

The Auditor-General
Audit Report No.6 2003–04
Performance Audit

APRA's Prudential Supervision of Superannuation Entities

Australian Prudential Regulation Authority

Australian National Audit Office

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of Australia 2003

ISSN 1036-7632

ISBN 0 642 80738 8

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Canberra ACT
15 September 2003

Dear Mr President
Dear Mr Speaker

The Australian National Audit Office has undertaken a performance audit in the Australian Prudential Regulation Authority in accordance with the authority contained in the *Auditor-General Act 1997*. I present the report of this audit and the accompanying brochure to the Parliament. The report is titled *APRA's Prudential Supervision of Superannuation Entities*.

Following its tabling in Parliament, the report will be placed on the Australian National Audit Office's Homepage—<http://www.anao.gov.au>.

Yours sincerely



P.J. Barrett
Auditor-General

The Honourable the President of the Senate
The Honourable the Speaker of the House of Representatives
Parliament House
Canberra ACT

AUDITING FOR AUSTRALIA

The Auditor-General is head of the Australian National Audit Office. The ANAO assists the Auditor-General to carry out his duties under the *Auditor-General Act 1997* to undertake performance audits and financial statement audits of Commonwealth public sector bodies and to provide independent reports and advice for the Parliament, the Government and the community. The aim is to improve Commonwealth public sector administration and accountability.

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Abbreviations

APRA	Australian Prudential Regulation Authority
AAS 25	Australian Accounting Standard 25 <i>Financial Reporting by Superannuation Plans</i>
ADI	Authorised Deposit-taking Institution
ANAO	Australian National Audit Office
APRA Act	<i>Australian Prudential Regulation Authority Act 1998</i>
ASIC	Australian Securities and Investments Commission
ATO	Australian Taxation Office
CRIMP	APRA's <u>C</u> ontrols, <u>R</u> isks, <u>I</u> nvestments, <u>M</u> anagement and <u>P</u> lanning methodology for superannuation funds
DID	APRA's Diversified Institutions Division
DPP	Commonwealth Director of Public Prosecutions
EMAS	APRA's Risk <u>E</u> xposure, Risk <u>M</u> anagement, Risk <u>A</u> ssessment and <u>S</u> upervision methodology for regulated financial entities
FSDCA	<i>Financial Sector Data Collection Act 2001</i>
INPRS	International Network of Pensions Regulators and Supervisors
ISC	Insurance and Superannuation Commission
OECD	Organisation for Economic Co-operation and Development
PAIRS	APRA's <u>P</u> robability <u>A</u> nd <u>I</u> mpact <u>R</u> ating <u>S</u> ystem for regulated financial entities
ROCS	ATO's Register of Complying Funds
SAF	Small APRA Fund
SG	Superannuation Guarantee contributions made under the <i>Superannuation Guarantee (Administration) Act 1992</i>
SID	APRA's Specialised Institutions Division
SIS Act	<i>Superannuation Industry (Supervision) Act 1993</i>
SOARS	APRA's <u>S</u> upervisory <u>O</u> versight <u>A</u> nd <u>R</u> esponse <u>S</u> ystem for regulated financial entities
Treasury	The Department of the Treasury

Glossary

Approved Deposit Fund	A superannuation fund maintained by an Approved Trustee which has the purpose of receiving, holding and investing certain types of rollover funds until such funds are withdrawn or the beneficiary reaches age 65 or dies.
Approved Trustee	Constitutional corporations licensed by APRA under Part 2 of the <i>Superannuation Industry (Supervision) Act 1993</i> (SIS Act) to act as the trustees of certain superannuation funds. In particular, the SIS Act requires that the trustees of <i>approved deposit funds, public offer superannuation funds, small APRA funds and pooled superannuation trusts</i> must be Approved Trustees.
Eligible Rollover Fund	A regulated superannuation fund or approved deposit fund which is required to treat all members as protected members and every member's benefits as minimum benefits.
Pooled Superannuation Trust	A unit trust maintained by an Approved Trustee which is used only for investing the assets of regulated superannuation funds, approved deposit funds, life offices and registered organisations.
Public Offer Superannuation Fund	A superannuation fund maintained by an Approved Trustee which conducts at least some of its business by issuing superannuation interests to the public or a fund which elects to APRA to be so treated.
Small APRA Fund	A regulated superannuation fund with less than five members maintained by an Approved Trustee.

Summary and Recommendations

Summary

Background

1. The regulation by APRA of Approved Trustees and of funds registered under the *Superannuation Industry (Supervision) Act 1993* (SIS Act) is the subject of this performance audit. In light of public attention on some recent superannuation fund failures, there has been an increasing focus on regulation of the superannuation industry. Recent reviews have concluded that the current prudential regime for superannuation, which has remained largely intact since the SIS Act was introduced, is generally sound and effective. In late 2002, the Government announced a package of reforms intended to improve fund governance and trustee competence, give the Australian Prudential Regulation Authority (APRA) powers that support more proactive and preventative action, and improve disclosure of information, particularly to fund members.
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 section 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. Responsibility for supervising superannuation funds is shared by APRA¹ and the Australian Taxation Office (ATO), as follows:
 - Since 1999, the ATO has supervised small, self-managed superannuation funds. There are approximately 231 000 such funds with assets of some \$100 billion. They represent some 95 per cent of superannuation funds.
 - APRA is responsible for the prudential supervision of 160 Approved Trustees and 12 429 funds registered under the SIS Act. At 30 June 2002, these funds held at least \$328 billion in members' funds.
3. APRA has undergone considerable organisational change since its establishment in July 1998. Initially, it incorporated staff from the Insurance and Superannuation Commission (ISC), the Government Actuary's Office and banking supervisors from the Reserve Bank of Australia. In July 1999, APRA gained responsibility for supervising credit unions, building societies and

¹ APRA's role includes certifying funds' eligibility for tax concessions, licensing certain funds' Approved Trustees, monitoring fund management and the delivery of benefits and, where necessary, intervening if it considers a fund's capacity to meet its financial promises to its members may be compromised. In addition to its superannuation fund regulatory responsibilities, APRA is the prudential regulator of banks and other authorised deposit-taking institutions (ADIs), general insurance and reinsurance companies, friendly societies and life insurance companies.

friendly societies and staff of State regulatory bodies were brought into APRA. In August 1999, APRA restructured its supervisory functions into two divisions (Specialised Institutions Division or SID, and Diversified Institutions Division or DID).

4. SID and DID comprised 64 per cent of APRA's staff as at 30 June 2002. Each division is responsible for supervising financial entities in each of the deposit-taking, insurance and superannuation sectors. Under the new arrangements, these two frontline divisions are supported by specialist units from the Policy Research and Consulting Division, who conduct on-site visits to institutions in conjunction with SID and DID supervisors. Simultaneously, APRA consolidated its head office in Sydney, losing experienced staff in the process. In April 2000, APRA started transferring the records of some 180 000 self-managed superannuation funds to the supervision of the 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 staff and, in the wake of the HIH Royal Commission, the replacement in July 2003 of the APRA Board and Chief Executive Officer with an executive of three APRA members appointed by the Treasurer.²

5. SID supervises institutions whose activities are mainly in one of the categories of deposit-taking, insurance or superannuation, and where those activities are predominantly within Australia. It is responsible for supervising 4 402 superannuation funds with \$162 billion in assets and 96 Approved Trustees licensed under the SIS Act.

6. DID is responsible for the supervision of functionally diversified groups that operate in more than one APRA regulated sector (deposit-taking, insurance, superannuation), and those with international links. It is responsible for supervising 6 093 superannuation funds with \$166 billion in assets and 64 Approved Trustees licensed under the SIS Act.³

7. In addition to the supervisory teams within DID and SID, the Consulting Services and Statistics units of Policy Research and Consulting Division have a direct role in supervision. As risk experts, Consulting Services' primary role is to conduct visits and assist the frontline 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 their institutions.

² The appointments were announced by the Treasurer on 27 June 2003, putting into effect the *Australian Prudential Regulation Authority Amendment Act 2003*.

³ Superannuation funds supervised by DID include some 6 027 small funds with balances up to \$20 million, through to several large public offer funds with up to \$19 billion in assets. Similarly, SID supervises 2 606 small funds, some significant public offer funds and 4 402 corporate funds, of which the largest have over \$10 billion in assets.

8. APRA has in its portfolio 1 934 lost funds inherited from ISC supervision. These funds registered for supervision after the commencement of the SIS Act in 1994, but were not subsequently supervised by either the former ISC or APRA (since 1 July 1998). APRA is actively pursuing these funds in order to identify their status with the aim of securing compliance with SIS Act reporting requirements, transferring them to the supervision of the ATO or winding them up by the end of January 2004.

Key findings

Regulatory framework

9. The main provisions of the SIS Act (outlined in Appendix 1) impose duties and obligations on trustees, such as the requirement to lodge annual regulatory returns. The SIS Act also provides APRA with supervisory and regulatory powers. In November 2000, APRA commenced the *Lost and Lazy Project* to identify, and take necessary action against, 7 520 'lost' funds that had not lodged annual regulatory returns for a number of years. Consequently, by June 2002, the number of lost funds had been reduced by more than two-thirds to 1 934. APRA advised ANAO that by the end of January 2004, they will have taken regulatory action to resolve the status of all lost funds. These actions, and the introduction of proposed reforms to the SIS Act, particularly universal licensing, will resolve the issue of lost funds. APRA also advised that the reforms are scheduled to commence in April 2004. A two year transition period for the proposed reforms does not commence until July 2004.

10. Annual returns are APRA's main source of information on the financial status of registered superannuation funds. The SIS Act requires trustees of superannuation funds to prepare annual statements of financial position, operations and cash flows. To date, APRA has not sought detailed annual financial information as part of superannuation fund annual returns from trustees. APRA advised ANAO that SID compensates for that by requesting and reviewing audited annual accounts.

11. In June 2003, APRA announced new superannuation annual returns to apply for financial years ending on and after 30 June 2004, and quarterly returns for funds with assets of \$50 million or more to apply from the second half of 2004. APRA advised ANAO that it anticipates the new returns will increase the availability of information within its statistical database, the consequent options for electronic analysis of trends and exceptions, and achieve greater efficiencies in APRA. ANAO considers a more comprehensive suite of returns from superannuation funds is likely to improve the quantity, quality and timeliness of financial information available to APRA for supervisory purposes.

12. APRA recognises that late lodgement of superannuation fund annual returns compromises its ability to perform its prudential function of detecting fund weaknesses and protecting the interests of fund members. APRA initially experienced a disappointing record of timely lodgement of annual returns from superannuation funds. Only 17 per cent of expected returns were lodged on time in 1999–2000, rising to 77 per cent in 2000–01 and, with active follow-up, 97 per cent of expected 2001–02 returns were received by July 2003.

13. Until 2001, APRA's pursuit of superannuation funds that had not lodged an annual return was limited to a single reminder notice mailed out to trustees of non-lodging entities almost 12 months after the end of the financial year for which the annual return had been due. APRA has advised ANAO that since the failure to lodge a return has become a strict liability offence (from 18 January 2001), it has actively pursued non-lodgements. More recent action has involved a combination of reminder letters and more effective sanctions that have improved the lodgement of superannuation fund annual returns.

Risk based supervision

14. Since August 1998, APRA has been seeking to adopt an explicit risk-based supervisory approach. Subsequently, a number of different risk-based methodologies have been developed.⁴ Most recently, in October 2002, APRA introduced an upgraded risk-rating system (the Probability and Impact Rating System/Supervisory Oversight And Response System or PAIRS/SOARS) that, for the first time, seeks to formally integrate the probability of a regulated entity's failure with the potential impact of that failure into a single combined supervisory measure.

15. APRA expects the implementation of this new system to place it in a stronger position to gauge the scale of its overall supervisory task, identify priority areas within the regulated population and allocate resources according to the degree of risk. The new system is also designed to encourage more vigorous intervention and narrow the scope of judgement for any individual APRA supervisor. APRA anticipates it will allow for more consistent authorisation, peer review and quality assurance processes. In May 2003, APRA advised ANAO that all large APRA regulated entities, accounting for approximately two thirds of Australia's prudentially regulated assets, had been rated under PAIRS. However, APRA will not individually rate the 7 821 small APRA funds (SAFs)

⁴ Initially, APRA applied the methodology used by its predecessor, the Insurance and Superannuation Commission (ISC). In August 1998, APRA started implementing the Controls, Risks, Investments, Management and Planning (or CRIMP) methodology, that had been under development in the ISC. CRIMP was replaced in July 2000 by EMAS (Risk Exposure, Risk Management, Risk Assessment and Supervision). In October 2002 EMAS was replaced by the Probability and Impact Rating System/Supervisory Oversight And Response System (PAIRS/SOARS).

under the management of an Approved Trustee, relying instead on its assessment of the Approved Trustee.⁵

16. APRA has recognised that forming an accurate assessment of the risk profile and risk management systems for all the superannuation funds it regulates is an essential part of ensuring the protection of fund members. However, as of June 2002, some 68 per cent of regulated superannuation funds had not been risk-rated, the majority of which were small funds managed by an Approved Trustee. Some registered superannuation funds managed by certain Approved Trustees have been individually risk-rated: most, however, have not.

17. ANAO sampling of superannuation funds and institutions where an on-site review was conducted in 2001–02 showed that APRA allocated risk-ratings in 93 per cent of cases and developed supervisory action plans in 90 per cent of cases. ANAO found that a risk-based approach to the supervision of superannuation funds has yet to be consistently and promptly applied within APRA. While SID showed evidence of the inspection and risk rating of subsidiary superannuation funds under the Approved Trustee, this was not evident in any of the DID reviews. Furthermore, while 71 per cent of SID risk ratings and supervisory action plans were complete within two months of the on-site visit, only 35 per cent of DID's risk ratings and 12 per cent of supervisory action plans were complete within that time.

Overall conclusions

18. APRA's review of superannuation funds and Approved Trustees has been impacted by re-organisation, relocation, and changes to case selection and auditing methodologies. A risk-based supervisory approach has 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 were not allocated a risk rating.

19. ANAO found that supervisory action within APRA varies significantly depending upon which of APRA's supervisory divisions is responsible for a particular fund or Approved Trustee. The supervisory approach, adopted by SID in recent years to balance efficiency with risk, was found to be generally effective in identifying exposures and underlying prudential risks and applying enforcement options. SID consistently applies a documented methodology for supervising superannuation funds, whereas DID does not have a documented separate methodology for reviewing superannuation entities within financial conglomerates. Also, SID has formalised a more systematic approach to

⁵ Senate Economics Legislation Committee, answers to Questions on Notice, Treasury Portfolio Additional Estimates 12–14 February 2003, Question Add 23, p. 2.

escalating supervision and undertaking enforcement actions compared to DID's informal consultative approach.

