

Audit Report No. 6, 2003-2004

APRA's Prudential Supervision of Superannuation Entities

Introduction

Background

- 4.1 The regulatory function of the Australian Prudential Regulation Authority (APRA) of Approved Trustees¹ and of funds registered under the *Superannuation Industry (Supervision) Act 1993* (SIS Act) was audited by the Australian National Audit Office (ANAO) during June – September 2002.
- 4.2 Superannuation funds are regulated primarily by the SIS Act. To become a regulated superannuation fund and qualify for concessional tax treatment, a superannuation fund has to elect to be regulated under s. 19 of the SIS Act. The Australian Securities and Investments Commission (ASIC) is responsible for regulating disclosure, consumer protection and member complaint provisions under the SIS Act.

¹ Australian National Audit Office (ANAO), Report No. 6, 2003-2004, *APRA's Prudential Supervision of Superannuation Entities*; p. 7; **Approved Trustee** – A corporation licensed by APRA under the SIS Act to act as the trustees of an approved deposit fund, a public offer superannuation fund, a small APRA fund (a fund with less than five members) or a pooled superannuation trust.

- 4.3 Responsibility for supervising superannuation funds is shared by APRA and the Australian Taxation Office (ATO):
- APRA supervises 160 Approved Trustees and 12 429 funds registered under the SIS Act, with member total assets of \$328 billion (at 30 June 2002); and
 - ATO supervises 231 000 small, self-managed superannuation funds (SMSF's) (95% by number of all funds) with assets totalling \$100 billion.
- 4.4 Supervisory techniques employed by APRA and ATO include checking compulsory returns, undertaking trend analyses, benchmarking with organisations of similar size, reviewing asset concentrations, checking risk management statements and meeting minutes, and holding discussions with key fund officials and fund auditors.
- 4.5 In August 1999, APRA (which was established on 1 July 1998) restructured its supervisory functions into two divisions:
- the *Specialised Institutions Division* (SID) which supervises institutions involved in deposit-taking, insurance or superannuation, and those that operate mainly in Australia; and
 - the *Diversified Institutions Division* (DID) which is responsible for supervising groups that operate in more than one APRA regulated sector, and those with international links. An example of a diversified group is the National Australia Bank (NAB) which is not a superannuation fund entity itself, but has superannuation funds that APRA would supervise.²
- 4.6 Each division is responsible for supervising financial entities in each of the deposit-taking, insurance and superannuation sectors. Under the restructured arrangements, these two frontline divisions are supported by specialist units from the Policy Research and Consulting Division, which conduct onsite visits to institutions in conjunction with SID and DID supervisors.
- 4.7 Prior to arranging an onsite visit, APRA conducts offsite preparatory work including requesting a fund to answer a preliminary questionnaire. Matters addressed during an onsite visit include reviewing operational risk and market risk, and impacts of particular instruments and processes. Discussions may be held with board management and auditors. An onsite visit may last several hours or extend over a few days. Normally notice of

2 Australian Prudential Regulation Authority (APRA), *Transcript*, 29 March 2004, p. 5.

intention to visit is served on a fund by APRA, but if assets are deemed to be at risk an onsite visit can take place without warning.

- 4.8 In April 2000, APRA started transferring the records of some 180 000 self-managed superannuation funds (SMSF) to the supervision of ATO, and the Government Actuary's Office moved to the Department of the Treasury (Treasury). More recently, there have been a number of changes in senior APRA staff in the wake of the HIH Royal Commission. The APRA Board and Chief Executive Officer were replaced in July 2003 with an executive of three APRA members (the Executive Group) appointed by the Treasurer.
- 4.9 In addition to the supervisory teams within DID and SID, the Consulting Services and the Statistics Units of Policy Research and Consulting Division also have direct roles in supervising the superannuation sector. As risk experts, the primary role of the Consulting Services Unit is to conduct onsite visits and assist the DID and SID personnel in their supervision of institutions. The Statistics Unit processes financial and other returns and produces a series of reports that are used by supervisors to monitor the institutions for which they are responsible.
- 4.10 The current prudential regime for superannuation has remained largely intact since the SIS Act was introduced, and is generally sound and effective.³ Nonetheless, in late 2002 the Government announced a package of reforms intended to:
- Improve fund governance and trustee competence;
 - Empower more proactive and preventative action by APRA; and
 - Improve disclosure of information, particularly to fund members.⁴

