APRA
Australian Prudential Regulation Authority

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Paul Balin
Acting Assistant Commissioner - Melbourne
Productivity Commission
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Dear Mr Balin

RE: DRAFT REPORT ON COST RECOVERY

We have received the release of the draft report on Cost Recovery on the 17th April 2001. The study is certainly comprehensive and provides an insight into government agency practices and ways to improve administration.

APRA is a new agency. We recognise some of the shortcomings of earlier arrangements and have resolved many of them. At times, we have not been successful in adequately communicating the progress that we have made todate. We are not clear why there remains a predominate focus on historical data with little explanation on the reasons for the anomalies. We are particularly concerned when such obsolete data is used to represent our current and future position. A forward-looking perspective on APRA's strategies would support both our current achievements and permit our stakeholders to genuinely contribute to further improvements.

Recent articles in the press (AFR 17/04/01 and Herald Sun 21/04/01) have been quick to point out the injustice of APRA receiving 150% of our costs. Such calculations can be derived from Table 1 of the draft Cost Recovery Report without any further effort being made to understand the data provided.

The misleading sensationalism of such observations is not constructive. Our ongoing dialogue with stakeholders on the adequacy of our levies in line with the services we provide needs to be based upon correctly stated facts. Table 4.3 repeats the data but leaves the reader with the obvious concern that 150% cost recovery is well in excess of the target of 100% aimed for. The source of this misinformation is the questionnaire that I completed and sent to Patrick Leplange.

The questionnaire required that APRA distinguish the additional revenue administered by it. However, the calculated ratio of cost recovery to total expenses is misleading. APRA made a strenuous effort, in its last annual report (note 5A), to explain *that $25.6 million had been collected on behalf of the Government, but was not part of APRA's revenue.* The revenue was for "excluded" superannuation funds (i.e. small funds). APRA did not set the levy and has merely been administering the funds during their transition of their regulation from the Insurance and Superannuation Commission (ISC) to the Australian Taxation Office (ATO). The only amount received by APRA from this revenue was $1.5 million as an appropriation to defray some of the costs we incurred in arranging that transition. APRA's revenue from cost recovery for 1999/2000 was $59.2 million as explained in note 5A. This is net of $2.9 million over collected, but committed to be returned to industry within the balance sheet (see note 10B).

APRA cost for the same period was $52.6 million operating expenses plus $6.2 million abnormal expenditure incurred in establishing APRA. Our total cost was therefore $58.8 million compared to cost recovery of $59.2 million. All of this is clearly explained within the Financial Statements of the Annual Report.

APRA is included in Appendix F as a case study. Since we have become a significant part of the draft Cost Recovery Report, it is important that the messages from such an exercise are based on current facts and out intended strategies if anything useful can be learnt from our position.

Firstly, I am curious why we get such additional attention. If the main notion of this report is that government levies are increasing and a significant part of this income comes from agency cost recovery mechanisms approaching $3 billion, then APRA is a small player being 1.6 per cent of such funding.

The up-front conclusion of the case study is that "APRA and ASIC undertake cost recovery on a large scale, recovering all or more than their operating costs. According to some enquiry participants, such as the ACCI, charges recovered from industry by their agencies amount to over-recovery. This potentially sets them apart from most of the Commonwealth agencies and as such justifies close examination of the rationales and arrangements for cost recovery in this area."

Table F1 is used to demonstrate that cost recovery by APRA is in excess of operating expenses. The costs are correctly stated in the table for both years. But the revenue in both years contains administered revenue from excluded superannuation that flowed to the CRF and did not come to APRA. The amount was $25.6 million in 1999/2000 and $17.6 million in 1998/1999. Excluding these amounts demonstrates that APRA just recovered its costs in 1999/2000 and significantly under-recovered its costs in 1998/1999. (The under-recovery is built into collection in future periods.) Therefore, APRA's inclusion as a case study is based on the incorrect interpretation of data and APRA should be removed from this part of the Report in future.

Table F3 provides an analysis of APRA's operating expenses from 1997/98 to 2000/01. This is an extract from our Annual Report. We want to make a few points about this.

Firstly, it is based on the estimated aggregate cost of prudential supervision and not just APRA's costs. APRA did not exist until July 1998.

Secondly, the note to the Annual Report indicates the Government Actuary costs are included until April 2000. This $1 million should be removed from the 1997/98 to 1999/00 to improve the comparison. The draft report advances the notion that costs have been reduced at a time of increased complexity and size of financial institutions. This does not adequately explain the primary reason for cost reduction, which has been the reduction in administrative costs following the merger of State-based financial institutions into APRA in mid 1999. Some savings could be expected from the merger of 11 agencies into one.

The case study progresses with some useful comments about the challenges confronting APRA regarding industry sectors. There is insufficient recognition of the benefit to banks in the removal of non-callable deposits in 1999 and the progressive approach APRA has taken in advancing risked based supervision in support of the Financial Institutions Inquiry (Wallis) reforms. Some of the more significant distortions can be found in comparing the maximum levies across industry sectors and the "capping" of maximum rates. APRA has promoted the concept that a single uniform levy across industry sectors will assist in reducing some of these anomalies.

