FINANCIAL PLANNING
ASSOCIATION *of* AUSTRALIA

3 July 2017

EDR Review Secretariat
Financial System Division
Markets Group
The Treasury
Langton Crescent
PARKES ACT 2600
Email: EDRreview@treasury.gov.au

Re. **Compensation scheme of last resort**

Dear Sir/Madam,

The Financial Planning Association of Australia (FPA) welcomes the opportunity to respond to the EDR Review Panel's paper on a compensation scheme of last resort (CSLR). We compliment the Panel for raising important issues for discussion.

The FPA strongly opposes the introduction of a CSLR and a past redress forum. However, if these arrangements are introduced, we strongly recommend that the existing regulatory and compensation framework is improved beforehand; and that each participant in the financial services industry is required to take responsibility for what they do.

If you have any queries or comments, please do not hesitate to contact me at policy@fpa.com.au or on 02 9220 4500.

Yours sincerely

Dimitri Diamantes CFP®
Policy Manager
Financial Planning Association of Australia[1]

[1] The Financial Planning Association (FPA) has more than 12,000 members and affiliates of whom 10,000 are practising financial planners and 5,600 CFP professionals. The FPA has taken a leadership role in the financial planning profession in Australia and globally:

- Our first "policy pillar" is to act in the public interest at all times.
- In 2009 we announced a remuneration policy banning all commissions and conflicted remuneration on investments and superannuation for our members – years ahead of FOFA.
- We have an independent conduct review panel, Chaired by Mark Vincent, dealing with investigations and complaints against our members for breaches of our professional rules.
- The first financial planning professional body in the world to have a full suite of professional regulations incorporating a set of ethical principles, practice standards and professional conduct rules that explain and underpin professional financial planning practices. This is being exported to 24 member countries and the 150,000 CFP practitioners that make up the FPSB globally.
- We have built a curriculum with 17 Australian Universities for degrees in financial planning. As at the 1st July 2013 all new members of the FPA will be required to hold, as a minimum, an approved undergraduate degree.
- CFP certification is the pre-eminent certification in financial planning globally. The educational requirements and standards to attain CFP standing are equal to other professional bodies, eg CPA Australia.
- We are recognised as a professional body by the Tax Practitioners Board.

FPA position on CSLR

Consumer protection and appropriate consumer compensation is the responsibility of all participants who have a role in causing, or an influence in allowing, consumer detriment. Until the regulatory and compensation framework is set to make each provider individually responsible and financial accountable to the end consumer for the provider's legal and ethical obligations, the FPA is unable to support the introduction of a compensation scheme of last resort (CSLR).

Although the FPA understands the reasons for some stakeholders wanting to introduce a CSLR, we recommend that further analysis or inquiry is conducted as to why there are unpaid Financial Services Ombudsman (FOS) determinations, before bolting on a costly scheme that does not actually address the underlying reasons as to why there are unpaid determinations.

In 2011, the Government appointed Mr Richard St John to undertake an extensive independent review of the consumer compensation system. This review examined the need for, and costs and benefits of, a statutory compensation scheme for consumers who suffer damage or incur loss as a result of misconduct by financial services providers.

In his final report, Mr St John concluded that it would be inappropriate and possibly counter-productive to introduce a CSLR without first strengthening the existing compensation arrangements.

> *"There would also be an element of regulatory moral hazard should a last resort scheme be introduced without a greater effort first to put licensees in a position where they can meet compensation claims from retail clients. It would reduce the incentive for stringent regulation or rigorous administration of the compensation arrangements."*[2]

While the Future of Financial Advice (FoFA) and other reforms detailed above have significantly improved proactive consumer protections in the last five years, few of Mr St John's recommendations in relation to the consumer compensation system have been progressed in this time. Further, we would like to see analysis of the effect of the FoFA reforms on the rate of growth in unpaid determinations, before going down the path of a CSLR.

For these reasons, he FPA does not support the establishment of a CSLR. In addition, we are concerned that both advice is seen as a proxy for failures across the entire financial services industry which unless fixed will mean that any proposed schemes is potentially exposed to risk of the whole system and the introduction of a CSLR would have a disproportionate impact on small business because of relative profitability of small and larger advice businesses.

FPA Response to Consultation Paper

Scope and principles

1. Is the Panel's approach to the scope of these issues appropriate? Are there any additional issues that should be considered?

[2] Compensation arrangements for consumers of financial services, Report by Richard St. John, April 2012, p. iii

FPA response

We agree that the amended Terms of Reference require the Panel to undertake two separate but related tasks:

- make recommendations on the establishment, merits and potential design of a compensation scheme of last resort; and
- consider the merits and issues involved in providing access to redress for past disputes

We agree that future and past disputes are separate categories. We disagree that the distinction should be based on when the decision that becomes unpaid was made or delivered. Rather, the distinction should be based on when the arrangement the subject of the dispute was entered into. This is to allow for the CSLR safety net to be factored in, with the minimum of regulatory cost, to the bargain between consumer and provider.

