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Professor Ian Ramsay
Chair, Independent Expert Panel
c/o EDR Review Secretariat
Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600
By email EDRreview@treasury.gov.au

Dear Professor Ramsay

Last Resort Compensation Scheme and past disputes

The Australian Bankers' Association (**ABA**) welcomes the opportunity to provide this submission to the Independent Expert Panel's (**Panel**) review of the financial system external dispute resolution framework (**Review**)[1] and to respond to the Panel's Supplementary Issues Paper dated May 2017.

This submission is in addition to our previous contributions to the review:

- ABA response to the issues paper dated 10 October 2016
- Supplementary response on the design features of a last resort compensation scheme dated 14 November 2016
- ABA submission on the interim report dated 1 February 2017, and
- Supplementary letter dated 15 March 2017.

With the active participation of 25 member banks in Australia, the ABA provides analysis, advice and advocacy for the banking industry and contributes to the development of public policy on banking and other financial services. The ABA works with government, regulators and other stakeholders to improve public awareness and understanding of the industry's contribution to the economy and the community, to ensure Australia's banking customers continue to benefit from a stable, competitive and accessible banking industry.

The ABA would like to thank the Panel for our meeting 19 May 2017 to discuss the issues canvassed in the Supplementary Issues Paper. This submission builds on that discussion and provides additional information as requested by the Panel. The ABA looks forward to continued engagement on these matters, if you would like further information, please contact Christine Cupitt, ccupitt@banksers.asn.au or 02 8298 0412.

Yours sincerely,

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[1] https://consult.treasury.gov.au/financial-system-division/dispute-resolution/

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Introductory comments

The ABA[2] supports establishing a mandatory, prospective, compensation fund that covers retail clients[3], including some small businesses[4] who have received poor financial advice from a financial adviser,[5] and have not been paid a determination made by the Australian Financial Complaints Authority (**AFCA**) due to the validated insolvency or wind up of the financial advice businesses, where all other redress avenues have been exhausted (**LRCS**).

Our support for a LRCS is qualified, and based on the following LRCS features:

- The scope is restricted to eligible determinations against financial advisers.
- The LRCS operates prospectively, commencing with the AFCA.
- The LRCS forms part of the EDR framework, with eligibility aligning with AFCA jurisdiction, and with compensations caps no greater than AFCA compensation caps.
- The funding structure clearly defines and governs fixed pre event contributions and the process and approval for any post event contributions.

The ABA believes the introduction of the LRCS should be accompanied by a series of other risk management reforms[6] that build on the recommendations of the report into *Compensation Arrangements for Consumers of Financial Services* April 2012 (St. John Report)[7], including:

- Review of ASIC's *Regulatory Guide 126: Compensation and insurance arrangements for AFS licensees* [RG 126] and *Regulatory Guide 166: Licensing: Financial requirements* [RG 166] to ensure they remain fit-for-purpose.
- Working with professional indemnity insurers to improve the availability and affordability of runoff cover.
- Improved monitoring and supervision by ASIC to ensure AFS Licensees have and maintain adequate compensation arrangements.
- Revised Australian Financial Services (**AFS**) licensing criteria, including criteria to ensure that only adequately capitalised businesses who have adequate compensation arrangements are provided with an AFS Licence.
- Appropriate enforcement powers for ASIC, including increased penalties, to take action where it deems an AFS Licensee is not maintaining adequate compensation arrangements and/or EDR determinations are unpaid.

Further information on the design of a last resort compensation scheme

This submission provides additional information as requested by the Panel in our meeting 19 May 2017, including further information on:

- The scope of the LRCS
- Prudential and financial system risks
- Emerging risks for managed investments schemes (**MIS**)

[2] The ABA notes that one member bank holds the view that only AFS licensees that are judged not to be able to meet claims from their own financial resources should fund the LRCS.
[3] As defined under s761G *Corporations Act* 2001 (Cth).
[4] Consistent with our position on small business eligibility for EDR, a business is not a small business if one of the following conditions is met:
- The number of employees is 20 people or more, or 100 people or more if the business is, or includes, the manufacture of goods (full-time equivalent); or
- Annual business turnover is $10 million or more; or
- Total credit exposure (TCE) of the business group, including related entities, to all credit providers is $3 million or more.

