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EXTERNAL DISPUTE RESOLUTION AND COMPLAINTS FRAMEWORK

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

Treasury has released exposure draft legislation, an explanatory memorandum, a consultation paper and a fact sheet (**EDR framework documents**) for the establishment of a single Ombudsman scheme to be known as the Australian Financial Complaints Authority (**AFCA**).

CIO considers that it is premature to discuss transitional issues when the passage of the legislation through Parliament is not guaranteed. In any event, we anticipate that a substantial transition period will be required, with any commencement date not being earlier than 1 July 2019.

One–stop shop

CIO continues to oppose the establishment of the 'one-stop shop' for financial disputes, including superannuation disputes, to replace CIO, Financial Ombudsman Service (**FOS**) and the Superannuation Complaints Tribunal (**SCT**).

Our reasons are as follows:[1]

1. Not fit for purpose

   AFCA is not fit for purpose. It is clear from the EDR framework documents that AFCA will neither provide better consumer outcomes nor be able to address past, or prevent future, financial scandals:

   (a) AFCA is not equipped to weed out poor entrenched corporate culture[2] or address the string of financial scandals that regularly grace the pages of our newspapers. These have caused public outrage and invited the scrutiny of numerous parliamentary inquiries. Not being able to investigate the root cause of these scandals, AFCA will be powerless to prevent their reoccurrence to the detriment of consumers.

   (b) AFCA's efficacy is further stymied by its inability to subpoena a third party to attend as a witness or produce documents, join third parties, cross-examine witnesses, take evidence on oath, investigate criminal fraud or impose penalties. Only a court or statutory tribunal can do this.

   (c) Not having statutory powers, AFCA will not be able to redress the power imbalance between big banks and small businesses or deal effectively with small business claims against banks, even with expanded monetary limits and compensation caps.

[1] Other detailed reasons are set out in our response to the Ramsay Review: http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/Reviews%20and%20Inquiries/2016/Review%20into%20EDR/Submissions/PDF/Credit%20and%20Investments%20Ombudsman%20Service%20Submission.ashx

[2] It is beyond AFCA's remit, and that of CIO and FOS', to expose bad behaviour by assigning and publicising moral culpability to, or imposing penalties on, financial firms.

For example, in the context of primary producer or small business loans and guarantees, AFCA will not be able to join, bind or obtain information from third parties that have been appointed by a bank, such as valuers, investigative accountants and receivers.[3] Nor will it be able to make or enforce decisions against them.

(d) AFCA will not be able to accept complaints from primary producer borrowers who have previously undertaken farm debt mediation.[4]

(e) AFCA will not be able to accept complaints against commercial lenders that are not required to be licensed.

(f) Not only will AFCA not be able to enforce its own decisions,[5] but consumers will also not be able to enforce AFCA's decisions or seek a judicial review of an unfavourable AFCA decision.[6]

2. Old wine in a new bottle

Despite being trumpeted as something entirely new and designed to ensure 'that consumers and small business have access to free, fast and binding dispute resolution',[7] AFCA has essentially the same powers and jurisdictions as CIO, FOS and the SCT.

For example, the exposure draft legislation prescribes certain key features and regulatory oversight under which AFCA will operate. But these are virtually the same as CIO, FOS and SCT's:

(a) The SCT already possesses the 'additional powers' that are being given to AFCA for superannuation complaints.

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[3] This was specifically recommended by both the Parliamentary Joint Committee on Corporations and Financial Services (The Impairment of Customer Loans) and the Small Business Loans Inquiry Report by the Australian Small Business and Family Enterprise Ombudsman (**ASBFEO**)

[4] This was a recommendation of the ASBFEO.

5 Because AFCA is not a statutory tribunal.

[6] Although a statutory tribunal may undermine AFCA's role as an alternative to the courts and its ability to offer informal, low cost and accessible dispute resolution, there is considerable merit in the establishment of a small business tribunal empowered to investigate and adjudicate small business or complex disputes that are outside the existing jurisdictional limits of CIO and FOS.

(b) To meet those few key requirements that CIO and FOS do not already comply with, CIO and FOS need only amend their existing terms of reference to allow them to increase their monetary limits and compensation caps, appoint an independent assessor, conduct more frequent independent reviews and use panels to decide certain types of cases.

(c) As for regulatory oversight, the proposal to allow ASIC to issue directions to the scheme operator to undertake specific measures adds little, if anything. ASIC already has the power to revoke CIO or FOS' approval if they do not meet ASIC's requirements. This constitutes a far greater incentive for CIO and FOS to comply with ASIC's requirements than the power to issue 'directions'.

