APPENDIX 3.1: AUSTRALIA'S PRUDENTIAL FRAMEWORK

A general justification for prudential regulation and supervision is that the community's tolerance for financial institution insolvency is lower than may be accepted for firms operating in other parts of the economy. It may serve to add to the stability of the financial system.

Some financial institutions have a large number of retail customers unable to make informed and sufficiently accurate judgements about the capacity of an institution to meet its promises, now and in the future. The consequences of failing to meet promises may be considerable. Other justifications include that the financial system is prone to other forms of market failure, such as externalities or contagion effects where a problem in one institution may spread to other institutions or sectors.

Instances of widespread contagion and market failure need to be distinguished from the occasional failure of an individual firm. Insolvency is a perfectly normal occurrence in competitive markets. For financial institutions, however, there is a concern to ensure that failure does not transmit to other financial participants or give rise to undue complexity or cost as it is resolved.

When it comes to dealing with the insolvency of a financial institution, the prudential framework tries to ensure that there is capacity to identify and manage the exit of a troubled institution before significant losses to certain stakeholders accrue. This is not always possible and the customers and other creditors of a financial institution may not always be repaid in full.

Australia's prudential regulation framework is designed around the distinct industries, with the requirements for deposit-taking institutions, life insurance companies, general insurance companies and superannuation funds established under separate legislation. Some legislation, for example the legislation underpinning the regulator, the Australian Prudential Regulation Authority (APRA), and that relating to shareholdings in financial institutions (except superannuation funds), applies across the sectors.

This reflects both an underlying principle of prudential regulation, that regulatory intensity should vary according to the type of market failure and risk involved; as well as the historical development of the legislation in question to suit formerly distinct but increasingly convergent markets for financial products.

The following discussion emphasises those aspects of the prudential framework considered most relevant to the concept of a limited explicit guarantee. This section is not intended to provide a comprehensive description of the prudential framework. In particular, the generally applicable aspects of the prudential framework, concerning authorisation, information gathering, monitoring and standards setting are not covered.

Instead, the most relevant components of the framework in the current context include the capital adequacy, liquidity and related prudential requirements, the prudential regulator's powers of intervention for either avoiding or managing failure, and the industry-specific rules for dealing with insolvency of financial institutions.

Authorised deposit-taking institutions

Capital adequacy and liquidity requirements

The prudential framework for deposit-taking institutions is established by the *Banking Act 1959* and a number of related instruments, including a range of prudential standards. The two standards considered most relevant in the current context are described below.

ADI Prudential Standard 110 (APS110) applies to all locally incorporated authorised deposit-taking institutions (ADIs) which includes banks, building societies and credit unions. Under APS110, an ADI is required to 'hold capital as a buffer to absorb unanticipated losses from its activities and, in the event of problems, enabling the ADI to continue to operate in a sound and viable manner while the problems are addressed or resolved'.

Capital adequacy requirements may be measured and applied at a number of levels, depending on the choice of corporate structure made for the ADI, its parent entity or subsidiaries. Capital adequacy requirements must be met at each of the stand-alone, consolidated banking group and conglomerate group levels (as relevant).

Under APS110, APRA requires ADIs to meet a minimum risk-based capital adequacy ratio of 8 per cent at both the stand-alone and consolidated banking group level, half of which must qualify as 'Tier 1' capital. This is the internationally accepted risk-based capital adequacy framework established by the Basel Capital Accord. In many cases APRA requires an ADI to hold capital in excess of the 8 per cent minimum international standard.

APS210 relates to liquidity requirements for ADIs. This standard 'aims to ensure that all ADIs have sufficient liquidity to meet obligations as they fall due across a wide range of operating circumstances'.

Under APS210, APRA requires an ADI to demonstrate an appropriate liquidity management strategy, and to demonstrate it has the capacity to meet its obligations under normal and particular adverse scenarios. Where an ADI does not demonstrate this capacity, APRA may require it to meet certain minimum liquidity standards.

Both of these requirements place primary responsibility on the board of the ADI to systematically assess and manage the risk that it faces according to the scope of its operations. For example, the risks of an ADI that operates as part of a conglomerate group require special consideration.

