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SENATE

SELECT COMMITTEE ON SUPERANNUATION AND
FINANCIAL SERVICES

**Reference: Prudential supervision, global financial services and superannuation
guarantee charge**

TUESDAY, 12 JUNE 2001

SYDNEY

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SENATE
SELECT COMMITTEE ON SUPERANNUATION AND FINANCIAL SERVICES

Tuesday, 12 June 2001

Members: Senator Watson (*Chair*), Senator Sherry (*Deputy Chair*), Senators Allison, Chapman, Conroy, Hogg and Lightfoot

Senators in attendance: Senators Allison, Chapman, Conroy, Hogg, Sherry and Watson

Terms of reference for the inquiry:

For inquiry into and report on:

- (a) prudential supervision and consumer protection for superannuation, banking and financial services;
- (b) the opportunities and constraints for Australia to become a centre for the provision of global financial services;
- and
- (c) enforcement of the Superannuation Guarantee Charge

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Committee met at 10.07 a.m.

CHAIR—I declare open this public hearing of the Senate Select Committee on Superannuation and Financial Services. This is a supplementary public hearing in terms of reference A of the committee's main inquiry into prudential supervision and consumer protection for superannuation, banking and financial services. The aim of today's hearing is primarily to take evidence from those involved in the regulation of Commercial Nominees Australia Ltd—CNAL—solicitors' mortgage schemes in Tasmania, and to a lesser extent, HIH Insurance.

The committee is aware of ASIC's investigation into possible illegalities in connection with the collapse of HIH and that a royal commission is to be established to look into the broader aspects of the insurance industry. However, while the royal commission will focus on the massive losses, we are concerned that there are not too many separate inquiries into the financial files and records as we believe that ASIC's and APRA's resources—but especially ASIC's resources—should be kept intact so that they may continue with full speed, and with adequate resources available, to enable them to bring people to justice and money back into the hands of those denied their legal entitlements.

We are concerned about the massive losses and we believe that that is an overriding role for a royal commission, particularly one addressing the thousands of people affected, and we wish to remind people that we believe that the committee does have an oversighting role in its broader or generic sense. This will provide a parliamentary input into the issues and the effects of the collapse of the country's second largest general insurer. As you are aware, the committee has been very much to the forefront in bringing to the public's attention concern about many of the losses in this area.

The committee deferred appearances by the regulator until this date—and this is important—because we felt, as a committee, that the priorities at the time were to get the payments out and to resolve with the insurance companies how best to resolve the intermediate problems and to obtain some justice for those adversely affected. As chair of the committee, I must say that I have been impressed by the speed with which ASIC has acted and with its action against allegedly offending parties. ASIC's activities have restored much of the faith in ASIC as a regulator and we thank it for what has happened and offer best wishes for the future.

All the witnesses who will appear before the committee are protected by parliamentary privilege with respect to the evidence given before the committee. This means that they are given broad protection from action arising from what they say and the Senate has power to protect them from any action that disadvantages them on account of the evidence given before the committee. The committee prefers to conduct its hearings in public. However, if there are any matters which you wish to discuss with the committee in private, the committee will consider your request.

Before I welcome the participants to today's hearing, perhaps Senator Sherry, the deputy chair, might like to comment on the matters that I have raised to date in relation to the role of the regulators, ASIC and APRA. Do you wish to make any comments, Senator Sherry?

Senator SHERRY—No.

CHAIR—Senator Sherry has informed me that he does not wish to add to comments that I have made. I would therefore like to welcome all of today's participants to today's hearing.

[10.11 a.m.]

HEDGE, Mr Peter James, Partner, PricewaterhouseCoopers

Mr Hedge—I have been involved with the trusteeship of certain do-it-yourself superannuation funds of which Commercial Nominees was previously a trustee. I was also involved as an investigator for APRA in relation to certain activities of other superannuation funds.

CHAIR—Do you have an opening statement to share with us?

Mr Hedge—No, I have come along because the committee was interested in making some inquiries as to our role in relation to these various funds. In response to some questions, we had sent some details of our role as the investigator under section 257 of three superannuation funds last year of which Commercial Nominees had been a trustee.

CHAIR—Thank you. Mr Hedge, when did you first become aware of problems within the CNAL group and who drew your attention to those problems?

Mr Hedge—The problems that we were aware of were in relation not to the CNAL group per se, but rather to the superannuation funds that APRA had appointed me to inspect. These funds were the Australian Workforce Eligible Rollover Fund, the Network Superannuation Fund and the Midas Superannuation Fund. I was appointed under section 257 as an investigator of those three superannuation funds in April last year.

CHAIR—Under the terms of that engagement, did you produce monthly reports to the regulator?

Mr Hedge—Yes.

CHAIR—Did you receive any input from any other independent source indicating that there were problems—apart from what you discovered yourself or from what you were told by the regulator, APRA?

Mr Hedge—Our investigation of those three superannuation funds clearly highlighted the problems that those three funds had.

CHAIR—Did your investigation show that they were not all just immediate problems—that there were a lot of problems going back a number of years in terms of trustee behaviour?

Mr Hedge—The problems were that the trustee of those three funds had invested money in various unit trusts which were noted as impaired assets at the time that the trustee advised APRA of the problems. As you are aware, a trustee has a duty under the SIS Act to advise APRA if they believe there is a material problem with a superannuation fund. This trustee had come to APRA and advised them that they believed AWERF, Network and Midas had problems

because they had discovered that certain of the unit trust that those super funds had invested in were not able to redeem those investments.

CHAIR—Who was the trustee and what year was it reported to APRA?

Mr Hedge—What had led to the appointment of section 257 was that Commercial Nominees as trustee had gone to APRA just prior to my appointment and advised them of this problem. My understanding is the reason Commercial Nominees advised them of the problem at that point was a new board of directors had been appointed to Commercial Nominees, and it was that new board that came before APRA with the problem that these three superannuation funds had.

CHAIR—Was it not true that an earlier trustee had also raised concerns?

Mr Hedge—I am not aware of there having been any other trustee of these three superannuation funds.

CHAIR—What was the date that a director was sent investment moneys to New York and we never saw much of him again? What was the year of that operation?

Mr Hedge—I did not see evidence that these three superannuation funds had sent money to New York.

CHAIR—Didn't one of the earlier trustees nick off overseas and get sent money while overseas for investment overseas?

Mr Hedge—I am not sure what you are actually talking about.

CHAIR—It appears that there were troubles with Commercial Nominees with certain of their funds before the new board of trustees referred their concerns to APRA. In other words, the concerns of the new trustees were not just immediate concerns, but obviously there had been a history which went back several years. I am just trying to establish that earlier history of where there were some inappropriate investments and some inappropriate non-arm's length dealings between certain directors. Didn't your brief go back into history?

Mr Hedge—My brief related to the three superannuation funds—AWERF, Networks and Midas, of which Commercial Nominees was a trustee. The impaired assets that the trustee had flagged to APRA were two unit trusts—the enhanced cash management fund and the enhanced equity fund. Those two unit trusts were unable to redeem the investments the superannuation funds had put into them. Our inquiries into where the assets of those unit trusts had gone made it obvious to us, as was reported in our reports, that the assets had been invested by the trustee of the unit trusts—which of course was also Commercial Nominees—in a whole series of investments, such as a retirement village development, a tomato farm and a mushroom farm development. There were various tax driven schemes which had caused the unit trusts to lose their money and, thus, in turn lose the superannuation funds' money.

CHAIR—The point I am getting at, Mr Hedge, is that your focus appears to be when they were unable to redeem their investments. What I am trying to get back to is an earlier stage:

who was responsible for making those investments in the first place? Were there any inappropriate non-arm's length transactions? You are not the person to speak to in relation to what happened prior to the new trustee's inability to redeem the assets, because the mischief did not rest on trying to redeem the assets; the problem seems to us to have been at an earlier stage. We are just trying to look at what went wrong at that earlier stage.

Mr Hedge—And it was clear that those unit trusts had inappropriately invested their money at a much earlier stage.

CHAIR—Are you an auditor?

Mr Hedge—No.

CHAIR—Would you have thought that, in auditing these unit trusts, et cetera, and the enhanced cash management fund, and in signing off the accounts, an auditor would have felt obliged to look at the appropriateness of moneys being directed to certain purposes and to ensure that they went into accounts for those particular purposes?

Mr Hedge—Are we talking about the superannuation funds accounts or the unit trusts account?

CHAIR—We are talking about all of them, actually—one umbrella.

Mr Hedge—They are two totally different entities as such.

CHAIR—They are definite entities, but I am talking about an auditor's role in terms of his signing off on the accounts, whether it is a superannuation entity or a unit trust entity. I would have thought that part of his audit mandate would have been to ensure that moneys designated for a cash management trust went into a cash management trust and that those moneys were invested in short-term assets—in most people's minds a cash management trust is essentially an investment in securities or cash that can be redeemed very easily and quickly—rather than in long-term or speculative assets. I would have thought that an auditor's duties included an examination of those particular issues in order to satisfy himself that the accounts presented a true and fair view. Coming from a Pricewaterhouse background, I am asking for your evaluation of an auditor's responsibilities.

Mr Hedge—You have raised a number of issues. First, as I understand it, an auditor's role is to comment on the accuracy and fairness of the accounts as presented by the entity as truly reflecting that entity's position. The second issue is whether a trustee has properly complied with the instructions of people putting money into a particular fund. I believe that is another issue. I suspect that what you are talking about now relates to the do-it-yourself funds, where a lot of money also has found its way into one of the unit trusts called the enhanced cash management trust. Many of those unit funds had not been audited for more than two years.

CHAIR—They had not?

Mr Hedge—No.

CHAIR—Why was that?

Mr Hedge—Because the trustee had not arranged and the auditor had not signed off the audit reports.

CHAIR—That was towards the end, though, wasn't it, in the 2000 accounts?

Mr Hedge—No. The June 1999 accounts were not completed in some cases.

CHAIR—That raises a problem. In any regulatory system, the regulators, I believe, are entitled to rely on the fact that the auditors have carried out their job in a professional manner. I would have thought that they should be able to rely on an auditor's examination to ensure the appropriate investment of those funds according to the trust deed. In auditing any sets of books, you really need to look at your charter and your trust deed to make sure that those moneys have been invested according to the charter in which it was set up. An auditor who fails to do that fails to do his job. At the same time, I believe that the regulators are entitled to rely on the fact that the auditors have done that sort of work, but apparently they have not. While we have heaped lots of criticism in terms of some of the regulators, some of their problems have been overreliance on the auditors, and the auditors have let down the system by failing to accurately carry out their mandate.

Mr Hedge—I think the issue starts with the trustee.

CHAIR—Of course it does, but the auditors audit the records of the trustees.

Mr Hedge—The auditor audits the records of the particular funds over which the trustee has the duty of trust. If the accounts prepared for those funds do not accurately reflect the fund's position and the auditor has signed off that they do, obviously that creates problems for those who in turn rely on the audited accounts.

CHAIR—All this sort of indicates that there is a time problem. If an auditor finds themselves in a position of not being able to sign off the accounts because they are unsatisfactory, or they are not written up on time or in an accurate manner, don't you think the auditor has a responsibility to go directly to the regulator to inform them of the situation, because time delayed in this situation is fairly critical? I am suggesting that perhaps the auditing profession should look at its own role in that, when it finds itself in a similar position to what you have outlined, it does also have a duty to go back to the regulator and tell them what is going wrong.

Mr Hedge—If that is a requirement of the legislation it would be appropriate.

CHAIR—Do you think there is a deficiency in the legislation?

Mr Hedge—As I said, not being an auditor, I am not—

CHAIR—You think that there would appear to be a deficiency in the legislation then?

Mr Hedge—If that is not included, then it is something that you could look at.

Senator SHERRY—I understand that one of the operators ended up in Nicaragua or Guatemala—I forget which exotic Central American destination. Do you know if extradition proceedings are being undertaken?

Mr Hedge—I think that what you are talking about are the former directors of Commercial Nominees.

Senator SHERRY—One of the former directors, yes.

Mr Hedge—There is a whole series of former directors of Commercial Nominees who are being investigated and various actions are being contemplated in relation to whether they have breached any laws in their capacity as directors of that company while that company was a trustee of various funds' money.

Senator SHERRY—So you are not aware of any extradition proceedings, if in fact they can be taken?

Mr Hedge—I am not aware.

Senator SHERRY—Regarding these three superannuation funds—AWERF, Networks and Midas—who were the trustees?

Mr Hedge—Commercial Nominees.

Senator SHERRY—In all cases?

Mr Hedge—Yes.

Senator SHERRY—With these three funds, who effectively was the employee representative? Under the SIS Act there is the requirement for an employer representative and an employee representative. Who represented the employee?

Mr Hedge—The AWERF fund was an eligible rollover fund, so to my knowledge there was no employee representative because it is not a particular company.

Senator SHERRY—It was a rollover fund.

Mr Hedge—That is right.

Senator SHERRY—What about the other two?

Mr Hedge—We were not aware of them falling within that requirement as well.

Senator SHERRY—Why is that?

Mr Hedge—Again, because the inspector did not see any evidence of that being the case.

Senator SHERRY—You have mentioned that the first was a rollover fund. Were the other two linked to a particular employer with employees' money being put in as SG? Or were these rollover type funds selling their product to individuals, either as rollover or as individual do-it-yourself type investments?

Mr Hedge—My understanding is that they were not ongoing active funds and that they were fairly small funds, having previously been linked to a particular employer.

Senator SHERRY—I gather from what you are saying and from the previous evidence we have taken that people who put money into these funds were individuals who chose, through a variety of mechanisms, these superannuation funds to put their moneys into.

Mr Hedge—I think you might be confusing these three funds with the other superannuation funds that Commercial Nominees was the trustee of.

Senator SHERRY—Where did these funds come from? What was the background of the individuals?

Mr Hedge—They are not individuals. AWERF has about 20,000 members.

Senator SHERRY—That is a rollover fund.

Mr Hedge—That is right.

Senator SHERRY—I understand. What about the other two?

Mr Hedge—They were related to particular employees. I have not seen any submissions to this committee in relation to these three funds.

Senator SHERRY—Nor have I.

Mr Hedge—The submissions that I have seen relate to what one might call the do-it-yourself superannuation funds of which Commercial Nominees was also a trustee.

Senator SHERRY—Regarding this eligible rollover fund, where was it receiving money from? These 20,000 people who have—

Mr Hedge—An eligible rollover fund is a fund into which an employer's superannuation scheme is able to roll over money.

Senator SHERRY—I understand that. Where do these moneys come from? Which area? What employer? What employees?

Mr Hedge—It is a very wide range. Any superannuation fund basically can use an eligible rollover fund.

Senator SHERRY—Yes, but who?

Mr Hedge—A lot of companies just rolled their money into this fund. There was no one particular source.

Senator SHERRY—Which employer funds, or industry funds for that matter, used the workforce eligible rollover fund? Can you give us a list, if you cannot tell us today?

Mr Hedge—I cannot give you that today, but there is a list of people.

Senator SHERRY—Can you give that to us?

Mr Hedge—Yes, and we can give you a list of the 20,000 members as well.

Senator SHERRY—I am not that the keen. We have enough paperwork. But I would like to know how these individuals' monies were placed, what was the source, what areas it was coming from.

Mr Hedge—The average amount is \$1000 to \$1500. A worker might, for example, join the company for six months. They will put superannuation to one side. The worker will leave—perhaps he will leave the country. The fund needs to move the money out of that particular company's fund.

Senator SHERRY—I understand that. I am just interested to find out what the source of the funds was; who the decision makers were.

Mr Hedge—It would have been the trustees of the various superannuation funds of those particular entities that rolled the money in.

Senator SHERRY—Thank you.

Senator ALLISON—I would like to ask you about the reports you made to APRA. There was one in May, there was one each month after that and one in November: is that correct?

Mr Hedge—Yes.

Senator ALLISON—Are those reports available to the committee?

Mr Hedge—You would have to ask APRA. Those reports went to APRA, and were specifically reports on these three funds.

Senator ALLISON—So they only went to APRA? They are not public documents?

Mr Hedge—They are not public documents. Again, you would have to check with APRA as to whether you are able to access them.

Senator ALLISON—So were they available to anybody in CNAL?

Mr Hedge—Yes, that company got a copy of the reports as well.

Senator ALLISON—Did the trustees receive a copy? Could you perhaps just tell us the distribution of the reports.

Mr Hedge—The reports went to Commercial Nominees Australia Ltd., as the trustee of those three super funds, and it went to APRA.

Senator ALLISON—As part of your investigations, were you required to look at the 1998 audit by Arthur Andersen?

Mr Hedge—Of which entity?

Senator ALLISON—Of CNAL.

Mr Hedge—No, because we were not investigating CNAL. We were investigating the three superannuation funds.

Senator ALLISON—So was the November 1999 investigations report also CNAL, rather than what you were invited to investigate?

Mr Hedge—I am not aware of a December 1999 report

Senator ALLISON—I understand that it highlighted differences in valuations. You do not know anything about it?

Mr Hedge—No.

Senator ALLISON—Did you take an interest in the area of the key features statements which were the basis of further investment in July to September? Were those key features statements accurate?

Mr Hedge—Our role did not involve any funds other than these three superannuation funds. I think what you are referring to with the key features statements are the small APRA funds or the do-it-yourself funds that individuals set up for themselves, which our investigation did not have anything to do with.

CHAIR—This is all very well, but didn't your investigations, as a result of what you found here, give you a hint that there might be other problems in other areas of the group? Surely to goodness, as a professional, something must have started twiggling with you that there may have been other problems. Why did you think they were just purely confined to this sort of problem? You seem to have taken a fairly superficial sort of oversight in terms of your responsibilities.

Mr Hedge—On the contrary, Senator Watson, we were appointed under a particular act to do a particular job, and it is very important to comply with the legal requirements of any such job. In relation to questions about what else CNAL may have done if, as trustee, it has made these mistakes, then no doubt that is something—

CHAIR—Did you say that in your report?

Mr Hedge—No doubt that is something—

CHAIR—Did you say that in your report?

Mr Hedge—Our report made the problems of these funds very clear, and no doubt those regulators with responsibility for overseeing a trustee entity would be aware of and would look at the meaning of the implications.

CHAIR—From what you had discovered, did you give any hint in your report that there may well be problems elsewhere in the organisation? It is all very well to pass the buck back to APRA, but—

Mr Hedge—No. We had no access to elsewhere in the organisation.

CHAIR—I know. But, as a result of the tremendous problems that you had discovered in your organisation, there must have been some signals of it being possible that there were problems elsewhere within this umbrella organisation. Did your report give any hint that there may well be problems elsewhere, or did you just confine yourself to the strict legal interpretation of what you had been appointed under, and no more?

Mr Hedge—It was clear that there were problems with—

CHAIR—Yes, I know it was clear. But in your report did you indicate to the regulators that, as part of their duties, they should be looking elsewhere in addition to these three particular unit trusts under which you had particular responsibilities?

Mr Hedge—Our report would not comment on anything other than our specific terms of reference. There was no question that the regulators were aware that CNAL had problems.

CHAIR—But you were not particularly helpful to them in terms of your report, apart from confining your remarks to the very narrow prescription under which your appointment mandate was given.

Mr Hedge—That would be a wrong interpretation.

CHAIR—What would be a correct interpretation? I am concerned about not sending the right sorts of signals to the regulator to indicate that the regulator needed to act—and to act very, very quickly—in view of the issues that you had raised.

Mr Hedge—The question of acting in relation to these three funds was discussed every month.

CHAIR—From what date?

Mr Hedge—From the first report.

CHAIR—What about the legal implications about the flow-on effects, say, down to a cash management trust?

Mr Hedge—Again, you are talking about a unit trust—

CHAIR—Correct.

Mr Hedge—which is regulated by ASIC and not APRA, and access to which, under section 257, was not available to the investigator.

CHAIR—Senator Allison, I interrupted you. Do you have any further questions?

Senator ALLISON—No, thank you.

Senator HOGG—In your opening remarks you said that Commercial Nominees new board had recognised that there were impaired assets. Did your role go back to finding out why the old board had not recognised that there were impaired assets?

Mr Hedge—No, at that point it did not look into what actions could be taken against the old board for having made those investments, or why the old board had not disclosed those impaired assets to APRA.

Senator HOGG—Is that part of your role? If it is not part of your role, whose role is it then?

Mr Hedge—The information was all there about what had happened in relation to these three funds. The next step, of course, was to decide how best to deal with the problem these three funds were in. That is something that was the subject of at least monthly discussions. APRA were in negotiations and discussions with the directors of CNAL in relation to these three funds quite regularly.

Senator HOGG—I accept that. But part of this committee's charter is to look at what happens prior to these things being discovered. In many instances no-one seems to want to take responsibility for what happened, or for identifying what happened, prior to the actual difficulties being reported and acted upon. That is why I am interested in your role.

Mr Hedge—That responsibility is now clearly being taken by the replacement trustee of those funds. In that capacity the replacement trustee, which I represent, is investigating and looking at all such civil and other actions that can be taken against the officers of CNAL in that, at the time, they made the decisions they did and invested the money in the way they did.

Senator HOGG—Those three funds that you looked after for a time or inquired into: what is their worth today compared with their original worth? Is it 20 per cent?

Mr Hedge—Of their assets of about \$25 million, they would have invested around \$10 million in EEF and ECMT. They were the two impaired assets that had been identified.

Senator HOGG—What are those impaired assets at \$10 million worth today?

Mr Hedge—At present there has been no value put on EEF and possibly 20 cents in the dollar has been put on ECMT, by the current replacement trustees of those two unit trusts.

Senator HOGG—When will a value be placed on EEF?

