Chapter 6: Observations on a last resort scheme

The conclusion reached in this report is that it would be inappropriate, and possibly counter-productive, to introduce a last resort compensation scheme at this stage. Nevertheless, given the attention afforded in the review to such a scheme, this chapter canvasses issues and provides views on the design and governance of a scheme should one be desired.

Ideally any last resort scheme would be integrated as far as possible with the schemes of last resort that are already in place in key areas of the financial sector, namely the National Guarantee Fund (NGF), the Financial Claims Scheme (FCS) and Part 23 of the Superannuation Industry (Supervision) Act 1993 (SIS Act).

6.1 The review was asked to consider the need for a statutory scheme of last resort to underpin the existing arrangements to provide assurance to retail clients of their ability to recover compensation for loss or damage attributable to misconduct of a financial services licensee. Such a scheme would be designed to provide retail clients with recourse to payment in circumstances where they are unable to recover compensation to which they are entitled from a licensed provider of financial services because the licensee has disappeared, become insolvent or otherwise has insufficient assets.

6.2 A scheme of the kind that has been canvassed would in effect extend or supplement the recourse already available to clients whose claims fall within the scope of other schemes of last resort such as NGF, FCS or Part 23 of the SIS Act.

6.3 Ideally a scheme of last resort for compensation would be integrated as far as possible with the NGF at least if not with the FCS and the last resort arrangements under Part 23 of the SIS Act. The existing last resort arrangements have developed in a piecemeal fashion and their amalgamation into a single scheme would have the advantages of clarity and efficiencies in both administration and cost. An integrated scheme would be simpler for consumers to interact with than multiple schemes.

6.4 That said, the report acknowledges the practical problems of implementing a single scheme in the short term given that the circumstances for recovery under each scheme vary significantly. Therefore, as a possible starting point, this chapter looks at issues that would arise with a stand-alone scheme.

6.5 There is a model for a comprehensive last resort scheme in the United Kingdom. The Financial Services Compensation Scheme (FSCS) provides a fund of last resort for customers who suffer losses, including from poor investment advice, and are unable to recover compensation because the service provider in question has stopped trading, has become insolvent or has insufficient assets. FSCS offers second tier protection for claims which slip through the first tier protection based on a mix of professional indemnity insurance and minimum capital requirements.

6.6 The review has had the benefit too of a submission by FOS on the design and structure of a last resort compensation scheme. Reference is made below to aspects of that submission.

6.7 While the reviewer does not recommend the introduction of a last resort scheme, this chapter provides his views on the elements of such a scheme should one be desired at any stage. The following aspects are addressed:

- purpose of scheme;
- liability standard;
- eligible claims;
- capping of payments;
- membership of scheme;
- scheme funding;
- authority for scheme;
- governance;
- systemic improvements;
- relationship to EDR schemes;
- relationship to existing schemes of last resort.

The key elements of a possible scheme are summarised in Table 6.1.

Table 6.1: Elements of a possible compensation scheme of last resort

Eligible claims	Retail client suffers loss or damage from a breach by a licensee of the relevant liability standard (breach of licensee's Chapter 7 obligations or related breach of contract or negligence) and licensee cannot be found, is insolvent or otherwise has insufficient assets. The scheme would make a decision on eligibility, including by reviewing awards made by a court or EDR scheme, and determine the amount of *compensable loss* on which a scheme payment would be based.
Payment of claims	Payments made under the scheme would be capped at a level lower than the amount of *compensable loss* in question. A suggested formula for this purpose is: • 70 per cent of the first $50,000 of the *compensable loss;* plus • 50 per cent of the next $130,000; and • no part of the award that exceeds $180,000. This would result in a maximum scheme payment of $100,000.
Membership base	All licensees who provide a financial service to retail clients would be required to be members, including APRA-regulated insurers, ADIs and trustees of superannuation funds.
Scheme funding	Members in a particular sector would contribute to an annual *compensation levy* if the scheme is dealing in that year with *compensable losses* that arise from licensees in that sector. The scheme would be post funded with levies 'ring fenced' to each sector. This means that members in a particular sector would not contribute to an annual compensation levy if the scheme is not dealing in that year with *compensable losses* that arise from licensees in that sector. Levies would be calculated on the member's *proxy revenue base*.
Authority for scheme	Scheme to be established by statute.
Governance	Members of the governing body would be appointed by and report through the Minister.

Purpose of scheme

6.8 A last resort scheme would be designed to underpin the existing compensation arrangements. It would enable retail clients to be compensated in circumstances where, by reason of the insolvency or lack of available financial resources of a financial services licensee with whom they have dealt, they are unable to recover loss or damage that is attributable to misconduct on the part of that licensee.

Liability standard

6.9 The current compensation arrangements are designed to support claims by retail clients based on a breach by a licensee of its obligations under Chapter 7 of the Corporations Act.

6.10 Accordingly, the standards of conduct and disclosure to which licensees are subject under the statute provide the starting point in considering the liability standard for compensable claims under a scheme of last resort.

6.11 As discussed in chapter 2, those standards go beyond the duties and obligations set out in Chapter 7 of the Corporations Act and require compliance with *financial services laws* more broadly including other Commonwealth, State or Territory laws dealing with conduct in the provision of financial services.

6.12 It is noted that a Treasury Paper in 2002 said it was not intended that the compensation arrangements cover the general obligation on licensees that they comply with *other financial services laws.*[1] Whatever the intention, the compensation arrangements do not appear to have been so limited in their application. It is suggested that the liability standard for a last resort scheme should be broad enough to encompass claims based on breach of other such relevant laws. In other words the liability standard should cover a breach of other financial services laws as defined in the Corporations Act.

6.13 There appears to be good reason also to go further and allow a last resort scheme to entertain claims based on negligence or breach of contract by a licensee in its provision of financial services to a retail client. Given the likely overlap in practice between the elements of relevant statutory and common law obligations, this would avoid fine distinctions and complex points of argument about the legal basis of a client's claim. Apart from complicating the claims handling process, such distinctions would be largely inexplicable to a consumer who is left with an outstanding claim based on a licensee's misconduct.

6.14 It is not proposed however that the relevant liability standard should extend to claims based on breach of general notions of fairness or obligations under the licensee's industry code of conduct, even though EDR schemes may make an award on this basis.