A range of other prudential requirements apply to how capital is measured, to liquidity management and lending practices (including large exposures, exposures to related entities, classification of impaired assets and provisioning policy) and to deal with a diverse range of business situations faced by ADIs. APRA is also able to require an ADI or class of ADI to meet higher minimum requirements.

In practice, an ADI facing financial difficulty should normally be identified by APRA as having breached prudential requirements before it reaches the point of insolvency or illiquidity.[1] ADIs are required to report quarterly on their capital adequacy levels and liquidity scenario results. In addition, the board of the ADI has a standing obligation to inform APRA of any breach or potential breach of the capital adequacy requirement.

APRA's failure management powers

APRA has powers at its disposal for dealing with a range of circumstances including actual or prospective breaches[2] of the Banking Act, its prudential standards or prudential regulations. APRA also has the capacity to issue directions for a number of reasons, including if this is considered necessary in the interests of depositors of an ADI. The range of directions that APRA may

1 Section 62A of the Banking Act sets out statutory provisions for failure to notify APRA of a breach of a prudential standard.
2 'Prospective breaches' applies to ADIs only.

give allow it to effectively influence the operations of the ADI with the objective of returning it to a prudentially sound position.

APRA also has powers to assume control of an ADI in certain circumstances. Under Section 12 of the Banking Act, it is APRA's duty to exercise its powers and functions for the protection of depositors. In addition to its general monitoring, investigation and enforcement powers, APRA may exercise its power to take control of an ADI or appoint a statutory manager (under the direction of APRA) to replace the board and management of an ADI if:

> '(a) the ADI informs APRA that the ADI considers that it is likely to become unable to meet its obligations or that it is about to suspend payment;
>
> (b) APRA considers that the ADI is likely to become unable to meet its obligations or is about to suspend payment; or
>
> (c) the ADI becomes unable to meet its obligations or suspends payment.'

Importantly, APRA or the statutory manager must retain control of the ADI until:

> '(a) the ADI's deposit liabilities in Australia have been repaid or APRA is satisfied that suitable provision has been made for their repayment; and
>
> (b) APRA considers that it is no longer necessary for it or an administrator to remain in control of the ADI's business; or
>
> (c) APRA considers that the ADI is insolvent and is unlikely to be returned to solvency within a reasonable time, and APRA has applied for the ADI to be wound up under the *Corporations Act 2001*.'

However, the most convenient and practical means of dealing with the prospective failure of a financial institution, however, is to find a willing buyer or buyers of the assets and liabilities. In the prudential context, this is often known as a transfer of business (or transfer of engagements). Ideally such a step would be taken while the realisable assets of the company are worth more than the liabilities; that is, prior to insolvency.

The *Financial Sector (Transfers of Business) Act 1998* provides APRA with the capacity to make a determination that certain business of an ADI or life insurance company is to be transferred to another regulated body of the same type. APRA is required to consult with various parties and to consider a range of factors before settling on such a course.

This course of action would generally be taken on prudential grounds, where the future prospects for the transferring body appear such that it would be unlikely to meet its obligations or would suspend payment at some point in the future.

In deciding upon such a course of action, APRA would need to be satisfied of a number of criteria. These include that it would be in the interests of the customers of the transferring body; that the receiving body has consented to the transfer; that it would be in the interests of the customers of the receiving body; and in the interests of the financial sector as a whole.

The Transfers of Business Act provides a convenient legal mechanism whereby the assets and liabilities of the transferring institution can be vested in the receiving institution with minimum disruption to depositors, policyholders and other creditors.

Except as provided for by the Banking Act, the winding-up of an ADI would occur under the Corporations Act according to any direction provided by the Federal Court.

APRA is given significant discretion in terms of the point at which intervention should take place and in terms of criteria for choosing between resolution methods. This can be contrasted with some overseas examples such as the United States where 'prompt corrective action' and 'least cost resolution' have been mandated by legislation.

Depositor preference provisions

In the event that the capital adequacy and failure management powers were proven to be insufficient, and an insolvent ADI needed to be liquidated, an additional level of protection exists for Australian depositors.