Mr Hedge—It will depend on whether the replacement trustee is successful in the legal actions being taken against the former officers and CNAL, as trustee, for their actions in investing that money in the way they did.

Senator HOGG—When is that likely to culminate?

Mr Hedge—I cannot talk for that trustee but, just knowing how long these matters take, it depends on the legal system and how quickly the matter can be processed.

Senator HOGG—Out of the \$10 million, how much was in the enhanced cash management?

Mr Hedge—It was, off the top of my head, about fifty-fifty.

Senator HOGG—So it was about a fifty-fifty split.

Mr Hedge—Yes.

Senator SHERRY—Who controlled and/or owned Commercial Nominees? Who was the person calling the shots?

Mr Hedge—My understanding—and we got this from our ASIC searches—is that it was a company called Power Capital Group.

Senator SHERRY—I said who, not the company. Who owns Power Capital Group?

Mr Hedge—Again, I am not sure what the current situation is; but when we were looking into it back then, they were interests associated with the former directors of CNAL.

Senator SHERRY—So it is the former directors. What are their names; do you know?

Mr Hedge—I would have to get the list, but it is all on publicly available records.

Senator SHERRY—Can you provide us with a copy of the list?

Mr Hedge—Yes. In fact, we have all those names and details in relation to the legal actions that we are looking at taking at present.

Senator SHERRY—If you can give us the list, that will be fine. Is it the person who is in Guatemala or Nicaragua? I am not sure which country it was, but one of those Central American countries, I think.

Mr Hedge—Yes. One of the former directors—I do not know about shareholders—is no longer in the country and was not in the country at the beginning of last year.

CHAIR—And was sent some money while he was in New York for investment; is that right?

Mr Hedge—I am not aware specifically of what you are talking about.

Senator SHERRY—He was on his way to Central America.

CHAIR—I understand that CNA was replaced in December 2000 as trustee of the three funds investigated by you.

Mr Hedge—Yes.

CHAIR—An acting trustee was appointed, Oak Breeze Pty Ltd. We understand that is an arm of Price Waterhouse; is that correct?

Mr Hedge—Yes. Oak Breeze was appointed as the—

CHAIR—They were appointed to the AWERF and ACT Super Management Pty Ltd, which was a KPMG trust company; is that correct?

Mr Hedge—Oak Breeze was appointed trustee of AWERF, and the KPMG acting trustee was appointed to Midas and Networks.

CHAIR—We are a little concerned about a lack of transparency in terms of your appointment, and about the limited resources that you are immediately able to bring to the big task in hand before you. Would you like to comment on that?

Mr Hedge—It appears that that comment was raised by a Mr Dally from Saxby Bridge, not in relation to the acting trusteeship of AWERF, but in relation to the acting trusteeship in respect of the 450 small APRA funds for which Oak Breeze was appointed as acting trustee in February of this year. That was a completely unfounded and unsubstantiated comment by a director of Saxby Bridge.

CHAIR—We need some assurances that you have the resources, skills and expertise to handle all the responsibilities under your jurisdiction. What levels of assurance can you give us in terms of transparency? You just said the comments were unfounded. Why are they unfounded? What sort of resources can you bring to bear, particularly in a timely and expeditious fashion?

Mr Hedge—They have been brought to bear. We have been the acting trustee of these funds since February.

CHAIR—How many people have been brought to court?

Mr Hedge—That is a matter of legal action and the resources are being marshalled in conjunction with all the parties that are considering taking action against these people in order to take the most effective, least costly, and expeditious approach towards recovering the money.

CHAIR—We have heard about ASIC's performance in relation to HIH and One.Tel. Why is the jurisdiction for which you are responsible so tardy? Why can one jurisdiction bring action pretty expeditiously and another need all this time before it can bring appropriate action to bear?

Mr Hedge—I think that you are confusing the issues.

CHAIR—I am not. This is the public perception.

Mr Hedge—And perhaps that is where the confusion is. We are the acting trustee of these various superannuation funds. These funds have only limited resources in order to bring these actions. These issues also fall under ASIC's jurisdiction and ASIC is investigating and looking at these matters. We are in constant contact with APRA and ASIC in relation to seeking and soliciting their support with their powers as regulators that an acting trustee does not have, and also in relation to the funding that they might be able to bring to bear to assist in recovering the money that the former trustee has so inappropriately invested.

CHAIR—But in a sense you are in a nice comfort zone at the present time. You need time and there is a lack of resources. The regulators have the resources provided that they are given the signals and the ammunition in respect of which they can take action. I return to the lack of consultation with fund members. What is your comment on that? You have not been very forthcoming in terms of communications with a lot of disaffected people.

Mr Hedge—Again, that is an inappropriate comment as well. As acting trustee, we have sent a number of reports to the fund members we are now reporting to. Every day, we talk to many people. About 450 funds are involved. We have even had meetings of fund members to discuss and explain the situation to them.

CHAIR—Yes, but unanswered correspondence. We have problems. Directors of Oak Breeze went on a holiday at the same time they were appointed as acting trustee of the small APRA funds.

Senator SHERRY—Guatemala and Nicaragua again, wasn't it?

CHAIR—Has the issue been raised as to whether or not Oak Breeze Pty Ltd holds the minimum \$5 million in net tangible assets? You are talking about lack of resources and all that sort of thing, so I am coming back to the issue of appropriateness.

Mr Hedge—No-one is talking about lack of resources. I saw that a Mr Dally made those comments in one of these committee inquiries. The details of that were faxed to me on Friday night and I was reading it on the weekend. As you are probably aware, Saxby Bridge is currently the subject of ASIC investigations and is also the subject of our own investigations. For this public committee to take those comments without any substantiating information, without understanding the context, is quite misleading.

CHAIR—We are giving you the opportunity of rebutting them in a public forum.

Mr Hedge—They have been rebutted. They were unsubstantiated comments, with no understanding of the context of the issues involved. The one in relation to the holidays, I suspect, is more mischievous, because the facts are that one of the directors of Oak Breeze was on holiday when Oak Breeze was appointed as acting trustee. That was me. Fortunately, PricewaterhouseCoopers and Oak Breeze do not come to a halt just because I am on a week's holiday.

CHAIR—We are putting ourselves in the position of people in a cash management fund who were in receipt of an allocated pension who suddenly found those pension payments had stopped. You are giving us all the reasons as to why a regulator had good reason to proceed slowly rather than expeditiously. That is my concern and the concern of this committee.

Mr Hedge—Fortunately, our appointment—

CHAIR—Because it is a comfort zone, where your fees are assured, but there are a lot of people out there whose homes are subject to being foreclosed under mortgage arrangements and there are people who are really in desperate situations.

Mr Hedge—No-one has mentioned at all that their homes were being foreclosed. The issue of the pensions—

CHAIR—What, people whose pensioners had been stopped?

Mr Hedge—I understood that those pensions had been stopped when the ECMT—the cash management trust—had been frozen last November by the directors. Now, since—

CHAIR—How are these people going to live? You can understand them getting desperate and making wild claims to us.

Mr Hedge—Which is exactly why, when we were appointed in February, we immediately tried to address the issue that had obviously been going on for four months prior to our appointment.

CHAIR—They still have not got their pensions restored, though, have they?

Mr Hedge—Yes.

CHAIR—They have?

Mr Hedge—Yes.

CHAIR—When did they get their pensions restored?

Mr Hedge—It depends on the individual case. In most cases they were restored some time ago.

CHAIR—Can you give us the schedule of when they were restored and how many are still outstanding?

Mr Hedge—If it is appropriate to release individuals' private and confidential financial information to this committee—

CHAIR—You could say 'A, B, C, D, E'. You could do it by—

Mr Hedge—As trustee, it is my responsibility to look after and make sure these funds are properly dealt with. It is a responsibility that is being undertaken in an appropriate way, particularly when one compares it to the way in which CNAL had been undertaking their responsibilities. There is no question in my mind that the previous trustee of these funds, with the benefit of the information I have now as the acting trustee, clearly breached trust and clearly did not do their job as a trustee in relation to these funds. It is my job now, as the acting trustee, to remedy these funds' problems.

CHAIR—That is the most positive thing that you have told us all day, Mr Hedge.

Mr Hedge—It is what we have been doing since we were appointed, it is why we were appointed and it is what we have been communicating to members.

CHAIR—Could you provide us with a supplementary submission outlining how many allocated pensions have not been restored and what other outstanding moneys there might be out of the cash management trust. Please take that on notice.

Mr Hedge—Again, allocated pensions are not the only issue. Members have contributed funds to the do-it-yourself or small APRA funds understanding that this money was to be deposited in cash. These people went to their financial planners, who advised them to set up these funds, and they were then advised that they had to make out their cheques to, and deposit the funds into, a cash management trust. First of all, that was incorrect advice, if that is what they were given, because there is no way that a contributing member can be forced to put their money into a pool of cash management trusts, yet it appears that many of these contributing members were led to believe that that was the only way in which they could put their cash into these funds. We are investigating those and other issues in relation to seeing just how wide the net will go, in my capacity as the acting trustee to recover the funds that were put into this enhanced cash management trust by the small APRA funds, and to try to recover the money that went into those funds.

In relation to other investments those funds made, again we are looking at whether they were just unfortunate investments that were authorised by the members and therefore the loss was part of the risk that was taken, or whether again CNAL or the financial planners advising the members somehow inappropriately organised that money to go into those particular investments.

We have 450 individual do-it-yourself superannuation funds that have put their money into many and varied investments. One common investment, which was the ECMT, enables us to try and pool resources to recover losses where those losses were as a result of a breach of trust or other offences that may have been committed by those who were entrusted with these people's

money. There are other investments where the individual funds have the problem, and we have to deal with those funds' investments as best we can.

Senator ALLISON—What was your fee for doing the investigation which went from May to November?

Mr Hedge—I do not have the details of that. Again, the May to November investigation was in relation to the three superannuation funds you mentioned.

Senator ALLISON—I understand that.

Mr Hedge—I understand that Senator Watson's questions, though, and most of the submissions that the committee has received, relate to the do-it-yourself small APRA fund.

Senator ALLISON—I realise that; if you can just answer the question.

Mr Hedge—I do not have the details.

Senator ALLISON—What is the figure, roughly—\$100,000, \$200,000?

Mr Hedge—I do not have the details. It is more than six months now.

Senator ALLISON—You must have some idea of the general order.

Mr Hedge—It is more than six months ago. It was a monthly report. A monthly fee was raised.

Senator ALLISON—Perhaps you can take that question on notice.

Mr Hedge—If it is relevant.

Senator ALLISON—It is relevant, I think. Can you also explain what your role now is? Are you doing any investigation, and if so for whom? According to your submission, your role as investigator ceased at the time APRA removed Commercial Nominees as trustee of the three funds in December.

Mr Hedge—Yes.

Senator ALLISON—Can you briefly explain what your role now is?

Mr Hedge—Our role now is as the acting trustee of AWERF and as the acting trustee subsequent to the AWERF appointment of the 450 do-it-yourself funds.

Senator ALLISON—And in that role are you funded by APRA or not?

Mr Hedge—The trustee is paid by the funds. However, in relation to some investigation work that we are undertaking to assist in some of the recovery actions that APRA is assisting us

to take, APRA has undertaken to reimburse those costs rather than those costs being funded by the funds that the trustee represents.

Senator ALLISON—So APRA instructed you following the cessation of your investigator role to become acting trustees; is that how the system worked?

Mr Hedge—Yes. We were appointed acting trustee under the SIS Act.

Senator ALLISON—Can you broadly indicate whether recommendations were made by you during the period of your investigation and whether those recommendations were adopted? What exactly was the difference you made with regard to the running of those three funds?

Mr Hedge—The difference we made was that obviously APRA knew the financial position of those three funds and was able to make sure that their financial position did not further deteriorate.

Senator ALLISON—So you did not make recommendations at all?

Mr Hedge—Every month, we would discuss what the best course of action was. In a situation like this, you either appoint an acting trustee earlier or appoint one later, or the problem is solved. The submissions that CNAL had been making to APRA were that they were endeavouring to work out and solve the problems that we had identified as inspector. As long as the position was not deteriorating, then my understanding was that APRA saw that as being a preferred option rather than to crystallise the loss at the outset.

Senator ALLISON—From your point of view, can you comment on the narrowness of those terms of reference? You have indicated in your answers to us today that you were not at liberty to investigate areas to do with CNAL and you were confined to those funds. Why do you think it was that those were such narrow terms of reference and you were not able to look into CNAL more broadly?

Mr Hedge—I think that is because they are the powers that APRA have under the SIS Act: to appoint an inspector under 257(2) of superannuation funds. My observation was that they were responding to the directors coming forward to APRA and saying, ‘Hey, we have a problem with these three funds.’ With the benefit of hindsight, and now particularly as acting trustee of these other 450 funds, one of the issues that I observe in relation to offences that CNAL have committed is they failed to notify APRA of these other funds also having impaired assets. That does not make sense. If you notify APRA that one group of funds have impaired assets, why would you not be notifying APRA of the other group?

Senator ALLISON—So would you argue that the directors of CNAL are liable in that case?

Mr Hedge—It is clear that they breached the SIS Act.

Senator ALLISON—Coming back again to the limited terms of reference, you say that is because that is what the act limits—

Mr Hedge—It empowers APRA to do.

Senator ALLISON—Does that lead you to suggest there ought to be some changes to the SIS Act to accommodate a more broad investigation?

Mr Hedge—I am not sure whether there are other provisions which may give APRA that power. APRA obviously had the power to appoint an inspector under 257(2) for all the superannuation funds that CNAL was the trustee of. Again, they obviously only appointed the inspector to those funds which CNAL had advised them had impaired assets.

Senator ALLISON—Could one of the reasons for limiting the investigation to these three funds be the cost of the investigation?

Mr Hedge—Again, with the benefit of hindsight, the small APRA funds would have found it a huge impost to have an inspector appointed to them if there was no sense or concern at the time that they had a problem.

Senator ALLISON—Was your appointment based on some sort of time charge arrangement? Or did you make a commitment to a certain sum of money?

Mr Hedge—We charged on a professional fee basis, which is based on time.

Senator ALLISON—Was it open-ended? Was there no cap or limit on the amount of time that you would spend?

Mr Hedge—We were not limited in what we could do, if that is your question. They were not limiting us by limiting our fee.

Senator ALLISON—Did you report to APRA monthly on the amount of time you were taking? Were your fees charged monthly?

Mr Hedge—Yes, we raised fees monthly and, again, we reported monthly. We would meet in those months to discuss how the funds were progressing.

Senator ALLISON—How many people did you have on this project for most of the period?

Mr Hedge—It was not a full-time project but each month I would have, on average, two other staff working with me.

Senator ALLISON—Were you full-time?

Mr Hedge—It was not full-time. The reports were to go and inspect and report.

Senator SHERRY—Who pays you?

Mr Hedge—All trustees are paid by the funds that they are trustee of.

Senator SHERRY—How long do you anticipate this will go on?

Mr Hedge—We have advised members that we want to have ceased to be the acting trustee by no later than the end of October. Originally, we were trying to make that earlier. Unfortunately, the uncompliant state of the funds and the standard of the records of the funds have made it difficult for us to do that.

Senator SHERRY—You said that there were breaches of the SIS Act. In your view, is there a prima facie case of theft or fraud involved?

Mr Hedge—That is an issue that we are looking at very closely. That is one of the other avenues that I, as trustee, can use to endeavour to recover money from these funds. As you may be aware, under the SIS Act there are provisions to the effect that, if the loss occasioned by the trust is a result of the former trustee's dishonesty or theft, there are avenues where I can claim compensation from the minister of finance for those funds. That is an issue that we are and have been looking at closely.

Senator SHERRY—Has any application gone in yet?

Mr Hedge—We have already had discussions. One application has gone in.

Senator SHERRY—To the minister?

Mr Hedge—Yes—or the office that handles these. I understand this is the first time that any such application has been made. We are also conscious that that is one of a number of avenues. Another avenue is suing the directors under their insurance policies but, as you will also be aware, one of the exclusions under those policies is, effectively, the inclusions under 229. So we are, in the funds' interests, dealing with this issue in a very serious and careful way.

CHAIR—It is a big responsibility. If you believe it is fraud, it annuls indemnity insurance. On the other hand, it gives you access to government compensation for a levy on all funds.

Mr Hedge—We are keeping all avenues open and pursuing them all vigorously.

Senator SHERRY—Do you know when you are going to get a response from the minister on this critical question?

Mr Hedge—I cannot pin the office down to a particular time.

Senator SHERRY—Whose office—the minister's office?

Mr Hedge—Yes. Our overtures to date have been treated with an open mind and everybody appreciates—

Senator SHERRY—I think the members would want an open chequebook, not an open mind.

Mr Hedge—As trustee, that is exactly what I want.

Senator SHERRY—Good.

CHAIR—Thank you, Mr Hedge, for appearing before the committee today.

[11.10 a.m.]

ELSING, Ms Luise, Manager, Companies, Sydney, Australian Stock Exchange

HAMILTON, Mrs Karen Leslie, General Counsel and Company Secretary, Australian Stock Exchange

CHAIR—Welcome. The committee invites you to make an opening statement and you may also comment on matters that have arisen during the committee hearings that you have been listening to.

Mrs Hamilton—Thank you. The Australian Stock Exchange appreciates the opportunity to appear before the committee this morning. I am joined by Luise Elsing, who exercised powers under the listing rules in relation to HIH Insurance Ltd. Our submission and our appearance today is in response to the committee's invitation to comment on the role ASX has played, or continues to play, in relation to HIH Insurance, including how this relates to regulators such as the Australian Securities and Investments Commission. To understand our role, it is necessary to examine the regulatory framework within which we operate. The regulatory framework for securities around the world generally favours a coregulatory regime. Since the introduction of securities industry legislation in the early 1970s, the Australian model for stock market regulation has been framed along these lines. It is designed to achieve a productive collaboration between the government regulator, in this case the Australian Securities and Investments Commission, and the market operator, with its close proximity and special expertise in relation to the market.

The ASX believes this model has served the Australian financial market very well and will continue to do so. A detailed description of the framework within which ASX operates, the diversity of our supervisory activities, the mechanisms to ensure our accountability in respect of them and our relationship with the Australian Securities and Investments Commission are set out in our written submission to the committee. The submission also sets out our role in relation to HIH. In essence, that role had three quite distinct elements. The first was the daily monitoring of trading behaviour in relation to HIH Securities and the identification of any unusual trading patterns and the referral of those to the Australian Securities and Investments Commission for further investigation. Secondly, there was the exercise of powers under our listing rules in relation to entities in the HIH group which were listed on our stock exchange market. The third role was dealing with a settlement default by HIH Casualty and General Insurance Ltd which, at the relevant time, was a non-broker participant in our equities clearing house, CHESSE.

We believe HIH is an example of the Australian coregulatory model for the securities industry working very well. We believe that ASX and the Australian Securities and Investments Commission worked effectively together with a view to ensuring market integrity. For us, the HIH incident is also a reflection of the efficiency of CHESSE. It was the first payment default that the CHESSE system has experienced in its history and it showed our ability to isolate and quickly rectify a default situation. With no more notice than that provided by the morning newspaper, ASX adjusted for the default to ensure that no other participants in CHESSE was aware of, much less affected by, the settlement default.

CHAIR—That is very encouraging. Ms Elsing, do you have any comments to make?

Ms Elsing—No.

CHAIR—On what date did you first advise ASIC and what was the outcome? We are encouraged by what you say about the system obviously working well, but can you give us the date that you first advised ASIC and what happened? Obviously some pretty important steps were taken.

Ms Elsing—The day that we first advised ASIC of our concerns in relation to HIH was Thursday, 22 February.

CHAIR—We are encouraged by your statement and by your actions. Obviously the system from your perspective is working well.

Mrs Hamilton—We believe so.

Senator SHERRY—Just on that notification, what were the indications to the ASX of the problems with HIH?

Ms Elsing—We had read in the media that morning that there were anticipated losses for HIH which could be in the range of \$500 million. In those circumstances, our normal procedure is to contact the company and ask them to comment on the media speculation. We were concerned that the company said it was not in a position to make those types of comments. The outcome was that the company requested a trading halt to give it time to consider how it would like to respond to our concerns. From our perspective, we were concerned that the company was not in a position at that point to make any comment to the market about the range of its losses. Those concerns led us to think that we needed to contact ASIC to let them know that.

Senator SHERRY—Do you always respond to media speculation? I have been on the receiving end of the media, and have received the media's thanks on occasions, but if we are honest about it, they are not always accurate. How do you draw the line between some sort of juicy media titbit and what is a reasonably reputable report on which to make inquiries?

Ms Elsing—As a front-line regulator, we review the media and we look at information that may be available to one section of the community which is not available to another section of the community. In amongst that, we do not distinguish between rear-window, less speculative or more speculative areas of the media; we just pick up all the information we receive and we take it back to the company and ask them to comment on it.

Senator SHERRY—There were quite a number of stories in the media about HIH over a considerable period of time. I am sure an informal network exists at the ASX, as it would exist in any organisation—you are looking a bit puzzled. I am talking about rumours or stories about a particular institution. Do you try and pick up information through an informal network as well?

Ms Elsing—We respond to all information that is provided to our unit, but I would not say that we have a strong informal network of information.

Mrs Hamilton—One of the greatest sources of our information is just monitoring what the price is doing and we do that on a daily basis. The interesting thing with HIH was that, in about September, it had produced its preliminary financial report to the exchange which was released over our company announcements platform. The market reacted quite severely in response to what it saw as poor performance by HIH and the share price dropped 46 per cent. We then saw a gradual decline in the share price which pretty much reflected the kinds of sentiments that were being expressed in the press about its financial performance, and concerns about its financial condition. Occasionally people will ring us up with information about their belief about a company, but mainly we can go on the information that we receive from our customers, the broking community, from monitoring the share price and what we read in the paper. Those would be our main sources.

