



American Home Assurance Company
ABN 67 007 483 267
Incorporated with Limited Liability in the USA
A Member of American International Group, Inc.

7th November 2002

Ms. Ruth Smith
Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Madam,

**RE: COMPENSATION FOR LOSS IN THE
FINANCIAL SERVICES SECTOR**

We refer to the above "Issues and Options" paper released by Treasury in September 2002, in respect of which comments were sought from entities engaged in the Financial Services Sector.

American Home Assurance Company appreciates the opportunity to provide feedback, and is pleased to document its views on the proposals made.

As indicated in the captioned paper, we would also be pleased to attend any meetings arranged during the consultation period to discuss the issues involved. If you could provide notification of the date(s), time(s) and venue(s) to the undersigned, once known, to facilitate such attendance, that would be appreciated.

Our responses will follow the heading and numbering used by Treasury in the paper under reply:

Principal Issue 1:

As we do not have statistics of the kind sought, we are not in a position to respond in respect of this issue.

Principal Issue 2:

Our view is that the answer here is "yes", with two qualifications:

- That the costs involved in such compensation arrangements should be passed on to the consumer, as it is for the benefit of the consumer that the costs will be incurred, and
- That a distinction is drawn between the different segments of the Financial Services Sector in determining the arrangements which are to apply – in other words that the solution is not a "one size fits all" response.

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Principal Issue 3:

American Home Assurance Company supports the concept of a legislated compensation regime, provided:

- That it does not impose an additional cost to business, with the final costs being passed on to the consumer;
- That the financial credentials of an organisation are taken into account when an assessment of the contributions to be levied is made;
- That a separate "subset" of the compensation regime applies to general insurance companies, in recognition of both their status as APRA regulated entities and in recognition of their separate and unique market environment.

Principal Issue 4:

- (a) We consider that compensation arrangements should be required in relation to a Financial Services Licensee whenever the Chapter 7 Licence criteria are breached and a consumer suffers financial loss as a direct result of that breach;
- (b) Application should be consistent whether or not a licensee is solvent. There is no logic to support placing solvent companies in a better or worse position than insolvent ones, especially in light of general insurers' position as APRA regulated entities;
- (c) No – compensation arrangements should apply equally to both solvent and insolvent licensees.

Principal Issue 5:

We are strongly of the view that such a scheme should apply only to Retail Clients as defined in the *Financial Services Reform Act 2001* and the regulations made thereunder.

The reasons for this view are:

- (a) the fact that the legislative intent of the aforementioned Act is to improve levels of consumer confidence in, and protection in respect of, the provision of financial products and services, and
- (b) the well founded presumption that through a combination of their own levels of sophistication, and the availability of qualified advisors to Wholesale Clients, a regime embracing other than Retail Clients would be needlessly burdensome to the industry without commensurate benefit in context of the thrust of the legislation concerned.

There would need to be maximum amounts of compensation specified, and in our view these amounts should again be varied dependent upon the segment of the Financial Services industry in which the particular licensee were engaged.

Principal Issue 6:

- (a) Again, as general insurers are APRA regulated entities, each should be individually assessed and have compensation arrangements which apply to the entity as an individual. We would support the notion of an entity deemed "A" (or similar – very secure) being only required to take out Professional Indemnity Insurance, whereas one rated at a lower level may also need to take out other forms of guarantee, such as some form of Bond, Fidelity Guarantee or other relevant security instrument.

- (b) Our view is that Professional Indemnity insurance should be mandatory for all licensees. In fact this requirement would, of itself, achieve a ranking of licensees, as an insurer taking this risk would differentiate on the basis of strength, track record, classes of business written. Skill sets and systems of the licensee, etc.

Principal Issue 7:

- (a) We would be happy to provide such information as we can on the availability of Professional Indemnity Insurance on a confidential basis should Treasury consider this would be of value. There are issues of market sensitivity involved, but as a member company of American International Group, a major underwriter of this and related classes of business world wide, we consider we could offer some useful insights on this point.
- (b) We are not in a position to provide a general comment on this point.

Principal Issues 8 and 9:

We have no comment to make in respect of these issues.

