

Senate Standing Committee on (Committee Name)

ANSWERS TO QUESTIONS ON NOTICE

Treasury Portfolio

Budget Estimates

1 June to 3 June

Question: BET 420

Topic: Written Questions from Senator Eggleston

Authorised deposit-taking institutions

- Does APRA believe that the strong regulatory environment set up by previous Governments was one of the reasons Australia's banking system remained strong?

Australia's banking system has long benefitted from strong bipartisan support for a robust regulatory framework.

It has been widely acknowledged that a number of factors have contributed to the resilience of the Australian banking system during the global financial crisis. As the IMF noted in late 2009, "Australian banks have coped well with the turmoil so far, largely because of robust supervision and regulation."

- How do you respond to comments by the RBA Governor that the liquidity proposals are heavy-handed?

APRA agrees with the RBA that some of the current Basel Committee proposals for enhanced liquidity risk management, particularly for higher liquidity buffers, require refinement in the Australian context.

On 16 December, the Basel Committee on Banking Supervision (Basel Committee) announced its global framework for promoting stronger liquidity buffers at internationally active banking institutions.

The centrepiece of this framework is a new standard for liquidity risk that aims to ensure that banking institutions have sufficient high-quality liquid assets to survive an acute stress scenario lasting for one month. The standard will come into effect on 1 January 2015. Under the new Liquidity Coverage Ratio (LCR) requirement, the bulk of high-quality liquid assets in most jurisdictions will take the form of holdings of government debt.

Fiscal prudence by a succession of governments means that the supply of government securities in Australia is relatively limited. A second level of eligible liquid assets that includes certain non-bank corporate debt is also in short supply in Australia. A small number of other jurisdictions are in a similar position. To address this situation, the Basel Committee's framework incorporates scope for alternative treatments for the holding of liquid assets. One alternative treatment is to allow banking institutions to establish contractual committed liquidity facilities provided by their central bank, subject to an appropriate fee, with such facilities counting towards the LCR requirement.

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The Reserve Bank of Australia (RBA) and the Australian Prudential Regulation Authority (APRA) have agreed on an approach that will meet the global liquidity standard. Under this approach, an authorised deposit-taking institution (ADI) will be able to establish a committed secured liquidity facility with the RBA, sufficient in size to cover any shortfall between the ADI's holdings of high-quality liquid assets and the LCR requirement. Qualifying collateral for the facility will comprise all assets eligible for repurchase transactions with the RBA under normal market operations. In return for the committed facility, the RBA will charge a market-based commitment fee.

The commitment fee is intended to leave participating ADIs with broadly the same set of incentives to prudently manage their liquidity as their counterparts in jurisdictions where there is an ample supply of high-quality liquid assets in their domestic currency. Detailed work on determining an appropriate fee based on this principle is currently underway. A single fee will apply to all institutions accessing the facility.

The approach will be applicable only to the larger ADIs (around 40 in number). APRA does not intend to apply the LCR requirement to ADIs that are currently subject to a simple quantitative metric, the minimum liquid holdings (MLH) regime. In APRA's view, the MLH regime is working effectively in delivering an appropriate degree of resilience for ADIs with simple, retail-based business models. Accordingly, APRA intends to retain the current approach for these ADIs.

For its part, APRA will require the larger ADIs to demonstrate that they have taken all reasonable steps towards meeting their LCR requirements through their own balance sheet management, before relying on the RBA facility.

The details of the RBA liquidity facility and APRA's prudential standard on liquidity risk management, which will give effect to the global liquidity framework in Australia, will be subject to consultation during 2011 and 2012.

Government's Bank Deposit Guarantee

- What percentage of the market had first-tier lenders (loans to small business) before the government's bank deposit guarantee?
- What percentage of the market had second-tier lenders (loans to small business) before the government's bank deposit guarantee?
- What percentage of the market had first-tier lenders (loans to small business) after the government's bank deposit guarantee?
- What percentage of the market had second-tier lenders (loans to small business) after the government's bank deposit guarantee?

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The data APRA collects is published by the RBA in the statistical table D7. This table breaks lending to business by size of loan. A loan size of less than \$2million is generally used to represent lending to small business. APRA can provide a subset of this data for the first and second-tier banks (see question below).

