FINANCIAL SERVICES COUNCIL

1 July 2017
EDR Review Secretariat
Financial System Division
Markets Group
The Treasury
Langton Crescent
PARKES ACT 2600

By email-
EDRreview@treasury.gov.au

Sent in Word and PDF Formats

Dear Colleagues

Supplementary Issues Paper (Paper)
Review of the Financial System External Dispute Resolution (EDR) Framework

The Financial Services Council (**FSC**) has over 100 members representing Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies.The industry is responsible for investing more than $2.7 trillion on behalf of 13 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange and is the fourth largest pool of managed funds in the world. The FSC promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

Thank you for the opportunity to provide a submission on this topic. Our comments follow.

Background

1. We note that on 2 February 2017 we lodged a submission with the Review Panel on the EDR Framework (**February Submission**). We also expressed views on the merits or otherwise of establishing a compensation scheme of last resort (**CSLR**). We lodged with our submission a report by Professor Pamela Hanrahan in relation to other avenues and approaches which might be considered, rather than a CSLR being adopted (**Hanrahan Report**).
2. The Paper details the history of the Review Panel's processes and notes that following the amendment of the Review Panel's Terms of

Financial Services Council Ltd ABN: 82 080 744 163
Level 24, 44 Market Street Sydney NSW 2000
T: +61 2 9299 3022 F: +61 2 9299 3198
E: info@fsc.org.au W: fsc.org.au

Reference, the Panel was required to undertake *two separate but related tasks*:

- *make recommendations on the establishment, merits and potential design of a compensation scheme of last resort; and*
- *consider the merits and issues involved in providing access to redress for past disputes.*

Copies of the February Submission and the Hanrahan Report are **attached**.

Executive Summary

3. Our views, and submission, by way of summary only at this stage are as follows-
   (a) For the reasons stated in our February submission, our view remains that as a matter of public policy or interest, the case for the introduction of such a more universal CSLR has not been established;
   (b) If, contrary to our submission, the concept of a CSLR is accepted, the scheme should **not** be introduced at least until such time as the recommendations in the **St John Report**[1]have been reviewed and measures introduced to address the issues that lead to licensees being unable to meet their consumer compensation obligations. Following implementation of the revised arrangements they need to be given an appropriate time to "work through" the financial sector to see if there then is an imperative for a CSLR. In this regard, we refer to the detailed comments we have made below concerning the St John and Hanrahan Reports;
   (c) Further, prior to the introduction of a CSLR, the reforms in progress to improve the competence and professionalism of advisers should be fully implemented and changes to the legislative breach reporting framework should be made to encourage and assist licensees to report and deal with "bad apples" **and** an assessment then made as to whether the necessity for such a scheme exists;
   (d) Moreover, the economic and industry specific implications of such a scheme do need to be given serious consideration having regard to the **Cadence Report**. This demonstrates the high cost of introduction of such schemes. In the result, ultimately a significant proportion of these costs would be borne by consumers and investors in the financial services industry;

[1] Expressions in bold are defined subsequently in our submission.

(e) A CSLR does not represent good public policy for the following reasons-

(i) CSLRs inherently promote moral hazard – for instance smaller, less-capitalised licensees could adopt less risk-adverse approaches and behaviours in the expectation that if something goes wrong, the scheme will "pick up the tab";

(ii) CSLRs generally are suggested as having a coverage that is wider than financial advice failures and include product failures-this gives rise to significant on-going liabilities for the scheme;

(iii) based on the proposals put forward for consideration by this review there is the suggestion that CSLRs have the very real potential to be retrospective in nature. It is neither good policy or equitable to enforce retrospective policy on an industry for the failings of other financial services providers. If the CSLR is retrospective, there is the prospect of the scheme having to address not only current FOS unpaid determinations but also future determinations relating to events that may date back a number of years. No modelling appears to have been undertaken to determine the size of the liabilities relating to this 'tail'. There also is an issue as to whether unpaid determinations or judgments of other tribunals and courts would fall within this process. The discussion in the Paper does not comprehensively analyse these issues or their potential impact;

(iv) a CSLR will be costly for those entities which are well-capitalised;

(v) CSLRs require funding and the precise parameters and scope of that funding is unclear;

(vi) any CSLR, ultimately, will be an additional cost to industry which is passed on to the consumer, either directly or indirectly.

(f) The overseas examples of CSLR, particularly that in the United Kingdom, does not augur well for any proposed Australian CSLR, particularly in the context of costs to industry and thus the broader economic impact and ultimately consumers and investors;

(g) If, contrary to our submission, it is determined to introduce a CSLR, in addition to the other matters we have mentioned at paragraph (b) above, then there are other conditions which should be placed on such a scheme to prevent the risk of potentially open-ended scope and unintended consequences. For example, that scheme must have clear parameters and be limited to advice matters which have been or could have been

the subject of **AFCA** determinations and then only in respect of events which occur on or after the commencement date of the CSLR-otherwise there is a real and significant risk in this regard of unfair retrospectivity being applied to the scheme.

Our detailed comments, expanding on these general themes, follow.

General Observations

4. The rationale for a potential CSLR is that in some circumstances financial services providers do not meet client compensation claims awarded by FOS, most commonly due to lack of financial resources. FOS has noted that between 1 January 2010 and 30 June 2016, 32 financial services providers[2] were unwilling or unable to comply with FOS determinations. As at 30 June 2016 the unpaid determinations amounts to $12,611,859 or $16.6m including interest and inflation.[3]

5. As part of the Future of Financial Advice Reforms a detailed review of compensation arrangements for retail consumers was undertaken and a report issued by Mr. Richard St John – *Compensation Arrangements for Consumers of Financial Services* (**St John Report**) in 2012. Mr. St John observed that retail consumers are generally able to recoup losses attributable to misconduct by licensees that they have dealt with. Following review of current arrangements, the St John Report concluded it would be possibly counter-productive to introduce a more comprehensive scheme of last resort.

6. The St John Report recommended priority first be given to putting licensees in a position where they can themselves meet compensation claims from retail clients through a more rigorous approach to compliance by licensees so that they will be in a position to compensate their own clients through their insurance arrangements and the capital resources they have at risk.[4] Mr. St John envisaged that a more stringent approach to licensing would be focused on licensees who are seen to pose most risk and that they would not impose a significant regulatory burden across the board.[5]

7. The St John Report noted that there were limited regulatory measures to protect consumers from licensee insolvency and therefore it would be inappropriate to require more responsible and financially secure licensees to underwrite the ability of other licensees

---

[2] Thirty-two financial services providers over 6 years did not meet their obligations. FOS noted they had over 13,500 members in the 2015-2016 Annual Review (see page 22). This is a very small proportion of members in any given year who are unable to meet FOS determinations.

[3] Page 52 – FOS 2016 Submission Review of the Financial EDR Framework **http://www.fos.org.au/custom/files/docs/fos-submission-to-edr-review.pdf**

[4] Page iv St John Report.

[5] Page iv St John Report.

to meet their compensation claims against them[6]. In short, that Report recommended that the regulatory framework for advisers and licensees should be 'made more robust and stable before a safety net, funded by all licensees, is suspended beneath it'[7].

8. The **St John Report also cautioned against introducing a CSLR** to underpin compensation arrangements '**as a shortcut'** of remedying deficiencies in the current regime **as it would not address the underlying problems**. It would not improve standards of licensee behaviour or lead to licensees having greater responsibility for their own conduct.[8]

9. We confirm the summary comments made in our February submission, (at pages 13 to 14), as follows-

> *By their nature compensation schemes of last resort, (**CSLR**) represent poor public policy because of, at least, the following material outcomes and risks which would severely erode any perceived consumer benefits:*
>
> > *1. CSLR inherently promote moral hazard – for instance smaller, less-capitalised licensees could adopt less risk-adverse approaches and behaviours in the expectation that if something goes wrong, the scheme will "pick up the tab";*
> > *2. CSLR generally are suggested as having a coverage that is wider than financial advice failures and include product failures-this gives rise to significant on-going liabilities for the scheme;*
> > *3. CSLR have the very real potential to be retrospective in nature. This raises the prospect of the scheme having to address not only current FOS unpaid determinations but also future determinations relating to events that may date back a number of years. No modelling has been undertaken to determine the size of the liabilities relating to this 'tail'. There also is an issue as to whether unpaid determinations or judgments of other tribunals and courts would fall within this process;*
> > *4. CSLR will be costly for those entities which are well-capitalised;*
> > *5. CSLR require funding and the precise parameters and scope of that funding is unclear;*
> > *6. CSLR, ultimately, will be an additional cost to industry which is passed on to the consumer, either directly or indirectly.*

[6] Page iii St John Report.
[7] Pages iii and iv St John Report.
[8] Page 143 (2012) St John Report.

10. In relation to the 2012 St. John Report and the Hanrahan Report, we made the comments,(page 16), set out below, which we also confirm-

> *Based on the St John report and the Hanrahan research, more appropriate and effective policy outcomes, are likely to include at least the following approaches:*
>
> *(i) a detailed review and consideration of capital adequacy for AFSL licensees (as is currently the case with REs and RSEs) to "cover" potential liabilities;*
> *(ii) the raising of the level of professional indemnity insurance, with the support of ASIC and the general insurance industry;*
> *(iii) …other steps should be taken to strengthen the regulatory framework before consideration is given to a CSLR. These are*
> *A. the reforms to improve the competence and professionalism of advisers announced by the Government, but not currently due to be fully implemented until 2024, should be finalised;*
> *B. changes to the legislative breach reporting framework should be made to encourage and assist licensees to report 'bad apple' representatives to ASIC and have those representatives dealt with;*
> *…*

11. In addition to the above, the recommendations from the St John Report should be reviewed and consultation take place on strengthening the existing system to improve licensing standards and place greater responsibility on licensees for their own conduct.

12. We also confirm the comments made in our February submission concerning the international comparisons for CSLR. It remains our view that these kinds of schemes have the potential to be extremely costly and potentially, give rise to virtually open-ended liability. As the Review Panel is aware, the FSC has commissioned economic modelling of a CSLR. The outcomes demonstrate the high cost of introduction of such schemes. We discuss this in further detail below. In the result, it seems to us that ultimately a significant proportion of these costs would be borne by consumers and investors in the financial services industry.

Cadence Economics (Cadence) Research on CSLR

13. As the Review Panel is aware, the FSC engaged Cadence to model potential costs of a CSLR, whose object would be to compensate retail

clients who suffer losses due to insolvency of an AFS licensee in the event of inappropriate advice, negligence, fraud or other actions. Cadence prepared a report in June 2017, a copy of which is **attached (Cadence Report).**

14. Included in the Report is the scheme costing should claims be limited to either $500,000 or $1 million. Based on the Cadence modelling, the direct annual scheme costs are expected to increase to $120 million or $125 million for those respective scenarios. These outcomes are detailed at page 4 of the Cadence report.

15. The costs of a CSLR were modelled over a 20-year period, to allow the consideration of how scheme costs could evolve over the life of the scheme.

16. Loss parameters were calibrated using historical data to develop a 3 tier probability loss model, that incorporated:

(a) 'Business as usual' loss tier, with an expected frequency of 17.5 years out of 20 years of the scheme;
(b) 'Major loss' (recession or single event failure) loss tier, with an expected frequency of 2 years out of 20 years of the scheme;
(c) 'Catastrophe' (GFC or major industry failure) loss tier, with an expected frequency of 0.5 out of 20 years, or a 1 in 40 year event.

17. The main results of the *Monte Carlo* simulation[9] show that:

(a) An advice only scheme, with the current FOS cap of $309,000 per claim, would cost the industry around $105 million per annum to fund;
(b) An advice and product scheme, with the **current** FOS cap of $309,000 per claim on advice claims, and an 80% cap on aggregate product losses, would cost the industry $310 million per annum to fund.

We note that under the EDR Framework proposals and draft legislation released by Treasury on 9 May 2017, the Australian Financial Complaints Authority (**AFCA**) will commence operations with:

- unlimited monetary jurisdiction for superannuation disputes;

---

[9] Monte Carlo simulations are used to model the probability of different outcomes in a process that cannot easily be predicted due to the intervention of random variables.
http://www.investopedia.com/terms/m/montecarlosimulation.asp

- $1 million limit on the size of non-superannuation consumer disputes (a 100 per cent increase on the current limit);
- a minimum $500,000 compensation cap for non-superannuation consumer disputes (a 62 per cent increase on the current cap);
- $5 million small business credit facility limit (a 250 per cent increase on the current limit)
- $1 million compensation cap for small business disputes
- (a 224 per cent increase on the current cap); and
- no monetary limits or compensation caps for disputes relating to guarantees supported by a mortgage or other security over the guarantor's primary place of residence.

Depending on the precise scope and parameters of any final CSLR, the overall costs could vary considerably as noted by Cadence.

18. The second round (indirect) impacts of the scheme were also modelled. This found that the deadweight loss of the scheme was approximately 47 cents per dollar raised. That is for each $1 raised in CSLR levies, an additional $0.47 of economic cost is borne by the national economy.

A number of scheme designs were tested (full results provided in table below).

CSLR annual cost estimates

	Annual direct costs $m	Annual indirect costs $m	Annual total cost $m	Direct cost per planner[1] $	Direct cost per AFSL[2] $	Direct cost per $1m FUM[3] $
Base case (advice only)	**105**	**49**	**154**	**4,549**	**28,354**	**323**
Wide scenario (incl Product Failures)	310	146	456	13,473	83,977	956
Claims capped at $500k	120	56	176	5,218	32,525	370
Claims capped at $1m	125	59	184	5,441	33,916	386
Eligible unpaid determinations $16m	106	50	156	4,602	28,687	327
Eligible unpaid determinations $116m	114	53	167	4,937	30,770	350
Recession frequency 12.5%	115	54	168	4,980	31,043	354
GFC frequency 5%	165	77	242	7,154	44,593	508
GFC claims ineligible	45	21	65	1,937	12,073	138
SLR admin costs removed	103	48	151	4,462	27,812	317
SLR admin costs x2	107	50	157	4,636	28,896	329
SLR Reserves $500m	143	67	210	6,220	38,770	442

1. Assumes 23,000 financial advisers on the Financial Advisers Register able to provide personal advice (ASIC Annual Report 2015-16)
2. Based on 3,690 AFS licensees licensed to provide personal advice (ASIC Annual Report 2015-16)
3. Based on estimate of $324 billion retail funds subject to levy (See: Rainmaker Table 34 FUM, Volume 15, Number 3, SEP Quarter 2016)

Key Assumptions

Loss Tier	Advice	Product	Probability of Event
'Business as usual'	$4million per occurrence (Based on FOS Data 2010 to 2016, and accounting for FOS determinations limited to $309k per claim)	$8 million (assumed 2 times advice failure claims paid based on historical experience)	87.5%
'Major loss' (recession or single event failure)	$400m per occurrence (representing 80% of total loss due to FOS determinations limited to $309k per claim)	$800m per occurrence (representing 80% of total loss due to FOS determinations limited to $309k per claim)	10.0%
'Catastrophe' (GFC or major industry failure)	$2.4 billion (Based on Storm Financial, Opes Prime, Deakin, and representing 80% of total loss due to FOS determinations limited to $309k per claim)	$4.8 billion (Based on WestPoint, Timbercorp, and representing 80% of total loss due to FOS determinations limited to $309k per claim)	2.5%

Other key assumptions include:

- CSLR administration cost at $2 million per annum
- **Retrospective eligible unpaid determinations are excluded.**

19. The Cadence Report notes the following ***key sensitivities***-

(a) Costs are driven primarily by the size of the advice and product loss (severity) used in each of the three loss tiers, and the probability (frequency) attached to this loss.

- In particular, introducing consideration of a 'major loss' and 'catastrophe' event significantly increases the annual funding cost of the scheme.

(b) With average claims at $120, 000 representing only one-third of the $309,000 cap, the impact of capping only reduces the CSLR funding requirements in the order of 10% to 20%.

- That is the current scheme covers around 80% of the loss distribution, while a $500,000 cap would cover 92 per cent and cost 10% more, while a $1 million cap would cover 98% and cost 20% more.

(c) Average 20 year CSLR costs are only marginally impacted by including retrospective claims that are known. If eligible unpaid determinations were $116 million, annual scheme funding costs would increase to $114m per annum for the advice case only case. However, this does not consider the timing of the payments and implies an assumed low cost of capital.

- A key issue with the modelling around this aspect is that a stochastic model cannot account for behavioural changes, for example-increased filing of claims with FOS from previous failures.

Comments

20. Having made these opening comments, we now will address the specific questions raised in the Paper, adopting for convenience the headings in the Paper.

SCOPE
Questions — Scope and principles
1. Is the Panel's approach to the scope of these issues appropriate? Are there any additional issues that should be considered?
2. Do you agree with the way in which the Panel has defined the principles outlined in the Review's Terms of Reference? Are there other principles that should be considered?

---

21. As a broad proposition, we do not have any specific objections to the Panel's approach to the scope of the issues nor the principles as such. However, the Principles do not appear to take into account the potential economic impact of such a CSLR, with the flow-on effect from industry to the broader economic matrix. The Cadence Report does consider these issues. In our view, more detailed modelling and consideration of these impacts must occur

and be subject to a fulsome and appropriate review. This impact should be reviewed in light of the mischief the CSLR is intended to address and whether there might be other more efficient ways of addressing the issue such a strengthening the licensing framework in accordance with Mr St John's recommendations and outlined in the Hanrahan report. We note Mr. St John's warning that the CSLR should not be used as a shortcut to remedying deficiencies in the current regime, as it will not address the underlying problems to improve licensing standards and place greater responsibility on licensees for their conduct.

As we have said, both the St. John and Hanrahan Reports outline useful approaches in this regard.

22. Considering the implications from an advice perspective alone, the Cadence research shows that the annual costs of a CSLR are significant and estimated to cost $105 million annually. Financial advice businesses have been subject to significant regulatory reform costs in recent years through the introduction of the Future of Financial Advice reforms and we have received anecdotal feedback to indicate that the cost of reform is impacting the viability of advisory practices.

