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26 November 2002

Ms Ruth Smith
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Dear Ms Smith

COMPENSATION FOR LOSS IN THE FINANCIAL SERVICES SECTOR: ISSUES AND OPTIONS (September 2002)

Thank you for the opportunity to comment on the "Compensation for Loss in the Financial Services Sector: Issues and Options" paper, issued September 2002. I enclose our submissions for your consideration.

Please do not hesitate to contact Duncan Stewart on (02) 9312 3661 or e-mail to duncan.stewart@cba.com.au should you wish to discuss any issues raised in this response.

Yours sincerely

per M A Leonard

Submission by Commonwealth Bank Group on "Compensation for Loss in the Financial Services Sector"

November 2002

Commonwealth Bank

Compensation for Loss in the Financial Services Sector

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Compensation for Loss in the Financial Services Sector

Executive Summary

The ambit of the discussion paper encompasses financial loss suffered by clients in connection with the provision of financial services. It covers the need to compensate these losses, and compensation requirements including those of Australian Financial Services Licence holders. It is the Group's submission that the statutory requirements for licencees should be clarified to limit compensation for financial loss to matters of fraud, defalcation, loss of funds entrusted to a financial services provider, or negligent advice.

In the Group's view, different considerations apply to financial markets and to other financial service providers. A fidelity fund, such as the ASX's National Guarantee Fund, is an important means of promoting confidence in a market. For this reason, the National Guarantee Fund and the Sydney Futures Exchange Fidelity Fund are appropriate means of compensation in respect to brokers and other participants on the ASX and SFE and these should be retained.

One option discussed in the paper is a statutory scheme to compensate financial loss suffered through wrongdoing in connection with the provision of financial services. A key advantage of this arrangement is that it would allow recovery of compensation in the event that those who committed the wrongdoing became insolvent. The Group submits that conglomerates that contain APRA-regulated bodies should not be included in such a scheme, given that insolvency risk is mitigated. Use of existing alternative dispute resolution mechanisms to investigate and resolve issues of this nature, were they to arise, should be emphasised.

Requirements for professional indemnity insurance should be included under Australian Financial Service Licence conditions. Further consideration of solvency thresholds is also desirable.

General Comments

The Options are Premature
The authors of the paper seek to improve their knowledge of the nature and extent of losses suffered by consumers of financial services. The losses at issue are those by consumers of financial services. This information is best collected from the Insolvency and Trustee Service of Australia (ITSA) and the Australian Securities and Investments Commission (ASIC). Further investigation of the efficacy of existing arrangements, and the different means to reduce insolvency risk, is also required before they are found to be flawed or major reform is desired. The risk is that the authors are attempting to solve problems that are not entirely clear. It is difficult not to conclude that discussion of the options in the paper is premature.

The Effect of the FSR Licencing Regime
The FSR reforms should be fully implemented and analysed before additional changes are considered. Accordingly, it is submitted that discussion on compensation reform mechanisms be deferred until at least two years after 11 March 2004, by which time existing market participants must have obtained an Australian Financial Services Licence or licences.

A Risk Management Approach
The best approach is to identify risks on an on-going basis and ensure that controls and processes are in place to reduce them. There are regulatory and market-based approaches to risk reduction. The financial services licensing requirements are obviously an example of the regulatory approach, which the Group supports.

Weight should be given to market approaches as well. For example, the need to protect reputation is a powerful motive to ensure that compensation is paid, particularly for conglomerates.[1] It is rightly noted in the paper that there is a "significant and immediate pressure on the relevant bank or insurance group to right the wrongs as soon as possible".[2] In general, the Group expects that compensation arrangements will involve a combination of regulatory and market approaches.

In putting measures in place to reduce risk, care should be taken not to exacerbate other risks. For example, to reduce the risk of monopoly, the government may favour small new entrants into a market to deliver financial services. On the other hand, small players may run greater risk of insolvency and so failure to pay compensation for loss occasioned in the provision of these financial services. It may not be possible to reduce both risks simultaneously.

Alternative Dispute Resolution Schemes must be considered
The paper does not cover internal or external dispute resolution schemes in detail. These schemes can be used to achieve compensation for those who suffer loss as a result of wrong-doing in the provision of financial services.

[1] It is also a motive to improve disclosure continuously to reduce information costs for consumers.

[2] Paragraph 63, pages 21-22.

