



4 May 2012

Ms Deborah O'Neill MP
Chair
Parliamentary Joint Committee on Corporations and Financial Services
PO Box 6100
Parliament House
Canberra ACT 2600

Dear Ms O'Neill,

Inquiry into the collapse of Trio Capital and related matters

I refer to the Australian Prudential Regulation Authority's (APRA's) appearance before the Committee on 4 April 2012, and the additional Questions on Notice forwarded by the Committee on 17 April 2012.

To assist the Committee meet its tight reporting timeframe, APRA has expedited its responses to the questions taken on notice at the hearing and subsequently by email. Attached is APRA's response.

I would like to bring to your attention a clarification to the response given by one of APRA's officers and recorded in the Hansard (page 15) of the 4 April hearing. APRA wishes to clarify the statements made in relation to the issue raised by Senator Sherry about default funds - 'defaults'. An extract of the transcript appears below:

Extract of transcript

Senator SHERRY: We are talking about the APRA funds here. The reality is we cannot stop theft and fraud. There will always be some people trying to steal from any system. One of the best protections we have got, aside from regulatory action, courts et cetera, is diversification. I am just puzzled as to why—you might give this some consideration on notice—it was around 30 per cent. From my knowledge it would certainly seem to be on the high side for any APRA-regulated trustee considering the diversification principle for investment as part of the strategy. Why would that not have prompted—it may have done—a sort of worry by APRA at an appropriate date?

Mr Brunner: There are a couple of issues here. Firstly, in terms of the whole industry, yes, that does look a little on the high side, but we do have funds that have a fairly high percentage of their investments in unlisted assets. It would raise some concerns and it did. It resulted in us looking more closely at the entity and was one of the reasons why it was moved to oversight in late 2006, because of the higher inherent risk of those unlisted assets. It is not that it was not recognised by APRA. It was recognised by APRA and it did actually result in us raising the risk profile of that entity. The other thing is that, as part of our further analysis, we would have to look at whether—because there were quite a number of funds involved and not all of them would have been default funds—members would have made a choice to go into those investments. They probably would have done so because of advice that had been given to them that these were investments that were generating quite good returns. People might have been attracted to those type of funds as well. We would have to look at that. It might not be something that was purely in the hands of the trustees through the default framework. It may well have been members making that—

Senator SHERRY: But predominantly it was default. We can say that: predominately.

Mr Brunner: Yes.

In relation to the phrase 'predominantly it was default', it should be noted that the arrangement was not predominantly in the hands of the trustees through the default framework. The Astarra superannuation funds were predominantly retail, choice superannuation funds where members selected their investments/ investment option via a financial planner.

Please contact me if you require any further assistance.

Yours faithfully

Thea Rosenbaum
Secretary

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Questions:

1. Had any of the directors of Trio undertaken specific superannuation training courses?
2. What level of management in APRA would have reviewed the late 2006 prudential review report?
3. Did in the change in trustee for the Professional Pensions PST from Trustee Company of Australia to Trio raise any concerns with APRA or Trustee Company?
4. Take up with ASIC and the ATO the need for warnings when people leave the regulated sector.
5. What were each of the trustees directors of Trio paid?
6. What was the approximate proportion of funds in the superannuation entities that were invested in the entity which placed the money overseas?

Auditors

7. What is APRA's expectation of the role of auditor in the audit of superannuation funds?
8. At the hearing in August last year, APRA noted that 'the only process in the system where assets are validated...is when the auditor does it and even then...the audit is still helicopter like rather than getting down to the nitty-gritty'. Knowing this, what reliance can reasonably be placed on auditor reports?
9. Should audit reports consider the 'nitty-gritty', that is, should auditors have a statutory obligation to look behind the spreadsheets? If so, should these obligations apply in all cases or only where there are anomalies evident from the spreadsheet information?
10. Do the prudential standards, for example for superannuation funds, take account of the limitations of the audit report?

Custodians

11. What are APRA's expectations of custodians?
12. Evidence from the committee's hearing with National Australia Bank on 29 September 2011, clearly indicates that custodians are not required to verify a fund's underlying assets.
 - The committee has received evidence that custodians are not required to verify a fund's underlying assets. Given this, from a prudential perspective what reliance should reasonably be placed on the role of custodians?
 - Do the prudential standards, for example for superannuation funds, take account of the limited role of custodians?

Trustees

13. Trustee independence.

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The Trust Company has drawn the New Zealand trustee governance model to the committee's attention. The Trust Company advises that New Zealand has 'maintained the independent trustee role but are significantly strengthening the licensing requirements around the trustee. Their focus is to ensure that the trustee has the relevant systems and capability to discharge a supervisory role.' (supplementary submission).