Senator CONROY—I want to refer to page 18 of your submission where you talk about your original referral to ASIC about Mr Rodney Adler and FAI. What was that in relation to initially?

Mrs Hamilton—That original referral was in relation to an on-market acquisition just prior to a takeover. In that situation, one of the things we would look at is—are you referring to the 1998 referral?

Senator CONROY—That is the second sentence. The first sentence states:

ASX has made several referrals to ASIC concerning Mr Rodney Adler and FAI—

by itself and then—

In addition, at the time of the takeover ...

Is that the same thing?

Mrs Hamilton—No, they are different things. Because we monitor trading behaviour every day, if there is any variation in the price or traded volume of a stock, we would refer that to ASIC. Over the years, there have been a handful of referrals in relation to FAI, just because of an unusual trading pattern.

Senator SHERRY—Can you expand on that?

Mrs Hamilton—Usually that would be in relation to a trading pattern perhaps being indicative of a market manipulation type of offence, or insider trading. We are not in a position to make a judgment whether that is established.

Senator CONROY—So you picked up some unusual trading and referred that off to ASIC on a number of occasions—

Mrs Hamilton—That is right.

Senator CONROY—in respect of activity inside FAI itself?

Mrs Hamilton—Yes.

Senator CONROY—I want to refer now to the takeover or the activity just prior to the takeover. Could you expand on what happened around that?

Mrs Hamilton—There had been an on-market acquisition in relation to the stock which was about to be made subject to a takeover. In that situation, we would look at or refer to ASIC for further examination whether there had been any prearrangement of that trading activity. Obviously, there can be a situation where you get a slight advantage if you trade ahead of the takeover, because your transaction is not subject to takeover conditions. You get the T-plus-three benefit of settling and seeing your money within three days. Again, because that is an unusual situation, we refer that for further investigation.

Senator CONROY—I just wanted you to take me through, hopefully, a little more detail on this unusual purchase. Is it correct that the market opened on a particular day and the 15 per cent was purchased very quickly following a notice from FAI? How did it actually work?

Mrs Hamilton—I do not have the full details with me. Perhaps we could provide those separately if the committee is interested.

Senator CONROY—Sure. My understanding was that the market opened and there was a notice up from FAI, saying, ‘Come and buy me,’ and within 15 minutes—does that sound familiar?

Mrs Hamilton—My understanding is that the transaction was fairly quick.

Senator CONROY—My understanding is that it was \$300 million within about 15 minutes. That is a quick transaction. Mr Williams must have been lucky to be sitting by his computer at the right moment to read Mr Adler’s notice on your board. It was just good luck, do you think? There was a fairly substantial purchase. How quickly after that purchase was the full takeover announced?

Mrs Hamilton—I do not have those details, I am sorry.

Senator CONROY—But all of this was referred to ASIC?

Mrs Hamilton—It was.

Senator CONROY—It is a little unusual, firstly, for a company to list itself on the stock exchange and say, ‘Come and buy me.’ Does an on-market transaction like that require due diligence to be performed by either party?

Mrs Hamilton—Not necessarily. You would hope, if you were buying a large parcel, that you would do a measure of due diligence to make sure that your money was being expended wisely.

Senator CONROY—But when you are racing into the market in 15 minutes it must be hard to organise due diligence—

Mrs Hamilton—Perhaps, unless you had been prepared to do the—

Senator CONROY—unless you had prior knowledge—

Senator SHERRY—Or a good credit card limit.

Senator CONROY—or a good credit card limit—that is right, Senator Sherry. If you are able to come back to us perhaps some time later in the day, that will be most helpful for the committee. Thank you for that. You mention in your evidence:

The referral also noted purchases of FAI by another person prior to the takeover.

Mrs Hamilton—That is right.

Senator CONROY—Were you able to establish who that was?

Mrs Hamilton—We were. It was confidential, though, so I would prefer, if you want to know the identity of that individual—

Senator CONROY—We can go in camera—that is okay. Was it a substantial purchase?

Mrs Hamilton—I do not have the details of how many shares—

Senator CONROY—Was there a related party?

Mrs Hamilton—It was, we believed, an associate of Mr Adler.

CHAIR—Senator Conroy, we might have to be careful—

Senator CONROY—No, I am not going any further. We do not have the terms of the royal commission yet. In your absence overseas, we were hoping—you were away for some considerable time—

CHAIR—The regulator has some responsibilities in this area and has taken certain action, and we would not want it to be prejudiced.

Senator CONROY—We will be asking ASIC questions along these lines as well, but we appreciate your caution, as always.

CHAIR—Thank you.

Senator ALLISON—Can you explain the process the ASX goes through when directors sell or buy shares in substantial numbers? Is there an automatic referral to ASIC if that is noticed? Is there a warning bell or an indication on your board that it is a director who is buying or selling?

Mrs Hamilton—Directors have an obligation to lodge a notification of any transaction by them in relation to the shares of a listed entity. An announcement will be made to the market that a director has entered into a transaction in relation to the shares of that company. Beyond that, we would see if that has had an impact on the price. If there is any unusual movement in relation to the price, we might see whether there is an uninformed market surrounding that dealing or whether there is anything else unusual in terms of the price, and if so we would make a referral to ASIC.

Senator ALLISON—Were any of your referrals to ASIC related to HIH?

Mrs Hamilton—Not in that way, no.

Senator ALLISON—I have a question about your company announcement platform—that is where you put information for public viewing, presumably. That goes online. Are there any ways in which people can access that information?

Mrs Hamilton—It goes out in the form of a signal to various information vendors and news services, which enables fairly broad distribution to the community. We also encourage companies to post company announcements immediately to their web sites so that the investor can access information in that way also. We also post it to our web site.

Senator ALLISON—With regard to the two media reports that you cite—firstly, of a \$185 million loss; and, secondly, of a loss approaching \$500 million—you rang HIH at that time and asked for verification of those figures; is that correct?

Mrs Hamilton—Yes.

Senator ALLISON—The answer you were given was, ‘We’re not ready to make a statement,’ or, ‘We can’t put a figure on the loss.’

Mrs Hamilton—Yes.

Senator ALLISON—You may not be able to answer this, but in your experience what often is the source of these reports to the media? Are they simply speculation? What other information does the media have access to which might give rise to what turns out to be an understatement but, nonetheless, accurate reporting of some significant losses?

Ms Elsing—From our analysis, these sorts of reports in the media come from journalists making some assumptions on publicly available information or taking it from some commentary that they might have had access to in relation to analysts, or the information can be leaked to the media by people involved in the company in some way or another.

Senator ALLISON—Would you mostly take these reports seriously?

Ms Elsing—Always.

Senator CONROY—I return to the question of an on-market acquisition. I appreciate that you may not have information readily to hand, but are you familiar with any other examples in recent memory of an on-market acquisition like that?

Mrs Hamilton—It is not really my area to comment on, I am sorry.

Ms Elsing—I cannot think of any offhand, but I am sure that we could—

Senator CONROY—I am sure that you could probably find one sometime in the last 10 years, but is it a rarity for a purchase to take place like that?

Senator SHERRY—Of that size.

Ms Elsing—I am not familiar with the sizes involved, but it is quite usual that people take large positions on market.

Senator CONROY—And then quickly announce a takeover?

Ms Elsing—It depresses the price if it is too quick.

Mrs Hamilton—It was also a sector of investment in which there was some familiarity in this case.

Senator SHERRY—Was there?

Senator CONROY—That was never proved, though.

Mrs Hamilton—Notionally.

Senator SHERRY—There was either too much familiarity or deliberately not enough.

Senator CONROY—You mentioned in your article that you are alerted sometimes by newspaper columns which make various references. Mark Westfield has written a string of columns over at least 12 months, some of them predicting dire outcomes for HIH, and he has been the subject of much vilification by HIH and its board. Did you take any action on seeing any of Mark Westfield's columns in terms of his projections of where the company was going? Did you query them at any stage?

Ms Elsing—The queries that we have made to the company are captured in the report that we have submitted. It is not really relevant to us who the journalist is or what a journalist's view is about the company's prosperity. What we are hunting for is specific information about results that one part of the public could be relying upon and trading to the detriment of another part of the public.

Senator CONROY—I do not think Westfield made any suggestions about the size of losses or gains; he just said, 'They're going down and it's going to be ugly.'

Senator CHAPMAN—In your submission you refer to purchases of FAI by another person prior to the takeover. You have not identified who that person is—

Senator CONROY—I have just been there, Senator Chapman.

Senator CHAPMAN—What was the relevance of that particular notification in terms of the context of the overall issues?

Mrs Hamilton—We were trying to set out in our submission our role in general in relation to HIH, so it is just a factual description of the three facets of our supervisory role in relation to the HIH group of companies.

CHAIR—Thanks very much. Congratulations on your role—we appreciate it. Please pass on our comments to your CEO. The level of detail in your submission was helpful to the committee; it meant that we had to ask fewer questions.

Proceedings suspended from 11.30 a.m. to 11.40 a.m.

DWYER, Mr Simon, Regional Commissioner, Australian Securities and Investment Commission

GETHING, Mr Michael, Western Australian Regional Commissioner, Australian Securities and Investments Commission

JOHNSTON, Mr Ian, Executive Director, Financial Services Regulation, Australian Securities and Investments Commission

KNOTT, Mr David, Chairman, Australian Securities and Investments Commission

MACKINTOSH, Mr Ian, Chief Accountant, Australian Securities and Investments Commission

McSHANE, Mr Darren, Director, Managed Investments, Australian Securities and Investments Commission

REDFERN, Ms Jan, Regional General Counsel, Australian Securities and Investments Commission

SEGAL, Ms Jillian, Deputy Chair, Australian Securities and Investments Commission

TREGILLIS, Mr Shane, Executive Director, Policy and Markets Regulation, Australian Securities and Investments Commission

WOOD, Mr Peter, Executive Director, Enforcement, Australian Securities and Investments Commission

CHAIR—Welcome. We appreciate your appearance before the committee today—especially yours, Mr Knott—and the fact that there is a large contingent of senior officers from ASIC at today's hearing. The committee is aware of ASIC's investigation into possible illegalities in connection with the collapse of HIH and that a royal commission is to be established to look into the broader aspects of the insurance industry.

While the commission will focus on the massive losses and the thousands of people affected, we as a committee are also concerned that there do not appear to be too many separate or simultaneous investigations into each of the financial files in the records. We believe ASIC's resources should be kept intact so that you may continue at full speed and with all the necessary resources available to bring those people to justice and to free moneys previously denied to those who would otherwise be entitled to funds.

We certainly appreciate the expeditious role that you have taken and the fact that you have taken that off your own bat, using your own resources very effectively. Nevertheless, the committee do have an oversight role, which will continue. We believe this will provide a necessary parliamentary input into the causes and effects of the collapse of the country's second largest general insurer. The committee deferred hearing from you and other regulators because we believed that the priorities were, first, to get the payment out and, second, to resolve with the

insurance companies how best to resolve the immediate problems. We believe we have done a great job there and also in delivering justice to those adversely affected. As chair of the committee, I would like to say that I have been impressed by the speed with which ASIC has taken action against allegedly offending parties. This action on your part, Mr Knott, has in large measure restored a lot of faith in ASIC as a regulator. We invite you to make an opening statement.

Mr Knott—We are completely in your hands, Chair, as to how you wish to handle this hearing. We have come prepared to deal with three separate matters: the CNA matter, the HIH matter and solicitors mortgages. We understood that members of the committee have differing interests. We have brief opening statements that we would like to deliver in relation to both CNA and solicitors mortgages. We have no opening statement to tender in relation to HIH. Our suggestion would be that we handle these matters sequentially, perhaps starting with CNA, but we are entirely in the hands of your committee.

CHAIR—I might ask an overriding question. In the discharge of your responsibilities to date, have you perceived any legislative problems preventing you from taking action expeditiously? We are asking for any imperfections you may have found in the legislation governing your role as a regulator.

Mr Knott—I think the short answer is no. I suggest that if I deliver a brief opening statement on CNA, I think that at least will put that issue into context and we could move from there and deal with HIH if you wish.

CHAIR—I was referring to matters such as safe harbour provisions in corporate law. Do those safe harbour provisions in any way impair the effectiveness of your role in taking action against directors or other people who may be guilty of misdemeanours? It could be assumed by some people that safe harbour protections raise the onus of proof that is required by a regulator before they can take action. These are the sorts of issues with which I was hoping you may be able to assist the committee.

Senator CONROY—Before you give that answer, Mr Knott, can I get you to explain what ‘safe harbour’ is for committee members who are not familiar with it.

Mr Knott—Certainly, Senator. In a sense, it is a short way of describing a codification that was introduced into the law quite recently to provide that directors do not have a strict liability. If they can demonstrate that they acted reasonably, that they took care, that a person in a similar position would have behaved in a similar manner, they will not be liable for offences under the Corporations Law.

CHAIR—Section 180, isn’t it?

Mr Knott—Senator, you are not going to ask me about sections today, are you? You keep changing them, Sir.

Senator SHERRY—This senator will.

Senator CHAPMAN—It is not a blanket exclusion of liability, is it, if there is fraudulent activity or anything of that nature?

Senator CONROY—Sometimes it is referred to as the ‘it seemed like a good idea at the time’ defence.

Mr Knott—As a matter of law, there is some debate about whether the codification of the so-called safe harbour really added much to the common law or, indeed, whether the common law defences were not essentially brought together into the Corporations Law. The issue really has not been fully tested, as we sit here today. I would answer the second question you asked, Senator—which I think is slightly different from the first—in the following way. There is no doubt that in a number of areas of the Corporations Law there is a starting position of enunciating an offence and then there are provisions which provide defences. We find that in some cases the provisions providing defences make the job of practical prosecution very difficult. The reason for that is that they usually introduce some element of subjectivity—reasonableness—areas that give rise to people looking in retrospect at a situation and saying, ‘Do we think this was reasonable?’ Prosecutors all around the world will tell you that that is what makes prosecuting white-collar crime a very difficult thing indeed.

CHAIR—Can you be more specific by way of a supplementary submission in identifying those defences that you find work against a regulator?

Mr Knott—Yes, I think we could do that. Indeed, we have made public statements in speeches and the like along these lines. One that comes immediately to mind is the area of insolvent trading.

CHAIR—So you will give us a supplementary submission in relation to these issues?

Mr Knott—We would be happy to expand on that in a submission.

Senator CONROY—You mentioned that it is easier to mount a defence. Would it be fair to say that the safe harbour provisions introduced recently into the Corporations Law have raised the bar a little further for you in mounting a successful prosecution?

Mr Knott—My own view is that whether the codification has really added substantively to what the law already said is yet to be tested. I would be happy for any contributions that Ms Redfern or Mr Wood would like to make.

Ms Redfern—I would have to say that I agree with that. It is true that these provisions have not yet been tested but, particularly in a criminal prosecution, I think the biggest hurdle that we usually overcome is establishing dishonesty before a jury at the level of beyond reasonable doubt. That has to be the biggest difficulty that we have. I think there is much in what the chairman says about what is already in the law and the way it has been approached in practice.

Senator CONROY—But would it be fair to say that safe harbour has not made it any easier for you?

Ms Redfern—It would not have made it easier, but it is hard to say whether it has actually made it harder.

Senator CONROY—But is the intent of the legislation, albeit untested at this stage, to lift the bar in terms of prosecution of directors in a variety of circumstances?

Ms Redfern—The particular provision you are talking about is not a criminal prosecution provision in any event, but again it has not been tested. It probably will be tested in due course.

Mr Knott—I think its background, if I remember correctly, Senator, is that it came about out of a number of cases that were being decided in the courts and were reaching different conclusions about the level of director liability. I think there was a great deal of concern in the commercial community about that uncertainty and the so-called safe harbour provision brought it together in one place.

Senator CONROY—Have you seen the terms of the royal commission yet?

Mr Knott—I have not, no.

Senator CONROY—Is that making it hard for you to complete your investigations or to have ongoing investigations, when you are unsure which parts are going to be taken from you and given to the royal commission?

Mr Knott—So as to be fully frank with this answer, part of the reason I have not seen them, Senator, is that I have stood aside for other reasons.

Senator CONROY—Of course. Perhaps you would like to pass the question on to Mr Wood. I apologise.

Mr Knott—Although ASIC has been consulted in relation to this matter, it is my understanding that we have not yet seen the final terms of reference.

Senator CONROY—As I said, is not having them published yet making it harder at this stage for you to continue with your investigations? Not that you—I am sure—know, Mr Knott, because you are not involved, but if anyone else at the table would like to venture a response, I should be grateful.

Mr Wood—Senator, I do not believe it is making it any more difficult at the moment, because the investigation is in the very early stages. It is at a point where the investigators are seeking to identify particular transactions, deals and relations which might be the subject of further investigation. In six months from now, hopefully, the investigation will have crystallised into discrete and identifiable areas. Just for the moment, I do not believe it causes any difficulty for us.

Senator CONROY—Hopefully, the terms of reference are not six months away though?

Mr Wood—Yes, I suppose that is true. We would prefer to know as soon as possible which line we are going to go down.

Senator CONROY—Thank you.

CHAIR—Mr Knott, this morning we heard how APRA effectively outsourced some of its responsibilities for investigation to an outside agency. Do you think you would have been able to bring the early action that you have in relation to several current matters had you adopted a similar line, given that you have essentially used your own internal resources to be able to bring about very quick action?

Mr Knott—Yes. I think we as an agency have a much longer tradition in the investigatory area, and more experience in that area. We do use external people to help us with specialisation skills that we do not have. For example, if we are in the insolvency area, we quite routinely use insolvency experts to help us. That may also be true if it is an accounting matter or some other technical issue. However, in terms of the core investigatory work we do, we strongly believe that using our own resources is the best avenue.

CHAIR—We have certainly taken note of that, and I think this morning's evidence was fairly pertinent in relation to that area.

Senator CONROY—Just in terms of your having to stand down or resign from the APRA board, one of the compelling arguments to support the introduction of the twin peaks model of regulation was the closeness with which APRA and ASIC would be able to work due to that coexistence on each other's boards. I asked Mr Thompson the other day how he felt he was going to be affected by your standing aside. You may have seen the *Hansard*. He indicated that he believed that ASIC might nominate someone other than yourself at a lower level. Do you think that that is a way to solve this apparent inherent conflict?

Mr Knott—I think the intention is that we will nominate someone else to the board. We are still working our way through that process internally. By definition, it will be a person lower than myself, if it is not me. As long as that person is sufficiently senior and has appropriate skills, I think the intention of the legislation should still be fulfilled.

Senator CONROY—Will the same sort of problem arise in the future do you think, even for this other individual—or vice versa, with Mr Thompson perhaps, in the APRA field? Do you see that solving the problem completely?

Mr Knott—I understand it will, but this goes to the issue of the precise reasoning of the legal opinion obtained by the government, which I am not at liberty to go into.

CHAIR—Mr Knott, you have indicated that you have specialist people at the table who can handle each of the areas that we are likely to question members of ASIC upon. We appreciate your coming to the committee today. We think it is an important gesture on your part, but we are quite happy as a committee if you wish to excuse yourself to attend to higher duties and we will proceed to question your officers in terms of their individual responsibilities.

Mr Knott—I value the opportunity to be excused, Senator, as you imagine; however, because there has been such debate in relation to the CNA matter, I do wish to make a statement on the record. I would like to do that at least and to answer any questions on that before I take advantage of your invitation.

Senator SHERRY—Mr Chairman, there is one matter that I do want to ask Mr Knott about in relation to solicitors mortgage funds. I appreciate that there is a specialist officer here, but there is something I would appreciate your view about, Mr Knott.

Mr Knott—I would be very happy to oblige. The first thing I want to do is to record that our commission is treating the CNA matter as a very serious one. We understand your concerns and the concerns of your committee, we understand the public concern that this incident has generated in respect of the regulation of superannuation and, most of all, we understand the distress experienced by superannuation savers who have lost money through the CNA group. I want to make it clear that these are not superficial comments. We are an agency committed to investor protection. We are an agency whose staff work against the odds to uphold standards of honesty and integrity in financial markets and to enforce the provisions of the Corporations Law where there is sufficient evidence to support legal action. In the course of that work, we routinely encounter cases of investor and consumer loss. This may arise in connection with the 8,000 or more companies that fail every year in this country, the financial scams and consumer rip-offs that we routinely see or in the context of risk markets or products which, by their very nature, carry potential for loss.

The scale of the problem is spelled out in detail in our annual report. We receive about 5,000 separate public complaints each year from persons believing they are entitled to some form of redress under the law. Many of these are from people who have lost money in one circumstance or another. It is self-evident that only a small proportion of those can be allocated the resources required for investigation and prospective legal proceedings. In addition to public complaints, matters come to our attention from a variety of other sources and must be assessed and analysed against competing claims on our resources. It is regrettable but inevitable that cases which, in an ideal world, would attract the further attention of the corporate regulator are unable to establish their priority claim against resources.

I am making this point to clarify some apparent confusion about ASIC's role and mandate as a conduct and disclosure regulator. We are not mandated to prevent financial failure or investor loss, but rather to police the requirements of the Corporations Law within the resources made available to us by the parliament. Obviously, we attempt to have a preventative impact through our educational, regulatory and enforcement activities. But, to my knowledge, there is no free market economy in the world that expects its securities regulator to prevent investor loss. There is an obvious and relevant analogy between our role as the corporate cop and the role of our police services. No-one considers it feasible to eliminate crime, no-one suggests that the existence of crime is attributable to failed policing and no-one believes it is possible to resource our policing services to a level that every street or household can be under constant scrutiny.

