Chapter 6: Guarantee scheme coverage

Overview

- A criteria-based approach has been used to explore the possible coverage of a guarantee scheme and allow cost estimates for any scheme to be modelled.
- The criteria proposed for determining coverage involve restriction to:
  - products that are supplied by prudentially regulated institutions;
  - 'capital certain' and 'critical' financial products issued by financial institutions; and
  - consumers who are unable to assess product risk.
- Designing a scheme necessarily involves tradeoffs between multiple objectives. The challenge is to balance concerns relating to such objectives as efficiency, equity, minimum complexity and minimum cost.
- Scheme design features which can assist in meeting these objectives include coverage limits, coinsurance or means testing.
- The vast majority of superannuation products would not be covered under the criteria proposed because they do not involve exposure to counterparty risk. Concerns about compulsory contributions being exposed to market and agent risk can be addressed by other means.
- An internationally suggested coverage level of twice average per capita income for deposit insurance would involve a cap of around $75,000, although survey data indicates that more than 94 per cent of households in Australia have deposit balances of less than $50,000.
- Insurance coverage levels would be expected to be significantly higher than for deposits, recognising the significant impact a failure would have on individuals with outstanding claims. A distinction between outstanding claims and loss of cover (associated with pre-paid premiums) may be made in determining coverage.

Design criteria

6.1 A discussion of the scope of any guarantee can be simplified by first considering some possible principles or design criteria. The Study has considered international experience and the structure of the prudentially regulated sectors of the Australian financial system in settling on the proposed criteria. These are also considered to reflect the broad direction provided by the Study's Terms of Reference, namely, to focus on limited explicit guarantees.

6.2 The criteria can then be used to illustrate the hypothetical range of covered institutions and products. This appears important as a test of the reasonableness of the criteria themselves; and has proven necessary to facilitate a more detailed discussion about the scope of any guarantee and in order to undertake preliminary modelling of costs.

6.3 The criteria and associated institutional and product coverage should be seen as a starting point for future debate rather than firm recommendations. They could readily be adjusted to reflect alternative assumptions.

Products that are supplied by prudentially regulated institutions or entities

6.4 A guarantee scheme has the potential to alter the incentives facing financial institutions, particularly if the pricing mechanism is not calibrated to take account of differences in risk. Institutions covered by a guarantee would need to be prudentially regulated to ensure that they continue to manage appropriately their overall risks and the risks they present to a guarantee scheme. In this way, prudential regulation, in particular capital adequacy requirements, can partially compensate for a lack of pure risk-based pricing.

6.5 Effective regulation and supervision will also limit the cost of a guarantee by reducing the incidence and severity of failure and, in some cases, resolving failures in ways that avoid claims on the guarantee scheme.

6.6 Restricting guarantee coverage to certain products offered by financial institutions regulated by the Australian Prudential Regulation Authority (APRA) reflects the need for prudential regulation. It should also preserve the ability for customers to take on risk through other products and/or other institutions.

‘Capital certain’ and ‘critical’ financial products issued by the financial institution

6.7 A guarantee scheme could be limited to only those products that are ‘capital certain’ promises backed by assets, and protected by the capital, of financial institutions. In other words, it might only apply to those products which are purchased without an objective of higher gains from risk-taking.

6.8 Such an approach means that products whose principal value fluctuates due to exposure to market risk would not be covered.[1]

6.9 The rationale for confining coverage to ‘counterparty’ risks, rather than market risks, is twofold. First, counterparty risks are impossible or extremely difficult for most individuals or retail consumers to judge in any cost effective manner. They are generally low probability, high adverse-consequence events. Second, market risk involves high probability, gain or loss events and is generally assumed knowingly by the consumer in pursuit of higher investment returns.

6.10 Only some capital certain financial products, specifically those which are essential or critical to participation in the modern economy, appear to warrant consideration for two reasons.

6.11 One is the difficulty individuals face in participating effectively in the modern economy without the use of such products.

6.12 The second is that broadening coverage beyond such a limited range would threaten the ability of the financial sector to provide the appropriate spectrum of risk-expected return choices necessary for efficient functioning of the economy, and inappropriately remove risk assessment responsibility from individuals in cases where they should perform that function.

