

Senate Standing Committee on Economics

ANSWERS TO QUESTIONS ON NOTICE

Treasury Portfolio

Additional Estimates

23 – 24 February 2011

Question No: AET 183

Topic: Supervision of Conglomerates - Capital

Hansard Page: Written

Senator Bushby asked:

Supervision of conglomerates – capital

1. How do APRA's proposals for conglomerates compare with other jurisdictions?
2. Does consideration (and implementation of) Basel II and Basel III capital adequacy requirements affect the supervision of conglomerates initiative?
3. Has APRA consulted with ASIC on its conglomerate capital proposals?
4. Is APRA aware of ASICs proposals (ASIC Consultation Paper 140 Responsible Entities: Financial Requirements) for additional capital requirements on Responsible Entities of Managed Investment Schemes?
5. APRA and ASIC's methodologies are different – why is APRA basing its methodology on a proportion of funds under management while ASIC is basing theirs on a proportion of total revenue?
6. How will APRA ensure that double counting is avoided?
7. How will APRA's conglomerate capital proposals interact with the proposals in the Cooper review relating to increased capital requirements for all APRA regulated superannuation funds?
8. Won't superannuation funds which are part of conglomerate groups be placed at a competitive disadvantage to those which are not covered by these proposals if the Cooper recommendations are not introduced?
9. Do these proposals mean that superannuation funds which are part of conglomerate groups will be safer than those outside a conglomerate group because their parent entity will be required to hold additional capital?
10. The Government's Stronger Super paper commits APRA to developing a risk-based approach for capital requirements in superannuation – has APRA commenced developing this framework? Is this likely to be an operational risk reserve or trustee held capital?

Answer:

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Background

Prudential supervision can be conducted at three levels:

- Level 1. A stand-alone entity basis. This is the traditional regulated entity (e.g. a single bank, insurance company or superannuation fund).
- Level 2. An industry sector group. These groups are predominantly composed of entities that are concentrated in activities in a single APRA-regulated industry (e.g. a group comprising a number of general insurance companies).
- Level 3. A conglomerate group. These groups are composed of entities that have significant cross-industry activities; that is, groups that have material operations in more than one prudentially regulated industry (e.g. a group with banking and insurance entities) and/or have one or more material unregulated entities across different industries.

APRA has been supervising stand-alone entities (Level 1) since its inception. APRA has been supervising banking and general insurance entities on a group basis (Level 2) for a number of years. APRA is currently consulting on proposals to supervise conglomerate groups (Level 3).

Group supervision takes account of the fact that many prudentially regulated entities that sit within a corporate group do not actually operate as fully stand-alone entities and their risks and operations need to be considered in the context of their broader group. APRA's approach to Level 2 group supervision essentially treats an industry sector group as a consolidated entity operating in that industry.

Conglomerate group supervision is primarily aimed at addressing contagion risk across a broad group. The global financial crisis highlighted the need for enhanced supervision of financial conglomerates to address the challenges and risks created by groups with activities in more than one financial industry or with a mix of activities across financial and non-financial industries, or across regulated and unregulated entities. Industry-specific supervision requirements do not adequately address the supervision of conglomerate groups and hence APRA is currently consulting on an appropriate framework for these groups.

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1. How do APRA's proposals for supervision of conglomerates compare with other jurisdictions?

The Joint Forum¹ is the key international group that has published principles on the supervision of financial conglomerates. APRA's proposals for the supervision of conglomerate groups align with these principles.

The Joint Forum principles on financial conglomerates are currently being reviewed and will be updated in response to a review that was commissioned by the G-20 Leaders in March 2009². APRA is an active participant in the Working Group reviewing the Joint Forum principles.

At this time, the only jurisdiction with published policies covering conglomerate groups is the European Union (EU). These policies are contained in the EU's Financial Conglomerates Directive (FCD). The FCD, which is also currently under review, provides specific legislation for the prudential supervision of financial conglomerates and financial groups involved in cross-industry activities. Many jurisdictions are currently developing conglomerate group policies that address the risks to regulated entities arising when they are part of a broader conglomerate group.

APRA's proposals for the supervision of conglomerate groups are more comprehensive than the FCD. APRA's proposed approach will allow effective supervision of any combination of industries within a conglomerate, on any ownership structure.

2. Does consideration (and implementation) of Basel III capital adequacy requirements affect the supervision of conglomerates initiative?

Consideration (and implementation) of the new BCBS capital proposals (Basel III) capital adequacy requirements indirectly affects APRA's proposed framework for the supervision of conglomerates.

¹ The Joint Forum (previously known as The Joint Forum on Financial Conglomerates) is an international group bringing together representatives from the international standard setters in each of the banking, insurance and securities sectors. It works under the international bodies for these sectors - the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS). The group develops guidance, principles and identifies best practices that are of common interest to all three sectors.

² G-20, 'Enhancing Sound Regulation and Strengthening Transparency', [www.g20.org/Documents/g20_wg1_010409\[1\].pdf](http://www.g20.org/Documents/g20_wg1_010409[1].pdf), March 2009.

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APRA's capital adequacy proposals for the conglomerate framework build on the existing standalone (Level 1) and industry group (Level 2) capital adequacy frameworks. Therefore, changes to these underlying frameworks will flow through to the proposed conglomerate capital adequacy framework. For example, any changes to the definition of capital arising from Basel III will flow through to the proposed conglomerate capital framework.

The Basel III proposals will be finalised prior to APRA finalising its Level 3 framework.

3. Has APRA consulted with ASIC on its conglomerate capital proposals?

APRA has provided briefings to ASIC on its Level 3 conglomerate proposals.

