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FINANCIAL SERVICES

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

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SENATE
SELECT COMMITTEE ON SUPERANNUATION AND FINANCIAL SERVICES

Monday, 25 June 2001

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

Senators in attendance: Senators Allison, Conroy, Hogg, Lightfoot, 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.

WITNESSES

BURGESS, Mr Earl, Senior Manager, Specialised Institutions Division, Australian Prudential Regulation Authority 1261

PHELPS, Mr Les, Executive General Manager, Specialised Institutions, Australian Prudential Regulation Authority 1261

STOW, Mr William, Manager, Specialised Institutions Division, Australian Prudential Regulation Authority 1261

THOMPSON, Mr Graeme, Chief Executive Officer, Australian Prudential Regulation Authority... 1261

Committee met at 8.04 p.m.

BURGESS, Mr Earl, Senior Manager, Specialised Institutions Division, Australian Prudential Regulation Authority

PHELPS, Mr Les, Executive General Manager, Specialised Institutions, Australian Prudential Regulation Authority

STOW, Mr William, Manager, Specialised Institutions Division, Australian Prudential Regulation Authority

THOMPSON, Mr Graeme, Chief Executive Officer, Australian Prudential Regulation Authority

CHAIR—Welcome. The committee's main reference in inquiring into prudential supervision and consumer protection, superannuation, banking and financial services follows from the public hearing we held with the regulators and others in Sydney on 12 June. The aim of today's hearing is to take evidence from representatives of the Australian Prudential Regulation Authority, particularly in relation to commercial nominees and APRA's management of small and medium sized funds, as well as information about superannuation funds generally. All of the witnesses who 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 evidence given before the committee. The committee prefers to conduct its hearings in public; however, if there are any matters that you wish to discuss with the committee in private, the committee will consider your request. I welcome all of the participants to today's hearing. Mr Thompson, we invite you to make an opening statement and to comment on any matters that may have arisen during the course of our inquiries or subsequently.

Mr Thompson—Yes, I would like to make a short opening statement, and I thank you for the opportunity. It is important that I address a couple of specific issues that were raised by members of this committee in recent hearings and in a Senate debate last Thursday. I would then like to comment briefly on APRA's submission to the Productivity Commission's inquiry into superannuation legislation. I will then make a final comment about APRA.

The first point I would like to touch on is the audit office's report on bank supervision, which I realise is not strictly on the agenda for this evening but was raised in an earlier hearing and has been the subject of comment in parliament. As a result of what I believe is selective reading of the ANAO's performance audit, there has been criticism of APRA's supervision of banks. I do not want to go into detail here, but I would like to set the record straight on a couple of general issues. Firstly, it has been reported that APRA does not wish to adhere to the Basel Core Principles of Effective Banking Supervision. On the contrary: APRA was one of the authors of those principles as a key member of the Basel committee's core principles liaison group. We were also one of the first supervisors in the world to publish a self-assessment of our compliance with those principles, in April of this year. We fully support the principles, even though they are not mandatory.

It has been said that APRA does not fully comply with the core principles. It is true that APRA does not satisfy fully each and every principle, and our published self-assessment in April said as much. However, it must also be recognised that the full set of principles and supporting criteria were finalised less than two years ago. There are 227 criteria, and no supervisor in the world could honestly say that it has complied fully with the letter of all of them. APRA's overall level of compliance is already very high, and we are moving to narrow the small number of gaps that still exist.

It has also been alleged that APRA adopts a light touch in supervising banks. On the contrary: we adopt an approach that will vary from bank to bank, depending on its size, complexity, history, risk profile, and so on. The most frequent complaint of banks since supervision shifted from the Reserve Bank is that APRA's approach is more prescriptive and demanding than previously. I would like to make the point that, notwithstanding the length of its report, the ANAO made only four formal recommendations about supervisory practice. APRA agreed with all of these, albeit with a partial qualification in one case. That one was about on-site visits, where the ANAO recommended that APRA conduct periodic on-site visits to all banks, with the level of assessed risk determining the appropriate frequency and intensity of visits. We agree wholeheartedly with this, with the qualification only that a scheduled visit may be deferred if we assess that it would offer no insights into a bank's risk management practices.

Our program for 2001-02 calls for high level prudential consultations with all banks, plus 50 on-site specialist visits to look more deeply into management credit risk, operational risk and market risk. This program is much the same as the one that we have just completed for this financial year. The bottom line is that the Australian banking system is very sound—one of the healthiest in the world—and this is due in no small part to the high quality of supervision practised by APRA and the Reserve bank over the past decade.

The second issue I would like to touch on briefly is the role of the Australian Government Actuary in general insurance supervision. There was some confusion about this at this committee's hearing on 12 June. Unfortunately this confusion seems to have continued in subsequent speeches and debates, even though we issued a clear statement of the facts on 13 June. In a nutshell, it is not true that APRA scaled back scrutiny of insurance companies by the Australian Government Actuary's Office after 1998 to save money. Firstly, the Insurance and Superannuation Commission—the insurance regulator up until 1998—stopped the practice of sending insurance company reports for routine review to the Australian Government Actuary's Office well before APRA was established. I understand that the process commenced in 1996. This was done because the ISC concluded that the practice was not useful. It was not done to save money. The practice did not involve full-scale actuarial investigations but merely reviews of each company's own working papers. APRA can commission actuarial reports from internal sources from the actuaries office or elsewhere whenever we assess that to be necessary.

APRA's new prudential standards for general insurers, due to be introduced next year, will for the first time require most companies to have an appointed valuation actuary with statutory reporting obligations to APRA. These new standards are the product of a major project of APRA's to overhaul thoroughly the supervision arrangements that are inherited for general insurance companies. This has been a long neglected area and is well overdue for reform. We also now conduct on-site reviews of general insurers, something that was not done regularly for insurance companies before APRA.

Turning now to superannuation reform, the superannuation industry in Australia is by and large very well managed and does an excellent job in helping Australians to build a nest egg for their retirement. There have been several improvements in the supervisory framework for superannuation funds in the past year. In particular, APRA has commenced a major project to improve the timeliness and quality of the information provided to us by funds. Enforcement powers were toughened last year, and we will certainly use these. It is our firm view, however, that further more radical changes are needed if small and medium sized funds are to be supervised as effectively as the community rightly expects. APRA's submission to the Productivity Commission draws out the challenges of supervising closely an industry which is characterised by numerous participants, where there are no entry tests and no capital requirements for most players and where important operations are often outsourced to others. Our submission outlines the areas where we will strengthen supervision within the current legislative structure in the immediate future. These are mainly to do with information and investment strategies.

Our submission also comments on the ongoing suitability of that legislative structure, and it summarises our priorities for medium-term reform on matters such as licensing capital and powers over third-party suppliers. We have not yet developed detailed proposals on these for government, but I was encouraged to see the chairman's endorsement of reform in these areas in the Senate debate last week. We do not underestimate the difficulties of getting industry support for the changes that are likely to be necessary. In the past year or so, the industry has resisted providing APRA with more timely financial data, and I was disappointed that this committee did not give us more support on that issue.

Last year, much of the industry also resisted stronger enforcement powers for APRA. Recently the industry has adopted the rhetoric of support for more proactive supervision by APRA, and that is what we fully intend, but I do not think the industry has yet accepted that a more proactive approach will inevitably boost our budgetary needs, particularly while the number of superannuation funds remains large. The main industry body advocated a 10 per cent cut in APRA's funding from the superannuation sector for the next financial year.

In concluding these remarks, I need to make a general comment on the criticism that has been directed at APRA in recent months. We have no problem at all with constructive criticism—in fact, we welcome it and we learn from it—but much of what has come APRA's way recently has not been constructive, in my view. It has not been well informed and it has not been balanced. Prudential regulators like APRA mostly go about their business in a fairly quiet way—licensing financial institutions, monitoring their financial soundness, examining major changes in transactions in financial markets and working with regulated entities to head off problems before they become serious.

As I noted in a recent Senate estimates hearing, at any time we would be dealing with upwards of 100 entities to resolve issues that could potentially cause loss for their members, policy holders or depositors. It is usually in the interests of these people that this work is kept low key and confidential. We do not, for the most part, seek publicity for it. Consequently it is an unfortunate reality that the public only hears of prudential supervision on those rare but inevitable occasions when financial institutions have major difficulties that require us to take enforcement action, or when financial institutions actually fail. Then we are at risk of hostile and unbalanced criticism. Of course, we are not alone with this dilemma; it is common for

prudential supervisors around the world. At present, one of our respected colleagues, the Financial Service Authority in the UK, is under some pressure over the well-publicised problems at Equitable Life and this month's move into provisional liquidation of Independent Insurance in the UK.

I make the point quite forcefully that negative and unbalanced commentary risks weakening APRA's capacity to do its job for the Australian community. It has a bad effect on the morale of our staff, and it risks damaging our ability to recruit the skilled people that we need. It can also hurt public confidence in Australia's regulatory arrangements and our whole financial system without good reason. Whatever the weaknesses in our system—and there is always room for improvement—it is undoubtedly still one of the best and most highly regarded in the world. That concludes my statement.

CHAIR—You mentioned some changes in the oversight of banks and risk profiles, et cetera. Following the failure of the Tasmanian Trust Bank, has APRA changed its oversight of the banking industry as a result of the lessons learned in relation to the Trust Bank?

Mr Thompson—The Trust Bank did not fail; it was purchased by another.

CHAIR—It was so close to failing that somebody bought it out at a bargain basement price.

Senator CONROY—You are not seriously tendering that as evidence, Mr Thompson!

Mr Thompson—The Trust Bank never breached prudential capital adequacy requirements.

Senator CONROY—That is your serious testimony to this committee?

Mr Thompson—The Trust Bank never breached statutory capital adequacy requirements.

Senator CONROY—That makes two courageous statements in one evening.

Mr Thompson—I believe that to be the case.

CHAIR—Were the standards too low? You are aware of my concern about the bank's decline, and its ratios declining, over quite a period of time. It certainly had to be disposed of fairly quickly at what most people in Tasmania regarded as bargain price—as a giveaway price.

Senator CONROY—It was obviously a going concern.

CHAIR—A lot felt that APRA could have been a little proactive. You have just told us that you do not believe it has breached anything, so obviously something is weak there. You still believe it was not a problem and, given the outcome, I am trying to marry the two up.

Mr Thompson—I am not sure what the point of the question was. Our concern is to protect the interests of depositors with banks. My recollection is—this was some years ago now—that that bank never breached prudential requirements for capital adequacy.

CHAIR—I am saying in hindsight.

Mr Thompson—Its profitability was poor, and it was placed on the market and purchased by a stronger bank. That is part of the workings of the market.

Senator SHERRY—The bank was in financial decline.

Senator CONROY—Substantial financial decline.

Mr Thompson—The bank was in a weakened financial position, and that is the reason it was placed on the market. It was never in a position where the safety of its depositors was seriously at risk.

CHAIR—But I would have hoped that the regulator would move in at a stage slightly ahead of the depositors funds being at risk. I am asking you: in the light of that, are the capital adequacy or the ratios tight enough after the lessons from that bank?