6.13 Accordingly, the following coverage might result:

- Products consumers need to participate in the payments system, such as a transaction account with an authorised deposit-taking institution (ADI). The alternative of conducting all transactions with cash is generally infeasible.
- Products that allow consumers to save with minimum risk, such as basic deposit accounts, term deposits, some life insurance products and

1 Some deposit products may have their interest rates exposed to market risk. This complication might be addressed by a guarantee scheme applying to the principal and credited earnings but not any uncredited earnings.

retirement saving accounts (RSAs). Saving underpins wealth accumulation and facilitates larger, infrequent expenditures. Arguably, in accumulating such saving, most consumers are not looking to take on any appreciable degree of risk.

- Products that allow consumers to protect against the loss of an asset or the loss of an ability to earn income, such as life and general insurance risk products. Insurance is an effective way for retail consumers to protect their assets and income and is motivated by a desire to avoid risk.

- Products that allow consumers to draw down their savings in retirement without exposure to risk, such as guaranteed annuity or pension products. Some retirement income products allow people to convert their accumulated superannuation assets into a guaranteed regular income stream that will last for a given number of years or until death.

6.14 One implication of not covering investment or market-linked products is that superannuation products in the accumulation phase and those which are exposed to market risk in the retirement phase would not be covered. The reasons for this are examined in greater detail below.

Consumers unable to assess product risk

6.15 A guarantee scheme may limit eligibility for compensation on the basis of whether the consumer is a 'retail' or 'wholesale' consumer. In this context, the relevant features that distinguish a consumer as being either retail or wholesale are their capacity to assess the creditworthiness of the financial institutions offering the products they wish to purchase and/or their ability to guard against counterparty risk.

6.16 Such a distinction might also be made to target assistance to those perceived to be relatively worse off in the event of a failure.

6.17 As discussed previously, information asymmetry is a significant problem in the financial sector and is one of the main reasons why many institutions are prudentially regulated. It requires considerable skill and resources to assess the likelihood of a financial institution being able to honour its obligations in full at some point in the future. A wholesale consumer is one that is assumed to have the resources to make this assessment or to otherwise be able to off-load or diversify their risks.

6.18 In practice, drawing the line between retail and wholesale consumers is an arbitrary decision. Three ways that this distinction can be drawn are: by specifying the type of consumers that fall into each category; by means testing; or by applying thresholds to compensation payments, so that low wealth individuals receive relatively more compensation. Such a distinction has been made in other contexts.

6.19 Criteria for distinguishing between retail and wholesale consumers exist in the *Trade Practices Act 1974*, the *Corporations Act 2001*, and the *Australian Securities and Investments Commission Act 2001*. Criteria were also developed for the support scheme established following the failure of the HIH Group of Companies (HIH). In these contexts a combination of factors are used to make the distinction, such as the type of product being traded, the price of the product and the number of employees of the business that is buying or selling a particular product.

The practical scope of a guarantee scheme

6.20 Adopting the high-level design principles discussed above would limit any guarantee scheme coverage to:

- ***financial institutions*** regulated by APRA;
- ***products*** essential for participation in a modern economy where the principal or policy benefit is guaranteed by the supplying institution;
- ***promises*** where failure would involve materially adverse consequences not compensated for by a higher expected return; and
- ***consumers*** who are unable to overcome the information asymmetry problems that exist in the financial sector.

6.21 The types of products relevant for coverage would be those purchased for transaction, saving and risk protection services. Therefore, the discussion in this Report focuses on deposits and insurance.

6.22 Investment-type products either directly purchased or as part of some collective investment scheme (for example, unit trusts and superannuation funds) would be excluded. Consumers would be knowingly exposed to market risk and counterparty risk on these products and to agency risk on others. In the case of superannuation, alternative mechanisms to provide protection against agency risk may be appropriate given special characteristics, such as compulsion and preservation.

Additional design features to limit costs and adverse behaviour

6.23 Additional criteria might prove necessary to ensure administrative efficiency, that the costs associated with a guarantee are sustainable and to reduce the potential for adverse behavioural responses. In addition, practical considerations may affect design characteristics so that some of the criteria are not fully realised. For example, it may prove difficult to limit scheme beneficiaries to a subset of consumers or to apply differential treatment to a range of products issued by a financial institution.

6.24 It may prove sensible to apply slightly different design features to different sectors of the financial system.

Basis of coverage

6.25 One design question relates to whether a limited scheme should compensate consumers for each account or policy they hold, or on a per consumer basis, in relation to each failed institution.

6.26 Providing compensation on the basis of each account or policy, rather than on a per consumer basis may give rise to incentives to hold multiple accounts just below the threshold, but overcomes some problems in dealing with joint accounts.

