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Dear Ms Smith

Compensation for Loss in the Financial Services Sector: Issues and Options

The Association of Superannuation Funds of Australia Ltd. (ASFA) welcomes the opportunity to make this submission to the Commonwealth Treasury on *Compensation for Loss in the Financial Services Sector: Issues and Options*.

ASFA is a non-profit, non-political national organisation whose mission is to protect, promote and advance the interests of Australia's superannuation funds, their trustees and their members. Our members, which include corporate, public sector, industry and public offer superannuation funds, account for more than 5.7 million member accounts and over 80% of superannuation savings.

Attached is a paper that outlines some issues and options in terms of implementing a compensation for loss regime with particular focus on its impact on superannuation funds.

If you have any questions or comments on the items raised in this submission, please feel free to contact me on 02 9264 9300.

Yours sincerely,

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Comments from ASFA on “Compensation for Loss in the Financial Services Sector: Issues and Options”

1. Introduction

Confidence in superannuation and related financial services system is bolstered through the provision of:

- Independent complaint procedures that can investigate and resolve most matters of complaint;
- Trustee or professional indemnity liability insurance to cover certain areas of operational risk;
- Availability of compensation arrangements in certain limited circumstances of: fraudulent activity, theft, or dishonest acts.

In the case of superannuation where compulsory payments are involved it is essential to have trust and confidence in the integrity of the system. Superannuation, unlike some other financial products, has benefited from having a robust set of mechanism to deal with instances of loss, particularly access to the Superannuation Complaints Tribunal (SCT) and payments under Part 23 of the *Superannuation Industry (Supervision) Act 1993* (“SIS”). To augment these mechanisms, ASFA also supports the introduction of a requirement for a superannuation fund trustee seeking an AFSL to hold trustee liability insurance, as a means of meeting their section 912B obligations.

It does need to be acknowledged that the payment of compensation to one party often involves a redistribution of benefits from other fund members or other funds. Many super funds are run on a not-for-profit basis where the members bear all of the cost – therefore any additional cost or levy impacts directly on their retirement benefits.

The scope and nature of the compensation for loss payments therefore need to be limited to those cases where breaches of the SIS or the Financial Sector Reform legislation have occurred and the Fund or adviser is unable to make payments as a result of fraudulent behaviour. Currently, this is covered by Part 23 of the SIS Act. We support some modest changes to this system to streamline the decision-making process.

Most other “lesser” complaints of loss should be dealt with through:

- Internal and external complaint handling processes (the SCT or approved external dispute resolution scheme);
- The professional indemnity provisions of the fund or adviser.

These provisions and mechanisms need to remain accessible to consumers and transparent in their operations.

With these avenues for redress in place it is ASFA’s view that the creation of a funded compensation regime is unnecessary and potentially counter-productive. Any genuine

gaps in the current compensation regime should be addressed through suitable renovation of those structures.

2. Superannuation Products

2.1 Nature / scope of part 23 SIS

ASFA notes that the scope of the Review excludes the loss of superannuation fund monies which are covered separately by Part 23 SIS.

Part 23 SIS covers the loss of superannuation where this has been due to “fraudulent conduct or theft” and where it is determined by the Minister to be in the public interest to compensate for the loss.

Drawing on the experiences of recent investigations (particularly involving CNAL and the WA Independent Superannuation Fund), ASFA recommended a number of changes to these arrangements to ensure a more timely and efficient provision of compensation where it is warranted. It should be noted however that the delays in these cases resulted largely from the investigation processes of APRA and some other administrative and legal interpretation uncertainties (given the novelty of the process).

ASFA’s recommendations for reform include:

- Confirming that the threshold test of ‘fraudulent activity’ does not require a conviction in court;
- Establishing a substantial loss benchmark of 10-20 per cent;
- Capping compensation at 80-90 per cent of benefit lost;
- Providing compensation on an expedited basis;
- Transferring power to investigate and recommend whether it is in the public interest to make a payment under Part 23 to an appointed body rather than the Minister. The Minister would still make the decision.