Mr Thompson—The capital ratios that apply to banks are set by international standards. They are not standards that have been developed in Australia.

CHAIR—Obviously, but you have given us a fairly positive response from APRA's point of view.

Senator CONROY—A glowing review of yourselves.

CHAIR—I am still saying that there is a major problem there that a number of us felt at the time—and others in hindsight—could have been addressed a little earlier. The final outcome might not have been quite as severe in that they might have got a better price at an earlier stage.

Mr Thompson—APRA's main concern, and the Reserve Bank's before it, was to protect the interests of the depositors. They were never at risk. I cannot recall the numbers now, because it is going back some time, but the bank was not profitable and the proprietors decided that the best course was to place the bank on the market and to sell to a stronger buyer.

CHAIR—So we could see a repetition of a Trust Bank again—where you will not move in until depositors funds are really at risk. Once you get to that stage, things happen very quickly. Today they might not be at risk, and tomorrow they are at risk. Markets today are so very volatile, so perhaps you should have an insurance margin for that sort of risk.

Mr Thompson—But that is the purpose of the capital adequacy requirement.

Senator SHERRY—Can you provide us with some sort of documentary oversight of the Trust Bank—just what its financial position was in a historical perspective up until it was sold to the Commonwealth Bank?

Mr Thompson—Yes, of course. In fact, I think that has been done in numerous hearings of Senate committees over the years.

Senator SHERRY—It has not been done here, has it?

Senator CONROY—We can see the thing on Trust Bank in the five years.

CHAIR—We did not have an inquiry into the trust.

Senator SHERRY—That is true.

Senator CONROY—We have sat on this committee for five years and never seen it.

Senator SHERRY—It must have been at estimates.

Senator CONROY—I am sure that Senator Watson and Nick can double that between them.

Senator SHERRY—I lined up in a queue in the old Trust Bank in Devonport. It has now merged with another bank. It was almost like five years in the queue, I can tell you, but you do not have much choice in Tassie now in terms of banking services.

Senator CONROY—It is an ACCC issue. I will defend them.

Senator SHERRY—That is true.

Mr Thompson—We can provide further information about Trust Bank. I may have been thinking about an estimates hearing two or three years ago which was devoted entirely to questioning about Trust Bank.

CHAIR—Turning to another topic, Mr Thompson, to what extent does APRA rely on external audit reports? You can answer it in relation to general insurance or in relation to superannuation if you wish.

Mr Thompson—We rely to varying extents on external auditors' reports.

Senator SHERRY—How about we go through in terms of subject area? We have the documents on superannuation on which I have a swag of questions. I have a couple of questions on CNAL. I have a couple of questions relating to the opening statement of Mr Thompson. He has raised the issue—

CHAIR—I have general questions in relation to four major issues which are not specific, and that is what I intended to cover.

Senator SHERRY—I was just thinking in terms of the flow of the committee. I am happy with general questions.

CHAIR—You say it varies, Mr Thompson. Can you quantify it a little bit for us?

Mr Thompson—The statutory obligations on external auditors vary from industry to industry. In the case of the banking industry, external auditors have a statutory obligation to

report to us on any developments that they think might be injurious to the interests of depositors. We hope that the government will introduce a similar requirement for the external auditors of general insurance companies in the legislation, which is scheduled to be introduced in the next few weeks and which we hope will become effective in the middle of next year. When that happens, the requirements on external auditors for general insurers will be similar to those that apply in the banking industry and in life insurance.

CHAIR—That leads me to my next question. Accountants and auditors have come under the spotlight. There have been calls to review auditing. Do you support the standards applicable to auditing?

Mr Thompson—Sorry, I did not hear you.

CHAIR—The accountants and auditors have come under the spotlight in relation to various failures because they have not picked up or uncovered a lot of problems. This question has been raised: do you or ASIC or the profession have a duty to review auditing and auditing standards, given the size of some of the failures and the failures of auditors to detect these at an early stage?

Mr Thompson—There could well be. Obviously, the royal commission into HIH will be investigating quite closely the role of the external auditors in that case.

CHAIR—Has it been a problem for you to date?

Mr Thompson—It is difficult to generalise. We find the external auditors' reports of use to us but they are only one element in our supervisory armoury. There are limitations on what the external auditors can do. We have explored with them over the years how far they can go in providing opinions on the adequacy of risk management systems in financial institutions. They are generally reluctant to express a view on the adequacy of systems. They feel that their skills and role are largely confined to expressing a view on the adequacy of financial statements and the financial controls in an institution. It was partly because of that limitation on what the external auditors were able and prepared to do in the banking area that on-site reviews of banks were commenced a decade ago.

Some years ago we introduced a system of asking the external auditors to do more targeted reviews for us, where we could provide more guidance on exactly which subject areas we would like them to express an opinion on. They are more comfortable with that model in the banking area, where there are more specific terms of reference for their work than a general request to draw to our attention anything that might be a matter of concern.

CHAIR—Do you think the legislation should be more prescriptive in terms of what is required of auditors in specialised areas, such as superannuation, general insurance, life insurance or even banking? Would it give regulators a higher degree of comfort in terms of reading their reports if auditors reported on specific things they had looked at, despite the fact that they say—perhaps in terms of certain systems—they are not well qualified to report on that, which would surprise me?

Mr Thompson—It is difficult to ask them to report on things that they are not qualified to report on. We have to find other ways of addressing those issues in a supervisory framework.

CHAIR—Do you think the public is aware of the fact that they are not qualified to report on such things as—as you reported—certain types of systems? That was how you described it, wasn't it?

Mr Thompson—The point that I made was that they were reluctant to report on the adequacy and quality of risk management systems—

CHAIR—Surprising!

Mr Thompson—or the risk appetite of banks because they felt that took them beyond their traditional role.

CHAIR—Traditions are going out fast in this highly technical world. I would have thought that shareholders, if not you, would certainly be looking to the audit report to cover such things as the adequacy of risk management. If they are not going to do it, who is going to do it?

Mr Thompson—For financial institutions, in the first instance it is the role of the board of directors and it is a matter, obviously, that a prudential supervisor takes an extremely close interest in. Increasingly prudential supervision is moving in the direction of focusing very much on the adequacy of risk management systems and relying less on simple quantitative ratios and absolute limits.

CHAIR—If we take that to its final conclusion, where you require these stringent requirements and you are going to look at them yourself, do you need auditors then? Are they a necessary part in terms of the system of checks and balances?

Mr Thompson—The auditors have an important role to play in providing an assurance about the accuracy of statements of financial condition. That is a different issue from forming judgments about the quality of risk management practices.

CHAIR—Thank you for your comments in relation to my comments in the chamber the other day about four or five areas that need improvement. The improvement information provided to APRA: what were you specifically referring to? That is the first area of change where you would like some enhancement or improvement.

Mr Thompson—The first area that we have been keen to tackle there is to get the information that we collect provided on a more timely basis. The other area that we are now looking at is improvements in the quality of that information. I might ask Mr Phelps to fill out a little more on that area.

Mr Phelps—What we would be trying to do is get information which would help in the analysis of the superannuation funds. What we get at the moment is essentially the size of the assets, whether they are in Australia or outside Australia, how many members there are, how much money went into the fund, how much money went out of the fund—that type of

information. It does not really allow you to get any insight into the quality of the assets of the superannuation fund.

CHAIR—What are the sorts of typical questions they will be facing in the future?

Mr Phelps—We would be looking for a break-up of the assets which would show, perhaps, commercial property mortgages, fixed interests and what sort of unit trust they were invested in. So you could then have something about which, without actually visiting the fund, you could get some idea and say, ‘This fund has got all its money in very high quality things and we can give them a medium risk or a low risk profile. But here’s another one that has got all its assets in commercial property mortgages, so we’d better go and see them and see who’s making those loans, whether they’ve got the credentials to make them and who they’re making them to.’ So it is trying to get information which allows some prudential assessment of the investment profile of the super fund.

The other thing which our present information flow does not allow, which is one of the questions that was put on notice to us, is the returns for the super fund. The information we get at the moment only allows that to be calculated by taking this number from that number and implying the return. It is not very accurate.

Senator SHERRY—So you are going to be asking for that information in future?

Mr Phelps—That is the sort of thing I would implement. For example, with our other supervision of friendly societies, credit unions and general insurance companies we are able to set what we call exceptions, so that if somebody comes in and their capital ratio is less than X, we want to know why. If their impaired assets are higher than this percentage—

Senator SHERRY—Mr Phelps, you are being a bit equivocal. Firstly, will you be asking funds for their declared return for each year? I know these things can be surveyed commercially, but there are thousands of funds. Secondly, will you be asking what their real rate of return is so we can actually get this data? More importantly, it is so that you can have it, but we would like a copy of it as well.

Mr Phelps—That is the sort of information which we would see as prudentially important to then be able to classify them in the sort of question you asked: how many funds made three per cent less than the average? There is also the simple question of how many funds made nothing or a small negative return—

Senator SHERRY—It is a good early warning sign of a problem, isn’t it?

Mr Phelps—Yes.

Senator SHERRY—Or late warning, depending on how bad it is. When are these changes being introduced?

Mr Phelps—There has to be about a year’s lag because there are so many super funds. To actually get everybody involved to agree to produce this information, we would have to—

Senator SHERRY—Sorry—when you say, ‘get everyone involved to agree to produce this information,’ why shouldn’t you just say, ‘We want this to improve prudential regulation and this is the information we want as the regulator’?

Mr Phelps—When I say ‘agree’, normally there would be consultation. You would get a lot of feedback that, ‘Well, we just can’t do that,’ for some reason, in the same way that, with respect to getting returns in on time, we got a lot of feedback to say, ‘We just can’t meet those deadlines.’

Senator SHERRY—From my point of view, that would be a nonsense argument. Go for it. If a fund cannot produce its return that is required to be in the annual report, and also tell you what the real rate of return is, frankly you are being given the run-around. We want to see you get into it and be a bit more pro-active. That is not unreasonable information.

CHAIR—There are some definitional problems, whether it is before commissions, after commissions and all those sorts of things.

Senator SHERRY—That was the other question.

CHAIR—They have not been standardised so two funds can report and get different results. Essentially, the result might be identical simply because of the manner in which they interpret how they report, or what they count as expenses or commissions and all these sorts of things.

Mr Phelps—Whether the expenses come out before the investment income. Yes, that is the argument why—

CHAIR—There is no standard there. First of all, I think this needs addressing as a matter of some priority because I know from my experience that there is a wide range of interpretations.

Senator SHERRY—I accept that, Chair. We have jumped far ahead of where I intended to be, in terms of the point in questioning. I asked on notice—and you could not provide it; I am not criticising you for that—for the details of fees and charges and commissions. Is it your intention to obtain that information as well on a comparable basis?

