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FINANCIAL SERVICES COMMISSION

DISCUSSION PAPER: COMPENSATION FUND PLANS FOR THE JAMAICAN FINANCIAL SERVICES SECTOR: OPTIONS FOR CONSIDERATION

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EXECUTIVE SUMMARY, RECOMMENDATIONS AND ACTION PLAN

Following a significant crisis in the Jamaica financial services sector in the mid 1990's, the Government of Jamaica undertook a number of steps to strengthen consumer protection and enhance consumer confidence in the sector including:

- Strengthening regulatory legislation for deposit taking institutions and augmenting the supervisory capability of the Bank of Jamaica;
- Establishing a deposit insurance fund to protect consumers that place funds in deposit taking institutions;
- Establishing the Financial Sector Adjustment Company to reorganize failed institutions and work to restructure the financial services industry;
- Strengthening the regulatory legislation with respect to the insurance industry;
- Establishing the Financial Services Commission ("FSC") to serve as the supervisory agency for the insurance industry, the securities industry and pension fund plans; and,
- Establishing a regulatory framework for pension fund plans.

It was also recognized that consumer confidence and protection with respect to non-bank financial services providers such as insurance companies, securities dealers and private pension fund plans would be enhanced with the establishment of compensation fund plans. In this regard, Section 9 of the *Financial Services Commission Act* states:

"The Commission may, after consultation with such providers of financial services and such other persons as it thinks fit, make regulations regarding the establishment, maintenance and use of compensation funds for the benefit of customers of financial services provided by such institutions, who have suffered pecuniary loss as a result of the operations of any such institutions."

The FSC is of the opinion that it is the appropriate time to examine the feasibility of establishing compensation fund plans for life insurance companies, general insurance companies, securities dealers and defined benefit pension fund plans.

As a starting point, the FSC retained a consultant, Mr Robert Hobart, to examine the major issues that must be considered in the establishment and operation of compensation fund plans. This paper presents the results of the consultant's examination and his recommendations for further action.

In conducting his examination the consultant utilized information from a number of sources:

- The consultant's ten years of experience as the Chief Executive Officer of the Credit Union Deposit Insurance Corporation of the Canadian Province of British Columbia;

- The consultant's ten years experience as the Superintendent of Financial Institutions of British Columbia which required interaction with the life insurance compensation fund plan in Canada, the property and casualty insurance compensation fund plan in Canada and the Canada Deposit Insurance Corporation;
- Brochures and other information from all major compensation fund plans operating in Canada;
- The consultant's two years experience as an advisor to the FSC with respect to the supervision of the Jamaican financial services sector;
- Best practice discussion papers prepared by the Financial Stability Forum, the Organization for Economic Co-operation and Development and the International Monetary Fund;
- Interviews with senior officials of a number of Jamaican entities including:
    - The Financial Services Commission;
    - The Life Insurance Companies Association;
    - The Jamaica Association of General Insurance Companies;
    - The Jamaica Deposit Insurance Corporation;
    - The Ministry of Finance and Planning;
    - The Jamaica Stock Exchange; and,
    - The Jamaica Securities Dealers' Association.

The examination of the major issues associated with the formation of compensation fund plans is outlined in the main text of the paper. The consultant's main recommendations are as follows:

1. It is recommended that priority be given to the establishment of solvency compensation fund plans. These would include plans for life insurance companies, general insurance companies and defined benefit pension fund plans. Fraud and negligence compensation fund plans are not viewed as a priority because there are suitable private sector and other alternatives available to mitigate potential consumer losses in this area. In this context, it is further recommended that a broadly based compensation fund plan not be established for securities dealers. Rather the FSC should work with the Jamaica Securities Dealers Association to develop regulatory rules to ensure that all securities dealers have acceptable levels of private sector third party liability insurance coverage to protect themselves and their customers against the misappropriation of any securities that are being held by dealers in customer accounts.

2. It is recommended that consideration be given to provide JDIC with the authority to establish and administer separate compensation fund plans for life insurance companies, general insurance companies and defined benefit pension fund plans. Administrative efficiency, the positive track record of JDIC, consistency in operations and public confidence were the primary factors resulting in this recommendation. At the current time, JDIC has 21 staff members. Taking advantage of existing infrastructure, it is likely that JDIC could manage the three additional plans with the addition of fewer than 15 staff members.

3. If Recommendation 1 is not accepted with respect to securities dealers, it is recommended that the Jamaica Stock Exchange Compensation Fund be modified to provide protection to customers of all securities dealers. The existing Plan has been in operation for several years and a substantial fund has already been accumulated. Any increased staffing requirements would be minimal. If this approach is accepted a number of issues would have to be resolved including:

- A determination of the funding and risk implications of a large number of new members in the compensation fund plan;
- A clarification and perhaps expansion of the instruments that would be covered by the plan; and,
- A review of the payout limits of the plan in the context of the existing client profile of securities dealers.

4. It is recommended that the compensation fund plan agency be granted the authority to make assessments, make payouts and protect the integrity of the fund assets that it is charged with administering. In this context, it must have the authority to obtain information from the supervisor or the member company, if necessary, to become aware of the existence of companies that have become problematic and may be approaching insolvency. It must also have the authority to participate with the supervisory agency with respect to problem remediation of financially distressed companies. Finally, the compensation fund plan must have sufficient authority to pursue the least cost alternative when dealing with a situation of potential or actual insolvency.

5. For purposes of cost control and the reduction of moral hazard it is important that payout limits, exclusions or coinsurance rates be established to define compensation fund plan covered liabilities and payouts. In determining appropriate limits, exclusions and coinsurance rates it is necessary to have information on the profile of industry customers, the type of products purchased and the value of the obligations owed to the customer or pension fund plan member. For this reason, it is recommended that the FSC gather this information from life insurance companies, general insurance companies, securities dealers and pension fund plans.

6. It is recommended that each compensation fund plan established in Jamaica make annual assessments on its members and seek to build a fund. Although annual assessment rates should only be determined after the examination of the customer profile information and the determination of covered liabilities, annual assessment rates of 15 basis points on covered liabilities (net of any discounts) would not have a significant impact on the annual after tax income of life insurance companies, general insurance companies or securities dealers. The initial assessment rates should continue for several years until the compensation fund plan has to some extent matured. Changes can then be contemplated depending on the level of the fund and the circumstances of the industry. It is also recommended that the assessment base for each company or pension fund plan approximate as closely as possible covered liabilities. Although risk based assessments are theoretically attractive, they are not recommended as they are felt to be impractical. Surcharges on unfunded liabilities for

pension fund plans and discounts for high capital levels for financial institutions can be used as an alternative to risk based assessments. It is not recommended that debt financing be used initially to build the fund unless there is compelling evidence to suggest that this will have a positive impact on consumer confidence. Government should not make an initial contribution to any fund except perhaps for an investment of $1 in share capital to establish that the compensation fund plan is an agency of government.

7. To avoid adverse selection, it is recommended that all companies in the industry and all defined benefit pension fund plans be required to be members of the compensation fund plan.

8. It is recommended that changes in legislation be considered to give pension fund plans and financial institution consumers the status of preferred creditors during the windup of companies. This can be accomplished by adding the appropriate provisions to the winding up sections of the legislation governing insurance companies, securities dealers and pension fund plans.

9. To avoid a collapse of consumer confidence it is recommended that the Government of Jamaica provide a back stop to any compensation fund plan in the form of a government guarantee of debt issued by the plan. This guaranteed debt could only be issued if the compensation fund plan was unable to meet its obligations to consumers.

10. It is not necessary or desirable to establish several compensation fund plans at the same time. Rather, it is more appropriate to establish them one at a time and allow a phase in period before moving on to the establishment of the next plan. Nor is it appropriate to establish a compensation fund plan that cannot be sustained by the industry. Based on information provided by the FSC, it is recommended that priority be given to the life insurance industry with respect to the establishment of a compensation fund plan followed by the general insurance industry, securities dealers (if Recommendation 1 is not accepted) and defined benefit pension fund plans. Nevertheless, the FSC should not lose sight of the goal of eventually establishing compensation fund plans for at least three of these sectors. There are a number of common activities, such as drafting regulations, which will be required with respect to the establishment of each of the funds. The FSC can move ahead with these activities even though it is premature to establish compensation fund plans for all sectors at the current time.

