Credit and Investments Ombudsman
PO Box A252
Sydney South NSW 1235

ABN 59 104 961 882

T 02 9273 8400
F 02 9273 8481
raj.venga@cio.org.au

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EDR Review Secretariat
The Treasury
Langton Crescent
PARKES ACT 2600

Email: EDRreview@treasury.gov.au

LAST RESORT COMPENSATION SCHEME (LRCS)

The Credit and Investments Ombudsman (**CIO**) welcomes the opportunity to make a submission in relation to the above.

CIO supports the establishment of a last resort compensation scheme (**LRCS**) but notes that its design and funding will be critical to its acceptance and success.

St John Report

We note that the St John Report[1] recommended strengthening the (then) existing compensation arrangements, including the holding of adequate professional indemnity insurance **(PII)** cover, to ensure that licensees had the financial resources to meet compensation liabilities.

[1] *Compensation arrangement for consumers of financial services* prepared by Mr Richard St. John.

The St John Report concluded that 'it would be inappropriate and possibly counter-productive to introduce a last resort compensation scheme at this stage'.[2]

Despite this, CIO supports the establishment of a LRCS given the limitations of PII as a compensation mechanism:

- funds available under a PII policy may not cover any or all of the compensation awarded against the consumer,
- the PII policy may not cover the conduct for which the compensation is ordered (e.g. fraud), and
- the amount of compensation payable may be less than the PII policy's excess.

We also note ASIC's observation that PII is designed to only protect AFS licensees against business risk and that it is neither intended nor designed to provide compensation directly to consumers.[3] A consumer cannot claim directly on the PII policy, only the insured AFS licensee can.

Concerns about LRCS

The St John Report should nonetheless not be dismissed as irrelevant to the present debate.

The Report noted that industry was concerned about the "lack of effective rights of review from (EDR) decisions" and that "the liability standard for EDR awards is not confined to breaches of legal rights but may include broader notions such as fairness or industry practice".[4]

It is certainly true that the existing ombudsman schemes, CIO and FOS, occupy a unique position in the dispute resolution landscape and enjoy broad discretions and powers:

- their decisions are binding on the financial firm if accepted by the

[2] although the Report also suggested that if the (then) current arrangements were reinforced, 'it would be open to round them out in due course with a more comprehensive scheme of last resort'.
[3] ASIC's Report 459: Professional indemnity insurance market for AFS licensees providing financial product advice, December 2015.

consumer and these are generally not judicially reviewable by the courts,

- unlike a court which must decide cases according to law and precedent, CIO and FOS are not bound by their previous decisions, are able to decide a dispute on grounds of fairness and industry good practice, and are not bound by any legal rule of evidence — this gives the schemes a good deal of latitude in deciding cases and exercising discretions and powers without having to be unduly concerned about judicial review, and

- not being a court or tribunal, neither CIO nor FOS can subpoena documents, take evidence on oath, cross-examine witnesses or investigate criminal fraud — yet they are able to adjudicate complaints where a claim for loss is up to $500,000 or the debt recovery or debt related small business dispute is up to $2,000,000 (with a proposal to increase that to $10,000,000).

Other arguments not favouring a LRCS include:

- it gives rise to the potential moral hazard of individuals assuming greater risk than they would otherwise take because someone else bears the risk of possible financial loss,

- the LRCS involves a degree of cross-subsidisation because legally compliant financial firms in one sector will be required to subsidise the non-compliant actions of financial firms in other sectors,

- the introduction of a LRCS may raise competition issues in the financial services industry because it could favour one sector of the industry over another,

- it would be inequitable to require more responsible and financially secure financial firms to underwrite the ability of other financial firms to meet claims against them for compensation, and

- there may be claims by consumers for compensation where the claims have not been the subject of a formal merits assessment and decision, and

[4] Report at 2.180

- a consumer will be able to access the LRCS even if the EDR decision was made in circumstances where the financial firm was unable to defend the claim brought before the EDR body because it was insolvent.[5]

Retrospectivity

Requiring the LRCS to deal with and pay out on past disputes may have significant implications for financial firms. Retrospectivity may:

- substantially increase PII premiums, particularly for smaller and non-ADI financial firms,
- result in some financial firms no longer being able to obtain PII cover, and
- result in existing PII cover being inadequate for past events or being vitiated given the non-disclosure of the event.

If past disputes are to be included at all, we suggest that they are restricted to cases where the financial firm is insolvent or otherwise unable to pay. It is not appropriate for retrospectivity to apply where the consumer was merely prevented from accessing redress (because, for example, the monetary value of the dispute exceeded the EDR scheme's monetary limits or the dispute was outside the EDR scheme's time limits or the dispute was not pursued for other unspecified reasons). In these cases, the dispute will not have been determined on its merits.

