaysia, New Zealand, and Papua New Guinea have spent time in APRA offices over the past year.<sup>25</sup>
- 2.21 APRA also participates actively in a number of international fora, such as the International Association of Insurance Supervisors (for which APRA

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21 Senate Superannuation and Financial Services Select Committee. *Hansard*. 15 June 2000. p SFS372.

22 Evidence p 19.

23 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 33. See also Submission p S7.

24 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 34.

25 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 35.

currently chairs the solvency subcommittee); the Basel Committee on Banking Supervision; the Core Principles Liaison Group and the associated Capital Liaison Group; the Joint Forum (on cross sectoral financial regulation); the IMF; the World Bank and the OECD Insurance Committee. While the Committee supports APRA's activities in this area, it would not wish to see these international activities being undertaken at the expense of getting APRA fully operational at this early stage in its development.

## **APRA's funding - Levies**

2.22 APRA is funded by levies paid by regulated financial institutions based on a percentage of assets held by the entity, subject to minimum and maximum levy amounts. This system attempts to ensure that the levy paid by each class of entity reflects the actual cost of supervising those entities.<sup>26</sup> The administration and determination of levies has been an ongoing point of contention for APRA since its inception. At the outset of the discussions about levies during the hearing, APRA stressed that the levies are set by the government and not by APRA. However, APRA indicated it is able to make recommendations to the government on this matter.<sup>27</sup>

## **Differences in levies between sectors**

2.23 In April 1999, the umbrella Association of Super Funds Australia estimated that superannuation funds were paying about 40% of the running costs of APRA while ADIs were paying 16%.<sup>28</sup> In addition, based on asset value, large ADIs (banks) currently pay significantly less than other institutions towards the cost of running APRA. While the assets of the big four ADIs (banks) represent 60% of the capital under regulation, in 1998-99, they paid only 16% of ADI regulatory costs. The apparent anomaly occurs because there is a maximum levy for any institution of \$1 million, resulting in ADIs with asset bases of over \$90 billion paying the same amount as ADIs with asset bases around \$20 billion.<sup>29</sup>

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26 Department of the Treasury. 'Reform Of The Australian Financial System.' *Economic Round-Up*, Winter 1998. Canberra, AGPS, p 21.

27 Evidence p 7.

28 *Super funds rail against soaring fees*. Blue, Tim. *The Australian*, 15 April 1999.

29 *Small banks protest over big four's APRA fees*. van Leeuwin, Hans. *Australian Financial Review*, 25 March 1999.



- 2.24 At the hearing, APRA indicated that there are two reasons why the superannuation sector provides the bulk of levy funding. Firstly, there are more APRA staff involved in supervising superannuation than any other sector. Second, the number of institutions is large. APRA is supervising between 4,000 or 5,000 superannuation funds compared with 50 or 60 banks.<sup>30</sup>
- 2.25 With regard to minimum and maximum levies, APRA's view is that the current levy structure is logical. Minimum levy payments are imposed because there is a minimum level of expenditure required to supervise an organisation regardless of its size. Maximum levy payments are imposed because beyond a certain size the cost of supervising an entity does not increase regardless of the size of the asset base.<sup>31</sup>
- 2.26 In addition, APRA claims it is very difficult to develop an accurate measure of exactly how much regulatory effort goes into individual financial institutions or individual groups of financial institutions. Regulatory effort will also vary from one year to the next. APRA reported that:

The bottom line here is that it is virtually impossible to come up with a formula for calculating levy rates for cost recovery of an organisation like APRA that will satisfy everybody every year.<sup>32</sup>

## Levy reviews

- 2.27 The Australian National Audit Office (ANAO) performance audit into the *Management of Commonwealth Non-primary Industry Levies*, tabled in February 2000, found that APRA was unable to accurately capture the administrative costs associated with the particular levies, and had significantly overcharged and undercharged on particular levies.<sup>33</sup>
- 2.28 In response to these concerns, on 3 August 1999, the Minister for Financial Services and Regulation announced a review of financial sector levies to determine whether existing levy arrangements were providing an effective funding mechanism for the supervision of prudential regulation.<sup>34</sup>

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30 Evidence p 10.

31 Senate Economics Legislation Committee. *Estimates Hansard*. 31 May 2000. p E320.

32 Evidence p 9.

33 Australian National Audit Office. *Audit Report No. 32: Management of Commonwealth Non-primary Industry Levies*. 2000. Canberra, AGPS, p 13.

34 House of Representatives Standing Committee on Economics, Finance and Public Administration. *Review Of The Reserve Bank Of Australia Annual Report 1997-98: Interim Report*. 1999. Canberra, AGPS, p 31.

- 2.29 The Minister indicated that industry groups were widely consulted during the levy review. The review found that the government should:
- continue imposing levies on a sectoral basis;
  - provide the ability to rebate excess levies back to industry in the event of overcharging;
  - recognise the lower level of demand placed on Australia's regulators by foreign bank branches in Australia; and
  - require regulators to provide more detailed specific activity cost information to assist with the levy setting process.
- 2.30 Broadly, the review has resulted in only small changes to the original levy framework.<sup>35</sup>
- 2.31 The outcome of the review contributed to the determination of the new financial sector levy structure for the 2000-01 financial year, released in June 2000. Total revenue collection from the financial sector during the financial year will reduce from \$66.6 million to \$61 million. This amount funds both APRA and ASIC. The levies will change in the following ways:
- superannuation levies will be halved to 0.02% of assets because of excess levy collections over the previous financial year;
  - the maximum levy payable by superannuation entities has increased by \$5 000 to \$46 000;
  - ADIs will have a slightly reduced levy rate because of overcollection in the previous financial year; and
  - general insurers will face an increased maximum levy, up from \$75 000 to \$100 000, because of increased supervisory work in this sector.<sup>36</sup>
- 2.32 APRA has also developed an averaging system for the determination of levy rates, which is aimed at preventing volatility in rates from one year to the next.<sup>37</sup>

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35 *Financial sector levies for 2000-01*. Minister for Financial Services and Regulation Media Release, 9 June 2000.

36 *Financial sector levies for 2000-01*. Minister for Financial Services and Regulation Media Release, 9 June 2000.

37 Evidence p 10.

## Future changes to levy arrangements

2.33 APRA admits that it is not comfortable with the current levy framework:

...increasingly as we go forward it will be more difficult to allocate costs to the traditional industry groups.<sup>38</sup>

2.34 While APRA does measure its administrative costs, it has difficulty in allocating those costs accurately to different sectors of the financial system. The measurement of administrative costs is done imperfectly at present because the legislative arrangements are based on collections from different sectors while APRA's work is organised on a risk basis.<sup>39</sup>

2.35 Another reason why APRA would like the levies changed is the growing number of conglomerate entities. Under the present arrangements, a levy is made under each licensed entity in a conglomerate, while the conglomerate is supervised as a single entity.<sup>40</sup>

2.36 In 2003 there will be a review of the effectiveness of the changes recommended in the Wallis Committee report. At that review, APRA hopes that the levy arrangements will change:

We hope that, when we get to 2003 and the whole framework is looked at afresh, we might be able to move to a single framework with a single levy across all industry groups.<sup>41</sup>

2.37 While the Committee sees merit in the concept of a single levy system, APRA must continue to work on methods for measuring the actual costs of supervising the individual entities to ensure that each entity is appropriately levied.