23. There are further significant costs expected to be incurred by advice industry participants in relation to the industry funding model for ASIC, ongoing funding of the new Financial Adviser Standards Education Authority and costs associated with increased professional standards and education requirements. Further, the financial sector will bear the costs of the proposed AFCA. Whilst we have been supportive of many of these reforms, consideration needs to be given to the impact of further regulatory reform and the ability of businesses to continue to absorb the cost of further regulatory change while still ensuring quality financial advice is available to, and affordable for, consumers.

24. We also express reservations as to the scope of the CSLR as outlined in the Paper and as expressed at paragraph 37. For example, it is stated that the CSLR potentially could apply where …

the consumer or small business did not pursue their dispute with the EDR scheme for other unspecified reasons (for example, because of personal circumstances, the costs of pursuing the dispute or emotional distress).

25. In our view, the CSLR if introduced should truly be that and only be available after all other reasonable and available avenues have been exhausted. Rights of access to the CSLR should be permitted only with approval of an independent body in other circumstances.

26. It is worth noting Mr. St John's observations that there are limited regulatory measures to protect consumers from licensee insolvency and the regulatory framework for advisers and licensees should be *made more robust and stable before a safety net, funded by all*

licensees, is suspended beneath it[10]. We question whether all other available avenues can be appropriately exhausted without strengthening the existing licensing framework.

27. In similar vein, we are concerned at the further observation at paragraph 37 that access could be permitted where the monetary value of the dispute exceeded the EDR scheme's monetary limits at the time, but could potentially fall within the monetary limits of the new Australian Financial Complaints Authority (once established). This is connected with the issue of legacy claims which we discuss below. However, if this is a concern, there ought to be some transitional period for introduction of such claims to the AFCA rather than imposing such a cost on the CSLR at the outset. For example, if a claim arose in the twelve months prior to the commencement of the CSLR but at that time exceeded the FOS jurisdiction but would fall within the AFCA jurisdiction had it been in existence at the time, such a claim should be able to be made to the CSLR. Alternatively, consideration ought to be given to the AFCA jurisdiction having such a limited retrospective operation.

28. The paper discusses the topic of redress for past disputes in some detail in terms of principles and scope. Our view is that if a CSLR is to be established then it ought to be **prospective only** (subject to some limited exceptions such as those discussed in the previous paragraph). Inherently, retrospectivity which has a real and significant impact on rights and liabilities ought not to be accepted as an appropriate course. The way in which the principles and scope are cast in the Paper raises the prospect of the CSLR having to address not only currently existing unpaid FOS determinations, but also future determinations relating to events that may date back a number of years. So far as we are aware, no modelling has been undertaken to determine the size of the liabilities relating to this 'tail'. We suspect that this could potentially be a long and sizeable tail. There also is an issue as to whether unpaid determinations or judgments of other tribunals, apart from AFCA, and courts would fall within this process. Certainly, the implication from the Paper is that they should be so included (paragraph 35). It is not clear to us why this should be the case.

COMPENSATON SCHEMES OF LAST RESORT

Questions — Existing compensation arrangements

3. What are the strengths and weaknesses of the existing compensation arrangements contained in the Corporations Act 2001 and National Consumer Credit Protection Act 2009?

---

[10] Pages iii and iv St John Report.

4. What are the strengths and weaknesses of the National Guarantee Fund, the Financial Claims Scheme and Part 23 of the Superannuation Industry (Supervision) Act 1993?
5. Are there other examples of compensation schemes of last resort that the Panel should be considering?

29. It is not clear to us that, at this stage, there is any particular benefit to be obtained by undertaking an exhaustive review and analysis of existing compensation arrangements as discussed in the Paper. The circumstances in which compensation can be claimed differ and as the Paper notes only some of these are targeted compensation schemes. These schemes cover losses associated with the following-
    (a) Where a market participant of the Australian Securities Exchange becomes insolvent and fails to meet its obligations to a person who had previously entrusted property to it;
    (b) Bank deposits and general insurance policies related to an Australian Prudential Regulation Authority (APRA) regulated entity in the event of insolvency: the Financial Claims Scheme[11]; and
    (c) Fraudulent conduct or theft related to APRA regulated superannuation funds: Part 23 of the *Superannuation Industry (Supervision) Act 1993* (Cth.) (**SIS**)[12]
30. After describing these targeted schemes the Paper goes on to state-

> *48. Given the existence of unpaid EDR determinations, it is clear this framework is not delivering effective outcomes for some of its users.*

With respect, it is not clear to us that the comparison and conclusion is correct and appropriate. The targeted schemes are quite specific in their scope and necessarily limited to areas falling within the relevant jurisdiction. If there is an issue with the framework then it is because that framework never was intended to be of more general and universal application- which appears to be the assumption underlying the Panel's comment.

31. In our view, these particular schemes discussed above are appropriate and adequate for the circumstances for which they were created. They were never intended to be schemes of

[11] The Financial Claims Scheme protects, subject to limits, retail clients of authorised deposit taking institutions (**ADI**s) and policyholders of APRA regulated general insurance companies from potential loss due to the failure of these institutions.

[12] Part 23 SIS makes provision for the grant of financial assistance to APRA regulated superannuation funds that have suffered loss as a result of fraudulent conduct or theft. The loss must also have caused a substantial diminution of the superannuation fund leading to difficulties in the payment of benefits.

universal application applying to all unsatisfied claims in respect of participants in the relevant industry sector. They are schemes which apply in specified circumstances only. We also note, that the Financial Claims Scheme and Part 23 SIS, relate to products and services which are prudentially regulated and have a robust financial and risk management framework in place to ensure the entities providing those products and services can meet their obligations. Prudential oversight significantly reduces the risk that the providers subject to the oversight are able to meet their obligations first and foremost whilst simultaneously significantly reducing the risk that a person will need to call on the targeted compensation scheme or that the losses of one providers will need to be funded by other market participants.

32. The Paper also discusses the following compensation arrangements-

(a) Firm level compensation arrangements, and;
(b) Compensation arrangements involving professional indemnity insurance.

The obligation to have these arrangements in place is sourced in the Corporations Act for financial services providers. As the Paper points out, these approaches were not intended to cover all of the circumstances in which a loss might be incurred by a consumer. Thus, the Paper refers to ASIC *Regulatory Guide 126: Compensation and insurance arrangements for AFS licensees, paragraph RG126.23,* and the range of matters including the following which were not intended to be covered by the arrangements-

- product failure or general investment losses;
- all possible consumer losses relating to financial services;
- claims for loss solely as a result of the failure (for example, through insolvency) of a product issuer (that is, it is not intended to underwrite the products of a product issuer); or
- a return on a financial product that has not met expectations.

For the reasons stated in our February submission and supported by the Hanrahan Report our view remains that as a matter of public policy or interest, the case for the introduction of such a more universal CSLR covering losses of this kind has not been established. We also further note that Mr. St John's recommendations for addressing the underlying problems and strengthening the licensing regime have not been implemented.

33. In our February Submission, we outlined the issues we believe exist with ex-Australian CSLRs. Given those comments and the

limitations of those schemes, we do not think they represent alternatives that the Panel should be considering.

34. In relation to question 5, regarding other compensation schemes of last resort that may be considered by the Panel, we refer the Panel to the Government Consultation Paper on *Reforms to address corporate misuse of the Financial Entitlements Guarantee Scheme- Consultation Paper*[13] . This paper contains a useful analysis of the kinds of sharp practices that can arise following the creation of moral hazard. The Financial Entitlements Guarantee (**FEG**) scheme also serves as an example of unexpected cost increases that can arise, even during a relatively stable economic periods.

Questions — Evaluation of a compensation scheme of last resort

6. What are the benefits and costs of establishing a compensation scheme of last resort?

7. Are there any impediments in the existing regulatory framework to the introduction of a compensation scheme of last resort?

8. What potential impact would a compensation scheme of last resort have on consumer behaviour in selecting a financial firm or making decisions about financial products?

9. What potential impact would a compensation scheme of last resort have on the operations of financial firms?

10. Would the introduction of a compensation scheme of last resort impact on competition in the financial services industry? Would it favour one part of the industry over another?

11. What flow on implications might be associated with the introduction of a compensation scheme of last resort? How could these be addressed to ensure effective outcomes for users?

12. What other mechanisms are available to deal with uncompensated consumer losses?

13. What relevant changes have occurred since the release of Richard St. John's report, Compensation arrangements for consumers of financial services?

---

35. In our February submission we outlined in detail our views of the benefits and costs of establishing a CSLR. In short, we accept that the impact of uncompensated losses is important for the individual consumers affected. However, in summary we have concerns about the cost, inequity, impact on competition and

[13] Australian Government Consultation Paper *Reforms to address corporate misuse of the Financial Entitlements Guarantee Scheme* May 2017, (**FEG Paper**)

innovation, and moral hazard a CSLR necessarily introduces. In addition, there exist significant challenges in structuring a robust and efficient funding model. We have detailed our specific concerns in the February submission and these are articulated further in the Hanrahan Report.

36. A CSLR necessarily would act as an inhibition to competition and for that matter, innovation. Smaller entities and start-ups may be unwilling or unable to meet the cost of any CSLR levy and be deterred or indeed unable to enter the sector.

37. In our view, the economic implications of the introduction of a CSLR have not been appropriately considered nor have the implications for sectors within the industry been considered. The Cadence Report is an initial attempt to articulate some of those concerns. Clearly, more extensive work is required to be undertaken in this area by Government and industry. In particular, an inherent bias may be created in favour of sectors subject to such a scheme, depending on the scheme parameters, compared with those not subject to the scheme. This is another aspect of "moral hazard' as outlined in our February submission and the Hanrahan report.

38. The risk of moral hazard is clearly demonstrated by the prevalence of misuse of the FEG scheme, which is currently the subject of Government consultation.[14] As reported by Ministers Kelly O'Dwyer and Michaelia Cash, the costs of the FEG scheme have increased dramatically over the period 2012-13 and 2015-16, up 75% on the previous 4 year period and there is evidence of corporate structuring to shift the cost of employee entitlements to the FEG scheme.[15] The Consultation Paper for this review notes that a survey of 650 FEG scheme claims showed that one in seven cases were the subject of 'sharp practices'.[16]

39. We have detailed in the February submission other steps we believe should be taken before it is clear as a matter of policy that a CSLR is required. In summary, these are-

(a) A detailed review and consideration of capital adequacy for AFSL licensees (as is currently the case with REs and RSEs) to "cover" potential liabilities;
(b) the raising of the level of professional indemnity insurance, with the support of ASIC and the general insurance industry (for example, holders of AFSLs should be required to hold insurance cover that reflects the guidelines required by the Professional Standards Council, including in relation to run-off cover) ;

[14] Ibid.
[15] Foreword to FEG Paper.
[16] Page 5 FEG Paper.

(c) Other steps should be taken to strengthen the regulatory framework before consideration is given to a CSLR. These are

(i) the reforms to improve the competence and professionalism of advisers announced by the Government, but not currently due to be fully implemented until 2024, should be finalised;
(ii) changes to the legislative breach reporting framework should be made to encourage and assist licensees to report 'bad apple' representatives to ASIC and have those representatives dealt with;
…

Further, it is arguable that a rethink and recalibration of the ASIC approaches to the "first-tier "protections under the Corporations Act for consumers needs to occur.

40. Since the time of the release of the St. John Report we do not believe there have been any relevant changes as such which ought to alter the conclusions in that Report. We do note however that there is a legislative progression to professionalism in the advice industry and the considerable restrictions applying to conflicted remuneration. These are themes taken up in the Hanrahan report and we confirm our support of those views. In short, these processes should be allowed to continue and settle in before it is clear that a CSLR is required and desirable as a policy matter.

Questions — Potential design of a compensation scheme of last resort

14. What are the strengths and weaknesses of the ABA and FOS proposals?

15. What are the arguments for and against extending any compensation scheme of last resort beyond financial advice?

16. Who should be able to access any compensation scheme of last resort? Should this include small business?

17. What types of claims should be covered by any compensation scheme of last resort?

18. Should any compensation scheme of last resort only cover claims relating to unpaid EDR determinations or should it include court judgments and tribunal decisions?

19. What steps should consumers and small businesses be required to take before accessing any compensation scheme of last resort?

20. Where an individual has received an EDR determination in their favour, should any compensation scheme of last resort be able to independently review the EDR determination or

should it simply accept the EDR scheme's determination of the merits of the dispute?

21. If a compensation scheme of last resort was established and it allowed individuals with a court judgment to access the scheme, what types of losses or costs (for example, legal costs) should they be able to recover?

22. Should litigation funders be able to recover from any compensation scheme of last resort, either directly or indirectly through their contracts with the class of claimants?

23. What compensation caps should apply to claims under any compensation scheme of last resort?

24. Who should fund any compensation scheme of last resort?

25. Where any compensation scheme of last resort is industry funded, how should the levies be designed?

26. Following the payment of compensation to an individual, what rights should a compensation scheme of last resort have against the firm who failed to pay the EDR determination?

---

41. Our view is that a CSLR should **not** be introduced for the reasons set out in our February submission and the Hanrahan report. However, for completeness we make the following observation in respect of the questions posed-

(a) if there is to be a CSLR, it should be circumscribed and have clear parameters around it. A scheme which is restricted in its scope to compensation claims for misconduct rather than operating as a guarantee for investment loss is preferable for reasons of equity and economic impact. For example, it seems to us to be appropriate that such a scheme should be confined to advice-related failures rather than having a broader remit, given that the majority of unpaid determinations originate in that sector;
(b) a CSLR should be linked to EDR schemes and specifically to the proposed AFCA. Thus, the AFCA eligibility and compensation cap rules should apply in like fashion to the CSLR;
(c) the CSLR should have no further remit than unsatisfied orders or decisions of the AFCA-it should be seen as a final resort of the EDR system where for some reason an AFCA liability remains unmet. In this sense, it should operate in similar fashion to the National Guarantee Fund;

(d) the CSLR should be funded by an appropriately designed levy to ensure that the sectors where the major liabilities are being incurred meet the levy;
(e) consideration does need to be given to the role of litigation funders in any CSLR. It is possible that in the absence of such funding recovery could not be pursued. However, this could perhaps be addressed by making the CSLR process an administrative and less formal process;
(f) Access to the CSLR should be available only when it is clear for example because of insolvency of the FSP that recovery is impossible;
(g) The CSLR should be able to stand in the shoes of successful CSLR consumer and be subrogated to the consumer's rights against the FSP;
(h) consideration needs to be given to a specified percentage, say 70% of the lost amount being recoverable (as occurs in the superannuation context and, for some sectors in the United Kingdom, the Financial Services Compensation Scheme: **FSCS**).

Questions — Potential design of a compensation scheme of last resort

27. What actions should ASIC take against a firm that fails to pay an EDR determination or its directors or officers?
28. Should any compensation scheme of last resort be administered by government or industry? What other administrative arrangements should apply?
29. Should time limits apply to any compensation scheme of last resort?
30. How should any compensation scheme of last resort interact with other compensation schemes?
31. Are there any aspects of compensation schemes of last resort in other sectors and jurisdictions that should be considered in the design of any compensation scheme of last resort?

---

42. A CSLR as we have indicated should be truly one of last resort. It should not be available to consumers if other compensation schemes provide them with a remedy;
43. There should be an appropriate time limit for pursuing a claim with the CSLR. This could be for example, no later than 24 months after the consumer became aware or reasonably ought to have been aware that the amount was not recoverable. As a safeguard

for unintended consequences, the CSLR could have a discretion to waive compliance with strict time limits in appropriate circumstances;

44. The CSLR itself should be an industry-run body with appropriate independent oversight. There would need to be legislative underpinning;

45. If there is to be a CSLR, appropriate models exist in Australia such as the National Guarantee Fund and various professional body fidelity schemes.

Questions — Legacy unpaid EDR determinations

32. What existing mechanisms are available for individuals who have legacy unpaid EDR determinations to receive compensation?

33. Is there a need for an additional mechanism for those with legacy unpaid EDR determinations to receive compensation? If so, who should fund the payment of the legacy unpaid EDR determinations?

---

46. We confirm the comments in our February submission that legacy unpaid determinations should not be amenable to a CSLR for the reasons set out in our submission. As noted above however, there may be circumstances where a limited retrospective operation could be given to the scheme. This may be for example where a claim did not then meet FOS compensation limits but now does under AFCA limits. The preference however is to address this issue in the initial AFCA jurisdiction. Our starting point however is that retrospectivity of any kind should be avoided as a matter of good public policy.

Question — Circumstances which have prevented access to redress

34. Other than circumstances that may be covered by a compensation scheme of last resort (such as outstanding unpaid determinations), what kinds of circumstances have given rise to past disputes for which there has not been redress? Are there any other classes besides those identified by the Panel?

35. What evidence is there about the extent to which lack of access to redress for past disputes is a major problem?

---

47. FSC members are not aware of any other circumstances preventing lack of redress. As the Hanrahan report alludes to, it is not clear that this is indeed a major problem.

Question — Approaches to providing access to redress for past matters
36. Which features of other approaches established to resolve past disputes outside of the courts (whether initiated by industry or government) might provide useful models when considering options for providing access to redress for past disputes in the financial system?

---

48. No comment.

Questions — Evaluation of providing access to redress for past disputes
37. What are the benefits and costs associated with providing access to redress for past disputes?
38. Are there any legal impediments to providing access to redress for past disputes?
39. What impact would providing access to redress for past disputes have on the operations of financial firms?
40. What impact would providing access to redress for past disputes have on the professional indemnity insurance of financial firms?
41. Would there be any flow on implications associated with providing access to redress for past disputes? How could these be addressed in order to ensure effective outcomes for users?

---

49. For the reasons previously given, in our view redress ought not to be provided in respect of past disputes in the sense outlined in the Paper.