ASFA continues to support such compensation requirements being funded through an ad hoc levy on the industry rather than through an annual levy or the establishment of a statutory scheme.

As detailed in the attached Appendix statutory funds require large overheads and infrastructure for the management and supervision of investing such a pool of funds. The establishment of such a statutory scheme has – in other jurisdictions – created confusion as to the role of other complaints bodies and has created a moral risk. The historic level of compensation and claims - within the superannuation industry - does not require the establishment of an ongoing statutory fund. It is more cost effective to levy such monies as required.

While ASFA supports the use of the levy, in part because it ensures confidence in the superannuation system, it should be remembered that, given the not-for-profit nature of many funds, the implicit costs of this arrangement are borne by other fund members.

2.2 Scope of the SCT

It also should be recognised that the SCT's jurisdiction in relation to superannuation is quite broad. It can, for instance, deal with all matters and decisions by the trustees except those regarding 'management of the fund as a whole'. It can, and has in the past, made determinations to compensate members who have suffered loss due to poorly executed retirement advice, where the adviser is linked with the trustee. The SCT can also deal with instances where poor advice or administration by the trustee has resulted in a loss. The ability of the SCT to deal with instances of loss (short of catastrophic loss due to fund failure) – should not be underestimated.

The SCT decisions and recommendations are binding on the Funds and typically cover such issues as:

- Disability claims;
- Death benefits;
- Issues relating to the disclosure of fees and charges, including agent misrepresentation;
- Distribution of surplus monies;
- Misrepresentation and malpractice by trustees.

In making its determination, the SCT is able to put itself in the shoes of the trustee. The lodging of a complaint with the SCT is free to the complainant, the SCT strives to minimise the need for costly legal involvement and the SCT has wide powers to subpoena documents and conciliate disputes. In making its determination, the SCT is able to place the complainant in a position in which they would have been had the trustee not failed to meet its obligations. In a determination against the trustee decision, the fund will likely pay the beneficiary for the loss incurred (including any foregone earnings). Failure by a trustee to adhere to a Tribunal decision can result in ASIC taking legal action and can lead to serious penalties for trustees including jail terms.

The operations of the SCT are funded by an annual levy on superannuation funds regulated through APRA.

2.3 Liability Insurance – Superannuation Funds

ASFA also supports a requirement for mandatory liability insurance for those superannuation fund trustees that acquire an AFSL. However, we would appreciate being able to consult with Government and ASIC on any specific requirements. ASFA is consulting with members on whether trustee liability insurance should be mandatory for all regulated funds.

In the wake of recent changes in the insurance industry ASFA is undertaking a review of the pricing and availability for such insurance across the industry and the nature of the coverage provided through such trustee liability insurance. Our review is aimed at some of the following questions:

- Scope of coverage required by trustees
- Scope of coverage currently available
- Any gaps in coverage – whether there is a need for amendment to legislation?
- Clarification of the insurance position in relation to advice provided by agents of the trustee.

3. Financial Advice

As noted above financial advice provided by fund trustees or their agents in relation to the produce provided by the trustee will be covered by the SCT, trustee liability insurance, or S.23 (SIS) arrangements.

However, activities related to independent / or other financial planners providing advice for the selection of a superannuation product and / or the rollover or investment of a superannuation payment into a non-superannuation product would not be covered under these arrangements.

The latter (non superannuation products) are separate from superannuation system but can impact on the confidence / integrity of superannuation products if consumers are poorly advised or sold products which do not best meet consumer needs.

In ASFA's opinion most of the issues / concerns are best resolved through the:

- Complaint procedures of FICS
- Licensing and professional indemnity insurance.

The establishment of an annual levy or standing statutory scheme is not appropriate.

3.1 Professional Indemnity Insurance for advisers

ASFA is aware that difficulties have recently arisen in regard to professional indemnity insurance for advisers.

