Australian Prudential Regulation Authority

Insurance

and

Superannuation

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APRA's Mission Statement

APRA has a new Vision, Mission Statement and Statement of Values. The high level statements, endorsed by a strategic meeting of the Board and Senior Management, set out in symbolic terms the aims and objectives of the new regulator.

According to Chief Executive, Graeme Thompson, APRA is "*to be a world class integrated prudential supervisor recognised for its leadership, professionalism and innovation*".

Leadership was a key quality when setting high standards for risk management in Australian financial institutions, he said. "Unless we are professional in all we do, we will not earn the necessary respect of those we supervise, the financial media or the general community." Innovation was also essential if APRA was to keep pace with change.

APRA's new Mission statement sets out the organisation's basic objective as a prudential supervisor. "*We are committed to establishing and enforcing prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by institutions we supervise are met, within a stable, efficient and competitive financial system.*"

APRA's statement of values stamps the regulators style of operation - the way it conducted itself internally and externally, Mr Thompson said. "*APRA will pursue the highest standards of individual and corporate integrity and be flexible, decisive, open and accountable.*"

Investment management expenses

Investment expenses are one of the major expenses of running a superannuation fund. In this article, we present a preliminary analysis of the direct investment expenses of large superannuation funds.

The primary difficulty in analysing the investment expenses of superannuation funds is explicitly measuring all expenses that are of an investment management nature. For example, expenses associated with individual mandates placed with investment managers, or with direct investment of assets by the fund itself may be handled in a relatively straightforward manner and are usually borne explicitly by the fund. However, it is far more difficult to assess implicit expenses associated with investment in unitised pooled funds where expenses are deducted prior to declaring changes in unit price and therefore prior to returns being made to the superannuation fund.

In this article, we do not attempt to consider such implicit expenses. The analysis is based solely on the investment expenses charged *directly* to the fund. This data is presented for superannuation funds with over $60 million in assets under management (AUM), and is drawn from the APRA Quarterly Survey of Superannuation. In this survey funds are asked to identify those investment management expenses charged directly to the fund.

Accordingly, these expenses have been considered in relation to the assets with which they are associated. Therefore, assets placed in pooled superannuation trusts, wholesale trusts, public unit trusts, or held in the statutory fund of life companies have not been included in this analysis. The results are presented by fund type in Figure 1.

Superannuation funds of this size display very similar levels of direct investment expenses, although there are minor differences by fund type. For example, the costs for industry funds seem to have been rising over the last three years, while the average costs for corporate funds have been declining. The lower than 50 basis points figures are similar to the lower end of the range of wholesale management fees revealed by an Intech survey released earlier this year. This suggests that given the expertise and desire, these funds are able to manage their investment for a cost directly comparable to the fees of a wholesale fund manager.

It is important to note that these figures are merely a measure of costs and do not, for example relate to investment charges for retail investments. A recent ASFA study suggests a management expense ratio of around 1.75 to 2 per cent is typical for such cases.

Figure 1: Direct investment expenses and fund type

This study also gives estimates for the average cost of investment management for industry, corporate and public sector funds, which are of a similar level to the costs shown here. The ASFA survey indicated average costs of investment management ranged from 0.52 per cent (for funds under $100 million AUM) to 0.28 per cent (for funds with over $500 million AUM).

APRA's figures similarly indicate that the costs of direct investment as a proportion of assets generally decline with increasing asset size, as shown in Figure 2. This may also be seen in the fact that defined benefit funds, which are typically larger than accumulation funds, also have slightly lower direct investment costs as a proportion of assets. Investment management costs will also be affected by the level of active management of the investments. For example, passive investments such as index-linked funds generally have significantly lower costs than investments which are more actively managed.

A comparison of administration expenses and direct investment expenses is presented in Table 1. This shows that administration expenses as a proportion of AUM are almost twice as large as direct investment expenses as a proportion of the assets they apply to. An important qualification of this result is the fact it applies to large funds with over $60 million AUM. There may be considerable deviation from this result for smaller funds.

Table 1 also shows that while direct investment expenses as a proportion of assets have remained steady over the last three years, there appears to have been a slight decline in administration expenses as proportion of AUM for these funds, possibly due to increased competition in this area.

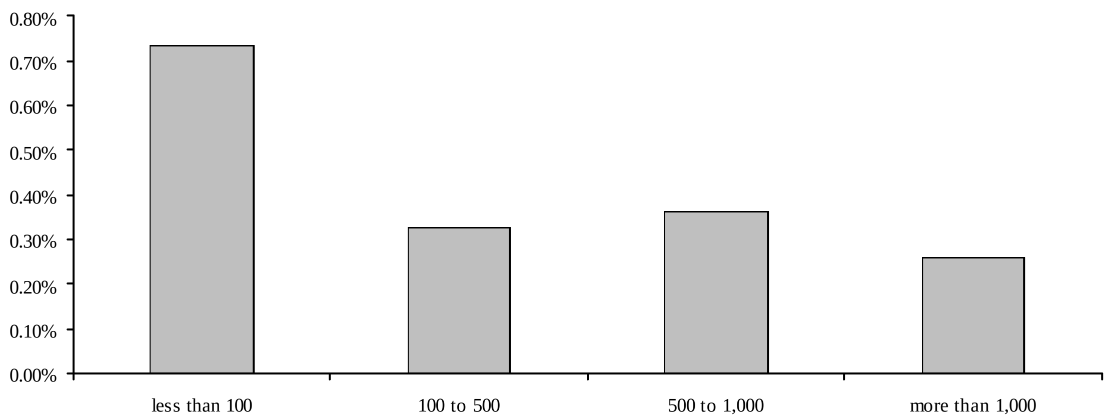
Table 1: Comparison of administration expenses and direct investment expenses

	Administration expenses	Direct investment expenses
1995-96	54.5	29.7
1996-97	53.8	31.1
1997-98	51.4	29.7

Note: Expenses are expressed as a proportion of assets in basis points. Investment expenses refer only to direct assets.

This analysis indicates that the explicit costs of investment for large superannuation funds, while significant, are relatively low and stable. If this stability continues, then this cost represents a baseline measurement of the cost of investment for funds above $60 million AUM. However, the absence of any consideration of investment charges, as distinct from costs, suggests that this figure will be an understatement of the total cost to members of investment. A further obvious restriction on comparison of total costs of investment is the need for such a comparison to consider the possibility of cost/return tradeoffs, as where these exist a simple comparison of cost may well be misleading.

Figure 2: Direct investment expenses and asset size



The growth in member contributions

In recent times member contributions have been growing at around twice the rate of employer contributions. In this article we explore which sectors of the market have been experiencing the greatest growth in member contributions and why this might be so.

Member contributions, also referred to as employee contributions, are contributions other than those made by an employer on behalf of an employee. They largely consist of contributions made by employees on their own behalf out of after tax income, either into their employer-sponsored scheme or into a personal top-up scheme. Depending upon their business structure, member contributions can also include contributions made by the self-employed. Member contributions are usually not tax deductible (with the exception of some limited employee contributions and self-employed contributions) and are treated as the undeducted component of a superannuation benefit for taxation purposes. Unlike employer contributions, member contributions are not subject to the superannuation contribution surcharge.

Member contributions displayed significant growth during 1997-98, increasing by 31 per cent over the previous year to $12.9 billion. In contrast, employer contributions increased by only 11 per cent to $20.9 billion. Moreover, much of the increase in employer contributions could be attributed to 'organic' growth driven by increases in average weekly earnings (up by around four per cent) and increases in the number of employed people (up by around two per cent) during this time. While employer contributions are also likely to be positively impacted by the increase in SG contribution levels from 1 July 1998, these organic growth factors for employer contributions do not necessarily lead directly to a corresponding increase in member contributions. The large increase in member contributions, while most likely influenced by the savings behavior and taxplanning practices of high income individuals and those close to retirement, clearly indicates that overall superannuation continues to be seen as a very attractive long term savings vehicle by Australian workers.

Contributions and fund type

As would be intuitively expected, retail funds accounted for the majority, at nearly 60 per cent (or $7.7 billion) of all member contributions received during 1997-98, up from a 51 per cent share in 1996-97. This result was achieved through an increase of 54 per cent in retail member contributions through the year.

Figure 1: Member contributions 1997-98

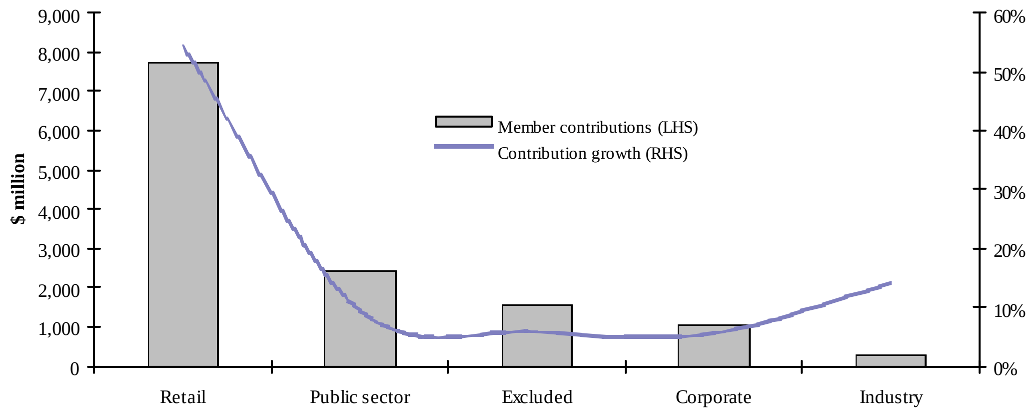


Table 1: Contribution concentration, 1997-98

Proportion of all contributions	Member contributions	Employer contributions
Top 10 funds	36%	29%
Top 20 funds	51%	41%
Top 50 funds	68%	58%

One of the reasons for the high level of member contributions made into retail funds is that in most cases where an individual is making additional voluntary superannuation contributions into a personal 'top up' scheme, this scheme is part of a retail (often a life company administered) superannuation fund. Also, anecdotal evidence suggests that spouse contributions (which are treated as member contributions) and the phenomenon of 'contribution recycling' (whereby a tax-paid lump sum superannuation benefit is taken and then immediately reinvested as a member contribution, usually for the purposes of maximising the undeducted purchase price on a pension or annuity) are significant drivers of member contributions. Retail funds are particularly well placed to offer these types of products.

Member contributions into industry funds represented the second highest growth in member contributions, increasing by 14 per cent (or $32 million) during 1997-98 to $260 million. This result suggests that the campaigns run by some of the larger industry funds to attract increased levels of member contributions into their funds met with some success. Notwithstanding this growth however, industry funds' share of all member contributions remains at only two per cent.

Corporate funds experienced the lowest growth in member contributions during 1997-98, with member contributions increasing by around five per cent (or $54 million) to $1 026 million. This result is consistent with the continued rationalisation that is occurring in this sector of the superannuation industry. See figure 1.

As can be seen from figure 1, the public sector represented the second highest level of member contributions after the retail sector at $2.4 billion or 19 per cent of all member contributions. This is most likely due to the compulsory requirement for members to make at least some contribution in many public sector schemes, particularly defined benefit schemes. Excluded funds represent around 12 per cent of all member contributions and corporate funds around eight per cent.

Concentration of member contributions

Member contributions are reasonably concentrated and in particular (as would be expected) are more concentrated than employer contributions. For example, the 50 funds receiving the highest amount of member contributions receive more than 50 per cent of all member contributions, whereas the corresponding 50 funds receiving the highest amount of employer contributions receive around 40 per cent of all employer contributions. See Table 1.

Additionally, the concentration of member contributions is increasing, with each of the categories shown in table 1 experiencing an average increase in concentration of around eight percentage points during 1997-98 over 1996-97.

Future developments

Member contributions currently represent around 38 per cent of all contributions made into superannuation. If the level of member contributions continues to grow at a faster rate than the level of employer contributions then this ratio will further increase. The level of member contributions represents a significant personal contribution by Australian workers towards their retirement savings. In fact, the $12.9 billion in member contributions is equivalent to around five per cent of workers' salaries and wages, up from four per cent in 1995-96. As previously mentioned however, member contributions do not have the 'organic' growth drivers that employer contributions have, and it remains to be seen whether the high member contribution growth will be maintained in the event of an economic downturn.

Focus on PSTs

Pooled Superannuation Trusts (PSTs) represent a distinct subgroup of the managed wholesale pooled funds market. In this article we analyse the PST market, the major APRA regulated segment of the wholesale funds management industry.

The Pooled Superannuation Trusts (PSTs) regulated by APRA are required to be used only for the investment of assets of regulated superannuation entities and some other, generally tax exempt, arrangements. For this reason PSTs can be considered as part of the wholesale pooled funds market. PSTs are distinct from similar wholesale trust arrangements in that they are responsible for paying the tax due on investment earnings, whereas standard trusts distribute all income and taxation is the responsibility of the investors.