(d) More significantly, if only one scheme is authorised by the Minister, as is proposed, it is inconceivable that the Minister would revoke AFCA's authorisation and leave tens of thousands of consumers with absolutely no redress against financial firms other than through costly legal proceedings.

Stakeholders would be entitled to ask: what then is the sanction for poor performance or non-compliance by AFCA?

3. No economic basis

The proposal to establish AFCA is not supported by economic analysis, sound argument or evidence:[8]

(a) The Ramsay Report on which the proposal is based does not demonstrate any cost benefits to replacing CIO, FOS and the SCT with AFCA.

(b) The Report's assertion that multiple EDR schemes result in increased

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[7] http://sjm.ministers.treasury.gov.au/media-release/044-2017/

[8] Economic analysis of the Ramsay Interim Report by ACIL Allen Consulting, January 2017

costs for the regulator is flawed. [9] On the contrary, the proposal to establish AFCA has led the government to announce that an additional $9.2 million will be made available to ASIC and Treasury to ensure they can implement appropriate law and regulatory reform.[10]

(c) Being a non-statutory monopoly, AFCA will be far less accountable and transparent to its stakeholders than a statutory scheme that is subject to appropriate checks and balances.

(d) AFCA will eliminate the benefits which the existing two ASIC-approved ombudsman schemes (CIO and FOS) currently provide: better consumer outcomes through benchmarking,[11] service quality comparison, innovation with better processes and services and pressure to keep costs down.

(e) Compared to firms in more competitive markets, a typical not-for-profit monopoly will tend to charge more for its services and spend it on bloated staff numbers, higher managerial salaries, excessive executive remuneration, lavish offices and other wasteful spending.[12]

(f) AFCA may also damage the prospects for increased competition in financial services. While the cost of having complaints heard by an ombudsman scheme which is inefficient (which typically can be expected where the body is a monopoly) may not be a significant cost to the major banks and insurers, it certainly will be for smaller players who operate on much thinner margins. Costs impede the latter's ability to compete on price, especially in the early stages of development[13].

(g) Unlike a conventional monopoly where buyers can walk away if the quality of the service is low or prices charged by the monopolist are

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[9] Page 8, http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/Reviews%20and%20Inquiries/2016/Review%20into%20EDR/Key%20Documents/PDF/EDR%20Review%20Final%20report.ashx

[10] http://sjm.ministers.treasury.gov.au/media-release/042-2016/

[11] This is discussed in detail in CIO's response to the Ramsay Interim Report: http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/Reviews%20and%20Inquiries/2016/Review%20into%20EDR/Submissions/PDF/Credit%20and%20Investments%20Ombudsman%20Service%20Submission.ashx

[12] Managerial Discretion and Expense Preference Behaviour, Robert Y Awh and Walter J Primeaux, Jr.

[13] See for example the submissions of Fintechs, Tyro Payments and RateSetter, both FOS members, to the Ramsay Review.

high, financial services providers will have no choice but to remain members of AFCA given that membership is mandatory.

This is not a problem under the current two ASIC-approved scheme model because competitive tension between CIO and FOS means that they have to be responsive and accountable to financial firms who can credibly threaten to take their membership to the other scheme.

4. Case study of a not-for-profit member-based monopoly

To appreciate the kind of allegations that can be levelled against a not-for-profit member-based organisation that enjoys a monopoly (in the same way that AFCA will), one only has to look at recent media reports about the board and management of CPA Australia, a company also limited by guarantee.[14] The media reports allege that:

- the CEO was appointed without the role being advertised,
- the constitution was changed repeatedly to extend the term limits of the directors who were supportive of the CEO,
- generous board fees were introduced for previously unpaid board positions,
- the basic right of members to appoint and remove directors was removed,
- the organisation maintained enormous surpluses compared to comparable organisations by overcharging its members, under servicing its members or underinvesting in the organisation,
- the board spent millions of dollars not on the company's corporate branding but on promoting the image of the CEO,
- the board set up a fully-owned subsidiary and received second salaries for being on the board of the subsidiary, and
- remuneration caps set out in the constitution were breached.

[14] Rear Window, Australian Financial Review, 6 June 2017: http://www.afr.com/brand/rear-window/why-is-cpa-australia-hoarding-91-million-20170605-gwkzda?

AFCA, being also a member-based non-for profit organisation which enjoys a monopoly, will not be immune from allegations of governance dysfunction, particularly since its directors will be appointed by the board itself, not by its members.