In addition to external dispute resolution (EDR), the Review should consider whether unpaid judgments and decisions from other dispute resolution processes should be claimable against the compensation scheme of last resort (CSLR). This is to ensure that the introduction of the CSLR doesn't create regulatory cost by pushing consumers to go through EDR.

In particular, the Review should consider whether claims should be able to be brought when the provider has ceased to be a member because, for example, it is insolvent. We understand that, for example, if a member of FOS becomes insolvent the directors of FOS may resolve that the member ceases to be a member. By limiting the scope of the CSLR to unpaid EDR determinations, claims against insolvent providers are effectively excluded.

In our view, there should be no CSLR. However, if such a scheme is introduced it should be limited to unpaid EDR decisions. This would reduce cost of the scheme, especially to lower-risk providers, because it would exclude claims against providers that have ceased to be members of an EDR because they are already insolvent. Although this exclusion would hurt some consumers, it would limit the scope for a CSLR to make consumers less careful in assessing the financial strength of providers.

> 2. Do you agree with the way in which the Panel has defined the principles outlined in the Review's Terms of Reference? Are there other principles that should be considered?

FPA response

We agree with the way the Panel has defined the principles outlined in the Review's Terms of Reference. We do not propose that any other principles be considered.

Compensation scheme of last resort

Existing compensation arrangements

> 3. What are the strengths and weaknesses of the existing compensation arrangements contained in the Corporations Act 2001 and National Consumer Credit Protection Act 2009?

FPA response

We agree with the current legislative model of licensees having arrangements in place for compensating consumers for loss or damage suffered because of breaches of the relevant legislative obligations by the licensee or its representatives. This is because the model provides a flexible approach to ensuring providers have the capacity to meet liabilities for disputes found against them.

A more prescriptive approach would add to regulatory cost by setting the requirements for protection in a way that consumers don't necessarily value or aren't necessarily willing to pay for.

We accept that this model has weaknesses, including:

- differences in compensation arrangements between providers creates complexity
- because the existence and quality of compensation arrangements at the time of resolution of any dispute is not guaranteed – this undermines transparency

We would suggest that, typically, these weaknesses arise because of the limitations of professional indemnity insurance. We agree that there are significant limitations in using professional indemnity insurance as a compensation mechanism, including:

- the total funds available under a policy may not cover all of the compensation awarded against the insured;
- the policy may not cover the conduct which gave rise to the order for compensation (for example, fraud);
- the amount of compensation payable may be less than the policy's excess; and
- cover may not have been taken out at all and self-certification often means this is only discovered after the firm is insolvent.

To address these issues, we recommend that the regulator take a more active approach in ensuring that providers have appropriate PI cover in place. Where cover in inadequate, providers should be required to upgrade their cover or build liquidity to meet their compensation liabilities.

One model for building liquidity is to require each licensee to build liquidity to cover a multiple of the excess under their PI insurance. It may be appropriate to allow existing licensees longer to build up the required liquidity. Further, licensees would need to publicly disclose where they haven't yet reached the prescribed threshold.

4. What are the strengths and weaknesses of the National Guarantee Fund, the Financial Claims Scheme and Part 23 of the Superannuation Industry (Supervision) Act 1993?

FPA response

National Guarantee Fund

The cap on total claims that arise because of any one provider becoming insolvent helps contain costs for the fund. However, the same restriction limits the amount each claimant may claim in respect of such a provider.

Although, based on the fund's history, the raising of a levy would be a rare event, the amount of the levy is essentially unlimited. A levy raised in a difficult economic environment could exacerbate those difficulties.

Financial Claims Scheme

Under the FCS, deposits are protected up to $250,000 for each account holder at each licenced bank, building society or credit union incorporated in Australia. This provides a basic level of protection. However, the limit can easily be avoided by spreading deposits across different financial institutions.

The scheme does not apply to claims against life insurers or private health insurers, meaning there is a significant gap in compensation arrangements.

All taxpayers are funding the scheme, rather than those who enjoy the benefit. This is distorts the market by encouraging deposits over other investments.

Part 23 of the Superannuation Industry (Supervision) Act 1993

The discretionary nature of this arrangement, and the fact that it's rarely exercised, means costs are better contained and consumers will be more likely to protect their own interests.