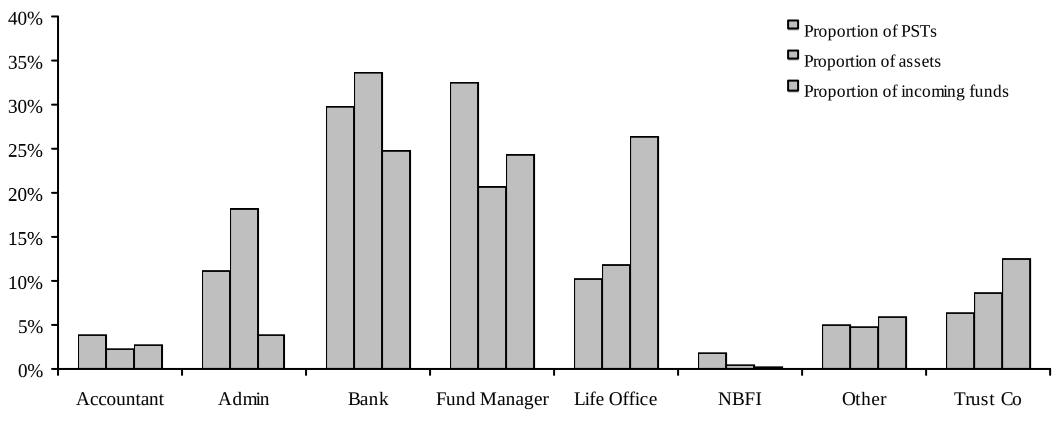
The advantages offered by a PST include providing a means to achieve a diversity of investments by smaller superannuation funds with insufficient assets to establish a diversified portfolio in their own right. Investment in pooled funds may also lead to increased efficiencies for larger funds. The significant distinction between PSTs and other wholesale pooled arrangements lies in the different relative tax efficiencies of each, which needs to be assessed in the context of the investors' total portfolio. For example, where a fund has significant franking credits from a direct equity holding, a standard wholesale fund may be more tax efficient than a PST. This is because the franking credits could be used to offset a tax liability from the standard wholesale fund distribution, whereas the PST distribution has its tax paid and may lead to the franking credits being unused.

The number of PSTs and their total assets under management (AUM) is shown in Table 1. Rainmaker Information Services estimate the total value of placements in pooled wholesale products at $182 billion at June 1997, suggesting that the share of this market occupied by PSTs is some 16.6 per cent (down from 17.6 per cent as at June 1996). While there has been steady growth in both the number of PSTs and their AUM, their share of the assets in superannuation sector has remained consistent at around nine per cent.

Table 1: Estimates of the size of the PST sector

	Jun-95	Jun-96	Jun-97
Number of funds	155	175	188
AUM ($ billion)	21.9	24.4	30.3

Figure 1: Ownership of PSTs



Ownership

PSTs are required by legislation to be operated by an Approved Trustee. The bulk of PSTs are operated by approved trustees within the banking and fund manager industries, followed by those operated within administration and life company groups. Administration, banking, and, to a lesser extent, life company groups tend to operate PSTs that are relatively larger than those operated in fund management groups. See Figure 1.

One reason for this may be that administration and bank groups tend to offer larger, 'balanced' PSTs that invest in a range of asset classes, whereas in fund management groups smaller PSTs tend to be offered that focus on particular asset classes. Thus although approximately 60 per cent of PSTs offer 'balanced', diversified portfolio style investment, these PSTs hold around 85 per cent of PST assets. In contrast, sector specific investments are offered by some 40 per cent of PSTs, that hold around 15 per cent of PST assets.

The 'other' category in Figure 1 refers to a small number of privately owned, non-public offer PSTs. They offer a means for entities, usually large corporations, with significant superannuation assets to efficiently combine the investments of a number of superannuation funds. For example, following a takeover, it may be more efficient for the superannuation fund of the entity that has been taken over to have its assets invested in units in the takeover corporation's private PST, rather than be merged with any existing superannuation fund operations of the takeover corporation. In this way, investment management efficiencies are maximised for all superannuation funds, while complex administrative issues are avoided. It should be noted that the SIS legislation requires that a PST be operated by an approved trustee – these 'other' arrangements are established under specific legislative exemptions.

Figure 1 also shows that PSTs operated within bank, fund manager, and life company groups are attracting similar shares of fund inflows (in the form of income from the sale of units), despite their differing share of AUM. This suggests that the fund manager and life company operated share of PST assets may be increasing, with the bank operated share decreasing. Interestingly, this situation in the wholesale managed fund sector is the reverse to that in retail life company operations. In the latter, the bank owned life companies, while having a lesser share of total AUM than the traditional life offices, are receiving a significantly larger share of new premium inflows than the traditional life offices. PSTs operated within administration groups have a far lower share of new PST inflows, suggesting that their market share may have peaked. However, one reason for this may be that PSTs operated by administration groups are only offered to their particular clients (rather than the industry more generally) who are more likely to be smaller sized funds.

Table 2: Fundsize distribution

Sizerange $	1995	1996	1997	1997 Operating costs as a proportion of assets
less than $1 million	23%	11%	11%	18.81%
$1 to $5 million	14%	21%	16%	1.93%
$5 to $10 million	10%	14%	10%	1.43%
$10 to $25 million	11%	10%	14%	1.71%
$25 to $50 million	12%	11%	11%	2.13%
$50 to $100 million	10%	10%	9%	1.69%
$100 to $200 million	5%	9%	11%	1.85%
$200 to $500 million	9%	8%	10%	2.39%
$500 to $1,000 million	5%	3%	5%	2.55%
more than $1,000 million	1%	2%	3%	1.95%
All	100%	100%	100%	2.12%

Table 3: Manner of Investment for PSTs

	1995-96	1996-97
Directly invested (Australian financial)	73%	72%
Directly invested (Australian property)	3%	1%
Directly invested (Overseas)	9%	9%
Placements with investment managers	14%	15%
Placements with Life Office Statutory Funds	1%	3%
	100%	100%

Assets and costs

PST distribution by size of AUM is presented in Table 2. This table also contains average figures for total PST costs as a proportion of AUM (based upon 1996-97 annual compliance returns). Costs here include administration and investment expenses, tax, and 'other' expenses. While the average size of PSTs by AUM has been increasing, there remain a significant minority with AUM under $1 million. As costs increase dramatically for PSTs of this size it would seem that they would be extremely unattractive as an investment vehicle to other superannuation funds and therefore it is likely that the number of PSTs in this range will continue to decline.

However, not all these small PSTs may be standalone entities. The PST may be merely an additional administrative arrangement, with the assets of the PST being channeled through to a broader asset pool, also utilised by an associated standard wholesale pooled fund. In this scenario, the PST represents an adjunct to the 'main' pool of funds which allows a broader tax strategy to be used by investors. Presumably, the tax efficiencies, and the presence of an established link with the associated wholesale fund, are the motivation for bearing the fees associated with higher operating costs. Naturally, this arrangement may also be utilised by larger PSTs as well to some extent.

Manner of investment and investment return

Assets are primarily invested directly by the PST suggesting that the extent to which PSTs are acting merely as an administrative vehicle (as outlined above) is not great. Table 3 shows a breakdown by manner of investment. Given that these trusts may be regarded as a broadly similar to other wholesale

Figure 2: PST investment returns 1996-97

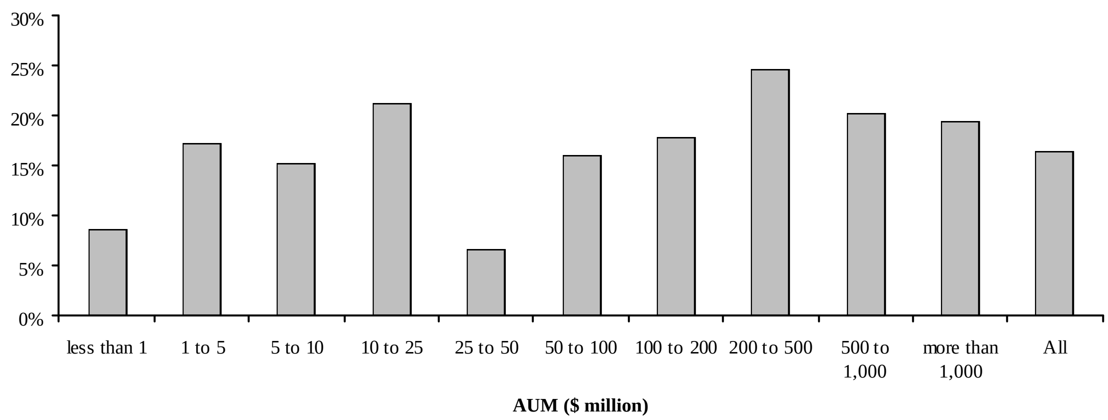


Table 4: Use of external service providers

Owner	Administrator	Investment manager	Custodian	Other
Accountant	29%	43%	100%	71%
Administrator	71%	76%	100%	33%
Bank	6%	20%	57%	81%
Fund manager	9%	21%	74%	36%
Life Co	26%	37%	84%	42%
NBFI	33%	0%	33%	33%
Trust Co	17%	100%	17%	75%
Other	21%	53%	68%	89%
All	*20%*	*37%*	*69%*	*59%*

managed funds this is unsurprising. In most cases where PSTs have placements with investment managers this will involve the majority, if not all, of their assets (i.e. the PST acts essentially as an administrative vehicle). In keeping with their wholesale nature, PSTs make relatively little use of life office policies, which tend to be retail investments.

The investment performance of PSTs by size of AUM is presented in Figure 2. This figure shows a considerable variation in return by size, which apart from being affected by individual performances, may also reflect structural factors associated with the investment strategies of the PSTs and may therefore be misleading. Thus the comparatively lower performance of trusts in the $25-50 million range may indicate a predominance of PSTs investing in more defensive asset classes in this range, compared to growth asset class focused trusts. Notwithstanding this, there does not appear to be a significant correlation between the size of a PST and its investment earnings.

Use of service providers

There are significant differences in the use of external service providers according to the operator of the PST. These are summarised in Table 4. The 'other' service providers include actuaries, lawyers, accountants, and other advisors. Note that 'external' here refers to a separate legal entity, which in some cases will obscure a broader association.

Conclusions

PSTs occupy a small but significant sector of the total wholesale pooled funds market, and represent a distinct means of integrating superannuation assets into this broader sector. Their size in terms of funds managed is increasing in line with the growth in size of total superannuation assets, and to some extent this is reflected in an increase in the number of PSTs themselves. However, their small share of the overall wholesale fund management market suggests that while they continue to remain a significant aspect of the management of funds by public offer entities (in particular), they remain an adjunct, rather than a primary aspect, of an overall investment strategy.

Use of investment managers in the general insurance industry

The general insurance industry is extremely reliant upon maximising investment returns to maintain continued strong profitability. In this article we examine the use of investment managers by the general insurance industry and compare this to their use by the life and superannuation industries.

Background

Previous APRA analysis has demonstrated that the general insurance industry has consistently been making underwriting losses (that is, paying more out in claims and underwriting expenses than they have been receiving in premium revenue). Nonetheless the industry as a whole has been making net profits due to the industry being able to consistently make returns from investments since the early 1980's.

The asset figures published for the general insurance industry are based on the balance sheets of general insurers rather than reflecting assets under management as is the case for life companies and superannuation funds. These balance sheet assets can be subdivided into income and non-income producing components. Non-income producing assets are an essential component of a general insurer's balance sheet. They include accounting based assets such as unpaid premiums, reinsurance assets (accrued claims recoveries and deferred reinsurance expense), deferred acquisition costs, most operating assets and intangibles. Shareholder assets and those assets reflecting policyholder equity (i.e., assets funding liabilities to policyholders) generating income and capital gains are income producing assets. For the purpose of this article we will consider those assets that insurers identify as their investment assets. These assets form the vast majority of all income producing assets. The outcome of this approach is that of the $77.8 billion as at June 1998 in total gross assets of the general insurance industry, only 68 per cent or $52.9 billion were considered by the industry to be investment assets.

Asset placement with Investment Managers

While the investment assets for the general insurance industry have grown from $39.4 billion in June 1995 to $52.9 billion in June 1998 (or 15 per cent per annum), the general insurance industry assets placed with external investment managers have only increased from $12.2 billion to $14.5 billion (or seven per cent per annum) over the same period.[1] This result indicates that there has been a steady decrease in the proportion of general insurers' investment assets placed with investment managers, from 31 per cent in

Figure 1: General insurance assets placed with investment managers

*Public sector general insurance investment assets for June 1998 are not currently available and have been estimated.

[1] Source: ABS No. 5655.0

June 1995 down to 27 per cent in June 1998. See Figure 1.

While it is not clear exactly why this may be the case some possible reasons may be:

- The cash flow nature of the general insurance industry encourages companies to concentrate on liquid short-term assets such as cash and short term securities. Making a placement with an investment manager may be viewed as a long term commitment of funds;
- Privatisation of the public sector insurers, which have traditionally managed their assets 'in-house' and which may have retained this approach even though privatised; and
- Investment managers not having been able to market themselves efficiently to this sector of the financial system.