Share of lending to small business* (%)

	End-2007	End-2009**
Major banks	77	86
Other banks	23	14

* Loans to business of less than \$2 million

** The end-2009 data for the major banks include BankWest and St George Bank, which merged with Commonwealth Bank and Westpac respectively over the period. The growth in market share for the major banks between end-2007 and end-2009 is largely attributable to these mergers.

- What effect has the government's bank deposit guarantee on first-tier lenders'-
 - Financial performance
 - Financial position
 - Performance ratio (to second-tier lenders)

The Australian Government's guarantee of deposits and wholesale funding in October 2008 proved pivotal in assuring ADIs' access to funding domestically and offshore. However, it is not possible to isolate the impact of the retail deposit and wholesale funding guarantee arrangements on the performance of first-tier or second-tier lenders as there were a number of factors impacting on performance over the period leading up to, and after, the arrangements came into effect. The major factors affecting performance were loan losses and increased provisioning arising from the global financial crisis. These were higher for those ADIs with a greater exposure to corporate, small business and commercial property lending; ADIs with a greater exposure to housing lending experienced much lower loss rates. Some ADIs also suffered losses on holdings of financial instruments. Performance was also affected by changes in the cost of funds, with the specific impact on each ADI largely determined by its funding composition - ie the split between wholesale funding (domestic and offshore) and retail deposits. Funding spreads for ADIs increased substantially during the early stages of the crisis but declined following a gradual return of confidence to global funding markets in response to the guarantee arrangements introduced by a number of countries. APRA data indicate that the after-tax return on equity, a common measure of performance, remained broadly unchanged or fell for most categories of ADI between 2007 and 2009.

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- What effect has the government's bank deposit guarantee on second-tier lenders'-
 - Financial performance
 - Financial position
 - Performance ratio (to first-tier lenders)

See above answer.

Basel Committee on Banking Supervision

- How do the current regulations as set by APRA compare to that of the Basel Committee? Is it reasonable for insurance companies to be held to the same standards at banks?

Over the past decade, APRA's prudential standards for authorised deposit-taking institutions have been built on, but are somewhat more conservative than, the minimum global standards promulgated by the Basel Committee. This conservative stance has been amply justified by international experience in the past three years. The IMF, in its September 2006 Financial System Stability Assessment for Australia, noted that "Australia has a very high level of compliance with nearly all essential and conditional criteria in the core principles for banking and insurance supervision."

When it can, APRA has sought to harmonize its behavioural standards (covering matters such as fit and proper and governance) across all its regulated industries, for the simple reason that prudence should be a fundamental attribute of boards and management across all these industries. Capital and other technical standards are inevitably tailored to each industry but, even here, APRA seeks to ensure that the requirements are harmonised where appropriate. In general, APRA supervises ADIs and insurance companies so that they achieve sound prudential outcomes and strong capital levels; the supervisory approaches take into account the particular characteristics of each industry. Nothing in APRA's legislative mandate suggests that depositors and insurance policy holders should receive different standards of protection from APRA.

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Funding and staffing

- The Portfolio Budget Statements show that APRA's departmental spending will peak in 2010-11 and then decline by around \$16 million to just over 103 million each year. Is this just related to the ending of funding associated with the global financial crisis – or are other programs ending?

The decline in funding is primarily related to the end of the Government's four-year appropriation of \$45.5 million in 2011/12. In addition, the appropriation for the Standard Business Reporting project of \$10.0 million terminates in 2010/11 and there have been minor imposed reductions (about \$1.2 million per annum) for savings in travel, properties and ICT expenditures.

- Can APRA provide in detail the specific programs that this funding has gone towards? In APRA's opinion, will it be necessary or short-sighted to wind back this funding after the global financial crisis and with markets still in a state of fluctuation?

The main activities to which the additional crisis-related funding has been allocated include:

- an increase in the intensity of supervision of regulated institutions, particularly those judged to be more vulnerable to adverse developments;
- comprehensive stress-testing of liquidity and capital in the ADI industry and of capital in the life insurance industry;
- increased data collection to improve industry monitoring and the frequency of advice to the Government;
- strengthening of Australia's prudential framework in the areas of executive remuneration and ADI liquidity and capital standards, in response to G20 mandates;
- developing a robust approach to the supervision of financial conglomerates, drawing on lessons from the crisis;
- increased engagement with international standards-setting bodies in developing regulatory responses to the global financial crisis;
- developing the administrative framework for the Financial Claims Scheme; and
- responding to applications for early release of superannuation benefits as unemployment rose in the earlier stages of the crisis.

