

The Auditor-General
Audit Report No.51 2003-04
Performance Audit

HIH Claims Support Scheme —Governance Arrangements

Department of the Treasury

Australian National Audit Office

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of Australia 2004

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Canberra ACT
10 June 2004

Dear Mr President
Dear Mr Speaker

The Australian National Audit Office has undertaken a performance audit in the in accordance with the authority contained in the *Auditor-General Act 1997*. Pursuant to Senate Standing Order 166 relating to the presentation of documents when the Senate is not sitting, I present the report of this audit and the accompanying brochure. The report is titled *HIH Claims Support Scheme—Governance Arrangements*.

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

Yours sincerely

A handwritten signature in black ink, appearing to read 'P. J. Barrett'.

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/Glossary

AAA	Allianz Australia Advantage Ltd
Allianz	Allianz Australia Insurance Limited
Amendment Act	<i>Taxation Laws Amendment Act (No. 6) 2001</i>
ANAO	Australian National Audit Office
Appropriation Act	<i>Appropriation (HIH Assistance) Act 2001</i>
ATO	Australian Taxation Office
CEIs	Chief Executive's Instructions
Claims Managers	Insurers engaged to provide claims management, payments and recovery services for the Scheme
CMA	Commonwealth Management Agreement
Corporations Act	<i>Corporations Act 2001</i>
Finance	Department of Finance and Administration
FMA Act	<i>Financial Management and Accountability Act 1997</i>
FMO	Finance Minister's Orders
Guidelines	<i>Guidelines for Issuing Indemnities, Guarantees and Letters of Comfort</i>
HARP	HIH Assistance Review Panel
HCSL	HIH Claims Support Limited
HIH	HIH group of companies placed into liquidation in August 2001. The insurance companies involved in the Group were: CIC Insurance Limited; FAI General Insurance Company Limited; FAI Reinsurances Pty Limited; FAI Traders Insurance Company Pty Limited; HIH Casualty and General Insurance Limited; HIH Underwriting and Insurance (Australia) Pty Limited; and World Marine & General Insurances Pty Limited. A further insurance company involved in the HIH Insurance Group, HIH Company Limited, was put into liquidation in August 2002.
ICA	Insurance Council of Australia

IPP	Information Privacy Principles
Liquidator, the	Joint liquidators of each HIH company
MFSR	Minister for Financial Services and Regulation
Minister, the	Minister for Revenue and Assistant Treasurer
NPP	National Privacy Principles
NRMA	NRMA Insurance Limited, now Insurance Australia Group
Owners' corporation	The legal name for a strata plan or body corporate or the legal body that owns a building with common property.
Privacy Act	<i>Privacy Act 1988</i>
R&SA	Royal & Sun Alliance Financial Services Limited, now Asteron Life Limited
Scheme, the	HIH Claims Support Scheme
Strategic Review	Strategic review of the Scheme undertaken in 2003
Treasury	Department of the Treasury
Treasury performance auditor	Private sector firm engaged by Treasury to undertake an external performance audit of the Scheme in 2002
Trust	HIH Claims Support Trust
Trust Deed	HIH Claims Support Trust Deed
QBE	QBE Management Services Pty Limited
QBE Insurance	QBE Insurance (Australia) Ltd
WGB	Wyatt Gallagher Bassett

Summary and Recommendations

Summary

Background

1. The HIH group of companies (HIH), one of Australia's biggest providers of insurance services, was placed into provisional liquidation on 15 March 2001. Joint liquidators (the Liquidator) were appointed on 27 August 2001.
2. On 14 May 2001, the Government decided to implement a scheme to provide assistance to policyholders experiencing financial hardship as a result of the HIH collapse—the HIH Claims Support Scheme (the Scheme). The Scheme formally commenced operations on 7 July 2001, although, with the Prime Minister's approval, the Department of the Treasury (Treasury) had begun making payments to salary continuance claimants in June 2001.
3. The responsible Minister was initially the then Minister for Financial Services and Regulation (MFSR). Following the November 2001 general election, responsibility for the Scheme was transferred to the Minister for Revenue and Assistant Treasurer (the Minister). Treasury is the Commonwealth department responsible for administering the Scheme.

Scheme structure

4. HIH Claims Support Limited (HCSL), a wholly owned subsidiary of the Insurance Council of Australia (ICA), was formed in May 2001 as a non-profit company to oversee and administer the Scheme. Under the Commonwealth Management Agreement, HCSL is responsible for the Scheme's day-to-day administration, including managing the call centre and website; receiving applications and assessing their eligibility; coordinating the claims management and payment process; and reconciliation of the proof of debt with the Liquidator. HCSL contracted a commercial service provider to operate the call centre and perform eligibility assessment and proof of debt reconciliation functions on its behalf.
5. Under tripartite Claims Management Agreements, four Australian insurers (Claims Managers) were appointed by HCSL and the Liquidator to perform separate, but related, services in respect of particular classes of claims. The Claims Managers agreed to participate in the Scheme on a cost-recovery basis. They act as the Liquidator's agent in providing claims management services, and as HCSL's agent in providing payment management and recovery services. The Commonwealth is not a party to the Agreements, and plays no role in the claims management process.
6. The *Appropriation (HIH Assistance) Act 2001* appropriated funds, to a limit of \$640 million, for the purposes of providing financial assistance and

meeting associated administrative costs. To date, Scheme payments have been made through the HIH Claims Support Trust, in which the Commonwealth holds the residual beneficial interest. The Commonwealth funds the Trust on a periodic basis. HCSL, as trustee, is responsible for distributing funds for claim payments and administrative expenses.

Process for receiving assistance

7. On 21 May 2001, the MFSR announced the criteria for determining which policyholders would be eligible to receive assistance.¹ An applicant who is denied eligibility in the first instance can seek an Internal Review by the Managing Director of HCSL. Where the Internal Review is unsuccessful, the applicant can appeal to the HIH Assistance Review Panel (HARP).

8. Once an applicant has been assessed as eligible, the application is forwarded to the relevant Claims Manager. The Claims Manager then requests the applicant's claim file from HIH, and proceeds to assess and manage the claim. The Claims Managers are required to manage claims in a manner that is consistent with sound industry practice and the obligations of the insurer toward its policyholders under the terms of the relevant policy and the general law. Once the Claims Manager has, on behalf of the Liquidator, determined or settled the amounts to be paid under a claim, they are responsible for paying the relevant parties on behalf of HCSL.

9. In applying for assistance, an applicant is required to offer to assign their rights under their policy. This includes the right to pursue, through a proof of debt, recovery from the Liquidator of amounts owed as a creditor of HIH. Through this process, the Commonwealth will ultimately seek to recover a proportion of claim payments made under the Scheme.

Scheme review and closure

10. Following a Strategic Review of the Scheme, the Government agreed in August 2003 to its closure to new applicants six months from the date of the closure announcement. The Scheme closed on 27 February 2004, with a limited gateway being established for 'special circumstances' applications made after that date.

11. Consequently, the eligibility assessment and call centre functions provided by HCSL will be no longer required.² However, claims management

¹ Press Release, Minister for Financial Services and Regulation, *Criteria for HIH Hardship Relief*, 21 May 2001.

² Other than for those accessing the Scheme through the limited gateway. Eligibility assessment for late applicants is to be undertaken by an independent person or organisation with insurance industry experience.

and payment functions for eligible applicants will continue for some years. Based on the findings of the Strategic Review, Treasury concluded that it was no longer cost-effective to maintain the existing service delivery structure, and the Government agreed to the phasing out of HCSL from the administration of the Scheme.

12. The existing Claims Management Agreements will also be terminated. Six months after Scheme closure, the claims management task will be consolidated with the remaining administrative tasks formerly undertaken by HCSL (including management reporting, data management and the proof of debt reconciliation). A new claims manager(s) to perform all of the consolidated tasks will be selected through competitive tender, and engaged on a commercial-fee basis under a new tripartite agreement with the Commonwealth and the Liquidator.

Audit scope and objectives

13. The objectives of this performance audit were to:

- review the governance and accountability framework for the Scheme, and
- assess the efficiency and effectiveness of Treasury's implementation and management of that framework.

14. The audit scope did not include independent testing of the existing operational functions, given the extent of previous internal audit and review activity, and the fact that the operational approach was to undergo extensive change. The audit focussed on providing assurance to the Parliament regarding the effectiveness of the Scheme's existing and prospective administrative arrangements in terms of appropriate standards of public sector governance and stewardship. The claims management services undertaken by the Claims Managers on behalf of the Liquidator were also excluded from the audit scope.

Key Findings

Governance framework (Chapter 2)

15. Access to industry expertise and infrastructure was critical to the Commonwealth's ability to implement a scheme of this nature in the short timeframe involved. As a result, delivery of the Scheme has involved a complex combination of public and private sector organisations. Treasury is responsible for policy development, and providing advice to Scheme participants on the interpretation of that policy. HCSL, through its Board, has been responsible for administering the implementation of the Scheme by its

sub-contractor and the Claims Managers (and their sub-contractors and service providers).

16. Having regard to the urgency required in originally developing the Scheme, the framework established exhibited many of the key elements of good public sector governance, as identified in the Australian National Audit Office's (ANAO) Better Practice Guide on public sector governance.³ However, the Scheme experience has also served to highlight the governance challenges that can arise in developing such a structure for the distribution of Commonwealth financial assistance.

17. Treasury's capacity to ensure that issues with policy implications were adequately identified, and subsequent decisions implemented, in a timely and effective manner has been inhibited in some respects by the nature of the existing responsibility and communication channels. Equally, concerns were expressed, at one point, within the HCSL Board regarding the nature of Treasury's involvement in various decision-making processes relating to eligibility criteria and assessment procedures. This particularly related to the extent to which the Board was consulted prior to decisions applicable to the operations of the Scheme being taken.

18. The occurrence of issues of this type declined as the Scheme matured. However, Treasury has identified that the enhanced degree of direct control it will have over some aspects of Scheme operations, under the more streamlined administrative structure to be established following its closure, will be of benefit.

19. The risk management arrangements for the Scheme have been generally sound, having regard to the high levels of inherent risk associated with its operation. In particular, the Scheme documents were designed to provide extensive levels of audit and performance oversight. A robust audit program will continue to be important as the Scheme transitions to the new phase of operations.

20. For the most part, eligibility assessment is undertaken on the basis that reliance will be placed on the information provided by applicants, which must be supported by a statutory declaration stating that the information is true and correct. The use of this approach was primarily motivated by the urgency involved, and the desire to avoid placing additional burdens on policyholders already experiencing hardship.

21. Between March 2002 and August 2003, the HCSL internal auditor sought to verify the eligibility of a sample of applicants who had been assessed

³ ANAO Better Practice Guide, *Public Sector Governance*, Canberra, July 2003, Volume 1, pp. 7–8.

as eligible.⁴ Of the 174 applications examined⁵, 12 (seven per cent) were found to be ineligible. Payment of \$171 433 had been made in respect of one of those applicants.⁶

22. In May 2004, HCSL advised ANAO that the error rate identified by the internal audit process 'reflects the fact that the applications selected for examination were in fact deliberately chosen on the basis of potential issues they might raise.' Nevertheless, given the internal audit results, there is still a clear risk that other applicants have been assessed as eligible based on inaccurate, and/or potentially fraudulent, information provided in their application. In future similar circumstances, it would be good practice for the responsible agency to identify, prior to implementing the scheme, the risks inherent in the use of a self-assessment application process, and document the considered risk treatment by the relevant decision-maker.

23. In establishing new contractual arrangements for the administration of the Scheme, ANAO considers that Treasury should identify the means by which there will be regular scrutiny of the new claims manager(s)' compliance with its privacy obligations. The contractual arrangements should also address the means by which actual or potential conflicts of interest will be managed and reported. These were areas that were not adequately addressed in the original Scheme documentation. The Commonwealth Management Agreement was amended in August 2003 to incorporate a clause addressing conflict of interest issues.

Scheme planning and implementation (Chapter 3)

24. There is clear evidence of an ongoing commitment by the Scheme participants to assist applicants and manage the Scheme in an efficient and effective manner. However, the logistics involved in establishing Scheme operations were very challenging. Consequently, it took longer than had been anticipated, or intended, to achieve significant progress in making claim payments to eligible applicants.

25. Progressively, the operation of the Scheme became more stable. As a result, it has been successful in delivering assistance to a large number of Australian individuals, small businesses (as defined in the Scheme eligibility criteria) and not-for-profit organisations affected by the collapse of HIH. As at April 2004, about \$339 million in claim payments had been made, representing

⁴ This involved the internal auditor verifying the applicants' eligibility through interviews and confirmation of application details from source documents.

⁵ This represented less than two per cent of applications assessed as eligible as at October 2003.

⁶ The eligibility of a further four applications, involving payments totalling \$135 261, was still being investigated as at March 2004.

46 per cent of such payments estimated to arise under the Scheme.⁷ The majority of outstanding claims were 'long-tail' in nature, and may take many years to resolve.

26. Over time, Treasury has been comprehensive in its consideration of the key elements required to successfully implement a grant program of this nature. However, due to the context in which the Scheme was initially planned and established, a number of issues important to its effective management were necessarily addressed concurrent with, or in a number of cases some time after, the commencement of Scheme operations.

27. In particular, when it was first established, there was not a full understanding of the extent of insurance business HIH had been involved in. Nor of the entities likely to apply for assistance. As a result, variations to the Claims Management Agreements had to be negotiated in order to provide for the handling of additional claim types. A number of circumstances have also arisen that necessitated clarification and/or enhancement of the originally announced eligibility criteria.

28. In March 2002, the HCSL internal auditor also identified a significant procedural weakness in the eligibility assessment process for small business applicants. In April 2002, it was further identified that some applications from universities had been approved as eligible under the not-for-profit category, without having provided the documentation required by the relevant procedure manual.

29. These factors had adverse consequences for the efficient and effective delivery of assistance to some applicants, particularly during the first year of the Scheme. Processing for a number of applicant groups, including some who had already been advised they were eligible, was temporarily halted while the various issues relating to eligibility criteria and assessment processes were addressed. Some applicants experienced significant delays before processing of their claim was able to commence or resume.⁸ Whilst it is clear that the actions taken were motivated by a desire to protect the Scheme's integrity, they did result in uncertainty for affected parties.

30. The eligibility assessment issues that arose resulted in some applicants being incorrectly assessed as eligible. In a small number of cases, payments had been made. The options to recover such payments are limited (see below).

⁷ Based on the actuarial review of the Commonwealth's gross liabilities under the Scheme completed in April 2003.

⁸ Delays in the resumption of processing for some applicants were exacerbated in part by the administrative care-taker arrangements that came into effect in the lead up to the Federal general election held in November 2001.

Financial management (Chapter 4)

31. Based on current estimates, the existing appropriation will not be sufficient to meet the expected cost of the Scheme. In the event expenditure reaches the \$640 million limit, no further payments will be able to be legally made without a further appropriation, or an increase provided to the existing appropriation. Treasury has not yet sought any additional appropriation, given the underlying uncertainty as to the final cost and the fact that spending to date has not yet approached the limit of the existing appropriation. As at April 2004, a third actuarial review of the Commonwealth's liabilities under the Scheme was underway.

32. The *Financial Management and Accountability Act 1997* (FMA Act) provides the central legal framework for Commonwealth financial management. It imposes obligations on officials in relation to the handling of public money in order to provide an appropriate degree of control of, and accountability for, the expenditure of such money. Legal advice provided to Treasury on 23 July 2001 was that, although the contrary is arguable, the money held on trust by HCSL for the purposes of the Scheme did not satisfy the definition of public money set out in the FMA Act. On the basis of that advice, the arrangements set out in the FMA Act framework were not required in respect to the handling and expenditure of Scheme funds by HCSL and the Claims Managers. Commonwealth oversight of the funds has been provided less directly through the reporting obligations imposed on those parties by the relevant agreements and the HIH Claims Support Trust Deed.

33. Over half of the expenditure expected under the Scheme had yet to occur at the time of audit. Accordingly, strong financial management controls will continue to be required for some years. In January 2004, the Treasury Executive Board agreed to arrangements for the engagement of the new claims manager(s) that will result in Scheme funds in its hands being regarded as public money. Consequently, future expenditure of those funds, including the engagement of sub-contractors or service providers, will be subject to FMA Act requirements. Treasury's legal advice was that their status as public money should give the Commonwealth greater control over the Scheme funds than at present.

34. The financial management arrangements to be implemented by Treasury for the new Scheme structure provide a sound basis for providing appropriate accountability for the significant amount of taxpayers' funds yet to be expended.

Recoveries

35. The original Scheme documents did not address the question as to how payments made to ineligible applicants could be recovered, or an applicant's eligibility withdrawn. Legal advice obtained by Treasury in May 2002 was

that, in a number of scenarios, there would be grounds on which to seek recovery of payments made to applicants later found to be ineligible. However, Treasury has also been advised that, in some scenarios, the Commonwealth's options for recovering or withholding both claim payments and service provider costs may be limited by the operation of contract law and/or the principle of estoppel.

36. Treasury has sought legal advice regarding the potential to pursue the recovery of a number of payments made to applicants later found to be ineligible, totalling at least \$1 022 153. As at March 2004, Treasury had decided that, based on legal advice received, it would not be pursuing recovery of two of those payments, totalling \$668 933. A decision in respect of the remaining amounts had not been made at the time of audit.

Indemnities

37. An important aspect of the Scheme structure was the provision by the Commonwealth of extensive indemnities and performance guarantees to HCSL, its officers and directors, the Claims Managers and the Liquidator in respect of liabilities that may arise in connection with their participation in the Scheme. This was an essential element in obtaining the participation of the private sector parties, which is a reflection of the non-profit basis on which HCSL and the Claims Managers had agreed to participate. The indemnities are very broad in their terms, but do not apply where the recipient has acted 'dishonestly', defined to mean actual fraud, dishonesty, bad faith, or wilful breach of a material term of the relevant contract.

38. None of the indemnities contains a financial limit. There was no evidence of a documented risk assessment, including consideration of the potential financial implications, having been conducted prior to the issuing of the initial indemnities under the Scheme in July 2001. At a minimum, the advice to the MFSR proposing that the agreements be executed should have explicitly recognised that the potential financial implications were unknown. This was not the case.

39. In February 2004, Treasury advised ANAO that it is expected that there will be no indemnities provided under the revised Scheme arrangements. This will represent a significant reduction in the risks being carried by the Commonwealth in respect of the future management of claims under the Scheme. At the time of audit, there had yet to be any call made on the indemnities already provided. However, the original participants will continue to be indemnified in respect of their actions under the Scheme up to the time their involvement was terminated.

Overall audit conclusion

40. Although much remains to be done (given the 'long-tail' nature of the bulk of outstanding claims), the Scheme has achieved the Government's objective of assisting policyholders affected by the collapse of HIH. This has been done in a manner that has, in the main, provided appropriate standards of public sector governance and stewardship for the significant amount of funds involved.

41. Overall, the structure initially adopted has proved effective in achieving the Scheme's objectives. The outcomes achieved to date are to the credit of the parties involved, given the challenging circumstances in which the Scheme was designed and implemented. The first year of operation was particularly difficult, with some applicants experiencing delays and frustration while gaps or problems in the eligibility assessment process were addressed.

42. The experience gained through the operation of the Scheme has provided a number of lessons that would be of benefit to agencies responsible for implementing any future Commonwealth financial assistance schemes. In particular, it has highlighted that the efficiency and effectiveness of the service provided to applicants, as well as the responsible agency's stewardship of the funds involved, is likely to be improved by maximising, to the extent the prevailing circumstances permit, the analysis undertaken to inform the design of eligibility criteria, application material and assessment guidelines. In addition, ANAO considers that, wherever possible, it is desirable for agencies to seek to maximise the extent to which financial arrangements for which they are responsible fall within the scope of the FMA Act.

43. ANAO found that, at the time of audit, Treasury was applying a comprehensive approach to planning the design of the revised Scheme structure and documents. The opportunity to undertake a more considered and complete analysis of each element of the revised structure, prior to it being implemented, should be of benefit to the Department in achieving a smooth transition.

44. ANAO made six recommendations to improve the governance, eligibility assessment and financial management arrangements for future Commonwealth financial assistance schemes. Treasury agreed with all six audit recommendations.

Agency response

45. Treasury's full response to the section 19 proposed audit report was as follows:

The HIH Claims Support Scheme (Scheme) is a unique example of Government and industry working together under considerable time constraints to implement a program of assistance. The impact of the collapse of

the HIH Group on policyholders was immediate, and the preparedness of the insurance industry to rapidly pull together a structure for service delivery meant that timely assistance was made available. Within seven weeks of the Government's announcement, the policy framework was established, the Treasury had commenced making payments to salary continuance policyholders and HIH Claims Support Limited (HCSL) was ready to process applications.

Since the commencement of operations the Treasury and HCSL have continually identified and acted upon opportunities to further enhance and refine both eligibility policy and operational performance. A comprehensive audit program has also been an effective mechanism to highlight where there is scope for improvement. A part of this program is the verification audit process, which utilises targeted judgement based sample selection criteria and has been very successful in identifying applications with the highest likelihood of failure.

Due to the ongoing focus on improvement, many of the issues raised in this report had been internally identified and actions taken to mitigate the risks. The most obvious example is the current restructure of the Scheme, which will result in a streamlined service delivery framework best suited to the future rate of claims run-off, within the scope of the *Financial Management and Accountability Act, 1997* (FMA Act).

This report will provide some valuable insights regarding lessons learned from the Treasury's experience of developing and implementing a program within a very short timeframe, with limited information and with an industry-based cost recovery service delivery structure.

Recommendations

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

Recommendation No.1
Para 2.63 ANAO *recommends* that Treasury develop and implement a specific strategy for monitoring compliance by the new claims manager(s) for the HIH Claims Support Scheme with contractual and legislative privacy obligations.

Treasury response: Agree.

Recommendation No.2
Para 2.74 ANAO *recommends* that, when entering into agreements with private sector entities for the delivery of public sector outcomes, Treasury identify in the relevant contractual documents the means by which actual or potential conflicts of interest will be managed and reported.

Treasury response: Agree.

Recommendation No.3
Para 3.46 ANAO *recommends* that, in implementing Commonwealth financial assistance schemes, agencies implement adequate checklists and sign-off procedures to confirm that eligibility has been assessed in conformance with stated procedures, including the receipt of necessary documentation.