For example, what would prevent AFCA directors from giving themselves hefty or undeserved pay increases? How would directors be removed for poor performance where there is no possibility of directors being voted out? What incentive would the board have to keep costs down and operate the scheme efficiently in circumstances where its members have no say as to how the budget is framed or how the scheme is run?

Further, the AGM attendance of not-for-profits is notoriously low and, as a result, controversial resolutions are often passed without adequate member engagement.

Consultation Paper

1. Question 1 - Additional powers

The draft exposure bill contemplates AFCA being given some statutory powers to allow it to manage superannuation complaints. These powers are the same as those the SCT currently possesses, namely:

- the power to join certain third parties to a superannuation complaint,
- the power to obtain information and documents which are relevant to a superannuation complaint, and
- the power to require people to attend conciliation conferences to assist in the resolution of a superannuation complaint.

While we question the constitutionality of providing a private company (as opposed to a statutory body) with statutory powers, we consider that no distinction should be drawn between superannuation complaints and non-superannuation complaints in terms of these additional powers.

Non-superannuation complaints can also involve third parties who are not members of the EDR scheme but may have an interest in the outcome of a complaint. For example, a third party beneficiary under a life insurance policy (held outside superannuation) will have an interest in the death benefit under the policy. Why should the scheme not be empowered to join such a third party to the complaint or obtain information and documents from them, or require them to attend a conciliation conference?

Similarly, in terms of complaints about primary producer and small business loans and guarantees, the EDR scheme should be able to join or obtain information and documents from third parties such as valuers, investigative accountants and receivers.

More generally, there is no logical reason for superannuation complaints to be treated differently from non-superannuation complaints. For example, life insurance policies that are held outside superannuation are likely to be of similar amounts to life policies held within superannuation. Amounts guaranteed in relation to a credit facility are often more than the average superannuation balance in retirement.

Further, it would not be efficient for an EDR scheme to apply different processes depending on whether or not the complaint relates to superannuation. Doing so would hinder even more the scheme's ability to move staff resources from one area (e.g. banking) to another (e.g. superannuation). Training staff to work in multiple areas, so they can handle different types of disputes as the need arises, while desirable, is a costly exercise.

2. Question 5 – Monetary limits

CIO has reservations about the proposal to increase the compensation cap to $1 million.

In the case of credit facilities, for example, while we accept that amounts borrowed have increased dramatically over the last few years in particular, the loss a borrower (as opposed to a guarantor) typically suffers will not be the amount of the loan, but rather the costs of the loan (interest and fees, for example), or the difference between what was lent and what should suitably

have been lent, or the loss of some equity in an asset used to secure a loan.

Where such a loss amounts to anything close to $1 million, it is likely that it will have been incurred in relation to an underlying credit facility or facilities of some significant magnitude, entered into as part of a transaction that is either unusual or complex such that the dispute may be better considered by a court.

Further, an EDR scheme's inability to subpoena a third party to attend as a witness or produce documents, join third parties, cross-examine witnesses and take evidence on oath means that its decisions are only ever going to be made 'on the papers'. This severely hampers its ability to investigate and determine, with the appropriate level of rigour and confidence, complex disputes or claims for large compensation amounts.

Perhaps this is why the monetary limits and compensation caps in other jurisdictions are much less than that of CIO and FOS', and certainly significantly less than the amounts being proposed. To name a few:

- UK Financial Ombudsman Service: Compensation limit is £150,000 (but can *recommend* more).
- Canadian Ombudsman for Banking Services and Investments: Monetary limit is C$350,000, but decisions are non-binding on both parties.
- New Zealand's Banking Ombudsman Scheme: Monetary limit is NZ$200,000.
- Singapore's Financial Industry Dispute Resolution Centre: Monetary limit, depending on the type of claim, is S$50,000 to S$100,000.
- Telecommunications Industry Ombudsman: Total value of any action it requires by the provider must not exceed A$50,000.
- Energy and Water Ombudsman Victoria: Compensation limited to A$20,000, or if both parties agree, an amount of no more than A$50,000.

3. Question 7 - Credit representatives

It continues to be absolutely necessary for credit representatives to remain members of an external dispute resolution (EDR) scheme for the following reasons:

(a) Cost savings illusory

Any proposal to exempt credit representatives from EDR membership would simply be an exercise in cost shifting. It will not prevent or reduce the number of complaints against credit representatives. There would be no actual cost savings because credit representatives will still need to be covered by their licensees, and any cost imposed by an EDR scheme on licensees to cover credit representatives will be passed on to credit representatives. This could potentially lead to credit representatives paying even higher costs if their aggregators or broker licensees seek to over recover.