Subsection 13A(3) of the Banking Act provides that:

> 'If an ADI becomes unable to meet its obligations or suspends payment, the assets of the ADI in Australia are to be available to meet that ADI's deposit liabilities in Australia in priority to all other liabilities of the ADI'.[3]

In addition, subsection 13A(4) provides that:

> 'An ADI is guilty of an offence if:
>
> (a) it does not hold assets (excluding goodwill) in Australia of a value that is equal to or greater than the total amount of its deposit liabilities in Australia;
>
> (b) APRA has not authorised the ADI to hold assets of a lesser value; and
>
> (c) there is no order in force under Section 11 determining that this subsection does not apply to the ADI.'

These provisions supplement the capital adequacy and managing failure powers by ensuring that in the event that an ADI is not able to meet its obligations, the remaining assets of the ADI in Australia are first used to repay the ADIs deposit liabilities in Australia.

The profile of liabilities of ADIs is considered in Appendix 2.1. This shows that most ADIs have a variety of liabilities — and in general, deposit liabilities account for between 50 and 95 per cent of total liabilities.

The relative importance of deposits in balance sheet liabilities varies across the ADI sector and among institutions. This implies that, in practice, the effectiveness of the depositor preference provisions would differ according to the differing buffers provided by the subordination of non-deposit liabilities.

The assumption behind the depositor preference provisions is that there will be a pool of assets in Australia that exceeds the value of deposit liabilities in Australia. Those assets cannot be used to repay other creditors until all deposits have been repaid. All deposits in Australia, regardless of type, (for example, whether retail or wholesale, of foreigners or residents, in Australian dollars or foreign currencies) or amounts are covered by these provisions.

3 This power is available to APRA prior to the point of formal liquidation.

Subordination of non-deposit claims also has implications for market discipline, potentially increasing monitoring by creditors other than Australian depositors. For institutions, however, with few non-deposit or offshore liabilities, depositors are perhaps the major source of market discipline.

The depositor preference provisions do not apply to deposits with foreign bank branches.[4] However, foreign bank branches are not permitted to take an initial deposit from an individual for an amount less than $250,000 (although account balances and subsequent deposits can fall below this level).

Life insurance companies

Capital adequacy requirements

The life insurance prudential framework is established by the *Life Insurance Act 1995*. The Life Insurance Act prescribes some generic requirements applicable to writing life insurance business and relies upon a number of subordinate instruments to give effect to its broad objectives.

The primary objective is to protect the interests of the owners and prospective owners of life insurance policies in a manner consistent with the continued development of a viable, competitive and innovative life insurance industry.

A life insurance company is restricted to the extent that it can mortgage or encumber the assets of a statutory fund. It is also restricted in the extent to which it may invest the assets of a statutory fund in a related company. Transfers of assets between statutory funds are also restricted. In relation to investment-linked products, the extent of any investment performance guarantee able to be offered is also restricted.

The Life Insurance Act also creates an obligation on life insurance companies to hold sufficient capital outside of the statutory funds. A separate Actuarial Standard, known as the Management Capital Standard, imposes this requirement.

4 Although depositor preference does not apply to deposits with foreign bank branches, Section 11F of the Banking Act provides that if a foreign ADI (whether in Australia or not) suspends payment or is unable to meet its obligations, the assets of the ADI in Australia (where applicable) are to be available to meet the ADI's liabilities in Australian in priority to all other liabilities of the ADI.

Box 3.1: Statutory funds and the management or shareholders fund

Part 4 of the *Life Insurance Act 1995* establishes the concept of the statutory fund. A life insurance company is required to establish at least one statutory fund in which it must report its assets — and premium revenue, investments and earnings — for the purpose of ensuring its life insurance product liabilities associated with that fund are able to be met. Every life insurance policy issued must be referenced to at least one statutory fund.

Actuarial standards relating to solvency and capital adequacy apply to statutory funds. The Solvency Standard seeks to ensure that the policy and other liabilities of each fund will be able to be met from the assets of the fund as they fall due. The Capital Adequacy Standard seeks to ensure that there are sufficient assets in each fund to provide adequate capital for the ongoing business of the fund.

