



1 June 2011

Statutory Compensation Review
PO Box 6295
KINGSTON ACT 2604

Email: futureofadvice@treasury.gov.au

Dear Sir/Madam

Thank you for the opportunity to respond to the 'Review of compensation arrangements for consumers of financial services' paper by Richard St John dated April 2011.

NICRI supports in principle the formulation and introduction of a mechanism of last resort to compensate retail consumers who have suffered financial losses as a result of breaches by financial services providers/licensees of their statutory obligations. However, we recognise the need for a pragmatic balance to be struck between the need for enhanced consumer protection and compensation for losses, and minimising any additional financial burdens that changes in regulation policy and process might have on licensees. NICRI views the latter aspect as important as any significant increase in the cost of provision and reduction in the availability of quality financial advice may act as a financial disincentive to low income and small retail investors.

NICRI endorses any administratively and practically feasible evolution of relevant policies and processes that would enhance the protection of retail consumers.

We offer the following comments in response to *Issues of Interest* in the report.

Chapter 2: Current Compensation Arrangements

Insurance market

ASIC concluded, on the basis of research in 2006, that the market for professional indemnity insurance was well supplied and competitive on price at that time. There appears to have been a tightening in this market in more recent years, in particular in the availability and cost of cover for financial advisers. Information and comment are sought on the current conditions in and prospects for the market in the supply of professional indemnity insurance to licensees. In particular, the following aspects are of interest:

2.1 The capacity of the insurance market to supply licensees with professional indemnity insurance cover that is adequate to the needs of licensees considering the specific features ASIC requires the licensee to take into account such as minimum levels of cover, excess amounts the licensee can confidently sustain, and coverage of EDR scheme awards.

NICRI notes the anecdotal evidence highlighted in the Consultation Paper in relation to the perceived tightening of the insurance market for financial services licensees in Australia. We are concerned that this perceived trend may increase the general risk of licensees being unable to meet or fund compensation rulings in favour of retail consumers. In stating this, we support ASIC in continuing their requirement of licensees taking adequate levels of cover and believe that those levels would need to be reviewed over time.

2.2 The circumstances in which the market has been able to supply run-off cover to a financial services licensee.

We note the anecdotal evidence in the paper that the insurance market in Australia is reluctant to provide financial services licensees with run-off cover should a licensee cease business or become insolvent. We are again concerned that this may raise the likelihood of retail investors being unable in practice to obtain compensation in full or in part. Therefore NICRI would strongly support measures that would protect consumers in circumstances that are out of their control.

2.3 The conditions, in terms of access and price, for reinsuring the risk of professional indemnity insurance provided to financial service licensees.

We recognise that high premiums may raise the marginal costs of operation of licensee businesses and/or provide a financial incentive for licensees to under-insure in terms of PII with potential detriment to their retail clients ie a reduced likelihood of obtaining full compensation in favourable rulings. We note under the Corporations Regulations that 'adequate' PII is required of licensees – we would support a more stringent overseeing of this requirement.

2.4 Changes in the availability of professional indemnity insurance for licensees since 2008 when s912B arrangements came into full operation, in terms of premiums, excess amounts, cost of including specific policy features, factors that have impacted on pricing this product, and the impact on licensees of any changes, particularly on those who provide financial advice.

NICRI cannot assist with specific data in this regard.

2.5 The longer term outlook for the insurance market in terms of the supply, cost and coverage of professional indemnity insurance for financial service licensees in accordance with the requirements of s912B, associated regulations and guidance from ASIC.

We are concerned about the potentially detrimental impact that any future deterioration in the financial services sector's access to adequate and affordable PII cover would have on the well-being of its retail clients. The PFS/Financial Ombudsman Service's compensation proposal regarding 'caps' would potentially remove barriers to perhaps make it more economically viable for PI Insurers to offer more enhanced cover and promote competition within the PI marketplace. We do recognise that compensation caps may affect some segments of claimants less favourably, but overall it seems that a broader coverage is a better outcome for retail clients.

2.6 The circumstances in which licensees have found it difficult to acquire professional indemnity insurance cover that meets their needs.

NICRI cannot assist with specific data in this regard.

ASIC requirements for professional indemnity insurance

In administering the requirement that licensees who deal with retail clients have in place compensation arrangements, ASIC provides formal guidance on the factors to be taken into account by licensees in assessing the adequacy of their professional indemnity insurance. ASIC is able to approve in writing compensation arrangements other than professional indemnity insurance. Information and comment are sought on the experience of insurers, licensees and consumers with this approach. In particular, the following aspects are of interest:

2.7 The utility and effectiveness of the guidance provided by ASIC to licensees in enabling them to assess the adequacy of their professional indemnity insurance.

