5 May 2015

By email: economics.sen@aph.gov.au

Scrutiny of Financial Advice
Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

Dear Sir/Madam,

Last resort compensation scheme

The following consumer organisations have joined together to make this submission to the Inquiry into Scrutiny of Financial Advice:

- Consumer Action Law Centre
- Consumers Federation of Australia
- Council of the Ageing (COTA) Australia
- CHOICE
- Financial Counselling Australia
- Financial Rights Legal Centre
- Superannuation Consumers Centre

The terms of reference for this inquiry include consideration of “whether existing mechanisms are appropriate in any compensation process relating to unethical or misleading financial advice and instances where these mechanisms may have failed”. It is our view that the fact there is significant uncompensated loss incurred by investors demonstrates that existing mechanisms have failed, and there is an urgent need to establish a last resort compensation scheme for consumers who sustain uncompensated losses in the finance sector.

We welcome the recent comments made by some of the members of the Senate Standing Committee that there is a need to consider a last resort compensation scheme.[i] We also welcome comments from some large banks that appeared before the inquiry that there is a gap in existing compensation frameworks. Consumer advocacy organisations have long supported the establishment of last resort compensation scheme, including in submissions to the Richard St John Review of Compensation Arrangements. This submission provides:

- an overview of the failure of existing compensation arrangements,
- the impact of uncompensated loss for affected consumers,
- the need for a last resort compensation scheme, and
- suggestions for the design of a last resort compensation scheme.

Current compensation arrangements

Current government policy is that consumers should be compensated where there is loss or damage due to breaches of financial services or credit laws. This is implemented through the requirements in financial services legislation that requires licensed businesses to have arrangements for compensating consumers.[ii] The law requires that this is generally satisfied through the holding of adequate Professional Indemnity (**PI**) insurance cover.

Despite the existence of this policy goal, it is clear that the current compensation arrangements for consumers of financial services are inadequate and are not achieving the policy objective. The Financial Ombudsman Service (**FOS**) submission to the Inquiry stated that FOS had determined that compensation be paid to consumers, but in some cases the compensation remains unpaid. FOS states that between 1 January 2010 and 31 March 2015, 126 Determinations remain unpaid. The value of the outstanding amounts awarded by the 120 Determinations was $12,862,911.70 plus interest (adjusting for interest and inflation, the present day value of these uncompensated losses is approximately $21.3 million).[iii] Unpaid determinations represent 24.47% of all determinations issued in the Investments, Life Insurance and Superannuation area. An unknown number of additional consumers suffer loss that is likely to have been caused by misconduct but do not pursue a claim in a court or External Dispute Resolution (**EDR**) forum.

A primary reason for failing to pay compensation is that the licensee is insolvent (or missing) and lacks adequate PI insurance. In its submission, FOS explained some of the factors as to why PI insurance cover may not result in consumers receiving compensation:

- the total funds available under an adviser’s insurance may not cover all of the compensation that FOS awards against that adviser;
- an adviser’s insurance may not cover the conduct for which FOS awards compensation against that adviser; and

- the amount of compensation that FOS awards against an adviser may be below the excess under their insurance policy.

It appears that a key reason for this outcome is that there is market failure in the PI market—the market is not able or willing to deliver affordable policies that cover the risk of all licensees being unable to pay compensation awards. In truth this is a small risk for insurers, given that FOS indicates that unpaid determinations have only involved 26 financial service providers. However, it also an unknown risk for insurers, and the response has been to only provide limited cover. Insufficient cover results in the risk of uncompensated loss.

There are also inadequate PI insurance arrangements in the credit industry. Currently, not all credit providers are required to have a PI insurance policy. Unless a licensee provides credit assistance, it is merely required to have 'adequate compensation requirements'.[iv] We understand that licensees are required to verify their compensation arrangements at the time they apply for their licence, which tends to be a multiple of their average expected loan or lease amount. However, ongoing compliance is only monitored by way of the annual compliance certificate, in which the credit provider self-certifies that they are compliant. The requirement for 'adequate compensation requirements' is therefore meaningless from a consumer compensation perspective, as the regulator may not even discover compensation arrangements are inadequate until after the business becomes insolvent.

The impact of uncompensated losses

Uncompensated losses arising from licensee misconduct can cause a range of financial and non-financial losses. They impact the affected consumer and their family, the community generally and the reputation of the financial services and credit industries. As noted above, the actual risk is small—compared to the total number of consumers that purchase financial products, only a small number of consumers are affected by uncompensated loss. However, should the loss occur, the impact is generally very substantial.