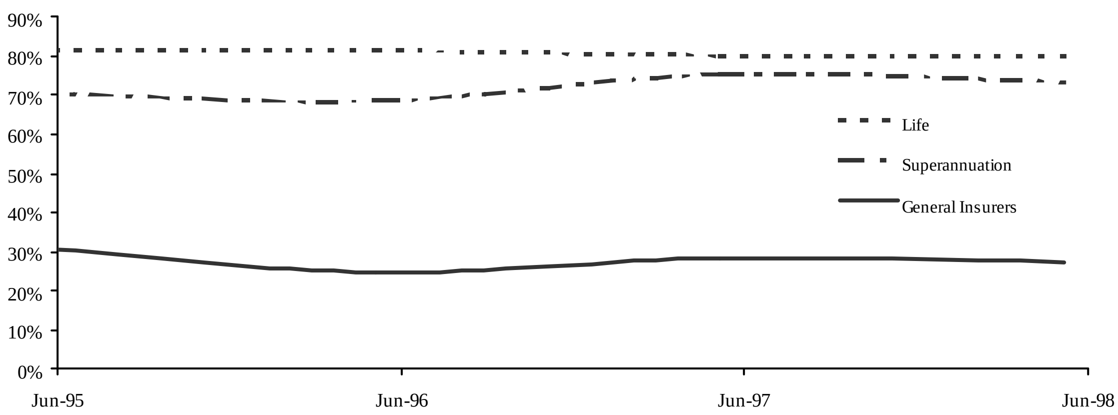
It is also likely that the use of external investment managers by general insurers is not consistent across the industry. Those insurers which form part of a wider financial service group which also includes an associated investment management operation may be more likely to use an investment manager. For example, around six of the 25 largest investment managers in Australia are part of a larger financial services group which also includes a general insurer. General insurers in these groups are perhaps more likely to use an investment manager than insurers where this is not the case.

Comparison of use of Investment Managers

Life offices have the greatest proportion of assets placed with investment managers at 80 per cent or $126.5 billion of their statutory fund assets as at June 1998. In the case of life offices the investment manager receiving the assets is usually an associated company to the life office. However, in more recent times there has been an increasing trend (as part of the wider trend to sector specialist managers rather than balanced managers) to use a larger number of managers.

Superannuation funds had 73 per cent or $263.9 billion of their assets as at June 1998 placed with investment managers (superannuation assets invested in life office statutory funds are deemed to be assets placed with an investment manager for this article). For many small but fast growing superannuation funds, especially industry funds, there was insufficient infrastructure within the fund to make 'in-house' management of the funds assets a viable option. In this environment investment managers were able to successfully provide the expertise required to manage these assets. However, the proportion of superannuation assets being directly invested by fund trustees is increasing at a greater rate than assets being placed with an investment manager. This may be a reflection of the increasing confidence and capability (in terms of expertise and economies of scale) of superannuation

Figure 2: Comparison of placements with Investment Managers



fund trustees to bring fund asset management ‘in-house’.

Clearly however, both the superannuation and life industries make significantly more use of investment managers than does the general insurance industry. See figure 2.

An important distinction between life offices and superannuation funds on the one hand and general insurers on the other is that in most cases superannuation fund members (other than defined benefit members) and life policyholders (other than capital guaranteed and annuity policyholders), rather than the institutions themselves, essentially bear the investment risk. In contrast, general insurance companies directly bear the investment risk. This may lead to general insurers desiring more direct control over investment decisions, rather than passing them to investment managers.

Future developments

The experience of the general insurance industry over the past two decades suggests that there may be no significant advantage to the industry in making increased use of external investment managers. However, for investment managers, if their use by general insurers were to increase to around about the level of use by superannuation funds and life companies (e.g. around 70 per cent of investment assets), they would gain overall an extra $25.5 billion (or 5.5 per cent) in assets under management. General insurers would then become their fourth largest source of funds behind superannuation funds, life offices and public unit trusts.

Superannuation survey highlights - September 1998

Main features

- Total superannuation assets had reached $364.6 billion by the end of September 1998, representing growth of 0.6% during the quarter, or 9.0% during the year ending September 1998.
- The number of member accounts rose 3 per cent during the quarter and now stands at around 18.8 million.
- Contributions during the year ending September 1998 were up 20.4% compared to the previous 12 months, increasing from $29.6 billion to $35.6 billion.
- The strongest growth continues to come from member contributions, increasing by 31% over the previous year to $13.8 billion. Employer contributions increased by 15% to $21.8 billion.
    - *the SG level increased from 6% to 7% from July 1998.*
- Benefit payments (excluding outward transfers) during the year ending September 1998 were up 13.1% compared to the previous 12 months, increasing from $18.8 billion to $21.3 billion.
- Net contributions (that is, contributions less benefits) for the year ending September 1998 were $14.4 billion, up 33% on the previous 12 months.
- Superannuation funds experienced an overall net investment loss during the September quarter, partly due to a downturn in Australian equity markets, so that net deposits accounted for all asset growth during the quarter.

Industry structure

The assets managed by small self-managed funds (ie, excluded funds with less than 5 members) grew fastest during the year ending September 1998, increasing by 20% (or $7.3 billion). This was closely followed by industry and retail funds which both grew by 17% (or $3.6 billion and $14.1 billion respectively) during the last year.

Corporate fund assets grew by 3%, or $2.1 billion during the year. Public sector assets grew by 6% ($4.6 billion).

Retail funds currently hold around 26% ($95.7 billion) of total superannuation assets, public sector funds hold 22% ($78.5 billion), corporate funds 18% ($65.7 billion), excluded funds 12% ($43.8 billion), and industry funds 7% ($24.9 billion).

The excluded fund, industry fund and retail market segments all increased their market shares slightly during the year ending September 1998, while that of the corporate funds and public sector declined marginally.

The proportion of the superannuation industry represented by the ‘ balance of statutory fund’ assets (which represents annuity products, fund reserves and unallocated profits of life office statutory funds) was 15% at September 1998.

The assets managed through Retirement Savings Accounts (including existing superannuation funds and sub-funds deemed to be RSA look-alikes) reached $591 million at September 1998. This is a growth of 123% (or $265 million) since September 1997, however it has been mainly due to the reclassification of existing assets as belonging to an RSA look-alike product. The share of superannuation assets in RSAs remains at less than 1%.

Contributions and benefits

During the September quarter, employers contributed $5.7 billion into superannuation, up 18.4% on the 1998 September quarter. Much of this increase can most likely be attributed to the 16.7% increase in the level of SG. In contrast, the $3.9 billion which employees contributed into superannuation during the same period was up 28.4% on the previous September quarter. Overall, September 1998 quarter contributions were up 20.4% on the September 1997 quarter.

As the contributions into small self-managed funds were estimated to be only 9.6% higher in the year ending September 1998 than the previous year, overall contribution growth is apparently being mostly driven by the membership of the large superannuation funds. Nonetheless growth in net contributions into small funds was 6.0% higher than in the previous 12 months, being partly fuelled by the growth in their number, eg. the number of excluded funds increased to 174,937 during the September quarter, (up 2%).

Inward transfers remained at their usual levels, accounting for 38% of all money deposited into superannuation funds during the September quarter.

Lump sums, excluding outward transfers, accounted for 80% ($4.5 billion) of the benefits paid during the September quarter. The remaining 20% ($1.1 billion) of benefits were paid as pensions. Outward transfers accounted for 47% of all fund withdrawals during the September quarter, similar in relative importance to inward transfers.

Benefit payments, excluding transfers, during the year ending September 1998 were up by 13.1% compared to the previous 12 months (with a similar increase in the level of both pension and lump sum payments). With the higher growth rate in contributions compared to benefit payments, net contributions (ie., contributions less benefits) rose dramatically (33.1%) for the year ending September 1998 compared to the previous year. During this period $14.4 billion in net contributions flowed into superannuation (compared to $10.8 billion in the previous year).

Manner of investment

Assets directly invested by trustees showed the strongest growth during the quarter, increasing by 2.1%. Assets placed with an investment manager declined by 0.8% and assets invested through the statutory funds of life offices grew by 1.1%.

Investment managers had 39.1% ($142.5 billion) of total superannuation assets at the end of September 1998, up from 38.8% at September 1997. The share of directly invested superannuation assets increased 1.8% to 27.1% ($98.7 billion), with the statutory funds of life offices continuing to steadily lose share, reaching 33.8% ($123.3 billion) of total assets, down from 35.9% in September 1997.

Asset allocation

The share of superannuation assets invested overseas fell during the quarter to 15.7% ($57.3 billion) at the end of September 1998, down $2.9 billion. However, the AUD depreciated against both the TWI and the US dollar (involving around half of all overseas investment) during the quarter (by 6.4% and 3.1% respectively) acting to automatically increase the AUD value of overseas investments. This suggests that there was a net inflow of overseas assets back to Australia during the quarter, else the value of overseas assets in their ‘home’ markets fell.

Superannuation investment held in equities and units in trusts decreased by 1.3% ($1.8 billion) during the September quarter. Measured against the 2% decrease in the ASX accumulation index in the September quarter, this suggests that there was still a small net increase in assets invested in equities markets by superannuation funds. Superannuation equity and trust holdings overall decreased slightly to 36.2% of total superannuation assets (from 36.8%).

Partly due to a decrease in both short and long term bond yields during the September quarter, holdings of interest bearing securities increased by 5.2% ($4.5 billion). The proportion of superannuation assets held as interest bearing securities increased 1.2% to 24.9%.

Holdings of cash, deposits and placements increased by 3.1% ($1.3 billion) in the September 1998 quarter (the vast majority of the increase being in loans and placements). They now represent 12.1% of the total value of superannuation assets.

These results suggest that more volatile equity and overseas markets have led to superannuation funds' adopting a more defensive investment strategy, with allocations to cash, placements and securities increasing while the proportion of funds in equities and overseas investments decreased.

The value of assets held in direct property rose marginally in the September quarter to 7.2% of total superannuation assets at the end of the quarter. Other investments account for around 2% of total superannuation savings.

Insurance highlights - September 1998

Main features

- Total life office statutory fund assets backing Australian policyholders liabilities had reached $153.2 billion by the end of September 1998, representing growth of 0.6% during the quarter, or 8.2% during the year ending September 1998.
- Total private sector general insurers assets had reached $57.2 billion by the end of September 1998, representing growth of 3.8% during the quarter, or 9.6% during the year ending September 1998.
- Life office premiums for the September 1998 quarter reached $10.8 billion, up 38.3% on the September 1997 quarter. During the year to September 1998 life offices received $35.0 billion in premiums.
- Policy payments made by life offices reached $8.2 billion for the September 1998 quarter, up 14.7% on the September 1997 quarter. During the year to September 1998 life offices made $29.5 billion in policy payments.
- Private sector general insurer premium revenue (less reinsurance expense) reached $3.7 billion for the September 1998 quarter, up 5.8% on the September 1997 quarter. Premium revenue for the year to September 1998 amounted to $14.3 billion.
- Private sector general insurer claims expense (less reinsurance and other recoveries revenue) reached $3.3 billion for September 1998 quarter, up 18.0% on the September 1997 quarter. Claims expense for the year to September 1998 amounted to $12.3 billion.
- Life offices experienced an overall net investment loss during the September quarter, partly due to a downturn in Australian equity markets, so that net premiums accounted for all asset growth during the quarter.

Industry structure

Life Insurance

Life office statutory fund superannuation assets increased by 1.1% ($1.3 billion) to $123.3 billion at the end of September 1998. Superannuation assets now represent 80.5% of the total assets in life office statutory funds up from 79.1% in September 1997. In contrast, life office statutory fund ordinary business assets fell by $338 million (or 1.1%) to $29.9 billion at the end of the September 1998 quarter.

Investment linked statutory fund assets rose over the quarter to $88.5 billion, up $128 million (or 0.1%), an increase of 8.3% (or $6.8 billion) for the year ending September 1998. These assets now represent 57.8% of the total assets in life office statutory funds, up from 53.8% in September 1997. Non-investment linked statutory fund assets increased to $64.7 billion, up $842 million (or 1.3%) over the quarter. However, non-investment linked assets fell by 7.9% ($5.6 billion) for the year ending September 1998.

General Insurance

Assets for private sector direct insurers increased by 3.4% ($1.4 billion) to be $43.9 billion at the end of September 1998. These assets now represent 76.7% of the total assets in the private sector general insurance industry, down 0.3% on the June 1998 quarter.

Reinsurers assets have increased by 5.3% ($672 million) to be $13.3 billion at the end of the quarter.

Premiums and policy payments

Life Insurance

Premiums received through life office for superannuation business were $9.3 billion for the quarter, up 40.4% ($2.7 billion) on the September 1997 quarter, superannuation premiums for the year to September 1998 amounting to $29.8 billion. Superannuation premiums now represent 86.1% of total life office premiums.

Premiums from the ordinary business were $1.5 billion for the quarter, up by 26.3% (or $311 million) on the September 1997 quarter, with total ordinary business premiums for the year to September 1998 amounting to $5.1 billion. Ordinary premium business now represents only 13.9% of total life office premiums.

The $35 billion received by life offices in premiums and $29.5 billion made in policy payments led to net premiums into life offices (ie. premiums less policy payments) over the year to September 1998 being

$5.5 billion. This result was due solely to superannuation business, with net premiums of $5.7 billion, as ordinary life office business had a negative net premium flow of $217 million for the year.