APRA has maintained a heightened level of supervisory intensity while the 'aftershocks' of the global financial crisis continue to be felt. The need for this level of intensity will be reviewed over the next two years in the light of global and domestic financial conditions.

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- What were the additional staffing levels provided to APRA as a result of the additional funding over the past two years?

The additional funding enabled APRA to add 30 front-line and industry/technical specialists, increasing permanent headcount levels from 570 to 600. In addition, five staff are involved in the Standard Business Reporting project and four staff in collecting data from unregistered foreign insurers. In addition to the permanent staff, APRA has a further 39 shorter-term staff mainly involved in release of superannuation benefits and in enhancing APRA's data collections. This brings APRA's complement to 648 staff on a full-time equivalent basis.

- What will be the staffing losses as result of this additional funding being wound back?

APRA's staffing levels will be a matter for discussion with the Government at that time, and will obviously depend on global and domestic financial conditions.

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Inquiry into Access to Small Business Finance

- Why has APRA not made a submission to the Senate Inquiry into Access to Small Business Finance? –

APRA provided the RBA with data for and comments on its submission and had little to add in a separate submission. In addition, two APRA officers appeared before the Senate Economics References Committee's inquiry into Access of Small Business to Finance on 12 April 2010 to assist it in its deliberations.

- Was APRA directed by Treasurer or his Office not make a written submission? If so who made the direction?

No.

Superannuation

- What role will APRA have in administering superannuation?

Under current legislative arrangements, APRA is responsible for specific sections of the *Superannuation Industry (Supervision) Act 1993* (SIS Act) pertaining to prudential supervision of superannuation funds other than self-managed superannuation funds (SMSF). It does so in consultation with the disclosure / market conduct regulator ASIC and the SMSF regulator, ATO. APRA's future role will depend in part on the Government's response to the Cooper Report.

- Is APRA sufficiently resourced and funded to vet superannuation performance?

APRA is currently adequately resourced to supervise the performance of superannuation funds. If this role is expanded, APRA will need additional resourcing for any new responsibilities.

- Is there justification for expanding the scope of the Authority to scrutinise other companies?

This is a matter for the Government.

- Why should smaller superannuation funds be forced to merge with each other?

APRA has no philosophical position about the right size of a superannuation fund. However, where the viability of a fund in conducting the necessary operations is questionable, having regard to its size, APRA would enquire of the trustee how it proposes to remedy the situation and act in members' best interests.

- What is the common process that APRA takes when it discovers a conflict of interest – such as where the trustee sits on boards with conflicting interests? Can APRA

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detail the number of conflicts of interest cases it has investigated after undertaking audits over the past two years?

APRA does not conduct audits as that term is commonly understood, but undertakes prudential reviews. Conflicts of interest actual or potential, real or perceived, crystallised or dormant - arise in superannuation just as they do in other regulated industries. In addition to trust law requirements, the obligation on trustees under the *Superannuation Industry (Supervision) Act 1993* to act in members' interests requires trustees to identify, robustly mitigate and in some circumstances avoid conflicts. Where an APRA review identifies that the risk management framework of trustees is not effective in managing conflicts, APRA requires remediation in an acceptable time frame.

APRA does not collate separate statistics of conflicts of interest cases identified across the superannuation industry.

- *Super profits tax*
 - '...we need a new revenue source to make it possible for the future. Therefore our super profits tax on the mining industry is about three things. Firstly, to make sure that workers right across WA and right across the country get a fair share when it comes to their superannuation. That's the first thing, raising that superannuation guarantee from 9 per cent to 12 per cent.' (Kevin Rudd, Doorstop Interview, Perth, 4/5/10)
 - How will the so called super profits tax, increase the superannuation employer co-contribution from 9 per cent to 12 per cent?
 - Is it accurate to say that the increase in superannuation employer co-contribution (9 per cent to 12 per cent) will be paid for in full by the employer?

APRA's role is to supervise superannuation funds. Matters relating to policy on the Superannuation Guarantee are matters for the Government.

- *Superannuation clearing house*
 - Has APRA been involved in the writing of the regulations for the superannuation clearing house?

No.

