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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

Review of financial system's external dispute resolution and complaints framework – Interim report

The Australian Bankers' Association (**ABA**) welcomes the opportunity to provide this submission to the Independent Expert Panel's review of the financial system external dispute resolution framework (Review)[1] and to respond to the Interim Report released on 6 December 2016 (Interim Report). This submission is in addition to the ABA's response to the issues paper, dated 10 October 2016, and our supplementary response on the design features of a last resort compensation scheme, dated 14 November 2016.

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.

Introductory comments

In April 2016, the Australian banking industry, in acknowledging there is more to do to promote good customer outcomes and to demonstrate sound practices so customers have confidence in the culture and conduct of banks, announced a package of initiatives to protect consumer interests, increase transparency and accountability, and build trust and confidence in banks.[2]

This include initiatives making it easier for customers when things go wrong, being:

- Enhancing existing internal complaints handling processes by establishing a dedicated customer advocate in each bank to ensure that retail and small business customers have a voice, and that complaints are appropriately escalated and responded to in a timely way.
- Supporting the broadening and strengthening of external dispute resolution (**EDR**) schemes with a view to increasing eligibility thresholds for retail and small businesses customers.

1 https://consult.treasury.gov.au/financial-system-division/dispute-resolution/
2 http://www.bankers.asn.au/media/media-releases/media-release-2016/banks-act-to-strengthen-community-trust

- Working with ASIC in expanding its review of remediation programs to cover all types of financial advice and products; and
- Evaluating a last resort compensation scheme and identifying an appropriate model.

In aggregate, these initiatives aim to ensure internal and external programs address customer concerns, make it easier for customers when things go wrong, and increase trust and give people confidence that when things do go wrong, banks will do the right thing.

The ABA believes this Review provides a complementary process to improve the EDR framework so that all the avenues for resolution of customer complaints are operating to the maximum benefit of consumers.

Response to the Interim Report

Our submission sets out high level design principles and proposed design features for a revised EDR and complaints framework for consideration by the Panel.

Specific responses to the recommendations and observations of the Interim Report are set out in Appendix 1, together with responses to the information requests in Appendix 2. Our detailed comments on the design of a last resort compensation scheme (scheme) are included in Appendix 3.

The ABA notes the overlap in the terms of reference between this review and other Government processes and reviews. We advise we have provided comments on EDR jurisdiction for small business credit disputes to the Small Business Loans Inquiry ('Carnell Inquiry') and the Financial Ombudsman Service (**FOS**) through its public consultation process.

Financial services dispute resolution

Simple, accessible and effective EDR plays a valuable role in enabling retail and small business customers (together, 'customers') to bring and resolve disputes with financial services providers (FSPs).

The ABA believes that EDR offers an important and accessible alternative to the court system as it is free for customers to access, does not require formal legal representation, and resolves disputes in a less adversarial way than the court system.

EDR works best in conjunction with effective complaints handling and Internal Dispute Resolution (IDR) programs. IDR programs are an important element of the FSP's overall relationship with its customers and manage a wide variety of complaints, including those that have not resulted in monetary loss. Many customers have their complaints successfully resolved though IDR.

But when EDR is needed to resolve a problem, the system must work as efficiently and quickly as possible to resolve disputes and achieve fair outcomes for customers.

Design principles

The ABA supports an EDR system with the following design principles. The EDR system must have the confidence of all parties; banks and other FSPs and consumers.

Simplicity

The EDR process should be simple and easy for customers to access, navigate and understand.
A revised EDR framework, which the banking industry supports, should have a single or simple path for resolution of disputes. Alternative bodies, processes or legal requirements may be required given the type of customer or nature of the dispute, however, these processes should operate in an integrated way.

Where more than one EDR scheme is in operation, the EDR framework should promote clarity and certainty for consumers by:

- Offering a single or simple path to EDR through an overarching gatekeeper, or ensuring clarity for consumers to be directed on where to access EDR to resolve a dispute.
- Minimising overlaps in terms of reference.
- Enabling more rapid allocation of disputes to the appropriate resolution pathway, ending the transfer of disputes between schemes or forums.
- Standardising regulatory oversight and approval of the operation of the EDR scheme(s).
- Standardising operating policy and process, leading to improved efficiency, and
- Rationalising industry and government funding models and allocation of adequate resources.

