Trustee Corporations Association of Australia

Compensation for Loss in the Financial Services Sector

Submission to Treasury

November 2002

1. INTRODUCTION

The Trustee Corporations Association of Australia is the national representative body for the trustee corporations industry in Australia. Its 17 member organisations include all of the Public Trust Offices and the great majority of the private trustee corporations.

Background information on the Association and the trustee corporation industry is provided in the Appendix.

The Association is pleased to offer comments on the Government's discussion paper *Compensation for Loss in the Financial Services Sector – Issues and Options.*

2. THE PROBLEM

The Association agrees that misconduct by financial services licensees leads to losses being suffered by retail consumers.

It is difficult to put hard numbers on this problem. Much inappropriate behaviour can be disguised when economic conditions are buoyant and investment inflows are occurring. It is in times of economic stress and liquidity crisis, particularly when accompanied by property crashes, that misconduct often becomes exposed.

Almost certainly, the losses are larger than suggested by ASIC and SEGC data, because regulators cannot reasonably be expected to pick up each instance of non-compliance or misconduct.

In this regard, it is instructive to recall the experience of trustee corporations which, prior to the introduction of the *Managed Investments Act 1998* (MIA), were charged with monitoring the activities of operators of managed investment schemes. In that role, trustee corporations picked up on a timely basis many, many instances of investors' funds being improperly used by fund managers, or attempts by managers to inappropriately charge various expenses against scheme assets. Some examples of that type of misconduct are shown in Attachment 1.

There is no reason to believe that such activity no longer occurs. However, it is likely that relatively infrequent, after-the-event checking by auditors and regulators will pick up only a portion of any inappropriate activity. As we have seen with unfortunate episodes such as the Commercial Nominees losses and the solicitors mortgage schemes debacle, even where misconduct is identified, it is often identified too late.

The Association feels that requiring financial services licensees to have in place appropriate compensation arrangements to cover losses due to misconduct is warranted. Such arrangements,

apart from promoting confidence in the financial system, are necessary to ensure fair treatment for consumers.

We suggest that qualification is required in respect of the assertion in paragraph 63 that if a financial services licensee linked to a bank or insurance company were to breach significant obligations to clients, there would be "*significant and immediate pressure on the relevant bank or insurance group to right the wrongs done as soon as possible."*

APRA policies mean that it should not be assumed that a bank would always come to the aid of a financially-troubled associate. Moreover, banks and insurance companies can and have failed. Unqualified, the paper's assertion might provide misleading comfort to investors.

3. PREVENTION

The Association submits that, while compensation arrangements are justified, prevention is far better than cure. A robust regulatory framework should therefore emphasise effective preventative measures that reduce the likelihood of misconduct arising in the first place, and hence the need for compensation.

For example, the Association has been arguing that investor protection would be strengthened in the managed investments and superannuation sectors by enhancing the present compliance monitoring function. This would entail:

- more frequent and timely monitoring of scheme operators' compliance with their obligations by an independent entity – this would minimise the likelihood of problems arising due to maladministration, negligence or fraud, and
- widening access to this role beyond accountants to other appropriately skilled and resourced service providers - increased competition in this area could be expected to put downward pressure on fees.

This, together with a requirement for scheme assets to be held by a custodian independent of the scheme operator, forms the basis for investor protection in almost all overseas economies.

We were pleased to see that the Government, in its recent response to the Superannuation Working Group's report on the safety of superannuation, supported recommendations to improve compliance by:

- permitting funds whose trustees might lack appropriate skills to "buy in" that expertise,
- requiring trustees to develop, and have audited annually, an appropriate Risk

Management Plan (RMP) for each fund they operate, and

- examining the feasibility of mechanisms for independent oversight of trustees' compliance with RMPs, and for reporting breaches to the regulator.