The audit

- 4.11 The ANAO audit focused on APRA's prudential supervision of Approved Trustees and superannuation funds registered under the SIS Act. The audit paid particular attention to the work of APRA's supervisory divisions.
- 4.12 The Department of the Treasury was also included in the scope of the audit because of its responsibilities for providing advice on the legislative framework for APRA's prudential supervision, monitoring developments

3 APRA, *Transcript*, 29 March 2004, p. 3.

4 ANAO, Audit Report No 6, 2002-2003, *APRA's Prudential Supervision of Superannuation Entities*, p. 11.

in the financial sector and advising on the policy implications of those developments. ATO was consulted during the course of APRA's audit because of its responsibility for receiving fund registrations and maintaining the publicly available register of complying superannuation funds. The audit, however, did not examine ATO's supervision of its superannuation funds.

Audit findings

- 4.13 ANAO found that APRA's inspection of superannuation funds and Approved Trustees has been affected by re-organisation, relocation, and changes to case selection and auditing methodologies. A risk-based supervisory approach had yet to be consistently and comprehensively applied in relation to all superannuation funds regulated by APRA. Some two-thirds of the superannuation funds supervised by APRA had not been allocated a risk rating. Risk rating methods are defined below (paragraph 4.62).
- 4.14 Supervisory action within APRA was found to vary significantly depending upon which of APRA's supervisory divisions was responsible for a particular fund or Approved Trustee:
- The **Specialised Institutions Division** (SID) supervisory approach balanced efficiency with risk. This approach was effective in identifying exposures and underlying prudential risks and applying enforcement options. SID consistently applies a documented methodology for supervising superannuation funds. Also, SID formalised a more *systematic approach* to escalating supervision and undertaking enforcement actions.
 - The **Diversified Institutions Division** (DID) did not have a documented separate methodology for reviewing superannuation entities within financial conglomerates. The DID approach to escalating supervision and undertaking enforcement actions was *informal and consultative*.
- 4.15 ANAO concluded that there was a series of administrative improvements that APRA could initiate to enhance its prudential supervision of Approved Trustees and superannuation funds.
- 4.16 The Audit made five recommendations, all of which were agreed to by APRA. One recommendation addressed the administration of APRA's regulatory framework, and four recommendations addressed APRA's supervision methodologies.

The Committee's review

- 4.17 On 29 March 2004 the Committee held a public hearing to review the progress made against the ANAO audit's recommendations. The public hearing was attended by:
- Australian National Audit Office;
 - Australian Taxation Office; and
 - Australian Prudential Regulation Authority.
- 4.18 The Committee took evidence on the following issues:
- APRA's supervision framework project;
 - Onsite reviews by APRA of superannuation entities;
 - Taxation compliance by superannuation funds;
 - Capital adequacy of superannuation funds;
 - Prudential standards;
 - APRA's risk rating system;
 - Codification of superannuation prudential standards;
 - Lost and lazy funds; and
 - Tax advantages to superannuation funds.

APRA's supervision framework project

- 4.19 APRA advised the Committee that the APRA supervision framework project currently being developed was aimed at achieving consistency in the supervisory methodology adopted by both SID and DID. Measures taken to improve the consistency of approach by SID and DID included:
- Creating a documented APRA supervision framework;
 - Setting specific industry-based procedures;
 - Issuing work instructions; and
 - Providing resource materials including templates.⁵

⁵ APRA, *Transcript, 29 March 2004*, pp. 4-5.

4.20 APRA further claimed that although there had been significant differences in the past between SID's and DID's cultures and documented practices, these had not translated to differences in the quality of supervision. Rather, the style of supervision had varied according to the nature of the organisation being looked at and the different means of achieving the outcomes.⁶

4.21 By way of clarification APRA noted that it is more difficult to identify and analyse the management processes used in the diversified institutions. APRA conceded that it was moving towards cross-divisional consistency in supervision but had yet to achieve its objective completely. With regard to the complementary activity of enforcement, APRA emphasised that:

We are extremely consistent in our enforcement action regardless of which division it came out of.⁷

Committee comment

4.22 The Committee concurs with APRA's appreciation of the nature of its supervisory function – characterised by complexity, size and diversity among the funds that it supervises – and is satisfied that APRA is taking the necessary steps, and with sufficient urgency, to consolidate a consistent approach to supervision across the organisation's divisions. The Committee notes that APRA has already achieved cross-divisional consistency in its enforcement activity.