Mr Phelps—That has been thought of as a disclosure item to—

Senator SHERRY—Okay, Mr Phelps. But I cannot go to any sort of decent comparable report and say, ‘What are the fees and charges, the commissions, on these particular products?’ I have got anecdotal evidence of some outrageous behaviour with certain products. I would just like to know what is happening in this area. It is quite critical, particularly if the retail choice provisions ever get up. Take that on board. I just think it is critical information.

Mr Thompson—The short answer to the question that you are raising is that we have not finalised our thinking about exactly what additional information—the detail of what additional information—we would like to collect. We do not want to impose an unreasonable burden on the industry but at the same time, obviously, we definitely need better information than we are collecting at the moment.

Senator SHERRY—You would appreciate, Mr Thompson, in this wonderful world—I say that somewhat sarcastically—of choice, consumers are entitled to know what is happening across the industry. I have got examples where choice applies, and I have had a fund shown to me, in the mining industry in Tasmania, where the commission is 10 per cent. Ten per cent! I know that this is abnormal, but it is very important information.

Mr Thompson—I do not want to get into issues of what ASIC is responsible for and what APRA is responsible for. But in a world of choice, issues of disclosure and proper education of consumers so that they can make those choices in a well-informed way do fall more to ASIC than to us.

Senator SHERRY—We have this, to some extent, airy-fairy debate about choice. In the UK, when we had the so-called mis-selling, it took a number of years—people were being ripped off everywhere. I do not think that I am overstating it; there were hundreds of thousands of them. Then all of a sudden, two or three years down the track, you have this huge break-out in the media where people suddenly discover en masse that they have been ripped off. This sort of information is very important, whatever happens with the legislative framework.

Mr Thompson—Yes.

Senator SHERRY—Can I just come back to your opening statement. Have you read Mr Thorburn's evidence of our hearing on Thursday, 12 June?

Mr Thompson—Yes.

Senator SHERRY—Senator Allison, the chair, myself and Senator Conroy were left with very clear indications—a very clear outline, and I have got it here—of the scaling back of government actuarial oversight of insurance companies. Are you saying that this is incorrect?

Mr Thompson—I am saying that it was not a decision by APRA.

Senator SHERRY—The ISC. That is in the evidence.

Mr Thompson—The ISC, well before APRA was established. There is no doubt that sending general insurance company reports routinely to the office of the Australian Government Actuary used to be a practice in the Insurance and Superannuation Commission, and it ceased.

Senator SHERRY—When did it cease to be a practice?

Mr Thompson—I understand that it ceased progressively over 1996-97. It had ceased entirely by the time APRA was established. There is no question about that fact.

Senator SHERRY—So you can confirm—Mr Thorburn was a bit unsure; it took a number of questions to get to the point—that the last year when HIH had a full actuarial overview was 1998. That is correct, is it?

Mr Thompson—I am not sure about exactly what was done in connection with HIH.

Senator SHERRY—Okay. You foreshadowed changes—a new system.

Mr Thompson—Yes.

Senator SHERRY—When is this new actuarial assessment going to commence?

Mr Thompson—The government's present intention is to introduce amendments to the Insurance Act within the next week or two, I believe. Those amendments will introduce a whole raft of new powers and standards for prudential regulation of the general insurance industry.

Senator SHERRY—Including a full actuarial assessment by APRA?

Mr Thompson—No. My reference to actuaries in my statement was that, for the larger companies, legislation will require them to appoint an approved valuation actuary, someone along the lines of the appointed actuary that life insurance companies have to have. That appointed valuation actuary will not only provide actuarial advice for the company itself, but will have a statutory reporting obligation to APRA.

Senator SHERRY—Will they forward a document to APRA annually?

Mr Thompson—Their role will be to advise the board about the evaluation of the outstanding claims liabilities of the company. In the event that the company decides, for whatever reason, not to follow the advice of the appointed valuation actuary, that fact will need to be reported to us and reasons for the company deciding to adopt a different valuation approach will need to be set out in full for us. In that sense, we are not dictating that the company takes the advice of the appointed evaluation actuary, but we will need to know and have a clear explanation of each instance where that is not done.

Beyond that, the appointed valuation actuary will have a general reporting obligation to us—somewhat similar to the reporting obligation we were referring to earlier for the external auditors of banks—to draw to our attention any developments in the company that might be putting or are likely to put at risk the interests of policyholders. And there will be the usual whistleblower protections available to the valuation actuary who follows that course.

Senator SHERRY—So this actuarial assessment, which you have outlined, is carried out and a document goes to APRA. Will APRA, as a matter of course, at least annually, check that actuarial evaluation? Will it be only a spot check? What will happen?

Mr Thompson—The main element is that this actuary will have a reporting obligation to us. In the event that the company decides not to follow the advice of the actuary, a full explanation as to why not will need to be presented to us. If we are not satisfied with the explanation that the company gives as to why it is not following the advice of the valuation actuary, we will obviously have available other steps to inquire into that. In the event that there was this difference of opinion, we would have the power to commission a full-scale independent valuation ourselves.

Senator SHERRY—But what if the actuary is under pressure from the company board? How do you pick up whether the actuarial assessment is accurate in those sorts of circumstances

without actively going as the government authority to check or at least to give some sort of oversight and detail of the actuarial assessment?

Mr Thompson—We are hoping to deal with that by giving the actuary a statutory obligation and whistleblower protection.

Senator SHERRY—Auditors have statutory obligations.

Mr Thompson—Yes. If the view was taken that APRA or any other prudential supervisor should do its own full-scale independent actuarial valuation of every insurance company every year, we would be looking at a very much more intrusive, expensive system of regulation than we presently have.

Senator SHERRY—How much more expensive?

Mr Thompson—Actuaries are very expensive people to engage. I have not done the sums, but it would be a major expansion of APRA's activity. I think it would risk intruding on the role of the board and the management of a company to ultimately run their companies in a prudent way.

Senator SHERRY—But if it helps pick up problems such as HIH, isn't that a good thing? Surely the net cost is worth it?

Mr Thompson—That is a debatable issue, and it is a debate that the community might wish to have. All I can say is that that approach would take us down a rather different supervisory track than we have been following for the past decade or so. It would take us down a different supervisory track than that this followed by most other countries and it would be much more expensive than what we have now.

Senator SHERRY—Changing subjects slightly, I have been doing some research for the HIH bill, which is coming on tonight, and I was pleasantly surprised that the US, UK, Japan and Canada all have some sort of guarantee fund for insurance companies that collapse. I must say I was pleasantly surprised that this was the case with even the US—good old free enterprise and minimal government interference. What is APRA's view on such a guarantee fund to rescue the policyholders?

Mr Thompson—I think that is really a matter for government. Those guarantee funds are generally not established and administered by the prudential supervisor; they are usually established by government and administered by other—

Senator SHERRY—Except in the UK agencies.

Mr Thompson—That is true.

Senator SHERRY—In the UK they have a levy.

Mr Thompson—Yes. There are various ways you set these schemes up. They can be prefunded or postfunded. They can be funded from general revenue or by levies on industry. I guess the main point I was making was that it is really a matter of government policy as to whether a protection fund of that kind or an insurance fund of that kind should be established.

Senator SHERRY—But do you accept that what I say is true: that in those four countries I mentioned they have such a fund, differently structured but they have a fund?

Mr Thompson—In developed industrial countries it is more common than not to have protection funds of that kind.

Senator SHERRY—I did not survey Europe—I did not get time.

Senator HOGG—Mr Thompson, when you were speaking to Senator Sherry, I was trying to work out in my own mind what would trigger a reaction from APRA having received this actuarial report. Is it going to be, ‘Oh, well, we’ve received it,’ and it is filed in the bottom drawer awaiting another day? It does not seem to me as if there is any trigger mechanism there. Am I correct?

Mr Thompson—There is a trigger mechanism in that, if there is a difference of view between the evaluation actuary and the company as to how the provisions of the company should be valued in any year, that needs to be drawn to our attention and the reasons for the difference of view need to be spelt out.

Senator HOGG—That is the obvious trigger. But there might be nothing as obvious as that which would trigger any suspicion on the part of APRA that there was something wrong in the documentation that had been passed over to you.

Mr Thompson—There are a number of elements that could provide a trigger. One would be concerns raised by the auditors, who obviously take an interest in the actuarial process in producing the accounts of the company, because at the end of the day the auditors sign off that those accounts represent a true and fair position. So that is a potential trigger. In our on-site inspections of insurance companies, we would look first-hand at the process by which actuarial valuations were conducted and form a view about the adequacy of those processes. There are a number of possible triggers.

Senator HOGG—You still have not convinced me. I can understand a couple of those that you have just mentioned, but I am not convinced that there is a trigger there that is independent of the system that you pick up on and say, ‘Look, there is something substantially wrong,’ or ‘We suspect there is something wrong and therefore we need to intervene.’ You have it in your power, I believe, to set up the triggers such that you will know how to react and when to react to those triggers. I am trying to find out what triggers you need to put in place to allow for this greater transparency.

Mr Thompson—I have mentioned a number of—

Senator HOGG—Yes, you have mentioned two.

Mr Thompson—I mentioned the auditors—

Senator HOGG—Yes, the auditors—I agree.

Mr Thompson—The actuaries, who will have a clearer, more formal responsibility to report to us than in the past. The actuarial profession has high standards of professionalism and independence, and I believe that we can go a long way in relying on this new role of appointed valuation actuary, which has not existed in the past in the general insurance industry. My understanding is that the experience of the appointed actuary in the case of the life insurance industry has been relatively successful since it was introduced some years ago. If you are looking for an absolute fail-safe, that we will always know if there is some problem with a valuation of a company's liabilities, the answer is that, short of actually doing the job ourselves—coming back to the earlier discussion—there is no 100 per cent guarantee. Even then, there is probably no 100 per cent guarantee, because there is a good deal of subjectivity in the valuation of insurance company liabilities.

We believe that, once this new regime is in place from the middle of next year, the protections will be much stronger than they have been in the past. The other thing that will come in as part of the new standards next year, which has not been the case in the past, is a requirement for certain common assumptions to be fed into the valuation of insurance company liabilities across all companies. There will be a requirement for a prudential margin at a figure that we specify. So the extent to which companies can adopt different approaches to the valuation of their liabilities will be considerably reduced compared with the previous regime.

Senator HOGG—So what you are now telling me is that there is going to be a like with like comparison which would in many ways act as a trigger for you to see that something was out of the ordinary.

Mr Thompson—Yes, it would and we believe that there has been too much room for flexibility in valuation of claims provisions of insurers in the past and that flexibility will be much reduced in the new regime.

Senator ALLISON—Can you expand on your comment in your opening statement, Mr Thompson, that the main industry body advocated a 10 per cent cut in APRA from that sector for 2001-02? Firstly, can you just clarify what the arrangement is for the payment of fees to APRA? Secondly, you say that a more proactive approach will inevitably boost our budgetary needs: can you indicate what you think is necessary by way of an increase in those budgetary arrangements? Thirdly, is there an argument for a different way of raising fees by APRA, given that you point out that most of your enforcement actions have involved funds with less than \$5 million in assets?