Questions — Design issues for providing access to redress for past disputes
42. What are the strengths and weaknesses of the Westpac proposal?
43. What range of parties should be provided with access to redress for past disputes? Should all of the circumstances described in paragraphs 133-144 be included?
44. What mechanism should be used to resolve the dispute and what criteria should be used to determine which disputes can be brought forward?
45. What time limits should apply?
46. Should any mechanism for dealing with past disputes be integrated into the new Australian Financial Complaints Authority (once established) or should it be independent of that body?

47. Who should be responsible for funding redress for past disputes? Is there a role for an ex gratia payment scheme (that is, payment by the Government)?
48. Should there be any monetary limits? If so, should the monetary limits that apply be the EDR scheme monetary limits?
49. Should consumers and small businesses whose dispute falls within the new (higher) monetary limits of the proposed Australian Financial Complaints Authority but was outside the previous limits be able to apply to have their dispute considered? Should access to redress for past disputes be provided through a transition period whereby the higher monetary limits are applied for a defined period retrospectively? If so, what would be an appropriate transition period?
50. If it is not possible to fully compensate all claimants, should a 'rationing' mechanism be used to determine the amounts of compensation which are awarded? Should such mechanism be based on hardship or on some other measure?
51. Are there any other issues that would need to be considered in providing access to redress for past disputes?

50. No comment as outlined in our response to the previous set of questions.

Should you have any questions, please contact the writer on 02-9299 3022.

Yours Faithfully

Paul Callaghan

General Counsel

cadence|economics

FSC Research Project
Statutory Compensation Scheme

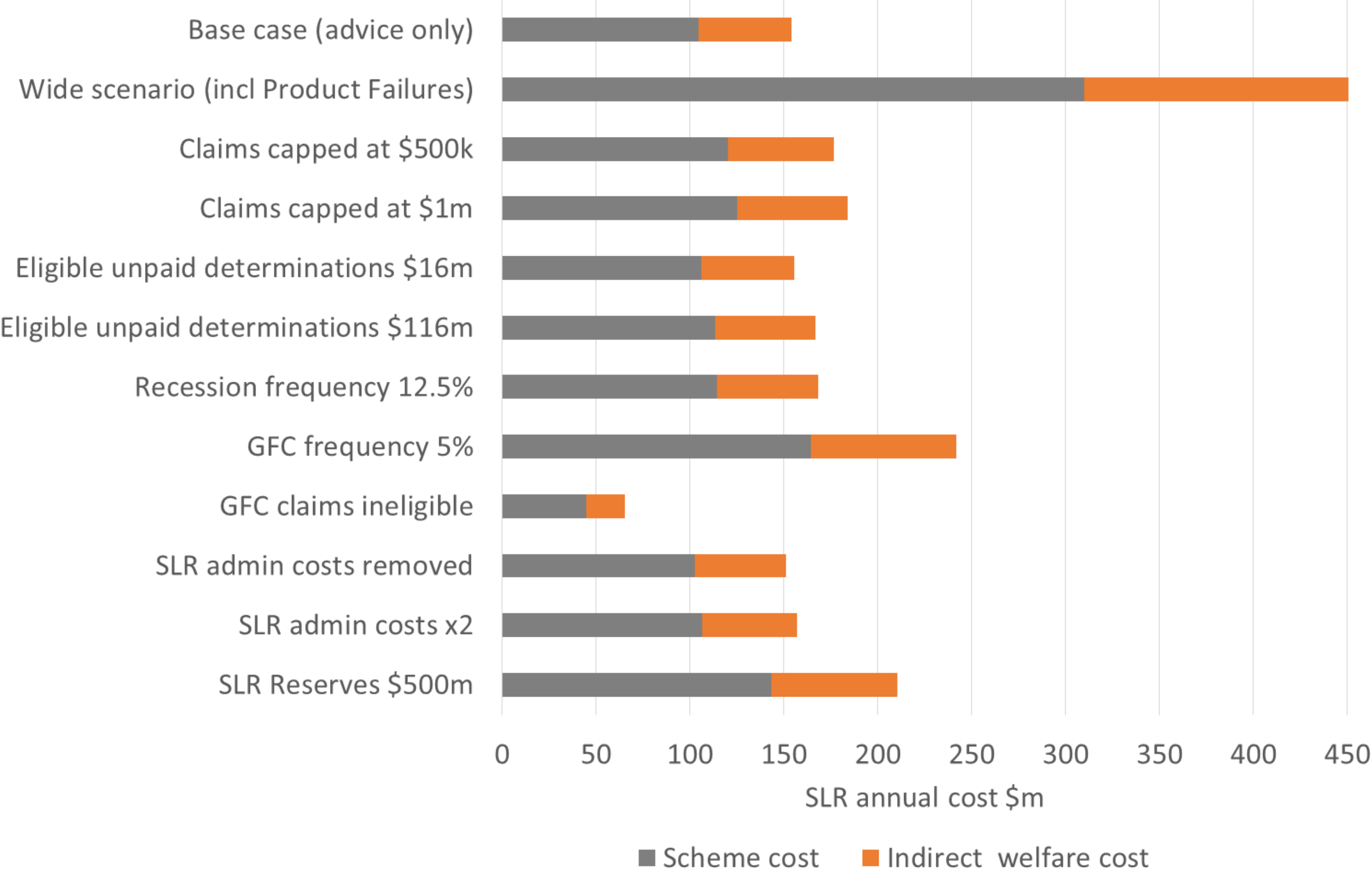
June 2017

Overview

- Executive summary: cost estimates and sensitivities
- Project overview
- SLR framework and assumptions
- CGE economic efficiency and economic outcomes
- Further policy considerations
- Appendices

cadence|economics

Executive summary: SLR annual cost estimates



Executive summary: SLR annual cost estimates

	Annual direct costs $m	Annual indirect costs $m	Annual total cost $m	Direct cost per planner[1] $	Direct cost per AFSL[2] $	Direct cost per $1m FUM[3] $
Base case (advice only)	**105**	**49**	**154**	**4,549**	**28,354**	**323**
Wide scenario (incl Product Failures)	310	146	456	13,473	83,977	956
Claims capped at $500k	120	56	176	5,218	32,525	370
Claims capped at $1m	125	59	184	5,441	33,916	386
Eligible unpaid determinations $16m	106	50	156	4,602	28,687	327
Eligible unpaid determinations $116m	114	53	167	4,937	30,770	350
Recession frequency 12.5%	115	54	168	4,980	31,043	354
GFC frequency 5%	165	77	242	7,154	44,593	508
GFC claims ineligible	45	21	65	1,937	12,073	138
SLR admin costs removed	103	48	151	4,462	27,812	317
SLR admin costs x2	107	50	157	4,636	28,896	329
SLR Reserves $500m	143	67	210	6,220	38,770	442

1. Assumes 23,000 financial advisers on the Financial Advisers Register able to provide personal advice (ASIC Annual Report 2015-16)
2. Based on 3,690 AFS licensees licensed to provide personal advice (ASIC Annual Report 2015-16)
3. Based on estimate of $324 billion retail funds subject to levy (See: Rainmaker Table 34 FUM, Volume 15, Number 3, SEP Quarter 2016)

cadence|economics

Project overview

- Cadence Economics was engaged by FSC to model potential costs of a Statutory Compensation Scheme of Last Resort (**SLR**) to compensate retail clients who suffer losses due to insolvency of AFS licencees in the event of inappropriate advice, negligence, fraud or other actions
- Key deliverables:
  - Develop model and estimate potential SLR cost under various scenarios/assumptions
  - Assess economic efficiency of SLR (cost vs benefit) using CGE model:
    - Wealth transfer
    - Indirect costs
    - Economic efficiency/inefficiency
  - Comment on policy or design considerations.
- Report key metrics:
  - Size of scheme
  - Cost of scheme by licencee and by FUM

SLR Model

cadence|economics

Framework and assumptions

- SLR financial assessment:
  - Stochastic model to forecast losses and claims arising from SLR
  - 20 year projection period
  - All projections and costings in real FY2016-17 dollars
  - Discount rate: 4.5% pa real (equivalent to 7% nominal rate with 2.5% inflation)

- Loss parameters based on 3 tier loss probability model:

Loss Tier	Description	Aggregate Advice Loss $m pa	Aggregate Advice Claims $m pa	Aggregate Product Claims $m pa	Expected Frequency	Probability %
1	Business as usual	4	3	6	7 years in 8	87.5%
2	Major loss (recession or single event failure)	500	400	800	1 year in 10	10.0%
3	Catastrophe (GFC or major industry failure)	3,000	2,400	4,800	1 year in 40	2.5%
Total						100.0%

SLR model assumptions

- **Tier 1 assumptions** (based on recent FOS experience 2010 to 2016):
  - FOS determinations limited to $309k per claim
  - Average FOS determinations: $25m pa
  - Average paid FOS determinations: $22m pa
  - Unpaid FOS determinations: $3m pa (assumed parameter for advice only failure) [4]
  - Claims represent approx 80% of total $4m pa loss (remainder exceeds FOS claim cap) [5]
  - Product failure estimated at 2 times advice failure (Advice plus Product losses $12m pa)

- **Tier 2 assumptions:**
  - Greater number of claims
  - Greater default of AFS Licencees
  - Estimated advice failures: $500m
  - Estimated advice claims: $400m (80% of losses, due to $309k cap)
  - Estimated product (MIS) failures: $1 billion (2 times advice loss)
  - Estimated product claims: $800m (80% of losses)

SLR model assumptions

- **Tier 3 assumptions** (based on GFC experience):
  - Advice failures: Storm Financial, Opes Prime, Deakin
  - Estimated advice failures: $3 billion
  - Estimated advice claims under FOS cap: $2.4 billion (80% of loss)
  - Product (MIS) failures: Westpoint, MFS, Timbercorp, etc
  - Estimated product losses: $6 billion
  - Estimated product claims under FOS cap: $4.8 billion (80% of loss)

- **Other key assumptions:**
- Expected SLR administration costs: **$2m per annum**[6]
- Base case assumes retrospective claims **excluded** (but sensitivity included)
- SLR modelled as **Government scheme**:
  - No contribution tax
  - No income tax on investment earnings
  - No tax deductions for SLR's claims/operating costs
  - Ignore prudential reserving and solvency considerations
  - Assumed funding deficits can be carried forward and offset against future levies

Base case and scenarios

Base case

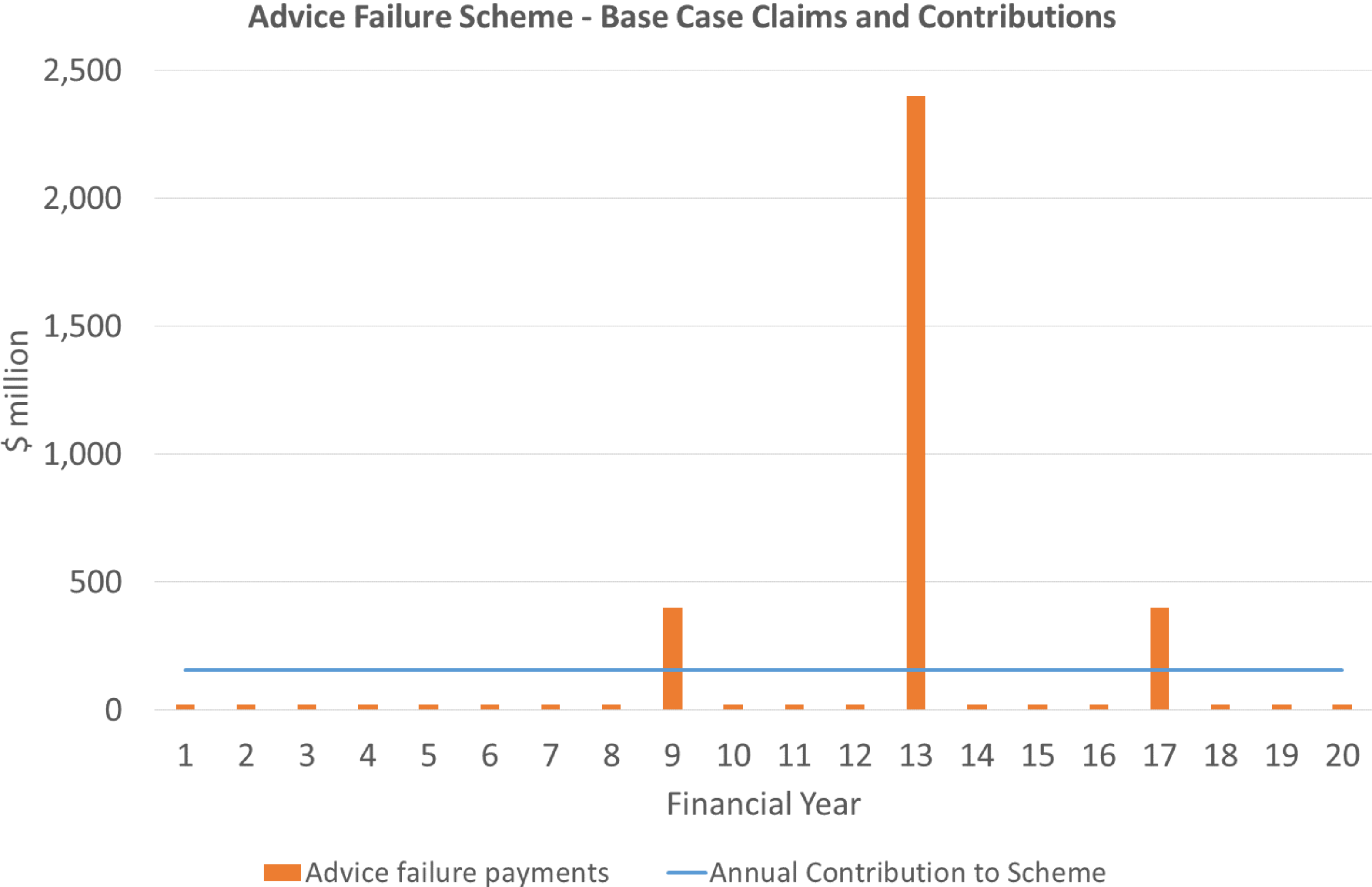
- Average claims: $103m pa
- Scheme cost: **$105m** pa (including $2m of admin costs)

Key sensitivities

- Include product failures (2x advice failures)
- Change $309k cap on claims
- Include current unpaid determinations (retrospective scheme)
- Increasing frequency/severity of loss events
- Changing SLR fund administrations costs
- Introducing SLR reserve target for solvency purposes

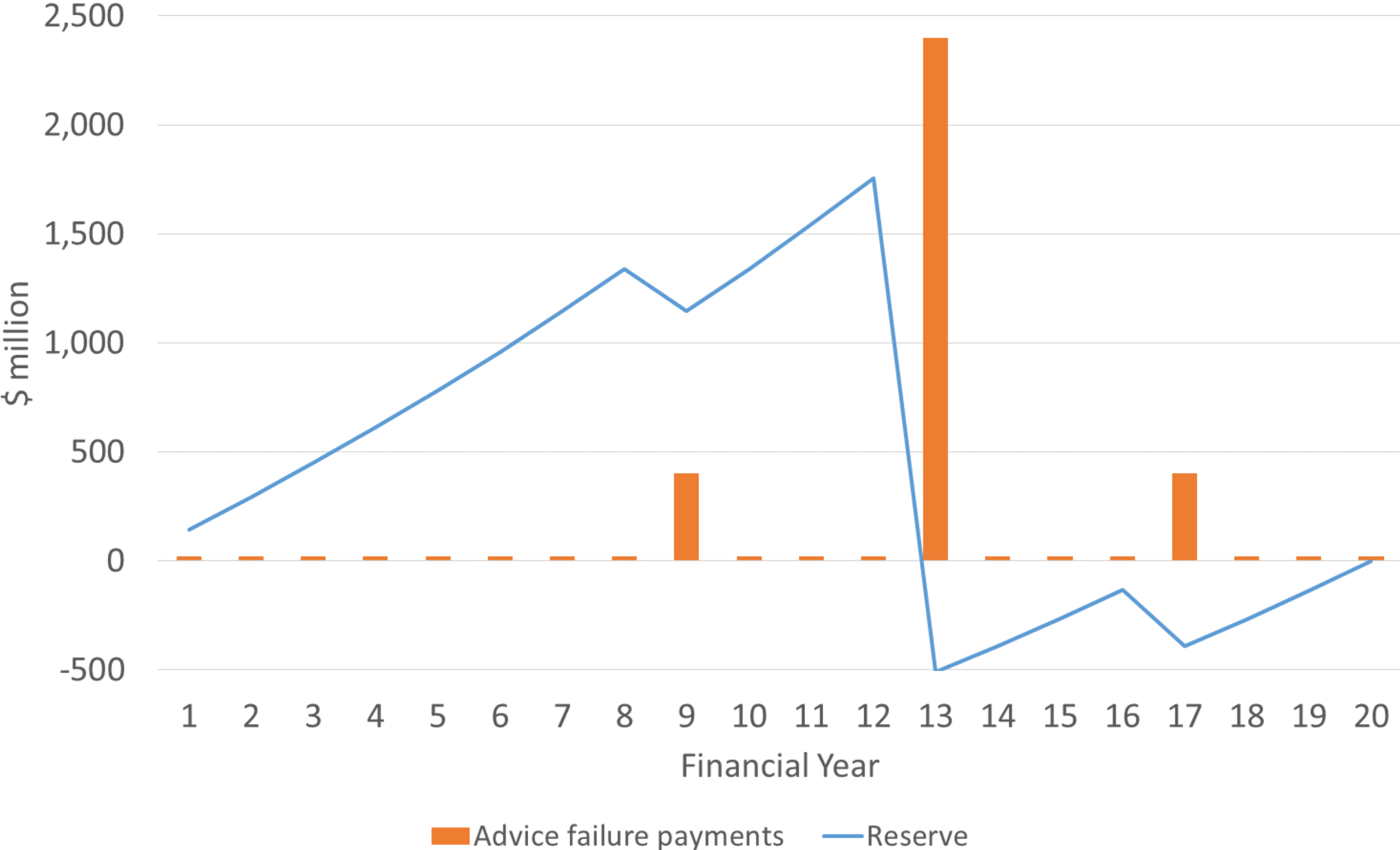
cadence|economics

Scenario #1 example: scheme contributions and claims[7]



cadence|economics

Scenario #1 example: reserving and solvency[7]