Onsite reviews by APRA of superannuation entities

4.23 The ANAO audit found that APRA did not conduct enough onsite reviews.

4.24 In response, APRA explained that its approach had been to target certain categories of funds as part of its onsite review program rather than merely to seek to reduce the number of funds for which onsite reviews were outstanding:

...we are looking at a better process to make sure we get good coverage of those smaller funds that sit underneath an Approved Trustee.⁸

6 APRA, *Transcript, 29 March 2004*, p. 4.

7 APRA, *Transcript, 29 March 2004*, p. 23.

8 APRA, *Transcript, 29 March 2004*, p. 4.

- 4.25 APRA advised that it also generated onsite visits as part of its risk assessment activities including:
- Operational risk visits;
 - Credit risk visits; and
 - Actuarial evaluation processes.
- 4.26 APRA explained to the Committee that it now had better data systems tracking fund activities at its disposal and these enabled a greater degree of risk assessment to take place offsite. Its approach was to use the better data to identify the small number of funds which warranted visits, thereby reducing the number of site visits in absolute terms, and possibly their duration, but not their overall effectiveness.

Committee comment

- 4.27 The Committee notes that APRA is developing a reputation for precision within the superannuation industry through its policy of refining its onsite visits program, with particular attention being directed at small funds. Through the use of superior data systems and good responses by funds to its questionnaires, APRA is able to target funds that warrant onsite investigation.
- 4.28 APRA is to be commended for developing a targeted approach to its onsite visits program particularly with regard to risk assessment. The outcome is that the effectiveness of the onsite visits program is enhanced without necessarily increasing the number of visits.

Taxation compliance by superannuation funds

- 4.29 ATO advised that it monitored those superannuation funds that had opted to be supervised by it, in regard to:
- Tax compliance status targeting large funds in the large business law context; and
 - Regulatory compliance status, confined to about the 270 000 funds Self Managed Superannuation Funds (SMSF) which are non-APRA funds.⁹
- 4.30 These funds, it should be noted, were not the subject of the ANAO audit.

9 Australian Taxation Office (ATO), *Transcript, 29 March 2004*, p. 6.

- 4.31 ATO gave the Committee an assurance that it has systems in place to identify any risk that an SMSF would not be able to meet its promises to its beneficiaries.
- 4.32 ATO elaborated on the education campaign that it had undertaken since the 1999 transition by the SMSFs to ATO supervision. The purpose of the campaign was to educate the fund managers about their taxation compliance responsibilities.

That education campaign has borne quite significant fruit. We conducted some benchmarking work on the 2001-02 financial year returns and found that for those who had been the subject of the education work the compliance was quite high both in income tax and regulatory responsibilities.¹⁰

For those funds...established prior to that process, the compliance status was not so high, and we have since moved to ramp up our compliance activities including lodgement enforcement and field audits.¹¹

- 4.33 Since 2002-2003 however, ATO has been moving from an educative program targeting SMSFs towards a campaign of audit and lodgement compliance. In support of its new campaign, ATO has initiated:
- Taxation audits of 1 000 SMSFs;
 - Follow-up of qualifications by external auditors for 5 000 funds;
 - Enforced lodgement for between 30 000 and 40 000 funds; and
 - Lodgement programs for 20 000 funds.¹²

Committee comment

- 4.34 The Committee is cognizant that ATO's taxation compliance activity is not an APRA function. It is, nevertheless, satisfied on the evidence presented that ATO has an efficient broad-based compliance program underway, covering both income tax and regulatory regimes for SMSFs.