Mr Thompson—On the first of those questions, APRA is funded by levies on the industries that we regulate. The levy rates are set each year by the Treasurer or, under delegation, by the Minister for Financial Services and Regulation.

Senator ALLISON—So it is not in legislation; the levy is set by the Treasurer.

Mr Thompson—The levy regime is set out in legislation, but the actual rates that will apply from one year to the next are determined each year by the Minister for Financial Services and Regulation. The legislation specifies maximum absolute amounts for each of the industry sectors, but beyond that the actual figures that apply for levies are not in legislation but are determined each year. What is determined each year is a levy rate, a rate per dollar of asset for each industry group, subject to a minimum amount in absolute terms and a maximum amount in absolute terms for each industry sector. So the process is that we will formulate a budget that we believe will be adequate for our purposes for the coming financial year; we discuss that with Treasury; a consultation paper is prepared for discussion with industry groups; industry groups express their views; then a recommendation, taking on board the industry comments, is forwarded from APRA and the Treasury to the minister for determination of the rates that will raise the amount that has been agreed.

Senator ALLISON—In the previous year when this took place, what was the difference between what APRA said it needed to perform this supervisory function and what was finally agreed?

Mr Thompson—For next financial year we basically have the funding that we thought was required.

Senator ALLISON—Which is what?

Mr Thompson—Our operating expenses for 2001-02 are budgeted at \$53 million.

Senator ALLISON—That is what you put to the Treasurer as being necessary?

Mr Thompson—Yes. That does not take into account any significant changes that might flow from this work that we have discussed in our Productivity Commission submission on superannuation, nor does it take into account costs associated with the royal commission, and it does not really build in a lot of fat for other surprises that might come along during the year.

Senator ALLISON—I am not sure I understand why it is that you seem to be suggesting that you could take a more proactive role in supervision if the budgetary arrangements were in place to do so, but that you did not ask for greater levels of funding for your operation. I am not sure what this means.

Mr Thompson—Our estimated operating costs for next year are higher than this year by \$2 million. We felt that that was adequate for the time being until we had gone further with this program that we have outlined in the Productivity Commission submission.

Senator ALLISON—So the extra \$2 million is to account for what you proposed to the Productivity Commission?

Mr Thompson—No, the extra \$2 million is what we assess we need to continue supervising as we have in the past year, with some additional topping up of resources in various areas. If, as a result of the program of work that we have outlined in the Productivity Commission submission, we decide that there is no alternative but significantly to boost the resources devoted to superannuation, then we would need to look for more funding than we have bid for

at this point. We felt that it was premature to do that until we had gone further in looking at the items that we have discussed here. It may be that with further rationalisation in the industry and with stronger powers, we may not need a significant increase in resources to cover the field effectively.

Senator ALLISON—To use your words, ‘A more proactive approach will inevitably boost our budgetary needs.’ Is that more proactive approach embodied in the Productivity Commission submission?

Mr Thompson—We intend to take a more proactive approach within the budgetary resources that we have bid for. If we came to the view, after completing the work—

Senator ALLISON—I am sorry, Mr Thompson, that is not what you said. You say in your opening statement, ‘A more proactive approach will inevitably boost our budgetary needs.’ Are you saying that is not the case now?

Mr Thompson—We have more funding for the next financial year than we had last year.

Senator SHERRY—But you said that is partly for the royal commission.

Mr Thompson—I said we have not provided anything in our budget for the royal commission. The industry argued that because the number of superannuation funds had actually fallen, our funding from the industry should decline. We have taken the view that, to be more proactive, as we would like to be within the existing powers that we have, notwithstanding that the number of funds has fallen, we needed at least the funding that we had last year. If we stepped up to a further level of activity, for instance, if we decided that the number of superannuation funds was going to remain at around the 3,000 mark that we currently have without approved trustees, and if we decided that to supervise those funds fully effectively required us to visit each of them every year, then we would need a further significant increase in our existing resources. But we have not come to that point yet because there may be other ways—

Senator ALLISON—Could you put a figure on that activity?

Mr Thompson—I am not sure that I can.

Mr Phelps—No. The present cycle sees us trying to visit smaller superannuation funds every five years and larger ones every three years, so to do it every year would be an extensive increase in required resources.

Senator SHERRY—But do you meet the current aim anyway—of three- and five-year visits?

Mr Phelps—It has not been met for the smallest institutions because we are still getting around to see some of them now for the first time.

Senator SHERRY—How long has it been then since the smaller funds have had a look-over and a visit?

Mr Phelps—For some of them it would be six years—the really small ones. That is why we are concentrating a lot of effort on them this year to make sure that there are not any super funds left that have not been visited by APRA or the ISC.

CHAIR—You did approach the risk assessment for information that comes to hand. Shouldn't you be looking at it on the basis of perceived weaknesses—like the tax office does when deciding whom they want to audit?

Mr Phelps—We do have some signals—for example, we keep an eye on companies that are having difficulties, because obviously their super funds might be a temptation for people to mishandle the superannuation money. As I said before, the information that we get annually from the super funds is more information about the size of the industry, the number of members and the size of the assets, rather than things that really help to zero in on institutions that are high risk. On the question of resources, if you could get that information which allowed you to better risk-rate the organisation, then you may not need so many resources for going visiting people, because you could make sure that you visited the right ones.

CHAIR—That is the point I am making about risk assessment.

Mr Thompson—And that comes back to the discussion earlier about the quality of information that we collect from these funds. In designing these new returns that we were discussing earlier, we would like to be in a—

Senator SHERRY—Would it make life a lot easier if, let us say, one of the minimum requirements was capital of \$5 million or \$10 million, and a lot of these smaller funds would obviously cease to exist. Would that make prudential regulation easier?

Mr Thompson—There are two parts to the answer. If there were fewer funds, the answer is yes. One of the difficulties at the moment was mentioned in a comment that Mr Macfarlane made a couple of months back that we have subsequently expanded on in various places. One of the difficulties in this sector is simply the number of players. But the addition of a capital requirement of some kind—even with the same number—would give us an extra degree of comfort as prudential supervisor because there would be some buffer there to absorb losses or misadventures of various kinds that funds encounter from time to time. The thing that distinguishes the great bulk of superannuation funds from every other sector in the financial system that we regulate is the absence of a capital buffer.

Senator CONROY—I wanted to refer to your glowing self-assessment of the regulatory system as undoubtedly one of the best and most highly regarded in the world. Noting your earlier comments about heading off problems before they became serious, which part of the \$840 million write-off that HIH had to make—which Mr Walker has now indicated that it had to make for the FAI purchase—did you head off?

Mr Thompson—I do not really think it is appropriate to get into the detail of HIH this evening.

Senator CONROY—I was not actually going to go into any detail about any of these things until I heard and read your opening statement. So I think, unfortunately, that you have invited the detail.

Mr Thompson—I said that that is one of the objectives. As we know, what has happened with HIH is not something that—

Senator CONROY—Is not something—

Mr Thompson—is welcome in any sense. We are having a royal commission to look into the reasons. One of the things which is obvious to us is that the prudential regulatory regime for general insurance companies was deficient, and that is why we have moved, as a matter of priority, to develop a new system which we hope will be introduced next year.

Senator CONROY—But originally, before this debacle, it was going to come fully into force in the year 2007, on your recommendations to cabinet.

Mr Thompson—That was never the case, Senator.

Senator CONROY—It was adopted by cabinet on your recommendation.

Mr Thompson—That was never the case.

Senator CONROY—I am sorry, but the officers testified—

Mr Thompson—The only element that was ever due to be delayed until 2007 was the move to fully implement the new capital standards—

Senator CONROY—And you do not think they were material to HIH falling over?

Mr Thompson—which is only one element of the new regime. The other elements, some of which we have discussed this evening, such as the appointed valuation actuary—

Senator CONROY—They were all available under the existing act.

CHAIR—Senator Conroy, let Mr Thompson finish.

Mr Thompson—and more consistency required in the valuation of claims provisions—in fact, all of the other elements of the new regime, including capital charges for operational risk, asset concentration risk and various other components, would all have been fully effective from day one. The only transitional arrangements that have ever been envisaged were in relation to full compliance with the new minimum capital standards. They are important—I am not suggesting that they are not—but they are not the whole regime. They were predominantly intended to give some breathing space to the small companies which will be affected by the increased minimum requirement from \$2 million to \$5 million in capital.

Senator CONROY—In relation to the valuation actuary, those powers exist under the current Insurance Act. I think you were here on the day that I went through this with your officers at some length.

Mr Thompson—There is no concept of an appointed valuation actuary in the present legislation.

Senator CONROY—You can instruct them to get a proper valuation.

Mr Thompson—Yes.

Senator CONROY—So with respect to the valuation question, if your officers had been heading off problems before they arose, you could have sought this. You could have received, asked for, or required receipt of independent actuarial advice or perhaps even asked for their own, but you did not.

Mr Thompson—Are we talking about HIH?

Senator CONROY—We are talking about HIH.

Mr Thompson—We went through that.

Senator CONROY—We did, and I am concerned that your answer seems to be trying to suggest—and you have made it now on a number of points—that the existing regulatory framework was flawed. *Hansard* will give us the exact words you said.

Mr Thompson—Yes.

Senator CONROY—The point I have sought to discuss with you and your officers over the last month concerns the existing powers that you had, and whether or not they are flawed, as you now claim.

Mr Thompson—I am not debating that, Senator. I am describing what I would regard as a very important element in the requirements that will be introduced next year, which is a requirement that all large companies will have an appointed valuation actuary with statutory reporting obligations to us.

Senator CONROY—Which you could achieve right now. You could just tell them that they have to have one of these. You do not need a new act of parliament to tell them to provide you with independent actuarial advice. You can direct it right now under your legislation.

Mr Thompson—I am not sure if that is the case. Certainly, the whistleblowers protection, which will be provided in the new legislation, would not be available under current legislation.

Senator CONROY—I accept the whistleblower protection. But in terms of getting actuarial advice, in a moment or two I will be able to quote to you a section of the act which you

administer which indicates that you are entitled to ask for these things. I will come back to that in a minute.

Mr Thompson—I know that, Senator. That is a provision in the existing act—

Senator CONROY—Yes, thank you.

Mr Thompson—and we will continue to have that power. What we will have in addition is an appointed valuation actuary working for each company with a continuous statutory reporting obligation to us.

Senator CONROY—But you could get that now.

Mr Thompson—I am not sure that we can actually do that.

Senator CONROY—Once a year you could say, ‘You’re going to do this.’

Mr Thompson—I am not sure if that is the case, but—

Senator CONROY—We both agreed that you have the power under the act to ask for these things. All I am saying to you is that, if you wanted to, you could ask for them regularly under the existing act.

Mr Thompson—There is the power to commission an independent valuation, and we discussed that at some length some time back. I see that as being distinct from creating a new role, as we will do next year, for an appointed valuation actuary with continuous reporting obligations to us. We will have that role in addition to the powers that are currently in the act. I do not see them as being the same thing.