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38 Evidence p 9.

39 Evidence p 9.

40 Evidence p 10.

41 Evidence p 9.

## Staffing and service standards

- 2.38 APRA has 425 staff, half of whom are located in Sydney with the other half spread between Canberra, Melbourne, Brisbane, Perth, Adelaide and Hobart.<sup>42</sup>
- 2.39 As part of the restructuring process and the consolidation of APRA's head office operations in Sydney, a number of experienced staff previously based in Canberra left the organisation.<sup>43</sup> The lack of experienced staff appears to have had a noticeable impact on relations between the superannuation and insurance industries and APRA. Criticism from the insurance and superannuation sectors have included that APRA is unable to retain good staff, that all the knowledge officers have left, and that this has had a real and dramatic effect on service levels.<sup>44</sup> On the whole, APRA rejects such criticism:
- ...We certainly do not get a general view from industry that service levels are as poor as suggested...<sup>45</sup>
- 2.40 However, in response to a claim by some regulated entities that inquiries of a general nature were responded to promptly, while it was difficult to get a response to inquiries of a complex nature, APRA indicated that:
- That is useful feedback...We do not pretend that these new arrangements can be bedded down perfectly overnight...<sup>46</sup>
- 2.41 The prudential supervisory responsibilities of 11 separate agencies were combined in APRA. That has meant a good deal of work on internal management and organisational issues in APRA's short life. In addition, APRA also expects its staff to operate across regulatory boundaries, and has decided to regulate regional institutions in the regions.
- 2.42 A related problem is the fact that, under the ISC, insurance and superannuation organisations could talk to one organisation about virtually any regulatory matter to do with their sector. This has now been replaced with a functional separation between regulators. A situation which the industries may not yet have adapted to. As a result, regulated industry have had to get used to new staff and new administrative

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42 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 94.

43 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 3.

44 Evidence p 17.

45 Evidence p 17.

46 Evidence p 17.

arrangements, and APRA has had to train a number of its staff on their new responsibilities.<sup>47</sup>

- 2.43 APRA reports that it has invested over \$823 000 on learning and development activities during the 1999-2000 financial year. This was distributed through a studies support scheme and a learning and development program. The studies support scheme covered applications for post graduate qualifications, while the learning and development program covered technical cross skilling training, management, communication, and information technology skills development. The cross skilling program was designed to meet the immediate technical needs of staff as they were selected for their new cross functional roles in APRA's new structure. In-house APRA experts delivered the training.<sup>48</sup>
- 2.44 APRA now believes it has adequate staff numbers and professional people to carry out its functions. When questioned about the morale of staff, Mr Thompson indicated that, although it was difficult to generalise, he believes staff morale was good.<sup>49</sup> In its submission, APRA also indicates that its Board is regularly informed of staff issues.<sup>50</sup>
- 2.45 Currently, APRA states that there are some pockets of staffing where there are gaps to fill, and APRA is going to the market to fill those gaps. The jobs are in the Sydney market, and are therefore hard to fill. However, across the board staffing is no longer a major issue for APRA.<sup>51</sup>
- 2.46 APRA has advised that there are some relativity issues in relation to staff pay. These stem from the different pay structures APRA inherited from previous organisations. APRA has not yet solved all the anomalies and distortions that were inherited from that process.<sup>52</sup>
- 2.47 On the whole APRA claims its standard of service in a number of areas is high. To demonstrate this, APRA quoted its national superannuation call centre, which operates at world's best practice, answering 900 calls a day with 90% being answered within 10 seconds.<sup>53</sup>
- 2.48 It is a cliché that the staff of any service organisation are its lifeblood. The bedding down of staff picture that APRA paints is not wholly supported

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47 Evidence pp 17-19.

48 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 37. See also Evidence p 30 and Submissions p S5.

49 Evidence p 30.

50 Submissions p S5.

51 Evidence p 30.

52 Evidence p 32.

53 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 19.

by everyone. At this stage the Committee is not in a position to reach a conclusion on the success or otherwise of APRA's staffing position. Accordingly, if this is seen as a problem when the Committee next meets with APRA, it will follow up with comments from APRA's staff and clients.

## PRUDENTIAL REGULATION

3.1 Over recent years, Australian financial institutions have operated against a background of a buoyant domestic economy and a more stable international environment. Total assets of the financial sector grew by around 11% in 1999-2000 to \$1 615 billion. Rationalisation has continued to be a feature of the financial sector, and there has been increased interest in the use of internet and electronic commerce, but these areas of the financial market are still in their infancy.<sup>1</sup> According to Mr Thompson:

In the main, prudential supervision concerns have not been significant, although the flow on effects from natural disasters in 1999 have constrained the general insurance and domestic reinsurance sectors.<sup>2</sup>

3.2 Of the industries regulated by APRA, banking was the most profitable, experiencing growth in assets during the 1999-2000 financial year of 18%, while superannuation grew at 17%. Building societies and credit unions experienced growth of around 5% during the financial year. However, in general insurance, profits were in general flat, with a third of registered general insurers experiencing a loss over the financial year.<sup>3</sup> The performance of each of these sectors is dealt with in greater detail below.

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1 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 8. See also Evidence pp 4-5.

2 Evidence pp 4-5.

3 Evidence pp 5-6.

## APRA's focus

- 3.3 APRA is a risk based prudential regulator. That is, APRA is concerned with how financial institutions control the risks in their activities in order to maximise the likelihood that financial institutions will be able to honour their obligations to their depositors and share holders.<sup>4</sup>
- 3.4 According to APRA, the major areas of focus in the prudential area in the last year have been:
- substantially completing a review of the prudential standards for conglomerate entities;
  - participating in the Basel Committee on Banking Supervision's review of the 1988 capital accord;
  - harmonising prudential standards for ADIs; and
  - commencing a major review of the prudential supervision of general insurers.<sup>5</sup>

These areas of focus are expanded on below.

## Conglomerates

- 3.5 Increasingly, financial services of all kinds are offered not by single stand-alone organisations, but within conglomerates or group structures containing different types of financial institutions with different risk profiles. Typically, some of these activities are covered by regulators while others are not.<sup>6</sup> These conglomerates have provided APRA with significant new challenges. Principle amongst these has been how to measure and manage risk across a diverse set of activities.<sup>7</sup>
- 3.6 APRA has conducted a review of the regulatory framework for conglomerates in two stages. The first stage was completed in early 2000, and dealt with: ownership of conglomerates by non-operating holding

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4 Evidence pp 2 and 26.