10 ATO, *Transcript, 29 March 2004*, p. 6.

11 ATO, *Transcript, 29 March 2004*, p. 6.

12 ATO, *Transcript, 29 March 2004*, p. 6.

Tax advantages to superannuation funds

- 4.35 Superannuation funds enjoy considerable tax advantages as a form of savings. Superannuation is taxed concessionally relative to other marginal rates applicable to taxpayers. Consequently the concessional treatment of monies accumulated through the compulsory superannuation system represents encouragement for members of funds to save for retirement. Voluntary savings in superannuation also attract these concessions.¹³
- 4.36 The Committee asked whether the responsibilities between APRA and ATO had been sufficiently regulated, to monitor effectively the tax returns of any delinquent funds (*i.e.*, lost and lazy funds)¹⁴.
- 4.37 ATO advised that its supervision of superannuation fund tax return lodgements followed the normal practice of self assessment by the lodging entity (whether a superannuation fund or any other entity) followed by an ATO compliance risk assessment. ATO conceded that there was no special attention being directed at these funds because it had not emerged from ATO analysis to date that that group of funds was less reliable taxation lodgers than others.¹⁵
- 4.38 ANAO, however, reminded the Committee that APRA had concluded to the contrary as it had advised ANAO that:

...a significant proportion of the lost funds had not been lodging taxation returns with ATO.¹⁶

Committee comment

- 4.39 A degree of uncertainty emerged from the evidence presented to the Committee by APRA, ANAO and ATO respectively, relating to the taxation return lodgement patterns of the group of funds that have switched from APRA to ATO supervision.¹⁷ A definitive analysis of lodgement patterns by these funds is required to detect if any are aberrant, or inconsistent with the patterns displayed by other taxpayers. The Committee recommends accordingly.

13 APRA, *Submission No. 4*, p. 2.

14 APRA, *Submission No. 6*, p.2; **Lost funds** are those that, having elected to be regulated by APRA prior to July 2000, did not lodge returns after that date and were unable to be traced by APRA easily; **Lazy funds** are those that APRA could trace, but only submitted returns under threat of prosecution.

15 ATO, *Transcript, 29 March 2004*, p. 15.

16 ANAO, *Transcript, 29 March 2004*, p. 14.

17 ANAO, *Transcript, 29 March 2004*, p. 14; ATO, *Transcript, 29 March 2004*, p. 15

Recommendation 4

- 4.40 **The Australian Taxation Office review those superannuation funds that have switched from Australian Prudential Regulation Authority supervision to Australian Taxation Office supervision, to ensure that all have lodged taxation returns appropriately.**

Capital adequacy of superannuation funds

- 4.41 APRA detailed the capital requirements of superannuation entities in a submission to the inquiry. An Approved Trustee of a *public offer superannuation entity* must:
- Maintain no less than \$5 million in net tangible assets; or
 - Be entitled to the benefit of a \$5 million approved guarantee; or
 - Have a combination of net tangible assets and an approved guarantee totalling \$5 million; or
 - Comply with written requirements regarding the custody of assets. As well, APRA requires holdings of both eligible assets and liquid assets to be at least \$100 000, respectively.¹⁸
- 4.42 APRA further submitted that although a public offer superannuation entity is not required to maintain capital reserves under the SIS Act, it may do so for other reasons. In such cases, APRA will review the fund's management of its capital reserves.
- 4.43 A trustee of a *non-public offer superannuation fund* is not required by the SIS Act or APRA to maintain a capital reserve, although it has the right to be indemnified out of fund assets for liabilities incurred when acting as a fund trustee.¹⁹
- 4.44 To complement the measures taken to tighten capital supervision by both public offer and non-public offer funds, the Government has placed its reliance on the 2002 package of reforms (see paragraph 4.10). The reforms include trustee licensing (by APRA) and the requirement for preparation of a risk management plan by each trustee to cover concerns about operational risk. If these are shown to be ineffective in protecting fund

¹⁸ APRA, *Submission No. 4*, p. 1.

¹⁹ APRA, *Submission No. 4*, p. 1.

assets, it is understood that the Government will consider reviewing the capital requirements for funds.²⁰

- 4.45 In any event, capital requirements changed on 1 July 2004 upon commencement of the new superannuation licensing scheme:

The *Superannuation Safety Amendment Act 2004* (SSAA), which [came] into force on 1 July 2004, provides for a more comprehensive approach to prudential supervision of superannuation trustees by APRA. Following the implementation of the SSAA, the superannuation industry will come into line with other institutions operating in the financial sector in that all trustees accepting superannuation contributions will have to be licensed by APRA. APRA worked closely with the Treasury in developing the legislative provisions contained in the SSAA.²¹

- 4.46 APRA explained that the structure of a superannuation fund may have no capital itself.²² While a fund may manage millions of dollars on behalf of its clients, it may not have any substantial amount of capital in its own name²³ A vexing question exists therefore, as to who should hold the capital.

