



# COST RECOVERY IMPLEMENTATION STATEMENT

For supervision of authorised deposit-taking institutions (ADIs) using the models-based approach for Basel II and accreditation of certain ADIs

Financial Year 2017-18

22 June 2018

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# 1. Overview

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## 1.1 Purpose

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This Cost Recovery Implementation Statement (CRIS) assesses the impact of imposing, by means of a disallowable instrument under paragraphs 51(1)(a) and (b) of the *Australian Prudential Regulation Act 1998* (the APRA Act), a limited fee in 2017-18 for the recovery of specific costs associated with the on-going supervision of authorised deposit-taking institutions (ADIs) which have received, or are seeking, APRA approval to adopt the models-based approach under *The International Convergence of Capital Measurement and Capital Standards - A Revised Framework (Basel II)* for assessing their capital adequacy requirements (the proposed fee). The purpose of the CRIS is to ensure transparency and consistency in the raising of such fees in line with the Government's cost recovery guidelines.

## 1.2 Background

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In December 2002, the Government adopted a formal cost recovery policy to improve the consistency, transparency and accountability of its cost recovery arrangements and promote the efficient allocation of resources. The underlying principle of the policy is that charges should be set to recover all the costs of products or services where it is efficient and effective to do so, where the beneficiaries are a narrow and identifiable group and where charging is consistent with Government policy objectives. Cost recovery policy is administered by the Department of Finance and outlined in the *Australian Government Cost Recovery Guidelines* (CRGs).

APRA is a statutory authority set up under the APRA Act and is subject to the *Public Governance, Performance and Accountability Act 2013* (PGPA Act). The primary purpose of APRA is to regulate bodies in the financial sector (APRA Act, section 8). APRA is funded by an annual appropriation, which is based on industry levies after the deduction of the Treasurer's determination for monies collected for the Australian Securities and Investments Commission (ASIC), the Australian Taxation Office (ATO), the Department of Human Services (DHS), the Australian Competition and Consumer Commission (ACCC) and for implementing the *Stronger Super – SuperStream* initiative (APRA Act, section 50<sup>1</sup>). In addition, APRA can charge fees for services and recover costs under section 51 of the APRA Act.

Where an institution requires a specific elective service, APRA can charge a direct fee under section 51 of the APRA Act. For specific one-off services outside direct supervision of APRA-regulated institutions, such as assistance offered to other Government agencies or overseas regulators, APRA seeks to recover the associated costs with specific fees (APRA Act, subsection 9A(2)). This reduces the levies that institutions pay and is seen by the APRA-regulated financial industry as desirable, as it reduces the cross-subsidies for both special services and services unrelated to direct supervision.

<sup>1</sup> APRA Act was amended 1 April 2018 replacing: 'implementing the SuperStream measures until 30 June 2018' with 'governing and maintaining the superannuation transactions network.'

APRA is required to undertake prudential supervision of ADIs according to its statutory authority laid out in the APRA Act and within the legal framework of the *Banking Act 1959* and the prudential standards made under that Act. Where practicable, prudential standards have been harmonised with international standards, including Basel II. Amongst other things, Basel II permits ADIs to determine their capital adequacy requirements using one of two methods: a standardised (default) method (the *standardised method*) or a models-based approach more closely aligned with an ADI's individual risk profile (the *models-based approach*). ADIs seeking to use the models-based approach need APRA's approval to do so. APRA has a decision-making framework to assess applications. Once APRA approves the use of the models-based approach, it then monitors the use of the model(s) by the ADI on an on-going basis.

## 2. Policy review

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Recovery of the proposed Basel II fee is supported by the following policy-based analysis:

### 2.1 Alignment with objectives

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The primary objective of APRA is set out within its Outcome Statement, being: "enhanced public confidence in Australia's financial institutions through a framework of prudential regulation which balances financial safety, and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, promotes financial system stability in Australia".

A financial institution's capital adequacy is central to assuring that financial promises can be met. A major component of APRA's supervisory work is the assessment of capital adequacy and this is implemented by APRA's prudential standards. Specific work carried out by APRA on the on-going supervision of ADIs using the models-based approach and accreditation of applicants which are seeking to use this approach should be cost recovered.

