

APRA's supervisory activities in
2006/07

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Authorised deposit-taking institutions (ADIs)

Authorised deposit-taking institutions ended 2006/07 in very sound financial condition, after another year of strong balance sheet expansion underpinned by broadly based growth in the domestic economy. Business credit grew at its fastest pace since the late 1980s and housing lending growth, which had been slowing earlier, picked up in the second half of the year. Asset quality remains high by both historical and international standards, although arrears rates on housing lending have continued to rise slowly and signs of stress in a small proportion of borrowers have emerged. Notwithstanding continued intense competition in both lending and retail deposit markets, the profitability of many ADIs was at record levels. Those same competitive pressures, and a wish to spread costs and risks, encouraged further consolidation among smaller ADIs; two regional banks have also announced plans to merge.

In the first months of 2007/08, greater volatility in global credit and equity markets, triggered by a marked deterioration in credit quality in the US sub-prime mortgage market, has limited the access of some ADIs to wholesale funds, particularly from offshore sources, and pushed up funding costs. ADIs have only minimal direct exposures to the US sub-prime mortgage market but the larger ADIs, over recent years, have relied increasingly on offshore wholesale funding. That said, with strong and diversified balance sheets and prudent management of key risks, the ADI sector is well-positioned to withstand the impact of these global developments, were they to continue.

Credit standards

Credit standards in housing lending have been a major focus of APRA's on-site supervision of ADIs for some time. A particular area of interest has been how ADIs assess the ability of their customers to service their housing loans ('debt serviceability'). During 2005/06,

APRA undertook a survey of debt-serviceability criteria used by ADIs, which confirmed that ADIs have materially increased the maximum amount they are prepared to lend to any given borrower. The survey was followed up during 2006/07 by a collection of detailed data on all housing loans approved by a large sample of ADIs during the month of September 2006.

APRA's comprehensive review of debt serviceability has not changed the general assessment that housing lending is a sound asset class for ADIs. Nonetheless, analysis of the detailed data has confirmed that the risk profile of housing loan portfolios has increased somewhat, whether measured in terms of higher loan-to-valuation ratios or debt servicing burdens on borrowers. The use of 'net income surplus' models in place of more traditional lending criteria has led to higher lending against given levels of borrower income. However, the key assumption of these models – that all net income above basic living expenses and other fixed commitments is potentially available to service the housing loan – has not been tested in adverse economic conditions. For this reason, boards and management of ADIs need to ensure that they understand the construction of the debt-serviceability models they are using, the quality of the data inputs, the sensitivity to parameters selected and the performance of the models over time. APRA's review has provided peer group data that enable it to direct its supervisory attention to those ADIs that appear to have the more aggressive lending practices.

Private equity

During 2006/07, a significant increase in activity by private equity funds in Australia, mirroring overseas developments, focussed public attention on a number of aspects of private equity. These included risks to participating financial institutions, the implications for investors and the broader economy, the efficiency of public capital markets and the potential for conflicts of interest. The Council of Financial Regulators (see Chapter

5 of this Report) undertook a review of various aspects of private equity in Australia and published its report in the Reserve Bank of Australia's *Financial Stability Review* in March 2007.

As part of this review, APRA surveyed banks operating in Australia about their exposure to the private equity market. APRA found that these exposures were generally spread across the largest Australian and foreign banks and were subject to appropriate credit controls. In aggregate, private equity exposures amounted to less than three per cent of total loans in the Australian banking system and the exposures were mainly restricted to senior debt with a sound credit rating. The Australian banks most active in private equity funding tend to have a fairly well diversified portfolio of exposures while the smaller institutions have exposures to only a handful of transactions, or none at all. The most active foreign banks operating in Australia tend to underwrite larger amounts than the Australian banks, owing to their larger global distribution networks and balance sheets.

APRA's approach to banks' activity in this area has focussed on ensuring that sound credit risk management processes are in place and that appropriate capital is held against potential losses. Currently, the banks that are most active in private equity have well-developed approaches to credit risk management. APRA would be concerned if smaller, less sophisticated ADIs were venturing into private equity without adequate lending policies and credit risk monitoring processes.