5 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 3. See also Evidence p 4.

6 *Prudential Supervision of Conglomerates*. Australian Prudential Regulation Authority Media Release, 11 March 1999.

7 Australian Prudential Regulation Authority. *Prudential Supervision of Conglomerates*. 1999. Sydney, APRA, p 2. See also Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 4.



companies; the limits of financial activities by non ADI sections of conglomerates; and group wide risk management practices. The second stage is currently under way, and is dealing with: capital adequacy; the treatment of capital in non ADI sections of conglomerates; and intra and extra group exposures.<sup>8</sup>

## Authorised Deposit-taking Institutions

- 3.7 Authorised Deposit-taking Institutions (ADIs) include such entities as banks, building societies, credit unions and friendly societies. During the hearing the Committee explored APRA's use of the generic term 'ADI' as a descriptor for these institutions. APRA indicated that the generic term was adopted in order to prevent any suggestion that there were first or second class deposit taking institutions in relation to prudential standards, while allowing these institutions to continue to differentiate themselves in the market place as banks, credit unions or building societies.<sup>9</sup>
- 3.8 In the banking sector, profits have been high, despite the continued decline in interest margins. Asset growth of about 11% and increases in non interest income have generated after tax returns to the equivalent of 18%. Bad debts remain low by historical standards. The capital ratio of the banking sector is 10%, much the same as it was two years ago. This compares with the standard minimum ratio of 8%.<sup>10</sup>
- 3.9 Banks are becoming more active in managing their capital. This is because of their efforts to maintain their returns on equity in the face of strong competition and their ability to measure their internal capital requirements more accurately than in the past. As a result, share buy-back and securitisation programs have become more common and currently an amount equivalent to around 7% of banks' collective balance sheets has been securitised and sold to investors.<sup>11</sup>
- 3.10 Building societies and credit unions experienced average growth of around 5% over the past year. Consolidation remains a significant issue in these sectors, with the number of institutions continuing to trend down and being much lower than five years ago.<sup>12</sup> Credit Unions in Australia

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8 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 24.

9 Evidence pp 15-16.

10 Evidence p 5.

11 Evidence p 5.

12 Evidence p 5.

have \$21.5 billion in assets compared to \$759 billion for all ADIs,<sup>13</sup> or about 2.8%. In contrast, in the United States, in 1999, credit union share of total assets was at 5.8%.<sup>14</sup>

- 3.11 Building societies' and credit unions' share of household deposits has increased over recent years. However, household deposits are only growing in line with the economy. These entities have not participated in the growth in superannuation or share ownership, so have only grown at 7-8% rather than 18% for banks.<sup>15</sup>

### APRA's activities

- 3.12 In APRA's view, the significant issues in relation to ADIs have been: the review of capital adequacy requirements; the harmonisation of prudential standards; the regulation of purchased payment facilities; and the regulation of credit derivatives.<sup>16</sup>

### Capital adequacy

- 3.13 Capital adequacy refers to the amount of capital held by ADIs to cover losses. Capital adequacy requirements for Australian ADIs are currently based on the Basel Committee on Banking Supervision's 1988 *International Convergence of Capital Measurement and Capital Standards*, commonly known as the Basel Accord.<sup>17</sup>
- 3.14 In June 1999, the Basel Committee released a draft replacement for the Basel Accord called *A New Capital Adequacy Framework*. The Basel Committee's proposed new Accord consists of three pillars: minimum capital requirements; a supervisory review process; and effective use of market discipline.<sup>18</sup>
- 3.15 APRA supports the general thrust of the new Accord. However, APRA believes some areas of the Accord should be reconsidered, including the

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13 Reserve Bank of Australia. *Bulletin*. September 2000. Sydney, RBA, p S3.

14 Credit Union National Association. *Depository Institutions Historical Profile: United States Totals*. Madison, CUNA, p 1.

15 Evidence pp 14-15.

16 Submissions p S2.

17 *Risk and Capital Management – An Overview*. Matten, Chris. *Risk and Capital Management: Conference Papers*. 2000. Sydney, APRA, p 9.

18 Basel Committee On Banking Supervision. *A New Capital Adequacy Framework*. 1999. Basel, Basel Committee on Banking Supervision, pp 1-2.

50% risk weight attached to housing loans, which it believes should be reduced.<sup>19</sup>

- 3.16 In addition, APRA welcomes the Basel Committee's recognition that the Accord ought to be suitable for application to ADIs of varying levels of complexity.<sup>20</sup> There is no indication at this stage when the new Accord will be finalised.

### Harmonisation

- 3.17 APRA's major activity in the area of ADI regulation has been the harmonisation of prudential standards across ADIs:

...we aim to create a single, consistent set of prudential rules for all deposit-takers – banks, building societies and credit unions – by mid 2000.<sup>21</sup>

- 3.18 The new standards came into effect on 1 October 2000.<sup>22</sup>

- 3.19 APRA intends to undertake a second stage of investigation, involving a more thorough reassessment of the harmonised standards, to ensure they address all significant risks facing ADIs.<sup>23</sup>

### Purchased payment facilities

- 3.20 Purchased payment facilities are facilities that a consumer pays for in advance and then uses to make various types of payments. A good example is a smart card. APRA believes that if a customer is entitled to demand repayment in Australian currency for the balance of the stored currency, then the purchased payment facility is akin to a deposit. On this basis, APRA and the RBA have determined that the holder of the stored value is carrying on the business of a bank, and should be regulated as such.<sup>24</sup> The Committee believes more work needs to be done to differentiate between larger and smaller amounts of repayment before smart card operators are required to obtain a banking licence.

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19 *Review Of Capital Adequacy Requirements*. Australian Prudential Regulation Authority Media Release, 15 March 2000. See also Australian Prudential Regulation Authority. *Review Of Capital Adequacy Requirements*. 2000. Sydney, APRA, p 2.

20 Australian Prudential Regulation Authority. *Review Of Capital Adequacy Requirements*. 2000. Sydney, APRA, p 3.

21 Australian Prudential Regulation Authority. *Annual Report 99*. 1999. Sydney, APRA, p 25.

22 *APRA releases ADI standards*. Australian Prudential Regulation Authority Media Release, 11 September 2000.

23 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 23.

24 *Regulation of Purchased Payment Facilities*. Australian Prudential Regulation Authority Media Release, 15 June 2000.

