Compensation for Loss in the Financial Services Sector
Issues and Options

IFSA Response to Treasury Issues Paper

Introduction

The financial services regulatory regime has been considerably strengthened with a more rigorous conduct and disclosure regime applying across a wider range of services, under FSRA. ASIC has proven itself to be an effective regulator and consumer protection agency and consumers have been given access to cheap and effective remedial action through mandatory external dispute resolution (EDR).

The extent to which this, or any other, industry should provide access to pools of money for the purpose of underwriting losses occasioned by inappropriate conduct is really the main point at issue in this inquiry. Any such underwriting by industry, on behalf of consumers, can only be achieved at considerable expense, such expense ultimately to be borne by consumers themselves. It is important to remember that, ultimately, all compensation arrangements involve the underwriting by one group of consumers of the losses incurred by another group.

The extent to which compensation arrangements should be mandated so as to ensure availability of assets to meet claims resulting from licensee misconduct is considered below. IFSA has not addressed all issues/questions as raised by Treasury, only those which it considers most pertinent to this initial, high level review.

Question 1. What is the problem?

The issues paper identifies as a problem the fact that licensees do not always have assets to meet claims arising from losses which result from misconduct in providing services to consumers eg defrauding clients of their funds.

IFSA does not have in its possession information as to the size of this problem, although we are not convinced that it is sufficiently large as to jeopardise, much less threaten, consumer confidence in the financial services industry.

Evidence from ASIC relates to intermediaries who have defrauded clients, usually via the making of unauthorised investments. Very few securities dealers have gone into external administration in recent years although the number for insurance brokers is somewhat higher. ASIC has recovered significant funds for consumers (eg 10.6 million for improper advice). The problem appears to be small, therefore, in relation to levels of overall participation by consumers in the financial services market. This is not to say, of course, that the impact of losses occasioned by fraudulent activity on individual consumers is not significant.

Level 24, 44 Market Street, Sydney NSW 2000 Ph: 61 2 9299 3022
Email: ifsa@ifsa.com.au Fax: 61 2 9299 3198

Question 2. Is requiring compensation arrangements justified?

Responses to various developments in the financial services marketplace indicate that consumers and investors expect the financial services industry to provide a high degree of professionalism and honesty and, therefore, security for their funds. In IFSA's view, this expectation manifests itself mainly in consumer demands for rigorous and effective regulation of the financial services sector. Consumers expect that, with some diligence on their own part, the regulatory regime will enable them to select product and service providers with reasonable assurance that such providers will conduct themselves honestly and competently and be in a position to meet proven claims made against them where this is not the case.

While the integrity of the regulatory regime and its effective enforcement is the key element underpinning consumer confidence IFSA accepts, however, that maintenance of compensation arrangements can also play an important role in maintaining such confidence and, therefore, facilitating participation in the financial services market place. This is particularly true for the financial services sector where, due to the complexity of offerings, consumers may sometimes have difficulty in assessing the worth of those providing products and services, especially where long term financial viability of providers is critical.

Increased dependence by consumers on the financial services sector has undoubtedly heightened the need for strong and well-founded consumer confidence in financial services. IFSA believes that Australian consumers currently have such confidence and that insurance-based compensation arrangements have a role to play in maintaining such confidence.

Strong consumer protection under FSRA

Australia's conduct and disclosure regime for financial services providers is currently undergoing transition to the new requirements introduced in the Financial Services Reform Act (FSRA). This regime imposes rigorous requirements on the providers of financial services. These include transitional measures based on former licence requirements such as ASIC imposed licence conditions to the effect that licensees maintain professional indemnity insurance, security bonds and solvency margins commensurate with the activities carried out. Professional indemnity insurance in particular, notwithstanding the current hard market, has been proven in the case of insurance brokers to be an effective compensatory mechanism ever since being mandated in the Insurance (Agents & Brokers) Act in 1984.

ASIC also imposes financial requirements on licensees, for the purpose of ensuring that service providers have sufficient financial resources to conduct licensed activities in compliance with the Corporations Act.

The Treasury Issues Paper sets out the protection and avenues for redress provided to consumers of financial services by the law, together with some of the limitations of these (paras 49 – 52), especially in situations where the financial services licensee is insolvent (para53). These protections are comprehensive.

Level 24, 44 Market Street, Sydney NSW 2000 Ph: 61 2 9299 3022
Email: ifsa@ifsa.com.au Fax: 61 2 9299 3198

While the FSRA licensing regime, including the ASIC imposed transitional measures, in particular professional indemnity insurance, and the new financial requirements, do not operate as a comprehensive compensatory regime, it strongly underpins consumer safety by reducing the likelihood of losses through inappropriate conduct in the financial services sector and insuring against losses caused by professional misconduct. The protections and avenues for redress referred to above, particularly professional indemnity insurance, are expensive to maintain but do, in our view, serve the purpose of protecting consumers without exposing the system to moral hazard of the kind that would be promoted by the existence of a broad or unrestricted compensation scheme.