Liquidity risk management

For an ADI, liquidity management – the ability to meet financial obligations as they fall due – is critical both to its continued operation and to the maintenance of stability in the financial system. Since the introduction of APRA's prudential framework in this area almost a decade ago, management of liquidity risk by ADIs has undergone considerable change, the main one being the recourse

to a broader range of funding sources, such as offshore credit markets and securitisation, to offset the erosion of traditional retail deposit bases. Wholesale funding is now well embedded in funding strategies of the larger ADIs. Under normal conditions, an ADI is able to operate with large mismatches in the maturity of its assets and liabilities but, as recent global credit market volatility has illustrated, liquidity can easily come under pressure if normal counterparties become defensive. For this reason, liquidity risk management practices of ADIs need to be at the forefront of best practice.

While the new Basel II Framework has focussed attention on credit risk and operational risk measurement and management, liquidity risk has not been subject to the same level of rigorous, systematic analysis. Against this background, APRA decided to undertake a review of its approach to liquidity risk management during 2006/07. This review has included an assessment of the current liquidity risk management practices of ADIs as well as a benchmarking study of liquidity monitoring and supervision techniques of other prudential regulators. The review aims to ensure that APRA's prudential requirements provide a sound and relevant basis for the assessment of liquidity risk management and one that is consistent with good practice globally. The assessment of current management practices has confirmed that a number of ADIs have developed robust stress-testing frameworks that go beyond APRA's specific requirements for managing liquidity.

In May 2007, APRA held a conference on liquidity risk management for industry participants and other regulators to discuss current practices and ongoing developments in liquidity risk management. APRA plans to publish a discussion paper on this topic for industry consultation later in 2007.

During the global credit market turbulence in the first months of 2007/08, APRA substantially stepped up its monitoring of ADIs' liquidity positions. This has involved daily contact with large ADIs and the Reserve Bank of Australia, regular reporting of liquidity positions and funding profiles, and liaison with other market participants and offshore regulators.

Trans-Tasman Council on Banking Supervision

In late 2006, a major milestone in the work of the Trans-Tasman Council of Banking Supervision was reached with the passage of legislation in Australia and New Zealand that will facilitate greater harmonisation and co-operation between the banking supervisors in both countries.

The Council was established in February 2005 with the aim of enhancing co-operation and information-sharing between respective supervisors of trans-Tasman banks; promoting and regularly reviewing trans-Tasman crisis response preparedness relating to events that involve banks common to both countries; and guiding the development of policy advice to both governments. The Council is chaired jointly by the Secretaries to the Treasuries of Australia and New Zealand and also comprises senior officials from APRA, the Reserve Bank of Australia and the Reserve Bank of New Zealand (RBNZ).

The legislation requires APRA and the RBNZ to support each other in the performance of their regulatory responsibilities and to consider the impact of their actions on financial system stability in the other country. The legislative changes comprise:

- general provisions that require each regulator to support the other in fulfilling the other's statutory objectives and, wherever reasonably possible, to avoid actions that could have a detrimental effect on financial system stability in the other country;
- a definition of 'detrimental actions' that specifically includes actions that interfere with or prevent the provision of outsourced services to a related party in the other country;

- a requirement that, where reasonably practical, the regulators consult each other before exercising a power that is likely to be detrimental to financial stability in the other's country; and
- a requirement that an administrator or statutory manager appointed to a bank advise the regulator if it has reasonable cause to believe that its proposed exercise of a function or power is likely to have a detrimental effect on financial stability in the other country.

The legislative changes will enable APRA and the RBNZ to afford banks additional flexibility in how they structure their businesses within the trans-Tasman markets, and this is expected to bring compliance cost reduction and efficiency benefits. In the context of these changes, the *Banking Act 1959* was amended to expand APRA's statutory responsibilities beyond the protection of depositors to include the promotion of financial stability in Australia.

