



No. 56 Superannuation Crime

Arie Freiberg

Superannuation funds in Australia are relatively safe. In recent years, losses due to criminal activity upon and within superannuation funds have been minimal, but the vulnerability of these funds to risky and/or fraudulent investment practices cannot be ignored. As the Barings Bank experience has shown, the age and reputation of a company is no guarantee of the safety of one's investments. With the likelihood of some \$2 trillion in the superannuation pool within 25 years, an aging population, and a proliferation of funds, the prospect of fraudulent activity should be extinguished very early.

This paper examines the potential problems and the types of regulatory response, and argues that despite Australia's good record in this area, the onus is upon all of us to be vigilant and check statements and reports very carefully. Law enforcement agencies also need to develop an awareness of and techniques to combat this particular form of white-collar crime.

Adam Graycar
Director

The 1995 Commonwealth Budget contained an announcement that increasing levels of compulsory and other forms of superannuation contributions would, by the year 2020, see the nation's superannuation savings pool rise from its present level of approximately \$187 billion to some \$2000 billion. However, the understandable desire to encourage private savings in order to ease growing strain on the public pension system carries with it the potential that this large savings pool will become prey to fraud, corruption, theft or incompetent management.

The sheer size of the asset pool and events elsewhere in the world have sounded alarm bells. Before his mysterious demise, British media tycoon, Robert Maxwell, allegedly stole the equivalent of over \$A900m from the pension funds of two of his public companies. In Australia, examples of theft and fraud in relation to superannuation funds are slowly emerging and experts have warned the industry of the dangers of crime. But how vulnerable to theft and fraud are Australian superannuation funds?

Vulnerability

Though startling at first sight, the \$187b superannuation "honey pot" is, in fact, a series of "pots", some more accessible and vulnerable than others. The superannuation industry is immensely complex and current law recognises a number of different types of funds.

In June 1995 there were some 107 000 superannuation funds which complied with superannuation taxation laws. The growth

**AUSTRALIAN INSTITUTE
OF CRIMINOLOGY**

trends

&

issues

in crime and criminal justice

June 1996

ISSN 0817-8542

ISBN 0 642 24014 0



Australian Institute
of Criminology
GPO Box 2944
Canberra ACT 2601
Australia

Tel: 06 260 9200

Fax: 06 260 9201

of small, so-called “do-it-yourself” funds is predicted to increase the total number of funds to 200 000 within five years.

The distribution of assets within the industry is highly skewed, with 75 per cent of funds having less than \$0.25m in assets and approximately 1 per cent of the funds covering about 85 per cent of the industry by assets.

Although it may be assumed that the large insurance and investment companies are relatively safe depositories for public moneys, including superannuation funds, the Barings Bank disaster and recent significant losses by banks, insurance companies and municipal authorities through theft and fraud, mean that all funds must be considered as vulnerable to crime. Even a minimal 1 per cent defalcation rate in the year 2000 would result in losses of \$60m per year.

Nature and Extent of Deviance

No data are currently available which indicate the extent of fraud in the superannuation industry. The Insurance and Superannuation Commission (ISC) estimates that over recent years losses in the industry have been minimal, possibly less than \$10m. Police data do not distinguish finely enough between types of fraud and the annual reports of the various supervisory agencies produce little information of value in this area. Law enforcement and regulatory authorities are, at best, reticent, possibly fearing that any untoward revelations would trigger a loss of confidence in the investment industry generally.

In England, the Maxwell fiasco, which affected over 30 000 people, stands out as an example of the colossal possibilities of superannuation fraud and exposed weaknesses in their system of regulating pension funds. In the

United States of America, approximately \$US2.5 trillion is held in pension funds covering some 200 million persons in 731 000 funds. As is the case elsewhere, it is difficult to obtain empirical evidence of the extent of pension fraud. Available information indicates that fraud, mismanagement and breaches of the prudential rules are not uncommon, but criminal prosecutions are relatively rare. In 1995, the United States Secretary of Labor, Robert Reich, launched a campaign against pension fraud after it was revealed that more than 300 companies were being investigated for potential civil and criminal violations of a voluntary contribution scheme under which employees have their contributions deducted from their wages by employers.

