



ASIC

Australian Securities & Investments Commission

Review of the financial system external dispute resolution framework

ASIC's response to supplementary issues paper

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Background

- 1 In April 2016, the Government announced a review of the financial system external dispute resolution (EDR) framework.
- 2 The original terms of reference directed the [panel](#) (comprising Professor Ian Ramsay as Chair and Julie Abramson and Alan Kirkland as members) to make observations on the establishment of a statutory compensation scheme of last resort.
- 3 In the [Interim report: Review of the financial system external dispute resolution and complaints framework](#), released on 6 December 2016, the panel observed at p. 23 that:
 - in circumstances where the market is unable to provide a solution to [the problem of uncompensated consumer losses], ... there is considerable merit in introducing an industry-funded compensation scheme of last resort.
- 4 In February 2017, the Australian Government amended the review's terms of reference to require the panel to:
 - (a) make recommendations (rather than merely observations) on the establishment, merits and potential design of a compensation scheme of last resort; and
 - (b) consider the merits and issues involved in providing access to redress for past disputes.

Note: See Treasury, [Amendment to terms of reference of the external dispute resolution review](#), media release, 3 February 2017.
- 5 In response to the amended terms of reference for the review, the panel issued [Supplementary issues paper: Review of the financial system external dispute resolution framework](#) (supplementary issues paper) on 31 May 2017, which sought the views of interested stakeholders regarding a compensation scheme of last resort and the provision of access to redress for past disputes.
- 6 This submission contains ASIC's response to the issues and questions raised in the supplementary issues paper.

A Overview of our positions

Key points

A compensation scheme of last resort is critical to protecting consumer trust and confidence in the EDR framework and the financial system.

While we support the introduction of a broad-based compensation scheme of last resort, we think it is essential that a scheme be introduced now to cover, at least, prospective unpaid determinations relating to financial advice. Such a scheme should also:

- cover consumer and small businesses;
- be established under legislation;
- compel licensee participation in the scheme (with that compulsion underpinned by a legislative requirement);
- be funded by industry, but independent of industry; and
- cover EDR, court and tribunal decisions.

Individual licensees and sectors should be encouraged by the panel to develop their own approaches to providing access to redress for past matters. As has been done in the past, licensees may choose, for example, to waive relevant jurisdictional limits.

To monitor the scope of professional indemnity (PI) insurance coverage, particularly in the context of the introduction of a compensation scheme of last resort, we consider that licensees should provide ASIC with data about their PI insurance on an ongoing basis.

Introduction

- 7 Financial products are essential for participation in the modern economy. The vast majority of consumers in Australia have a bank account, superannuation is compulsory for those in the workforce, and most people have insurance for their cars, their homes and their lives. Yet financial products are inherently complex, and often require consumers to make important decisions involving risk and uncertainty.
- 8 Financial products represent extreme examples of 'credence goods', where the performance and quality of the good is not apparent even after purchase (and, in many cases, not apparent for decades after purchase). This means that assessing quality can be very difficult for consumers
- 9 Many financial products, especially investment products, are also purchased infrequently and so provide limited opportunity for feedback and learning. Some include critical long-term promises to the purchaser (e.g. insurance) and often involve significant sums of money.

- 10 Furthermore, the nature of many financial products and services, including the timing mismatch between purchase and identifying a problem, means that if things go wrong, the consequences for the consumer can be more severe than for most other purchases.
- 11 These are some of the reasons why having an efficient and effective EDR and compensation framework is integral to promoting consumer trust and confidence in the Australian financial services system.
- 12 Indeed, the first EDR schemes were developed by the financial services sector itself, in order to promote consumer trust and confidence and in recognition of the fact that consumers faced considerable barriers to pursuing disputes through the court system. These barriers include:
- (a) the significant costs of pursuing legal action; and
 - (b) the asymmetry in information and resources that generally exist between financial services and credit providers and their clients and consumers.
- 13 Following the 1997 Financial System Inquiry (Wallis Inquiry), reforms were introduced that mandated membership of an ASIC-approved EDR scheme for financial service and product providers. These reforms provided very large numbers of consumers with access to justice and the provision of compensation and redress.
- 14 The Australian EDR framework, which ASIC has worked to shape, is widely regarded as one of the best in the world and has responded effectively to incidents ranging from the global financial crisis to natural disasters.
- 15 However, the EDR framework has a significant structural gap—there is no mechanism to ensure that consumers receive compensation in circumstances where the AFS licensee or credit licensee (licensee) lacks the financial resources to pay an EDR determination.