Design of LRCS

Given financial firms are being asked to indemnify losses caused by other financial firms, and the need to provide PII insurers with some level of comfort so they continue to offer cover, CIO considers that any LRCS should have the following features:

(a) It should be mandatory, but not retrospective.

(b) It should cover individuals and small businesses.

(c) It should cover unpaid determinations or awards by an EDR scheme, court or relevant tribunal.

[5] Complaints can be closed early in the EDR process if there is no reasonable prospect of any order for compensation being met.

(d) The compensation or monetary caps applying to the LRCS should not exceed the compensation caps or monetary limits for the EDR scheme.

(e) Alternatively, the compensation caps or monetary limits should not exceed $250,000, which reflects the level of protection available to depositors and policy-holders under the Financial Claims Scheme administered by the Australian Prudential Regulation Authority (**APRA**). After all, a person who invests their money with a financial planner should not be entitled to recoup more than a person who has invested in an APRA-regulated entity. This also minimises the risk of moral hazard.

(f) It should only apply where the financial loss is attributable to a financial firm which has become insolvent or is otherwise unable to pay (and not because, for example, the monetary value of the dispute exceeded the EDR scheme's monetary limits or the dispute was outside of the EDR scheme's time limits).

(g) The determination of the EDR scheme supporting the order to pay compensation must be based on the merits of the dispute (rather than, for example, drawing an adverse inference because the financial firm has not been able to provide the information requested).

(h) Other redress avenues must have first been exhausted; for example, the financial firm's PII has failed to cover the claim, either as a result of the policy being exhausted or because the insurer relied on an exclusion clause to refuse indemnity.

(i) The administrator of the LRCS must operate as a stand-alone scheme. As a matter of probity, it must be independent of and separate from the decision-maker. Otherwise the rigour of the EDR scheme's decision-making may potentially be compromised by the knowledge that any award of compensation will be paid out notwithstanding.

(j) Like the UK's Financial Services Compensation scheme, the LRCS should independently review the EDR determination and decide for itself whether the consumer should be paid compensation, rather than simply accepting the EDR scheme's determination of the merits of the dispute. This is another reason why the LRCS must be independent of the decision-maker.

(k) The review criteria could be the same as those of the existing EDR schemes: applicable law, fairness in all the circumstances, applicable industry codes and good industry practice. We appreciate that industry would prefer the criteria to be limited to applicable law so they are not required to pay for unpaid determinations which are based solely on concepts such as fairness.

(l) If it is intended that the LRCS should also be available in relation to unpaid judgments of a court or tribunal, then litigation funders should not be able to recover from the LRCS, either directly or indirectly through their contracts with the class of claimants. This is because of the likely quantum of compensation such funders typically expect to recover, the likelihood that it would open the floodgates to a large number of claims that would not otherwise be brought, and the fact that compliant financial firms would bear the entire cost of these claims. Similarly with class action litigation.

(m) Consistent with other last resort schemes, the LRCS should ideally be established as a statutory scheme. We note that the Financial Conduct Authority in the United Kingdom, which performs a similar regulatory function to ASIC in Australia, administers the UK's Financial Services Compensation Scheme. Similarly, the Financial Claims Scheme in Australia, which protects depositors of authorised deposit-taking institutions and policyholders of general insurance companies from potential loss due to the failure of these institutions, is administered by APRA. In both these instances, a statutory levy to fund the last resort scheme is imposed on industry participants. As noted earlier, it is inappropriate for such a levy to be collected, held and disbursed by a private body such as an EDR scheme.

(n) Following the payment of compensation to an individual, the LRCS should have a right of subrogation to pursue the financial firm which failed to pay the EDR determination or court decision.

Allocation of funding

CIO is not convinced that the LRCS should extend beyond financial advice. In the case of CIO, more than 80% of all unpaid determinations was attributable to a single mortgage broker in relation to two unpaid CIO determinations. In this case, the

broker provided the consumers with unlicensed financial product advice in relation to investments before it went into liquidation.

We note that 53% of financial firms responsible for unpaid FOS determinations were financial planners, with another 13% being responsible entities of managed investment schemes. Almost a fifth of all financial planning and investment determinations go unpaid, representing almost a quarter of all compensation that was awarded for financial planning complaints.

Given that the overwhelming majority of unpaid determinations to date are attributable to financial planners and managed investment schemes, it would be inequitable for financial firms in other sectors, such as mortgage brokers, aggregators, debt purchasers and others, to bear a burden that is not proportionate to the number of unpaid determinations in their respective sectors.

Raj Venga
Chief Executive Officer and Ombudsman