20. ANAO considers that there are a series of administrative improvements that APRA can initiate to enhance its prudential supervision of Approved Trustees and superannuation funds. With respect to its regulatory functions, improvements could be made to: APRA's reporting of superannuation fund's lodgement of annual returns; and risk identification and review. As to operational processes, ANAO considers that improvements can be made to: the timely documentation of APRA's supervisory reviews of superannuation funds; and the development of a standardised supervisory approach to Approved Trustees and superannuation funds.

Agency responses

21. A proposed report was issued to APRA, Treasury and the ATO. ATO provided a number of factual comments. Treasury had no comments on the Section 19 draft report. APRA agreed with all five audit recommendations. APRA advised ANAO of its response to the audit as follows:

APRA accepts the overall conclusions of the report and recognises the need for administrative improvements to enhance its prudential supervision of Authorised Trustees and superannuation funds.

In APRA's view, the complexity, size and diversity among the superannuation entities it supervises, requires it to tailor its supervision stance in terms of strategy, approach and resourcing. However, in response to this report, APRA will refine its risk-based supervision approach and methodology to ensure the consistency of supervisory action plans and documentation.

The ANAO audit focussed on APRA's supervision of superannuation entities during 2001–02. There have been significant changes since then, as summarised below:

- The PAIRS/SOARS risk-based methodology, that has been developed with reference to international best practice has been further rolled out across the APRA supervisory divisions.
- A Quality Assurance and Consistency Unit has been established which will focus on ensuring there is a consistent application of supervisory methodologies and timely and comprehensive documentation of supervisory activity.
- Risk Assessment and Internal Audit has increased its activities in the monitoring of APRA's supervision strategies and action plans.

APRA will report on its attention to the findings and recommendations of this ANAO audit in its 2003–04 Annual Report.

Recommendations

Set out below are the ANAO's recommendations and APRA's abbreviated responses. APRA's more detailed responses are shown in the body of the report immediately after each recommendation.

Recommendation No. 1
Para 2.37

ANAO *recommends* that APRA improve its supervisory accountability by including in its annual report performance information on the lodgement of annual returns based on all registered superannuation funds for which it is responsible under the SIS Act rather than the expected number of returns.

APRA response: Agreed.

Recommendation No. 2
Para 3.28

ANAO *recommends* that APRA undertake risk assessments for all regulated superannuation funds and Approved Trustees for which it is responsible under the SIS Act, with the timing and intensity of these assessments prioritised in the overall context of the implementation of the new risk-based methodology.

APRA response: Agreed.

Recommendation No. 3
Para 3.41

ANAO *recommends* that APRA undertake supervisory reviews of all registered superannuation funds and Approved Trustees for which it is responsible under the SIS Act, having regard to APRA's risk-based supervisory strategy.

APRA response: Agreed.

Recommendation No. 4
Para 3.48

ANAO *recommends* that APRA implement systems and procedures that ensure the timely allocation of a risk rating and the timely approval of supervisory action plans at the conclusion of each review.

APRA response: Agreed.

Recommendation No. 5
Para 3.62

ANAO *recommends* that APRA apply a consistent supervisory approach, along the lines of that adopted by Specialised Institutions Division, for escalating its supervision and enforcement where prudential concerns are identified.

APRA response: Agreed.

Audit Findings and Conclusions

1. Introduction

This chapter provides brief descriptions of superannuation entities, APRA's structure, the legislative framework for the supervision of superannuation and the audit.

Background

1.1 Superannuation savings are a major source of retirement income for Australians and an important element of the Government's retirement incomes policy. At June 2002, APRA estimated that \$520 billion in superannuation assets (see Figure 1.1) was held on behalf of members in over 24 million member accounts.⁶

1.2 Funds supervised under the SIS Act account for 82 per cent of all superannuation assets. Those supervised by APRA account for 63 per cent. At June 2002, APRA was responsible for 2 674 superannuation funds (comprising mainly corporate funds, industry and public sector funds, along with retail funds, approved deposit/rollover funds and pooled superannuation trusts) managing \$325.4 billion, or over 62 per cent of total superannuation assets. APRA was also responsible for 7 821 SAFs managed by an Approved Trustee, with total assets of \$2.6 billion. SAFs, together with the 231 000 small self-managed superannuation funds supervised by the ATO, comprise almost 99 per cent of registered superannuation funds, but account for less than one fifth of total superannuation assets.

1.3 The SIS Act is the cornerstone of the prudential regulation of the superannuation industry in that most superannuation contributions are made to funds that have elected to comply with the provisions of the SIS Act in order to obtain concessional taxation treatment. The concessional taxation treatment of superannuation is estimated to involve tax expenditures of \$9.77 billion in 2001–02, projected to rise to \$12.55 billion by 2005–06.⁷

1.4 Prudential regulation aims to promote prudential behaviour by financial institutions so as to increase the likelihood that they will be able to meet their

⁶ Coverage has risen steadily since the introduction of award superannuation in 1988 and compulsory Superannuation Guarantee (SG) contributions in 1992. From July 2002, employers were required to pay SG contributions of nine per cent of the earnings base for each eligible employee (generally those paid \$450 or more per month) into a fund certified as a complying fund under section 40 of the SIS Act.

⁷ The bulk of estimated superannuation tax expenditures in 2001–02 arise from concessional taxation of employer contributions (\$4.65 billion), fund earnings (\$4.42 billion) and unfunded lump sums (\$0.45 billion); from discounting superannuation funds' capital gains (\$0.38 billion); and from deductions allowed the self-employed (\$0.19 billion). Source: Treasury *Tax Expenditures Statement 2002*, p. 111.

obligations to their depositors, policyholders or members.⁸ It is concerned with the quality of regulated entities' systems for identifying, measuring and managing business risks.⁹

Figure 1.1

Superannuation Industry Distribution of Funds: June 2002

Fund Type	Number of Funds	Assets (\$b)
<u>Corporate funds</u> : sponsored by a single employer or group of related employers <u>Industry funds</u> : drawing members from a large number of usually unrelated employers across a single industry <u>Public sector funds</u> : the sponsoring agency or business enterprise is majority government owned	1 862	118.1
<u>Retail funds</u> : primarily public offer funds where members join by purchasing policies sold through intermediaries	324	200.2
<u>Approved deposit and eligible rollover funds</u> : for receiving, holding and investing certain termination and rollover payments on behalf of members	328	7.1
<u>Pooled superannuation trusts</u> : investing <i>only</i> the assets of other superannuation entities	160	. ¹
<u>Small funds</u> : with less than five members supervised by APRA:	7 821	2.6
Funds supervised by APRA under the SIS Act²	10 495	328.0
Self-managed funds supervised by ATO under the SIS Act	231 000	100.5
Total funds supervised under the SIS Act	241 495	428.5
Exempt public sector funds ³	67	54.5
Retirement savings accounts ⁴	n/a	3.4
Annuities, life office reserves etc ⁵	n/a	27.7
Other entities ⁶	n/a	5.9
Total superannuation funds	241 562	520.0
Notes: ¹ Assets of pooled superannuation trusts are already counted in parent superannuation funds' assets. ² Excludes 1 934 'lost' SIS funds not supervised by APRA and approximately 64 600 funds formerly registered under the <i>Occupational Superannuation Standards Act 1987</i> and not regulated by APRA or the ATO. ³ Exempt from supervision under the SIS Act by regulations made under section 10 of the SIS Act (SIS regulations, Schedule 1AA). ⁴ Regulated by APRA under the <i>Retirement Savings Account Act 1997</i> . ⁵ Regulated by APRA under the <i>Life Insurance Act 1995</i> . ⁶ APRA advice to ANAO, 30 June 2003.		

Sources: APRA and ATO advice to ANAO.

⁸ Superannuation Working Group, *Options for Improving the Safety of Superannuation—Background Issues*, 24 December 2001, pp. 1–2.

⁹ *ibid.*

1.5 APRA aims to ensure that trustees are aware of their obligations to members and manage the funds in their care in members' interests. APRA describes its supervisory approach as:

Forward looking, primarily risk-based, consultative, consistent and in line with international best practice. This approach also recognises that management and boards of supervised institutions are primarily responsible for financial soundness.¹⁰

1.6 The benefit structures of superannuation funds take two basic forms.¹¹ Accumulation funds provide members with a lump sum of accumulated contributions and earnings once the member retires from the workforce and has reached preservation age. Defined benefit funds pay lump sums and/or income streams according to pre-determined criteria. In this context, APRA advised ANAO in April 2003, that:

Defined benefit funds have been in decline and many have been closed to new members, but the recent sustained falls in market values have highlighted their vulnerability to investment performance. Funds have moved into an unsatisfactory financial position (vested benefits not covered by assets) and accrued benefit coverage has fallen steeply. APRA has been working with trustees and actuaries to understand the emerging solvency issues and action being taken to address them. APRA has also identified weaknesses in the legislative framework in identifying and remedying deficits in time and has proposed changes to the Government. In the meantime it is using the existing powers and moral suasion to persuade employers to top up contributions.

APRA's structure

1.7 The Financial System Inquiry, the first full-scale review of the Australian financial system since the 1981 Campbell Inquiry, was established in June 1996. The Inquiry's mission was to provide a stocktake of the results of the deregulation of the financial system since the early 1980s and make recommendations on future regulatory arrangements. The Inquiry reported in March 1997 and, among other things, concluded that the prudential regulation of financial institutions should be centralised and recommended that a single Commonwealth prudential regulator be established.

1.8 The Government accepted the Inquiry's recommendations, with APRA being established on 1 July 1998 by the *Australian Prudential Regulation Authority Act 1998* (APRA Act). In terms of prudential supervision of superannuation funds, APRA replaced the ISC. In addition to its superannuation fund regulatory

¹⁰ APRA, *Brochure*, at <<http://www.apra.gov.au>>.

¹¹ Productivity Commission, *Review of the Superannuation Industry (Supervision) Act 1993 and Certain Other Superannuation Legislation*, Inquiry Report No.18, 10 December 2001, p. 18.

responsibilities, APRA is the prudential regulator of banks and other authorised deposit-taking institutions (ADIs), general insurance and reinsurance companies, life insurance companies, and friendly societies. APRA's stated mission is 'to establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by the institutions that we supervise are met within a stable, efficient and competitive financial system.'

1.9 In addition to its two supervision divisions (SID and DID), APRA has a third division responsible for supervisory policies, research activities and providing specialist advice and services to frontline supervisors. APRA's other operational units provide infrastructure support and administrative functions to the supervisory and policy divisions. APRA has also established internal committees such as the Licensing Committee and the Superannuation Cross Divisional Committee, to consider industry-specific issues across APRA, for interpretive advice, to promote consistency, to warn of emerging risks and to encourage the exchange of best practice.

1.10 A Quality Assurance and Consistency Unit has also been established. Its functions include: developing best practice supervision and enforcement processes across APRA, in conjunction with business divisions; ensuring a high level of consistency in supervisory and enforcement practice and the interpretation of prudential policy across APRA; and developing external benchmarks for APRA's supervision and enforcement.

1.11 APRA is funded primarily by levies¹² collected from regulated institutions, with a contribution from interest on funds invested, fees for service and miscellaneous cost offsets such as insurance recoveries.¹³ In

¹² The Treasury *Review of Financial Sector Levies* (April 2003) notes that among the specific requirements of the Government's cost recovery policy are the following:

- cost recovery arrangements should have clear legal authority;
- cost recovered revenue should be clearly identified in agency financial statements in both annual reporting and portfolio budget documentation;
- cost recovery arrangements should have sound economic underpinnings and should not be undertaken solely to raise revenue for Government activities;
- cost recovery arrangements should, as a matter of principle, be considered on an activity basis rather than as broadly applying to the agency as a whole;
- where functions undertaken for Government are directly linked to service and product delivery, they are validly considered to be integral to the costs of the activity and should be included in agency charging;
- in some instances it may be appropriate for entities to introduce levies rather than a fee for service; and
- significant cost recovery arrangements should have appropriate mechanisms to promote consultation with stakeholders.

¹³ APRA, *Annual Report 2001–02*, p. 53.

2001–02, APRA revenue totalled \$62.2 million with expenses of \$59.2 million.¹⁴ In 2001, APRA received an additional \$2.1 million for 2001–02 and \$3.1 million for 2002–03 and out-years for increased prudential supervision of superannuation.¹⁵ The 2002–03 Commonwealth Budget provided APRA with further additional funding of \$12 million over four years to undertake additional work to allow more intense supervision of conglomerate groups, and to improve its ability to analyse operational risk, liability valuation and insurance risk for ADIs and general insurance companies.¹⁶ APRA's estimated total appropriations in 2003–04 are \$68.6 million.

1.12 APRA's enabling legislation requires it to balance financial safety with efficiency, competition, contestability and competitive neutrality. Accordingly, it is a matter for APRA to identify an appropriate supervisory approach and advise Government on the resources that are necessary to meet its objectives.¹⁷ In this context, the cost of supervision of superannuation entities is estimated to have been \$18.3 million in 2000–01 and \$33.3 million in 2001–02 (see Figure 1.2).

¹⁴ Ibid., p. 56.

¹⁵ *Mid-Year Economic and Fiscal Outlook 2001–02*, October 2001, p. 32.

¹⁶ Budget Paper No.2 2002–03, *Budget Measures*, pp. 29 and 158.

¹⁷ ANAO Audit Report No.42 2000–01, 30 May 2001, *Bank Prudential Supervision*, p. 42, paragraph 3.1. Further details on the levy setting process are provided in Chapter 2 of Audit Report No.42 2000–01. Financial sector levies in respect of superannuation are estimated at \$25.9 million in 1998–99, \$31.9 million in 1999–2000, and \$30.5 million in 2002–03. APRA's predecessor, the ISC, was also funded, in part, by industry levies. In its final year (1997–98), the ISC received \$49.2 million in superannuation industry levies out of total funding of \$73.2 million for supervising the superannuation industry (including those funds now regulated by the ATO). Total expenditure in 1997–98 on supervising the superannuation industry was \$72.5 million. Source: ISC, *Annual Report 1997–98*, pp. 118–119.

Figure 1.2**Cost of Superannuation Supervision: 2000–01 to 2001–02**

	2000–01	2001–02
Superannuation levies raised	\$24.6m	\$28.2m
Less levies retained in the Consolidated Revenue Fund for ASIC and ATO ¹	(\$8.6m)	(\$8.4m)
Net superannuation levies appropriated to APRA	\$16.0m	\$19.8m
Superannuation levies foregone ²	\$2.3m	\$2.3m
Sub-total: Ongoing costs	\$18.3m	\$22.1m
SIS Act compensation payments (net of GST) ³	Nil	\$11.2m
Total:	\$18.3m	\$33.3m
Notes:		
¹ Revenues collected by APRA are first remitted to the Commonwealth's Official Public Account. An amount, specified by the Treasurer in an annual determination made under section 50(2) of the APRA Act, is retained in the Consolidated Revenue Fund to assist in the funding of ASIC (for consumer protection and market integrity functions) and ATO (for its responsibilities for unclaimed superannuation monies and lost members). The remainder is appropriated to APRA under section 50(1) of the APRA Act. Source: APRA, <i>Annual Report 2002</i> , pp. 62 and 70.		
² In 2001, APRA estimated superannuation levy revenue foregone at \$2.3 million, comprising \$1.3 million for annual returns not lodged, \$0.3 million from trustees' incorrect calculations, and \$0.7 million from annual returns that were incorrect or incomplete.		
³ Part 23 of the SIS Act enables the Treasurer to grant financial assistance to members of superannuation entities that have suffered loss as a result of fraudulent conduct or theft. In 2001–02, payments were made to members of the Australian Independent Superannuation Fund and members of 180 small funds that suffered losses in funds managed by the Approved Trustee, Commercial Nominees Australia Limited. ¹⁸		

Source: ANAO analysis of APRA data.