Compensation scheme of last resort

- 16 The value of unpaid EDR determinations as reported by the two ASIC-approved EDR schemes (the Financial Ombudsman Service (FOS) and the Credit and Investments Ombudsman (CIO)) is currently \$14,324,078.50¹. Uncompensated consumer loss threatens to:
- (a) undermine trust and confidence in the effectiveness of the EDR framework and the financial system more generally; and

¹ FOS Circular, April 2017: unpaid FOS determinations total \$13,909,635.50. [Interim report: Review of the financial system external dispute resolution and complaints framework](#), released on 6 December 2016, p. 165: unpaid CIO determinations total \$414,443 as at 1 November 2016.

- (b) impose costs on the wider Australian community e.g. if individuals are forced to rely on other forms of financial support, including the social security system.

17 A number of inquiries have considered the problem of unpaid determinations without resolving it: see the appendix to this submission. The review panel now has an opportunity to propose a solution to this longstanding problem in light of:

- (a) The review's broad mandate to consider changes to Australia's EDR framework to ensure that it effectively meets the needs of users of financial services.
- (b) The proposed introduction of a single EDR scheme, the Australian Financial Complaints Authority (AFCA). A single scheme, rather than multiple schemes, provides a better foundation from which to address prospective unpaid determinations.
- (c) The shift in regulatory philosophy towards industry funding, where industries pay for the regulation that they generate. The introduction of an industry-funded compensation scheme of last resort is consistent with this shift. That is, those sectors that generate unpaid determinations and will benefit from their resolution—in the form of enhanced consumer trust and confidence—should contribute to the payment of those determinations.
- (d) Growing industry consensus (as shown by, for example, the Australian Bankers Association's proposal for a compensation scheme of last resort) that a solution to unpaid EDR determinations is necessary to build trust and confidence in the EDR framework and the financial system more generally.

AFCA

In May 2017, the Australian Government released the panel's [Final report: Review of the financial system external dispute resolution and complaints framework](#), as well as the Government's response to the final report (see The Hon. Scott Morrison MP, [Building an accountable and competitive banking system](#), media release, 9 May 2017).

The panel's central recommendation (which the Government accepted) was to establish a single EDR body—AFCA—for all financial disputes, including superannuation disputes.

AFCA will replace the Financial Ombudsman Service, the Credit Investments Ombudsman and the Superannuation Complaints Tribunal.

18 We consider that a collective solution is required to respond to the growing number of unpaid determinations.

19 We support the introduction of a broad-based compensation scheme of last resort that addresses uncompensated losses across the EDR jurisdiction. However, we consider it essential to now introduce a scheme that addresses, at least initially, the area of acute need—that is, unpaid determinations concerning financial advice.

20 Of those firms that have failed to pay FOS determinations, 53% of them are financial planners and advisers. The next largest categories are operators of Managed Investment Schemes at 13% and credit providers at 11%. While only a very small percentage of all EDR scheme members leave unpaid determinations, they represent more than 18% of all accepted determinations issued by FOS in favour of consumers in their Investments and Advice team. As a proportion of total compensation awarded by that team, the value of unpaid determinations is 24.8%

21 In light of these considerations, we think that an important first step is to introduce a compensation scheme of last resort which:

- (a) covers unpaid determinations concerning financial advice.

Note: We anticipate that such a scheme would be scalable—that is, its coverage, powers and operation could be effectively extended in the future to deal with broader types of losses.

- (b) is prospective (i.e. open to claimants who in the future receive a decision in their favour, but which is not ultimately paid, rather than claimants with a legacy uncompensated loss);
- (c) covers consumers and small businesses;
- (d) is established under legislation;
- (e) compels licensee participation in the scheme (with that compulsion underpinned by a legislative requirement);
- (f) is funded by industry, but independent of industry; and
- (g) covers EDR, court and tribunal decisions.

22 Ideally the establishment of any compensation scheme of last resort would include a mechanism for addressing legacy uncompensated loss. However, we acknowledge the challenges associated with this issue including, for example:

- (a) *funding*—who pays for these losses? Currently, legacy uncompensated loss stands at \$14,324,078.50 (see paragraph 16). However, this figure understates the actual value of all uncompensated loss. It does not, for example, include the losses referred to in subparagraph (b) below.
- (b) *equity*—which claims should be included? Arguably, claims that were lodged at an EDR scheme and abandoned because of the insolvency of the financial firm should also be automatically eligible for

consideration. However, the inclusion of this category of claims would raises difficult questions about how to assess the merits of those claims.

