EDR Review Secretariat
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Dear Secretariat

SUPPLEMENTARY ISSUES PAPER: REVIEW OF THE FINANCIAL SYSTEM EXTERNAL DISPUTE RESOLUTION AND COMPLAINTS FRAMEWORK

The Insurance Council of Australia[1] (the Insurance Council) appreciates the opportunity to comment on the Supplementary Issues Paper which examines the feasibility of a compensation scheme of last resort (Supplementary Issues Paper) in the context of the Review of the Financial System External Dispute Resolution and Complaints Framework (the Review).

While only affecting a relatively small number of people, the problem of consumers not receiving compensation awarded to them by external dispute resolution schemes is an important one, in terms both of the impact on individuals and their families and public confidence in the financial services industry.

The matter has a long history and has been examined several times since the commencement of the Financial Services Reform regime in 2002. The most notable of these was the Report provided to the Federal Government in 2012 by Richard St John (St John Report). The Insurance Council urges the Panel to carefully consider the conclusions and recommendations of St. John Report, which involved a significant amount of research, consultation and deliberation with industry, consumer representatives and regulators.

In light of the analysis already undertaken, the Insurance Council is disappointed that the Supplementary Issues Paper provides an unfocused examination of the question. The problem is presented as one being inherent across the financial services industry when it is

[1] The Insurance Council of Australia is the representative body of the general insurance industry in Australia. Our members represent more than 90 percent of total premium income written by private sector general insurers. Insurance Council members, both insurers and reinsurers, are a significant part of the financial services system. March 2017 Australian Prudential Regulation Authority statistics show that the private sector insurance industry generates gross written premium of $45 billion per annum and has total assets of $123.6 billion. The industry employs approximately 60,000 people and on average pays out about $142 million in claims each working day.

Insurance Council members provide insurance products ranging from those usually purchased by individuals (such as home and contents insurance, travel insurance, motor vehicle insurance) to those purchased by small businesses and larger organisations (such as product and public liability insurance, professional indemnity insurance, commercial property, and directors and officers insurance).

commonly recognised that the majority of disputes giving rise to uncompensated consumer losses stem from financial planning advice or managed investment schemes.

By framing the problem of uncompensated losses as being generic rather than having causes specific to particular segments of the financial services industry, the Review risks erroneously identifying a broad-based solution, the total cost (i.e. administrative actions and associated costs required to set up and manage such a solution) of which may well exceed the harm to be addressed. We note that the Supplementary Issues Paper found that, as at 2 May 2017, uncompensated consumer losses totalled $13,909,635.50 (including interest), or $399,862 (excluding interest) in relation to FOS and CIO respectively.

The Insurance Council strongly submits that there is no justification for a scheme of last resort that would involve cross-subsidisation of compensation costs by industry sectors, such as general insurance, unrelated to the consumer's financial loss. As the Panel would appreciate, the moral hazard and inequity inherent in such a scheme would work against the interests of all stakeholders.

This is why a targeted approach specifically tailored to the underlying problem to be solved will be the most effective way of promoting equitable outcomes for consumers and creating consumer confidence in financial services, which plays an integral role in any advanced economy.

Fundamental problems need to be tackled

In order to minimise in the first place the number of disputes which may rise to compensation awards, the issues of poor quality financial advice and financial advisers failing to maintain adequate compensation arrangements need to be tackled. This necessity was a key finding of the 2012 Review by Richard St. John into a statutory compensation scheme for financial services[2] (the St. John Report).

The St. John Report concluded that a scheme of last resort could not be justified and that further rigour should be introduced into the regulatory regime to ensure Australian Financial Services Licensees (Licensees) are held responsible for having current and adequate professional indemnity insurance. As noted in the Supplementary Issues Paper, several recommendations of the St. John Report, not so far implemented, would strengthen the consumer protection regime[3]:

- requiring Licensees to provide additional assurances to ASIC in relation to their professional indemnity insurance cover; and
- ASIC taking a more proactive stance on monitoring licensee compliance with compensation requirements.