- Does APRA believe that Medicare is the best operator of this service?
- These are matters for the Government.
 - In the recent debate on the Government's proposals for a superannuation

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clearing house, Treasury argued that APRA has no regulatory oversight of superannuation clearing houses. Can APRA explain exactly how clearing houses are regulated?

APRA has no role in regulating clearing houses. Since 2006, clearing house operators have been required to hold an Australian Financial Services Licence (AFSL) issued by ASIC – refer ASIC Information Release 06-34.

- My understanding is that APRA has released guidance on the operation of clearing houses in the past, including in a circular to industry on September 2006. Can APRA clarify whether the guidance is for actual clearing houses, or whether it is for superannuation trustees using those clearing houses?

APRA's primary focus is on trustees that it licenses and regulates and its guidance, including that referred to in the question, is targeted at these trustees.

APRA released guidance to trustees in September 2005 to confirm that contributions submitted through a clearing house entered the superannuation system under the SIS legislation when they were received by the fund – refer to [FAQ 12.1](#) available on the APRA website. This was subsequently included in the Contributions circular in 2006 as part of APRA's normal practice when reissuing guidance material.

- Given that trustees have a number of responsibilities under the SIS Act to ensure payments are received at the required time from the employer, whether a clearing house is used or not, if a clearing house failed to remit the super payments to the trustee by the due date, is it the case that the trustee would be liable and not the clearing house? Has APRA ever investigated a trustee where this had been the case?

Clearing house arrangements can take the form of:

- (a) a third party providing the clearing house service for employers;
- (b) the fund administrator providing the clearing house service; and
- (c) the trustee undertaking the clearing house in-house.

A number of trustees / administrators have made arrangements with a third-party service provider to provide clearing house services to employers for the payment of superannuation contributions in respect of their employees. The arrangements usually involve either preferential pricing (e.g. - no set-up costs, a discounted service fee per employee, etc) or a subsidised or free service (the costs being met by the trustee or the administrator of the default fund subject to reaching a minimum threshold of employees as members of the default fund). It is unusual for a trustee to operate a clearing house service in its own right.

In the majority of cases, a contract for clearing house services is made between the clearing house provider and the employer. The contractual conditions include specific

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provisions on the timing of payments to ensure an employer meets its Superannuation Guarantee obligation deadline and on the resolution of disputes.

If a clearing house fails to remit contributions in line with the provisions of the contract made with the employer, the employer needs to take up this breach of contract with the clearing house provider. As part of normal business operations, a trustee should have systems to monitor any delays in the receipt of expected contributions (having regard to reputational risk and operational risk issues) to ensure contributions do come into the fund, but they are generally not liable for any delay in receiving the amount. A trustee's liability starts once the contributions are received into the nominated superannuation fund of the member (as per their member choice election).

APRA has not investigated any specific case against a trustee; as part of its ongoing supervision of superannuation trustees, APRA reviews complaints registers to see how complaints have been addressed (e.g. where they relate to contributions not being received).

- Does APRA have any power in this situation to hold the clearing house responsible, or is this something that would need to be conducted by the trustee within the law of contract?

This would generally be a matter for the employer to pursue with the clearing house as a service provider as part of their contractual arrangements. A trustee/administrator may liaise with the clearing house provider to address any issues where the trustee has promoted the use of that clearing house provider to employers, and employers experience difficulties. A trustee's risk management framework should capture and address all material risks. Depending on the nature of the industry and past experience with the employer / clearing house, non-receipt of contributions on time would be captured in the framework.

- Does APRA have the view that clearing houses should be prudentially regulated? Are the contractual obligations between the trustee and the clearing house – which essentially enforce APRA rules – enough to ensure compliance?

This is a matter for the Government.

- *Cooper Review and routine supervision*
 - How many recommendations of the Cooper Review does APRA support?

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APRA has had extensive input into the deliberations of the Cooper Review Panel. Decisions on which recommendations are adopted are a matter for the Government.

- I refer to comments made by Mr Stephen Glenfield, manager of the specialised institutions division at APRA, who was commenting on the Cooper Review at an AIST conference on 29 April. Mr Glenfield told AIST that APRA audit super funds every two years. Can APRA provide the committee with a list of every superannuation fund audited by ASIC over the past two years and the cost of auditing each?

APRA does not undertake 'audits' as such, but prudential reviews. The APRA Act has strict secrecy provisions that preclude APRA from releasing the details of the funds reviewed. The costs of APRA supervision of each regulated industry are set out in the annual levy determination made by the Minister.