Of course, alternative dispute resolution schemes do not address issues of insolvency risk. However, where insolvency risk is mitigated by controls, alternative dispute resolution schemes are of value. The risk is that if these schemes are not discussed, over-reliance on statutory schemes as 'the solution' may develop.

The requirements of the Australian Standard on Complaints Handling are worth noting. Organisations should develop policies on the provision of remedies, including compensation.[3] The essential elements of complaint handling are consistent with those listed in the paper for a foreign compensation scheme.[4] Furthermore, the Standard mandates the following approach to dispute resolution schemes:[5]

> *The system for dispute resolution should be a staged process of intervention – going from the least interventionist to the most interventionist (litigation through court). The least interventionist is also the most informal process, leaving most of the control with the parties involved in the dispute (unresolved complaint).*

It is clear that dispute resolution through a company's complaint handling system is less interventionist than an external dispute scheme, or (potentially) a statutory scheme, or legal action. It follows that, provided insolvency risk is addressed, internal and external dispute resolution should be first undertaken without the need for more interventionist measures. The Group submits that the approach taken to dispute resolution, quoted above, be expressly endorsed.

[3] AS 4269 – 1995, paragraph 3.10, page 9.

[4] cf. AS 4269 – 1995, Section 2 page 6-7, and the description of the UK compensation scheme, paragraph 110, page 32.

[5] Id, paragraph 5.3, page 12.

Specific Comments

The Problem and Objective
Chapter 2 of the Issues Paper highlights the key objectives of compensation arrangements, namely to ensure that retail consumers of financial services have appropriate remedies so that they maintain confidence in the financial marketplace and continue to participate in it.

As mentioned in the Issues Paper, the Wallis Committee recommended the development of a single set of requirements for investment sales and advice including "financial resources or insurance in cases of fraud or incompetence."

Chapter 2 indicates that there have in the past been two key areas where losses have been suffered:

(i) fraud and unauthorised transactions by investment advisers and insurance brokers;

(ii) insolvency and unauthorised transfer of securities (typically involving fraud) by brokers and others.

Any proposed compensation arrangements therefore must address these problems. However, it is important to establish boundaries on what the compensation arrangements can cover. It is impractical to expect compensation arrangements to cover the full breadth of a licensee's obligations under Chapter 7 at a realistic cost.

For example, the compensation arrangements should not apply to losses in value of the financial products themselves ie normal investment risks, which are disclosed to investors as part of the product disclosure requirements under Part 7.9 of the Financial Services Reform Act (FSRA).

Furthermore, section 912B of FSRA currently requires compensation arrangements to be in place for loss or damage suffered for breach of a financial services licensee's obligations under Chapter 7. A licensee's obligations are extremely broad including for example the obligation under section 912A(1)(c) to "comply with the financial services laws". "Financial services laws" is defined as including any Commonwealth, State or Territory legislation relating to the provision of financial services. This wording should be amended so that the coverage of the section is more clearly focussed.

Recommendation 1

Section 912B it too broad and should be amended to limit compensation arrangements to financial loss or damage suffered by retail clients because of:

- fraud and defalcation by a licensee or its representatives;
- loss of property entrusted to a licensee due to insolvency (prior to issue of a financial product);
- negligent financial product advice by licensees or their representatives.

Maintenance of the National Guarantee Fund
The explanatory memorandum for the Financial Services Reform Act, when dealing with section 912B states the following:

> *"due to the wide range of business activities that will be undertaken by licensees, the compensation arrangements that will be required will vary significantly depending on the type of financial services which the licensee provides."*

In the Group's view, compensation arrangements for market participants should be treated differently to other financial service providers. A key objective with regard to market participants is to ensure confidence in the relevant market.

The National Guarantee Fund and its predecessors were established primarily to maintain investor confidence in the relevant market and having a fund with substantial assets such as the National Guarantee Fund is key to this objective.

Recommendation 2

The National Guarantee Fund and SFE Fidelity Fund should be retained in their current form and similar fidelity funds should be required for other financial markets.

APRA-regulated Bodies
The question is posed regarding financial services licensees which contain APRA-regulated bodies: "Should such bodies be exempt from any requirements for professional indemnity insurance or, indeed, any compensation arrangements?"[6]

The Group's response is that professional indemnity insurance should be required, discussed below. Conglomerates that contain APRA-regulated bodies should also be exempt from a proposal for a statutory scheme to compensate financial loss occasioned in the provision of financial services.

