The Institute of Chartered Accountants in Australia

15 November 2002

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

Dear Ms Smith,

Re: Compensation for Loss in the Financial Services Sector – Issues and Options

The Institute of Chartered Accountants would like to thank the Government for the opportunity to express its comments in relation to the paper referred to above.

In general, the Institute is in favour of there being mandatory compensation requirements for loss caused by a range of circumstances.

Our response to the issues paper is to look at the Principal and Secondary Issues as outlined in pages 3 – 5 in the issues and options paper.

PRINCIPAL ISSUES

It would be appreciated if, in responding to these questions, you particularly address the
costs and benefits of your suggestions to consumers, business, government and the community.

1. Can you provide any evidence of the nature and extent of losses suffered by consumers of financial services to assist us to understand the extent of the problem? (page 18)

   The Institute has not done any research in this particular area.

   High profile instances of consumers losing money from corporate misconduct have occurred in the last few years – for example, HIH and Commercial Nominees.

2. Is requiring compensation arrangements in the financial services sector justified? (page 27)

   Compensation arrangements are justifiable only if there is considered to be a hole in the myriad of mechanisms currently available to consumers to seek compensation for loss.

   The most common way that consumers seek compensation for loss is to make a complaint. In our view a case can be made for stating that there are currently too many avenues for consumers to make a complaint. Many of

these avenues can be used either simultaneously or one after another.

In other words consumers now have the capacity to continually complain about a particular issue to different bodies because all current complaint mechanisms operate independently of one another and none is able to make the other complaint avenues unavailable. Some consumers take advantage of their ability to do this.

The Institute believes it is important that consumers have an avenue to make a complaint where wrong has been done or caused by an AFSL, or their representatives. Further, the Institute believes that that avenue must be easy to access and provide for speedy resolution.

However there is a fine line between making such arrangements too easy or too difficult to access.

The Institute is of the view that there needs to be a review of all the various compensation/complaint mechanisms available to consumers. (Whilst we recognise that this particular current review is only about compensation arrangements, we consider it important to point out that at times the compensation / complaints regime, as a whole, can be extremely expensive and time-consuming for all licensees even where they are innocent.) For example a consumer can use the following avenues to seek redress:

- Internal dispute resolution system
- External dispute resolution system (for example, FICS, Banking Ombudsman)
- Industry body dispute resolution system (for example, the Institute provides a system whereby consumers can complain about the activities of an ICAA member[1])
- Industry Regulator
- Superannuation Complaints Tribunal (where relevant)
- Common law
- State-based small claims tribunals

3. What is the purpose of compensation arrangements which are required by legislation? (page 31)

The principal purpose of any compensation arrangements must be to ensure that the interests of consumers are protected.

A secondary purpose must be to ensure consumers continue to have confidence in the financial services industry as a whole including the regulatory frame-work which under-pins the industry.

[1] However we should point out that the ICAA complaints mechanism doesn't provide any avenue for compensation. The point is however that consumers can complain.

4. (a) In what circumstances should compensation arrangements be required in relation to a financial services licensee? (page 40)

Compensation should be required where negligence (in whatever form it takes) has led to loss by the consumer.

(b) Should different criteria or a different mechanism apply depending on whether the financial service provider is solvent or unable to pay/insolvent? (page 40)

Not necessarily. Ideally the same system should apply to ensure that the system is as simple as possible.

(c) Should compensation arrangements relate only to the situation where the financial services licensee is unable to pay/insolvent? (page 40)

Insurance is the best way to spread risk. Government should reform the laws where possible/necessary to ensure that it is available and affordable.

5. Who should be entitled to claim? (page 42)

It should not matter if the client is "retail" or "wholesale".

Financial services licensees

6. What compensation requirements should be imposed on financial services licensees? (page 48)

(a) Should financial services licensees be required to have professional indemnity insurance? Are there other appropriate mechanisms which could be alternatives at the option of the licensee? (page 48)

Professional Indemnity Insurance (PI Insurance): In August this year, the CEO of the ICAA, Mr Stephen Harrison, together with other Institute representatives gave evidence before the *Senate Economics References Committee's "Inquiry into the Impact of Public Liability and Professional Indemnity Insurance Cost Increases"*. Mr Harrison's opening remarks provide excellent back-ground on the views of the Institute regarding PI Insurance especially the fact that it is compulsory for members of the Institute who wish to hold a practicing certificate and that this requirement may not be able to continue if the current state of the PI Insurance market remains as it currently is for a number of years. Mr Harrison's opening remarks can be found in hansard[2].

PI Insurance is our preferred solution to this issue however the problems with the PI market make this difficult to mandate. Without reform to PI, its availability and affordability cannot be assumed therefore reform is needed.

Other alternatives: the Institute may be prepared to consider the

[2] http://www.aph.gov.au/hansard/senate/commttee/s5693.pdf

establishment of a compensation process that operates in a similar fashion to Part 23 of the *Superannuation Industry (Supervision) Act 1993* ("SISA").

The object of Part 23 of the SISA is to make provision for the grant of financial assistance for certain superannuation entities that have suffered loss as a result of fraudulent conduct or theft. The Minister responsible for the administration of this legislation is then required to determine if it is in the public interest to grant the financial assistance.