6.15 Nor is it proposed that the relevant liability standard should extend to claims based on loss from fraud that cannot otherwise be attributed to a breach of a licensee's obligations, negligence or breach of contract. For example, the liability standard would be met if the consumer were to establish that, in perpetrating fraud

1 The Treasury, *Compensation for loss in the financial services sector: issues and options*, September 2002 paragraph 189.

that resulted in consumer loss, the licensee had engaged in dishonest conduct in breach of section 1041G of the Corporations Act. The liability standard would not be met if the claimant is unable to establish that the licensee's actions were in a breach of its statutory or common law obligations.

6.16 The suggested liability standard, as discussed above, would approximate the position under the UK FSCS where a claimant has to make out an outstanding claim based on a 'civil liability' of a licensed firm.

Eligible claims

6.17 In order to qualify for compensation under a last resort scheme a consumer would need to establish not only a claim against a licensee for damages based on a breach of the relevant liability standard but also that a licensee was not in a position to meet the claim.

6.18 A scheme should be able to respond to a claim where it is satisfied the claimant suffered loss or damage from a breach by a licensee of the relevant liability standard and that the licensee is not in a position to compensate the claimant for that loss. This could be on the basis that the licensee is:

- insolvent or bankrupt;
- cannot be contacted at its last place of business and reasonable steps have been taken to find it (that is, it has disappeared); or
- is otherwise unable to pay its liabilities.

Where satisfied that a licensee is in this position the scheme would declare it to be in default, thereby paving the way for possible claims by other clients.

6.19 Given that the current compensation arrangements are designed for the protection of retail clients, it might be expected that a scheme of last resort would be confined to claims by parties who satisfy the definition of retail clients under the Corporations Act. In principle this approach makes sense. It is noted however that this would be a difficult test to apply in practice. An alternative approach, along the lines of the UK FSCS, would not require claimants to establish that they were retail clients but would rely on the capping of payments under the scheme to limit the exposure of the scheme to any claimants who may be regarded as non-retail. In any event, any changes to the relevant definitions in the Act, arising from the current Treasury review, could affect the practicality of relying on the definition of retail clients to limit eligible claimants.

6.20 If a scheme is intended to benefit only retail clients, another more straightforward approach might be to rule out claims that exceed say $500,000 (that figure being a relevant threshold in the statutory distinction between wholesale and retail clients). This approach is used by EDR schemes to determine whether or not to accept a dispute as one with a retail client. For example, the terms of reference for FOS provides that a dispute is outside the jurisdiction of FOS 'where the value of the applicant's claim in the dispute exceeds $500,000'.[2]

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2 FOS Terms of Reference, 1 January 2010 (as amended 1 January 2012), paragraph 5.1(o)

Decision making by scheme

6.21 The scheme would need to satisfy itself that an earlier award of a court or EDR scheme was based on a breach of the liability standard. This review process might result in the scaling down of an award so as to recognise only that portion of the award attributable to a breach of the relevant liability standard, and to exclude any punitive damages or costs.

6.22 A last resort scheme should be in a position to assess for itself the merits of claims for compensation. This would include the eligibility of the claimant, the existence of relevant liability to pay compensation on the part of a licensee, the licensee's inability to meet that liability and the amount of the compensable loss.

6.23 The scheme in its discretion would determine the *compensable loss* eligible for last resort payment. This is the amount, or proportion, of the consumer's loss that relates to the licensee's breach of the relevant liability standard.

6.24 The scheme would not expect a claimant to go through a court or EDR process before submitting a claim to the scheme. The scheme would be able to take into account but would not be bound by an award of compensation already made by a court or an EDR scheme.

6.25 FOS suggested in its submission that the scheme should pay out individual unpaid awards made in favour of a claimant by an EDR scheme. In its view a re-evaluation of the eligible claim by the scheme 'would add significantly to costs and professional resources required and add major delays to the delivery of compensation [and] would also require further explanation to consumers who are already distressed'.[3]

6.26 While those concerns are understandable, it is important that a scheme make an independent judgment about a consumer's entitlement to a last resort payment, and the amount to be paid. Given that the cost of payments under the scheme will be transferred to other licensees who are not at fault, the scheme itself should be accountable for decisions on the payment of last resort compensation. As a practical matter, the existence of an earlier EDR award or court decision may facilitate the scheme's decision making but it should still go through the process. Also, once a licensee is found to be in default, it would make more sense for further claims to be brought direct to the scheme, rather than referred back to an EDR or a court process.

6.27 This approach would be consistent with that of FSCS in the United Kingdom which in making its own assessment of the merits of a claim may have regard to court decisions or ombudsman determinations but does not give effect to them as such.

6.28 FSCS makes its own ruling on a firm's insolvency or incapacity to pay without waiting for insolvency or bankruptcy to be formally declared. It considers the eligibility of a claim for compensation under its rules. It gathers and examines evidence of conduct, and look at the client's attitude to risk to determine whether advice given was suitable to the client's needs. FSCS must be satisfied there was a financial loss for which the firm is civilly liable. FSCS may have regard to a decision or determination of a court or ombudsman in its assessment of the merits of a claim.

3 FOS submission 2009, prepared by Professional Financial Solutions Pty Limited, *Proposal to Establish a Financial Services Compensation Scheme*, October 2009, page 13.

6.29 It is noted also that, in the decision making and review mechanisms for a scheme of last resort, care would be needed to ensure it is based on the exercise of administrative powers rather than judicial powers which would risk the scheme being invalid on constitutional grounds (see also 'authority for scheme').

Transfer of disputes from EDR schemes

6.30 It is expected that a dispute being handled by an EDR scheme would generally be transferred to the last resort scheme once a licensee was declared to be in default. Arrangements could be made between the last resort scheme and EDR schemes for the continued handling or transfer of claims that are in train when a licensee is found to be in default.

Time limit for claims

6.31 There would need to be a time limit for the bringing of claims in the interests of manageability of a last resort scheme. It would be reasonable to expect consumers to bring their claims within a period of say one year of the licensee's default or insolvency. Once a licensee is found to be in default it would be appropriate for the scheme to publicise that fact in order to draw out other claims. This process would bring some finality to the calculation, funding and settling of *compensable losses* arising from the misconduct of an insolvent licensee member of the scheme.