Separate statutory funds must generally be created in respect of investment-linked life insurance business and life insurance business written outside of Australia. Section 30 of the Life Insurance Act provides that the principal requirements of a life insurance company in relation to statutory funds are as follows:

> ‘(a) all amounts received by a life company in respect of the business of a fund must be credited to the fund;
>
> (b) all assets and investments related to the business of a fund must be included in the fund;
>
> (c) all liabilities (including policy liabilities) of the company arising out of the conduct of the business of a fund must be treated as liabilities of the fund;
>
> (d) the assets of a fund are only available for expenditure related to the conduct of the business of the fund;
>
> (e) statutory funds may not be restructured or terminated without the approval of APRA; and
>
> (f) profits and losses of a statutory fund may only be dealt with in accordance with Divisions 5 and 6 (the object of those Divisions being to ensure that such profits and losses are dealt with in a manner that protects the interests of policy owners and is consistent with prudent management of the fund).’

The purpose of the Management Capital Standard is to ensure, as far as practicable, that:

(a) the financial position of a life company reflects an appropriate capital commitment, outside the statutory funds of the company, to the life insurance business of the company; and

(b) a life company will be able to meet its obligations in respect of any business it carries on that is not life insurance business as those obligations fall due.

The purpose of statutory funds and the various capital standards is to underpin the insurer's ongoing ability to meet their promises to policyholders and other creditors even though they may experience a range of adverse conditions.

Protection is provided primarily by ensuring that there are sufficient statutory fund assets to match estimated policy liabilities and ensuring assets are used for this purpose. An additional protection is that sufficient capital is required to be available, external to the statutory funds, to be used to support them if necessary.

Prudential Standard 3, made under the Life Insurance Act, imposes an additional prudential capital requirement on life insurance companies. Under the Standard, a life insurance company must hold more than $10 million outside of its statutory funds as a reserve capital commitment to its life insurance business.

The Standard notes that 'it is ultimately the responsibility of the life company's board and senior management to ensure that the life company has, at all times, capital resources that are appropriate to the scale, complexity and mix of its business'.

Friendly societies

Friendly societies are regulated by APRA under the Life Insurance Act. As part of the Financial System Inquiry reforms, friendly societies, along with credit unions and building societies were brought under the responsibility of the national regulator. Prior to this they were subject to State regulation.

Box 3.2: Life insurance concepts

This box provides an introduction to a number of concepts relevant to the life insurance industry.

Risk products — these are similar to ordinary insurance products, but typically provide a benefit in the event of death, disability or injury. Policyholders pay a premium for insurance cover and receive a lump-sum benefit contingent upon a particular event. Such policies may also involve a long-term savings component, such as in the case of endowment policies in which premiums paid over a number of years provide both death cover and entitlement to a cash payment at some future date.

Income products — in return for payment of a lump sum, the customer receives a stream of income for a specified period. These are also referred to as annuities. They are similar to, but more flexible, than pensions available through superannuation funds.

Investment-linked products — these may be based upon either risk or income products. The benefit payable to the customer is subject to market risks and investment performance.

Guaranteed products — these are a specific form of risk or income product. The benefit payable to the policyholder is underwritten by the life insurance company. For example it might promise to pay an income stream for life rather than for a fixed period; or promise to deliver an indexed rate of return despite actual market performance. The policyholder would pay a higher premium or receive a lower income in return.

Surrender value — some life insurance products may allow the customer to redeem some of the value of a future benefit. Penalties would usually apply.

Immediate, allocated, deferred annuities — these terms relate to the timing and flexibility in the income stream customers receive from annuity products.

To the extent that friendly societies conduct life insurance business,[5] they are regulated in the same way as life insurance companies. Specific provisions applying to friendly societies are contained within the Life Insurance Act.