[5] Relevant Provider under s910A of the *Corporations Act* 2001 (Cth).
[6] These complementary risk management reforms are explored in more detail in our submission of 1 February 2017, pp 16-17.
[7] https://futureofadvice.treasury.gov.au/content/consultation/compensation_arrangements_report/downloads/Final_Report_CACFS.pdf

- Coverage for court awards and class actions, and
- Levy calculation and risk weighting measures.

We have also set out further information on:

- The linkage with the AFCA
- Incentives
- Existing unpaid determinations, and
- Comments on the Financial Ombudsman's Service (**FOS**) proposal.[8]

Scope of the LRCS

A clearly defined scope for the LRCS is critical to ensuring that consumers have certainty and clarity around the types of claims that will be covered by the LRCS, and will support the long term success of the LRCS by providing greater certainty on the potential financial exposure of the LRCS.

For example, the National Guarantee Fund (**NGF**) has a set of four clearly defined circumstances[9] in which the scheme will respond. Claims and events outside those clearly defined events are not covered by the NGF.

The LRCS should be limited to determinations on financial advice failures where personal advice on Tier 1 financial products,[10] and / or general advice on Tier 1 financial products is provided to retail customers, including some small businesses, by a financial adviser. The failure could relate to Corporations Act breaches, fraud, negligence, misrepresentation and administrative errors in relation to the provision of financial advice.

The LRCS should cover general advice provided by financial advisers as well as personal advice to avoid market distortions and take account of the low level of consumer understanding of the difference between personal and general advice. The LRCS should not cover general advice provided by product issuers such as managed investment scheme operators, or retail bank staff providing retail banking services. The LRCS should not cover businesses that only provide dealing or arranging services, such as securities dealers or derivatives dealers, nor should it cover research houses that publish reports containing general advice.

Prudential and financial system risks

The requirement for a Financial Services Provider (**FSP**) to contribute to fund a LRCS introduces risks relating to cross subsidisation and exposure to losses arising from the failure of other FSPs.

APRA regulated institutions, in particular, are required to understand and manage prudential and financial system risks in accordance with standards set by APRA. Risk management will generally include meeting capital requirements, which has cost impacts for the APRA regulated institution, its shareholders and customers.

These risks can be reduced through the design of the LRCS and funding requirements, including:

- Scope – A clearly defined and appropriately narrow scope of coverage, which takes account of the relative risks of different types of financial services and FSP conduct. The ABA believes that the scope of coverage of the scheme can only extend to financial advice from a financial adviser and that it would be unacceptable from a prudential risk perspective to include other financial services and products, in particular, managed investment schemes (**MIS**).[11]

[8] pp 29 – 30, Supplementary Issues Paper.
[9] p3, http://www.segc.com.au/pdf/ngf_information_booklet.pdf
[10] As defined in *ASIC RG 146, Training of financial product advisers.*
[11] A detailed explanation of the risks relating to including MIS is set out in our submission dated 1 February 2017, pp 19-20.

- Fixed funding contributions – The funding structure should clearly define and fix pre event and any post event contributions. The ABA believes ongoing modelling should be undertaken to understand the prospective exposure of the LRCS and align and fix contributions against that exposure. Clear and fixed funding arrangements are required, in particular, for Authorised Deposit-Taking Institutions (**ADIs**) that cannot provide unlimited guarantees.

Current and emerging risks for managed investments schemes (MIS)

Market place lending

As discussed with the Panel in our meeting 19 May 2017, the ABA believes that there are emerging risks with MIS that mean that MIS should be excluded from the scope of the LRCS.

Market place lending offered to retail clients will generally be offered by an AFS licensed responsible entity, operating a registered managed investment scheme.[12] Market place lending differs from traditional lending models, where lenders use depositor or wholesale borrowed funds to make loans. In these situations, the risk of the loan is with the lender, and risks for depositors and wholesale borrowers are managed through separate arrangements.

Instead, market place loans are made by investors, where, through an online platform, investors may:

- Select the loans they wish to invest in
- Are matched with loans that meet specified criteria, or
- Are exposed to part of a loan or a pool of loans.

Generally, the investor does not enter into a contract with the borrower, instead the loan is between the market place lender (the responsible entity or its custodian) and the investor. However, because of the use of the managed investment scheme structure, the risk of the loans eventually rests with the investor. Notably, the financial claims scheme covering deposits does not apply to funds invested through market place lending.

Risks for market place lending investors include:

- Lending risk
- Reliance on the scheme operator to assess the credit risk, and
- Lack of access to compensation as scheme operators do not need to maintain compensation arrangements that will cover the total amount of monies invested.

