

ENFORCEMENT



One of the main aims of APRA's supervision of financial entities is to identify risks and ensure that action is taken by the entity to control or mitigate them. Sometimes APRA's enforcement powers must be used to achieve this. Nevertheless, institutional failures, and exits from business for other reasons, are natural features of competitive markets, and APRA also needs clearly defined and adequate powers to manage such events to minimise their adverse effects.

APRA's Specialised Institutions Division, which supervises a large number of mostly small institutions, has a specialist team to handle cases where enforcement action or very intensive monitoring of an entity is required. The team also manages the steady flow of mergers among authorised deposit-taking institutions (ADIs) and friendly societies and has responsibility for ensuring that the large number of superannuation funds which inform APRA each year they intend to wind up, observe the correct procedures.

Larger and more complex institutions, including those with overseas parents, are supervised by the Diversified Institutions Division. Experience has shown that there is not generally a need for a similar specialised enforcement team – problems

usually can be solved in other ways because of the significant emphasis larger institutions have to place on reputational risk. They also tend to have more ready access to capital which is ultimately the last line of protection for policyholders/depositors/fund members against fraud, misrepresentation, operational failures or other areas of non-compliance.

The table below indicates the types of actions undertaken across the various industries. The actions include the replacement of trustees of superannuation entities and appointment of an inspector or investigator to undertake detailed examinations of institutions. Also included are various types of referrals to other regulatory bodies and industry or professional bodies. Some actions relate to parties associated with APRA-regulated institutions, such as disqualification or referrals of external auditors to professional bodies.

The table on page 14 shows the number of institutions monitored by the rehabilitation and enforcement team during the year and those transferred back to the regional supervision teams when issues were effectively resolved.

Enforcement actions undertaken during the year

	ADIs	Superannuation	General insurers	Friendly societies	S66 Banking Act*	Total
Refer to police/ASIC/ DPP	0	8	0	0	1	9
Refer to ATO	0	5	0	0	0	5
Show cause letter issued	0	3	11	0	0	14
Replace trustees	0	4	0	0	0	4
Follow-up delayed contributions	0	11	0	0	0	11
Investigator/liquidator/ inspector appointed	0	2	8	0	0	10
Disqualify auditor/ refer to industry body	0	2	0	0	0	2
Other**	4	10	9	0	18	41

* Companies or individuals suspected of conducting banking business without proper authorisation

** Includes actions such as notices issued, directions made to institutions, and undertakings obtained from institutions

While the great majority of enforcement actions relate to the smaller institutions and are handled in Specialised Institutions Division, there have also been some actions involving large institutions and handled within the Diversified Institutions Division. By far the most significant such case in 2000/01 was HIH Insurance. This is discussed in the following section, followed by accounts of other notable enforcement cases.

HIH Insurance Group

When APRA was formed in mid-1998, it inherited the supervision and enforcement practices of its predecessor agencies, initially the Reserve Bank of Australia and the Insurance and Superannuation Commission. Until it had determined its own preferred regulatory approach in insurance, which was implemented in the second half of 1999, the previous practices had to be continued, namely, focusing on scrutinising regular statistical returns rather than on-site reviews of insurers' operations.

Weaknesses in the *Insurance Act 1973* (recently overhauled at APRA's initiative) meant the regulator had inadequate supervisory and enforcement powers when concerned about the soundness of a general insurer. For example, unlike other finance industries, general insurers could not be made subject to more stringent requirements (such as greater capital) when they engage in higher-risk business, and there were problems with the consistency of reported provisions for liabilities. APRA's first annual prudential consultation with

the HIH Insurance Group – a complex group of more than 200 subsidiaries, including seven Australian-authorized insurers/reinsurers and others overseas – took place in March 2000, followed by a credit-risk visit in July. These identified a number of matters of concern, which we pursued with the company while pressing it to improve its risk-management arrangements.

The Group's externally audited accounts for the year to June 2000 showed net assets of nearly \$1 billion and solvency for statutory purposes about double the required level. The unaudited accounts for the September quarter continued to show clearly adequate solvency when we received them in January. In the light of these figures, APRA concluded that it lacked adequate grounds under the existing Insurance Act for appointment of an inspector.

A further consideration was that such an appointment is usually a precursor to closure of a company, which causes substantial negative changes to its balance sheet and therefore worsens the position of policyholders, who are APRA's concern. Their best interests are served if their policies can be transferred in an orderly fashion to other insurers.

The situation changed early in 2001, when HIH admitted experiencing difficulties in finalising its financial results for the six months to 31 December. APRA impressed on the company's management that it was essential to provide these data on time. When it failed to do so, we considered we had

Institutions supervised by rehabilitation and enforcement

Industry	Number as at 30 June 2000	Institutions added during the year	Institutions returned to regional supervision teams	Institutions transferred/wound up	Number as at 30 June 2001
Authorised deposit-taking institutions	27	14	9	7	25
SIS institutions	32	27	8	16	35
Friendly societies	12	9	1	5	15
General insurers	5	3	0	2	6
SIS institutions winding up	0	78	0	13	65
Other*	16	13	0	20	9
TOTAL	92	144	18	63	155

* Includes non-APRA regulated groups suspected of conducting unauthorised financial activity

grounds to act and at the beginning of March issued a notice to HIH to show cause why an inspector should not be appointed to investigate its financial affairs. On the eve of the expiry of the notice, HIH entered voluntary provisional liquidation; APRA appointed an inspector on the following day, the first legal opportunity to do so.