11. An action plan to implement recommendations 1 through 10 above should be developed. This plan should begin with the following steps:

(i) **Continued Research –** Two principal tasks are envisioned during this phase:

a. Discussions with stakeholders - The FSC should release a discussion paper on compensation fund plans to all stakeholders. The FSC would request written comments on the discussion paper from all stakeholders.

b. Survey of client profiles – Consistent with Recommendation 5, the FSC should require life insurance companies, general insurance companies and securities dealers to provide profiles of their customers including information on product types and the value of obligations owed to customers. This activity would occur simultaneously with activity 1.a. The FSC would use the customer profile information to determine appropriate limits and exclusions for the various compensation fund plans. It is not possible to undertake this activity for pension fund plans until such plans become registered.

(ii) **Final Decisions on Operation and Control**. Based on stakeholder views and other considerations, final decisions will be made regarding whether a fund is necessary (in the case of securities dealers) and whether JDIC is the appropriate delivery vehicle for the other funds. Once these decisions are made, they should be broadly communicated to the public.

The FSC invites comments and suggestions from interested parties regarding the contents of this discussion paper. The deadline for the submission of comments is **January 5, 2006**. Please direct your comments to:

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COMPENSATION FUND PLANS FOR THE JAMAICAN FINANCIAL SERVICES SECTOR – OPTIONS FOR CONDSIDERATION

A. Background

The Financial Services Commission ("FSC") was established as a result of a financial sector crisis that occurred in the mid 1990's. During that crisis, a number of significant financial institutions in Jamaica including several major life insurance companies became insolvent and were unable to pay legitimate claims to the public. It was recognized at that time that the legislative framework for insurance industry supervision was inadequate and that the administration of the framework would require significant improvement if a similar crisis was to be avoided in the future. Steps were taken to develop new legislation and the regulations that were necessary to effectively regulate and supervise insurance companies.

In addition, to improve the administration of the legislative framework, the FSC was established on August 2, 2001 as an autonomous entity to supervise non-bank financial institutions including insurance companies and securities dealers as well as pension fund plans. At the current time, the FSC is active in administering 15 Acts and Regulations pertaining to the insurance and securities industries. Legislation and regulations with respect to pension fund plans are in the final stages of development and are expected to take effect in the near future.

The improved supervisory framework for Jamaica was intended to increase stability, public protection and public confidence in the non-bank financial services sector. It was also recognized that public confidence would be enhanced if, in addition to effective supervision, public protection was augmented by compensation fund plans established to mitigate consumer losses that might result from the operations of a non-bank financial services provider.

In this regard, Section 9 of the *Financial Services Commission Act* states:

"The Commission may, after consultation with such providers of financial services and such other persons as it thinks fit, make regulations regarding the establishment, maintenance and use of compensation funds for the benefit of customers of financial services provided by such institutions, who have suffered pecuniary loss as a result of the operations of any such institutions."

The FSC is of the opinion that it is the appropriate time to examine the feasibility of establishing separate compensation fund plans for life insurance companies, general insurance companies, securities dealers and private pension plans. This discussion report represents an initial step in the process leading to the formation of such plans.

Compensation fund plans are not new to Jamaica. In fact, there are two such plans currently in operation in Jamaica including the Jamaica Deposit Insurance Fund and the Jamaica Stock Exchange Compensation Fund. As a starting point for this report, these funds are described to determine whether they can be used as a model for the compensation fund plans envisaged under Section 9 of the *Financial Services Commission Act.*

It is evident that compensation fund plans can take a number of forms and can be designed in many different ways. The second part of this report outlines some of the basic options for such plans by focusing on key issues surrounding the form of potential plans including:

- The objectives of a compensation fund plan;
- The ownership and control of the plan;
- The authority of the plan;
- Coverage to be provided by the plan including limits, exclusions and coinsurance;
- The funding of the plan;
- Other operational issues; and,
- Start up considerations.

There is no perfect choice with respect to any of the feasible options that are outlined in this report and all have particular costs and benefits. Differing objectives will result in different plan features. In addition, differences among industries require different plan features

B. Highlights of Existing Jamaican Compensation Fund Plans

1. Jamaica Deposit Insurance Fund

The Jamaica Deposit Insurance Fund ("the Fund") was established in 1998 and is administered and managed by the Jamaica Deposit Insurance Corporation ("JDIC"). The legislative framework for the Fund is outlined in the *Deposit Insurance Act* and the Deposit Insurance Regulations.

There are two objectives of the Fund. The first objective is to protect depositors, especially small and unsophisticated depositors, from the insolvency of a deposit taking institution including all six commercial banks, all seven trust and merchant banks and all four building societies authorized to conduct business in Jamaica as at March 31, 2004. This objective is met by reimbursing depositors for any loss of their deposits up to a maximum of $300,000 per depositor per institution.

Depositors are not unduly constrained by this limit because they can increase their coverage beyond the $300,000 limit by simply diversifying their deposit holdings among different deposit taking institutions. This can increase the risk to JDIC to the extent that individual insolvencies of member institutions are not independent events.

All deposits are covered under this plan including: savings and chequing account deposits; time deposits; certificates of deposit; manager's cheques, money orders and drafts; travelers cheques; and membership shares in a building society. There are a number of banking liabilities that are not covered including: investments in commercial paper, brokered/managed funds, debentures, deposits made by any of the member institutions covered by the fund and deposits made by statutory bodies or the Government of Jamaica.

Depositors are not required to pay for this protection. Rather the seventeen member institutions have and continue to pay assessments to fund this protection to the consumer.

As a result of meeting the first objective of consumer protection, the second objective of enhancing confidence and stability of deposit taking institutions in Jamaica is thought to be met.

JDIC is governed by a seven member board of directors which includes the Financial Secretary, the Governor of the Bank of Jamaica, the Chief Executive Officer of JDIC and four other directors appointed by the Minister of Finance and Planning. The 21 staff members of JDIC are organized into 4 divisions including:

- Insurance and Risk Assessment;
- Claims and Recoveries;
- Finance and Corporate Services; and,
- Legal Counsel and Corporate Secretary.

In meeting its mandate JDIC is empowered to conduct a number of essential activities:

- *Establish and maintain a deposit insurance fund* – JDIC has established, manages and invests a fund with assets of approximately $1.2 billion to be used if a member institution fails and payments are required to be made to depositors;
- *Levy and collect fees from member companies* - To build and maintain the fund, JDIC levies annual assessments on member companies. At the current time the assessment rate for member companies is 15 basis points of total insurable deposits;
- *Monitor the risk profile of member companies* – Using information provided from the Bank of Jamaica, JDIC monitors member companies to ensure that it is prepared should a member company experience financial distress;
- *Maintain readiness to pay claims if necessary* – JDIC has never had to deal with an insolvency or make a depositor payout. However, it must continue to be prepared for an insolvency and have systems and procedures in place to reimburse depositors as quickly as possible should the need arise. It must also have systems in place to recover its rightful share of the funds from the sale of assets of the failed member company on liquidation. During 2004, JDIC engaged in a payout simulation to test its systems and procedures; and,
- *Public education* – As part of the objective of maintaining public confidence, it is required that there be public awareness of the role of JDIC and the rights and responsibilities of those that deposit funds in member companies. JDIC

undertakes this activity through advertising, the production and dissemination of brochures and the holding of consumer seminars.

2. Jamaica Stock Exchange Compensation Fund

The Jamaica Stock Exchange Compensation Fund was established in 1970 and is administered by the Jamaica Stock Exchange. The legislative framework of the plan is outlined in sections 27 to 35 of the *Securities Act.*

The purpose of the plan is to compensate clients of member securities dealers who have lost money as a result of a defalcation or fraudulent misuse of securities held by the dealer on behalf of a client in the event that the dealer is unable to meet its obligation because of insolvency or some other reason. It is important to emphasize that the plan has been established to protect consumers against the loss of securities being held by the dealer rather than any losses resulting from the change in market value of the securities being held.

According to the brochure provided by the fund, the plan covers stocks and shares of companies listed on the Jamaica Stock Exchange and any claim in denominated money market instruments. The legislation appears to specify a somewhat larger scope of coverage. Section 30 of the *Securities Act* states that "a compensation fund shall be held and applied for the purpose of compensating persons who have suffered pecuniary loss as a result of a defalcation or fraudulent misuse of securities or documents of title to securities or of other property…."

Members of the compensation fund plan include all ten securities dealers that are members of the Jamaica Stock Exchange. Jamaican securities dealers that are not members of the stock exchange are not members of the plan.