- 3.21 Purchased payment facilities are one of a number of means by which non ADIs can participate in the payments system. APRA indicates that it has received approximately ten inquiries from non ADIs seeking to become payment services providers. These proposals involve internet based payment services as well as purchased payment facilities. According to APRA, it is difficult to say at this stage whether these proposals will require an ADI licence.<sup>25</sup>

### Credit derivatives

- 3.22 Credit derivatives (also called securitised loans) are contractual arrangements that allow ADIs to hedge their exposures to particular borrowers and write large volumes of loans without breaching internal credit limits by allowing a third party to adopt the credit risk.<sup>26</sup> Since credit derivatives facilitate the transformation of credit risk profiles, concentrations of credit exposure may be hidden. Consequently, APRA has issued guidelines that require ADIs to inform APRA of any concentration in exposures. The guidelines also deal with the capital adequacy requirements relating to the risks involved in this sort of activity.<sup>27</sup>

### Fit and proper

- 3.23 An ADI must ensure that its directors and senior management are fit and proper to hold their positions. According to APRA's guidelines, this involves being able to demonstrate expertise in the field; and competence, integrity and a good reputation in business.<sup>28</sup> During a recent Senate Estimates hearing, APRA revealed that it had not determined precisely how it would define whether an individual was fit and proper.<sup>29</sup>
- 3.24 At the Committee's hearing, APRA pointed out that as a result of the harmonisation process, a fit and proper requirement has only recently been applied to ADIs. It said, rather than APRA imposing a prescriptive approach, institutions are required to have good systems in place so they
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25 Submissions pp S3-S4.

26 *APRA Draft Guidelines Get Cool Reception*. Hogan, Roger. *Australian Financial Review*, 20 December 1999.

27 Australian Prudential Regulation Authority. *Guidance Note To Prudential Statement C1, Capital Adequacy of Banks: Capital Adequacy Treatment of Credit Derivatives in the Banking Book*. 1999. Sydney, APRA. See also Australian Prudential Regulation Authority. *Guidance Note To Prudential Statement C3, Capital Adequacy of Banks: Capital Adequacy Treatment of Credit Derivatives in the Trading Book*. Sydney, APRA, pp 2-3.

28 Australian Prudential Regulation Authority. *Guidelines on Authorisation of ADIs*. 2000. Sydney, APRA, pp 4-5.

29 Senate Economics Legislation Committee. *Estimates Hansard*. 31 May 2000. p E325.

are sure the directors and senior management they are getting are fit and proper.<sup>30</sup> The Committee feels this response is less than adequate and looks to APRA to further justify its approach in the coming year.

### Credit card debt

- 3.25 During the hearing, the Committee inquired whether APRA had any concerns about the level of credit card and household debt. In November 1999, the RBA estimated that the ratio of household debt to disposable income in Australia had reached the level of 94%.<sup>31</sup>
- 3.26 APRA indicated that household debt has been an area of focus for the organisation in its consultation with ADIs to ensure they had systems in place to monitor the debt. APRA also indicated that it does not monitor household debt directly, but rather monitors ADIs to ensure they are effectively monitoring household debt.<sup>32</sup> This is a matter that does concern the Committee and we will continue to monitor it.

### Superannuation

- 3.27 In 1999-2000, the superannuation sector continued to grow rapidly. Growth in the past year was about 17%, and there are now just over \$450 billion worth of savings in superannuation funds. Polarisation is the key to the superannuation market currently, with superannuation business moving out of mid range funds to either the largest 360 funds or down to small funds of less than five members.<sup>33</sup>

### APRA's activities

- 3.28 A number of issues have arisen in relation to APRA's supervision of the superannuation industry. These are: APRA's approach to supervision; the responsibilities of auditors to superannuation funds; the quality of super fund trustees; and the regulatory approach to people who are over 65 years of age and still working. Staffing in this area is also an issue, see paragraphs 2.38-2.44.

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30 Evidence p 33.

31 Reserve Bank of Australia. *Semi-Annual Statement on Monetary Policy, November, 1999*. RBA, Sydney, p 17.

32 Evidence pp 22-23.

33 Evidence p 6.

- 3.29 Amendments to the *Superannuation Industry (Supervision) Act 1993* (SIS Act) transferred the regulation of excluded superannuation funds with fewer than five members from APRA to the ATO on the basis that all members are fund trustees and should be able to protect their own interests.<sup>34</sup>

### APRA's approach

- 3.30 As the regulation of a large number of the smaller funds has now moved to the ATO, APRA is considering how to regulate the remaining funds.<sup>35</sup> APRA's approach is risk based, involving assessing which funds are riskier than others (for a description of APRA's methodology, see paragraphs 3.6-3.10).<sup>36</sup>
- 3.31 From the perspective of the superannuation funds, the new approach is considered intrusive, and they believe APRA:

... needs to embark on a campaign to explain its role...<sup>37</sup>

APRA's response has been that:

We believe that we are not a black letter law regulator. Our approach is to be consultative and flexible, but to draw a firm line when we need to, and I think we have the resources, the talent, the experience to supervise in that mode.<sup>38</sup>

- 3.32 It is the view of the Committee that new regulatory bodies have a responsibility to educate both the organisations being regulated and the general public about the relative benefits of the adopted regulatory approach. Such education cultivates an understanding about the regulator's role. From the Committee's investigations there appears to be a need for APRA to take on a more educative role with the regulated industries. APRA should ensure that it commits adequate resources to that task. The Committee will follow this up at the next hearing.

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34 *APRA passes small super fund administration to ATO*. Australian Prudential Regulation Authority Media Release, 19 October 1999.

35 Evidence p 19. See also Australian Prudential Regulation Authority. *Annual Report 99*. 1999. Sydney, APRA, p 19. See also *The Energetic Enforcer*. Hely, Susan. *Superfunds*, No 227, July 1999, p 19.

36 Evidence pp 19-20.

37 *Sizing Up APRA: Friend or Foe*. McIlwraith, John. *Superfunds*, No 227, July 1999, p 15.

38 Evidence p 17.

## Superannuation auditors

- 3.33 At the hearing, APRA said its reviews of superannuation funds have revealed a number of instances in which auditors are not fulfilling their responsibilities.<sup>39</sup> Many auditors are continuing to sign audit reports without completing the required audit work or without the required level of knowledge and skill.<sup>40</sup> CPA (Certified Practising Accountants) Australia has also raised the quality of superannuation fund auditors, indicating they are working with APRA to raise the standard of superannuation auditing.<sup>41</sup>
- 3.34 APRA does not believe that poor auditing quality is a system wide problem, although it admits there are certain cases where governance has not been as strong as it should have been.<sup>42</sup> The activities of nine auditors of superannuation funds were reviewed during the year 1999-2000, resulting in three auditors being disqualified and two being referred to their professional association for disciplinary action.<sup>43</sup>

## Trustees

- 3.35 The *Australian Financial Review* reported on comments by Deloitte Touche Tohmatsu national partner, Mr Richard Rassi, concerning the level of neglect by super fund trustees. According to Mr Rassi, three out of four super funds have prudential and compliance issues of some description. The major areas of concern are the irregular reconciliation of assets, important profit and loss items, and membership rolls. According to Mr Rassi, trustees are not adequately trained, and lack accounting or business backgrounds.<sup>44</sup>
- 3.36 In evidence, APRA said it does not agree with this assessment, arguing that only a minority of funds suffer from these problems and that the situation is improving.<sup>45</sup> There are fewer super funds than there used to be, so there is an increasing pool of people with experience available to perform the role of trustees. In addition, it is now common for trustees of medium to larger funds to develop, with the help of professionals,

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39 APRA. Coulthard, Murray. *Charter*, No 11, December 1998, p 63.