- At the hearing on 30 August 2011, the issue of trustee independence was raised. A red flag for APRA was the quality of the trustee board's activities and questions in 2005 about the board's independence. What legislative or other regulatory measures can be taken to ensure that trustees are independent?
- The Trust Company has drawn the New Zealand model of trustee governance to the committee's attention. Is it a model that Australia should be considering?

Role of Board

14. What does APRA see as the role and responsibilities of the board?
15. At the hearing on 30 August, APRA noted that it is developing prudential standards for superannuation funds as part of the Stronger Super reforms.
 - Can you provide the committee with an update about the prudential standards under development for superannuation funds?
 - Will these standards address the regulatory weaknesses, particularly regarding trustee boards, evident in the collapse of Trio Capital?
16. What are the arrangements to meet with the investor group?

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Answers:

1. Yes, five directors undertook external specific superannuation training.
2. The 2006 prudential report was reviewed, and signed off, at Senior Manager Level in line with APRA signoff protocols at that time
3. In February 2004 APRA received a request from Trio (known as Tolhurst Capital Limited at that time) seeking approval to transfer the trusteeship of the Professional Pensions PST from Trust Company Superannuation Service Limited (Trust Co) to Trio. This transfer from Trust Co to Trio occurred on the 1 June 2004. APRA has no record of any concerns raised by Trust Co at or around this time.

No prudential concerns were identified by APRA as part of its assessment of this application for change of trusteeship.

4. APRA will raise this issue in its regular liaison meetings with ASIC and the ATO.
5. APRA did not specifically collect information on the remuneration of directors at the time. Under the Stronger Superannuation Reforms, APRA will be in a position to collect this type of information in the future.
6. It ranged from 17% at year end 2005 to 26% at year end 2008.

Auditors

7. Auditors of APRA-regulated superannuation funds are required to complete an approved form of audit report for each financial reporting period. This report lists the requirements that auditor must signoff. Copy of the latest Approved Form of Audit Report for reporting periods commencing 1 July 2012 is now available on the APRA website.

Under the Stronger Super Reforms a prudential standard for Audit requirements will be issued.

8. Whilst there may be limitations, the auditor plays an important role which is subject to statutory and professional obligations. The work of the auditor both supplements and complements APRA's supervision. In recognition of the reliance placed on the auditor's work APRA consults extensively with the profession on a regular basis, including formal meetings at least twice a year with representatives of the Institute of Chartered Accountants in Australia, CPA Australia, the major firms, Australian Accounting Standards Board and the Auditing and Assurance Standards Board, where expectations and industry issues are discussed, particularly in relation to the year-end audit.
Given that all APRA funds are subject to annual audits, the latest financial statements are viewed as important information and are routinely reviewed by APRA supervisors. Where audit qualifications or other issues are noted by the auditor it certainly attracts APRA's attention.
9. There are statutory obligations in relation to the scope of an audit and auditors are also expected to carry out their duties in accordance with recognised professional standards. APRA believes that auditor obligations go beyond looking and relying on "spreadsheets" and in accordance with professional judgement include an evaluation of the integrity of the numbers reviewed.

Audit coverage is set out in APRA's Approved Audit Form pursuant to the *Superannuation Industry (Supervision) Act 1993* (SIS Act). This Form is divided into three parts which the auditor is required to address:

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- i) financial position of the fund;
- ii) APRA returns and compliance with specific SIS and Corporations law legislation; and
- iii) expected future compliance with the trustee's Risk Management Statement and the fund's Risk Management Plan.

The content of this audit form is reviewed and updated by APRA each year, in consultation with the audit profession, and includes specific guidance for auditors in line with APRA's expectations.

10. The proposed Prudential Standards cover a much wider ambit than the audit report. However, is it proposed that one Prudential Standard will specifically deal with Audit and Related Matters, which will include the Approved Audit Form and a range of auditor obligations and responsibilities. It is also expected that compliance with a number of the proposed Prudential Standards will be added to the Approved Audit Form.

Custodians

11. APRA does not supervise custodians.

Custodians are classified as a 'material business activity' of a Registrable Superannuation Entities (RSE) licensee and are subject to the outsourcing requirements of the SIS legislation.