Legislation

1.13 The SIS Act was introduced as part of a package of legislation to substantially increase the level of prudential protection provided to the superannuation industry, strengthen the security of superannuation savings and protect the rights of superannuation fund members.¹⁹ Among other things, the SIS Act:

- provides for registering superannuation funds for supervision and for certifying their eligibility for tax concessions and Superannuation Guarantee contributions;
- outlines the basic duties and responsibilities of fund trustees including charging trustees with managing and investing members and employers'

¹⁸ The Government is committed to recouping financial assistance paid under Part 23 of the SIS Act through levies to be made under the *Superannuation (Financial Assistance Funding) Levy Act 1993* and has introduced amendments to improve the efficiency of the collection process. Source: Treasury *Review into Part 23 of the Superannuation Industry (Supervision) Act 1993*, 3 June 2003, p. 9.

¹⁹ Superannuation Industry (Supervision) Bill 1993, *Explanatory Memorandum*, p. 1.

contributions for the primary purpose of providing members with income upon retirement;

- provides for a system of prescribed standards applicable to the operation of superannuation entities;
- gives APRA certain powers to enforce standards, prudential requirements and other obligations placed on trustees;
- gives APRA certain powers to gather information, monitor funds and investigate or direct their affairs in certain circumstances;
- obliges trustees and others to report to APRA on the financial condition of the superannuation entity and to attest its compliance with the SIS Act; and
- provides for the Commonwealth to compensate the members of superannuation entities that fail due to fraud or theft.

1.14 The SIS Act distinguishes between funds that must have a trustee licensed by APRA (known as an Approved Trustee) and those that need not. Funds which must have a licensed trustee are:

- public offer superannuation funds, which are authorised to offer superannuation interests to members of the public (as distinct, say, from a fund established to provide benefits solely for the employees of a particular employer);
- approved deposit funds, maintained solely for receiving, dealing with and paying benefits from eligible termination payments;
- pooled superannuation trusts, which solely invest the assets of other regulated superannuation funds (including other pooled superannuation trusts) and the superannuation assets of life insurance companies; and
- Small APRA Funds (SAFs), which have less than five members and wish to be supervised by APRA. All other funds with less than five members are self-managed superannuation funds. From October 1999, responsibility for their supervision was transferred from APRA to the ATO.

1.15 Funds that need not have a licensed trustee are standard employer-sponsored funds, usually corporate, industry or regulated public sector funds. The trustees comprise employer and employee representatives and they must register to be supervised under the SIS Act on the basis that their sole or primary purpose is the provision of age pensions.

Standard setting

1.16 The SIS Act provides extensive powers for the setting of standards for the operation of superannuation entities. Under the SIS Act, APRA can set standards for superannuation funds either by making regulations under Part 3 or by using the permanent modification powers in Part 29:

- Part 3 provides the power to set standards in relation to the operation of regulated superannuation funds. The potential scope of SIS operating standards is broad, with no restriction on the matters which might be subject to regulation, so long as the standards are directed towards the prudential and retirement incomes protection objectives underlying the SIS Act, and do not contradict any of the specific provisions of that Act. However, APRA advised ANAO that the scope of the standards is limited in their application to trustees themselves.
- Part 29 enables APRA to permanently modify, without reference to Parliament, certain provisions in the SIS Act and regulations made under these provisions (including existing operating standards made under Part 3 of the SIS Act). There is no limitation on the purpose for which the permanent modification powers can be used, aside from the need to adhere to the objects and purposes of the SIS Act and general administrative law requirements.

1.17 The approach to setting standards for regulated superannuation funds under Part 3 of the SIS Act is similar to that in the authorised deposit-taking (banking) and insurance sectors. As in those sectors, a three tiered model applies, involving: an Act containing prudential principles or powers; detailed requirements enunciated in subordinate prudential standards that are issued as disallowable instruments; and non-binding guidance notes. At the time of this audit, some 13 standards had been made under Part 3 of the SIS Act, generally providing additional explanations of the provisions within the Act, or further explaining the intent of the legislation.

1.18 It is the Part 29 permanent modification powers in the SIS Act that set the superannuation standard setting process apart from that in the other regulated sectors supervised by APRA. There have been 23 permanent modification declarations made under Part 29 of the SIS Act. Six of these included provisions amending an operating standard previously made under Part 3 whilst one declaration created a new operating standard.

1.19 In its report to the Government, the Superannuation Working Group²⁰ recommended that APRA consider developing operating standards that cover capital, investment rules, outsourcing, governance and operational risk. The Government responded to the recommendations of the Superannuation Working Group on 28 October 2002. In its response, the Government stated that it supported the development of appropriate operating standards and the application of conditions to a trustee's licence, as well as using other tools such as superannuation circulars, to ensure that the regulatory framework meets its objective of ensuring appropriate risk management systems are in place to minimise the chance of fund failure. APRA advised ANAO in April 2003 that:

In respect of recommendations regarding investment management, outsourcing and operational risk management, APRA has provided draft operating standards dealing with these matters to Treasury as the first step in the development and consultation process. APRA has also recommended amendments to Part 3 of the SIS Act to enable operating standards to be made in relation to fitness and propriety of trustees and adequacy of resources of trustees to undertake their duties, and has submitted draft operating standards on these matters to Treasury. APRA is currently developing guidance material which, while not legally enforceable, will assist trustees in understanding the proposed new requirements in preparation for licensing.

1.20 Regulated investment standards would be in accord with the international best practice, including the principle 'that investment by pension funds should be adequately regulated, including an integrated assets/liabilities approach, for both institutional and functional approaches, and the consideration of principles related to diversification, dispersion, and maturity and currency matching.'²¹ The principles for the regulation of superannuation recently released by the Organisation for Economic Co-operation and Development (OECD) also recommend that:

An adequate regulatory framework for private pensions should be enforced in a comprehensive, dynamic and flexible way in order to ensure the protection of pensions plans' beneficiaries, the soundness of pensions funds and the stability of the economy as a whole. ... Effective supervision of pension funds and plans must be set up and focus on legal compliance, financial control, actuarial examination and supervision of managers. Appropriate supervisory bodies, properly staffed and funded, should be established in order to conduct when relevant off and on site supervision, at least for some categories of funds and in particular when problems are reported. Supervisory bodies should be endowed

²⁰ The Superannuation Working Group was established in October 2001 by the Minister for Financial Services and Regulation to consult on proposals to improve the safety of superannuation. It comprised representatives from the Treasury, APRA and ASIC and reported to the Government in March 2002.

²¹ See Principle 11 of the OECD's *Fifteen Principles for the Regulation of Private Occupational Pensions Schemes*, 11 April 2003, at <<http://www.inprs.org/data/publications/files/fifteenprinciples.pdf>>.

with appropriate regulatory and supervisory powers over individual plans, in order to prevent mis-selling cases arising from irregularities in the distribution and expenses methods.²²

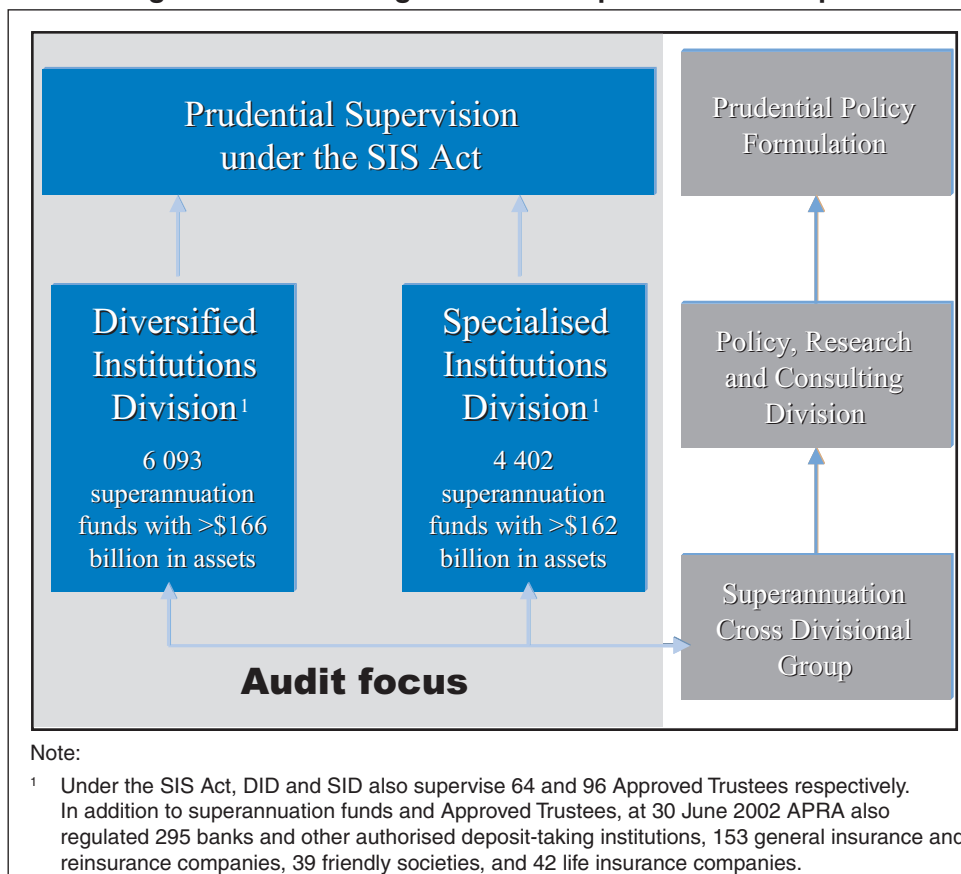
1.21 APRA advised ANAO that it is a member of the OECD Working Party on Private Pensions and of the International Network of Pensions Regulators and Supervisors (INPRS). These bodies are APRA's main link to international pension regulators along with joint forums and bilateral discussions with co-regulators such as the Financial Services Authority in the United Kingdom and the Office of the Superintendent of Financial Institutions in Canada. There is little specific liaison on a fund by fund basis, as the Australian superannuation system requires that funds are set up here as stand-alone trusts so that, even if an international entity is the trustee and/or fund manager for an Australian superannuation fund, there is no cross border regulation of the superannuation fund itself.

Audit approach

1.22 This audit focuses on APRA's prudential supervision of Approved Trustees and superannuation funds registered under the SIS Act. The audit pays particular attention to the work of APRA's supervisory divisions, identified in Figure 1.3.

1.23 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 in the financial sector and advising on the policy implications of those developments. The ATO was consulted during the course of the audit given its responsibility for receiving fund registrations and maintaining the publicly available register of complying superannuation funds.

²² *ibid.*

Figure 1.3**APRA's Organisational Arrangements for Superannuation Supervision**

Source: APRA advice to ANAO.

1.24 APRA advised the ANAO that superannuation entities outside the coverage of the SIS Act (and outside the scope of this audit) include: approximately 64 600 funds originally registered under the *Occupational Superannuation Standards Act 1987* (the SIS Act's predecessor) which are not currently regulated by either the ATO or by APRA;²³ 67 public sector superannuation funds that are exempt from the SIS Act and which hold assets estimated at \$54.5 billion on behalf of judges, governors, parliamentarians, certain state public servants and certain Commonwealth and State office holders; assets of \$3.4 billion in accounts supervised by APRA under the *Retirement Savings Account Act 1997*; and \$27.7 billion in superannuation assets held in life office statutory funds and supervised by APRA under the *Life Insurance Act 1995*.

²³ APRA advised the ANAO on 17 June 2003 that a sample of *Occupational Superannuation Standards Act 1987* funds had been made from APRA's database and none could be found on the ATO's *Register of Complying Funds*. APRA advised ANAO that these funds are not able to claim superannuation tax concessions and will be reviewed as part of APRA's *Lost and Lazy Project*.

1.25 ANAO's objectives for this audit were to assess the efficiency and effectiveness of APRA's prudential supervision of superannuation funds. Specifically, the audit objectives involved:

- evaluating APRA's superannuation supervisory activities; and
- assessing the effectiveness of APRA's supervision of superannuation entities.

1.26 Audit fieldwork was conducted from June 2002 to October 2002. Issues Papers were provided to APRA and Treasury for comment in March 2003 followed by a Discussion Paper in May 2003. An extract of the Discussion Paper was also provided to ATO in June 2003. A proposed report was issued to APRA, Treasury and the ATO under section 19 of the *Auditor-General Act 1997* in July 2003. The audit schedule was extended to accommodate APRA's additional workload in respect of the HIH Royal Commission and to allow for changes in its senior management. The audit was conducted in accordance with ANAO Auditing Standards at a cost to ANAO of \$315 000.

2. Administration of the Regulatory Framework

This chapter describes the regulatory framework in more detail, including the registration of superannuation funds and the licensing of Approved Trustees. It also discusses APRA's experience of funds' lodgements of annual regulatory returns.

Background

2.1 Trustees have primary responsibility for ensuring that superannuation savings are prudently invested and managed, fund members are given adequate information on which to base member investment choice decisions, and are kept informed of the nature and performance of the fund's investments. In this context, the main elements of the superannuation prudential regime are the trust structure, investment guidelines, disclosure requirements to APRA, APRA circulars to trustees and regulator scrutiny.²⁴

2.2 In light of public attention on some recent superannuation fund failures, there has been an increasing focus on regulation of the superannuation industry. A number of inquiries have been held into the industry, including a review by the Senate Select Committee on Superannuation and Financial Services into prudential supervision and consumer protection of superannuation, banking and financial services.²⁵ More recently, a National Competition Policy review of the SIS Act and certain other superannuation legislation conducted by the Productivity Commission concluded that, overall, the SIS Act provides an effective framework for the prudent management of fund members' interests.²⁶

2.3 In October 2001, the Government established the Superannuation Working Group, comprising representatives from APRA, ASIC and Treasury and chaired by a member of APRA's Board, to undertake public consultations on proposals to update the legislative framework and improve fund governance. The Working Group reported to the Government in March 2002. It concluded that the current prudential regime for superannuation, which has remained largely intact since the SIS Act was introduced, is generally sound. Nevertheless, some changes were recommended to modernise the regime and enable APRA to undertake preventative action rather than enforcement action after a breach has occurred.

