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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 be 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.

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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 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.