The impact of uncompensated loss was the subject of research commissioned by ASIC's Consumer Advisory Panel and reported in Susan Bell Research, *Compensation for retail investors: the social impact of monetary loss,* ASIC Report 240, May 2011.

The Bell research reported on the experiences of 29 consumers affected by losses. Some of the research's key findings included:

- 17% of the group were living below the poverty line and had either lost their home or were perilously close to losing it;
- a further 27% were experiencing a significant decline in living standards to the point where they were now 'living frugally'. Many suffered from long-term depression;
- affected consumers draw more on community resources than would otherwise be the case; and
- one of the most significant impacts of these investors' losses is the damage to their confidence in the financial system.

More generally, the risk of uncompensated loss has significant implications for community trust and confidence in the financial sector. The Murray Financial System Inquiry recently stated that “confidence and trust in the system are essential ingredients in building an efficient, resilient and fair financial system that facilitates economic growth and meets the financial needs of Australians”.[v]

The need for a last resort compensation scheme

A last resort compensation scheme is the only way to ensure that consumers who suffer loss from misconduct are compensated. It is effectively the missing piece of the financial services regulatory architecture.

Any last resort compensation scheme would only be called on in a minority of cases—those where loss flows from proven misconduct by a licensee, the licensee then cannot meet the claim and the consumer cannot be compensated by recourse to PI insurance arrangements.

It has been suggested, including in the Richard St John Report into Compensation Arrangements, that the establishment of a last resort compensation scheme will create ‘moral hazard’. That is, there is a risk that consumers will make decisions in the knowledge that compensation will be available and will be less likely to take responsibility. We reject this concern. In our view, this risk is not realistic as almost no consumers understand the detail of regulatory arrangements and a scheme can be designed to minimise this risk. For example, there could be limits to the compensation available through the scheme. This is discussed further below. The scheme would also be ‘last resort’: that means that a consumer who alleges liability against a licensee would first have to seek a compensation award from a court or external dispute resolution. If this was unpaid, they would have to seek payment from any PI insurer. Only if PI insurance did not provide cover, would a consumer have a valid claim on the fund.

Further, rather than create 'moral hazard', the establishment of a last resort compensation scheme would create both an important constituency for effective reform and a mechanism to identify and perhaps implement reform. More responsible and better capitalised firms (such as the big banks) will want to ensure that the scheme is called on as rarely as possible and will thus have an incentive to advocate for reforms that minimise misconduct. The scheme itself may have a role in monitoring and acting on problems that lead to claims on the scheme.

The clearer ‘moral hazard’ risk involves a licensee becoming insolvent and allowing affected consumers to claim on the compensation scheme. The relevant directors and managers involved in the licensee may then seek to establish a new business and obtain another licence. This risk could be dealt through a number of design measures. First, the scheme might only make compensation payments on the basis that the claimant assigns their rights against the licensee to the scheme. This would enable the scheme to pursue recoveries against directors and managers where possible—the scheme would have an incentive to do this. Second, claiming against the scheme could trigger enforcement investigations against any relevant directors or managers that were involved in misconduct. ASIC’s banning power could be used to prevent the possibility of businesses “phoenixing”.

There are options that could be considered other than a last resort compensation scheme. For example, the Government could seek to specify mandatory levels of PI insurance cover to ensure it covered the risk of uncompensated loss. Another alternative is to require licensees to have more stringent capital adequacy requirements that could be called upon. Both these options are likely to impose significant costs on industry. Moreover, it is not clear that a private PI insurance market would be willing to provide this level of cover—there has been failure in other private last resort insurance markets, for example, home building warranty insurance in a number of states where private providers have opted not to provide cover due to uncertainty in pricing for the risk. In comparison, a last-resort compensation scheme can operate as an industry-wide insurance mechanism: a comparatively low cost arrangement that can provide cover for a small risk that, if eventuates, will have substantial impacts on an individuals and families.

A last resort compensation scheme can also enable other elements of the compensation system—EDR and PI insurance—to work more effectively. If it is established, consumers will have confidence that taking their complaint to EDR will not result in uncompensated loss. It may also allow the PI insurance market to work more effectively: insurers will be able to price policies affordably, allowing the product to play the role it was designed for, and not for it to be expected to provide for entire consumer protection.

Suggestions for the design of a last resort compensation scheme

The Financial Ombudsman Service has prepared a proposal outlining the design and functioning of a financial services compensation scheme.[vi] We endorse this work (completed in 2009) and suggest that it could be reviewed and updated in light of recent market activities.