- What are the processes for determining when an audit will take place and the terms of undertaking that audit? Is each audit standardised in line with the SIS Act (Superannuation Industry Supervision) to gather comparable statistics and potential conflicts of interest?

As a rule, APRA aims to review each regulated superannuation fund on a two-year cycle. However, a fund's risk assessment and supervisory stance, emerging market risks and exposures, unremedied issues from previous reviews and market intelligence all affect the frequency of review activity. The detailed scope of each review is tailored to the above factors and is often aimed at specific aspects such as market risk, unit pricing, governance etc. APRA's focus is on identifying and remedying entity-specific issues.

- Is there any procedure by which a member of the public or an investor could access the findings of the audits that APRA undertakes of superannuation funds?

No. APRA requires regulated entities to treat its findings as confidential so as to promote effective and cooperative resolution of any prudential issues. As noted above, APRA itself has strict secrecy provisions that prohibit the release of its findings.

- Finally, has APRA been given or been promised any additional funding to implement recommendations from the Cooper Review? Has APRA begun working on administering any possible recommendations such as increased disclosure requirements of superannuation funds?

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As noted previously, consideration of the recommendations of the Cooper Review and necessary funding decisions are a matter for the Government.

- *Superannuation Statistics*
 - With regards to the publishing of superannuation reporting data, can APRA explain what use APRA believes the data publishing provides to general investors in superannuation? You have previously stated that the data is not intended to use when making comparisons between funds, but for what other purpose does the data publishing serve?

In a compulsory, preserved and tax-concessional industry such as superannuation, release of industry performance data is one way of keeping the public informed. Data on performance represents the cumulative impact of the various choices a trustee affords its members. While its value for assessing individual options is limited (and hence greater disaggregation may be warranted in future), overall performance itself is indicative of trustee skill, efficacy and performance.

APRA's whole-of-fund rate of return gauges the relative performance of trustees in generating long-term returns for fund members' retirement benefits. Prudently maximising long-term returns assists superannuation trustees to meet their obligations under the *Superannuation Industry (Supervision) Act 1993* to act in the interests of members. Whole-of-fund returns are, however, not the sole point of comparison among funds. APRA proposes to expand its collections and publications over time to include items such as performance relative to asset benchmarks, and representative investor performance at the investment option level.

- Is APRA aware of criticism that the data published is useless for a comparison of funds, because it is not published into segments? Superannuants do not invest in the fund as a whole, but in tailored funds with different asset classes.

Yes. Some of the criticism is based on the presumption by some commentators that trustees' only responsibility is to provide a suite of investment options, whether they are likely to perform well or not, and let the member beware.

As the *Response to Submissions* paper on fund-level disclosure (on APRA's website) explains:

"Many trustees use a business strategy that relies on subsection 52 (4) to create menus of investment choices that are available to members ... The fact that offering large numbers of investment options is an allowable strategy does not relieve trustees

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of the responsibility for the fund's investment strategy and the requirement to provide retirement benefits in the members' interest.

One sensible way for a trustee, and any other observer, to test the success of a trustee's member-directed investment strategy is to consider the relative return of the fund compared to all other funds.

Fundamentally, if a trustee is unable to generate competitive long-term returns across the fund, then the trustee directors need to reconsider their whole-of-fund investment strategy."

- What would be the potential costs to APRA of publishing the data in segments depending on the type of asset the fund segment invests in? Are there any impediments to doing so?

The costs to APRA would not be substantial. However, as APRA's performance statistics examine long-term trustee performance, funds would need to retrospectively provide APRA with investment options material going back over the past seven years. Future publications of segmented data will depend upon the Government's response to the Cooper Review.

- Through the operations of the SIS Act, are APRA able to pick up any of this fraud through the collection of reporting data or internal auditing of super funds? What powers does APRA believe it has to help prevent this type of fraud?
- *Fraud*
 - I have some questions referring to the fraud recently caught by the NSW police, where criminals are using self managed super funds (SMSFs) to access the accounts of APRA regulated fund members and transfer their superannuation savings. For the benefit of the committee, can APRA explain how these fraud schemes work?

This issue is addressed in APRA's guidance to trustees issued on 5 February and 5 May 2010. (available from the APRA website).