### 2.2 Description of activity

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The activity for which the proposed fee is made is the on-going monitoring of the capital adequacy of ADIs using the models-based approach and assessing applications from ADIs seeking to use this approach.

### 2.3 Stakeholders

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Current stakeholders are the ADIs which have either adopted or are seeking to adopt the models-based approach to determine their capital adequacy. These are Australia and New Zealand Banking Group Limited (ANZ), Commonwealth Bank of Australia (CBA), National Australia Bank Limited (NAB), Westpac Banking Corporation (WBC), Macquarie Bank Limited (MBL), ING Bank (Australia) Limited (ING), Bendigo and Adelaide Bank Limited (BEN) and Suncorp-Metway Limited (SUN).

## 2.4 Cost recovery alternatives

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Identifying the specific method of cost recovery is based on considering how APRA is most appropriately funded for the activity. APRA has a choice of recovering costs through levies applied across all APRA-regulated institutions, the ADI sector or a specific fee for services to the ADIs which use or seek to use that approach for assessing their capital adequacy.

The CRGs advise that, where possible, a fee for service is preferred to a levy provided the fee is efficient, cost effective and consistent with policy objectives. The use of levies gives rise to potential cross-subsidies, which is not consistent with cost recovery policy.

There are three choices available to APRA in respect of the work required for the model-based approach: (i) decline to carry out work; (ii) use levies to fund the costs; or (iii) use a specific fee for service. The first option is not desirable. The competitiveness of major ADIs requires a prudential framework in Australia which is consistent with international standards and practice. The use of levies to recover the cost would require cross-subsidy by ADIs that will not benefit from the models-based approach, including building societies, credit unions and other ADIs, and is not consistent with cost recovery policy. The use of a specific fee to recover the costs associated with the supervision of ADIs using the models-based approach and the accreditation of applicants seeking to use this approach will target the beneficiaries of the work.

## 2.5 The efficiency and effectiveness of the charge

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APRA is largely funded by the financial industry. There is an annual consultation process for levies which considers the costs of APRA and the sources of funding including fees, levies and the interest earned on investments. This provides a stable, transparent and easily administered means of funding the operations of APRA. Generally, direct cost recovery, in which supervisory work performed is charged to an institution, is not efficient and levies provide a sounder basis. Direct fees for service often result in volatile charges that are unpredictable for both APRA and institutions. In addition, as a general rule, APRA would not be able to procure and fund in advance the specialist expertise needed to carry out supervision without the certainty of funding prior to carrying out the activity. Furthermore, when applied in inappropriate circumstances, direct charging may have negative spill-over effects, with institutions requiring advice being deterred from seeking it on the basis of the higher costs involved.

Nevertheless, direct charging is appropriate in certain circumstances. In particular, where elective services are provided by APRA (e.g., assessment and issuing of a licence to a particular institution), direct user fees are appropriate and avoid cross-subsidisation. The work on the accreditation and supervision of ADIs under the models-based approach falls into this category because it is referable to specific ADIs and can be directly measured. The major recipients of the charge have been advised and understand the basis of the costs that are incurred in carrying out this work.

A small proportion of the cost of the Basel II work relates to the standardised method, which uses 'supervisory risk estimates'. It is the default method for measuring capital adequacy under Basel II. The standardised method is used by those ADIs that do not elect to use the

models-based approach and this cost is therefore appropriate to be recovered through financial sector levies.

## 2.6 Conclusion

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The work on the on-going supervision of ADIs using the models-based approach and the accreditation of applicants is an activity which is referable to specific ADIs and can be directly measured. A direct fee is therefore the most appropriate means of recovery of the costs involved.

## 3. Design and implementation

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### 3.1 Basis of charging

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All relevant ADIs contribute to the Basel II work associated with accreditation and on-going supervision of the models-based approach.