General Insurance

Net premium flows (ie. Premium revenue less claims expenses) amounted to $436 million during the September 1998 quarter, down $293 million (or 40.2%) on the September 1997 quarter.

The underwriting result for the private sector general insurers decreased by 11.1% or $66 million over the quarter, to be -$527 billion for the September 1998 quarter.

Net operating profit (loss) was -$32 million for the quarter, up $59 million (or 64.8%) on the previous quarter.

Asset allocation

Life Insurance

The share of life office statutory fund assets backing Australian policyholders liabilities (life office assets) invested overseas fell during the quarter to be 12.9% ($19.8 billion) at the end of September 1998, down $2.2 billion. However, the AUD depreciated against both the TWI and the US dollar (involving around half of all overseas investment) during the quarter (by 6.4% and 3.1% respectively) acting to automatically increase the AUD value of overseas investments. This suggests that there was a net inflow of overseas assets back to Australia during the quarter, else the value of overseas assets in their ‘home’ markets fell.

Life office assets held in equities and units in trusts decreased by 1.8% ($717 million) during the September quarter, partially reflecting a 2% fall in the ASX accumulation index. Life office equity and trust holdings overall decreased slightly to 25.9% of total life office statutory fund assets (from 26.5%).

Partly due to an increase in both long and short term bond yields, life office holdings of interest bearing securities increased by 4.7% ($2.6 billion). The proportion of life office assets held as interest bearing securities increased 1.5% to 38.7%.

Holdings of cash, deposits and placements increased by 13.7% ($1.9 billion) in the September 1998 quarter (the vast majority of the increase being in loans and placements). They now represent 10.4% of the total value of life office assets.

General Insurance

The share of private sector general insurer assets held outside Australia increased to 13.5% ($7.7 billion) during the quarter, up by 1.0% or $874 million over the previous quarter. This result has most likely been influenced by the decrease in the $AUD mentioned previously.

In other asset classes, the proportion of general insurers assets held in equities was 19.2% (or $11.0 billion), up by 3.1% (or $329 million) during the quarter. Holdings in cash, deposits and placements were $5.5 billion (or 9.6% of the total assets), down by 4.1% (or $237 million) for the quarter. Interest bearing securities were $14.4 billion (or 25.1% of all assets), down by $371 million (or 2.5%) during the quarter.

Other assets for the private sector general insurers increased by 10.7% ($1.7 billion) to be $17.7 billion as at September 1998.

Superannuation survey methodology overview

Results of the APRA Quarterly Survey of Superannuation are combined with estimates of other industry components to provide timely and comprehensive estimates for the total superannuation industry. This paper explains the methodology behind these estimates.

The APRA Quarterly Survey of Superannuation (the Survey), a joint APRA and ABS initiative, was introduced in 1995. Results from the Survey are combined with other APRA estimates to provide total aggregates for the superannuation system. These estimates are published quarterly in this Bulletin.

APRA estimates for the superannuation funds and ADFs outside the scope of the Survey fall into the following two categories:

- medium size superannuation funds and ADFs not included in the Survey; and
- small self-managed superannuation funds (excluded funds[1]).

The Survey

The Survey currently collects information from the largest 365 superannuation funds in Australia, representing around 80 per cent of total (excluded and non-excluded) superannuation assets. The cut-off test for inclusion in the Survey, which is reviewed annually, is more than $60 million in assets under management.

A cut-off threshold was selected as the preferred method due to the highly concentrated nature of the superannuation industry. For example, as at June 1997, in addition to covering 89 per cent of superannuation assets in non-excluded funds, the 365 funds in the Survey also accounted for:

- 91 per cent of members;
- 91 per cent of contributions;
- 91 per cent of benefits; and
- 94 per cent of gross transfers.

Medium size super funds and ADFs

There are currently around 4 200 medium sized funds (predominantly small corporate superannuation funds and small approved deposit funds), representing approximately 8 per cent of assets and 8 per cent of members. In terms of overall industry aggregates (e.g. assets), these funds are collectively the smallest industry sector.

Estimates for this sector are obtained by extrapolating the Survey results to obtain a value for total large and medium sized superannuation funds and ADFs. The actual size of the extrapolation varies from variable to variable depending upon the relative concentration of the variable in the Survey funds. These concentration ratios are based on previous APRA annual return data, which covers the entire population of regulated superannuation funds.

The proportion of the directly invested assets of these funds invested overseas is obtained from annual return data. The remainder of their directly invested assets is allocated into asset classes using the proportions they hold of Survey fund assets.

Small self-managed super funds (excluded funds)

Excluded funds are outside the scope of the Survey. Although excluded funds currently comprise 97 per cent of all regulated funds, they account for only one per cent of members and were therefore not considered appropriate for inclusion in the survey.

Data describing the characteristics of excluded funds are sourced from past APRA audited annual return information, the SIS Statistical Questionnaire[2], a survey of excluded funds conducted by the ISC in

[1] An excluded fund is defined by the Superannuation Industry Supervision (SIS) Act as a superannuation fund with less than five members.

1997 and anecdotal evidence from industry practitioners.

These sources are the basis for identifying three very important defining characteristics of excluded funds that shape the sector's input into total industry aggregates:

- *equity per member* - excluded funds have significantly higher average equity per member than other superannuation funds.
- *propensity to directly invest in the market*-the decision to establish an excluded fund is often based on an intention by individuals to exert increased control over their superannuation investments. This control is illustrated by the fact that 85 per cent of excluded fund assets are directly invested in the market, with only 15 per cent invested through investment managers and life offices. This compares with 26 per cent directly invested for all other superannuation funds. The high degree of direct investment by excluded funds is also consistent with the fact that excluded funds acting individually have limited market power to gain cost effective access to wholesale investment products[3].
- *contributions per member* - excluded funds have extremely high contribution rates per member.

Importantly, analysis of the 1994-95 and 1995-96 ISC annual return information indicates that current excluded funds have essentially the same broad characteristics as excluded funds in the pre-SIS environment. This is also supported by anecdotal evidence from industry practitioners and other industry surveys. While the broad characteristics, such as high equity per member, propensity to directly invest and high contributions per member, have remained the same, there has been some change in emphasis in newly established funds[4]. The ratios for excluded funds will continue to be revised in line with annual return data and other industry information.

Notably, APRA has been conservative in estimation of excluded fund aggregates, recognising the inherent error margins associated with interpolating quarterly data from annual return information. An example is the estimation of the number of excluded funds. The Survey methodology assumes that 10 per cent of excluded funds operating at a certain date either wind-up within a year of that date or are dormant[5]. These assumptions are based on previous ISC excluded fund annual return information and are revised on an annual basis. It is therefore possible that excluded fund aggregates derived using the Survey methodology are lower than the actual totals.

Another conservative assumption concerns the method used to calculate the average investment return for excluded funds. The investment return calculation is a weighted average of index returns (eg ASX Accumulation Index) based on the average asset allocation of excluded funds. One of the results of this method is that 25 per cent of excluded fund assets are assumed to increase only with CPI.

In the presentation of directly invested assets by asset class, previous ISC surveys of excluded funds are used to apportion the directly invested assets of these funds.

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[2] The SIS Act was enacted in 1993. When funds elected to become regulated under the SIS regime they were asked to complete short statistical questionnaire to provide the ISC with selected statistics of the fund as at June 1994.

[3] Some investment managers are however beginning to respond to the developing excluded fund market by tailoring retail investment products that more closely match the fee structures of the larger wholesale investment industry. It is likely that these products may encourage greater indirect investment by excluded funds in the future.

[4] These differences are outlined in the article *"ISC Bulletin and Annual Return comparison"*, ISC Bulletin, June 1996.

[5] A dormant fund is a fund that has been established but has had no income or expenditure and has zero assets

Life Act superannuation

Life Act superannuation refers to superannuation products sold directly from life office statutory funds (eg deferred and immediate annuities) that are regulated solely under the Life Act. The scope of the Survey includes, subject to the Survey threshold criteria, all superannuation and approved deposit funds outside life offices and virtual funds[6] within life offices, but excludes superannuation investment products sold directly from statutory funds. However, the APRA figure for total superannuation assets includes Life Act superannuation, as superannuation assets in life office statutory funds (including Life Act superannuation) is captured by APRA Life Office statutory returns.

The components of the industry are summarised in Figure 1.

Estimation of total assets

The calculation of total superannuation assets is achieved through merging the Survey data and APRA data for life office statutory fund superannuation assets with data from the ABS Survey of Balance Sheet Information (SOBSI), which is a quarterly asset survey of investment managers. The SOBSI survey and Life Office statutory returns together measure superannuation assets invested in pooled investment instruments and products. Data describing the directly invested assets of Survey funds, and the directly invested assets of medium sized funds and excluded funds, is combined with the pooled asset results to produce the estimate for total superannuation assets.

Fund type

The fund type categorisations used reflect the functional or economic (as opposed to legal or regulatory) segmentation of the market.

They include Corporate, Industry, Public Sector, Excluded and Retail.

Corporate funds are sponsored by a single non-government employer, or group of employers.

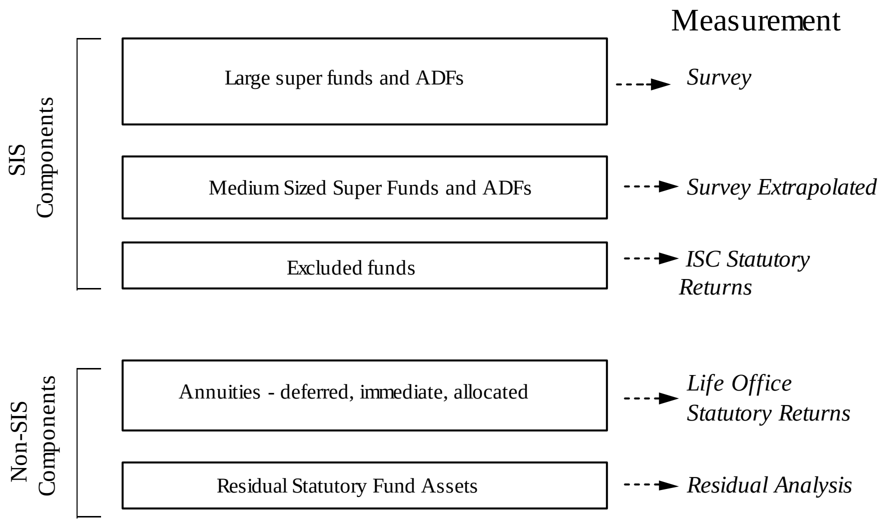
Industry funds are those established under an agreement between the parties to an industrial award.

Public sector funds are sponsored by a government employer or government controlled business enterprise.

Excluded funds are superannuation funds that have less than 5 members (also known as the self-managed, DIY or ' mum and dad' funds) and single member ADFs.

Retail funds are pooled superannuation products sold commercially and competitively through intermediaries, including master trusts and personal superannuation products.

Figure 1 - Components of the Superannuation Industry



The Balance of statutory funds is the remaining superannuation assets residing in life office statutory funds, after the assets explicitly known to reside in the other fund types have been allocated.

Retirement Savings Accounts (or RSAs)

As part of APRA's continuing effort to provide a comprehensive understanding of the superannuation industry, figures are now produced for the assets placed with Retirement Savings Accounts (RSAs). These figures include both assets with RSAs established under the RSA Act (or standard RSAs) and those in public offer superannuation funds that have been deemed to be RSAs (RSA look-a-likes). Information on RSAs is sourced where available from existing APRA data collections as well as directly from the provider when necessary.

Reporting basis

Participants in the survey are requested to follow, as far as possible, the Australian Accounting Standard AAS25 and to report assets at net market valuation.

Net market value refers to the amount which could be expected to be received from the disposal of an asset in an orderly market after deducting costs expected to be incurred in realising the proceeds of such a disposal. Respondents to the ABS SOBSI survey are also requested to report assets at their market value.

Data quality

The Survey has been running for nearly three years and the statistics contained in the Bulletin may be considered robust. Due to accounting difficulties with identifying fees and charges, net earnings rather than detailed income and expense results are published in this Bulletin.

The total superannuation asset figures do not include any provision for the unfunded superannuation liabilities of Australian governments to public sector superannuation funds. However, the total asset figures do include the assets of some public sector superannuation funds that are exempt from direct APRA supervision but are captured by the Survey.

The new survey form introduced in the previous quarter has highlighted some data reporting problems with the survey forms previously used which in turn has necessitated some revisions in this publication to previously published data. While the data collected in the redesigned form is comparable with the previous statistical series, some compositional aspects are currently under investigation and this could lead to revisions to the published data in future editions of the Bulletin.

Revisions

This Bulletin contains revisions to previously published statistics. The Survey is recalibrated each year based on annual return data. As this data is obtained in arrears it will lead to periodical revisions of the back series. Where figures have been rounded, discrepancies may occur between sums of the component items and totals.

Comparability with other superannuation statistics

There are major methodological differences between how directly invested assets are measured by the APRA Quarterly Survey of Superannuation from June 1995 and previously published ISC or ABS superannuation asset data.

However, to assist users of superannuation statistics, the ABS includes estimates for the increased directly invested component of superannuation funds and ADFs for quarters prior to June 1995 in 'Managed Funds' (Cat. 5655.0). These estimates are also included in the directly invested assets and total assets tables in the Bulletin. The estimates have been based upon a historical analysis of ISC superannuation annual return statistics and ABS National Account statistics.