It should also be borne in mind that although licensees are legally liable for the actions of their credit representatives, credit representatives also have obligations at law in their own right.

(b) Procedural fairness

Exempting credit representatives from EDR membership will mean that they will no longer have input into the resolution of a dispute involving the discharge of their (separate) legal obligations. The scheme will be completely reliant on the licensee's evidence only. This would be made worse in cases where the credit representative is no longer a representative of the licensee. This is inconsistent with the principles of procedural fairness.

Exempting credit representatives from EDR membership will also result in credit representatives no longer having a say in how the EDR scheme is run despite their bearing a proportion of the costs, directly or otherwise.

(c) Significant consumer confusion

Removing mandatory EDR membership for credit representatives will result in significant level of consumer confusion because consumers using a broker (the overwhelming majority of whom are credit representatives) generally have no contact with the licensee or the lender and often have no idea who the licensee or lender is.

Accordingly, consumers will look only to the credit representative to resolve any disputes. If credit representatives are exempted from EDR membership, the consumer will generally have no way of knowing that the credit representative is 'covered' by the licensee's EDR membership.

At present, if a consumer has a dispute with a credit representative, the consumer can easily ascertain which EDR scheme the credit representative belongs to. Both CIO and FOS' websites each have a search engine which allows consumers to search for member financial firms (68% of CIO complaints and 77% of FOS complaints are made online). This allows consumers to search for and lodge complaints against persons or businesses, like credit representatives, without having to know who the relevant licensee is.

If credit representatives are not required to be members of an EDR scheme:

- the schemes will not maintain records of credit representatives and their details will not be discoverable through the schemes' website search engines, and
- a consumer checking the credit representative's details against the scheme's website will find nothing, and will very likely assume that the scheme is not able to accept their complaint.

Even if the National Consumer Credit Protection Act 2009 (Cth) were to be amended to require the credit representative's credit guide to set out the contact details of its licensee's EDR scheme (rather than the contact details of their own), the reality is that consumers do not generally read credit guides. Indeed, our experience is that consumers approach us, via our website or otherwise, without reference to anything contained in a credit guide.

ASIC does maintain a record of credit representatives, although it appears that these records are not always up-to-date, given licensees can be tardy in their reporting obligations. More relevantly, consumers do not know that information about a credit representative and its licensee may be obtained from these records. The consumer may also not know which licensee, if more than one, the credit representative was acting for.

In short, if mandatory EDR membership for credit representatives is removed, consumers using brokers would not know who their complaint should be directed to and from whom redress may be available. This would make EDR far less accessible to consumers.

(d) Need for a reliable record of credit representatives

Even if the scheme volunteered to maintain records of credit representatives, the information would become outdated within a very short time because of the high degree of credit representative movement within the industry. As we understand it, ASIC struggles to keep this information up to date and is completely reliant on licensees providing it with updates. Details about credit representatives as recorded by CIO are only up-to-date and complete because of the requirement for them to be members of an EDR scheme.

Further, ASIC relies on the information CIO provides (eg. cancellation report of members) to monitor licensees recording up-to-date information about the movement of their credit representatives. If credit representatives were to be exempt from EDR, there is really no way for ASIC to monitor how diligent licensees are in providing this information to ASIC.

(e) ASIC's recent report on brokers

This is certainly not the time to remove or dilute broker accountability, particularly in view of ASIC's recent report on brokers (Report 516: Review of mortgage broker remuneration), which found that:

- Brokers (most of whom are credit representatives) play a very important role in the home loan market and are responsible for arranging around half of all home loans in Australia.
- Loans provided through the broker channel are on average larger and have a higher loan-to-valuation ratio (LVR) than loans provided directly through lenders.
- Loans obtained through brokers are larger, and more likely to be interest-only (all other things being equal, loans with higher amounts, and/or interest-only terms will cost the consumer more in interest and may take longer to pay down).
- Brokers did not make sufficient inquiries into consumers' expenses.
- For some lenders, loans provided through brokers are more likely to go into arrears than loans provided directly to consumers.
- Consumers who use brokers are different to consumers who go directly to lenders, and this may create different consumer outcomes.
- The standard model of upfront and trail commissions creates conflicts of interest (for example, a broker may recommend a loan that is larger than the consumer needs or can afford or recommend a loan to a particular lender, to maximise their commission payment).
- In addition to monetary commissions, brokers also receive soft dollar benefits from lenders and aggregators, and this is likely to be a significant motivator for brokers to send loans to a lender to qualify for those benefits even where the choice of lender may not be in the consumer's interest.