5 Some friendly societies provide health insurance products.

Similar to the concept of statutory funds for life companies, friendly societies are required to quarantine assets in approved benefit funds. Unlike statutory funds, however, approved benefit funds can only offer one product per fund and may not invest in physical infrastructure. Friendly societies are required to manage the supporting capital of the approved benefit fund within stringent guidelines. Approved benefit funds are also subject to strict rules of application on investment strategies and payment of returns. Friendly societies offer products ranging from low-risk (effectively capital guaranteed) to purely investment linked products. They do not offer annuity products.

Friendly societies are subject to similar prudential requirements, capital adequacy standards and actuarial standards as life insurance companies offering investment-linked products.

APRA's failure management powers

In addition to providing APRA with general abilities to monitor, investigate and direct life insurance companies, the Life Insurance Act establishes a framework for managing the failure of life insurance companies. This framework reflects the long duration of a typical life insurance company's liabilities and the associated complexity involved in dealing with its run-off.[6]

APRA has at its disposal a range of directions powers that allow it to require compliance with the prudential framework or in the interests of policyholders. These directions powers allow APRA to influence the operations of a life insurance company and to return it to a prudentially sound position.

The Life Insurance Act also governs situations where it proves necessary to restructure or terminate the statutory funds of a life insurance company. Such an action requires the approval of APRA to ensure that, in the case of a transfer, the interests of policyowners of either the transferring or receiving funds are not unfairly affected. APRA's approval is required in the case of a termination of a statutory fund in order to ensure an appropriate distribution of assets and settlement of liabilities.

External administration of a life insurer would proceed in accordance with the Judicial Management provisions of the Life Insurance Act. APRA and the life insurance company (if it has given required notice) have the capacity to petition the Court for the appointment and direction of a Judicial Manager.

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6 In addition, the *Financial Sector (Transfers of Business) Act 1998*, described above, can apply to the business of life insurance companies.

Applications by other parties to wind-up life offices can be made but are suspended should APRA seek appointment of a Judicial Manager.

The Judicial Manager assumes control of the company but must apply to the relevant Court for instructions. APRA is entitled to be heard and to make its own submissions in these proceedings. The general courses of action the Judicial Manager may recommend to the Court include for the transfer of all or some of the business to another company, to allow the company to continue trading (potentially having made adjustments to its policy liabilities) or to wind-up the company.

Only the Judicial Manager or APRA may apply to the Court for an order that a life insurance company be wound-up. Except as provided for by the Life Insurance Act, the winding-up of a life insurer would occur under the Corporations Act according to any direction provided by the Court.

To date, there has been no usage of the liquidation arrangements, and thus no experience of how they would work in practice.

Policyholder preference provisions

Statutory funds and benefit funds create 'firewalls' between funds that protect investments in one fund from movements in the value of assets in another fund or the life insurer itself. The funds do not ensure that the value of the assets are sufficient to meet policy liabilities. Assets contained in the management fund (outside the statutory funds) of a life insurer are not available to meet any particular liability, but may be used to make additional injections of capital into statutory or benefit funds from time to time.

In liquidation, statutory or benefit fund assets are quarantined to service the relevant fund liabilities. The order of preference in the Corporations Act applies, such that liquidation costs and employee entitlements attributable to the fund (if any) are met first, and then those liabilities to policyholders above other creditors. Life insurers are restricted in the extent to which they may mortgage statutory fund assets.

General insurance companies

Capital adequacy requirements

The prudential framework for General Insurance is established by the *Insurance Act 1973* and related instruments. Significant changes to the Insurance Act, including the ability for APRA to make prudential standards, took effect from 1 July 2002. The Insurance Act requires an insurer to hold assets in Australia of a value greater than or equal to the total amount of its liabilities in Australia with a minimum capital requirement of $5 million.[7] The Prudential Standards (for example, GPS 110) provide guidance as to how these amounts should be calculated, and about acceptable risk management practices.

General insurers have a choice between developing an in-house capital measurement model (approved by APRA) or a prescribed approach in order to calculate their minimum capital requirement.[8]

In either case, an insurer's minimum capital requirement is determined with reference to a range of risk factors that may impact on its ability to meet its obligations to policyholders and other creditors. At a minimum, these approaches should ensure that an insurer's exposure to insurance risk (insurance liabilities being greater than anticipated), investment risk (exposure to market fluctuations and credit risk) and concentration risk (exposure to catastrophes) are adequately understood and managed. Other relevant risk factors would be incorporated into an in-house capital measurement model.