- 23 We have discussed some of the issues associated with the introduction of a compensation scheme of last resort in more detail in Section B.

Access to redress for past disputes

- 24 We agree with the panel that:
- ‘Consumers and small businesses that have obtained a decision from any dispute resolution process (including from a tribunal or court) have had access to redress and therefore are outside the Review’s amended Terms of Reference’²
- 25 We also consider that that access to redress should not be available to consumers and small businesses with disputes that, under the law that existed at the time of the dispute, a legal entitlement to a remedy did not exist.
- 26 As the panel observed in the [supplementary issues paper](#), ‘[t]he question of providing access to redress for past disputes is very complex’ (paragraph 34). This complexity is due, in part, to the significant variation in the nature and scale of past disputes against licensees. For this reason, we suggest that the panel encourage individual entities to develop their own approach to providing access to redress for past disputes.
- 27 Licensees have effectively done this in the past by permitting access to remediation schemes and to EDR schemes, through waiving jurisdictional limits (including time and monetary limits). The current industry-based EDR scheme rules expressly permit parties to a dispute to agree to waive jurisdictional limits to enable the EDR scheme to hear the dispute.
- 28 There is also merit in approaching access to redress for past matters at a sector level. For example, we welcome Westpac’s proposal for a ‘bank-related past issue forum’.
- 29 If late or extended access to redress is to be offered beyond individual and industry sector concessions, we consider that that the criteria for access should be:
- (a) *clear*—Consumers should be clear about the criteria to be applied in determining whether a matter is eligible for redress.
 - (b) *fair*—The criteria applied in determining whether a matter is eligible for redress should be fair.

² paragraph 35 of the [supplementary issues paper](#)

- (c) *certain and consistent*—The criteria for eligibility should be consistently applied and not be arbitrarily changed to accommodate certain classes of consumers or small business.

PI insurance—Collection of data by ASIC

- 30 PI insurance is an essential component of the compensation framework and a 'first line of defence' against uncompensated loss.

PI insurance requirements

Licencees must have adequate arrangements for compensating retail clients and consumers for loss or damage due to breaches of the financial services or credit laws.

The Corporations Regulations 2001 (Corporations Regulations) and National Consumer Credit Protection Regulations 2010 mandate that the key form of compensation a licensee must have is an acceptable contract of PI insurance.

[Regulatory Guide 126 Compensation and insurance arrangements for AFS licencees](#) (RG 126) and [Regulatory Guide 210 Compensation and insurance arrangements for credit licencees](#) (RG 210) discuss the key features a PI insurance policy must have for it to be 'acceptable'.

Generally, licencees' PI insurance cover must:

- be adequate, taking into account the licensee's business (the volume of business, the number and kinds of clients or consumers, the kind of business and the number of representatives) and the maximum liability to compensation claims that realistically might arise;
- cover EDR scheme awards;
- cover fraud or dishonesty by directors, employees, other representatives and other agents of the licensee; and
- have a limit of at least \$2 million for any one claim, and in the aggregate for licencees with total revenue from financial services or credit provided to retail clients and consumers of \$2 million or less.

- 31 A compensation scheme of last resort is not intended to replace PI insurance but to complement it. PI insurance must remain the 'first line of defence' so that any scheme is truly a 'last resort' for uncompensated loss.
- 32 If a compensation scheme of last resort is introduced, we think that there is merit in considering whether those licencees that rely on PI insurance to meet their licensing obligations should provide ASIC with data about their PI insurance on an annual, ongoing basis.
- 33 This data would be used to monitor the scope of professional indemnity (PI) insurance coverage, particularly in the context of the introduction of a

compensation scheme of last resort. The data may also be used to better perform our role as a risk-based regulator. For example, decisions about surveillance targets may be informed by the PI insurance coverage of particular industries and entities.

34 We contemplate that any data collected would be submitted in digital format and we would consult about the most cost effective way to do this.

35 This data may include, for example:

- (a) the insurer's name;
- (b) the level of cover;
- (c) the amount of the excess; and
- (d) whether any PI insurance claims have been paid in the previous year.

36 In considering whether licensees should provide data about PI insurance to ASIC on an annual basis, we note that—other than in the context of a specific surveillance action—ASIC currently only collects information about a licensee's PI insurance at the time of licence application.