ASIC seeks to maximise self-assessment of licensees' individual PII needs and adequacy but in a manner consistent with ASIC's general guidelines. However, it appears ASIC does not monitor and assess the adequacy of licensees' continuing PII coverage and its consistency with the ASIC guidelines. NICRI is concerned about this apparent lack of longer term monitoring from a retail client/investor perspective. We also are concerned about whether a self-assessment focused approach is consistent with Government and ASIC consumer protection objectives. We believe that ASIC should be more stringent in ensuring licensees' PII cover is, and remains in the long term, consistent with ASIC's guidelines.

2.8 The adequacy of the current administrative approach in providing assurance that licensees meet their requirements to have adequate insurance cover.

NICRI's comments in 2.7 are applicable and relevant in this regard also. We are not convinced that the current approach ensures licensees do meet their requirements to have adequate PII cover because it appears there is no monitoring of long-term compliance.

2.9 The appropriateness of the current exemptions from the need to hold professional indemnity insurance cover.

As these entities are expected to have the financial capacity to meet compensation claims, we assume that APRA would have stringent safeguards in place to ensure exempted companies would have the backing to meet any compensation obligations.

2.10 The scope for a licensee in practice to make alternative compensation arrangements with the approval of ASIC.

ASIC can approve alternative compensation arrangements where it assesses them as adequate, taking into account factors such as volume of business, number of clients, the kinds of services provided and the licensees' number of representatives. NICRI is somewhat reluctant to support this form of exemption from the PII requirements if the information regarding alternative compensation arrangements are not transparent. However, we note that there is no convincing information or evidence presented in the Consultation Paper that these entities are failing to meet awarded compensation.

Process for claiming compensation

Information and comment are sought on the experience of respective parties with the process for claiming and recovering compensation for loss or damage arising from a breach of a statutory obligation by a licensee. In particular, the following aspects are of interest:

2.11 Awareness by retail clients of the available dispute resolution schemes and compensation arrangements, and the degree of clarity to consumers about using those processes.

NICRI operates a national phone based information service and receives calls which include areas of complaint regarding various financial service providers and intermediaries. The majority of these callers have little or no knowledge of existing dispute resolution processes, therefore we feel that there is considerable room for improvement in consumer awareness in this area.

2.12 Any issues arising from the existence of separate compensation schemes and arrangements in various segments of the financial services sector (for example, NGF and FCS).

NICRI recognises that more specific or unique circumstances may justify a more tailored solution and that a one-size-fits-all approach is unlikely to satisfactorily resolve the underlying issues involved in those cases. We thus have no philosophical or in-principle objection to tailored schemes for those cases.

2.13 The possible scope for bringing together some of these schemes and arrangements or moving towards some form of common administration.

NICRI supports the common administration of these various specific schemes if there are demonstrable efficiencies or administrative cost savings to be gained, and provided a pooled administrative model is logistically feasible and non-problematic

2.14 The experience of respective parties in making and responding to claims for compensation in terms of time, cost and outcomes, including claims pursued through an internal or external dispute resolution scheme or the courts.

We have several case studies from callers to our information line concerning claims to EDR seeking compensation for losses incurred due to inappropriate advice. The main concern from these callers is the extraordinarily long time it took to be recompensed for their claim. In fact, one of our callers has been told it will be several years before a decision can be made because of illegal activity on the part of the advisor. This leaves him without funds to enter an adequately funded retirement.

2.15 Circumstances in which retail clients have been unable to recover compensation awarded to them, or have not pursued claims because of the low probability of being able to recover any award in practice.

We have received calls from consumers affected by the collapse of Storm Financial, Westpoint and others. Many of these callers – smaller investors – stated that they were embarrassed, ashamed, and reluctant to pursue any compensation as they felt that the potential stress would not be worth the compensation amounts they would receive ie they had a low expectation of receiving any real form of compensation at all.

2.16 Circumstances in which retail clients have found it difficult to pursue a claim for loss or damage against a provider of financial services, including where the provider is no longer carrying on business, has become financially stressed or insolvent.

We are aware of a situation involving an elderly woman (late 70s) who was advised to use proceeds from a reverse mortgage to invest in a tea plantation and 'so called' blue chip shares. It would seem that the tea plantation has failed and the shares are unaccounted for. The advisor has since gone bankrupt. While she is supportive of FOS investigating her claim, she has no expectation of receiving any compensation. The reverse mortgage she entered to finance these failed investments is now growing due to compounding interest and she is, understandably, in real financial stress.