SLR Modelling outputs and findings

Findings

- Inclusion of product failures materially affects SLR cost
- SLR cost primarily driven by the Tier 3 event severity and frequency (eg another GFC)
- SLR cost sensitive to Tier 2 event assumptions (modest failures/recession scenario)
- Compensation can be significantly limited by excluding Tier 3 event payments, but question equity and overarching purpose of scheme (ie why have a scheme that is destined to fail when it is most needed?)
- Average 20 year SLR costs impacted only marginally by including retrospective claims (assuming modest cost of capital)
- SLR fund admin costs small in context of Tier 2 and Tier 3 losses, but material in context of long periods of Tier 1 losses

CGE Economic Model and SLR Efficiency

cadence|economics

Purpose of CGE Model

CGE Model

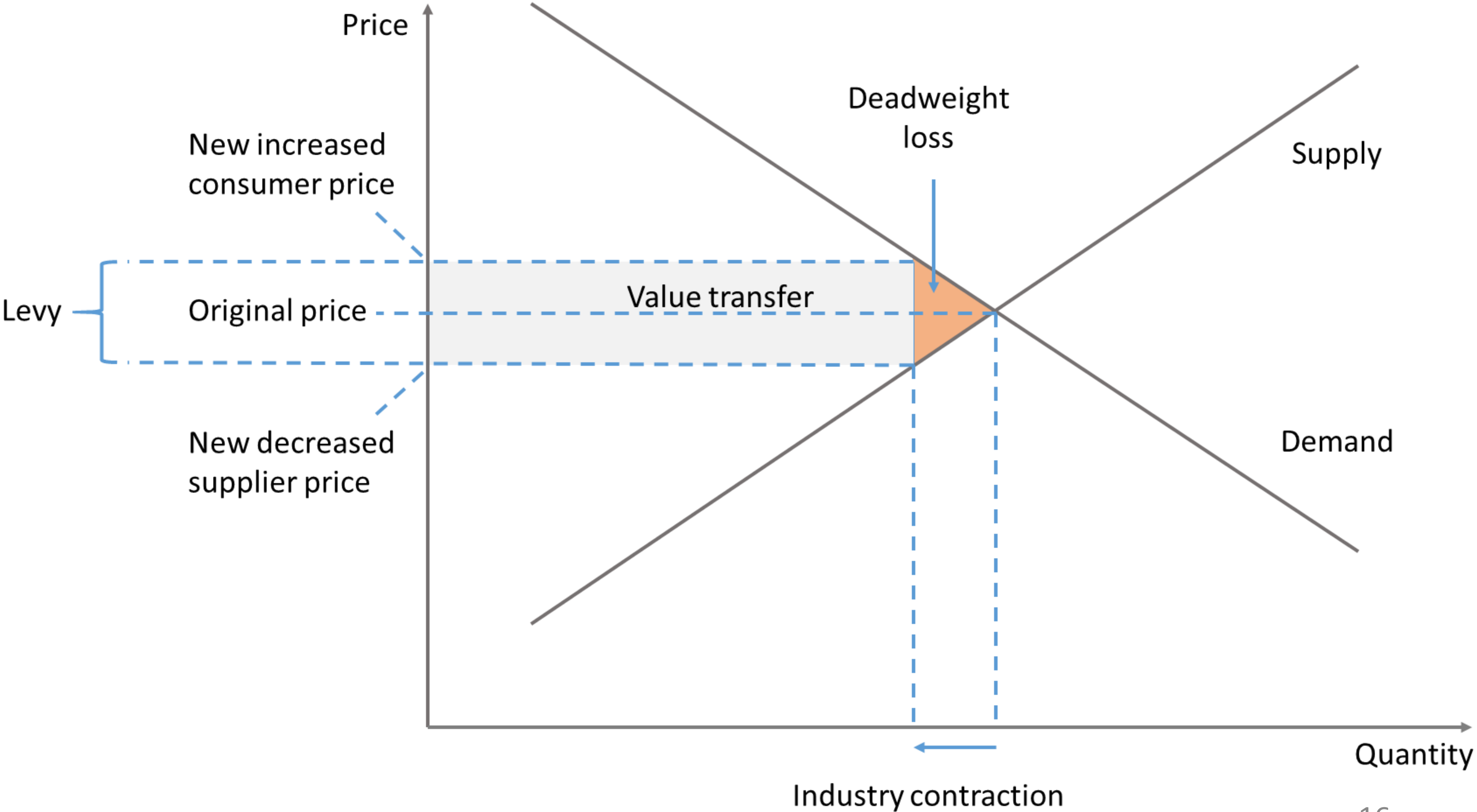
- Framework to assess economic impact of SLR against a baseline
- CGE model aggregates demand, supply and determines equilibrium price for commodities and factors to assess economic welfare costs
- SLR levy functionally similar to microeconomic industry tax

Categories of SLR costs

- Wealth transfers (tax-like in nature): *$103m pa*
- Direct administration costs: *$2m pa*
- Additional claims / FOS work: *Included in $2m annual admin costs*
- Indirect costs (deadweight loss): *Quantified by CGE model*

cadence|economics

Indirect scheme costs



cadence|economics

CGE results for base case SLR

Change in economic metric	20 year average
SLR annual levy ($m)	105
Aus Gross Domestic Product ($m)	-33
Aus Gross National Product ($m)	-49
Aus employment (FTE)	-223
Financial services employment (FTE)	-606
Aus real wage bill ($m)	-14
Financial services real wage bill ($m)	-38
Financial services industry output ($m)	-128
Deadweight loss (cents per dollar)	-47

cadence|economics

Levy and tax efficiencies

- Cadence calculates deadweight loss of **47 cents in the dollar**.
- That is, for each $1 raised in SLR levies, an **additional** $0.47 of economic cost is borne by national economy
- KPMG analysed the efficiency of various taxes for the Henry Review of taxation
- Taxes on insurance are in a similar category to the proposed tax on financial services, with a marginal excess burden (MEB) or deadweight loss of 67 cents in the dollar
- SLR levy lower than 67 due to, for example, imposition on households rather than businesses
- There are a range of more efficient tax bases to fund the SLR

Source: KPMG Econtech (2009) *CGE Analysis of the Current Australian Tax System*

Rating	Tax	MEB	AEB
Low	Tobacco excise [a]	-8	-23
Low	Import duties [b]	-3	-7
Low	Petroleum resource rent tax [c]	0	0
Low	Municipal rates	2	1
Low	GST	8	6
Low	Land taxes [d]	8	6
Low	Alcohol excise and WET [a]	9	7
Medium	Fuel taxes	15	10
Medium	Stamp duties other than real property [e]	18	18
Medium	Luxury car tax [f]	20	9
Medium	Labour income tax	24	16
High	Conveyancing stamp duties [g]	34	31
High	Motor vehicle registration [h]	37	32
High	Motor vehicle stamp duties [h, i]	38	38
High	Corporate income tax	40	23
High	Payroll tax	41	22
Very High	Insurance taxes	67	47
Very High	Royalties and crude oil excise	70	50
Very High	Gambling taxes [j]	92	54

Source: KPMG Econtech's MM900 model estimates

Interpreting the CGE results

- Deadweight loss of 47 cents reflects inefficient and expensive levy
- Could raise SLR levy monies more efficiently: GST and personal income tax (broad revenue base, lower excess marginal burden, less behavioural change)
- Avoid direct levy on industry if possible (as consumers will substitute away from higher priced financial advisory services):
  - Lower industry output
  - Lower industry employment
  - Lower wages and corporate profits
  - Economic inefficient outcome (smaller levy base with distorted price signals)
- Price distortion can lead to differential product/service levies (consumers could substitute away from financial planning services for non-levied products such as industry super funds, for example, or non-financial services)

cadence|economics

Interpreting the CGE results

- Levy on financial advisory services sees reduction in industry activity and output
- Industry employment drops 606 FTE, of which 383 find alternate employment outside industry and 223 remain unemployed
- Reduction in industry activity also reduces wages slightly
- Industry reduction offset in part by growth in other industries
- Australian GDP drops by 32 cents for every $1 raised by the SLR levy
- Economic outcomes could be improved by raising levy more efficiently

Policy Issues to be considered

SLR design considerations

- Protect against what risk events – catastrophic events or business as usual losses only?
- Advice only failures or cover for product failure?
- How delineate between product and advice (complicated legal and economic definitions)?
- How optimally limit claims and scheme costs?
- Role and importance of claim caps and what is the optimal cap?
- Aim to avoid excess scheme surpluses?
- How avoid scheme deficits or insolvent scheme?
- How raise levy without adversely affecting industry or particular market participants?

Behavioural issues

- Stochastic model ignores behavioural changes, moral hazard and gaming.
- Possible behaviours to be considered in scheme design and costings could include:
  - Fewer AFS licencees but more Authorised Corporate Representatives (ie trend seeing firms minimise cost but maximise access to SLR)
  - Product managers advise on their products to allow clients to benefit from an "Advice-only" SLR
  - Corporates become AFS licencees to raise capital more easily (eg failed listed toll roads such as BrisConnect or Rivercity Motorway could have obtained AFSLs to provide capital guaranteed security offerings)
  - Trend towards greater claims as Australian society becomes more litigious that may see historical experience understate future costs
  - Significant rise in class actions could see future claims exceed expectations
  - Compensation lawyers aggressively pursuing SLR claims on 'no win, no fee' basis particularly in circumstances where a large fund surplus has accumulated
  - More claimants use FOS rather than courts (particularly in case where SLR has been designed to cover only FOS determinations)
  - Limit on FOS claims may come under greater political/policy pressure (ie purpose of FOS cap may change dramatically with introduction of SLR)

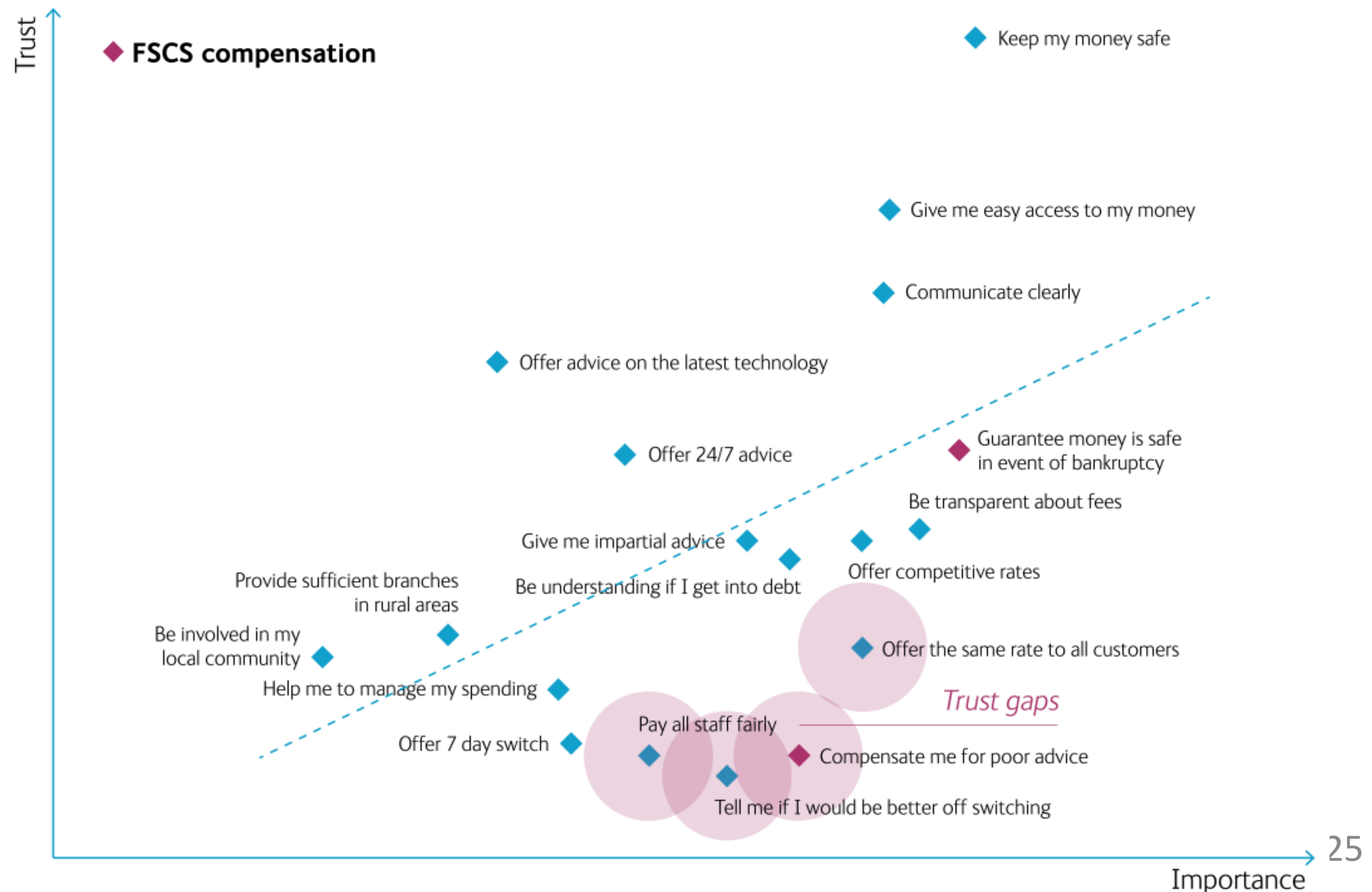
Public policy considerations

- While the SLR (depending on the exact design) would cover claims in normal years, there is the potential for Government to be exposed to a large deficit following a major adverse event. This could be funded by a retrospective tax or 'trigger levy'. Alternatively, the scheme would need to generate large surpluses quickly to cover an adverse event, which is also problematic.
- The *Australian Government Cost Recovery Guidelines* (2014) note that this scheme would require:
  - a taxation act of Parliament
  - a Regulation Impact Statement, considering alternatives to regulation, such as whether a market for a consumer insurance product could be created
  - a Cost Recovery Implementation Statement signed off by the Treasurer and Minister for Finance.
- These regulatory requirements would see the scheme subjected to a cost-benefit analysis:
  - Costs comprise mainly of administrative costs, deadweight cost of the tax, start up costs, additional legal costs, claims processing and moral hazard effects
  - A potential benefit is 'improved trust in financial advice and products', which may be negligible (see following slide)
  - Assuming the industry is relatively competitive, the cost of the levy would be passed on to consumers.

Public policy considerations

- In the UK, where the Financial Services Compensation Scheme (FSCS) has operated since 2001, a recent study[8] found public trust in being compensated for losses from poor advice is low (see extract below).
- It is likely that the 'trust' benefits component of the cost-benefit analysis of the scheme may be negligible

Source: Decision Technology (2015) *Mind the Gap: Restoring Consumer Trust in Financial Services* report for UK FSCS



Public policy considerations

- Recent improvements to the regulation of financial advice and products (such as FOFA) may need additional time to work before considering an additional layer of protection via the SLR
- Australia has one of the world's most generous social safety nets, including: the aged pension, Medicare, concession card, Pharmaceutical Benefits Scheme and the National Disability Insurance Scheme. Government may wish to consider the role of the SLR in the context of existing broad-based social safety nets
- At the State level there are compensation schemes for victims of crime. Limits are typically $30,000 to $75,000, depending on the jurisdiction and seriousness of the injury or death. Governments may wish to consider benchmarking compensation limits across various schemes, for example for financial and violent crimes