Collection of PI insurance data: Current arrangements

Before granting an AFS licence, we ask licence applicants to certify that they have PI insurance that meets our minimum requirements. As part of this process, the information we collect includes:

- the name of the insurer;
- whether the policy covers fraud of representatives, employees and agents;
- the amount of cover;
- whether the policy covers legal costs in addition to the amount paid out as a result of a successful claim;
- the amount of the excess;
- whether the licensee considers that it has the financial resources necessary to cover the excess and any gaps in cover.

This information enables ASIC to prevent an applicant from obtaining a licence where their PI insurance is manifestly inadequate. Beyond this initial information-gathering process, ASIC does not routinely collect information about PI insurance from licensees. This has led to—as noted by the panel in the [supplementary issues paper](#)—‘a paucity of data about the professional indemnity insurance market, in particular, the policies held by financial services licensees and credit licensees’ (paragraph 60).

37 For the avoidance of doubt, the purpose of this data collection would not be to assess the adequacy of the PI insurance coverage of individual firms. Such an assessment would require ASIC to collect more detailed information about all aspects of the firm, and to in effect ‘step into the shoes of management’.

B Compensation scheme of last resort

Key points

While we support the introduction of a broad-based compensation scheme of last resort, we think it is essential that a scheme be introduced now to cover, at least, prospective unpaid determinations relating to financial advice.

Such a scheme should also:

- cover consumer and small businesses;
- be established under legislation;
- compel licensee participation in the scheme (with that compulsion underpinned by a legislative requirement);
- be funded by industry, but independent of industry; and
- cover EDR, court and tribunal decisions.

- 38 We agree with the panel's assessment that a compensation scheme of last resort should be triggered where:
- (a) a dispute has been the subject of a decision and compensation order; and
 - (b) that compensation order has remained unsatisfied because, for example, the firm is insolvent, has ceased trading or otherwise has insufficient assets to pay the claim.

Type of claims

Question 17: What types of claims should be covered by any compensation scheme of last resort?

- 39 As set out in paragraphs 19 and 21, while it would be desirable to introduce a broad-based compensation scheme of last resort that addresses uncompensated losses across the EDR jurisdiction, we consider it essential to introduce a scheme that addresses, at least initially, the area of acute need; that is, unpaid determinations concerning financial advice.
- 40 Such a scheme should be designed to be scalable—that is, its coverage, powers and operation could be effectively extended in the future to deal with broader types of losses and additional funding entities.

Access to the scheme

Question 16: Who should be able to access any compensation scheme of last resort? Should this include small business?

- 41 Retail and small business consumers should be able to access a compensation scheme of last resort. Definitions of these categories should be aligned with the definitions that will be applied by AFCA.

Question 19: What steps should consumers and small businesses be required to take before accessing any compensation scheme of last resort?

- 42 Consumers and small businesses should meet qualifying criteria before being able to access a compensation scheme of last resort. The process and means by which they satisfy these criteria should be as 'frictionless' as possible. The criteria may include, for example:
- (a) a consumer or small business receiving a determination from AFCA (or a court judgment or tribunal determination) in their favour; and
 - (b) AFCA certifying that the relevant firm is insolvent, has stopped trading or has insufficient assets to meet the claim against it.
- 43 The qualifying criteria should support the principles guiding the review. In particular, they should promote:
- (a) *efficiency*—Compensation should be paid in a timely and efficient way, subject to time limits. This has advantages for those licensees who participate in the scheme; for example, increased industry certainty around funding. Consumers and small business will also benefit, particularly in circumstances where they are suffering financial hardship.
 - (b) *equity*—Consumers should be able to easily access the scheme and should not, for example, need legal advice or representation to do so.

Court judgments and tribunal decisions

Question 18: Should any compensation scheme of last resort only cover claims relating to unpaid EDR determinations or should it include court judgments and tribunal decisions?

Question 21: If a compensation scheme of last resort was established and it allowed individuals with a court judgment to access the scheme, what types of losses or costs (for example, legal costs) should they be able to recover?

44 An initial, limited compensation scheme of last resort should cover financial advice related claims resulting in unpaid AFCA, court and tribunal³ determinations. The scheme should only pay for direct financial loss.

45 This approach would support:

- (a) the broader philosophy of the EDR framework, the purpose of which is to provide a free, efficient and accessible alternative to going to court;
- (b) greater funding certainty for contributing licensees, by excluding claims outside the EDR jurisdiction; and
- (c) the broader policy goal of building trust and confidence in the EDR framework in particular.

46 It would also avoid unduly distorting individual decisions about the forum in which to pursue a claim (i.e. AFCA, court or tribunal).

Question 22: Should litigation funders be able to recover from any compensation scheme of last resort, either directly or indirectly through their contracts with the class of claimants?

