AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY

COST RECOVERY IMPACT STATEMENT

For supervision of Authorised Deposit-Taking Institutions (ADIs) using the models-based approach for Basel II and accreditation of certain ADIs

6 June 2013
CONTENTS

1. OVERVIEW .............................................................................................................. 2
  1.1 Purpose ........................................................................................................ 2
  1.2 Background ................................................................................................... 2

2. POLICY REVIEW .................................................................................................. 3
  2.1 Alignment with objectives ........................................................................... 3
  2.2 Description of activity .................................................................................. 3
  2.3 Stakeholders .................................................................................................. 3
  2.4 Cost recovery alternatives ............................................................................ 3
  2.5 The efficiency and effectiveness of the charge ............................................ 4
  2.6 Conclusion ..................................................................................................... 4

3. DESIGN AND IMPLEMENTATION ........................................................................ 5
  3.1 Basis of charging ............................................................................................ 5
  3.2 Legal requirements for the imposition of charges ....................................... 5
  3.3 Costs to be included in charges .................................................................... 5
  3.4 Outline of charging structure ....................................................................... 5
  3.5 Duration of the charge .................................................................................. 6
  3.6 Recipients of the charge ............................................................................... 6

4. ONGOING MONITORING .................................................................................... 6
  4.1 Monitoring mechanisms ............................................................................... 6
  4.2 Stakeholder consultation ............................................................................ 6
  4.3 Periodic review .............................................................................................. 6

5. CERTIFICATION .................................................................................................. 7

APPENDIX ................................................................................................................ 8
1. OVERVIEW

1.1 Purpose
This Cost Recovery Impact Statement (CRIS) assesses the impact of imposing, by means of a disallowable instrument under paragraphs 51(1)(a) and (b) of the *Australian Prudential Regulation Act 1998* (the APRA Act), a limited fee in 2012-13 for the recovery of specific costs associated with the on-going supervision of authorised deposit-taking institutions (ADIs) which have adopted the models-based approach under *The International Convergence of Capital Measurement and Capital Standards - A Revised Framework (Basel II)* and accrediting certain ADIs which have sought to use that approach for assessing their capital adequacy requirements (the proposed fee). The proposed fee falls within the description of a material amendment to an existing significant cost recovery arrangement. The purpose of the CRIS is to ensure transparency and consistency in the raising of such fees in line with the Government’s cost recovery guidelines.

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

The policy applies to all *Financial Management and Accountability Act 1997* (FMA Act) agencies. In line with the policy, individual portfolio ministers are ultimately responsible for ensuring agencies’ implementation and compliance with the Cost Recovery Guidelines.

APRA is a statutory authority set up under the APRA Act and is subject to the FMA Act. The primary purpose of APRA is to regulate bodies in the financial sector (APRA Act section 8). APRA is funded by an annual appropriation which is based on industry levies after the deduction of the Treasurer’s determination for monies collected for ASIC, the ATO, the Department of Human Services (DHS) and for implementing the *Stronger Super – SuperStream* initiative (section 50 of the APRA Act). In addition, APRA can charge fees for services and recover costs under section 51 of the APRA Act.

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

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

2. POLICY REVIEW

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

2.1 Alignment with objectives

The primary objective of APRA is defined within its Outcome Statement, being: “enhanced public confidence in Australia’s financial institutions through a framework of prudential regulation which balances financial safety, and efficiency, competition, contestability and competitive neutrality”.

A financial institution’s capital adequacy is central to assuring that financial promises can be met. A major component of APRA’s supervisory work is the assessment of capital adequacy. For ADIs, the international standard for determining appropriate risk-weights for capital adequacy purposes is set by Basel II and this is implemented in Australia by APRA’s prudential standards. Specific work carried out by APRA on the on-going supervision of ADIs using the models-based approach and accreditation of applicants which are seeking to use this approach should be cost recovered.

2.2 Description of activity

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

2.3 Stakeholders

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

2.4 Cost recovery alternatives

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

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

There are three choices available to APRA in respect of the work required for the model-based approach: decline to carry out work; use levies to fund the costs; or use a specific fee for service. The first option is not sustainable. The competitiveness of major banks requires a
prudential framework in Australia which is consistent with international standards and practice. The use of levies to recover the cost would require cross-subsidy by the ADIs that will not benefit from the models-based approach, including building societies, credit unions and other ADIs, and is not consistent with cost recovery policy. All of the ADIs mentioned above already pay the maximum levy under the restricted component of the financial sector levy. The further cost of Basel II would not increase their marginal levy rate, so the bulk of funding the accreditation and supervision of ADIs under the models-based approach for Basel II would fall onto those that will not benefit from this work. The use of a specific fee to recover the costs associated with the supervision of ADIs which are using the models-based approach and the accreditation of applicants seeking to use this approach will target the main beneficiaries of the work.