6.27 Providing compensation on a per consumer basis may create incentives to diversify across institutions. Financial innovation in the form of a broker market for deposits of the maximum insured size (whereby brokers place wholesale funds from consumers in a portfolio of smaller insured deposits at different institutions) is the sort of response which might be expected.

6.28 Experience from overseas suggests a trend towards a per consumer, per institution basis. However, there are some exceptions to this general rule, with the United States (US) and Canada being examples, where separate, additional coverage is provided for the various capacities in which an individual might operate an account.[2]

Basis of participation

6.29 Participation in a guarantee scheme may be either voluntary or compulsory on the part of each of the financial institutions. Most schemes require all financial institutions in the relevant category to participate in order to avoid problems of adverse selection.[3]

6.30 Institutions are also generally not given the option to offer consumers the choice between guaranteed and non-guaranteed products (of the same category). If this were allowed, consumers may tend to use the guaranteed products offered by perceived riskier institutions and the non-guaranteed products offered by those institutions perceived to be relatively safe. This potential adverse selection problem could be overcome if it is possible to correctly price the levy applying to participating institutions according to their risk of failure.

Severity of loss

6.31 A guarantee scheme, where possible, should only compensate for losses that are significant. For example, at the time that an insurance company fails, a distinction could be drawn between its liabilities to those with outstanding claims and liabilities in terms of unearned premium revenue (unexpired policy cover). The losses for consumers in relation to the latter category are unlikely to be catastrophic (being limited to the value of premium paid), assuming that replacement cover is available from an alternative insurer at a similar price.

6.32 It may also be appropriate to set floors on the amount of compensation provided by any scheme to reduce administrative costs and to ensure that only the more severe losses are compensated. This seems most applicable to general insurance claims relating to relatively minor asset

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2 Separate cover is provided in relation to accounts held solely, accounts held jointly, accounts held in trust and accounts for retirement savings purposes.
Varying from a per consumer, per institution approach leads to problems in applying standardised thresholds. For example, the Federal Deposit Insurance Corporation (2001) illustrates how a family of four could, via a particular structuring of accounts, achieve coverage of $2 million of funds placed with one institution, despite a stated cap of $100,000 per depositor.

3 Adverse selection is the problem of parties who are most likely to produce an undesirable (adverse) outcome being the most likely to nominate for protection (or be selected).

damage. However, it would run counter to the approach most commonly taken internationally, whereby schemes fully compensate for losses up to some minimum amount and partly compensate for losses above this point.

Monetary limits

6.33 Most deposit insurance and many insurance guarantee schemes apply a monetary limit to the amount of compensation payable. The limit is usually lower for deposits than it is for general insurance, life insurance and pension schemes. This is consistent with the generally greater severity of personal loss associated with failures of the latter type, together with arguably greater difficulty for consumers to assess the financial institution risk involved.

6.34 The limit could be set as either a monetary limit or as a proportion of the total liability. In some circumstances monetary limits could be used as a substitute for means testing. Proportional limits could be used in circumstances where there is a desire to reduce the cost of the scheme but it does not make sense to unduly penalise those consumers with large exposures to a failed institution.

Coinsurance

6.35 It is common for financial guarantee schemes to limit the amounts of compensation payable to consumers to a proportion of the actual loss. For example, under the current arrangements to address cases of fraud and theft in superannuation it has been Government policy to pay compensation of 90 cents per dollar of the fund loss. The coinsurance approach ensures that consumers bear some part of the cost arising from the failure of their institution and hence provide them with some incentive to exert caution when placing their money with a financial institution. Such an arrangement also forms part of the broader question of how to allocate costs among parties. Where individuals have little or no choice as to where they place funds the logic of coinsurance arrangements may be less compelling. In this case, the moral hazard is reduced as is the ability of these persons to exert market discipline.

6.36 There are numerous examples where coinsurance is not applied. These relate to a preference to rely on monetary caps alone; or where there is little to be gained (in terms of reduced moral hazard) by penalising the person to be compensated. A latter example is payments to third-party beneficiaries of insurance policies (for example, where personal injuries are concerned). Since these beneficiaries do not select the institution, no moral hazard problem arises and broader objectives of social equity and fairness might suggest that they should be fully compensated.

Means testing

6.37 Some schemes, particularly insurance guarantee schemes, do not pay compensation to consumers who, by reference to their net worth, assets or income, are deemed to be less vulnerable or less seriously affected by a financial institution's failure. In some cases, means tests also apply to small business consumers.