Treasury response: Agree.

Recommendation No.4
Para 3.59

ANAO *recommends* that, prior to the commencement of application assessment for Commonwealth financial assistance schemes, agencies:

- (a) define all key terms used in the eligibility criteria; and
- (b) verify that the application forms are designed to provide the information necessary to enable eligibility to be assessed against all approved criteria.

Treasury response: Agree.

Recommendation No.5

ANAO *recommends* that, prior to implementing Commonwealth financial assistance schemes, agencies:

Para 3.65

- (a) undertake, to the extent possible in the relevant circumstances, a comprehensive analysis of the entities that are likely to apply. This would assist in the appropriate design of the eligibility criteria and application documentation; and
- (b) where the financial assistance is provided on a discretionary basis, include appropriate disclaimers in the documentation to be provided to potential applicants reserving the right to alter, or terminate, the scheme.

Treasury response: Agree.

Recommendation No.6

ANAO recommends that agencies:

No.6

Para 4.49

- (a) take steps to maximise, wherever possible, the coverage by the FMA Act of taxpayers' funds for which they are responsible; and
- (b) where that is considered either not possible or undesirable, fully document the rationale for that position.

Treasury response: Agree.

Audit Findings and Conclusions

1. Introduction

This chapter discusses the establishment of the HIH Claims Support Scheme, the outcome of a recent strategic review of its operation, and the ANAO audit.

Background

1.1 On 15 March 2001, the NSW Supreme Court appointed provisional liquidators to one of Australia's biggest providers of insurance services, the HIH group of companies (HIH).⁹ On 27 August 2001, the court placed each of the companies in the group into formal liquidation and ordered the commencement of winding up proceedings. The provisional liquidators were appointed joint liquidators (the Liquidator) of each HIH company.

1.2 In the period immediately following the HIH collapse, a Government Task Force on HIH was formed to coordinate the Federal Government's response to the situation. The HIH Royal Commission was established on 29 August 2001 to inquire into the reasons for, and circumstances surrounding, the collapse. The Royal Commissioner handed down his report in April 2003.¹⁰

Impact of the HIH collapse

1.3 In the period leading up to its collapse, HIH negotiated a number of joint venture arrangements with Allianz Australia Insurance Limited (Allianz) and QBE Insurance (Australia) Ltd (QBE Insurance). The provisional liquidators subsequently negotiated further commercial arrangements with QBE Insurance and NRMA Insurance Ltd (NRMA), now Insurance Australia Group. Those arrangements secured the interests of a large number of former HIH policyholders.

1.4 However, the collapse of HIH had very significant consequences for many in the community who found themselves uninsured for claims made by or against them. The main classes of policyholders that remained exposed were those with:

- claims on retail policies that were not in force at 1 January 2001 (including old claims on house and contents, personal motor vehicle, small business and rural policies); and

⁹ The insurance companies involved in the HIH group were: CIC Insurance Limited; FAI General Insurance Company Limited; FAI Reinsurances Pty Limited; FAI Traders Insurance Company Pty Limited; HIH Casualty and General Insurance Limited; HIH Underwriting and Insurance (Australia) Pty Limited; and World Marine & General Insurances Pty Limited. A further insurance company involved in the HIH insurance group, HIH Company Limited, was put into liquidation in August 2002.

¹⁰ The HIH Royal Commission, *The failure of HIH Insurance*, Volume I, *A corporate collapse and its lessons*, April 2003.

- claims on all corporate policies, including the public liability of many local government councils, professional indemnity, medical malpractice, directors and officers indemnity, industrial special risk, fire and peril, burglary, crop and disability policies (such as group salary continuance).

1.5 In general, insurance policyholders have no priority claim on the assets of an insurance company that goes into liquidation. Policyholders with outstanding claims are unsecured creditors of the company in liquidation, and must seek a return on that debt in the eventual distribution of any remaining assets by the liquidator.¹¹

1.6 In April 2001, the HIH provisional liquidators stated that the only creditors who could expect prompt payment of their claims were those identified for the special arrangements involving coverage by other insurers, as noted above. The provisional liquidators expected that reliable estimates of other creditor payment outcomes would not be possible for at least one year. It was also likely that there would be a delay of at least two years before the first payment to creditors, with a delay of up to ten years before the final payments were made.¹²

Decision to provide assistance to policyholders

1.7 Australia does not have an established insurance policyholder protection scheme.¹³ In the period immediately following the HIH collapse, the Government held discussions with the Insurance Council of Australia (ICA), the insurance industry peak body, regarding the steps that might be taken to assist policyholders.

¹¹ Under section 562A of the *Corporations Act 2001* (Corporations Act), reinsurance recoveries collected by a liquidator are allocated in priority to the claims of creditors or groups of creditors whose claims lead to a particular recovery. However, the application of that provision is not straightforward and it is not yet clear how the reinsurance arrangements of the various HIH companies will be applied in the distribution of assets to creditors.

¹² Statement by Provisional Liquidator, *Update 11th April 2001*.

¹³ The HIH Royal Commissioner recommended that the Commonwealth Government introduce a systematic scheme to support the policyholders of insurance companies in the event of the failure of such a company—Recommendation 61, The HIH Royal Commission, *op. cit.*, p. 301. On 12 September 2003, the Treasurer announced the Government's final response to the recommendations of the Royal Commission. The Government's response to Recommendation 61 was: 'This matter was last considered under the Financial System Inquiry (the Wallis Inquiry) which recommended against establishing such a scheme. The Government will commission a study by an eminent person into the merits of financial system guarantees. The study will include how any guarantee might be funded and how it might impact on consumers and incentives in financial markets...' Treasury advised ANAO that Professor Kevin Davis, who had been commissioned to lead the study, reported to the Treasurer on 26 March 2004.

1.8 On 7 May 2001, the ICA announced an insurance industry plan to help HIH policyholders.¹⁴ On the same day, the ICA wrote to the then Minister for Financial Services and Regulation (MFSR) stating that the general insurance industry in Australia believed that emergency action should be taken to assist individuals who were suffering as a result of the provisional liquidation of HIH. The ICA proposed that a scheme for delivering assistance be funded by a levy on insurance policies, with an appropriate contribution from Governments.¹⁵ The ICA advised that the insurance industry was prepared to take responsibility for operating the assistance scheme, and to provide expertise and resources to meet needs quickly.

1.9 On 14 May 2001, the Government decided to implement a scheme to provide assistance to policyholders experiencing financial hardship as a result of the collapse of HIH—the HIH Claims Support Scheme (the Scheme). The responsible Minister was initially MFSR. Following the November 2001 general election, responsibility for the Scheme was transferred to the Minister for Revenue and Assistant Treasurer (the Minister). The Department of the Treasury (Treasury) is the Commonwealth department responsible for administering the Scheme.

1.10 On 17 May 2001, the MFSR and the ICA jointly announced the formation of a new non-profit company, HIH Claims Support Limited (HCSL), to oversee and administer the Commonwealth Government’s assistance package for HIH policyholders in hardship.¹⁶ HCSL is a wholly owned subsidiary of the ICA.

1.11 On 21 May 2001, the Government decided to fund the Scheme through the Commonwealth Budget, and also agreed that it would be administered on the Commonwealth’s behalf by HCSL on a not-for-profit basis. In announcing the Government’s decision on the same day, the MFSR also announced the

¹⁴ Media Release, *Insurance Industry Announces Plan to Help HIH Policyholders*, Insurance Council of Australia, 7 May 2001.

¹⁵ The ICA proposed a levy on policies in the first year of one per cent of premiums.

¹⁶ Press Release, *Joint announcement by the Minister for Financial Services & Regulation and the Insurance Council of Australia—Non-profit structure to deliver HIH support*, 17 May 2001.

criteria for determining which policyholders¹⁷ would be eligible to receive assistance.¹⁸

Claims managers

1.12 The MFSR further announced on 21 May 2001 that HCSL would sub-contract, on a cost-only basis, claims management and payments services to four Australian insurers (Claims Managers).¹⁹ The Claims Managers were selected by the ICA on the basis of an indication from the companies, each of whom is represented on the ICA, that they were willing to participate in the Scheme.

1.13 HCSL entered into tripartite Claims Management Agreements with each Claims Manager and the provisional liquidators (now the Liquidator). Each Claims Manager has been engaged to provide services in respect of particular classes of insurance business written by HIH. The Claims Managers are:

- QBE Management Services Pty Limited (QBE)²⁰—corporate claims, professional indemnity and public and product liability claims;
- Allianz Australia Advantage Ltd (AAA)²¹—retail, rural and small business claims;
- Royal & Sun Alliance Financial Services Limited (R&SA) (now Asteron Life Limited)—salary continuance claims; and
- NRMA—claims where the other Claims Managers have a conflict of interest.

1.14 Under the Agreements, HCSL and the Liquidator appointed the relevant Claims Manager to perform separate, but related, services:

¹⁷ The Scheme replicates, to the extent possible, the ordinary legal relationships that exist between an insurance company, a policyholder and a third party seeking damages. Had HIH continued in business, third parties would have no direct right of claim under a policy, except where specifically allowed by legislation (Section 51 of the *Insurance Contracts Act 1984* – where the insured has died or cannot, after reasonable enquiry, be found; and Section 601AG of the Corporations Act – where a company is deregistered and the policy covered the liability immediately before deregistration). In all other circumstances, third parties need to sue the policyholder for the loss suffered, and it is up to the policyholder to make a claim on the insurer in order to satisfy any judgment or settlement. Unless and until the policyholder applies for assistance and is assessed as eligible, a third party has no access to the Scheme. Some third parties have experienced difficulties in this regard.

¹⁸ Press Release, Minister for Financial Services and Regulation, *Criteria for HIH Hardship Relief*, 21 May 2001.

¹⁹ *ibid.*

²⁰ A subsidiary of QBE Insurance.

²¹ A subsidiary of Allianz.

- the Liquidator appointed them to provide claims management services.²² In this capacity, the Claims Manager acts as the agent of the Liquidator; and
- HCSL appointed them to provide payment management and recovery services.²³ In this capacity, the Claims Manager acts as the agent of HCSL.

1.15 In structuring the Scheme, two of the key concerns were to avoid:

- jeopardising the Liquidator’s reinsurance asset recoveries (which could reduce the overall pool of funds available for distribution to creditors, including the Commonwealth, and also potentially expose the Commonwealth to litigation by the Liquidator); and/or
- undermining the Commonwealth’s ability to prove a debt in the eventual distribution to creditors of HIH.

1.16 Accordingly, the Commonwealth is not a party to the tripartite Agreements, and plays no role in the claims management process. The Claims Managers are required to manage claims on behalf of the Liquidator in a manner that is consistent with sound industry practice and the obligations of the insurer toward its policyholders under the terms of the relevant policy and the general law.²⁴ The Claims Management Agreements require the Claims Managers to liaise with the Liquidator in cases of large claims or claim payments.

Scheme funding arrangements

1.17 The Scheme was included as a Budget measure in the 2001–02 Budget. The measure stated that ‘a provision for cash expenditure in excess of \$0.5 billion over the next four years has been made.’²⁵ The *Appropriation (HIH Assistance) Act 2001* (Appropriation Act), assented to on 30 June 2001,

²² This involves the examination, investigation, verification, adjustment, assessment, management and settlement of claims, including the determination of coverage entitlement in accordance with the terms of the HIH policy.

²³ This involves arranging payment to relevant parties; establishing an approved bank account to be used solely for the purposes of Scheme transactions; monthly reconciliation of all account transactions; calculation of claim estimates, including estimated costs of third party service providers; reporting to HCSL in accordance with the requirements of the Agreement; identification and pursuit of recoveries from third parties where considered cost effective; accounting to HCSL and the Liquidator for their proportion of sums recovered; and generally accounting for and ensuring the proper disposition of all funds made available by, or received for the benefit of, HCSL.

²⁴ Disputed insurance claims can be referred to Insurance Enquiries and Complaints Ltd for personal lines claims, and Financial Industry Complaints Service Ltd for salary continuance claims. Other claims disputes are subject to the usual recourse to the courts.

²⁵ This provision was made by the Department of Finance and Administration (Finance) in the contingency reserve.

appropriated funds from the Consolidated Revenue Fund to a limit of \$640 million for:

- providing financial assistance to HIH eligible persons, either directly or indirectly; and
- meeting administrative costs associated with providing that financial assistance.

1.18 The mechanism established for making payments under the Scheme was the HIH Claims Support Trust (Trust).²⁶ The Commonwealth funds the Trust on a periodic basis and holds the beneficial interest in it. HCSL, as trustee, is responsible for authorising claim payments and distributing the funds to Claims Managers. HCSL also distributes funds to reimburse Claims Managers and itself for administrative expenses, including the payment of fees to sub-contractors and third party service providers. Any recoveries obtained by Claims Managers from third parties to a claim are paid into the Trust to help fund the Scheme.

1.19 The Commonwealth (as settlor) and HCSL (as trustee) entered into the HIH Claims Support Trust Deed (Trust Deed) establishing the Trust on 6 July 2001. On the same day, HCSL, in its capacity as trustee, entered into the Commonwealth Management Agreement (CMA) with the Commonwealth. Under the CMA, HCSL's principal responsibilities are to:

- manage the Scheme call centre and website;
- receive applications and assess their eligibility under the Scheme criteria;
- assign eligible applications to the relevant Claims Manager and coordinate the claims management and payment process;
- manage insurance recoveries, including reconciliation of the proof of debt with the Liquidator;
- undertake audit and accountability functions; and
- provide performance and financial reporting to the Commonwealth.

²⁶ The Trust has two Accounts, the Scheme Payments Trust Account and the Management Expenses Trust Account, which are established as separate bank accounts held in the name of HCSL. HCSL transfers funds from the Scheme Payments Trust Account to Claims Managers as and when claims are payable. The Commonwealth replenishes the Account to an agreed level each month, usually \$15 million. The administrative costs incurred by HCSL and the Claims Managers are drawn from the Management Expenses Trust Account, which is funded by the Commonwealth on an as needs basis. Any interest earned on the funds remains to the credit of the Trust.

1.20 HCSL contracted a commercial service provider, Wyatt Gallagher Bassett (WGB), to operate the call centre and perform eligibility assessment and proof of debt reconciliation functions on its behalf.

1.21 The Scheme formally commenced operations on 7 July 2001, although, with the Prime Minister's approval, Treasury had begun making payments to salary continuance claimants in June 2001 (see paragraph 3.3).

Process for receiving assistance

1.22 To receive assistance under the Scheme a policyholder must have:

- applied for assistance under the Scheme; and
- lodged an insurance claim under an HIH policy with HIH (in liquidation).

1.23 Once an applicant has been assessed as eligible for assistance, their application is forwarded to the relevant Claims Manager. The Claims Manager then requests the applicant's claim file from HIH, and proceeds to assess and manage the claim. Once the Claims Manager has, on behalf of the Liquidator, determined or settled the amounts to be paid under a claim, they are responsible for making all disbursements to the relevant parties on behalf of HCSL²⁷

1.24 Where an application is denied eligibility in the first instance, the applicant can seek an Internal Review by the Managing Director of HCSL. Where the Internal Review is unsuccessful, the applicant can appeal to the HIH Assistance Review Panel (HARP).²⁸ As at the end of February 2004, 221 applications had been subject to an Internal Review. The decision to reject eligibility was confirmed in 74 per cent of cases (164). Of those, 115 applications had been subject to review by HARP, with eligibility being

²⁷ On 26 June 2001, the Government announced that it would legislate to ensure that Commonwealth payments to eligible policyholders did not attract additional income tax or Goods and Services Tax (GST). The *Taxation Laws Amendment Act (No.6) 2001* amended the application of GST to certain Scheme activities such that payments made to HIH policyholders in return for the assignment of their rights under the policy are treated for GST purposes as if they were made by HIH. The Act also amended the application of income tax to certain Scheme activities, as follows: a) Scheme payments received by an HIH policyholder, in return for the assignment of rights, are treated as if they had been received from HIH and under the terms and conditions of the relevant policy; b) both the ordinary and statutory income of the Trust or a prescribed entity (HCSL) is exempt from income tax; and c) a capital gain or loss made by a policyholder as a result of assigning their rights is disregarded. The Act was assented to on 1 October 2001, with the operation of the HIH-related amendments backdated to 15 May 2001, or 1 January 2001 for some GST-effects.

²⁸ In agreeing to the Scheme, the Government also agreed to the establishment of a mechanism to allow payment of assistance to those found ineligible as a result of anomalies in the application policyholder categories, income tests and small business employee threshold identified for the Scheme. HARP consists of independent members appointed by the Minister, and receives secretariat support from Treasury.

allowed in 60 per cent of cases. HCSL advised ANAO that, in the great majority of those matters, eligibility was allowed following the exercising by HARP of its discretion to allow eligibility where it identified an anomaly.²⁹

1.25 In applying for assistance, an applicant was required to offer to assign their rights under their HIH policy to HCSL (in its capacity of trustee of the Trust). This includes the right to pursue, through a proof of debt, recovery from the Liquidator of amounts owed as a creditor of HIH. Through this process, the Commonwealth will ultimately seek to recover a proportion of claim payments made under the Scheme.

Scheme review and closure

1.26 Consideration of a review of the ongoing management of the Scheme began in mid-2002. In October 2002, the Minister sought the Prime Minister's agreement to Treasury engaging a suitably qualified organisation to conduct a detailed study of the ongoing administrative and operational requirements of the Scheme. The Minister advised that:

The Scheme is now entering a new phase. The flow of new applications has slowed considerably and preliminary research indicates that the majority of potential applications are likely to have already applied for assistance. Consequently, HCSL's main function is now the financial management of the Scheme—a task that does not require either the existing infrastructure or insurance expertise...In these circumstances it is my view that now would be an opportune time to reassess the Scheme's operations and administration. The objective of such a review would be to determine whether the existing structure is the most cost effective manner in which to continue to deliver support.

1.27 The Prime Minister agreed to the review, requesting that it be undertaken speedily, and proposals for improvements brought forward promptly. In late December 2002, Treasury commissioned a consulting firm to undertake a strategic review of the Scheme (Strategic Review). The Strategic Review focused on: options for closing the Scheme to new applicants; assessment of the ongoing role of HCSL and the Claims Managers; identification of the political, operational and financial risks involved in changing the Scheme; and recommendations of the best structure for the Scheme on a go-forward basis.

1.28 The Strategic Review was completed in March 2003. Following consideration of the recommendations made, in August 2003 the Government agreed to the closure of the Scheme to new applicants six months from the date of the closure announcement. The Scheme closed on 27 February 2004. The

²⁹ HCSL further advised that: 'Such discretion is not available to the Managing Director during the internal review process and applications that do not meet the eligibility criteria must therefore be rejected.'

Government also agreed that a limited gateway be established for ‘special circumstances’ applications made after that date.³⁰

1.29 Six months after Scheme closure, the administrative arrangements for the Scheme will be fundamentally changed. HCSL and the existing Claims Managers are to be phased out from the Scheme. The remaining administrative tasks (including management reporting, data management and the proof of debt reconciliation with the Liquidator) will be consolidated with the claims management function under a single service provider.³¹

The audit

1.30 Due to the quantum of funds involved and the high level of public and parliamentary interest, ANAO included a potential performance audit of the HIH Claims Support Scheme in the Audit Work Plan for 2002–03.

1.31 Initial examination by ANAO identified that a significant level of other audit and review activity has been applied to various operational aspects of the Scheme. This has included an active internal audit program under the supervision of the HCSL Audit Committee. An external auditor has undertaken an annual audit of the statutory accounts of HCSL and the Trust.

1.32 Further, in April 2002, Treasury engaged a private sector firm (Treasury performance auditor) to undertake an external performance audit of the Scheme. The auditor’s August 2002 report concluded that the Scheme had:

- assisted eligible individuals and small businesses facing hardship as a result of the HIH Group collapse;
- demonstrated where the Commonwealth Government and the insurance industry can work together to bring about constructive outcomes for citizens in need;
- minimised the risks of the Scheme to the Commonwealth; and
- provided a certain level of public confidence in the Scheme.³²

1.33 The report also made a number of recommendations for improving various aspects of the Scheme operations.

³⁰ This was in order to protect the interests of applicants who would otherwise have been eligible to apply but who, as at the cut-off date, were unaware of a relevant fact regarding their right to claim.

³¹ The new claims manager(s) is to be engaged on a commercial-fee basis and will be selected through a select tender process. Following an open ‘Expression of Interest’ process, Treasury issued Request for Tender documents to four companies in March 2004. The recommendations from the tender evaluation panel were agreed to by the Treasury delegate on 6 May 2004. Treasury advised ANAO that, as at May 2004, contract negotiations were underway between Treasury, the Liquidator and the preferred tenderer.

³² *The HIH Support Scheme Performance Audit*, August 2002, p. 5.

1.34 The Strategic Review of the Scheme was concluded shortly prior to when the ANAO audit was due to commence, and audit fieldwork was conducted concurrently with the Government's consideration of the recommendations made for the future conduct of the Scheme. The decision to close the Scheme to new applicants and fundamentally change the existing administrative arrangements was taken by Government at the time of ANAO's fieldwork.

ANAO audit scope

1.35 Against that background, this audit focussed on providing transparency and assurance to the Parliament regarding the effectiveness of the Scheme's existing and prospective administrative arrangements, in terms of appropriate standards of public sector governance and stewardship for the significant Commonwealth funds expended to date, and still to be expended.³³ The objectives of the audit were to:

- review the governance and accountability framework for the Scheme, and
- assess the efficiency and effectiveness of Treasury's implementation and management of that framework.

1.36 The audit scope did not include independent testing of the existing operational functions, given the extent of previous internal audit and review activity and the fact that the operational approach was to undergo extensive change shortly after this audit was completed. The claims management services provided by the Claims Managers were also excluded from the audit scope, as those services are undertaken on behalf of the Liquidator under the respective Claims Management Agreement.

Audit criteria

1.37 In developing the audit criteria to be applied in forming a view in respect to the matters examined, regard was had to the 2003 ANAO Better Practice Guide on public sector governance.³⁴ Discretionary financial assistance programs, such as the HIH Claims Support Scheme, also demonstrate many of the characteristics of government grant programs.³⁵ In this Scheme, HIH policyholders who meet predetermined eligibility criteria are able to receive a

³³ As at January 2004, Treasury estimated that over \$120 million would be paid to HIH policyholders over the following two years.