Senator CONROY—One is an ongoing thing that happens automatically, and one would happen if you asked. I accept that there is a hair to split there in terms of the information that APRA would receive and how it received it. It is a great hair to split; we are at least agreed on that. The liquidator has now indicated that the FAI debt is \$840 million, 2½ years after APRA approved the takeover on the basis that there was no prudential threat by HIH. Which respect to the \$840 million, how did you help to head off problems before they occurred in this ‘world’s best regulatory system’?

Mr Thompson—We are moving to a much stronger system of prudential regulation of general insurance. I am not able to go into chapter and verse of APRA’s activities, investigations and recommendations in relation to HIH or the FAI transaction some years ago. The staff who were involved are no longer with us. At the moment, we are busily putting together our submission to the royal commission. I really do not think it is reasonable for us to delve into that ahead of the royal commission and until we have had an opportunity to put together our records, to interview the staff involved and various other things that will need to be done in preparation for the Royal Commission.

Senator CONROY—It is a bit late to be pleading the fifth. We have now had three meetings where we discussed this at length.

Mr Thompson—I appreciate that, but I cannot give you a detailed answer to that particular question. We now have the terms of reference of the royal commission, which we have not had previously. I would prefer that APRA be allowed to put together its submission to that royal commission. We have not done that, and I am not in a position to discuss it in detail.

Senator CONROY—The Taxation Office refuses to answer questions by the parliament because there is a court case against it; we now have APRA saying, ‘We’re not going to answer questions because we’ve got a royal commission going on.’ This is the parliament. This is the oversight of your organisation.

Mr Thompson—I am not able to answer that particular question, even if I thought it were appropriate to do so.

CHAIR—You can have one last question, Senator Sherry, before we move to CNAL.

Senator SHERRY—It will depend on the answer. I know you want to get onto CNAL, and so do I.

CHAIR—Before you start, I want to move to Commercial Nominees, where we will start with an update. Following that, we want an update on Queensland funds like Law Employees, EPAS, and those sorts of things. We do have quite a lot to cover.

Senator SHERRY—There is information you can provide to us from documents available to APRA, which does not require any research. I understand that there were a number of communications from Mr Karp to the minister about the position of HIH, specifically but not exclusively, on 2 November and 28 February, and APRA’s statutory obligation to advise the minister about the financial condition of HIH. Can those correspondences be provided to the committee?

CHAIR—Take care, because information to the minister of a general nature is not permissible in terms of statutory information. I might have to take advice on that one.

Senator SHERRY—I am asking.

Mr Thompson—My view is that we are probably not in a position to provide a copy of the advice we provided to the minister.

Senator SHERRY—Can you tell me what part of the act precludes you from doing that?

Mr Thompson—I thought it was part of the processes of Senate committees that statutory authorities and departments of government would not share with committees the content of their advice to ministers, but I am happy to take advice on that.

Senator CONROY—But you are cooperating with the royal commission.

CHAIR—There are two components, though. There is advice to ministers.

Senator SHERRY—It is not policy advice.

CHAIR—You are obliged to report to a minister in relation to a default. I am not sure whether that is protected.

Senator SHERRY—I do not believe it is.

CHAIR—That is where I might need some advice.

Senator CONROY—I think Senator Watson is correct.

CHAIR—The first one certainly is.

Senator CONROY—It is part of your statutory reporting requirements.

Mr Thompson—I agree with the senator; I think we should take advice.

Senator CONROY—You are cooperating with the royal commission and providing them with this information?

Senator SHERRY—They probably have not asked for it yet.

Senator CONROY—I am looking at an article where your spokesperson indicates that you intend to cooperate fully with the royal commission.

CHAIR—Have you finished your question, Senator Sherry?

Senator SHERRY—The royal commission is a royal commission—I understand what that is all about—but that does not prohibit the parliament and its committees—

Senator CONROY—At any stage.

Senator SHERRY—That is right. It does not prohibit the parliament, at any stage, from asking for—and I believe it should receive—information. I do not believe we are giving you an onerous request. We have asked about HIH. Frankly, we could have gone for hours, weeks and months on HIH, but there is a royal commission.

CHAIR—We have limited time tonight.

Senator SHERRY—Yes, but there is certain information that I think is very readily available and should be provided to the Senate committee.

CHAIR—Are you asking questions? You have made your statement. We will move to questions on Commercial Nominees. Can somebody give us an update in relation to

Commercial Nominees? I understand a number of the allocated pension people have started to receive some payments. Can you give us an update there?

Mr Thompson—I will defer to Mr Phelps on Commercial Nominees.

CHAIR—The questions will be confined to Commercial Nominees firstly.

Mr Phelps—There are new trustees in place for the various superannuation funds, where CNA was previously the trustee. Those trustees have got the pensions flowing again and are getting the funds in order. The accounts for last year were not done and the accounts for this year have to be done. The funds need to have those accounts and audits done to remain complying superannuation funds, so that is being attended to by those new trustees.

The new trustees are simultaneously seeing what evidence they can put together to assist in cases which might be brought against people that ran CNAL. There is also an inspector in place, and that inspector's job is to piece together that evidence. There are new trustees in the enhanced cash management trust and the enhanced equity fund. Ferriers are in there. They are piecing together evidence and making claims for loans and trying to recover assets. People within APRA are coordinating the efforts and the evidence that is coming from these various sources with a view to bringing whatever actions can be brought against the previous directors of CNAL. So that is the process that is in full swing at the moment.

CHAIR—Given that 80 per cent of the funds in the cash management fund have been lost, what new sources of funds are coming in to pay these allocated pensions? They are not being paid ahead of other obligations in terms of indebtedness within the enhanced tax management fund, are they? Have they been given a priority so that you can commence these pensions? What about the other moneys that are in the funds? It is not jeopardising their entitlements to moneys, is it? I just want to make sure that there is no conflict between all the competing parts.

Mr Phelps—It was noted from the material that was provided a fortnight ago that we had not mentioned that the pensions had all been reconstituted. The pensions have been reconstituted because many of the people had money in things other than the cash management trust. The cash management trust was only one part of their investments. That is not the case in all cases. As you well know and we well know, some people had 100 per cent in the cash management trust. The reason that the pensions have begun to get going again is that those people had assets other than in the cash management trust.

CHAIR—But the pensions of people who had assets only in the cash management trust have not started. Is that right?

Mr Phelps—The information from Pricewaterhouse was that all pensions have been recommenced. That would imply that there was nobody on a pension who had money only in the cash management trust. As you quite rightly point out, the cash management trust is presently worth only 20 cents in the dollar.

CHAIR—What moneys have you recovered, and who have you recovered moneys from? Have you sued auditors or directors or people like that?

Mr Phelps—No, that has not happened yet. The evidence is still being accumulated from both sides: from the individuals who had documentation about where their money was going; and from Ferriers, who are looking at the actual transactions that the trusts were involved in. That information is being collated and strategies are being developed to take action, but to this point no action has been instigated.

Senator HOGG—What sort of time line do you have in mind there? One of the problems here is that, to those people, it seems to be dragging on and on. You must have in mind some fixed point in time to bring this to some sort of conclusion such that decisive action can be taken.

Mr Phelps—Our objective would be within a couple of months, but that depends on our getting our hands on things that the courts will accept as concrete evidence. That is our objective.

Senator SHERRY—I am glad you did not ask how long is a piece of string.

Senator ALLISON—When did APRA become aware that some of the investments were not at arms length from the organisation? When you understood that, what action was taken? What was possible to be taken?

Mr Phelps—As we mentioned previously, the main event was the new directors coming in on 15 March last year and saying that they had two trusts that had inappropriate investments in them that had been made by the former directors. As the reports came in from the investigator during that year, there was certainly evidence of related party transactions—where the evidence did not come through was that these transactions were not done at arms length. That is the sort of information that is now being pieced together. There is a complete new trustee who has all the records of the previous company.

Senator ALLISON—What process could have been adopted to make that apparent at an earlier stage?

Mr Phelps—For it to become apparent at an earlier stage, I would say that APRA would have had to appoint an inspector—an investigator was appointed—into the whole operations of CNA. The reason that was not done at the time was that these new directors seemed to have no affiliations with the past. It was almost as if there was a new trustee. It was thought that the combination of these new directors with an investigator would get to the bottom of whether these assets could be realised and, in the process of trying to realise assets, they would find out for sure whether they were done at non-arms length terms and conditions in the first place. The fact that a loan cannot be recovered is pretty strong evidence that it was not made on proper terms.

The question you asked me a fortnight ago was: were the terms of reference for the investigator broad enough? I conceded that if I had the time over a much broader brief would have been given, but it was thought that the combination of new people who seemed committed to sorting things out would get to the answers—but in the event they did not.

Senator ALLISON—What could APRA have done had it understood the close relationship that existed? What would be in your powers, having discovered the situation which eventuated?

Mr Phelps—The sorts of things which could have been done would have been to have inspectors investigate the whole of the affairs of the CNA, not just the things that related to the three funds that the investigator was appointed to. The process which is normally followed is to get the trustees out and get new trustees in who have got complete access to all the records. We did not feel as though we had sufficient evidence to do that until it was done, in one case in November and in the other case in February. But that is the sort of process which would have had to have been followed: to write to them and give them show-cause that we were going to take their licence off them altogether. Speeding up the process would have involved having to do that earlier in the piece, and it was essentially a matter of judgment as to whether the evidence that was coming through about the quality of these assets was sufficient to take that step.

Senator SHERRY—I have received, via Mr Bob Horne who is a member of the House of Representatives, some correspondence from a Mrs Margaret Lawrence who says she represents approximately 25 former employees of National Textiles. You would be aware of National Textiles and the difficulties the employees had getting their entitlements. Having been through that stress, they were informed—

CHAIR—Is this to do with the CNA audit?

Senator SHERRY—Yes, I am getting to it. They were informed by NSP Buck Pty Ltd in October 2000 that if they did not do anything proactively their moneys would be transferred to the Australian Workforce Eligible Rollover Fund administered by CNAL. Mrs Lawrence has been advised that the moneys that she received as a result of the collapse of National Textiles were placed in the new pooled division and that it is not an impaired asset—in other words that her money is safe. That is what she has been advised, but she is being told that she cannot access the money before 30 November this year. Can you tell me why that is?

Mr Burgess—I can answer that. I have spoken to Mrs Lawrence on a number of occasions. About the second pool division, the non-exposure to impaired assets is correct. I would be guessing, but about three weeks ago I put Mrs Lawrence in touch directly with Mr Peter Hedge, the director of Oak Breeze, the acting trustee of the Australian Workforce Eligible Rollover Fund, to try and sort out the problem that she had and get her access to her funds at an earlier date.

One of the problems that all of the acting trustees have had, including the acting trustees of the two unit trusts, is the state of the records and the lack of records. I believe that the date that Mrs Lawrence is probably referring to is 31 October, which is a date that APRA and the acting trustees have agreed for them to retire on, having prepared the tax returns and the APRA returns for some funds for 1999, all of the funds for 2000 and all the funds for 2001.

Senator SHERRY—Can you appreciate the trauma this poor woman is going through, along with the former employees of National Textiles? They had been through one battle, thinking they had lost their money and their entitlements. They got it, and now they are going through commercial nominees. That must be shocking!