²⁴ Superannuation Working Group, *Options for Improving the Safety of Superannuation*, Issues Paper, 2 October 2001, p. 4.

²⁵ Senate Select Committee on Superannuation and Financial Services, *Prudential Supervision and Consumer Protection for Superannuation, Banking and Financial Services*, First Report, August 2001, p. iii.

²⁶ Productivity Commission, *op.cit.*, p. xiv.

2.4 In response to the Working Group's report, the Government announced in October 2002²⁷ that it will introduce a number of reforms, including:

- the licensing of all superannuation trustees;
- the preparation and maintenance of a risk management plan by all trustees as a condition of their license, addressing investment, outsourcing, governance, compliance and fraud;
- enhanced disclosure of important fund information to fund members, APRA, and the public through ASIC's electronic facilities; and
- appropriate enforcement powers for APRA to underpin the new framework including those to issue directions, disqualify trustees, vary conditions and suspend or revoke the license.

2.5 Originally intended to commence on 1 October 2003 with a two year transitional period for trustees to comply, APRA advised ANAO that the new framework may now be introduced in April 2004, with a two year transition period commencing in July 2004. These reforms, together with APRA's existing operating standards-making power, are expected by the Government to ensure that trustees remain responsible for fund governance and that APRA has appropriate tools to act where necessary.²⁸

Registration for tax concessions

2.6 The SIS Act provides for two distinct procedures in respect of superannuation funds: the election to be regulated under SIS and registration as a *regulated fund*; and the subsequent issuing of a regulated fund with a *certificate of compliance* so that it can benefit from tax concessions and receive Superannuation Guarantee contributions.

2.7 To become a *regulated fund*, the trustees must lodge an election to be regulated under section 19 of the SIS Act. Section 19 requires that the fund must have a trustee, and that the trustee be a constitutional corporation or that the sole or primary purpose of the fund is the provision of old-age pensions. Funds that lodge a notice of election to be regulated under the SIS Act receive an acknowledgement of their regulated status. A trustee's election to be regulated is irrevocable.²⁹

²⁷ Senator The Hon. Helen Coonan, Minister for Revenue and the Assistant Treasurer, *Safety of Superannuation a Priority for Reforms*, Press Release C114/2, 28 October 2002.

²⁸ Ibid. The Government proposes to introduce the *Superannuation Safety Amendment Bill* during the 2003 Spring sittings of Parliament.

²⁹ See section 19(5) of the SIS Act.

2.8 APRA advised the ANAO that to become a complying fund, a regulated fund must submit a satisfactory annual return after registration. APRA then issues a notice of compliance in accordance with the SIS Act, qualifying the fund to receive tax concessions under the *Income Tax Assessment Act 1936* Part IX and to receive Superannuation Guarantee contributions.³⁰

2.9 A complying fund remains so until APRA notifies it that its complying status has changed.³¹ APRA can issue a notice of non-compliance only when a fund fails to comply with one or more regulatory provisions of the SIS Act and if the fund fails the SIS Act *culpability test*. The culpability test proceeds in two stages:

- The first determines the involvement of fund members in the contravention of the SIS Act. If *all* fund members were knowingly concerned with the contravention, the test proceeds to the second stage. If *some* fund members were knowingly concerned with the contravention *and* none of the other members (those not knowingly concerned, the *innocent members*) would suffer substantial financial detriment if the fund's assets were taxed at 47 per cent, then the test proceeds to the second stage.
- The second stage involves the regulator making an assessment of whether the contravention was serious and if, having taken into account the consequences of taxing fund assets at 47 per cent and all other relevant circumstances, the regulator considers the fund is non-complying, then the fund is notified of its non-complying status.

2.10 Funds that pass the culpability test remain complying funds for taxation purposes though they may be in contravention of one or more regulatory provisions of the SIS Act (for instance, the requirement to lodge annual returns). Funds that fail the culpability test remain regulated at all times: that is, they will be taxed as non-complying but continue to be subject to the requirements of the SIS Act, including its penalty regime.³²

2.11 Consistent with the SIS Act culpability test, in particular the requirement that no innocent member suffer any substantial financial detriment as a result of the fund becoming non-complying,³³ the ISC and APRA have made only

³⁰ Superannuation is taxed at a concessional rate of 15 per cent when contributions are made to a complying superannuation fund, when investments in such funds earn income and when unfunded superannuation benefits are paid out. (Source: Treasury, *Tax Expenditures Statement 2002*, p. 109.) In most circumstances, the ATO requires APRA's certificate of compliance, issued by APRA under section 40 of the SIS Act, before allowing funds access to superannuation tax concessions. Section 40 also obliges APRA to give to the Commissioner for Taxation particulars of such notices.

³¹ A complying fund that becomes non-complying pays tax at the rate of 47 per cent of its total assets calculated in the year of income in which it is given its notice of non-compliance under section 40 of the SIS Act. In subsequent years, its taxable income is taxed at 47 per cent.

³² CCH Australia Pty Ltd, *Australian Master Tax Guide 2003*, p. 262.

³³ *ibid*, pp. 260 and 262.

17 funds non-complying since the culpability test came into force in October 1994. These were mainly self-managed superannuation funds with a small number of members who were also the trustees. APRA has not issued any notices of non-compliance since 1999–2000, when responsibility for supervising self-managed superannuation funds passed to the ATO.³⁴

2.12 As of June 2002, APRA advised ANAO that it was responsible for supervising 12 429 superannuation funds registered under the SIS Act (see Figure 2.1). The total population of registered superannuation funds includes 1 934 that registered for supervision after the introduction of the SIS Act in 1994, but which have not been subsequently supervised by either the former ISC (up to 30 June 1998) or by APRA (since 1 July 1998).

2.13 In November 2000 APRA found it had not received recent annual returns from 7 520 funds and commenced the *Lost and Lazy Project*, which sought to identify and take necessary action against lost funds (those that APRA could no longer locate) and lazy funds (those that could be located but had, for whatever reason, not lodged annual returns).³⁵ Located within APRA's statistics operations unit, the *Lost and Lazy Project* worked in conjunction with supervisory staff so that, by July 2001, APRA had reduced the number of lost and lazy funds to 3 501. APRA also found that a significant proportion of lost funds had not been lodging taxation returns with the ATO.

2.14 In August 2003, ATO advised ANAO that the lodgement of tax returns is a major process within the ATO and that it is inevitable that some entities may not lodge on time, or may not lodge at all. The ATO is in the process of enforcing the lodgement of tax returns from funds which are regulated by APRA. It is likely that this will include lost funds.

2.15 ATO advised ANAO that the ATO's 2003–04 compliance program includes:

- enforcing lodgment of outstanding tax and regulatory returns for 20 000 self-managed funds identified as 'high-risk' through data matching activities;
- conducting detailed field audits of 1 000 funds that are at risk of non-compliance; and
- reviewing high-risk trustees, including those disqualified through bankruptcy, to ensure their appropriateness to act as trustees.³⁶

³⁴ In nominal terms, the total estimated superannuation tax concessions allowed since the introduction of the SIS Act culpability test amount to \$62.985 billion for the financial years 1994–95 to 2001–02 inclusive. Source: Treasury estimates in the *Tax Expenditure Statements* of various years.

³⁵ APRA, *Review of the Methodology behind APRA Superannuation Statistics*, 2001, p. 6.

³⁶ Australian Taxation Office, 18 August 2003, *Compliance Program 2003–04*, p. 10.

Figure 2.1**Superannuation Funds Registered Under the SIS Act: June 2002**

	Number of Funds	Assets (\$b)
Funds managed by one of APRA's Approved Trustees: ¹		
• Small APRA Funds	7 821	2.6
• Public offer superannuation funds	324	200.2
• Approved deposit funds and eligible rollover funds	328	7.1
• Pooled superannuation trusts	160	²
Total managed by APRA Approved Trustees	8 633	209.9
Corporate, staff or industry funds:	1 862	118.1
Total registered and supervised funds:	10 495	328.0
Registered funds which are uncontactable: ³	1 934	Figure not available
Total registered funds	12 429	>328.0
Notes:		
¹ Approved Trustees are licensed by APRA under Part 2 of the SIS Act and are required to hold net tangible assets of \$5 million which may be held by the Approved Trustee, through a guarantee from a custodian or the Approved Trustee's parent company, or by a combination of assets and guarantee amounting to \$5 million.		
² The assets of Pooled Superannuation Trusts are included in assets of other regulated funds. At 30 June 2002, Pooled Superannuation Trusts held assets of \$41.5 billion.		
³ Uncontactable funds are those that registered for supervision after the introduction of the SIS Act in 1994 but which have not been subsequently supervised by either the former ISC (up to 30 June 1998) or by APRA (since 1 July 1998).		

Source: APRA advice to ANAO, 23 May 2003.

2.16 A superannuation fund's election to be supervised under the SIS Act is irrevocable. The SIS Act does not allow for a fund's de-registration after it elects to be supervised. From that time, regardless of the status of a fund's compliance with the SIS Act or its complying status for taxation purposes, it remains at all times registered, regulated and liable to supervision, either by APRA or by the ATO, until such time as the trustees wind up its affairs.

2.17 In August 2003, APRA advised ANAO that, over the period February to May 2003, the 1 934 lost funds had been placed in an enforcement and rehabilitation project, along with another 268 funds which APRA could not contact in relation to lodging their 2001–02 SIS annual returns. By August 2003, APRA advised ANAO that it had categorised these 2 202 funds as follows:

- 95 APRA regulated funds with all past returns now lodged and the funds returned to normal supervision;

- 61 funds that have advised that they are APRA regulated but have not as yet provided past due annual returns. These are to be subject to non-lodgement prosecution and returned to supervision;
- 385 funds that have wound up and are to be removed from the APRA database;
- 396 self-managed superannuation funds subject to regulation by the ATO, to be removed from the APRA database; and
- 526 funds that have advised that they are self-managed superannuation funds or that they have wound up but are yet to provide appropriate documentation.

The remaining 739 cannot be contacted and by 31 August 2003 APRA will have exhausted all reasonable contact options for these funds. APRA has established a further enforcement project commencing September 2003 to: prosecute for non-lodgement of annual returns all those remaining funds that haven't lodged returns or the appropriate documentation to confirm that they are wound up or a self-managed superannuation fund; suspend the existing trustee for the remaining lost funds, appoint an acting trustee (Ministerial consent is required), formulate a wind up scheme (which is a disallowable instrument) and direct the Acting Trustee to wind up these funds; and provide a fully reconciled list of APRA regulated superannuation entities. APRA anticipates finishing the enforcement project in respect of the 739 remaining uncontactable funds by the end of January 2004.

2.18 ATO advised ANAO that it maintains a database of complying superannuation funds, the Register of Complying Funds (ROCS). ROCS was created in 2000 when responsibility for self-managed superannuation funds moved from APRA to ATO. The initial data was provided by APRA and, since then, ATO and APRA have worked to improve the quality of the data in ROCS. There is currently a weekly interchange of data between the ATO and APRA, which updates ROCS with details of new funds, funds which wish to change regulators, funds subject to a change in complying status and funds that have wound up. On this basis, ATO advised ANAO that it is confident that the data in ROCS is quite reliable.

Licensing arrangements

2.19 At the commencement of ANAO's audit, there were 160 Approved Trustees, responsible for 8 633 (or 69 per cent) of all registered funds and \$209.9 billion in assets. APRA's approval process for Approved Trustees is intended to provide for enhanced prudential supervision of this part of the industry. The purpose of the approval process is to assess whether applicants are committed, competent and viable.

2.20 APRA's supervision of Approved Trustees includes the monitoring of the licenses it issues under the SIS Act. The SIS Act's provisions to license extend

from the Constitutional power to make laws in respect of corporations. To gain a license, trustees must be incorporated and must satisfy APRA that they have sufficient assets to meet the consequences of risks arising from their duties as trustees, and that they can be relied upon to properly perform those duties. They must also satisfy any other conditions APRA chooses to set in the trustee license, referred to as an Instrument of Approval.

2.21 APRA's standard Instrument of Approval³⁷ requires an Approved Trustee to: provide certain information to APRA annually or as the need arises; maintain adequate professional liability and other insurance; maintain a formal contingency plan in the event of accident, disaster, crime or system failure; have properly regulated agreements with fund managers; to meet specific capital requirements; and restricts their commercial activities to certain superannuation business.

2.22 APRA is also, through an Instrument of Approval, able to:

- specify additional conditions;
- set requirements for the custody of assets;
- have access to an Approved Trustee's information, books and premises;
- approve specific commercial activities of the Approved Trustee; and
- set the manner in which the Approved Trustee meets the SIS Act's capital requirements.

2.23 The trustees of the remaining 3 796 funds (with at least \$118.1 billion in assets) are not currently licensed by APRA. Included in the reforms to the superannuation prudential supervision regime announced by the Government in October 2002 was the decision to implement a universal superannuation licensing regime to be administered by APRA. From April 2004, as a prerequisite to operating as a superannuation fund trustee, all trustees must be licensed by APRA. Existing trustees will be given two years to obtain a superannuation trustee license from APRA. These licenses are to be subject to conditions, including a requirement for a risk management plan (including a fraud control plan) for both the trustee and each fund under their trusteeship.

2.24 APRA advised ANAO that they anticipate that trustees will be able to apply a single risk management plan where they are responsible for only one

³⁷ The standard Instrument of Approval was updated in January 2001 to harmonise capital requirements with those of ASIC.

fund or where all funds under their care have the same risk profile:

In the case of a single employer non public offer corporate fund, the trustee exists solely to be trustee of that fund. That trustee's operations and the fund operations will overlap 100 per cent and so will the risk management strategy of the trustee and the risk management plan of the fund. Thus both requirements may be incorporated in one framework. At the other end of the spectrum, an approved trustee may be trustee of hundreds of funds that essentially have similar risk profiles. Flexibility in the [proposed legislation] will allow the trustee to 'attach' a fund risk management plan to its risk management strategy, building a framework that covers the trustee's operations of those funds. ... A risk management plan may effectively apply to a large number of funds ... and a large number of funds will have the same plan. If a particular fund had a materially different risk profile, perhaps generated by its investment strategy, the trustee would vary the risk management plan in respect of that fund.

2.25 APRA also anticipates that, under the proposed legislation, trustees will be expected to: establish minimum standards of competency; have in place adequate financial resources to cover operational risk; establish appropriate standards for outsourcing arrangements; and meet other conditions considered appropriate by APRA.