Generosity of promise

6.38 A feature of some schemes is to limit the generosity of the promises (such as the rate of interest or maximum term for deposit products or the terms of an insurance contract) that can be offered to consumers of guaranteed products. The rationale is to obviate the moral hazard of institutions seeking to leverage off a guarantee by offering very generous promises and investing the funds in higher risk-return propositions. However, such limitations may be difficult to apply in practice, and may not be necessary if the prudential standards apply appropriate penalties in the form of higher minimum capital requirements. Coinsurance may also reduce the need.

Further issues to consider

Whether to establish different schemes for different sectors or within each sector

6.39 It is generally the case internationally that different schemes are established for the key sectors of deposit-taking, life insurance and general insurance, and where they exist, pension schemes. Schemes also vary in the types of risks or outcomes that they cover.

6.40 Different considerations within each sector - for example, varying business mixes giving rise to different risks to consumers, the degree of market concentration affecting the viability of pooling the risks of failure, or concerns that institutions may cross-subsidise institutions in another sector – might also explain the existence of sub-schemes. These may include separate schemes for banks and other classes of deposit-taking institutions, or for the different classes of insurance. It may be necessary to apply a different combination of design variables for the different sectors.

6.41 In some cases, an umbrella governance arrangement is used to coordinate the operation of separate schemes. For example, in the United Kingdom, the Financial Services Compensation Scheme (FSCS) provides coverage for depositors, policyholders and investors. The FSCS operates multiple sub-schemes covering institutions accepting deposits, insurance providers and designated investment businesses. For levy collection and compensation purposes, each sub-scheme is kept separate from the other.

Need for clear distinction between guaranteed and non-guaranteed products

6.42 An important design choice arises as to whether to:

- explicitly prescribe those products which must be subject to a guarantee; or
- allow guaranteed and non-guaranteed versions of the same product.

6.43 Under either option, consumers would need to appreciate that some products would be subject to a guarantee and some would not. Given the diversity of products that already exists in the financial system, and the propensity towards innovation, it appears inevitable that financial institutions would find ways to offer (perhaps via subsidiaries) both guaranteed products and other products which are similar but not guaranteed.

Restrictions based on nationality

6.44 Limiting the coverage of a guarantee scheme to liabilities repayable in Australia would be consistent with the coverage of Australia’s prudential framework. This would exclude the liabilities of overseas branches of Australian incorporated ADIs and insurance companies. It would include liabilities in Australia to foreigners who have deposits or insurance policies with Australian incorporated ADIs and insurance companies. This coverage would be similar to the coverage of the Canadian and US schemes.

6.45 An alternative, more restricted approach would be to exclude liabilities in Australia to non-residents who have deposits or insurance policies with Australian incorporated ADIs and insurance companies.

Coverage of superannuation

6.46 In considering whether to include superannuation products within a guarantee scheme it is useful to separate superannuation into its accumulation and drawdown phases.

6.47 Three general categories of products are offered in the accumulation phase:

- ***defined contribution*** products in which the value of the member's claim is market-linked;
- ***defined benefit*** products in which the value of the fund assets is also market-linked, but where the consumer's employer provide a guarantee that the amount specified as an entitlement on retirement will be available; and
- ***RSAs*** offered by ADIs or life insurance companies which are akin to deposit products, but with restrictions on the ability to make withdrawals.

6.48 The proposed design principles discussed above would exclude defined contribution products from a guarantee scheme because the consumer is taking on a managed exposure to market risk and not counterparty risk. A consumer's exposure is not so much to the viability of the institution (trustee) as it is to the capacity of the trustee to prudently manage investments on their behalf. That is, once monies are placed within the superannuation environment, the value of a member's ultimate retirement benefit is subject to investment fluctuations.

Box 6.1: Other forms of risk in the superannuation environment

In addition to market risk, consumers face other forms of risk in the superannuation environment, which are generally dealt with through other mechanisms. These include:

- Contribution risk — under the Superannuation Guarantee legislation, employers are required by law to make contributions to their employees' superannuation fund every three months. In the event that an employer becomes insolvent, its unpaid wages and superannuation contributions rank above many other debts in liquidation.

- Fraud and theft — losses suffered by members due to fraudulent conduct or theft may qualify for compensation under Part 23 of the *Superannuation Industry (Supervision) Act 1993* (SIS Act) or members may be protected by virtue of liability insurance taken out by the trustee.

- Mismanagement — action can be taken against the trustee for a breach of their duties to members. This could include the risk that trustees fail to work in the members' best interests because of conflicts of interest. Action may include removing and replacing the trustee or seeking a Court's award of compensation. Members may be protected by virtue of liability insurance taken out by the trustee.