However, these same factors also mean that consumers in like circumstances who have uncompensated losses may be treated differently. Further, self-managed superannuation funds (SMSFs) are not covered by this compensation arrangement, meaning that members of SMSFs may be denied compensation even though members of APRA funds in comparable circumstances at the same time, do receive compensation.

5. Are there other examples of compensation schemes of last resort that the Panel should be considering?

FPA response

In the United Kingdom a comprehensive two-tiered compensation regime requires investment firms to hold professional indemnity cover and capital appropriate to their risks and activities. The UK regulator appears to play an active role in administering these tier one arrangements, with firms required for example to notify the regulator that they have renewed their insurance policies and follow up action by the regulator where no confirmation is received.

Further, personal investment firms (PIFs) are generally required to have a minimum amount of capital, being the higher of a flat dollar amount and a percentage of the PIF's annual revenue for the previous financial year. Broadly, PIFs are firms engaged in dealing, arranging or advising on certain investment products.

The second tier arrangement in the UK is a last resort compensation scheme (the Financial Services Compensation Scheme) which provides some recompense for consumer loss arising from poor advice or investment management, fraud or failure to return investment funds where the firm is insolvent or otherwise unable to meet the claim. These arrangements provide broader protection than is generally available in Australia or elsewhere.

We recommend that the Panel considers recommending the adaption of the UK's first-tier arrangements to the Australian context. Further, although we oppose having a CSLR, we propose that if one is recommended, that it be bolted onto the first-tier arrangements, modified for the Australian context, discussed above.

Evaluation of a compensation scheme of last resort

6. What are the benefits and costs of establishing a compensation scheme of last resort?

FPA response

Benefits

A CSLR would provide a safety net for consumers who wouldn't otherwise have their award of compensation paid.

Costs

The introduction of a CSLR would have significant implications for the cost of running a financial advice business, because the associated levy would either increase costs directly or through increased PI premiums.

In addition, a CLSR might incentivise consumers and regulators to take more risk than they otherwise would. Also, where lower-risk providers pay a share of levies that is excessive considering their risk level, such providers would be incentivised to take more risk.

Also, making membership of a CSLR compulsory for all financial services providers would force market participants who don't necessarily see the marginal benefit of the extra protection provided by the CSLR to pay for it anyway.

Even assuming all market participants see a net benefit in providing the extra protection, there may be an incentive for the PI market to transfer risk to the CSLR to minimise costs by having other financial services providers cover the cost of providing compensation. Although these savings would be neutralised by the associated increase in costs to the CSLR being passed back to providers, the problem is that providers are incentivised to provide the extra protection of the CLSR, through that scheme because they expect other providers to do the same and the CSLR is compulsory. This outcome reduces efficiency as some claims that would otherwise be dealt without the need to go through the CSLR, now require that extra step.

Should a CSLR be implemented it should include all financial services participants. Costs should be distributed appropriately across the sector to ensure the viability of the scheme and not disadvantage any particular group of providers. It should not exclude self-insured entities, product providers, research houses and other providers of services that influence, either directly or indirectly, a consumer's financial decisions.

7. Are there any impediments in the existing regulatory framework to the introduction of a compensation scheme of last resort?

FPA response

In our view, a system which effectively forces providers to provide insurance for each other can only be justified if providers can require each other to adhere to collectively decided risk management practices. Although it would be possible for such adherence to be a condition of membership of an EDR scheme, there is a high risk that, where there is only one EDR scheme (which will soon be the case), dominant member interests would impose risk management requirements that would stifle competition from minority interests.

Another impediment is that EDR seems to treat losses resulting from products failing to do what was reasonably expected of them, as losses resulting from advice failures. This problem should be addressed at the EDR level before any CSLR is introduced.

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?

FPA response

We would expect the introduction of a CSLR to encourage consumers to:

- bring claims where they wouldn't otherwise have done so

- take additional risk

To address this, if a CSLR is introduced:

- the scheme should have modest caps for each claim
- the payment of compensation should be at the discretion of the scheme
- a consumer should not be permitted to split claims in order to avoid the claims cap.

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

FPA response

CSLR levies would increase costs for financial services providers, either directly through the levies or through increases in PI premiums to cover expected levies. This would come at a time when regulatory costs are already set to increase significantly, with the introduction of industry funding for the ASIC funding levy and the Financial Adviser Standards and Ethics Authority (FASEA), and independent third-party monitoring of adviser compliance with a new statutory code of ethics.

In addition, financial firms would, presumably, need to disclose to consumers of their services that those consumers have access to the CSLR. Disclosure would presumably need to be upfront and, if the firm still exists, at the time of a complaint.

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?

FPA response

A CSLR is more likely to cause stress to small financial services providers financially than larger ones, because of differences in profitability and financial resources. This may result in some firms exiting the market. It may also be a significant barrier to entry.