The future work program of the Council will include looking at improved co-operation on crisis management, promoting seamless service provision for customers and sharing experiences on improving the quality of insurance regulation.

More generally, APRA continues to build a close and constructive working relationship with the RBNZ. This includes regular information exchange, frequent meetings between supervisory staff, staff secondments, shared training, joint visits to Australian-owned banks in New Zealand and a co-ordinated approach to the cross-border implementation of the Basel II Framework under the Terms of Engagement signed in March 2005.

General insurance

The general insurance industry had another year of sound underwriting results in 2006/07, continuing the recent track record of solid profits and strong capital levels. The industry is currently very well capitalised with aggregate

capital more than twice APRA's minimum requirement. Claims experience generally remained favourable, although some insurers had significant exposure to storm and water damage in New South Wales and Victoria in June 2007 that weighed on profitability. The Hunter Valley storms and their aftermath have led to insurance claims exceeding \$1.2 billion.

Restructuring and consolidation in the general insurance industry continued during 2006/07. The acquisition of Promina by Suncorp was a major development, but there were other transactions including a merger of the two largest medical defence organisations and the amalgamation of their associated insurers. A trend towards ownership stakes by insurers in broking organisations continued, as did the acquisition of some underwriting agencies by insurers.

The industry continues to make good progress in developing robust risk management frameworks and strengthening governance, but there is evidence that the premium cycle has entered a softening phase, particularly for commercial insurances. As last year's Report noted, signs of a softening market in some business lines were then emerging and the trend appears to have continued during 2006/07. While substantial loss leading in premium setting has not been observed, anecdotal evidence of significant price discounting is building. Insurers are also seeking new avenues for growth in gross written premiums, including moving into new insurance classes and new international markets.

APRA will continue to monitor developments in this area and, in its dialogue with boards and senior management, to highlight the dangers of underpricing risk in pursuit of growth in premiums. In its supervisory activities, APRA has been emphasising the importance of strong risk management and pricing disciplines along with the need to monitor claims development trends closely; the benign claims experience of recent years cannot be expected to persist indefinitely.

Financial Condition Reports

As part of its second round of general insurance reforms, APRA introduced the requirement that general insurers have their Approved Actuary provide an annual Financial Condition Report. This requirement applied from 1 October 2006. It is a major initiative by APRA and follows a similar long-standing requirement in the life insurance industry. The Financial Condition Report is an important source of financial information, risk assessment and performance analysis, for both APRA and the institution's board.

It is too early to provide any detailed analysis or industry-wide perspective on the quality and effectiveness of these reports. Nevertheless, APRA is already finding them an outstanding source of analytical information, and informal feedback suggests that many boards have also found them to provide valuable insights into their institutions.

Reinsurance and contract certainty

Another of the initiatives in APRA's second round reforms that came into effect in 2006 is the requirement for insurers to have placing slips or cover notes for all their reinsurance arrangements within two months of inception of their reinsurance treaties and to have full contract wordings signed within six months.

This requirement, which also now has a parallel in the London insurance and reinsurance markets, has had the effect of remedying a widespread and sub-standard practice of the Australian general insurance industry, and has had a powerful effect on reinsurance administration. Once it became clear that APRA would introduce the requirement, industry practice changed rapidly and compliance has proceeded very smoothly and to a high standard, with a beneficial outcome for all parties.

National Claims and Policies Database

The third set of reports from the National Claims and Policies Database (NCPD), covering the year 2006, was released in September 2007. These aggregate industry reports include data on claims and policies submitted by all APRA-regulated general insurers providing public and product liability insurance or professional indemnity insurance. The reports give an indication of trends in the levels of premiums and claims costs across the industry, at a national and state level.

Now that three full years of data are available, analysis and trend information from the data are becoming more meaningful. For example, the 2006 reports include for the first time some cohort analysis of claim numbers and claim finalisations.

APRA has also been working with industry to develop additional NCPD reports that will enable more detailed analysis to be undertaken by risk factors such as occupation groups and variations to product or policy coverage.