The then Federal Government released its response[4] to the St. John Report in April 2013 and accepted its recommendations. The Federal Government undertook[5] that it would, among other things, consult on legislative changes to strengthen the professional indemnity insurance requirements of providers of financial services by:

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[2] Report by Richard St. John, *Compensation arrangements for consumer of financial services*, April 2012.
[3] Report by Richard St. John, *Compensation arrangements for consumer of financial services*, April 2012, page 74 refers.
[4] Australian Government release, *Comprehensive Response to Combating Superannuation Investment Fraud*, 26 April 2013.
[5] Australian Government release, *Comprehensive Response to Combating Superannuation Investment Fraud*, 26 April 2013.

- giving legislative force to key aspects of ASIC standards of adequacy for professional indemnity insurance such as the scope of cover, policy exclusions and coverage of representatives; and
- requiring Licensees to report annually to ASIC, as part of their financial reporting requirements, on the adequacy of their professional indemnity insurance cover.

These proposals were not taken up. Consequently, the Insurance Council would support measures which facilitated a more proactive enforcement by ASIC of Licensees' requirements under ASIC *Regulatory Guide 126 Compensation and insurance arrangements for AFS licensees* (RG 126)[6]. Such action would help ensure that the level of indemnity cover held by a Licensee is appropriate, which in turn would help mitigate the risk of uncompensated consumer losses.

Furthermore, the Insurance Council submits that more should be done to enhance the quality of financial advice and the consumer protection arrangements in place for this sector. In this regard, the Insurance Council would endorse any proposals from the Panel to help further lift the professionalism of licensed financial advisers.

While the Insurance Council endorses the initiatives recently announced[7] by the Federal Government to lift the professionalism of licensed financial advisers, we believe that more should be done beyond this to make Licensees responsible for the consequences of their own misconduct. This includes (as also pointed out in the St. John Report) providing ASIC adequate powers to: enforce standards required of licensees and to sanction firms that do not comply; and assess the adequacy of Licensees' financial resources as viewed in conjunction with their professional indemnity insurance cover (and not just their professional indemnity insurance arrangements in isolation)[8].

The role of professional indemnity insurance

The Supplementary Issues Paper canvasses the important role of adequate professional indemnity insurance as the usual means by which firms ensure they have arrangements in place to compensate consumers when losses arise. However, also referenced in the Supplementary Issues Paper are views expressed by some stakeholders around the potential 'significant limitations' of using professional indemnity insurance as a compensation mechanism.

The purpose of professional indemnity insurance is to protect the financial well-being of the insured from liability for third party loss arising from a breach of professional duty. This would include most areas of breach under Chapter 7 of the *Corporations Act 2001*, such as the provision of inappropriate advice and/or disclosure documents. In doing so, a professional indemnity policy also operates to ensure in the large majority of cases that Licensees are able to pay any compensation awarded against Licensees for breaches of the financial services law. Professional indemnity insurance is not of itself intended to act as a compensation mechanism for investors; although it may appear to operate in such a fashion

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[6] ASIC Regulatory Guide 126, *Compensation and insurance arrangements for AFS licensees*: an AFS licensee should consider if the level of indemnity cover is adequate to cover liability arising under an award made by an EDR scheme.
[7] Press release by The Hon Kelly O'Dwyer MP, Minister for Revenue and Financial Services, Higher standards for financial advisers to commence, 9 February 2017.
[8] Report by Richard St. John, *Compensation arrangements for consumer of financial services*, April 2012, pages 80 & 83 refer.

on occasion, it is designed solely for the benefit of the insured. As also recognised by the Panel in the Supplementary Issues Paper and by ASIC in its Regulatory Guide 126, professional indemnity insurance cannot be made to operate as a guarantee that compensation will be paid in all circumstances.

