Appendix A: Summary of consultation paper

Background

A.1 The review is directed to the adequacy of arrangements for the compensation of retail clients where they suffer damage as a result of a breach by a provider of financial services of its statutory obligations, rather than loss in value of an investment in the absence of misconduct by a licensee. The rationale for the focus on retail clients is that they are less likely to be able to look after their own interests than are wholesale clients.

A.2 The review is being undertaken in the context of the Future of Financial Advice reform package announced in April 2010. It follows a recommendation of a Parliamentary Committee that the Government investigate the costs and benefits of different models of a statutory last resort compensation fund for investors.

A.3 The regulatory framework for financial services, based on the Wallis Report, subjects deposit takers, insurers and superannuation funds to prudential regulation and applies to all providers of financial services a set of requirements governing the way they conduct their business.

A.4 Providers of financial services are required to be licensed and to comply with stipulated standards in their conduct towards their clients and in the disclosure of information to clients.

A.5 Licensed providers of financial services who deal with retail clients are also required to have in place a system for the resolution of disputes and arrangements to compensate clients for loss or damage arising from a breach of the licensee's statutory obligations in regard to conduct or the disclosure of information.

Current compensation arrangements

A.6 Compensation arrangements required of licensees are intended to reduce the risk that claims by retail clients cannot be met by licensees due to their lack of available financial resources.

A.7 The compensation arrangement required of most licensees is to hold professional indemnity insurance. Certain licensees are exempt from this requirement on the basis of their relative financial strength.

A.8 Professional indemnity insurance is an indirect means for compensating clients. Where a licensee's policy responds to a claim it assists the licensee to pay any compensation awarded to a client. Where this is not the case, the client's prospects of recovery will depend on the available financial resources of the licensee.

A.9 Retail clients may seek redress by legal action through the courts or by using the dispute resolution process a licensee has to make available.

A.10 Separate more direct statutory compensation arrangements cover some critical elements of the financial services sector:

- National Guarantee Fund (and similar arrangements) protects clients of stockbrokers;
- Financial Claims Scheme covers losses by depositors or policyholders due to insolvency of an authorised deposit taking institution or general insurer; and
- a scheme of financial assistance to compensate for loss incurred by a superannuation fund trustee from fraud.

A.11 There appears to have been a hardening in the professional indemnity insurance market for some, but not all, financial services providers in recent years. On the supply side, the number of insurers providing cover for financial advisers has contracted. Anecdotal evidence suggests that premiums for financial advisers have increased substantially in recent years.

A.12 Claims lodged by financial service providers under professional indemnity insurance policies appear to have increased significantly, particularly from 2008 onwards.

A.13 Professional indemnity insurance assists licensees to meet claims by clients in many cases, but has some limitations where there are insolvency issues, policy exclusions, and gaps in the cover. Caps on the amount of cover taken out limit the extent to which insurance can ensure that clients are compensated where they succeed in a claim against a licensee.

A.14 Where a licensee does not have a policy that responds to a successful claim, the client's prospects of recovering compensation will depend on the available financial resources of the licensee.

A.15 While precise data is hard to come by, there are cases where retail clients succeed in obtaining awards of compensation but are not able to recover that compensation.

Comparison with other arrangements

A.16 The United Kingdom has a two tiered approach to the protection of retail consumers and small businesses with claims against financial intermediaries:

- investment firms generally have to meet a capital requirement as well as hold professional indemnity cover; and
- a comprehensive scheme provides last resort protection where a firm becomes insolvent or is otherwise unable to meet a claim.

A.17 Other members of the European Union, Canada and the United States have narrower compensation arrangements to protect clients against losses of funds held by investment firms on their behalf.

A.18 Within Australia, compensation arrangements are in place in some industry sectors apart from the financial sector.

Observations and issues

A.19 Australia has a relatively well developed regime for the protection of consumers in the financial services sector, including a licensing regime for providers of those services, the imposition of statutory conduct and disclosure obligations and rights of redress for consumers — which include access to a low cost dispute resolution system and arrangements to provide some assurance about recovery of compensation for loss or damage attributable to licensee misconduct.

A.20 The focus of the review is on the adequacy of the default arrangements for the protection of consumers where they do not have access to the last resort protection in relation to stockbrokers, deposit takers, general insures and superannuation funds.

A.21 The current compensation arrangements, based largely on professional indemnity insurance, provide a measure of assurance but no guarantee that retail clients will be able to recover compensation to which they may be entitled.

A.22 The risk for a client, where a licensee does not have recourse to insurance to cover the client's claim, is that the licensee may have stopped trading, become insolvent or have insufficient assets.

A.23 There is an apparent shortfall in the delivery of compensation under current arrangements. Cases have arisen where retail clients have not been able to recover compensation to which they are entitled. While it is not easy to quantify the problem, clients have missed out on substantial recoveries and in any case the consequences for individuals can be harsh.

A.24 Any move to provide further protection for retail clients could include measures to reduce the incidence of cases where clients suffer loss or damage from inappropriate licensee advice or conduct. This might be through improvements in professional standards for financial advisers on the one hand, and efforts to improve the financial literacy of consumers on the other.

A.25 Mechanisms to enhance the effectiveness of professional indemnity insurance in underpinning the compensation arrangements could also be considered. This might include:

- a tighter approach to the administration of the requirement for professional indemnity insurance;
- the promotion of standard professional indemnity insurance cover including to deal with claims after licensees cease to trade; and
- improved disclosure of insurance arrangements and facilitation of third party rights.

A.26 The ultimate risk for clients in recovering compensation stems from a licensee's creditworthiness. This raises the question whether more attention should be given to the adequacy of licensee financial resources.

A.27 Beyond measures of this kind, or in conjunction with them, a further option would be to introduce a scheme to provide retail clients with last resort recourse to compensation to which they are entitled. In designing such a scheme, key issues would include:

- liability standards;
- eligible claims;
- payment of claims;
- membership of scheme;
- funding of scheme;
- authority for scheme;
- governance arrangements;
- systemic improvements;
- relationship to EDR schemes; and
- relationship to existing schemes of last resort.

A.28 A balance will have to be made between the effectiveness of any enhanced compensation arrangements in protecting consumers and promoting confidence in the financial services sector, and their impact on the cost and supply of financial services to retail clients and the overall efficiency of the sector. It is relevant to consider:

- the degree of harm suffered by retail clients under current arrangements;
- the impact of that harm on confidence in financial markets and consumer participation in those markets;
- the effects on wider regulatory settings and market impacts; and
- the effects on barriers to entry in the financial services sector and on the cost of provision of those services.

A.29 Current compensation arrangements do not purport to deal with loss or damage suffered by consumers from investment failures other than as a result of licensee misconduct. In practice the line may be somewhat blurred and this needs to be kept in mind in considering possible new measures.