Appendices

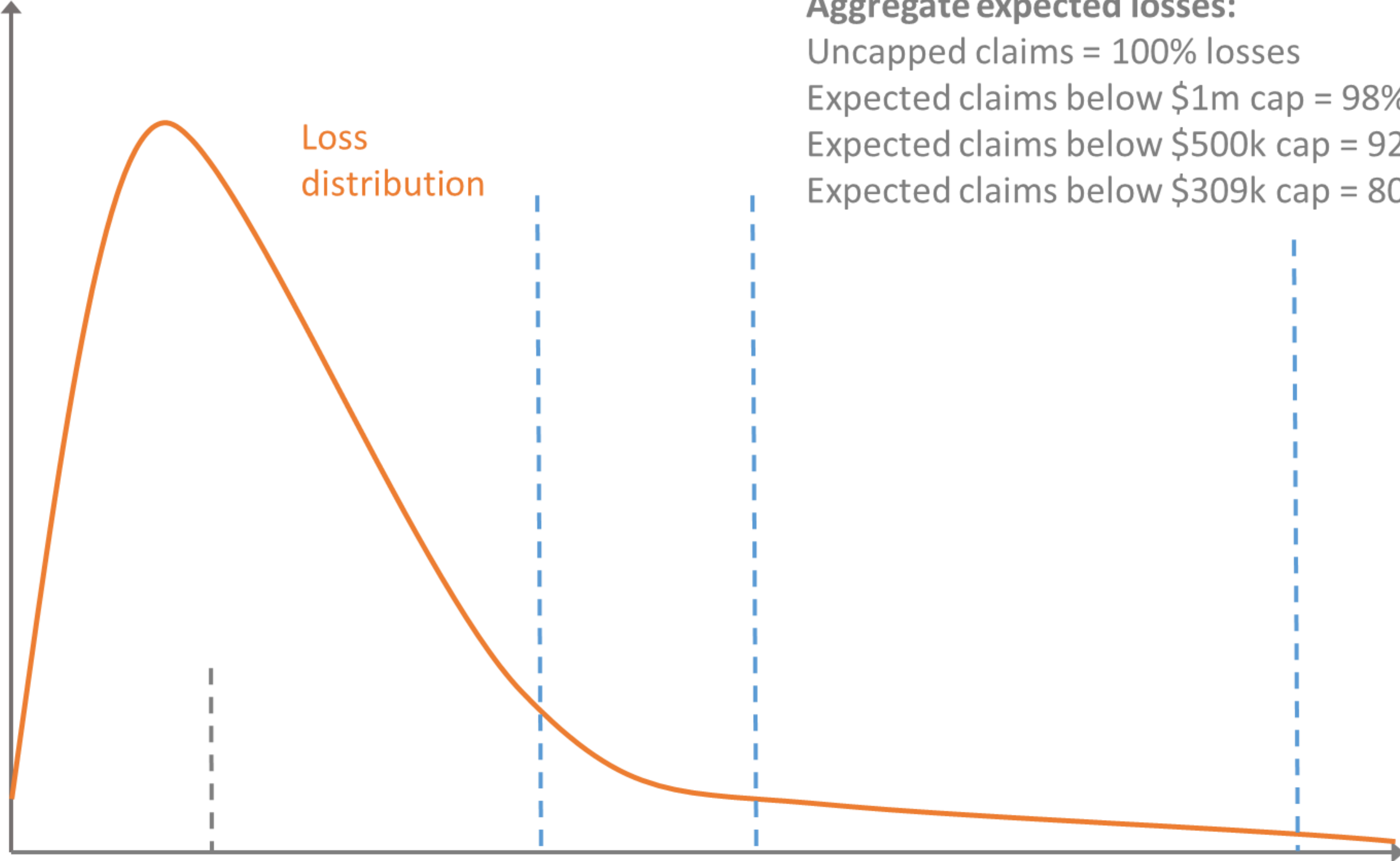
Appendix 1: Impact of capping claims

- The average claims for advice failures were in the order of $65,000 (PFS 2009 report) to $96,667 (Grant Thornton 2014 report) per unpaid determination when the FOS claims were capped at $280k.
- Using the more recent estimates, for average unpaid determinations in the order of $120,000 (allowing for three years compound at 6%), a cap of $309,000 is nearly three times the average, indicating that a relatively small proportion of claims are more than $309,000
- Other case study examples provided by FOS indicate that the impact of applying caps reduces the amount of unpaid determinations in the order of 10% to 20%, although there are some outliers where consumers suffered large losses
- Higher caps (either $1m or $2m) would result in unpaid determinations being very close to 100% of the amount of unpaid claims prior to applying the cap
- The average losses for product failures tend to be higher than advice failures. However, agribusiness products (Willmott and Great Southern) had average investments in the order of $50,000, in which case the cap has little effect
- The SLR is to benefit retail investors, rather than institutions, so average losses up to $100,000 cover the bulk of historical experience, and are well below the proposed caps
- In cases where a retail client's house was used as security for a margin loan, the claims can be considerably higher. Storm collapsed with $3 billion debts to 14,000 clients, an average of $214,000 (and some clients lost properties worth several times that)
- Cadence Economics also examined Monte Carlo simulations of losses, which provide similar results. With average claims at $120,000 being only one-third of the $309,000 cap, the impact of capping only reduces SLR funding requirements in the order of 10% to 20% (depending on the choice of probability distribution and parameters)

The impact of capping at $1m, versus the current $309,000 cap, is likely to increase the funding for the SLR in the order of 20%. For the SLR sensitivity analysis, claims are 92% of losses with a $500k cap and 98% of losses with a $1m cap

cadence|economics

Appendix 1: Impact of capping claims (continued)



Aggregate expected losses:
Uncapped claims = 100% losses
Expected claims below $1m cap = 98% of losses
Expected claims below $500k cap = 92% of losses
Expected claims below $309k cap = 80% of losses

cadence|economics

Appendix 2: SLR administration cost assumptions/observations

- Common risk is to underestimate new scheme costs
- Difficult to quantify costs in absence of definitive operating model
- Potential costs to be considered:
  - Board fees ($300k)
  - Executive staff and EA salaries (2-3 FTE)
  - Levy collection costs and size of finance team (possibly up to 4 FTE)
  - Policy/communications workload and size of communications team (1-2 FTE)
  - Claims staff levels and claim assessment costs (likely to step up materially in event of Tier 3 catastrophe but averaged out for this analysis)
  - Legal fees – claim related, scheme related, scheme compliance, etc
  - Investment related costs (internal investment officer, asset consulting fees, etc)
  - Office space, overheads and other on-costs
  - Reporting costs (monthly bulletins, quarterly statements, annual reports)
- Costs expected to exceed $800k upper estimate calculated by Grant Thornton in 2014
- Cost estimate can be benchmarked to Workcover authorities, FSC, CIO, SCT or smaller insurance funds such as Victorian Legal Practitioners Liability Committee.

cadence|economics

Appendix 3: Overview of CGE Model

- The Cadence Economics General Equilibrium Model (CEGEM) is of a genre of economic models (computable general equilibrium, or CGE) that are used extensively by the Australian Government to assess the economy-wide impacts of major policy changes
- The Cadence Economics team have extensive background in the development and application of a wide number of CGE models. The CEGEM model has been developed using the Python programming language, with a highly customisable Excel front end interface that provides an adaptable and powerful assessment framework
- CEGEM is a multi-commodity, multi-region, dynamic model of the Australian and world economy, including significant flexibility in regional and sectoral aggregations
- CEGEM is a based on a range of assumptions, parameters and data that constitute an approximation to the working structure of an economy. Its construction has drawn on the key features of other economic models such as the global economic framework underpinning models such as GTAP and GTEM, with state and regional modelling frameworks such as Monash-MMRF and TERM
- The model assumes labour markets operate such that employment and wages adjust in each year according to labour supply and demand
- The model assumes the prices and levels of capital, goods, services and interest rates adjust such that the demand and supply for each sector of the economy, and the economy as a whole, remain in equilibrium each year

Appendix 4: Glossary

- AEB – Average Excess Burden
- AFS – Australian Financial Service
- AFSL – Australian Financial Service Licence or Australian Financial Service Licencee
- CEGEM – Cadence Economics General Equilibrium Model
- CGE – Computable General Equilibrium
- CIO – Credit and Investments Ombudsman
- EDR – External Dispute Resolution
- FOS – Financial Ombudsman Service
- FSC – Financial Services Council
- FSCS – UK Financial Services Compensation Scheme
- FTE – Full time equivalent
- FUM – Funds under management
- GDP – Gross Domestic Product
- GFC – Global Financial Crisis
- GST – Goods and Services Tax
- GTAP – Global Trade Analysis Project
- GTEM – Global Trade and Environmental Model
- MEB – Marginal Excess Burden
- MIS – Managed Investment Scheme
- SCT – Superannuation Complaints Tribunal
- SLR – Statutory Compensation Scheme of Last Resort

cadence|economics

Appendix 5: Footnotes and references

1. Assumes 23,000 financial advisers on the Financial Advisers Register able to provide personal advice (ASIC Annual Report 2015-16)
2. Based on 3,690 AFS licensees licensed to provide personal advice (ASIC Annual Report 2015-16)
3. Based on estimate of $324 billion retail funds subject to levy (See: Rainmaker Table 34 FUM, Volume 15, Number 3, SEP Quarter 2016)
4. Parameter cross referenced to FOS 2015-16 Annual Report: $16.7m of unpaid determinations at June 2016. Equivalent to approx $3m pa for the 6½ year period Jan 2010 – Jun 2016
5. Modelling and cross references detailed in Appendix 1
6. Administration costs discussed in Appendix 2
7. Single scenario shown for illustrative purposes only. Costings in this report were based on stochastic model parameters and Monte Carlo simulations.
8. Decision Technology (2015) Mind the Gap: Restoring Consumer Trust in Financial Services report for UK FSCS

General reliance restriction

This report is only for the use of Financial Services Council. It was prepared for the purpose of highlighting the economic impact of a scheme of last resort. You should not use the advice for any other purpose. This report should not be used or relied upon by anyone else and we accept no duty of care to any other person or entity. Due to the uncertain nature of economic data, forecasting, and investment returns Cadence Economics does not warrant the completeness or accuracy of the analysis or estimates provided in this report. This report does not constitute financial or investment advice.

© Cadence Economics Pty Limited 2017

www.cadenceeconomics.com.au

FSC FINANCIAL SERVICES COUNCIL

03 February 2017

EDR Review Secretariat Financial System Division
Markets Group
The Treasury
Langton Crescent
PARKES ACT 2600

By email only: EDRreview@treasury.gov.au

Dear Colleagues

FSC submission to the Treasury 6 December 2016 Review of the financial system external dispute resolution framework (Interim Report)

The Financial Services Council (**FSC**) has over 100 members representing Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies. The industry is responsible for investing more than $2.7 trillion on behalf of 13.0 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange and is the third largest pool of managed funds in the world.

The FSC promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

Thank you for the opportunity to provide a submission on the Review of the financial system external dispute resolution and complaints framework.

In this submission, references to **FSP** means Financial Services Providers who are members of FOS or users of the SCT.

The FSC has not submitted comments on the Credit and Investment Ombudsman (**CIO**) unless indicated specifically.

Whilst we have addressed recommendations 6 – 10 which refer to the manner in which the "schemes" will operate our strong preference, as expressed in relation to recommendation 1, is that the current SCT structure be retained and not replaced with an industry ombudsman scheme.

Our comments on the Interim Report follow.

YOUR FUTURE FIRST
Financial Services Council Ltd ABN 82 080 744 163
Level 24, 44 Market St Sydney NSW 2000
T. +61 2 9299 3022 F. +61 2 9299 3198
E. info@fsc.org.au W. fsc.org.au

DRAFT RECOMMENDATIONS – Page 24 of Interim Report

Draft recommendation 1
A new industry ombudsman scheme for financial, credit and investment disputes

There should be a single industry ombudsman scheme for financial, credit and investment disputes (other than superannuation disputes) to replace FOS and CIO.

The FSC has no objection to this draft recommendation.

Draft recommendation 2
Consumer monetary limits and compensation caps

The new industry ombudsman scheme for financial, credit and investments disputes should provide consumers with monetary limits and compensation caps that are higher than the current arrangements, and that are subject to regular indexation.

The FSC and its Members oppose an increase to the current monetary limits and compensation caps which are $500,000 and $309,000 respectively.

On page 16 of the Interim Report, the Panel found that the *'current monetary limits and compensation caps are no longer fit-for-purpose and bear little relationship to the value of some financial products (for example, mortgage balances)…'*.

The Panel does not make any recommendations as to what the monetary limits and compensation caps ought to be. The Panel does however note on page 104 that the Australian Bankers' Association (ABA) is of the view that the new scheme should have power to award compensation up to $1M while the Joint Consumer Group put the limit as high as $2M.

Increases of the monetary limits and compensation caps to such levels are strongly opposed by FSC and its Members oppose increases for a number of reasons.

YOUR FUTURE FIRST

Financial Services Council Ltd ABN 82 080 744 163
Level 24, 44 Market St Sydney NSW 2000
T. +61 2 9299 3022 F. +61 2 9299 3198
E. info@fsc.org.au W. fsc.org.au

The FOS in its submission on pages 34-36 makes reference to the mean price of residential dwellings in Australia and the growth in average wages when commenting that monetary limits have not kept pace. FOS does not propose specific adjustment and recommends consultation.

The FSC does not agree with a 'one-size fits all approach' to monetary limits and compensation caps. Consideration should be given to different product types. What may be appropriate for banking products may not appropriate for life insurance and investment products.

Increases in monetary limits and compensation caps are likely to increase the complexity of matters and decrease efficiency. In circumstances where there is no right of appeal for our Members, there is also a lack of equity.

The FSC submits that the underlying principles governing an EDR scheme such as fairness and equity are to be applied equally to both consumers and financial services providers. For example, a right of appeal for consumers and financial service providers if the decision does not accord with well-established legal principles. This is particularly important if the monetary limits and compensation caps were to increase above their current ceilings.

If the limits are to be increased, the FSC considers that the case managers should have the requisite expertise and training, particularly in well-established legal principles because, as admitted by FOS, its case managers have varying levels of expertise. This disparity has, and continues to result in inconsistent decisions for the FSPs.

In addition, an increase of the limits to over $1M, will make it increasingly difficult for FSPs to properly consider appropriate steps to be taken in relation to disputed claims because of the uncertainty surrounding a FOS determination. The Terms of Reference only require FOS to have regard to legal principles and so there is no certainty as to how FOS might apply the concept of fairness when there is no legal liability underpinning the claim.

In any newly constituted EDR, the FSC also recommends that the Terms of Reference include such concepts of not allowing a claim to progress if the EDR body determines that a reasonable offer has been made which has not been accepted by the claimant. This will reduce the number of claims that progress through to recommendation or determinations that are solely based on unreasonable expectations by the claimant. It should also contribute to improved efficiencies.

YOUR FUTURE FIRST

Financial Services Council Ltd ABN 82 080 744 163 Level 24, 44 Market St Sydney NSW 2000 T. +61 2 9299 3022 F. +61 2 9299 3198 E. info@fsc.org.au W. fsc.org.au

The Richard St John Report comments in relation to EDR schemes

The Richard St John report *Compensation arrangements for consumers of financial services* (April 2012) (the **St John Report**) was obtained by the Federal Government when considering 'the need for, and costs and benefits of, a statutory compensation scheme for financial services'.

The St John report made a number of pertinent comments in relation to EDR schemes.

The St John Report noted (at pages 46 and 47) that:

> *2.178 EDRs clearly play an important role in providing consumers with ready access to a process for the resolution of disputes with providers of financial services. It is timely however to reflect on the way in which they have developed and on underlying issues which seem to be becoming more pronounced as the jurisdiction of EDRs is extended to include claims for substantial damages.*
>
> *2.179 While industry has been involved in and generally supportive of the development of EDRs, there appears to be some disquiet about aspects of their working in practice. The concerns go to issues of fairness, touching on the rule of law, and of cost. These concerns are of lesser significance in the context of the handling of run of the mill complaints by consumers about the administration of their accounts or policies, which constitute a large proportion of EDR business, and may be accepted in the interest of a ready means for the resolution of consumer disputes. The concerns are more serious however when considered in the context of the recently expanded jurisdiction of EDRs to consider claims up to $500,000 and to award compensation up to $280,000.*
>
> …
>
> *2.181 It appears that more attention needs to be given to underlying issues of due process and transparency in the context of the expanded jurisdiction of EDRs in order to maintain confidence in the system and contain any undue cost burden on the provision of financial services.*
>
> *2.182 There will always be some trade-off between the provision of low cost, flexible dispute resolution services for consumers and ordinary procedural and due process safeguards.*

YOUR FUTURE FIRST
Financial Services Council Ltd ABN 82 080 744 163 Level 24, 44 Market St Sydney NSW 2000 T. +61 2 9299 3022 F. +61 2 9299 3198 E. info@fsc.org.au W. fsc.org.au

> *The answer may lie in the provision of somewhat more rigorous and transparent processes for claims for compensation in excess of a reasonable monetary threshold. I suggest that issues of the kind noted above call for further consideration including by EDR schemes themselves and ASIC in its overview role.*

Paragraph 2.180 of the St John Report (at page 46) refers to, among others the following matters:

- The lack of rights of review;
- The fact 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.

The St John Report summed up his observations on the EDR process in Recommendation 2.5.5 (at page 149) as follows:

> **Recommendation 2.5.5: External Dispute Resolution scheme processes**
>
> *Given their key role in the regime for the protection of consumers of financial services, and marked increases in their jurisdiction, External Dispute Resolution schemes and ASIC should give more attention to the adequacy of the EDR scheme processes as those schemes grow beyond their origins as forums for small claims. Issues for consideration include: rights of review; transparency; capacity of a member to join in a proceeding other members that might be liable; cost contribution by complainants; liability standards; relevance of regulatory guidance and other operational issues discussed in Chapter 2* [of the St John Report].

The FSC agrees with many of the comments quoted (or paraphrased) from the St John Report and is of the view that these comments remain relevant.

The amounts which currently may be awarded by FOS are well beyond "small claims" amounts and are awarded under principles of fairness rather than legal obligations. This is appropriate for small claims but not for claims that potentially could be many hundreds of thousands of dollars.

The FSC and its Members are of the view that should there be any increase to monetary limits and compensation caps (which is opposed), there should be a

YOUR FUTURE FIRST
Financial Services Council Ltd ABN 82 080 744 163
Level 24, 44 Market St Sydney NSW 2000
T. +61 2 9299 3022 F. +61 2 9299 3198
E. info@fsc.org.au W. fsc.org.au

right of appeal on questions of law if the ordered compensation is in excess of the current limits.

Further, the FSC notes the information contained in Appendix 1 of the Interim Report which provides a detailed analysis of EDR practices overseas and in other sectors in Australia.

The FSC notes that international EDR schemes have similar or substantially lower monetary limits and compensation caps than by FOS and the CIO current limits:

Four schemes in NZ – NZ$200,000 each
UK – approx. AUD$240,000
Singapore – approx. AUD$94,000
Canada – OBSI – approx. AUD$355,000

Moreover, most other ombudsman schemes in Australia have substantially lower monetary limits and compensation caps than those currently adopted by FOS and the CIO.

Draft recommendation 3
Small business monetary limits and compensation caps

The new industry ombudsman scheme for financial, credit and investment disputes should provide small business with monetary limits and compensation caps that are higher than the current arrangements, and that are subject to regular indexation.

The FSC refers to and relies on the above submissions in response to this draft recommendation.

Draft recommendation 4
A new industry ombudsman scheme for superannuation disputes

SCT should transition into an industry ombudsman scheme for superannuation disputes.

YOUR
FUTURE
FIRST

Financial Services Council Ltd
ABN 82 080 744 163
Level 24, 44 Market St
Sydney NSW 2000
T. +61 2 9299 3022
F. +61 2 9299 3198
E. info@fsc.org.au
W. fsc.org.au

Given the SCT's strengths, our preference is to implement initiatives to enhance the operation of the SCT (e.g. increased funding and process improvements) and address key concerns regarding dispute delays within the existing SCT structure rather than move to an industry ombudsman scheme. The effectiveness of these initiatives should be carefully considered (within 12 to 24 months) before a complete overhaul of the SCT is pursued.