40 *Auditors don't always add up*. Adams, Wayne. *The Australian*, 9 December 1998.

41 Senate Superannuation and Financial Services Select Committee. *Hansard*. 15 June 2000. p SFS437.

42 Evidence p 20.

43 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 16.

44 *Super fund trustees accused of neglect*. Dunstan, Barrie. *Australian Financial Review*, 5 April 2000.

45 Evidence p 11.

training packages for themselves so that new trustees go through a training regime.<sup>46</sup>

### Over 65s

- 3.37 Under Regulation 6.21(3A) of the SIS Act, superannuation funds are required to check on a monthly basis whether contributors over the age of 65 years are still eligible to make superannuation contributions. In order to continue contributing, contributors must work over ten hours a week.
- 3.38 APRA has recommended that the employment status of people who fit this criteria be checked every month. One problem with this approach is that people who fit this criteria will have to respond to superannuation fund correspondence every month in order to remain a member. If they miss a correspondence, the fund will be required to pay out their benefit.
- 3.39 When this happens, two further problems emerge. The first is that because the fund is unable to communicate with the member, the member may not be able to instruct the fund on the preferred method of receiving their benefit. The second is that, if the member is still properly employed, they will have to pay to reinvest their benefit.<sup>47</sup>
- 3.40 Unfortunately, the legislative requirements in this area are quite prescriptive and APRA's view is that there is no scope for an alternative approach.<sup>48</sup>
- 3.41 The Committee believes that, given the greater flexibility in work patterns, there should also be a more flexible approach to the superannuation treatment of employees over the age of 65.

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### Recommendation 1

- 3.42 **That the Government review Regulation 6.21(3A) of the *Superannuation Industry (Supervision) Act 1993* to make it less onerous for working people over the age of 65 to continue to contribute to a superannuation fund.**

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46 Evidence p 22.

47 Investment and Financial Services Association. *Submission to the Senate Superannuation and Financial Services Select Committee*. 2000. Sydney, IFSA, p 396.

48 Submission pp S8-S9.



## Insurance

- 3.43 The year 1999-2000 was one of continuing difficulties for general insurance sector. This is a similar picture to that of the previous financial year and partly reflects the continued effect of natural disasters experienced over the previous few years. Problems generally focussed on the reinsurance sector of the market. This small segment of the market recorded losses of \$3 billion in 1999-2000. Overall solvency levels within the industry remained well above statutory minimums and Australian policy holders were not affected by the disruptions to this sector.<sup>49</sup>
- 3.44 The life insurance industry saw some further restructuring during the financial year, with mergers amongst some of the larger players encouraged by increasing competitive pressure in the international and domestic market.<sup>50</sup>

## APRA's activities

- 3.45 APRA points out that the performance of the insurance sector underscores the need for prudent underwriting and a strong, risk focussed management, particularly in high-risk areas such as reinsurance. The experience also strengthens the need for reform of the supervisory framework for the general insurance sector.<sup>51</sup>

## Reform of prudential regulation for general insurers

- 3.46 In April 2000, APRA released a policy discussion paper on the reform of the prudential supervision of general insurance companies.<sup>52</sup>
- 3.47 The purpose of this paper was to set out detailed proposals on a new prudential regulation regime for general insurance companies. The scope of the proposals cover all insurance companies authorised to conduct business in Australia with the exception of Lloyd's underwriters.<sup>53</sup>
- 3.48 The paper sets out a series of principles for the proposed supervisory regime:

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49 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 10. See also Evidence p 5.

50 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 11.

51 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 11.

52 Australian Prudential Regulation Authority. *Proposed Reforms to the Prudential Supervision of General Insurance Companies in Australia*. 1999. Sydney, APRA, 36 p.

53 Australian Prudential Regulation Authority. *Proposed Reforms to the Prudential Supervision of General Insurance Companies in Australia*. 1999. Sydney, APRA, p 4.

- it will be targeted at the protection of policy holders;
- it will be more responsive to the risk profiles of individual insurance companies;
- it will enhance the transparency of the general insurance industry;
- it will reflect international best practice;
- it will minimise restrictions on competition;
- it will reflect APRA's supervisory objective of regulating like risks in a like manner across industries; and
- it will respond appropriately to risks that may affect the ability of a general insurer to meet its policy holder liabilities.<sup>54</sup>

3.49 APRA is proposing to make new prudential standards for: capital adequacy; liability valuation; qualitative requirements for reinsurance arrangements; and operational risk.<sup>55</sup>

### Capital adequacy

3.50 APRA's policy discussion paper points out that the current minimum capital adequacy requirements for general insurers, set at \$2 million, is too low in comparison with the other institutions regulated by APRA. However, 40 of the 160 authorised general insurers are currently subject to the \$2 million minimum capital adequacy rule, so any change to this rule will have a substantial impact on a number of players in the industry.<sup>56</sup>

3.51 APRA is proposing to increase the minimum capital adequacy requirement to \$5 million. Current market participants will have up to five years to reach this level of capital adequacy.<sup>57</sup>

3.52 APRA indicates that many of these smaller insurers are a part of larger conglomerates, which may minimise the level of restructuring in the industry. In addition, APRA believes that any restructuring should impact minimally on service levels to particular areas or in particular sectors of the general insurance market. APRA intends to test the proposed capital adequacy standards using actual company data to assess

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54 Australian Prudential Regulation Authority. *Proposed Reforms to the Prudential Supervision of General Insurance Companies in Australia*. 1999. Sydney, APRA, p 5.

55 Australian Prudential Regulation Authority. *Proposed Reforms to the Prudential Supervision of General Insurance Companies in Australia*. 1999. Sydney, APRA, p 6.

56 Submissions p S6.

57 Australian Prudential Regulation Authority. *Proposed Reforms to the Prudential Supervision of General Insurance Companies in Australia*. 1999. Sydney, APRA, pp 8-9.

the precise impact of the proposal.<sup>58</sup> It said this test will be under way by the end of 2000. The Committee will monitor this process closely.

- 3.53 APRA said these proposals are unlikely to have an effect on the competitiveness of the industry because the top 20% of the industry write about 90% of the business.<sup>59</sup>

## Collection of statistics

- 3.54 APRA is currently undertaking a review of its statistics collection that it expects to take up to two years to complete. Its aim is to remove the old collections that are not much use and install new collection that are. APRA says it is interested in the collection of quantitative rather than qualitative data, so the new collections will cover the quantitative aspects of the financial services sector, but will not cover a lot of the qualitative aspects.<sup>60</sup> Overall, APRA says it will move towards a comprehensive, integrated and modernised set of data collections. The key problems currently identified by the review are:

- the presence of disparate data collection systems from predecessor agencies;
- the complex data structures that have built up over time, making frontline supervisors dependent on the handful of people who understand the system;
- the extensive resources required to support and maintain the inherited systems;
- problems with the design and content of the statistical returns; and
- the labour intensive nature of the data collection systems.<sup>61</sup>

- 3.55 APRA says it has devised a two stage process for dealing with these problems. The first is to improve the performance of the existing systems. The second is to completely re-engineer the processes and practices associated with the collection and storage of statistics.<sup>62</sup>

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58 Submissions p S6.

