Council of Financial Regulators – Failure and Crisis Management in the Australian Financial System

The Council of Financial Regulators is a non-statutory body whose members include the Governor of the Reserve Bank of Australia (RBA), the Secretary to the Treasury, the Chief Executive of the Australian Prudential Regulation Authority (APRA) and the Chairman of the Australian Securities and Investment Commission (ASIC). Its ultimate objectives are to contribute to the efficiency and effectiveness of financial regulation in Australia and to promote the stability of the Australian financial system.

Consistent with this mandate, the Council recently completed a comprehensive review of Australia's failure and crisis management arrangements. This was the first such review since APRA was established and follows the publication of the "Study of Financial Guarantees" undertaken by Professor Kevin Davis following the failure of the HIH Group of Companies. The Council was also conscious that these arrangements will come under scrutiny over the next half year as part of the Financial Sector Assessment Program (FSAP) of the International Monetary Fund.

The review endorsed many of the arrangements currently in place for dealing with distressed financial institutions. However, the Council did note a number of areas where some improvements could be made to existing arrangements, many of which concern the protocol for inter-agency cooperation.

The Council also identified an issue which would arise on closure of a distressed financial institution. In these circumstances, there is currently no mechanism for providing depositors/policy holders with access to their funds on a timely basis. While the relevant legislation give depositors/policyholders first claim on the assets of a failed institution, it makes no provision for timely payments. Given the lengthy nature of the wind-up process, it could take many months, or even years, before funds are available for distribution. As demonstrated by the case of HIH, this can create financial hardship for many households and businesses, which can generate pressure on Government to 'do something'. In the Council's view this is an inappropriate outcome both for the more vulnerable members of society and for Government. At the same time, while wishing to remedy this shortfall in Australia's failure management arrangements, the Council is not attracted to the cumbersome pre-funded deposit insurance and financial system guarantee schemes found in many other countries.

Against this background, the Council has recommended to the Government that it consider a 'minimalist' Financial Claims Compensation Scheme with the following characteristics:

- The scheme would be administered by APRA. No new agency would be necessary.
- The scheme would apply to retail deposits in authorised deposit-taking institutions (ADIs) and the policyholder claims of life insurers and general insurers.
- The scheme would provide depositors with access to 90 per cent of their funds in a closed institution up to a maximum limit (for example, $50,000).
- Depositors would also be able to lodge a claim for further monies, up to a predetermined amount, against the scheme in limited and specified circumstances (for example, up to $1 million where an ADI had failed just after the proceeds of a house sale were deposited).

- The arrangements for compensation would only apply to the financial institution's liabilities in Australia. The scheme would not apply to financial products offered by Australian authorised financial institutions in other countries.

Monies provided to the scheme to assist depositors/policyholders would be repaid from the sale of assets of the failed institution; and only if there proved to be a shortfall would the scheme need to levy other financial intermediaries. There would be no cross-industry subsidisation within the scheme so that there would be no recourse to authorised deposit takers to compensate for any losses incurred by the failure of an insurer and vice versa.

In the Council's view, there is much to commend these proposals which would assist in a more expeditious and orderly closure of a financial institution and, by doing so, help promote the overall stability and efficiency of the Australian financial system.

PROPOSED DESIGN OF A FINANCIAL CLAIMS COMPENSATION SCHEME

Limited scheme mandate

The intention is for the scheme to provide prompt payments to eligible depositors and policyholders, with payments only occurring after a decision to close the institution had been made. The scheme would not transfer resources to creditors (other than depositors) who would not be eligible for compensation, nor to shareholders of an insolvent institution.

Coverage principles

The scheme would apply to ADIs (that is, banks, building societies and credit unions), life insurers (including friendly societies) and general insurers (and limited superannuation products). Only 'capital certain' promises would be covered (deposits, claims on insurance policies, and guaranteed life insurance savings and annuity products). Managed investments and ordinary superannuation products would not be covered given their exposure to fluctuations in the market value of the consumer's interest in the underlying investments. Eligibility tests would target the scheme to individuals, small businesses and community organisations with a relatively low limit on compensation.

Design features to limit the scheme's coverage are explained in further detail below.