There are few documented cases of fraud in the superannuation industry in this country and most commentators agree that no “Maxwell-type” fraud has yet occurred (Klumpes 1993). The National Crime Authority, in its report on money laundering (NCA 1991) found little evidence of that activity in the life insurance industry, but a later review of law enforcement arrangements (Australia 1994) stated that superannuation funds

have been vulnerable to trustees, without adequate checks, acting at the direction of the employer, or to publicly criticised practices such as employers refunding surplus superannuation funds to their own balance sheets.

Neither of these are necessarily criminal activities.

The Senate Select Committee on superannuation publicly identified five cases of malfeasance in the industry (Senate Select Committee 1992), identifying irregularities ranging from \$34 000 to nearly \$1m. Since then another six cases have come to light, where losses have not yet

been identified, but where funds with assets ranging from \$9m to \$180m were frozen, wound up or where the trustee company was placed in liquidation.

State and federal police forces are faced with an increasing number of investigations into superannuation fraud. The Major Fraud Group of the Victoria Police has successfully prosecuted one superannuation related fraud and has a number of ongoing investigations in relation to superannuation. The completed case involved eight thefts totalling approximately \$600 000 over an 11-year period by an accountant who was acting as trustee for the superannuation funds. This case is not unusual and the Victoria Police have a number of solicitors under investigation.

The Problems

The vulnerability of superannuation funds to illegal activity can best be understood by examining the flow and control of money and the relationship between the structure of those funds and their susceptibility to fraud. The following problems have been identified (Fairley 1992; Chapman 1994; Maher 1992):

- improper registration and use of fund assets;
- collusion between trustees and fund managers improperly to divert assets;
- collusion between trustees and managers in overcharging fees or paying unauthorised expenses;
- falsification of records;
- misappropriation of assets;
- improper or bogus loans to interested parties;
- failure to pay benefits.

More specifically, research has identified the following areas of concern.

The superannuation guarantee
Under the superannuation guarantee legislation employers

must make payment to superannuation funds on behalf of employees.

In a recent review of the operation of the ISC, the Australian National Audit Office (ANAO) identified the possibility that superannuation guarantee payments are not being paid into an appropriate fund. It notes that some 2000 funds which do not wish to claim taxation concessional status are not supervised by the ISC and that, because of this, "it is feasible that some moneys which purport to satisfy the employer's SG obligations, could be placed in non-regulated funds without the knowledge of the ISC or the ATO" (ANAO 1995, p. 9).

There is also evidence that some companies have failed to pay the current 5-6 per cent superannuation guarantee charge for their employees, although overall, the level of compliance is said to be high. The reasons for this vary. In some cases, the employer-sponsor may experience cash flow difficulties and use the charge to support the business, or the employer-sponsor may simply forget to remit the requested amount. As members only receive a report on their scheme annually, the employer's failure to remit the contributions may remain undetected for some time. The failure to remit employees' contributions can detrimentally affect the rights of employees in the event of an employer's insolvency.

Taxation fraud or losses

In order to be eligible for tax concessions, a superannuation fund must comply with legislation and obtain the relevant certificate from the ISC. However, the differences between the tax regimes of complying and non-complying funds leave the way open for abuse of the revenue. The

ANAO audit of the ISC revealed serious weaknesses in the reporting regime between the ISC and the ATO. The ATO bases its assessment of taxation upon information supplied by the ISC in relation to a fund's complying or non-complying status. However, it appears that some superannuation funds have been claiming the concessional tax rate without first having obtained compliance status by the ISC. The ANAO identified some 7817 funds, with assets totalling \$33.5b, which had lodged returns with the ISC but not income tax returns, creating the potential for serious losses to the revenue. These losses include not only the differences in tax rates, but penalties and interest in relation to non-complying fund returns, as well as delays in payments, which result in higher interest costs to the Commonwealth. The ANAO estimated that despite the fact that most of these funds had no liability to taxation, due to the operation of pension liability provisions, possible losses could amount to \$50m.

The interface between the ISC and the ATO was of particular concern to the ANAO. Its audit of the ISC found that a comprehensive compatibility check of ISC and ATO records had never been undertaken and a pilot attempt to do so was thwarted by program errors in the ATO's database. It also identified numerous errors in the ISC's data, attributed to data transfer problems in 1991 as well as problems in the tax file numbering system and its relationship to the ISC's record system. The ANAO concluded (ANAO 1995, p. 22):

Based on the results of the ANAO compatibility check there appears to be the potential for a significant loss of ISC revenue with the potential for a far greater loss to ATO revenue . . . The results of this check

highlight the need for the ISC and the ATO to develop a more effective system of control to safeguard their respective revenue base derived under SIS.