6.32 Also, a last resort scheme would ordinarily be expected to operate prospectively and deal only with claims from defaults arising after the scheme comes into place. While this could lead to harsh results for some consumers, the introduction of transitional arrangements to enable a scheme to accept claims arising within a limited time before its introduction would complicate the funding of the scheme by industry. No matter what approach is used, there is likely to be some arbitrary divide between consumers who are able to bring claims and those who are not.

Capping of payments

6.33 It is suggested that, as a matter of principle, payments under a last resort scheme should be less than the *compensable loss* calculated for an eligible claim and that payment should also be subject to an upper limit, or dollar cap.

6.34 One reason for this is to lessen the risk of moral hazard if consumers make decisions in the knowledge that compensation will be available on a last resort basis in the event of any misconduct on the part of the licensees with whom they choose to deal.

6.35 It has been argued that the existence of a scheme could result in riskier conduct by licensees too given that their clients will have recourse to compensation. It is questionable however whether this is likely to be the case where access to compensation under the scheme will depend on the financial failure of a licensee, particularly if the licensee is required to have more 'skin in the game' (as proposed in this review).

6.36 A second reason is to contain the cost of the scheme that will be funded by licensees who were not themselves responsible for the consumer losses in question.

6.37 It is proposed therefore that payments under any last resort scheme should be limited to a proportion of the compensable loss up to a specified cap. The actual payment formula would be a matter for judgment, with a range of options possible.

6.38 In its submission, FOS proposes a maximum compensation payment linked to the compensation cap ($280,000) that applies to EDR schemes for investment related complaints. It suggests a payment formula of:

- 90 per cent of the first $120,000; plus
- 70 per cent of the next $80,000; plus
- 50 per cent of the next $80,000.

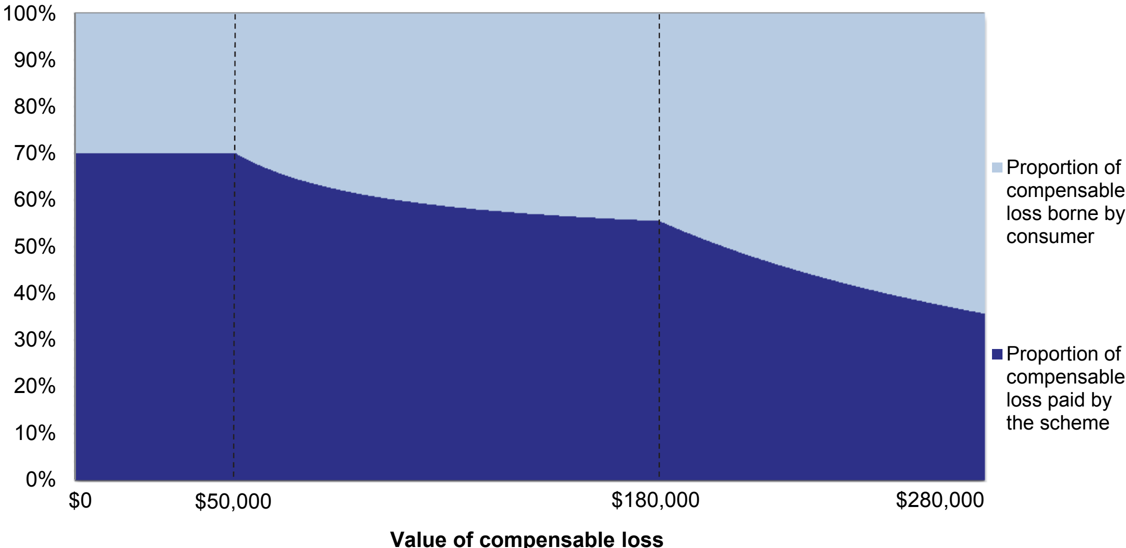
This formula would allow a maximum scheme payment of $204,000.

6.39 It is suggested that, as a starting point, a more modest payment formula would be appropriate. For example:

- 70 per cent of the first $50,000 of the *compensable loss;* plus
- 50 per cent of the next $130,000; and
- no part of the award that exceeds $180,000.

This formula would allow a maximum scheme payment of $100,000. The proportion of a *compensable loss* that would be paid under this approach, and the proportion that would remain unpaid for a compensable loss up to $280,000, is shown in Chart 6.1.

Chart 6.1: Proportion of compensable loss paid by last resort scheme



6.40 By way of comparison, FSCS provides a maximum recovery of 100 per cent of a claim up to £50,000 per claimant (£100,000 for couples). It is understood that around 95 per cent of compensation claims fall within the cap.

6.41 A scheme should also have discretion to make payments of lesser value than would be calculated under such a formula or to stagger payments over (say) a two

year period. This might be necessary where the scheme is faced with large-scale claims that exceed the maximum funding that could be levied in any one year.

Timing of payments

6.42 It would be desirable for the scheme to be able to compensate a claimant promptly once it has been determined that a licensee is in default and that a compensable loss has been suffered. If the scheme is to operate on a post-funded basis it would need the capacity to borrow funds or levy members on an interim basis. Once a scheme has operated for a few years, it will be better able to estimate the average annual working capital it requires and where necessary impose interim levies on that basis.

6.43 The scheme should have discretion to spread payments to claimants over two years or more if dealing with an insolvency that has caused loss to numerous consumers.

Membership of scheme

6.44 It is envisaged that a scheme of this kind would be funded by industry, with membership required as a licensing condition for licensees who provide financial services to retail clients. Adherence to the scheme would be part of the overall compensation arrangements required of licensees.

6.45 Consideration needs to be given to the sectors of the industry that would be required to participate in funding the scheme and to the allocation of contributions across those sectors. It is suggested that members should be categorised into appropriate sectoral groups and each sector should bear the primary responsibility for *compensable losses* arising within that sector. A sectoral approach is used for the purposes of collecting EDR scheme levies, though the composition of the sectors used for the FOS funding base may not be entirely appropriate for a last resort scheme especially in regard to the funds management sector (see scheme funding below).

6.46 Some submissions suggest that their sector should be excluded from a scheme based on their good track record with consumers - that is, either consumers have not suffered loss in dealing with the sector, or have been compensated.[4] The argument put forward is that more financially secure or responsible sectors should not be expected to underwrite claims against licensees who are less well capitalised or have a poor track record with their clients.

6.47 Those submissions in effect support a narrowly based scheme that draws its membership from sectors that experience uncompensated consumer loss as a result of licensee insolvency.