Unpublished statistics

A wide range of information, collected via the APRA Quarterly Survey of Superannuation and APRA Annual Returns is available from APRA on a fee for service basis, subject of course to strict privacy constraints (a data request form may be found at the end of this Bulletin).

More information regarding investment managers is available on request from the ABS.

APRA Speeches

APRA - The Outlook for Prudential Regulation

Speech made by Graeme Thompson, Chief Executive Office, Australian Prudential Regulation Authority, to Investment & Financial Services Association, Canberra, 8 September 1998.

I welcome this opportunity to address you today as Chief Executive of the newly-formed Australian Prudential Regulation Authority - APRA.

Reorganising the regulators

This agency was born on 1 July, only 9 weeks ago, from the widely-held view that the regulation of Australia's financial system could be organised more logically - and more efficiently.

This view was endorsed and promoted by the Wallis Committee, which recommended last year that responsibility for financial regulation should be allocated on a *functional* basis - that is, one agency for each of the major types of regulation.

This has translated into:

- an agency responsible for the *stability* of the financial system as a whole and for the payments system - a traditional central banking role which remains with the Reserve Bank;
- an agency overseeing *competition* in the financial system - that is the Australian Competition and Consumer Commission;
- an agency to promote efficient and fair *market conduct,* including disclosure standards and consumer protection arrangements - the Australian Securities and Investments Commission; and
- an agency responsible for *prudential* regulation - which is, of course, where APRA fits in.

Prudential regulation, as the name suggests, is about promoting prudent behaviour by insurance companies, superannuation funds, banks and other financial institutions - with the objective of protecting the interests of policyholders, investors or depositors depending on the financial institution involved. It is concerned fundamentally with the quality of an institution's systems for identifying, measuring and managing the various risks in its business and (in most cases) with the adequacy of the capital held as a buffer against unexpected losses.

Another important role for the prudential regulator is resolving the position of financial institutions which have actually become unviable, so that the interests of savers are protected to the maximum extent. APRA has extensive formal powers of investigation, intervention and administration for this purpose. (My experience is that moral suasion and arm twisting can sometimes be quite effective in these circumstances too.)

As the comprehensive prudential regulator in the Australian financial system, APRA has taken over the responsibilities:

- of the Insurance and Superannuation Commission for supervising superannuation funds and life and general insurance companies; and
- of the Reserve Bank for supervising banks.

It is planned that later this year (or as soon as practicable thereafter) we will also take over the regulation of building societies, credit unions and friendly societies. This is now done by various State supervisory agencies, such as FINCOM and VicFIC, under the umbrella of the Australian Financial Institutions Commission (AFIC).

Our direct responsibilities will then cover around 85 per cent of the assets in Australia's financial system. The main groups for which we will not have supervisory responsibility are finance companies, merchant banks and non-superannuation funds management vehicles. For the next year we will regulate excluded super funds, but it is intended that these will move to the Tax Office in mid 1999.

Along with the prudential regulatory functions of the ISC and the RBA, APRA has acquired the staff who did the work in those agencies - about 450 people in all. When the State regulation transfers, another 90 or so people will join us.

APRA's head office is in Sydney and we will also be represented in Melbourne, Canberra, Brisbane, Adelaide and Perth.

We are a statutory authority, similar to the Reserve Bank, governed by a Board of 9 members, with a considerable degree of autonomy from Government. Describing our role, our Act says that "APRA is established for the purpose of regulating bodies in the financial sector in accordance with other laws of the Commonwealth that provide for prudential regulation or for retirement income standards, and for developing the policy to be applied in performing that regulatory role". One function of our Board is "to determine APRA's policies (including goals, priorities, strategies and administrative policies)".

We are, of course, ultimately accountable to Parliament and will produce an Annual Report. We are also to keep the Government informed of our prudential policies. In the event of a difference of opinion about policy the Government may overrule APRA, with an explanation of this tabled in Parliament - similar to the monetary policy provisions in the Reserve Bank Act.

Like the old ISC we will be funded mostly by industry levies. The levy rates are determined annually by the Treasurer.

One prudential regulator

It is worth keeping in mind the advantages which the Wallis Committee saw in having just one prudential regulator, instead of the diverse arrangements we had been accustomed to.

The Committee said:

"A single regulator:

· offers regulatory neutrality and greater efficiency and responsiveness;

· provides a sounder basis for regulating conglomerates;

· offers the prospect of greater resource flexibility and economies of scale in regulation that should enhance the cost-effectiveness of regulation; and

· provides the flexibility and breadth of vision to cope with changes that seem likely to occur in the financial system in coming years."

The challenge for APRA is to deliver on these potential benefits.

I should emphasise that, in talking about "regulatory neutrality", there is no suggestion that all financial institutions can or should be regulated in exactly the same way. We recognise that there are clear differences among financial institutions in the nature of their core business, and the risks inherent in their activities. Such differences call for distinctive regulatory standards and requirements.

APRA's creation does, however, reflect the fact that some of the traditional dividing lines between financial services are becoming less clear and that different business lines are increasingly being grouped under common ownership in conglomerates. It also recognises that many financial risks *are* common across institutional categories and can be supervised in similar ways. Techniques developed in one area could well be suitable in others. There is no good reason, for example, why methods to manage operational risk in insurance companies cannot be employed in banks, or vice versa.

A single regulator like APRA will be well-placed to foster the cross-fertilisation of ideas and methods from various regulatory fields.

APRA and IFSA

What will APRA mean for IFSA members?

On the regulatory front, the main immediate change for industry is some shuffling of responsibilities in line with the Wallis Committee's functional model.

In respect of life insurance, all of the Life Act, except most of Part 10 (which deals with such things as the issuing of policies, bankruptcy protection, unclaimed moneys and lost policies), has come to APRA. All corresponding subordinate legislation - Regulations, Commissioner's Rules (now called Prudential Rules) and Actuarial Standards - are basically unchanged. All policies and interpretations of the former ISC have been adopted by APRA.

Meanwhile, the Insurance Contracts Act and the Insurance Agents and Brokers Act have gone to ASIC, along with those sections of the Life Act mentioned above.

On the superannuation front, the regulatory responsibilities in the Superannuation Industry Supervision (SIS) legislation have been similarly divided between APRA and the ASIC according to the Wallis Committee's functional model.

Broadly speaking, APRA is interested in the way members' funds are being managed by trustees, while ASIC is concerned with the quality of information flowing from trustees to members and the handling of member complaints.

These new allocations of responsibilities will no doubt become grey at the edges from time to time, and from issue to issue. For instance, complaints by members about their treatment by super funds often point to issues of prudential concern. We and ASIC also recognise that a number of players operate in both the superannuation and managed funds arenas with the same staff and systems, so we will be aiming not to impose different requirements on them unless there are good prudential reasons to be more protective in relation to superannuation.

We intend, therefore, to work closely with ASIC wherever our interests overlap or abut. We have established a bilateral co-ordinating committee for this purpose, and are drawing up a Memorandum of Understanding to cover matters such as information-sharing and co-operation in policy-making and problem-solving. The Chairman of ASIC is on our Board.

The Wallis reforms seem to have caused particular misunderstanding about responsibility for superannuation policy. Industry was used to dealing with the ISC on virtually all aspects of this (except where the Department of Social Security and the Tax Department have been the reference points).

I have mentioned the division of responsibility between APRA and ASIC. In addition, under the new arrangements, Commonwealth Treasury now has prime responsibility for the development of legislation and regulations in respect of Government superannuation policies such as preservation rules and other matters with taxation implications.

Where the policies of the APRA Board are to be expressed through legislation or regulation, APRA is the prime contact for industry although Treasury would of course be involved too as adviser to the Treasurer.

I should note that the regulation of insurance company shareholdings is now administered by Treasury under the new Financial Sector (Shareholdings) Act. The prudential aspects of any acquisitions would, of course, have to pass muster with APRA.

As with ASIC, we plan to meet regularly with Treasury to discuss issues of common interest and make sure the new system is working as smoothly as possible.

Apart from these shuffles of regulatory responsibilities, you will notice little change in regulation in the immediate term. In the areas of policy which fall to APRA, the same prudential standards and regulations continue in force. And the same people, previously at the ISC, are administering those policies. It is pretty much "business as usual" for now. One exception is that we have started conducting joint prudential consultations with mixed conglomerate groups.

Before talking about some of the policy issues on our medium-term agenda, let me first come back on the topical issue of levies.

Some insurers and super funds are paying more this year than in the past, while some are paying less. These changes are a result of several factors:

- the move from flat rate levies to graduated ones (based on assets) for life insurers;
- levies for some industries have not covered the full cost of their supervision in the past (in fact, there is still cross-subsidisation from excluded funds in this year's figures);
- an increase in the amount allocated for consumer protection;
- the decision that levies would cover APRA's establishment costs.

One thing which has not changed with the advent of APRA is the "running cost" of prudential supervision. Our operating budget this year is simply an aggregation of the running costs of prudential regulation in the ISC and RBA. In coming years we aim to cut this - as we reap the efficiency benefits which should come with a single agency and our reviews of inherited methods and systems.

Tasks ahead

As well as ensuring that we work smoothly with the other regulatory agencies, we have some important integration tasks of our own.

One is to weld the various groups of staff we inherit into a coherent, professional body of regulators with a common supervisory ethos. Over time we will be rotating staff to get those cross-fertilisation benefits I referred to earlier. We will also have an active APRA-wide training program.

Over time, we will also be seeking opportunities to harmonise prudential standards and techniques across the range of activities and institutions we regulate.

The easier task here is with requirements across all deposit-takers - banks, building societies and credit unions. This is not so difficult because their regulatory frameworks have been similar for some time. APRA recently made some changes to the rules for banks so that there are now no significant differences in the respective capital adequacy requirements.

A larger task is a study of the scope for harmonising prudential requirements between deposit-takers and insurance companies. There was evidence presented to the Wallis Committee suggesting opportunities for regulatory arbitrage between banks and life insurance companies arising from differences in capital charges on similar products. We will be looking into this.

In addition, there is the question of whether some of the techniques developed in supervising particular institutions can be exported and applied to other institutions regulated by APRA. At present, for instance, different use is made of external auditors by supervisors of different industries. There are various mixes of on-site and off-site surveillance. There are different uses of scoring systems to rate the condition of insurance companies, banks and credit unions.

As input to the harmonisation project, we will:

- develop common terminology for risks across sectors;
- develop a common understanding of the present differences and similarities in the risk assessment and capital regimes across sectors; and then
- assess the legitimacy of those differences, the potential for arbitrage and the scope for more consistency.

We are also pushing ahead with the further evolution, already begun in the ISC, of our techniques for regulating superannuation funds. Very broadly, our objective is to streamline and refine our off-site and on-site review processes so that they can identify more effectively those areas of risk or weakness which require APRA's attention. We would devote correspondingly fewer resources than in the past to areas where there were no alarm bells ringing. For strong, well-managed funds this should mean less paperwork and less time spent with our review teams.

The philosophy of concentrating our energy on areas of greatest perceived risk is one which will be applied APRA-wide.

I expect that a more focussed approach, together with the increasing familiarity of industry with the provisions of the SIS legislation, will allow us to cut the resources used in regulating super. This would be consistent with maintaining (at least) the effectiveness of prudential oversight.

Another key task is to develop the most cost-effective techniques for overseeing the activities of financial conglomerates - one of the objectives for which we were established. APRA will reduce the number of regulatory points of contact for such conglomerates. We have already begun to conduct integrated prudential consultations for bancassurance groups and will look next at integrated inspections.

In the medium-term we will be designing an organisation structure for APRA which allows us most efficiently to combine our statutory responsibilities for individual components of conglomerates with the need to appraise the overall health of such groups and to recognise that risk management is increasingly conducted on a conglomerate-wide basis.

Our supervision of groups will be informed by the work of the Joint Forum on Financial Conglomerates, the international body developing standards of best practice for regulators. APRA has succeeded to the ISC's seat on this.

APRA's style

A few words on APRA's general supervisory style are warranted..

We set out to be a highly professional, "market savvy" prudential regulator. We will aim to be capable of adapting our supervisory requirements flexibly in response to (or, better, in anticipation of) innovations in markets and products.

We intend to consult closely with industry on trends, issues and concerns, on new policy proposals and on how policies are being implemented. We aim to be approachable, and as well informed as practicable.

To build on the excellent contacts which the ISC has already had with industry, I propose to formalise regular, high-level meetings between APRA and IFSA.

My goal is a regulatory approach which strikes a sound balance between the need to minimise risk of loss to the people doing business with regulated financial institutions - which is of course APRA's main purpose - and a recognition that overly intrusive and prescriptive regulation can get in the way of desirable innovation and structural change in the financial system.

I fully support that provision of the APRA Act which says:

> "In providing this (prudential) regulation and developing this (prudential) policy, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality."

In other words, safety is very important but the community needs a financial system with other qualities as well.

Lest I give the impression that APRA will be a "soft" regulator, I should also emphasise that we intend to use our various enforcement powers rigorously and vigorously where that is warranted. The experience of many other countries in recent years clearly demonstrates the risks in undue regulatory forbearance.