In the event assistance is granted under the SIS Act process then the Minister must also decide if the money is paid out of Consolidated Revenue or out of the Superannuation Protection Reserve (a reserve funded by a levy on certain super funds).

Subject to seeing final proposals and enabling legislation, the Institute believes that a similar frame-work, with important modifications, could potentially apply to entities licensed under Part 7 of the Corporations Act 2001.

(b) What should the mechanism adopted be required to cover? (page 51)

As noted above, compensation should be provided where a loss has occurred due to the negligent actions of an AFSL or their representative.

7. (a) What, if any, difficulties are being experienced in the financial services sector with the cost and availability of professional indemnity insurance? For example, is run-off cover available? (page 49)

Refer to our response to 6(a) above. We have recently conducted a survey of our members. Part of that survey dealt with PI Insurance and how the current market-place is impacting on our members. The results of the survey can be found our the Institute's website[3].

Additionally we would also like to refer you to our submission to the Senate Committee referred to in question 6(a). We have attached a copy of this submission for your reference.

(b) What, if any, difficulties have consumers had in being compensated from professional indemnity insurance policies? (page 49)

The Institute has no information in relation to this particular issue.

Market licensees

8. Should market licensees continue to be required to make compensation arrangements (as they have in the past and are in Part 7.5)? (page 58)

The Institute has no views in relation to this particular issue.

[3] http://www.icaa.org.au/news/index.cfm?menu=291&id=A105494295

9. Should prescribed CS (clearing and settlement) facility licensees be required to have compensation arrangements in relation to unauthorised transfers/certificate cancellation or some wider conduct? (page 60)

The Institute has no views in relation to this particular issue.

A broad statutory scheme?

10. Do the financial services industry and consumers consider that a broad statutory scheme is warranted? (page 62)

As per our answer to question 6 we may be willing to consider the merits in having a broad statutory scheme that is designed to provide some financial coverage in cases involving fraud or theft as currently occurs in the super industry.

11. If so:

(a) should it be available prior to insolvency or only on inability to pay/insolvency? (page 63)

The Institute does not believe that the scheme should be made available prior to insolvency but only on inability to pay/insolvency.

(b) on what grounds should claims be paid? (page 63)

If necessary, the scheme could be made available on a wider range of criteria than theft or fraud that applies to the super industry. (The ALP has proposed that the SIS Act compensation regime should be expanded to include "losses from in-house dealing and other breaches of the SIS Act".) The willingness of the ICAA to support this would very much depend on the eventual cost of such a scheme to industry participants.

SECONDARY ISSUES

If a statutory scheme were warranted

12. Who should operate the scheme? (page 70)

We believe ASIC should run the scheme in conjunction with other industry regulators and bodies.

13. What special governance and accounting requirements would be appropriate? (page 71)

The Institute believes that this issue would need to be addressed in detail once the specifics of a proposal have been set out.

14. Could the one scheme cover financial services in relation to all financial products and sectors of the industry? (page 72)

Ideally the scheme would cover the whole market.

15. If market licensees no longer had to make compensation arrangements, what should happen to the funds in the National Guarantee Fund and the exchange fidelity funds? (page 73)

The Institute has no views in relation to this particular issue.

16. How should it be funded initially and in the longer run? (page 75)

Ideally the scheme should be run using a levy which applies to all AFSLs.

17. What would be the appropriate powers of the operator? (page 76)

It would be fair to say that the Super Complaints Tribunal does not operate without controversy. (It is common for industry participants to perceive a bias in some of the SCT activities.) The ICAA would be keen for this to be avoided in any new scheme that is created.

Other issues

18. Should special provision be made for financial services licensees which are regulated by APRA, have high financial requirements or high market capitalisation, or have the requisite connection with such a body? (page 78)

Yes.

19. How should the loss be measured and should consequential loss be covered? (page 80)

The Institute believes that if you make the use of all financial products riskless to the end-user then they will act accordingly.

20. Capping:

(a) Should there be capping of the amounts paid in response to claims? (page 81)

The Institute believes that there should be some capping.

(b) If capping is accepted, what form would be appropriate? (page 82)

The ICAA believes that the Professional Standards Scheme a good model to apply.

21. What is the appropriate connection with Australia? (page 84)

The Institute has no views in relation to this particular issue.

22. What is the appropriate relationship between compensation arrangements and external dispute resolution schemes? (page 87)

Please refer to our views above.

23. Should excess funds in a statutory scheme be available for financial industry development purposes, or should there be mechanisms to discourage the build up of such excess funds? (page 88)

Excess funds, if they ever arise, should be used to reduce levies payable to operate the scheme in future years.

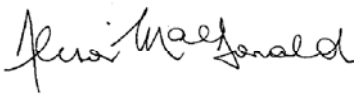
24. Should there be time limits for claiming and, if so, how should they be set? (page 89)

The Statute of Limitations should apply.

25. What is the appropriate level of detail in the legislation? (page 89)

The Institute believes that the scheme should be sufficiently robust and that ideally it should be statutorily based. The *Superannuation (Resolution of Complaints) Act 1993* provides a good basis.

Yours Sincerely,



Alison MacDonald
Manager Business & Practice Support