Mr Burgess—That was why I intervened and arranged for Mrs Lawrence to speak directly to Peter Hedge. I have not received any feedback but, if you would like me to take that on notice, I can follow it up.

Senator SHERRY—Yes, if you could. Mrs Lawrence is distraught. Whether it is the end of October or early November—whatever the date is—it is still some months away. My understanding is that Mrs Lawrence cannot claim social security because it as admitted asset that she will get back at some time in the future. Because of the existence of that admitted asset, she cannot claim anything. Again, this is additional pressure being brought to bear on Mrs Lawrence and her colleagues who were formerly from National Textiles.

CHAIR—The evidence that we got from Centrelink in Hobart was that that is discounted for the purposes of the pension.

Senator SHERRY—That is true, but I am not sure whether that evidence actually went to CNAL in this particular case.

Mr Burgess—My understanding is that Mrs Lawrence's funds are 100c in the dollar. She has no exposure to any impaired assets.

Senator SHERRY—But she cannot access the assets at the moment.

Mr Burgess—That is correct.

CHAIR—That is not impaired.

Senator SHERRY—For that reason she cannot access social security. So she has nothing at the moment. That is my understanding.

Mr Burgess—I will take it on notice and follow it up and come back to the committee.

CHAIR—I have just received an email from Mr Trimmer which says:

I've obtained a copy of Hansard Proof Copy, from the 12 June Select Committee, chaired by Senator Watson. I need to refer the Senate and Committee to a number of items therein, where the facts may not exactly match the comments/evidence recorded:

Page SFS 1108—Senator Watson asks Mr Hedge (of Oak Breeze—newly appointed Trustee to the ex-CNAL 400-500 'small APRA' superannuation fund, of which 8 are my clients) twice, whether superannuation pensions had been recommenced to consumers—Mr Hedge answers 'yes' twice.

Just in case this implies to the SFS Select Committee that ALL allocated pensions have been re-commenced, I wish to stress that this is certainly NOT the case. One of my clients had his Allocated Pension payment stopped for November 2000 (last paid Oct 2000). It has not been reinstated.

If you require further details, I will seek the client's permission to disclose further information.

I do not ask you to respond straight away. You might like to take that on notice and get back to Mr Hedge. That is a serious issue. As there are no further questions on CNAL, we might move

to the other areas. You have taken on notice a number of questions. Are you having any difficulties responding to any of those questions?

Mr Phelps—We provided some information this morning with respect to the questions that were asked last Thursday.

CHAIR—We have some more questions that we will put on notice for you. Can you give us an update, where appropriate, on the status of APRA's activities in relation to the Law Employees Superannuation Fund? Has there been any progress?

Mr Phelps—The issue with the Law Employees Superannuation Fund was reviewed by APRA in early 1999. On the basis of that, there was to be no further APRA action taken. But I understand that there are some aspects of that which ASIC are still reviewing. That is the current situation.

CHAIR—Is ASIC keeping you informed about what they are doing?

Mr Phelps—They are not keeping us informed on a day to day basis, but we know they are still making inquiries.

CHAIR—As there are no further questions on the Law Employees Superannuation Fund, we will move to the Employees Productivity Award Superannuation Fund, EPAS. Can you give us an update on that?

Mr Phelps—Similarly, with EPAS, ASIC announced that they were taking the action. They are running that case and are in the process of taking statements and getting their case together.

Senator SHERRY—Have they laid charges yet?

Mr Phelps—They have filed—

Senator SHERRY—They have filed the charges?

Mr Phelps—Yes.

Senator SHERRY—Does that include theft and fraud? That is critical in terms of the compensation provisions.

Mr Phelps—I have the actual statement that ASIC put out when they laid the charges. There are about five or six areas.

Senator SHERRY—It is on the public record, is it?

Mr Phelps—Yes.

Senator SHERRY—To save time, could you give that to us and, if there is any further information, could you let us know?

Mr Phelps—It is included with one of the documents that we supplied previously. I have it here somewhere.

Senator SHERRY—Have they had replacement trustees?

Mr Phelps—In the EPAS case, the trustees retired in favour—

Senator SHERRY—What do you mean by ‘retired’?

Mr Phelps—They handed it over to another—

Senator SHERRY—They had no option, though, did they?

Mr Phelps—No.

Senator SHERRY—I do not want to transgress into some of the evidence that was given in camera before, but is there a clear policy for determining who replacement trustees will be?

Mr Phelps—Yes. In the material that we supplied a week ago, we said that, in the CNAL case, we invited applications from firms which we felt would have had the resources, the solvency and the experience—

Senator SHERRY—I saw that. Is that standard policy?

Mr Phelps—Yes. We get four submissions in. We go through them and pick people from the four.

Senator SHERRY—Does that include from associated industry fund coverage? For example, with EPAS—the motel industry overwhelmingly—there are existing hospitality industry funds. Does it include a submission from them?

Mr Phelps—It has not. In certain circumstances I think it could be quite sensible thing to include a bigger fund. The process up to now has looked more at professional trustees who could step in and be the acting trustee. In all other industries that we look after, the more usual thing is for a bigger entity to absorb the smaller entity. I have seen some cases in the last 18 months where I think that would be—

Senator SHERRY—Sorry—you have seen some cases where that has happened?

Mr Phelps—No, not where it has happened but where I think it might have been a better thing to have happened.

Senator SHERRY—Given what you have just said, why is it not going to be policy to do that?

Mr Phelps—It could be an alternative in some cases for funds having sort of closed down. I mean, the trustees have taken the decision to close themselves down and put all their workers into AMP or some sort of major—

Senator SHERRY—I understand that. I have actually done that myself as a former trustee of a fund. But, where there is a fund that is relevant in the motel or hospitality industry, surely it would be a good idea as a matter of policy to at least invite them to put forward a submission for administering and eventually taking over the fund? Don't you think that is a good idea?

Mr Phelps—Certainly, we usually have trouble getting a big enough list of people who are suitable; so any suggestions regarding where we might get some more applicants is good.

CHAIR—Has the Hairdressers Association Superannuation Fund come good?

Mr Phelps—The problems which you were told about in Brisbane really happened back in 1991, 1992 and 1993 under previous legislation.

CHAIR—My last report was that they are performing extremely well.

Mr Phelps—Once a new administrator was appointed and some new trustees were put in place, in about 1994-95, the advice they had was they would be most unlikely to be successful in actions against the previous trustees because the previous legislation did not really provide the props to take that action. The fund has been visited a couple of times by our officers in the ensuing years and has been commented upon quite favourably.

CHAIR—I move to the West Australian case where a trustee of a solicitors fund was convicted of fraud. Are these the sorts of funds that Mr Macfarlane was talking about?

Mr Phelps—Yes. In fact, that one was a multi-employer sponsored fund where there were several groups of solicitors using these two solicitors to run the fund. The solicitor that admitted the fraud has been committed and sentenced to a jail term.

Senator SHERRY—How long was the sentence?

Mr Phelps—I think it was six years. What transpired was that this trustee had been reworking the books for a period of about five or six years. He admitted to stealing about \$250,000. By carefully reconstructing the accounts over the last five years, and liaising with the people about exactly how much they thought their contributions to the fund were, it would now appear that the amounts which have been stolen, defrauded, are well over \$250,000.

Senator SHERRY—Is interest included in that or not?

Mr Phelps—It works both ways. Some of the investments which were recorded in the accounts as having made excellent returns were, in fact, never made in the first place. So the money was stolen before and the whole investment was fictitious. This fund was producing information to members that it was making 21 per cent and 18 per cent but, in fact, some of the investments which were recorded as having been made were never actually purchased by the

trustee. The new trustee is now getting to the end of all that reconstruction and has reached the point of being able to say, 'Here is the amount of money that has been defrauded.' The new trustee will be submitting a claim for compensation under the legislation.

CHAIR—So there will be full restitution by somebody?

Mr Phelps—As we know, Senator, this legislation has not been activated previously; this will be the first one through. There is that section which says that it has to be in the public interest and so we have got—

CHAIR—Again, 'in the public interest' does not really mean that it has to be half a million Australians who are affected. It can be a small number of Australians; it can still be in the public interest if they have lost a substantial amount of their superannuation savings.

Mr Thompson—It is a ministerial decision to activate this fund.

CHAIR—There is no public interest provision in section 229 though, is there?

Mr Stow—Perhaps I could answer that. The minister may make a determination under section 229, as to financial assistance, if he is satisfied that it is in the public interest.

Senator SHERRY—It does not say 'public interest'.

CHAIR—It does not talk about public interest.

Senator SHERRY—It says, 'The trustee may apply to the minister for a grant of financial assistance.'

CHAIR—That is all it says.

Mr Thompson—The important thing is that it is a ministerial decision.

CHAIR—Yes. We will await that decision.

Senator SHERRY—That is the first time we have the potential of the compensation mechanism being activated in Australia, isn't it?

Mr Phelps—Yes.

CHAIR—Or maybe CNAL, depending on what amount of money you can recover.

Mr Thompson—CNAL could be another case if fraud is established.

CHAIR—If you do not recover enough money.

Mr Thompson—This is not a pre-funded protection scheme. As I understand it, the funding is either from consolidated revenue or by way of levy on industry.

CHAIR—There have been certain reports within the industry that APRA has been asked to resolve certain management issues within Host Plus. Are these serious and is the security of their money impaired in any way? We have had a phone call or two about that. We understand APRA has been called in. What has happened?

Mr Phelps—It is not normal to talk about individual institutions' work in these hearings.

CHAIR—Do you want to go in camera? We did that in relation to questions on another fund on one occasion.

Senator SHERRY—Chair, as you have raised it publicly, it is a bit difficult for them not to complete their answer in public.

CHAIR—The other one was in public, and we took the details in private. Is it the wish of everybody to go into camera on this aspect?

Mr Phelps—It is not to do with the investments or the investment profile of the organisation.

CHAIR—So they are secure and there is no risk of that?

Mr Phelps—It is to do with decision making processes at the board level.

CHAIR—You might like to give us a document so that we might consider its status at a later point.

Mr Thompson—We would be happy to.

CHAIR—In view of what happened to a couple of the other funds, perhaps we should get that information.

Senator SHERRY—By way of general description, is this a minor dispute? If it is not going to the financial health of the fund, do you consider it to be a minor matter, an administrative matter or a decision making matter?

CHAIR—We are not sure but, if APRA has been called in, what do we mean 'called in'? Perhaps you might like to take it in that we will consider the status of the document when we have received the details.

Senator SHERRY—Following on from that, when you say, Mr Chair, that APRA has been called in, it would not be unusual for queries to be raised with APRA about a whole host of funds, for a whole host of reasons.

Mr Phelps—It is not unusual at all.

Senator SHERRY—I must say I have to declare an interest. I am a member of Host Plus. I am not an active member, but I have some money there. I was a bit worried when the chair initially raised it.

CHAIR—I just commented on reports.