Evaluation of a compensation scheme of last resort (continued)

11. What flow-on implications might be associated with the introduction of a compensation scheme of last resort? How could these be addressed to ensure effective outcomes for users?

FPA response

As discussed, where the levy a member of a CSLR is charged is not aligned with the risk-level of that member, lower-risk members incentivise higher-risk ones. This encourages lower-risk providers to take more risk because they have to pay for it anyway. In turn, the average risk-level across the member base increases.

To address this problem, we recommend that, if a CSLR is introduced, the levy of a member be based on the risk-level of that member. The risk-level should be calculated based on the specific risk characteristics of that member, and a change in any one input should reflect in a different risk-level score.

Measurable risks associated with the provision of financial services could include:

i) Complaints history – To identify a pattern of behaviour, consideration should be given to the number of complaints lodged about the licensee, both through internal dispute resolution (IDR) and external dispute resolution (EDR) over a number of years. It is important to

consider complaints lodged through IDR as some licensees may settle claims to avoid EDR. Consideration may need to be given to IDR reporting requirements.

ii) Professional membership – Professional association membership is also a risk differential as members have to adhere to higher professional, education and ethical standards than those prescribed in the law. For example, of the 23,000 advisers registered on the ASIC Financial Adviser Register more than 11,000 practicing advisers are FPA members. This means FPA membership represents approximately 45% of the adviser population. However, FPA members have accounted for significantly less than 10% of financial advisers banned by ASIC since 2009.[3] The fact that more than 90% of financial advisers banned by ASIC were providers who are not members of the FPA and therefore not subject to the additional regulatory oversight of our professional obligations, clearly demonstrates the consumer protection benefits of professional standards[4].

Statistical under-representation when compared to the total financial adviser population subject to ASIC banning, is a proof point of the positive effect of professional obligations and membership. It demonstrates the vital role professional bodies play in 'norming' good professional behaviour beyond legal minimum standards, and managing risk for the protection of consumers. It also provides a measurable risk for an industry funding model for ASIC.

It must be noted however, that as highlighted in the PJC Report, not all associations are professional bodies.

iii) 'Independent' licensees - There are licensees that meet the definition of 'independent' in s923 of the Corporations Act which means they do not accept or receive any form of conflicted remuneration.

iv) Financial ratios – for example, leverage; liquidity; excess capital to revenue, and return on capital

12. What other mechanisms are available to deal with uncompensated consumer losses?

FPA response

As discussed, financial services firms should be required to build up capital that is adequate considering its risk-level and the specifics of its other arrangements, for example, its professional indemnity insurance. Other options include insuring the consumer for such losses.

Alternatives to a CSLR could include:

[3] This figure drops to less than 6% for Certified Financial Planner® members, which highlights the benefits of higher education standards.
[4] ASIC banning analysed against FPA membership data between 2009 – 2015 financial years

- St John review into consumer compensation – Review the recommendations made by Mr St John to improve the professional indemnity insurance arrangements and the existing consumer compensation regime.

- Expand regulatory reach - Proactive regulation of product providers, research houses and other gatekeepers is critical to improving consumer protection. Most financial products have a degree of complexity and there is an expectation in the community that product providers will provide a basic level of assistance to consumers deciding whether the product is suitable for them.

- Limited Liability Schemes - Professional Standards Legislation limits a professional's civil liability in return for improved risk management at the practice level and improved standards of conduct of providers. Such schemes provide consumer protection benefits as they require the highest professional standards and conduct to be maintained by its members. In turn, the risk of claims against members of the scheme is minimized.

- Professional indemnity (PI) insurance - Make professional indemnity insurance work to ensure that all financial service providers are bearing the costs of their own business activities and not compensating others – that is, a 'user pays' system based on the risks associated with each business' activities. Existing arrangements with PI insurance should be reviewed and considered before jumping to the establishment of a CSLR. In particular, we recommend investigating how competition in the PI insurance market could be enhanced to improve cost and quality of cover.

- Continuing PI cover – When a company goes into liquidation insurance premiums are not paid, leading to the cancellation of cover. An administrator should be required to keep paying PI premiums once a company goes into liquidation to keep the PI cover going so EDR claims can be paid.

- Improve transparency of PI cover – Include information about the licensee's insurer on the ASIC Financial Adviser Registry.

13. What relevant changes have occurred since the release of Richard St. John's report, *Compensation arrangements for consumers of financial services*?