We endorse the following suggestions for the design of a last resort scheme:

- That it apply to all financial services and credit licensees: while it is financial advice that has caused the most uncompensated loss through the Financial Ombudsman Service, the risk applies in relation to all licensees, including credit providers. As noted above, there are problems with the design of compensation arrangements in the consumer credit sector.

- That it only accept claims from retail clients (consumer claims) and operate as a last resort scheme, that is, only be available for claims after all avenues have been exhausted, including a relevant award from an EDR scheme or a court.

- That its governance involve both industry and consumer representatives. The EDR scheme governance arrangements offer a working effective example. They provide for independence from industry and other stakeholders, while involving them through an independent corporate governance entity. This can facilitate effective industry engagement which can improve the culture of risk management inside financial services and credit licensees.

- That its awards of compensation are tiered and capped at appropriate levels. The proposal prepared by FOS mentioned above suggests compensation limits of 90% of loss incurred up to a certain tier, limiting total compensation to an amount equating the compensation limits of EDR schemes. Tiers and caps would have to be increased over time.

- That it will be retrospective to allow consumers with a compensation claim arising from behaviour before the scheme is implemented to make a claim. As new consumer protections such as the Future of Financial Advice (FoFA) reforms have only recently been implemented, to be effective and go some way towards restoring consumer confidence, the scheme needs to address problems created in the last ten or more years that still have not been addressed by major financial institutions

- That it be funded by industry, through a levy imposed by the government.

We recognise that the funding mechanism is perhaps the most controversial part of a new scheme. In particular, many of the large institutions may argue that they should not contribute to the cost of the scheme, as they are already able to compensate their customers for any loss.

There are a number of reasons that we think that the industry broadly should contribute to the cost of the scheme. First, it must be acknowledged that many of the financial advice scandals have been the result not only of poor financial advice, but also financial products that have not been appropriate to the needs of consumers. Those products are for the most part designed and/or distributed by larger better capitalised industry participants. Large participants also benefit from the sales activities of smaller financial advisers when they provide finance to investors. Given the integrated nature of the financial services sector, it makes sense that all levels of the supply chain should contribute, including product issuers.

Second, we submit that large product manufacturers have not experienced significant penalties as a result of their involvement in financial advice misconduct. The Murray Financial System Inquiry recognised that the penalty regime is low in Australia comparatively to other jurisdictions, and that it should be reviewed.[vii] In the United Kingdom, for example, penalties available to the Financial Conduct Authority are unlimited, and in recent years that have been a number of instances of multi-million pound penalties. In this context, it is not unreasonable to expect all licensees in Australia to contribute to compensating uncompensated loss caused by financial misconduct.

Finally, we note that it may be appropriate for the Government to make a small contribution to the establishment of such a last-resort compensation scheme, given the wider benefit to the community in reduced calls on social security, health and other welfare services as a result of uncompensated losses.

Enclosed with this submission are copies of the research report on the social impact of monetary loss prepared by Susan Bell Research and the joint consumer submission to the Richard St John Review.

Please contact Katherine Temple on 03 9670 5088 or at katherine@consumeraction.org.au if you have any questions about this submission.

[i] 'Compensation scheme needed for financial planning victims', *The Sydney Morning Herald,* 21 April 2015: http://www.smh.com.au/business/banking-and-finance/compensation-scheme-needed-for-financial-planning-victims-say-senators-sam-dastyari-and-nick-xenophon-20150421-1mpmtg.html

[ii] section 48, *National Consumer Credit Protection Act 2009*; section 912B, *Corporations Act 2001*

[iii] For further information, see Financial Ombudsman Service Circular Issue 21, April 2015: http://www.fos.org.au/the-circular-21-home/fos-news/unpaid-determinations-update.jsp

[iv] See http://asic.gov.au/regulatory-resources/credit/credit-general-conduct-obligations/rg-210-compensation-and-insurance-arrangements-for-credit-licensees/

[v] Financial System inquiry, December 2014, page xv: http://fsi.gov.au/files/2014/12/FSI_Final_Report_Consolidated20141210.pdf

[vi] Financial Ombudsman Service, A proposal to establish a financial services compensation scheme: http://www.fos.org.au/custom/files/docs/proposal_to_establish_a_financial_services_compensation_scheme_revision_october_09_pdf.pdf

[vii] See: http://fsi.gov.au/publications/interim-report/07-regulatory-architecture/execution-of-mandate/