Nowhere has APRA been more misunderstood than its commitment to straightening out levies collected from the superannuation sector. APRA inherited arrangements with major cross-subsidies - we have openly stated what the issues are and many have been resolved during the transfer of small funds to the ATO. This has cost both resources and management time for an activity, whose regulation was deemed to be better aligned to the expertise of the ATO rather than prudential supervision of financial institutions, which is the expertise of APRA. Suggestions that APRA had benefited significantly are clearly wrong. Excluded superannuation funds have not funded APRA.

The ANAO has reviewed APRA's financial governance arrangements both during last year's cross-portfolio review of levies and during its current performance audit of bank supervision. APRA contests two of their primary notions that they have expressed from the inception of such reviews.

Firstly, ANAO has supported an inflexible view of cost recovery by industry sectors. This is not compatible with APRA's "risk-based" approach to prudential supervision.

Secondly, the ANAO strongly advocate activity based costing as a solution to all problems. ABC is an excellent tool for a strict cost recovery regime, where precision is required in ensuring accurate costing. It is the "accountants" solution and well matched to many costing situations. However, it does not match APRA's needs. APRA's levies are clearly taxes paid by entities to fund regulatory activity conducted for the benefit, over time of their customers. The levies are not "fee for service" charges.

APRA needs an economic model. Levies are determined for the year ahead. A strict user pays model is going to cause more distortions than it solves. For example, how much are we to charge a failing institution for its supervision, and is this compatible with our mission to protect deposit holders and premium takers? Who will ask for advice if we charge by the hour for it? The important feature of the current model adopted by ARPA, is that APRA as a statutory authority recovers its costs from industry in a transparent way that clearly indicates how such recoveries are spent.

Table F4 is taken from an ANAO report on cross-portfolio levies. The table refers to appropriations for 1998/99. This was the first years in APRA's existence. The method of funding was a mix of budget and cost recoveries.

In this transition year, this table shows excluded superannuation funds contributing $33.8 million and costs of $3.5 million. This estimate by the ANAO describes activity administered by APRA, but which did not form part of APRA's funding. Similarly Treasury had modelled revenue and program costs to transition activity from the ISC and the RBA into the new organisation. Three years on, little value is derived from focusing on the historical transition of prior entities into APRA. Problems were known, were resident in prior arrangements and could not be fully resolved immediately on APRA's formation. Strategies and programs were put into place to respond to these issues.

Of greater relevance is what APRA is intending to do in the future. The facts for the current year 2000/01 are:

	$ Million
APRA's Forecast Expenditure	51.0
Less:	
Other income (mainly interest)	1.7
Operating deficit	0.3
Over collection from prior year	3.0
Under collection from current year	0.6
	45.4
Add:	
Collection on behalf of ASIC for identified costs	12.6
Collection on behalf of ATO for identified costs	2.4
	60.4
Levy collection in the current year:	
ADI's	22.5
Superannuation	24.2
Life Insurance	8.4
General Insurance	5.2
Retirement Savings	0.1
	60.4

There is no over collection. This information is available to industry in the current Consultation Paper, the comparable budget estimates are in the Portfolio Budget Statement and the numbers will be confirmed in the Financial Statements.

The draft report points to a number of safeguards in APRA's governance. There have been opportunities for stakeholders to both receive information from APRA and input to changes in the way levies are administered. However, appendix F relies heavily on the input from two sources, ASFA and the NRMA, to detract from the achievements of APRA.

APRA consults with eleven industry associations representing more than 10,000 institutions. The institutions range from about 8800 institutions with less than $5 million each in assets, to 163 institution with assets in excess of $1 billion each. APRA's costs of $50 million compare to the total assets under supervision of $1355 million being 0.004%. Determining a fair levy is a challenge that has been taken seriously by APRA. The remarks made by ASFA on page F22 are not fairly balanced with other consultative activity in that year. What is omitted from their statement is that four months earlier, Treasury and APRA had requested responses to the financial sector levy review. In addition, the levy rate for superannuation was halved from 0.04% to 0.02%, with the maximum rising from $41,000 to $46,000. The total amount collected from superannuation dropped from $29.7 million to $25.1 million for the year 2000/01. The comment attributed to ASFA on page F23 regarding minimum levies assigned to superannuation and life insurance both being $5000 is incorrect. The superannuation minimum in the 1999 review of 1999/2000 levy was $200.

The following paragraph is also incorrect. Superannuation accounted for 38% of APRA's costs in 1999/2000 but ADI's contributed 44%. APRA's timesheets on supervision in 2000/01 indicate that APRA is committing more than 130 direct supervisory staff on superannuation out of 340 in total. This is significantly more than for any other sector.

In summary APRA has consulted industry, does listen to a wide range of representatives, is aware of sectorial interests and does attempt to balance competing interests. The case study is based on obsolete data and the narrow view of a small sample of APRA's "clients". Quoted facts are significantly in error and the conclusions reached are therefore unlikely to be sound. A simple comparison of the issues identified pre-APRA with their current resolution will demonstrate considerable progress. APRA has strategies for making levies funding fairer; this is not advanced by imposing inappropriate costing methods.

APRA requests that the Productivity Commission significantly refines the draft report to provide a more contemporary view of APRA, balancing past issues with current progress. Please advise how this will be done.

Yours faithfully

Jim Flaye
Chief Financial Officer