Targeted coverage

It is intended that the scheme apply to more vulnerable consumers such as individuals, small businesses and community organisations. Liabilities to associates, liabilities to other corporations and liabilities between financial institutions would generally not be covered. For deposits, a universal, relatively low threshold is contemplated for ease of administration (that is, avoiding the need to assess a depositor's eligibility to claim). It will be necessary to define the product coverage in legislation. To this end, achieving a workable consistency with existing definitions within the *Corporations Act 2001* and the prudential regulation framework laws will be important. (See Coverage limits).

Restricted basis of coverage

For deposits, it is intended that each individual, small business or community organisation should be able to make only a single claim against the scheme for each failure of a financial institution (all relevant claims would be aggregated). For insurance categories, eligible customers would be allowed to apply in relation to any policies that they held with the failed insurer (subject to any aggregate limits on compensation). Appropriate penalties are proposed to protect the scheme against fraudulent or multiple claims.

Non-protection of third parties

It is proposed to generally exclude third-party beneficiaries of insurance policies from the right to access the scheme. This is to avoid interfering with their existing rights under the law to pursue their claims against the insured. The exceptions to this rule are for group life insurance policies, where an individual's beneficial ownership of the policy's benefits would be recognised (as it is under existing law). In addition, where a policyholder is bankrupt/insolvent, deceased/deregistered, or cannot be found after reasonable enquiry, the scheme would operate to fulfil obligations to third parties, to the extent that their claim can be proven, and the original policy would have covered the liability.

Nature of loss

For the insurance categories, it is intended to make redress to eligible policyholders that have a claim against the failed institution up to the time that it fails and for 28 days thereafter. The period of grace will enable policyholders of the failed insurer 28 days to find replacement cover. Claims would be processed in accordance with the terms of the original policy, including any deductibles. This may include, under relevant long-tail policies, coverage of incurred but not reported (IBNR) liabilities. The scheme is not intended to compensate policyholders for the value of pre-paid insurance premiums. For certain life insurance products whose price or availability depends on the age or health circumstances of the policyholder (for example, term life insurance), it is also proposed that the scheme could provide the benefit of continuity in cover. In practice, this would occur through the transfer of the original policy to another insurer.

Coverage limits

For the deposit category, monetary limits would cap the cost of the scheme. A relatively low maximum payout (say $50,000) is proposed, with the scheme administrator having tightly prescribed discretion to repay larger balances in specified circumstances. These might include short-term deposits which are held in the course of settling major transactions (such as housing sales) by retail depositors.

For the insurance categories, eligibility criteria and coinsurance are preferred means of limiting the potential cost of the scheme, given that the value of assets or income protected by insurance products may vary widely across society. The scheme administrator should have discretion as to whether to pay in instalments, in order to be able to manage liquidity exposures. It is not proposed to index the limits to ensure greater awareness of (and a real reduction over time in) the extent of coverage, although they may require updating from time to time as the legislation is amended.

Coinsurance

Initial payouts to claimants would be 90 per cent of the full entitlement under the scheme. The remaining 10 per cent would be paid out at a later date, if recoveries from subsequent asset sales are sufficient. This leaves open the possibility that claimants might sustain a loss of up to 10 per cent on their full entitlements under the scheme plus any amounts held on deposit in excess of $50,000. The Council regards this as a coinsurance premium, which is consistent with the scheme's aim of providing targeted financial assistance, rather than a complete guarantee against all loss.

Other eligibility criteria

In order to apply the scheme to small business and community organisations, it will be necessary to define the target beneficiary groups. In addition, in relation to insurance categories, the scheme administrator should have the power to determine that certain categories of insurance or certain policyholders should be excluded from the scheme. An appropriate test may be whether covering such classes or customers would meet the objectives of the scheme or would be contrary to the public interest.

A possible small-business test could be based upon multiple requirements, each of which should be satisfied, specified in terms of assets, revenue and employee numbers, and should exclude related entities within a larger corporate structure.

Geography/nationality

It is proposed to apply the scheme only to the financial institution's liabilities in Australia, reflecting the objective of the scheme as a limited customer-protection device. For example, the scheme would not apply to financial products offered by Australian-authorised financial institutions in other countries. Foreign bank branches offering products in Australia would not be covered on the basis that they are not required to meet the same prudential requirements as Australian incorporated ADIs (and are not permitted to accept 'retail' deposits in Australia).