FPA response

Relevant changes:

- introduction of FoFA and FASEA
- application of Tax Agent Services Act (TASA) and Tax Practitioners Board (TPB) to advisers
- legislation to provide for a single EDR scheme to replace FOS, CIO and the SCT
- consultation on consumer protection legislation, including product suitability rules

Potential design of a compensation scheme of last resort

14. What are the strengths and weaknesses of the ABA and FOS proposals?

FPA response

ABA proposal

Strengths include that:

- the consumer must have explored other avenues for enforcing a determination before being able to access the CSLR
- a condition of access is evidence (possibly from a registered liquidator or administrator) that the assets of the provider will not cover the determination
- the scheme would be limited to prospective claims
- levies would be pre-funded. This encourages the scheme to be operated with greater prudence than a post-funded levy (assuming that there is no ability to charge a post-funded levy or where post-funded levies an only be charged in exceptional circumstances). There should be similar constraints placed on borrowing and there should also be limits on increases in pre-funded levies, to encourage the scheme to exercise financial prudence.

Weaknesses include that:

- liability is limited to the advice sector. In our view, the proposal should be amended to require EDR to develop clear rules for apportioning responsibility. In turn, CSLR levies should also be funded by product issuers and research houses (in that capacity).
- compensation caps are the same or no greater than EDR scheme caps. We'd prefer caps to be the lesser of a percentage of the decision, and a flat dollar amount. This is important to manage the moral hazards of having access to a CSLR.
- there appears to be no time limit on claims. Time limits are important to help minimise the potential exposure of a CSLR.

FOS proposal

Strengths include:

- there is a prescribed time limit on claims
- levies would be pre-funded. This encourages the CSLR to be operated with greater prudence than a post-funded levy (assuming that there is no ability to charge a post-funded levy or where post-funded levies can only be charged in exceptional circumstances). There should be similar constraints placed on borrowing and there should also be limits on increases in pre-funded levies, to encourage the scheme to exercise financial prudence

Weaknesses include:

- liability is limited to the advice sector
- access is not limited to decisions made by an EDR scheme. EDR decisions are hybrid of commercial settlement and political compromise. In return for providing basic protections to consumers and improved efficiency, members collectively influence the EDR's approach to determinations. There is an argument that a CSLR funded by EDR members could be bolted on to an EDR scheme, given the collective influence members have over the approach to determinations, However, it is hard to see how such an argument would apply for court and tribunal decisions, given they are made by bodies independent of the financial services firms.

- for a complainant to access the CSLR, the scheme, court of tribunal who has made the determination that is unpaid must declare that the person against whom the determination is made is in default. This is a lower requirement than the ABA proposal, thereby heightening the risk that the scheme will not genuinely be one of last resort. Even if the CSLR can recoup payments from EDR members who are in default, the scheme will need to provide the funds upfront and cover the cost of seeking to recoup compensation where practicable. We prefer the ABA"s model, which puts the onus firmly on the consumer.

15. What are the arguments for and against extending any compensation scheme of last resort beyond financial advice?

FPA response

In support of extending any CSLR beyond financial advice, there is a need to address the risk that, for example, EDR schemes attribute losses resulting from product failures to advice failure. For example, there is a risk that EDR schemes will see the full associated loss as arising solely from advice provided even where the product has been negligently managed. This risk is especially high where the EDR scheme only has jurisdiction in respect of the advice aspect of the complaint, because the issuer of the failed product hasn't engaged in conduct (such as misrepresentation or misleading conduct) that provides grounds for an EDR scheme to award compensation against them. EDR schemes need to address this problem before any CSLR is introduced.

However, there appears to be no clearly developed approach to dealing with providers failing to live up to reasonable expectations. This is an impediment to ensuring that the failures of other providers aren't attributed to the advice provided.

Consumer protection and appropriate consumer compensation is the responsibility of all participants who have a role in causing, or an influence in allowing, consumer detriment. This is a matter of equity. Until the regulatory and compensation framework is able to ensure that each provider has responsibility and financial accountability to the end consumer, the FPA is unable to support the introduction of a Compensation Scheme of Last Resort.

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

FPA response

In our view, anyone who can access an EDR scheme should be able to access a CSLR. We expect that the new one-stop-shop EDR for the financial services industry would be available to:

- retail consumers; and
- wholesale clients who have not been excluded by (and at the discretion of) the EDR

This reduces complexity for consumers.

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

FPA response

In our view, all claims covered by an EDR should be covered by a CSLR. This reduces complexity for consumers.

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?

FPA response

EDR decisions are hybrid of commercial settlement and political compromise. In return for providing basic protections to consumers and improved efficiency, members collectively influence the EDR's approach to determinations. There is an argument that a CSLR funded by EDR members could be bolted on to an EDR scheme, given the collective influence members have over the approach to determinations, However, it is hard to see how such an argument would apply for court and tribunal decisions, given they are made by bodies independent of the financial services firms.