ASIC Report 526, *Survey of market place lending providers*[13], reported that as at June 2016, eight respondents reported a total of $176 million in investments, 22% or $39 million from retail investors and 13% or $13 million from trustee investors, who are generally self-managed superannuation fund trustees. ASIC noted that:

> "Some respondents that are currently wholesale-only providers have indicated that they intend to broaden their marketplace lending product offering to retail client investors in the future. The fact that many providers operate registered schemes seems to suggest that they may have plans to, or may wish to have the option available to, offer their marketplace lending product to retail client investors in the future."[14]

In addition to the reasons set out in our submission dated 1 February 2017, these emerging risks mean the ABA cannot support the LRCS covering determinations against MIS operators. The fact that potential exposure of the LRCS is impossible to model, leaves the LRCS exposed to underfunding and

[12] ASIC's information sheet (INFO 213) provides an overview of the key obligations that may apply to marketplace lending business models: http://asic.gov.au/regulatory-resources/financial-services/marketplace-lending/marketplace-lending-peer-to-peer-lending-products/#obligations
[13] http://download.asic.gov.au/media/4276660/rep-526-published-1-june-2017.pdf
[14] p22, http://download.asic.gov.au/media/4276660/rep-526-published-1-june-2017.pdf

compromises the long term viability and success of the LRCS. It also introduces financial risks for contributors that cannot be quantified and could be material.

Financial requirements

The respective regulatory settings for APRA regulated institutions and managed investment schemes are designed to serve different public policy objectives. Notably, the financial requirement for MIS are not designed to ensure compensation of investor losses.

Financial requirements, including capital requirements, for APRA regulated institutions are intended to ensure that the financial commitments of those firms are met within a stable, efficient and competitive financial system. Whereas, the financial requirements for AFS licensees, including managed investment schemes, are set to manage the risk that the AFS Licensee's financial resources are not adequate to ensure it can carry on business in compliance with the AFS licensee obligations, and / or ensure the orderly wind up of the AFS Licensee.

The fact that a MIS holds an AFS licence does not mean that the MIS cannot fail, nor that in the event of failure it will have sufficient resources to compensate investors. The ABA does not support managing the risk of MIS failure through the LRCS.

Link with the AFCA

The LRCS should be viewed as a component of the EDR framework, and should pay compensation in respect of unpaid determinations of the AFCA. Aligning with the EDR framework provides a policy basis for determining jurisdiction, compensation caps, and a consistent basis on which disputes will be decided, and does away with the need for any merits review function of the LRCS.

Alignment with the EDR framework is consistent with the objective of compensating retail customers and some small businesses, minimises costs, as using the EDR framework is free for consumers, and means that the proceeds of determinations and compensation by the LRCS go direct to the consumer, rather than in professional fees.

The ABA notes that the link with the AFCA, and the requirement for an AFCA determination, may affect consumers whose financial adviser is no longer a member of AFCA due to insolvency or wind up. Further consideration is required on what arrangements may be required to enable these financial advice consumers to bring their dispute to AFCA and how the costs of receiving those disputes will be met. It does not necessarily follow that current members of the AFCA should meet these costs.

Co-regulatory approach

The ABA has previously advocated for a LRCS that is established by industry through terms of reference, to enable the LRCS to be set up quickly and allow flexibility for it to respond to change over time. Compulsion to contribute to the LRCS would be underpinned by a legislative or regulatory requirement for AFS Licensees who offer financial product advice to a retail clients to be a member and contribute to the LRCS.

The ABA retains our view that the LRCS should operate through industry-based terms of reference, however, we believe the enabling legislation should more detailed, and clearly set out the scope of the scheme, key elements of the terms of reference, and the mechanism to require FSPs to pay, to promote certainty for industry and consumers.

Court awards and class actions

The ABA does not support consumers with unpaid court awards, including class action awards, seeking redress through the LRCS on the following bases:

- The LRCS should be an integrated part of the EDR framework.
- Payments from the scheme should be used to compensate consumers, rather than being used for legal and professional fees or court costs, which are likely to form part of any unpaid court award.

- Exclusion of court awards does not materially affect a consumer's access to redress, this can be readily sought through the EDR scheme.
- Proposals to limit the eligibility of court awards to awards which would otherwise fit within the AFCA jurisdiction and / or exclude class actions will require the development of complex rules, compromising simplicity and undermining the link between the LRCS and the EDR framework.
- The exposure to court awards is harder to quantify and may compromise the quality of financial modelling and ultimately the success of the LRCS.