4. Is APRA aware of ASIC's proposals (ASIC Consultation Paper 140 Responsible Entities: Financial Requirements) for additional capital requirements on Responsible Entities of Managed Investment Schemes?

ASIC has provided briefings to APRA on its proposed additional capital requirements on Responsible Entities of Managed Investment Schemes (ASIC Consultation Paper 140 Responsible Entities: Financial Requirements). APRA considers that the differences in the nature of the superannuation and managed investment industries are such that it is not axiomatic that the same approach to capital adequacy should be used.

APRA's proposed capital requirement for conglomerate groups in respect of funds management activities (excluding life companies) is the greatest of:

- 0.25 per cent of funds under management; or
- any regulatory capital requirement of the entity (which would include the ASIC requirements); or
- the internal capital allocation of the entity.

5. APRA's and ASIC's methodologies are different – why is APRA basing its methodology on a proportion of funds under management while ASIC is basing its on a proportion of total revenue?

APRA's proposed capital requirements are assessed against the risk to the conglomerate group of its funds management activities. APRA considered a range of possible methodologies, including those based on revenue, during the development of its proposals.

APRA's proposed methodology is broadly based on the current capital requirements for funds management type activities conducted in a life insurance company, which

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is based on a proportion of funds under management. The life insurance regime is risk-based and funds management is a major activity for many life companies.

6. How will APRA ensure that double counting is avoided?

APRA is conscious of the need to ensure that there is no inadvertent double counting between APRA's and ASIC's regulatory requirements. APRA's proposed capital requirement for conglomerate groups in respect of funds management is provided in the response to question 4. As indicated, other regulatory capital requirements are taken into account in APRA's proposed approach for determining the capital requirement for Level 3 conglomerate groups.

In determining capital adequacy for a conglomerate group, APRA is proposing that a group assess, for its global operations, measures of capital to cover the risks that it faces (required capital) and the amounts of capital deemed to be eligible to cover risks (eligible capital). APRA's proposals provide direction on how these items should be calculated. To ensure consistent measures of capital adequacy, APRA seeks to ensure the same requirements are applied to similar areas of activity no matter in what location they are undertaken and regardless of any differences in local regulatory requirements applied to group members undertaking the same activity. This applies, for example, regardless of whether the business undertaken is banking, insurance or funds management.

The required capital in respect of any funds management operation within a conglomerate will be included in the determination of the overall required capital for the group based on APRA's proposed formula, as outlined in the response to question 4. Whatever eligible capital is held by a funds management operation is included within the group's aggregate total eligible capital. The difference between aggregate conglomerate group required capital holdings, and aggregate group eligible capital holdings, is then used to determine the overall capital position of the conglomerate group. Where local regulators require capital to be held within the funds management operations, the amount of any eligible capital held for this purpose will simply form part of group eligible capital for assessment of conglomerate group capital adequacy.

In the case where a funds management operation holds eligible capital, perhaps in response to local regulatory requirements, in excess of that required to meet its prudentially assessed required capital holdings, then any surplus eligible capital held by the funds management entity will be eligible to meet deficits in capital requirements elsewhere in the group. On the other hand, where capital held by a funds management operation to meet local regulatory capital requirements, if any, is less than that required under APRA's required capital assessment, the group will

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have a capital shortfall in the funds management operation that will need to be met by surplus eligible capital elsewhere in the group.

It should be noted, however, that APRA's capital requirements are about the group as a whole and APRA only assesses the capital needs and holdings of non-prudentially regulated entities as part of assessing total group financial strength. APRA does not set capital requirements for individual unregulated entities themselves.

7. How will APRA's conglomerate capital proposals interact with the proposals in the Cooper review relating to increased capital requirements for all APRA regulated superannuation funds?

The Cooper Review has recommended that new capital requirements for trustees, on a risk-weighted basis, be phased in over time.³

The final conglomerate proposals in respect of funds management activities will consider any new capital requirements for superannuation entities when the requirements arising from the Cooper Review are finalised.

The interrelationship between APRA's conglomerate proposals and any regulatory capital requirements applying to an entity within the group is explained in the response to question 6.

8. Won't superannuation funds which are part of conglomerate groups be placed at a competitive disadvantage to those which are not covered by these proposals if the Cooper recommendations are not introduced?

APRA's prudential focus is to ensure that adequate capital is held for the conglomerate group as a whole to ensure that APRA-regulated parts of the group are adequately protected from risks arising in other parts of the group, whether they be APRA-regulated or not. As a practical matter, the APRA capital requirements in this case are very small relative to the earnings available to trustees within a conglomerate group. In many instances, these requirements are less than what these entities already hold and also less than the reserves held by many superannuation entities that are not part of a financial conglomerate. APRA expects that any effect in this area will be too small to affect competition.

³ Recommendation 6.1 Review into the Governance, Efficiency, Structure and Operation of Australia's Superannuation System.

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9. Do these proposals mean that superannuation funds which are part of conglomerate groups will be safer than those outside a conglomerate group (because the former's parent entity will be required to hold additional capital)?

The safety of a superannuation entity must be assessed broadly. Capital support is only one aspect of such an assessment.

It is also important to separate a 'capital requirement' from the 'capital held' by a superannuation entity, which may be higher. Further, APRA's conglomerate proposals require capital to be held by the group and not specifically by the superannuation fund or its trustee.

10. The Government's Stronger Super paper commits APRA to developing a risk-based approach for capital requirements in superannuation – has APRA commenced developing this framework? Is this likely to be an operational risk reserve or trustee held capital?

APRA has done some preliminary thinking around the development of its approach for risk-based capital requirements for superannuation. APRA will await the outcomes of the Stronger Super consultative process to assist the development of the framework for operational risk reserves/capital, including whether it is likely to be a reserve or capital requirement.