We understand from our members that the insurance market generally has the capacity to provide Licensees with professional indemnity policies that enable them to satisfy their obligations under ASIC RG 126. Industry feedback is that those Licensees which have difficulties in obtaining professional indemnity insurance are likely to have business models or processes that create a higher probability of breach of the Licensee's professional duty of care, or have an adverse claims history. It is not uncommon for professional indemnity insurers to receive applications for insurance where it is not clear what financial services the potential licensee proposes to provide – these are generally taken to be an unacceptable risk.

While there are a number of situations where professional indemnity insurance may not react to reimburse an insured fully, or in part, for compensation awarded against them, the largest proportion of situations where insurance policies do not reimburse the Licensee concern fraud by the Licensee where they are the sole operator (fraud by an employee or authorised representative being usually covered), or where the Licensee is no longer a going concern.

The Insurance Council also notes that the Global Financial Crisis of 2008 increased the cost of capital and with it the price of reinsurance cover generally. The impact on professional indemnity insurance is that this has resulted in reinsurers being more careful in selecting the risks they are now willing to cover. This particularly applies to the financial planning sector, where considerable losses have been experienced in Australia due to several large scale financial collapses (e.g. Storm Financial and Westpoint Corporation)[9]. These developments have justifiably been reflected in current professional indemnity insurance market.

Moral hazard risk

A key concern for the Insurance Council in considering the feasibility of a scheme of last resort is the moral hazard which would result from removing all risk from financial decision making. This concern was also emphasised in the St. John Report which concluded that a last resort compensation scheme would not address the underlying problem of improving the standards of Licensee behaviour or motivate a greater acceptance by them of responsibility for the consequences of their own conduct[10].

As explained in the Supplementary Issues Paper, the introduction of a scheme of last resort may, for example, encourage consumers to become complacent about the fundamental risks of dealing in the market and incentivise risker behaviour by consumers and financial firms, while also reducing the incentive for compliance with existing compensation arrangements[11]. Compounding this would be a diminished incentive for Licensees to take out adequate professional indemnity insurance. The collective financial impact of these scenarios on a

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[9] See: the Parliamentary *Inquiry into Financial Products and Services in Australia* for information about the Storm Financial collapse; and ASIC's webpage for information about the Westpoint collapse.

[10] Report by Richard St. John, *Compensation arrangements for consumer of financial services*, April 2012, page 10 refers.

[11] The Australian Treasury: *Supplementary Issues Paper: Review of the financial system external dispute resolution framework*, May 2017, page 21 refers.

scheme of last resort would be unsustainable, given, for instance, the likely increase in the volume of risker transactions that result in financial losses.

The moral hazard for Licensees would be magnified if the last resort compensation scheme was funded, even in part, by other Licensees from a financial services sector which had neither any responsibility for the breach of the law giving rise to the case for compensation nor any capability of influencing the achievement of better outcomes.

Existing compensation arrangements are adequate for the sectors for which they were designed

The Insurance Council notes that the Supplementary Issues Paper canvasses statutory compensation arrangements that already exist in many areas of financial services, such as the National Guarantee Fund and Financial Claims Scheme. There has been in the past, some comment about a "patchwork" of schemes as if there is some flaw or inadequacy in their design. However, these sector-specific arrangements have been constructed with regards to the characteristics of the sectors to which they apply. The Insurance Council is unaware of any findings that demonstrate their inadequacy.

Conclusion

In fulfilling its mandate, the Insurance Council urges the Review to focus first on measures which would reduce the potential number of misconduct incidents which may give rise to compensation awards and then regulatory action to ensure the adequacy of professional indemnity insurance held by Licensees. The Review would then have a good grasp of the number of consumers left uncompensated and the amount of forgone compensation. With a sound understanding of the problem, the Review could then properly consider funding options to ensure outstanding compensation awards are paid.

The Insurance Council would urge the need for adequate consultation on any funding option that the Review may determine appropriate. This particularly applies to the finer details underpinning any funding option, given the potential for unintended consequences for industry participants that are either directly or indirectly involved.

If you have any questions or comments in relation to this letter, please contact me on tel: (02) 9253 5121 or email: janning@insurancecouncil.com.au.

Yours sincerely

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