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

FPA response

We agree with the ABA proposal that, before being able to access the CSLR, the consumer must have explored other avenues for enforcing the EDR determination. This ensures that the scheme is truly a compensation scheme of last resort. This is important to minimise the extent to which the introduction of a CSLR will encourage consumers to take more risk than they otherwise would have.

20. Where an individual has received an EDR determination in their favour, should any compensation scheme of last resort be able to independently review the EDR determination or should it simply accept the EDR scheme's determination of the merits of the dispute?

FPA response

In our view, the CSLR should simply accept the EDR scheme's determination of the merits of the dispute. Although review by the CSLR would enhance comparability of outcomes, it would also increase regulatory cost. Further, unless the CSLR could rehear the entire matter, there is a significant risk that their assessment of the merits will be based on incomplete information.

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?

FPA response

We are against allowing people with a court or tribunal judgement to access the CSLR. If, despite our opposition, people with an unpaid court or tribunal judgement could access the scheme, costs should be limited to the losses caused directly by the financial services provider who is being claimed against. Restricting compensation will help contain regulatory costs and, in turn, reduce the potential for the erosion of competition in the financial services industry.

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?

FPA response

We recommend that the Panel consults with litigation funders about restricting their ability to recover fees from claimants.

23. What compensation caps should apply to claims under any compensation scheme of last resort?

FPA response

In our view, compensation should be the lower of a prescribed percentage of the claim amount and a prescribed flat dollar amount. This will minimise the extent to which the introduction of a CSLR will increase the risk consumers, providers and regulators will take.

24. Who should fund any compensation scheme of last resort?

FPA response

As discussed, we are against having a CSLR. If, despite this opposition, a CSLR is introduced, we recommend industry funds the scheme, where each provider pays a levy based on their particular risk-level

Industry funding

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

FPA response

As discussed, we are against having a CSLR. If, despite this opposition, a CSLR is introduced, we recommend industry funds the scheme, where each provider pays a levy based on their particular risk-level.

Risk-based funding would minimise the extent to which providers would increase their risk-level because they are sharing compensation costs with the other providers in their pool.

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?

FPA response

The CSLR should only be available where the complainant has proved that the assets of the provider will not cover the claim. In the unlikely event that the provider can nevertheless cover the claim (including at some future point in time), the CSLR should be able to recoup its costs from the provider.

Potential design of a compensation scheme of last resort (continued)

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

FPA response

ASIC should be able to apply to the court to freeze the assets or redirect the income of a provider against which an EDR decision is made, where there is something more than a mere possibility that the claim will not be paid.

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

FPA response

We're strongly of the view that any CSLR should be administered by industry if it is funded by industry. Having a CSLR involves forcing financial services providers to provide an additional warranty and fund it by a form of insurance. Industry would have to provide this added protection regardless of the willingness of consumers to pay for it. Given the burden is imposed on providers, it seems reasonable that providers can at least control the costs associated with administering this government-imposed protection. Further, providers would have an incentive to run the scheme efficiently if they are paying for it.

29. Should time limits apply to any compensation scheme of last resort?

FPA response

We strongly believe that time limits should apply. As mentioned above, we believe that to be eligible to access any CSLR the claimant should have explored the avenues available to enforce the EDR decision and obtained proof that the assets of the EDR member against which the decision was made are insufficient to meet the compensation order.

A reasonable time limit would allow claimants time to take debt recovery action and, if necessary, meet the conditions for accessing the CSLR. This helps the scheme contain its exposure while giving claimants a reasonable opportunity to access the scheme.

30. How should any compensation scheme of last resort interact with other compensation schemes?

FPA response

The CSLR should only be able to be accessed after the other avenues, including any other compensation schemes, for enforcing an order for compensation, or obtaining compensation in its place, are explored.

31. Are there any aspects of compensation schemes of last resort in other sectors and jurisdictions that should be considered in the design of any compensation scheme of last resort?

FPA response

As discussed, we're strongly in favour of risk-based levies. This means the levy for each member of the CSLR should be based on that member's particular risk-level, based on for example, measures of leverage, liquidity, excess capital to revenue, and return on capital and on complaints history. This should apply to advice providers as well as other financial services providers, such as product providers.

Legacy unpaid EDR determinations

32. What existing mechanisms are available for individuals who have legacy unpaid EDR determinations to receive compensation?

FPA response

We understand that ASIC can use its powers to enforce a determination of the SCT, including to take court action for a performance injunction.

We understand ombudsman schemes can take court action to enforce its contract against a member who doesn't pay a compensation order.

33. Is there a need for an additional mechanism for those with legacy unpaid EDR determinations to receive compensation? If so, who should fund the payment of the legacy unpaid EDR determinations?