Levy

Levy structure

Consistent with the proposed scope of the LRCS, the levy requirement should apply to all AFS Licensees who offer financial advice to a retail clients, including some small businesses.

Broadly, the ABA supports the levy structure proposed by the FOS[15] comprising:

- A prefunded establishment levy, based on borrowings from industry and repaid through future levies
- Prefunded management levies to support the operation of the LRCS and repay establishment levies, and
- Prefunded compensation levies.

There should be certainty as to the amount of annual levies, with provisions made to 'smooth' payments from the LRCS in the event of a major failure or large scale losses that mean compensation exceeds reserves, including proportionately capping compensation paid to consumers in any year and staggering distributions to later years.

The LRCS terms of reference and remit of the LRCS Board should require regular review and indexation of levies, taking account of historical claims data and forward projections, to ensure the LRCS remains suitably capitalised.

The ABA does not support industry being required to provide uncertain and uncapped post event funding to 'top up' the LRCS if the reserves are exhausted. This introduces uncertainty for all contributors (from small businesses to large institutions) and could have capital implications for banks. In the event LRCS reserves are exhausted, an additional formal process should be undertaken to prospectively review levies to ensure they are adequate going forward. Provisions should also be made to manage excess funds as they accumulate.

Calculation

Funding contributions will need to be calculated, taking into account different advice models, such as general advice representative models, product manufacturers that provide financial advice, and robo-advice businesses.

Two options could be considered.

1) Contributions should be appropriately risk weighted, taking into account:
    - The risk profile of the operating model
    - The scope of the licensee's PI insurance (exclusions), and
    - Other risk management arrangements put in place by the licensee.
2) Contributions are calculated on a per adviser / licensee basis, similar to the ASIC industry funding model, noting that the amounts will be different to that model. Where robo-advice and general

15 Updated Proposal to Establish a Financial Services Compensation Scheme, FOS, May 2015

advice providers fall in scope of the LRCS, their contributions should be relatively weighted against the volume of advice provided.

Ideally, the funding calculation should encourage best practice risk management by financial advisers. For example, funding calculations could assess the risk of the financial adviser's business model or look at specific measures, such as the adequacy of compensation arrangements. However, there will be complexity and cost in designing and applying a risk based calculation. Using PI premiums as a proxy will not suit all business models and may unfairly disadvantage some financial advisers whose premiums are higher due to factors other than the risk profile of their business.

More investigation is required to determine whether the benefits may be outweighed by the cost and complexity of a risk weighted system.

Incentives

LRCS have been criticised for providing incentives for increased risk taking by FPSs and customers. Accordingly, certain measures should be built into the design of the LRCS, and the AFCA terms of reference to manage these risks.

- The scheme should truly be last resort, the professional indemnity insurance (PI insurance) and capital of the FSP should be utilised first, and the insolvency of the FSP be validated independently.
- Compensation paid by the LRCS should be capped and be no greater than the compensation caps of the new AFCA.
- As the LRCS uses the AFCA determination as the basis for payment, the AFCA terms of reference should require the authority to reduce the compensation awarded, based on the contribution to the loss by the customer. These terms could be similar to the current arrangements under the FOS terms of reference.
- ASIC should be given appropriate enforcement powers, including increased penalties, to take action against FSPs where determinations are unpaid and stop managers of those FPSs from obtaining another AFSL or ACL.
- ASIC should be informed of any financial adviser that fails to pay a determination. Ideally ASIC would then take steps to wind up the FSP and ensure that there has not been any assert-stripping before claims are paid. This could be similar to the provisions that allow ASIC to appoint liquidators to companies that have been phoenixed so that the liquidators can pursue directors and officers or others who have wrongfully received assets. It also puts the advisers at risk of penalty or criminal proceedings that the special liquidator may recommend.
- PI insurers should be held to account to ensure speedy claims management.
- The LRCS should be given priority as a creditor in circumstances where the claims are paid before the FSP is formally wound up, in case, through the winding up of the FSP, some funds become available. Allowing clients to make a claim against a LRCS in circumstances where there remain assets in the FSP which could meet part or all of the claim would be unfair to the LRCS contributors. Contributors would in effect be supporting other creditors of the advice provider who will be able to recover more from the advice provider because the claim by the client is paid by the LRCS.
- Any rights of a client who is compensated by the LRCS against any other party in relation to the loss, such as possible claims against directors of the entity providing advice.