59 Australian Prudential Regulation Authority. *Proposed Reforms to the Prudential Supervision of General Insurance Companies in Australia*. 1999. Sydney, APRA, pp 8-9.

60 Evidence p 24.

61 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 29.

62 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 30.

- 3.56 Ultimately, this change will require the replacement of the current fragmented legislative framework for the collection of statistics with a single piece of legislation to govern the collection of all information for regulated entities. Another objective will be to collect data electronically, using encryption mechanisms to ensure confidentiality, and to provide a single collection system to institutions to facilitate data entry of all important types of forms.<sup>63</sup>
- 3.57 The *Commonwealth Government Response to the Committee's Regional Banking Services: Money too far away* inquiry indicates that the government has advised APRA to take into account Recommendation 2 of that inquiry, which recommends the collection of comprehensive data on the access communities have to financial services, as part of APRA's review of statistics collection.<sup>64</sup> The breadth of means of access to banking services has increased significantly over the last five years, so APRA is looking at ways it can capture and measure that breadth of access in order to adequately respond to that recommendation.<sup>65</sup>

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## Recommendation 2

- 3.58 **That APRA provide yearly statistics which include the location and level of face to face banking in Australia.**

## Cross-sectoral issues

- 3.59 APRA has been exploring a number of cross-sectoral issues. One of these is operational risk. APRA was one of the first agencies to put in place an operational risk team, which examines the methods in place to prevent operational risk. The driving force behind establishing this team is the number of institutional failures that have occurred as a result of operational risk. APRA hopes the team will be able to undertake some benchmarking studies across the regulated industries to determine how these issues are dealt with. After that, APRA will release a discussion paper on the issue.<sup>66</sup>

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63 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 27.

64 Minister for Financial Services and Regulation. *Commonwealth Government response to the recommendations of the House of Representatives Standing Committee on Economics, Finance and Public Administration inquiry into Regional Banking Services*. 2000. Canberra, pp 6-7.

65 Evidence p 25.

66 Evidence p 27.

- 3.60 Another cross-sectoral issue for APRA has been the growth in electronic commerce. APRA has initiated a project to examine the prudential aspects of the rapid development of electronic commerce. The objectives are to ensure that financial institutions have adequate processes to identify, assess and manage the risks associated with electronic commerce. A consultative document will be produced in late 2000.<sup>67</sup>
- 3.61 The new cross-sectoral initiatives, along with APRA's proposed approach to levy restructuring discussed in Chapter 2, indicate that APRA is increasingly focussed on delivering regulation on a cross-sectoral basis where this is appropriate. The Committee will investigate these developments at future hearings.
- 3.62 Another example of APRA's cross-sectoral approach is its supervisory methodology. APRA's supervisory methodology is risk based, and differs between specialised institutions and diversified institutions, rather than between industry sectors.
- 3.63 In August 1999, the Specialised Institutions Division introduced a risk assessment system in which a single rating is assigned to each institution based on a risk assessment process.<sup>68</sup>
- 3.64 Supervisory staff are required to form an opinion on the capacity of an institution to manage the risks to which the institution is exposed. These opinions form an overall assessment of an institution's risk profile, which drives the development of an appropriate supervisory strategy and actions. The frequency and intensity of supervision varies based on the institution's overall risk profile as assessed by the supervisory staff. In this environment the supervisory review timetable for an institution that is considered low risk will span two to three years, while institutions regarded as high risk will have a review timetable of 6 months or less.<sup>69</sup>
- 3.65 Conglomerate entities require the oversight of individual regulated entities as well as oversight of the health of the whole group. This incorporates three broad activities:
- risk assessment;
  - execution of a supervision plan; and
  - ongoing evaluation.<sup>70</sup>

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67 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 27.

68 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 21.

69 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 20.

70 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 21.

- 3.66 The supervision of conglomerates comprises a cycle of work that is coordinated on an annual or longer basis, premised on continuous supervision or on-going monitoring. This involves:
- quarterly prudential reviews;
  - the application of an institutional risk rating;
  - a supervisory action plan;
  - a prudential consultation; and
  - site visits.<sup>71</sup>
- 3.67 Considering the number of institutions APRA is responsible for, the number of incidents of serious problems during 1999-2000 was relatively small. Most of APRA's actions relate to suggestions for improvements to risk management processes rather than observed lapses.<sup>72</sup>
- 3.68 The Rehabilitation and Enforcement area within the Specialised Institutions Division in APRA deals with those institutions where a significant impairment issue has been identified that will threaten the institution's viability. In these circumstances the supervision process is more intensive, involving high levels of interaction with the individual institutions, incorporating additional reporting requirements, monthly monitoring of performance, regular contact with institutional representatives and more on site visits. During the 1999-2000 financial year such intensive supervision successfully rehabilitated 22 institutions and was also involved in the smooth exit of 16 institutions from the market. Currently, 65 institutions remain under intensive supervision.<sup>73</sup>

## Overall conclusion

- 3.69 The Committee is satisfied with APRA's progress in the area of prudential regulation. Work in the area of conglomerate and ADI regulation appears to be progressing, while APRA has indicated that it will be focusing on insurance regulation in the near future. Performance by the regulated industries has on the whole been good.

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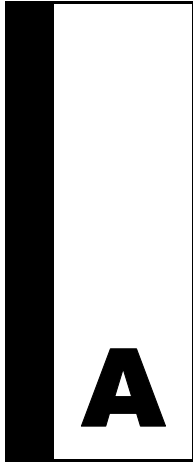
71 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 21.

72 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, p 17.

73 Australian Prudential Regulation Authority. *Annual Report 2000*. 2000. Sydney, APRA, pp 15-16.

- 3.70 The general view of the industries being supervised is that the transition to the new regulatory framework has been smooth, with a number of modest achievements. The Committee concurs with this view. APRA has successfully navigated the transitional period and its work towards establishing a new regulatory framework for Australia's financial institutions is progressing well.
- 3.71 However, it should be added that APRA has been fortunate to be born in a benign economic climate. The Committee will continue in its hearings to test these conclusions to determine whether APRA can cater for a less benign economic situation.