Principal Issue 10:

It is our view that a statutory scheme which differentiates those with solid financial credentials (and those which are APRA regulated) from those whose credentials are not as strong, and who may not be APRA regulated, makes sound sense. Again, however, we would be concerned if such a scheme attempted to apply a general set of standards to all Financial Services Licensees without regard to industry or individual entity characteristics. For this reason, a scheme which provided "subset" applications by industry type, and within that having regard for the licensee as a unique entity would be considered vastly preferable.

Principal Issue 11:

A broad based Statutory Scheme would not be the preferred model (refer further comments following an a possible model for general insurers), however if such a scheme were introduced:

- (a) It should be available both pre and post insolvency/inability to pay, and
- (b) Claims should be paid based on the broad range of losses suffered by Retail Clients as a direct result of wrongdoing by Licensees or their representatives in the course of providing Financial Products and/or Services.

Secondary Issue 12:

A separate body to administer the scheme would be the preferred option subject to the costs involved, and the degree to which such a body would be capable of determining appropriate outcomes across the range of industries involved in the provision of Financial Services. Costs again should be borne by the consumers for whose benefit the structure is being set up. An "umbrella" body, with sub committees which each addressed a segment of the Financial Services Sector would have the best chance of achieving both balanced outcomes and the desired result for retail consumers.

Secondary Issue 13:

We do not consider, as previously set out, that a “one size fits all” solution is the best way to go, having regard for the breadth and diversity of the participants in the Financial Services sector. It is also not appropriate to treat APRA regulated entities the same as non APRA regulated entities, nor to treat the extremely secure in the same way as the less secure.

Any scheme would require a charter to be developed in consultation with the relevant industry sector, and it would need to be transparent in its dealings to both that sector and the relevant consumer groups to be credible in the discharge of its functions. It would require annual external audit, and perceived independence of operation from either the Licensees or the consumers.

Secondary Issue 14:

It is our strongly held view that one scheme could not effectively cover financial services in relation to all products and sectors of the industry. Our reasons for this view have already been stated elsewhere in this submission.

Secondary Issue 15:

We have no response to make in respect of this Issue.

Secondary Issue 16:

In the initial stages funding would need to come from consolidated revenue until such time as a levy on retail customers produced a fund balance adequate to the task at hand. Such ability to self fund should be assumed as twelve months from the date of initiation of the scheme, to allow the cost to be distributed over a full complement of retail purchasers of General Insurance. There should be no initial or ongoing cost to the licensees for the scheme, particularly as any such cost would be added to the cost already involved in compliance with regulation by both APRA and ASIC.

Secondary Issue 17:

An operator of such a scheme would need the power to raise and invest funds, make determinations on claims lodged against the fund, and disburse appropriate settlement monies to successful retail client claimants. Again we would like to raise the qualification that such a scheme would need to include a segment specifically related to General Insurance to ensure that the appropriate expertise were available in making determinations of successful claims.

Secondary Issue 18:

In our view the answer to this is a definite “yes”. For APRA regulated entities, and particularly those rated highly for their security (refer previous comments in this respect) it could be feasible to exempt such bodies from a central scheme altogether. Such an exempt entity could be required to have other privately obtained security facilities such as Professional Indemnity Insurance, Directors’ and Officers’ Liability Insurance, Bonds or similar to guarantee the ability of such entities to meet legitimate claims.

Secondary Issue 19:

The loss should be quantified based on the facts of each claim, and represent the actual physical loss of the retail client, excluding consequential loss. Consequential loss would only be payable where required to place the client back into the position he enjoyed before the licensee breached the terms of its licence and caused the loss. In other words, a strict application of the General Insurance principle of indemnity would be required. No awards for any form of damages beyond those noted should be within the jurisdiction of the scheme operator/tribunal of fact.

Secondary Issue 20:

- (a) At least in the initial stages, we would suggest that capping is appropriate, because the scheme would take twelve months to "self fund" based on what we have proposed above. Also, capping would mean that top class APRA rated licensees would be able to purchase appropriate insurance protection from the consequences of licence breaches more easily in the marketplace if the limits per claim were known. For the latter reason, long term capping would be a preferred alternative as well.
- (b) A monetary limit of (say) \$100,000.00 per General Insurance claim, which could be reviewed each twelve months as a part of the annual review of the functionality of the scheme.