Annual returns

2.26 Each registered fund is required by the SIS Act to lodge an annual return with APRA. Annual returns are APRA's main source of information on the financial status of registered superannuation funds.³⁸ They verify the continued existence and operation of registered superannuation funds. For those funds that have not recently been visited or reviewed, annual returns provide a snapshot of their condition and the possibility of the early detection of an entity in difficulty, supplemented by audited financial statements, member information and, where appropriate, actuarial reports of financial condition. They are a critical aspect of off-site surveillance on which APRA, as a risk-based supervisor, relies to gauge the financial and compliance condition of funds. Significant changes in the financial data or the membership of a fund may alert APRA to matters that require its supervisory attention or intervention.

2.27 Annual returns identify and confirm details about the trustee, including their address and contact details, and comprise other summary information on

³⁸ In conjunction with the Australian Bureau of Statistics, APRA also conducts a quarterly survey of superannuation entities with more than \$60 million in assets to provide aggregate data for the National Accounts. This survey is the basis of APRA's quarterly publication of superannuation data, *Superannuation Trends*.

the superannuation fund's financial and membership status, along with auditors' certificates of compliance with the SIS Act. The returns are due four months after the end of the financial year and are required for each superannuation entity under a trustee.³⁹ Originally a paper return, APRA has progressively introduced electronic lodgement of annual returns on diskette and, most recently, on-line lodgement and certification.

2.28 While lodging an annual return is a requirement for funds' compliance with the SIS Act, APRA has experienced a disappointing record of timely lodgement. For instance, of returns due at the end of October 2000, only 17 per cent of the expected number due were lodged on time and only 58 per cent had been lodged by March 2001, nearly five months after the due date and nearly nine months after the end of the 1999–2000 financial year.⁴⁰ The non-lodgement of annual returns is not confined to a particular class or profile of entity, nor is it a recent phenomenon.

2.29 Prior to 2001, the ISC and APRA had not pursued outstanding annual returns and as a result, by November 2000, APRA did not know:

- the exact number of superannuation funds in existence;
- which funds, especially SAFs, were associated with which Approved Trustees;
- which funds should be under APRA's supervision and which should be supervised by the ATO; and
- how many funds should lodge annual returns and what quantum of levies should be raised.

2.30 To address these shortcomings, in October 2001 APRA expanded the scope of the existing *Lost and Lazy Project* to include the pursuit of funds' annual returns for the 2000–01 financial year. Actions taken included writing to trustees to remind them to lodge returns. Also, from 18 January 2001, for 2000–01 and later annual returns, a fund's failure to lodge a return was converted from a fault liability offence to a strict liability offence.

2.31 As a strict liability offence, it was no longer necessary for APRA to demonstrate the trustee's intent to breach the SIS Act to secure a conviction and a penalty.⁴¹ APRA advised ANAO that this was a fundamental change aimed at ensuring returns were lodged and APRA's supervision database was accurate and noted that:

³⁹ Self-managed superannuation funds supervised by the ATO have six months to lodge their returns. All entities supervised by APRA have four months.

⁴⁰ APRA Media release of 14 November 2001 at <http://www.apra.gov.au/media-releases/01_44.cfm>.

⁴¹ The *Financial Sector Legislation Amendment Act No. 1 2000* made the non-lodgement of annual returns a strict liability offence.

Until the non-lodgement of annual returns became a strict liability offence in January 2001, APRA had no really effective power to act upon funds that did not lodge annual returns. Without this annual return information, APRA had no mechanisms to determine the size of and risks relating to those funds.

2.32 ANAO notes that failure to lodge an annual return is, *prima facie*, a contravention of the SIS Act and, at a minimum, an indicator that the trustee may have operational difficulties. APRA has at all times had available to it powers to monitor and investigate superannuation funds, conferred by Part 25 of the SIS Act. These long-standing powers include the power to request information, require the production of books, request the trustee to undertake an investigation of the fund, and appoint an inspector to the fund.

2.33 APRA recognises that late lodgement of annual returns compromises its ability to perform its prudential function of detecting fund weaknesses and protecting the interests of fund members.⁴² In this context, APRA has, on occasion, publicly reported its performance in obtaining annual returns.⁴³ However, this reporting has focused on returns expected to be received.

2.34 APRA expects to receive returns from funds that lodged a return in either of the previous two years. If a registered fund has not lodged a return in either of these years, APRA does not expect to receive a return in the current year. This approach means that APRA does not report on its performance in obtaining annual returns from funds that have either not recently lodged a return, or have never lodged a return. For example, in April 2001, APRA informed Treasury that at mid-March 2001, of the 10 534 superannuation funds which APRA had expected to lodge annual returns for 1999–2000, 4 446 had failed to do so. The expected number of returns excluded funds that had not recently lodged annual returns. Many of these funds were considered ‘lost’ and many had never lodged an annual return since electing to be supervised under the SIS Act.

2.35 The combination of reminder letters and more effective sanctions resulted in 71 per cent of expected 2000–01 returns being lodged by the due date, compared to 17 per cent the previous year.⁴⁴ However, at December 2001 there were still 10 per cent of expected returns outstanding and APRA was in the process of referring 17 funds to the Commonwealth Director of Public Prosecutions (DPP). As of early August 2002, 13 funds had been referred to the DPP and two trustees had been charged.⁴⁵

⁴² APRA, *Annual Report 2002*, p. 27.

⁴³ APRA Media Release, *Update on superannuation returns*, 14 November 2001.

⁴⁴ *ibid.*

⁴⁵ APRA, *Annual Report 2002*, p. 27.

2.36 APRA advised ANAO in April 2003 that 77 per cent of expected returns (67 per cent of returns from *registered* funds⁴⁶) for 2001–02 had been lodged by the due date, 31 October 2002. By December 2002, 87 per cent of expected returns had been lodged (76 per cent of returns from *registered* entities) compared to 90 per cent at the same time the previous year. APRA advised ANAO that, by July 2003, 97 per cent of expected 2001–02 returns had been received.

Recommendation No.1

2.37 ANAO *recommends* that APRA improve its supervisory accountability by including in its annual report performance information on the lodgement of annual returns based on all registered superannuation funds for which it is responsible under the SIS Act rather than the expected number of returns.

APRA response

2.38 Agreed. The recommendation will be adopted for reporting in the 2003–04 year.

APRA analysis

2.39 Annual returns are used in two ways by APRA, as part of prudential reviews of a fund and, by SID, to generate exception reports.

2.40 Exception reporting identifies ‘at risk’ institutions by highlighting the industry outliers, based on key performance indicators. For superannuation these indicators include solvency levels, operating losses for the last two years and in house assets greater than five per cent of total assets.⁴⁷ At the time of audit, SID had generated two sets of exception reports, based on the 2000 and 2001 annual returns. SID uses annual returns, and quarterly survey data for large funds with assets in excess of \$60 million, to generate these reports. DID does not regularly use exception reporting in its supervision of the superannuation industry.

2.41 Annual returns are also used when conducting a prudential review of a fund. SID and DID analyse a fund’s annual return at the start of an off-site or on-site review, supplemented by audited financial statements, member information and, where appropriate, actuarial reports of financial condition. This allows them to gauge the financial and compliance condition of funds. Problems identified at this stage can then be followed up in the process of the review. In this context, ANAO notes that, if prudential reviews are not carried

⁴⁶ As a percentage of the 12 429 *registered* superannuation entities under APRA’s supervision at 30 June 2002.

⁴⁷ Maximum allowable percentages of in house assets vary depending on when the assets were acquired and are prescribed by sections 77 to 83 of the SIS Act.

out on a regular basis, it is possible that critical information contained in the annual return will not be reviewed or subjected to deeper analysis by DID, and may only be subject to substantial analysis by SID where the fund is highlighted in its exception reporting.

Financial information

2.42 The SIS Act requires trustees of superannuation funds to prepare annual statements of financial position, operations and cash flows⁴⁸ of each fund for which they are responsible and requires fund auditors to give an opinion on whether the financial statements are presented fairly in accordance with the applicable accounting standards. In the case of almost all APRA supervised superannuation entities, the applicable standard is Australian Accounting Standard 25 *Financial Reporting by Superannuation Plans* (AAS 25).

2.43 With the exception of Commonwealth public sector and military superannuation defined benefit funds, the SIS Act and regulations also require the trustee of a defined benefit fund to obtain an actuarial certificate of funding and solvency in relation to the fund. The actuary's certificate must certify the solvency of the fund on the date on which the certificate takes effect and must specify a date on which the certificate expires. The expiry date must be a minimum of one year and a maximum of five years after the date of effect, except for funds that are paying pensions, for which annual certificates are required. Among other things, the certificate must specify:

- the minimum contributions reasonably expected to secure the solvency of the fund at the expiry date of the certificate; and
- *notifiable events* which, should they occur, would require the certificate to cease to have effect and would require a new certificate to be obtained.

2.44 To date, APRA has not required regulated superannuation entities to include actuarial certificates or detailed annual financial information in their annual SIS Act returns. This means that the existing returns provide little information on a fund's liquidity and few details of the underlying assets of a fund. APRA advised ANAO in May 2003 that:

APRA cannot unilaterally change returns and that any change in annual returns requires consultation with the industry to establish a need and ensure that there is the capacity within existing systems to provide the necessary information.

2.45 Until 1 July 2002, APRA had complete discretion to determine the form of the SIS Act annual return. Since then, the SIS Act provisions have operated in conjunction with the *Financial Sector (Collection of Data) Act 2001* (the FSCDA),

⁴⁸ Sections 112 and 113 of the SIS Act.

which empowers APRA to determine reporting standards for regulated entities, including superannuation funds under the SIS Act. The FSCDA provides APRA with the discretion to consult financial sector entities on proposed standards, though the validity of a reporting standard is not affected if APRA does not consult.⁴⁹

2.46 In August 2001, APRA started reviewing the SIS Act annual return to assist it to more effectively supervise superannuation funds and identify funds that may be experiencing problems or that are not being managed in a prudent manner. In January 2003, APRA released for public consultation drafts of a revised set of prudential returns designed to give a more accurate insight into the status of the superannuation industry through the provision of improved data including the detailed composition of investments, investment performance and the level of fees and charges.⁵⁰

2.47 In June 2003, APRA finalised new annual returns to apply for financial years from 2002–03 onwards. The new annual returns comprise:

- a statement of financial performance and a statement of financial position;
- three statements of investments, namely a selected disclosure of investments, a statement of derivative financial instruments and a statement of exposure concentrations;
- a statement of related party transactions;
- a profile of fund membership;
- a superannuation entity profile; and
- a trustee statement.⁵¹

2.48 APRA also announced that, from the second half of 2004, funds with assets of \$50 million or more will be required to submit a reduced suite of quarterly returns, focusing on financial performance and condition, investments, derivatives and exposure concentrations.

⁴⁹ FSCDA, sections 13(5), 13(6) and 13(7).

⁵⁰ APRA Media Release of 15 January 2003 at <http://www.apra.gov.au/media-releases/03_03.cfm>.

⁵¹ APRA Media Release of 27 June 2003 and associated forms at <<http://www.apra.gov.au/Statistics/Lodging-Returns-Superannuation.cfm>>.

3. Supervision Methodologies

This chapter describes and discusses APRA's risk-based supervision methodologies, their application by its supervisory divisions and the scope of its supervision of superannuation funds. It concludes with an analysis of a sample of APRA's on-site reviews conducted during 2001–02 and their supervisory outcomes.

Risk-based supervision

3.1 Since its establishment, APRA has used a number of different methodologies for supervising superannuation funds and Approved Trustees. Initially, APRA applied the methodology used by its predecessor, the ISC. In July 1998, an internal APRA report concluded that most reviews conducted by the former ISC were reasonably effective in identifying and addressing risks in the superannuation funds reviewed. However, APRA advised the ANAO that it considered there were deficiencies in the ISC methodology's pro-forma approach, which focussed on operational rather than investment risks.

3.2 In August 1998, APRA started implementing a less prescriptive, risk-based approach to review, developed by the ISC. This approach required supervisors to focus on five major areas when reviewing the operations of superannuation funds and Approved Trustees, namely: Controls, Risks, Investments, Management and Planning (the methodology was referred to as CRIMP). CRIMP paid greater attention to planning a review and tailoring it to the particular fund, drawing on the necessary components from the full suite of ISC superannuation audit modules, and was expected to result in time-savings and the easier attainment of cost recovery rates.

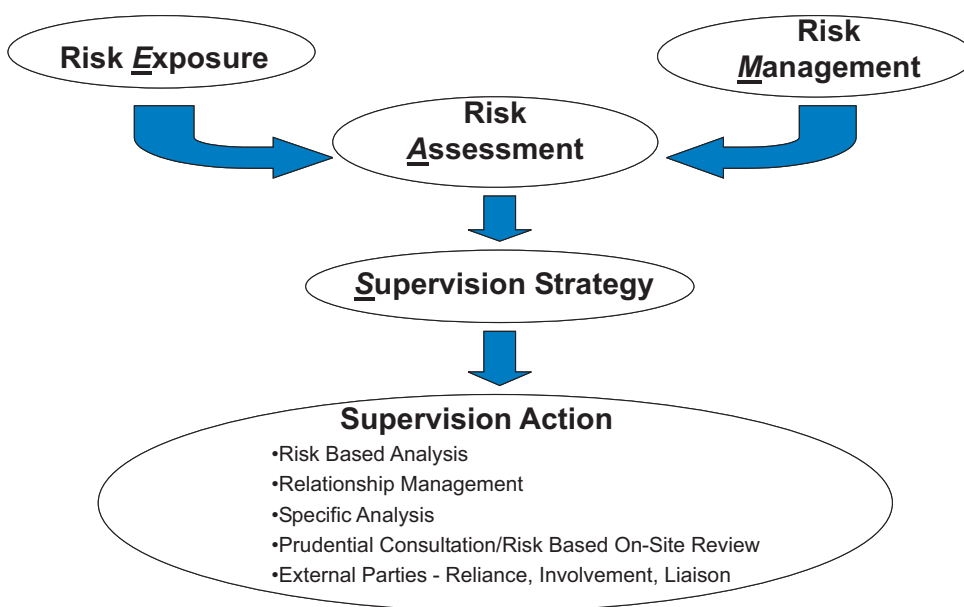
3.3 In September 1999, both SID and DID undertook to work towards developing supervisory approaches to be applied across all financial institutions. The focus for DID was to develop an approach for the supervision of financial conglomerates. SID aimed to develop an approach primarily for supervising stand-alone entities. The implementation of a common methodology for assessing the risk posed by regulated entities commenced in October 2002, though SID and DID retain different approaches to supervision. In respect of superannuation funds, ANAO was unable to observe a sound basis for maintaining distinct approaches, especially in light of the SIS Act's separate requirements for registering and regulating individual funds and for licensing Approved Trustees.

Specialised Institutions Division

3.4 In July 2000, SID adopted a risk-based supervision framework known as EMAS (Risk Exposure, Risk Management, Risk Assessment and Supervision). EMAS was a significant departure from its predecessors, as it was used for supervising all SID's regulated financial entities (including authorised deposit taking institutions and insurance entities), whereas the ISC audit methodology and the CRIMP methodology were specific to superannuation entities. The EMAS methodology was designed to result in a risk rating for each regulated entity, which was then to form the basis for future supervision (see Figure 3.1).