6.48 While that approach is understandable, there is an argument that a viable last resort scheme would need a broad industry base and draw its licensee membership from all sectors that provide services to retail clients. This view is supported by some other submissions.[5]

4 ICA, NIBA and Stockbrokers Association of Australia submissions.
5 FOS submission 2011, Joint Consumer Submission and Professional Investments Services submission.

6.49 It is noted that trustees of self managed superannuation funds are not required to be licensed under the Corporations Act and would thus not be required to be members of a scheme. They may however be eligible to make claims under the scheme.

6.50 A broad base would give a scheme the capacity to make last resort payments in respect to unpaid awards of compensation arising from an insolvency in any sector should the need arise. Such a base would include licensees who are exempt from the need to hold professional indemnity insurance as an APRA-regulated insurance company or ADI.

6.51 It is accepted that there is a lower risk of failure within some sectors than in others. For example, prudentially regulated sectors (that is, general insurance, life insurance, ADIs and APRA-regulated superannuation funds) have to meet APRA capital and other requirements. These higher financial standards provide some further assurance that prudentially regulated licensees will not fail.

6.52 However, the prudential system refrains from providing a guarantee that an APRA-regulated entity will not fail. The Wallis Report noted this possibility in stating:

> The cornerstone of prudential regulation of [ADIs] and other regulated financial institutions is capital to provide a buffer against unexpected loss. In the absence of major, unexpected economic upheaval or regulatory failure, the prudential regulator should have adequate notice of financial distress before a capital deficiency emerges. In these circumstances, the regulator should be in a position to arrange the exit of the distressed institution, by merger or sale, before depositors' funds are put at risk. This risk, however, cannot be eliminated, especially in a world where technology is continually opening up new instruments, markets and risks.[6]

6.53 In recent decades there have been a number of large and notable failures in the financial sector. These include the collapse of the State Bank of South Australia and the State Bank of Victoria, the Farrow Group of building societies, the case of fraud and subsequent collapse of life insurers Occidental Life and Regal Life, and the failure of general insurers, the HIH Group of Companies (HIH). Some of these failures led to one-off support schemes for affected consumers, including a rescue package for HIH policyholders and a $900 million bail out of depositors implemented by the Victorian Government following the collapse of the Farrow Group building societies.[7] Some of these collapses occurred before the affected financial institutions were regulated under the current APRA regulatory framework.

6.54 The existence of FCS explicitly recognises that failure of prudentially regulated entities is a possibility since it provides depositors and policyholders with last resort compensation if their ADI or general insurer becomes insolvent.

6.55 Further, Chapter 7 of the Corporations Act requires all licensees who have retail clients to have compensation arrangements and does not exclude any sector from those requirements. Whilst the Corporations Regulation provides that prudentially regulated insurers and ADIs are not required to hold adequate professional indemnity insurance, it does not mean that these entities are exempt from the need to pay compensation to retail clients should they be liable.[8] The apparent rationale is that

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6 Financial System Inquiry, *Financial System Inquiry Final Report (Wallis Inquiry),* 1997, page 353.

7 The corporate group comprised the Pyramid Building Society, the Geelong Building Society and the Countrywide Building Society.

8 Corporations Regulation 7.6.02AAA(3).

insurers and ADIs are able to self insure any compensation liabilities that might arise because they meet APRA's prudential requirements.

6.56 The establishment of a scheme on a broad industry base would also facilitate a process of rationalising the several last resort compensation schemes for financial services. It would recognise a shared interest of all participants in the financial services industry in maintaining retail confidence in their market.

Scheme funding

6.57 Members of an industry sector would be subject to an annual *compensation levy* if the scheme is dealing in that year with *compensable losses* that arise from the insolvency of licensees within that sector. They would not have to meet a compensation levy if the scheme does not deal in the year in question with relevant *compensable losses* within that sector.

6.58 In order to provide licensees with some certainty, levies when required from the members of a sector should be limited to no more than a fixed percentage of their *proxy revenue base* (as explained below). FOS proposes in its submission a maximum levy rate of one per cent of the *proxy revenue base.*[9] Such an approach is adopted here for working purposes.

6.59 In the interests of equity and efficiency, and to limit the potential exposure of each licensee, it is suggested that levies should also be calculated with reference to minimum and maximum amounts (or 'floors' and 'ceilings'). The application of the 'floor' would mean that a member would not be asked to contribute an amount that is uneconomic to collect, whereas the application of the 'ceiling' would limit the maximum contribution expected from members with large revenue bases. For example:

- if one per cent of a member's proxy revenue base resulted in a levy below a minimum levy amount, the member would still be asked to contribute the minimum levy amount; and
- if one per cent of a member's proxy revenue base would result in a levy above the maximum levy amount, the member's contribution would be limited to the maximum levy amount.

In principle all members in the sector in which a *compensable loss* was recognised by the scheme would be required to fund the last resort payments to cover those losses.

Ring fencing

6.60 An important question is whether levies from one sector should be ring fenced and only used to compensate losses in the same sector or whether levies from one sector could in some circumstances also be used to support compensation in another sector.

6.61 In principle, the cost of a scheme should be spread amongst its members in the most equitable and effective way. If all member licensees contribute to the

9 FOS submission 2009, page 9.

compensation levies the cost is spread across a broader base and each member's share is lower.

6.62 Careful consideration would need to be given to the classification of sectors for the purposes of scheme funding. Broadly speaking each sector should include licensees that provide similar financial products and services, and are required to operate with similar professional indemnity insurance and/or capital requirements. This suggests that a sector should not mix prudentially regulated licensees with those that are not. Managed investment schemes for example should be grouped separately from APRA-regulated superannuation funds.

6.63 It needs to be borne in mind that levies upon APRA-regulated superannuation funds would be funded from the assets of those funds and would reduce returns to members. Therefore, it might be appropriate to contain levies from APRA-regulated superannuation funds to compensate losses in that sector rather than exposing member assets to levies to meet compensable losses in other sectors.

6.64 For these practical reasons a 'ring fenced' approach is supported. This means that members in a particular sector:

- would contribute to an annual compensation levy if the scheme is dealing in that year with *compensable losses* that arise from licensee insolvencies in that sector; and

- would not contribute to an annual compensation levy if the scheme recognises no *compensable losses* in that year arising from licensee insolvencies in that sector.