COMPENSATION MECHANISMS

The Association supports the view that the obligation to put in place appropriate compensation arrangements should rest with the financial service provider [paragraph 158]. The benefits of this approach are that it:

- encourages prudent operations - prudent operators will pay lower fees for insurance or other forms of compensatory underpinnings,
- provides more vigilant monitoring – insurers, lenders, providers of letters of comfort, compliance monitors, etc with their own funds and reputation at stake, are often more vigilant than regulators, as HIH has shown.
- minimises "moral hazard" - as noted in the discussion paper, the expectation of taxpayer bailouts creates moral hazard. It reduces the incentive for consumers and service providers to press for appropriate behaviour. This is because they can assume the impact of consumer losses will be borne not by them, but by some form of industry or Government "safety net".

  The result can be careless or reckless behaviour, because the safety net fractures the proper alignment between risk and reward. That is, if a high risk and/or low fee activity pays off, the participants keep the gain - if it does not, then any loss is mitigated by the safety net. The result is a clear bias toward risky behaviour. This risk should not be underestimated, as clearly demonstrated by the Savings & Loan crisis in the US in the 1980s.
- reduces taxpayer bailouts – this should very much be a last resort, and should be applied only after other substantial compensation has been paid by responsible participants, and should provide for total repayment of less than 100 cents in the dollar. Taxpayer bailout should be minimised, whether via general taxes, or via an industry levy that will ultimately result in higher fees and/or lower earnings.

Therefore, the Association believes that, in addition to the effective compliance mechanisms mentioned above, financial services licensees should be required to have adequate financial resources to underpin their operations, including to provide compensation for consumer losses due to wrongdoing by the licensees.

Those resources should comprise a minimum level of capital, together with professional indemnity insurance, or some other acceptable guarantee, commensurate with the nature and scale of the particular financial services business.

5. COVERAGE OF COMPENSATION ARRANGEMENTS

The FSRA is designed to protect consumers. The Association believes that the proposed compensation arrangements should be required in respect of all activities that fall within the FSRA definition of *"provides a financial service"*.

Consumers should not be denied compensation because the misconduct does not involve superannuation, as raised in paragraph 116 of the discussion paper.

Consumers should not be denied compensation depending on whether a licensee is solvent or insolvent [paragraph 120].

Consumers should not be denied compensation because the service provider is a funds manager [paragraph 125]. It is relevant that many superannuation funds invest in managed funds.

We believe that, in relation to paragraphs 126-127, it would be most consistent with the intent of the FSRA if compensation arrangements applied only where breaches arise with requested services covered by the FSRA, and are provided by entities licensed to do so (or their representatives). Such breaches would include losses as a result of an entity providing an unrequested service, whether or not that service is covered by the FSRA, and whether or not the supplier is licensed to provide that service.

FSRA compensation mechanisms should not apply where breaches arise with requested services:

- provided by entities not licensed to do so (this will encourage consumers to use licensed entities), or
- not covered by the FSRA (although the Association would support similar compensation arrangements being in place under other relevant legislation).

As regards the cause of a loss [paragraphs 129-147], we believe that the grounds for claiming against a licensee for losses should be broad, and thus favour option (vi).

Finally, given that APRA regulation does not and cannot preclude misconduct by a financial services licensee, we do not feel that such licensees should be exempt from the standard compensation arrangements [paragraphs 265-269].

Attachment 1

Manager Misconduct under the Collective Investments Regime

The Association is aware of many instances where the compliance monitoring function carried out by trustee corporations under the former collective investments regime picked up fraud and negligence by fund managers, large and small, thereby resulting in direct savings for investors.

Some examples include:

- a manager bought a property, then floated a unit trust in order to sell the property into it, and submitted claims for $7 million for work done in the short period that it had owned the property. The trustee found that over $750,000 constituted illegitimate claims, including accounts for work done on other properties and penalties for late payment of payroll tax.
- a manager sought to purchase for a trust a block of land adjacent to an existing trust-owned property. The trustee rejected the proposal after discovering that the manager had previously declined an offer to buy the property, but was now proposing to buy it, at a price some 30% higher, from one of the manager's executives who had recently exchanged contracts on the property.
- a fund manager proposed acquiring shares in a company which had recently made an unsuccessful share issue. Because the manager was also an underwriter of the stock issue, the trustee declined to authorise the purchase of the shares until the full impact of the underwriting shortfall had been absorbed by the market. As a result, the fund bought the shares later at a much lower price.
- a trustee, on discovering faulty methodology for unit pricing, commissioned a review by auditors and then required the manager to make good any losses to investors after fixing the pricing system.
- a manager submitted expense claims which, on review, were found to include golf club memberships, airfares for executives' wives to attend weekend conferences, and flowers for the chairman's wife. The trustee rejected those claims.
- a trustee company blocked a proposal by the manager to amend the trust deed in a way which exempted the manager from liability for losses caused "through its own negligence".