47 We understand this question to be directed at concerns that litigation funders will fund court action on behalf of one or more claimants (noting that litigation funders are increasingly funding individual actions, as well as class actions) and then access a compensation scheme of last resort to recover a compensation award by a court.

48 Claimants who choose to pursue their dispute in court are often unable to fund that action because of the financial loss they have suffered as a consequence of misconduct by licensees. In these circumstances, claimants' access to justice is dependent on:

- (a) a litigation funder underwriting their legal costs (including an award of costs against them); or
- (b) a law firm prosecuting the claim on a 'no-win, no-fee' basis.

49 On this basis, it is difficult to argue that consumers should be precluded from accessing a compensation scheme of last resort if they have chosen to pursue their claim with the assistance of a litigation funder (or a law firm operating on a 'no-win, no-fee' basis).

Independent review of decisions

Question 20: Where an individual has received an EDR determination in their favour, should any compensation scheme of last resort be

³ Assuming that a formal merits assessment of the dispute has been undertaken by the tribunal.

able to independently review the EDR determination or should it simply accept the EDR scheme's determination of the merits of the dispute?

- 50 A compensation scheme of last resort should not be required to independently review AFCA's determination. To do so would add a layer of decision making into the EDR framework that:
- (a) is unnecessary, given the accountability mechanisms that AFCA will be subject to, including:
 - (i) the appointment of independent assessors to reviews complaints about dispute handling generally;
 - (ii) a licensee's right of appeal to a court if AFCA's decision is 'one to which no reasonable tribunal could properly come on the evidence'⁴;
 - (b) may lead to perverse outcomes, where licensees who fail to pay an AFCA compensation award are able to access (through the scheme) a merits review which is not available to licensees who do pay;
 - (c) would delay the payment of compensation to consumers and small businesses, which may compound the financial hardship and emotional distress that they experience; and
 - (d) would add substantially to the costs of the scheme, which costs would be borne by industry in the first instance

Administration

Question 28: Should any compensation scheme of last resort be administered by government or industry? What other administrative arrangements should apply?

- 51 Membership of and contribution to a compensation scheme of last resort should be mandatory for the selected licensee group. and should be imposed via legislation
- 52 Governance of the scheme could be similar in key respects to AFCA and it is possible that the scheme could achieve cost efficiencies by leveraging from AFCA's administration systems and infrastructure.
- 53 ASIC should have an oversight role of the scheme to ensure that it is functioning adequately to fulfil its objectives, similar to the role that is envisaged for ASIC in respect of AFCA.

⁴ *Cromwell Property Securities Limited v Financial Ombudsman Service Limited & Ors* [2014] VSCA 179

Funding

Question 24: Who should fund any compensation scheme of last resort?

Question 25: Where any compensation scheme of last resort is industry funded, how should the levies be designed?

- 54 A compensation scheme of last resort should be funded by those sectors of the financial services industry that have clients who can be compensated by the scheme.
- 55 This is consistent with our position (see paragraph 17(c)) that those sectors that generate unpaid determinations and will benefit from their resolution—in the form of enhanced consumer trust and confidence—should contribute to the payment of those determinations. As the financial adviser professionalism, education and ethical standards reforms take effect over time, we expect that the funding costs for the scheme will decrease.
- 56 Details about the funding of the scheme will be shaped by decisions about the scope of the scheme. We think, though, that the levies should be designed in a manner consistent with the principles guiding the review. In particular, they should promote:
- (a) *transparency and accountability*—The calculation of levies should be transparent and publicly available; and
 - (b) *equity*—The design and imposition of levies should be fairly distributed among participants of the scheme.

Failure to pay an EDR determination

Question 26: Following the payment of compensation to an individual, what rights should a compensation scheme of last resort have against the firm who failed to pay the EDR determination?

- 57 After compensating a consumer or small business, a compensation scheme of last resort should have the right to recover that compensation on a subrogated basis (i.e. it will pay the consumer or small business and then assume their rights and duties regarding the compensation to recover those costs).

Question 27: What actions should ASIC take against a firm that fails to pay an EDR determination or its directors or officers?

- 58 Under Australia's current AFS and credit licensing regimes, licensees that deal with retail clients or engage in regulated credit activities must be a member of an ASIC-approved EDR scheme.

59 Currently, if a licensee fails to pay an EDR determination, the EDR scheme may terminate that licensee's membership of the scheme.

NB: The EDR scheme may choose not to terminate a licensee's membership for non-payment of a determination because, for example, the licensee has current disputes with other customers.