Employer-sponsored funds

Employer-sponsored funds which are administered "in house" are particularly vulnerable to fraud, especially when the trustees are inexperienced or have been selected to favour the employer's interest.

The kinds of problems which may arise in such funds include the purchase of assets at inflated values to the detriment of the fund and to the benefit of the employer; fraudulent manipulation of benefit records through privileged access to information systems; the creation of invalid data sets in order to generate unauthorised payments; illegal manipulation of journal entries facilitated by the interweaving of employer-sponsor and fund information systems and unauthorised asset transfers between entities, particularly at the time fund management contracts are terminated or cancelled.

Excluded funds

Excluded funds are funds that have fewer than five members and are usually set up for small family businesses. Although they account for about 3 per cent of all members, they are a fast growing segment of the market, with "self-managed" funds becoming more and more popular as disillusionment grows with professionally managed funds. Their obligations under the superannuation legislation are less onerous in that they do not need to have equal representation of members and management and have less strict reporting requirements. Because of the closed nature of these funds, internal fraud is less likely, but the ANAO has identified problems where non-related

employees also participate in the fund and has recommended that these excluded funds should be targeted for audit purposes (ANAO 1995, p. 10).

Industry funds

An industry fund is a fund to which employees of particular industries may belong. Around 100 industry schemes have been established so far. Some industry funds are characterised by a high level of worker mobility between employers and between funds. Itinerant workers frequently have small superannuation balances in relation to which they may be unaware or simply careless. It is not unknown for up to one-third of fund members to be "lost".

The number and size of these balances and the difficulties of tracing the members leaves the system open to fraud in the following manner. An employee of a company acting as an administrator for several industry funds, with a high level of authority and access to the information system, can identify fund members who frequently move between employers, or those who cannot be located, and whose balances are below \$500. By falsifying requests to the trustees to withdraw funds, the person may divert each of these small benefits to their account. Because relatively small amounts are involved, the fund member is unlikely to be aware of the loss or, if aware, unwilling, incapable or uninterested in taking action. The large number of apparently trivial transactions is also likely to ensure that the trustees' interest or scrutiny is minimal.

Public offer funds

In this type of fund, generally equal representation on trustee boards is not required, but the trustee must meet minimum capital requirements. Public offer funds are also vulnerable to fraud.

For example, a public offer fund may be established by an accounting firm for its clients. The partners of the firm will become the trustee, which will be responsible for the operation of the fund including accounting, record-keeping and investments. Under this scenario, one partner of the firm will be delegated the primary responsibility for the fund, although the partners will meet periodically to discuss investment options. The concentration of powers in the hands of one person, the position of trust that that person holds, and the lack of scrutiny of his or her actions by the trustees or policy committees render this type of fund particularly vulnerable to fraud.

Public sector funds

Public Sector funds do not have the requirement to be regulated under SIS. Consequently, the controls around which the system of compliance is built, are not universally applied. Thus the ISC is unable to conduct its audit reviews and apply the annual return provisions of the Act. The supervision of these funds is only as good as the regulatory provisions contained within the special statutory provisions applicable to the individual funds.

Pooled and master funds

Most superannuation funds in Australia are managed or administered by life insurance companies or professional fund managers. Although their record to date has been reasonable, it is in this area that the greatest potential for large scale losses exists. The recent example of an internal theft of nearly \$100m from a reputable Australian bank indicates just how vulnerable the practices and procedures of well-established and trusted institutions are to internal crime.

Regulation

The superannuation industry is primarily regulated by the *Superannuation Industry (Supervision) Act 1993* (Cwlth), although superannuation itself is embedded in various laws relating to taxation, corporations, compulsory payments and the like. The legislative regime is the product of years of endeavour by such bodies as the Australian Law Reform Commission, the Companies and Securities Advisory Committee, Senate committees and others.

Regulation combines the specification of minimum rules to which funds must adhere to qualify for concessional income tax treatment, the codification of prudential standards and a range of civil and criminal sanctions for breaches of the statute. It utilises a number of control mechanisms including general and specific disclosure requirements, whistle-blowing provisions, record keeping and wide powers of investigation.