An insurer is required to hold eligible capital in excess of its minimum capital requirement. The approach adopted by APRA is somewhat similar to that for ADIs, where the quality of capital used to meet requirements is assessed according to the nature of subordination and cash flow rights which the financial instrument included in the capital base gives to its holders.

Foreign insurers operating in Australia as branches are subject to modified capital adequacy requirements, such that they must hold assets in Australia in excess of their liabilities in Australia at least equal to their minimum capital requirement.

7 The Insurance Act also provides some definition of such assets and liabilities — see Section 116A of the Insurance Act.

8 At this point no general insurance company has elected the in-house model approach.

A general insurer is encouraged to disclose the components of its eligible capital, the basis of calculation and estimate of its minimum capital requirement to the market in the interests of transparency.

APRA's failure management powers

In addition to providing APRA with general abilities to monitor, investigate and direct insurance companies, APRA has a number of powers for managing the failure of insurance companies, although these are more limited than for ADIs and life insurers. Subject to meeting certain prerequisites, APRA has the power to issue directions to a general insurer to effectively exert control over its operations and to return it to a more prudentially sound position.

Such directions can prevent the insurer from renewing or issuing new policies or undertaking additional liabilities. They may also restrict the insurer's ability to dispose of or deal with its assets. Directions may also relate to the way in which assets and liabilities are provisioned in the accounts of the insurer, which may precipitate a need for it to raise additional capital.

As with other financial institutions, the preferred means of managing failure is to find a willing buyer of the assets and liabilities of a failing entity.

Under Sections 15 and 17 of the Insurance Act, APRA may commence proceedings leading to the revocation of the authority of an insurer to operate in Australia. This may be done on a variety of prudential and national interest grounds including breaches of the prudential requirements, that capital adequacy requirements have not been met, or that the insurer is insolvent. APRA may direct a general insurer to assign its liabilities to another company to facilitate the revocation of its authority to operate as a general insurer.

Part III of the Insurance Act also contains a regime for enabling the voluntary transfer and amalgamation of insurance companies. Any such restructuring of a general insurance company in Australia must be done in accordance with a scheme of arrangement confirmed by the Federal Court. Unlike for ADIs and life insurers, there is no special regime for external administration of general insurers.

The requirement for the Federal Court to confirm a voluntary restructure of an insurance company is designed to ensure that a range of interests are balanced, including those of policyholders, and that an appropriate actuarial assessment has been made of the viability of the transfer.

APRA's ability to apply for an order to wind-up a general insurer is contained in Division 4 of the Corporations Act. APRA may take this course of action when a general insurer is insolvent or when it has appointed an inspector to investigate and report on the affairs of the company and the liabilities of the company (calculated in accordance with the prudential standards) exceed its assets.

Preference provisions

Liquidation of a general insurer would proceed in accordance with the Corporations Act. Section 116 of the Insurance Act specifies that an insurer's assets in Australia are first applied to the discharge of its liabilities in Australia (policy and other liabilities) in preference to its liabilities elsewhere. However, policyholders do not rank above other creditors, in contrast to the case for ADIs and life insurance companies.

Superannuation

Capital adequacy and operating standards

The focus of the prudential framework applying to superannuation, as established by the *Superannuation Industry (Supervision) Act 1993* and Regulations, is somewhat different to that for ADIs, life insurance and general insurance. A major difference in the case of superannuation is that the trustee does not provide any form of capital promise to members. Where capital guarantees do exist (for example, defined benefit funds), they are provided by the employer.

The discussion which follows addresses the generic concept of superannuation. However, it is worth briefly noting that financial institutions may also feature in the superannuation sector. Life insurance companies, registered annuity providers and retirement savings account providers are some relevant examples. For example, some 30 per cent of superannuation business involves life insurers.