The key advantage of a statutory scheme is to compensate loss suffered as a result of wrong-doing, when those who provided the financial service have become insolvent. However, APRA-regulated bodies already maintain extensive controls to mitigate insolvency risk. It is also noted that "APRA supervises the capital adequacy of a locally incorporated ADI on both a stand-alone and consolidated Group basis, covering the global operations of the ADI and its subsidiaries".[7] Whilst capital reserves are not available to for use in compensating the loss at issue, these reserves should mitigate the risk of insolvency for related entities within a conglomerate. It follows that conglomerates that contain APRA-regulated bodies are at low risk of being unable to compensate loss occasioned in the provision of financial services.

[6] Paragraph 267, page 77.

[7] APRA, AGN 110.1 – Consolidated Group, paragraph 1.

Emphasis should be given to the use of existing internal and external dispute mechanisms for the investigation and compensation of loss occasioned through wrong-doing. The motive to limit reputation damage within a conglomerate is also relevant.

In addition, small entrants are less able to invest in controls to reduce the risk of fraud and other wrong-doing. There is a potentially higher risk that their customers would ultimately draw upon a statutory fund of compensation. This means that one group of customers could effectively cross-subsidise the other, depending on how the scheme is funded. Indeed, pooled funds are an inefficient means to allocate responsibility for risk.

Recommendation 3

Conglomerates that contain APRA-regulated bodies should be excluded from a statutory scheme to compensate financial loss occasioned through the provision of a financial service.

Professional Indemnity Insurance and Surety Bonds

Existing compensation arrangements require licensees to lodge surety bonds with ASIC and (for responsible entities and insurance brokers) to take out adequate Professional Indemnity (PI) insurance. Surety bonds should be retained for those situations where professional indemnity insurance is not available.

The Group endorses use of PI insurance based upon risk analysis of the licensee's business. As noted in the paper, the burden falls on those responsible for the relevant conduct, it is standard practice, and does not require new infrastructure or costs.[8]

The authors of the paper refer to several disadvantages especially relating to pay out of insurance claims. However, it should be noted that there are long-term market pressures at issue that mitigate these risks. The insured party needs to ensure that the contract is worded so that legitimate pay outs occur and that it remains viable. The insurer needs to remain viable as well, and retain its customers on an on-going basis. In addition, APRA has a role to oversee the insurers and thereby ensure that these businesses are managed so that legitimate claims are not denied or deferred to maintain solvency.

It should be a condition of the relevant Australian Financial Services Licence that the licensee maintain appropriate professional indemnity cover. The condition for PI cover should not prescribe limits or deductibles. This is because the insured are likely to have different limits and deductibles according to their size, and there is a risk that conditions could be unduly restrictive. Maintenance of PI insurance could be overseen by ASIC.

[8] Paragraph 174, pages 46-7.

Recommendation 4

Professional indemnity insurance should be required for financial service licensees who provide financial services to retail clients. The licence conditions should not prescribe limits or deductibles for this insurance.

Solvency Thresholds

A solvency threshold requirement is proposed as an alternative option in the discussion paper.[9] This requirement could be a condition of the relevant Australian Financial Services Licence. Maintenance of these requirements could be overseen by ASIC.

The chief advantage of solvency requirements is that it would effectively impose financial discipline upon licensees. They would need to proactively manage their businesses to remain solvent and able to pay compensation for losses occasioned in the provision of a financial service.

Solvency requirements would create compliance costs, which the reviewers are concerned would have an adverse effect on new entrants to the sector.[10] However, if a statutory compensation scheme, discussed above, involved levies, it could achieve the same exclusion.

Recommendation 5

Solvency requirements should be considered in addition to other measures as a means to reduce the risk of financial loss in the provision of a financial service.

Conclusion

Of the options listed in Chapter 11 of the Issues Paper, the Group believes option D is the most appropriate ie:

- market operators to have compensation arrangements (ie a continuation of the National Guarantee Fund and SFE Fidelity Fund for ASX and SFE participants);
- financial service providers to have professional indemnity insurance where possible and where not available, appropriate surety bonds;
- no broad statutory scheme.

If a scheme to compensate loss occasioned in the provision of a financial service were recommended, the Group submits that it should exclude conglomerates containing APRA-regulated bodies.

[9] Paragraph 57, page 20.

[10] Id.