The NCPD is funded primarily by entities that contribute to it. The 2006/07 year was the first year in which NCPD costs were recovered by a specific levy on contributors as part of APRA's normal annual levy process.

Life insurance and friendly societies

The life insurance industry experienced sound growth during 2006/07 and the profitability and financial position of the industry remain strong. Revenue growth from superannuation business was supported by favourable investment markets and risk insurance premiums continued to show healthy growth. However, the growth in life insurance assets over the year was lower than the growth of total superannuation assets.

Superannuation contributions to life insurance companies continue to be overshadowed by contributions to other superannuation vehicles, causing some further decline in the market share of the life insurance industry in superannuation.

Consolidation within the life insurance industry has continued, largely through intercompany rationalisation of APRA licences and some acquisition activity. Consolidation and rationalisation are also features of the friendly society industry, particularly among smaller societies facing challenges in attracting new members and maintaining sufficient resources to meet ongoing business needs. One friendly society has recently demutualised so that it can focus on business activities outside the benefit fund structure and other societies are also investigating new business lines. Those societies offering educational and prepaid funeral products continue to enjoy the strongest growth.

Over recent years, unit pricing issues have been a recurring problem in APRA's supervision of the life insurance and superannuation industries. The release of *Unit Pricing – Guide to good practice*, published jointly by APRA and the Australian Securities and Investments Commission (ASIC) in November 2005, has been a catalyst for improvements in the risk management and control framework for unit pricing. Nonetheless, unit pricing problems continue to emerge, partly as a result of company acquisitions producing multiple administration systems that are difficult and expensive to integrate. Compensation for unit pricing errors by APRA-regulated institutions has been substantial. At the same time, however, remediation efforts have led to more robust unit pricing, administration and risk management in many institutions.

Governance arrangements in the life insurance industry have improved, with stronger processes by some life companies to meet the requirement that policyholder interests be given priority over shareholder interests.

Legacy products and systems

The difficulty in rationalising legacy products, which have become increasingly difficult and costly to support, has been a recurring problem for the life insurance and superannuation industries. In response to recommendations of the Taskforce on Reducing Regulatory Burdens on Business, the Treasury published an issues paper in June 2007 covering product rationalisation across the life insurance, superannuation and managed investments industries. This will be followed by an options paper that will also be subject to formal consultation. APRA welcomes this progress, including recognition in the issues paper that any mechanism for rationalising products must not weaken protection for life insurance policyholders and superannuation fund members.

In its dealings with industry, APRA continues to stress that any improvements in the mechanism for rationalisation of legacy products need to be accompanied by industry efforts to limit the complexity of future products. That said, providers of life insurance and investment products continue to compete for market share through product differentiation that involves adding more features to products. This can perpetuate the problem of products that become, over time, unnecessarily complex and costly to administer.

Risk insurance, claims and underwriting

Over recent years, a significant trend in risk insurance has been the move from individual (retail) insurance to group insurance, generally provided as a benefit of a superannuation fund. This trend, which is expanding the coverage of life insurance across the Australian population, has been accompanied by strong competitive pressure on the pricing of both individual and group insurance. In this environment, APRA continues to emphasise to institutions the importance of robust pricing and risk management processes.

APRA has been in discussion with industry over the lack of experienced staff in life insurance underwriting and claims management. Over the last few years the increased focus of the industry on superannuation business has meant less attention being given to developing underwriting and claims management skills. This has led to a skills shortage that is affecting the quality of the decisions that are being taken in these critical areas. APRA has been encouraging institutions to put more effort into company and industry training programs to increase the available resource pool.

The recent introduction of automated underwriting processes by many institutions is a positive development for the industry, although the effect on pricing for mortality and morbidity will not be known for some time. These processes should improve the efficiency of underwriting but will not reduce the need for appropriately trained and experienced underwriting staff to manage the more complex underwriting decisions.