In previous periods, these member dealers were assessed annual fees and as the result of fee payments and investment income the fund currently has assets totaling in excess of $450 million. Fees have not been assessed in recent years because it is felt that there are sufficient assets in the fund to easily handle any claims for compensation payments that might arise.

The limit for claim payments to consumers is $1 million dollars per member dealer. The Jamaica Stock Exchange does, however, have the authority to increase payments to consumers if it considers the assets of the fund sufficient to provide such payments.

According to officials of the Jamaica Stock Exchange, the chances of significant claims against the fund are becoming increasingly remote. Securities listed on the Jamaica Stock Exchange are generally no longer held by member dealers. Rather they are now held by Jamaica Central Securities Depository Ltd. with share transactions being processed by book entry.

The plan is very similar to the Canadian Investors Protection Fund (see Section 4(f) of this report) which provides similar coverage for consumers who hold accounts with Canadian securities dealers. The major difference is that, unlike Jamaica, all securities dealers in Canada are members of the Canadian plan.

C. Options for Consideration

1. Objectives of Compensation Fund Plans

(a) Solvency Compensation Fund Plans

The Jamaican Deposit Insurance Fund is a good example of a compensation fund plan that protects consumers against losses arising from the insolvency of a financial institution. The plan reimburses bank depositors who have suffered a loss of their deposits because of a deposit taking institution insolvency up to a maximum of $300,000. Deposit insurance fund intervention is triggered as a result of an insolvency. It does not depend on the factors that resulted in the insolvency.

These types of compensation fund plans are very common throughout the world and have been established for banks, trust companies, building societies, credit unions, life insurance companies, general insurance companies and defined benefit pension plan funds. They are typically established to provide consumer protection in the event of the insolvency of a financial services provider and as a result serve to increase the consumer confidence and the stability of the financial services industry. It is common for such funds to emphasize that the focus of their protection is for the "small and unsophisticated consumer" rather than for all consumers. Such funds are not intended, however, to directly provide compensation for consumer losses associated with specific fraudulent or negligent transactions.

In addition to increasing consumer confidence in the financial services industry, solvency compensation fund plans have a secondary benefit of clarifying consumer rights and the liability of government in the event of financial institution failures. When supervised financial institutions fail and cannot pay legitimate amounts due to consumers, there is typically a public outcry and demands that the government fully compensate the affected consumers. In many cases, governments provide such compensation and create a legal precedent for similar action in the future.

The establishment of a compensation fund plan allows consumers to obtain appropriate compensation for their losses within the defined rules of the plan. Moreover, because compensation fund plans are typically funded by industry participants, the compensation provided to those affected by an insolvency in a given industry is in reality being provided by other industry members. Because it is the industry that has obtained the benefit of increased public confidence resulting from the compensation fund plan, it is reasonable that the industry rather than the general tax payer pay the cost of this benefit.

Compensation fund plans do involve costs. First, there are costs to the industry in the form of increased rules, bureaucracy and fee payments resulting from the establishment and operation of the plan.

Second, it is often argued that compensation fund plans increase moral hazard in the financial services sector. If the consumer is being fully protected from the potential costs of placing funds in a company that has a high risk of insolvency, the consumer will not have an incentive to perform due diligence and select a more prudent or lower risk company in which to place funds. Because of this, companies have an incentive to pursue higher risk business strategies. With these higher risk business strategies the company may be able to offer higher returns to the consumer than competing companies with more prudent business strategies. Competitive pressure may cause the entire financial services industry to engage in an excessive level of risk taking relative to a situation where there is no compensation fund plan. This moral hazard concern is well recognized and compensation fund plans have typically been designed with features which are thought to reduce the affects of moral hazard to acceptable levels.

(b) Fraud and Negligence Compensation Fund Plans

A second type of compensation fund plan can be established to reimburse consumers that experience financial loss due to the negligent or fraudulent behavior of a provider of financial services.

These fraudulent and negligence compensation plan funds are not very common throughout the world. A major reason for this is because financial services institutions are typically very willing to provide the consumer with compensation in the event of a negligent or fraudulent transaction by a company employee or agent. Companies, in turn, protect themselves against such risk through the purchase of liability insurance which is readily available in the private market. In fact, in many jurisdictions there are regulatory requirements that make the purchase of such insurance mandatory as a condition of being registered to conduct financial services business. For example, Section 72 of the *Insurance Act* requires that corporate insurance agents and brokers have appropriate bond insurance coverage before they can be registered.

Some jurisdictions also handle consumer complaint issues against companies regarding negligent, fraudulent or misleading behavior by requiring companies to establish a formal consumer complaint handling process. In addition, these are often supplemented by the establishment of an independent financial services consumer ombudsman who has the authority to require companies to appropriately remedy all consumer complaints including those involving negligence and fraud.

Industry associations, in some jurisdictions, have formed compensation fund plans to protect consumers against the negligent or fraudulent actions of industry members. These self insurance schemes have typically been formed, however, because it is thought that the consumer protection that results can be provided more cheaply than having individual industry members purchase the appropriate levels of insurance coverage in the private market.

Some might argue that the Jamaica Stock Exchange Compensation Fund is a fraud and negligence compensation fund plan rather than a solvency compensation fund plan because it compensates consumers for losses resulting from misappropriated securities. However, it would appear the plan contemplates that in normal circumstances the member dealer will compensate the consumer for any misappropriated securities. It is only when the member dealer is unable to provide this compensation due to insolvency that the compensation fund plan steps in. For this reason, the Jamaica Stock Exchange Compensation Fund perhaps should be considered to be a hybrid type of compensation fund plan.

It should also be recognized that it may not be necessary to establish a compensation fund plan to provide consumer protection with respect to misappropriated securities or other fraudulent or negligent acts by securities dealers. An alternative is the establishment of a regulation that requires all securities dealers to purchase appropriate levels of private sector third party liability insurance to protect their customers and themselves from illegal or negligent acts by their employees.

It is likely that many securities dealers already purchase such insurance to protect themselves against fraudulent acts of their employees. Such policies would pay claims of any third party that was harmed by the negligent or fraudulent acts of the securities dealer or its employees regardless of the solvency position of the dealer. In most cases, the third party would receive the claims payment even if the dealer was insolvent as the solvency position of the dealer would typically have no bearing on third party liability claims. However, any concern that a dealer's insolvency would affect the rights of a potential third party claimant could be easily dealt with in any regulatory requirement and the particular insurance contract that was issued.

(c) Options for Consideration

In Jamaica, it is recommended that priority be given to the establishment of solvency compensation fund plans. These would include plans for life insurance companies, general insurance companies and defined benefit pension fund plans.

Fraud and negligence compensation fund plans are not viewed as a priority because there are suitable private sector and other alternatives available to mitigate potential consumer losses in this area.

Jamaica has two alternatives with respect to securities dealers. A compensation fund plan is currently in place which with modest changes could be used to provide protection to all customers of securities dealers. However, an acceptable alternative exists through private sector insurance coverage. If this second alternative is accepted, it will be necessary that regulatory rules be established to ensure that all securities dealers have acceptable coverage.

2. Ownership and Control of the Compensation Fund Plan

(a) Feasible Options

There are three typical options regarding the ownership and control of compensation fund plans.

- Separate agencies could be established for each industry with ownership and control of the agency resting with the private sector members of the industry in question.
- Separate agencies could be established for each industry with ownership and control of the agency resting with the government.
- Separate compensation fund plans could be established for each industry with all plans being administered by the Financial Services Commission.

Each of these options is similar to compensation fund plan options that are operating in other jurisdictions. For example, in Canada the life insurance industry, general insurance industry and securities industry have each established compensation fund plans that are owned and controlled by the respective industries. Deposit insurance for banks and trust companies, on the other hand, is provided by a federal government agency. Finally, a pension plan compensation fund plan is operated by the pension plan supervisor in the Canadian province of Ontario and a credit union deposit insurance fund is operated by the credit union supervisory agency in the Canadian province of British Columbia.

A fourth general option is available in Jamaica. Separate compensation fund plans could be established for each industry with all of the plans being administered by JDIC. One agency with separate plans for each industry is, in fact, the approach used in Great Britain.

For securities dealers in Jamaica, a fifth option is available and that is the continuing operation of the Jamaica Stock Exchange Compensation Fund with an expanded membership base to include all securities dealers.

A sixth option – one compensation fund plan for the entire financial services industry – is not being put forward as a feasible option. Although this option may offer the benefit of administrative simplicity, there are significant differences between different financial services providers which make such an option impractical. Moreover, different sectors of the financial services industry have different risk profiles. These different risk profiles suggest that such features as fund size and fee assessments should differ among industries. This would not be possible with one plan and as a result there would be considerable and inappropriate cross subsidization among industries.