We support the SCT's model and believe it has been very effective in overseeing inherently complex superannuation-related disputes, often with case and trust law considerations. As per the SCT's latest annual report, the complexity of these cases is increasing. We are concerned that an ombudsman model may put at risk the SCT's capabilities and expertise that has been developed over many years to manage these disputes.

However we also recognise growing concerns regarding delays in resolving disputes at the SCT. We firmly believe these issues are as a result of SCT's limited resourcing and the inability to prioritise certain disputes rather than the overall structure of the SCT.

We note that on 20 April 2016 the Treasurer announced additional funding for the SCT of $5.2 million to help deal with legacy complaints and improve internal processes. Given this funding is targeted at addressing issues regarding dispute delays, we believe the SCT model should be given more time before a complete overhaul and transformation to an ombudsman format is implemented.

According to the SCT's 2015/16 Annual Report the introduction of process improvements has increased efficiency throughout the year. Efficiency gains have resulted in the average number of complaints finalised per member of staff rising to 70.4 compared with the five year average of 60. We welcome this development and encourage the consideration of other initiatives to enhance the process of dispute handling. For example, FOS have implemented a model to fast-track low value or simple cases and this could also be appropriate for the SCT. Attached is a summary of the FOS model.

Further we would be concerned with the credibility and enforceability of decisions of an ombudsman scheme given the different nature of SCT disputes compared with those of say FOS.

FOS requires claimants to agree to be bound by a determination. FSPs are bound by virtue of their membership of FOS.

YOUR FUTURE FIRST

Financial Services Council Ltd
ABN 82 080 744 163
Level 24, 44 Market St
Sydney NSW 2000
T. +61 2 9299 3022
F. +61 2 9299 3198
E. info@fsc.org.au
W. fsc.org.au

The SCT's jurisdiction predominantly addresses whether a Trustee decision is fair and reasonable in the circumstances. It is rare for the SCT to substitute its own decision for that of the Trustee. The vast majority of its cases either confirm the Trustee decision as being fair and reasonable or the SCT remits the matter back to the Trustee to reassess its decision. In addition, we question how an ombudsman scheme could enforce a decision against a non- fund member or an unsatisfied claimant (e.g. in a death benefit distribution dispute) without legislative power to do so.

Relatively simple amendments could in our view be made to the current SCT legislation to allow for implementation of a number of process improvements.

Draft recommendation 5
A superannuation code of practice

The superannuation industry should develop a superannuation code of practice.

Although we understand the attraction of a superannuation code of practice at a high level, we note that the superannuation industry and trustees already are subject to significant and extensive statutory obligations including the *Corporations Act 2001*, the *Superannuation Industry (Supervision) Act 1993*, and associated Regulations; regulatory oversight by ASIC and APRA; licensing conditions and ASIC regulatory guidance and APRA prudential standards for RSE licensees.

Further, superannuation trustees are subject to general law obligations and duties such as trustee and fiduciary obligations; which traditionally have been seen as imposing some of the highest general law obligations of good faith.

Additionally, we note that the FSC has recently launched the life insurance industry's Life Insurance Code of Practice. In the context of superannuation and life insurance, the FSC is working with the superannuation and insurance industries to deliver end to end commitment to the insurance experience for superannuation members. These discussions are ongoing.
Thus, it is not clear to us at this stage how a code of practice could usefully add to these matters and indeed may cause some degree of confusion duplication and increased compliance costs (which will ultimately be borne by fund members). Nevertheless, our members remain open to further discussion on this topic.

YOUR FUTURE FIRST

Financial Services Council Ltd ABN 82 080 744 163 Level 24, 44 Market St Sydney NSW 2000 T. +61 2 9299 3022 F. +61 2 9299 3198 E. info@fsc.org.au W. fsc.org.au

Draft recommendation 6
Ensuring schemes are accountable to their users

Both new schemes should be required to meet the standards developed and set by ASIC. As a minimum, ASIC's regulatory guidance should require the schemes to:

- ensure they have sufficient funding and flexible processes to allow them to deal with unforeseen events in the system, such as an increase in complaints following a financial crisis or natural disaster;
- provide appropriate level of financial transparency to ensure they remain accountable to users and the wider public;
- be subject to more frequent, periodic independent reviews and provide detailed responses to recommendations of independent reviews, including updates on the implementation of actions taken in response to the reviews and a detailed explanation when a recommendation of an independent review is not accepted by the scheme: and
- establish an independent assessor to review the handling of complaints by the scheme but not to review the outcome of individual disputes.

In addition, ASIC's regulatory guidance should require the new scheme for financial, credit and investment disputes to regularly review and update its monetary limits and compensation caps so that they remain relevant and fit-for-purpose over time.

Draft recommendation 7
Increased ASIC oversight of industry ombudsman schemes

ASIC's oversight powers in relation to industry ombudsman schemes should be enhanced by providing ASIC with more specific powers to allow it to compel performance where the schemes do not comply with EDR benchmarks.

Information request - Page 161 of Interim Report

On what matters should ASIC have the power to give directions? For example, should ASIC be able to give directions in relation to governance and funding arrangements and monetary limits?

ASIC's approach to its oversight of EDR schemes is set out in Regulatory Guide RG 139. The matters that it takes into account when considering initial and

YOUR FUTURE FIRST
Financial Services Council Ltd ABN 82 080 744 163 Level 24, 44 Market St Sydney NSW 2000 T. +61 2 9299 3022 F. +61 2 9299 3198 E. info@fsc.org.au W. fsc.org.au

ongoing approval of such schemes include accessibility, independence, fairness, accountability, efficiency and effectiveness. These considerations are based on the principles in the Benchmarks for Industry-Based Customer Dispute Resolution Schemes (**DIST Benchmarks**), published by the then Department of Industry, Science and Tourism in 1997. Those benchmarks were reviewed and relaunched in 2015. The Benchmarks are complemented by a separate document, the Key Practices for Industry-Based Customer Dispute Resolution. The Benchmarks, and Key Practices, are necessarily general and not prescriptive. This means that they can be followed by a wide range of dispute resolution schemes but also means that a wide range of arrangements could be seen as being compliant with the Benchmarks. This flexibility has enabled the Benchmark Principles to endure and remain relevant but also means that differing views could reasonably be held as to whether a particular scheme complies with the Benchmarks.

The Benchmarks do not refer to considerations of governance and funding nor monetary limits. The accompanying Key Practices refer briefly to considerations of governance and funding arrangements but only in relation to the principle of independence. They do not refer to monetary limits.

The Interim Report states (at 6.65) that ASIC is unable to take appropriate action to address a specific problem with a scheme, where it fails to comply with the relevant legislation or regulatory guidance. There is no suggestion in the Interim Report that the current EDR schemes do not comply with the Benchmarks, any legislation or ASIC's requirements as set out in RG 139. Even if ASIC did have additional powers in relation to EDR schemes, it is not apparent that the outcome would be any different. If a scheme failed to comply with the benchmarks and ASIC revoked its approval of the scheme, members and consumers would be in the same position that they are now.

Appendix 1 of the Interim Report includes an analysis of dispute resolution practices overseas and in other sectors. Based on that analysis, there are no equivalent industry ombudsman schemes that are subject to direction from the regulator although a number of industry ombudsman schemes must be approved by the regulator (as is the current arrangement under the *Corporations Act*) and in some cases one or more of the members of the board of the industry ombudsman scheme can only be appointed with the approval of the regulator or relevant Ministers.

We do not consider that ASIC needs further powers in relation to EDR schemes, and certainly not powers to compel performance with generic EDR principles. If, contrary to this view, ASIC were to be given additional powers, ASIC should

YOUR FUTURE FIRST
Financial Services Council Ltd ABN 82 080 744 163
Level 24, 44 Market St Sydney NSW 2000
T. +61 2 9299 3022 F. +61 2 9299 3198
E. info@fsc.org.au W. fsc.org.au

only be able to compel performance with specific requirements that are clearly articulated in advance and that are formulated only after consultation with all interested stakeholders.

Draft recommendation 8
Use of panels

The new industry ombudsman schemes should consider the use of panels for resolving complex disputes.

Users should be provided with enhanced information regarding under what circumstances the schemes will use a panel to resolve a dispute.

The FSC is of the view that clear guidance should be issued on what constitutes a 'complex dispute'. For example, is this by reference to dollar value, consequence of a dispute, time taken to resolve or some other measure?

From a consumer perspective, consideration should be given to whether this will create a need for legal representation for the complainant.

Draft recommendation 9
Internal dispute resolution

Financial firms should be required to publish information and report to ASIC on their IDR activity and the outcomes consumers receive in relation to IDR complaints. ASIC should have the power to determine the content and format of IDR reporting.

Information request - Page 162 of Interim Report

What IDR metrics should financial firms be required to report on? Should ASIC publish details of non-compliance or poor performance IDR, including identifying financial firms?

We understand that this matter is being considered by ASIC and APRA. The FSC supports a requirement to report publicly on IDR, however the content and format should be developed with industry input to ensure the content and degree of detail is appropriate and achievable in relation to the protection or privacy legal privilege and availability of data.

YOUR
FUTURE
FIRST

Financial Services Council Ltd
ABN 82 080 744 163
Level 24, 44 Market St
Sydney NSW 2000
T. +61 2 9299 3022
F. +61 2 9299 3198
E. info@fsc.org.au
W. fsc.org.au

Draft recommendation 10
Schemes to monitor IDR

Schemes should register and track the progress of complaints referred back to IDR.

Currently, if a claim decision has been made and the claimant wishes to lodge a formal complaint via the relevant IDR Avenue, RG 165 allows 45 days for the complaint to be reviewed and provide a final response to the claimant.

In relation to the recommendation outlined above, and considering the current mandatory IDR process requirements on insurers, we would anticipate minimal progress points to consider tracking or reporting are available. Also as it is rare that new information is requested, and more relevant received in this time frame, it again offers further limitations in relation to reportable progress of decisions or reviews.

Current IDR process includes notification responding that a complaint has been received and will be reviewed by the relevant IDR team indicating that a review will be conducted and in line with RG165 advice of the 'final response' to them within 45 days and 'best practice' timeframes shorter than this should regularly be achieved..

We note RG165.93 The 45 day timeframe to provide a final response:

(a) *Does not recommence where new information is provided in respect of the complaint or dispute. We consider that this will encourage financial service providers, credit providers and credit service providers to ensure they have sufficient facts and information to handle the complaint or dispute at an early stage of the IDR process;*

Noting this section of the regulatory guide, and as it encourages the provider to have sufficient facts and information on file to respond as quickly as possible, there is minimal consideration given to requesting new information to review the previous decision. As a result, there is limited opportunity to track any progress other than recording the review as 'continuing'.

When noting the above and considering the draft recommendation provided, we have formed the view that there is limited points of review to track the progress of complaints made to IDR. We would consider an initial response to the complainant acknowledging receipt of complaint and outlining a review will be completed within the 45 day requirement (including date decision required),

YOUR FUTURE FIRST
Financial Services Council Ltd ABN 82 080 744 163
Level 24, 44 Market St Sydney NSW 2000
T. +61 2 9299 3022 F. +61 2 9299 3198
E. info@fsc.org.au W. fsc.org.au

followed by the advice outlined the review conclusion reached by the IDR process be sufficient.

In relation to the registration of complaints received for IDR, we understand that providers have a registration/recording process in place at this time. We would expect the registration and recording of such complaints continues and with this it also provides an opportunity to record the details (numbers, reasons and outcome) to ASIC for transparency and consideration. For the reasons outlined, we are of the opinion that further reporting and tracking of IDR responses could have a detrimental impact upon this service to the consumer, given the relatively short period to act currently, such that the additional process steps would arguably detract from upholding an otherwise comprehensive service, prior to the further consumer safeguard of EDR. Overall therefore, our recommendation is to not insist on further reporting and instead ensure each Insurer confirms their internal reporting mechanism such that this may be made available to interested parties, should the need arise.

OBSERVATIONS

Panel observation – Page 26 and 168 of Interim Report

The Panel is of the view that there is considerable merit in introducing an industry-funded compensation scheme of last resort.

General Observation

For the reasons set out below, addressing the regulatory framework, including capital adequacy of licensees, appropriate professional indemnity insurance and increased professionalism for the advice industry, should be prerequisites to the contemplation of the introduction of a CSLR.

Any proposal to establish a CSLR necessarily should be approached with a very high degree of caution and extensive review, consultation and research must take place.

Public Policy

By their nature compensation schemes of last resort, (CSLR) represent poor public policy because of, at least, the following material outcomes and risks which would severely erode any perceived consumer benefits:

1. CSLR inherently promote moral hazard – for instance smaller, less-capitalised licensees could adopt less risk-adverse approaches and

YOUR FUTURE FIRST

Financial Services Council Ltd ABN 82 080 744 163 Level 24, 44 Market St Sydney NSW 2000 T. +61 2 9299 3022 F. +61 2 9299 3198 E. info@fsc.org.au W. fsc.org.au

behaviours in the expectation that if something goes wrong, the scheme will "pick up the tab";

2. CSLR generally are suggested as having a coverage that is wider than financial advice failures and include product failures-this gives rise to significant on-going liabilities for the scheme;

3. CSLR have the very real potential to be retrospective in nature. This raises the prospect of the scheme having to address not only current FOS unpaid determinations but also future determinations relating to events that may date back a number of years. No modelling has been undertaken to determine the size of the liabilities relating to this 'tail'. There also is an issue as to whether unpaid determinations or judgments of other tribunals and courts would fall within this process;

4. CSLR will be costly for those entities which are well-capitalised;

5. CSLR require funding and the precise parameters and scope of that funding is unclear;

6. CSLR, ultimately, will be an additional cost to industry which is passed on to the consumer, either directly or indirectly.

CSLR: International Comparison

We understand that Oliver Wyman (OW) has been engaged by FOS and the Australian Bankers' Association to provide comment on a CSLR. We also understand that OW has examined the Financial Services Compensation Scheme of the UK (FSCS) as a model

Our research indicates the following matters concerning FSCS-

(a) Claims against the life and pensions advice sector led to a compensation bill of just less than £84m, up from £35m the previous year – largely because the average pay-out against advisers who recommended high-risk investments to hold in self-invested-personal pensions, or SIPPs, rising year-on-year from £29,500 to £38,600 ;[1]

(b) £77m was paid out to people with claims against financial advisers that later stopped trading ;[2]

(c) it appears that FSCS may impose an interim levy on pension advisers due to a £28m shortfall in contributions from the sector ;[3]

(d) it also appears that FSCS could pay compensation of over £50 million in respect of a Costa Rican tree plantation investment scheme operated

[1] https://fscs.org.uk/industry/news/2016/july/fscs-pays-out-271m-against-failed-financial-services-firms-in-one-year/

[2] Ibid.

[3] http://www.portfolio-adviser.com/print_article/portfolio_adviser/news/1032951/fscs-levy-uk-advisers-bumped-dodgy-sipps?print=true

YOUR FUTURE FIRST
Financial Services Council Ltd ABN 82 080 744 163
Level 24, 44 Market St Sydney NSW 2000
T. +61 2 9299 3022 F. +61 2 9299 3198
E. info@fsc.org.au W. fsc.org.au

by Ethical Forestry SA and 'disregard' any SIPP valuations which could prevent payment of "fair compensation" for investors. [4]

Alternative Approach

The concept of a CSLR was last formally considered at a governmental level by Mr Richard St John in 2012. Mr St John concluded then that it would be inappropriate, and possibly counter-productive, to introduce a last resort compensation scheme at this stage.

In order to test whether the reasons given by Mr. St. John in his report remain relevant and if the regulatory and commercial matrix has not altered so as to arrive at a different conclusion, the FSC engaged Professor Pamela Hanrahan to provide a review of the St John research and to provide a commentary based on the current regulatory landscape.

Professor Hanrahan arrived at the following conclusions:

- the public interest case for introducing such a scheme has not yet been made;
- as with Mr. St John, Professor Hanrahan thought that a CSLR, could well introduce an element of regulatory moral hazard by reducing incentive for stringent regulation or rigorous administration of the compensation arrangements;
- the interests of Australian consumers at this stage would best be served by more effective regulation directed at both institutional and compliance risk in the financial services sector;
- CSLR face challenges in building and maintaining sustainable funding bases-there are potentially difficulties in anticipating and planning for likely claims and thus losses, and if a CSLR is post-funded, levies are likely to increase in circumstances where the financial sector as a whole is under pressure- this may impact disproportionately on smaller organisations;
- Notwithstanding the findings in the St. John report, ASIC has not changed its practices on "first-tier protections" for consumers under the Corporations Act. For example, ASIC has not amended its Regulatory Guide 126 Compensation and insurance arrangements for AFS licensees (December 2010) or Regulatory Guide 210 Compensation and insurance arrangements for credit licensees (March 2010) were not updated to reflect the recommendations in the St John Report.

[4] http://citywire.co.uk/new-model-adviser/news/fscs-set-to-pay-out-over-50m-forestry-investment-scheme/a977515

YOUR FUTURE FIRST
Financial Services Council Ltd ABN 82 080 744 163
Level 24, 44 Market St Sydney NSW 2000
T. +61 2 9299 3022 F. +61 2 9299 3198
E. info@fsc.org.au W. fsc.org.au

- Licensees should be required to hold insurance cover that reflects the guidelines required by the Professional Standards Council, including in relation to run-off cover.

Based on the St John report and the Hanrahan research, more appropriate and effective policy outcomes, are likely to include at least the following approaches:

(i) a detailed review and consideration of capital adequacy for AFSL licensees (as is currently the case with REs and RSEs) to "cover" potential liabilities;
(ii) the raising of the level of professional indemnity insurance, with the support of ASIC and the general insurance industry;
(iii) at least three other steps should be taken to strengthen the regulatory framework before consideration is given to a CSLR. These are
A. the reforms to improve the competence and professionalism of advisers announced by the Government, but not currently due to be fully implemented until 2024, should be finalised;
B. changes to the legislative breach reporting framework should be made to encourage and assist licensees to report 'bad apple' representatives to ASIC and have those representatives dealt with;
C. the problems created by conflicted remuneration where it remains in the sector should be addressed.