End piece

I will conclude by saying that I think Australia's financial system has, by and large, been well served by its regulatory arrangements. This assessment has only been confirmed recently by a comparison with the situation of many other countries in our region.

In prudential supervision, APRA's challenge is to build on the strengths of the agencies whose responsibilities and staff we have now inherited. And to move forward with our financial system into the next century, adapting our supervision to the evolution and changing shape of that system.

My ambition is to make APRA into a respected, professional world-class prudential regulator which will promote confidence in Australia's institutions and thereby contribute to the growth and diversification of our financial system.

We look forward to a long and constructive relationship with IFSA, and with all of its members individually.

Thank you.

Regulation: The New APRA

Speech made by Keith Chapman, Chief Manager, Superannuation, to BLEC "Legal Issues in Superannuation" Conference, Sydney, 29 October, 1998.

I welcome this opportunity to address you today on this topic. It is quite clear that the issues listed under this topic on your programs; ie

- Prudential Supervision
- Market Supervision
- Role of ASIC
- Effect of the new regulatory environment on the superannuation industry

are all-important ones. They are also ones which I believe it is clear, based on the short time in which this new regulatory environment has been in place (ie only for the last three-and-a-half months since 1 July), that the superannuation industry has not yet come to grips with. Despite APRA only having been in existence for a total of 17 weeks, however, there has been a clear indication for a much longer period of time about what the new structure will look like. Despite this many players in the superannuation industry (and, to be fair, in our other supervised industries of banking, life insurance and general insurance) appear to have yet to realise the changes that have occurred.

Reorganising the regulators

The new regulatory regime was born on 1 July, only 17 weeks ago, from the widely held view that the regulation of Australia's financial system could be organised more logically - and more efficiently.

This view was endorsed and promoted by the Wallis Committee, which recommended last year that responsibility for financial regulation should be allocated on a functional basis - that is, one agency for each of the major types of regulation.

This has translated into:

- an agency responsible for the stability of the financial system as a whole and for the payments system - a traditional central banking role which remains with the Reserve Bank;
- an agency overseeing competition in the financial system - that is the Australian Competition and Consumer Commission;
- an agency to promote efficient and fair market conduct, including disclosure standards and consumer protection arrangements - the Australian Securities and Investments Commission; and
- an agency responsible for prudential regulation - which is, of course, where APRA fits in.

Before I discuss some issues in relation to prudential regulation it is worth noting that, for superannuation in particular among the financial sector industries, there are other players involved. These include the Treasury (broad Government policy), ATO (taxation arrangements and I am sure that you will all agree that these are complex and numerous in respect of 'special' arrangements for superannuation) and DSS (in relation to particular aspects of the industry such as assets test exempt income stream products).

However, despite the apparent 'plethora' of Government agencies involved in the superannuation industry, each does have a functional responsibility:

- Treasury - Government policy
- ATO - taxation arrangements
- DSS - specific rules in relation to social security entitlements
- ASIC - market integrity, consumer protection and disclosure; and
- APRA - prudential regulation

But what is Prudential Regulation?

Prudential regulation, as the name suggests, is about promoting prudent behaviour by insurance companies, superannuation funds, banks and other financial institutions - with the objective of protecting the interests of policyholders, investors or depositors depending on the financial institution involved.

It is concerned fundamentally with the quality of an institution's systems for identifying, measuring and managing the various risks in its business and (in most cases) with the adequacy of the capital held as a buffer against unexpected losses.

Another important role for the prudential regulator is resolving the position of financial institutions which have actually become unviable, so that the interests of investors/ savers/ members are protected to the maximum extent. APRA has extensive formal powers of investigation, intervention and administration for this purpose. (My experience is that moral suasion and arm twisting can sometimes be quite effective in these circumstances too for many of our regulated entities although this is a little less relevant to some segments of the superannuation industry who seem to take a fairly minimalist approach.)

As the comprehensive prudential regulator in the Australian financial system, APRA has taken over the responsibilities:

- of the Insurance and Superannuation Commission for supervising superannuation funds and life and general insurance companies; and
- of the Reserve Bank for supervising banks.

The Government had intended that later this year we would also take over the regulation of building societies, credit unions and friendly societies. At present such regulation is done by various State supervisory agencies, such as FINCOM and VicFIC, under the umbrella of the Australian Financial Institutions Commission (AFIC). It is now clearly impractical that this particular change will occur in calendar 1998 but APRA certainly hopes that the transfer of these responsibilities will occur in a timely fashion in 1999.

After this transfer APRA' s direct responsibilities will cover around 85 per cent of the assets in Australia's financial system. The main groups for which we will not have supervisory responsibility are finance companies, merchant banks and non-superannuation funds management vehicles. For the 1998/99 financial year we will continue to regulate excluded super funds, but we are working with other interested agencies to have legislation in place so that these can move to the Tax Office in mid 1999.

Along with the prudential regulatory functions of the ISC and the RBA, APRA has acquired the staff who did this work in those previous agencies - about 450 people in all. When State regulation transfers to APRA, another 90 or so people will join us.

APRA' s head office is in Sydney and we are, and will be, also represented in Melbourne, Canberra, Brisbane, Adelaide and Perth. At present we are still located in the same premises previously occupied by the ISC and RBA but we will shortly be moving into new Head Office premises at 400 George Street in Sydney.

We are a statutory authority, similar to the Reserve Bank, governed by a Board of 9 members, with a considerable degree of autonomy from Government. Describing our role, our Act says that "APRA is established for the purpose of regulating bodies in the financial sector in accordance with other laws of the Commonwealth that provide for prudential regulation or for retirement income standards, and for developing the policy to be applied in performing that regulatory role". One function of our Board is "to determine APRA's policies (including goals, priorities, strategies and administrative policies)".

We are, of course, ultimately accountable to Parliament and will produce an Annual Report. We are also to keep the Government informed of our prudential policies. In the event of a difference of opinion about policy the Government may overrule APRA, with an explanation of this tabled in Parliament - similar to the monetary policy provisions in the Reserve Bank Act.

Like the old ISC we will be funded mostly by industry levies.

Levies

The levy rates are determined annually by the Treasurer. I will comment briefly about levies as these have been an issue of great concern to the superannuation industry in particular (but not exclusive to that industry I might add). The cost of actual prudential supervision by APRA has not increased in 1998/99 despite the increase in levies which have affected some of our supervised entities. There are certainly additional costs associated with the establishment of the organisation which the industry is funding via levy payments. This is as a direct result of a decision of Government and is not something that any of us had any control over. Once the establishment costs are 'eliminated' APRA's running costs for supervision are no higher than those previously incurred by our predecessors the ISC and RBA (obviously only the banking supervision side of the latter).

Before talking about some of the issues on our medium-term agenda, I think it worth making some additional comment on the topical issue of levies.

Some insurers and super funds are paying more this year than in the past, while some are paying less. These changes are a result of several factors:

- the move from flat rate levies to graduated ones (based on assets) for life insurers;
- levies for some industries have not covered the full cost of their supervision in the past (in fact, there is still cross-subsidisation from excluded funds in this year's figures);
- an increase in the amount allocated to ASIC for consumer protection;
- the decision that levies would cover APRA's establishment costs.

One thing which has not changed with the advent of APRA is the "running cost" of prudential supervision. Our operating budget this year is simply an aggregation of the running costs of prudential regulation in the ISC and RBA. In coming years we aim to reduce this - as we reap the efficiency benefits which should come with a single agency and our reviews of inherited methods and systems.

It is extremely difficult to predict what levy rates might be for the 1999/2000 financial year. This is because of factors such as the majority of APRA establishment costs being 'levied' in 1998/99 but, on the other hand, the current subsidy from excluded fund levies being eliminated in the next financial year as these funds move to ATO supervision. The Government has foreshadowed that this move should substantially reduce the levies for these funds. Therefore there are two conflicting pressures on levy rates for 1999/2000 and it will not be until closer to that time that APRA will be in a position to estimate likely levies.

We do intend to be an organisation which is committed to consultation and I am very hopeful (and intend to do all in my power to achieve) a longer timeframe for consultation and discussion on levy rates for the next financial year than we had the luxury of 'enjoying' this year.

One prudential regulator

It is worth keeping in mind the advantages which the Wallis Committee saw in having just one prudential regulator, instead of the diverse arrangements we had been accustomed to.

The Committee said:

"A single regulator:

- offers regulatory neutrality and greater efficiency and responsiveness;
- provides a sounder basis for regulating conglomerates;
- offers the prospect of greater resource flexibility and economies of scale in regulation that should enhance the cost-effectiveness of regulation; and
- provides the flexibility and breadth of vision to cope with changes that seem likely to occur in the financial system in coming years."

The challenge for APRA is to deliver on these potential benefits.

I should emphasise that, in talking about "regulatory neutrality", there is no suggestion that all financial institutions can or should be regulated in exactly the same way. We recognise that there are clear differences among financial institutions in the nature of their core business, and the risks inherent in their activities. Such differences call for distinctive regulatory standards and requirements.

APRA's creation does, however, reflect the fact that some of the traditional dividing lines between financial services are becoming less clear and that different business lines are increasingly being grouped under common ownership in conglomerates. It also recognises that many financial risks *are* common across institutional categories and can be supervised in similar ways. Techniques developed in one area could well be suitable in others. There is no good reason, for example, why methods to manage operational risk in insurance companies cannot be employed in banks, or vice versa.

A single regulator like APRA will be well placed to foster the cross-fertilisation of ideas and methods from various regulatory fields.

What does APRA mean for superannuation trustees?

On the superannuation front, the regulatory responsibilities in the Superannuation Industry Supervision (SIS) legislation have been similarly divided between APRA and the ASIC according to the Wallis Committee's functional model.

Broadly speaking, APRA is interested in the way members' funds are being managed by trustees, while ASIC is concerned with the quality of information flowing from trustees to members and the handling of member complaints.

These new allocations of responsibilities will no doubt become grey at the edges from time to time, and from issue to issue. For instance, complaints by members about their treatment by super funds often point to issues of prudential concern. We and ASIC also recognise that a number of players operate in both the superannuation and managed funds arenas with the same staff and systems, so we will be aiming not to impose different requirements on them unless there are good prudential reasons to be more protective in relation to superannuation.

We intend, therefore, to work closely with ASIC wherever our interests overlap or abut. We have established a bilateral coordinating committee for this purpose, and have signed a Memorandum of Understanding to cover matters such as information sharing and co-operation in policy-making and problem solving. As you would be aware, the Chairman of ASIC is on our Board.

We are aware of uncertainty in the industry about exactly what the roles of the two regulators are and how they will operate. Accordingly, we have developed a useful explanatory booklet (which unfortunately is not ready for these presentations but should be very shortly) which explains the roles of APRA and ASIC and also how we will be working together in the future.

I noted earlier the role of Treasury in the industry. The Wallis reforms seem to have caused particular misunderstanding about responsibility for superannuation policy. Industry was used to dealing with the ISC on virtually all aspects of this (except where the Department of Social Security and the Tax Department have been the reference points).

As I noted previously under the new arrangements, the Commonwealth Treasury now has prime responsibility for the development of legislation and regulations in respect of Government superannuation policies such as preservation rules and other matters with taxation implications.

Where the policies of the APRA Board are to be expressed through legislation or regulation, APRA is the prime contact for industry although Treasury would of course be involved too as adviser to the Treasurer.

As we do with ASIC, we do, and will, meet regularly with Treasury to discuss issues of common interest and make sure the new system is working as smoothly as possible.

Apart from these shuffles of regulatory responsibilities, you will notice little change in regulation in the immediate term. In the areas of policy which fall to APRA, the same prudential standards and regulations continue in force. And, pretty much, the same people, previously at the ISC, are administering those policies. It is pretty much "business as usual" for now. One exception is that we have started conducting joint prudential consultations with mixed conglomerate groups.

Tasks ahead

As well as ensuring that we work smoothly with the other regulatory agencies, we have some important integration tasks of our own.

One is to weld the various groups of staff we inherit into a coherent, professional body of regulators with a common supervisory ethos. Over time we will be rotating staff to get cross-fertilisation benefits. We will also have an active APRA-wide training program.

Over time, we will also be seeking opportunities to harmonise prudential standards and techniques across the range of activities and institutions we regulate.

There is the question of whether some of the techniques developed in supervising particular institutions can be exported and applied to other institutions regulated by APRA. At present, for instance, different use is made of external auditors by supervisors of different industries. There are various mixes of on-site and off-site surveillance. There are different uses of scoring systems to rate the condition of our supervised entities.

As input to the harmonisation project, we will be looking to:

- develop common terminology for risks across sectors;
- develop a common understanding of the present differences and similarities in the risk assessment and capital regimes across sectors; and then
- assess the legitimacy of those differences, the potential for arbitrage and the scope for more consistency.

We are also pushing ahead with the further evolution, already begun in the ISC, of our techniques for regulating superannuation funds. Very broadly, our objective is to streamline and refine our off-site and on-site review processes so that they can identify more effectively those areas of risk or weakness which require APRA's attention. We would devote correspondingly fewer resources than in the past to areas where there were no alarm bells ringing. For strong, well-managed funds this should mean less paperwork and less time spent with our review teams.