Secondary Issue 21:

The appropriate connection with Australia is the possession of an AFS Licence by the entity which has provided the Retail Financial Product or Financial Service to a retail client. Therefore wherever the retail client may be located, if they deal with a holder of an AFS licence then the compensation scheme applies to compensation for that retail client.

To do otherwise would create a scheme which discriminated against Financial Services Licensees on the basis of where the retail client were located.

Secondary Issue 22:

○ The answer to this issue lies in the identity of the body charged with running the Compensation Scheme. If that body were to be the same body which operates an approved External Dispute Resolution Scheme for a segment of the Financial Services Industry already, then there would be a clear nexus between the two. In the absence of this duality of function residing within the one body, then there should be no connection between the two at all, as their mechanisms for resolving retail client complaints are quite different.

If, for instance, Insurance Enquiries and Complaints Ltd ("IEC"), which is an approved EDR scheme, were to become the operator of the Compensation Scheme for the General Insurance Industry, then, subject to the industry's agreement to a revised set of Terms of Reference for IEC, it could discharge both functions through separately constituted internal capabilities, as a sub committee of the umbrella body proposed earlier.

Secondary Issue 23:

The approach should be to discourage the buildup of funds in excess of an actuarial verification of what is required to discharge the scheme's current and future liabilities. The object of the exercise is to provide funds for compensation to retail clients who have suffered loss as defined, and therefore stockpiling of

funds surplus to needs should be avoided. After the first year of operation some idea of the necessary pool of funds will have been established, and by the expiry of five or six years from commencement it would be expected that the required monies could be estimated with some precision.

Secondary Issue 24:

Six years, in common with most Statutes of Limitation, would seem appropriate for a scheme which is being set up to protect retail clients as an alternative mechanism to taking legal action through the courts. Receipt of compensation from the scheme should be an automatic bar to the client's proceeding with any legal action in respect of the same cause.

Secondary Issue 25:

The appropriate level of detail would be such as reflects the overall framework within which a compensation regime would operate. The details, on an industry by industry basis, could be worked out between Treasury, ASIC and the relevant industry body, plus IEC if that route for implementation were adopted. Appropriate Regulations under the enabling legislation (presumably an amendment to the *Financial Services Reform Act 2001* itself) could then be introduced as a result of that consultation.

Other matters which did not present themselves as either Principal or Secondary Issues in the "Issues and Options" paper, on which we would also like to comment are as follows:

- Separation of Product Types:

The scope and diversity of the Financial Services Sector, plus the complexity of some of the products and services offered within it, mandate (in our view) the separate treatment of products and services from each segment of the sector. Thus, Banks would be dealt with separately from Stockbrokers, and both would in turn be viewed differently from General Insurance Companies and Life Insurance Companies. The operator of a compensation scheme would be able to build up specific expertise and resources dedicated to each segment (sub committees), thereby establishing credibility with all stakeholders and ensuring an appropriate level of specialist knowledge for use in determining claims by retail clients.

- The Conduct Causing the Loss:

We believe that for a compensation regime to be effective, and address the aspects of conduct by Licensees which are necessary to give effect to the intent of the legislation, compensation should apply to all breaches, including breaches of product disclosure requirements and the giving of advice, if these breaches cause direct loss to the retail client.

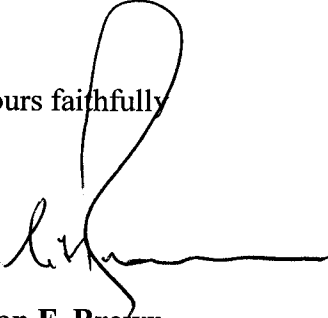
- Unlicensed Providers:

It is our view that the scheme should only apply to loss (as defined above) caused by the holders of Australian Financial Services Licences, or such others for whom the holders of those licences are legally responsible. The purpose of the compensation scheme is to give the retail client public confidence in dealing with Licensees or their duly appointed representatives, and for this reason the charter of the scheme should limit its response to claims involving those parties.

We would be happy to elaborate further on any of the foregoing, should that be of value to Treasury's deliberations on this subject.

In the absence of any request for further information, we look forward to the opportunity to participate in meetings to progress matters further.

Yours faithfully

A handwritten signature in black ink, appearing to read 'Alan F. Brown', with a large, stylized loop at the top.

Alan F. Brown
General Manager
Compliance, Risk Management & Corporate Affairs