APRA has issued the following guidance on our expectations of Custodians:

- [APRA Cross-Industry Circular No.1 – Custodian requirements for APRA supervised entities \(November 2000\)](#);
- [APRA Superannuation Guidance Note 130.1 – Outsourcing \(July 2004\)](#)
- *APRA Insight, Issue 1, 2011- article titled [Custodian operations in the superannuation industry](#)*
- [Standard Additional \[RSE\] licence conditions for Public Offer RSE licensee \(refer to C.1 to C.10 for custodian requirements\), where an RSE licensee appointed a custodian to meet their capital requirements under s. 29DA of the SIS Act.](#)

12. The core role of custodians is to hold assets securely for their beneficial owners, the superannuation trustees, and transacting assets on behalf of their beneficial owners. Custodians can also provide capital backing in certain circumstances. These roles are important from a prudential perspective in-so far as they go but APRA is aware of the limitations of these core functions.

Custodian may be engaged to undertake a broader range of services. The nature and extent of services provide by a Custodian would be articulated in the service contract with the RSE licensee.

APRA's article Custodian operations in the superannuation industry Insight Issue One 2011) also emphasises the RSE licensee role and obligations when engaging with Custodians. It highlights APRA's expectations of how RSE licensees engage and monitor such services. It is expected the proposed prudential standards will strengthen the risk management frameworks implemented for this type of outsourced service provider.

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Background to the New Zealand superannuation legislative framework

New Zealand maintains a dual responsible entity regime consisting of a trustee and a manager for retail superannuation providers, not dissimilar to that which existed in Australia prior to the commencement of the SIS Legislation in 1993.

Amendments to the *KiwiSaver Act 2006* were made in 2011 to change the responsibilities of the trustee and the manager, with a transition period ending on 30 September 2012. Under these amendments, the manager becomes the issuer of membership interests in a KiwiSaver scheme for securities legislation purposes and is legally responsible for the administration of the scheme, and the trustee becomes the external supervisor of the KiwiSaver scheme and is responsible for overseeing the manager and for the custody of scheme assets.

Trustees must be licensed under the *Securities Trustees and Statutory Supervisors Act 2011* and may not delegate the function of supervision of the scheme manager.

Trustees and managers must be independent of each other (not associated).

Both trustees and managers are subject to the express duty of acting in the members' best interests when exercising powers and performing duties and subject to the general prudent person of business principle, while the manager must also adhere to the requirements of the *Trustee Act 1956* in respect of investment of fund monies.

The Trust Company drew the attention of the Committee to the New Zealand model of trustee governance in the context of Trust Company's comments on perceived weaknesses in the single responsible entity approach of the Managed Investment Scheme regime.¹

Addressing the specific question of the Committee

The new New Zealand model may have had relevance for governance structures of Australian superannuation funds had the SIS legislation not replaced the dual governance structure in place in the early 1990s. Trustees of all APRA-regulated superannuation entities are already subject to many of the changes only now being introduced in New Zealand, such as rigorous licensing processes, and remain responsible for all delegated functions, such as investment management. Contracts for the provision of services, such as administration and investment management must meet prescribed requirements, including where the service provider is a related party of the trustee. Trustee obligations to act in the best interests of beneficiaries are being strengthened in the Stronger Super package of legislative reforms.

Role of Board

14. Trustees are solely responsible and directly accountable for the prudential management of members' benefits. The prime responsibility for ensuring that the trustee's responsible officers are fit and proper remains with the trustee. The fit and proper operating standard (the standard) is designed to ensure that the interests of superannuation members and beneficiaries are overseen competently by appropriately skilled, honest and trustworthy individuals.²

¹ See Trust Company submissions to the Committee and Hansard of 30 August 2011.

² [APRA Prudential Practice Guide 520 - Fitness and Propriety \(para 2\)](#)

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Other matters

15. The draft superannuation Prudential Standards are being released on 27 April 2012 for consultation with industry. The consultation process closes on 20 July 2012. APRA intends to finalise the prudential standards by December 2012. APRA's prudential standards will take effect on 1 July 2013.

Overall, the prudential standards will update, heighten and strengthen the prudential requirements that apply to RSE licensees arising from the Stronger Super Reforms³, specifically in the areas of:

- Governance related prudential standards;
- Risk Management related prudential standards; and
- Investment governance prudential standard.

The proposed Prudential Standards and accompanying legislative changes such as higher trustee duties provide a stronger framework to protect beneficiaries and encourage better practices across the industry. However, whilst the changes are likely to make it more difficult for the unscrupulous, aid early detection and minimise occurrences, it is not possible to totally eradicate the risk of fraud.

16. APRA wrote to Victims of Financial Fraud (VOFF) on April 12 offering a meeting with Deputy Chair, Mr Ross Jones on Wednesday 18 April 2012. This offer was declined. APRA will continue to try to organise a meeting with the VOFF.

³ Refer to [APRA Discussion Paper](#) titled "*Prudential standards for superannuation*" dated 28 September 2011