Figure 3.1

Specialised Institution Division's EMAS (Risk Exposure, Risk Management, Risk Assessment and Supervision) Methodology



Source: APRA presentation to ANAO, 26 June 2002.

3.5 SID reviewed its supervision practices in 2001 and again in 2002. The objective of each review was to assess the implementation of EMAS and the quality of supervision performed across regions and industries. The final report of the second review concluded that all APRA regional offices were applying the EMAS methodology, that supervision practices had generally improved since the 2001 review and that there had been a significant increase in the number of on-site reviews completed by SID. The areas considered to require attention included the timing and suitability of action taken on higher risk institutions,

the accuracy of risk-ratings and appropriateness of supervision strategies, and planning for reviews of superannuation funds and Approved Trustees.

Diversified Institutions Division

3.6 In July 2000, DID revised its supervision methodology to address risks within a financial group as a whole as well as within its component regulated entities. The revised methodology is predicated on two broad assumptions, namely: DID supervises sophisticated institutions that will have access to further capital or solvency support, if required, either from the market or an overseas parent company; and the institutions will have well developed and documented internal controls as well as regulatory compliance systems. DID considered that this environment enabled it to adopt a less intrusive off-site supervision regime, where it could (at a high level) verify the effectiveness of control processes through targeted on-site visits, the various management attestation arrangements and external audit sign-offs.⁵²

3.7 The DID risk-based methodology incorporated three broad activities: risk assessment; execution of a supervisory plan; and ongoing evaluation. Risk-ratings were based on a prudential review and consultation with an institution, intended to be conducted annually. Risk-ratings were to be applied from an agreed rating regime to each component regulated entity and an overall rating to the institutional group. The rating reflected factors such as capital adequacy, prevalence of high-risk business activities, concentration of funding risks, large exposures, product lines and management effectiveness and structure and stability. However, in June 2003, APRA advised ANAO that DID does not have a documented separate methodology for reviewing the superannuation funds within a financial conglomerate: as a first step it conducts annual reviews at an institutional level rather than separate, detailed reviews of each component entity. This is followed up by individual entity reviews depending on risk characteristics.

Current risk rating system

3.8 In early 2002, APRA completed a survey of risk rating practices in the United States of America, Canada, the United Kingdom and the Netherlands. After considering the results of this survey, and having regard to the different rating systems then in place in SID and DID, it was decided to develop a common risk rating system across the two divisions. The anticipated benefits of a common approach included greater consistency within and across the two divisions,

⁵² APRA memo, DID Review Methodology Working Group, 21 June 2000.

operational efficiencies in data collection and administration and efficiencies in training and developing supervisory personnel.

3.9 In October 2002, APRA began introducing an upgraded risk rating system known as the Probability and Impact Rating System (PAIRS). The PAIRS methodology is the first APRA risk assessment system to formally integrate the potential impact of failure with the probability of a regulated entity's failure into a single combined supervisory measure, known as the *Supervisory Attention Index*.⁵³

3.10 To estimate a Supervisory Attention Index, supervisors first estimate the impact of an entity's failure by considering the assets involved and categorizing them on a quantitative scale of impact, as follows:

- **Low:** assets under \$250 million (corresponding to an *impact index* less than 1.25);
- **Medium:** assets of more than \$250 million but less than \$2.5 billion (corresponding to an *impact index* between 1.25 and 12.5);
- **High:** assets of more than \$2.5 billion but less than \$12.5 billion (corresponding to an *impact index* between 12.5 and 62.5); and
- **Extreme:** assets over \$12.5 billion (corresponding to an *impact index* greater than 62.5).⁵⁴

3.11 APRA has set a minimum impact index of 0.25 (for entities with less than \$50 million in assets) and a maximum of 250 (for entities with assets of \$50 billion or more). Consequently, the great majority of APRA's regulated entities are rated as *Low* and *Medium* impact, but the bulk of regulated money is controlled by a relatively small number of *High* and *Extreme* impact firms.⁵⁵ ANAO notes that, at May 2003, of the 21 APRA regulated entities with an *Extreme* impact rating, three are Approved Trustees with superannuation interests. Of 84 APRA regulated entities with *High* impact ratings, 24 are Approved Trustees with superannuation interests. ANAO estimates that 90 per cent of superannuation funds under APRA's supervision will have a *Low* impact rating.⁵⁶

3.12 In addition to an impact rating and impact index, supervisors using PAIRS must develop an assessment of the overall probability of failure of an entity. This is achieved by evaluating and assessing an entity's: component risks;

⁵³ APRA's PAIRS indexes and ratings will not be publicly available.

⁵⁴ Sources: APRA, *How PAIRS Ratings are Determined*, at <<http://www.apra.gov.au/PAIRS/Ratings.cfm>> and *APRA Risk Rating System Harmonisation and Enhancement Project–PAIRS*, April 2002, p. 16.

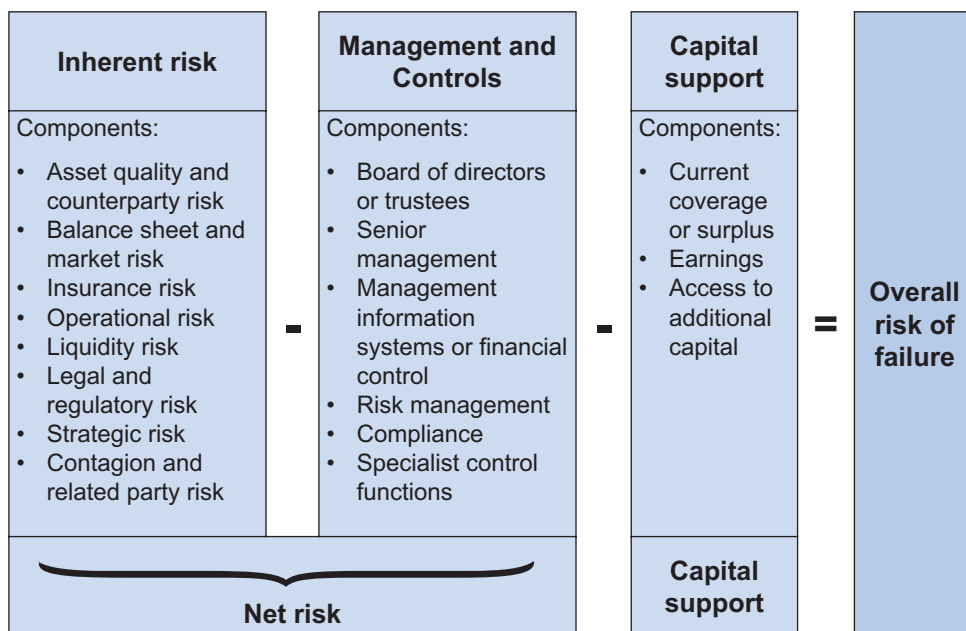
⁵⁵ APRA, *How PAIRS Ratings are Determined*, at <<http://www.apra.gov.au/PAIRS/Ratings.cfm>>.

⁵⁶ APRA advice to ANAO, 23 May 2003. ANAO estimated the proportion of superannuation funds with *Low* impact ratings from APRA's 2001 SIS annual return data.

component management and control structures; and the components of its capital support, as outlined in Figure 3.2.

Figure 3.2

Assessing the overall risk of failure under the Probability and Impact Rating System (PAIRS)



Source: ANAO analysis of APRA data.

3.13 Supervisors must assess or rate each component of inherent risk; management and control; and capital support in absolute terms, taking into account industry benchmarks or averages as appropriate. Supervisors may also assign various weightings to the components, though PAIRS allows less discretion in the weighting of the management and control components than to other components. The numerical values assigned to each component are then combined to give a *probability index* indicating APRA's overall *probability rating* of the risk of failure of the entity. An index less than 1 corresponds to a *Low* probability rating; an index between 1 and 15 corresponds to a *Medium* rating; an index between 15 and 75 corresponds to a *High* rating; and an index over 75 gives an *Extreme* rating.

3.14 Finally, the probability and impact indexes are multiplied to give a *Supervisory Attention Index*. The possible values of the index cover a very large range (from 1 to 56 250) though APRA anticipates that the bulk of its regulated population will have an index under 15. APRA anticipates that an index of 225 or higher will only arise for a small number of particularly high probability

and/or impact entities. For a conglomerate, APRA advised ANAO that an overall PAIRS Supervisory Attention Index is calculated by adding the indexes calculated for its component entities.

3.15 APRA anticipates using its Supervisory Attention Indexes for three main purposes. At an organisational level, the total of the indexes for all regulated entities is a proxy for the total amount of supervisory attention and resources that should be applied. At the entity level, PAIRS provides an objective measure of risk and supervisory oversight with the corresponding allocation of resources applied to those entities with the highest index. Within an industry, the indexes can be used to track relative riskiness over time. For instance, if the total indexes for all the entities in an industry rise markedly over time, it is likely to indicate that the industry is moving into a state of higher risk.

3.16 The indexes can also be used to allocate supervisory attention to groups or classes of entities. For instance, while individual high impact entities may have high Supervisory Attention Indexes, there are relatively few such entities. The total of their indexes may be many times less than the total for a large number of entities with low Supervisory Attention Indexes, indicating that the total supervisory attention and resources paid to entities with low indexes should be correspondingly greater.⁵⁷

3.17 APRA also intends using Supervisory Attention Indexes to decide its supervisory stance with respect to individual entities, using the Supervisory Oversight And Response System (SOARS). SOARS is best thought of as APRA's propensity to intervene and once the PAIRS Supervisory Attention Index is set, one of four supervisory stances applies, as follows:

- **Normal:** APRA collects and analyses data and makes routine on-site visits.
- **Oversight:** A significant step-up in information collection and in the intensity of supervision. APRA may increase minimum capital requirements for 'Oversight' institutions. As a general rule, APRA is to intervene early and often in these 'middle' risk situations, particularly with larger regulated institutions.
- **Mandated Improvement:** The institution is operating in an unsustainable way. APRA will direct institutions in this category to present and execute a remediation plan that addresses the area of identified weakness and restores financial stability. At this level, APRA is to allow the regulated institution to retain control of its destiny but will clearly signal that improvements must be made. APRA may issue directions and take other enforcement actions.

⁵⁷ APRA, *APRA Risk Rating System Harmonisation and Enhancement Project–PAIRS*, April 2002, p. 17.

- Restructure:** The institution is in serious danger of failure. APRA is to apply its full enforcement powers, including issuing directions to replace persons and service providers and to restrict business activities. APRA's paramount concern will be to quarantine the entity from further deterioration and to minimise losses to depositors, policyholders and superannuation fund members.⁵⁸

3.18 Under SOARS, the stance APRA intends adopting with respect to an individual entity depends directly on APRA’s calculation of the entity’s impact and probability ratings under PAIRS, as shown in Figure 3.3.

Figure 3.3
Adopting a supervisory stance under the Supervisory Oversight And Response System (SOARS)

		PROBABILITY RATING				
		LOW	MEDIUM		HIGH	EXTREME
			LOW	HIGH		
IMPACT RATING	EXTREME	NORMAL	OVERSIGHT	MANDATED IMPROVEMENT	RESTRUCTURE	RESTRUCTURE
	HIGH	NORMAL	OVERSIGHT	OVERSIGHT	MANDATED IMPROVEMENT	RESTRUCTURE
	MEDIUM	NORMAL	NORMAL	OVERSIGHT	MANDATED IMPROVEMENT	RESTRUCTURE
	LOW	NORMAL	NORMAL	OVERSIGHT	MANDATED IMPROVEMENT	RESTRUCTURE

Source: ANAO analysis of APRA data.

3.19 The PAIRS/SOARS system is intended to encourage more vigorous intervention by APRA supervisors and narrows the scope of judgement for any individual APRA supervisor, as PAIRS data will also be used to indicate each supervisor’s obligation to report on regulated institutions to APRA’s Executive Committee and, in some instances, the relevant Minister. APRA anticipates it will allow for more consistent authorisation, peer review and quality assurance processes.

3.20 APRA expects the implementation of PAIRS/SOARS to place it in a stronger position to gauge the scale of its overall supervisory task, identify

⁵⁸ APRA, *APRA Insight*, 1st Quarter 2003, p. 4.

priority areas within the regulated population and allocate resources according to the degree of risk. However, in APRA's view:

The great majority of the SID supervised universe will fall into the Low Impact Rating (under \$250 million assets) category and therefore, by itself, the Impact Rating will be of little assistance in differentiating the level of supervisory attention required by the different types and sizes of SID entities. The impact index addresses this to some extent but the issue remains significant for the significant balance of the SID supervised universe with assets below \$50 million. For that significant small sized end of the SID population, the only guide to the relative allocation of SID supervisory attention will be the Probability Rating. This is no different from the situation under the present [EMAS] rating system.⁵⁹

3.21 ANAO notes that superannuation funds with less than \$50 million in assets comprise approximately 90 per cent of APRA's regulated entities and contribute more than 10 per cent of levies raised under the *Superannuation Levy Imposition Act 1998*. For these funds, their relatively low level of assets will result in a low or very low PAIRS *impact rating*. Accordingly, APRA is likely to under-estimate the total amount of supervisory attention required unless Supervisory Attention Indexes are calculated and aggregated for *all* superannuation funds regulated by APRA, including SAFs. This would achieve an improved estimate of APRA's total supervisory task and better indicate the supervisory attention and resources required by individual sectors of the financial industry and/or by different types of regulated entities.

Risk assessment

3.22 APRA has recognised that forming an accurate assessment of the risk profile and risk management systems for all superannuation funds and Approved Trustees it regulates under the SIS Act is an essential part of ensuring the protection of fund members.⁶⁰ APRA advised ANAO that, by June 2001, 3 069 superannuation funds supervised by SID, and 121 superannuation funds supervised by DID, had been allocated a risk rating under the then current supervisory methodologies used by the two divisions (see Figure 3.4). This represents 70 per cent and two per cent respectively of the registered superannuation funds supervised by each division (excluding 'lost' funds that are not currently supervised).

⁵⁹ APRA, *APRA Risk Rating System Harmonisation and Enhancement Project–PAIRS*, April 2002, pp. 15 and 16.

⁶⁰ APRA, *Annual Report 2002*, p. 15.

Figure 3.4**Registered and Supervised Funds by Risk Rating: June 2002**

Risk Rating	Criteria	SID	DID	Total
Low	APRA has no prudential concerns such that there are no significant issues with any aspect of the entity's operations or any apparent trend or event that would, in the medium term, be expected to have a substantial adverse impact on the entity.	1 855	105	1 960
Medium	An operation where APRA has identified an adverse trend or developing situation and needs to closely monitor developments.	886	13	899
High	APRA has numerous and/or significant concerns with one or more aspects of its operations that it is seeking to have recognised and addressed by the entity.	130	Nil	130
Extreme	APRA has serious prudential concerns with one or more aspects of its operations and doubts about its ability or willingness to address them in a timely manner.	16	Nil	16
Managed Exit	APRA considers the management/ shareholders do not have the ability/ capacity to address its prudential concerns.	182	3	185
Total risk-rated funds		3 069	121	3 190
Non-risk-rated funds		1 333	5 972	7 305
Total supervised funds		4 402	6 093	10 495

Source: APRA advice to ANAO. Supervised funds exclude the 1 934 'lost' funds.