³⁴ ANAO Better Practice Guide, *Public Sector Governance*, op. cit.

³⁵ A grant is a sum of money paid to organisations or individuals for a specified purpose directed at achieving goals and objectives consistent with government policy. In a strict legal sense, a grant is a 'gift' from the Crown, which may, or may not, be subject to unilaterally imposed conditions. Source: ANAO Better Practice Guide, *Administration of Grants*, Canberra, May 2002, p. 1.

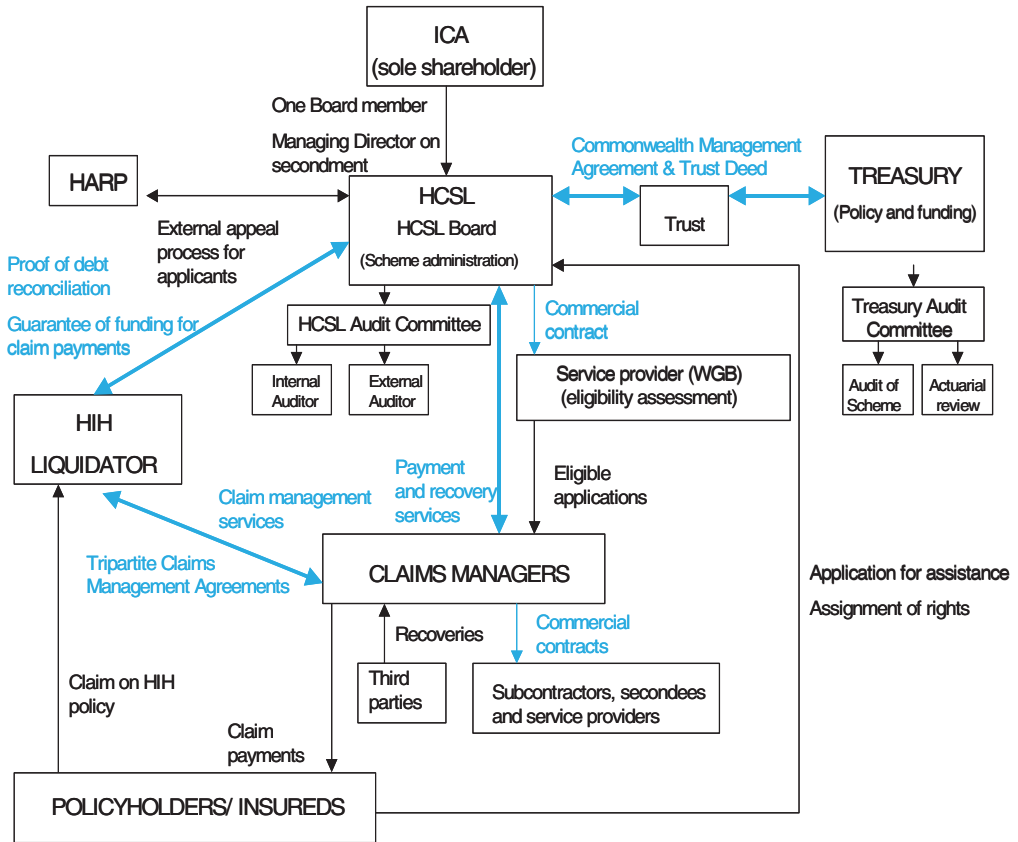
discretionary grant in the form of the payment to them, or other parties on their behalf, of an amount that would otherwise have been payable by HIH under the relevant insurance policy.³⁶ Accordingly, in undertaking this audit ANAO also had regard to the 2002 ANAO Better Practice Guide on the administration of grants.³⁷

1.38 Audit fieldwork was conducted between June and November 2003. The audit was conducted in accordance with ANAO Auditing Standards at a cost to the ANAO of \$307 000.

³⁶ Under the Scheme, unique features attach to the provision of the grant. They are the requirement that the policyholder assign their rights as an unsecured creditor of HIH, and that the amount of any payment is determined independently of the Commonwealth, according to HIH claims management practices and industry standards.

³⁷ ANAO Better Practice Guide, *Administration of Grants*, op. cit.

Figure 2.1
Original Scheme structure



Source: ANAO analysis.

2. Governance Framework

This chapter discusses the governance framework established for the Scheme, and the revised arrangements that are to be established following the closure of the Scheme to new applicants.

Scheme structure

2.1 Delivery of the Scheme has involved a complex combination of public and private sector organisations. Treasury is responsible for the overall implementation of the Scheme and for the achievement of its objectives in a manner that satisfies public sector standards of accountability and financial management. Accordingly, the Department has responsibility for policy development in respect to the Scheme, and for providing advice to Scheme participants on the interpretation of that policy. HCSL, through its Board, has been responsible for administering the implementation of the Scheme by its sub-contractor and the Claims Managers (and their sub-contractors and service providers). The original structure of the Scheme is set out in Figure 2.1.

2.2 The evidence available to ANAO demonstrated that, in designing and implementing the Scheme structure, there was a high level of awareness of the need to provide a sound governance framework for the significant sums of public money that would be involved. Having regard to the urgency required in originally developing the Scheme, the framework established exhibited many of the key elements of good public sector governance, as identified in ANAO's Better Practice Guide on public sector governance.³⁸

2.3 A notable area of interest was that the Scheme structure was not designed to maximise the benefits of coverage of the funds involved by the *Financial Management and Accountability Act 1997* (FMA Act), which is an Act for the proper use and management of public money, public property and other Commonwealth resources, and for related purposes (see Chapter 4).

Span of control

2.4 Access to industry expertise and infrastructure was critical to the Commonwealth's ability to implement a scheme of this nature in the short timeframe involved. In announcing that HCSL would administer the Scheme on the Commonwealth's behalf, the MFSR stated that:

Unlike the States, the Commonwealth Government has no existing infrastructure that is able to process the tens of thousands of claims from existing HIH policyholders. The non-profit corporation gives us a practical

³⁸ ANAO Better Practice Guide, *Public Sector Governance*, op cit., Volume 1, pp. 7–8.

framework using existing industry infrastructure and expertise to help HIH victims.³⁹

2.5 In this respect, the Strategic Review reported that stakeholders⁴⁰ were of the view that HCSL's role as conduit between the Commonwealth and the Claims Managers (and WGB) had been vital, in that the company possessed both insurance and Commonwealth-oriented capability and an understanding of the methods and language of both.⁴¹

2.6 There was mutual commitment on the part of both Treasury and HCSL to delivering financial assistance to HIH policyholders in an effective and accountable manner. However, it is also clear that the range of parties involved contributed to administrative complexity. Both Treasury and HCSL experienced frustration at various times, particularly during the first year in which a number of difficult policy issues arose. The parties' views on the most appropriate means of resolving issues differed on a number of occasions. In this respect, the Treasury performance auditor's August 2002 report found that:

Given that one of the underlying objectives of the Scheme was cooperation between the Commonwealth, the ICA and all participants administering the Scheme, evidence suggests that the relationship amongst management is sometimes strained and this at times impacts the Scheme's performance.⁴²

2.7 Treasury's capacity to ensure that issues with policy implications were adequately identified, and subsequent decisions implemented, in a timely and effective manner was inhibited in some respects by the nature of the existing responsibility and communication channels.⁴³ Equally, concerns were expressed, at one point, within the HCSL Board regarding the nature of Treasury's involvement in various decision-making processes relating to eligibility criteria and assessment procedures. This particularly related to the extent to which the Board was consulted prior to decisions applicable to the operations of the Scheme being taken. In March 2004, Treasury advised ANAO

³⁹ Press Release, 17 May 2001, op. cit.

⁴⁰ Stakeholders consulted included HCSL, WGB, Claims Managers, the Liquidator and the HCSL internal auditor.

⁴¹ The Review also reported that: 'HCSL was seen by industry participants as possessing detailed industry knowledge which was critical in assisting resolving the array of complex issues including new classifications and eligibility that have arisen during the course of the Scheme's existence.' Source: *Strategic Review of the HIH Support Scheme*, March 2003, pp. 23 and 27–28.

⁴² *The HIH Support Scheme Performance Audit*, op. cit., p. 34.

⁴³ For example, other than through attendance at Strategy Management Committee meetings (which are attended by representatives from all Scheme participants), Treasury has not had direct communication channels with the various Claims Managers and service providers regarding the implementation of policy decisions. There have been occasions where this absence has contributed to operational difficulties.

that the Department's approach had been to become involved where matters cut across the Government's policy intent in relation to the Scheme.

2.8 As the Scheme moved into a more stable and mature phase, the occurrence of these types of issues declined. However, the Scheme experience has served to highlight the governance challenges that can arise in developing such a structure for the distribution of Commonwealth financial assistance.

2.9 The Treasury performance auditor concluded that improvements to certain elements of the Scheme would result in operational issues being dealt with more rapidly and directly in future. Recommendations made included Treasury gaining representation on the HCSL Board, and revision of the Scheme Protocol's to provide for closer working relationships between all participants.⁴⁴

2.10 The 2003 Strategic Review also recommended that, to assist in ensuring on going positive communication and congruency of goals, the operation and membership of the Board be reviewed as the HCSL role was progressively phased down. In particular, the Review considered that existing Board membership could be altered by either reducing Board members or by replacing one member with a Treasury representative.⁴⁵

2.11 In April 2003, Treasury obtained legal advice that the Commonwealth has no legal right to appoint a representative to be a director of HCSL or attend meetings of the Board as an observer. The legal advice further noted that, even if the company or Board agreed to such an appointment:

...there are legal and practical limitations which would, in our view, impair the effectiveness of doing so as a strategy to influence the deliberations of the HCSL board. Recent practice in the Commonwealth has not been to appoint such representatives as directors and observers although, when successful, such arrangements can improve communications between the Commonwealth and a board of directors. A more appropriate and effective strategy is to use the reporting and liaison obligations imposed on HCSL in the [CMA] to influence the decision making of HCSL's board, although we recognise that sometimes the formality of these arrangements can inhibit the development of a candid relationship between the Commonwealth and a company board.

2.12 On the basis of this advice, Treasury has not pursued this issue further.

New Scheme structure

2.13 Following the closure of the Scheme to new applicants in February 2004, the eligibility assessment and call centre functions provided by HCSL,

⁴⁴ *The HIH Support Scheme Performance Audit*, op. cit., p. 8.

⁴⁵ *Strategic Review of the HIH Support Scheme*, op. cit., p. 28.

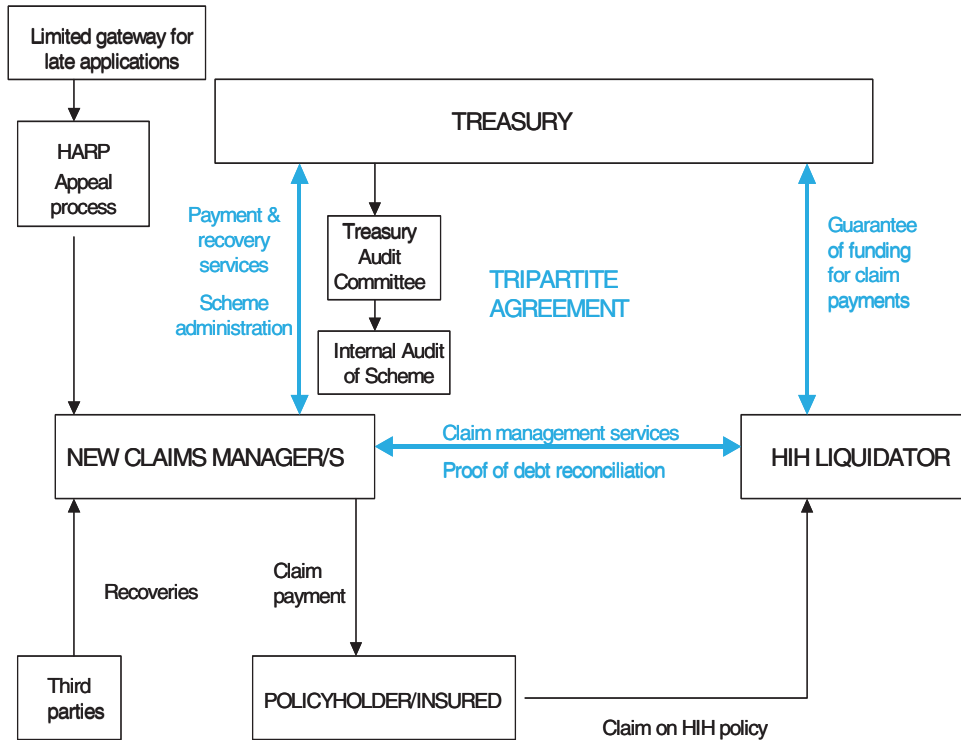
through WGB, will be no longer required.⁴⁶ However, claims management and payment functions for eligible applicants will continue for some years. This includes long-term payment streams under salary continuance policies, and professional indemnity and public liability claims that may take a number of years to crystallise or reach settlement.

2.14 Based on the findings of the Strategic Review, Treasury concluded that it was no longer cost-effective to maintain the existing service delivery structure, and the Government agreed to phasing HCSL out from the administration of the Scheme. The existing Claims Management Agreements will also be terminated. Through a new tripartite agreement with the Commonwealth and the Liquidator, a new claims manager(s) will be engaged on a commercial-fee basis to provide the consolidated services.

2.15 Under the revised structure, Treasury will have an increased role in the management of the Scheme, particularly in relation to contract management, risk management, management of legal issues and audit functions. The Department has identified that the enhanced degree of direct control it will have over some aspects of Scheme operations under the new arrangements will be of benefit. The more streamlined administrative structure, shown in Figure 2.2, is expected to result in net savings of \$2.2 million over four years.

⁴⁶ Other than for those accessing the Scheme through the limited gateway. Eligibility assessment for late applicants is to be undertaken by an independent person or organisation with insurance industry experience.

Figure 2.2
Revised Scheme structure



Source: ANAO analysis.

2.16 In commenting on the draft audit report in May 2004, the ICA advised ANAO that:

...We think that future industry Government partnerships could be well informed by the HCSL experience. In particular, it must be recognised that the arrangements entered into between the Commonwealth and ICA/insurers were designed to inter alia harness private sector resources, expertise and knowledge, sufficient not only to provide industry best practice in dealing with claimants, but also to satisfy the needs of the liquidator of HIH and provide confidence to the Commonwealth in proving its debts.

ICA and insurers entered into these arrangements in good faith on a ‘not for profit’ basis. There has been no actual or potential commercial advantage to insurers or ICA in these arrangements and indeed there has been significant lost opportunity cost as well as direct costs, which have not been recovered.

We note that the Government has decided it is no longer cost effective to maintain the existing service delivery structure and has announced major changes to the administration of the Scheme. ICA supports the transfer to a new arrangement but as it is not party to the information that has been considered by Treasury in reaching this conclusion it is unable to offer any

informed comment of the costs and benefits of the proposed new arrangements.

We note therefore that whilst the Audit report compares the operation of HCSL with certain Public Sector standards and requirements, these were not part of the arrangements or undertakings that ICA entered into with the Commonwealth.

Risk management

2.17 HCSL and Treasury engaged a private accounting firm to undertake business risk assessments from their relative perspectives during the first six months of the Scheme's operations. Separate fraud control plans, the HCSL internal audit program, and Treasury's audit program for the Scheme were subsequently developed on the basis of those assessments.

2.18 The separate, but related, fraud risk assessments prepared for HCSL and Treasury revealed very high levels of inherent fraud risk in the Scheme operations. A number of controls designed to reduce the level of assessed risk were articulated in fraud control plans. In developing those plans, both Treasury and HCSL had regard for the requirements of the *Fraud Control Policy of the Commonwealth*.⁴⁷

2.19 In reviewing the HCSL Fraud Control Plan in March 2002, the HCSL internal auditor recommended that a Code of Conduct be drawn up to apply to all those in the Scheme. A Code of Conduct was approved by the HCSL Audit Committee in December 2002 and recommended for consideration by the HCSL Board. Following comments on the proposed Code, a revised draft was circulated for comment in March 2003 and subsequently adopted. ANAO considers that action in regard to this recommendation could have been taken in a timelier manner.

Fraud reporting procedures

2.20 The HCSL Fraud Control Plan recommended that HCSL establish formal procedures for the reporting and subsequent investigation of fraudulent matters.⁴⁸ Specific action does not appear to have been taken in respect to that recommendation. In this respect, HCSL advised ANAO in May 2004 that:

...while there may not have been formal procedures for the reporting of fraudulent matters, there was in place at the commencement of the Scheme a

⁴⁷ In May 2002, that policy was replaced by the *Commonwealth Fraud Control Guidelines*.

⁴⁸ In noting that recommendation, the Treasury Fraud Control Plan recommended in February 2002 that Treasury require HCSL to inform them of all fraud reports and provide regular updates on the status of reported fraud.

process for the reporting of “matters of significance”. This process was adopted as and when appropriate.

2.21 In June 2002, Treasury identified the need to improve the existing arrangements with HCSL in respect to the reporting and management of fraud.⁴⁹ In particular, the Department considered that there was a need to create a protocol for the recording and reporting of fraudulent activity, including defining fraud for the purposes of the Scheme, and identifying the specific circumstances in which it may occur. A fraud reporting protocol was subsequently agreed between the parties. This represented an improvement in this aspect of the Scheme governance arrangements, and is an issue that will need to be carefully considered in drafting the contractual arrangements with the new claims manager(s).

Change management

2.22 The decision to close the Scheme to new applicants and revise the existing administrative and claims management arrangements presents a number of significant risks that need to be effectively managed.⁵⁰ Treasury has implemented, or is planning to implement, comprehensive processes in order to mitigate and manage risk during the transition to the new arrangements, including:

- development and implementation of a comprehensive risk management strategy, including appointment of a Risk Adviser and a Change Manager;
- implementation of a Project Consultative Committee, involving Treasury, HCSL and the Liquidator;
- use of an independent consultant to develop tender documentation for the selection of the provider of the consolidated claims management and administrative functions, and manage the tender and contracting process; and
- use of legal and probity advisers.

Scheme database

2.23 An important aspect of the Scheme management has been the establishment of the Scheme database using a software system developed by WGB. Under the agreement between HCSL and WGB, WGB grants to the

⁴⁹ This was in the context of considering options for the recovery of payments made to ineligible applicants.

⁵⁰ These include the risk of existing Claims Managers not continuing to provide their services to the required standard up to the planned transition time, and disruption to claims handling.

Commonwealth and HCSL a licence to use the software system for the purpose of administering the Scheme.

2.24 In August 2003, Treasury obtained legal advice as to what rights the Commonwealth has regarding information and software used by WGB in relation to the Scheme. Treasury was advised that the Commonwealth is not a party to the agreement between HCSL and WGB, and that it is not clear that the Commonwealth would have the power to enforce the agreement. In addition, the Commonwealth does not obtain the benefit of the warranties issued by WGB under the agreement (for example, the warranty that it has sufficient rights to grant the licence).

2.25 Accordingly, Treasury was advised that, to avoid any doubt, the Commonwealth should enter into a deed with WGB which stipulates that the relevant provisions of the agreement with HCSL are replicated in respect to the Commonwealth. Treasury was advised that the need for the Commonwealth to enter such a deed would be even more important if the intention was to wind up HCSL.

2.26 In March 2004, Treasury advised ANAO that a deed had yet to be negotiated with WGB, but also made the following observation:

It is clear from the wording of the contract between WGB and HCSL that the intention was that the Commonwealth would have the same entitlements to licenses and warranties as HCSL. The need for a deed between the Commonwealth and WGB arises only when HCSL no longer has a contract with WGB. This matter was identified as a proposed action in the current transition planning process, and there is no reason to believe that there will be any difficulty in having the rights that are granted to the Commonwealth in the current contract between HCSL and WGB replicated in a separate deed.

Audit

2.27 ANAO has previously noted that Commonwealth agencies that perform well, in acquitting their external accountability responsibilities, typically seek to incorporate these requirements in the earliest stages of their planning, policy development, decision-making and program design work.⁵¹ This is an area in which there was particular focus during the initial design of the Scheme.

2.28 The Scheme documents were designed to provide extensive levels of audit and performance oversight. The CMA included provision for audit access by the Commonwealth and/or the Auditor-General to the accounts and records of HCSL and its sub-contractors. It also specified a number of audit and performance review obligations and rights. Similarly, the Claims

⁵¹ ANAO Better Practice Guide, *Public Sector Governance*, op. cit., p. 20.

Management Agreements provide HCSL, or an auditor appointed by it, with access to the Claims Managers' premises and records for the purpose of performing audits and inspections and enabling HCSL to comply with its obligations under the CMA.

2.29 In accordance with those provisions, the Scheme systems and controls have been the subject of an extensive program of internal and external audit. The Liquidator has also reviewed aspects of the claims management processes.

HCSL internal audit

2.30 The HCSL Audit Committee⁵² has pursued an active internal audit program covering various aspects of the Scheme's operations. The level of assurance provided has varied depending upon the nature of the audit assignment undertaken. Significant findings have been made in a number of important operational areas of the Scheme, including in relation to:

- the eligibility assessment process;
- controls applied to administrative expenses claims submitted by Claims Managers and HCSL;
- the compliance of Claims Managers and WGB with requirements in respect to the recording, maintenance and reconciliation of application and claim management information;
- controls to prevent inadvertent payment being made to ineligible applicants; and
- controls to detect duplicate service provider payments by Claims Managers.

2.31 Both Treasury and HCSL have established systems for monitoring the implementation by relevant parties of internal audit recommendations. This process has proven reasonably effective, although in some cases there was considerable delay between a recommendation being made and relevant action being taken.

2.32 At the June 2003 meeting of the HCSL Audit Committee, the HCSL internal auditor tabled a letter dated 20 March 2003 confirming that there was no evidence that the internal controls of the Scheme were not operating satisfactorily.

⁵² The HCSL Audit Committee consists of non-executive directors of HCSL who are independent of the ICA.