Experience studies

The competitive pressure on individual and group insurance is also occurring at a time when the life insurance industry is not well equipped to measure the underlying mortality and morbidity experience across the industry. Some institutions have ceased contributing to industry experience studies or are producing inadequate data, and the consequence can be a misunderstanding of the underwriting risks being assumed. APRA has been encouraging the industry to improve the quality and timeliness of mortality and morbidity experience studies and, should this not occur, APRA may have to consider becoming directly involved in the collection of such data.

Superannuation

The superannuation industry received a major fillip in 2006/07 from high investment returns and, in particular, record inflows following the Government's 'Better Super' reforms. APRA's major supervisory focus, over the first full year of the new superannuation licensing regime, was the implementation of the risk management requirements and other operating standards that were introduced as part of the licensing regime. APRA was also active in finalising the transfer of member benefits and the winding-up of funds where trustees decided to exit the industry.

Superannuation licensing

The new superannuation licensing regime began on 1 July 2006 with 307 trustees with Registrable Superannuation Entity (RSE) licences and 6,885 registered superannuation funds, comprising 612 funds with more than four members and 6,273 Small APRA Funds. After a period of intense industry consolidation leading up to and during the licensing transitional period, the number of licensed trustees and registered funds has shown little change.

The trustees of around 800 funds did not apply for an RSE licence and, of these, 186 trustees had not finalised alternative arrangements for the entities under their trusteeship by 30 June 2006. APRA appointed acting trustees to six funds whose trustees had not taken sufficient action to transfer members. The remainder of the 186 trustees entered into formal undertakings with APRA to finalise alternative arrangements within a reasonable timeframe. By end June 2007, formal undertakings with only seven trustees (representing eight funds) remained outstanding.

Supervisory activities

Under the new licensing regime, trustees are required to have appropriate risk management systems, meet a fitness and propriety standard, have adequate financial, technical and human resources to conduct their operations and, where material business activities are outsourced to service providers, have written agreements with these providers that meet prescribed conditions. During its supervisory reviews, APRA has been assessing whether what was provided by trustees in written policies in their licence application reflects actual practice and whether these policies are commensurate with the business strategies of the trustee and responsive to changing market conditions and legislative requirements. APRA's preliminary assessment after the first year of the new regime is that there is still some way to go, across the industry, in implementing risk management structures and practices appropriate to the actual circumstances of funds. This parallels the experience of the general insurance industry which, after its re-licensing in 2002, faced a steep learning curve in implementing enhanced risk management requirements.

Some of the risk management issues APRA has been addressing with trustees include ensuring the actual risks of the trustee and fund operations are identified, built into the trustee's risk management documentation and dealt with appropriately in practice; recognising and dealing with actual and potential conflicts of interest through the use of appropriate risk controls or avoidance; and liquidity management in the context of the removal of maximum benefit limits and the reduction in the maximum timeframe for transfers under revised portability rules.

Outsourcing

Superannuation is characterised by a high level of outsourced service provision. APRA has been reviewing trustees' contract management, including their due diligence processes and the monitoring of service providers. The new operating standard on outsourcing gives APRA greater access to key service providers; reviews of these providers, involving on-site visits by APRA's specialist risk staff, will commence in 2007/08. Given the concentration of service providers in the superannuation industry, APRA will achieve operational efficiencies by applying the findings from these reviews across the range of trustees that use these providers.

Investments and operational risk

Operational risk is a major inherent risk of superannuation funds because of their large volume of transactions and the need to keep accurate records of entitlements over long periods of time, whether the fund delivers investment returns through unitisation or through crediting rates. Errors in one financial year can be easily compounded across subsequent years.

APRA does not have a philosophical position in favour of either unitisation or the use of crediting rates, since trustees that use crediting rates to distribute investment returns face substantially the same issues and risks. The frequency with which trustees determine unit prices or crediting rates should be suitable to the member activity within the fund. In its supervisory activities, APRA has been assessing the reasonableness of the crediting rate and unitisation methodologies adopted by trustees and how well these work where investment choice, fund choice and portability of benefits give rise to *ad hoc* transactions, sometimes involving large amounts.