(b) Evaluation Criteria

There are a number of criteria that can be used to evaluate the feasible options.

- *Industry considerations*- It can be argued that because it is industry members that are providing the funding for compensation fund plans it is very important for the plans to fully take industry needs and requirements into account. An industry owned and controlled fund would be superior with respect to this consideration although the other options outlined could partially address this consideration through the establishment of industry advisory committees.

- *Consumer confidence* - One of the primary objectives of a compensation fund plan is to increase confidence in the financial services industry. It is likely that the options involving government ownership and control of the plans are superior with respect to this consideration because they involve greater independence of operation than an industry operated and controlled compensation fund plan.

- *Administrative efficiency* - All stakeholders value administrative efficiency and minimum operating costs. Administrative efficiency would likely be maximized if all compensation fund plans were administered by JDIC due to scale economies. Moreover, JDIC has experience in operating a compensation fund plan to the extent that it has successfully operated the deposit insurance fund for the past six years. Administrative efficiencies through scale economies would also be obtained if all the compensation fund plans were managed by the FSC. It is clear that there would be duplication of functions and expenses if individual agencies were established for each compensation fund plan.

- *Information requirements* - Each compensation fund plan will require information with respect to each of its member companies. The information required is typically confidential financial information and is usually provided by the agency in charge of supervising the industry. This issue would not arise if FSC was also the compensation fund plan manager since the information required in its capacity as a compensation fund plan manager would generally be the same information required in its capacity as the industry supervisor. Plans operated and controlled by the industry would have some difficulty with respect to access to information. Presumably such plans would have representatives of industry members as plan Board of Director members. It is uncertain whether specific companies in an industry would be prepared to allow the supervisory agency to share confidential information with individuals from competing companies who held Board of Director membership in the compensation fund plan. This issue becomes particularly critical when a plan member is in financial distress. In such a situation the compensation fund plan will want increasingly detailed and confidential information such as business and operating plans of the company in question.

- *Consistency of Operations* - There is an advantage in having consistency with respect to the operations of compensation fund plans. Two examples in this regard are fee assessment operational requirements and communication with the public. Consistency in operations would be greatest if JDIC or FSC were charged with managing the compensation fund plans.

- *Conflicts of Interest* - It is not acceptable for individuals charged with operating and controlling the compensation fund plan to be in a conflict of interest or perceived conflict of interest situation. This is difficult to achieve when the decision makers of a compensation fund plan are also industry participants. For example, in some cases the most efficient method of dealing with an insolvent company is to have the compensation fund plan provide funds to a competing company in return for that company acquiring the existing liabilities of the insolvent company. When the decision makers in such transactions are also members of the industry, allegations of conflict of interest are likely to arise.

- *Dominance of a particular sector* - A final consideration is with respect to the dominance of one industry. This is not a consideration for compensation fund plans that deal with single industries. However, it may be of concern where several compensation fund plans are administered by a single agency as in the case of the JDIC and FSC options. If one industry is much larger than the others, a disproportionate amount of time may be spent on that industry and procedures may be adopted that are fully suitable for the dominant industry but not suitable for the other industry plan members.

(c) Preferred Options

There is no doubt that different stakeholders will prefer different options with respect to the ownership and control of each compensation fund plan depending on their perception of the importance of each of the evaluation criteria.

Nevertheless, it is recommended that consideration be given to provide JDIC with the authority to establish and administer separate compensation fund plans for life insurance companies, general insurance companies and defined benefit pension fund plans. Administrative efficiency, the positive track record of JDIC, consistency in operations and public confidence are the primary factors resulting in this recommendation.

A second best option is for the FSC to establish and administer separate compensation fund plans for life insurance companies, general insurance companies and defined benefit pension fund plans. Administrative efficiency, efficiency in information sharing and public confidence are the FSC's advantages in this regard. However, the fact that the FSC does not have any compensation fund plan operational experience makes it the second best option. In fact, if the FSC is chosen as the delivery vehicle for compensation fund plans, it is suggested that JDIC be approached to second one of its senior officials to the FSC to help develop and implement the plan.

With respect to securities dealers the most realistic option, should a compensation fund plan be established, is one where the existing Jamaica Stock Exchange Compensation Fund was modified to provide protection to customers of all securities dealers. The existing plan has been in operation for several years and a substantial fund has already been accumulated. If this approach is accepted a number of issues would have to be resolved including;

- A determination of the funding and risk implications of a large number of new members in the compensation fund plan;
- A clarification and perhaps expansion of the securities instruments that would be covered by the plan; and,
- A review of the payout limits of the plan in the context of the existing client profile of securities dealers (see Section 4(h) of this report).

3. Authority of the Compensation Fund Plan

(a) Feasible Options

There are a range of options with respect to the authority that can be granted to the agency administering the compensation fund plan.

At a minimum, the authority of the agency can be limited to the activities of making required payments when necessary and levying premiums to fund these payments on either an ex ante or ex post basis.

At a maximum, the agency administering the compensation fund plan can be given the authority to grant membership, gather detailed information from plan members, conduct on-site inspections of plan members, impose detailed operating requirements on plan members, assess fees, pay claims and take charge of any liquidation. Because the member companies of compensation fund plans are typically subject to supervision by a financial services regulatory agency, the granting of such extensive operating powers to the compensation fund plan agency is often regarded as regulatory duplication in the sense that both the supervisor and the compensation fund plan can impose regulatory or quasi regulatory restrictions on the operations of a member company or pension fund plan.

Clearly, the authority granted to the compensation fund plan agency should acknowledge the fact that plan members are also supervised financial institutions. Because of this, each of the members will be required to meet certain requirements before they will be registered or licensed to conduct business. They will also be subject to supervisory requirements in the conduct of their business. Providing the compensation fund plan with similar authority is indeed duplication and can be a source of legitimate concern for plan members.

Nevertheless, an effective compensation fund plan agency must not only be granted sufficient authority to collect and invest premiums and make payments when necessary, but must also be granted sufficient authority to protect the financial interests of the fund that it is administering.

When an institution is about to become insolvent or has become insolvent, liquidation and payment of funds to customers is not the only option. Other options exist such as a capital injection accompanied perhaps by new management and a revised business plan or the making of a payment to a competing company to take responsibility for the liabilities of the insolvent company. In any event, sufficient authority should be granted to the agency to pursue the least cost option in the event of the financial distress or insolvency of a member institution.

Transferring the insolvent company's liabilities to another company with a compensatory payment to the acquiring company is particularly important with respect to insolvencies in the life insurance industry because of the long term nature of many life insurance policies. Because it may be impossible for the consumer to obtain a new policy because of health deterioration or age, keeping the current policy in force with a different, but financially sound company, provides superior protection to the policy holder.

(b) Preferred Option

With appropriate supervisory legislation that is being adequately administered by the supervisory agency, adding a second layer to the supervisory process through the compensation fund plan is not efficient and in fact may be detrimental to the industry.

Nevertheless, the compensation fund plan agency must not only be granted the authority to make assessments and make payouts, it must also be granted the authority to protect the integrity of the fund assets that it is charged with administering. In this context, it must have the authority to obtain information from the supervisor or the member company, if necessary, to become aware of the existence of companies that have become problematic and may be approaching insolvency. It must also have the authority to participate with the supervisory agency with respect to problem remediation of financially distressed companies. Finally, the compensation fund plan must have sufficient authority to pursue the least cost alternative when dealing with a situation of potential or actual insolvency.

4. Compensation Fund Plan Coverage, Limits and Exclusions

(a) Rationale for Limits and Exclusions

Compensation fund plans rarely offer full benefits to all consumers. There are two primary reasons for this. The first of these is affordability. While it may be desirable to provide full coverage to all consumers, it must be remembered that large potential benefits will result in large costs. The costs of any compensation fund plan must be affordable by those paying the assessments.

Second, as indicated earlier in this report, full coverage creates a moral hazard problem. With full coverage provided by the compensation fund plan, consumers do not have an incentive to undertake due diligence regarding the risk profile of the member company. Without this due diligence, financial services companies have an incentive to engage in higher risk activities in an attempt to attract customers by offering higher returns than competitors.