Eligibility assessment

2.33 An area in which internal audit has been of particular importance, in addressing high levels of inherent risk, is the reliance on third party information in the eligibility assessment process. An applicant for assistance must fill out an application form.⁵³ They are also required to sign a statutory declaration stipulating that the information provided is true and correct, and attesting to specific matters relevant to his or her eligibility.⁵⁴

2.34 The eligibility assessment procedure applied has been to take the information given by applicants at face value, unless there was some reason to seek clarification or further information.⁵⁵ HCSL was instructed by Treasury that, if the statutory declaration had been signed, no further verification of the information provided was required, noting that it is an offence to sign a false declaration.

2.35 The HCSL Fraud Control Plan of February 2002 recommended that HCSL and Treasury determine whether the risks associated with reliance on third party information were considered acceptable. If that was not the case, it was recommended that HCSL should put in place controls for the verification of third party information. In March 2004, Treasury advised ANAO that:

The decision to accept statutory declarations in lieu of requesting the provision of further documentary evidence of all aspects of eligibility was made in the context of ensuring that the application and eligibility assessment process did not place further burdens and hardship upon applicants. This process allowed for applications to be made and eligibility to be assessed quickly and efficiently. It was made clear in application documentation that applications may be the subject of audit, and the verification audit process was introduced as a detective control measure.

2.36 Between March 2002 and August 2003, the HCSL internal auditor provided four reports on exercises directed at verifying the eligibility of applicants who had been assessed as eligible.⁵⁶ These involved the internal

⁵³ Applicants are also provided with 'Notes for Applicants', which are to be read in conjunction with the Application form. The Notes set out the policyholders and persons insured who qualify for assistance under the Scheme.

⁵⁴ In some circumstances, applicants are required to provide relevant documentation when applying for assistance. For example, trust applicants are required to provide a certified copy of the trust instrument. However, in general, the key information on which eligibility is assessed is provided through statements made on the application form.

⁵⁵ A significant problem in the eligibility assessment process has been the provision by applicants of incomplete application forms, resulting in processing delays as further information is sought.

⁵⁶ One of these exercises was conducted as an agreed-procedures engagement, which, by definition, can provide no assurance.

auditor verifying the eligibility of a sample of applicants through interviews and confirmation of application details from source documents.⁵⁷

2.37 Of the 174 applications examined as at October 2003, 12 (seven per cent) were found to be ineligible. The eligibility of 11 of those applicants was rescinded prior to payment being made. Payment of \$171 433 had been made in respect of the remaining applicant. The eligibility of a further four applications, involving payments totalling \$135 261, was still being investigated as at March 2004.

2.38 To date, there has been one case of possible fraud involving false statements on a statutory declaration referred to the Australian Federal Police for investigation. The fraud reporting protocol between Treasury and HCSL was amended in July 2003, to incorporate a section on the actions HCSL should take where it believes that an applicant may have made a false statement on a statutory declaration.

2.39 The internal audit eligibility verification reviews have provided a level of assurance regarding the robustness of the eligibility assessment process. Further, the number of applicants assessed as eligible, who have subsequently been found to have provided incorrect information on their application form, represents a very small percentage of the over 10 000 applications accepted as at October 2003. However, it should also be noted that, as at that date, less than two per cent of applications assessed as eligible had been subject to independent verification.

2.40 In May 2004, HCSL advised ANAO that the error rate identified by the internal audit process 'reflects the fact that the applications selected for examination were in fact deliberately chosen on the basis of potential issues they might raise.' Nevertheless, given the results of the internal audits, there is still a clear risk that other applicants have been assessed as eligible based on inaccurate, and/or potentially fraudulent, information provided on their application form. This is reflected in the views expressed by the HCSL Audit Committee in considering the first verification of eligibility report in April 2002. The minutes of that meeting stated, *inter alia*:

...In part, discussion included the prior acceptance of claim forms that the audit review had subsequently found to contain irregularities. The committee again confirmed its understanding that the instruction from Government was that claim forms be accepted on face value given that the claim form was supported by a statutory declaration signed by the claimant.

In part, discussion included the question of irregularities and/or potential 'fraud' on claims that had already been accepted and paid. The committee agreed that it was virtually impossible to detect and/or prove fraud by the

⁵⁷ The sample size was 24 in the first internal audit, and 50 in subsequent reviews.

accepted 'face value' method implemented by Government and that little, if anything, could be done to retrieve payments already made where irregularities on the claim forms had been detected.⁵⁸

2.41 The risk of ineligible claims being paid is inherent in the eligibility assessment process adopted for the Scheme. As is discussed in Chapter 4 (see paragraphs 4.51 to 4.60), the recovery of payments incorrectly made to ineligible applicants is problematic. In those circumstances, the main value of post-event audit of the eligibility assessment process is the identification of policy and procedural issues that should be addressed to improve the effectiveness of future eligibility assessments.⁵⁹

2.42 ANAO acknowledges the urgency that was involved in implementing the Scheme, and the desire to avoid placing additional burdens on policyholders already experiencing hardship. It is also acknowledged that issues of practicality and cost-effectiveness need to be considered in designing the approach that will be taken to the application assessment process in a scheme of this nature.

2.43 However, where it is intended to rely on information provided by applicants to any future financial assistance schemes, it would be good practice for the responsible agency to identify, prior to implementing the scheme, the risks inherent in such an approach, and to document the considered risk treatment by the relevant decision-maker. This would include obtaining appropriate legal advice on the implications there may be for the recovery or withholding of payments, once an applicant has been advised that they are eligible. There was no evidence of advice of this nature having been obtained by Treasury until invalid payments had already been identified.

Management reporting

2.44 The CMA, Trust Deed and Claims Management Agreements each placed a number of performance and financial reporting obligations on HCSL and the Claims Managers. Further protocols supporting the execution of each

⁵⁸ The Minutes further stated: 'This raised the question of irregularities and/or potential 'fraud' on claims that had been accepted but not yet paid. The committee agreed that it was still under an obligation to accept the claim form on its 'face value' as required by Government, but agreed that obvious irregularities ought to be referred back to the claimant for correction and/or withdrawal of the claim. It was agreed that the old claim form might have caused confusion to claimants resulting in mistakes being made by the claimant and that the new claim form, designed by Government, should assist to reduce the future incidence of irregularities. It was agreed that overall the scheme was still obliged to accept claim forms as required by Government guidelines but that the concern would be referred to Treasury for discussion...' Source: Minutes, HCSL Audit Committee Meeting, 3 April 2002.

⁵⁹ In some cases, the timing of the claims management process has meant that applicants identified through internal audit as having been incorrectly assessed as eligible had not yet had their claims paid. In some cases, it has been possible to avoid incurring payments by rescinding the applicant's eligibility. However, this has not always been the case, particularly in regard to service provider fees already incurred.

party's obligations, including a statement of outputs and performance indicators, were developed during the first months of Scheme operations. Given Treasury's distance from the day-to-day operations of the Scheme, this management reporting process was another key element in the Commonwealth's governance arrangements for the Scheme.

2.45 The extent and rigour with which Scheme participants have met their reporting obligations have improved over time. This was partly due to an evolution in the understanding of all parties as to the most efficient means of meeting those obligations, while maintaining appropriate levels of accountability. This was particularly the case in respect to the development of operational reporting procedures between HCSL and Treasury. The Department now receives comprehensive reporting from HCSL on the Scheme's operations.

2.46 In order to improve communication in resolving significant issues as they arose, in 2002 Treasury and HCSL adopted a workshop approach, often involving the Claims Managers and the Liquidator. This complemented the regular, monthly meetings of the Strategy Management Committee, at which representatives of each of the Scheme participants provided updates on a range of standing agenda items. The evidence available to ANAO suggests that this approach was useful in improving Treasury's ability to adequately oversight important aspects of Scheme operations.

Information systems

2.47 At the time of its collapse, HIH managed the various classes of policies across a number of electronic and paper-based information systems, many of which were reportedly in a poor state of maintenance.⁶⁰ This had significant implications for the effective and consistent reporting of operational information by Claims Managers, as well as for the management of claims. Further, the available systems did not initially capture all of the data required by at least one of the Claims Managers in order to meet their reporting obligations.

2.48 Over the course of 2001 and 2002, the Liquidator worked to migrate the information contained on the five major systems existing within the HIH Group onto a single integrated system, known as LAIRS. In tandem with that process, a Scheme-wide database was implemented, utilising a software system developed by WGB, to control the eligibility assessment process and track applicants' claims.

⁶⁰ For a number of months, QBE performed claims management procedures manually and AAA was required to manage claims across five separate HIH information systems.

2.49 In August 2002, the Treasury performance auditor recommended that the HCSL internal auditor review the roll over reconciliations to LAIRS and the WGB database, to ensure all information had been accurately and completely recorded. In response, Treasury commented that the HCSL Board had previously agreed to recommendations made by the internal auditor regarding how HCSL might obtain comfort over the functionality and stability of the systems migration. This was to be via a letter of comfort obtained from the Liquidator in accordance with Auditing Guidance Statement 1042, *Reporting on Control Procedures at Outsourcing Entities*.

2.50 An independent audit report provided to the Liquidator in November 2003 found that, in all material respects, the HIH general information technology internal control objectives identified by the Liquidator were achieved and the control procedures operated effectively and continuously from 1 July 2002 to 30 June 2003. Treasury obtained the report in April 2004.

Claims monitoring

2.51 Treasury does not receive regular reports regarding the progress of Claims Managers in finalising claims. In this respect, the Strategic Review reported that:

Our observation is that the information supplied to Treasury on a periodic basis, is not sufficient to enable Treasury to make a realistic assessment of the state of progress of Claims Managers in managing claims to finality, quite apart from the financial consequences which are being addressed by both the actuarial valuation and the periodic audits.⁶¹

2.52 The Strategic Review proposed that Claims Managers submit a monthly report to Treasury providing an ‘aged analysis’ of finalisations of claims. Although this information is not standard reporting for the industry to its own management, the Review believed that the Commonwealth’s unique arrangements under the Scheme and its otherwise remoteness from direct supervision justified this request. In March 2004, Treasury advised ANAO that the provision of an aged analysis report by the new claims manager had been addressed in the tender documentation.

⁶¹ The report further commented that: ‘It is axiomatic in the insurance industry that early resolution of liability matters gives rise, on balance, to lower potential costs, whether it be by way of minimised legal costs or to lower claimant expectations earlier in the life of a claim (or both). The rate of resolution, “at the right price”, should be indicative of the potential value creation or savings through claims management, and hence should be of interest to Treasury and HCSL’ Source: *Strategic Review of the HIH Support Scheme*, op. cit., p. 40.

Privacy

2.53 The *Privacy Act 1988* (Privacy Act) places specific obligations on Commonwealth agencies to protect the privacy of personal information held, or collected, by them. Those obligations are set out in Information Privacy Principles (IPP). The *Privacy Amendment (Private Sector) Act 2000* amended the Privacy Act to extend privacy obligations to private sector entities. Relevant organisations are required to comply with a set of National Privacy Principles (NPP), or implement a privacy code approved by the Privacy Commissioner. The amendments to the Privacy Act commenced on 21 December 2001.

2.54 The CMA imposes a number of obligations on HCSL in respect to the handling and protection of personal information. In particular, it is required to comply with the IPPs as if it were an agency as defined in the Privacy Act, or to implement a privacy code approved by the Privacy Commissioner. The HCSL contract with WGB imposes similar information protection requirements. The Claims Management Agreements require the Claims Managers to comply with the NPPs as if they were an agency as defined in the Privacy Act, or to adopt and implement a privacy code approved by the Privacy Commissioner.

Monitoring of privacy obligations

2.55 The Privacy Commissioner has previously commented to ANAO that, if contractual clauses are to deliver effective privacy protection, there needs to be a mechanism in place to ensure that both parties meet their privacy obligations.⁶²

2.56 In February 2002, HCSL advised Treasury of the arrangements it was putting in place to satisfy information protection and privacy obligations, including those relating to WGB and the Claims Managers.⁶³ HCSL advised that it hoped to finalise and implement those arrangements in the near future and that, from that point, compliance with privacy obligations would become an important part of its internal audit program.

⁶² ANAO Audit Report No.9 2000–01, *Implementation of Whole-of-Government Information Technology Infrastructure Consolidation and Outsourcing Initiative*, Canberra, 6 September 2000, p. 235.

⁶³ In February 2002, HCSL advised Treasury that the HCSL Board had agreed in principle to adopt the General Insurance Information Privacy Code (Privacy Code) developed by the ICA. Under the Privacy Code, privacy complaints are made to the Privacy Compliance Committee of Insurance Enquiries & Complaints Limited (IEC), rather than the Privacy Commissioner. In March 2002, Treasury advised HCSL that such a regime is appropriate for the Claims Managers should they become a party to the Privacy Code, but that it would be best for privacy complaints made against HCSL (if any occur) to go straight to the Privacy Commissioner for adjudication. In June 2002, HCSL advised Treasury that, following consideration of issues raised by the Department, the HCSL Board had decided not to pursue accession to the Privacy Code, and that the Board accepted that this meant that HCSL would be subject to the Privacy Act, as well as the contractual provisions set out in the CMA.

2.57 In June 2003, the HCSL internal auditor completed reviews of the processes put in place by HCSL, WGB, and the three main Claims Managers (and their sub-contractors) to manage personal information collected by them. The internal auditor reported that, based on the reviews performed, nothing had come to its attention that caused it to believe that the privacy processes put in place by the relevant companies had not been operating effectively. However, in each case, issues were identified that the internal auditor considered exposed the relevant company to the risk of not being able to effectively demonstrate their compliance with the NPPs.

2.58 In the case of HCSL, the issues identified related to the informality of the monitoring undertaken by it of privacy compliance by WGB and the Claims Managers.⁶⁴ In the case of WGB and the Claims Managers, the issues identified related to control weaknesses in the collection and management of personal information. It was also noted that, in some cases, no specific privacy training was provided to relevant staff. In another case, there was inadequate documentation of the training provided.

2.59 At its July 2003 meeting, the HCSL Audit Committee agreed that the Scheme would need to implement its privacy policies and practices and, where applicable, the appropriate training programs would be required. Refresher training on privacy issues for the call centre operators was completed in July 2003.

2.60 In implementing the Scheme, Treasury did not articulate a specific strategy or process for monitoring compliance by HCSL with its privacy obligations as set out in the CMA. Other than the privacy reviews undertaken in 2003 by the HCSL internal auditor, Treasury's monitoring of HCSL's compliance has been based on by-exception, self-assessment reporting through the forum of the monthly Strategy Management Committee meetings.

2.61 Treasury advised ANAO that, since March 2003, there had been a requirement to report any breaches of privacy obligations via that Committee. In September 2003, HCSL advised the Strategy Management Committee that it would be providing a report template to all Claims Managers to facilitate monthly reporting on any developments in relation to privacy compliance, such as queries, complaints and training undertaken. In March 2004, Treasury advised ANAO that these reports were now provided on a monthly basis.

⁶⁴ The HCSL management comment in response was that the recommendations for more formal procedures for demonstrating compliance with privacy obligations were noted, but it was satisfied that current arrangements were adequate for its purposes. It was further noted that protection of personal information had been a big feature of HCSL's management of the Scheme, as evidenced by the lack of any complaints in this area. HCSL advised the internal auditor that it would implement one recommendation, and review the remaining recommendations to determine areas where existing procedures might be improved.

2.62 In establishing new contractual arrangements for the administration of the Scheme, it will be necessary for Treasury to identify the extent to which additional provisions may be needed in order to satisfy all relevant Privacy Act requirements.⁶⁵ As part of that process, ANAO considers that Treasury should identify the means by which there will be regular scrutiny by the Department of the extent to which the new claims manager(s) is complying with its privacy obligations. In March 2004, Treasury advised ANAO that privacy matters had been separately considered in the draft contract relating to the tender process for a new claims manager, and that specific privacy reporting had been documented as a requirement.

Recommendation No.1

2.63 ANAO *recommends* that Treasury develop and implement a specific strategy for monitoring compliance by the new claims manager(s) for the HIIH Claims Support Scheme with contractual and legislative privacy obligations.

Treasury response

2.64 Treasury agrees with this recommendation. Reporting obligations have already been included in the draft contract for the new claims manager.

Conflict of interest

2.65 The first Managing Director of HCSL, appointed by the HCSL Board in May 2001, was seconded from a senior position within the ICA. The appointment was on a full-time basis. In mid-2002, the Board agreed to a proposal that the Managing Director return, part-time, to the ICA, while also continuing part-time in the Managing Director role. Documentation reviewed by ANAO indicates that the Managing Director resumed part-time work at the ICA at that time.

2.66 Upon being advised of the Board's decision, Treasury expressed concerns about the potential for a conflict of interest to arise, or to be perceived, with the Managing Director fulfilling both roles.⁶⁶ Treasury also

⁶⁵ The Privacy Act amendments contain new provisions that apply to Commonwealth agencies and their contractors, where that contractor meets the definition of a 'contracted service provider'. The Privacy Commissioner has indicated that simply having a contract provision that says the contractor agrees not to do an act or engage in a practice that would breach an IPP if done or engaged in by an agency will generally not be sufficient to ensure that an agency has met its obligations under the amendments. In a number of cases, agencies will need to have more specific or practical provisions. Source: Office of the Federal Privacy Commissioner, Information Sheet 14 – 2001, *Privacy Obligations for Commonwealth Contracts*, December 2001, p. 5.

⁶⁶ In July 2002, Treasury advised the Chairman of the HCSL Board that Treasury's view was that there was both a perception, and also the potential, that a conflict may arise between the responsibilities relating to exercising and enforcing rights available to HCSL under the Claims Management Agreements in respect of contracted services provided by the claims managers, and those arising from an active role in a member funded organisation representing the interests of those same claims managers.

argued that the fiduciary duties owed to the Commonwealth by HCSL, as trustee of the Trust, emphasised the importance of avoiding any actual or potential conflict of interest.

2.67 In response, the HCSL Chairman advised Treasury that, given the stage of maturity of the Scheme, the Board did not believe that there was an ongoing need for a full-time commitment by the Managing Director. The Chairman further advised that the Board had considered the issue carefully, but had concluded that the potential conflict of interest was no different in the part-time role than that which already existed. The Chairman considered that the existing processes for managing conflicts of interest (including Board protocols and the internal audit process) provided appropriate protection against such conflicts should they arise. In this respect, the ICA commented to ANAO in May 2004 that:

...concerns about perceived or potential conflicts of interest were first raised with ICA only after the Scheme had been in operation for some 18 months. To date, this 'conflict' has never been clearly articulated to ICA, nor have there been any actual examples in the Scheme's three year history.

2.68 Ultimately, this was a matter for the HCSL Board. Under the CMA, Treasury had no capacity to direct the manner in which the Managing Director of HCSL was appointed or engaged. The CMA did not contain a clause relating to the management and reporting of conflicts of interest.

2.69 In September 2002, at the request of Treasury, HCSL engaged its internal auditor to undertake a review of the issue. The internal auditor's November 2002 report⁶⁷ concluded as follows:

In our opinion the proposed changes to the management structure of HCSL...do not significantly increase risk of potential conflicts of interest issues associated with the management of the HCSL Scheme (*sic*)...We believe the potential conflicts of interest as articulated by Treasury...are in existence in the current Scheme management structure and that existing governance mechanisms⁶⁸...enables HCSL to effectively manage these issues.

⁶⁷ The internal auditor performed the procedures requested by HCSL, and reported that: 'The procedures performed...do not constitute either an audit in accordance with Australian Auditing Standards, a review in accordance with Australian Auditing Standards applicable to review engagements or an agreed upon procedures assignment as defined under Australian Auditing Standards. As such, an audit or review opinion is not expressed. Had we performed additional procedures or had we performed an audit in accordance with Australian Auditing Standards or a review in accordance with Australian Auditing Standards applicable to review engagements, other matters might have come to our attention that would have been reported to you.'

⁶⁸ These include that Board protocols require a Board member to declare any conflict or potential conflict and to abstain from any discussion or vote in relation to those matters; the HCSL Audit Committee is made up entirely of non-executive directors; the annual draft internal audit plan is considered by the Audit Committee and Treasury before being ratified; and all Audit Committee members and Treasury receive full copies of all audit reports.

2.70 However, the internal auditor also recommended that the CMA be modified to require HCSL to notify the Commonwealth of any changes to the Managing Director's role within the ICA, and that the Managing Director certify that he continued to believe that his ICA duties did not give rise to any conflicts of interest with his duties as the Managing Director of HCSL. The need for a conflict of interest clause was supported by legal advice provided to Treasury. In December 2002, the HCSL Board approved a resolution to accept the conclusions in the report and that the report be forwarded to Treasury.

2.71 In February 2003, the Board agreed to a proposal to replace the existing Managing Director with another officer on secondment from the ICA, also on a part-time basis, subject to the Commonwealth providing that officer with an indemnity. Treasury took the view that the appointment of the new Managing Director provided an opportune time to amend the CMA in respect to conflict of interest. This was undertaken as a parallel exercise with putting an indemnity for the incoming Managing Director to the Minister for approval. The Minister approved the indemnity and the conflict of interest clause negotiated with HCSL in August 2003.

2.72 It was not originally envisaged that the Managing Director role would be undertaken on a part-time basis. Nevertheless, the Scheme structure created an environment in which there was always an inherent risk that a conflict of interest would arise or be perceived. In those circumstances, together with the distance between the Commonwealth and the day-to-day administration of the Scheme, the original omission of a conflict of interest clause from the CMA did not satisfy the normal expectations of public sector governance and accountability.

2.73 ANAO notes that Treasury has obtained specific legal advice on the potential for conflicts of interest to arise under the options available for engaging a new claims manager following the restructure of the Scheme, and the means by which they could be addressed.

Recommendation No.2

2.74 ANAO *recommends* that, when entering into agreements with private sector entities for the delivery of public sector outcomes, Treasury identify in the relevant contractual documents the means by which actual or potential conflicts of interest will be managed and reported.

Treasury response

2.75 Treasury agrees with this recommendation. Management and reporting of conflicts of interest is addressed in the draft contract for the new claims manager, and in the standard form Treasury consultancy and services contracts.