It is precisely for these reasons that most developed countries impose an additional overlay of regulation, called prudential regulation, for specific sectors of the economy where failure is perceived to carry more than the usual level of economic, financial or social risk. In the main, prudential regulation is targeted to those classes of institutions whose failure is considered

likely to give rise to systemic loss—that is, risk not limited to the owners and creditors of the particular failed entity. But prudential regulation can be extended beyond that category of risk to other situations where, for public policy reasons, an additional overlay of regulation beyond normal disclosure and conduct regulation is considered desirable. That is the position Australia has adopted in respect of superannuation.

It is not my intention this morning to dwell at length on issues of prudential regulation. I am sure that members of this committee will have read the opening statement delivered by APRA's chief executive to the Senate Economics Legislation Committee on 5 June. It is a very thoughtful statement which places the realistic expectations of prudential supervision into some perspective, but these are matters more appropriately pursued by your committee with APRA than ASIC.

However, against that general background that I have outlined, I need to place on record some key points in respect of CNA. ASIC is not a prudential regulator; we have neither mandate nor responsibility for monitoring institutional safety or risk or the investment strategies and decisions of superannuation funds. ASIC is not the enforcement arm of the prudential regulator; it has its own enforcement framework which may be utilised as appropriate. Twin peaks is not about coregulation or regulation by committee; each regulator has a mandate and they are fundamentally different. That there should be cooperation and information sharing is undisputed, but when the matter at issue is essentially under the ambit of one of the regulators, it is not reasonable that mere knowledge should transfer obligation to the other. ASIC had knowledge that APRA was concerned about CNA approximately eight months before we intervened in our own right. It was a superannuation problem involving an approved trustee which we understood to be under active scrutiny of the prudential regulator. Suggestions that we should have intervened a lot earlier are in our view unreasonable.

In making these comments, I am not passing any judgment on the performance of the prudential regulator. That is a matter between this committee and APRA. However, I am forced by the widespread publicity attracted by this matter, including many misguided references to ASIC and our role, to state our position plainly. I am not to be interpreted as saying that we could not have intervened earlier. However, as will be clear from the chronology which my colleagues are able to discuss with you, I do not believe that any substantive criticism is justified when all of the facts are taken into account. Moreover, it appears to me that, even in retrospect, our intervention would not have predated September 2000, after which time very little new money was invested in the CNA group. As I say, these are matters upon which my colleagues will be pleased to take questions.

The CNA matter has raised a number of issues which will undoubtedly result in further debate and may lead to additional public policy and regulatory initiatives. Mr Thompson last week outlined some of the possible reforms being considered by APRA, and they are proposals which would be strongly supported by ASIC. In the meantime, we have substantially progressed discussions over recent weeks to document more specific protocols between our agencies in respect of matter referrals. Our objective in doing so is to eliminate any misunderstandings about which agency has primary carriage of particular investigations or responsibility for their management. While I do not believe that any such misunderstandings were prevalent in the CNA case, we believe that these protocols will bring added focus to areas of potential overlap.

In the meantime, as you know, we have been actively investigating aspects of this matter since December 2000. While it is not yet possible to forecast whether specific offences will be actionable, we are treating this matter as a priority, including actions to recover moneys. Just briefly, action undertaken to date includes: service of 22 notices to CNA and associated parties requiring production of documents, all of which have been satisfied; compulsory examination of certain offices and related parties of the CNA group; voluntary interviews of potential witnesses; the freezing of CNA's bank account; court appointment of a receiver to, and the winding up of, the Confidens Investment Trust, which is estimated to recover 80 cents in the dollar for investors; and assistance to the new trustee, Ferrier Hodgson, of the ECMT and the EEF in relation to 10 actions in the New South Wales District Court for recovery of moneys from former directors and associates of CNA.

Finally, I would like to counsel appropriate objectivity and perspective as we progress the general debate about superannuation. On the one hand, it is important that the limitations on prudential supervision be better understood and that reforms to improve regulatory effectiveness be undertaken. On the other hand, there is nothing in our experience to date to warrant widespread community alarm about the safety of superannuation savings. Superannuation fund failures, distressful as they are to those affected, have been isolated and have involved a very small proportion of funds under management. A responsible debate is needed, and ASIC looks forward to making its contribution to that process. Thank you for allowing me to make this statement.

CHAIR—Thank you. Mr Knott, the committee fully appreciates the distinction between the responsibilities of APRA and ASIC, and I think my earlier comments reflect this understanding. Your assurances on the safety of superannuation monies are indeed very timely, because we were somewhat disappointed by the Governor of the Reserve Bank's comments about the extension of concerns to certain levels of security in terms of superannuation monies. I did not think that that was particularly helpful, so your comments today give us a level of assurance about the superannuation industry that is perhaps very timely. Thank you.

Mr Knott—Can I just say though that, in fairness to Mr Macfarlane's comments, I believe Mr Macfarlane was doing no more than placing on the record some limitations to prudential supervision, particularly under the structure where so many superannuation funds are subject to a prudential supervisory regime. The sort of initiatives that he hinted at, and which Mr Thompson then enumerated last week, are positions which we would fully endorse. But I think the key point is to put this in perspective and not to assume that we have a great number of these funds falling over.

CHAIR—Thank you.

Senator SHERRY—Just on that point, I am glad you said that, Mr Knott, because I look through the sorts of issues that APRA are considering as policy options and it does seem to me that the sheer number of funds, particularly of smaller superannuation funds, does make it difficult to supervise this area as adequately as they would like. Do you agree with that?

Mr Knott—I do agree with that. I think it is the number issue and I also think that the law is not at present sufficiently expansive in the types of standards that ought to apply to investment. For example, the small number of cases that we have seen of funds experiencing problems have

all involved large exposures to essentially non-liquid assets. In the banking area, we are used to having large exposure standards—they have been there for years. We see them in the other deposit taking institutions. They are the sorts of things that were included on Mr Thompson's list that, frankly, I think are long overdue and would make an even safer system than the one we have.

Senator SHERRY—I make one other point, and I assume that you are aware of this: superannuation is the only financial product, as I understand it, where, if theft and fraud is found to have taken place, there is a compensation mechanism under the SIS Act. I think that that is important for good social reasons, because superannuation is for retirement. Do you endorse the continuation of that safety mechanism in the event of theft and fraud and the payment of compensation where that has been found to have occurred?

Mr Knott—The caveat I should use to introduce my answer is that this is an APRA area and not an ASIC area. It arises under SIS.

Senator SHERRY—But you have commented on these matters in your opening remarks.

Mr Knott—Yes. In general, I think there are some areas of the economy that warrant compensation arrangements of one type or another. We have had the debate in this country many times in relation to banking and bank insurance and the like. I think that one can make a fairly strong case in the superannuation area for some type of scheme, yes.

CHAIR—In order to bring about that release of moneys quickly do you think that, for the smaller failures, a setting aside of some of the licensing or regulatory fees, to be paid into an insurance fund, would be a quicker way of providing justice to people who have been adversely affected rather than having the levy process, which is more cumbersome and more time consuming? I am interested in trying to get moneys into people's hands a lot quicker than at present. What is your view on a two-tier indemnity? The ultimate fall back for the larger failures obviously is the levying process provided by SIS. I just wonder whether there should be an intermediate arrangement, because there are a number of failures from the small funds involving several millions of dollars—or even \$10 million—where the regulator is obviously not going to go to all the fuss of making a levy but where an insurance or indemnity fund may provide a more expeditious vehicle to provide a settlement.

Mr Knott—It might. I think that degree of technical issue is something I would prefer to defer to the context of a really considered debate. I say that because it is only one aspect that would need to be considered. These schemes typically have to look at the reason for failure. Is this simply a liquidity problem? Is this a solvency problem? Is this a problem of people losing money within the approved risk parameter or of people having gone outside the approved risk parameter?

CHAIR—We are talking about fraud.

Mr Knott—Or is it straight fraud? All of those sorts of things need to be considered in any scheme of this sort. It is not a matter that we have given a great deal of thought to. As I say, it is essentially a matter within the purview of government and the prudential regulator.

CHAIR—What is your relationship and how closely do you work with the Institute of Criminology?

Mr Knott—I am beginning to think I should have taken advantage of your opportunity to excuse myself. I am not aware of the degree to which the agency deals with that institute.

CHAIR—I might ask one of your other officers later on.

Senator SHERRY—Do you still intend to leave early, Mr Knott?

Mr Knott—No, I am happy to wait and address the solicitors mortgage issue.

Senator SHERRY—I am happy to let you go. My specific issue went to the solicitors mortgage fund, and I have other questions.

Senator CONROY—In the light of Mr Macfarlane's comments and Mr Thompson's comments last week about a number of other insurance companies that APRA is having a look at, are you involved in looking at any other superannuation funds or insurance companies at the moment? Have you been called in yet?

Mr Knott—To my knowledge, no. But I have not asked that question specifically across the agency. That is not to say that there could not be lower level dialogue, but there is nothing to my knowledge at commission level where anything of that type has been raised.

Senator ALLISON—This is quite a specific question. I was just reading your letter, Mr Knott, about the timing of the notification to ASIC of problems with CNAL. It is a long letter, but it still does not tell us when you first were informed that there were problems or when APRA first advised you. Could you perhaps give us some dates?

Mr Knott—I can in general terms, and then I will defer to my colleagues. I certainly have taken the opportunity to brief the chair on this issue, and I understand that in a substantive sense there is no outstanding matter at issue. This matter was first mentioned at the end of March 2000. As I said in my opening statement, we had knowledge of the matter—I might say at a relatively junior level of the organisation; nevertheless, it was institutional knowledge. As my colleagues will be able, I hope, to persuade you our view is, even in retrospect, that prior to September of last year our knowledge was not such as would have warranted our intervention.

Senator ALLISON—So where did that March 2000 information come from?

Mr Knott—I defer to Ms Redfern.

Ms Redfern—Perhaps I can give more detail. Officers of APRA met with some officers of ASIC in the New South Wales what we call DISC team and basically raised with them that APRA was proposing or taking steps to have an investigator appointed to three—

Senator ALLISON—So your first advice came from this meeting with APRA, and it was APRA that told you in that meeting there was a problem?

Ms Redfern—Yes, that they were proposing to appoint an investigator to three superannuation funds and that there would be an investigation undertaken and down the line somewhere there might be some issues in relation to the Corporations Law, breach of directors duties. They were identifying basically what they were doing.

Senator ALLISON—Was ASIC's advice sought on the narrowness or otherwise of the terms of reference for that investigator?

Ms Redfern—No. We were not advised about the nature of the concerns in any detail, the scope of any investments, and the name 'enhanced cash management trust' was not mentioned that initial meeting.

Senator ALLISON—So there was a subsequent meeting?

Ms Redfern—Probably closer to around August-September and a more detailed discussion during November 2000, when the final Pricewaterhouse report became available.

Senator ALLISON—Were you given copies of the interim report in May and subsequent monthly updates?

Ms Redfern—No, we were not. We did not receive all of the reports until September, the final report mid-November. We received one of the reports mid-August to third week of August 2000.

Senator ALLISON—In hindsight are you surprised or can you see a problem with such narrow terms of reference for the investigator?

Ms Redfern—That is really an APRA question, because a number of the issues that were identified were really SIS legislation breaches and basically relating to CNA as an approved trustee, as it was not only the three funds but also approximately 480 do-it-yourself small APRA funds.

Senator ALLISON—Is this is an example of where there are grey areas between your responsibility and APRA's?

Ms Redfern—No, I do not think so. I see it as fairly straightforward, in the sense that we deal with disclosure issues. APRA deals with, really, the governance issues in relation to trustee operating standards, regulations in relation to investment strategies. We deal with disclosure issues, reports, minutes of meetings, complaints.

Senator ALLISON—What about arms-length investments? Is that a matter for ASIC to—

Ms Redfern—No, that is a trustee responsibility, and that would be dealt in the APRA area of responsibility.

Senator ALLISON—So enhanced cash management trust was not regulated by ASIC?

Ms Redfern—It was set up as an excluded offer by CNAL in about 1998. So in that sense I suppose it did not fall within the managed investments scheme regulatory regime.

Senator ALLISON—Are there many other schemes of that sort that are also outside ASIC's jurisdiction?

Mr Johnston—It would be impossible to say. The very nature of an excluded offer means it does not come under the Managed Investments Act, so we would not know how many there were.

Senator CHAPMAN—Mr Knott, has your attention been drawn to an article by Mr Trevor Sykes in the weekend *Financial Review*?

Mr Knott—You would have to refresh my memory.

Senator CHAPMAN—In relation to corporate collapses, he makes two suggestions. They would be characterised as dealing with the consequences of collapses rather than as preventative measures. He suggests that in the first instance it ought to be compulsory for liquidators, receivers or whoever has moved in to control a public company to report publicly on the causes of a collapse. He says that this was done in another form back in the 1950s and 1960s. He also suggests that in the situation of a major company collapse there ought to be an investigation carried out by a judge or QC with expert assistance from accountants and businessmen which would, in effect, roll into one the investigation and the committal procedures. Would you care to comment on the efficacy of those suggestions and whether they would be of any benefit?

Mr Knott—Mr Sykes always has very interesting ideas, as you know, Senator. I have not, as it happens, read the article and I would like to think more about the two suggestions. Immediately, on the first, I am thinking about the implications of third-party rights in terms of public commentary. There is an obligation on liquidators and other insolvency officers to report suspected breaches of the law to us. My understanding is that the idea of that framework is that that enables us to investigate those matters confidentially and, therefore, preserve the integrity of those investigations. So I am not quite sure how the other proposal works in that sense. The second idea is one that I think I would not even volunteer a comment on without having thought about it further.

CHAIR—I think Trevor Sykes is perhaps one of the most incisive financial journalists that Australia has ever had and I would like to refer all members of the committee and, indeed, the audience to his book *The bold riders: behind Australia's corporate collapses*, which I think was published in the early 1990s. It is a very incisive account of the corporate collapses and what went on behind the scenes and is worth reading.

Senator SHERRY—I have two general questions with respect to ASIC and solicitors mortgage funds which I think you would be better to answer. You would have a knowledge that there has been a significant number of failures in a number of states around the country. They are not isolated failures and they involve some thousands of investors in solicitors mortgage funds. Do you believe that the law societies, who are delegated with responsibility for regulation in this area, were doing the job that was expected by investors and that, in fact, it was a mistake to allow the law societies to regulate these products?

Mr Knott—I would have to differentiate. I would not uniformly put all the law societies into a single group but it does seem reasonably self-evident that the self-regulatory role that they undertook as a result of policy in the early to mid 1990s has not been fully discharged.

Senator SHERRY—It has not worked.

Mr Knott—It has not worked but I do differentiate to say in some places more than others. I think in fairness one needs to do that.

Senator SHERRY—I have another general question on I think a very serious matter. I understand you are aware of the public comments without the protection of privilege concerning the Tasmanian Law Society in my home state. Mr Sid Dwyer, who was formerly an inspector for the law society of solicitors mortgage funds, and Mr Cyril Clarke, who was the principal executive officer of the Tasmanian Law Society and will be giving evidence to our committee on Friday of this week, have alleged that at least one legal firm used their position within the law society to restrict the oversight, the inspection or the auditing of solicitors mortgage fund in Tasmania. As a consequence, Mr Dwyer, as the inspector, resigned and Mr Cyril Clarke also resigned. I regard those allegations as very serious. Are you aware of those allegations?

Mr Knott—In general terms, I am aware of them.

Senator SHERRY—Have you commenced any investigation into these matters?

Mr Knott—I will have to defer to Mr Johnston on that specific question.

Senator SHERRY—Just before you do that, Mr Johnston might be able to answer my next question as well. If there is a prima facie case of people being ‘pressured’—and we do not have all the facts yet—not to do their job, of them being nobbled in other words, what possible legislation may have been breached if this activity may have taken place? Could you give me some information on that?

Mr Knott—If we could take the questions sequentially, that would give my enforcement colleagues a chance to think about your second question. We might ask Mr Johnston about your first question.

Mr Johnston—In relation to the first question, the general point is that the very fact that there is a possibility that that can happen is a pointer as to why ASIC feels that self-regulation is not the way to go in respect of these types of matters because there is always the possibility of that accusation, whether it be right or otherwise. In relation to the specific matter, we are aware of the allegation that was made. We are considering that matter, but it is not under formal investigation at this stage as defined under our legislation. However, it is a matter that is under our notice, if I can put it that way.

Senator SHERRY—And is that because you have only just heard about it in the last few weeks?

Mr Johnston—Yes, over the past few weeks.

Senator SHERRY—That is understandable.

Mr Knott—To add to that, as you have your broader discussion about solicitors mortgages, you will perhaps gain a better understanding of our rather large and comprehensive national approach to this whole matter over recent months. It was one of the first priorities established by the new commission after November last year. I think that eight firms have already been subject to scrutiny and that is utilising the assistance of Mr Tony Hodgson, a former liquidator.

Senator SHERRY—There are nine firms.

Mr Knott—So we are doing a lot in that area. There is more than we can do right now.

Senator SHERRY—We can come to that. You are the chairman and your view on these issues is important. What is your response to what can be done about the second part of my question?

Ms Segal—When we get into the detail, it behoves us to examine that. However, I think that if the Law Society has not undertaken the degree of supervision required of it if it was, as you say, in some way nobbled or for some other reason has not undertaken the degree of supervision it was required to, it would be in breach of the provisions under which it was then not subject to regulation if it was dealing with it under an exemption or class order provisions. Action could be taken against the society for doing what it was doing illegally.

Senator SHERRY—Who would take that action? Frankly, the people in Tasmania who have lost their money do not have the resources to do that. Can ASIC take action?

Mr Knott—I am not convinced that we can, but we will take that on notice.

Senator SHERRY—Thank you.

Mr Knott—In many of these cases, one thinks about whether some disciplinary action is available under professional conduct rules, but of course those rules are, in many cases, largely administered by the law societies in any event.

Senator SHERRY—There are other problems which we are going to go into in detail but, since our initial hearing on this matter in Tasmania four or five weeks ago, these new allegations, where the very internal process of the Law Society as an organisation is alleged to have been corrupted, are extraordinarily serious and the most serious allegations yet. However, you may be able to progress the investigation further after Friday.

CHAIR—Perhaps in relation to what Senator Sherry has brought to the committee's attention, without buying into the allegations of nobbling, from the committee's perspective it seemed somewhat unusual that there was not a uniform audit of all solicitors mortgage funds and that much of the evidence seemed to centre on the words that were used in the enacting brief in terms of what is covered by a term inspection. Of course, inspections are not identical to audits. Some appeared to be covered under the rules of inspection. The majority were covered under the concept of audit, where a thorough audit appeared to be done. That has raised in our

minds a number of concerns that we will pursue in Hobart, but obviously that is outside your jurisdiction.

Senator CONROY—I was seeking your views, Mr Knott, in terms of avoiding a repetition of the sort of things we have just been talking about. Do you think that the current provisions of the financial sector reform bill will ensure that that cannot happen again?

Mr Knott—I am not sure that I would put it in such a positive way. We still have to work our way through the approved professional body provisions of that bill. The wording of the bill includes a number of additional requirements on an approved professional body before it can adopt a self-regulatory role, and we would want to ensure that they were rigorous requirements—perhaps more rigorous than those that were applied in the case of the solicitors mortgages. I do not think you can ever say, in terms of regulation, that it cannot happen again. History tells you not only that it can but also that it is likely to happen, in general terms; for example, corporate failure, regulatory failure—how ever you want to describe it—and it happens right around the world.

CHAIR—Mr Knott, if—

Mr Knott—I find myself again reluctant to be excused, because there is just one matter that I overheard in a previous presentation that I may be able to answer that others cannot, and that is in relation to the stock exchange referrals to ASIC on HIH, which were mentioned in the ASX submission. That was not a submission that we had time to consider prior to its being published in the press last week, but I can say that, as far as we can ascertain to date, prior to the 1998 referral relating to the 14.2 per cent transfer of shares in FAI, there was only one other referral ever made, and it was in 1992, 1994, or something like that. We do not have details of that yet. It will have to be dug out of the files and we will have to talk to the exchange to understand it.

In relation to the shareholding that was discussed this morning, there was a reference to us. The reference was in relation to a possible breach of the takeover provisions, in the sense that a large parcel of shares was sold prior to an offer being made and that it potentially advantaged the seller of the shares above other shareholders. As I understand it, ASIC issued notices to a number of people in relation to that transaction and interviewed or spoke to the brokers involved but it was unable to acquire evidence of a type that would be supportable at law in a court that there had been some pre-acquisition agreement. Of course, unless one can establish that to the rules of evidence, the matter can go no further. My understanding is that ASIC's inquiries were quite comprehensive. They included consideration of other attempts made by the vendor to dispose of the shares. There was evidence that that had happened. As a result of those inquiries it was decided that there was insufficient evidence to support further enforcement action. That in brief, as I understand it, was the situation in relation to that matter.

There was one further matter—and as I understand it, only one—in 2000 relating to some trading in some convertible notes of HIH, completely unrelated to HIH or the people involved. The only other interaction between us was in February of this year, which the ASX outlined earlier. Our view of that last interaction is substantially identical to the ASX's, although we do not believe we had any discussion with the ASX on the matter before 26 February.

CHAIR—It is our understanding that you have a good working relationship, which is encouraging.

Mr Knott—We do have a good understanding. Sometimes we have differences of opinion, as you would expect, but overall I think a coregulatory system has worked reasonably well.

Senator CONROY—As you may have heard me say earlier, the ASX indicated that they had made several referrals to ASIC concerning Mr Rodney Adler and FAI Insurance prior to the takeover issues. Are you familiar with those?