(b) Types of Limits and Exclusions

In an attempt to deal with both the affordability issue and the moral hazard issue, limits and exclusions are generally established in the pay out rules of a compensation fund plan. These can take a number of forms:

- A maximum limit can be put on the value of payouts to individual consumers;
- Certain groups can be excluded from receiving payouts. Typically, these take the form of so called sophisticated consumers such as government agencies, commercial enterprises or non-residents. It is argued that these individuals and groups have the necessary skills and information to protect themselves from an insolvency by doing the necessary due diligence before selecting a given financial institution with which to conduct business;
- Certain types of products can be excluded from coverage such as foreign currency products or products that are thought to be only purchased by sophisticated or commercial users; and,
- Coinsurance may be introduced. Under a system of coinsurance the compensation fund plan does not compensate the consumer for the entire loss. Rather the consumer is only provided with a specified percentage of the entire loss. It is argued that this coinsurance provides an incentive for all consumers including the "small and unsophisticated consumer" to undertake due diligence with respect to the selection of a financial institution and thus is very effective in reducing the moral hazard problem. However, coinsurance is not likely to be effective in reducing moral hazard if it is applied to those that do not have the necessary skills to assess the risk profile of a financial institution.

Limits and exclusions are likely to differ by industry sector because different financial services sectors typically provide products that meet different consumer objectives.

However, in some cases different industry sectors provide very similar products which meet similar consumer objectives. A good example of this can be found in the deposit taking and life insurance industries in Jamaica. A significant proportion of life insurance company consumer liabilities in Jamaica are associated with life insurance products that are very similar in design to savings deposit accounts offered by banks in Jamaica. There is little doubt that the two products are competitive products, at least in the mind of some consumers. Because JDIC has imposed a $300,000 coverage limit on deposit products, it seems reasonable that these very similar life insurance products should be subject to the same coverage limit. To have higher coverage for these insurance products would provide these products with a competitive advantage over the competing products offered by deposit taking institutions. To provide a lower coverage level would put the insurance products at a competitive disadvantage.

Although it is important for limits and exclusions to be consistent among competing products, it does not mean that there should be one limit set for all financial services products.

For example, while it may be acceptable to have a limit of $300,000 for "savings" products offered by life insurance companies, such a limit would likely be considered too low with respect to limits for death benefits. Similarly, a $300,000 limit would be too low for those having general insurance claims or those exposed to an under funded pension plan.

(c) The JDIC Approach to Limits and Exclusions

JDIC has taken the position in its inaugural annual report that "deposit insurance is intended to provide protection to the small unsophisticated depositor who is not in a position to assess the risks of the institution in which the depositor chooses to put his or her savings."

To accomplish this objective it has limited payouts (i.e. covered liabilities) to a maximum of $300,000, has excluded certain persons from coverage including deposit taking institutions and government agencies and has excluded certain products such as commercial paper and debentures from coverage, presumably on the grounds that the small and unsophisticated consumer does not invest in such products.

Based on information provided by JDIC, its approach to limits and exclusions is quite effective especially the imposition of the $300,000 maximum payout limit per depositor. The limit reduces the dollar value of total potential deposit payouts on an industry wide basis by over half from $232 billion to $105 billion. However, the $300,000 limit does not significantly reduce the number of depositors that would receive a full payout. These decline from slightly in excess of 3.5 million depositors to slightly over 3.4 million depositors. The proportion of depositors fully covered by the JDIC plan is thus approximately 97%.

The $300,000 limit has four significant effects. First, it reduces the covered liabilities and funding exposure of the compensation fund plan by over one half. In other words, if the $300,000 limit was not in effect the annual assessments required to be paid by member companies would have to more than double from 15 basis points to over 33 basis points.

Second, because the number of depositors that are not subject to full coverage is very small, confidence in the deposit taking industry is not significantly eroded as a result of the imposition of the payout limit. Approximately 97% of depositors are not affected by the payout limit.

Third, because some depositors (i.e. the 3% that do not have full coverage) have a great deal to lose if a member company fails, it is in their interest to undertake considerable due diligence when selecting the company in which to place their deposit. Because of this, the problem with moral hazard is greatly reduced. If member companies wish to pursue high risk strategies, they might not lose a significant number of depositors, but there is a great potential for them to lose a significant level of deposits.

Finally, the imposition of the limit is an administratively simple method of excluding excessive payouts to those depositors that are not "small and unsophisticated".

(d) Life Insurance Company Limits and Exclusions – A Canadian Example

Compensation fund plans for life insurance companies are somewhat more complex than those for other industries for two reasons.

First, life insurance products are typically long term in nature. As a result, when an insolvency occurs it is not simply a matter of winding up the company and paying the policy holders a set amount. Rather, the liquidator of the company will attempt to place the policy liabilities with other companies. Naturally, other companies will require the liquidator to provide sufficient assets of reasonable quality to fund the policy liabilities for which they will be come accountable. Due to the insolvency, there will be a short fall in assets and the compensation fund plan is called upon to provide funds to the company which acquires the assets and liabilities of the insolvent company.

For example, if an existing insurance company has $100 million in liabilities and $75 million in assets, it is insolvent by $25 million. If the liquidator approaches a competing company to assume the liabilities and assets of the insolvent company, the competing company will only do so if the liquidator is able provide an additional $25 million in assets. Alternatively, in the absence of any additional assets, the acquiring company would be willing to assume both the assets and liabilities of the insolvent company if it is agreed that all policy holders will accept only 75% of the benefits that were originally contracted for.

It is the compensation fund plan that enters the picture and with unlimited coverage the plan would provide the acquiring insurance company with $25 million in assets from its fund. Policy holders would retain their original benefits. If there are coverage limits set by the compensation fund plan, an estimate can be made to determine the value of the funds to be transferred by the compensation fund plan to the acquiring company. For example, it may be determined given the payout limits of the compensation fund plan that the plan will contribute $20 million to the acquiring company. In this case, the $5 million shortfall would be made up by reducing the policy benefits of those whose policies exceed the payout limits of the plan.

Under this arrangement, premium payments by the consumer must continue at the originally agreed amount. If the consumer is dissatisfied with this outcome, he or she has the option of surrendering the policy and obtaining a pay out of any cash value (subject to compensation fund plan limits) associated with the policy.

The second complexity for life insurance compensation fund plans is the result of consumer objectives. Consumers purchase products from life insurance companies for a number of reasons including protection against the financial impact of loss of life, protection against the financial impact of disability and for savings and investment purposes. These different purposes suggest that different limits may be appropriate for the same consumer depending on the type of product purchased. Moreover, some life insurance policies are bought by consumers to serve more than one purpose. For example, a typical whole life insurance policy provides death benefits as well as a savings or investment component.

The life insurance compensation fund plan in Canada has dealt with this by establishing different limits for different types of policies and consumer objectives. The limits (expressed in Canadian dollars) are as follows:

- Monthly income – a limit of $2,000 per month or if benefits exceed $2,353, 85% of benefits that were originally provided. Monthly income benefits are typically provided through products such as single payment annuities, disability payments or long term care payments.
- Health Expense insurance – a limit of $60,000 or if benefits exceed $70,589, 85% of benefits that were originally provided. These products typically involve travel insurance, supplementary medical insurance or critical illness insurance.
- Death benefits – a limit of $200,000 or if benefits exceed $235,295, 85% of benefits.
- Cash value coverage – a limit of $60,000. These limits are provided for traditional whole life policies and other polices that provide a savings or investment component. Note that the $60,000 limit provided by the life insurance compensation fund plan in Canada is identical to the limit that has been established by Canada Deposit Insurance Corporation for deposit and savings products offered by deposit taking institutions.
- Accumulated value coverage – a limit of $60,000. Some life insurance products offer premium prepayments or dividends to be put into deposit type accounts. The life insurance compensation fund plan has established limits consistent with

those offered on competing deposit products through Canada Deposit Insurance Corporation.

With respect to group insurance, the life insurance compensation fund plan in Canada allows coverage to continue for the lesser of six months or the termination of the group contract. It is felt that limited coverage should only be provided because there are suitable alternatives in the market to replace group coverage through other carriers.

The life insurance compensation fund plan operating in Canada does involve some complexity. It has used exclusions for group insurance, limits for the savings or investment component of insurance products and a combination of coinsurance and limits for other products to deal with moral hazard and cost control. It has also taken the necessary action to ensure that savings and investment type products do not have a competitive advantage over deposit type products by establishing identical limits to those of Canada Deposit Insurance Corporation.