Whereas the focus in these other sectors is on the financial institutions holding sufficient capital and engaging in appropriate risk management practices, the primary concern of the prudential supervision of superannuation is the fiduciary relationship between the trustee and the ultimate beneficiary of a superannuation fund (member). In this way, superannuation is more akin to funds management, as is investment-linked life business.

This relationship centres around the trustee's management and investment of superannuation monies on behalf of and in the best interests of the members. In essence, the trustee is entrusted to receive, invest and generate financial benefits in retirement for members.

The design of the regulatory framework reflects both the compulsory nature of superannuation and the preferential taxation treatment of monies invested in the superannuation environment. Accounting for each member's monies in the superannuation environment is essential from both perspectives. It is important to note that the element of compulsion applies only to some superannuation monies — the superannuation guarantee or award component. Members may also wish to make additional (non-mandatory) contributions towards their retirement savings, for example, through salary sacrifice arrangements or as un-deducted contributions (personal contributions out of after-tax-income). A significant part of the rationale for doing so relates to the preferential taxation treatment of such forms of saving.

A number of capital adequacy-type standards apply in relation to superannuation funds, including a requirement that mainstream funds must maintain sufficient assets to cover any benefits that are defined as minimum benefits of fund members. There are also a range of operating standards and other rules that establish a framework for the accumulation and investment of and payments of benefits from the assets of superannuation funds.

In general the Standards relate to the operation and governance of superannuation funds, create rules around investment, borrowing and lending, establish an accounting and reporting framework, and apply Standards to the various parties involved in managing, investing and accounting for superannuation monies.

Additional safeguards apply where access to a fund is open to participation by the general public and lacks the scrutiny of having member participation in the trustee entity. For public offer funds, capital adequacy and other prudential requirements applying to their approved trustees are designed to ensure the integrity of the trustee's operations.

The regulations define what is meant by the solvency of a superannuation fund. This varies according to the type of fund, particularly in terms of the nature of the retirement benefits that it promises to support. In general, a fund would be considered insolvent at the point that its assets were insufficient to cover the promised benefits or obligations to members or unit holders. The value of promised benefits or obligations to members or unit holders would differ between defined benefit and accumulation funds, and on a case-by-case basis.

APRA's failure management powers

In parallel to the situation for financial institutions, the primary responsibility for managing the financial position of a superannuation fund rests with the trustee. The trustee's obligations in respect of managing the fund are set out in the legislation and regulations. These obligations apply from the inception of a fund and acceptance of monies through to managing any period of technical insolvency or ultimately winding-up a fund. A trustee is potentially subject to a range of civil and criminal sanctions for failing in their duties.

A trustee is obliged to notify APRA in a range of situations, including an obligation regarding significant adverse events. When facing insolvency or technical insolvency, the trustee is required to either initiate a program to return the fund to solvency within five years or commence winding-up proceedings.

APRA has a number of powers to deal with the possibility that a trustee is not managing a superannuation fund (or like vehicle) in the interests of its members.

Under Part 17 of the Act, APRA may, with Minister's consent, suspend or remove a trustee if there are substantiated grounds for the trustee's disqualification, if there are grounds for the revocation of approval as an approved trustee, or if the trustee's conduct has posed or may pose an unsatisfactory risk to the financial position of the fund. Where a trustee is suspended or removed, APRA must appoint an acting trustee. APRA may terminate the appointment of an acting trustee at any time, and may provide directions to the acting trustee.

Also under Part 17 of the Act, APRA may formulate a scheme leading to the winding-up or dissolution (or both) of a superannuation fund. In essence, this may entail the transfer of a fund's assets and liabilities to another fund, or placing the assets and liabilities within the control of an alternative trustee.

Priority arrangements

In the winding-up of a superannuation fund, the fund's assets are to be distributed in accordance with the Superannuation Industry (Supervision)

Regulations. In general, this provides that the costs of administration and winding-up are met in priority to liabilities to members.

Additional rules relate to the distribution of remaining assets to members, in accordance with the nature of the fund. Relevant considerations include whether it was in surplus or not when winding-up commenced, and the nature of benefits promised to members (for example, if it was a defined-benefit fund or an accumulation fund).