Existing unpaid determinations

The banking industry is mindful of the very real social impacts of past issues, monetary loss and unpaid determinations on consumers. The impacts on the wellbeing of individuals, and the effects on broader consumer trust and confidence in financial services are well documented.[16]

Public commentary about these losses indicates that they can be attributed to some of the worst examples of illegal and poor conduct by individuals and FSPs (that are no longer in business), together with failures in regulatory settings and enforcement. For this reason, the ABA does not support the proposed LRCS, or another separate mechanism funded by industry, paying existing unpaid determinations.

Existing unpaid determinations should be distinguished from future unpaid determinations relating to financial advice as our support for a prospective scheme covering financial advice is based on:

- The ABA's strong support for the overall reform program to improve the quality of financial advice and rebuild consumer trust and confidence in financial advisers
- The LRCS being the final element of a significant reform program already underway to professionalise the financial advice industry, and
- The LRCS being an important part of financial advisers forming a profession and access to the LRCS is a benefit arising from seeking advice from an authorised financial adviser.

FOS' proposal

The ABA is grateful to FOS for its ongoing engagement on the development of the LRCS.

Scope

The primary aspect of the LRCS where the FOS and ABA proposals do not align is the scope of the LRCS. The ABA has consistently argued for a prospective LRCS that covers retail clients and some small businesses who have received poor financial advice from a financial adviser, and have not been paid an eligible EDR determination.

The ABA believes that this narrow and clearly defined scope will best promote the long term success and viability of the LRCS and appropriately manage risks for contributors to the LRCS. As noted above, we are concerned that the inclusion of a broader scope of financial products and services will present unquantified and unacceptable risks that will compromise viability of the LRCS. The ABA and member banks do not support for a broader scheme.

Common ground

We consider there are many areas of common ground between the ABA and FOS proposals. Importantly, the proposals agree that the LRCS should:

- Provide a material degree of protection for consumers (individuals and small businesses) who have not been paid an eligible determination owed to them by a FSP
- Be simple and easy to access for eligible consumers
- Be prospective (noting the differences between the models on existing unpaid determinations) and align with the commencement of the AFCA
- Be cost effective to administer, and utilise existing EDR decision making infrastructure (noting the FOS proposal also includes eligible court awards), rather than the LRCS having its own merits review process, and
- Have a prefunded levy structure.

[16] See for example, http://download.asic.gov.au/media/1343636/rep240-published-May-2011.pdf ;

Past disputes

As with unpaid determinations, the banking industry is mindful of the very real social impacts of past issues and monetary loss on consumers. Issues relating to why certain consumers have not had satisfactory redress for past disputes are complex, and the Panel has identified 4 types of circumstances where a consumer's dispute may not have had satisfactory redress.

There is not an apparent, clear process, with a sound public policy basis for providing redress in these circumstances. In designing any arrangement to consider past disputes, risks will need to be managed relating to introducing new and separate arrangements to provide access to redress for past matters, which may undermine existing legal concepts and policy settings.

Financial firm insolvent or otherwise unable to pay

Making a claim against and seeking compensation from a business that is insolvent or otherwise unable to pay is an issue that is unfortunately faced by consumers across all industries and service providers. The public policy basis for setting up arrangements for one class of consumers to hear claims where the respondent is out of business would need to be carefully considered.

Practical considerations would include how a claim could be brought where there is no respondent, challenges with access to records and documentation, and how the eligibility criteria to access the arrangements, including scope of issues and timeframes, could be fairly developed.

Monetary value too large

EDR thresholds are set with the policy objective of providing free access to dispute resolution for small, consumer disputes. Point in time EDR thresholds reflect the prevailing economic and financial conditions at the time. Where the historical dispute was outside the prevailing EDR thresholds, we would be concerned about retroactively changing established EDR thresholds for one class of consumers, and potentially undermining the policy in place at the time of the historical dispute.

Avoiding future unresolved issues

Disclosure

The ABA believes a possible measure to avoid future unresolved issues may be to build on existing disclosure of the customer's right to access EDR to provide more information the jurisdiction of the EDR and . Currently, the disclosure requirements involve details about EDR. Additional disclosure should make it clear that access is subject to the scheme's monetary limits and publishing those limits as part of the disclosure.