6.65 As a starting point, it is proposed that the following categories would be treated as separate sectors for the purposes of a scheme:

- general insurance;

- life insurance;

- APRA regulated superannuation funds (as noted above, self managed superannuation funds would not be subject to a last resort scheme);

- fund managers (other than APRA regulated superannuation funds, but including product issuers of pooled investment products such as managed investments);

- financial advice;

- authorised deposit taking institutions; and

- other credit providers.

It should be noted that the broad category of 'fund managers' currently used by FOS for its membership levies would be separated into two sectors – APRA-regulated superannuation funds and other fund managers.

6.66 Even with a ring fenced approach, consideration might be given to allowing a scheme flexibility in some circumstances to impose levies in a related sector. This might need to happen in a case where the insolvency of a licensee or licensees leads to compensation liabilities that exceed the capacity of the sector in question.

6.67 Any ability to draw on levies from another sector should be limited to cases where a linkage can be established between the sectors in question. For example, where *compensable losses* attributable to the financial advice sector exceeded the capacity of the sector to pay, the scheme might be empowered to seek a co-contribution from the funds management sector on the basis of that sector's reliance on financial advisers to distribute their products.

6.68 FSCS for its part has multiple layers of classes which allow levies to spill into a related sector should the need arise and ultimately to extend across all classes where last resort payments for a particular sector exceed the levy thresholds of that sector. Under FSCS:

- when a financial provider defaults, a levy is made first against that firm's sub-class up to its annual levy limit;
- if the compensation required exceeds that levy limit, the other sub-class within the class will be required to contribute up to its annual levy limit;
  - four of the five classes in the FSCS have sub-classes, such as fund management and intermediaries in the investment class;
- if the compensation required exceeds the annual levy limit from that class, all other classes are asked to contribute to a general pool.

This flexible approach allows FSCS to meet exceptionally high claims that exceed the capacity of a particular sector. In this respect, it goes further than the sectoral approach to levies in last resort schemes such as NGF, FCS and Part 23 of the SIS Act.

Proxy revenue basis for levies

6.69 All licensees would contribute to the establishment costs and operating costs of the scheme. In addition, member licensees would contribute to compensation levies if the scheme is dealing in that year with *compensable losses* that arise from the member's specific sector.

6.70 FOS and Professional Financial Solutions (PFS) have carried out work to estimate the possible revenue base for a scheme. This work is discussed below for indicative purposes.[10] It includes actuarial modelling undertaken by PFS of a funding model for a scheme. The Australian Government Actuary has given some assurance on the methodology used by PFS.

6.71 The PFS modelling uses a proxy revenue base for each sector to calculate the maximum funding base for the scheme given certain assumptions. It would calculate the specific levies for each member by reference to that member's proxy revenue base. Proxy revenue bases are currently used to calculate FOS membership levies. FOS members have accepted and used proxy revenue bases to produce a broadly equitable distribution of fees between sectors despite their varying income bases.

6.72 Where required, each member would contribute a levy of up to one per cent of its individual proxy revenue base, but subject to floors and ceilings as described above.

10 FOS submissions 2009 and 2011, with clarification provided to the review by FOS and PFS.

6.73 The operating costs of a scheme were estimated by FOS and PFS to be in the order of $3 million per annum.[11] This estimate assumed that the scheme would make last resort payments based on awards that had already been made by the courts or EDR schemes. The decision making process proposed in this report could add to the resources needed and costs of the scheme.

6.74 The modelling by PFS estimates that the scheme would deal with up to $12 million of compensable losses in an average year.[12] This estimate is based on FOS experience of uncompensated consumer loss under the current arrangements. As discussed in Chapter 2 it is difficult to verify this estimate independently and the measure has to be used with some caution. Whatever the total of compensable losses, actual payouts by the scheme would be reduced by the application of any capping formula.

6.75 The preventative measures proposed in this report, as well as the *Future of Financial Advice* changes for financial advisers, might be expected in time to place downward pressure on the size of compensable losses paid by the scheme.

6.76 The proxy revenue base for each sector and the maximum annual contribution that could be levied is shown in Table 6.2. The table shows the maximum contribution that could be levied upon each sector if one of the following alternative bases were applied:

- each licensee contributes one per cent of its proxy revenue base; or
- each licensee contributes one per cent of its proxy revenue base with a minimum individual contribution of $500 and a maximum of $250,000.

As discussed above, the possible application of floors and ceilings would be with a view to moderating the financial impact on the largest licensees whilst requiring even the smallest licensees to pay a tangible amount.

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11 In FOS submission 2009, a lower annual operating cost was quoted (page 17). It has been clarified with PFS that this was for a part year operating cost, and that their estimate for a full year operating cost is in the order of $3 million.

12 FOS submission 2009, page 16.

Table 6.2 Possible basis of sectoral funding for a last resort scheme [a]

Sector	Proxy revenue base	Maximum annual contribution based on levy of one per cent $ million	Maximum annual contribution based on levy of one per cent with a minimum of $500 and a maximum of $250,000 $ million
General insurance	20 per cent of premiums	$44 million	$12 million
Life insurers	20 per cent of premiums	$37 million	$5 million
Insurance brokers	100 per cent of brokerage fees	$20 million	$12 million
Funds under management [b]	0.7 per cent of funds under management	$102 million	$34 million
Financial advisers	0.3 per cent of funds under advice	$19 million	$8 million
Authorised deposit taking institutions	1.5 per cent of deposits	$178 million	$11 million
Other credit providers [c]	1 per cent of loan portfolio	$173 million	$14 million

Source: FOS submission using PFS modelling, and further information provided by PFS.

a The information in the table is based on FOS membership data collected on the basis of current FOS sectors for membership levy purposes.

b Data from the current FOS membership base does not separate 'funds under management' into APRA regulated superannuation funds and other funds under management (eg managed investment schemes). This classification might need to be reconsidered for an appropriate levy base for a last resort scheme.

c The current FOS membership base separates ADI business into 'deposit' and 'loan portfolio' with membership fees calculated on both proxy revenue bases for those entities that undertake both deposit taking and lending. This classification might need to be reconsidered for an appropriate levy base for a last resort scheme.

Post funding basis

6.77 As foreshadowed in the discussion of 'payment of claims', the scheme would technically levy its members on a post funded basis. This means that compensation levies if required would be sought once a year from relevant sectors to meet the scheme's known annual *compensable losses*. However, funding the scheme entirely on a post funded basis would put the scheme in the position of delaying payments to eligible claimants until the scheme received its annual funding levies or borrowed the required funds.