Australian branches of foreign general insurers authorised under Australian legislation would be covered (as they undertake retail business). Similarly, any new branches of foreign life insurers authorised under Australian legislation would be covered.[1]

Currency

It is proposed to apply the scheme to relevant Australian dollar denominated liabilities. Liabilities payable in foreign currencies would not be covered.

Netting/set-off

It is proposed that netting/set-off would not be permitted under the scheme. This is in order to preserve the value of assets of the financial institution and to simplify the process of establishing the value of assets in liquidation.

Funding principles and levy arrangements

The scheme would be post-event funded.

Initial Funding

An initial source of liquidity would be via a standing Budget appropriation. In the case of ADIs, additional funding could be raised through a loan from the RBA to the entity managing the scheme, where the liabilities of this entity to the RBA are subject to a full Government guarantee.

Repayment of scheme liabilities

The first mechanism for recovering scheme costs is through sales of the assets of the distressed institution. The scheme would assume the rights of those it has compensated to claim against the estate of the failed institution. Any priority that eligible customers would have enjoyed over the assets of the failed institution would automatically pass to the scheme in the liquidation process. In the event that the proceeds of asset sales are not enough to cover the scheme's costs, industry levies would be raised to cover the shortfall.

Costs of the scheme

The operating costs of the scheme would include the extent of compensation paid, as well as any administrative expenses incurred. The extent of the Government's interest expenses should also be allocated to the scheme and hence, cost-recovered.

Funding pools

To facilitate ex post application of industry levies, it is proposed to establish a number of separate cost pools in order to account for the net cost of compensation paid and to attribute the administration costs of any scheme. Three separate pools would be established for ADIs, life insurers and general insurers. The use of such pools would remove the potential for cross subsidies between the relevant sectors.

Levy base

The proposed levy base for each pool would correspond to the value of covered liabilities (for deposits and annuities) or to the value of premiums for covered products (for risk products). This would provide a mechanism for allocating scheme costs among remaining participants within a sector according to their market share. This is intended to ensure, to the extent possible, that those

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[1] The Australia-US Free Trade Agreement, which commenced on 1 January 2005, provides for US life insurance companies to operate branches in Australia.

institutions (and hence their customers) which do not stand to benefit from the scheme (as they do not offer protected products) are not required to contribute.

Levy rates

The scheme administrator should determine flat-rate contributions as a percentage of relevant deposits or percentage of relevant premiums, with reference to the relevant funding base and each contributor's share of that base. The timeframe for determining and calling contributions should be flexible, subject to annual limits on collections (see below).

Annual limits on collections

The legislation would establish upper limits on the total amount that could be collected in a given year. Subject to these limits, total collections should recover the net (of expected recoveries) compensation payments plus interest and administration expenses for each event. Where recoveries occur over a number of years, the relative contributions should be recalculated for changes in market share. If in a given year the scheme realises recoveries in excess of its costs, it could refund the difference to the industry based upon its contribution history.

Disclosure requirements

A product labelling and disclosure system is proposed to require financial service providers offering financial products to eligible customers to disclose whether the product is protected by the scheme. A combination of 'positive' and 'negative' disclosure is proposed.

The positive aspect would require disclosure to those consumers covered by the scheme.

Negative disclosure may be appropriate where consumers are not covered by the scheme because the product they purchased was issued by an entity outside this jurisdiction, but would otherwise have been covered if it had been issued domestically (for example, for deposits with branches of foreign ADIs and insurance purchased from a direct offshore foreign insurer). It is not proposed that there would be a general negative disclosure obligation for other products wholly outside the scheme (for example, investment-linked products). Disclosure would also be required in relation to wholesale products provided to eligible customers.

Disclosure should be required through existing mechanisms, where available. It is proposed that the content of disclosure would be a short, simple prescribed statement to the effect that the product is covered and to explain where further information can be obtained.

Governance principles

Legislation

If the scheme is to operate independently, it needs legislation which specifies its governance and operational arrangements. This would include defining the powers, responsibilities and accountabilities of the scheme administrator as well as details of the scheme's coverage and sources of liquidity.

It is proposed that the scheme be established as a statutory fund with its own legal identity, backed by a special appropriation from the Consolidated Revenue Fund. In the case of ADIs, the RBA could meet initial liquidity demands, by providing the scheme with a loan whose repayment is guaranteed by Government.