- 4.47 To clarify its approach to regulatory and capital management methods, APRA advised that it looks at robustness of the treatment of each superannuation fund's capital.²⁴

Given that our capital adequacy internal targets are... what Basel or the statutory minima would dictate, we do take into account... robustness.²⁵

- 4.48 APRA noted too that the proposed Basel Capital Accord²⁶, which is due for introduction on 1 January 2007 and which will affect all deposit taking

20 APRA, *Submission No. 4*, p. 2.

21 APRA, *Submission No. 4*, p. 2.

22 APRA, *Submission No. 6*, p. 1; Superannuation funds by their trust structure operate as mutuals and do not easily admit provision of external capital that could cushion foreseen and other risks in return for appropriate reward. Even where owners of trustees provide capital these have to be remunerated through a reduction in crediting rates.

23 APRA, *Transcript, 29 March 2004*, p. 12.

24 APRA, *Submission No. 6*, p. 1; Robustness – means the strength or certainty that the superannuation entity's financial promises to its beneficiaries will be met.

25 APRA, *Transcript, 29 March 2004*, p. 16.

26 The Basel Capital Accord was produced by the Basel Committee on Banking Supervision. This committee does not possess any formal supranational supervisory authority and its conclusions do not have legal force. Rather, it formulates broad supervisory standards and guidelines and recommends statements of best practice to encourage convergence towards common approaches and common standards. Its capital measurement system provides for the

institutions in Australia, is based on consistent approach to capital requirements across the superannuation sector.²⁷

- 4.49 If APRA has concerns about a fund being undercapitalised and at risk of collapsing and thus threatening the security of client deposits, it increases the capital requirements of the fund.²⁸ In assessing capital adequacy, APRA takes into account an entity's capitalised costs by deducting any such capitalised costs from the stated capital so as to present a conservative picture.²⁹ Further APRA has issued guidelines to authorised deposit takers as to how they should treat capitalised costs. APRA's advice to the Committee was that:

capitalised expenses should not be counted as assets that are available for prudential regulation and capital purposes, and they should be written out for prudential regulation.³⁰

Committee comment

- 4.50 The Committee expresses its concern regarding capital adequacy of funds. It notes that the new statutory provisions introduced on 1 July 2004 will provide measures that APRA can use to tighten up the capital requirements of funds, and in so doing are expected to reduce risk of fund failure substantially. In recognising that the new provisions have yet to be tested in a practical sense for their effectiveness against their goals, the Committee is prepared to allow time for the measures to take effect. It recommends accordingly.

Recommendation 5

- 4.51 **The Australian Prudential Regulation Authority conduct a review of the effectiveness of the new prudential provisions with respect to capital adequacy of superannuation funds registered under the *Superannuation Industry (Supervision) Act 1993* and implement corrective action targeting funds deemed still to be at high risk due to inadequate capital bases.**

implementation of a credit risk measurement framework, and includes minimum capital requirements, supervisory review of an institution's internal assessment process and capital adequacy, and effective use of disclosure to strengthen market discipline as a complement to supervisory efforts. Source: Bank for International Settlements, *The Basel Committee on Banking Supervision*, <http://www.bis.org/bcbs/aboutbcbs.htm>, accessed 5 August 2004.

27 APRA, *Submission No. 4*, p. 4.

28 APRA, *Transcript, 29 March 2004*, p. 16.

29 APRA, *Submission No. 6*, p. 1.

30 APRA, *Transcript, 29 March 2004*, p. 17.

Prudential standards

4.52 APRA does not stipulate the accounting treatment to be used by funds. According to APRA, that function is adequately covered by appropriate accounting standards.³¹ APRA confirmed, however, that there are differences between accounting standards and prudential standards.³²

The prudential treatment of capital, or any other accounting treatment, need not fully align with what the accountants or auditors would require...