The following table shows the history of the fee income from the Basel II-related charges:

\$m	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Revenue	2.2	2.3	1.7	1.83	2.23	1.76	1.73
Expense	2.4	2.2	1.6	1.83	2.23	1.76	1.73
Net operating result	-0.2	0.1	0.1	-	-	-	-

### 3.2 Legal requirements for the imposition of charges

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APRA has power (relevantly) under section 51 of the APRA Act to impose fees for service. As the proposed fee is reasonably related to the cost of undertaking the work associated with the models-based approach under Basel II, the fee does not amount to taxation.

### 3.3 Costs to be included in charges

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The total recoverable costs for undertaking the work associated with the models-based approach are estimated to be \$1.726 million for 2017-18 (exclusive of GST). It is intended to recover \$278,000 each from ANZ, CBA, NAB, WBC and MBL, \$112,000 from ING, BEN and SUN (amounts exclusive of GST). The derivation of the estimated costs of this service has been modelled by APRA's finance group. A table is included in the Appendix.

These costs do not include the costs of supervising ADIs using the standardised method, which are recovered through financial sector levies.

The direct staffing costs associated with the accreditation and supervision of ADIs under the models-based approach are tracked using APRA's time management systems. In addition to direct costs, associated indirect support costs including facilities, IT and insurance costs are also allocated.

### **3.4 Outline of charging structure**

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APRA has limited resources to apply to elective services. Currently, five large ADIs benefit significantly from the more efficient use of capital from the models-based approach. Consistent with the approach taken in 2016-17, and on the basis that there is no material difference in the approach to modelling supervision taken between them, ANZ, CBA, NAB, WBC and MBL will be charged an equal amount of the relevant costs. ING was, for the bulk of 2017-18, accredited relatively late in the year, while BEN and SUN are in the process of accreditation and do not benefit at this point. The three ADIs are also charged an equal amount, but is lower than the five ADIs that were accredited to use models for the full year.

### **3.5 Duration of the charge**

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The proposed fee is intended to recover the specific costs incurred in 2017-18 directly associated with the on-going supervision of ADIs which have adopted the models-based approach and the accreditation of applicant ADIs. These charges are determined based on the complexity and sophistication of work for each of the institutions involved.

### **3.6 Recipients of the charge**

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The recipients of this charge are the ANZ, CBA, NAB, WBC, MBL, ING, BEN and SUN. A table of the estimated proportional costs is shown in the Appendix.

## **4. Ongoing monitoring**

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### **4.1 Monitoring mechanisms**

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The costs of the ongoing supervision of the capital adequacy of ADIs using the models-based approach and the accreditation of applicants seeking to use the approach are charged to a unique cost code and monitored as part of APRA's annual budget review processes. Analysis of the costs incurred is undertaken by APRA's finance group and an annual recommendation is made to the APRA Members for approval of the proposed cost recovery arrangement.

The cost of developing the standardised approach is monitored as part of ongoing monitoring of APRA's overall levy arrangements.

## 4.2 Stakeholder consultation

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The recipients of the charge have been advised and understand the basis of the costs that are incurred in carrying out this work.

## 4.3 Periodic review

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The cost recovery arrangements for assessing applications and ongoing supervision under the models-based approach are subject to an annual review process

# 5. Certification

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I certify that this CRIS complies with the Australian Government Cost Recovery Guidelines.



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Wayne Byres  
Chairman  
Australian Prudential Regulation Authority  
Date: 25 June 2018

## Appendix

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Basel II – Costing Template for 2017-18
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	\$'000
A. Forecast costs - Basel II	
Employee expense	1,426
Allocated Overheads	<u>300</u>
Total forecast costs - Basel II	\$1,726
Total costs to be recovered – 2017-18	\$1,726

Which represents a charge for effort based on these approximate percentages:

Australia and New Zealand Banking Group Limited	16.1%
Commonwealth Bank of Australia	16.1%
National Australia Bank Limited	16.1%
Westpac Banking Corporation	16.1%
Macquarie Bank Limited	16.1%
ING Bank (Australia) Limited	6.5%
Bendigo and Adelaide Bank Limited	6.5%
Suncorp-Metway Limited	<u>6.5%</u>
	100.0%