However, problems remain. The industry is made up of a complex web of relationships between numerous participants each of which has a role to play in the prevention of fraud. Amongst the most important of these participants are the contributors and beneficiaries, employer/ sponsors, trustees, custodians, investment managers and advisers, administrators, auditors, actuaries, the ISC, the ATO and law enforcement agencies. Some of these parties, such as the contributors and beneficiaries, can do little to detect fraud other than to maintain a state of alertness in relation to the general state of the fund and the timeliness and comprehensiveness of the information that is provided to them. Others, such as the trustees and auditors, play a central role in the process.

Trustees

The trustee is the person or entity responsible for the operation of the trust. It has the responsibility for controlling the fund's investment strategy, meeting its fiduciary obligations to members and ensuring compliance with the regulatory regime. Amongst the most important provisions of the statutory regulation of superannuation funds are the provisions which: require equal member and employer representation on trustee boards for funds with more than five members; prohibit lending money to members; restrict loans or investments in employer sponsors to 5-10 per cent; protect the trustee from direction from any other person, including the employer; prohibit borrowing of funds other than for short-term cash flow purposes and payment of benefits; require investments to be at arm's length; prohibit certain convicted persons and bankrupts from holding office; require annual audits and the provision of a range of relevant information relating to the fund.

However, it is questionable whether trustees yet have the experience, knowledge and skills to supervise the activities of a fund and perhaps oppose a strong employer. The provision of free national training courses for trustees to raise their awareness of fraud is a welcome ISC initiative in crime prevention.

Auditors and actuaries

The spate of corporate collapses in Australia over the past decade has focused attention upon the role of auditors who have been the subject of numerous law suits by disgruntled shareholders, creditors and the corporations which themselves have been the victims of fraud. In relation to the superannuation industry, auditors play a central role, as all complying funds are required to submit an annual independent

audit to the ISC. It is upon this report, together with the trustees' annual return, that the ISC's system of compliance is built.

In its audit of the ISC, the ANAO detected a significant difference in the quality of audits between the large and small funds. Whereas the very large funds tended to be audited by the large accounting firms with specialised staff whose work was of very high quality, small and medium sized funds were less well-served by their auditors (ANAO 1995, p. 34).

With effect from the 1995-96 year of income, fund auditors under SIS are expected to provide more than a mere review of a fund's financial statements. In addition, the ISC is encouraging fund trustees to arrange prudential reviews, that is, reviews of the security, effectiveness and productivity of the fund's investment and administrative practices.

Major concerns have been expressed in relation to the independence of auditors from the sponsoring employer, union or promoter of a scheme and over the possible fate of auditors who exercise their whistleblowing functions. In 1995-96, superannuation funds will be required to engage external auditors to undertake audits of administrative compliance. The SIS legislation requires an auditor or actuary who forms an opinion that a contravention of the Act may have occurred, may be occurring or may occur, to report in writing to the trustee. The trustee has an opportunity to rectify the problem, but if the auditor is not satisfied that appropriate action has been taken, the auditor is required to inform the ISC, by which time, of course, it may be too late to prevent further harm.

To date, the ISC has been unimpressed by the performance of auditors of superannuation funds and its own audits have

found a significant level of non-compliance, generally for minor technical breaches (Harris 1994) which had either not been found, or had been ignored, by the auditors. Standards had been breached in 80 per cent of the cases.

Insurance and Superannuation Commission

The industry regulator has three primary responsibilities in relation to superannuation: to promote the growth and prudential management of retirement savings through superannuation; to protect fund members' superannuation benefits through a regime of supervision and control; and to ensure that taxation concessions provided to encourage superannuation are properly used.

Although the Commissioner and his inspectors have been armed with a formidable array of investigatory powers, the Commission does not see itself as a police agency. Its supervisory framework is "premised upon the principle that primary responsibility for superannuation rests with trustees and fund managers" (Chapman 1994). Its supervisory role is to monitor the performance of trustees, fund managers, custodians, actuaries and auditors: in effect to audit the auditors. It seeks to review the systems and controls put into place by funds, rather than their technical compliance with the rules.

Despite its relatively benign approach to regulation, the Commission is aware of the industry's vulnerability to malfeasance and is developing a regime of fraud control which includes the identification of the kinds of fraudulent activity which may occur. Its trustee education program mentioned earlier is an important part of this process.

The ANAO's audit of the ISC found that although the agency's planning had been soundly based, there were deficiencies in its management and administration, particularly in relation to its relationship with the ATO.