Some current gaps and issues raised from a consumer's perspective include:

- Run off cover (for a set period, including a period for claims after the planners retirement);
- Non-avoidance / disclosure issues;
- Identification of insurer to the consumer
- Exclusions

In ASFA's view the government needs to establish minimum standards of cover required as a pre-requisite for obtaining a license. Because of the link in consumers minds between advice and superannuation products (even where the advice is independent of the fund), ASFA would appreciate the opportunity to be consulted on these standards. ASIC would also need to ensure the currency of this insurance on an annual basis as a license requirement, together with a valid membership of an approved complaints handling scheme.

3.2 Nature / Scope of Compensation Arrangements

As detailed above ASFA does not support a standing statutory scheme for potential compensation payouts as it is not warranted and:

- It creates a confusion re the role of complaint bodies;
- Involves redistribution costs between members and types of financial products;
- Creates a moral hazard;
- Requires substantial overheads and cost.

Appendix 1 – International Experience re Statutory Schemes

US Experience - Pension Benefit Guaranty Corporation (PBGC)

Since the introduction of the ERISA regime in 1974, the US has had the Pension Benefit Guaranty Corporation (PBGC), which protects and insures the benefits of some pension fund members.

Most private sector defined benefit funds are required to pay hefty annual premiums to the PBGC. As most defined benefit schemes in the US are pension paying, compensation is in the form of the PBGC assuming responsibility for pension payment. The payment is based on numerous criteria including the former fund's design and benefits, age of recipient and amounts recovered by PBGC from the former fund / employer.

Moral hazard has been a serious problem for PBGC. Significant reforms had to be introduced to the PBGC after employers exploited the PBGC system in corporate restructures during the 1980s. As a result, the PBGC liabilities ballooned and soon it had to manage a massive multi-billion dollar deficit throughout the 1990s. Premiums rose dramatically and benefit payment guidelines tightened. More recently, stronger economic performance and fewer corporate collapses have also contributed to the PBGC developing surpluses by the late 1990s.

The PBGC is a significant Government agency with responsibility for paying monthly pensions to 500,000 Americans. The PBGC now has over 750 employees to administer its programs.

UK Experience – Pensions Compensation Board (PCB)

The Pensions Compensation Board (PCB) was established as part of the regulatory regime (along with the Pensions Benefits Act 1995, OPRA and the Pensions Ombudsman) flowing out of the Pension Law Review Commission (PLRC). The PLRC was established in the wake of the collapse of the Maxwell funds in the early 1990s.

The PCB commenced operation on 6 April 1997, along with most of the Pensions Benefits Act regime. The Board consists of a part-time chairperson and two part-time members, appointed by the relevant Minister. The Board only meets when matters are before it and members are paid a flat daily rate when meeting.

The PCB is to be funded through a regular levy paid on a per member basis. However, as no compensation claims were made in the first two years of the PCB's existence meant no levy was administered for 1998/99, 1999/2000 or 2000/01. However, unlike the US PBGC, which only covers defined benefit funds, the UK PCB covers both defined benefit and defined contribution funds.

While the US PBGC's activities are focussed on wind-ups and employer insolvency situations, the UK PCB will also provide compensation when the Board has reasonable grounds to believe a dishonest act or gross incompetence has occurred and loss resulting occurred after 6 April 1997.

Generally speaking, in the case of defined contributions schemes, compensation is available when a plan has lost more than 10% of its assets through a dishonest act or gross incompetence. For defined benefit schemes, compensation is paid when the assets are below 90% of the Minimum Funding Requirement. Compensation up to 90% of the amounts lost is available to all defined contribution members and current members of defined benefit funds. 100% compensation is available in respect of members of defined benefit funds receiving a pension or within 10 years of retirement age.

Application is made in writing to the PCB by trustees, members or their representatives and must be made within a year of the loss, if known.

The PCB's first award was made nearly 2 years after its establishment. In July 1999, it determined to provide 90% compensation (33,300 pounds) in relation to the transfer of assets between two funds where dishonesty was found to be involved. More recently, an employer-sponsored fund with 300 members, is under investigation - 3 million pounds is alleged to have been misappropriated from the fund prior to the employer's insolvency in late 2000. The PCB intervened early to provide relief for pensioners affected.