

15 November 2002

Ms Ruth Smith
Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600
By e-mail: rsmith@treasury.gov.au

Dear Ruth

Compensation for loss in the financial services sector

I write to provide comments by Credit Union Services Corporation (Australia) Limited (CUSCAL) on the September 2002 Issues Paper *Compensation for loss in the financial services sector*.

CUSCAL is the main industry body for credit unions. Credit unions are Authorised Deposit-taking Institutions (ADIs) competing in the retail financial services market and providing a range of financial products and services to their members. Credit unions are mutuals – owned by their members, for their members.

Australia's 196 credit unions have total assets of \$25.7 billion and 3.5 million members. Credit unions' total capital as a proportion of risk weighted assets is 14.5%, well above the regulatory minimum.

CUSCAL agrees with the Issues Paper that compensation arrangements are justified for losses suffered as a consequence of the conduct of Australian Financial Services (AFS) licensees.

Consumers can suffer severe financial hardship, such as the loss of all their retirement savings, as a consequence of an intermediary's bad advice, dishonesty, failure to act, or unauthorised actions.

As the Issues Paper notes, "the primary purpose of compensation arrangements is to ensure there are assets to meet proved claims."^[301]

Compensation arrangements for retail clients of APRA-regulated bodies are provided for in the capital and risk management requirements imposed by prudential standards and prudential supervision.

CUSCAL supports consideration of an industry-funded statutory compensation arrangements scheme for non-APRA regulated AFS licensees.

Such a Scheme could be based on the model outlined in CASAC's September 2001 Consultation Paper *Retail Client Compensation in Financial Markets*.

We agree with CASAC that:

“Any expectation that this Scheme may allow retail clients to trade without risk (which would create a moral hazard) could be reduced by:

- ensuring that the scheme's limitations were widely understood, for instance that it:
 - only protects retail clients of intermediaries
 - only deals with the relationship between the client and the intermediary. It does not cover losses arising from poor investment choices (market risk), other than claims by the client against the intermediary for negligent advice concerning those investments
 - imposes limits on the amount of compensation paid, which may therefore require clients to bear some of the risk
- requiring retail clients who seek compensation to subrogate their rights, thereby preventing any individual from ‘double dipping’ against the funds of an insolvent intermediary.”

“Intermediaries would fund the Scheme. This may raise the concern that financially sound intermediaries are, in effect, collectively paying for the misconduct of insolvent intermediaries. However, if the Scheme's costs are sensibly limited and kept within internationally competitive levels through appropriate capping of claims, those costs to intermediaries will be justified by the benefits of a well-publicised, easily accessible, understandable and expeditious compensation scheme which can provide substantial protection for retail investors, and may also encourage their greater participation in financial markets.”

CUSCAL notes that CASAC's proposed Scheme would cover only “investments”, not deposits, superannuation and insurance.

APRA-regulated bodies

APRA regulated bodies, such as ADIs, are subject to detailed prudential standards and guidance notes and ongoing monitoring and supervision to promote safety and soundness.

APRA's prudential standards for ADIs cover capital, liquidity, credit quality, large exposures, equity associations and outsourcing.

APRA's prudential standard on capital adequacy says:

“Capital is the cornerstone of an ADI's strength. It provides a buffer to absorb unanticipated losses from an ADI's activities and, in the event of problems, enables the ADI to continue operating while those problems are addressed or resolved. The maintenance of adequate capital reserves by an ADI can engender confidence in the financial soundness and stability of the ADI by providing continued assurance that the ADI will continue to honour its obligations to depositors and creditors.

“Beyond the minimum levels of capital specified by this and the associated set of capital adequacy standards, it is the responsibility of the board of directors and

management of an ADI to make regular assessment of the ADI's capital adequacy to ensure that its capital resources are appropriate to the level and nature of *all* the risks to which the ADI is exposed.

“An ADI should have suitable systems in place to identify, measure and manage the risks associated with its activities, and to hold capital commensurate with its overall risk profile. As part of the process, the ADI should maintain and implement capital management plans setting out its overall strategy for managing capital resources over time. The capital management plan should be consistent with the ADI's overall business plan and should include actions and procedures for monitoring compliance with the required minimum capital ratio (including the corresponding minimum Tier 1 capital ratio). Trigger ratios should be set to alert management of, and avert, potential breaches to the minimum capital ratios.”

APRA's prudential standard on audit and related arrangements for prudential reporting says:

“It is the responsibility of an ADI's board and management to ensure that the ADI meets prudential and statutory requirements and has management practices to limit risks to prudent levels. The risk management practices must be detailed in risk management systems descriptions which should be regularly reviewed and updated (at least annually) to take account of changing circumstances.

“An ADI is required to provide APRA with high level descriptions of its key risk management systems covering all major areas of risks and keep APRA informed of all material changes to their risk management systems descriptions as they are made.”

APRA's preserved transitional prudential standard 4.1.6 covers operations risk for credit unions. The related Prudential Note 4.1(vi) says:

“Credit unions carry a range of operations risk in carrying out their day-to-day business. Many of these risks are insurable, others are not. Of particular importance in the latter category are credit unions' administrative systems and the consequences of breaches of legislation. In smaller credit unions, overdependence on a small number of key personnel can constitute a substantial risk to their operations. Other risks arise from litigation associated with a wide variety of possible events and actions, including discrimination, negligent advice and invasion of privacy. Whether or not these risks are insured or even insurable, credit unions must demonstrate an understanding of the risks involved and the capacity to measure, monitor and control them.

“An important source of insurable operations risk arises from potential damage to the physical assets of the credit union through accident or fire. While compulsory worker's compensation covers potential loss through accidents involving staff, there is a similar risk to members of the public that is not automatically insured. Other operational risks arise from the potential of legal action against the credit union or its directors.

“In addition to compulsory worker's compensation, all credit unions should carry effective insurance with a reputable insurance company to protect their personnel,

operations and physical assets. At a minimum, each credit union should carry the following insurance policies:

- (a) fidelity guarantee;
- (b) asset protection, including fire and malicious damage;
- (c) director' and officers' liability;
- (d) public liability;
- (e) professional indemnity; and
- (f) business interruption."

Conclusion

CUSCAL's position is that the prudential requirements imposed on ADIs minimise the likelihood of insolvency and maximise the availability of "assets to meet proved claims."

This meets the need for compensation arrangements for AFS licensees that are APRA-regulated. CUSCAL supports consideration of an industry-funded, statutory compensation arrangements scheme for non-APRA regulated AFS licensees.

We look forward to seeing a more detailed proposal from Treasury on this issue. I can be contacted on 6232 6666 if you wish to discuss CUSCAL's comments.

Yours sincerely

LUKE LAWLER
Senior Adviser, Policy and Public Affairs