3. Scheme Implementation

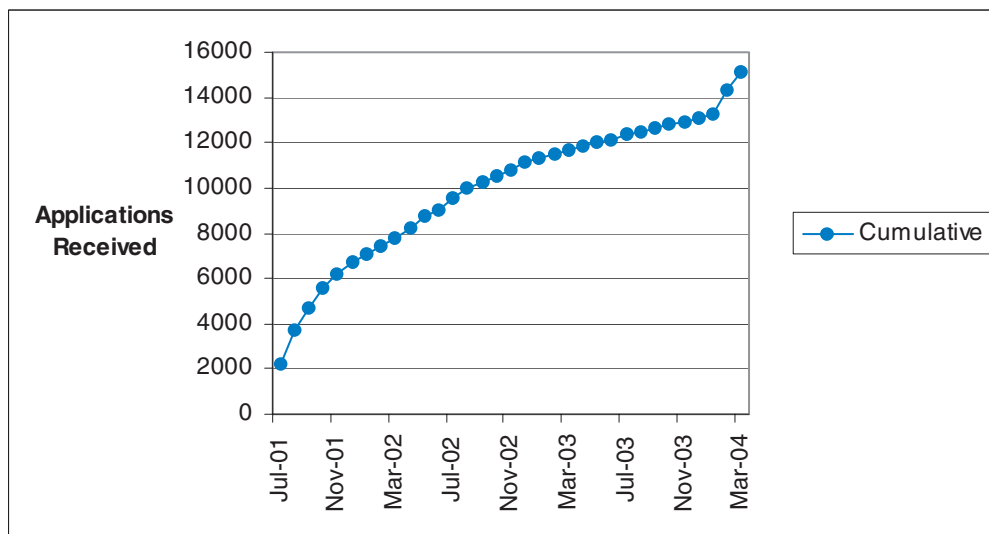
This chapter discusses aspects of the planning and operational implementation of the Scheme.

Scheme progress

3.1 The total volume of applications for assistance made to the Scheme has been at the low end of original expectations. Early estimates were that there would be between 15 000 and 25 000 applications. Following a significant spike immediately prior to the closure to new applicants, a total of 14 937 applications for assistance had been received by the Scheme as at May 2004.⁶⁹ The flow of applications received by the Scheme is set out in Figure 3.1.

Figure 3.1

Flow of applications to the Scheme



Source: ANAO analysis of HCSL operational reports to Treasury.

3.2 The evidence available to ANAO indicated that the focus of Government, Treasury and the industry participants was on getting the Scheme operational as soon as possible in order to provide assistance to HIH policyholders experiencing financial hardship. This is reflected in the relatively

⁶⁹ Excluding 238 duplicated applications. In May 2004, HCSL advised ANAO that approximately 150 applications had been received after the Scheme closure date of 27 February 2004. Treasury advised ANAO that such applications were being returned to the applicants. Those applicants may seek entry to the Scheme through the limited gateway established for special circumstances. If unsuccessful, they will need to seek recourse from the Liquidator through the normal processes applying to unsecured creditors.

short timeframe that elapsed between the Government agreeing to provide financial assistance on 14 May 2001 and the Scheme commencing formal operations under HCSL on 7 July 2001.

3.3 The first applicants to receive financial assistance payments were salary continuance claimants whose claims had already been approved by HIH. Treasury obtained approval from the Prime Minister on 6 June 2001 to enter into an agreement with the provisional liquidators to enable the Department to resume payments to those claimants, pending completion of the necessary agreements with HCSL and the relevant Claims Manager.⁷⁰

3.4 However, the logistics involved in establishing broader Scheme operations were very challenging. A large number of participants and service providers needed to be drawn together in a short space of time. Entirely new systems, procedures and operating protocols had to be established to support both the eligibility assessment process and the claims management function. The Claims Managers have reported that the latter was also particularly affected by the poor state of the HIH information systems and records. There were difficulties in obtaining the relevant HIH files, with some files unable to be located. The sudden cessation in HIH's operations had also resulted in a number of issues that needed to be tracked and resolved.⁷¹

3.5 Consequently, it took longer than had been anticipated, or intended, to achieve significant progress in making claim payments to eligible applicants. As Figure 3.2 indicates, by the end of December 2001, only \$28.5 million in claim payments had been made. Over time, however, the operation of the Scheme became increasingly more stable. As a result, it has been successful in delivering assistance to a large number of Australian individuals, small businesses (as defined in the Scheme eligibility criteria) and not-for-profit organisations affected by the collapse of HIH.

3.6 As at 20 May 2004, 11 284 applications (76 per cent of applications received) had been approved as eligible and referred to Claims Managers.⁷² As at the end of April 2004, about \$339 million in claim payments had been made

⁷⁰ Treasury made total salary continuance payments of \$1.9 million between June and July 2001. Payments made prior to the assent on 30 June 2001 of the HIH assistance special appropriation were made using funds appropriated to Treasury Outcome 3 – Well Functioning Markets. Treasury had received legal advice that Outcome 3 could be used because HIH was listed as an activity in the Treasury Portfolio Budget Statement.

⁷¹ This included issues such as payments that had been dishonoured and un-presented cheques, and the need for the Claims Managers to review each claim file before they could actively manage claims.

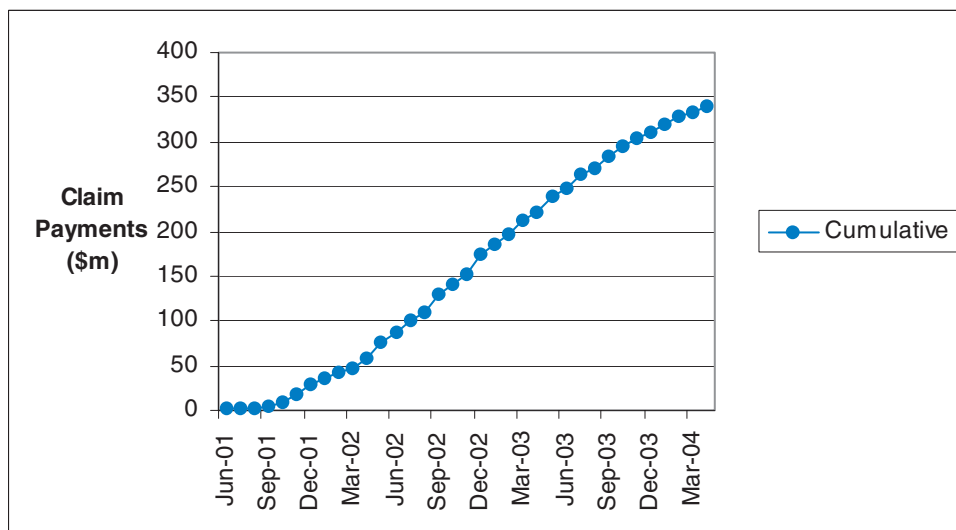
⁷² The eligibility of 1745 applications was still being assessed. A further 58 were eligible, but awaiting the provision of a correct assignment of rights form; and 128 were subject to Internal Review after being denied eligibility.

(see Figure 3.2). This represented 46 per cent of claim payments estimated to arise under the Scheme.⁷³

3.7 The majority of applications for assistance for policies relating to household building and contents, personal motor vehicles, property and commercial lines were paid by September 2002. Most of the claims that remained outstanding at the time of audit were ‘long-tail’ in nature, including public liability and professional indemnity claims. It may be many years before all of those are resolved.

Figure 3.2

Claim payments to April 2004



Source: ANAO analysis of data provided by Treasury.

Scheme planning

3.8 Effective planning is the cornerstone of an economic, efficient and effective grant program. The planning process helps to achieve consistency between strategic and operational objectives, performance measures and appraisal criteria. This, in turn, maximises the likelihood that those applications that are selected to receive assistance conform to government objectives.⁷⁴

3.9 The initial planning for a Scheme to assist policyholders affected by the HIH collapse was undertaken in a necessarily contracted timeframe, and in a

⁷³ Based on the actuarial review of the Commonwealth’s gross liabilities under the Scheme completed in April 2003.

⁷⁴ ANAO Better Practice Guide, *Administration of Grants*, op. cit., p. 5.

fluid policy environment.⁷⁵ Treasury's performance in that regard was comprehensive, given the prevailing circumstances.

3.10 Figure 3.3 identifies the key elements that should be considered in planning for an effective grant program. As Figure 3.3 also shows, ANAO found that Treasury has considered each of those elements in respect to the HIH Claims Support Scheme.

⁷⁵ Initial planning undertaken by Treasury was on the basis that any proposed Scheme would be funded through an industry levy, as had been proposed by the ICA. The Government subsequently decided that the Scheme would be funded through the Budget.

Figure 3.3

Planning for an effective grant program

Key Planning Elements		Considered by Treasury	
		Pre-implementation	Post-implementation
Establish the need for the program	Establish the need for the program or where the greatest need exists and map relationships with other funding sources to avoid duplication.	✓	
Define operational program objectives	Seek authority for the program. Define, authorise and document program objectives in terms of measurable outcomes.	✓	✓
Risk management	Identify, analyse, assess, prioritise and develop strategies for managing risks. Establish rules of eligibility.	✓	✓
Design program for value for money	Estimate all grant and administrative costs, including monitoring and evaluation. Assign administrative responsibilities. Allocate resources.	✓ ✓ ✓	✓ ✓
Design program for accountability	Ensure compliance with administrative law and access and equity provisions. Develop accountability framework and reporting mechanisms.	✓ ✓	 ✓
Establish performance measures	Develop performance measurement and monitoring strategies.		✓
Select funding strategy	Consider the risks and benefits of alternate funding strategies.	✓	
Consider taxation issues	Liaise with the Australian Taxation Office to determine tax implications.	✓	
Produce program guidelines	Develop program guidelines and adequately train staff.		✓

Source: ANAO Better Practice Guide, *Administration of Grants*, Canberra, May 2002⁷⁶ and ANAO analysis.

⁷⁶ This guide was originally published in 1994 and revised in 1997, and drew on a similar booklet prepared by National Audit Office of the United Kingdom, titled *Promoting Value for Money from Grants*. The 2002 revision reflected ANAO's experience in auditing a number of grant programs.

3.11 However, as Figure 3.3 also indicates, due to the context in which the Scheme was initially planned and established, a number of issues important to its effective management were necessarily addressed concurrent with, or in a number of cases some time after, the commencement of Scheme operations. This had adverse consequences for the efficient and effective delivery of assistance to some applicants, particularly in the first year of operation.

3.12 ANAO found that, at the time of audit, Treasury was applying a comprehensive approach to planning the design of the revised Scheme structure and documents. The opportunity to undertake a more considered and complete analysis of each element of the revised structure prior to it being implemented should be of benefit to Treasury in achieving a smooth transition.

Claims Management Agreements

3.13 Outstanding insurance claims could not be passed to the insurers who had agreed to participate in the Scheme until they had agreed a Claims Management Agreement. An Agreement was finalised with AAA on 6 July 2001, with the first general assistance payments being made in August 2001. R&SA took over responsibility for salary continuance payments following finalisation of its Agreement on 7 August 2001. At that time, it also became responsible for managing salary continuance claims not previously approved.

3.14 The Claims Management Agreement with QBE, who was to be primarily responsible for public liability and professional indemnity claims, was the last to be finalised. This delayed, to some extent, the allocation of relevant eligible applications for claims management. The Agreement was finalised on 4 September 2001.

3.15 The negotiation of those Agreements was complex, involving not only the contracting parties (HCSL, the Liquidator and the insurer), but also the Commonwealth, which, by virtue of the CMA, retained a right of oversight of the terms and conditions HCSL was authorised to enter into. Separate legal and other advisers represented each party. Treasury commented to ANAO that:

...such conditions make for inherently protracted negotiations, and it is a credit to all parties that contracts were able to be agreed within such short timeframes.

3.16 A Claims Management Agreement with NRMA to manage claims where the relevant Claims Manager has a conflict of interest was executed on 15 May 2002. To date, very few claims have been referred to NRMA to manage.

Unallocated claims

3.17 Each Claims Manager was contracted to provide services in respect of discrete classes of claims. However, when the Scheme was initially being established there was limited knowledge about the full extent of insurance business HIH had been involved in. This limited the ability to effectively plan for the type of insurance claims that would be involved and the resources needed to manage them.

3.18 As a result, the original Claims Management Agreements did not cover all of the types of claims that emerged as applications for assistance were received. As at December 2001, around 10 per cent of applications fell outside of the umbrella of claims R&SA, AAA and QBE had been contracted to manage. As a result, there was no approved claims manager to handle the claims of over 650 applicants who had been assessed as eligible.⁷⁷

3.19 Under a variation to its Agreement signed in mid-January 2002, QBE took responsibility for handling, through sub-contractors, most of the previously unallocated classes of insurance. The relevant sub-contracts were finalised in late February 2002. Only then could management of those claims commence.⁷⁸

3.20 Further classes of unallocated claimants continued to be identified during 2002, including in respect to workers compensation top-up policies, ACTU salary continuance policies, the Australian Rugby Union's policy for personal injury and categories of claims for extended motor vehicle warranty. Further variations to the QBE Agreement to deal with those claims were put in place over the course of 2002.

Local government claims

3.21 In announcing the Scheme, the Government offered to contribute to local government claims on a one-for-one cost-sharing basis with the respective States.⁷⁹ In the period since, there has been protracted negotiation

⁷⁷ This included some commercial motor vehicle claims; commercial property, including business interruption; personal accident; marine; livestock; bloodstock; jewellers block; and aviation.

⁷⁸ Other delays to processing also occurred as a result of a lack of availability of specialist claims managers to handle a number of specialised forms of insurance in respect of which claims had emerged.

⁷⁹ Initially, assistance was to be available where a council's exposure to losses arising from the HIH collapse exceeded 10 per cent of its average total revenue over a specified period. This was amended in May 2003 to exposures exceeding 15 per cent of average ordinary rates revenue for the relevant financial year and the two preceding financial years. Councils will bear a share of the loss equal to 15 per cent of their average ordinary rates revenue. The criteria were revised to overcome concerns that a significant proportion of total council revenue is tied to specific purposes and not available to meet HIH exposures. Source: Media Release, Minister for Revenue and Assistant Treasurer, *HIH Assistance—Commonwealth Offer on Council Claims*, 27 May 2003.

with the States regarding the terms on which the Commonwealth assistance will be provided.

3.22 In February 2004, Treasury advised the Additional Estimates hearing of the Senate Economics Legislation Committee that negotiations with the States on this issue were ongoing and that, consequently, no payments had been made to date to any local government applicant under the Scheme.⁸⁰

Eligibility criteria

3.23 The objective of the Scheme is to provide assistance to those experiencing financial hardship as a result of the collapse of HIH. In developing the criteria for determining who would receive assistance, Treasury identified a need to balance equity and simplicity. A more complex Scheme may provide for more rigorous testing of the financial hardship of applicants, but would be more costly to administer and possibly provide slower service delivery. The eligibility criteria announced by the MFSR on 21 May 2001 reflected that principle.

3.24 Where an application relates to salary continuance, income protection or disability policies; personal injury claims; or claims for a total loss on a primary place of residence, assistance is available at the rate of 100 per cent of the amount HIH would have paid, as long as the insured is an Australian citizen or permanent resident, an Australian small business (as defined for the Scheme) or an Australian not-for-profit organisation (including those structured as trusts). No further financial hardship test is applied.

3.25 For all other claims, assistance is available to eligible applicants at the rate of 90 cents in the dollar.⁸¹ To qualify for that assistance, private individuals must satisfy an income test, or the value of the claim must be more than 10 per cent of family taxable income for 1999–2000. Family trusts are also subject to threshold income and asset tests before they are eligible for assistance under these claims.

3.26 No hardship or income test is applied to applications by businesses, including trusts managing a business. To qualify for assistance, a business must satisfy the definition of an ‘Australian small business’ approved for the Scheme. In the interests of simplicity, a ‘number of employees’ test was selected to serve as a proxy test for the size of a business and, therefore, its

⁸⁰ Hansard, Senate Economics Legislation Committee, 19 February 2004, p. E64.

⁸¹ The rationale for paying 90 per cent of claims was to reduce moral hazard concerns by requiring those who buy insurance to accept some residual risk for the decisions they make. This co-insurance feature is common in many industry support schemes elsewhere in the world.

capacity to absorb the impact of the HIH collapse.⁸² The Government decided to apply a threshold of 50 employees or less as at 21 May 2001 in defining an eligible small business.

3.27 In all cases, the payment of support to eligible applicants is only available where a claim had been made under the relevant HIH insurance policy before 11 June 2001 or it relates to an event that occurred before 11 June 2001.

Additions and clarifications

3.28 Since the Scheme commenced operations, a number of circumstances have arisen that necessitated clarification and/or enhancement of the originally announced criteria. To some extent, this was another consequence of the limited knowledge that initially existed about the type of claims that could be expected.

Owners' corporations

3.29 The circumstances of owners' corporations that held HIH policies were not specifically addressed by the Scheme eligibility criteria.⁸³ During the initial months of operation, HCSL assessed the eligibility of applications by owners' corporations against the criteria relating to small businesses. Legal advice provided to Treasury in September 2001 was that owners' corporations are not small businesses and, therefore, not an entity capable of receiving assistance under the eligibility criteria.⁸⁴ In mid-September 2001, Treasury advised HCSL that separate eligibility criteria were being developed for lot owners in owners' corporations, to provide them with the same access to assistance as individuals and small businesses.

3.30 Treasury issued guidelines on the approach to be taken in assessing the eligibility of applications from residential owners' corporations on 18 October 2001. HCSL raised a number of concerns with the administrative complexity of the guidelines and proposed an alternative approach. HCSL subsequently

⁸² There are a number of options that could be applied in such a test. The Australian Bureau of Statistics defines small business as less than 20 employees. Under section 10.1 of the Corporations Act, a company is classified as small if it satisfies at least two of the following tests: (a) annual gross operating revenue of less than \$10 million; (b) gross assets of less than \$5 million at the end of the year; and (c) fewer than 50 employees at the end of the year. The ICA proposed that the definition in the Financial Services Reform Bill 2001 (less than 100 employees for a manufacturing business and less than 20 employees for a business engaged in other activities) be used for the purposes of the Scheme.

⁸³ Owners' corporation is the legal name for a strata plan or body corporate or the legal body that owns a building with common property. Owners' corporations are required by statute to maintain public liability insurance, building insurance and workers' compensation. The Scheme applies to the first two types of insurance policy.

⁸⁴ An owners' corporation is also not a private individual nor a not-for-profit organisation.

placed a freeze on the further processing of applications from owners' corporations on 3 November 2001, pending the finalisation of the guidelines.

3.31 Following extensive discussions between Treasury and HCSL, the acting Prime Minister approved additional eligibility criteria and assessment guidelines for residential owners' corporations on 1 February 2002.⁸⁵ Application of the same process to lot owners in commercial owners' corporations was approved on 23 May 2002. In developing the eligibility process, it was acknowledged by Treasury that there would be very limited scope for the Commonwealth to make any recoveries from the Liquidator in respect of amounts paid to individual lot owners.⁸⁶ However, it was considered that this consequence should be accepted in the interests of providing those parties with equity of access to the Scheme.

Trusts

3.32 In October 2001, HCSL sought advice from Treasury on the appropriate assessment criteria for trusts. Treasury determined that additional criteria would need to be developed. On 12 November 2001, HCSL was advised to suspend the processing and payment of all trust applications pending finalisation of the criteria.

3.33 The acting Prime Minister agreed to eligibility criteria and assessment guidelines for two categories of trusts (small businesses operating through trusts and not-for-profit organisations structured as trusts) on 1 February 2002. Additional eligibility criteria for processing applications from other trusts were approved on 23 May 2002.⁸⁷

⁸⁵ Under the process adopted, the owners' corporation, as the policyholder, is responsible for managing the claim itself (acting as a prudent uninsured). Individual lot owners can apply to the Scheme for assistance, with their eligibility being assessed against the criteria applying to individuals, small businesses or trusts, as appropriate. When the matter is settled, the owners' corporation will levy the lot owners to meet the claim. Qualifying applicants can then apply for a payment under the Scheme by submitting a statutory declaration identifying the levy to which they are subject. The Scheme will reimburse them either 90 or 100 per cent of the levy, depending on the nature of the claim. In December 2001, Treasury advised the Minister that, although this approach created more administrative burdens for HCSL and may also result in increased costs than under some other options considered (such as treating owners' corporations as analogous to small business), it preserved the policy integrity of the Scheme in that it provided for limitation of access to cases of genuine hardship.

⁸⁶ It is the owners' corporation, as the policyholder, that is an unsecured creditor of HIH. HCSL does not take any assignment of rights from the owners' corporation. While there is an assignment of rights by the lot owner, legal advice to Treasury is that, in practical terms, this may not amount to anything in terms of being able to lodge a proof of debt for amounts paid to individual lot owners. However, where all lot owners in an owners' corporation apply for assistance and are deemed eligible, the claim is assigned to a Claims Manager to be handled as a normal claim within the Scheme and any payments made will be included in the proof of debt.

⁸⁷ 'Other Trusts' includes family trusts that are not of a small business type.

Entities not carrying on a business as at 21 May 2001

3.34 In January and February 2002, Treasury received legal advice that, on a strict application of the criteria, an applicant that ceased to be a partnership or Australian-incorporated company or association prior to 21 May 2001 could not apply for assistance under the small business category. It was noted that a declaration of zero employees as at 21 May 2001 could be an indicator of such entities. On that basis, in February 2002, Treasury advised HCSL that it should cease processing applications from small businesses that revealed zero employees, pending consideration of the legal advice.⁸⁸

3.35 Revised Notes for small business applicants issued in March 2002 included the first explicit statement of a requirement that applicants must have been carrying on a business as at 21 May 2001.⁸⁹ On 23 May 2002, the acting Prime Minister approved amendments to the eligibility criteria to enable the processing of applications from entities that had ceased operating prior to 21 May 2001.

Partnerships

3.36 In June 2002, the Notes provided to small business applicants were further amended to address the circumstances of partners in insured partnerships that were dissolved prior to 21 May 2001, but who were then involved in other partnerships. For the purposes of the Scheme, the applicant is deemed to be a 'related entity of a larger organisation', and therefore ineligible, if they were carrying on business in partnership with another person or persons as at 21 May 2001 which had more than 50 full-time equivalent employees.⁹⁰

Current eligibility criteria

3.37 The Scheme eligibility criteria as they currently stand are set out in Figure 3.4.

⁸⁸ By the end of January 2002, 751 small business applications declaring nil employees as at 21 May 2001 had been received (representing 18 per cent of small business applications to that time, and 10.7 per cent of all applications). Of those, 58 per cent had been assessed as eligible under the Scheme.