A copy of a note prepared by Professor Hanrahan for us in this regard is **attached**.

INFORMATION REQUESTS

Information request - Page 131 of Interim Report

Should schemes be provided with additional powers and, if so, what additional powers should be provided? How should any change in powers be implemented?

Some stakeholders submitted to the EDR Review that the schemes' powers be increased, in particular, to allow them to compel documents, require discovery, award penalties that are a multiple of losses and make directions enforceable by injunction. Others submitted that the caps on awards of non-economic loss should be raised. The FSC does not support the extension of the schemes' powers in these ways, for four main reasons.

YOUR FUTURE FIRST
Financial Services Council Ltd ABN 82 080 744 163 Level 24, 44 Market St Sydney NSW 2000 T. +61 2 9299 3022 F. +61 2 9299 3198 E. info@fsc.org.au W. fsc.org.au

First, expanding the schemes powers in these ways will undermine the purpose of the schemes, which is to provide quick, efficient and cheap alternatives to litigation that operate with minimal formality and technicality.[5] In particular, disputes will be unduly complicated and lengthened by introducing discovery or other compulsory document production, and by the in-depth factual investigations necessary to substantiate significant awards for non-economic loss and consequential loss.

Secondly, such powers are not appropriate for bodies (such as the schemes) that lack the protections of court processes. This is particularly the case in relation to a power to award punitive damages and damages for non-economic loss. Such awards involve judgments about the commercial morality of the financial services licensee. It is inappropriate for such judgments to be made in a forum that does not have the rules of evidence, cross-examination or rights of appeal or review. Similarly, claims for damages for consequential loss are complicated and inappropriate for such schemes.

It has been the experience of our Members that FOS, in particular, has tended to award non-economic loss in matters which are not deserving and where no evidence has been put before FOS to support such a claim.

Thirdly, the submissions overlook the fact that the schemes do not operate in a vacuum but rather as part of a suite of dispute resolution options. It is not necessary for the schemes to have all the powers proposed because there are other dispute resolution options that have those powers, such as the courts and administrative tribunals like NCAT. Where it is necessary or appropriate to invoke those powers, then complainants can bring proceedings in those tribunals. It is unnecessary and inefficient to replicate the jurisdiction of those other tribunals in the schemes.

Finally, the schemes are dispute resolution bodies[6] not enforcement bodies. As such, it is inappropriate for the schemes to have punitive powers such as the ability to award damages that are a multiple of clients' losses. Regulation and enforcement should be left to the regulators and the courts, which are specialists in these activities and have the necessary protections in place. On a related note, there are practical difficulties with vesting FOS and CIO, non-statutory bodies whose jurisdiction and powers are based on the agreement of their members, with enforcement powers such as the ability to grant injunctions or compel document production.

[5] See, e.g. FOS Terms of Reference at [1.2]; *Superannuation (Resolution of Complaints) Act 1993* (Cth), s 11.

[6] *Corporations Act 2001* (Cth), s 912A; *Superannuation (Resolution of Complaints) Act 1993* (Cth), s 11.

YOUR FUTURE FIRST

Financial Services Council Ltd ABN 82 080 744 163 Level 24, 44 Market St Sydney NSW 2000 T. +61 2 9299 3022 F. +61 2 9299 3198 E. info@fsc.org.au W. fsc.org.au

Please feel free to contact Paul Callaghan or Michael Beatty on (02) 9299 3022 if you have any questions on the FSC submission.

Yours faithfully,

Paul Callaghan
General Counsel

Michael Beatty
Senior Legal Counsel

YOUR FUTURE FIRST
Financial Services Council Ltd ABN 82 080 744 163
Level 24, 44 Market St Sydney NSW 2000
T. +61 2 9299 3022 F. +61 2 9299 3198
E. info@fsc.org.au W. fsc.org.au

LAST RESORT COMPENSTION SCHEME

1. This note is prepared for the Financial Services Council (FSC).

2. In its Interim Report delivered in December 2016, the expert panel appointed by government to review Australia's financial system external dispute resolution and complaints framework (the EDR Review) made the following observation:

> The Panel is of the view that there is considerable merit in introducing an industry-funded compensation scheme of last resort.[1]

The FSC has asked me to comment on this observation.

3. There have been ongoing discussions in Australia over several years about the need to implement a last resort compensation scheme for the financial sector. These include, in relation to financial services,[2] the 2012 report by Mr Richard St John on compensation arrangements for consumers of financial services,[3] and the updated proposal by the Financial Ombudsman Scheme (FOS) for a financial services compensation scheme issued in May 2015.[4] Mr St John concluded in 2012 that it would be 'inappropriate, and possible counter-productive, to introduce a last resort compensation scheme at this stage'. The EDR Review has reached a different view.

4. I have not been asked to make recommendations on the various design options for a last resort compensation scheme that have been canvassed in discussions. Instead, my focus is on the public interest arguments for and against having such a scheme at all. However, my task still requires some working assumptions about the parameters and features that such a scheme might eventually have. The working assumptions in paragraph 6 are put forward only for the purposes of these comments, and remain open for debate if a scheme is to proceed.

5. My overall conclusion is that the public interest case for introducing such a scheme has not yet been made. Like Mr St John I am concerned that such a scheme, while clearly

---

[1] Australian Government, The Treasury *Interim Report - Review of the financial system external dispute resolution and complaints framework*, 6 December 2016, Ch 7.

[2] Chapter 7 of the EDR Review's Interim Report contemplates that a scheme would cover both financial services and credit – see for example the reference to statutory obligations of both Australian financial services licensees and credit licensees in its footnote 6 on p 166.

[3] Australian Government, Richard St John *Compensation arrangements for consumers of financial services*, April 2016 (St John Review).

[4] Financial Ombudsman Scheme, *Updated Proposal to Establish a Financial Services Compensation Scheme*, May 2015 (FOS Proposal).

of benefit to individual consumers who are adversely affected (often very significantly) by uncompensated losses, 'could well introduce an element of regulatory moral hazard by reducing incentive for stringent regulation or rigorous administration of the compensation arrangements'.[5] For the reasons set out below, I conclude that Australian consumers would be better served at this stage by more effective regulation directed at both institution risk and compliance risk in the sector.

Assumptions about scheme features

6. My working assumptions about the type of scheme are as follows:

   (a) The policy rationale for (and therefore coverage of) such a scheme is linked to the existing statutory requirements on certain financial firms 'to have arrangements in place to compensate consumers where losses arise following a breach of financial services or credit laws'.[6]

   (b) Accordingly, it covers any Australian financial services (AFS) licensee that provides a financial service to a retail client,[7] and any credit licensee.[8]

   (c) Its purpose is to ensure that, if a competent body[9] has ordered that an eligible claimant[10] is entitled to compensation for breach of the financial services or credit laws[11] by a licensee, the claimant is not left out-of-pocket because the licensee is unavailable or unable to pay.[12] As such, it underpins the financial

[5] St John Review at [7.43].

[6] EDR Review at [7.6]. Note that consumer credit activities are not covered by the UK Financial Services Compensation Scheme (FSCS) and it is not proposed to extend coverage to this part of the UK financial sector: see Financial Conduct Authority, *Reviewing the funding of the Financial Services Compensation Scheme – Consultation Paper 16/42*, December 2016 (UK FSCS Review) at [9.2].

[7] Section 912B of the *Corporations Act 2001* (Cth) (Corporations Act). 'Financial service' and 'retail client' are as defined in Pt 7.1 of the Corporations Act, not Pt 2 of the *Australian Securities and Investments Commission Act 2001* (Cth) (ASIC Act).

[8] Section 48 of *National Consumer Credit Protection Act 2009* (Cth) (National Credit Act).

[9] That is, a court, a tribunal or an ASIC-approved external dispute resolution (EDR) scheme. This assumes that the barriers to customers accessing EDR where the licensee has been removed from membership will be addressed. In this regard, see the useful comments in the FOS Proposal, p 8.

[10] The EDR Review is commenting on consumer claims. A working definition of 'consumer' (in the context of financial services) is provided in s 12BC of the ASIC Act. But for these purposes I will assume, given the broader trajectory of reform in this area, that eligible claimants might also include small businesses, retail clients of financial services providers who are not 'consumers' in the technical sense, and some wholesale clients (for example, trustees of self-managed superannuation funds (SMSF) with balances under a designated threshold).

[11] That is, Ch 7 of the Corporations Act or the National Credit Code.

[12] For example, because it has disappeared or is insolvent.

sector's existing dispute resolution and compensation arrangements and is not a substitute for them.

(d) It does not respond in respect of compensation payable by an unlicensed person. It is not intended to, and does not, protect claimants against investment risk.[13] It is not available in respect of unpaid compensation orders arising out of conduct by a licensee that does not involve a breach of the financial services or credit laws.[14] Further, it does not cover claims arising out of the operation by a responsible entity of a registered managed investment scheme.[15]

(e) It allows the claimant to recover a percentage of the total amount of compensation owed, up to a specified maximum amount for each claim.[16]

(f) To access the scheme, the claimant must establish that they have first taken all reasonable steps to recover from the licensee. It is not available to a claimant who is entitled to recover under another last resort scheme.[17]

(g) The scheme is funded by levies imposed on licensees. It is divided into divisions depending on the nature of the services provided, with different levies for different divisions.

(h) The scheme is established and operated along broadly similar lines to the National Guarantee Fund.[18]

---

[13] Mr St John makes this point at [7.29]. He says, 'It needs to be stressed that consumers generally do not have a claim against a licensee by reason only of the failure of the product or poor investment performance, other than any rights they may have as creditors in the insolvency of a product issuer. Losses suffered by consumers upon the failure or poor performance of an investment in which they have put their money are not in themselves compensable now and would not be compensable under a last resort scheme… Such losses are only compensable where they can be attributed to a breach of a licensee's obligations.'

[14] That is, where a licensee has provided a financial service or engaged in a credit activity without complying with the applicable statutory standards. This would not include situations where there has been a breach of a voluntary code or where an EDR scheme has decided that the payment of compensation is fair despite the licensee having apparently complied with the law.

[15] There are sound policy reasons why claims of this kind might be excluded, and I have assumed for present purposes that a scheme would not cover them. The current FOS terms of reference exclude disputes relating to the management of a scheme or fund as a whole. Similarly, the Superannuation Complaints Tribunal cannot deal with a complaint that relates to the management of a fund as a whole: s 14(6) of the *Superannuation (Resolution of Complaints) Act 1993*) (Cth). But note the discussion of coverage of fund management and collective investment schemes in the UK FSCS Review at [9.22] – [9.27].

[16] The maximum amount would likely reflect the maximum amount of compensation that could be ordered by an EDR scheme. It is proposed that current limits be increased: see EDR Review at [5.46] – [5.49].

[17] That is, under Pt 23 of the *Superannuation (Industry Supervision) Act 1993* (Cth) (SIS Act), the Financial Claims Scheme or the National Guarantee Fund.

[18] See Div 4, Pt 7.5 of the Corporations Act.

7. As at January 2017, there are 5,778 AFS licensees of which 4,211 are authorised to provide financial services to retail clients.[19] There are 5,710 credit licensees.[20]

Policy considerations

8. Those arguing in favour of a compensation scheme of last resort point to the negative impact that unpaid compensation has on the individual consumer and the broader financial system.[21] Those opposed generally express concerns about cost, inequity, impact on competition and innovation, and moral hazard. There are also challenges in devising a robust funding model.

9. Another important consideration is the proper relationship between what is sometimes described as the 'first tier' protections (in the form of the statutory obligations on licensees to have adequate compensation arrangements under s 912B of the Corporations Act and s 48 of the National Credit Act) and a last resort scheme.

10. Finally, a scheme that is industry-funded raises concerns about the respective roles of the industry – which in this case is not a profession – and its regulator the Australian Securities and Investments Commission (ASIC) in mitigating the risk of claims against the scheme.

11. I consider these issues below.

Negative impacts of unpaid compensation

12. There is no doubt that being unable to recover compensation to which they are entitled hurts the individuals affected. For that affected individual, the question of whether failure by licensees to pay compensation is an isolated or widespread occurrence across the sector (see paragraph 21 below) is irrelevant.

13. This impact on individual customers matters, particularly in circumstance where they are not otherwise financially resilient.[22]

14. Although we often talk about individuals who deal with financial services and credit licensees as 'consumers' or 'investors', they are now arguably a special class. Since

[19] https://www.data.gov.au/dataset/asic-afs-licensee. The *ASIC Annual Report 2015-16* says at p 19 that 3,690 licensees are authorised to provide personal financial product advice.
[20] https://www.data.gov.au/dataset/asic-credit-licensee.
[21] EDR Review at [5.85].
[22] For example, in retirement.

the 1990s the extent to which individuals have been forced to become 'financial citizens' has steadily increased. Shifts in government policy and social mores have meant that members of the middle class are now expected to purchase their future financial security in the market.[23] This is a qualitatively different category of customers from those with discretionary funds available who (perhaps imprudently) risk it in speculative investments instead of, say, at the racetrack or the casino. Over the same time, the range of financial products and services available in the Australian retail market, and their inherent complexity, has grown rapidly. The growth of shadow banking (or what is now referred to as 'market-based finance') has meant that credit is now available much more freely, and to a wider group of people and businesses, than before – including those whose long-term prosperity will predictably be permanently damaged by debt spiral.

15. Recent studies in behavioural economics suggest that many consumers, even if they want to engage with complex financial choices, are not very good at them.[24] Financial literacy across the community is generally quite low.[25] The policy response by government is often to steer consumers towards regulated advisers to assist them, however a combination of conflicts of interest, lack of competence and poor practice in the adviser community – in both large and small licensees – has meant that many consumers have not been well served by this approach.[26]

---

[23] That is, an adequate income in retirement, or for them or their family in the event of death, disability or illness that is above the minimum safety net provided by the social security system.

[24] For a useful summary of the literature, see Financial Conduct Authority, *Occasional Paper No. 1 - Applying behavioural economics at the Financial Conduct Authority*, April 2013.

[25] In 2015, 'Almost half of the [Australian] population is vulnerable in regard to financial knowledge and behaviour, with close to 48% of people reporting that they only have a 'basic understanding' of financial products and services and more than 9% reporting that they have 'no understanding'': Muir, K, Reeve, R, Connolly C, Marjolin A, Salignac F and Ho K (2016) *Financial Resilience in Australia 2015*, Centre for Social Impact, UNSW Australia, for National Australia Bank at p 9. For a useful list of resources on measuring financial literacy, see http://www.financialliteracy.gov.au/research-and-evaluation/australian-research-and-evaluation.

[26] ASIC from time to time conducts reviews of the quality of advice provided to retail clients by financial services licensees and their representatives. While the methodology used in these reviews may be challenged, if the results are even broadly indicative they reflect badly on the both the industry and the regulator. ASIC *Report 413 - Review of retail life insurance advice*, October 2014, found that 'more than one-third (37%) received life insurance advice that failed to comply with the law' (at [151]) and that where the adviser received an up-front commission (the dominant remuneration structure in the industry), the fail rate was 45%. ASIC *Report 377 - Review of advice on retail structured products*, December 2013, found that only one-half of the advice given complied with the (then) reasonable basis requirement in the Corporations Act (at [38]); here the problem was not so much conflict of interest as the fact that the advisers themselves did not understand the products. ASIC *Report 337 - SMSFs: Improving the quality of advice given to investors,* April 2013, found that of 74 advice files reviewed, 21 were graded 'poor', 52 were 'adequate', and only 1 was 'good'. That is, the SMSF trustees actually benefited from the advice in only 1.3% of cases reviewed, and in 28.4%

16. In this context, we need to decide as a community whether it is fair that an individual consumer should be left to bear the loss when they are entitled to compensation but they cannot recover it, or whether others ought to contribute to cover at least part of the amount owed in these circumstances. (I consider the question of who those others might be at paragraph 36 below.)

17. No regulatory system, however intense, can ever eliminate all institution risk[27] in the financial sector, even prudential regulation.[28] The problem to which the proposed last resort scheme would respond arises because a consumer has dealt with a licensed entity that is subject to a regulatory requirement to have arrangements for compensating its clients for loss or damage resulting from breaches of the law but those arrangements are not, in the event, adequate. If the risk of loss remains entirely with the consumer, then a rational consumer would investigate the financial strength of a licensee before dealing with it, and choose to deal with well-resourced licensees only. The fairness question turns in part on whether we ought to expect and empower consumers to choose between licensees on this basis. In this regard, it is important to note that there is no reason to suppose that a consumer will necessarily get a higher quality service from a better resourced licensee – in fact the reverse may well be true.[29]

18. Aside from the impact on the individual consumers involved, unpaid compensation is said to harm the financial system because it leads of a loss of consumer trust and confidence in that system. This claim is harder to substantiate. First, the number of

---

of cases the advice 'did not comply with [the suitability requirement in] s 945A of the Corporations Act… and resulted in the investor being worse off after having received the advice' (at [64]). ASIC *Report 279 - Shadow shopping of retirement advice*, March 2012, found that the advice given was poor in 39% of cases, adequate in 58% of cases, and good in only 3% of cases. Again, the 'poor' advice was in fact non-complying advice in that it failed to meet the (then) suitability requirement in s 945A of the Corporations Act. Even in the adequate category ASIC found that 'many of the advice examples that were rated as adequate had good elements, but the overall advice generally fell short of being good because of a *key problem* with the recommended strategy or products' (at [20], emphasis added). See also, Parliamentary Joint Committee on Corporations and Financial Services *Inquiry into financial products and services in Australia*, November 2009; Parliamentary Joint Committee on Corporations and Financial Services *Inquiry into the Collapse of Trio Capital*, May 2012; Senate Economics Reference Committee *Final Report: Performance of the Australian Securities and Investments Commission*, June 2014; Senate Economics Reference Committee *Agribusiness managed investment schemes – bitter harvest*, March 2016.