6.78 Therefore, the scheme might need the capacity to raise an interim levy based on an estimate of expected *compensable losses* from each sector within an annual cycle. The scheme would be expected to make such an estimate based on prior experience of *compensable losses* in that sector as well as its assumptions of the further loss not yet brought to the scheme from known licensee insolvencies. In this way the fund could effectively 'pre fund' a proportion of the levy to improve its cash flow to deal with likely *compensable losses* from a sector.

6.79 In practice a scheme might need to use a mix of interim and post-funded levies to meet the timing and size of compensable losses in a year.

Borrowing facilities

6.80 The scheme should have a borrowing facility to help it pay consumers ahead of funding from annual levies being received. Given the additional costs that would be incurred by borrowing, this facility might be used on a fall back basis.

Assignment of rights

6.81 The scheme should also take an assignment of rights from claimants who accept a last resort payment. This would put the scheme in the consumer's shoes as an unsecured creditor in the licensee's insolvency. Any amount recovered in such proceedings would be returned to the scheme, and the consumer would be entitled to any amount in excess of the last resort amount received under the scheme.

Funding large scale loss

6.82 In order to manage an exceptional incidence of *compensable losses*, such as following large-scale consumer losses from licensee insolvency, the scheme might need to reduce the payments made to individual claimants in order to ensure they were all able to receive some compensation within the scheme's available financial resources. Alternatively, the scheme might consider compensating claimants on the usual basis but spreading payments over more than one year.

6.83 There is no proposal for financial support by Government in the event that member levies or other funding were insufficient to deal with consumer loss.

Authority for scheme

6.84 A last resort scheme would need statutory backing in order to ensure its funding through the ability to impose levies on licensees.

6.85 All three of the other last resort schemes that operate in the financial system are established by statute, as is the Superannuation Complaints Tribunal (SCT).[13]

6.86 In the United Kingdom, FSCS operates as a company limited by guarantee established under the *Financial Services and Markets Act 2000*.

6.87 Having regard to constitutional constraints, care would need to be taken to ensure that in dealing with claims for compensation the scheme was exercising administrative rather than judicial powers. This points towards an approach whereby the scheme administrator would have a discretion, but would not be obliged, to compensate a consumer where satisfied that the preconditions had been met. This is broadly the approach followed under FSCS and Part 23 of the SIS Act.

Governance

6.88 Having regard to the power under the scheme to impose levies on licensees, as well as the importance of decisions on claims for consumers, there should be a clear line of accountability to government. While a body to administer the scheme might include individuals with relevant industry or other experience, appointments should be made by government and there should be appropriate reporting arrangements.

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13 The Financial Claims Scheme was established by the *Financial System Legislation (Financial Claims Scheme and Other Measures) Act 2008* which amended both the *Banking Act 1959* and the *Insurance Act 1973*. The National Guarantee Fund has its statutory basis in Division 4 of Part 7.5 of the Corporations Act (it was originally established by the *Australian Stock Exchange and National Guarantee Fund Act 1987*). The scheme for loss by APRA-regulated superannuation funds is established in Part 23 of the *Superannuation Industry (Supervision) Act 1993*.

6.89 The Superannuation Complaints Tribunal (SCT) provides a possible governance model. SCT is an independent dispute resolution body that deals with superannuation related complaints arising from decisions and conduct of regulated trustees and insurers in relation to a superannuation fund member. SCT is established by statute, and the chairperson and other members are appointed by the Government.[14] It reports annually to the relevant Minister and its report is tabled in Parliament. SCT's decisions are not subject to review by the Administrative Appeals Tribunal.

6.90 FSCS in the United Kingdom is a company established by statute and funded by the financial services industry through levies which are paid to the regulator in the first instance. FSCS provides its annual report to the regulator. Under proposed changes to the regulatory architecture expected to commence at the end of 2012, the dual regulators - the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) - will be jointly responsible for board appointments, with the chairman's appointment subject to approval by HM Treasury. FSCS will be required to produce an annual plan to be approved by PRA and FCA, and it will be subject to audit by the National Audit Office. The parties to a claim may request an internal review of an FSCS decision with final review by an executive director of FSCS.

6.91 It is noted that, under Part 23 of the SIS Act, formal decision making power lies with the Minister. It may be thought however that, under a broader scheme with potentially a larger volume of claims, it would be appropriate to delegate the administration of a scheme and the processing of claims to a board or authority.

Systemic improvements

6.92 A last resort scheme should be in a good position to assess the workings and any shortcomings in the compensation arrangements required of licensees. It could play a role in drawing the attention of industry bodies, regulators and government to areas that may call for systemic improvements.

6.93 The scheme could be required to provide feedback to stakeholders on systemic problems with a view to identifying ways in which licensee standards can be raised, the incidence of harm to consumers can be mitigated and claims against the scheme can be contained. This would be consistent with the requirement on EDR schemes to report any 'systemic issues' and 'serious misconduct' to ASIC.[15]

Relationship to EDR schemes

6.94 A scheme of last resort would be expected to establish a working relationship with EDR schemes. This might involve protocols between those bodies on operating procedures including the management of complaints that are being dealt with by an EDR scheme when a licensee goes into default.

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14 *Superannuation (Resolution of Complaints) Act 1993.*

15 ASIC Regulatory Guide 139, April 2011, paragraphs 109-32.

Relationship to existing schemes of last resort

6.95 The existing last resort schemes in the financial services sector have developed over the years in a somewhat piecemeal fashion. They are structured along different lines, are administered by different bodies, and have different rules and processes. The establishment of a further scheme of last resort within the same industry would add to the multiplicity of arrangements.

6.96 There will be a need at the very least to ensure the development of protocols for the guidance of consumers, as well as scheme administrators, in identifying the appropriate scheme to handle a particular claim.

6.97 Beyond that it would make sense to move to develop an overall framework that would encompass the various last resort schemes. While the rules for handling different categories of claims might vary, the overall administration and responsibility would be brought under one roof. This would lead to administrative and cost savings as well as providing more clarity for consumers.