⁸⁹ Applicants who did not meet that requirement were advised they should still apply and include a brief explanation of the circumstances in which they ceased to carry on the business, but that this should not be interpreted as a promise that the Commonwealth would waive this requirement.

⁹⁰ This was based upon legal advice provided to Treasury in February 2002 that the correct approach was to apply the small business test for eligibility to each of the former partners of dissolved partnerships.

Figure 3.4

Eligibility criteria for assistance under the HIH Claims Support Scheme

Applicant	Eligibility criteria for receiving assistance
Australian citizen or permanent resident (includes New Zealand citizens) - Income test only applies to claims other than for personal injury; salary continuance, disability or income protection; or total loss where primary place of residence.	<ul style="list-style-type: none"> • 1999–2000 family taxable income below \$77 234 (one child, increased by \$3139 for each additional child), or the claim is more than 10 per cent of family taxable income.
Small business	<ul style="list-style-type: none"> • Australian owned. • 50 or fewer full time equivalent employees and carrying on a business as at 21 May 2001. • Not a related entity of a larger organisation. • If operated through a trust, the trust instrument must confer on the trustee the power to carry on a business; and the trustee must be the policyholder, or a third party with relevant cut-through rights.
Not-for-profit organisation	<ul style="list-style-type: none"> • Australian based. • If structured as a trust, the trustee must be the policyholder, or a third party with relevant cut-through rights.
Lot owner in owners' corporation	<ul style="list-style-type: none"> • Criteria relating to individuals or small business, as relevant. • The owners' corporation has levied a contribution in respect of an uninsured loss, and the contribution relates to the lot owner's share of an amount that would have been paid under an HIH policy.
Other trusts, including family trusts	<ul style="list-style-type: none"> • Trustee is an Australian citizen or permanent resident, or Australian company; and is the policyholder or named insured. • The trust's total net income in 1999–2000 was less than \$80 373, or the claim is more than 10 per cent of total net income of the trust for that year. The trust must have assets equal to or less than \$1.386 million as at 30 June 2001.
The following are excluded from the Scheme: <ul style="list-style-type: none"> • claims where the insured is not an Australian citizen or permanent resident; • any business that is not an Australian business or does not meet the definition of a small business; • claims for reinsurance contracts or in the nature of a reinsurance contract issued by HIH; • insurance mandated by State and Territory Governments including compulsory third party motor vehicle, workers' compensation, builders' warranty and professional indemnity for legal practitioners (to the extent it is compulsory); • claims where the insured was a director or officer or an associate of a director or officer (as defined under the Corporations Law) of any company within HIH 3 years before its failure; and • claims where the insured was an individual, or an associate of an individual, who was in a position to influence or advise the directors or officers of any companies within HIH 3 years before its failure. 	

Source: Press Release, Minister for Financial Services and Regulation, *Criteria for HIH Hardship Relief*, 21 May 2001 and ANAO analysis of Treasury documentation.

Eligibility assessment

3.38 Timely and accurate eligibility assessment is critical to the achievement of the core objectives of a financial assistance program such as the HHH Claims Support Scheme. The issues relating to eligibility criteria and assessment that arose over the course of the Scheme had an impact on its performance in this area, especially during the first year of operation.

Incorrect eligibility assessment

3.39 As noted, the risk that applicants would be granted eligibility based upon incorrect information contained in their application is inherent in the ‘face value’ approach adopted for the Scheme (see paragraphs 2.32 to 2.42). However, there have also been instances in which problems in the Scheme eligibility assessment process itself resulted in ineligible applicants being incorrectly assessed as eligible.

Owners’ corporations and trusts

3.40 Prior to the processing of claims by owners’ corporations being frozen in November 2001, 22 owners’ corporations were incorrectly granted eligibility as small businesses and paid a total of \$148 790.⁹¹ A further 141 were incorrectly granted eligibility, but had not been paid. It is not possible to determine from available records how many of the individual lot owners in those owners’ corporations would have been eligible for assistance anyway under the new guidelines. Analysis undertaken by HCSL in February 2004 indicated that, on average, 53 per cent of the lot owners in owners’ corporations that have applied under the Scheme have been found to be eligible.⁹²

3.41 Treasury also raised concerns with HCSL that applications from trusts had been granted eligibility and, in some cases paid, before the Government

⁹¹ The bulk of this amount related to a payment of about \$125 000 made under one claim.

⁹² On personal injury matters (in respect of which eligibility is not subject to an income test), an average of 70 per cent of lot owners within a corporation had been found to be eligible. For claims for property damage, the average was significantly lower, with 35.5 per cent of lot owners being eligible.

had approved the relevant eligibility criteria. Ultimately, this does not appear to have resulted in payments being made to ineligible applicants.⁹³

Not-for-profit organisations

3.42 Both the HCSL procedure manual and the application form stated that an applicant seeking eligibility as a not-for-profit organisation must provide a copy of its Charter, Constitution or other defining document that prevents it from distributing profits or assets for the benefit of particular persons, either during the life of the organisation or upon its winding up.

3.43 In April 2002, it was identified that HCSL's service provider had incorrectly approved some applications from universities as being eligible under the not-for-profit category on the sole basis of Australian Taxation Office (ATO) certificates provided by the applicant, which stated that they were a 'Tax Exempt Institution'. Following identification of this issue, applications made in reliance on the same form of ATO certificate were not accepted as being eligible.⁹⁴

3.44 In June 2002, Treasury advised HCSL that the only basis on which a university could be eligible under the Scheme was as a not-for-profit organisation. Treasury further advised that HCSL was required to undertake its own assessment of not-for-profit status based on the documentation called for in the application form, noting the following:

Whilst the tax status of an Australian not for profit organisation is useful as an indicator (the ATO uses essentially the same criteria for determination of not for profit status as described in the Application for Assistance), it does not remove responsibility from HCSL to ensure this assessment is made by reference to defining documents.

3.45 On the basis of legal advice received, Treasury advised HCSL that it would be appropriate for HCSL to re-assess eligibility as not-for-profit organisations of all universities for which eligibility had been previously

⁹³ HCSL had advised Treasury that payments totalling \$2.5 million had been made to 71 trust applicants in advance of the eligibility criteria being approved. In June 2002, HCSL advised Treasury that, in re-processing applications for assistance by trusts under the new criteria, no applications previously granted eligibility had been found to be ineligible. In response to ANAO enquiries, in February 2004 HCSL undertook further analysis of 28 of those applications (accounting for 94 per cent of the \$2.5 million previously identified) which indicated that the earlier advice had incorrectly identified 17 of them as trust applications. This was because the later analysis had identified that, although the insured might be a party to a family or other trust, the trust was not the entity making an application to the Scheme and was not noted on the policy schedule. In all but one case, HCSL confirmed that those applicants would have qualified for assistance as a small business or sole trader. HCSL also confirmed that the remaining nine trust applications had been subsequently confirmed as eligible under the trust guidelines.

⁹⁴ This issue was further complicated by confusion as to whether a university's status as having been created by an Act of a State Parliament resulted in them being ineligible (on the basis they were related to a larger entity).

denied. This assessment would need to take account of the defining documents of the applicant.

Recommendation No.3

3.46 ANAO *recommends* that, in implementing Commonwealth financial assistance schemes, agencies implement adequate checklists and sign-off procedures to confirm that eligibility has been assessed in conformance with stated procedures, including the receipt of necessary documentation.

Treasury response

3.47 Treasury agrees with this recommendation. Checklists and sign-off procedures are being utilised for both the HIH Claims Support Scheme and the late application facility (the “Gateway”).

Small business applications

3.48 Over half of the applications for assistance under the Scheme have come from small businesses. The eligibility test for small business applicants is based upon four core elements. The applicant must:

- be an individual, partnership or Australian-incorporated company or association;
- have had 50 or fewer full time equivalent employees as at 21 May 2001;
- have been carrying on a business as at 21 May 2001; and
- not be a related entity of a larger organisation.

3.49 The first verification of eligibility audit, undertaken by the HCSL internal auditor in late 2001 and early 2002, identified a significant procedural weakness in the eligibility assessment process for small business applicants. Although the Notes for Applicants (to which applicants were referred by the application form) had identified the related entity exclusion, the application form did not require an applicant to make any assertions regarding the underlying ownership or related entities of the small business. Further, the term ‘related entity’ had not been defined for the purposes of the Scheme. As a result, those undertaking the eligibility assessment simply did not have the information necessary to form a judgement in respect of one of the core elements of eligibility.

3.50 At the time this issue was identified, over 4000 small business applications had been processed, although the majority of those claims had yet to be finalised. When the matter came to Treasury’s attention, the Department took prompt action to address concerns about the potential for payments to be made to ineligible applicants. On 1 March 2002, Treasury asked HCSL to suspend all small business applications until appropriate controls could be put

in place. Settlement negotiations on the claims of applicants already assessed as eligible were suspended.

3.51 Most small business applicants were then asked to submit a revised statutory declaration⁹⁵, which required them to attest to their related entity status. Known as the 'small business review', this process involved the eligibility of all small business applicants being re-assessed. A mail out of revised Notes for Applicants and statutory declarations to all small business applicants commenced in March 2002. The processing of outstanding claims was only able to be resumed when a satisfactorily completed new statutory declaration had been received and the eligibility of the applicant confirmed.

3.52 HCSL expressed a number of concerns about the way in which this issue was managed. These included a lack of consultation with HCSL prior to requesting the cessation of payments to small business applicants⁹⁶, and concern that delays in settlements and payments could increase Scheme costs and cause damage to the reputation of the Scheme and its participants. In this respect, Treasury advised HCSL that any small business claims ready for payment could go ahead if a search of the Australian Securities and Investments Commission's database confirmed that the small business was not a related entity or foreign owned. HCSL records indicate that this approach was successful in confirming the eligibility of many applicants with claims ready for payment, but that it was also a complex, time consuming and expensive process.

3.53 The small business review did result in considerable disruption to the processing of small business applications, and to the timely settlement of claims. However, it was also successful in reducing, to some extent, the Scheme's exposure to making payments in respect of ineligible applicants.

3.54 The process resulted in some applications being withdrawn and others being found to be ineligible. In other cases, the applicant did not return a revised statutory declaration. In the latter half of 2002, HCSL undertook the process of rescinding the eligibility of a number of applicants based on the outcome of the small business review.⁹⁷ Twelve cases were identified in which payments totalling \$850 720 had already been made in respect of small business applicants that were found to be ineligible or failed to return a revised

⁹⁵ The internal auditor had recommended that an amended statutory declaration form should be issued in the interests of preserving the integrity of the established eligibility criteria for small business.

⁹⁶ HCSL argued that, as a result, there was no clear communication strategy in place to explain the situation to the affected applicants.

⁹⁷ As at 20 May 2004, a total of 249 applications had been withdrawn from the Scheme, 20 of which were identified as having been withdrawn following the small business review; and 117 applications were identified as having had their eligibility rescinded.

statutory declaration. The options to recover such payments are limited (see paragraphs 4.51 to 4.60).

3.55 The quantum of savings that may have resulted from avoiding payment to ineligible applicants has not been identified, but is likely to be substantial given the nature of claims involved in a number of small business applications.⁹⁸ Any additional costs in terms of claim settlements or claim management expenses, that may have arisen from the temporary freeze on the processing of small business applications and claim settlements, have also not been identified.

Service companies

3.56 In April 2003, HCSL queried whether employees of service companies used by partnerships to provide support and management services should be included as employees of the partnership for the purposes of assessing eligibility as a small business. In May 2003, Treasury advised HCSL that staff employed by a service company should be included in the count of employees, where such staff perform work solely in connection with the business of the partnership and the revenue used to pay their salaries comes from the fees generated by the partners and professional staff of the firm. In August 2003, additional Notes for partnership applicants were produced to clarify this matter.

3.57 This issue was first considered some 21 months after the Scheme commenced operations. Prior to that, the information provided to applicants had made no reference to whether such employees should be included in the employee count attested to by the applicant. HCSL had not been required to factor in any 'related entities' in terms of service companies attached to the partnership in assessing the eligibility of applicants. On that basis, it is possible that there will have been cases where applications from partnerships have been incorrectly assessed as eligible.

3.58 In June 2003, Treasury confirmed to HCSL that, where applications by partners or former partners had been found to be eligible on the basis of the information provided by them, there was no requirement for HCSL to re-open the applications and seek additional information from the applicants.

⁹⁸ In this respect, the Chair of the Treasury Audit Committee was advised in July 2002 that: '...there is no information available at this stage as to the potential savings to the Scheme in not paying out on ineligible applications for assistance, other than for the matter previously advised where eligibility was formally withdrawn (estimated at \$2.53m)...'

Recommendation No.4

3.59 ANAO *recommends* that, prior to the commencement of application assessment for Commonwealth financial assistance schemes, agencies:

- (a) define all key terms used in the eligibility criteria; and
- (b) verify that the application forms are designed to provide the information necessary to enable eligibility to be assessed against all approved criteria.

Treasury response

3.60 Treasury agrees with this recommendation. In relation to the Scheme, all key terms were defined and forms redesigned in early 2002.

Service delivery

3.61 Resolving the various issues identified in respect to eligibility criteria and assessment procedures resulted in delays in the processing of applications and claims for the affected classes of applicants.⁹⁹ Processing for some groups was halted altogether for substantial periods, including, in some cases, the claims of applicants who had already been advised that they were eligible. Whilst it is clear that the actions taken were motivated by a desire to protect the Scheme's integrity, they did result in uncertainty for affected parties.

3.62 In the case of lot owners, even after the relevant eligibility criteria and assessment guidelines were approved in February 2002, uncertainty continued to surround the issue for some months, as the detailed documentation needed to implement the guidelines was finalised.¹⁰⁰ Also, lot owners in owners' corporations that had applications pending, when processing of those claims was halted in November 2001, were required to individually re-apply. This led to a considerable level of uncertainty and frustration for those affected. As discussed above, a similar situation arose in respect to small business applicants.

3.63 It is not unreasonable to expect that, in the assessment of applicants' eligibility over the course of a significant financial assistance program, situations will arise that were not originally envisaged. However, it is also apparent that some of the difficulties experienced arose due to gaps in the design of the original eligibility criteria and/or assessment material. A

⁹⁹ This was exacerbated in part by the administrative care-taker arrangements that came into effect in the lead up to the Federal general election held in November 2001.

¹⁰⁰ A variation to the Claims Management Agreement with AAA was finalised on 9 September 2002 to allow processing of lot owners' claims in accordance with the eligibility guidelines approved in February and May 2002.

significant contributing factor in that regard was the contracted timeframe available for planning the Scheme before operations commenced and, to some extent, the limited knowledge that initially existed about the type of claims that could be expected.

3.64 The experience gained through the operation of the Scheme has highlighted that the effective implementation of financial assistance schemes will be enhanced by maximising, to the extent the relevant circumstances allow, the analysis undertaken in order to inform the design of eligibility criteria, application material and assessment guidelines. In this respect, Treasury advised ANAO in March 2004 as follows:

The collapse of HIH affected thousands of policyholders, many of whom were not receiving incomes and were running legal defences through the courts without assistance. In implementing the Scheme as quickly as possible in order to alleviate this hardship being suffered by former HIH policyholders, there was always going to be a trade off between timely delivery of assistance for the majority of policyholders and slower delivery for the classes that were the subject of ongoing policy development. Unanticipated classes of applicants and different classes of insurance that were not known at the time of Scheme development were addressed as they emerged. Although some of the classes of applicants that had not previously been considered may have been identified with more time spent on the planning process, Treasury's experience of the emergence of these issues indicates that it is unlikely that all of the possible classes of applicants would have been identified.

Recommendation No.5

3.65 ANAO *recommends* that, prior to implementing Commonwealth financial assistance schemes, agencies:

- (a) undertake, to the extent possible in the relevant circumstances, a comprehensive analysis of the entities that are likely to apply. This would assist in the appropriate design of the eligibility criteria and application documentation; and
- (b) where the financial assistance is provided on a discretionary basis, include appropriate disclaimers in the documentation to be provided to potential applicants reserving the right to alter, or terminate, the scheme.

Treasury response

3.66 Treasury agrees with recommendation. In relation to (b), disclaimers have been included on all 'Gateway' application documentation and guidelines.

4. Financial Management

This chapter discusses aspects of the financial management of the Scheme.

Appropriation and actuarial reviews

4.1 Special appropriations are appropriations for specified purposes created by an Act of the Parliament, which is separate to the annual appropriation Acts. The appropriation may be ‘standing’, in that the amount appropriated has to be calculated based on the terms of the legislation rather than being specified in the appropriation itself. Alternatively, the special appropriation may be limited to an amount specified in the relevant Act.

4.2 Money was appropriated for the Scheme as a special appropriation that is limited to \$640 million. The Appropriation Act states that the money is appropriated for the purposes of:

- providing financial assistance to HIH eligible persons, either directly or indirectly; and
- meeting administrative costs associated with providing that financial assistance.

4.3 Treasury based the amount of appropriation sought on broad estimates made by the provisional liquidators in May 2001 of the gross undiscounted liability across the various HIH business lines.¹⁰¹ Adjustments were made to those estimates for the percentage of claim payments under each business line that were to be payable under the Scheme eligibility criteria.

Actuarial reviews

4.4 Two actuarial reviews of the Commonwealth’s liabilities under the Scheme had been undertaken at the time of audit. The outcome of the first review, completed in April 2002, was a decrease of seven per cent (\$43 million) in the estimated gross cost of the Scheme, to \$597 million. This consisted of claim payments of \$524 million and administrative expenses of \$73 million. The actuary advised Treasury that the key factor contributing to that reduction was the lower than expected number of applications being received by the Scheme, partially offset by an increase in the assumed average size of claims and the inclusion of projected management expenses.

¹⁰¹ The provisional liquidators advised Treasury that the initial estimate was based on an extrapolation of the actuarial information available at that time, but was subject to uncertainty. In August 2001, the provisional liquidators confirmed to Treasury that there was extreme uncertainty surrounding the valuation of Scheme liabilities, and that more robust estimates of the extent of the Commonwealth’s liabilities under the Scheme would be dependent not only on further actuarial analysis, but also on experience with the processing of claims.

4.5 The second review, completed in April 2003, resulted in a central estimate of gross cost of \$812 million.¹⁰² This consisted of \$735 million in claim payments and \$77 million in administrative expenses.¹⁰³ This was a 27 per cent increase over the original estimate, on which the appropriation was based, and 36 per cent higher than the estimate made in the 2002 valuation. The \$215 million increase in the Scheme valuation between April 2002 and April 2003 primarily related to increases in the estimated cost of public liability and professional indemnity claims.¹⁰⁴ Figure 4.1 sets out the changes that have occurred over time in the Commonwealth’s estimated gross liability under the Scheme.

Figure 4.1

Summary of gross valuation of Scheme liabilities as at April 2003

2001 Appropriation (\$m)	Business Segment	2002 Actuarial (\$m)	2003 Actuarial (\$m)
	Inflated & Undiscounted		
163	Public Liability	246	382
316	Professional Indemnity	164	194
5	Special Liability Categories	n/a	54 ¹
102	Salary Continuance	73	56
54	Short Tail Portfolios	41	49
nil	Administrative Expenses	73	77
640	Estimated Gross Scheme Cost	597	812
Note 1: This item related to an allowance for special categories of liability and professional indemnity claims (including management expenses) that were not explicitly modelled as part of the 2002 valuation.			

Source: 2002 and 2003 actuarial reviews of Commonwealth liabilities under the Scheme and ANAO analysis.

4.6 Due to the ‘long-tail’ nature of a large number of claims, the estimated cash flow projection under the 2002 valuation showed the Commonwealth having to commit funding until at least the year 2024. This compared to the

¹⁰² This estimate incorporates an allowance for future inflation.

¹⁰³ The estimate was based upon an assumption that the existing Scheme administrative structure would continue for the life of the Scheme, and did not take account of any cost reductions that may be achieved through the revised administrative structure being implemented.

¹⁰⁴ A significant reason for this increase was that, at the time of the 2002 valuation, application activity had slowed considerably and the valuation had assumed this trend would continue. However, shortly after the 2002 valuation was completed, the number of applications being received each week increased, and then levelled off at a higher level. Other contributing factors were: the inclusion of an explicit allowance for claims arising from three special categories of applicant—local government, litigation funding and third parties with cut-through rights; and the development of case estimates for liability claims that exceeded the actuary’s 2002 expectations (despite a significant allowance being made for adverse development as part of the 2002 valuation). Source: *Actuarial Review of Commonwealth Liabilities under the HIH Support Scheme, Part I, Executive Summary*, 1 April 2003.

provision in the 2001–02 Budget for cash to be paid out over five years. The revised cash flows under the Scheme projected by the 2003 actuarial review are set out in Figure 4.2.

Figure 4.2

Summary of projected cash flows as at April 2003

	01–02 \$m	02–03 \$m	03–04 \$m	04–05 \$m	05–06 \$m	06–07 \$m	to 2024+ \$m	Total \$m
2001–02 Budget	200	180	160	100	0	0	0	640
2002 Actuarial	92.7	150.1	91.7	54.1	38.9	29.9	139.5	596.9
2003 Actuarial	275 (actual & estimated to 30 June 03)		151	96	68	51	171	812

Source: 2002 and 2003 actuarial reviews of Commonwealth liabilities under the Scheme and ANAO analysis.

Sufficiency of appropriation

4.7 Based on the 2003 estimate, the existing appropriation will not be sufficient to meet the expected cost of the Scheme. As with any actuarial valuation, however, there is an inherent level of uncertainty associated with valuing the Commonwealth’s liabilities under the Scheme. The April 2003 report of the second actuarial review advised Treasury that:

...there are a great many uncertainties regarding the eventual cost of the Scheme. While we have endeavoured to establish what we believe is the ‘central estimate’ of Scheme cost in accordance with our professional standards, it should be noted that by definition our estimate is only the ‘mean’ or ‘expected value’ of the *distribution* of all possible eventual outcomes for Scheme cost. The extent of the uncertainties existing in the Scheme at this point in time means that the distribution of outcomes for Scheme costs covers a wide range, wider than we would normally associate with similar types of claim liabilities for an Australian general insurer of comparable size.¹⁰⁵

¹⁰⁵ The actuary further reported that: ‘One way of quantifying the uncertainty in Scheme costs is to express the future claim cost in terms of a claim distribution, and quantify the uncertainty in terms of the probability of claims exceeding or falling below our central estimate. The 75th per centile of the future Scheme payments (“Scheme liabilities”) identifies the value below which lie 75 per cent of the possible outcomes for outstanding Scheme liabilities or, in other words, there is a 3 in 4 chance that Scheme liabilities will turn out to be at or below the 75th percentile level (and a 1 in 4 chance they will be higher). The 75th percentile is the minimum level of sufficiency [*the Australian Prudential Regulation Authority (APRA)*] requires all general insurers to report on their Balance Sheet when reporting insurance liabilities...the 75th percentile of Scheme costs is estimated to be \$982 million (including payments to date). The excess of the 75th percentile over the central estimate (\$169 million in this case) is the value that is required to be reported by Australian general insurers as the ‘risk margin’ for APRA purposes.’ Source: *ibid.*, Part II, *Summary of Assumptions*.