2.17 Any experience in pursuing compensation from financial services providers who are not in fact licensed as required.

NICRI has had no experience in this regard.

2.18 Any practical difficulties arising from differences between the standards of liability for licensees under Chapter 7 of the Corporations Act, the general law and under EDR schemes, and the ambit of liability covered in professional indemnity insurance policies obtainable by licensees.

No comment.

2.19 Any issues in practice with compensation claims against licensees by retail clients in regard to the distinction between inappropriate advice or misconduct by a licensee on the one hand and investment losses in the absence of such misconduct on the other.

NICRI endorses a distinction between retail investor losses as a result of breaches by their financial advisers of statutory obligations, and losses from unfavourable market-based forces, trends and volatility that is outside the control or influence of their advisers. A retail consumer's right to seek compensation in the former seems appropriate but there is no justification for rights of recourse against advisers in the latter case. However, NICRI appreciates that the line between the two sources of loss can be blurred and we note the right of an aggrieved individual to seek recourse through the civil courts.

NICRI has had experience over the past few years as a result of the GFC where consumers have suffered paper losses. We have found that they failed to make the distinction between the effects of the market and the appropriateness of the advice. This also applies, even more so, in the situation of consumers being advised to put funds into mortgage trusts which were subsequently frozen and are still unable to access all or part of their funds. In this particular case the blurred lines cover the area of the product or fund itself being affected through market forces but also the perceived lack of strategy that would maintain a person's liquidity requirements ie funds placed in cash.

2.20 Ability of clients to pursue claims through EDR schemes against parties, other than licensees with whom they have dealt, who may bear some responsibility for loss or damage (for example directors or auditors).

No comment.

2.21 Ability of licensees to seek recourse against other licensees or parties, who may bear some responsibility for the loss or damage suffered by a retail client, in relation to an award of compensation in favour of that client under an EDR scheme.

NICRI has no experience/data relevant to this issue, but we support in principle a licensee's right to recourse in this regard.

Chapter 3:

Premium and payout experience

Information and comment are sought on trends in premiums for professional indemnity insurance borne by licensees, and on claims experience under those policies, from 2008 when the requirement for

professional indemnity insurance was applied broadly to licensees. In particular, the following aspects are of interest:

3.1 The trend in premiums for professional indemnity insurance taken out by financial services licensees, and the factors behind that trend.

NICRI recognises the business expediency for PII providers to cover claim payments and ensure a reasonable return on business capital. Increases in the incidence and aggregate quantum of PII claims in the aftermath of the Global Financial Crisis [GFC] necessitated sharp rises in premiums for the financial services sector, evidenced in the data presented in the Consultation Paper. In recognising this business reality, we believe it critical that Government address issues of PII affordability for the financial services sector.

3.2 The trend in claims paid under professional indemnity insurance held by those licensees and the value of claims made under those policies which are still outstanding.

NICRI has no relevant data in this regard.

3.3 As a subset of the above, the proportion of the premiums received from, and claims paid out to, licensees who provide financial advice.

NICRI has no relevant data in this regard.

3.4 The typical grounds upon which claims under professional indemnity insurance policies are not met.

NICRI has no relevant data in this regard.

Experience with compensation arrangements

Comment and perspectives are sought on the effectiveness of current compensation arrangements, including the costs and benefits for consumers and industry of the reliance on professional indemnity insurance as the default arrangement for compensation. In particular, the following aspects are of interest:

3.5 The costs and benefits of professional indemnity insurance for licensees and the financial services industry more broadly.

Even given the high cost of PI Insurance, it forms an essential part of business requirements with the flow on benefit being a more robust consumer protection regime. It offers the consumer reassurance when these mechanisms are in place when making their decision to proceed with their investment decisions.

3.6 The level of assurance to retail clients that claims for loss or damage will be dealt with and awards for compensation paid.

NICRI fails to see how the level of assurance to which claims will be dealt with and awards paid to retail clients in future can be objectively and meaningfully measured. Consumers generally seem not to be confident in successfully pursuing compensation, as evidenced in the ASIC/CAP Susan Bell research paper.

3.7 The contribution of the current compensation arrangements in maintaining confidence by retail clients in dealing with financial services providers, including financial advisers, and in underpinning responsible behaviour by licensees.

By requiring ASIC to review current Australian procedures and the approaches used in foreign jurisdictions and put forward its proposed changes in the Consultation Paper, the Australian Government seems concerned that current compensation arrangements provide inadequate confidence by retail clients with the financial services sector. We are aware of the recent ASIC Consumer Advisory Panel report carried out by Susan Bell Research showing that only 7% of investors launched action against planners, banks or investment schemes, when suffering losses. That figure suggests that consumers have little confidence in the current compensation/EDR arrangements.