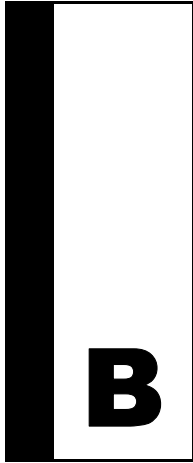
David Hawker MP  
Chairman  
12 October 2000



## **Appendix A – List of Submissions**

Submission No.	Individual/Organisation
1	Australian Prudential Regulation Authority





## **Appendix B – List of Public Hearings and Witnesses**

Monday, 4 September 2000 - Canberra

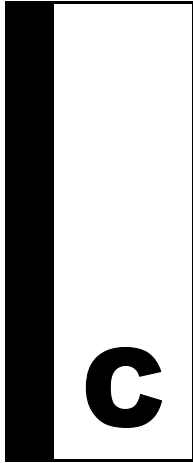
*Australian Prudential Regulation Authority*

Mr Brian Gray, Executive General Manager, Policy, Research and Consulting Division

Mr Tom Karp, Executive General Manager, Diversified Institutions Division

Mr Les Phelps, Executive General Manager, Specialised Institutions Division

Mr Graeme Thompson, Chief Executive Officer



## **Appendix C – APRA Submission**

**Hearing before House of Representatives Committee on Economics, Finance  
and Public Administration, 4 September 2000**

**Responses to written questions dated 11 September 2000**

### **Community obligations for banks**

- 1. Do fee-free banking products have any prudential implications for ADIs offering such products?***

The main concern of a prudential regulator like APRA is that ADIs are able to cover their aggregate operating costs and earn a reasonable return on their shareholders' funds. This is necessary if they are to remain viable and able to meet their obligations to repay depositors. The *structure* of fees and other charges with which ADIs recover costs is not, of itself, a matter of prudential interest.

- 2. Do banks have obligations to the wider community above and beyond their obligations to their shareholders? Is so, what are those obligations?***

APRA's primary concern is that banks can continue to meet their repayment obligations to depositors. APRA seeks to ensure this, as far as is practicable, through its powers of prudential supervision and crisis management.

**3. *Are there any prudential implications or concerns if the banks were to agree to a social charter of community obligations? What concerns would APRA have?***

APRA would carry out its responsibilities within the legislative framework provided by Parliament. It is conceivable that additional obligations imposed upon, or accepted by, banks would make prudential supervision more difficult.

### **Industry based depositor protection**

**4. *Does APRA agree with the approach to industry based depositor protection recommended in the Wallis report? What steps has APRA taken to implement and communicate this view?***

If this question refers to the Wallis Committee's recommendation for a single regime of prudential supervision for all deposit-takers, it is relevant to note that APRA has recently issued a single set of harmonised prudential standards covering banks, credit unions and building societies. This followed extensive consultation with industry. These standards provide a consistent framework of supervisory requirements across all ADIs but do not mean institutions that differ widely in size and sophistication have to observe exactly the same rules.

Alternatively, the question may refer to the Wallis Committee's support for the concept of industry-based self-help arrangements. The Committee said that participation in such schemes should be voluntary and should be taken into account in determining nature and intensity of prudential regulation applied to financial institutions. APRA agrees with those views and has communicated that to industry.

### **Payments systems**

**5. *How does payments systems impact on the prudential stability of ADIs?***

Robust and reliable payments systems – such as Australia has – are very important to the prudential stability of ADIs. Because ADIs can acquire very large settlement exposures with others, an unreliable payments system can create uncertainty and loss. Payments systems without devices to monitor and control settlement risk can cause problems in one part of the financial system to be spread quickly to otherwise healthy ADIs. For these reasons APRA takes a close interest in payments system safety and is represented on the Reserve Bank's Payments System Board.

**6. *Has APRA investigated the issue of competition in the payments systems?***

No. APRA has no power in relation to payments system competition – this is a responsibility of the Reserve Bank and the Australian Competition and Consumer Commission.

**7. *Does a payments systems competitor that is not an ADI require a licence?***

It is difficult to give a simple answer to this question because it is possible to participate and compete in the payments system in many different ways. Some activities require licences and others do not. For instance, a retail store does not need to be an ADI or to be otherwise licensed to issue credit cards that are used for certain payments.

Any institution wishing to combine payments services with *deposit taking* requires an ADI licence from APRA.

Non-ADI issuers of purchased payment facilities (eg stored value cards) also need to be licensed by APRA if the facility is widely used and has a feature allowing unused value to be redeemed for cash. Non-ADIs issuing purchased payment facilities that do not have these features require an authority from the Reserve Bank or an exemption from the Payment Systems (Regulation) Act 1998. (These arrangements are described in a Reserve Bank/APRA media release of 15 June 2000.)

An institution wishing to operate an *exchange settlement account* with the Reserve Bank needs to conform with the policy announced by the Bank on 1 March 1999. This provides that, while any ADI is eligible for such an account, non-ADIs will also be eligible if their payments business meets certain criteria.

**8. *What prudential barriers would a payments systems competitor need to overcome to receive approval?***

Payments system competitors that wish to take deposits need to satisfy APRA's normal prudential tests for ADIs.

APRA is currently developing supervisory requirements for non-ADIs wishing to issue purchased payment facilities and having the features referred to in the previous answer. It is likely that these will be similar to requirements for a normal ADI licence, but with some modifications. They will include requirements relating to capital and liquidity.

**9. *Have any groups/bodies corporate approached APRA about becoming payments systems providers?***

APRA has received approximately ten inquiries from non-ADIs about becoming payment service providers. The proposals have been at a preliminary stage and have involved plans for either stored value card or internet-based payment services.

**Credit card interchange fees**

**10. *Has APRA been consulted by the ACCC in relation to the ACCC's current investigation into credit card interchange fees?***

No. If any issues of a prudential nature were to arise in its investigation the ACCC would consult APRA. The APRA/ACCC Memorandum of Understanding (concluded in December 1999) provides for such consultation.

**Staffing**

**11. *How has APRA sought to retain and build its corporate memory?***

In filling positions in its new integrated structure last year, APRA sought to retain a critical mass of key, experienced staff and was mostly successful in doing so. The top forty officers presently engaged in prudential supervision in APRA all held senior or middle ranking positions in its predecessor agencies.

In establishing APRA there was of course some loss of experience at senior and middle levels. To an extent this was inevitable – indeed, necessary – if APRA was to deliver more cost-effective supervision than under the previous dispersed arrangements, and to have its key policy functions in Sydney. Predecessor agencies had some 550 jobs involved directly or indirectly with prudential supervision, while APRA's structure has around 420.

Moreover, for APRA to deliver the synergies expected by the Wallis Committee from pooling the expertise and procedures of the various predecessor agencies implied that people experienced in one part of the financial system would become engaged in supervising industry sectors with which they were unfamiliar in the early stages.

**12. Can you provide some detail on how APRA has trained both its new and old staff in the requirements of the new regulatory framework?**

APRA has conducted a very extensive internal training program over the past year, as described in its recent Annual Report. This has been designed to familiarise staff from predecessor agencies with industries and issues they had not previously encountered, as well as to bring new staff up to speed as quickly as possible. New recruits have strong backgrounds in accounting, economics and finance. From August 1999 to September 2000 over 1200 internal training sessions have been conducted – including basic technical training, risk assessment workshops and induction programs.