4.8 The ANAO's audit opinion on the Treasury financial statements for 2000–01, 2001–02 and 2002–03 included an emphasis of matter highlighting the level of uncertainty associated with the estimating the Commonwealth's liability under the Scheme. One of the benefits identified by Treasury in closing the Scheme to new applicants, was that this would assist in crystallising the Commonwealth's liability and bring more certainty to future actuarial assessments. Applications closed on 27 February 2004. As at April 2004, a third actuarial review of the Commonwealth's liabilities under the Scheme was underway.

4.9 Treasury has not yet sought any additional appropriation for the Scheme, given the underlying uncertainty as to the final cost and the fact that spending to date has not yet approached the limit of the existing appropriation. ANAO notes that, in the event expenditure on claim payments and administrative expenses reaches the \$640 million appropriation limit, no further payments will be able to be legally made without a further appropriation, or an increase provided to the existing appropriation.

4.10 The estimate, on which the appropriation limit proposed by Treasury was based, did not include a provision for administrative costs associated with providing the financial assistance to policyholders. As well, Treasury did not prepare a separate estimate of those costs. This was despite the Appropriation Act stating that the \$640 million was appropriated partially for that purpose. The subsequent actuarial reviews have included a specific estimate of administrative costs (see Figure 4.1).

4.11 ANAO considers that, in identifying the amount to be appropriated under a limited special appropriation for multiple specified purposes, explicit provision should be made for the costs associated with each of those purposes. The basis of that estimate should be appropriately documented.

Proof of debt

4.12 The operation of the Scheme will result in the Commonwealth becoming one of the largest unsecured creditors of HIH. Accordingly, the process by which the Commonwealth will seek to prove a debt in the winding up of HIH is an important function in the financial management of the Scheme. The actuarial reviews undertaken to date have made no allowance for any amounts the Commonwealth may be able to recover through this process.¹⁰⁶ In

¹⁰⁶ Due to the level of uncertainty, the actuary has also made no allowance for recoveries that may be achieved through 'normal' insurance recoveries through salvage and subrogation, or HIH's reinsurance arrangements. The latter are the responsibility of the Liquidator to pursue. In April 2003, the actuary advised Treasury that: 'The ability of the Scheme to benefit directly from reinsurance protection on claims for which the Scheme makes payments is unclear, and is likely to remain so for some time...' Source: *ibid.*, Part I, *Executive Summary*.

July 2003, the Liquidator announced that it hoped to make a first interim dividend payment of no more than five cents in the dollar in second half of 2004.

4.13 As at March 2004, the Liquidator had not yet accepted any proofs of debt. In order to make the Commonwealth's ultimate proof of debt process more efficient, the first process being undertaken is to attempt to get an agreed reconciliation with the Liquidator of the claim payments made to date.¹⁰⁷

4.14 Treasury is not directly involved in the reconciliation process. Under the original Scheme structure, the proof of debt process was to be undertaken by HCSL, in its capacity as trustee of the Trust. Accordingly, applicants have been required to assign their rights under their HIH policy to HCSL.

4.15 A number of difficulties have been encountered in this process. This was due in large part to the considerable information system challenges faced by the Liquidator and the Claims Managers, which contributed to data integrity issues. There have also been ongoing discussions with the Liquidator regarding the process that should be followed to achieve proof of debt agreement in a cost-effective way.

4.16 At the time of audit, reconciliation had been completed for claim payments made up to 31 December 2003, with total payments of \$305.5 million having been reconciled with the Liquidator.¹⁰⁸ As at February 2004, correspondence had been sent to the Liquidator requesting acknowledgement of a debt of \$241.3 million, the amount of payments reconciled to the end of June 2003. A response was pending at the time of completion of this report. The HCSL internal auditor was also undertaking an audit of the reconciliation process and methodology used in completing the 30 June 2003 reconciliation.¹⁰⁹

4.17 Under the revised Scheme structure, due to commence operations in mid-2004, the proof of debt reconciliation function will be transferred to the new claims manager(s) to be contracted by Treasury. With the phasing out of HCSL from the Scheme, the rights assigned to it by policyholders will need to be transferred to the Commonwealth or its representative.

¹⁰⁷ The claim payment data provided by the Claims Managers is reconciled against the records in HCSL's accounting system. That data is then compared with the Liquidator's figure, which is based on the information recorded in the relevant insurance systems.

¹⁰⁸ A minor variance of \$18 717 had yet to be resolved. The total amount reconciled will be adjusted down to account for the tax credits available to HCSL/the Commonwealth. In addition, an adjustment will also be made to gross up 90 per cent payments to 100 per cent to reflect the rights assigned to the Commonwealth.

¹⁰⁹ In reporting on the 30 June 2003 reconciliation, WGB had also advised HCSL, in September 2003, that a number of possible improvements to procedures and reporting had been identified in respect of the reconciliation process and payment-recording processes utilised by the Claims Managers.

Public money

4.18 The FMA Act provides the central legal framework for Commonwealth financial management. That legislation, with its supporting FMA Regulations and Finance Minister's Orders (FMO), sets down the fundamental principles and essential rules to be followed for the proper use and management of public money in the Commonwealth public sector. As a Department of State, Treasury is governed by the FMA Act.

4.19 In particular, the FMA Act framework sets out agencies' obligations to manage public resources efficiently, effectively and ethically. It imposes obligations on officials in order to provide an appropriate degree of control of, and accountability for, the expenditure of public money.

4.20 To fall within the scope of the FMA Act, funds must satisfy the definition of public money set out in section 5 of the Act, as follows:

- (a) money in the custody or under the control of the Commonwealth; or
- (b) money in the custody or under the control of any person acting for or on behalf of the Commonwealth in respect of the custody or control of the money;

including such money that is held on trust for, or otherwise for the benefit of, a person other than the Commonwealth.

4.21 Figure 4.3 outlines the principal obligations imposed under the FMA Act for handling and expending public money.

Figure 4.3**Requirements for handling and expending public money**

Obligation	Reference
<p>Public money must be kept in an official bank account.</p> <ul style="list-style-type: none"> - The account must be opened pursuant to an agreement with a bank that meets core protocols. Public money received must be banked by the next banking day. 	<p>FMA Act ss. 8 - 11 FMO 3.1.2</p>
<p>A person must have been issued with a valid drawing right before withdrawing an amount from an official account or making a payment of public money.</p> <ul style="list-style-type: none"> - A valid drawing right is also required before requesting that an amount be debited against an appropriation or debiting an amount against an appropriation. 	<p>FMA Act ss.13, 26, 27 FMO 3.3</p>
<p>Persons responsible for handling public money must not misapply or improperly use it.</p>	<p>FMA Act s.14</p>
<p>The person who had nominal custody of public money is liable to the Commonwealth for its loss unless they can prove they took reasonable steps to prevent it.</p>	<p>FMA Act s.15</p>
<p>Proper accounts and records must be kept.</p>	<p>FMA Act ss.19, 48</p>
<p>Before approving a proposal to spend public money, the approver must be satisfied, after making reasonable inquiries, that the proposed expenditure is in accordance with Commonwealth policies, and will make efficient and effective use of the public money.</p> <p>A person must not enter into a contract, agreement or arrangement under which public money is, or may become, payable unless a proposal to spend public money has been approved in those terms.</p> <ul style="list-style-type: none"> - an official must not approve a proposal to spend public money unless authorised to do so. 	<p>FMA Regs. 9, 11, 13</p>
<p>Officials performing duties in relation to the procurement of property or services must have regard to the Commonwealth Procurement Guidelines.</p>	<p>FMA Reg 8</p>

Source: ANAO analysis of the FMA Act, FMA Regulations and FMOs and Commonwealth Procurement Guidelines.

Consideration of FMA Act implications under the Scheme structure

4.22 As noted, Commonwealth funding for the Scheme has flowed to the Claims Managers through the HIH Claims Support Trust, of which HCSL was trustee. In turn, the Claims Managers acted as HCSL's agent in making Scheme payments. A determining factor in deciding to operate the Scheme through a

trust was taxation effects.¹¹⁰ However, ANAO also notes that, in the context of contractual negotiations regarding the CMA and Trust Deed, Treasury's legal adviser advised HCSL's legal adviser on 29 May 2001 that:

...the Commonwealth does not wish an agency [*relationship*] to arise. This is important to ensure that the Commonwealth's funds do not fall within the scope of the Financial Management and Accountability Act.¹¹¹

4.23 The effect of an agency arrangement is that the agent is able to make a contract between the principal and a third party, which binds the principal. The agent acts on behalf of the principal. Documentation identifying the rationale for seeking to exclude the Scheme funds from the scope of the FMA Act was not identified by ANAO within Treasury records.

4.24 On 29 June 2001, Treasury sought formal legal advice as to whether money held in the Trust Fund would be public money for the purposes of the FMA Act. Written advice provided to Treasury on 23 July 2001 was that, although the contrary is arguable, the money held on trust by HCSL for the purposes of the Scheme did not satisfy the definition of public money set out in the FMA Act.

4.25 The legal advice concluded that the money held in the Trust did not meet part (a) of the definition because the money the Commonwealth settled on the Trust was not in the custody of the Commonwealth, and nor can it be said that the Commonwealth 'controls' money in the Trust. The legal advice considered that, as a matter of ordinary language and conventional legal usage, HCSL as trustee, controlled the money in accordance with the Trust Deed and related agreements.¹¹²

4.26 The legal advice further considered that, although an alternative view could be argued, the better view was that, before money can be public money

¹¹⁰ In May 2001, Treasury advised the Treasurer that the intention was that HCSL should be effectively exempt from income tax, and that the advantage of making HCSL trustee of a trust that is held for the sole benefit of the Commonwealth was that the funding entity should be effectively exempt from income tax.

¹¹¹ Legal advice provided to Treasury in October 2003 observed as follows, in relation to the existing structure: 'We assume the Scheme was deliberately structured this way to provide a significant degree of separation between the Commonwealth and the operation of the Scheme. It may be that one perceived advantage of this arrangement was that the funds in the HIH Trust would not be public money.'

¹¹² *Australian Accounting Standard 24—Consolidation* requires a reporting entity to prepare a consolidated report if it has the capacity to control another entity. In November 2001, the ICA received accounting advice that it should not consolidate HCSL's operations or the Trust into its accounts. This gave rise to an implication that control of HCSL and the Trust lay with Treasury. In February 2002, the Assurance Audit Services Group within ANAO asked that further consideration be given to the question of control within the definition of public money in respect to the funds held in the Trust. In April 2002, Treasury obtained further legal advice which, after considering the accounting advice, confirmed the view that the money held by HCSL on trust was not 'under the control' of the Commonwealth for the purposes of the definition of public money. Subsequently, Treasury also received accounting advice confirming that the accounts of both HCSL and the Trust should be consolidated into Treasury's annual financial report.

on the basis of part (b) of the definition, it must be held by an agent in the conventional legal sense. The legal advice considered that HCSL was not holding the money and making payments as the Commonwealth's agent in this sense and, accordingly, it would probably not be correct to treat the money as public money.

4.27 On the basis of this advice, the arrangements set out in Figure 4.3 were not required in respect to the handling and expenditure of Scheme funds by HCSL and the Claims Managers. Commonwealth oversight of the funds has been provided less directly through the reporting obligations imposed on those parties by the relevant agreements and the Trust Deed, including the provision of bank statements.

4.28 Treasury requested the legal advice as to whether the funds held by HCSL in the Trust would be public money seven days prior to the CMA and Trust Deed being executed on 6 July 2001. Written advice on the matter was not received until some two weeks after that execution.

4.29 Section 12 of the FMA Act stipulates that an official or Minister must not enter into an agreement or arrangement for the receipt or custody of public money by an outsider unless the Finance Minister has first given a written authorisation for the arrangement; or the arrangement is expressly authorised by the FMA Act or by another Act. In light of that obligation, it would have been preferable for Treasury to have fully considered the question of whether the money in the custody of HCSL would be public money prior to executing the relevant Scheme documents, in order to determine whether an approval in the terms set out in section 12 was required.

Application of FMA Act under revised Scheme structure

4.30 In October 2003, Treasury obtained legal advice regarding the options for engaging a new claims manager following the phasing out from the Scheme of HCSL and the existing Claims Managers. Treasury was advised that the available options were that the new claims manager could be:

- appointed as the Commonwealth's agent, and make Scheme payments for and on behalf of the Commonwealth;
- appointed as the successor trustee to HCSL of the Trust; or
- contracted by the Commonwealth to operate the Scheme in its own right, using funds provided by the Commonwealth, and be paid by the Commonwealth to do so.¹¹³

¹¹³ Under this option, once funds were provided to the contractor for the purposes of payment to policyholders, the funds would pass out of Commonwealth control. The money would be held by the contractor in its bank account, or invested, for its benefit.

4.31 Each of these options had implications for the degree of control the Commonwealth would have over the new claims manager and Scheme funds, as well as for the application of the FMA Act to handling and expending those funds. The only scenario in which it was likely that the Scheme funds would be public money in the hands of the new claims manager, and therefore subject to the requirements of the FMA Act framework, would be where it was appointed as the Commonwealth’s agent (see Figure 4.4).

Figure 4.4

Implications arising from options for appointment of new claims manager

Capacity	Scheme funds public money?	Degree of Treasury control over Scheme funds
Agent	Yes.	Greater control over Scheme funds than at present.
Trustee	No. ¹	Same as present arrangements.
Contractor	No. Funds would be held in the new claims manager’s own right.	Same potential for control over funds as at present—would depend on the terms of the contract.
Note 1: The legal advice noted that this conclusion would have to be reviewed if the Commonwealth was given any greater control in respect of the activities of the new claims manager as compared with the control it currently had in respect of HCSSL.		

Source: Legal advice provided to Treasury in October 2003.

4.32 Treasury’s legal advice was as follows:

The status of the Scheme funds as public money should give the Commonwealth greater control over those funds than at present. This is because the funds will be required to be kept in an official account, and access to that account will in law require a ‘drawing right’. In the event of suspected fraud the Commonwealth should be able to revoke relevant drawing rights and block access to the account.

4.33 Treasury obtained further legal advice, in November 2003, on the legal and financial management implications of having the new claims manager holding and dealing with money as agent of the Commonwealth.

4.34 Following consideration of the advice received, in January 2004 the Treasury Executive Board agreed to a recommendation that the new claims manager for the Scheme be engaged as an agent of the Commonwealth in providing payment and recovery services. Under a new tripartite agreement, the new claims manager will continue to act as the agent of the Liquidator in managing claims under applicants’ HIH policies.

4.35 The Executive Board also noted that, under this arrangement, Scheme funds would be regarded as public money in the hands of the new claims manager, who will be required to comply with obligations under the FMA Act. In undertaking financial tasks on behalf of the Commonwealth, the staff of the

new claims manager will be considered officials of Treasury for the purposes of the Act.

4.36 The Executive Board was advised that the key criteria used in making the recommendation on the preferred financial management model were:

- that Treasury complies with the requirements of the FMA Act, which specifies the fundamental principles underpinning public sector financial management;
- all costs are to be met from the budget approved by the Government for undertaking the restructure and ongoing management of the Scheme; and
- the model adopted should not prevent the Commonwealth from giving directions to the new claims manager on the appropriate use of public money.

4.37 While acknowledging that there is likely to be an additional cost associated with requiring a claims manager to operate under the agency arrangement, the Executive Board was advised that, against the key criteria, it was the most appropriate model for managing public money and providing flexibility in contract management.

Sub-contractors and service providers

4.38 An area in which the new arrangements will represent a significant change is in respect to the expenditure of Scheme funds by the new claims manager, particularly payments to sub-contractors and third party service providers.

4.39 On 21 May 2001, the Government agreed that the services provided by HCSL and the participating insurers would be on a non-profit basis.¹¹⁴ However, it was recognised in the initial planning stages for the Scheme that the availability of suitable personnel to assess and manage eligible claims would be a significant problem.

4.40 A meeting of various stakeholders, including Treasury's legal adviser, the ICA, the (then) provisional liquidators, and representatives of the Claims Managers held in late May 2001 considered this issue. Treasury's legal adviser advised Treasury as follows:

...The consensus at the meeting was that if HIH claims personnel are not involved, the insurance industry will not be able to marshal the claims handling resources which will be necessary to assess and manage eligible

¹¹⁴ The HCSL internal auditor has undertaken periodic reviews directed at confirming the basis of administrative expenses claimed by those companies.

claims. There will not be enough suitably qualified claims personnel, and (perhaps apart from [AAA]) other insurers will not have the IT and infrastructure to cope. Even if the personnel problem could be overcome by arranging secondments of suitably qualified insurance lawyers, this will be an extremely expensive (*sic*) option.

4.41 Treasury was further advised that QBE had established that there were approximately 10 000 professional indemnity and public liability claims and that it did not have the resources to handle those claims. To fulfil its obligations under its original Claims Management Agreement, QBE seconded staff from a legal firm on a commercial basis. It has also engaged sub-contractors to provide claims management services for specialist classes of claims it took responsibility for under subsequent variations to the Agreement.¹¹⁵

4.42 Also, an integral part of the claims management process for many claims is the need to engage third party service providers. This is particularly the case in relation to liability claims, for which QBE and AAA are responsible.¹¹⁶

4.43 The relevant Claims Managers have directly engaged all sub-contractors and service providers on a commercial basis. Based on information provided to ANAO by the Claims Managers, of the \$18.87 million in administrative expenses paid to Claims Managers to October 2003, at least 64 per cent (\$12 million) related to commercial fees paid to sub-contractors and service providers.¹¹⁷

4.44 Equally, HCSL was formed as a very small organisation that would be likely to require external assistance in order to undertake the range of obligations it had under the CMA. HCSL contracted with WGB, on a commercial basis, to provide the resources to perform the eligibility

¹¹⁵ Under the two Deeds of Variation negotiated with QBE to expand the classes of claims managed under its Claims Management Agreement, QBE was authorised to, at its sole discretion, delegate or sub-contract its obligations with respect to the services for the additional categories of claims to named sub-contractors.

¹¹⁶ The Claims Management Agreements contemplate the engagement by the Claims Managers of third party service providers (including accountants, auditors, solicitors, barristers, actuaries, experts, loss assessors, investigators, loss adjusters or any other advisers or consultants) where the Manager reasonably considers it necessary or desirable for the purposes of discharging its duties under the Agreement.

¹¹⁷ This represented 82 per cent of AAA's expenses, and 56 per cent of QBE's expenses (this excludes the costs associated with staff QBE has seconded from a legal firm to undertake claims management functions). High-level review undertaken by Treasury of the administrative expenses being incurred by the three principal Claims Managers identified significant variation in the rate at which expenses were incurred in the management of claims. As at April 2003, expenses paid to the three Claims Managers represented, respectively, 4 per cent, 5.5 per cent and 10.9 per cent of claim payments made. Expenses incurred per \$1000 of claim payments were \$45 to \$50, \$45 to \$55 and \$80 to \$90 respectively.

assessment, call centre and proof of debt services. As at October 2003, \$5.4 million in fees and expenses had been paid to the sub-contractor.

4.45 Had the Scheme been designed to be within the scope of the FMA Act, regard would have to have been given in the engagement of those sub-contractors and service providers to the requirements of the competitive tendering and contracting policies of the Commonwealth.

4.46 Expenditure by the new claims manager on sub-contractors or service providers will be subject to the FMA Act, including the requirement that officials approving expenditure proposals must satisfy themselves that the proposed expenditure will make efficient and effective use of the public money.

4.47 ANAO considers that, wherever possible, it is desirable for agencies to seek to maximise the extent to which financial arrangements for which they are responsible fall within the scope of the FMA Act and are, therefore, subject to the relevant requirements for the handling and expenditure of public money.

4.48 In March 2004, Treasury advised ANAO as follows:

The model chosen for service delivery [*under the original Scheme structure*] was determined by Treasury as being the most appropriate, given the circumstances. HCSL and claims managers had volunteered to provide services on a cost-recovery basis and a series of contracts needed to be negotiated immediately. Treasury's advice is that there was no other outsourced service delivery model operating in the Commonwealth at the time that had been framed under the FMA Act. The framework that has been used for the Scheme has proven to be robust and there is no suggestion that the model chosen is deficient.

The recent decision by Treasury to move towards an arrangement under the FMA Act is based on a fundamentally different service delivery model, which includes a competitively tendered commercial relationship between Treasury and a service provider. Implementing such an arrangement will take approximately ten months, which is in the context of a program that is already well established.

Recommendation No.6

4.49 ANAO *recommends* that agencies:

- (a) take steps to maximise, wherever possible, the coverage by the FMA Act of taxpayers' funds for which they are responsible; and
- (b) where that is considered either not possible or undesirable, fully document the rationale for that position.

Treasury response

4.50 Treasury agrees with this recommendation. An assessment of the options for future Scheme service delivery has been fully documented, and the decision was taken to maximise the coverage of the FMA Act.

Recovery of payments to ineligible applicants

4.51 Processes such as the HCSL internal audit program and the small business review have identified instances in which payments were made in respect of applicants who were incorrectly assessed as being eligible for assistance. The quantum of such payments identified to date is small in terms of the total payments made under the Scheme¹¹⁸, but does include some substantial amounts in terms of individual payments.¹¹⁹ It is also probable that other payments have been made to ineligible applicants, given the self-assessment approach adopted. Some of these may be identified in future internal audits.