FPA response

We oppose government imposing additional mechanisms for those with legacy unpaid EDR determinations to receive compensation. If, despite our opposition, such a mechanism is introduced, difficult problems arise. For example, if industry has to fund the mechanism, providers other than those responsible for the unpaid determination will also bear the cost for it even though the firm that caused the loss may end up not contributing to the mechanism at all. Further, providers will be subject to potentially substantial liabilities that they wouldn't have reasonably expected they would have to pay. In these circumstances, there is a strong case for taxpayers to fund, or at least subsidize, any mechanism for those with legacy unpaid EDR determinations to receive compensation.

We acknowledge that EDR scheme rules have excluded many cases of consumer loss. However based on estimates of how large this liability would likely be, it would be impossible for industry to fund such a compensation scheme.

Providing access to redress for past disputes

Circumstances which have prevented access to redress

34. Other than circumstances that may be covered by a compensation scheme of last resort (such as outstanding unpaid determinations), what kinds of circumstances have given rise to past disputes for which there has not been redress? Are there any other classes besides those identified by the Panel?

FPA response

The classes of cases that have given rise to past disputes for which there has not been redress include:

- financial firm was insolvent or otherwise unable to pay
- action was not affordable or available (e.g. EDR was not available because of monetary or time limits, and the cost of court action was unaffordable for the consumer), or was too complex or traumatic, to the consumer

In addition to the classes of circumstances identified by the Panel, a financial services firm's unwillingness to pay a compensation order may have given rise to past disputes for which there has not been redress.

35. What evidence is there about the extent to which lack of access to redress for past disputes is a major problem?

FPA response

FOS reports that '…unpaid determinations represent 17.8% of all accepted determinations issued in favour of consumers by the Investments and Advice (I&A) team' (FOS Circular – Issue 28 February 2017). However, it is unclear whether FOS has attempted to take action in contract against members; or whether ASIC has attempted to exercise its powers (e.g. to seek injunction for performance). In other words, it is unclear whether unpaid determinations are a problem merely because existing

mechanisms to adequately deal with them haven't been utilised to their full potential or whether there is a failure of professional indemnity insurance as a mechanism to provide the capacity to provide adequate compensation. We again point to the failure to consider the findings of the St John Report from 2011. Finally, it appears that advice failures are being used as a proxy for failures elsewhere in the financial services industry which unless fixed will mean that any proposed scheme is potentially exposed to the risk of the whole system.

Approaches to providing access to redress for past matters

> 36. Which features of other approaches established to resolve past disputes outside of the courts (whether initiated by industry or government) might provide useful models when considering options for providing access to redress for past disputes in the financial system?

FPA response

In our view, important features include:

- any compensation is awarded at the discretion of the CSLR decision-maker – this approach helps contain costs and counteracts the windfall gain (in the form of an added layer of protection) to consumers
- the mechanism is only available where:
    - both the dispute hasn't been heard by a court or tribunal; and through no fault of their own, the claimant hasn't been able to access EDR; or
    - there is an unpaid EDR determinations for products or services provided under an agreement entered into before the introduction of a CSLR
- compensation is capped at the lower of a percentage of the unpaid compensation order; and a prescribed flat dollar figure – this helps contain regulatory costs.
- taxpayers cover the cost or, at the very least, subsidise the mechanism – this approach is arguably more equitable than alternatives as the cost is based on regulatory limitations, and would help contain regulatory costs that each person who pays for the mechanism bears.
- the mechanism does not involve re-deciding the matter – any fair appeal mechanism will add to the cost of EDR. Given that the provider has no reciprocal right of appeal (except to a court in extremely limited circumstances), an appeal function would provide a one-sided benefit. As such, we believe that there would need to be broad industry support for an appeal function. We don't believe such support exists. This approach is arguably more equitable than alternatives.

Evaluation of providing access to redress for past disputes

> 37. What are the benefits and costs associated with providing access to redress for past disputes?

FPA response

Benefits include:

- more consumers who need compensation will receive it, without the need for costly court action

Costs include:

- there are classes of compensation that would be borne by those who are not responsible for the loss
- increased compensation costs, either directly or through increased PI insurance premiums

38. Are there any legal impediments to providing access to redress for past disputes?

FPA response

We understand that professional indemnity insurance would not cover firms for past disputes where those firms didn't cause the loss to the consumer.

39. What impact would providing access to redress for past disputes have on the operations of financial firms?

FPA response

Providing access to redress for past disputes would add a significant cost to firms where compensation isn't taxpayer-funded. If industry was required to fund past disputes, it would divert funds away from business operations and potentially impact client service offerings and cost of advice, particularly for small to medium firms who have less capacity to cover the additional unexpected cost.