(e) General Insurance Company Limits and Exclusions – A Canadian Example

General insurance companies provide short term contracts to individuals and entities for the protection of specific risks. From the perspective of the consumer there is no investment or savings component with respect to general insurance. In addition, there is limited feasibility in transferring the policy liabilities of an insolvent general insurance company to an existing carrier since most contracts will expire over the next year. Nevertheless, it is sometimes a lengthy process to liquidate a general insurance company because outstanding claims may take a number of years to resolve.

A general insurance company has two types of liabilities with respect to the insurance consumer. The first of these is unearned premiums. A consumer of general insurance typically pays an up front premium for coverage that will extend for a year. If the consumer pays the premium on February 1 and the company becomes insolvent on March 1, the consumer has lost 11/12ths of the premium payment. Because the insurance company is insolvent and will not honor any claims incurred after the date of insolvency, the consumer is forced to purchase a new policy from another company in the market.

Virtually every policy holder will experience a loss of unearned premiums as a result of the insolvency of a general insurance company, although each person will experience a relatively small loss in this regard. Most general insurance compensation fund plans cover this loss of unearned premium. In Canada, the general insurance compensation fund plan reimburses the consumer for 70% of unearned premiums up to a maximum payment of C$700.

In addition, at the date of insolvency a general insurance company will have liabilities in the form of outstanding claims. These may take the form of claims that have been settled but not yet processed, claims that have been submitted by the consumer but not yet settled and claims that have been incurred by the consumer but not yet reported. Very few consumers will incur losses related to claims, but the individual losses that are incurred can be substantial.

The general insurance company compensation fund plan in Canada makes claims payments due to the consumer up to a maximum C$250,000. This maximum is very similar to the minimum insurance coverage that a motor vehicle owner is required by law to purchase in Canada.

Finally, the general insurance company compensation fund plan in Canada excludes coverage for certain classes of insurance. These classes include liability insurance, marine, aviation and transport insurance and pecuniary loss insurance (as defined by the Jamaica *Insurance Act*). These are excluded on the grounds that it is thought that only commercial interests or sophisticated consumers purchase such products.

(f) Securities Dealers

Securities dealers in most jurisdictions have liabilities to consumers in the form of operating accounts. Consumers place their holdings of securities including cash, bonds, shares, commodity contracts and futures contracts into these accounts for safe keeping and to facilitate trading and other transactions performed by the dealer on behalf of the consumer.

Compensation fund plans in these jurisdictions have been established to protect the consumer from losses in these accounts should the dealer become insolvent. It is important to note that such compensation fund plans are not intended to protect the consumer in the event that the assets held in the accounts decline in value. For example, the Canadian Investors Protection Fund (“CIPF”) does not pay compensation if the securities owned by the consumer and held in an account of the dealer decrease in value because of the insolvency of the company that issued the securities. However, the CIPF will pay compensation if the securities dealer becomes insolvent and the funds or securities held in the account are no longer available for distribution to the consumer.

The payment limit for the CIPF is the compensation of losses of up to C$1 million. This limit is somewhat different than the limits established by other compensation fund plans operating in Canada in that the C$1 million payment limit to the consumer is in excess of any asset recoveries that the consumer might make through the liquidation process. For most compensation fund plans, asset recoveries associated with plan payouts become the property of the plan.

The CIPF and similar compensation fund plans generally contain a very significant exclusion in that securities issued by the dealer for purposes of business financing (securities lending and purchase/repurchase agreements) are not covered by the plan. This is consistent with the intent of such plans in that they are meant to protect the securities that are placed in the dealer’s accounts rather than the underlying value of the securities placed in these accounts.

In the Jamaican context, this would suggest that the significant repurchase agreement liabilities of securities dealers in Jamaica would not be covered by the compensation fund plan. There are two reasons to suggest that the Canadian approach to excluding investments in repurchase agreements issued by dealers is likely the correct approach for Jamaica. First, repurchase agreements are typically investment vehicles for sophisticated investors who have the skill to evaluate the risks of the instrument and the risk of a securities dealer. In Jamaica, for example, significant levels of repurchase agreements are purchased by insurance companies, the management of which should have the skill to make appropriate investment decisions. Second, because JDIC does not cover commercial paper or repurchase agreements, it would be inconsistent for the securities dealer compensation fund plan to provide such coverage.

In many ways, the CIPF operating in Canada and the Jamaica Stock Exchange Compensation Fund are very similar. Both are providing coverage in the event that customer owned securities that are being held by member dealers are unavailable to the customer when a securities dealer becomes insolvent. Neither covers customer losses that might occur because of declines in the market value of the securities. Nor do they cover any losses in value of security instruments that may have been issued by the securities dealer. Finally, neither covers any loss due to misappropriated securities if the dealer remains solvent, as the customer has direct recourse to the dealer in such a situation.

The Canadian CIPF is, thus, basically a more broadly based version of what exists in Jamaica in the sense that all dealers are members of the CIPF. For this reason, the Jamaica Stock Exchange Compensation Fund is considered an appropriate model for consideration as discussed previously in Section 2(c) of this report.

(g) Defined Benefit Pension Fund Plans

Pension fund plans can take two different forms including defined contribution pension fund plans and defined benefit pension fund plans. Under a defined contribution pension fund plan, the plan sponsor and plan members agree that specified contributions will be made to a "pension fund" on a periodic basis. These contributions are invested in various assets that are held by the fund. Upon retirement, the plan member receives pension benefits which are in accordance with the specified contributions that have been made and the investment income that has been generated as a result of these contributions. The investment risk associated with the fund is borne by the pension plan member to the extent that the magnitude of his or her pension benefits will depend on the investment returns achieved by the fund.

Defined benefit pension fund plans, on the other hand, guarantee a certain level of pension benefits to the plan member upon retirement. Like a defined contribution pension fund plan, these benefits can only be paid by making contributions to the fund and by investing these contributions. Unlike defined contribution pension fund plans, however, the magnitude of the regular contributions from the plan sponsor is not specified. Regular contributions are generally required, but the magnitude of the contributions is determined by the value of the assets held by the fund in relation to the fund's actuarial liabilities which are based on the pension benefits that have been guaranteed.

If it is determined that the value of the investment assets exceeds the value of the actuarial liabilities, no contributions are required from the plan sponsor. A major determinant of the magnitude of contributions made by the plan sponsor is the investment income generated by the fund assets. For a given level of guaranteed benefits, higher levels of investment returns will require lower contributions from the plan sponsor. Thus, the investment risk associated with the fund is borne by the pension fund plan sponsor to the extent that the magnitude of the sponsor's contributions will depend on the investment returns achieved by the fund.

International practice has been to limit the establishment of compensation fund plans for pension fund plans to defined benefit pension fund plans or in exceptional cases to defined contribution fund plans that have some sort of a payment guarantee, such as a minimum payment guarantee, contained in the rules of the pension fund plan. This is because a defined contribution pension fund plan does not contain a guarantee with respect to pension benefits. Pension benefits are strictly based on contributions made to the fund and the investment returns that have been received by the fund. Thus, from a theoretical perspective there can be no funding shortfall or pension fund plan deficit with a defined contribution fund plan and therefore no need for a compensation fund plan.

From a practical perspective, however, there are two reasons why it is possible for a defined contribution pension fund plan to be in a "deficit" position. First, it is possible that the pension fund manager has stolen or misplaced the assets of the fund. The remedy for this risk of fraud or negligence, as recommended earlier in this report, is to require the purchase of private sector liability insurance by pension fund managers. Second, it is possible that the plan sponsor does not make the required contribution to the plan. When this occurs it becomes immediately known that the contributions have not been made and there are regulatory and legal remedies that can be quickly taken to remedy such a problem before it becomes significant.

Two conditions are necessary before a compensation fund plan payment will be required in the case of a defined benefit pension fund plan. The first condition is that the plan must have a deficit in the sense that its assets are insufficient to pay the pension benefits that have been guaranteed. When this is the case, regulatory authorities typically require the plan sponsor to increase contributions to eliminate the deficit. It may, however, only be possible to eliminate this deficit over a period of a number of years. The second necessary condition is that the pension fund plan sponsor is unwilling or unable to make the required contributions to eliminate the pension fund plan deficit over a reasonable period of time. The most common cause of this is the insolvency or windup of the company that has sponsored the pension fund plan. However, it is possible that the plan deficit is so large that a rehabilitation scheme requiring the plan sponsor to increase contribution payments is not practical and will lead to the insolvency of the company sponsoring the plan. In such a situation a compensation fund plan might provide funds to assist in returning the plan to an acceptable financial position.