6.98 FSCS provides a model for such a comprehensive scheme. FSCS is a single last resort scheme for financial services that provides similar coverage to NGF for customers of stockbrokers, to FCS in compensating deposit holders and policyholders upon the insolvency of a bank or general insurer, to Part 23 of the SIS Act for trustees of superannuation funds, and to a last resort scheme for compensation of consumer loss from licensee misconduct as discussed in this chapter. FSCS began operating in its current form in 2001 following the amalgamation of six sectoral compensation schemes.

6.99 The practical problems of bringing together three existing schemes that have been established on a piecemeal basis and a new scheme are not to be underestimated. Issues such as the treatment of funds contributed to NGF by brokers in the past would need to be resolved. This could possibly be addressed by ring fencing those funds for relevant categories of claimants. It is noted too that the last resort schemes under the SIS Act and FCS are not operated as separate entities like NGF, but rather on the basis of ministerial discretion.

6.100 The features of the current last resort schemes for consumers of financial products are summarised in Table 6.3.

Table 6.3: Current last resort schemes for consumers of financial products

	National Guarantee Fund	Financial Claims Scheme	Part 23 of SIS Act
Coverage	Client loss from dealing with market participant of ASX where the participant: • fails to complete a sale or purchase of securities; • makes unauthorised transfer of securities; • cancels or fails to cancel certificate of title to quoted securities; or • becomes insolvent and cannot meet obligations to client on property entrusted to participant.	Retail client recovery of protected deposits in the event their authorised deposit-taking institution (ADI) becomes insolvent. Eligible policyholders and other claimants are covered for the amount payable in respect of a valid claim by a general insurer when the insurer becomes insolvent.	Ministerial discretion to make grant of financial assistance to an APRA-regulated superannuation fund if the superannuation fund incurs a loss as a result of fraudulent conduct or theft and the Minister is satisfied that the loss caused a substantial diminution of the fund leading to difficulties in the payment of benefits, and that public interest requires a grant to be made.
Claimants	Wholesale or retail clients.	Retail depositors of ADIs, and policyholders of APRA-regulated general insurance companies.	Trustees of APRA-regulated superannuation funds.
Compensation limits	No cap on claims of compensation for loss arising in any of first three cases (other than the overall limit of the amount available to the fund); Where loss arises from stockbroker insolvency, compensation is limited to 15 per cent of minimum size of NGF (currently required to be $76 million).	$250,000 per depositor per ADI. For general insurance, APRA appoints a party, such as the failed insurer, a designated insurer or an agency, to determine payments based on a standard claims assessment process.	At Minister's discretion. The last grant of assistance made under Part 23 was for 100 per cent of the eligible loss. Previous grants were for 90 per cent of the eligible loss.
Funding	ASX participants (via past contributions to the former state exchange fidelity funds), and investment growth on this amount. There is provision for a levy mechanism should additional funds be required. No levy is currently imposed.	Recovery action through insolvency proceedings, and if assets insufficient, through industry levy on other ADIs or general insurers respectively.	Industry levy on APRA- regulated superannuation funds and approved deposit funds.
Administration	The statutory basis of this scheme is Division 4 of Part 7.5 of the *Corporations Act 2001*. Cases are administered and decided by the Board of Securities Exchanges Guarantee Corporation (SEGC) or its delegate.	FCS was established by the *Financial System Legislation (Financial Claims Scheme and Other Measures) Act 2008* which amended both the *Banking Act 1959* and the *Insurance Act 1973*. FCS is administered by APRA and the scheme is activated at the discretion of the Treasurer after APRA has applied to the Federal Court for the relevant ADI or general insurer to be wound up.	Part 23 of the *Superannuation Industry (Supervision) Act 1993* establishes the scheme which is administered by APRA. The Minister must seek advice from APRA and must be satisfied that the loss has caused a substantial diminution of the fund leading to difficulties in the payment of benefits and, if satisfied, must determine whether the public interest requires the grant of financial assistance and the amount of assistance.
Review mechanism	If the Board of SEGC disallows a claim, the claimant may appeal to the court within 3 months and the court may order the Board to allow the claim.	The founding statute does not establish a review mechanism.	The founding statute does not establish a review mechanism.

UK compensation arrangements

6.101 There is a model for a comprehensive compensation arrangement, including last resort arrangements, in the United Kingdom. It comprises a two-tiered compensation regime for losses arising from activities of financial services providers. Depending on their size and risk profile, investment firms have to meet a capital requirement as well as hold professional indemnity cover (first tier). There is also a fund of last resort, FSCS, for certain consumer claims (second tier).

6.102 Under the first tier, the minimum capital requirements for investment firms are risk-based and are dependent on the type of activity being undertaken (for example, an investment firm dealing as principal will be subject to more demanding requirements than one advising or dealing as an agent) as well as the nature of the assets on the balance sheet.

6.103 Professional indemnity insurance is another component of the first tier arrangements. Under an EU directive, insurance intermediaries (which include those arranging life assurance) must hold a minimum level of professional indemnity cover. It is also regarded as best practice in the UK for all investment intermediaries to have adequate professional indemnity insurance. Some categories of firms can choose to hold additional capital as an alternative to the prescribed levels of insurance cover.

6.104 Investment firms are required to meet the capital and professional indemnity insurance requirements set out in the relevant Prudential Sourcebook. The requirements are generally less onerous than those imposed on deposit-taking institutions such as banks and building societies, but can still be substantial as they are intended to reduce the impact of insolvency.

6.105 The second tier is FSCS which operates as a fund of last resort for certain customers of firms authorised by FSA to operate services of deposit taking, insurance, home finance, investments, and pensions and endowments. An individual or small business customer can look to FSCS for compensation in circumstances where a firm against which it has a claim is insolvent or is otherwise unable to meet the claim, being a claim based on civil liability arising from bad investment advice, poor investment management, misrepresentation, fraud, or failure to return the invested funds of the claimant.

6.106 Where a claimant is compensated under FSCS, its rights against the firm with which it dealt are assigned to FSCS which can pursue recovery. If FSCS recovers more from the firm than it paid out under the scheme it returns the excess to the claimant.

6.107 The scheme is funded by levies on firms authorised by FSA. The levy model covers five broad classes of financial services providers, each with its own annual levy limit. When a financial provider defaults, a levy is made first against that firm's class up to the levy limit. If the pool of compensation required exceeds that levy limit, other classes of providers are asked to contribute up to their own annual levy limits. This cross subsidisation from other classes provides a general pool which is currently over £4 billion. The levies are collected on a 'pay as you go' basis to meet the amounts known or likely to be required each year.