Senator SHERRY—So long as the declared returns of the last ten years continue, I will be extraordinarily happy. They are fantastic returns.

Mr Thompson—If we could provide something to the committee in writing, that might be the best way to proceed.

CHAIR—Senator Sherry, do you want to comment on Mr Macfarlane's comments?

Senator SHERRY—Thank you for providing the information you did, as it gives us a good base to go on. You are aware of Mr Macfarlane's comments about small and medium sized funds. Can you be a bit more precise to the committee? What are we looking at here, from APRA's point of view, in terms of the size of the fund, number of members, asset size and that sort of thing?

Mr Phelps—The ones that have drawn the most attention have been managing up to, say, \$5 million. Some of these funds would have a couple of hundred members, but more typically they have 20 or 30 members. You could say that a lot of the issues will be resolved as the grandfathering provisions for the in-house assets gradually disappear, but that is not the whole answer to this and it will be quite a long-term solution if that is the one that is relied upon. The issue is funds that have three commercial properties that are all pretty much in the same sort of area in the same sort of industry and look awfully like a concentration of risk, and yet the investment strategy says that they are going to invest in property. It is funds that finish up with all their money in a car park. The act says that there should be diversification, yet it also says that as long as the trustees take that into consideration and implement a strategy the only penalty is that, if the investment finishes up going wrong, members can take action against them for having that strategy.

We are taking much greater interest in the actual investments of funds. You will see from the list of things that we come across when we visit funds that there are a lot of things which are very important, like equal representation and making sure that that is handled properly, that the fund keeps proper minutes, that the trustees meet regularly. If you were going to see somebody only once every five years or so, you would probably say, 'What I need to be sure of is that this fund is being run properly and that the trustees understand their responsibilities. I need to know that I can go away and come back in five years time and expect it still to be being done properly.' That is quite a legitimate approach. But the reports that I was getting when I first came into this job did not go on and say, 'These are the investments.' It is the investments that bring us all unstuck. The culture really was to say, 'If the trustees have selected these investments in good faith and after careful consideration, it is their investment strategy and it is the trustees' right to be able to do that.' We have already started to be more forceful in expressing an opinion about whether having just three properties is enough diversification.

Senator SHERRY—If you express an opinion that it is not enough, can you tell them to change their investment strategy? Do you have the power to do that?

Mr Phelps—At the moment, you would have to go back and say, 'We think that this sort of strategy will, over time, lead to an impairment of the fund or an unsatisfactory condition of the

fund.’ We would then be in the position of our prediction versus their prediction. As we have said, in a lot of cases, once you point out to these people that they have an unbalanced portfolio, they are quite happy to talk and to try to fix it up.

Senator SHERRY—You say ‘lack of equal representation’—I thought that there was a requirement for equal representation of employer and employee trustees.

Mr Phelps—There is.

Senator SHERRY—So some of them are just not doing it?

Mr Phelps—Yes. Sometimes we go along and there have been, say, two of each. Somebody has dropped out of the trustee board, and they have not got around to filling the job. So one of our things is to get it filled.

Senator SHERRY—One thing that has worried me a lot is the extent to which employee trustees are genuinely employee trustees. I have seen cases where employers suggest that a fund be set up and the employee representatives end up being the accountant and some other person in management. In theory, they take their hat off as part of the management team and put a new hat on when they go into the trustee meeting representing employees. Have you done any work as to whether or not they are genuinely employee representatives?

Mr Phelps—No, Senator. There is no study that we could point to. There is a question—a slightly different point from the one you are making—as to whether employee representatives get overawed or bullied or overrun by the employer representatives. That is a suggestion that is sometimes made.

Senator SHERRY—If you were an employee and your boss was sitting at the same trustee meeting, it is a great theory to say that you will act independently but in practice it is not quite so easy to be independent. Can you understand that?

Mr Phelps—Yes, I can understand that. And I would think that probably the smaller the firm the more difficult that would become.

Senator SHERRY—You say ‘lack of indemnity insurance’. It is not a requirement at the moment, is it?

Mr Phelps—No. As long as they disclose it, they can have no indemnity insurance.

Senator SHERRY—Disclose it?

Mr Phelps—They are meant to put it in their statement to members.

Senator ALLISON—On a slightly different subject: I have been looking through the list you provided of actions and the number of auditors who have been found wanting in various ways. Is it possible to give the committee some sort of characterisation of these auditors? Are they all one-off operators, small accountancy firms, or do they come from large organisations? It is an

extraordinary number. I would have thought that auditors were more trustworthy people than this would suggest.

Mr Phelps—One of the important sources of those auditors getting disqualified was the large number of family funds, excluded funds, that went to the tax department. Because there were 200,000 of those funds, one of the techniques for monitoring what was happening in that sector was to go to some of the suburban accountants that might be doing it for 30 or 40 funds and to try to become convinced that the auditor knew what they were doing and that, when they signed their certificates to say that these were compliant funds, they really were so. That process turned up most of those people who got disqualified, because people were signing compliance certificates and it was quite clear from investigation that they really were not correct. They were mainly small auditors doing small funds.

Senator ALLISON—But some of them were undertaking fraudulent practices; they were not just being a bit incompetent?

Mr Phelps—Yes, Senator. If people were convicted of something, that would obviously be a reason for having a look at their work as auditors. They could have been found guilty of fraud under some other circumstances.

Senator ALLISON—These are qualified accountants, are they not? You cannot be an auditor without being an accountant.

Mr Phelps—The SI(S) Act provides for somebody to be an approved auditor for the purposes of the SI(S) Act. That is done by specifying a relationship to one or the other of a number of professional associations. If you meet that test, you are an approved auditor for the purposes of SIS, without any further inquiry into your knowledge or your expertise in superannuation.

Senator ALLISON—So these would have been members of the CPA?

Mr Stow—Not necessarily. There are other associations that will qualify you to be an approved auditor under the SI(S) Act. The National Institute of Accountants is one, the Association of Taxation and Management Accountants is another. You do not have to be a CPA, you do not have to be a chartered accountant, and you do not have to demonstrate any special expertise in superannuation, notwithstanding that part of the requirement to sign off on an annual return is compliance with specified requirements of the SI(S) Act and regulations.

Senator ALLISON—Is that a problem?

Mr Stow—I think it is.

Senator ALLISON—Should we be looking at more stringent requirements for auditors?

Mr Stow—I am straying into a policy area, but—

CHAIR—It sounds like it.

Mr Phelps—That would be a possibility. There are so many super funds and so many auditors involved, but I guess you could imagine a process where you had to have a particular certificate to be allowed to be the auditor of a superannuation fund. We work with the auditing and accounting bodies and encourage them and, with 200,000 little funds all being audited—I would have to take advice on exactly how many of these there are—I would not know how many thousands and thousands of auditors are involved in that process. For some of them to be found to be signing off on small funds without being fully aware of their responsibilities under the act is the type of situation that this sort of information exposes.

Senator ALLISON—Having exposed it, what I am trying to get at is whether there should be some recommendation out of this committee or whether you would like to make a recommendation about auditors? There are so many in this list, it seems to me to have emerged as a serious problem.

CHAIR—I am surprised at the answer, because when we go to section 113 of the SI(S) Act, it says that the trustee of a superannuation entity must make such arrangements as are necessary to enable an approved auditor to audit. In the committee just a moment ago it was suggested that it may not necessarily be an approved auditor. To be an approved auditor I understood that a person had to have experience in relation to the auditing of superannuation, and that just an ordinary auditor would not necessarily be an approved auditor. Is that correct or am I under a misapprehension?

Mr Stow—I think that the answer to the question of what is an approved auditor for the purposes of the SI(S) Act is, as I have already suggested, if a person holds a specified relationship—it is referred to in the regulations, and I will look for it while this goes on and draw the committee's attention to it before we finish.

Mr Phelps—We can certainly disqualify them from being auditors of superannuation funds without their being disqualified as auditors of other things.

CHAIR—Yes, but my understanding was that before they got the tick to be an approved auditor there were certain levels that they had to pass such as having experience, being a member of a recognised body and so on. I thought that perhaps a register or something was kept, but from your answer I am a bit worried that a name can appear if you have certain initials after your name, without experience or without approval in a formal sense. Here is an area where you could pop up overnight, quite frankly.

Mr Phelps—Perhaps we should come back to you in writing.

Senator ALLISON—While you look for that, I would like to ask what the process is when it is discovered that an auditor is incompetent. I suppose if they are acting fraudulently a charge would be laid. If the issue is lack of auditor independence or lack of auditor competence and integrity—looking at action No. 35—does APRA then go back to the professional association that determined that this person was a suitable auditor and therefore able to do audits and say, 'We've found lack of independence and incompetence. Will you please remove this person from your list of suitable auditors for superannuation'?

Mr Phelps—We can remove them from the list and disqualify them from being auditors of superannuation. But referring people back to their industry bodies is another technique that is also used.

CHAIR—That is a different issue to being approved in the first place.

Mr Phelps—Yes.

CHAIR—I am just worried about the difference in your perception vis-a-vis the difference in my perception as a law-maker.

Mr Stow—I may have unwittingly misled the committee. What I had in mind were the small funds about which Mr Phelps was talking about. The provisions there for being an approved auditor really depended on it being a person who was registered or taken to be registered under the Corporations Law as an auditor, a person who was a member of the Australian Society of Certified Practising Accountants, the Institute of Chartered Accountant or the National Institute of Accountants or who was a fellow or a member of the Association of Taxation Management Accountants.

CHAIR—But no experience?

Mr Stow—No.

Senator ALLISON—So they just have to be a member? They are not approved in any other sense, except by virtue of their membership?

Mr Stow—That was the case. I am just seeing whether this is part of the changes. But, certainly, that was the case for what used to be the excluded funds.

Mr Phelps—And it was with the excluded funds where most of these auditors were disqualified. It is not such a recurring issue with the funds that we have left.

CHAIR—So you can have lower qualifications for an excluded fund. What is the rule once you get past an excluded fund—no experience again?

Mr Stow—That now seems to turn on the requirement to be satisfied that the person will audit the fund or funds in accordance with the Australian auditing standards issued by the Australian standards board or with similar standards. So there is a test of that kind.

CHAIR—But, again, no experience? So a rookie can come in and say, ‘Yes, I’ve just passed my examination; I know what the Australian auditing standards are. Therefore, I can audit a fund other than excluded fund.’ Is that correct?

Mr Phelps—Our reviews would have to prove that they were unsatisfactory.

CHAIR—The ISC certainly indicated when this legislation was being framed that they wanted something over and above a qualification, that they wanted experience.

Senator ALLISON—I was not quite clear, Mr Phelps, with respect to what you said about what happens to an auditor who is found to be incompetent. They may be inexperienced—I do not know—but they are found to be incompetent. Do you go back to the body of which this person is a member? In the event that you do that, do you seek to have that person removed as a member of that organisation? What are the remedies in place for that person not to perpetuate the incompetence?