Chapter 4:

Given the compensation arrangements for financial services in other countries, and in respect to other professions and occupations domestically, views and comments are sought on:

4.1 The practical operation of those other arrangements including their costs, benefits and scope, and their effectiveness in contributing to consumer protection and the underpinning of consumer confidence in relevant markets.

NICRI supports the conclusion in the Consultation Paper that the approach adopted in the UK is the most pertinent in the review of the effectiveness and potential enhancement of compensation arrangements for retail clients of Australian financial services providers.

The UK system is a two-tiered approach to the protection of retail consumers: (a) a requirement to hold appropriate levels of PII and, depending on providers' size and risk profile, to retain or set-aside a prescribed minimum level of capital to ensure firms can meet their PII policy excess obligations to ensure successful claimants receive awarded compensation in full; and (b) a financial services industry-funded Financial Services Compensation Scheme (FSCS) run independently of the UK regulator that provides last resort protection for retail clients where a provider becomes insolvent or is otherwise unable to meet compensation obligations.

NICRI supports in principle the notion of a similar fund of last resort in Australia provided the fund can be structured for efficient operation, is restricted as proposed by ASIC to losses from provider breaches of statutory obligations, and does not lead to significantly increased cost of provision of financial services to retail clients that would provide disincentive to lower income or smaller retail investors to seek expert financial advice. Furthermore NICRI is concerned to ensure that any such scheme is structured such that it is in practice an avenue of last resort compensation for affected retail clients and not one so poorly structured and administered that it comes to be perceived as an easier first option for aggrieved clients seeking recourse for financial loss.

Precedent last resort schemes have been established by Australian State and Territory legislation and apparently effectively operated for other non-financial services industries. As examples, the Consultation Paper cites solicitor's trust account fidelity funds as consumer protection from misuse of clients' deposited funds, builder's home warranty insurance schemes in some jurisdictions and motor dealers customer protection compensation funds. These various funds are usually funded by levies on industry participants. ASIC proposes in the Consultation Paper that a financial services last resort fund would be similarly industry-funded and NICRI strongly supports this funding approach particularly on the rationale that self-funding should provide an effective financial incentive for individual financial services

providers to take all steps possible to reduce the incidence of statutory breaches by their authorised representatives in the first instance.

4.2 The possible relevance of those arrangements as models for the compensation of consumers of financial services in Australia.

NICRI comments and views here have been articulated/incorporated into our response to 4.1 above.

NICRI is aware of and supports the proposal put forward by the Financial Ombudsman Service to establish a compensation scheme to protect Australian consumers.

Chapter 5:

Information and comment is sought on the issues and possible remedial measures canvassed in this chapter, including on:

5.1 The nature and extent of any shortfall in the delivery of compensation under current arrangements.

From a consumer welfare perspective NICRI would encourage ASIC to promote the formulation and subsequent implementation by Government of policies and processes that provide greater assurance that awarded compensation is delivered in full, or to the maximum extent feasible, to successful claimants. We would strongly endorse in principle any policy and process that can achieve this without undue financial burden on and/or operational disruption to licensees' businesses.

5.2 The scope for further measures to lift the standards of licensee conduct or assist consumers in looking after their own interests.

NICRI considers it imperative that more assistance in the way of information be available to consumers to assist them in looking after their own interests in terms of investing. Whilst organisations such as NICRI are currently delivering information on investments for consumers we feel this is an area that needs to be enhanced. A knowledgeable consumer is less likely to enter into inappropriate financial services products being promoted by unscrupulous financial advisors and would therefore have less cause to seek EDR and compensation assistance.

We would hope the proposed FoFA reforms of introducing a Statutory Best Interests Duty would also lift the standards of licensees and their authorised representatives.

5.3 The scope for a tighter approach to the administration of the current requirement to hold professional indemnity insurance.

We have previously in this response mentioned a more stringent regime for financial services licensees to hold adequate levels of PII cover and for ASIC to oversee these requirements.

5.4 The scope for more standardisation in the kind of professional indemnity insurance cover available for financial service licensees or classes of licensee.

NICRI also sees considerable merit in the formulation and adoption of an industry-funded PII scheme such as the medical practitioner's PII scheme. This scheme provides doctors with more affordable PII than what would otherwise be accessible in the market and may be akin to PII "master policies" negotiated with PII providers by some professional bodies in the financial services industry [discussed in

paragraph 5.75 of the Consultation Paper]. We endorse any review of and public consultation on the feasibility of such a scheme in the financial services sector in Australia.