APRA has also been reviewing the implementation of investment strategies for member investment choice and the risk mitigants which support those strategies. Investment in alternative and unlisted assets has been increasing in a search for yield and trustees need to apply appropriate due diligence, both before entering into these investments and in their ongoing valuation for the purpose of distributing investment earnings to members.

Eligible Rollover Funds

APRA is aware of a number of emerging issues concerning the operation of Eligible Rollover Funds (ERFs), including conflicts of interest (e.g. investing in products offered by referring institutions), investment strategies that may not be suited to members, the process a trustee uses to select an ERF, and monitoring of lost members accounts and the approach to account consolidation. APRA considered these issues during the superannuation licensing process and a further review is under way.

Supervision of sub-funds

A by-product of consolidation in the superannuation industry is the proliferation of sub-funds. Many previously stand-alone corporate funds have converted under the successor fund provisions to become sub-funds of master trusts or of industry funds. This is not an unexpected development. APRA has been working with trustees to assist them in understanding and effectively managing the risks presented in particular by defined benefit sub-funds. APRA is also reviewing the application of actuarial reporting requirements in the *Superannuation Industry (Supervision) Act 1993* (SIS Act) to ensure that funding and solvency certifications, remediation and wind-up requirements for technical insolvency and ongoing actuarial reporting all operate effectively at a sub-fund level. APRA will be consulting industry on this during 2007/08. APRA expects its annual prudential returns will be amended to better cater for sub-funds when the returns are next reviewed.

Pandemic planning

Increasing instances of avian influenza have heightened concerns about a potential human influenza pandemic. The World Economic Forum has rated the threat of such a pandemic as one of the most serious risks facing the global economy. While not wanting to overstate the likelihood of a pandemic in Australia, APRA has been working with industry and Government to ensure that Australia's financial system is able to cope with the potential impact. APRA's interest is ensuring that regulated institutions have taken prudent and reasonable precautions to enable them to continue operating and meet their core obligations to depositors, policyholders and other beneficiaries.

Over the course of 2006, APRA met with major banks, insurance companies and industry associations to gather information on how pandemic risks were being addressed. On the basis of these discussions, in October 2006 APRA released an information paper and a prudential practice guide to assist APRA-regulated institutions with their planning for a potential pandemic. The guide summarises the considerations and better practices APRA observed at those financial institutions that were, at that time, more advanced in developing their pandemic approaches. It outlines key aspects of pandemic plans and how pandemic planning differs from traditional business continuity planning, critical financial sector functions in a pandemic, and external factors that need to be considered. It also discussed modelling financial impacts of a pandemic.

During 2006/07, APRA also undertook a stress-testing exercise involving general insurers, life insurers and friendly societies to gauge the potential financial impacts of a pandemic. All institutions active in business lines that could potentially experience higher claims in a pandemic participated in the exercise. Institutions estimated claims and projected their financial position on a consistent basis according to a set of scenarios provided by APRA

covering varying infection and mortality rates and other parameters. The stress test provided APRA and insurers with a general indication of the level of severity of a pandemic that could begin to cause financial difficulty for different segments of the insurance industry. APRA and the industry can now incorporate this information into their own pandemic planning efforts.

APRA is encouraged by the co-operative approach being taken to pandemic planning and believes that the Australian financial system is well advanced relative to other sectors and countries. The Australian deposit-taking and insurance industries have been proactive and timely in addressing pandemic risks to ensure that regulated institutions can continue to provide essential services to the public even in very difficult circumstances and, in the case of insurers, to understand and manage the insurance risks involved.

APRA has also undertaken its own pandemic planning exercise. APRA's pandemic plan focuses on its role in maintaining confidence in financial institutions and in supporting financial stability. The plan ensures that APRA is well-placed to meet its obligations under the *Commonwealth Government Action Plan for Human Influenza Pandemic*. APRA has also taken a number of practical protective measures and is developing contingency arrangements to support its pandemic planning.