Accessibility

The EDR system should be readily accessible. Current arrangements to ensure accessibility for customers should be reinforced and continuously improved to ensure the following design features:

- **Free for consumers***:* EDR should continue to remain free for the customer to access, including retail and small businesses.
- **Remove information asymmetry***:* EDR schemes should continue to make available simple information about their processes, provide information to suit consumers with disabilities or languages other than English, and operate community outreach programs and provide information in community languages. FSPs should continuously improve the way they integrate EDR into their complaints handling policies and procedures, and to let retail and small business customers know about their rights to access EDR at key times[3].
- **Transparency***:* EDR schemes should ensure their communications with FSPs and consumers are clear throughout the process. It is important for all parties to be engaged and kept up-to-date with proceedings, and determinations should be clearly explained to the FSP and the consumer.

Effectiveness

Resolution of disputes through EDR should be fast, allow flexibility, be supported by appropriately skilled and funded resources and ensure satisfactory resolution of disputes for customers.

To enable speedy and satisfactory dispute resolution, a revised EDR framework needs to be designed to ensure the following:

- **Adaptability***:* Able to amend governance structures, revise terms of reference, review operating processes and reallocate resources so that the scheme can continue to evolve and respond to emerging issues.
- **Flexibility***:* Allows for a broad range of negotiated (and imposed) outcomes to individual disputes.
- **Capability***:* Is equipped with appropriate financial resources and organisational capability to resolve disputes with varied and complex features.

[3] The ABA notes that the banking industry commitment to have a Customer Advocate in each bank will provide an avenue for identifying improvements with customer communications about complaints handing and IDR as well as access to EDR. http://www.bankers.asn.au/media/media-releases/media-release-2016/new-voice-for-customers-in-complaints-with-banks

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Design features

Small business disputes

The EDR framework should continue to cater for disputes brought by small businesses.

As well as products created specifically for the small business market, many small businesses use 'retail' financial and credit products, such as general insurance, credit cards and transaction accounts designed for the 'retail market'. These disputes should be heard by the EDR schemes that hear similar disputes brought by retail customers to ensure simplicity and clarity for small businesses on where to go to have their disputes heard and maintain efficiencies.

Expanding the EDR eligibility thresholds and monetary limits for both retail and small business credit disputes, is a way to ensure the EDR Framework remains fit-for-purpose to support small businesses.

Jurisdictional limits and compensation caps

The ABA supports an increase to the eligibility thresholds and monetary limits of EDR schemes to ensure EDR is accessible to customers and that compensation is meaningful, taking account of EDR's mandate to resolve disputes other than those that are more suited to be heard in court.

General jurisdiction

We propose:

- Customers should be able to bring disputes up to the value of $1 million, and
- The EDR scheme should be able to make awards up to $1 million.

Small business credit disputes

We support increasing the eligibility thresholds and monetary limits for small business credit disputes.

That increase should be accompanied by a revised test for small business, to ensure the ongoing efficiency and accessibility of EDR schemes for genuine small businesses and reflect the intention that EDR is an alternative dispute resolution process for small and less complex disputes.

The standing of a small business should be assessed against a clear definition of 'small business' that takes into account:

- The number of employees
- Business turnover
- Size of the loan or investment for business purposes, and
- Total credit exposure of the business group.

The test should be quick and simple to apply, to ensure efficiency and accessibility. We note concerns about introducing new criteria in addition to the number of employees, however we believe that these additional criteria can be identified readily through information held by the FSP and the applicant, at least as easily as identifying the number of employees.

Expanding the criteria beyond the number of employees is critical to ensure the small business test is future proofed in the context of increasing automation and the digital economy, where large businesses can operate with comparatively few staff members.

There are a number of small business tests used for legal and commercial purposes. For the purpose of expanding the EDR small business credit jurisdiction, we propose the following small business test.

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)

- Annual business turnover is $5 million or more
- Size of loan for business purposes is $3 million or more, or
- Total credit exposure of the business group, including related entities, to all credit providers is $3-$5 million or more.

A business would not be small if any one of the conditions was satisfied. So, for example, a business with only 19 employees but with an annual turnover of $15 million would not be classified as a small business. In such a case, the court system is better placed to consider the matter.

The revised test for small business should apply together with the following jurisdictional limits:

- Small businesses should be able to bring credit disputes up to the value of $1 million
- The EDR scheme should be able to make awards in relation to credit disputes up to $1 million, and
- The credit facility limit should be $3 million.

Debt recovery proceedings in respect of facilities up to $3 million should be prohibited while a dispute is being considered by FOS.

The rationale for monetary limits on both the size of claim and amount of compensation reflects the intention that EDR is an alternative dispute resolution process for small disputes and customers who do not have the resources to use the court system. This ensures EDR resources, and therefore speedy resolution of claims, are available to those customers who most need them.

Importantly, the quantum of eligibility limits and compensation caps should not expand EDR jurisdiction to very complex and high value business matters, where determinations are binding on the FSP and there is no right of appeal on the substance of the determination.