Evaluation of providing access to redress for past disputes (continued)

40. What impact would providing access to redress for past disputes have on the professional indemnity insurance of financial firms?

FPA response

Unless PI insurance cover adapts to cover firms for past disputes where those firms didn't cause the loss to the consumer, we can't see how providing access to past disputes would affect the professional indemnity insurance of financial firms. However, if the introduction of such redress is accompanied by measures to recoup (subject to the terms of the PI policy) compensation costs from the PI insurer of the firm that caused the loss, redress for past disputes will result in increased premiums or a reduction in product quality.

41. Would there be any flow-on implications associated with providing access to redress for past disputes? How could these be addressed in order to ensure effective outcomes for users?

FPA response

Some claims that would not otherwise have been brought, would be brought if access to redress to past disputes were provided. This could add significant regulatory cost to those who have to fund the redress mechanism, which in turn increases the magnitude of the equity issue where those funding the redress mechanism didn't cause the loss being compensated.

Design issues for providing access to redress for past disputes

42. What are the strengths and weaknesses of the Westpac proposal?

FPA response

Strengths include:

- decisions would be made by an expert panel made up of legal and commercial capability
- there would be a user-pays element for financial firms who have determinations made against them
- disputes must come within stated time limits (for example, statute of limitations).
- the dispute must not have been previously heard, for example, by FOS (but see comment below) or a court.
- if the customer is a 'larger business' customer, then it must not have resources to take its dispute to court (for example, it must be insolvent)

Weakness include:

- the scheme would be limited to bank-related disputes
- the dispute must not have been previously heard by an EDR – given our position of excluding access to a CLSR in relation to disputes over agreements already entered into, we would expect that EDR disputes in relation to such agreements would be covered by the past issues forum.
- If the customer is a 'larger business' customer, then it must not have resources to take its dispute to court (for example, it must be insolvent).

43. What range of parties should be provided with access to redress for past disputes? Should all of the circumstances described in paragraphs 133-144 be included?

FPA response

The mechanism should only be available where:

- both the dispute hasn't been heard by a court or tribunal; and through no fault of their own, the claimant hasn't been able to access EDR; or
- there is an unpaid EDR determinations for products or services provided under an agreement entered into before the introduction of a CSLR

Extending access to a broader range of situations, for example, where a consumer failed to take action where it was reasonably practicable for them to do so, would undermine the principle of the accountability of the consumer.

44. What mechanism should be used to resolve the dispute and what criteria should be used to determine which disputes can be brought forward?

FPA response

Any compensation should be awarded at the discretion of the decision-maker – this approach helps contain costs and counteracts the windfall gain (in the form of an added layer of protection) to consumers.

45. What time limits should apply?

FPA response

We believe that the time limits should be aligned with the statutory limits for the same loss.

46. Should any mechanism for dealing with past disputes be integrated into the new Australian Financial Complaints Authority (once established) or should it be independent of that body?

FPA response

We believe that any CSLR should be independent. This is because, for reputational reasons, an EDR scheme would be expected to give more weight to compensating the consumer who has an unpaid determination, than containing the costs of the CSLR.

47. Who should be responsible for funding redress for past disputes? Is there a role for an ex gratia payment scheme (that is, payment by the Government)?

FPA response

Past disputes should, at the very least, be subsidised by Government because the problem being addressed is caused, in part, by regulatory limitations.

48. Should there be any monetary limits? If so, should the monetary limits that apply be the EDR scheme monetary limits?

FPA response

Assuming the award of compensation is discretionary and taxpayer-funded, we are comfortable with EDR scheme monetary limits applying. However, if the scheme is industry funded (or substantially industry-funded) the limits would need to be modest to avoid existing firms having to compensate for the regulatory limitations.

49. Should consumers and small businesses whose dispute falls within the new (higher) monetary limits of the proposed Australian Financial Complaints Authority but was outside the previous limits be able to apply to have their dispute considered? Should access to redress for past disputes be provided through a transition period whereby the higher monetary limits are applied for a defined period retrospectively? If so, what would be an appropriate transition period?

FPA response

In our view, in these cases consumers and small business should not be able to access the past redress mechanism. If, however, such disputes are able to be considered, a transition period would be appropriate where it would help contain compensation costs.

50. If it is not possible to fully compensate all claimants, should a ‘rationing’ mechanism be used to determine the amounts of compensation which are awarded? Should such mechanism be based on hardship or on some other measure?

FPA response

We think a rationing mechanism is appropriate. Although we see some merit in rationing being based on hardship, there is a risk that such an approach would involve highly subjective judgments.

Are there any other issues that would need to be considered in providing access to redress for past disputes?

FPA response

We are not aware of any further issues.