Whereas the provisional liquidator is responsible for the interests of all creditors, APRA is responsible for the interests of policyholders. To protect their rights as far as possible, we issued directions to the authorised insurers in the HIH Group not to undertake new insurance business, reconstruct the insurance operations, sell major assets or alter reinsurance arrangements without our approval.

APRA actively facilitated arrangements with other insurers to take over many of HIH's policies, resulting in more than one million policyholders retaining their insurance coverage and some \$1.3 billion in outstanding claims being covered in full. Subsequently, builders' warranty insurance policies written by HIH were also taken over by other insurers.

Six of the seven authorised general insurance companies in the HIH group were placed into liquidation on 27 August 2001 and are consequently no longer subject to the requirements of the *Insurance Act 1973* or supervision by APRA.

All the issues surrounding the HIH collapse are to be examined by a Royal Commission, to which we will make a comprehensive submission.

Commercial Nominees

In April 2000, an investigator was appointed to three superannuation funds of which Commercial Nominees of Australia Ltd (CNA) was the Approved Trustee. Following receipt of the investigator's report in November 2000, CNA was replaced as trustee of these three superannuation funds in December 2000. At the same time APRA asked CNA to show cause as to why its status as an Approved Trustee should not be revoked. The revocation took place in February 2001, at which time Acting Trustees were appointed to 475 small funds of which CNA had been the trustee and another four public offer funds. APRA then appointed an inspector to these small funds that had an exposure to the Enhanced Cash Management Trust, an investment vehicle associated with CNA.

In addition to acting as trustee of the superannuation funds, CNA had been the trustee of the Enhanced Cash Management Trust, which had incurred an estimated loss of 80 per cent. Also in February 2001, the Australian Securities and Investments Commission (ASIC) announced that CNA was being replaced as trustee of the Enhanced Cash Management Trust and the Enhanced Equity Fund.

APRA has been working closely with the inspector and the replacement trustees to determine the causes for the substantial losses suffered by the superannuation funds of which CNA was the trustee and to determine the scope for legal remedies.

Other actions

In May 2000, APRA appointed an inspector to Reinsurance Australia Corporation (ReAC) after it suffered substantial losses and its capital fell below the minimum statutory solvency requirements of the Insurance Act. The inspector remained in place throughout 2000/01 as ReAC continued to run down its insurance liabilities.

In June 2000, a trustee of a Western Australian superannuation fund confessed to defrauding the fund over a five-year period. APRA appointed an Acting Trustee to take control of the fund, including reconstructing the accounts of members and identifying all recovery options. The reconciliation of members' records has been a lengthy process. The Acting Trustee has lodged with the Minister for Financial Services and Regulation an application for compensation under Section 229 of the *Superannuation Industry (Supervision) Act 1993* (SIS Act) which provides a mechanism whereby superannuation fund members may apply for compensation when they have lost money due to fraud or theft. This legislative provision has not previously been activated.

In June 2001, APRA replaced the trustee of a small Victorian superannuation fund where the assets of the fund had been used to purchase illiquid assets related to the employer's business. APRA and the Acting Trustee are exploring ways of recovering value for the fund members.

In May 2000, APRA became concerned that a small general insurer, while remaining commercially solvent, may have breached its minimum statutory

solvency requirements. In July, APRA appointed an inspector to investigate the financial position of the company, and later issued directions requiring it to write down a major asset, increase its provisioning for claims and reduce its exposure to related parties. The company has met its obligations under the directions, and is at present soundly placed to meet its foreseeable liabilities.

In April 2001, Jakob Hans Jost was sentenced to 54 months imprisonment and fined \$7,000 after being convicted for operating an unauthorised bank in Australia, and related matters. He had operated a deposit-taking business known as Eagle Bank in the 1990s and used the proceeds for a property development.

In June 2001, the Federal Court, on APRA's application, ordered Global Monetary Corporation Pty Ltd and two individuals not to use the name Global Monetary Bank or carry out banking activities, pending further hearing of the matters. The company was also required to publish notices on Internet sites stating that it was not authorised to carry on banking business, including acceptance of money on deposit.

During the year, APRA referred the conduct of Ross Zagari, a Melbourne accountant, to ASIC for extensive breaches of the superannuation legislation. Zagari was later convicted in the Victorian Supreme Court and sentenced to 3½ years' imprisonment for fraudulently obtaining the payment of \$2.5 million in superannuation benefits on behalf of 114 clients between August 1996 and October 1999 and other offences. A further 64 offences involving almost \$1 million were taken into account. He had lodged false documents with APRA, and our small funds unit identified these offences.

Superannuation powers

The SIS Act was amended with effect from January 2001 to give APRA an array of more effective enforcement options. Various "fault liability" offence provisions, where the prosecution needed to prove that an act or omission was reckless or deliberate, were changed to "strict liability", where it has to be proven only that the act or omission has occurred.

Prior to these changes, persons were disqualified from being the trustee or investment manager of a superannuation entity only if they had been

convicted of an offence of dishonesty, or if they were a bankrupt under administration. APRA now has the power to declare persons to be disqualified if they have been associated with breaches of the superannuation legislation of such seriousness or frequency that APRA considers they should be disqualified, or if APRA determines that they are otherwise not a fit and proper person to fulfill such roles.

In addition, APRA now has the power to accept an enforceable undertaking under the SIS Act. Other changes introduced at the same time improved the capacity of a replacement trustee appointed by APRA to take control of the affairs of a superannuation fund, and created an offence for persons without the requisite qualifications to hold themselves out as an approved auditor or actuary.

As the offence provisions are not retrospective, APRA has not yet used these powers directly. However, we believe the changes to legislation have made industry participants much more willing to address matters of serious concern to us in a prompt and effective manner. APRA will not hesitate to use the new powers when necessary.