The enabling legislation would define, and therefore limit, the scheme's coverage (for example, in terms of eligibility criteria, product coverage, coinsurance arrangements and limits on compensation). No additional restrictions on the size of the special appropriation are proposed, although it would be possible to impose a limit per event.

The *Financial Management and Accountability Act 1997* would apply to the use of scheme funds (because the initial source of liquidity is public money).

Establishing a special account would allow compensation payments, administration costs, recoveries and levies to be separately identified. For example, if recoveries were to exceed compensation paid plus administration costs, the surplus could be repaid to eligible customers. If a deficiency of asset recoveries was expected and levies were imposed, but ultimately the levies were found to exceed total costs, the surplus could be refunded to industry.

Independent administration by APRA

APRA's legislative remit would be broadened. It would appear possible to extend the existing powers and frameworks established by the *Australian Prudential Regulation Authority Act 1998* (for example, APRA's capacity to engage staff and consultants, protection from liability etc.) to enable APRA to perform the functions of scheme administrator. APRA would also need to be granted standards-making powers in relation to administrative matters associated with the scheme. These standards would require relevant regulated entities to maintain data that would allow for efficient administration should the need arise.

The remit would also need to allow APRA to sub-contract the actual operation of the scheme. For example, the scheme administrator would need to interact closely with any statutory manager, judicial manager or liquidator, or third-party service providers engaged by them. APRA would have the flexibility to determine whether such an external party could appropriately administer aspects of the scheme such as claims assessment, claims payment and claims recovery services.

APRA would be responsible for ensuring that any payments are made in accordance with the legislation and for arranging for the scheme's claims to be pursued in liquidation. It would also establish systems to initiate recovery action against erroneous payments and fraudulent claims (see Enforcement).

APRA's costs of administration would be recoverable through the scheme.

Use of third-party resources

APRA or an insolvency practitioner would be expected to perform all relevant functions following activation of the scheme. Hence, these parties may be the most obvious candidates for performing some of the scheme's operational functions, with appropriate oversight by the scheme administrator in the case of an insolvency practitioner.

In the case of a failed ADI, APRA or the statutory manager would be in control with a view to ensuring that depositors are paid out in advance of the liquidation process. Therefore, APRA or the statutory manager could be well placed to make or supervise payments under the scheme. The scheme would then participate as a depositor in any distribution of assets.

For life insurers and general insurers (under the proposed framework), a court appointed judicial manager would be in control of a distressed institution, with a view to determining and recommending appropriate resolution strategies. In this case, APRA, as the prudential regulator and scheme administrator, would be closely involved in the process.

If it is determined that the distressed insurer be placed into liquidation, the scheme's resources would be made available to the liquidator to pay out eligible claims once they are proven (that is, earlier than would normally occur). In this case, the liquidator may have engaged a claims manager to handle claims assessment and recoveries (claims assessment is also a prerequisite for payments under the scheme).

It may also be necessary for APRA to have the flexibility to engage a third-party eligibility assessor. As the scheme administrator, APRA could have discretion as to the appropriate course of

action for assessing eligibility and effecting payments. In some cases, it may be desirable to engage independent service providers than to enter into agreements with the liquidator and other participants.

The legislation would need to provide appropriate authorisation for these parties to receive or hold public money.

Audit

The scheme administrator should be required to engage an external auditor to review scheme operations (once the scheme has become operational).

Appeals

Appeals against decisions based on eligibility criteria or the quantum of a payment should be reconsidered by the scheme administrator in the first instance. That is, a different decision maker within the body engaged for eligibility assessment and claims determination purposes would reconsider the matter. Applicants could then have recourse to the Administrative Appeals Tribunal.

Enforcement

The scheme administrator should be responsible for initiating any civil actions for recoveries of payments in error and fraudulent claims.

The scheme administrator and other parties performing functions under the scheme should also refer relevant information to authorities for criminal matters.

Specific areas of consultation

Coverage of products

The precise specification of products that would be covered by the scheme remains to be determined, subject to the agreed parameters.

Determination of relevant compensation limits

Further information on the costs and coverage associated with various limits should guide a decision on this matter.

Design of levy arrangements

Industry input is required to finalise the form of the levy arrangements to ensure appropriate coverage. This would include considering whether to establish separate pools to avoid cross-subsidies between sectors.