Mr Knott—That is my point in saying to you that to date we have been able to identify one.

Senator CONROY—Just the one, so referrals plural does not coincide with ASIC's recollections?

Mr Knott—Not inquiries made internally to date, but it may well be that the ASX has a record of some other referrals that we have not been able to identify.

Senator CONROY—I want to go to the actual takeover and the transaction. You heard me ask the ASX whether it was a normal practice for a company to indicate on market that it was available for purchase. In your view, is that an unusual transaction?

Mr Knott—No, I would say it is quite a common transaction. Many large parcels of shares are sold immediately prior to the launch of a formal takeover and in many cases that is not against the law. It would have been against the law to make a takeover offer—under the then law; it has changed—which gave a particular person an advantage which was not available to other shareholders. As I understand, that was the specific issue we were looking at. It would also be against the law if there had been an understanding in relation to the acquisition which would take the acquirer above the takeover threshold. So they would be the two issues that one would be looking at. There is a vast number of other issues where a bidder will acquire a strategic stake in a company on market, at very short notice and effectively by pre-arrangement prior to a bid.

Senator CONROY—But there was no pre-arrangement here that you were able to establish.

Mr Knott—That was the issue and we were unable to establish pre-arrangement.

Senator CONROY—So they went on market at 10 o'clock, at 10.15 a.m. 14.3 per cent changed hands and then a takeover was announced?

Mr Knott—That is my understanding of the broad framework of that transaction. I do not know the exact timing, but it was something of that sort.

Senator CONROY—That would be an unusual transaction though?

Mr Knott—That is why it was referred to us and why we investigated it. Of course, if somebody is known to have been looking to dispose of shares, if that were a matter of

knowledge in the marketplace, and that knowledge might have been acquired because of discussions that the potential vendor had had with other parties—quite legitimate discussions that could take place—and somebody watching that market was interested in acquiring the stake, it could happen.

Senator CONROY—Mr Williams must have thought it was his lucky day when he got up and turned on the screen.

Mr Knott—As I say, we were unable to establish any prior agreement between the parties.

Senator CONROY—Were you able to establish whether any due diligence took place in relation to this—

Mr Knott—I have not asked that question.

CHAIR—It should be asked.

Mr Knott—Yes. I might be wrong, but I would be surprised. Due diligence in relation to the particular stake in the company would suggest to me—

Senator CONROY—Hard to do in 15 minutes.

Mr Knott—It would suggest to me that there might be some pre-agreement, if one had had time to do it.

CHAIR—I think that is a question which you should ask. Thank you, Mr Knott. Questions on CNAL.

Senator SHERRY—I have questions on solicitors mortgage funds. Can I start with that?

CHAIR—Yes, provided we stick to solicitors mortgage funds and then we will go to CNAL. There is an opening statement on solicitor's mortgage funds.

Mr Johnston—Yes, there is a brief statement. I am joined at table by Darren McShane, who is the manager of our managed investments program nationally. The regulation of mortgage investment schemes across the whole of Australia has been a significant focus for the commission over the last two years and especially over the last six months. There is quite a long history of securities regulation of mortgage schemes, which is set out in some detail in the submission that we have provided to the committee. I do not intend to retrace all of that detail just now.

In short, the growth of the industry in the early 1990s led to a public hearing by ASC, as it was then. The results of the public hearing were that in 1992 the ASC granted relief from compliance with the prescribed interest provisions of the Corporations Law to schemes in New South Wales, Victoria, Tasmania, Queensland and South Australia but only where there were supervisory and indemnity arrangements put in place with relevant supervisory bodies. In 1997 the ASC became concerned about the operation of some of these schemes under that relief and

commissioned a report which became the basis of a review of policy and the application of law to mortgage investment schemes. Ultimately, in early 1999 ASIC released new policy for the future regulation of mortgage schemes which brought regulation of those schemes onto a footing more in common with other managed investment schemes.

ASIC has become aware in more recent times that a number of investors in schemes regulated under the previous regulatory regime have suffered or are likely to suffer significant losses. This is why in late 2000 ASIC made inquiries of well-known run-out operators in order to ascertain the size and scope of this issue. In February 2001 the commission announced a major review of solicitors run-out schemes. As part of that inquiry ASIC, with the assistance of Mr Tony Hodgson, has visited a number of run-out operators across Queensland, Tasmania and Victoria to review their operations. ASIC has in recent weeks received an interim report from Mr Hodgson, which we are reviewing to develop a strategy for dealing with a range of issues, including dealing with losses in run-out schemes, setting new standards for conduct of ongoing registered managed investment schemes, considering whether further relief should be given or an extension of the run-out period, and methods by which defaulting run-out loan books can be brought to a conclusion.

In Tasmania a significant proportion of ASIC's enforcement resources have in recent times been employed in investigating matters relating to mortgage schemes. Our submission details some of those matters, including three specific investigations in relation to solicitors mortgage funds in Tasmania. The potential outcome from those matters includes the full gamut of criminal, civil penalty or civil recovery proceedings. Thank you for allowing us to make that opening statement.

Senator SHERRY—Thank you. I was going to ask about the Hodgson report. When will that be available for the committee? You said it is an interim report so far.

Mr Johnston—We have an interim report at this stage. We will not be finished this investigation until the second half of the year. When we announced the review in February we said that it would go at least until 30 June and probably after that. We would expect to have a final report with specific recommendations probably around August or September.

Senator SHERRY—On page 16 you identify findings from surveillance visits, including in my home state of Tasmania, Queensland and Victoria. You list the breaches as:

- Lack of, or poor borrower assessment and loan approval practices ...
- Non-compliance with NTA, cash flow and PI insurance requirements ...
- No evidence of a compliance monitoring and reporting procedure being undertaken. Identified as a breach of the compliance plans and subsequently the Corporations Law.
- Misleading information provided to investors, or potential investors. ...

That is just the summary. The great puzzle I have, not just in respect of my home state of Tasmania but most other states where problems have taken place, is understanding why all of a sudden there has been this break out of problems in the last few years.

Mr Johnston—I think I need to differentiate. The surveillance visits we are talking about here are in relation to those schemes that are registered under the Managed Investments Act not just the run-out schemes. I am not sure that we would say it is a late break-out. That regime has only applied over the past couple of years since that act came into being. That regime set out a

format of regulation whereby we license the entity. The entity then has to comply with conditions that we place on the licence and various other matters that are contained in the Managed Investments Act. We then conduct, if you like, a rolling review as much as we can on the risk basis of those operators who have registered managed investment schemes and this is the sort of conduct that we observe. This is a relatively recent regime.

Senator SHERRY—But it does not mean this sort of conduct was not occurring prior to the new regime?

Mr Johnston—No, it does not. It does not indicate that; that is quite right.

Senator SHERRY—In fact, certainly the evidence we have received in Tasmania to date would indicate this mix of problems.

Mr Johnston—And, of course, prior to the Managed Investments Act these schemes were not under this jurisdiction.

Senator SHERRY—Yes, I understand that. Regarding the observations made from the material that you gathered in Tasmania, why have the problems in Tasmania emerged in the last four or five years?

Mr Johnston—Specifically, there are some differences, of course, in the market in Tasmania, whereby there have been declining property values. Some speculative lending happened in Tasmania—that also happened in Queensland, particularly in Far North Queensland. So a combination of those two things would differentiate it, say, from Victoria where the position is much better.

Senator SHERRY—There are additional problems, though, aren't there?

Mr Johnston—There are additional problems that we have observed in relation to some specific funds.

Senator SHERRY—That is what I am asking about.

Mr Johnston—As we mentioned in the submission, we are taking action in respect of those and there are specific investigations under way.

Senator SHERRY—So there are investigations that could lead to criminal penalties and civil proceedings?

Mr Johnston—That is right. We are reluctant, of course, to talk about operational matters.

Senator SHERRY—Yes, I understand why you cannot do that, but they are the matters that are under investigation.

Mr Johnston—Yes. If I can just go back a step, we mentioned the Hodgson report—we have an interim report at the moment. I am happy to talk about some of the findings that have been made by Mr Hodgson.

Senator SHERRY—I thought you would not be able to but, if you can, yes.

Mr Johnston—We will not give you a copy of the full report at this stage but when we have a final report I will be happy to do so. Some of the indications that we have are common throughout the three jurisdictions visited. Some of the observations that he made included: very poor assessment of borrower criteria; and poor valuation practice—that is, the appointment of valuers and also the practices that the valuers were undertaking. The most common element there was that lenders appear to be happy to accept the borrower's valuation rather than commission their own valuation of properties that are the subject of the loan. So it is a combination of poor borrower assessment and using the borrower's valuation, of course, that would give rise to difficulties, one would imagine, in the value of the loan's security and the ability of the borrower to repay without any proper assessment being done of either of those.

Senator SHERRY—But why weren't legal firms doing these things? It seems pretty basic to most observers of financial investment products.

Mr Johnston—That is a question we asked but it is not a question to which we necessarily received a satisfactory answer.

Senator CHAPMAN—When you were referring to the lender there, were you referring to the solicitor rather than to the ultimate lender, the investor?

Mr Johnston—Yes, to the solicitor who is providing the service. Regarding some of the outcomes from that, we would expect—as far as our legislation will allow—that we will at least give guidance to, or perhaps look at imposing licence conditions on, mortgage operators going forward in relation to how they appoint valuers, and look at the basis on which that is done.

Senator SHERRY—Assuming that they have a basic level of expertise to make a reasonable call on the sorts of issues you have mentioned.

Mr Johnston—Yes, but we do need to look at our jurisdiction in terms of the ability that we have to ask people to do that.

Senator SHERRY—You have identified the loans in default in Tasmania as \$23.3 million. My understanding is that will come down as some people will recover at least part of their money—perhaps all of it. Does that include interest lost?

Mr Johnston—We should probably explain that we think our definition of a default may be different from the definition of default being used by the Law Society. We have quite a wide definition. We would say that a loan is in default if, for example, the borrower has missed an interest payment or that that has gone on for a period of perhaps two or three payments. We would also want to point out that the amount in default does not necessarily equal the loss that will be suffered at the end of the day. While we would not be prepared to hazard a guess at this

stage, if there is \$23 million in default we would not expect the loss to be anywhere near that figure.

Senator SHERRY—But does that include interest? Some people would be getting their money back but they are not going to get interest back.

Mr McShane—These figures are based on the responses given by the mortgage operators to an audit which ASIC commenced earlier in the year. The question to which they were responding was the value of the mortgage which is in default. In response to that question, I assume it does not cover the amount of interest which might also be outstanding.

Senator SHERRY—You have detailed it for Tasmania. Could you take it on notice to give us the figures for the other states, if you have them available. They would be interesting to look at.

Mr McShane—Yes, we can do that, Senator

Senator SHERRY—I will quote from some of the areas of the submission the Law Society made back in 1992, I think it was, when it was delegated regulatory control of this area:

That assurance does not provide a guarantee that the loss could never be so large as to remain not wholly compensated for. But, coupled with the supervisory and investigatory roles of the Society, it is extremely unlikely that any deficiency could occur on such a scale as to leave any member of the public without full compensation.

The submission went on to say:

Investors enjoy a high degree of protection against the risk of loss whether occasioned by negligence on the part of the solicitor either in proffering advice or in giving effect to advice which has been given and accepted, an unusually high degree of protection for all clients and investors.

There are lots of other things I could quote to you, but one of the things that worries me is that, given the outcomes to date in Tasmania, the undertakings given by the Law Society in 1992 do not appear to have been met.

Mr Johnston—We would agree with that, Senator.

Senator SHERRY—Why do you think the Law Society has not been able to meet these undertakings?

Mr Johnston—I think that is a question for the society. I am not sure that I can proffer a reason as to why they have not been able to meet those undertakings. Even though it predates the people at this table, among the things the ASC looked at at the time that that system was set up were the submissions not just from the Tasmanian Law Society but from the various bodies in relation to their ability to supervise these schemes. Also, without meaning to defend anyone who made such statements, in the context of the day it was a very different industry at that time. Our understanding would be that law firms were conducting lending as an incidental part of their practice, and they were generally matching clients who needed to borrow money with clients who were able to lend money. There is no doubt that the whole industry grew from there and that solicitors then started extending themselves beyond just the client relationship and were

advertising for both lenders and borrowers. Perhaps at the time it was made that was a more considered statement and perhaps a more defensible statement.

Senator SHERRY—That is an interesting point at which to lead into the role of Garrisons. Garrisons pushed \$3 million to \$4 million into a number of solicitors mortgage funds in Tasmania. They appear to have picked them up and endorsed them as a new investment product for them. You suspended a man called Mr Hudson for six months, I think, in Tasmania. What was he suspended for?

Mr Johnston—Do you want to know about the purpose of the suspension or the conduct that gave rise to it?

Senator SHERRY—Both.

Mr Johnston—The conduct that gave rise to it was that he was putting clients into that type of investment without due regard to the risk profile of the client and whether or not that actually matched the needs of the client at the time that he was giving advice.

Senator SHERRY—Six months to me seemed to be pretty light. He still worked for Garrisons over the period.

Mr Johnston—I think there were some other conditions that were put around the suspension at that time, in relation to education and a greater understanding of what his responsibilities were.

Senator SHERRY—The evidence Garrisons gave us was that there were four or five advisers who were promoting the product. Were any others investigated?

Mr Johnston—What we did as a result of the conduct of Mr Hudson was look at Garrisons more generally from, if you like, a systemic point of view, and that matter is under our attention just now.

Senator SHERRY—So that is still being investigated?

Mr Johnston—Exactly.

Senator SHERRY—You referred earlier to the change in focus of solicitors mortgage funds. What puzzles me is that all of a sudden Garrisons picked up solicitors mortgage funds in Tasmania and channelled money in. Why did that happen? Have you been able to identify why they decided on that course of action?

Mr Johnston—That is not something I have knowledge of.

Senator SHERRY—You have not been able to check that?

Mr McShane—I cannot comment on the specific facts of that matter but, historically, rates of return on mortgage funds have been slightly higher than other market rates for investment products.

Senator SHERRY—I understand that, but Garrisons are the only financial advisory firm in Tasmania that for some reason decided, ‘We’re going to channel money into this product.’ You were quite right when you said earlier that it was fairly conservative, that people actually were clients of the solicitors firms—if they had some money they would invest—but all of a sudden you had money funnelled in and, from a Tasmanian point of view, quite significant sums of money. Do you believe that, in directing clients to these products, or actually placing clients’ moneys into these products, Garrisons had a responsibility to check where the moneys were being placed once they had placed the money for clients—that the investments were bona fide?

Mr Johnston—Do you mean the underlying assets of the individual loans themselves?

Senator SHERRY—Yes.

Mr McShane—I suppose that the answer is that, in making their assessment of the suitability of the investment in the context of the individual client, they ought to have had an understanding about the underlying investment, but whether there was any duty to continue to supervise the lower level investment after that point I think would be a moot question.

Senator SHERRY—But surely, if you recommend a product, let us say a \$100,000 mortgage in whatever the solicitors mortgage fund is in property X, that money is secured against property X for some period of time. I do not know about the legal obligation but Garrisons, as a financial advisory service, should have been keeping an eye on where the money was going.

Mr Johnston—That is arguable. The point that I would make is that, in relation to Garrisons, we did mention that there are a number of specific investigations under way in Tasmania and they cover the range of civil action, civil recovery action and criminal action.

Senator SHERRY—Okay, I understand your reluctance. You may have read the transcript. Garrisons just say, ‘Look, it was all the Law Society’s fault. They’re the ones that had to look after the area.’ But you have ongoing investigations and you cannot disclose the details. Can you give us a time line on when these investigations might be concluded or when we might have some indication of what is happening?

Mr Johnston—We are always reluctant to do that—you have a different time line in relation to each of the types of matters; the time taken to get a criminal matter up would be different from a civil recovery action, for example. I would not wish to comment or imply that that applies to any particular—

Senator SHERRY—I certainly do not want to jeopardise any possible action.

CHAIR—Before you continue, Senator Sherry, I think it is appropriate at this stage of the proceedings that I should make a disclosure of some recent contact with Garrisons about their obligations to their clients which commenced over the weekend by phone and concluded at 7.15 this morning with face-to-face contact with certain of their representatives. I think they were

certainly quite moved as a result of the proceedings in Hobart recently. I am advised that tomorrow, Wednesday, 13 June, a press release will be issued by Garrisons and, at the same time, letters will be sent to clients of Garrisons. I say no more than that, but I think it is appropriate that, given Senator Sherry's questioning this morning, I should have made that declaration and statement to both the committee and the public at large.

Senator SHERRY—Thank you. I appreciate why you cannot give us a time line on the investigations in Tasmania, but, frankly, I thought you had concluded your investigations because of the actions against Mr Hudson.

Mr Johnston—No, that is not the case.

Senator SHERRY—Okay. I have to say that Garrisons were pretty sparse on with the evidence that they gave before the committee. They certainly gave us the impression that it was over.

Finally, we got into what I think was a fairly esoteric argument with the Law Society about inspection versus audit. I see in your submission that you talk about 'compliance checks being conducted solely by walking around'. What is an adequate check—walking around, actually looking at the valuations that are coming in or doing a bit more than just adding up the figures in the columns and walking in and out? What would be reasonably expected to have occurred?

Mr McShane—Do you mean in the context of the supervision by the Law Society or in some other context?

Senator SHERRY—Yes. What would a reasonable person expect of a regulator in checking a financial product?

Mr McShane—Can I put that in the context of the current regime, the regime whereby the direct responsibility for supervision of compliance is within the entity. To perhaps compare that to the responsibility of compliance committee members, the commission has said that they ought to do more than merely rely on information given to them, perhaps adopt an approach of healthy scepticism of information provided to them. But what is appropriate in any given facts circumstance is impossible to generalise, of course, it depends what the material is and the material against which one is trying to make an assessment.

Mr Johnston—The Managed Investments Act does put some requirements on in terms of compliance plans, compliance committees meeting or a preponderance of independent directors on the board of a company, so that gives guidance to what happens under the managed investments regime. But the statements that were made by the various law societies, going back into the early 1990s, were of the nature that said they would have the sufficient resources to supervise these schemes. Some of them proffered rules which were not approved by ASIC or the ASC as it was then. It was not the case that the ASC approved the rules that they had but the rules were one of the things that were taken into account.

Senator SHERRY—I think that is important because, frankly, there is a bit of buck passing here. The law societies seem to be putting a lot of emphasis on the fact that you approved their regulatory frameworks. From what you are saying there is a difference.

Mr Johnston—We would contend that the regulatory frameworks, as you referred to them, would have been part of the submission that they made and we would have approved the body to be the supervisor. But that does not mean that we approved the regime that they then have sitting underneath.

Senator SHERRY—Yes. That is fine.

CHAIR—Can we move to questions on CNAL. I think we have finished with the solicitors mortgage. We are having another hearing in Hobart on Friday, and I draw the public's attention to that hearing.

Senator ALLISON—I still have some questions with regard to the solicitors mortgage funds.

CHAIR—Are you happy to keep going with solicitors mortgage funds, Senator Sherry?

Senator SHERRY—Yes, I do not have anything on CNAL.

Senator ALLISON—The subject came up, when we were in Hobart, of the monitoring role that the law society would have with regard to the schemes. Did ASIC involve itself in the adequacy of that monitoring? What was ASIC expecting the law society to do with regard to that monitoring?

Mr Johnston—I think, to some extent, it goes back to Senator Sherry's question. At the time approvals were given, we did look at the regime they would have in place. But, as the front-line regulator, once it was up and running, it would be fair to say that we left the front-line regulator to do the job.

Senator ALLISON—In your view, whose responsibility would it be to watch the regulator? Is it the legal ombudsman? Is that the avenue for this? I know they are charged with investigating complaints, which they do not seem to have done much of, but who is the higher authority?

Mr Johnston—The way the exemption or the class order was set up, it was not so much creating a higher authority, it was establishing the fact that it was a regulator that was put in place that had a task to perform. But there was not an ongoing supervision of the performance of the regulator. As to the position of the legal ombudsman that would vary from state to state.

Senator ALLISON—Certain undertakings were given by the law society with regard to compliance, that is fair to say, is it not? Are you suggesting that there is no agency, no process, by which the measurement of those compliance commitments can be judged?

Mr Johnston—I would have to cast my mind, I guess, to the nature of the regime because I was not there at the time. But the fact that it was a law society, and that it was solicitors who were operating within those schemes, meant that there were some professional conduct obligations in some of them and there were rules that had to be followed and presumably would be enforced under the professional conduct or misconduct provisions of the legislation that was there.

Senator ALLISON—If there was misconduct, how would you expect the knowledge of it to come through? Would it come through ASIC first of all? If somebody complains about the misconduct of their investments, where does it go to?

Mr Johnston—Any complaints that were made, were referred to the law society as the lead regulator.

Senator ALLISON—If there is dissatisfaction with the response of the law society, where does it go after that?

Mr Johnston—Mr Tregillis was here at the time.

Mr Tregillis—Under the 1992 declaration the law society made certain submissions about how it would supervise. We accepted that as the basis of the exemptive regime so, really, the obligation, as Mr Johnston says, was on the law society. If we became aware through complaints or other mechanisms that they were not actually fulfilling those requirements, ASIC would have a role. As the submission documents, it was in mid-1996-97 when we became concerned that the nature of the industry had changed, and there were other events. We commissioned an independent third party report that looked at two things. It reviewed the industry, what had changed and who were the players in it, so that gave us a better feel for the dynamics in the industry which, I think, had changed quite dramatically over that five years. Secondly, in a number of the states it reviewed current practices and monitoring procedures, and that triggered the subsequent review by ASIC which effectively said that we were no longer satisfied that the current regime we had put in place in 1992 was adequate. That actually predated the Managed Investments Act implementation. That was introduced in 1998 so, really, in the context of the managed investments we put in place, the new regime effectively does remove the role of the law society for most of the actively managed schemes. That was the sequence that occurred.