The philosophy of concentrating our energy on areas of greatest perceived risk is one which will be applied APRA-wide.

I expect that a more focussed approach, together with the increasing familiarity of industry with the provisions of the SIS legislation, will allow us to reduce the resources currently used to regulate super. This would be consistent with maintaining (at least) the effectiveness of prudential oversight.

Another key task is to develop the most cost-effective techniques for overseeing the activities of financial conglomerates - one of the objectives for which we were established.

In the medium-term we will be designing an organisation structure for APRA which allows us most efficiently to combine our statutory responsibilities for individual components of conglomerates with the need to appraise the overall health of such groups and to recognise that risk management is increasingly conducted on a conglomerate-wide basis

Immediate future for superannuation review work

I believe that the superannuation industry has shown a great deal of progress and improvement over the past four to five years since SIS first came into place. The proportion of funds reviewed by the ISC (and now APRA) where there are generally acceptable arrangements in place has increased and the level of industry inquiries of APRA about basic legislative questions has fallen. However, there is a considerable amount of additional work which still needs to be done by the industry.

For the remainder of this financial year the Superannuation Group of APRA will be putting its focus in supervision of the industry on five key aspects of operations.

We will be looking at the way in which trustees have carried out the following duties:

1. Controls: implement and monitor a decision, control and compliance regime which effectively addresses the funds' legislative obligations and other identified risks.

2. Risks: implement a considered risk assessment process which identifies all risks and emerging challenges both in terms of internal decision and control processes and the external environment.

3. Investment: develop a properly considered investment strategy which is consistent with, and is being implemented to achieve, the investment objective adopted for the fund.

4. Management: meet high standards of competence, integrity and knowledge (either directly

or acquired) to properly carry out its responsibilities to members of the fund and, where appropriate, implement corporate governance initiatives such as a ‘conflict of interest’ policy and a policy in relation to related party transactions and disclosure.

5. Planning: implement a strategic plan that places due focus on the long-term nature of member interests.

You will note the ‘meaningful’ acronym that these produce - ie CRIMP.

According to the Macquarie Dictionary there are twelve separate meanings to this word. I’m not sure that any of those definitions are particularly apt to what APRA does to trustees although on occasions it may well be argued that we do ‘press (trustees) into small regular folds’ or ‘procure (trustees) for service by inducing them’ [I’m not sure about the morality of the expanded version of this last meaning - ie ‘Procure seaman, solders, etc or service by inducing, swindling or coercing them’].

Nevertheless the acronym does, in our view, serve a useful purpose of being something fairly simple but which covers all the fundamental duties of trustees.

End piece: APRA’s objectives

APRA’s goal is a regulatory approach which strikes a sound balance between the need to minimise risk of loss to the people doing business with regulated financial institutions - which is of course APRA’s main purpose - and a recognition that overly intrusive and prescriptive regulation can get in the way of desirable innovation and structural change in the financial system.

To this end there is a very important, perhaps the most important, provision in the APRA Act which says:

“In providing this (prudential) regulation and developing this (prudential) policy, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality.”

In other words, while safety is very important the community needs a financial system with other qualities as well.

I hope that you all take away from this presentation today a better understanding of the new functional regime for the regulation of the superannuation industry. This new regime certainly does not have a ‘one stop shop’ regulator for all superannuation issues but I believe there are now clear ‘one stop shops’ for particular industry functions across all elements of the financial industry. While APRA will be carrying on with ‘business as usual’ for superannuation regulation this is on the basis of continuing with previous ISC policies and standards. It does not mean that we will do the same thing this year as we did last year or two years ago. If nothing had happened with Wallis the ISC would also not have continued with the same approach.

You will see some changes in the way we approach our industry supervision work - this could vary from multi-disciplinary teams if we are looking at a fund in a conglomerate structure to simply a different, and hopefully clearer, focus on key issues. I suggest that you remember the CRIMP criteria - when we come to examine your fund, or that of your clients, these are the aspects we will be putting our focus on and expect trustees to measure up well against.

Thank you.

APRA - The Regulatory Challenge

Speech by Graeme Thompson, Chief Executive Officer, An Open Forum with ASIC and APRA Securities Institute of Australia, Sydney, 9 November, 1998.

Introduction

I am very pleased to be here today as the CEO of APRA – the Australian Prudential Regulation Authority. We are not to be confused with the Australasian Performing Right Association, just as ASIC is not to be confused with a running shoe.

As you know, the new APRA was born on 1 July this year. We are therefore the twin of ASIC. I believe that twins often repeat each other, so I hope you will understand if some of my remarks overlap with Alan's.

We both owe our birth to the widely-held view that the responsibilities for regulating Australia's financial system could be arranged more logically and more efficiently. This would best place Australia to deal with the rapid changes which are occurring (and will continue to occur) in financial markets.

APRA – like ASIC – is a key part of the reforms advocated in 1997 by the Wallis committee of inquiry into the financial system and subsequently implemented by the Commonwealth Government.

Wallis Committee

Basically, the Wallis Committee recommended that financial system regulation should be organised on a *functional* basis. By this, it meant there should be dedicated agencies responsible for each of:

- the stability of the financial system as a whole and the payments system – this remains my former employer, the Reserve Bank (RBA);
- overseeing competition in the financial system – that is the Australian Competition and Consumer Commission;
- promoting efficient and fair conduct in financial markets, including disclosure about financial products and consumer protection arrangements – this is the Australian Securities and Investments Commission, the expanded much improved version of the old ASC which Alan has been describing; and
- prudential regulation – which is where APRA fits in.

A prudential regulator like APRA has two main roles. One is indicated by the name itself – to encourage *and promote prudent* behaviour by regulated financial institutions so as to reduce the likelihood of their being unable to meet their obligations to the people who put money with them. In other words, we try to ensure that banks can repay their depositors, that insurance companies meet their obligations to policyholders, and so on.

Like all prudential regulators, we are, therefore, concerned with how financial institutions go about identifying, measuring and managing the risks in their business. And we prescribe, among other things, minimum standards for capitalisation and liquidity and limits on the concentration of risk exposures. With superannuation funds, we aim to see that fund trustees have properly articulated investment strategies and appropriate governance procedures.

Because no regime of prudential regulation is totally fail-safe, the other main role of a prudential regulator is to sort out the position of a financial institution which has become unviable (or looks likely to become so). The aim here is to see that depositors or policyholders get what is due to them, even if the financial institution itself goes under with losses to its shareholders. For this purpose - in addition to our regulatory authority - APRA has extensive powers of investigation, intervention and administration.

In fact, we have much clearer and stronger powers than the RBA had as bank supervisor to intervene in a problem bank and take action to protect the interests of its depositors.

[Even with all these powers, there are no absolute guarantees – prudential regulators like APRA operate ultimately on a "best endeavours" basis.]

APRA's interest in the securities industry is clearly from a different perspective than ASIC's. Our concern is how their securities activities might affect the soundness, the viability, of prudentially regulated financial institutions.

What we are

APRA is a Commonwealth statutory authority, like the RBA, with a good deal of autonomy from Government. We are managed by a Board which has all the standard responsibilities under the Commonwealth Authorities and Companies Act. We are funded by levies on the industries we regulate. (In an interesting example of outsourcing, our levies also include an amount to fund some of ASIC's activities.)

Our Head Office is in Sydney; in fact, we have taken up residence only today at 400 George Street. We also have offices in other major capital cities, including Canberra.

So far, we have taken over the supervision roles of the RBA and the ISC covering banks, insurers and superannuation. It is planned that in 1999 we will also take on the State-regulated building societies, credit unions and friendly societies.

Our direct responsibilities would then cover more than 85 per cent of the assets in Australia's financial system. The main groups for which we will not have regulatory responsibilities are merchant banks, finance companies and non-superannuation managed funds which are judged not to warrant prudential regulation.

We presently have regulatory responsibility for the so-called excluded superannuation funds. We are strong supporters of the Government's intention to transfer the regulation of these 180,000 entities to the Tax Office next year.

The major pieces of legislation for which we are responsible are the Banking Act, the Life Insurance Act, the Insurance Act and the prudential aspects of the Superannuation Industry (Supervision) Act. Of these the main changes are in the Banking Act.

For the time being, we have adopted virtually unchanged all of the existing prudential policies, standards and guidelines of the RBA and ISC.

As well as taking over their regulatory responsibilities, we have acquired their staff – around 400 people in all. With the transfer of State regulation, another 90 or so people will join us.

Why we are

A natural question is: what benefits will flow from having *one prudential regulatory agency*, rather than the previous several? I think that, over time, people should look for benefits from APRA's creation in five broad areas:

(i) More consistent regulation of similar financial activities and risks wherever they occur.

With a single agency, it will be easier to achieve consistency in prudential regulations. This will reduce opportunities for regulatory arbitrage or "jurisdiction shopping", and will contribute to achieving that mythical level playing field among different groups of financial institutions.

We don't plan to make any rapid or big changes to prudential supervision policies, but over time we will be looking to harmonise the regulation of similar activities where that makes sense.

For instance, we will have a single, consistent set of prudential rules for all deposit-takers - banks, building societies and credit unions. There might also be opportunities for greater harmonisation of prudential standards - such as capital adequacy - between deposit-takers and insurance companies.

We are not, of course, thinking that all financial institutions can be regulated in exactly the same way. But there is no reason why, for instance, the techniques used to supervise operational risk or market risk should be markedly different in a bank and life insurance company.

(ii) Better coping with *structural change* in the financial system.

It's clearly possible that a natural tendency for "turf protection" by specialised regulatory agencies could get in the way of desirable reorganisation and innovation in financial markets. I think this will be less of a risk with a single regulator. The Wallis Committee thought that, as the financial system evolved and traditional boundaries and categories became less clear, APRA's broad view of financial system developments would be a particularly important attribute.

(iii) More efficient and effective regulation of *financial conglomerates.*

Increasingly, we have seen the emergence of conglomerate groups comprising significant-sized entities (mainly banks and insurance companies) which were answerable to different, specialist regulators (that is, the RBA and ISC).

APRA will reduce the number of regulatory contact points for such groups. We have already begun to conduct joint prudential consultations, and will probably move soon to joint inspections. And we will aim to rationalise statistical collections from conglomerates.

APRA, as the comprehensive regulator, will also be better placed to make an assessment of the overall financial health of a conglomerate, to see where weaknesses in one component might threaten the health of others, and to take action to guard against this happening. It is accepted internationally that someone needs to be able to take such a global view of financial conglomerates. As part of this, we will be reviewing the various ways in which the overall capital adequacy of a conglomerate can be measured.

(iv) More effective use and *management of scarce supervisory talent.*

Australia's limited supply of skilled supervisors has been scattered among several agencies. Bringing all these people together in APRA will allow us to use them most efficiently on the issues and pressure points where they are most needed i.e. - where the risks are greatest. This can, of course, change from time to time.

We also expect to gain efficiency and effectiveness benefits from cross-fertilisation of the different experiences, skills and ideas of staff from the various agencies coming into APRA.

(v) Clear focus on prudential regulation

The essence of the Wallis reforms is to establish a single dedicated prudential regulator. APRA will be able to concentrate its energies entirely on prudential regulation. We won't be distracted by other quite different, although important, issues - such as how consumer complaints are being handled and how financial institutions are explaining their products and fee structures to customers. In the new world, as we've heard, these concerns fall mostly to ASIC.

If we manage things well, the upshot of all these factors *should* be more effective prudential regulation, at a lower cost to industry. Too good to be true? The proof of the pudding will be in the eating, but these are certainly our objectives.

It's worth noting that some countries have set up agencies similar to APRA in recent years – the United Kingdom and Korea among them – while others are clearly contemplating such reform. As a result, there is a lot of interest internationally in how APRA is being established and our progress in delivering the benefits I've listed.

Expectations

APRA's arrival has indeed raised *expectations of change*.

Clearly, however, we *won't* be the *one-stop, financial regulator* which some commentators who haven't read the Wallis Report seem to expect. Under the Wallis functional model there are clearly four agencies involved in financial regulation. And most financial institutions will need to deal with all of us from time to time.

While the roles of the various agencies are, in principle, distinct, they will also overlap quite often in practice. Good communication and smooth working relationships will, therefore, continue to be very important. For those of us bedding down the new system, this is one of our prime objectives.

As Alan has noted, we've established a co-ordination committee with ASIC to ensure efficient information-sharing and maximum co-operation. The broad principles of co-operation are set out in a memorandum of understanding.

We have a similar agreement and similar co-ordination committee with the RBA. APRA would obviously need to work very closely with the RBA if weakness in a bank or other financial institution posed a threat to the wider financial system. Consequently, a clear understanding of our respective responsibilities and shared commitment to problem resolution are critical.

The RBA and ASIC are both represented on our Board. Furthermore, all three of us get together in the Council of Financial Regulators.

Another expectation is that the Wallis reforms and the advent of APRA will increase competition in banking through facilitating a rush of *new entry* to the banking system.