Enforcement activities

From time to time, APRA takes enforcement action against individuals and supervised institutions where this is necessary to protect the interests of depositors, policyholders and members of superannuation funds (APRA's 'beneficiaries'). APRA may also take action to prevent unregulated entities from conducting business which can only lawfully be conducted by an authorised financial institution.

APRA's approach is to seek to work co-operatively with boards and management of supervised institutions to resolve issues that are likely to impinge on the ability of an institution to meet its financial promises. On occasions, however, APRA's cooperative approach will be unsuccessful either because the institution is not willing to cooperate or is unable to do so. Under these circumstances, it is critical that APRA take prompt enforcement action under the legislation it administers to safeguard the interests of beneficiaries. The enforcement actions available to APRA are to instigate investigations into the affairs of supervised institutions and appoint inspectors, disqualify persons and organisations from participating in the management of supervised institutions, issue directions to the institutions and accept enforceable undertakings. APRA can also take criminal actions against persons and institutions or seek restraining orders. In April 2007, the Government announced its decision to introduce a court-based process for decisions to disqualify individuals under APRA-administered legislation, similar to the disqualification framework used by ASIC. Legislation to give effect to this decision is currently before the Parliament.

Where possible, APRA publicises its enforcement actions. Widespread publicity communicates to boards and management the minimum standards of behaviour that APRA considers acceptable from supervised institutions and their responsible persons, and enhances public confidence in the integrity of the financial system.

During 2006/07, APRA undertook 159 enforcement actions. This is substantially less than the previous year, when APRA accepted enforceable undertakings from a number of trustees of superannuation funds that were exiting the industry but had not finalised the transfer of member benefits and the wind-up of the fund. As noted in last year's Report, the enforcement workload now tends to involve a smaller number of more complex cases and, at times, vigorous legal challenges to its actions; such cases can consume substantial time and resources.

APRA has continued its enforcement activity relating to the failure of HIH Insurance. A number of HIH matters were stayed during 2006/07 pending a High Court decision on APRA's jurisdiction to disqualify overseas-based individuals from acting in a senior management role in an Australian insurer, and on APRA's use of evidence presented to the HIH Royal Commission. In February 2007, the High Court decided both matters in APRA's favour and the previously stayed matters were reactivated. Two further disqualifications related to HIH Insurance have been made.

During the year, APRA concluded its investigation into a set of improper financial reinsurance transactions entered into by General Reinsurance Australia Limited (GRA), the Australian subsidiary of General Reinsurance Corporation, between 1997 and 2001. The report of the industry expert appointed by APRA to act as Inspector was released to GRA after obtaining the Attorney-General's advice and an excerpt was released in the public interest. The Inspector found that GRA engaged in 'questionable behaviour' in knowingly issuing financial reinsurance contracts to certain insurance companies that enabled those companies to falsely state their profits and/or solvency position. The companies concerned were Zurich Australian Insurance Limited, FAI Insurance Group and New Cap Reinsurance Corporation Ltd. Following the investigation, APRA imposed a condition on GRA's authorisation that requires it to maintain a majority of independent directors on its local Board. APRA has disqualified a total of 16 individuals involved in these improper financial reinsurance transactions, accepted an enforceable undertaking from one other person and is considering potential enforcement action in other cases. Five of the disqualifications are under review by the Administrative Appeals Tribunal (AAT).

In the superannuation industry, the accountant of Western Truck Superannuation Fund was disqualified for having falsified the accounting records and tax returns of that Fund. The directors of the Firezone Protection Services Superannuation Fund were disqualified because the trustee improperly appropriated money from the

Fund for use by the employer sponsor. The accountant and auditor of Wall and Ceiling Superannuation Fund were each convicted in the County Court of Victoria on charges of intentionally entering into or carrying out a scheme to deceive APRA. The scheme involved backdating unit trust deeds and falsifying accounting records to avoid the operation of the in-house asset rules in relation to investments in purpose-built commercial factories leased to the employer sponsors.