6.108 Recently FSA announced that it will resume a review of the funding model for FSCS which will look at issues such as the composition of the funding classes,

the levy thresholds applicable to each and their tariff bases.[16] FSA expects to consult interested parties in the first half of 2012.

Operation of UK arrangements

6.109 The effectiveness of the first tier requirements in protecting consumers is hard to gauge. Professional indemnity cover is not a product which is intended to protect consumers directly. It is designed to cover the liability risk of the insured (the investment firm) and in so doing may enable consumers to recover from the firm. The regulator pays attention to the financial adequacy of firms as well as their insurance cover.

6.110 The effectiveness of FSCS appears to have been more robustly tested following the global financial crisis and global downturn.

6.111 FSCS received 24,301 claims in the investment sub-class in 2009-10 compared with around 4,000 in the previous year. This class of claims represented by far the largest proportion of the total of 31,592 claims across all classes. The significant increase in investment claims is attributable in large part to the number of claims received following the failure of Keydata Investment Services Limited, Pacific Continental Securities (UK) Limited and Square Mile Securities Limited.

6.112 FSCS processed around 15,000 claims in the same period and 90 per cent resulted in payout offers. The average compensation payment was £10,799.[17] According to FSCS's annual report, most of the claims were in relation to the mis-selling of investment products such as pensions, 'penny' shares and endowment policies. Further details of FSCS are provided in Table 6.4.

16 Financial Services Authority (UK) Media Release, 3 October 2011. The statement says the review initially started in 2009 but was put on hold.
17 FSCS Annual Report 2009-10.

Table 6.4: UK Financial Services Compensation scheme

Scope

FSCS works as a fund of last resort for certain customers of firms, authorised by FSA, which provide deposit taking, insurance, home finance, investment, pension and endowment services.

Claims may be brought by retail and small business customers.

Grounds for compensation

A customer can look to the scheme for compensation where a financial services provider is unable to pay claims against it because it has stopped trading, has insufficient assets or is insolvent. Claims against a firm that is still trading must be dealt with by the firm or the Financial Ombudsman Service.

For investment claims, FSCS provides protection where:

- an investor suffers a loss giving rise to a civil liability based on bad investment advice, poor investment management, misrepresentation or fraud; or
- an authorised firm cannot return investments or money owed to a customer.

For claims based on inappropriate advice, FSCS only pays compensation for actual (or direct) financial loss that is essential and fair (to put the consumer back in the position he or she would have been in but for the advice). The Financial Ombudsman Service, on the other hand, may also order a firm to pay for 'distress and inconvenience' (or indirect or consequential loss).

Compensation not available

Compensation is not available where:

- the claimant has not suffered financial loss;
- an investment has not performed well;
- the financial services firm did not cause the financial loss;
- the financial services firm is still trading and has sufficient resources to meet a claim itself;
- the firm is no longer in business but it (or its owners) are still able to pay the claim.

Conditions

Claimants may be asked to assign their rights against the financial services firm to FSCS. Any recoveries by FSCS through the exercise of those rights, in excess of the compensation paid, are returned to the claimant.

Assessment of claims

FSCS considers the eligibility of a claim for compensation under its rules. FSCS has regard to guidance from the regulator where relevant and discusses approaches with the Financial Ombudsman Service and relevant trade bodies.

In considering a claim based on inappropriate advice, FSCS gathers and examines evidence (from the consumer, as well as client files and information from the product provider) and looks at the consumer's attitude to risk and investments to establish whether:

- the advice to invest in the product was suitable for the needs of the consumer at the time; and
- the consumer was advised of the risks associated with the product.

To proceed with the claim, FSCS must be satisfied that there is a financial loss for which the firm is civilly liable.

This assessment process is followed whether or not a court or the Financial Ombudsman Service has made a decision in favour of the claimant. While FSCS's rules do not specifically recognise court decisions and ombudsman determinations, FSCS is not precluded from having regard to a decision or determination in its assessment of the merits of claim.

Compensation payable

The maximum recovery in relation to firms declared in default on investments is 100 per cent of the claim and not more than £50,000 in the aggregate for all types of claims (per investor, per defaulting firm).

Funding

The scheme is funded by levies on firms authorised by FSA. It also receives recoveries and has access to borrowing facilities.

Separate levies apply to each of five broad classes (deposits, life and pensions, general insurance, investments and home finance). The latter four classes have two sub-classes made up of firms which are either providers or intermediaries and:

- engage in similar styles of business with similar types of customers; and
- share a common interest in protecting their collective good name.

(A firm could belong to more than one sub-class according to the activities it undertakes.)

A firm's contribution reflects the levy applicable to its sub-class and the level of the firm's activity (for advisers, the basis is commission and fee income).

The model operates on the basis that a sub-class will meet the compensation claims from defaults in that sub-class up to its levy threshold. Once a sub-class reaches its threshold the other sub-class within the class will be required to contribute to any further compensation costs up to its own threshold for the class.

The levy limits for each class are:

- deposit - £1,840 million;
- general insurance - £970 million (£775 million for providers and £195 million for intermediaries);
- life and pensions - £790 million (£690 million for providers and £100 million for intermediaries)
- investment - £370 million (£270 million for fund management and £100 million for intermediaries); and
- home finance - £130 million (£70 million for providers and £60 million for intermediaries).

A final layer of cross-subsidy is available from the general retail pool, through which all other classes support any class which has reached its threshold. The general retail pool has an aggregate capacity of approximately £4.03 billion.

Firms pay a Management Expenses Levy which comprises base costs (not dependent on levels of activity) and specific costs (the costs of assessing claims and making payments). The overall management expenses levy limit (that is, the limited amount that FSCS can levy without further consultation) for 2010-11 has been set at £1 billion.

Levies are collected on a pay as you go basis to reflect the amounts known, or likely, to be required each year to provide liquidity for timely payment of compensation claims.

Governance

The compensation scheme is operated by FSCS, a company limited by guarantee and established by FSA under the *Financial Services and Markets Act 2000*. FSCS is independent of the government and the financial industry. It is independent of FSA in decision-making but is accountable to it as FSCS's rules are made by FSA and included in the compensation section of its Handbook.[18]

Board appointments are made by FSA with HM Treasury approval for the Chairman .

18 Financial Services Authority (UK) *Handbook.*