[27] Institution risk refers the risk that a regulated entity will not be around to discharge its obligations: see Australian Law Reform Commission and Company and Securities Advisory Committee *Report 65 – Collective Investments: Other People's Money*, May 1991, p 2.

[28] Hence the need for last resort schemes under the Financial Claims Scheme and Pt 23 of the SIS Act.

[29] A last resort scheme responds at the point of intersection of two failures. The first is a failure by a licensee to meet its statutory performance obligations in the provision of a regulated service, giving rise to a liability to pay compensation. The second is a failure by the licensee to have sufficient financial resources available and accessible to pay it. The risk of the first is 'compliance risk' and of the second is 'institution risk'. It should not be assumed that the two are always related.

individuals directly affected by the absence of a last resort scheme each year is quite small and whether their experience is widely known (and therefore germane to overall community confidence) is not clear. This is discussed in paragraph 21. Secondly, there is good reason to believe that any lack of confidence in the financial system since the global financial crisis is more likely to have resulted either from questionable behaviour by large, well-resourced financial institutions or from losses resulting from the collapse of investment schemes (like the agribusiness schemes) that would not be compensable in any event. This is discussed in paragraph 22 below.

19. The EDR Review says that 'it is clear that many Australian consumers currently lack confidence in the financial system and this is due, at least in part, to the issue of uncompensated consumer issues'.[30] This comment is worth unpacking. First, consumer behaviour suggests the opposite – in fact, consumers' uptake of financial products and services is rising rapidly and the market share of major financial institutions is also rising. It might be more accurate to say that consumer sentiment towards the financial sector is negative, which is different from saying that consumers lack confidence in the financial system itself. What they probably lack is a belief that financial institutions *as a group* deal with customers fairly (this might explain their reticence to change from one financial institution to another even in the face of compelling evidence that a financial institution dealt inappropriately or unfairly with its customers). The 'expectation gap' about what the regulatory or dispute resolution systems can and should deliver for individual consumers when they have had a poor outcome is also likely to be a significant contributor to community dissatisfaction. Finally, the wider political climate at present is also highly corrosive to trust in institutions and the rule of law; whether this is a cause or effect of general consumer distrust in the financial sector remains to be seen.

20. Regulators often speak of the need to 'promote investor and financial consumer trust and confidence'; indeed, this is one of ASIC's three stated strategic priorities. But what really matters is *warranted* trust and confidence. As the global financial crisis demonstrated, there is nothing to be gained from encouraging people to have trust and confidence in a system that does not deserve it. It might increase the size and profitability of the financial sector over the short term but this is not a desirable end in

[30] EDR Review at [7.2].

itself, particularly if reversals result in losses being borne by those least able to absorb them, or socialised. As the Murray Inquiry points out, 'the focus of financial system policy should be primarily on the degree of efficiency, resilience and fairness the system achieves in facilitating economic activity, rather than on its size or direct contribution (such as through wages and profits) to the economy'. [31]

21. While the impact of uncompensated losses is important for the individual consumers affected, it is not clear that the problem is significant at a system-wide level. (Indeed, if it were this would indicate a more fundamental problem with the relevant licensing regimes or their administration by ASIC.) In trying to quantify the size of the problem in 2012, Mr St John said at [7.28] that 'ASIC and FOS … say … that a number of small and medium sized licensees are likely to be wound up each year with outstanding liabilities running to several million dollars. On this basis it appears that the incidence of claims where consumers cannot recover compensation to which they are entitled is substantial but not all that large in overall terms'. The estimates provided by FOS and the Credit and Investments Ombudsman (CIO) in 2016 as to the scale of the problem were consistent with this finding. However, it is correct to point out (as ASIC did in its submission to the EDR Review) that the figures 'should be treated as a minimum given the difficulties with quantifying losses suffered by those who haven't lodged a dispute and those whose dispute was closed early as there was no reasonable prospect of any compensation order being satisfied´.[32]

22. The fact that compensable losses are going uncompensated might be expected to impact on consumer confidence in the financial system if they were widespread or well-publicised. Neither seems to be the case. What may have contributed to negative consumer sentiment towards the financial system are reports of poor behaviour by well-resourced financial institutions, or the spate of large (but not necessarily compensable) investment losses suffered by investors in certain sectors during and after the global financial crisis.

Cost, inequity, competition and moral hazard

23. The first objection to a last resort scheme is usually cost – that it will be costly and that those costs will be passed onto consumers. There is no doubt that there would be costs

[31] Financial System Inquiry, *Final Report*, November 2014, p 3.
[32] EDR Review at [7.3] - [7.5].

involved and careful modelling (including having regard to the experience of the UK's Financial Services Compensation Scheme (FSCS) over the last 15 years) will be required. Cost can, to a significant degree, be controlled by the design of the scheme, for example by imposing an upper limit on total claims against a single failed licensee.

24. Another objection relates to the inequity inherent in such a scheme. The issue here is that, as with any last resort compensation scheme, it requires adequately-resourced licensees that have 'done the right thing' to make available (shareholders') funds to clients of other licensees, when they were not to blame for the defaulting licensee's failure and could do nothing to prevent it. (I return to this latter point in paragraph 37 below.) This is manifestly inequitable. In the face of that inequity a scheme like this can only be justified on other grounds. Two suggest themselves. The first is that all licensees benefit indirectly from increased consumer confidence in the sector as a whole. The second is that a licence is a privilege, conferred by the state, that allows financial firms to profit from providing rationed services and therefore it is legitimate for the community to expect some contribution to the public good in return for that privilege. Where industry-funded compensation schemes exist, it appears to be that some combination of these two grounds is used to justify it.

25. A third objection relates to the stifling effect of such a scheme on competition and innovation. The concern is that smaller firms and start-up businesses may be unable or unwilling to absorb the cost of the necessary levies and may be deterred from entering the sector.

26. The fourth is a concern about moral hazard. Moral hazard describes the risk to insurers that insureds will change their behaviour once they have insurance, either by taking less care or incurring larger losses than they would have if they were uninsured. In the present context, moral hazard arising out of the existence of a last resort compensation scheme might manifest itself in different ways. For example, a consumer might be less diligent in checking compliance history or financial standing before choosing a licensee than would otherwise be the case. An aggrieved customer may not pursue a defaulting licensee as aggressively as they would otherwise. A licensee in financial difficulty might worry less about trying to salvage its position if it knows that its customers will not be left entirely out-of-pocket. A decision-maker might be more inclined to award compensation to a customer knowing that a 'deep pocket' is available to cover the loss.

ASIC may decide to set lower thresholds or be less rigorous in enforcing licensees' statutory obligations in relation to compensation arrangements.

27. These concerns about moral hazard are the reason why, among other things, last resort schemes usually allow for a claimant to recover only part of the compensation that the defaulting licensee had been ordered to pay. This may go part of the way to addressing the issue, but it not an entire answer.

28. Mr St John's view, expressed at [7.43] was that 'a last resort scheme would have the effect of imposing on better capitalised and/or more responsibly managed licensees the cost of bailing out the obligations of failed licensees. It would not work to improve the standards of licensee behaviour or motivate a greater acceptance by licensees of responsibility for the consequences of their own conduct. It could well introduce an element of regulatory moral hazard by reducing incentive for stringent regulation or rigorous administration of the compensation arrangement'.

Funding

29. Last resort schemes also face challenges in building a sustainable funding base. In its Consultation Paper on the funding of the FSCS released in December 2016, the Financial Conduct Authority points to the volatility in the levies payable by financial firms covered by that scheme.[33] Part of the difficulty is that firms cannot anticipate and plan for likely losses, which can be affected by general market conditions and by legal and regulatory changes.[34] In schemes that are post-funded, levies are likely to increase in circumstances the financial sector as a whole is under pressure, which may impact disproportionately on smaller firms.

Relationship between the first-tier protections and a last resort scheme

30. I now turn to consider the relationship between the first-tier protections against institution risk contained in s 912B of the Corporations Act and s 48 of the National Credit Act, and a last resort compensation scheme.

31. When he recommended against introducing a last resort compensation scheme for financial services in 2012, Mr St John did so on the basis that it would be inappropriate

[33] UK FSCS Review, Ch 7.
[34] For example, the government's recent proposal to increase the accountability of financial product issuers and distributors: see http://kmo ministers.treasury.gov.au/media-release/111-2016.

and possibly counter-productive to do so. His significant concern was that the first-tier protections in place at that time were either not sufficient, or were not being adequately enforced by ASIC. He goes on to say at [7.44] that:

> What has stood out in this review is the relatively light-handed nature of the primary level of regulation designed to put financial advisers and other licensees in a position to meet their own obligations to consumers. It is not tight enough in my view to provide an appropriate filter to limit the instances in which consumers are unable to recover compensation and for which it might be reasonable to look to other licensees to meet the cost.

32. This point is well made. Despite his clear findings, ASIC has not changed its practices on the first-tier protections. Its Regulatory Guide 126 *Compensation and insurance arrangements for AFS licensees* (December 2010) and Regulatory Guide 210 *Compensation and insurance arrangements for credit licensees* (March 2010) were not updated to reflect the recommendations in the St John Report.

33. In its Report 459 *Professional indemnity insurance market for AFS licensees providing financial product advice* in December 2015, ASIC said at [78] – [79]:

> We consider that no amount of tightening the existing PI insurance requirements would be sufficient to deal with the issue of uncompensated loss. From our discussions with insurers in the past, it is clear that they would not be willing to write cover that indemnified advice licensees for all liability to retail clients.
>
> In addition, we note that increasing capital adequacy requirements to the extent needed to cover all retail client losses may place an unreasonable burden on advice licensees, especially small advice licensees.

34. These comments suggest that the nature of professional indemnity insurance or the place it occupies in the model is not well understood. Insurance will not and is not intended to indemnify licensees for all liability to retail clients. Its function is to reduce the institution risk in the sector to an appropriate level before asking others to take up the residue. To meet Mr St John's recommendations, licensees should be required to hold insurance that reflects the guidelines required by the Professional Standards Council, including in relation to run-off cover.[35] ASIC should instigate a formal process for ensuring that licensees hold current cover when required – a task that is

[35] See Professional Standards Councils *Policy Statement on Professional Indemnity Insurance*, available at http://www.psc.gov.au/sites/default/files/Professional%20Indemnity%20Insurance.pdf.

routinely undertaken by law societies, bar associations, and professional accounting bodies.[36]

35. There is no clear evidence that the community benefits from allowing undercapitalised or under-insured licensees to operate. Any compensation provided under a last resort scheme will be limited. For the reasons pointed out in paragraph 14 above, the community is now much more exposed to risks in financial services and credit than it was when current policy settings were adopted and Mr St John makes a compelling argument, following a thorough review of the evidence, that there is a need to raise the bar. To do so will clearly have implications for competition and innovation, as higher standards operate as a barrier to entry. But the task of the regulator is to make an informed assessment that balances these considerations against consumer safety.

Industry funding and the role of ASIC

36. The model mentioned by the EDR Review is for a scheme funded by levies on industry. The possible justifications for this approach are set out in paragraph 24. Other approaches are possible. A scheme could, for example, be funded by a levy on financial assets or transactions (that is, ultimately paid for by clients, like the last resort scheme under Pt 23 of the SIS Act)[37] or provided by government (like the Fair Entitlements Guarantee covering unpaid wages in insolvency).

37. My final observations relate specifically to this question of industry funding. In an industry-funded scheme, all industry participants are asked to carry the institution risk of the weakest firms. In professions, professional bodies have a measure of control over who is admitted to practise and can support and enforce professional standards (including of competence and probity) to help them manage the risk associated with such a scheme between themselves. This is not the case in the financial services sector in Australia. Instead the industry is open to anyone who meets the low threshold currently set by ASIC. Further, unlike professional advisers like lawyers and

[36] See J Morgan and P Hanrahan 'Professional indemnity insurance: protecting clients and regulating professionals' (2017) *40 UNSW Law Journal* (forthcoming).

[37] The cost of providing financial assistance under Part 23 is recouped through an industry levy imposed on regulated superannuation entities eligible for financial assistance. This is done under s 6 of the *Superannuation (Financial Assistance Levy) Act 1993* (Cth). Therefore, the cost is borne ultimately by those other superannuation fund members, not by the government or the trustees.

accountants, financial services providers are not currently covered by the legislative professional standards schemes that limit liability for professional failure.[38]

38. If a last resort compensation scheme is required to pay compensation in circumstances where institution risk has not been appropriately monitored by ASIC – for example, where professional indemnity insurance would have responded had it been maintained or met ASIC's requirements – the consequences of that regulatory failure are being borne by others in the industry even though they are not in a position to prevent that failure.

39. I pointed out above that a last resort compensation scheme operates at the intersection of two failures by a licensee – a compliance failure (giving rise to the liability to pay compensation) and an institution failure (that gives rise to inability to discharge that liability). We are also not yet at the point where compliance risk is sufficiently managed across the general population of licensees for a scheme to be adopted. Three important changes are indicated. First, the reforms to improve the competence and professionalism of advisers announced by the government, but not currently due to be fully implemented until 2024, should be finalised.[39] Secondly, changes to the legislative breach reporting framework should be made to encourage and assist licensees to report 'bad apple' representatives to ASIC and have them dealt with.[40] Thirdly, the problems created by conflicted remuneration where it remains in the sector should be addressed.

Professor Pamela Hanrahan

Sydney, 2 February 2017.

---

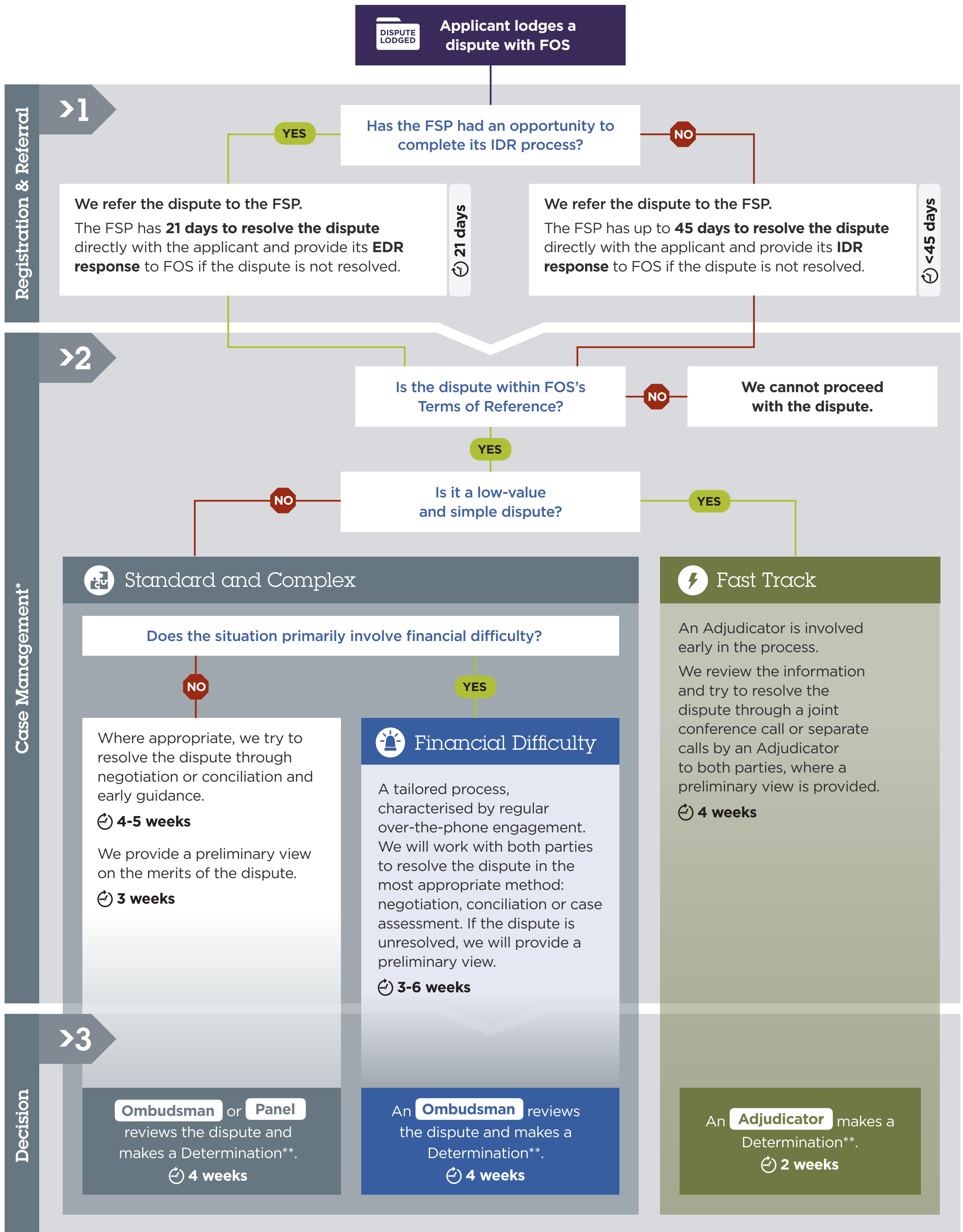
[38] Including under *Civil Law (Wrongs) Act 2002* (ACT); *Professional Standards Act 1994* (NSW); *Professional Standards Act 2004* (NT); *Professional Standards Act* 2004 (Qld); *Professional Standards Act 2004* (SA); *Professional Standards Act 2005* (Tas); *Professional Standards Act 2003* (Vic); *Professional Standards Act 1997* (WA); *Treasury Legislation Amendment (Professional Standards) Act 2004* (Cth); the ASIC Act; and the Corporations Act.

[39] See http://kmo ministers.treasury.gov.au/media-release/094-2016.

[40] This could be done by requiring licensees to report to ASIC when they believe on reasonable grounds that a representative is not a fit and proper person, with the benefit of qualified privilege.

FOS dispute resolution process

(starting 1 July 2015)



These are average expected timeframes.

* A single case worker will manage the dispute wherever possible.

** A financial services provider is bound by a Determination if an applicant accepts it.