It is noteworthy that the issues surrounding compensation fund plans for defined benefit pension fund plans are somewhat different than those involving a seller/buyer relationship as in the case for deposit taking institutions, securities dealers and insurance companies. In the case of pension fund plans, the “customer” does not explicitly choose a plan from among a set of competing products but accepts membership in a plan incidental to accepting employment with the company offering the plan.

Because of this, the moral hazard problem of the consumer selecting higher risk deposit taking or insurance companies as the result of the implementation of a compensation fund plan does not appear significant with respect to pension fund plans. Nevertheless, it has been argued that a plan sponsor, knowing full well that a compensation fund plan will guarantee pension fund plan benefits, will attempt to increase the risk of the plan’s assets in order to generate higher investment returns and thus require lower contributions. Such an incentive, however, exists with or without a compensation fund plan and assumes that the plan sponsor has complete control over the investment policy of the pension fund plan.

Pension fund plan benefits, however, form part of an overall compensation package. Employers have a choice, when offering an overall compensation package to employees, of distributing employee benefits between current income through wages or through future income through enhanced pension fund plan benefits. A financially troubled employer may thus have an incentive to offer increased pension plan benefits rather than immediate wage increases. To reduce this exposure, compensation fund plans in most jurisdictions exclude coverage on pension plan benefits that have been granted within the three years prior to a company’s insolvency.

Affordability is the prime determinant with respect to compensation fund plan payout limits in the sense that it is important that the payout limits established by the compensation fund plan be affordable in the context of the assessments that will have to be made on member pension fund plans. An examination of the profile of the magnitude of guaranteed pension plan benefits is required to make this determination.

It is generally quite easy to establish a compensation fund plan payment limit which allows the pension recipient to achieve a minimum but acceptable standard of living. But such a payment limit may be regarded as very low for a large number of persons given that defined benefit pension fund plan benefits are typically based on the working income of the member. Therefore, it may seem very unreasonable to impose such a low limit on payouts for moderate and high income earners.

A coinsurance scheme may provide a very practical payout alternative for pension related compensation fund plan payouts. For example, a payout minimum could be established which would be the lesser of actual guaranteed benefits or an amount required to achieve a minimum but acceptable standard of living. Above this level, payouts could be 85% or some other percentage of the benefits guaranteed to the plan member.

(h) Selecting Limits and Exclusions

Compensation fund plans have used various methods to control costs and reduce moral hazard. These include the imposition of limits, the exclusion of certain products, the exclusion of certain persons and the imposition of coinsurance.

The exclusion of certain products or persons from the plan is generally a matter of judgment as to the characteristics of who is not “small and unsophisticated” and the products that these persons demand. Clearly, products such as aviation insurance or commercial paper are not typically purchased by the “small and unsophisticated” consumer.

Payout limits can also be set using judgment based on general information available in the market. For example, the general insurance company compensation fund plan in Canada has a maximum claims payout limit which is similar to the minimum level of insurance coverage that a motor vehicle owner is required by law to purchase. It can be safely assumed that the “small and unsophisticated” consumer of motor vehicle insurance will have at least this level of coverage.

Rational limits, however, should only be established after an examination of the profile of industry customers. This appears to be the methodology that JDIC has employed to establish its depositor protection pay out limit of $300,000. As previously stated in this report, JDIC is fully aware of the total number of deposit holders in its member companies and that 97% of total depositors hold deposits of $300,000 or less.

Similar customer profile information on the types of products purchased and the value of the obligations owed to the customer or pension fund plan member is not currently available for life insurance companies, general insurance companies, securities dealers or pension fund plans. It will be necessary for the FSC to acquire such information to determine the cost exposure of a compensation fund plan and to determine appropriate compensation limits, exclusions and coinsurance that can be applied to limit cost exposure to appropriate levels.

5. Funding Options

Virtually all compensation fund plans are funded by the industries that receive the benefits associated with the increased public confidence. There are three funding methods that can be employed.

(a) Pre-funding by Annual Assessments

By far the most common approach to funding a compensation fund plan is to assess an annual fee on all companies or pension fund plans that are members of the compensation fund plan. The payments are used to build up a fund.

A determination must be made for the appropriate level of the annual assessment based on the size of the fund that is required. There is no definitive answer as to the appropriate size of the fund especially during the early stages of the compensation fund plan. After a compensation fund plan has been in operation for a number of years and payouts have been made, it is possible to make an actuarial estimate as to the appropriate fund size.

At the current time, JDIC has an annual assessment levy of 15 basis points on a base of insurable deposits with the accumulated fund approaching 1.5% of its total liability exposure. There is considerable variation of deposit insurance fund targets throughout the world ranging from 0.4% of liability exposure in Italy to 20% in Kenya. Many jurisdictions, however, have not specified a fund target. In addition, a significant majority of jurisdictions have actual funds of less than 1% of their liability exposure.

Although it is not possible to determine the level of "covered liabilities" for general insurance companies, life insurance companies and securities dealers in the absence of limits and exclusions that have yet to be specified, financial information provided by companies to the FSC indicates that a compensation fund plan annual assessment rate of 15 basis points on total liabilities would be affordable by these three industries.

JDIC appears to have an informal fund target of 2 percent of covered liabilities. If such a guideline were adopted it would take a number of years for any compensation fund plan adopted by the other sectors to reach this level. If assessment rates were 15 basis points per annum three factors would determine the length of time that would be required to achieve the target fund size of 2 percent of covered liabilities:

- the level of claim payments (if any) that were required to be made by the compensation fund plan;
- the annual growth rate over time in covered liabilities of member institutions; and,
- the investment returns on fund assets.

If it is assumed that there are no claims payments and that the rate of return on the invested assets of the compensation fund plan is equal to the annual rate of growth in covered liabilities, it would take slightly in excess of 13 years (i.e. 200 bp/15bp) to achieve the 2% fund target. Under these assumptions the returns on invested assets fully fund the growth in covered liabilities on an annual basis. However, it can generally be expected that the annual rate of return of the fund assets will exceed the annual growth rate in covered liabilities. As a result, the fund target will be reached several years earlier than these assumptions suggest.

(b) Post Funding

An alternative method of funding that is sometimes used by compensation fund plans is post funding in the sense that assessments on industry are made after the insolvency has occurred. This assessment regime is in fact utilized by the general insurance company and life insurance company compensation fund plans in Canada. It has been utilized in other jurisdictions as well although it is far less common than pre-funding through assessments.

The justification for this approach is the claim that financial services industry practitioners are better at investing funds than those that are administering compensation fund plans. Moreover, post funding is seen as a viable option by those that feel that compensation fund plan officials will attempt to increase the plan's fund even if further increases are not necessary.

There are clearly some difficulties with this approach. First, it is questionable whether consumer confidence will be enhanced without a compensation fund plan "fund" with actual assets that can be used in the event of an insolvency. Without such a fund, the consumer is only being provided with a promise to pay. Second, with post funding the compensation fund plan has the risk that it may not be able to raise the level of required funds in times of need. The propensity for company failures increases during times of economic recession and during these times a number of companies can be subject to financial stress. Having to pay additional assessments during these times might not be a practical alternative.

Finally, post funding leads to the ironic anomaly that the insolvent company that creates the need for funding is the only company in the industry that does not have to make a contribution to remedy the situation.

(c) Debt Funding

It is also possible to use debt to establish the fund of the compensation fund plan. Under this approach the compensation fund plan could issue debentures to member companies or pension plans in proportion to the fund's liability exposure of their behalf. These debentures would pay a rate of interest as determined by the compensation fund plan and would appear as assets on each company's or pension plan's balance sheet. When the compensation fund plan was required to make compensation payments, the debentures would be redeemed and member companies and pension fund plans would be immediately be assessed the amount of the redeemed debentures.

This approach is not a common approach to funding compensation plan funds although it has been used as a start up approach in some jurisdictions. The advantage of the approach is that it allows the compensation fund plan to quickly establish a fund of an appropriate size to help increase consumer confidence without requiring significant assessment expenditures by plan members. Annual assessments of modest amounts can then be used to pay off the debentures over time.

(d) Assessment Issues

It is generally the case that the compensation fund plan sets an assessment rate to be applied to each company's or pension plan's covered liabilities with covered liabilities taking into account compensation fund plan payment limits, exclusions and coinsurance rates. This appears to be a fair method of assessment to the extent that each company's assessment is based on the value of its contribution to the compensation fund plan's liability exposure. In some cases, where limits, exclusions or co-insurance are particularly complex, proxy indicators are used to estimate covered liabilities. In all cases, however, company estimates of "covered liabilities" should be verified by an independent auditor.