Mr Phelps—I guess the scale of the thing is that referring them back to their industry body is the minor end of the scale—where we are just not satisfied with some aspects of their work. Where we are completely dissatisfied, we would go the route of disqualifying them as an auditor for superannuation funds and would simultaneously tell—

Senator ALLISON—How does that disqualification work? Is that just a list that you keep and you advise the auditor that they are disqualified and they cannot do any more work. If you then see them come up on anything, what will you do? What are teeth behind this disqualification?

Mr Phelps—I have not been personally involved with anyone who has tried to become an auditor after they were disqualified. I am not sure of the exact—

Senator ALLISON—What is the process for checking? Do you automatically know who the auditor is in any fund? Do you keep a list and check it on a regular basis?

Mr Phelps—Yes. That sort of checking is now becoming much more thorough now that 187,000 funds have gone to the tax department. While there were 200,000 funds, the sheer volume of numbers made it difficult for any system to keep track to ensure that some auditor did not slip back in. It is now much more practical for people to keep track of those sorts of things.

CHAIR—To go back to the audit of CNAL, here was an auditor who seemed to be somewhat at sea in terms of his responsibilities in relation to the task before him. I just find it strange that a person can be in that position and plead that situation. I can understand your rationale for the very small funds, and I am happy to accept that. But once you move into funds where there are substantial amounts of money put in by outside interests, et cetera, it was certainly intended to be lot stricter than what has been outlined tonight.

Mr Phelps—The auditors of the three larger funds would be relying on the audits of those trusts. Whether they were in their rights to have done that is one of the things that we are looking closely at in this investigation.

Senator SHERRY—On page 5 of your submission it says:

While such serious issues may arise in funds of any size, the greatest incidence of severe problems lies in the smaller funds with assets up to \$5 million.

We touched on this earlier. What do you mean by ‘the greatest incidence of severe problems’? Are we talking about half or a quarter? Can you give us some indication?

Mr Phelps—On the material that we provided before, I think it is up to 99 enforcement actions. About 20 of those, as Senator Allison pointed out, relate to auditors. About 60 of them relate to funds of that sort of size.

Senator SHERRY—Less than 500?

Mr Phelps—There were only a few that were over 500. The great majority of them were \$1 million.

Senator SHERRY—You have used \$5 million. So approximately 60 were serious problems? Is that what you are saying?

Mr Phelps—The great majority of funds which are under notice at any time are under \$5 million.

Senator SHERRY—So it could be more than 60 funds over a period of the last five years, but in some years different funds?

Mr Phelps—These were the ones where some action finished up being taken. As Mr Thompson said before, it still is the case that in a great majority of cases we identify problems, talk to the trustees, twist their arm a bit, and things get fixed up.

Senator SHERRY—That is why it would be interesting to see what their average long-term returns are for each year, to see what the impact is on the funds. We know in the case of EPAS it was minus 45 per cent or something. What worries me is that, looking at your statistics, we have 1,820 funds under \$5 million. We have \$2.27 billion and we have 72,000 members in this area where the level of problem is greater. That is what worries me.

Mr Thompson—That is an important focus of this program that we have outlined in the submission. It is an area where some sort of licensing criteria and possibly some capital requirements could improve the level of comfort that we all have with them or force some rationalisation in the number of funds of that size.

Senator SHERRY—Those figures that I just used, roughly, based on your data, sound significant. In the overall context of the total size of the industry they are quite small. Conversely, if you were a member of one of those funds that had a very poor return or the moneys were stolen—

Mr Thompson—That is right.

Senator SHERRY—even one person hurt is one too many.

Mr Thompson—That is why we do not feel that we can say, ‘We are looking here at less than one per cent of the sector, let’s not worry about it.’ We think we do need to resolve something which does not actually fit together in terms of what people expect and in terms of the capacity of the supervisor to look closely at what they are doing.

Senator SHERRY—In terms of problems in this sector, do you think the fund members themselves have a conception, a knowledge or an understanding of the way these funds are operating?

Mr Phelps—No, I think in a lot of these funds people see superannuation as something that just happens and even though there is an equal representation committee, it is just something that the firm looks after. The firms were very keen to be involved in this until this in-house asset legislation was introduced a year or so ago, which is now starting to have some teeth. Their financial advisers said to them, ‘Here’s a way of providing some finance back to your own firm, by having a super fund.’ They are getting disenchanted with the fact that they are not allowed to do that any more and the number of these funds is coming down.

Senator SHERRY—On page 7 you have listed the number of replacement trustees appointed by APRA. In 1994-95 there is a fund with 5,000 members. Can you tell us what fund that was? The other one was in 1999-2000, the one with approximately 900 members. They are the two I was interested in just because of the sheer size.

Mr Phelps—Sorry, I do not recall the names of those. Can I take it on notice?

Senator SHERRY—Yes. In the next paragraph headed, ‘Actuarial reports on defined benefits superannuation,’ the response there worries me. You say:

Actuarial reports for defined benefit superannuation funds are usually reviewed as part of our preparations for an on-site visit.

‘Usually’ does not say to me that it is always done. Why not?

Mr Phelps—It is part of the usual practice. I could not point to anything to say that it is mandatory, that it is done every time.

Senator SHERRY—That worries me because I assume this review is carried out by the actuary picked by the super fund, not by APRA’s actuary.

Mr Phelps—Yes, the actuarial review would be conducted by an actuary paid for by the super fund.

Senator SHERRY—How often does APRA’s actuary check the actuarial valuations of these defined benefit funds?

Mr Phelps—There is not any regular process for an actuary to be involved. It is just the people that do the normal supervision.

Senator SHERRY—You might take that on board. That certainly concerns me because the actuary’s report in respect of defined benefit funds is very important. I think you could have the same problem that we may or may not have had with HIH and other insurance companies, so I am concerned that you are not checking these actuarial reviews. You say, ‘Such reports are normally prepared every three years.’ Is that a reference to the fund’s actuary preparing the report every three years? Is that a requirement?

Mr Phelps—That is the normal cycle, yes.

Senator SHERRY—Is that a requirement under the act that it be every three years?

Mr Phelps—Yes.

Senator SHERRY—It is. You say, ‘It is normally prepared’ but it has to be done every three years. What if it is not done?

Mr Phelps—I am not sure. I would have to take on notice what the penalty is for it not being done.

Senator SHERRY—You might take on notice, too, how many defined benefit funds there are in existence and some idea of the size and the number—that data would be interesting. Also, where you have your data for the number of replacement trustees, I would be interested to know what the returns to the members were, if you have that data.

Mr Phelps—This is the sort of losses that were involved when the trustees were replaced?

Senator SHERRY—Yes, how it impacted on the earnings rate.

Mr Phelps—Yes.

Senator SHERRY—We have already talked about data on retail fees and charges, and I have made comments about that. I would urge you to include that in future regulatory data required of industry. Turning finally to levies, I read the Productivity Commission draft report of April 2001—I suppose it goes back to issues Senator Allison was discussing with you earlier—which talks about cost recovery in selected regulatory agencies. Are you aware of this report?

Mr Thompson—Yes, it is wrong.

Senator SHERRY—You jumped in.

Mr Thompson—The easiest way to deal with that might be for us to send you a copy of the correspondence we have had with the Productivity Commission.

Senator SHERRY—So you are disagreeing with their findings?

Mr Thompson—Yes.

Senator SHERRY—They say here that cost recovery revenue is 88.3 and, as a percentage of cost recovery over total expenses, you are recovering 150 per cent of your costs. In other words, the levy is raising excess revenue over the cost of supervision.

Mr Thompson—That is not the case. I think the short answer to how they got to that result was that they included the levies collected from excluded funds as an APRA revenue when it never was. As a transitional arrangement before those funds were shifted to the tax office,

APRA did actually administer the collection of levies from those funds but they never came to APRA. They were never designed or intended to represent the cost of supervision of those funds.

Senator SHERRY—So those funds that were levied—

Mr Thompson—They went to consolidated revenue. We never saw them other than we administered their collection.

Senator SHERRY—So in terms of matching the moneys that the tax office got against their administrative costs, we would need to pursue that issue with them.

Mr Thompson—I am not sure what happens to money once it goes into consolidated revenue. The short answer to your question is yes, but perhaps the best thing might be if we send you a copy of the correspondence we had with the Productivity Commission.

Senator SHERRY—Excellent, thanks. This is not for you to answer, but I am interested to see what ASIC's response is to their claimed of 249 per cent cost recovery. But that is for ASIC.

CHAIR—If you would not mind sending answers to questions taken on notice both at the 12 June hearing and tonight. If you would not mind also updating data provided last year in your submission No. 90. In terms of being an approved specialist, obviously an approved actuary is certainly a higher qualified person than an auditor, because an 'actuary' means a person who is a fellow or an accredited member of the Institute of Actuaries of Australia; whereas an 'approved auditor' means a person including a class of person specified in the regulations, which Mr Stow is still trying to find for us.

Mr Stow—Mr Chair, the regulation is 1.04 for self-managed funds that are now with the ATO—

CHAIR—No, I am not interested in those; I am interested in your funds.

Mr Stow—The requirement is a combination of things. You must be a registered company auditor and either have one of those specified relationships with one of the professional associations or be approved by APRA in the way in which I mentioned before, which is satisfy APRA that the person will audit the fund or funds in accordance with the Australian auditing standards issued by the Auditing Standards Board or with similar standards.

CHAIR—But no experience?

Mr Stow—It does not expressly refer to any particular experience in superannuation as far as I can see.

CHAIR—Maybe you might like to look at that in terms of your update.

Mr Phelps—Yes.

Senator SHERRY—One last issue: I have corresponded with APRA about the Harris Scarfe superannuation fund. The Harris Scarfe retail company collapsed, whatever happens to it, I do not know—

CHAIR—It has not collapsed just because it is sold.

Senator SHERRY—Whatever happens, the Harris Scarfe super fund had members, and some of them in Tasmania have contacted me. Do you have any update—you might take it on notice? It just seems to me logically that the funds would cease to exist and members do certain things with their accrued entitlements. Do you have any comment to make on the Harris Scarfe super fund?

Mr Phelps—As we said in the correspondence, when companies get into difficulties is one of the trigger points so some people from APRA went around and saw the trustees the next day. We got assurances from the trustees that their money was all up to date. There is a legal amount invested in the company, which is less than five per cent and which they are allowed to do. But I will give you an update because some other oversight has been done there to make sure—

Senator SHERRY—You say that you went around and checked, I am wondering how thoroughly you checked—I am not making any allegations. I have a couple of members in Tasmania who are saying to me, ‘Harris Scarfe is going to whatever, we don’t know. Why is the super fund continuing? I cannot transfer my money out.’ It seems to me in those circumstances that it is appropriate for them to be allowed to transfer their money out, and the trustees are denying them the right to do that. I think in these circumstances it is not an unreasonable request.

CHAIR—The time allocated for tonight’s hearing has just about expired, so this concludes the committee’s proceedings. On behalf of the committee, I thank all the witnesses who have given evidence for their participation. I would like to thank in particular Mr Thompson for appearing. Your evidence tonight has been very helpful.

Committee adjourned at 10.29 p.m.