Senator ALLISON—What was ASIC's relationship with the legal ombudsman in Tasmania, for instance? What did you see as their role? Were they required to report to you the complaints they had monitored and collected?

Mr Tregillis—I am not aware that they reported specific complaints to us directly from the ombudsman. They would report to parliament. So there is no direct statutory relationship. There is nothing in the instruments of exemption that formally give a role for the ombudsman in that state or the various other equivalents in other jurisdictions.

Senator ALLISON—Would earlier action have taken place had the legal ombudsman referred those complaints directly to ASIC?

Mr Tregillis—I do not have a sufficient knowledge of the nature of the complaints. The sequence was as I have outlined—that we became generally concerned about the change to the industry. It changed, as Mr Johnston said, from something that was incidental to legal practice to increasingly, in some states in particular, something that was being actively marketed as a separate line of business by the practitioners. That is really what triggered our concern, plus a couple of notable events that lead to the wide-scale review we conducted in 1996-97, and that

then led to the change in the regime so that it is now effectively regulated directly by ASIC under the Managed Investments legislation.

ACTING CHAIR(Senator Sherry)—Talking earlier about Tasmania, obviously the property market in Tasmania has declined to some degree; however, there were lending limits on sums of money in terms of the value that could be lent out, weren't there? I would have thought they were reasonable lending limits—that is, 50 per cent, I think, in the case of not having an independent valuation and 60 per cent in the case of a valuation. What I am saying is that, even if there were a property decline, as occurred in Tasmania in some areas, people should still have got all their money back, shouldn't they?

Mr McShane—I understand the loan to value ratio implemented by the original relief was a requirement of an 80 per cent loan to value ratio, which could be higher if mortgage insurance was in place and that was one of the matters that was subject of the review in 1997.

ACTING CHAIR—The earlier?

Mr McShane—Yes. The relief from 1992 provided that. So, yes, there was in a sense some margin for change in property values or even valuation error, but with a margin.

ACTING CHAIR—Most areas of Australia do not have the same sort of property market as Tasmania. What about areas where property has been going up in value? Why are there problems there?

Mr Johnston—The problems there are not to the same extent. Queensland is a little different. In some areas of Queensland, the property market was going up, and in other areas of Queensland it was not going up. Again, the practice that we observed of borrowers' valuations being used gave us concern because, as you can imagine, it was possible for a valuer instructed by a borrower to have different regards to matters from a valuer instructed by a lender. It was a very common practice of them using borrowers' valuations. That may explain quite a lot of that behaviour.

Senator HOGG—In your opening statement, you mentioned something about Far North Queensland being an area of particular concern. Could you elaborate on that for us briefly?

Mr Johnston—A number of loans were made in respect of developments in that region that were somewhat speculative in nature. It was not so much an observation of the region as a whole as an observation in relation to a number of matters whereby there was lending of a speculative nature.

Senator HOGG—So it is not a matter of a number of solicitors mortgage funds in North Queensland, it could well be that the funds are elsewhere, but the speculation and property—

Mr Johnston—Both. There are some funds operated by firms in that region, and there are other funds that were operated by firms in Brisbane which had lent money on developments in North Queensland.

Senator HOGG—Have you investigated this and, if you have, are the results of that investigation available?

Mr Johnston—Sorry, when you ask whether we have carried out an investigation into that—

Senator HOGG—Into the problem in North Queensland.

Mr Johnston—No, not specifically. We have not done a discrete investigation into North Queensland.

Mr McShane—But our surveillance coverage has included both North Queensland and Brisbane practices which had investments in North Queensland.

Senator HOGG—Thanks.

Senator SHERRY—I asked earlier about the size of the problem in other states and you had identified Tasmania as a maximum of \$23.3 million excluding interest. As a matter of interest, do you have an overall figure for the country? Is it \$100 million or \$200 million?

Mr Johnston—In terms of default?

Senator SHERRY—Yes.

Mr Johnston—From memory, I think it is about \$300 million across the country.

Senator SHERRY—So it is a fairly substantial problem.

Mr Johnston—Again, as I said earlier, we want to point out that that is the figure in default; it is not necessarily the figure of loss, which we would expect to be considerably less than that.

Senator SHERRY—But you appreciate that many of the people, for example in Tasmania, are elderly. They have waited a number of years already for part or all of their money with no interest and they may have to wait another year or two to determine the full extent of their loss, if there is a loss. You are dealing with a group of people in the community who, for very obvious reasons, are very upset and angry. That is an important issue in itself.

Mr Johnston—Yes, it is and, quite frankly, that is one reason why we launched this investigation into the run-out schemes. One of the vexing questions for us going forward will be how we handle the run-outs at the end of the October period. We are trying to develop some criteria based on the work done by Mr Hodgson as to which we should allow to continue to run out. We may grant some extensions, but there will be other cases where the best answer is to have some schemes wound up or put into some form of administration. I suggest that there will not be an across-the-board answer.

Senator SHERRY—Ultimately, who should pay? In some cases, the guarantee funds will not be able to pay. In some cases they are not paying interest or they are unable to pay the balance of the principal. Who should pay?

Mr Johnston—That is a difficult question. If there are instances where we believe that there is reason for us to take recovery action against a party, we will look at doing that and that could involve operators, valuers or a number of people. In other cases, if there has simply been market loss, one would expect the investors to bear the market loss. There are also other actions, as I mentioned, that we are looking at whereby we will call people to account even if no recovery is made, as there may be a breach of the law that we can prosecute.

Senator SHERRY—But, putting aside property loss, there may be cases in which some people will not get their money back.

Mr Johnston—Yes, that is right.

Senator SHERRY—Thank you.

CHAIR—I am told that the committee has no further questions on CNAL—that will be a great relief to everybody. I thank everybody who has appeared before the committee this morning. It has been a productive meeting and we appreciate your evidence.

Proceedings suspended from 1.15 p.m. to 1.50 p.m.

BURGESS, Mr Earl Gayford, Senior Manager, Rehabilitation and Enforcement, Specialised Institutions Division, Australian Prudential Regulation Authority

GOLE, Mr Bill, General Manager, Coordination, Rehabilitation and Enforcement, Specialised Institutions Division, Australian Prudential Regulation Authority

KARP, Mr Thomas, Executive General Manager, Diversified Institutions, Australian Prudential Regulation Authority

PHELPS, Mr Leslie John, Executive General Manager, Specialised Institutions Division, Australian Prudential Regulation Authority

STOW, Mr William Ernest, Manager (Legal), Rehabilitation and Enforcement, Specialised Institutions Division, Australian Prudential Regulation Authority

THORBURN, Mr Craig Walton, General Manager, Diversified Institutions Division, Australian Prudential Regulation Authority

CHAIR—Welcome. Mr Karp, I understand you have an opening statement.

Mr Karp—I have a statement in respect of HIH. I would like to explain to the committee why APRA has not provided a written submission detailing its role in respect of HIH Insurance and, because there is little understanding of how prudential supervision is undertaken, I will broadly clarify how APRA now goes about its supervision of institutional groups like HIH. I will also outline the main activities of APRA in relation to HIH from March this year.

Firstly, HIH's failure is to be examined in detail by the announced royal commission and we expect that APRA's role in respect of HIH will clearly be covered in the terms of reference of the royal commission. We have only just commenced the major task of compiling an extensive submission on APRA's role for the royal commission. There is also currently an investigation under way by the Australian Securities and Investments Commission into the failure of HIH and the conduct of those associated with HIH. It is clearly important that any detailed examination of activities surrounding the collapse of HIH be conducted in a careful manner so that any future proceedings against parties involved in any wrongdoing are not jeopardised and any compensation which can be obtained from such parties is not put at risk. I am sure that this is being considered by the government in determining the terms of reference of the royal commission and how the ASIC investigation will interact with the royal commission.

The supervision of authorised insurance companies within the HIH Insurance group obviously stretches back a number of years covering both the period since APRA was formed from 1 July 1998 and earlier periods when supervision was conducted by the Insurance and Superannuation Commission. It should be remembered that APRA was formed very quickly after the government's acceptance of most of the recommendations of the financial system inquiry, or the Wallis committee, and that legislation to establish APRA was passed only in June 1998. Consequently, the initial phase of APRA involved simply combining the operations and staff of the ISC with those of the banking supervision area of the Reserve Bank of Australia

while the infrastructure of the new organisation was put in place and the preferred longer term structure and method of operating were determined.

In conjunction with APRA assuming the responsibility for supervising building societies, credit unions and benefit fund friendly societies, a new structure was implemented in August 1999. This new structure no longer contained separate groups to supervise specific types of institutions which operated across the financial sector. Rather, in line with the trend of financial convergence, a main financial sector driver identified by the Wallis committee, APRA's new structure provided for the supervision of financial conglomerates and institutions with international connections in one division and the supervision of domestic, monoline institutions in another division. Both of these front-line supervisory divisions are supported by a policy, research and consulting division which, amongst other things, provides specialist risk teams to conduct on-site visits to examine specific aspects of an institution's operation in some detail.

For institutions such as HIH, APRA's new supervision methodology involves examining all regular statistical returns but also reviewing the operations of each institution annually, which involves a high level prudential consultation visit to understand the institution's current management and operating structure, business strategy and issues it is facing. These annual reviews help set the program for specialist risk team visits. Prior to this new 1999 APRA structure and supervision methodology, general insurance companies were visited occasionally, but the visits were not highly structured and did not involve any specialist risk analysis in detail. So APRA's prudential consultation visit to HIH in March 2000 and credit risk visit in July 2000 were the first such visits. From the middle of 2000, we had identified a number of concerns with HIH's operation and we pursued these concerns with the company.

HIH is a complex insurance group comprising over 200 subsidiaries, including seven Australian authorised insurers and other insurance operations overseas, predominantly in the US and the UK. This, combined with the inherent uncertainty in general insurance business, especially long-term liability and indemnity classes and the ultimate outworking of complex reinsurance arrangements, makes the assessment of the financial state of such insurance groups very difficult.

The fact that the provisional liquidator is taking quite some time to reach an early view of the financial position of HIH, that he is stressing that this is only an early view and that he cannot yet provide company-by-company positions is clearly an indication of this difficulty. Supervision under the Insurance Act is focused on the individual authorised insurance companies so, apart from the public accounts, the information which APRA received under statutory returns related only to the individual Australian authorised insurers, and with numerous intercompany transactions this made it difficult to assess quickly the position of the overall group on a regular basis.

Throughout the latter half of 2000, while we were pursuing the various identified concerns and pressing for improvements to HIH's risk management arrangements, the HIH companies reported as meeting statutory solvency requirements. This included the externally audited accounts as at June 2000 that showed net assets of about \$950 million and solvency for statutory purposes at about double the required level. In that situation, we did not assess that we had grounds for appointing an inspector to investigate the financial affairs of the authorised insurers within the HIH group. Appointment of an inspector is usually the first step towards

shutting a company down and, often, liquidation, so it is not a step that a regulator should take lightly.

I need to make it clear that APRA's responsibility is to protect policyholders, and we have no responsibility towards shareholders. *Prima facie* it does not matter to us if an insurance company survives as a separate legal entity. However, what does matter greatly to us is that existing policyholders' rights are protected as far as possible if an insurance company is not going to survive. We are mindful that, once an insurer is forced to close its doors and move from a going concern to a wind-up operation, its financial position changes overnight as a number of items on its balance sheet have to be reassessed in a different light and some will then have little or no value; for example, future income tax benefits and the recovery of deferred acquisition costs.

Because of these effects it is always preferable for the rights of existing policyholders in a weakened insurer to be moved across to other insurers. This is normally done via a takeover of the weakened insurer or portfolio assumption and purchase of the renewal rights. The arrangements with Allianz, NRMA and QBE have strengthened the position of many of HIH's policyholders, and as a result of these arrangements at least one million policyholders have retained current insurance coverage that they would not have had. Around \$1.3 billion worth of outstanding claims for retail, small business and rural policyholders are being covered in full and paid through normal claims procedures, and 750,000 travel insurance policies remain current with all valid claims being met.

With the difficulty HIH experienced in early 2001 in finalising its financial results for the six months to 31 December 2000, we impressed on HIH's management the importance of determining this and providing returns as at 31 December on time. Press speculation at the time was that the loss could be up to \$500 million, which, based on published audited accounts as at 30 June 2000, would still have left HIH above statutory solvency levels required by the Insurance Act, albeit only marginally, but over \$400 million above commercial solvency.

When the December returns were slightly overdue and amid speculation of losses which would make HIH only marginally meet statutory solvency, we issued show cause notices as to why we should not appoint an inspector to investigate the financial affairs of the authorised insurers. This resulted in our appointing an inspector on 16 March, the earliest date possible after the expiry of the show cause notice. The inspector is still in place and has been collecting many documents and examining them to help us establish how the financial position of HIH developed.

The HIH authorised insurers have also been under directions from APRA since late March not to undertake new insurance business, reconstruct the insurance operations, sell major assets or rearrange reinsurance arrangements without approval from APRA. Even though we have a good working relationship with the provisional liquidator, he has a duty to all creditors, not just to policyholders, and these directions were aimed at protecting policyholders' rights as far as possible. The directions have had a practical effect, with some transactions requiring our approval so far. Reinsurance recoveries are one of the major assets of the HIH companies and it is crucial that everything is done to ensure that reinsurance recoveries are utilised for policyholders. The APRA inspector has assisted with advice on these complex legal issues to achieve this as far as possible.

APRA has been working closely with the provisional liquidator to establish the latest financial position of the HIH companies and of the various policyholder groups who still have claims against the companies. We worked closely with ASIC to provide the comprehensive media release of 17 March, just after HIH went into provisional liquidation, which outlined in depth the position for policyholders. We have also been part of the government's HIH task group working to provide the government with the most up-to-date information on HIH and the policyholder groups and assisting in the development of the protection arrangements which have been announced over the past few weeks.

APRA will continue to work with the provisional liquidator on the financial position of the HIH companies and their compliance with APRA directions. Also, we will obviously now be working to provide a major submission to the royal commission which will cover in depth the actions that APRA took at various stages of its supervision of HIH, and why. Whether or not these actions were adequate in the circumstances will be explored by this judicial inquiry.

Mr Phelps—The material that I have was provided on Thursday and it is in your binders.

CHAIR—Thank you.

Mr Phelps—Would you still like me to go through it?

CHAIR—No, I do not think so. Mr Karp, according to earlier advice provided to the committee, Mr Graeme Thompson, APRA's CEO, was to appear today. In later advice from APRA, his name was not on the list of APRA witnesses. Would you mind explaining to the committee why Mr Thompson is not here to assist the committee in its inquiries? We also noted that no apology has been tendered in terms of Mr Thompson's absence today. We would also remind APRA that the ASIC chair, Mr David Knott, saw fit, amidst all his busy duties, to discharge his parliamentary responsibilities in terms of appearing before the committee today to answer questions as a witness.

Mr Karp—I can simply take that message back to Mr Thompson. He is not here today because a lot of the explanations given on some of these matters were covered in questioning in Senate economics committees last week, but I can simply take back your message to him.

CHAIR—Thank you for that.

Senator CONROY—I wanted to revisit a couple of issues that we talked about last week. I was interested to note that in your opening statement you described your sense of their financial position around December. I wonder if you could take me through whether the fact that HIH reinsured rather than provisioned, as they are entitled to do, with your approval, makes a difference in terms of their solvency with regard to those issues that you were considering.

Mr Karp—I will make some general points on that. We did cover some of this ground last week. In terms of the statutory solvency requirements which insurers must meet, the solvency requirements are based on their net liabilities—that is, net after reinsurance. So to the extent that they have reinsurance and that reinsurance reduces their claims liabilities, the solvency margin is based on the reduced claims liability and, to the extent that they have reinsurance arrangements which do that to a greater extent than other companies, they will need less

solvency requirement because of that. It is true that in this case HIH were a large user of reinsurance and did not have prudential margins in their outstanding claims liabilities or provisions. That was a factor which was taken into account in assessing their position, and it is one that we discussed with them some time after we met with them in March. Mr Thorburn might like to add some comments on that.

Mr Thorburn—With respect to the fact that a company holds provisions with or without prudential margins, the current requirements are such that they need to comply with the accounting standards for insurance companies which permit companies to choose whether or not to have a prudential margin. The absence of a prudential margin was more one that was inconsistent with industry practice than banned, so to speak. If the company had adopted an absence of a prudential margin and had reinsurance in line with industry practice then it would be quite clearly in a less satisfactory position because it would not be relying on anything at all. The company's view was that it chose to rely on heavier than normal reinsurance and we were able to verify that it did, in fact, have heavier than normal reinsurance in place.

Senator CONROY—I am recalling how Mr Karp described the assessment that you are making of their financial position. Solvency is about having enough money to pay your debts. I am trying to get an assessment of, with the fact that they did not provision, that they had this reinsurance, how you were able to calculate what their level of debts were. For the purposes of saying 'Yes, they are solvent. Tick,' you get into a situation where you have to make some assessment of their liabilities. Given that they have gone the reinsurance route, that is a harder position to assess, which means you cannot simply say, 'Assets. Liabilities. Yes, they can pay their debts.' I am trying to get an understanding of how it was you came to the conclusion, even as late as you did. I appreciate that by this stage it was very late in the process.

Mr Karp—A general point worth making is that the assessment of the solvency position of an insurance company—and, in particular, a general insurance company—is a very hard thing to do. As you would know, the main liabilities of insurance companies are future payments or obligations to policyholders. These obligations are difficult to assess because they are not entirely known. They have to be assessed on a probabilistic basis in terms of not only whether a claim is going to occur but the size of that claim that might occur and then whether reinsurance will be paid or not. So there are a number of assessments that have to be made and they are not particularly easy assessments to do. They are the sorts of things that a lot of specialists do on a regular basis and do not always get right.

In one sense, the solvency position of a general insurance company is a probabilistic statement. You cannot say 100 per cent that a general insurance company is solvent. Even with large prudential margins, it is possible that major catastrophes could occur and wipe out those prudential margins and put an insurance company into an insolvent position. So it has to be a probabilistic statement and it has to be based on the actual position of the company and the assessment of those claims and the assessment of the reinsurance arrangements for that particular company.

Mr Thorburn—I might just add that all companies have to have reinsurance. It is actually not a sensible position for a company to have no reinsurance at all. We do receive from companies an assessment of their liabilities, both gross before allowing for reinsurance and net after allowing for reinsurance.

Senator CONROY—Does APRA do any calculations when they see these numbers, or do they just accept the numbers that they have been given by the company? Does someone run a rough ruler over them and say, ‘That looks a bit thin,’ or ‘That looks fine,’ or, ‘We have received them,’ and that is it?

Mr Thorburn—There are some specific requirements with respect to the level of reinsurance that companies must have and also some reasonableness checks in the manner in which it has been determined.

Senator CONROY—I think Mr Karp explained last week that, because of the strategy undertaken by HIH which differs largely from the other companies in the industry, it required an annual approval to carry this degree of reinsurance. When that annual approval is granted, what assessments are made as you tick over each year? What do you look at to say that that is still within reasonable bounds?

Mr Karp—We look at reinsurance arrangements on a regular basis. Where companies have a new reinsurance program, or a major adjustment to the reinsurance program, we look at that in detail. To the extent that the same reinsurance program is simply being renewed and left in place, it is looked at less thoroughly because we have looked at that previously. I did mention last week that a number of the issues that we look at, when looking at a reinsurance program, include the actual net retained risks that the insurer is keeping compared with its level of solvency. In particular, we look at what we call the highest retained risk that an individual insurer will keep. That is the risk that it might have to pay out on an individual claim to its own account. That is net of what it gets from reinsurers, and that is on an individual claim basis. We also look at what we call the maximum event retention, which is looking at the maximum amount that the reinsurer would have to pay in respect of a catastrophic event. We have guidelines as to amounts that the reinsurance program should reduce the highest risk retention and the maximum event retention down to for that to be an acceptable reinsurance program.

Mr Thorburn—I just have a factual correction, and I think this might be a matter of interpretation as much as anything, from Mr Karp’s comments last week. All insurers have their reinsurance approved annually. There is no special requirement on HIH.

Senator CONROY—I understand that. You mentioned that if it was just a rolling over of existing reinsurance, you look at it ‘less thoroughly’—I think those were your words. We talked last week about HIH’s acquisition of FAI. After the acquisition, did HIH retain the same reinsurance position or would you consider that that amalgam required further examination? I am sure that it changed the profile of HIH’s position in some way. Did APRA simply give the tick—the less thorough check—on the new conglomerate, even though that potentially changed the risk profile?

Mr Karp—Clearly, with the acquisition of FAI, the programs had to be adjusted as the total portfolio of the combined operation was brought together. I cannot give you the precise details of how we analysed that, but it would not have been a normal rollover because the program itself would have had to be changed because of the FAI acquisition and the combination of that into the HIH portfolio.

Senator CONROY—So HIH's reinsurance approval, at this particular point, was not just the fact that you had inherited it from the ISC. It was not the case that this was the same one they had that rolled over and ticked over each year, so, 'Yes, tick'? This was substantively different because of the amalgamation risk profile that required you to have—and I am not trying to put words in your mouth; I am trying to avoid doing that—what you described as the 'less thorough' going-over, so when they came together, you gave it a more substantive going-over?