3.23 The majority of the superannuation funds not yet rated by APRA were SAFs managed by an Approved Trustee. Whilst Approved Trustees have been risk-rated, the individual registered superannuation funds overseen by these Approved Trustees generally had not. Although a limited number of SAFs with an Approved Trustee have been risk-rated in their own right, in most instances APRA only risk-rated the Approved Trustee. APRA advised ANAO in May 2003 that:

APRA has applied the risk rating of the Approved Trustee to the SAF's for which they are responsible and has applied the supervisory action plan of the Approved Trustee to the SAFs. Review of SAFs extends to the prudential soundness of the Approved Trustee and exception reporting on individual SAFs covering in house assets, solvency, profitability, asset concentration and non-financial assets. The issue is fundamental to risk based supervision ... SAFs comprise \$2.6 billion out of the \$329 billion subject to APRA supervision. They normally have *vanilla* investment strategies that are tested for consistency by APRA on a sample basis during a review of the Approved Trustee. SAFs are also reviewed for prudential

soundness and the correctness of information provided to APRA. Any SAF with a different investment strategy or risk profile is reviewed on an individual basis. APRA's review of SAF's will follow the existing methodology and they will not be risk rated individually.

3.24 Whilst Approved Trustees are responsible for the oversight of each superannuation fund for which they are trustee, each fund remains a separate and distinct legal entity regulated under the SIS Act. Each fund can have a different investment strategy and structure that reflects the risk profile of the members.⁶¹ Accordingly, risk assessments that are based on the controls, management systems and consolidated position of the Approved Trustee may be misleading. ANAO fieldwork revealed that, in one instance, APRA's intervention to resolve the operational issues of an Approved Trustee found:

- almost 5 000 outstanding annual returns for SAFs (see section 36 of the SIS Act);
- more than 30 SAFs from which the trustee had borrowed (see section 67 of the SIS Act);
- more than 50 SAFs in which investments may not have been conducted on an arms length basis (see section 109 of the SIS Act);
- more than 20 SAFs without an investment strategy (see section 52(2)(f) of the SIS Act and SIS regulation 4.09); and
- more than 500 SAFs with investments outside their documented investment strategy.

3.25 ANAO notes that of the \$2.6 billion in assets held in SAFs, the top 10 per cent hold assets of \$1 billion, with balances as high as \$25 million per fund member. SAFs contribute more than 10 per cent of the superannuation supervision levies raised by APRA. Verifying the complying status of such funds is necessary for the proper application of tax concessions and to protect the retirement income objectives of the SIS Act.

3.26 APRA has announced a two-year conversion period for PAIRS/SOARS to provide the time needed to risk-rate regulated financial institutions as well as corporate and public offer superannuation funds. Starting in October 2002, the application of PAIRS/SOARS was prioritised so that all institutions rated *extreme* or *high* impact under previous risk assessment methodologies were to be rated on the new system by March 2003. In May 2003, APRA advised ANAO that:

⁶¹ In addition, as a prerequisite to obtaining a superannuation trustee license under the universal licensing regime announced by the Government in October 2002, a risk management plan is to be required for each trustee and the funds under its trusteeship. While the plans for a number of funds under an Approved Trustee may be the same, there will be scope for individual variation between funds.

All extreme/high impact APRA regulated entities have been PAIRS rated. There are 21 entities with an 'Extreme' rating, of which three are Approved Trustees. Of the 84 entities with a 'High' rating, 24 are Approved Trustees.

3.27 ANAO found no evidence of individual Supervisory Attention Indexes for the individual large public offer superannuation funds managed by high impact Approved Trustees. APRA also advised ANAO that there are no plans in place to rate all regulated institutions, including SAFs managed by an Approved Trustee.

Recommendation No.2

3.28 ANAO *recommends* that APRA undertake risk assessments for all regulated superannuation funds and Approved Trustees for which it is responsible under the SIS Act, with the timing and intensity of these assessments prioritised in the overall context of the implementation of the new risk-based methodology.

APRA response

3.29 Agreed. APRA's strategy on the supervision of superannuation entities will be reviewed in light of the recommendation.

3.30 With respect to SAFs, APRA will focus on the systems of the Approved Trustee and address issues in the individual SAFs consistent with the risk-based PAIRS/SOARS supervision methodology adopted for all APRA supervision activities.

3.31 A similar approach will be taken to the supervision of superannuation entities within an APRA regulated conglomerate financial group, with primary attention given to the group's risk management systems before review of individual entities within the group.

3.32 The PAIRS/SOARS methodology provides a clear process for front line supervisors to focus on the significant issues in risk-rated supervision.

Prudential reviews

3.33 An effective supervisory approach involves both off-site (or desk-top) and on-site examination and monitoring of regulated entities. Off-site supervision enables industry trends and developments to be monitored as well as analysis of the financial condition of individual regulated entities. It often involves analysis of statistical returns and other information obtained from each entity by supervisors as well as publicly available information. In comparison, on-site visits by supervisors assist them to: verify that risk management systems and internal controls are in place; assess the reliability of information provided to the supervisor; and obtain additional information needed to assess the condition

of each entity. In this context, on-site reviews provide APRA with the most comprehensive supervisory information about a superannuation entity.⁶²

3.34 APRA conducts both on-site and desk-top reviews (the latter using material that includes annual returns) of superannuation entities. Reviews may be part of a program of reviews or may be triggered by events such as a serious complaint from a member or anomalies arising from annual returns. The aim of the prudential review of superannuation funds is to ensure that they are being managed in line with the long-term purpose of providing retirement benefits to members and in accordance with legislative requirements and standards. APRA's power to visit funds to conduct prudential reviews in cooperation with the trustees derives from Part 25 of the SIS Act. It gives APRA powers to collect and assess information from funds' trustees for the purpose of confirming compliance with the requirements of the Act and funds' subsequent certification of entitlement to receive Superannuation Guarantee contributions and tax concessions.

Scheduling

3.35 In a risk assessment-based supervisory system, reviews are scheduled based on an assessment of the nature, significance and scope of the risks to which individual entities are exposed, including the business focus, the risk profile and the internal control environment. Furthermore, recognising the inherent limitations of off-site analysis, better practice is for all supervised entities to be visited on a regular basis, with higher risk entities visited more often and/or subject to more intensive visits.⁶³

3.36 In this context, since 1995–96, the ISC had an Australia-wide program of reviewing superannuation funds.⁶⁴ The ISC's targeted review frequency was, on average, once every three years for industry funds and those managed by Approved Trustees, and once every five years for all other funds with more than five members. Funds with fewer than five members were subject to limited specific focus programs. In its final year of operation (1997–98), the ISC conducted 999 on-site reviews of superannuation funds, having conducted 786 on-site reviews in 1996–97.⁶⁵

⁶² In this report, on-site reviews include those nominated by APRA as prudential consultations, operational reviews conducted by APRA's Policy, Research and Consultation Division, and tri-partite meetings. All data cited for on-site reviews records visits in these categories.

⁶³ ANAO Audit Report No.12 1995–96, 28 November 1995, *Risk Management by Commonwealth Consumer Product Safety Regulators*, pp. 50–60 discusses the application of these principles in regulatory environments.

⁶⁴ Insurance and Superannuation Commission, *Annual Report 1997–98*, p. 54.

⁶⁵ Figures cited exclude ISC on-site reviews of small funds. Source: Senate Select Committee on Superannuation and Financial Services, *First Report*, August 2001, p. 49.

3.37 By late 1999, APRA had refined its supervision process and aimed to visit each of the several hundred large funds with assets in excess of \$60 million once every financial year, with other funds to be visited on a three to five year cycle. In May 2003, APRA advised ANAO that:

For Specialised Institutions Division, the review cycle now comprises a desk review of annual returns, review of audited statements and on-site reviews every two years, on average, for all but small APRA funds.

3.38 APRA's review of superannuation funds and Approved Trustees has been affected by reorganisation, relocation, and changes to case selection and auditing methodologies. For example, in relation to the latter, some 30 months elapsed between the cessation of the ISC's case selection methodology and SID's compilation of EMAS risk-ratings to inform future case selection and supervisory action. In overall terms, the reported rate of on-site review of superannuation entities has only recently recovered to exceed 1998–99 levels, as shown in Figure 3.5.

Figure 3.5

APRA on-site reviews of superannuation entities: 1998–99 to 2001–02

	1998–99	1999–00	2000–01	2001–02
Number of on-site reviews of superannuation entities ¹	893	333	622	1 073
Reported number of superannuation entities ²	11 433 ³	11 433	11 696	11 562
Proportion reviewed	8%	3%	5%	9%
Notes:				
¹ Figures exclude on-site reviews of self-managed superannuation funds. They include 54 reviews of Approved Trustees in 2000–01 and 75 in 2001–02.				
² Figures cited are from APRA Annual Reports so that, for instance, the number reported for 2001–02 is 867 short of the correct figure of 12 429 advised by APRA and cited in this report.				
³ ANAO estimate for 1998–99, using reported 1999–2000 population.				

Sources: Senate Select Committee on Superannuation and Financial Services, *First Report*, August 2001 and APRA annual reports.

3.39 Figure 3.5 indicates that, at best, APRA conducted on-site reviews of nine per cent of registered superannuation funds in 2001–02 and, at worst, three per cent in 1999–2000. In aggregate, in its first four years of operation APRA conducted on-site reviews of 25 per cent of the reported number of superannuation funds it is responsible for supervising. Over the same period, APRA conducted desk-top reviews of 17 percent of the reported number of superannuation funds it is responsible for supervising. Desk-top reviews numbered 200 in 1998–99, 314 in 1999–2000, 215 in 2000–01, and 1 271 in 2001–02. APRA advised ANAO that the large number of desk-top reviews in

2001–02 was due to: ‘a specific focus on reviewing the financial statements of a large number of funds, which did not occur in previous years.’

3.40 This finding was reinforced by ANAO’s examination of APRA’s supervisory records for a random sample of 50 funds that were not reported to have been reviewed by SID or DID in 2001–02. In 32 instances (64 per cent) APRA held no supervisory files on the regulated funds such that there was no documentary evidence of any APRA supervisory activities. Having regard to the pace of change in the financial services industry, ANAO considers all regulated funds should be subject to periodic supervisory review.

Recommendation No.3

3.41 ANAO *recommends* that APRA undertake supervisory reviews of all registered superannuation funds and Approved Trustees for which it is responsible under the SIS Act, having regard to APRA’s risk-based supervisory strategy.

APRA response

3.42 Agreed. APRA’s comments in respect of Recommendation 2 apply.

Risk-ratings

3.43 The major outputs expected to result from prudential reviews are the allocation of a risk rating for the entity and development of a supervisory action plan. APRA advised ANAO that, during 2001–02, it conducted 1 100 on-site reviews of registered superannuation funds (1 084 by SID and 16 by DID).

3.44 To examine the process by which APRA allocates its risk-ratings and develops supervisory action plans, ANAO examined a sample of reviews, selected as follows:

- Documentation associated with a random sample of 48 of the 1 084 funds reportedly visited by SID was requested from APRA. Of the 48 selected, examination of APRA’s records revealed that 45 had been subject to an on-site review in 2001–02. Of the remaining three, one was subject to a desk-top review. APRA advised ANAO that another fund was managed by an Approved Trustee whose operations and IT risk management systems for its subordinate funds were reviewed by APRA though the subordinate fund was not individually assessed. APRA advised ANAO that the third fund had been wound up and that, in that circumstance, no review was documented nor risk rating applied. On this basis, SID’s advice to ANAO overstated the number of on-site reviews conducted by SID in 2001–02 by some six per cent.

- DID advised ANAO that it conducted 16 on-site reviews of institutions that included superannuation funds during 2001–02. Documentation associated with all 16 reviews was requested and provided to ANAO.

3.45 For those funds and institutions in the sample where an on-site review was conducted in 2001–02, ANAO found (see Figure 3.6) that risk-ratings were allocated in 95 per cent of cases and that supervisory action plans were developed in 90 per cent of cases.

Figure 3.6

ANAO examination of a sample of 2001–02 APRA on-site reviews of superannuation funds or institutions

	SID funds	DID institutions	Total
ANAO sample size	48	16	64
Less: no evidence of 2001–02 APRA review	2	0	2
Fund/institution subject <u>only</u> to desk-top review	1	0	1
Funds/institutions reviewed by APRA in 2001–02	45	16	61
Risk rating analysis:			
Funds/institutions allocated a risk rating	43	15	58
Comprising:			
• Managed Exit risk rating	0	0	0
• Extreme risk rating	0	0	0
• High risk rating	5	0	5
• Medium risk rating	12	4	16
• Low risk rating	26	11	37
Funds/institutions not allocated a risk rating	2¹	1	3
Supervisory Action Plan analysis:			
Funds/institutions where a supervisory action plan was developed	42	13	55
Funds/institutions without a supervisory action plan	3²	3	6
Notes:			
¹ APRA advised ANAO that one of these funds was transferring to the supervision of the ATO and that the other was winding up, in which case APRA does not allocate a risk rating.			
² APRA advised ANAO that one of these funds was transferring to the supervision of the ATO and another was winding up, in which case APRA does not document an ongoing supervision plan.			

Source: ANAO analysis of APRA data.

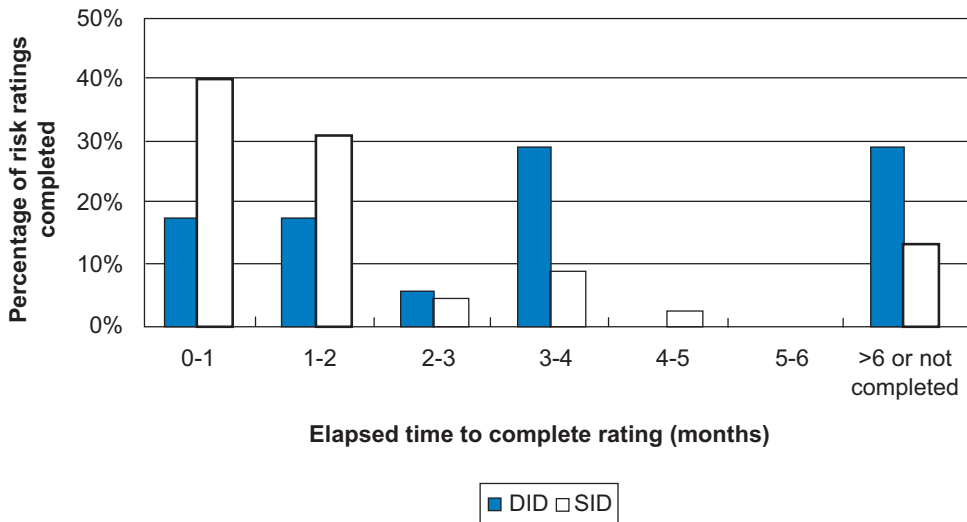
3.46 ANAO found in a sample of reviews that a significant difference was evident in the scope and the timeliness of the review outcomes. Whereas the sampled SID reviews of certain Approved Trustees showed evidence of the inspection and risk rating of subsidiary superannuation funds under the

Approved Trustee, this was not evident in any of the reviews of Approved Trustees conducted by DID.