In IFSA's view, FSR strikes an appropriate balance for consumers, providing a secure, credible and stable environment for the provision of financial services while avoiding the unacceptable costs of, and moral hazard implicit in, a regime whose credibility rested too heavily on compensation arrangements.

Question 3. What is the purpose of compensation arrangements that are required by legislation?

IFSA agrees with the view expressed in the Issues Paper, viz. that the primary purpose is to ensure that assets are available to meet proven claims resulting from licensee or representative misconduct.

Question 4. In what circumstances should compensation arrangements be required and, if so, should criteria vary according to whether the licensee/provider is solvent or insolvent?

In IFSA's view compensation arrangements, in the form of professional indemnity insurance (PI), should be in place to ensure that a licensee is able to adequately compensate retail consumers for actual losses occasioned by inappropriate behaviour on the part of the licensee, where such behaviour is in breach of the licensees' legal obligations. That is, to provide reasonable assurance that funds will be available where the licensee is required to pay a claim.

Financial responsibility for the adverse consequences of inappropriate licensee behaviour must rest with the licensee, in accordance with the FSRA scheme of regulation. Licensee responsibility is the cornerstone of effective regulation under FSRA and any form of compensation arrangement which has the potential to undermine incentives to comply with the FSRA legal requirements, must be avoided. In other words the actual requirements of the Corporations Act are that "the licensee" and not the industry "must have arrangements for compensating" retail customers "for loss or damage suffered because of breaches of the relevant obligations" of the licensee (s912B(1))

The most appropriate and sustainable means of ensuring providers are able to pay compensation to retail consumers in such circumstances is through a regulated mechanism of professional indemnity insurance (PI).

Level 24, 44 Market Street, Sydney NSW 2000 Ph: 61 2 9299 3022
Email: ifsa@ifsa.com.au Fax: 61 2 9299 3198

Question 5. Who should be entitled to claim?

Retail clients of licensees.

Question 6. What requirements should be imposed? Should licensees be required to have PI cover? What should be covered?

In IFSA's view, compensation arrangements should be based on professional indemnity insurance.

A requirement for licensees to maintain a minimum level of PI insurance serves dual purposes. On the one hand it can provide retail consumers with a high level of assurance that, in the event of sustaining material financial damage due to behaviour which is in breach of a licensed providers' legal obligations, the financial resources to pay a successful proven claim, will be available regardless of the size and character of the service provider.

In addition PI insurance, which entails underwriting on the basis of the insurer's assessment of risk, will be priced accordingly, thereby providing an incentive to licensees to introduce and maintain comprehensive risk management systems. This is important, given that negligence related actions are likely to comprise a significant proportion of future claims against licensees. IFSA is strongly of the view that PI insurance, subject to our comments below on conglomerates, is the only viable basis for compensation arrangements with respect to negligence based claims.

While the Corporations Act requires that "arrangements will continue to cover persons after the licensee ceases carrying on the business of providing financial services, and the length of time for which that cover will continue" (s912B(3)(b)) there are acknowledged difficulties with 'Run Off Cover' which will need to be worked through. Nevertheless PI continues, in our view, to be the most appropriate compensation mechanism to meet licensees' obligations.

We are also of the view that consideration should be given to highly capitalised conglomerates with a capacity to either self insure to the statutory limit of PI or maintain large deductibles. This would be particularly appropriate for conglomerates where one or more licensees are also APRA regulated. Such organisations typically include banking and insurance groups with robust risk management systems, high PI levels of cover with substantial excess limits due to their financial capacity and who would have no difficulty in meeting any award made for compensation to a retail customer by an External Dispute Resolution scheme.

Negligence based claims

Given the nature of the services provided by the majority of licensees in the financial services sector and the potential for disappointment on the part of individual consumers, it seems reasonable to assume that a very high proportion of future claims against licensees will be negligence based.

Consumer expectations with regard to investment advice, in particular, will in many cases inevitably be disappointed during market downturns, causing individuals to seek

Level 24, 44 Market Street, Sydney NSW 2000 Ph: 61 2 9299 3022
Email: ifsa@ifsa.com.au Fax: 61 2 9299 3198

to pinpoint blame and liability for compensation purposes. This is likely to translate, in turn, to efforts to extend the coverage of negligence laws to encompass a wider range of behaviours and situations. As with personal injury claims, extension of liability for negligence to an ever – widening range of circumstances could severely test the willingness of the community to contribute to a pool of money for the purpose of protecting those who are less than diligent.

Governments in Australia are already aware of the systemic strains caused by courts extending the coverage of negligence laws for the purpose of ensuring the provision of adequate compensation to accident victims. In the financial services context, trends such as those that have manifested themselves in relation to personal injury claims could have catastrophic consequences for service providers, the regulatory regime and consumers themselves.

Basing compensation arrangements, especially for negligence related claims, on PI insurance will ensure that the regime provides incentives for providers to maintain best practice risk management regimes. Underwriters will be diligent in supervising and enforcing high standards, ensuring that only those providers who maintain high standards will be eligible for cover. Providers, other that conglomerates mentioned above, unable to secure PI cover will not be licensed, thereby ensuring that consumers are not exposed to situations whereby, in the event of a proven claim, funds will be unavailable.