The difference between what a prudential regulator wants and what an accountant may want... [is a]... reflection of different objectives.³³

4.53 Under the *Superannuation Safety Amendment Act 2004* there are a number of new prudential requirements that must be met by funds in order to obtain a licence including:

- A risk management strategy;
- Access to adequate financial, technical and human resources for their operations;
- Outsourcing requirements between Trustee and service provider, in writing and reviewed periodically;
- Clearly articulated net tangible asset requirements;
- Determination by APRA of approved guarantee requirements where required; and
- Issue to by APRA of new certification to a Trustee where required.³⁴

4.54 The Basel Committee's global project for harmonisation of accounting standards has provided APRA with an opportunity to consult with the accounting, life insurance, actuary professionals to clarify acceptable prudential standards for superannuation funds.³⁵

4.55 APRA was queried as to its view on the acceptability of accounting practices, and responded that where there are divergences, it advises its funds to:

31 APRA, *Transcript, 29 March 2004*, p. 16.

32 APRA, *Transcript, 29 March 2004*, p. 17.

33 APRA, *Transcript, 29 March 2004*, p. 17.

34 APRA, *Submission No. 4*, p. 3.

35 APRA, *Transcript, 29 March 2004*, p. 17.

Produce its returns on prudential bases, have them audited, have the fund board attest to them, and lodge them according to prudential rather than accounting requirements.³⁶

Committee comment

- 4.56 The Committee notes that currently there are divergences between accounting standards and prudential standards. APRA is aware of these divergences and is ensuring its requirements are met by instructing its supervised funds to lodge their returns against APRA prudential standards. The Committee endorses the additional attention being directed at prudential standard-setting, especially with respect to propriety of trustees through the imminent licencing and recertification process. The Committee urges APRA to continue liaising with other accounting bodies to encourage harmonisation of the two sets of standards.

APRA risk rating system

- 4.57 APRA described the APRA-wide risk rating system that it had developed over the last 18 months.³⁷ It noted that, as at June 2002,

Less than one per cent of the almost \$3 billion in superannuation under APRA's supervision was accounted for by the small APRA funds, or SAFs. With respect to these SAFs (which have fewer than five members) the focus is on the Approved Trustee, and every Approved Trustee has been risk rated.³⁸

- 4.58 Expanding on this observation, APRA said that rather than rate each individual SAF and continue re-rating them endlessly, it focusses on risk rating all the responsible Approved Trustees complemented by sample testing of the SAFs. If risk ratings of a SAF and its Approved Trustee were at odds, APRA would review and re-rate as appropriate.³⁹
- 4.59 APRA acknowledged that it is currently developing a more structured framework for rating its SAFs via the Approved Trustee route so that it is more confident that its ratings are correct.⁴⁰

36 APRA, *Transcript, 29 March 2004*, p. 19.

37 APRA, *Transcript, 29 March 2004*, p. 3.

38 APRA, *Transcript, 29 March 2004*, p. 3.

39 APRA, *Transcript, 29 March 2004*, p. 3.

40 APRA, *Transcript, 29 March 2004*, pp. 3-5.

- 4.60 APRA advised too that it has completed a significant amount of work on developing a rating template for SID and DID to use when working on the non-small APRA funds.
- 4.61 The risk rating model employed is broadly based on assessing the probability of financial failure of an entity as well as taking into account the size of the entity, and it is aimed at being proactive.⁴¹ APRA collects information about regulated entities through returns, market intelligence, prudential reviews and entity-generated requests for dispensation. It maps the information into identified risk categories.⁴² The risk rating so assigned to an entity is used to determine APRA's supervisory stance. The system comprises three phases:
- Risk type identification, which could relate to:
 - ⇒ Operations;
 - ⇒ Markets and trading;
 - ⇒ Credit;
 - ⇒ Governance;
 - ⇒ Legal and regulatory aspects, and
 - ⇒ Compliance.
 - Risk mitigation methods including:
 - ⇒ Checks on fund senior management;
 - ⇒ Audit;
 - ⇒ Actuary work;
 - ⇒ Internal audit work;
 - ⇒ Checks on the board; and
 - ⇒ Governance aspects.
 - Capital checks including:
 - ⇒ Continued availability of capital; and
 - ⇒ The quality of the earnings stream.⁴³
- 4.62 APRA's risk rating technique rates entities on two basic parameters – potential impact of failure and probability of default – taking into account the above information.⁴⁴ The model is known by APRA as the Probability