Mr Karp—I want to make it clear that my words earlier were meant to convey that when an insurer changes its reinsurance program then we will look at it very closely because it is a dramatic change in its reinsurance program and the effects on the retained business within the company. To the extent that they are simply renewing that same reinsurance program, there is not a need for us to go over it and re-examine it in detail. That is really what my earlier comments were meant to convey.

Senator CONROY—Why do you require it to be checked annually if there is no need?

Mr Karp—There is a need to ensure that they have the reinsurance in place, that it is in fact renewed. It becomes more a process of confirming that the program that had previously been approved is in fact still in place, that it is in place in the form that it was originally approved and that those reinsurance arrangements are in fact renewed and on foot.

Senator CONROY—You used the word 'dramatic' in terms of the coming together of these two bodies and the change that that would have made in terms of their reinsurance profile. What extra checks did you go through to approve its ongoing reinsurance strategy?

Mr Karp—I cannot provide you with precise details here. The extent of that change would have been the same as the type of change that would have occurred if an existing reinsurer simply wanted to change its whole reinsurance program. We would have been looking at the program in total, reassessing it against these limits—highest risk retention and maximum event retention—and looking at the program overall, rather than simply checking if things were being renewed and put in place as was previously advised.

Senator CONROY—But you accept that bringing together FAI and HIH like this would have been a dramatic change in their reinsurance profile?

Mr Karp—It would have required a reassessment of the overall reinsurance program.

Senator CONROY—I think you were here earlier—I know some of your colleagues were—when we were discussing the HIH FAI purchase and the unusual manner in which that purchase took place. We did canvass some of this last week. I briefly wanted to revisit some of the discussion in the light of some new information we received this morning. It has been confirmed by ASIC that they examined the HIH takeover of FAI. Because of the manner in which the takeover took place—being listed on the market and 15 minutes later 14.3 per cent of the shares were purchased—in actual fact that would have avoided criminal prosecution; there would have been no due diligence, because due diligence would have implied that there was some degree of cooperation beforehand between FAI and HIH. I think Mr Knott described that that would have triggered a lengthy investigation and possible prosecution if due diligence had taken place. Given that this was a pretty shonky transaction—you mentioned last week that you

already had concerns about FAI—in the way that it was structured and taken through on the market, and that it was referred to ASIC for consideration, did APRA look at the prudential position of HIH with the acquisition?

Mr Karp—I did point out when we were discussing this issue last week that APRA did look at the situation—it had a responsibility under the legislation to provide advice on this. It did so, as I pointed out in my earlier statement. This was really in the early months of APRA's existence, when essentially we were still operating under old structures—if I can call them that—and old methods. This transaction was looked at from a prudential point of view by the people who were essentially running the general insurance group of the ISC which moved into APRA in its early months before the new structure was put in place. So it was looked at.

Senator CONROY—You had a regulatory requirement to approve this transaction, and the officers from APRA-ISC had a look at it, accepting that no due diligence was done by either company?

Mr Karp—The responsibility was to look at the impact of the transaction on the policyholders from a prudential point of view; not necessarily at precisely how the transaction was undertaken. The assessment was done by those officers at the time and the recommendation was that the transaction did not raise prudential concerns.

Senator CONROY—Last week Mr Thompson—and you, I think—made the point that there was no-one in the room with us last week that had worked on that approval. Is there anyone in the room today who did?

Mr Karp—Not to my knowledge, no.

Senator CONROY—Is there anyone still working at APRA that was involved in the approval of this transaction—that it would not affect the prudential position of HIH?

Mr Karp—Not to my knowledge, no. They have all since left APRA.

Senator CONROY—We discussed this last week: within 18 months—I think it was a shorter time—of the purchase of FAI by HIH for around \$325 million, there was a \$400 million write-down of FAI's assets. In other words, it was wiped off the balance sheet of HIH within 18 months. Does that suggest to you that there may have been a prudential issue with this merger?

Mr Karp—Hindsight is a wonderful thing. At the time there were still solvency requirements within the company; the fact that these numbers suggest that HIH paid far too much money for FAI does not necessarily mean that the transaction would have raised great prudential concerns. Clearly, losing that much money on that transaction would weaken HIH, because it paid too much money for the FAI acquisition, so in that sense it is weaker. Whether it was enough to raise prudential concerns to such a level that the transaction should not have taken place I think is a bit of a different issue. As I said, hindsight is wonderful, but I do not really know that even now you could say, on prudential grounds, that because of that the transaction should not have taken place.

Senator CONROY—You indicated last week that APRA had pre-existing concerns about FAI's own balance sheet. The transaction is conducted on market in a way that avoids due diligence; it is clearly shonky; and it is referred to ASIC. How quickly did APRA give approval for this from the announcement date? What was the timeframe? Are we talking about a week, a month, six months, before the tick was given?

Mr Karp—I do not have the exact dates in front of me, Senator. I believe the recommendation that the transaction did not raise prudential concerns would have been made at the end of October.

Senator CONROY—I am trying to remember the exact date of the transaction.

Mr Karp—I cannot recall the exact date of the transaction. I could find that out for you.

Senator CONROY—I might come back to you on that. You are saying that even in hindsight you do not believe, even though FAI has been written out of the balance sheet within 18 months, that you would necessarily have stopped this transaction because you felt it endangered HIH's prudential position?

Mr Karp—I have already acknowledged that it clearly weakened HIH's position. At the end of the day, as a prudential regulator we are there to make judgments about the impact on the company and the eventual impact on policyholders. To the extent that an insurer engages in a transaction which loses money and reduces its net wealth, as long as that does not get to a stage where it will actually start to seriously impact on the solvency position of the company and weaken it so much, we are in a position to say that we do not have any major prudential concerns. This transaction clearly did weaken HIH. I cannot remember the numbers off the top of my head now as to HIH's net asset position at the time, but if we assume that it was reduced by \$400 million at the time, given hindsight, I believe that HIH still would have been clearly solvent and statutorily solvent now. I would have to check that and confirm it with you.

Senator CONROY—I go back to our earlier conversation when we were discussing the question of solvency. Statutory solvency is easy to judge, except in the insurance game. As you have said, it is almost impossible to actually make the call in all circumstances.

Mr Karp—It is, but if you take such a conservative view of an insurance company's position and you look at all of these transactions in that particular light, you would probably get to a stage where you may never approve any transaction at all. As always, there are balancing and competing issues here and an on-balance judgment has to be made. At the time, even though we had concerns with FAI, it was statutorily solvent; in fact, it was quite a bit above the statutory solvency limit. HIH was also above those limits.

Senator CONROY—I come back to this issue: your lapse from making an insurance judgment to the words 'statutorily solvent'. The point I am trying to make to you is that they are not necessarily applicable because of the nature of the industry. It is not like in any other industry where you can say that your cash flow can meet your liabilities. That is statutorily solvent. But this is not like other industries.

Mr Karp—Statutory solvency is more than that. Statutory solvency is a buffer above commercial solvency. Commercial solvency is that, on an assessed balance sheet basis, you have enough assets to meet your liabilities. Statutory solvency requires you to have a buffer above that. Both of these companies were above that buffer. For us to make judgments about prudential concerns, we would have to come to the view that such a transaction would weaken companies to the extent that the policyholders' interests were significantly affected. I believe one way of looking at that is to see if that combined entity would have become statutorily insolvent.

Senator CONROY—But this is a company that, after a roughly \$325 million purchase price, had no value in 12 to 18 months. You cannot suggest to me that FAI was solvent when, within 18 months, it had no value on the books of HIH—they had written it down completely.

Mr Karp—All I can do is come back to my point about hindsight. At the time, the information we had and the assessments that we made were based on that information. Both companies were statutorily solvent and the combination of them was.

Senator CONROY—Last week you mentioned that ISC, the forerunner to APRA, started talking about prudential revision and reform in 1995, the very beginning of the process.

Mr Karp—Yes.

Senator CONROY—Why, then, did it take so long for anything to evolve? Even today in the year 2001, six years later, I think we have only just seen legislation being introduced. Why has nothing happened? Have APRA been dragging their feet?

Mr Karp—There are a couple of questions there. Going back to the timing issue overall, it does take many years for these things to occur. It is not something that you actually can change quickly or dramatically overnight. To give you an example of that, the reform of the life insurance regime was actually announced, in my recollection, in late 1989, and that took until 1995 to get into place.

Senator CONROY—This is not a badge of honour, Mr Karp.

Mr Karp—These things require time because they are complex; you need to identify the issues which are of concern and to identify solutions to those issues which can actually be put in place in a practical way. It does mean that you have to tease out the issues from a regulator's perspective, tease out the issues from a consumer's perspective and tease out the issues from the industry's perspective. You then need to develop some proposals and get those proposals out in the public domain to enable them to be examined fully by all stakeholders and, frankly, for issues of practicality to come out, because whenever you develop these proposals you can never think of all the possibilities and the impacts they may have. So, to make something workable, you need to go through this process of developing proposals; exposing them; consulting with industry and others and discussing them; working through that process until you can get to a stage of putting more concrete proposals to government; getting government to accept them; and then getting them through the legislative timetable. I think it is just a fact of life that these things take a few years. They cannot be done in a short space of time.

Senator CONROY—Six years for the last one; six years for this one. That is the sort of time frame you believe is acceptable? Two full parliaments have come and gone.

Mr Karp—Coming back to the point: you made a reference earlier to when APRA was dragging its feet, I think. Mr Thompson made it clear last week that APRA identified very early in its life that this was an issue that needed to be picked up and moved on relatively quickly. In that sense, a lot of the work has been done in the last 2½ to three years to get to a stage where we now have quite concrete proposals and imminent legislation to make a change. The discussions in the latter years of the ISC with the industry were really the early beginnings of raising concerns about a couple of issues in the industry and trying to get those concerns fully enunciated and understood by a number of parties. It just takes a while to build up the momentum.

Senator CONROY—Especially if there is resistance.

Mr Karp—There was some resistance from the industry initially to some of the broad ideas, but once some concrete proposals were actually put on the table and people could see some of the way ahead, then the industry came on board. That does not mean to say, as we discussed last week, that they came on board with every issue. They did come on board with a notion of change but not with every issue, and over the last couple of years we have been refining those issues with the industry.

Senator CONROY—I think last week we discussed that cabinet adopted a final end point for the reforms to come into place—I think it was 2007. In November-December there was a cabinet meeting at which the government decided that that was the time frame that was recommended by you?

Mr Karp—Yes, at that stage, the timetable was in fact to have legislation in place and effective from 2003 but with transitional arrangements for companies to meet what were going to be higher capital requirements by 2007. As you know, that timetable has been shortened.

Senator CONROY—That has been shortened now following this debacle. So, from 1995, the first legislation was originally intended to be in place, but the HIH debacle forced a bit of a rethink: 1995-2003 with an end point implementation deadline of 2007—that is, 12 years.

Mr Karp—When the process was started in 1995, there was no particular time frame in which to achieve this. It was simply raising some concerns about the arrangements, and they were mostly about the valuation of liabilities, the companies and the level of statutory solvency. These were all concerns that were raised at that time, not because it was felt these were dire shortcomings. It was simply a view that the system could have been improved. It was also in the knowledge that insurance supervision around the world was being re-examined—in particular, via a body called the International Body of Insurance Supervisors, which was set up in 1994. Insurance supervision around the world was being looked at for the first time at the international level and there was a lot more comparison of regimes around the world. That was one of the reasons for considering relooking at our system at the time.

Senator CONROY—Do you think a 12-year time frame is a reasonable one? Do you think the community has an expectation that it will take 12 years to reform? The insurance industry is

a powerful industry. Do you think the community should accept a 12-year timetable just because there is some resistance?

Mr Karp—I am not quite sure it is my role to proffer an opinion on that. All I can say is that reforms of this nature are quite large. They are quite wide ranging. A lot of technical issues have to be resolved, not just at the domestic level. As part of this process, we have had to gauge where things are moving internationally and to try and ensure that whatever proposals we come up with and put in place in Australia are not out of step with those international developments. It is a time consuming and complex process. It is not something that you can change dramatically in a short time.

Senator CONROY—I want to go back to one of the questions I asked last week, which you were not sure about. Hopefully, someone at the table will be able to help. I asked whether any stage of the discussions with HIH went to the issue of having to raise new capital. Mr Gray, who is not here today, said that he was not sure. Do you have any further information on that?

Mr Karp—No. At this stage, I cannot give you an answer to that. I do not have any further information. I will have to take that on notice and get back to you.

Senator CONROY—I want to turn to the issue of expert independent actuarial advice. No doubt, the industry is not going to be particularly excited by that proposal. At this stage, have you considered making independent actuarial advice mandatory?

Mr Karp—As part of the new proposals, we will be requiring most insurers to have an appointed valuation actuary, and that valuation actuary will have to assess the outstanding claims and premium provisions of the company according to guidance notes or actuarial standards which are laid down. We have not determined or required that that be independent actuarial advice. Our experience is—and this comes from the life insurance area, where appointed actuaries are and have been required for many years—that the actuaries, in a professional way, can exercise their judgments and report to companies, directors and regulators, having confidence that they can criticise things even though they are actually employed by the company.

In the life insurance arena, we do have a mixture of both consultants who provide actuarial advice to companies and employed actuaries who provide that actuarial advice. In my experience in that arena, the quality of the advice that is given and whether it is critical of the company and its practices and its financial position does not correlate with whether the actuaries or consultants are employed. Another point I would make generally is that it is very hard to define or determine ‘independent’ in that context.

Senator CONROY—How about ‘not paid for by’?

Mr Karp—‘Not paid for by’ is an interesting one. All of the people I am aware of who perform these roles but who are not employed by companies are actually paid by the company to do these roles. If that is a criterion for independence then it seems to me that, unless you get into the arena of someone else other than the company paying for this work to be done, it becomes very hard to say you are independent.

Senator CONROY—Let me give you an example that is in the current legislation to do with valuation processes for the takeover of a minority 10 per cent. If a company has 90 per cent and wants to mop up the remaining 10 per cent shareholding, ASIC in actual fact appoints an independent valuer but it is paid for by the company. Those shareholders in the minority 10 per cent have some faith that the answer they are going to get out of this independent valuer will actually be a little fairer than what they may have got if it was bought and paid for by the very people who are trying to take them over. Does that give you a sense of a concept of independence, that it still actually has people paying for it even though it has been appointed by ASIC in this case?

Mr Karp—Yes, it does. This is in the realm of future developments and policy issues, which is somewhat outside the brief and responsibility I have. The one comment I will make on that is that I think there is a bit of a difference between individual transactions that are occurring and then bringing a group or an individual expert in to assess that transaction and value it versus a situation where you are requiring professionals to provide advice on the major part of the balance sheet of a company when it is quite a complex one and one on which, in my experience, you will only get quality advice on if the people who are giving that advice have a good understanding of the company and how its internal processes work, what its underwriting levels are and how its claims processes work. That is because all of those things feed into making good and professional judgments about outstanding claims provisions. I am not quite sure that it would be that easy to actually bring outsiders in now and again to look at that. That is not to say that it could not be done, but on a regular basis I think there would be some practical problems with it.

Senator CONROY—I think that is what companies argued when they were opposing this particular proposal: that, in making some sort of a calculation of a share price, it is very difficult for an independent person to come in from outside with no understanding of the company; but we managed to successfully overcome that.

Senator SHERRY—I asked the acting Government Actuary at estimates last week about this issue and he told me to ask you about it. When was the last time APRA carried out an actuarial assessment of HIH?

Mr Thorburn—I am not sure that I can provide you with the precise date. I will have to look it up and take it on notice.

Senator SHERRY—Approximately?

Mr Thorburn—The process was that, as a matter of course, outstanding claims provisions would be assessed by the Government Actuary. That process changed at the then Government Actuary's instigation to attempt to focus on exceptions rather than on all cases.

Senator SHERRY—When did that change occur?

Mr Thorburn—My recollection is that that would have been in 1998, but I would have to check. Primarily the reason for that was to say that, if a company's position, on the basis of some broader run-the-ruler-over sort of ratio analysis, does not justify the effort, then that effort would not be undertaken.

Senator SHERRY—Is this when the Government Actuary was working for APRA—within the same organisation?

Mr Thorburn—Yes. So, subsequent to that, there was a system put in place to look at these ratios and consider referrals.

Senator SHERRY—You did not quite answer my question though. Am I right in assuming that 1998 was the last time a Government Actuary looked at HIH?

Mr Thorburn—I would have to check the year, but that is in keeping with my answer, yes. There was a time when that process stopped altogether.

Senator SHERRY—I note that you say that it was the Government Actuary's initiative. What was APRA's attitude to this change of policy on actuarial assessment?

Mr Thorburn—This was at the time of the previous structure.

Senator SHERRY—The old ISC?

Mr Thorburn—Yes. The then general insurance group from the ISC, which was still part of APRA at that stage, was comfortable with that change.

Senator SHERRY—Do you think, in hindsight, that it was a mistake?

Mr Thorburn—I do not think it affected the position with respect to HIH.

Senator SHERRY—Why not? An actuarial assessment by the Government Actuary might have picked up some of the problems.

Mr Thorburn—Well, it may have. But I am not saying that—

Senator SHERRY—If it was not done, you were never going to pick it up.

Mr Thorburn—I am not saying it was not done because of anything to do with HIH. I am saying the process changed for all companies.

Senator SHERRY—But, consequently, HIH has not had an actuarial assessment carried out by the Government Actuary since 1998?

Mr Thorburn—That is right, yes.

CHAIR—Mr Thorburn, you are a practising actuary. It does seem extraordinary to us, looking in from outside, that regulators are prepared to accept such a strategic gulf, in terms of their expectations of an actuary's role for life companies and their very diminished role in respect of insurance companies. As an actuary, are you surprised that there should be this gulf and, as a regulator, are you going to allow it to continue?

Mr Thorburn—The reform proposals that have been put forward by APRA do not allow this gulf to continue, so our position is that we believe that it should be removed. Secondly, however, the technical developments—the actuarial skill set, in effect—to deal with life insurance is different from that needed to deal with other kinds of insurance, and it has been developed over a much longer time. The underlying nature of the contracts is substantially more stable. Mortality is quite predictable by comparison and the amounts of the claims payable under life insurance policies are much less variable.

CHAIR—We see this in legislation. When are these proposals going to come before the parliament?

Mr Karp—They are part of the government's proposals at the moment, so the legislation which will be coming forward quite soon, as I understand, will require valuation actuaries for general insurance companies.

CHAIR—Mr Karp, APRA has always put great store on corporate governance. Were you surprised that there was no due diligence in terms of the takeover of FAI, and what action did you take when you discovered that? If corporate governance rates so highly in terms of good administration, what action did you take—or is it just an ideal that is not really policed? When you discovered that, what did you do, and what was your reaction, given that publicly, in all your documentation, you put great store on this concept of good corporate governance. Obviously, if there is no due diligence, there is no good corporate governance. I would have thought that that was an immediate reason to jump in, in a very big way. Otherwise, it is just paying lip-service and it is more honoured in the breach than in the observance.

Mr Karp—All I can do there is come back to earlier comments that this particular transaction was looked at by the general insurance people who were supervising general insurers at the time. They made the decision not to act on that and to take it further.

CHAIR—That information came back to you, or to somebody very senior. If you really were serious about corporate governance, why didn't you overrule them? It is all very well to allow people in junior areas of responsibility to take on responsibilities but, if you perceived this to be so important, why did you just sit back and allow their judgment to prevail?

Mr Karp—We are talking about senior people in the organisation at the time. We are not talking about junior people who were making those decisions and making the recommendations in respect of that transaction.

CHAIR—It is just surprising.

Senator SHERRY—Just before we go to CNAL, I have one last question on HIH. We now have a situation where the public is funding a compensation mechanism for the victims of HIH. There will be more insurance companies that collapse. Do you see it as necessary to extend the compensation mechanism to ensure that victims of future collapses are provided protection in the same way as HIH victims?

Mr Karp—I do not really feel that that is an issue I should be commenting on. It seems to me that that is a broader government policy issue and it goes beyond, potentially, insurance as well.

It seems to me that, if you went into that arena, it would raise questions about the issue of compensation schemes across the whole financial services sector.

Senator SHERRY—But you do give advice on these issues. In your submission you have listed the areas of policy examination in respect of superannuation. Surely, from an equity point of view, when a person has lost their salary continuity, investments from workers compensation or whatever—quite heart-rending losses—how can you differentiate between the victims of HIH and the victims of a future insurance company collapse and not pay them compensation? It is very difficult, isn't it?

Mr Karp—Yes, I think it is very difficult. I still come back to the point that it seems to me that this is a broad government policy issue and one that is not really appropriate for me to weigh into and provide specific comment on.

Senator SHERRY—But you are asked for your advice on these issues, surely?

Mr Karp—We are asked for advice on issues from time to time, some specific and some general. I am not aware that we have been asked for advice on the broader issue.

Senator SHERRY—But you were asked for advice on what should happen about compensation to HIH victims, weren't you?

Mr Karp—We were involved in providing advice on the arrangements that were put in place, and that was advice about how to put those arrangements in place to make them work.

Senator ALLISON—I would like to go back to the decision in 1998 that the Government Actuary not undertake assessments for all companies. What were the criteria established for selecting those exceptions to be audited?

Mr Thorburn—I think it is actually quite complicated to answer here. I am happy to provide that in detail but, in effect, it related to a series of analyses of actual volumes of the company's business compared with its provisions and the loss ratio that the companies were experiencing on particular classes of business—in other words, the profitability of that business compared to what should therefore be around the ballpark estimate. So it is a fairly lengthy list of exclusions.

Senator ALLISON—Is there a document prepared by APRA which shows why HIH was not targeted as an exception to be subject of the Government Actuary's assessment?