60 If an EDR scheme terminates a licensee's membership, ASIC may take administrative action to remove the licence of the entity in question. If ASIC removes the licence of an entity, this effectively terminates the business of the entity—and, potentially, any PI insurance policies held by the entity.

61 This underscores the need for more effective mechanisms to address the issue of unpaid EDR determinations. Those mechanisms should include not only the establishment of a compensation scheme of last resort but also new powers to enable ASIC to ban individuals from managing financial firms (as recommended by the Financial System Inquiry: see recommendation 24).

Moral hazard

Consumer moral hazard

Question 8: What potential impact would a compensation scheme of last resort have on consumer behaviour in selecting a financial firm or making decisions about financial products?

62 We understand this question to be directed at concerns about 'moral hazard'—in essence, that consumers will be encouraged by the existence of a compensation scheme of last resort to take investment or financial risks that they would otherwise not take.

63 We think that these concerns are unfounded for the following reasons:

- (a) **Selecting a financial firm:** Consumers do not have the ability to identify which financial firms are more or less likely to become insolvent. And even if they did, the prospect that they would choose to engage with that firm—on the basis that they would be compensated by a scheme of last resort—is remote. This is particularly so given the necessary steps involved in accessing the scheme (e.g. only after internal dispute resolution, EDR). These steps are 'frictions', meaning that the consumer would pay a significant personal cost in the form of time and effort in their pursuit of compensation.
- (b) **Decisions about financial products:** Consumers currently bear the risk of investment losses if they choose to purchase risky financial products; EDR schemes cannot make awards to consumers to compensate them for investment losses; and this would not provide a basis upon which to access a compensation scheme of last resort. An EDR scheme can only

make an award where it finds that financial losses are attributable to licensee misconduct.

64 The consumer moral hazard argument is based in traditional economic theory, which assumes that individuals are rational actors who will read, understand and accurately assess all information and consider the entire lifecycle of a transaction and its probable consequences at the point of entry.

65 This model of consumer behaviour conflicts with evidence that humans are not perfectly rational actors, but are influenced by a number of biases and other factors that can change from decision to decision, depending on the context (particularly the choice environment). In the particular context of financial advice, we note also that consumers generally seek financial advice to reduce risk, not increase their exposure to it.

66 Given this understanding of consumer behaviour, the concern that consumers will base their decisions about financial firms and financial products on the existence of a compensation scheme is unfounded.

Licensee moral hazard

Question 9: What potential impact would a compensation scheme of last resort have on the operations of financial firms?

67 We similarly understand this question to be targeted at whether, for individual financial services providers, a compensation scheme of last resort might encourage a careless approach to compliance and the advice that they provide, on the understanding that their clients will be compensated should something go wrong.

68 Although there may be a risk that the behaviour of some licensees could be influenced by the existence of a compensation scheme, we consider it to be a small risk, given that:

- (a) Licensees are subject to the financial services laws regulated by ASIC. A consumer will generally only seek access to a compensation scheme as a result of a licensee breaching the financial services laws. The substantial cost of possible regulatory and enforcement action against a licensee is a significant disincentive for poor compliance.
- (b) Licensees must have their own compensation arrangements that would need to be exhausted prior to accessing a compensation scheme.

69 However, it is important to ensure that any scheme is genuinely one of 'last resort'. PI insurance and the financial resources of the firm must be exhausted before access to the compensation scheme of last resort is granted.

Competition

Question 10: Would the introduction of a compensation scheme of last resort impact on competition in the financial services industry? Would it favour one part of the industry over another?

- 70 We consider that the introduction of a compensation scheme of last resort, including a limited financial advice related scheme, may have a positive effect on competition. Currently, prudentially regulated institutions can be perceived to have a competitive advantage over institutions that are not, as prudentially regulated institutions have an enhanced capacity to meet EDR (or court or tribunal) compensation orders up to the maximum amount payable, and where there are multiple claimants. This is not always the case with non-prudentially regulated entities.
- 71 The introduction of a compensation scheme of last resort may reassure consumers that, in the event that they are awarded a compensation order against a non-prudentially regulated institution, they will be paid. In this way, the introduction of a compensation scheme of last resort will 'level the playing field'.
- 72 It is arguable that the collection of levies from firms participating in a compensation scheme of last resort might:
- (a) represent a barrier to entry; and/or
 - (b) cause some firms to exit the market.
- 73 However, we consider this would be justified on the grounds that the introduction of a compensation scheme of last resort will promote trust and confidence—and therefore consumer participation—in the financial system.