The ISC's audit function was subject to particular scrutiny. In 1993-94 it audited 1238 funds (or 1.66 per cent of all funds) of which 16 per cent did not measure up against one or more of the operational standards (ISC *Annual Report 1993-94*, p. 59). Forty-six of the larger funds were scrutinised and a number of breaches were detected, the majority of which related to information disclosure and member reporting standards. 1059 of the smaller (less than \$1m) funds were audited and breaches were detected across the full range of requirements. A key area of concern in relation to these funds was the "in-house" asset rule. In 1992-93 year, the auditors visited 500 funds and completed 462 audits. Although no major prudential problems or frauds were detected, they found that a substantial number of funds had failed to comply with standards: 60 per cent related to disclosure and member reporting practices; 24 of the 462 funds lost their tax concessional status. The audit program revealed that the risk of non-compliance was greater where the employer was the sole trustee of the fund and where the principal contact point named in the fund's annual return was also its auditor.

The ISC is not alone in lacking experience in superannuation fraud control and investigation. The Australian Federal Police, the Director of Public Prosecutions and the National Crime Authority all remain relative novices in the field and there is clearly scope for further research and cooperation between these agencies. In the meantime, state fraud squads remain severely under-resourced.

Conclusion

Crime against superannuation funds is always a possibility. The pillage of companies in the 1980s was not a unique event in history and will recur, given the right conditions. Most at risk are those funds where the control of assets remains closest to employers and trustees.

The prudential system now in place which relies upon devolved supervision and enforcement provides a useful framework for fraud control, but is at risk if it emphasises cost efficiency over security. To prevent failure, the ISC must become more than a benign regulator; auditors must adopt an attitude of constant vigilance and eternal suspicion; fund members must be vigilant; trustees must be fully educated and empowered to exercise their prudential rights and duties; and law enforcement agencies must improve their expertise to understand and investigate this arcane area of law.

Whilst the superannuation and taxation systems remain uncoupled and uncoordinated, the revenue remains at risk. Though the larger funds appear to be safe from the minor frauds, they may be subject to cataclysmic losses through rogue or imprudent investment practices which can lead to a loss of public confidence in the financial system and ultimately de-stabilise it. On the other hand, the numerically greater small funds are more likely to be the targets of more frequent frauds, but they will be relatively small. Regulation and enforcement are ongoing and evolving processes. As each weakness or loophole is inevitably uncovered, the government's response must be quick and sure and in the interests of the beneficiaries of the funds, not of the insurance companies, the professional advisers or its own agencies.

References

- Australia 1994, *Report of the Review of Commonwealth Law Enforcement Arrangements* AGPS, Canberra.
- Australian National Audit Office 1995, *Audit Report No. 28 1994-95, Insurance and Superannuation Commission, Superannuation Industry (Supervision) Act Administrative Arrangements* AGPS, Canberra.
- Chapman, K. 1994, "Superannuation and Insurance Fraud", paper presented to the National Crime Authority, Management of Serious White Collar Crime Investigations Course, Goulburn, NSW.
- Fairley, A. 1992, "Maxwell and the Mirror Group Pension Funds—Are the warning bells in Australia any better?" Australian Federation of Superannuation Associations, National Superannuation Conference, 21 October.
- Harris, F. 1994, "A breach is a breach is a breach!" *Superfunds* vol. 22 (Feb).
- Klumpes, P.J.M. 1993, "Maxwell and the accountability of superannuation schemes in Australia: A critical review of law reform", *Australian Business Law Review*, vol. 21, p. 194.
- Maher, C. 1992, "Vulnerabilities to fraud in the superannuation industry", paper presented to the National Crime Authority, Management of Serious White Collar Crime Investigations Seminar.
- National Crime Authority 1991, *Taken to the Cleaners* AGPS, Canberra.
- Senate Select Committee 1992, *Safeguarding Super: The Regulation of Superannuation Funds* AGPS, Canberra.

ACKNOWLEDGMENTS

The author wishes to acknowledge his debt to Rob Anderson and Di Thompson of Deloitte Touche Tohmatsu for their invaluable advice and assistance; to David Hellings of the NCA, to Roger Brown of the ISC for saving him from error and to his students in the Department of Criminology.

Note: A complete account of the research reported here will be found in a forthcoming issue of the *Australian Business Law Review* published by the Law Book Company.

Professor Arie Freiberg is Professor of Criminology, University of Melbourne



Inquiries about the Trends and Issues series should be forwarded to:
 Dr Adam Graycar, Director
 Australian Institute of Criminology
 GPO Box 2944
 Canberra ACT 2601 Australia