According to ASIC's report, lenders were not able to provide ASIC with consumer outcomes for individual brokers or broker businesses. This means that lenders have little visibility of patterns of poor loan performance connected to brokers.

EDR membership for credit representatives provides an audit trial which would otherwise be non-existent. This is particularly important since, according to ASIC's report, lenders could not readily provide ASIC with the authorised credit representative number, or the information provided was incorrect or outdated.

Licensee not be liable for representative's conduct in certain circumstances

Under the National Credit Act, a licensee's liability for its credit representative's conduct is limited to conduct that relates to a credit activity, as that term is defined in section 74(a) of the Act. If the conduct being complained about does not relate to a credit activity, any liability for loss cannot be sheeted to the licensee (Australian Credit Licensee or ACL). Unless the credit representative is a member of an EDR scheme in its own right, the consumer's only recourse is through the court system.

Conduct in relation to the following products or services are not credit activities for the purpose of the National Consumer Credit Protection Act:

(a) consumer leases for a fixed term of four months or less or for an indefinite period,

(b) credit or leases provided to small businesses,

(c) credit provided to purchase commercial property like farm land, retail property or warehouses, and

(d) other services like budget monitoring, debt management, credit repair, property spruiking and (unlicensed) financial advice.

A complaint against a credit representative can be and often is made years after the occurrence of the event that gave rise to the complaint, typically because the loss suffered was not evident or had not materialised until then. By this time, the licensee may no longer be a member of the EDR scheme because it no longer engages in regulated credit activity, engages only in non-regulated activity, has ceased trading and exited the industry, has become insolvent, has ceased to exist or cannot be located.

In these circumstances, CIO looks to the credit representative to address the complaint and provide redress where appropriate. This is only possible if the credit representative is a member of the scheme.

If the event giving rise to the complaint occurred when the credit representative was a credit representative of, say, Licensee A, but the consumer raises the complaint only after the credit representative has become the credit

representative of, say, Licensee B, Licensee B is not responsible for the credit representative's prior conduct as representative of Licensee A (section 76(3)(d)). But Licensee A is. However, if Licensee A is no longer a member of the scheme for any reason, the scheme can still look to the credit representative to accept responsibility for the complaint and provide such redress as may be appropriate. If the credit representative is not, or is not required to be, a member of an EDR scheme, the consumer's only recourse is through the court system.

CIO has also encountered cases where a finance broker has provided financial advice without holding an Australian Financial Services (AFS) licence or having been appointed an authorised representative of an AFS licensee. Obviously the (ACL) licensee of the credit representative is not responsible for the conduct of the credit representative in these circumstances because the provision of financial advice is not a credit activity. However, if the finance broker is a credit representative member of CIO, the scheme will hold them to account for any loss that may be suffered as a result of the advice.

If the complaint relates to an event that took place before the National Credit Act commenced, the ACL licensee of the credit representative is not responsible for the credit representative's conduct. In these circumstances, CIO looks to the credit representative to address the complaint and provide redress where appropriate. Obviously, unless the credit representative is, or is required to be, a member of an EDR scheme, the consumer's only recourse is through the court system.

CIO can also join a credit representative to a complaint if the ACL licensee is not in possession of information relevant to the complaint in circumstances where the credit representative is no longer a credit representative of the ACL licensee.

(f) <u>Lessons from Timbercorp and Southern Plantation</u>

While AFS licensees are required to join an EDR scheme such as CIO or FOS, financial advisers who are appointed authorised representatives are not. This is in stark contrast to the National Consumer Credit Protection Act, under which credit representatives of ACL licensees are required to join an EDR scheme.

The cases of Timbercorp and Great Southern Plantation, both of which have now gone into liquidation, clearly illustrate the need for authorised representatives to be also required to join an EDR scheme.

Both these companies are reported to have paid representatives commissions of 10% or more to sell their managed investments to unsuspecting investors, many of whom had been encouraged to borrow against the equity of their home to invest in these products. Because the licensees had gone into administration, the only recourse for these hapless investors was to seek compensation from their representatives through the court system - a lengthy and expensive process.

More accessible, expedient and cost effective redress would have been available to these investors had the authorised representatives been required, under Chapter 7 Corporations Act, to join an EDR scheme.

Similarly, because authorised representatives are not required to be a member of an EDR scheme, CIO has not been able to deal with complaints about authorised representatives providing investors with inappropriate advice where the AFS licensee has gone into administration.

Consequently, CIO is strongly of the view that it is absolutely necessary for credit representatives to continue to be required to be members of an ASIC-approved Ombudsman scheme.

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