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New protections for depositors and policyholders

Today I announce a package of measures to further enhance the stability of the Australian financial system.

Although Australia's financial system remains sound in the face of significant turbulence on global financial markets, the Rudd Government is determined to provide as much certainty and protection to customers as possible.

Accordingly, the Rudd Government will introduce legislation to establish a Financial Claims Scheme (FCS).

The FCS follows thorough consideration by the Council of Financial Regulators dating from 2005, and reflects recommendations made by the HIH Royal Commission in 2003 and the global Financial Stability Forum earlier this year.

The scheme can assist depositors and policyholders in the unlikely event that a financial institution fails.

The Government has also accepted recommendations of the Council that a number of changes be made to the regulatory framework to allow better management of failing financial institutions.

These measures will enhance our regulators' ability to act comprehensively and decisively in relation to a failed financial institution. The measures will also enhance the regulators' capacity to

recapitalise a distressed bank, credit union, building society (authorised deposit-taking institutions) or general insurer.

Depositors in authorised deposit-taking institutions (ADIs) already receive preference in any liquidation, which means they will almost certainly recover all of their funds eventually. However there is currently no mechanism to provide depositors or general insurance policyholders with timely access to at least some of their funds in the event of a failure.

Early access to funding is important to ensure that Australian families can continue to meet day to day costs while the liquidation of an institution is carried out.

In light of the potential for delays to cause real hardship, and to further assist the management of a failing institution, the FCS will allow customers to quickly recover money in deposit accounts. Customers will be able to recover monies up to a specified cap, with the remainder likely to be recovered when the ADI is liquidated.

To avoid the need for ad hoc arrangements of the sort established in the wake of the HIH failure, the FCS will also provide compensation to policyholders who have valid claims with a failed general insurer.

The FCS will not cover life insurance, superannuation or market-linked investment products or products offered by institutions which are not regulated by APRA.

The Commonwealth Government, through APRA, will fund payments under the FCS, with the costs to be recovered through the liquidation of the failed entity. In the unlikely event that the liquidation does not provide full recovery of the Government's costs, a levy may be applied to relevant financial institutions.

Although Australia's financial system is sound, and Australians have rarely suffered losses as a result of financial institution failure, these enhanced crisis management arrangements will give customers even greater certainty when dealing with APRA-regulated financial institutions.

Background Information - Financial Claims Scheme

History

The Council of Financial Regulators, which includes the heads of the Australian Prudential Regulation Authority (APRA), the Australian Securities and Investments Commission (ASIC), the Reserve Bank of Australia (RBA) and the Treasury, examined Australia's crisis management arrangements and found there was a strong case for introducing a mechanism to provide both depositors in an authorised deposit-taking institution (ADI) and policyholders in an APRA-regulated general insurer with access to some of their funds in a timely manner should a financial institution fail.

The arrangements announced today have been under consideration by the Council of Financial Regulators since 2005, and reflect recommendations made by the HIH Royal Commission in 2003 and the Financial Stability Forum earlier this year.

The *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience* recommended that governments around the World should review and, where necessary, strengthen deposit insurance arrangements. The introduction of an FCS will put in place an explicit depositor protection scheme. Australia will review its arrangements against international standards for depositor protection when they are settled.

Current Arrangements

Under existing depositor preference arrangements, depositors receive priority over other creditors in the liquidation of a bank, building society or credit union. These arrangements mean depositors would be able to recover their entire deposits in almost all circumstances.

However, it can take many months, or even years, before funds are available for distribution, creating severe financial hardship for many households.

Generally, insurance policyholders with valid claims have been compensated by government in the past, as occurred in the collapse of the HIH group of companies. However these arrangements have been ad hoc, leading to delays and uncertainty for policyholders.

The Financial Claims Scheme

The FCS will be administered by APRA and will make early payments to eligible depositors or general insurance policyholders using Government funds in the first instance. APRA would then take the place of the depositors/policyholders in the liquidation of the failed institution. If APRA was unable to recover the full costs of the scheme in the liquidation, relevant financial institutions could be levied to recover the costs of the FCS.

Access to the FCS would be focussed on providing timely access to funds for those least able to effectively assess the risk of dealing with a particular institution.

- In relation to banks, building societies and credit unions, payments to individual depositors will be capped at a set amount per depositor. The cap will be set to ensure that most depositors will receive their deposits in full under the FCS.
 - Those with deposits which exceed the cap will have access to the amount up to the cap under the FCS, and will recover the remainder of their funds from the liquidation of the institution in most circumstances.
- In the case of a general insurance failure, eligible policyholders with a valid claim against the failed insurer will receive a payment under the scheme equivalent to the value of their claims, less any excess or deductible amounts.
 - Eligibility for coverage for general insurance policyholders will be limited to individuals, small businesses and not-for-profit organisations.

Investment products, such as superannuation, life insurance, and managed funds will not be covered by the FCS because with many of these products there is an incentive for consumers to pursue higher returns through risk-taking. Protecting investors against loss while rewarding them for risk-taking could lead to large and adverse distortions in the market.

Other products offered by life insurers or friendly societies will be excluded from the FCS, as the statutory fund structure imposed on life insurers already provides significant protection to policyholders, and the likelihood of failure leading to loss is very low.

Broader crisis management arrangements

The Council of Financial Regulators also considered the suite of powers available to regulators for managing financial instability and distressed financial institutions. A number of reforms were identified to enhance the ability of regulators to effectively manage a distressed financial institution and to maintain financial stability including:

- regulating non-operating holding companies (NOHCs) of prudentially regulated life insurers, recognising that NOHCs can have a significant impact on the safety of these entities;
- harmonising court injunction powers across prudential legislative instruments so that APRA, or any person whose interests are affected, can seek injunctions for conduct relating to the financial health of an entity;
- providing consistent arrangements for transfer of business in banking, general insurance and life insurance, with appropriate oversight by the courts or APRA;
- providing for judicial management of a general insurer in the event of a failure, which would override external management under the *Corporations Act 2001* (the Corporations Act), thereby better protecting the interests of policyholders; and
- facilitating the recapitalisation of failing entities by removing potential legal barriers.

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