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

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

A small proportion of the cost of the Basel II work relates to the standardised method, which uses ‘supervisory risk estimates’. It is the default method for measuring capital adequacy under Basel II. The standardised method is used by those ADIs who do not elect to use the models-based approach and this cost is therefore recovered through financial sector levies.

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

3.1 Basis of charging
All relevant ADIs contribute to the Basel II work associated with accreditation and on-going supervision of the models-based approach. APRA continues to supervise the use of models by ADIs to determine their capital adequacy positions and assess applications of certain ADIs seeking to adopt this approach.

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

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>3.7</td>
<td>3.8</td>
<td>2.2</td>
<td>2.2</td>
<td>2.1</td>
<td>2.2</td>
<td>2.3</td>
</tr>
<tr>
<td>Expense</td>
<td>4.2</td>
<td>4.0</td>
<td>2.1</td>
<td>2.2</td>
<td>2.1</td>
<td>2.4</td>
<td>2.2</td>
</tr>
<tr>
<td>Net operating result</td>
<td>(0.5)</td>
<td>(0.2)</td>
<td>0.1</td>
<td>0.0</td>
<td>0.0</td>
<td>(0.2)</td>
<td>0.1</td>
</tr>
</tbody>
</table>

Please refer to section 1.2 for further details on the process followed for under or over collections which arise from fees derived for specific services.

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

3.3 Costs to be included in charges
The total recoverable costs for undertaking the work associated with the models-based approach are estimated to be $2.3 million for 2012-13 (exclusive of GST). It is intended to recover $420,000 each from ANZ, CBA, MBL, NAB, and WBC and $200,000 from ING (amounts exclusive of GST). The derivation of the estimated costs of this service has been modelled by APRA’s finance group. A table is included in the Appendix.

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

The direct staffing costs associated with the accreditation and supervision of ADIs under the models-based approach are tracked using APRA’s time and programme management systems. In addition to direct costs, associated indirect support costs are allocated to Basel II. This includes facility, IT, stationery and insurance costs.

APRA committed the equivalent of 16 staff to Basel II-related work during 2012-13. This was in line with the 2011-12 commitment, reflecting a similar mix of skills applied to complex accreditation work and specific supervision undertaken in the period.

3.4 Outline of charging structure
APRA has limited resources to apply to elective services. The continuing Basel II-related work cannot be funded out of APRA’s existing resources. Currently five large ADIs benefit
significantly from the more efficient use of capital from the Basel II models-based approach. Consistent with the approach taken in 2011-12, and on the basis that there is no material difference in the approach to Basel II supervision taken between them, ANZ, CBA, MBL, NAB and WBC will be charged an equal amount of APRA’s Basel II-related costs. ING’s application for accreditation continued across 2012-13 and the determined charge reflects the cost recovery of APRA’s associated effort.

3.5 Duration of the charge
The proposed fee is intended to recover the specific costs incurred in 2012-13 directly associated with the on-going supervision of ADIs which have adopted the models-based approach and the accreditation of applicant ADIs. These charges are determined based on the complexity and sophistication of work for each of the institutions involved.

3.6 Recipients of the charge
The recipients of this charge are the ANZ, CBA, NAB, WBC, MBL and ING.

A table of the estimated proportional costs is shown in the Appendix.

4. ONGOING MONITORING

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

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

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

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

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

John Francis Laker
Chair
Australian Prudential Regulation Authority
Date: 6 June 2013
### Basel II – Costing Template for 2012/13

$'000

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee expense</td>
<td>1,998</td>
</tr>
<tr>
<td>Direct Office Administration</td>
<td>2</td>
</tr>
<tr>
<td>Allocated Overheads</td>
<td>232</td>
</tr>
<tr>
<td><strong>Total forecast costs - Basel II</strong></td>
<td><strong>2,232</strong></td>
</tr>
<tr>
<td><strong>Total costs to be recovered 2012/13</strong></td>
<td><strong>2,300</strong></td>
</tr>
</tbody>
</table>

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

- ANZ Banking Group Limited: 18.3%
- Commonwealth Bank of Australia: 18.3%
- Macquarie Bank Limited: 18.3%
- National Australia Bank Limited: 18.3%
- Westpac Banking Corporation: 18.3%
- ING Bank (Australia) Limited: 8.5%

Total: 100.0%