- Investment risk — this risk is managed through the prudential framework, the duty imposed on trustees to manage funds in the best interests of members and through investing in a diverse range of assets.

6.49 The regulatory framework for superannuation contains a range of provisions addressing other forms of risk — such as the non-payment of contributions, breach of duties by trustees, funds that are facing financial difficulty — together with a range of regulatory, civil and criminal remedies. Appendices 3.1 to 3.3 provide additional detail. Moreover, in practice, the Australian Government already has in place a 'safety net' for superannuation funded by taxpayers in the form of the old age pension for those with limited assets and/or income in retirement.

6.50 Defined benefit products would also be excluded, according to the proposed design principles, because the promise of capital certainty is being provided by a non-prudentially regulated body (the employer). Defined benefit fund members are covered by Part 23 of the SIS Act for losses as a result of fraud or theft. Compensation is, however, provided only where the loss is unable to be met by the employer while remaining solvent. If greater protection for the members of defined benefit schemes is raised as a concern, a guarantee scheme may not be the most desirable or direct remedy. For example, it might be possible to strengthen requirements for employers to fully fund their defined benefit schemes. Expected changes to accounting rules will soon require businesses to account for any shortfall in their superannuation schemes, potentially reducing any incentives to under-fund such schemes. This may promote better funding practices and may hasten the trend away from defined benefit schemes.

6.51 Superannuation funds placed in an RSA with an ADI or life insurance company could be eligible for inclusion in the proposed scheme, given their likeness to deposit products and the associated capital certain promise. It may not be appropriate, however, to apply the same (relatively low) monetary limits to RSAs as to other deposit products offered by ADIs as the balances in RSAs could be very large for consumers that have been contributing for many years. However, the inclusion of RSAs and not other superannuation products could potentially affect competition within the industry; contrary to the objective of competitive neutrality.

6.52 There are at two general categories of products offered in the drawdown phase: market-linked annuities and pensions; and guaranteed annuities and pensions. Consumers of market-linked products, such as allocated and growth annuities and pensions, deliberately expose their principal to market risk and so these products would be excluded from any guarantee scheme by the proposed design criteria. Consumers of guaranteed annuity and pension products receive a guaranteed indexed income stream for a fixed number of years or for life that is not affected by movements in market prices. As such, these products may warrant inclusion in any guarantee scheme.

6.53 The compulsory nature of superannuation raises the concern that individuals are thus required (perhaps involuntarily) to bear market risk on a large portion of their financial wealth. Because the criteria utilised to determine coverage of any guarantee scheme excludes market risk, such savings would not be protected from adverse market movements.

6.54 It would be unwarranted and costly for a government to consider any scheme which protected superannuation fund members against short-term market downturns in asset values that could be achieved by, for example, requiring funds to protect against market downturns by purchasing put options on the stock market index, or by holding a larger proportion of low risk assets. The effect of reducing short-term risk bearing by funds would be to reduce the average returns likely to be achieved by superannuation funds over the long term horizon of importance to their members.

6.55 However, to the extent individuals have concerns that the retirement value of their compulsory long-term superannuation savings may be diminished by an untimely market downturn, some possible policy options could be considered. One such option would be to ensure that all members of superannuation funds have freedom to choose, within the fund, between alternative portfolios with different risk characteristics. Thus, members approaching retirement could elect to have their funds placed in a portfolio of low risk assets (such as government bonds) to protect against market risk. Younger members, for whom the 'swings and roundabouts' effect of economic cycles have time to take effect, may elect to invest in more risky portfolios.

6.56 One policy concern with this approach may be that risk averse individuals may elect for excessively conservative investment strategies which work against accumulation of adequate retirement income. In addition, this approach assumes that consumers are able to understand and take appropriate actions to manage market risk. Although the problems of imperfect information and risk assessment capability are less in this context than in dealing with counterparty risk (that is, the possible failure of a financial institution) this may remain a cause for concern. If so, policies to ensure that superannuation funds provide appropriate information to members to enable them to make informed portfolio choices appropriate for their life cycle position and risk tolerance could be considered.

6.57 Concerns about compulsion also can arise from the resulting inability of members to 'exit' a fund which is performing poorly (and is expected to continue to do so). This impacts adversely upon market discipline of fund managers and trustees by preventing members from sanctioning poorly performing agents. Full portability of superannuation would resolve this problem, but potentially create problems of excessive transfers between funds if members react excessively to short-term return performance. Limited portability, enabling members to direct future contributions to a different fund (but with past contributions remaining under the management of the previous fund), may be an option worthy of pursuing in this regard.