Regime should allow self insurance by licensees

As detailed above it is important that an insurance based compensation regime provide sufficient flexibility to allow substantial service providers to self insure to varying degrees, where they are able to demonstrate they have the resources.

Coverage of PI based compensation arrangements

IFSA sees no in-principle objection to PI based compensation arrangements covering the full spectrum of risks to which licensees are exposed. That is, PI based arrangements should cover licensees against successful claims against them with regard to all the activities they undertake within their licence, including negligence, fraud and dishonesty.

With regard to the exact nature of a mandatory PI based compensation regime, IFSA would expect to make further submissions at a later date. There will be many detailed issues to consider, including the rights and obligations of insurers in any scheme which mandates cover, especially if the regime extends to mandating terms of cover.

Special consideration will also be required with respect to certain types of APRA regulated entity, in light of the consumer protection requirements that apply to such entities.

Compensation arrangements must be aligned to activities undertaken

Compensation arrangements, if they are to be fair in application, must be closely aligned to the level of risk related to the activities covered. That is, they should not

Level 24, 44 Market Street, Sydney NSW 2000 Ph: 61 2 9299 3022
Email: ifsa@ifsa.com.au Fax: 61 2 9299 3198

simply be 'deep pocket' solutions whereby large, soundly run market participants are forced by virtue of their higher levels of capitalisation, to underwrite failures by other market participants. In achieving the aim of aligning compensation arrangements with risk levels, therefore, our view is that an insurance based scheme is most likely to be effective in this regard.

External Dispute Resolution

As far as remedies for inappropriate conduct are concerned, retail consumers now have universal access to free external dispute resolution (EDR) for the purpose of resolving individual complaints with licensees. Mandatory membership by licensees of EDR schemes enables consumers to pursue financial claims without having to engage legal resources or suffer the consequences of delays in the courts.

In IFSA's view, this mechanism compliments PI insurance as the principal basis for compensation arrangements under FSRA.

Question 10. Is a broad statutory compensation scheme warranted?

In IFSA's view, such a scheme is not warranted. A limited scheme may be warranted, however, to deal with certain situations (see below).

Special compensation arrangements where licensee insolvent

IFSA expects that arguments will be advanced in favour of a limited compensation scheme to deal with circumstances where PI based compensation arrangements are considered to be inadequate on their own – some may insurance based compensation arrangements as in need of supplementation in certain circumstances where consumers might otherwise have to bear personally catastrophic losses. The most obvious example of such a situation might be where a licensee is insolvent and has failed to maintain the required PI cover or where a principal of a licensee engages in uninsurable activities such as fraud.

While IFSA does not support the introduction of even a 'limited scheme' for compensation, it is cognisant of the fact that there may be many different views in this area. IFSA would, therefore, be prepared to engage in discussion of such an option if it can be demonstrated that the quantum of losses in such circumstances justify such an expensive 'solution'.

For reasons of cost and viability the objectives of any such scheme were it to be seriously considered, would have to be very limited by comparison with the PI based arrangements. Unless constrained to very limited circumstances, a minimum 'safety net' scheme would bring with it unacceptable moral hazard and huge potential to undermine both the industry and the regulatory regime. A scheme must, therefore, be clearly limited to claims against client assets and must, equally clearly, not apply to negligence based claims, whether in respect of financial product advice or the operations of managed investment schemes.

With respect to managed investment schemes, in particular, responsible entities are currently required to maintain PI insurance, including cover for fraud and losses

Level 24, 44 Market Street, Sydney NSW 2000 Ph: 61 2 9299 3022
Email: ifsa@ifsa.com.au Fax: 61 2 9299 3198

caused by misconduct. It would be neither appropriate nor viable for a 'safety net' compensation scheme to cover losses occasioned by the collapse of a managed investment scheme, given the likely size of claims, in totality, relative to the size of the payment pool.

In IFSA's view, consideration of a 'safety net' scheme should only be in the context of very limited circumstances, where all of the following criteria are met;

- The defaulting provider holds an AFSL – it is not difficult for consumers to ensure that the entities or individuals with whom they choose to deal are licensed (or authorised) and consumers must take at least this much responsibility for conducting their financial affairs with some diligence. In addition, it would be entirely unfair to impose a compensation burden with respect to all potential 'providers', licensed or otherwise, on licensees;
- The licensee is insolvent or unable to pay;
- The claim is proven and all avenues for redress from the licensee have been exhausted;
- The consumer loss is with respect to money which has been entrusted to the licensee and it is proven that the licensee has dishonestly misappropriated, misused or misapplied such monies;
- Compensation for loss is capped.

Level 24, 44 Market Street, Sydney NSW 2000 Ph: 61 2 9299 3022
Email: ifsa@ifsa.com.au Fax: 61 2 9299 3198