As indicated the potential for and our support for “master policies” that some industry bodies have already negotiated on behalf of member firms with insurance providers. We acknowledge the view expressed in the Consultation Paper that more standardised or one-size-fits-all PII policy terms could potentially lead to more affordable policies for licensees. We note however [paragraphs 5.72 through 5.75] that tripartite negotiations that ASIC organised between itself, the insurance industry and professional bodies representing licensees did not lead to agreement on a standard form of professional indemnity insurance policy. This might serve to emphasise the insurance industry’s widely perceived reluctance from a business risk management perspective to provide PII cover for the financial advisory sector in the wake of high profile collapses such as that of *Storm* and *Count Financial*, as well as more general business risk-related concerns the insurance industry has had in the aftermath of the GFC of 2008—2009.

5.5 The usefulness of improved disclosure about a licensee’s professional indemnity insurance policy.

NICRI supports the view that enhanced disclosure in this regard would improve prospective retail investor understanding of potential risks about the adequacy of their financial advisers’ PII cover as a protection against inability to recover awarded compensation. We support the assertion that enhanced risk understanding by prospective investors should in turn promote more informed and sound investment decisions by them.

5.6 Possible arrangements to deal with claims for compensation after a licensee ceases to trade.

ASIC’s concerns over the perceived lack of assurance in terms of the recovery of awarded compensation in such “run-off” situations is a weak point in the current regulatory reliance on PII cover for consumer protection are reflected in its attempts to require the inclusion of automatic run-off cover in professional indemnity insurance policies [5.80 through 5.82]. However ASIC did not proceed with its proposal when consultation with insurers indicated they were generally unwilling to provide automatic run-off cover.

NICRI shares ASIC’s concerns over the general lack of run-off cover and the potential exacerbation of compensation recovery problems. Governments are likely to be highly reluctant to seek to legislatively impose run-off cover provisions on the insurance industry in recognition that such cover is not generally provided because it is not commercially viable for PII providers to do so. ASIC puts forward some broadly based or structured remedial possibilities, including a separate group policy that deals specifically with run-off and pools the risk of claims arising from multiple licensees that had ceased to trade, an approach under consideration by the UK regulator requiring firms to ‘leave resources behind’ when they cease to trade, a trust to hold run-off cover, and the transfer of responsibility for future compensation claims to a firm that still operates.

NICRI believes there may also be merit in the industry’s examination of the feasibility of pursuing a medical practitioners’ PII type arrangement or scheme.

A simplistic approach may be to require licensees to enter into 2 year PII coverage which would offer a minimum of at least 12 months insurance after ceasing trading. Insurers could insist on 12 monthly reporting to ensure that the following 12 – 24 months coverage is in place to offer consumers some recourse in the event of the licensee failing.

5.7 The case for additional requirements in regard to the financial security of licensees.

NICRI believes there is a compelling case for more stringent assurances for retail clients that individual licensees have the financial resources to ensure the payment in full of any compensation awarded against them that is or may not be met from licensee's PII. We perceive the problem is exacerbated in reality by the fact that even if ASIC assesses current resources of particular firms to be adequate, there is absolutely no guarantee that the firm's resources will still be adequate at the time or point of any actual adverse determination against it. Company asset sheets are fluid—often changing significantly over time—and we encourage continued monitoring and intervention by ASIC where it is deemed in the public good. There is serious risk that resources will have diminished at the point of payment or will be significantly reduced in the lead-up to the prescribed time of payment for an unfavourable ruling against a licensee.

A watertight approach to consumer assurance and protection in this critical regard is the formulation and implementation of a compensation fund to bridge any payment shortfall and in which ASIC is legislatively empowered to levy licensees to establish and ensure an adequate pool of compensation funds that can be drawn against for this purpose over time.

5.8 The merits, and key design components, of a last resort scheme to provide compensation for retail clients, including the approach to industry funding.

NICRI endorses a last resort scheme funded through industry levies and as described and/or proposed in the Consultation Paper as an appropriate medium for the creation of a bridging fund of the type we favour in our response to 5.7 above. There are significant structural, logistical and efficacy issues that will need to be addressed to ensure the finally established fund meets the underlying objectives cost-effectively and efficiently and NICRI would take a keen professional interest in and would participate in public consultation specific to an actually proposed scheme.

From a budgetary and equity perspective NICRI strongly endorses industry-funding of such a last resort fund.

NICRI strongly endorses the PFS/Financial Ombudsman Service's proposal to establish a compensation scheme. We feel FOS is ideally equipped to establish and operate a scheme that offers a high level of protection to consumers.

Yours faithfully

Wendy Schilg
Chief Executive Officer