3.47 While 71 per cent of the sampled SID risk ratings and supervisory action plans were complete within two months of the on-site visit, only 35 per cent of DID's risk-ratings were completed within two months of visit (see Figure 3.7). With respect to supervisory action plans, only 12 per cent of DID's were completed within two months of visit whereas 71 per cent of SID's were completed within that time (see Figure 3.8). ANAO found that a risk-based approach to the supervision of superannuation funds has yet to be consistently and promptly applied within APRA.

Figure 3.7

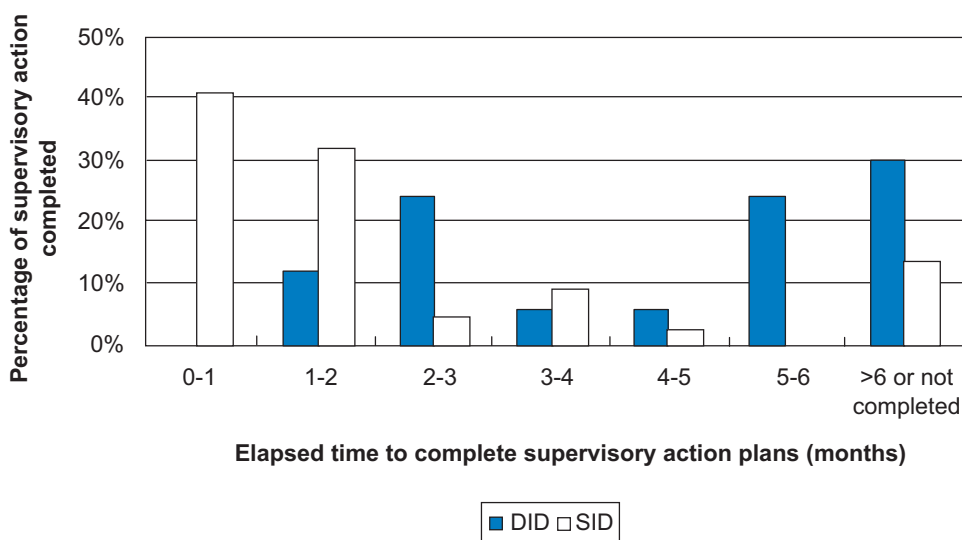
Timeliness of risk rating of a sample of 2001–02 APRA on-site reviews of superannuation funds or institutions



Source: ANAO analysis of APRA data.

Figure 3.8

Timeliness of the development of supervisory action plans for a sample of 2001–02 APRA on-site reviews of superannuation funds or institutions



Source: ANAO analysis of APRA data.

Recommendation No.4

3.48 ANAO *recommends* that APRA implement systems and procedures across its supervisory divisions that ensure the timely allocation of a risk rating and the timely approval of supervisory action plans at the conclusion of each review.

APRA response

3.49 Agreed. The requirement for timely and full documentation will be implemented immediately and ongoing compliance will be monitored by the Quality Assurance and Consistency Unit.

3.50 APRA's practice for on-site visits is a closing meeting where the supervised entity is provided with feedback on the issues found by APRA and APRA's expectations of remediation. The outcomes of on-site visits will be communicated in writing to the supervised entity and relevant APRA documentation updated.

Supervisory action

3.51 Regulators often have available to them a range of risk treatment options. This assists regulatory effectiveness by enabling an appropriate initial response and, where this proves unsuccessful, escalated regulatory responses. APRA

advised ANAO that, in its view, effective supervision is more than enforcement and the exercise of legally available powers. A successful outcome to a wide range of supervision problems that do not involve criminal or negligent elements is best achieved by working directly with Trustees to rectify any identified problems.

3.52 Short of replacing a trustee or revoking a licence (both of which require Ministerial consent), the strongest enforcement action available to APRA is to undertake an inspection under section 263 of the SIS Act.⁶⁶ APRA may notify a trustee that it intends conducting an investigation and appointing an inspector of the fund's affairs if it appears to APRA that the SIS Act has been contravened, that the fund's financial position is unsatisfactory, or that the trustee has ignored determinations of the Superannuation Complaints Tribunal. Other enforcement actions available to APRA under the SIS Act include:

- directing an acting trustee to wind up a fund;
- requiring the trustee to appoint a person (or a committee) to investigate the financial position of the entity and report to the trustee and to APRA;
- asking the trustee (or another concerned party) to enter into a legally binding undertaking;
- disqualifying an auditor and/or referring them to their professional body;
- disqualifying a person from the roles of trustee, custodian or investment manager;
- writing to trustees (or others) asking that they show cause why one (or more) enforcement actions should not be taken by APRA; and
- referring matters to the police, the ATO, the DPP and ASIC where appropriate.

3.53 If convicted of an offence under the SIS Act, individuals or trustees may be liable to fines or gaol sentences. Section 193 of SIS Act prescribes 12 Civil penalty provisions attracting fines of up to \$220 000 for an individual or \$1.1 million for a body corporate. Conviction of certain offences can attract gaol terms of up to five years (in the case of an unauthorised trustee offering superannuation interests to the public). In most cases, lesser penalties apply: for instance, a maximum fine of \$2 750 against a trustee who fails to lodge a SIS Act annual return (\$13 750 if the trustee is a body corporate).

⁶⁶ The appointment of an inspector gives APRA and/or the inspector extensive additional powers to: obtain information and freeze assets; to give directions to persons concerned with the operations of the fund; to enter premises and require the production of books; to apply for warrants to seize books not produced; and to examine people under oath.

3.54 As outlined by Figure 3.9, in 2001–02 APRA has reported that it made greater use of its SIS Act enforcement powers than in 2000–01. The increase comprises a significant number of funds wound-up, due in part to the *Lost and Lazy Project*, and the pursuit of outstanding contributions to funds. In general, SID makes significantly more use of the SIS Act enforcement powers than DID. In addition, at 30 June 2002, SID had 43 superannuation entities under intensive supervision, including three Approved Trustees responsible for a number of superannuation funds, and was supervising the wind-up of a further 91 funds.

Figure 3.9

**APRA Enforcement Actions against Superannuation Entities:
1998–99 to 2001–02**

Year	1998–99	1999–00	2000–01	2001–02
Fund made non-complying ¹	5	1	n/a	n/a
Replace trustee	2	5	4	1
Appoint inspector, investigator or liquidator	2	3	2	3
Disqualify auditor	6	3	2	0
Refer to police, ASIC, DPP	8	10	8	8
Refer to ATO	5	5	5	8
Issue a 'show cause' letter	5	2	3	16
Pursue outstanding contributions ²	—	—	11	50
Transfer of assets to another fund	5	7	16	19
Wind-up of fund	4	6	13	141
Payment of benefits due ²	5	2	—	—
Other ³	4	3	10	22
Total	51	47	74	268
Notes:				
¹ Self-managed superannuation funds, disqualified under the SIS Act <i>culpability test</i> . For financial years 2000–01 on, responsibility for supervising these funds lies with the ATO.				
² Not separately reported in some years.				
³ Includes issuing notices or directions to trustees, entering into enforceable undertakings, revoking the license of an approved trustee, freezing fund assets and meeting with boards of trustees.				

Sources: Senate Select Committee on Superannuation and Financial Services, *First Report*, August 2001, p. 52, APRA *Annual Report 2001*, p. 14, and APRA *Annual Report 2002*, p. 24.

Supervisory action plans

3.55 APRA's supervisory action plans are intended to summarise supervisory priorities and tasks. Where a plan had been developed, consistent with a risk-based supervisory approach, ANAO found that APRA had planned more intensive supervision of entities rated to represent a higher risk compared to those rated a lower risk.

3.56 In June 2002, SID formalised the process for escalating supervision of entities to include: a preliminary review of any existing risk rating to confirm the supervisor's assessment and compile all relevant documents; the development of an initial action plan (which may include further enquiries); the development of a case management plan, including a recommendation to a senior manager on future supervisory and enforcement action; and, if further action is recommended, sign-off involving senior analysts, senior legal advisors and senior managers. Every matter which might involve the formal use of APRA's legal powers must be signed off by senior managers. APRA advised ANAO that:

At the time of the audit, there had been no instances of formal enforcement action within DID. In general, formal enforcement action occurs within DID and SID as a last resort. Relationships between DID and supervised entities are based on a consultative model where DID works with higher risk entities to have them upgrade their practices and standards and make rectification where necessary. DID's usual approach to perceived weaknesses involves planning to increase the frequency or intensity of prudential reviews and consultations as well as visits by the specialist consulting teams.

3.57 APRA advised ANAO in May 2003 that the PAIRS/SOARS methodology provides a schedule for escalating authorisation for supervisory action as APRA's supervisory concern increases:

Given the size, capital bases, support from sponsoring employers and associated entities also regulated by APRA and the sophistication of institutions supervised by DID, the consultative approach is often more appropriate. DID have not encountered any super funds that required escalation or enforcement.

3.58 The PAIRS/SOARS authorisation schedule applies to both APRA's supervisory divisions but does not constitute a plan for reviewing and escalating supervisory action. In June 2002, DID was supervising three entities with the highest risk rating of 'Managed Exit'. In such cases, APRA considers that the entity's management do not have the ability or capacity to address APRA's prudential concerns and APRA's focus is on enforcing the entity's orderly exit from the industry rather than rehabilitating it into normal supervision.

3.59 Although more intensive supervision of institutions rated to represent a higher risk has been planned, there have been significant differences in planned supervisory action among superannuation entities that have received the same risk rating. For example, of the 12 SID funds included in ANAO's random sample of rated superannuation entities that received a medium rating,⁶⁷ planned further supervision ranged from the review of annual financial statements and annual

⁶⁷ A medium rating meant that APRA had identified an adverse trend or developing situation that needed to be closely monitored.

returns data, to a desk review in two years, to no action at all. While supervisors may well have planned different supervisory actions for sound reasons, any such reasons were not documented in supervisory action plans. APRA advised ANAO that:

The supervisory approach may vary depending on particular circumstances including risk rating. Prudential issues may require different prudential action but may still result in the same risk rating. Action is determined on a case-by-case basis.

3.60 The effectiveness of the supervisory action plans has also been adversely affected by an apparent inability to undertake planned actions. In particular, planned prudential review timetables are not consistently implemented. For example, ANAO examined three reviews conducted prior to the 2001–02 financial year where another review was planned to have taken place prior to mid-2002. There was no evidence that these reviews had taken place.

3.61 APRA advised ANAO that differences in planned supervisory action can be attributed to the previous methodologies and that PAIRS now formalises the supervisory responses across risk-ratings. ANAO notes that supervisory action within APRA varies significantly for superannuation entities depending upon whether SID or DID is responsible for the entity.

Recommendation No.5

3.62 ANAO recommends that APRA apply a consistent supervisory approach, along the lines of that adopted by Specialised Institutions Division, across all divisions for escalating its supervision and enforcement where prudential concerns are identified.

APRA response

3.63 Agreed. The recommendation will be implemented immediately. The implementation of PAIRS/SOARS provides a consistent framework for reporting to senior management and undertaking supervision activity for more risky institutions.

3.64 At the date of the audit there were no instances within DID where formal enforcement action had been necessary. Issues identified had been resolved through supervision activity. However, where there are significant enforcement actions which arise, DID will call on relevant rehabilitation and enforcement expertise and staff within APRA for assistance and input, thus ensuring consistency of process.

Canberra ACT
15 September 2003



P.J. Barrett
Auditor-General

Appendix

Appendix 1

Key provisions of the SIS Act

Trustees' duties and obligations	Sanctions
Statutory covenants apply to trustees (section 52) that they act honestly, diligently and invest according to a properly formulated investment strategy	Contravention is not an offence. Those suffering loss or damage may take action to recover amounts lost (section 55)
Specific requirements are that trustees: <ul style="list-style-type: none"> • ensure that the sole purpose of the fund must be to provide old age pensions (section 62) • must not borrow from or lend to members (sections 65, 66 and 67) • must not pay out of a fund to an employer (section 117) • must make investments at arms-length (section 109) • adhere to in-house asset limits (Part 8) • must notify APRA of significant adverse events (section 106) 	Fines up to \$220 000
• appoint an auditor	Gaol term up to two years
• adhere to equal representation rules where applicable (section 63)	Fines up to \$11 000
• adhere to operating standards	
• arrange to deal with member complaints (section 101)	
• keep records, reports, information from investment managers (sections 102-105)	
• submit annual SIS returns (section 36)	Fine up to \$5 500
APRA's powers	Sanctions
To register funds and certify their tax compliance: <ul style="list-style-type: none"> • irrevocable registration (section 19) • certification of tax compliance (section 40) 	Allows access to tax at 15 per cent Non-complying funds taxed at 47 per cent
To license Approved Trustees (Part 2) including: <ul style="list-style-type: none"> • setting any conditions on the license (sections 26 and 27) • revoking a license with the Minister's approval (section 28) 	Operating without a proper license can result in a gaol term up to five years.
To set operating standards governing the operation of regulated superannuation funds (Parts 3 and 29)	Fines up to \$11 000
To disqualify certain trustees, custodians and investment managers (Part 15)	Operating while disqualified can result in a gaol term up to two years.
To remove trustees with the Minister's consent (Part 17) and: <ul style="list-style-type: none"> • appoint an acting trustee • direct an acting trustee 	Fines up to \$11 000

continued next page

APRA's powers	Sanctions
To monitor and investigate (Part 25), including powers to: <ul style="list-style-type: none"> • require information, produce books and to visit premises • to require a trustee to appoint investigators to report to APRA • to appoint an inspector, require assistance from persons and examine them under oath and apply for search warrants 	Fines up to \$11 000 Gaol terms up to two years.
To advise the Minister on claims for financial assistance made by funds that have suffered loss due to fraud or theft (Part 23)	n/a

Note: Sanctions cited are those that apply to individuals when the intent to offend has been established (*fault liability*) and a conviction secured. For bodies corporate, the fines are five times those cited. Since January 2001, certain contraventions of the SIS Act (such as the failure to lodge an annual return) may be prosecuted as *strict liability* offences, in which case intent need not be established and a lesser penalty applies (the maximum fine is \$2 750 rather than \$5 500).

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