Covered liabilities, however, is a relatively simplistic measure of risk to the compensation fund plan in that it only covers the pay out risk of the plan. The measure, however, does not take into account the probability that the member company will become insolvent and require a payout to be made. For example, a well capitalized and well managed company with a given level of liabilities presents far less risk to the compensation fund plan than a company with an identical level of liabilities that has a low capital base and is poorly managed.

For this reason, it is often argued that compensation fund plan assessments should be based not only on the level of "covered liabilities" but also based on the risk profile of the company. Assessment payments to the compensation fund plan on the basis of risk also provides an incentive for member companies to reduce their risk profile.

Although the idea of risk based assessments is a good one, it is difficult in practice to implement. Generally speaking, the most important factor in determining the future risk of a company is the company's business plan, investment policy and the capabilities of company management. These are very difficult to quantify and different persons can certainly disagree on what constitutes a high or low risk business plan. If complete risk based assessments are to be made, it is likely necessary to have an appeal process to adjudicate differences of opinion regarding risk levels between officials of the compensation fund plan and officials of the companies paying the assessment.

It is quite common, however, for pension plan compensation fund plans to levy two assessment fees on member pension plans. The first fee is a regular assessment fee and is based on either the number of plan members or the value of the liabilities of the pension plan fund. The second assessment fee is a surcharge and it is levied on the unfunded liabilities of the plan. The surcharge raises additional revenue from pension fund plans that are of higher risk. It also may provide a small encouragement to the pension fund plan sponsor to reduce the unfunded liability of the pension fund plan. Although the pension fund plan is required to pay the assessment fee, the surcharge represents a variable expense that has an impact on the required contribution to the fund that must be made by the plan sponsor.

A similar approach could be used for financial institutions. In Jamaica, there are different regulatory capital tests for different types of companies including the minimum assets test for general insurance companies, the minimum continuing capital and surplus requirement for life insurance companies and capital to assets tests for securities dealers.

The compensation fund plan could encourage companies to hold greater levels of capital by offering fee assessment discounts to companies that exceeded the minimum regulatory requirements by a certain amount. If the discounts were sufficiently large, companies could be encouraged to increase their levels of capital.

Providing surcharges on pension fund plans with unfunded liabilities and discounts for well capitalized companies is a funding approach that is partially based on risk. It is not difficult to implement because both unfunded liabilities and capital are easy to quantify and subject to verification by auditors and appointed actuaries. A formal adjudication and appeal process is not required. However, it must be recognized that unfunded liabilities and capital are very limited indicators of risk and certainly only one element in determining the risk profile of a pension fund plan or a company.

(e) Preferred Option

It is recommended that each compensation fund plan established in Jamaica make annual assessments on its members and seek to build a fund. While it is impossible to determine and finalize assessment rates without examining information yet to be gathered by the FSC, assessment rates of 15 basis points on covered liabilities (net of any discounts) would not have a significant impact on the annual net incomes of life insurance companies, general insurance companies or securities dealers.

The initial assessment rates could continue for several years until the compensation fund plan has to some extent matured. Changes can then be contemplated depending on the level of the fund and the circumstances of the industry.

It is not recommended that debt financing be used initially to build the compensation fund plan “fund” unless there is compelling evidence to suggest that this will have a positive impact on consumer confidence.

It is also recommended that the fee assessment base for each company approximate as closely as possible covered liabilities. Although risk based assessments are theoretically attractive, they are not recommended as they are felt to be impractical. Surcharges on unfunded liabilities for pension fund plans and discounts for high capital levels for financial institutions can be used as an alternative to risk based assessments.

6. Other Issues

(a) Compulsory or Voluntary Membership

It is usual for all companies or defined benefit pension plans that are registered to conduct business to be required to be members of the compensation fund plan. This is especially true if assessments are made without fully taking into account the complete risk profile of each member company or pension fund plan. Without fully reflecting risk in the assessment, compensation fund plan members with lower risk are, in fact, providing a subsidy to higher risk members. Because of this, lower risk members have an incentive to opt out of the compensation fund plan. Without compulsory membership the end result is that only members that are of high risk and unwilling to reduce their risk profile remain as plan members. Compulsory membership thus reduces the potential of adverse selection.

(b) Priority Creditor Status

When dealing with an insolvency, the costs incurred by a compensation fund plan are partially recovered from the sale of assets of the insolvent institution. Compensation fund plan costs can be significantly reduced if pension plan members and company customers are given preferred creditor status with respect to the distribution of assets on the windup of a company.

In many jurisdictions, a preferred creditor ranking is given to employees with respect to unpaid wages and salaries. This could quite easily be expanded to include any unfunded liabilities in the company's pension fund plan. Similarly, in many jurisdictions, customers of financial institutions are ranked behind employees and the fiscal authorities but ahead of other creditors with respect to company windups.

Changes to legislation may need to be considered in this regard since the preferred ranking of pension fund plan members and company customers ahead of other creditors could result in significant cost savings for compensation fund plans. For example, a common clause in insurance company legislation in many jurisdictions (but not Jamaica) is as follows: "Notwithstanding any law to the contrary, in the event of liquidation, insolvency or bankruptcy of a registered insurer the owners of insurance policies issued by the insurer shall have preference against all other creditors of the insurer". Adding such a "notwithstanding clause" to the Jamaica Insurance Act and the pension legislation would establish priority creditor ranking.

(c) Government Backstop

It is generally the case that government provides compensation fund plans with a backstop should the plan not have sufficient funds to meet its obligations in the event of an insolvency. Without such a backstop, there could be a very significant erosion of consumer confidence if a company became insolvent and the compensation fund plan could not perform its promised obligations.

The backstop is typically in the form of a government guarantee of debt that the compensation fund plan would issue in the event that its accumulated fund was insufficient to meet payment commitments to consumers. The debt would be repaid over time from future assessments.

Although it is common for governments to provide such a backstop to compensation fund plans that have established a fund, it is understandable that governments have usually been reluctant to grant such a backstop for compensation fund plans where fees are normally assessed after the insolvency has occurred.

(d) Independence and Accountability

It is important that any compensation fund plan have reasonable independence in decision making from both the government and members of the industry that it serves. This can be accomplished by appointing a board of directors with the majority of members having no formal employment relationship with government. In addition, to avoid any potential conflicts of interest, persons having an ownership or employment relationship with companies in the industry being served by the compensation fund plan should be ineligible for appointment to the Board of Directors.

At the same time, the compensation fund plan should be accountable to its owner and to the industry it serves. This can be accomplished through the requirement to publish audited annual financial statements as well as an annual report which outlines the plan's activities over the previous year.

7. Conditions Required for the Commencement of Plan Operations

It is not necessary and perhaps not prudent in Jamaica to establish compensation fund plans for each of the four sectors simultaneously (i.e., life insurance, general insurance, securities and pension fund sectors). There are benefits to phasing in the establishment of plans over a period of several years, giving the appropriate time to allow lessons learned from the establishment of one plan to be used in establishment of subsequent plans.

It is also important to determine whether companies in a given industry have sufficient financial strength to participate in such a plan before the plan is established. It is inappropriate to allow a company or pension plan to participate in a compensation fund plan if it is expected to require a compensation fund plan payout in the near future. Moreover, it is inappropriate to commence a plan if member companies or pension plans do not have the financial capacity to fund a possible insolvency of a compensation fund plan member. A compensation fund plan should not be established if as a result of a pay out, fund assessment rates have to be set so high that it results in the insolvency of other members. In such a case the establishment of the plan would exacerbate the financial condition of the industry and reduce consumer confidence.

Based on analysis of information provided to the FSC by its licensees, it is recommended that priority be given to the life insurance industry with respect to the establishment of a compensation fund plan followed by the general insurance industry, securities dealers (if the recommendation to establish rules to ensure that all securities dealers have acceptable levels of private sector third party liability insurance coverage is not accepted) and defined benefit pension fund plans.

In adopting this phased approach the FSC should not lose sight of the goal of eventually establishing compensation fund plans for at least three of these sectors. There are a number of common activities, such as drafting regulations, which will be required with respect to the establishment of all the plans. The FSC can move ahead with these activities even though it is premature to establish compensation fund plans for all sectors at the current time.

The FSC invites comments and suggestions from interested parties regarding the contents of this discussion paper. The deadline for the submission of comments is **January 15, 2006**. Please direct your comments to:

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