Mr Thorburn—I do not have such a document, no. There is a document summarising how the actual ratios are determined across the board and what the trip wires would be, which I can provide.

Senator ALLISON—Why is there nothing on HIH specifically?

Mr Thorburn—If I understand correctly, your question is: have we prepared a report about why we did not do something with respect to the Government Actuary?

Senator ALLISON—There was some sorting out process. You decided that some companies would be subject to the Government Actuary's assessment, and some would not be. Am I right in that? I think that is what you said earlier.

Mr Thorburn—Yes.

Senator ALLISON—Did you simply do it on a whiteboard?

Mr Thorburn—No.

Senator ALLISON—There must have been some detailed assessment of how you arrived at HIH being on one side of the ledger, as it were, but not the other.

Mr Thorburn—It is a set of criteria applied continuously to every company for every set of returns. The outcome of those calculations is what actually then determines—

Senator ALLISON—So you must have a document that has the calculations on it.

Mr Thorburn—Yes, we do.

Senator CONROY—You were the Government Actuary at this point, weren't you?

Mr Thorburn—Yes.

Senator SHERRY—You were the Government Actuary?

Mr Thorburn—Yes.

Senator ALLISON—So can that be provided to the committee?

Mr Thorburn—That can be provided to the committee, yes.

Senator ALLISON—How many Government Actuary assessments were made in the 12 months following 1998, and how does that compare with the previous period of, say, five years?

Mr Thorburn—I would have to take that on notice.

Senator ALLISON—We do not need actual figures, but roughly would it be two per cent or 50 per cent?

Mr Thorburn—I do not have any personal experience to draw on to answer your question, and so I would have to check that.

Senator ALLISON—With regard to the initiative to change the system to identify exceptions rather than to do the actuarial assessment on all companies, you cannot even give some idea of what this meant—that is, what proportion of all companies were exceptions?

Mr Thorburn—I do not have that information for you, no, but I can obtain it for you.

Senator ALLISON—Thank you. What were the budgetary consequences of this decision? How much was saved in changing this process?

Mr Thorburn—At the time, the work that the Government Actuary's Office did for APRA was not charged to APRA because it was within APRA. The staff member who was involved in doing this work was one person full time, and that person was reallocated to other work at the time and fully occupied. So there was no effect really in a budgetary sense.

Senator ALLISON—Let us look at it in the internal sense. What was the effect on the budget for that work previous to the decision? If you are changing the amount of work being done, there has to be some shift.

Mr Thorburn—In effect, this one staff member was then dedicated to doing work for non-APRA clients of the Government Actuary's Office rather than for APRA. The staff member was a Senior Officer Grade B on the public service scale—which, from my recollection, would put him on a salary of around \$60,000.

Senator ALLISON—So that would be the annual saving from this decision?

Senator SHERRY—Just before you answer that, that is not the correct picture, surely. I asked the Government Actuary about this last week. He said that there had been a reduction in staff numbers in the Government Actuary's Office I think from about 12 in 1996 to seven or eight today.

Mr Thorburn—I watched him give his answer—

Senator SHERRY—Good, I am glad that you did.

Mr Thorburn—I am hesitant to provide too much commentary for what is another agency, but I think you will find that the total effect—

Senator SHERRY—Don't be hesitant; the actuarial supervision of the HIH is a pretty critical issue.

Mr Thorburn—The total effect of the Government Actuary's staffing was not entirely driven by this decision. This decision was the one staff member; there were other decisions taken by both APRA and other organisations, in terms of the volume of use to which they would put the Government Actuary's Office. So I think my answer is consistent. It would only be inconsistent if we explained the entire amount, which we do not.

Senator ALLISON—You said a little earlier that it made no difference—and I am not sure whether this was auditors or actuaries—whether they were consultants or employees. Was that actuaries?

Mr Karp—Yes, I made that comment. That was my experience, yes.

Senator ALLISON—What is the basis of that statement? Have you done a study of the difference?

Mr Karp—No, I have not done a formal study. But, from my experience—and this comes from the life insurance arena, where for many years we have had appointed actuaries, some of whom have been employed and some of whom have been consultants—as well as doing the calculations in respect of life companies on their liabilities and on the reserving position, the actuaries there have a responsibility to produce what is called a ‘financial condition report’. That is a document that contains many numbers and trends; it delves in depth into the financial health and likely health into the immediate future of the life company, but it also has a lot of commentary in it. In my experience, a number of the employed actuaries have been quite critical of their companies and some of the action taken. That is really the basis of my comment.

Senator ALLISON—That is because they prepare an annual report that is available to anyone who wants to read it; is that one of the reasons?

Mr Karp—It is not available to anyone who wants to read it; it is available to the company and to the regulator—but it is very clear that it always goes to the regulator.

Senator ALLISON—You said earlier that there were a number of reasons why you could not transfer that process, that requirement, to general insurance from life insurance, if I am paraphrasing you correctly.

Mr Karp—Yes.

Senator ALLISON—I put it to you that HIH has been in such financial difficulty because of the ‘long tail’ nature of the business that they do. Surely that would suggest it is even more imperative to have that actuarial assessment.

Mr Karp—That is one of the reasons why the requirement to have that is now being brought in as a legislative requirement. I should point out that HIH and virtually every other company that writes ‘long tail’ insurance business does, in fact, use actuaries at the moment. So it is not as though we have HIH and a number of such companies writing this type of business not using actuaries; they do use them and have been using them for a number of years. This requirement will not only make it an absolute requirement that they must use actuaries to do their provisioning; it will go a step further: it will require that those actuaries follow certain guidance as to how they do those calculations. Then we will end up having a greater degree of consistency in the way actuaries and companies set their provisions in this area, which is something we have not had in the past.

Senator ALLISON—So were the actuaries that you speak about with HIH employees or consultants?

Mr Karp—They were a mixture.

Senator SHERRY—Surely that is why it is so important to have a Government Actuary, or at least someone working to APRA, checking up on the actuaries who are employed or paid for by the insurance company in question.

Mr Karp—That is one way of getting another oversight.

Senator SHERRY—A pretty important way, I would have thought.

Mr Karp—It is not the only way.

Senator CONROY—When this one individual was taken off this particular task, I think in 1998, I imagine that APRA could have paid a fee to the Government Actuary's Office to provide this information. In other words, instead of it being at no cost—and I think that was because you were internal to the agency, as described by Mr Thorburn—APRA could have decided that, even though the one individual at no cost had been taken off, you could have paid the Government Actuary's Office a fee to continue to provide this service, couldn't you?

Mr Karp—Yes, we could have.

Senator ALLISON—Perhaps I can come back to the process of establishing which company requires the Government Actuary to do an assessment. Do you review all companies every year?

Mr Thorburn—Yes, we do.

Senator ALLISON—Perhaps I can ask about CNAL and whether there is a connection between CNAL and HIH, in your view, with the collapse of the two.

Mr Karp—I am sorry; a connection in what sense?

Senator ALLISON—Are there any similarities in the reasons behind the financial problems?

Mr Karp—Not in my view. I will ask Mr Phelps whether he wants to comment, because he is responsible for CNAL. I think they are quite different cases.

Mr Phelps—No, Senator. I see the circumstances as being quite different. It is not anywhere near as difficult to value a superannuation fund's balance sheet as it is to value a general insurer's balance sheet. The question in the case of CNAL is more about the lack of information about those investments, in an ongoing sense, which was available to APRA, and the ISC before it, over the period 1994 to the year 2000, when the new directors came in and made these revelations that a lot of the things that had been done in that previous period were unsatisfactory.

Senator ALLISON—I will just finish with a question about whether you would be confident that the collapse of HIH would have been prevented had the new Financial Services Reform Bill been in place at this point in time or, say, 12 months earlier?

Mr Karp—You mentioned the Financial Services Reform Bill. That is more to do with requirements, licensing of people giving advice and so on. The proposals that we were talking about here are really about reforming the Insurance Act. Are you referring to those?

Senator ALLISON—To both, if you can answer the question for both of them.

Mr Karp—I do not think the changes in the Financial Services Reform Bill would necessarily have had much impact on the HIH situation. The proposals to reform the Insurance Act would have had an impact. They would have required HIH to have greater statutory capital than it had, so there would have been either a greater buffer or, in fact, HIH would have had to change some of its practices so that they did not have to hold as much statutory capital. They would have also been required to have risk management practices in place, so I think it would have gone some way towards requiring HIH to do things in a way which would have made them stronger in a financial sense and stronger in a governance sense. But I do not think I can sit here and say that if those proposals were all in place HIH would not have collapsed.

Senator ALLISON—Has the HIH collapse been instructive in terms of what you would want to see in this Insurance Act? Have you reviewed your position on those regulations since the collapse? What does it teach us? Are there changes you would make to that proposal?

Mr Karp—We have been looking at that and in the weeks available—it is not a huge amount of time—there have been some adjustments to the proposals that have been put forward, which are lessons coming out of the HIH experience. I would have to say it is probably too early at this stage to really say that we have learnt all the lessons out of HIH and that all of the improvements are actually on the table. I expect that some of that may come down the track.

Senator ALLISON—Is it possible to give the committee some examples of where you have changed direction?

CHAIR—Take it on notice.

Mr Karp—This particular area is one where Treasury have responsibility for making those changes. We have highlighted a few areas for Treasury and the government to look at. Because they are still doing that and finalising it, I do not think it is entirely appropriate for me to raise it here.

Senator ALLISON—Is it the business of Treasury because it goes to the question of adequate resources for APRA?

Mr Karp—No.

CHAIR—Why is it a Treasury matter?

Mr Karp—It is the responsibility of Treasury because it goes to the issue of government policy and legislation. For the legislation in this arena we get asked for advice, but it is their responsibility to advise the government directly on that and to carry those legislative changes through. APRA's responsibility is more to administer that legislation once it is in place and to put into place prudential standards, which the legislation will give us power to do when it is in place.

Senator CONROY—Mr Karp or Mr Thorburn, just for clarification, who made the decision to transfer the actuarial officer off this role? Was it APRA or the actuarial office that made the

decision to cease the Government Actuary role and to transfer the individual? Who made the decision?

Mr Thorburn—The decision was: ‘We want the Government Actuary’s resources to be devoted to the extreme cases rather than to all cases.’ Therefore, a process had to be put in place in which the general insurance group would work out what cases should be referred to the actuary rather than the actuary having to deal with them all.

Senator CONROY—So APRA made the request that they wanted to concentrate only on the high risk cases?

Mr Thorburn—I think it was a consultative discussion. Within the actuary’s office at the time we thought we were doing a lot of work which was not adding value and we wanted to focus on the areas that were.

Senator SHERRY—And this is against a background of a squeeze on the resources made available for actuarial—

Mr Thorburn—Not at that time.

Senator SHERRY—In 1998?

Mr Thorburn—There was no squeeze at that time.

Senator SHERRY—Why did we get evidence last week that the number of people in the Government Actuary’s office had declined? In 1996, I think there were a dozen and it was down to seven or eight today.

Mr Thorburn—I think that in 1998 there were still a dozen.

CHAIR—Perhaps you might like to put that on notice. Mr Karp, there was no reference in your submission to the fact that there had been a resumption of payment of most allocated pensions. This was brought to our attention by a representative from Pricewaterhouse through the enhanced cash management trust in relation to commercial nominees. I am surprised, given that very significant event. Why didn’t you refer to that in your submission?

Mr Phelps—That information had been provided to us by Pricewaterhouse in one of the many discussions we have been having with them.

CHAIR—It had not or did not?

Mr Phelps—It had. They had assured us in a discussion a few weeks ago that one of the things that had been corrected was that all the pensions had been put back in place.

CHAIR—But, given all the publicity about the plight of these sorts of people, I am surprised that this significant event was not reported to us through your submission today. I regard it as a fairly significant oversight.

Senator SHERRY—You will agree with the chair's criticism. It should have been in your report to us today.

Mr Phelps—While at the back we tried to respond to some of the questions that have been raised.

CHAIR—It has been the focus of public attention—the plight of these sorts of people.

Senator SHERRY—Why didn't you put it in?

Mr Phelps—There is a great variation in individual circumstances. Some people's accounts have been able to be put in order reasonably quickly by Pricewaterhouse. That was part of the corrections that they have been able to achieve.

Senator SHERRY—I understand that. But you know the interest the committee has taken in this issue, particularly the chair, and rightly so. I would have thought it an obvious piece of information that should have been in your submission. Why didn't you include it?

Mr Phelps—Leaving that piece of information out was not done deliberately.

Senator SHERRY—Whether it was done deliberately or otherwise, why was it not included?

Mr Phelps—There are a lot of discussions going on with Pricewaterhouse in their position as acting trustee.

CHAIR—You might like to take that on notice and perhaps enlighten the committee about any other issues of public interest that have not been drawn to our attention that have since been rectified or where substantial progress has been made. It appears that, in relation to CNAL, any possible action by APRA may well have been delayed because APRA waited for a report from the auditors which was delayed because of an unsatisfactory state of the financial records of the group. Where a corporation's or trust's assets are impaired, and also where there is an unsatisfactory state of their records, do you support the notion that registered company auditors should have a legislative obligation to report such a problem directly to the regulator, or even to their shareholders, at the earliest opportunity?

Mr Phelps—Yes. The audit reports that APRA gets are from the auditors of the funds.

CHAIR—We do not need the process. I am putting forward to you a proposition about a legislative prescription. I am seeking your response, not the process through which auditors respond.

Mr Stow—There are obligations on auditors of particular funds and the focus of the legislation is on individual funds to report matters that become apparent to them as matters which ought to be reported to APRA. In this case, what complicated things, if I can put it in that way, was that the assets of these super funds effectively consisted, in a lot of cases, of units in two unit trusts which—as the committee heard this morning—were set up as, at that time, excluded offers. This meant that, as to the audit of accounts for those two unit trusts, that was a

precursor to any proper consideration of the financial position of the superannuation funds which were involved.

CHAIR—If there were a legislative prescription for auditors to respond immediately they became aware of this unsatisfactory state of affairs, and to report either to their shareholders or to the regulator, then this would have enabled you to take earlier action than was the case. In earlier hearings, you said that you could not take earlier action because you were awaiting a report for the accounts to be signed off and nobody was prepared to sign the accounts off. I am saying that in such circumstances early action can save people a lot of money. We are looking for remedies today and this is a remedy we have put forward and we are seeking your response.

Mr Phelps—The process that we went through was that we had the—

CHAIR—I know the process that you went through and why you took such a long time. I am putting forward a proposition to you and seeking to find out whether you think this is a viable proposition or not. We know why you were delayed and we were most unhappy about it. We are now trying to seek a solution to it. You are the regulators and we are seeking your response.

Mr Phelps—I think, in this case, the earliest date at which the accounts for the year 2000 would have been expected to have been done was 31 October, which was when we were insisting that the accounts for these trusts be prepared so that the situation could be determined as to whether we had reasons for taking all this business off CNA and whether we could reach the position that the funds were in an unsatisfactory position.

CHAIR—I am not asking you questions. CNA has provided the reason for putting forward the proposition about changing the legislative prescription in relation to auditing practice in Australia. I am seeking your response and I am having a lot of difficulty getting a response from you because you keep wanting to go back to CNAL. I am not interested in that process. We have visited that and discovered the problem and we have found a number of reasons for your inaction. We are now seeking a response to a fairly simple proposition. Please take it on notice if you cannot give me a quick answer, because we are running out of time.

Mr Phelps—What I am trying to get to is that the auditors of the individual funds had not got to the point of being confronted with not being able to do the accounts, because they had not got to 31 October. Whether the auditors of those individual funds should have had a more ongoing through-the-year look at CNA is the question I guess you are posing, which I will take on notice.

CHAIR—Okay. As a general proposition—completely divorced from CNAL now—in our earlier hearing, I raised with APRA the setting up of an insurance type of fund, possibly financed through the annual levy which is currently levied on superannuation funds and others, to provide a fidelity type fund to meet losses from the smaller end of town where failures have occurred through fraud. I am not suggesting that this should impair the separate provision under SIS, where all funds can have a separate levy where there is a significant catastrophe which is occasioned by fraud.

Mr Phelps—My understanding is that the present piece of legislation has two options: either the money is just paid out of general revenue or there is a separate decision about whether all funds would be levied for the amount or not.

CHAIR—So there is provision at the present time that, in lieu of the fidelity type fund, you can draw on moneys from the government to pay out, for example, any shortfall that might be occasioned by funds such as EPAS or some of the smaller fund failures?

Mr Phelps—APRA cannot do that. The minister has to—

CHAIR—Yes, but you have power to make a recommendation to the minister.

Mr Phelps—But it still has to be related to fraud or theft.

CHAIR—That is right, yes. I have said that.

Senator SHERRY—Just on that issue, current legislation in the event of theft and fraud provides for 100 per cent compensation. Again this is a recognition of the importance of superannuation being retirement moneys. Do you believe that that is an appropriate compensation level?

Mr Phelps—I think that in some of the Wallis material there was talk about 80 per cent, but that did not get carried through into the legislation. The legislation says fraud or theft and if it is considered in the public interest. The big issue, which we have discussed before, is that that legislation has not been used as yet—

Senator SHERRY—I understand that, but—

Mr Phelps—Whether it has got any deficiencies in practice is something that—

Senator SHERRY—But you are not considering any recommendations to reduce it or get rid of it, are you?

Mr Phelps—We are not, no.

Senator ALLISON—Why was it that the enhanced cash management trust was not an APRA regulated entity?

Mr Phelps—The superannuation funds are the entities which are subject to our supervision. Superannuation funds invest a great bulk of their money into trusts. It is quite usual for money to be pooled into a trust and for approved trustees to have an equity fund and a cash management fund and a property fund. The problem in this case was that the so-called cash management trust did not invest in investments which were anything like what the normal person, including me, would expect a cash management trust to invest in. The actual deed of this thing said that it was to lend money to people to buy shares, so even its own deed did not sound like a cash management trust.

Senator ALLISON—Does that suggest to you that a trust which is used by the superannuation funds ought to be subject to APRA oversight and regulation?

Mr Phelps—The great majority of large approved trustees deal in this way through these trusts and it has not created any difficulties.

Senator SHERRY—It has not created any difficulties up until CNA.

Mr Phelps—Sorry, up until CNA.

Senator SHERRY—Senator Allison is quite right. This is an obvious flaw that needs correcting, isn't it?

Mr Phelps—One of the ways in which we already responded in a subsequent case was to tell the approved trustee that they cannot have such trusts.

Senator ALLISON—Are you leaning towards that approach?

Mr Phelps—I alluded to this earlier, when I said that this entity had been supervised for six years, and that the extent of the type of investment activity that it was involved in had not been uncovered. We are certainly looking through such trusts, and when we visit superannuation funds now and they say, 'We have certain investments in trusts,' we say, 'Well, what is in the trusts? We want to see what is in those,' and we are quite prepared to express a view about whether that seems suitable or not. That is what is happening at the moment. But the practical difficulty is that there will be trusts that will invest in trusts that will invest in trusts—as there was even in the CNA case, in which there was an enhanced cash management trust that invested in a Peel Valley mushroom trust that lent money to somebody else. How far APRA's reach should be extended is a question.

Senator ALLISON—That would suggest that there should be some limit on the trust's trust's trusts.

Mr Phelps—If there was a situation in which the trust is within an approved trustee and there is nothing in that trust except superannuation money then we will certainly include that as part of our supervisory process. We will say, 'Well, as far as we are concerned it is just part of our job to look at that.'

Senator ALLISON—So that is an option for APRA? You can include that if you decide to do so? There is no jurisdictional impediment?

Mr Phelps—Some people will object and suggest that we do not have the right to do it, but to date we are doing it.

Senator SHERRY—Could you give some sort of opinion or a paper on that? I would like to know who is objecting and on what grounds they are doing so.

Mr Phelps—I will take that on notice.

Senator ALLISON—On the decision for Mr Hedge to investigate those three funds, those three entities, why were the terms of reference so narrow? Why was no investigation into other funds related to CNAL?

Mr Phelps—The new directors came to us in March 2000 and said that they had found that there were two trusts which they thought had inappropriate assets in them, but that they were confident of recovery of the assets in the enhanced cash management trust. They had no obvious connections to previous directors and they seemed to be people of good experience. They said there was one asset in something called the enhanced equity fund, which they were concerned about, and the three superannuation funds that Mr Hedge was appointed to had exposures to the enhanced equity fund. They also had a small exposure to the enhanced cash management trust, and it was thought that appointing Mr Hedge to those three funds would provide evidence about the recoverability of the assets in both the enhanced cash management trust and the enhanced equity fund.

Senator ALLISON—Did that judgment prove wrong?

Mr Phelps—If I had my time over again, I would have given him wider terms of reference.

Senator ALLISON—Do you reject the idea that the reason for the narrower terms of reference was cost—that is, cost to those various funds, the smaller ones?

Mr Phelps—I do not recall that being part of any consideration. This was a fairly efficient way of getting access to see how recoverable they were and of making sure that the directors were following through and trying to sell the assets in those two trusts.

CHAIR—The time allotted for the hearing has now expired and the committee will have to continue taking evidence at a later time. In the meantime, we might have some questions on notice.

Senator CHAPMAN—Why can't we continue?

CHAIR—People have given commitments to leave at 3.30 p.m. We will have to adjourn.

Senator CHAPMAN—We could form a subcommittee.

CHAIR—We are not in a position to do that at the moment, so we will have another full hearing with representatives from APRA.

Senator SHERRY—I suggest that we adjourn and have a further hearing with APRA in Canberra as soon as possible.

CHAIR—The next hearing of the committee will be at 9.30 a.m. on Friday, in Hobart, at Hadleys Hotel. We thank the witnesses.

Committee adjourned at 3.30 p.m.