In the banking area, APRA obtained orders in the Federal Court preventing an unauthorised financial business, the 'Federal State Bank of Australia' from calling itself and acting like a 'bank'. The court accepted evidence that hundreds of thousands of dollars in fake currency and cheques were being passed off as legitimate and that the word 'bank' had been used illegally. APRA has also been investigating the unregulated entity Terra Nova Cache, established and managed by Mr David Siminton, self-proclaimed Governor of the 'Principality of Camside' in South Yarra, Victoria. APRA alleges that Mr Siminton has been conducting unauthorised retail 'banking' through Terra Nova Cache. APRA obtained court orders freezing assets and prohibiting Mr Siminton, who is an undischarged bankrupt, from conducting banking business. Mr Siminton was subsequently convicted for contempt of court. Judgment in the main case seeking to restrain Mr Siminton or Terra Nova Cache permanently from breaching the *Banking Act 1959* has been reserved.

Over the five years to 30 June 2007, APRA has removed by disqualification or enforceable undertaking:

- 81 senior personnel in superannuation (another 13 were disqualified, but had their disqualifications overturned under internal or AAT review);
- 37 senior personnel in general insurance (another three individuals were disqualified but had their disqualifications overturned on internal review). In all but six cases, the disqualifications applied to individuals involved with events leading up to the failure of HIH Insurance; and
- one senior person in the credit union industry and one senior person in the friendly society industry.

Eleven disqualified individuals have appeals under way in the AAT.

Enforcement actions¹

| | ADIs | | Super-annuation | | General insurance | | Life insurance | | Friendly societies | | Other ² | | Total | |
|---|----------|-----------|-----------------|-----------|-------------------|-----------|----------------|----------|--------------------|----------|--------------------|-----------|--------------|------------|
| | 2006 | 2007 | 2006 | 2007 | 2006 | 2007 | 2006 | 2007 | 2006 | 2007 | 2006 | 2007 | 2006 | 2007 |
| AAT/Federal Court review | | | 13 | 1 | 3 | 5 | | | | | 1 | | 16 | 7 |
| Amendment of IOA ³ | | | 1 | | | | | | | | | | 1 | 0 |
| Appointment of Acting Trustee | | | 1 | 11 | | | | | | | | | 1 | 11 |
| Appointment of liquidator/Inspector | | | | | | | | | | | | | 0 | 0 |
| Civil litigation | | 3 | 3 | 3 | 1 | 2 | | | | | 3 | 4 | 7 | 12 |
| Directions and contravention notices | | | 2 | 4 | 2 | | | | | | 6 | 17 | 10 | 21 |
| Disqualification of auditors/directors | 1 | | 22 | 7 | 12 | 6 | | | 1 | | 1 | 2 | 36 | 16 |
| Enforceable undertaking | | | 164 | | 1 | | | | | | | | 165 | 0 |
| Follow-up delayed contributions | | | 8 | 18 | | | | | | | 1 | | 9 | 18 |
| Investigation action | 1 | | 7 | 4 | | | | | | | 3 | 4 | 11 | 8 |
| Other action | 4 | 3 | 8 | 26 | 4 | 5 | | | | | 10 | 3 | 26 | 37 |
| Prosecution | | 1 | | 2 | | | | | | | 1 | | 1 | 3 |
| Refer to other agency/police | | 3 | 9 | 6 | 3 | 1 | | | | | 3 | 3 | 15 | 13 |
| Removal of trustee/ withdrawal of IOA/ revocation | | | 1 | | 3 | | | | | | | | 4 | 0 |
| Show cause letter | 2 | 1 | 52 | 11 | 7 | 1 | 1 | | | | | | 62 | 13 |
| Total | 8 | 11 | 291 | 93 | 36 | 20 | 1 | 0 | 0 | 1 | 28 | 34 | 364 | 159 |

¹ Year ending 30 June.

² Includes institutions not regulated by APRA suspected of conducting unauthorised financial activity.

³ Instrument of Approval.