I believe that the new regulatory framework *will* increase competition and efficiency in banking. More cost-effective and flexible regulation will help. Also, entry to banking should be more readily available to some new players because a wider range of group *structures* will be acceptable under the laws which APRA administers. (For instance, banks may now be established under non-operating holding companies, and the APRA Board is turning its mind to a policy on the extent to which non-financial business may be conducted alongside a bank underneath a holding company.)

But new entry into banking will *not* become easier through any relaxation of prudential standards. As the licensing agency, we will not be watering down existing requirements for the quality of banks' management and risk control systems, or for capitalisation. Furthermore, the general presumption in favour of dispersed ultimate ownership of banks and other deposit-takers will remain. This is still seen as important in reducing the likelihood of depositors' funds being misused in shareholder's interests.

Policy development

I have already touched on some of the main items on our policy development program, which includes:

. a more formal policy framework for the prudential regulation of conglomerate groups;

. a harmonised prudential supervision framework for banks and other ADI's;

. investigation of possibilities to harmonise supervision across ADI's and insurers;

. continuation of work already commenced to improve the cost-effectiveness of superannuation regulation and to review the solvency requirements for general insurers.

We will also be participating in a review begun by the Basle Committee of the 1988 Capital Accord. The objective of this is a more sophisticated system for measuring the amount of capital which banks need to hold against credit risk; it will include consideration of recognising banks' internal models, as is now permitted with market risk.

Logistics

Let me detour with some observations on the fascinating *managerial and logistical challenges* of putting APRA together.

By some time in 1999 eight distinct groups of staff will have joined APRA. Each brings its own employment terms, skill sets and culture - even language. Of course, their management systems – statistical databases, payroll, budgeting - also vary.

These groups have to be welded into a single, motivated workforce with consistent employment conditions and a common supervisory ethos. The job is complicated by the geographic dispersion of our staff. The main policy talent alone is now spread between Sydney, Canberra and Brisbane. We will want to bring this into the Sydney Head Office over time.

The spread of people and systems obviously adds to our integration task across the board, and makes it more difficult to communicate effectively what we are doing and planning. At the same time, it makes it even more important that we do have good communication across APRA.

We are learning a good deal from the experience of others in making mergers work. We have also, of course, been absorbed in such delicate issues as logo selection, office sizes and layout and the allocation of parking spaces in our new premises! Time consuming – but all part of the challenge and fun of starting a new organisation.

In designing APRA's long term structure and skill mix, we will be aiming for the right combination of functional and institutional focus. By this, I mean that we want to be able to maximise consistency in regulatory treatment of similar functions and similar risks in the financial system. At the same time, we must not lose sight of the fact that prudential regulation is, at the end of the day, about the health of institutions.

While sorting through the logistics of our merger and clarifying our vision of APRA's future shape and role, we need also to make sure that nothing falls down a crack. The last thing we need in our early years is a financial disaster! For this reason, I am pleased that, while we have had some staff losses, we've retained most of the key supervisory people from the ISC and RBA. For those of you dealing with APRA, the faces will remain much the same in the near term. (Over time there will, of course, be some changes as we seek out more efficient ways of doing prudential supervision.)

And, as I' ve already noted, we continue with all existing supervisory policies for the time being.

It' s also to our advantage that we take on our responsibilities when the Australian financial system is in pretty good shape. Notwithstanding some fall-out from the Asian crisis and continuing downward pressure on interest margins, returns on equity in the banking system are healthy and capital ratios are well above minimum requirements. Although the banks' problem assets have risen over the past year or so, they remain relatively low and Asian exposures are most unlikely to cause significant damage to overall balance sheet strength. Similarly, our insurance sectors are in good shape.

Even so, the experience of financial turmoil in other parts of the world drives home the need for constant vigilance by prudential regulators.

What sort of prudential regulator?

What will APRA' s general regulatory style be?

My aim is an approach which strikes a sound balance between the need to minimise risk of loss to the people entrusting their savings to licensed financial institutions - which is clearly APRA' s main purpose - *and* a recognition that overly intrusive and prescriptive regulation can get in the way of desirable innovation and structural change in the financial system.

There's a provision in the APRA Act saying:

> "In providing this (prudential) regulation and developing this (prudential) policy, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality."

In other words, safety and confidence in the financial system is very important, but for the long term we need a financial system with other qualities as well.

In pursuing our charter, APRA aims to be a highly professional, forward-looking and enlightened(!) regulator. We will keep in close touch with new developments in financial markets - including through on-going contact with industry groups and consultation on particular prudential policies. Genuinely open, two-way communication with industry will be a very high priority.

We will also develop strong overseas links, both with supervisors in other countries and with the international associations of regulators such as the Basle Committee on Banking Supervision, the International Association of Insurance Supervisors and the Joint Forum on Financial Conglomerates. Our prudential standards will remain firmly anchored to international standards of best practice supervision where these exist.

From what I' ve said, it should be clear that we aim to be a "market friendly" regulator, not a hostile or combative one. But, as I also emphasise when talking to industry groups, we will have a policy of decisive action in response to breaches of prudential standards or to signs of emerging weakness in financial institutions. I don' t want APRA to stand accused of regulatory forbearance, as supervisory agencies in other countries have in recent years.

End piece

I will conclude by saying that I think Australia's financial system has, by and large, been well served by its regulatory arrangements. I believe this assessment has only been confirmed recently by a comparison with the situation of many other countries in our region.

In prudential supervision, APRA's challenge is to build on the strengths of the agencies whose responsibilities and staff we inherit. And to move forward with our financial system into the next century, adapting our supervision to the evolution and changing shape of that system while maintaining the basic levels of safety which the community expects. Considering the likely pace and range of change, and the talent of financial institutions in finding new ways to lose money, this is indeed an exciting "regulatory challenge"!

We look forward to working hand in hand with ASIC on this.

I welcome your interest in our task, and thank you for your kind attention.

Index of speeches by APRA officers

The following speeches and presentations were given by APRA Executives in recent months.

Copies of selected speeches and presentations may be available by contracting APRA. Requests should be made on the 'Speech Request Form' found in the "Order Forms" section in this Bulletin. Alternatively, selected speeches may be obtained directly from our internet home page: "http://www.apra.gov.au".

Index of recents speeches

Thompson, G. "*Introducing APRA*" presented to IBSA, Sydney, 12 November 1998.

Thompson, G. "*Meet the Mega Regulators: Introducing ASIC and APRA*" presented to Securities Institute of Australia, Sydney, 9 November 1998.

Thompson, G. "*Introducing APRA*" presented to Business Forum Luncheon, Chartered Institute of Companies Secretaries, 5 November 1998.

Karp, T. "*APRA and ASIC Setting up Shop Together*" presented at ASFA Conference, Adelaide, 4 November 1998.

Carmichael, J. "*Introducing APRA*" presented at the ASFA Conference, Adelaide, 4 November 1998.

Chapman, K. "*Regulation: The New APRA*" presented to BLEC Conference, Melbourne, 27 October 1998.

Thompson, G. "*Introducing APRA* " presented to Monash Law School Foundation, Melbourne, 27 October 1998.

Carmichael, J. *Introducing APRA*" presented to AFMA Conference, Sydney, 19 October 1998.

Phelps, L. "*Introducing APRA*" presented to Credit Union Internal Auditors Association 6th Annual Conference, Sydney, 15 October 1998.

Phelps, L. "*Introducing APRA*" presented to group of JNSW Credit Unions, 9 October 1998.

Carmichael, J. "*Introducing APRA*" presented to CEDA Board Briefing, Melbourne, 6 October 1998.

Other APRA publications

APRA produces a range of publications containing important information on various aspects of the superannuation, insurance and banking industries. Below is a list of these publications, a short description of their contents and cost per copy.

For further information, please see APRA's internet homepage at 'http://www.apra.gov.au'.

Superannuation

'Superannuation Trustee Newsletter' — *Free*

The newsletter provides commentary on all the latest news and developments in superannuation from a trustee's perspective.

'Approved Trustee Newsletter' — *Free*

An information letter sent to approved trustees highlighting key matters of interest as they arise.

'The Trustee Guidebook to Superannuation' — *$AUD 10 each*

The guidebook provides a summary of what APRA expects of trustees and the APRA' s approach to the administration of the SIS legislation. The guidebook is aimed primarily at non-excluded fund trustees.

'Good Practice Guide' — *$AUD 15 each*

The guidebook provides a practical guide to improving prudent management of a superannuation fund and is based on the APRA' s supervisory findings. The guidebook is aimed primarily at trustees of corporate and industry superannuation funds.

'Super Fraud - How to reduce the risk, A Best Practice Guide' — *$AUD 10 each*

This Guide is designed to proved trustees with a practical strategy and approach to fraud detection and prevention with a special focus on electronic commerce. Its accompanying Fraud Checklist should be completed a regular basis by trustees as part of their strategy to minimise the risk of fraud within their fund.

'Small Super Funds Guidebook' — *$AUD 10 each*

This is a guidebook for trustees and advisers of superannuation funds with fewer than five members, that is excluded funds. It sets out the rules that apply to these funds and the ISC's approach to the administration of the SIS legislation. It is a companion to the Trustee Guidebook.

'Fraud Video 'Is Your Fund at Risk' — *$AUD 50 each*

A 40 minute video providing case studies and practical guidance to trustees and service providers on fraud prevention in superannuation funds with a special segment on electronic commerce. The video helps trustees to identify practical ways to assess and reduce the risk of fraud in their superannuation fund. The training video draws on the Insurance and Superannuatin Division's 1998 successful series of national fraud prevention workshops and comes complete with the Super Fraud Guide and Checklist.

'APRA and ASIC' *Free*

A guide for trustees of Corporate, Public Offer and Industry Superannuation Funds to the roles and responsibilities of the Australian Prudential Regulation Authority and the Australian Securities and Investments Commission.

'ISC Superannuation Digest'

The Digest includes in one volume of old ISC Superannuation Circulars, other APRA releases such as discussion papers and broad overview statistical information, as well as the text of all superannuation legislation administered by APRA.

The Digest is available by subscription through CCH Australia Ltd - freecall 13 24 47.

For further information, please see APRA's internet homepage at 'http://www.apra.gov.au' or telephone (02) 6213 5266.

Life Insurance

'Half Yearly Financial Bulletin' *$AUD 50 per copy*

Contains selected financial data of life companies, primarily at aggregate level but also including some company level abstracts, for companies balancing during the year to date.

'Company Financial Returns' *$AUD 500 per copy*

Diskette containing all the returns of life companies collected under Prudential Rules 21 (Financial Statements) for companies balancing during the year to date.

'Company Market Statistics Returns' *$AUD 500 per copy*

Diskette containing all the returns of life companies collected under Prudential Rules 32 (Collection of Statistics) for companies balancing during the year to date.

Note: Contact Daniel Marson-Pidgeon on telephone 02- 6213 5333 for more details.

General insurance

'Selected Statistics on the General Insurance Industry' *$AUD 15 per copy*
$AUD 30 for diskette

Contains statistics and aggregate financial and underwriting information for private sector insurers balancing during the year to date. Published bi-annually. Voluntary information provided by public sector insurers is included annually in the June edition. This publication can be obtained at any Commonwealth Government Bookshop.

Note: Contact Daniel Marson-Pidgeon on telephone 02-6 213 5333 for more details.

Banking

'Australian Banking Statistics'

Contains statistics on the assets and liabilities of individual banks, including a breakdown by State.

Annual subscriptions to this publication are available for A$20. Alternatively, copies are available free of charge from the APRA internet homepage at 'http://www.apra.gov.au/abs'.

Australian Government Actuary

'Australian Life Tables 1990-92'

'Deaths in Australia'

These publications can be obtained at any Commonwealth Government Bookshop.

Actuarial valuations for Australian Government Superannuation Plans:

Commonwealth Superannuation Scheme (PSS)
Public Sector Superannuation Scheme (PSS)
Military Superannuation and Benefits Scheme (MSBS)
Defence Force Retirement and Death Benefits Scheme (DFRDBS)

These publications can be obtained at any Commonwealth Government Bookshop.

Research papers

Thorburn, C. "*What the Guarantee Means: A Statement of the Structural Conditions Supporting the Aged Pension in Australia*", Sixth Annual Colloquium of Superannuation Researchers, University of Melbourne, 1998.

Higgins, T. "*Australian Mortality:Improvement and Uncertainty in an Ageing Population*", Sixth Annual Colloquium of Superannuation Researchers, University of Melbourne, 1998.

Thorburn, C. "*Where Have all the Children Gone?:Some Current Notes on Australian Fertility*", Sixth Annual Colloquium of Superannuation Researchers, University of Melbourne, 1998.

Antcliffe,S., and Thorburn "Preservation in the Public Sector Superannuation Scheme", Fifth Annual Colloquium of Superannuation Researchers, University of Melbourne, 1997.

Thorburn, C. "*The Relative Capital Requirements Imposed for Providers of Capital Guaranteed Retirement Savings Accounts*" Transactions of the Institute of Actuaries of Australia, 1997.

Thorburn, C. *Three papers on the development of the annual life tables,* Office of the Australian Government Actuary, 1997.

Duval, D. "*The Financing and Costing of Government Superannuation Schemes*", Office of the Australian Government Actuary, 1994.

Copies of these papers can be obtained by contacting the Office of the Australian Government Actuary (telephone 02-6 247 2299).