4.52 In other areas of Commonwealth administration where applicant self-assessment is used as the basis for payment in the first instance (such as the tax assessment process administered by the ATO and the social security benefits system), there is legislative provision for effective post-payment audit and recovery processes. This is supported by legislation and systems enabling the use of data matching to facilitate cost-effective identification of claims warranting review. These provisions and systems do not apply to a scheme such as the HIH Claims Support Scheme.

4.53 The drafting instructions in respect to the Appropriation Act for the Scheme provided to the Office of Parliamentary Counsel by Treasury in May 2001 advised that: 'Under these arrangements the Commonwealth would rely on general law remedies for the recovery of monies improperly spent.' The question as to how payments found to have been made to ineligible applicants could be recovered, or an applicant's eligibility withdrawn, was not addressed in the original Scheme documents.

4.54 Procedures to be followed in relation to various scenarios in which ineligible applicants previously granted eligibility could be withdrawn from the Scheme were agreed between Treasury and HCSL in July 2002. This

¹¹⁸ The payments of which ANAO is aware represent less than 0.5 per cent of total payments made to January 2004. However, issues relating to possible payments to ineligible claimants have been identified through a number of different processes. The way in which records relating to such issues have been retained and organised do not support the generation of a consolidated listing of all payments that may have been made to ineligible claimants. Accordingly, ANAO is unable to provide assurance as to the completeness of this amount.

¹¹⁹ For example, payments of \$497 500, \$232 480 and \$171 433 have been made in respect of the settlement or management of three ineligible applicants.

included scenarios in which eligibility was withdrawn by HCSL, and others where the applicant withdrew their application. There was also consideration of the steps that should be taken where payments had been made and/or were owed to the relevant Claims Manager's service providers for costs incurred in managing the claim.

4.55 Legal advice obtained by Treasury in May 2002 was that, in a number of scenarios, there would be grounds on which to seek recovery of payments made to applicants later found to be ineligible. However, Treasury has also been advised that, in some scenarios, the Commonwealth's options for recovering or withholding both claim payments and service provider fees¹²⁰ may be limited by the operation of contract law and/or the principle of estoppel.¹²¹ Estoppel would arise if the applicant had changed their behaviour or acted to their detriment in a material way as a result of being granted eligibility. The likelihood and extent of any estoppel payments would depend on the particular circumstances of each case.

4.56 Where no payments have been made, legal advice to Treasury was that, where HCSL has or will withdraw an applicant's eligibility, the applicant's offer to assign should be formally rejected before any fees owing to service providers are paid. This prevents the contract with the applicant from being crystallised. However, it also has the additional effect that HCSL will not have any assignment of rights to support a proof of debt for any amounts subsequently paid out.

4.57 Treasury has sought legal advice regarding the potential to pursue the recovery of a number of payments made to ineligible applicants, totalling at least \$1 022 153. As at March 2004, Treasury had decided that, based on legal advice received, it would not be pursuing recovery of two of those payments, totalling \$668 933. A decision in respect of the remaining amounts had not been made at the time of audit. Payments made in respect of claims by policyholders that do not satisfy the eligibility criteria stipulated by the Government can still be included in the proof of debt lodged with the Liquidator. However, the dividend received is likely to be significantly smaller than the amount paid.

¹²⁰ Including fees that may have been incurred by the Claims Manager before the eligibility of the applicant was questioned.

¹²¹ Estoppel is an equitable and common law doctrine. In broad terms, a party who induces another party to make an assumption about an existing state of affairs or makes a representation about future conduct is estopped (that is, precluded) from asserting the existence of a different state of affairs, or departing from that representation if: (a) the other party has acted in reliance on the assumption or representation; and (b) the other party would suffer detriment if departure from the assumption or representation were to be allowed.

Voluntary payments

4.58 Further legal advice obtained by Treasury in June 2002 was that, in circumstances where no information was withheld by the applicant and HCSL ought to have known that the applicant was ineligible from information provided, any payments made would be classified as voluntary and would not be recoverable by the Commonwealth.

4.59 In July 2002, Treasury advised the Minister that this situation applied in respect to the payments made to owners' corporations incorrectly assessed as eligible small businesses, and in one other case of payment to an ineligible applicant that the Department was aware of at that time.

4.60 On this basis, in August 2002, the Minister sought the Prime Minister's approval to make discretionary payment of Scheme claims in circumstances where applicants who had been incorrectly granted eligibility sought payment, and legal advice was that the claimant would have strong grounds for payment being enforced by a court. The Prime Minister approved that request in October 2002.

Appropriation coverage of incorrect payments

4.61 Section 83 of the Constitution provides that no money shall be drawn from the Treasury of the Commonwealth except under appropriation made by law. In approving the Scheme, the Government determined that assistance would only be provided to those applicants who satisfied identified eligibility criteria. However, the Appropriation Act for the Scheme appropriated money in broader terms.

4.62 The Act states that money is appropriated, inter alia, for the purpose of providing financial assistance to HIIH eligible persons, either directly or indirectly. An 'HIIH eligible person' is defined as a person who:

- is a policyholder, insured or beneficiary under a policy of insurance issued by a HIIH company; and
- has suffered financial loss as a result of the insolvency of the HIIH companies.

4.63 A person or entity may meet this definition, but not qualify for assistance under the eligibility criteria set down for the Scheme. However, because the Appropriation Act makes no reference to the eligibility criteria, payments made to ineligible policyholders are captured by the appropriation.

Indemnities and guarantees

4.64 An important aspect of the Scheme structure was the provision by the Commonwealth of extensive indemnities¹²² and performance guarantees¹²³ to HCSL, its officers and directors, the Claims Managers and the Liquidator in respect of liabilities that may arise in connection with their participation in the Scheme.¹²⁴ The indemnities are very broad in their terms, but do not apply where the recipient has acted ‘dishonestly’, defined to mean actual fraud, dishonesty, bad faith, or wilful breach of a material term of the relevant contract.

4.65 Finance has issued guidelines to Australian Government entities regarding their responsibilities when considering entering into arrangements involving indemnities and guarantees on behalf of the Commonwealth. The guidelines that were current at the time the Scheme was implemented were the *Guidelines for Issuing Indemnities, Guarantees and Letters of Comfort* (Guidelines), issued by the Department of Finance Administration (Finance) under Finance Circular 1997/06.¹²⁵ The Guidelines specified that agencies should ensure that these instruments:

- contain a financial limit, where possible¹²⁶;
- specify events or periods covered by the indemnity, and/or include termination clauses. Alternatively, an indemnity should be reviewed periodically¹²⁷;
- specify conditions regarding the requirement to notify the Commonwealth of any impending disputes or claims (including those from third parties); and

¹²² An indemnity is a legally binding promise whereby one party undertakes to accept the risk of loss or damage another may suffer. Source: Finance Circular 1997/06, *Guidelines for Issuing Indemnities, Guarantees and Letters of Comfort*, p. 2.

¹²³ A guarantee is a legally binding promise whereby one party undertakes to another party to be responsible for the debt or obligations of a third party, should that party default in some way. Source: *ibid.*

¹²⁴ The parent companies of two of the Claims Managers were also required to provide the Commonwealth with a performance guarantee in respect to the relevant Claims Manager’s obligations under their Claims Management Agreement.

¹²⁵ These were replaced in September 2003 by revised guidelines issued under Finance Circular No. 2003/02.

¹²⁶ That requirement became mandatory under the 2003 guidelines.

¹²⁷ Each indemnity provided under the Scheme was expressed to be unlimited in time. The Commonwealth’s capacity to terminate the indemnities provided to HCSL and its officers and directors was reliant on also giving notice to terminate the CMA itself. The Claims Management Agreements provided for the terms under which HCSL may terminate the Agreement itself, but did not specifically provide for the indemnity to be terminated independently of the Agreement.

- in the case of indemnities, contain subrogation clauses to protect the Commonwealth's interests.¹²⁸

4.66 The first indemnities and guarantees issued under the Scheme were those relating to HCSL, its officers and directors and AAA, which were executed on 6 July 2001. Legal advice provided to Treasury on the same day was that each of those indemnities substantially complied with the relevant content requirements set out in the Guidelines. Treasury has obtained similar legal advice in respect to indemnities subsequently granted to other participants in the Scheme.

Directors' indemnities

4.67 The HCSL Managing Director advised Treasury in June 2001 that indemnity of directors (and of the participating insurance companies) was likely to be a major issue, and that it was unlikely any directors would continue to act in the absence of full protection. Treasury documentation records verbal advice from the MFSR in June 2001 to the effect that the then Minister for Finance and Administration had agreed to the provision of a Commonwealth indemnity to the directors of HCSL, and that Treasury should proceed with the agreements with HCSL on that basis.

4.68 Treasury subsequently sought comments from Finance on the proposed indemnity for HCSL directors. Finance raised a number of concerns, including that the proposed indemnity did not exclude from coverage any breach of directors' duties under the Corporations Act.¹²⁹

4.69 Treasury's legal adviser did not accept that the indemnities should be amended in those respects due to representations that had been made to the prospective directors by the MFSR concerning the strength of the indemnity to be provided. Further advice provided to Treasury by the legal adviser on 6 July 2001 regarding the indemnities' compliance with the Guidelines was as follows:

Whilst we do not consider [*the exclusion of liabilities arising from negligence*] to be a requirement of [*the Guidelines*], we add for completeness that both HCSL and its officers would not agree to the exclusion of negligent conduct from the scope of the indemnities. We do not consider the stance taken by HCSL or its officers to be unreasonable, having regard to the role and functions to be undertaken by HCSL in respect of the Scheme. The fact, however, that negligent conduct falls within the scope of the Commonwealth indemnities does not in any way derogate from, or absolve HCSL's officers from, carrying

¹²⁸ Finance Circular 1997/06, op. cit., p. 8.

¹²⁹ These included failure to exercise a reasonable degree of care and diligence in the performance of duties as an officer; failure to exercise powers for the purposes for which these have been conferred; making improper use of information or position and failure to avoid conflicts of interest.

out their functions and duties in accordance with their Corporations Law and general law duties as officers of HCSL.

4.70 ANAO notes that the directors would be indemnified for any financial implications that may arise as a result of any failure by them to carry out their functions and duties in accordance with their Corporations Act and general law duties as officers of HCSL. ANAO further notes that the Chairman and three non-executive directors of HCSL have received payment of directors' fees, which are funded by the Commonwealth.¹³⁰

4.71 ANAO considers that, in such circumstances, it would be good practice for agencies to document explicit consideration by the relevant decision-maker of the terms of a proposed indemnity, including the payment and quantum of directors' fees, in determining that the contractual arrangements satisfy the requirements of FMA Regulation 9 (that is, are in accordance with Commonwealth policies and make efficient and effective use of public money).

QBE indemnity

4.72 A pro forma Claims Management Agreement is an appendix to the CMA. It provides for HCSL to grant an indemnity to the Claims Manager in respect of all costs and losses that may arise as a result of their performance of the payment and recovery services undertaken on HCSL's behalf. The only exclusion to the indemnity is any loss arising due to the Claims Manager's dishonesty, as defined in the Agreements. Although the Commonwealth is not a party to the Claims Management Agreements, the Commonwealth ultimately backs the Claims Managers' indemnities by virtue of the indemnity provided to HCSL. The indemnities executed with AAA, R&SA and NRMA accorded with the pro forma.

4.73 The QBE Agreement, executed in September 2001 after protracted negotiations, departed from the terms of the pro forma Agreement in several respects. In particular, the indemnity provided is significantly wider in its terms. It includes an indemnity in relation to the performance of the claims management services QBE is engaged by the Liquidator to perform.

4.74 In August 2001, Treasury advised the Office of MFSR that it believed that the Commonwealth should strongly resist indemnifying QBE for the claims management services. After discussions with the QBE Chief Executive Officer, MFSR's Office advised Treasury that, in order to get the negotiation of the Claims Management Agreement resolved, it had been agreed that QBE

¹³⁰ Fees paid are \$50 000 per annum for the Chairman, \$33 000 per annum for the Chair of the Board Audit Committee, and \$28 000 per annum for each of two other directors. The HCSL Managing Director and the ICA representative on the Board, on his own election, do not receive directors' fees.

would be indemnified by the Commonwealth for the claims management services.

4.75 Treasury then sought legal advice as to whether the proposed indemnity accorded with the Guidelines. The advice provided noted the following:

As I'm sure you appreciate this is highly unusual, even more so than what was agreed with [AAA]...The indemnity to [AAA] did not contain all these elements [*set down in the Guidelines*] (e.g. financial limit, termination clause, subrogation clause). However, because the [*Commonwealth*] is going wider with respect to QBE, you might want to consider including them.

4.76 Treasury considered that, given the negotiations that had taken place, it did not think that it was able to open up the issue of placing any limits on the extended indemnity to be provided to QBE by HCSL. It was noted that a formal sign off from the then Minister would be required. The brief to the MFSR seeking approval of the QBE Agreement did explicitly identify the additional coverage of the indemnity. The MFSR provided the HCSL Board with a letter of comfort authorising it to enter into the QBE Claims Management Agreement in the terms negotiated.

Insurance

4.77 The Guidelines require that, as part of the risk benefit analysis to be carried out before an indemnity is issued, agencies should consider whether there is an alternative means of achieving the same benefits (for example, by having the other party take out appropriate insurance).

4.78 The CMA provides that HCSL shall make all reasonable efforts (in consultation with the Commonwealth) to obtain and maintain from time to time any insurance that HCSL considers appropriate to obtain, again in consultation with the Commonwealth. HCSL was not obliged to obtain insurance. The Claims Managers were required to make all reasonable efforts (in consultation with HCSL) to obtain appropriate insurances. The indemnities provided would apply excess of the benefit of any insurance policy procured.

4.79 There was an extensive delay in HCSL obtaining relevant insurance cover. In August 2001, the HCSL Board accepted, in principle, a quote from one insurer. However, the nature of HCSL's exposure changed with the additional protections and indemnities subsequently given to QBE. As a result, the insurer asked to see the QBE insurance cover, and that of the other Claims Managers, before providing any further quotes for HCSL insurances. The Claims Managers have not been able to obtain insurance cover in respect of their involvement in the Scheme.

4.80 In late 2002, HCSL obtained a quote for insurance in respect of its involvement in the Scheme through the ICA's insurance brokers. The cover is

limited¹³¹ and is not retrospective. The HCSL Board reviewed the quote and recommended that it be accepted, notwithstanding its limitations, given the potential for residual actions against HCSL and its officers. In December 2002, Treasury advised HCSL that, given the Board's recommendation, it would have no objection. The cost of that insurance, which is funded by the Commonwealth, is \$180 000 per annum.

Risk assessment

4.81 The Treasury Chief Executive's Instructions (CEIs)¹³² state that the general philosophy underpinning indemnities is that the liability should rest with the party best able to minimise the potential loss.¹³³ In this case, Treasury's distance from the day-to-day administration of the Scheme would suggest that, in many respects, other participants were in the best position to minimise any potential losses.

4.82 However, the provision of the guarantees and indemnities by the Commonwealth was an essential element in obtaining the participation of the private sector parties. This is a reflection of the non-profit basis on which HCSL and the Claims Managers had agreed to participate, although the commercial nature of sub-contract arrangements meant a degree of profit was inherent in the Scheme.

4.83 None of the indemnities provided by the Commonwealth in respect of the Scheme contains a financial limit. In this respect, the legal advice provided to Treasury on 6 July 2001 was as follows:

[The Guidelines] only requires, however, that the relevant indemnity contain a financial limit "where possible". In the circumstances of the Scheme it was neither possible (i.e. neither HCSL nor the directors of HCSL would agree to undertake their role without full indemnification, which includes no financial limit on the amount of the indemnity), nor, in our opinion, reasonable in the circumstances for the Commonwealth to impose such a financial limit. In terms of the latter, we note that HCSL is undertaking its role of managing and implementing the Scheme on a "not-for-profit" basis and is the product of a co-operative arrangement between the Commonwealth and the insurance industry to assist qualifying individuals and small businesses affected as a result of the HIH Companies being placed in provisional liquidation.

¹³¹ In particular, the professional indemnity cover excludes claims directly or indirectly related to the handling or management of claims by the Claims Managers. The HCSL Board noted that this is where the bulk of the risk of any claim against HCSL would lie.

¹³² FMA Regulation 6, issued under s. 52(1) of the FMA Act, provides that the Chief Executive of an agency is authorised to give instructions (to be called 'Chief Executive's Instructions' (CEIs)) to officials in that agency on any matter necessary or convenient for carrying out or giving effect to the FMA Act or Regulations, including for ensuring or promoting the proper use and management of public money. Departmental officials are required to comply with both the FMA Regulations and the CEIs.

¹³³ Treasury CEIs, p. 9–15.

Against this background, we consider it appropriate that the Commonwealth indemnities to be provided to HCSL and its officers not be subject to any financial limit. The imposition of a financial limit in respect of these indemnities would expose those parties to an unreasonable risk in the event that the quantum of a relevant liability exceeded any financial limitation imposed by the Commonwealth.

4.84 ANAO notes that, even where it was not considered possible to include a financial limit in an indemnity, the Guidelines and the Treasury CEIs also identified a clear requirement to investigate, as part of a comprehensive, documented risk assessment, the potential financial implications of an indemnity before it is provided.¹³⁴ There was no evidence of a documented risk assessment process, including consideration of the potential financial implications, having been conducted prior to the issuing of the initial indemnities under the Scheme in July 2001. At a minimum, the advice to the MFSR proposing that the agreements involving HCSL and AAA be executed should have explicitly recognised that the potential financial implications arising from the indemnities were unknown. This was not the case.¹³⁵

4.85 Treasury applied significantly more focus to assessing the compliance of indemnities subsequently issued or extended under the Scheme against the Guidelines. However, ANAO identified only one instance in which the advice provided to the Minister addressed the question of quantifying the potential financial implications.¹³⁶

4.86 In March 2003, Treasury recognised the need to undertake a risk assessment prior to granting the indemnity requested by the incoming HCSL Managing Director. In undertaking that process, the following was recognised:

The program was put together very quickly, and certain Commonwealth requirements regarding indemnities were not fulfilled due to timeframe issues. We now have the time to undertake the proper processes, and this includes assessing risks and addressing them.

¹³⁴ See, for example, pp. 2, 4 and 11 (footnote 4) of the Guidelines, and pp. 9 to 16 of the Treasury CEIs.

¹³⁵ The MFSR was asked to agree that, for the purposes of FMA Regulation 9, the entering into of the CMA, Trust Deed, HCSL officers' indemnity and AAA Claims Management Agreement (including indemnity) involved an expenditure of public monies which was in accordance with the Commonwealth's policies and would make an efficient and effective use of those monies. Such assessments should involve explicit consideration of the implications for the value for money of the arrangements arising from the granting of the indemnities and their potential financial implications.

¹³⁶ That instance related to the Minister's approval of the January 2002 Deed of Variation to the Claims Management Agreement with QBE to enable that company to handle previously unallocated classes of claims. In that case, the Minister directed Treasury to seek specific confirmation from its legal adviser that: the implicit increase in the exposure of the Commonwealth under the Deed of Variation was not quantifiable; and that, given the proposed arrangements with the sub-contractor, the Deed of Variation was consistent with the Guidelines.

4.87 In February 2004, Treasury advised ANAO that it is expected that there will be no indemnities provided by the Commonwealth under the revised Scheme arrangements. The new claims manager will be engaged on a commercial basis, and will be expected to obtain its own insurance. Treasury advised ANAO that the Liquidator had accepted that the Commonwealth would not provide it with an indemnity under the new tripartite agreement. This will represent a significant reduction in the risks being carried by the Commonwealth in respect of the future management of claims under the Scheme.

4.88 At the time of audit, there had yet to be any call made on the indemnities already provided under the Scheme. However, the original participants will continue to be indemnified in respect of their actions under the Scheme up to the time their involvement was terminated.

Administrative expenses

4.89 HCSL and the Claims Managers agreed to participate on a cost-recovery basis. HCSL is reimbursed for its administrative costs, including the fees charged by its sub-contractors. The costs incurred by the Claims Managers include both their own administrative costs, and service provider and other costs associated directly with managing and settling insurance claims. The latter are likely to be accepted by the Liquidator in the proof of debt. The ICA is reimbursed for the administrative costs it incurs through the secondment of its staff to HCSL and the use of its facilities.

4.90 As at April 2004, \$35.9 million had been paid out for administrative expenses incurred by HCSL and the Claims Managers. Post-payment procedures conducted by the HCSL internal auditor are the principal control on the administrative expense claims submitted. Successive internal audits, the most recent at the time of audit having been completed in June 2003, found instances where expenses were inaccurately calculated and/or were not supported by sufficient documentation.

4.91 In both March and June 2002, the HCSL internal auditor reported that there was an over-reliance on detective controls in the processing of administrative expense claims.¹³⁷ In June 2002, the internal auditor noted that HCSL management had agreed to examine the most cost effective mechanism

¹³⁷ In this respect, the internal auditor reported in March 2002 that: 'to facilitate the timely payment of claims, HCSL do not require service providers to submit invoices and documentation supporting claims. As a result, HCSL rely on audit to review the validity and accuracy of claims. This results in over-reliance on the audit process, which will detect irregularities after funding has been reimbursed to service providers. HCSL should implement preventative controls to reduce the likelihood of reimbursement of invalid and/or inaccurate claims...'

to implement preventative controls and perform validation testing of administrative expense invoices by 31 July 2002.

4.92 The August 2002 report of the Treasury performance auditor also noted this reliance on internal audit.¹³⁸ Among the measures recommended to address this issue was that Treasury have HCSL employ administrative staff to ensure all payments are appropriately validated with detailed supporting documentation prior to funds being released. Treasury commented that it would discuss the proposal with both the performance and internal auditors to assess the risk and cost associated with the existing controls compared to those associated with adopting the recommendation.

4.93 In March 2003, Treasury proposed that, in light of the audit findings relating to incorrect invoicing by Claims Managers, and the nature of management expenses, the CMA be revised to improve the Department's capacity to oversight any significant divergence between budgeted administrative expenses and funding requests received. Under the revised Scheme arrangements, Treasury will have direct control of the scrutiny of invoices received from the new claims manager.

Canberra ACT
10 June 2004



P. J. Barrett
Auditor-General

¹³⁸ The report found that: '...this process is not only expensive relative to the Scheme but fundamentally it does not ensure that funds are being expended appropriately at the time incurred.' Source: *The HIH Support Scheme Performance Audit*, op. cit., p. 14.

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