Third party issues

6.58 The design criteria suggest excluding wholesale consumers from the coverage of any guarantee scheme. However, an exception may arise where the consumer of the product is considered to be a wholesale consumer but the ultimate beneficiary of the product is a retail consumer. For example, a large business buys an insurance policy from a general insurer to cover itself in case one of its workers is injured and makes a claim for compensation. If the general insurer fails and is unable to pay a worker's compensation claim by the large business, should a guarantee scheme compensate the large business or should the business be expected to meet all or part of the worker's claim from its own resources? Another common example where this issue is relevant is where an employer takes out group life insurance for its employees.

Product coverage

6.59 Following from the above discussion, the following table shows possible product coverage of a guarantee scheme based on the design criteria outlined earlier.

Table 6.1: Product coverage

	Guaranteed Products	Non-Guaranteed Products
Deposits	**ADIs** Transaction accounts Savings accounts Cash management accounts Term deposits Retirement savings accounts Capital guaranteed performance deposits **Life insurers/Friendly Societies** Capital guaranteed deferred annuities Retirement savings accounts	**ADIs** Bank accepted bills (Negotiable) Certificates of deposit
Risk	**General insurers** Home and Contents Domestic and Commercial motor vehicle Business premises CTP motor vehicle Workers' Compensation Builders' Warranty Marine and Aviation Professional Indemnity Public Liability Travel Salary continuance **Life insurers** Accident Trauma Death Disability Business continuity	**General insurers** Mortgage A large proportion of policies in the marine and aviation, public and product liability, and commercial motor vehicle classes will not be covered as they are taken out by wholesale consumers. Consideration needs to be given to whether to exclude liability classes where the policyholder is a wholesale consumer. **Life insurers** Consideration needs to be given to whether to exclude group life insurance policies where the policyholder is a wholesale consumer.
Income stream	**Life insurers** Guaranteed annuities **Superannuation funds** Guaranteed pensions	**Life insurers** Allocated, growth annuities **Superannuation funds** Allocated, growth pensions
Investments		**Subsidiaries of ADIs** Unit trusts Cash management trusts **Life insurers** Non-risk component of whole-of-life policies Managed funds Approved deposit funds **Superannuation funds** Defined contribution funds Defined benefit funds Approved deposit funds Pooled superannuation trusts

Deposit products

6.60 The difficulties likely to occur in distinguishing between transaction and savings products offered by ADIs suggest that a guarantee scheme should not attempt to make the distinction.

Possible coverage

Australian dollar deposits of households, private unincorporated businesses and community service organisations repayable in Australia held in transaction, savings, cash management, term deposit and RSAs with locally incorporated ADIs.

6.61 The objective of coverage, as well as protecting against loss of wealth, is to provide rapid restitution to restore liquidity of the consumer, and support continued operation of the retail (high volume, low value) payments system. Rapid restitution and simplicity may be facilitated by relatively low monetary limits, limited coinsurance and few, if any, other qualification requirements.

6.62 This proposed coverage would exclude large-denomination, deposit-like products such as bank accepted bills and certificates of deposit. These products are likely to be used almost exclusively by wholesale consumers and can be traded in secondary markets at values that will fluctuate in accordance with interest rate movements and changes in perceived counterparty risk of the issuer.

Coverage limits

Monetary limits

6.63 A rule of thumb, identified by the Financial Stability Forum (FSF 2001) in its guidance on deposit insurance, is to set thresholds at twice the average level of per capita income. In the Australian context, that would suggest a threshold of approximately $75,000 per customer. Chapter 5 reported that more than 80 per cent of Australian households have total deposit balances of less than $60,000. A higher threshold may be appropriate for RSAs (and eligible rollover funds) given the purpose for which balances are held.

Coinsurance

6.64 Coinsurance may be appropriate both to leave some incentives in place for consumers to consider their choice of financial institution; and in order to ensure they share in a reasonable proportion of scheme costs. For example, compensation of 90 cents per dollar of deposit may be appropriate. However, since many consumers who would be covered have a limited ability to assess or to avoid risk and would indirectly share in meeting the cost of compensation schemes through premiums paid by institutions, the benefits from coinsurance may be limited.

Principal and interest

6.65 Transaction accounts will generally not be used for generating investment returns. However, savings products are usually associated with an objective of generating interest income or other forms of earnings. It seems both appropriate and convenient to compensate for interest already credited to the account (subject to any monetary limits) but there may be practical problems in compensating for accumulated interest that has not yet been credited.