41 APRA, *Transcript, 29 March 2004*, p. 7.

42 APRA, *Submission No. 6*, p. 1.

43 APRA, *Transcript, 29 March 2004*, p. 7.

44 APRA, *Transcript, 29 March 2004*, p. 8.

and Impact Rating System (PAIRS).⁴⁵ From this, entities are categorised using a four-tier 'supervisory stance':

- Normal supervision;
- More oversight;
- Mandated improvement; or
- Restructure.⁴⁶

- 4.63 The next stage in the process involves peer review sessions within APRA at which all risk assessments are 'put to proof' prior to the agreed risk assessments being formally accepted signed off by the APRA Executive Group. A PAIRS assessment is not limited to an annual event. The assessment frequency is increased for any fund that experiences a substantial change in its affairs, for example when it acquires a new business.
- 4.64 The PAIRS framework links into the Supervisory Oversight and Response System (SOARS) which determines APRA's propensity to intervene once the PAIRS Supervisory Attention Index is established.⁴⁷ Together PAIRS and SOARS are APRA's new and improved supervisory methodology.⁴⁸
- 4.65 Entities designated to be in the two lower supervisory levels – normal supervision and more oversight – are inspected on site by APRA supervisors. Control of a superannuation entity rated within the mandated improvement tier may still rest with its approved trustee, but an entity at restructure level would be subjected to some APRA enforcement, such as replacing trustees, imposing enforceable undertakings, with the most severe sanction being disqualification of trustees.⁴⁹
- 4.66 Some five per cent of the APRA portfolio sits in the two high intensity tiers (*ie*, those requiring APRA intervention) and this proportion of the total has been found over time to be relatively static. As an indication of the scale of its intervention activity, APRA advised that during the period July 2003 to April 2004, fifteen individuals had been excluded under the

45 ANAO, Audit Report No. 6, 2003-2004, *APRA's Prudential Supervision of Superannuation Entities*, p. 49.

46 APRA, *Transcript, 29 March 2004*, p. 8 & p. 21.

47 APRA, *Submission No. 2*, p. 2.

48 APRA, *Transcript, 29 March 2004*, pp. 20-21.

49 APRA, *Transcript, 29 March 2004*, p. 8

SIS Act (comprising twelve involuntary disqualifications and three enforceable undertakings).⁵⁰

- 4.67 PAIRS delivers other advantages to APRA by reinforcing any suspicions relating, say, to particular administrators of a superannuation fund, and providing a logical and accountable basis for resource allocation.⁵¹

Committee comment

- 4.68 The Committee endorses APRA's approach to risk-rating its SAFs as cost-efficient and is satisfied that APRA's risk rating methodology and management have been upgraded to a level sufficiently sensitive to identify any questionable fund management practices. APRA's remedial responses involve taking appropriate action. Where more drastic action has been found necessary, the penalties available to and imposed by APRA appear to be effective in encouraging recalcitrant funds to observe the required standards.

Lost and lazy funds

- 4.69 The Committee heard evidence from APRA and ATO relating to the identification and status of APRA's lost and lazy funds following the rationalisation of supervisory responsibilities in 2001.⁵²
- 4.70 There had been a sizable transfer of funds between the two agencies, resulting in a net stream of some 4 000 funds to ATO. ATO advised the Committee that its self-managed funds were growing at about 2 500 per month, so the introduction of 4 000 new funds from APRA's area was not of consequence in the overall scheme.
- 4.71 Cost was the principal determinant driving fund movements between the two agencies. Some funds preferred to reside within the lower-cost ATO administration, however the offset was that those funds had to administer themselves.⁵³

50 APRA, *Submission No. 4*, p. 1.

51 APRA, *Transcript, 29 March 2004*, p 22.

52 APRA, *Submission No. 6*, p.2; **Lost funds** are those that, having elected to be regulated by APRA prior to July 2000, did not lodge returns after that date and were unable to be traced by APRA easily; **Lazy funds** are those that APRA could trace, but only submitted returns under threat of prosecution.

53 ATO, *Transcript, 29 March, 2004*, p. 12.

- 4.72 APRA advised the Committee that, after an extensive advertising campaign, all of its lost and lazy funds have now been traced, as of late March 2004. Most, in fact, had been wound up by their trustees without APRA having been advised, some had never started and some others had moved to ATO as SMSFs.

Committee comment

- 4.73 The Committee commends APRA for tracking down and reconciling all of its lost and lazy funds.