Complementary measures

PI insurance

- 74 PI insurance is an essential component of the compensation framework and a 'first line of defence' against uncompensated loss. However, given the role PI insurance plays in the Australian EDR and compensation framework for the financial services and credit industries, it is important to recognise its limitations as a consumer protection mechanism.
- 75 PI insurance is designed to protect licensees against business risk, and not to provide compensation directly to investors and financial consumers. It is a means of reducing the risk that a licensee cannot pay claims because of insufficient financial resources; however, it has some significant limitations, many of which have been identified by stakeholders responding to the

panel's [Issues paper: Review of the financial system external dispute resolution framework](#) (released on 6 September 2016).

- 76 The limitations include:
- (a) the total funds available under a policy may not cover all of the compensation awarded against the licensee;
 - (b) the policy may not cover the conduct that gave rise to the order for compensation;
 - (c) the amount of compensation payable may be less than the policy's excess, or the excess payable may be too high for a licensee to meet;
 - (d) a licensee may be in breach of its contractual obligations under the policy (e.g. failing to take reasonable steps to lessen liability in relation to a claim);
 - (e) a claim may be made after the cancellation of an insolvent licensee's policy (and automatic run-off cover is not generally available); and
- Note: Generally, a licensee will be required to notify its insurer if it becomes insolvent; in many cases, the insurer will then cancel the insurance policy.
- (f) a claim may be made after the licensee has failed to renew its policy or pay premiums.

77 These limitations cannot be overcome by more intensive, ongoing monitoring by ASIC; however, we consider that there is merit in exploring the prospect of licensees providing ASIC with data about their PI insurance on an annual basis: see paragraphs 30–36 for more detail.

78 Further, while we agree that there is scope for industry to work with PI insurers to improve the cost, availability and coverage of PI insurance, we do not think that it is realistic or cost effective to require licensees to have PI insurance policies that would indemnify licensees for all liability to retail clients. ASIC cannot intervene in a commercial market to compel insurers to adapt their PI insurance products to suit a purpose different from, and beyond, the purpose for which it was designed: see also our discussion of PI insurance at paragraph 187 of [Senate inquiry into forestry managed investment schemes: Submission by the Australian Securities and Investments Commission](#) (September 2014).

Financial requirements

Compensation and insurance arrangements

79 The Corporations Act requires AFS licensees to have arrangements to reduce the risk that losses suffered by retail clients cannot be compensated because

of a licensee's lack of financial resources.⁵ The primary way to comply with these requirements is to have adequate PI insurance.

80 Financial resources are a factor in determining the adequacy of PI insurance. Licensees must assess adequacy based on an estimate of claims that may be made against the licensee and other relevant factors of their business. One of these factors is whether a licensee has the financial resources to make the PI insurance work in practice.

81 As set out in paragraph 36, currently ASIC only systematically collects and assesses information about a licensee's PI insurance—including, specifically, whether a licensee has the financial resources necessary to cover any excess and gaps in cover—at the time of licence application..

Financial resource requirement

82 AFS licensees are also required to have adequate financial resources to provide the financial services covered by their licence and to carry out supervisory arrangements: s912A(1)(d) of the Corporations Act. The objective of this financial resource requirement is not, however, to provide a source of compensation for clients. In any event, financial resource requirements cannot, realistically, be set at a level that would enable firms (particularly non-prudentially regulated firms) to respond to large scale misconduct or multiple large claims.

Existing compensation schemes

83 There are three existing last resort compensation arrangements that protect consumers from specific types of loss in the financial system. They are:

- (a) the National Guarantee Fund, which is a scheme funded by ASX participants that covers consumer losses arising from a stockbroker or market participant misappropriating funds or property;
- (b) the Financial Claims Scheme, which is funded by the Australian Government and covers loss by depositors or policyholders due to insolvency of an authorised deposit-taking institution or general insurer; and
- (c) Pt 23 of the *Superannuation Industry (Supervision) Act 1983*, which gives the Minister the discretion to make grants of financial assistance for loss incurred by a superannuation fund trustee (but not self-managed superannuation funds) from fraud or theft.

⁵ There are separate requirements for credit licensees: see [Regulatory Guide 207](#) *Credit licensing—financial requirements* (RG 207) and [Regulatory Guide 210](#) *Compensation and insurance arrangements for credit licensees* (RG 210).