Special dispensation

6.66 Despite the need for some level of monetary threshold, this category of financial product might be expected to present a number of special cases for consideration. For example, deposit accounts may temporarily contain the proceeds of a property settlement, insurance settlement or superannuation fund rollover. Some accounts, such as real estate and legal agent trust accounts may contain funds on behalf of many individuals.

6.67 Rather than a uniformly prescribed set of monetary limits, there may also be a need to accommodate special cases on a discretionary basis. For example, in the event an individual lost the proceeds of a recently arranged loan or asset sale. Such provisions would be difficult to administer and involve additional costs.

Maximum maturity of term deposits

6.68 Many deposit insurance schemes around the world appear to apply some arbitrary limits on the maturity of term deposits that are covered. A commonly imposed cap is five years. This appears to be on the basis that there should not be a guarantee over products where there is a ready risk-free or low risk alternative (such as government bonds) available. Presumably this also reflects an expectation that a consumer who is willing to lock away their savings for such a long period is making an explicit choice. However, there appear no definitive criteria for distinguishing between short-term and longer-term term deposits on such an arbitrary basis.

Modelling

6.69 The Study's modelling has proceeded on the assumption that all household, private unincorporated business and community service organisation deposits would be insured. The relative proportion of these deposits to total liabilities and total deposits differs across the range of ADIs.

Table 6.2: Retail deposit coverage

	Major banks	Other domestic banks	Foreign subsidiary banks	Building societies	Credit unions
Per cent of liabilities	25	35	29	77	88
Per cent of deposits	53	65	53	79	94

Source: Australian Prudential Regulation Authority, June 2003 (see Appendix 2.1).
Retail deposits are assumed to be those of households, private unincorporated business and community service organisations.

6.70 Further information would be required to extend the analysis and to consider how monetary thresholds, coinsurance and other design features might serve to further reduce the potential scheme costs. Estimates of how thresholds affect costs have not been incorporated into the model at this stage because sufficiently disaggregated data is not available.

6.71 For example, initial analysis based on an APRA survey of a sample of ADIs revealed the following breakdown of deposits.

Table 6.3: Deposit thresholds

Product Coverage	Coverage limits	Per cent of class	Per cent of consumers
All Deposits (excluding Certificates of Deposit (CD))	$250,000 $100,000 $50,000	65-80 of all deposits (excluding CD) 50-60 of all deposits (excluding CD) 35-45 of all deposits (excluding CD)	99.2-99.8 97-99 94-98
Household Transaction Deposits	n/a	10-40 of all deposits (excluding CD) 35-40 of household deposits	n/a
Household Savings and Term Deposits	n/a	30-50 of all deposits (excluding CD) 60-65 of household deposits	n/a
Household Foreign Currency Deposits	n/a	0.03-0.6 of all deposits (excluding CD) 0.1-1 of household deposits	n/a
Small Business Transaction Deposits	n/a	4 of all deposits (excluding CD) 40-75 of small business deposits	n/a
Small Business Savings and Term Deposits	n/a	1-2 of all deposits (excluding CD) 25-60 of small business deposits	n/a

n/a Data not available.
Source: Australian Prudential Regulation Authority, June 2003.

Risk products

Possible coverage

Outstanding claims under 'personal asset and income' insurance policies offered by APRA-regulated life insurance or general insurance companies

6.72 The objective of coverage would be to provide restitution to retail policy holders in accordance with the terms of their policies of insurance.

6.73 Consideration needs to be given to whether to cover outstanding life insurance claims under group policies taken out by an employer on behalf of its employees.

Third-party claims covered by liability insurance policies offered by APRA-regulated general insurance companies

6.74 The objective of coverage would be to provide appropriate restitution either to the policyholders or directly to the third-party beneficiaries of 'liability' insurance products.

Interim cover for unexpired insurance policies

6.75 The objective would be to cover any claims made by policyholders under their existing policies for a specified period of time after the collapse of their insurer, in recognition of the fact that it may not be possible to find alternative insurance immediately. Consideration would need to be given, however, to the possibility that replacement cover may not be available because of a lack of an alternate provider, or because a person may have become uninsurable. In such circumstances both future cover and cover for liability from past (but not yet recognised) events may be unavailable or the cost of effective cover may be prohibitive.

Coverage limits

Monetary limits

6.76 The value of assets and income protected by personal classes of insurance will differ markedly across the spectrum of products. In some cases, such as for home and contents insurance, the protected assets may reflect a large proportion of an individual's or household's wealth. In the context of life insurance, the lump sum or present value of future income may appear large, but this might be expected given the need to provide an income to beneficiaries for a long period.