Internal training has been supplemented with external learning and development, including an active studies support program.

These programs are guided by the Learning and Development Reference Group, with representatives of both management and staff.

**13. Is the Board aware of any 'serious' staff issues? Are the staff related problems identified by the supervised institutions well understood by the Board?**

APRA's Board is regularly informed of issues affecting the management of the agency, including those to do with staff. It endorsed the restructure of APRA in 1999, including the movement of many staff into new roles, as essential to achieving an integrated approach to prudential supervision across the financial system. Members of the Board have close contacts with industry participants and would be aware of industry views.

### **General Insurance regulation**

**14. What types of insurance companies currently do not meet the proposed minimum capital adequacy requirements?**

The aim of APRA's proposed new capital requirements is to improve the protection available to policyholders - by tailoring capital more closely to the risk profile of individual general insurers. Compared with the present situation insurers with more risk in their business will have a higher minimum capital requirement relative to lower risk insurers.

APRA has undertaken some preliminary work to estimate the potential effect of the new requirements which will not be finalised for some time. As a general rule, we expect that for many companies, their minimum capital requirement will rise, but the impact will be alleviated by the fact that the industry as a whole currently has actual capital levels well in excess of the present regulatory minimums (around two and a half times the minimum). Even after the new arrangements are put into effect, overall capital holdings

seem certain to exceed the regulatory minimum level of capital by a significant amount. However, the distribution of required capital will change across the industry.

Until the new proposals are “road tested” with actual company data, it is difficult to assess the precise impact on individual insurers. APRA will be asking the general insurance industry to undertake this road-testing exercise toward the end of 2000. Results from this analysis will be used to recalibrate the proposals to remove any anomalies or unintended effects, and to ensure they do not generate commercially unrealistic outcomes.

On present indications, about 40 small insurers (those with required capital currently at \$2 million) will need to raise additional capital to meet a new minimum requirement (current proposals place this at \$5 million, to be more in line with minimum capital required in other parts of the financial sector). Many of these small companies, however, are also part of larger corporate groups (as a result of takeover activity, the top ten insurers hold one third of the 159 licences). These insurers may opt to consolidate licenses or access additional capital from within the group. Nonetheless, some rationalisation of small insurers is likely over the transition period, particularly in the case of small stand-alone companies. To facilitate the transition, APRA proposes a 5-year phase-in period once the industry consultation is complete and the new arrangements are introduced.

**15. *The increase in the minimum capital adequacy requirement will clearly involve a significant rationalisation of the general insurance industry. Will the rationalisation result in a loss of services in particular areas of the country or in particular sectors of the general insurance market?***

Any rationalisation is unlikely to have significant impacts on particular areas of the country or particular sectors of the market. While the reforms might reduce the number of insurers operating in Australia, APRA does not envisage any impact on competitiveness in the market. Currently, the top twenty insurers in the Australian market write 90 per cent of the premium revenue and that situation is unlikely to change. In addition, insurers do not typically maintain infrastructure in regional areas. Most insurance business, in contrast to banking, is conducted by way of call-centres or through agents. Therefore, any reduction in services to regional areas would be minimal.

**16. *What measures, if any, does APRA have in place to ensure that service levels are maintained for customers of smaller insurance firms?***

APRA’s reforms are intended to increase protection for policyholders.

Beyond that, as noted in the previous response, APRA does not expect its reforms to have any noticeable impact on service levels.

**Interaction with other regulatory bodies**

- 17. *How do you go about resolving conflicting interpretations of regulations by different regulatory bodies?***
- 18. *How are differences of interpretation detected? How long do they take to resolve?***
- 19. *Is APRA satisfied with the process for resolving conflicting interpretation of regulations?***

APRA is not aware of any “conflicting interpretations of regulations” by different regulatory bodies.

That said, APRA and other regulatory agencies, particularly ASIC and the RBA, need to work closely together to minimise overlaps and avoid gaps, and to ensure appropriate cooperation and information sharing. Mechanisms to help with this include the Council of Financial Regulators, the representation of ASIC and the RBA on APRA’s Board, representation of APRA on the Payments System Board, and by regular liaison meetings of both senior and operational staff.



**Hearing before House of Representatives Committee on Economics,  
Finance and Public Administration, 4 September 2000**

**Question taken on notice at the hearing**

***Why does APRA insist on people over 65 proving they are still in the workforce every month to be able to stay in a super fund?***

Regulation 6.21(3A) of the Superannuation Industry (Supervision) legislation requires the trustee of the fund to keep itself informed about the ongoing employment status of a member who is over 65. The regulations provide, subject to certain provisions, for compulsory cashing of some benefits as soon as practicable after the member turns 65 and is not "gainfully employed on either a full-time or part-time basis".

In addition, there is a requirement that:

- "(a) the trustee of the fund must make reasonable attempts to keep itself informed about the member's ongoing employment status; and
- (b) if the trustee of the fund cannot find out the member's ongoing employment status, the member is taken not to be gainfully employed."

The definitions are quite specific -

"Gainfully employed" means employed or self-employed for gain or reward in any business, trade, profession, vocation, calling, occupation or employment (SIS Reg.1.03(1)).

"Part time" in relation to gainful employment means gainfully employed for at least 10 hours, and less than 30 hours, each week (SIS Reg 1.03(1)).

"Full time" in relation to gainful employment means gainfully employed for at least 30 hours each week (SIS Reg 1.03(1)).

### **Consequences of these definitions**

#### ***Contributions:***

In the case of a member aged between 65 and less than 70, contributions can only be accepted by a fund in respect of that member if the member is gainfully employed on at least a part-time basis, or if contributions are mandated employer contributions (generally contributions made to satisfy an employer's Superannuation Guarantee obligations). (SIS Reg. 7.04(1B))

*Cashing of Benefits:*

The benefit payment standards of SIS require that, where a member aged 65 and less than 70 is not working at least on a part time basis, or if aged 70 or over on a full-time basis, benefits must be compulsorily cashed in favour of the member (SIS Regs. 6.21(1)(a) and (b)).

After a member turns 65 years, the trustee of the fund must make reasonable attempts to keep itself informed about the member's ongoing employment status. If the trustee cannot find out about the member's status, the member is taken not to be gainfully employed. (SIS Reg.6.21(3A))

It is a matter for the trustee of a superannuation entity to have arrangements in place to enable it to determine whether a member satisfies the relevant gainful employment test. In respect of members aged 65 or above, it is APRA's view that monthly monitoring is a reasonable approach to meeting the legislative requirement to test ongoing employment.

Given the clarity of the definitions, it is APRA's view that there is no scope for trustees to average the hours worked by a member over a period of time; nor is it acceptable for trustees to apply the gainful employment test, for members aged 65 or over, in other than a strict manner. Accordingly in the absence of other legislative direction, APRA considers that monthly reporting is appropriate.