84 These last resort compensation arrangements cover very specific but different losses that may be suffered by consumers in the financial system. A limited compensation scheme of last resort, covering losses attributable to financial adviser misconduct, would add another scheme to this landscape. Ideally, compensation arrangements across the financial system would be simplified, realising potential economies of scale and reducing consumer confusion and uncertainty. The proposed establishment of a single EDR scheme—AFCA—provides a strong basis for consideration of a broader based compensation scheme.

Appendix: Previous related submissions

ASIC submission	Terms of reference of inquiry	Inquiry report
Senate inquiry into consumer protection in the banking, insurance and financial sector: Submission by the Australian Securities and Investments Commission (PDF 1.4 MB), particularly paragraphs 568–574	The terms of reference of this inquiry included the availability and adequacy of redress and compensation to victims of misconduct, including options for a retrospective compensation scheme of last resort	The committee is due to report on the last sitting day of the 2018 autumn sittings of the Australian Parliament
Senate inquiry into the scrutiny of financial advice: Submission by the Australian Securities and Investments Commission (PDF 459 KB), particularly paragraphs 230–237	The terms of reference of this inquiry included whether existing mechanisms are appropriate in any compensation process relating to unethical or misleading financial advice and instances where these mechanisms may have failed	The committee is due to report on 30 June 2017
Senate inquiry into forestry managed investment schemes: Submission by the Australian Securities and Investments Commission (PDF 447 KB), particularly Section H	The terms of reference of this inquiry included compensation arrangements for small investors in forestry managed investment schemes who have lost life savings and their homes after the collapse of a forestry scheme	Agribusiness managed investment schemes: Bitter harvest , particularly paragraphs 17.21–17.40. The committee concluded: In light of the evidence, the committee recognises that some form of compensation scheme for the victims of bad financial advice warrants much closer consideration. The committee resolved that, rather than duplicate work and examine this matter as part of [this] inquiry, it would investigate a compensation scheme of last resort as part of its [scrutiny of financial advice] inquiry. One of [that inquiry's] terms of reference goes directly to this matter—whether existing mechanisms are appropriate in any compensation process relating to unethical or misleading financial advice and instances where these mechanisms may have failed.
Financial System Inquiry interim report: Submission by the Australian Securities and Investments Commission (PDF 961 KB), particularly paragraphs 183–198		Financial System Inquiry: Interim report : The interim report of the Financial System Inquiry requested information on what options, if any, exist for addressing the issue of consumer loss, given the limitations of professional indemnity insurance

ASIC submission	Terms of reference of inquiry	Inquiry report
<p>Financial System Inquiry: Submission by the Australian Securities and Investments Commission (PDF 1.97 MB), particularly paragraph 752</p>		<p>Financial System Inquiry: Interim report, particularly pp. 3-83–3-86</p>
<p>Review of compensation arrangements for consumers of financial services (confidential submission)</p>	<p>The purpose of the review was to consider the need for and costs and benefits of a statutory compensation scheme</p>	<p>Compensation arrangements for consumers of financial services (PDF 970 KB), particularly Chapter 6</p>

Key terms

Term	Meaning in this document
AFCA	Australian Financial Complaints Authority
AFS licence	An Australian financial services licence under s913B of the Corporations Act that authorises a person who carries on a financial services business to provide financial services Note: This is a definition contained in s761A.
AFS licensee	A person who holds an AFS licence under s913B of the Corporations Act Note: This is a definition contained in s761A.
ASIC	Australian Securities and Investments Commission
Corporations Act	<i>Corporations Act 2001</i> , including regulations made for the purposes of that Act
Corporations Regulations	Corporations Regulations 2001
credit licence	An Australian credit licence under s35 of the National Credit Act that authorises a licensee to engage in particular credit activities
credit licensee	A person who holds a credit licence under s35 of the National Credit Act
EDR scheme	An external dispute resolution scheme approved by ASIC under the Corporations Act (see s912A(2)(b) and 1017G(2)(b)) and/or the National Credit Act (see s11(1)(a)) in accordance with our requirements in Regulatory Guide 139 <i>Approval and oversight of external complaints resolution schemes</i> (RG 139)
licensee	An AFS licensee or a credit licensee
National Credit Act	<i>National Consumer Credit Protection Act 2009</i>
PI insurance	Professional indemnity insurance
retail client	A client as defined in s716G of the Corporations Act and Ch 7, Pt 7.1, Div 2 of the Corporations Regulations 2001
s47(1)(i) (for example)	A section of the Corporations Act (in this example numbered 47(1)(i)), unless otherwise specified
supplementary issues paper	Supplementary issues paper: Review of the financial system external dispute resolution framework , 31 May 2017