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Appendix

TRUSTEE CORPORATIONS ASSOCIATION OF AUSTRALIA

The Trustee Corporations Association, formed in 1947, is the national body for the trustee corporations industry in Australia.

It represents 17 organisations, comprising all 8 Public Trust Offices and all but 2 of the 11 private statutory trustee corporations.

The Association has a staff of 4 and operates out of premises in Sydney. It is controlled by a National Council, which comprises the Chief Executive Officer of each member institution, and an Executive Committee, comprising a small group of those persons.

Member products and services

In the 1870s, Governments first enacted legislation to extend the role of executor or administrator of an estate, traditionally taken on by a natural person, to licensed trustee corporations. This was to benefit the public by providing greater expertise and resources than are available from an individual, together with perpetual succession to a client establishing a long-term trust.

Today, trustee corporations provide a wide range of financial services to individual, family and corporate clients. Services include:

- **Traditional personal wealth management**

- Wealth protection and transfer
    - estate planning
    - writing wills
    - acting as executor of deceased estates
      establishing, and acting as trustee of, personal trusts, including testamentary trusts
    - preparing Powers of Attorney
    - administering client assets under Powers of Attorney
- Protecting vulnerable members of the community
    - by acting as guardian or financial manager, usually under Court order, for persons unable to look after their own affairs, including minors and the intellectually-disabled
- Acting as trustee of charitable trusts and foundations
    - including for medical research, galleries, museums, and education scholarships

- **Other personal business**

- trustee or administrator for small superannuation funds
- providing tax advice and preparing tax returns
- financial planning

- **Funds management**

- offering most types of unit trusts and common funds

- **Corporate activities**

- registry operations
- custodial services
- trustee for debenture and convertible note issues
- securitisation facilities
- compliance monitoring
- trustee or administrator for retail superannuation funds

Member organisation characteristics

- Reputation of trust, based on:
  - High professional and ethical standards
  - Prudent corporate governance
  - Specialist skills
- Providing security and peace of mind to clients, based on:
  - Over a century of experience
  - Continuity of operation, including operating perpetual trusts
- Quality customer service and advice, based on:
  - Courtesy and empathy
  - Integrated, competitive product offerings
  - Reliability of service delivery

Industry statistics

In aggregate, trustee corporations have about $300 billion of assets under administration, and capital resources of about $600 million. They employ more than 3,500 staff in over 90 offices around Australia.

Almost 2 million Australians have wills recorded with trustee corporations.

Each year trustee corporations:

- write about 60,000 wills and powers of attorney
- administer about 10,000 deceased estates
- administer assets under agency arrangements or guardianships for about 10,000 people
- prepare about 50,000 tax returns.

Association objectives

- To advance and protect the interests of beneficiaries of trusts and other operations administered by statutory trustee corporations
- To advance the cause of investor protection in the Australian financial system, by promoting the importance of independent review generally and independent compliance monitoring specifically
- To represent and advance the interests of member statutory trustee corporations
- To be recognised as an important group of non-banking financial institutions
- To provide professional education and set professional standards for officers of statutory trustee corporations

Association members

ANZ Executors & Trustee Company Ltd

Equity Trustees Ltd

Guardian Trust Australia Ltd

National Australia Trustees Ltd

Permanent Trustee Company Ltd

Perpetual Trustees Australia Ltd

Public Trustee for the ACT

Public Trustee New South Wales

Public Trustee for the Northern Territory

The Public Trustee of Queensland

Public Trustee South Australia

The Public Trustee Tasmania

Public Trustee Western Australia

Sandhurst Trustees Ltd

State Trustees Ltd

Tasmanian Perpetual Trustees Ltd

Tower Trust Ltd