6.77 Relatively higher monetary limits might therefore be appropriate for the risk products category than for deposit accounts. Alternatively, it may be more appropriate to rely on a combination of coinsurance and eligibility criteria rather than strict monetary caps.

Coinsurance

6.78 In general, coinsurance would be an attractive design feature due to its limited but targeted risk-sharing properties. It is, however, difficult to justify application of coinsurance to third-party beneficiaries of insurance policies who did not take out the cover in the first place.

Eligibility and means testing

6.79 An insurance guarantee scheme might be targeted, or introduced at lower cost, by imposing eligibility and means tests. Scheme administration would be more complex as a result.

Modelling

6.80 The Study's modelling has assumed that only outstanding claims (as reported to APRA) are covered. Insufficient information exists on the profile of household insurance policies to determine the impact of monetary limits and coinsurance, and on the cost of providing interim cover.

6.81 The following inputs have been assumed for modelling purposes at this stage.

Table 6.4: Risk products — proportion of total liabilities covered

Sector	Coverage (per cent of liabilities)
General insurance (provision for outstanding claims)	61
Life insurance (conventional risk products, including group policies)	9[4]

Source: Australian Prudential Regulation Authority, June 2003.

4 The bulk of life insurers' liabilities are superannuation liabilities (86.1 per cent as at June 2003). Life insurers also offer other investment products that are not proposed to be included in a guarantee scheme.

Income products

Possible coverage

'Guaranteed' life insurance annuities and superannuation pensions offered by APRA-regulated entities

6.82 These are a special category of income product which entails a guaranteed income promise on the part of the provider. The purchaser is not exposed to market fluctuations in the value of their asset and may not surrender the policy in the way that allocated or growth annuity or pension products may provide.

6.83 The objective of coverage could be to provide a lump-sum conversion equivalent or an ongoing income stream reflecting the residual principal value of such products. Coverage could be on a per person, per institution basis.

Other providers and products

6.84 It would be necessary to identify and, if appropriate, prescribe coverage of other similar products (that is, where the level income from the annuity or pension or the residual capital value are guaranteed by the financial institution; and where the purchaser is not taking on market risk) offered by other APRA-regulated financial institutions.

Coverage limits

Monetary limits

6.85 These products already have monetary thresholds applied for tax and social security purposes. The current limit on the amounts that may be placed in pensions and annuities, to gain the associated benefits, is twice the 'reasonable benefit limit'.

6.86 Given that the residual value of the annuity reduces as income is paid out, it would be necessary to calculate an appropriate amount of compensation, reflecting residual principal.

6.87 Life insurance and pensions tables exist for calculating values of annuity products (that is, for family law purposes).

Coinsurance

6.88 Coinsurance may be an appropriate feature if it is believed that the initial choice associated with choosing a provider of a guaranteed annuity or pension product might be made on a more informed basis as a result.

Modelling

6.89 It is difficult to differentiate between life insurance savings and income products with available data, as the categorisation appears to depend on the stage in a product's life cycle rather than on terminology. For this reason, life insurance savings and income products have been taken together for modelling purposes. The following table represents those non-investment linked liabilities of life insurers.

Table 6.5: Savings and income products — proportion of life insurance liabilities

Product category	Coverage (per cent of liabilities)
Investment account	7.2
Group investment account	5.7
Term annuity	3.9
Lifetime annuity	3.7
Total	20.5

Source: Australian Prudential Regulation Authority, June 2003.

6.90 Further information is required to establish the proportion of these liabilities that are capital guaranteed; and the proportion of outstanding liabilities associated with 'guaranteed annuities'. Information relating to superannuation pensions is also needed.

Investment products

6.91 There is a broad spectrum of investment products available to retail financial consumers, in some cases by APRA-regulated financial institutions, which would not appear to fall within the logical scope of coverage for reasons discussed earlier in this Chapter.

6.92 Excluded products to which retail consumers are likely to have greatest exposure are superannuation products in both the accumulation and drawdown phases. Prudential regulation of superannuation funds seeks to reduce these risks by measures including the requirement for superannuation trustees to meet fitness and propriety tests and Part 23 of the SIS Act (addressing losses due to fraud or theft).

6.93 APRA-regulated financial institutions also offer a range of investment products to retail customers through subsidiary operations. For example, cash management trusts, managed funds and other collective investments, and securities of the institutions themselves would fall outside the scope of coverage suggested by the design criteria.