Farm debt mediation

Farm Debt Mediation (**FDM**) is a specialised mediation process that allows a farmer and their FSP to negotiate a better financial outcome. Mediators are trained to understand the unique and complex circumstances affecting farming operations and agri-business lending.

The ABA believes that FDM should remain separate to the EDR schemes.

We support the implementation of a nationally consistent farm debt mediation model across Australia, and have been working with the Australian Government and agricultural organisations on legislative options. We have also been working with State governments as they look to adopt mandatory models, similar to NSW and Victoria.

Enduring funding for financial counselling services

Financial counsellors are an essential public service. They provide independent and free advice and information to individuals and families during difficult financial and emotional times and help their clients deal with debt problems, including from mainstream financial institutions, other lenders (including payday lenders), and other creditors (including retailers, utilities and telecommunications companies). We recognise the importance of the work financial counsellors do in helping people through incredibly challenging times often due to a change in their circumstances, such as loss of employment or relationship breakdown, or health related issues.

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The ABA supports an enduring model of government funding for financial counselling services to ensure these services continue to make a significant difference for many Australians experiencing financial difficulty and facing other economic and social challenges. It is important for the government to provide funding for financial counsellors' casework. Additionally, we have recently announced an initiative to work with financial counsellors to support the setup of a new debt repayment service to help people manage multiple debts[4]. This initiative aims to achieve better customer outcomes by helping people get control of their finances and debts including from non-bank lenders and creditors.

Consultation and transition

The reforms proposed in the draft recommendations are complex, involve potentially significant legal and regulatory changes and will require significant government and industry effort and resources to put into effect. We support building in sufficient transitional timeframes, particularly in relation to new industry reporting obligations.

Last resort compensation scheme

The ABA supports establishing a mandatory, prospective compensation fund that covers individuals and small businesses who have received poor financial advice, and have not been paid a determination made by an ASIC-approved EDR scheme, due to the validated insolvency or wind up of financial advice businesses, where all other redress avenues have been exhausted.[5]

A detailed analysis of the design features of a last resort compensation scheme is set out in Appendix 3.

Closing remarks

The ABA and our member banks are strongly committed to making sure the EDR system is improved and works well now, and into the future.

The ABA would welcome the opportunity to discuss these issues further with the Panel.

In the meantime, if you have any questions in relation to this submission, please do not hesitate to contact me or Christine Cupitt, Policy Director – Retail Policy on (02) 8298 0416 or christine.cupitt@bankers.asn.au.

Yours sincerely

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[4] http://www.bankers.asn.au/media/media-releases/media-release-2016/we-hear-you-banks-announce-more-changes-to-make-banking-better

[5] 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 scheme.

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Appendix 1 – Response to draft recommendations and observations

	Draft recommendation	Industry position
1	**A new industry ombudsman scheme for financial, credit and investment disputes** There should be a single industry ombudsman scheme for financial, credit and investment disputes (other than superannuation disputes) to replace FOS and CIO.	The ABA supports a single industry ombudsman scheme for financial, credit and investment disputes (other than superannuation disputes). The merits of establishing a new body to replace the existing ombudsmen should be weighed against the potential time and cost savings of merging FOS and CIO. Alternatively, a single or simple path to EDR through an overarching gatekeeper, or ensuring clarity for consumers to be directed on where to access EDR to resolve a dispute, should be adopted ('one-stop-shop').
2 / 3	**Consumer monetary limits and compensation caps** The new industry ombudsman scheme for financial, credit and investment disputes should provide consumers with monetary limits and compensation caps that are higher than the current arrangements, and that are subject to regular indexation. **Small business monetary limits and compensation caps** The new industry ombudsman scheme for financial, credit and investment disputes should provide small business with monetary limits and compensation caps that are higher than the current arrangements, and that are subject to regular indexation.	The ABA supports increasing monetary limits and compensation caps to ensure appropriate access to EDR by retail and small business customers. *General jurisdiction* We believe: • Retail and small business customers should be able to bring disputes up to the value of $1 million, and • The EDR scheme should be able to make awards up to $1 million. *Small business credit disputes* We believe: • Small businesses should be able to bring credit disputes up to the value of $1 million. • The EDR scheme should be able to make awards in relation to credit disputes up to $1 million. • The credit facility limit should be $3 million. Debt recovery proceedings in respect of facilities up to $3 million should be prohibited while a dispute is being considered by an approved EDR scheme.

	Draft recommendation	Industry position
		A revised small business credit jurisdiction should be accompanied by a revised small business test. Specifically, 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 good (full-time equivalent); or • Annual business turnover is $5 million or more; or • Size of loan for business purposes is $3 million or more; or • Total credit exposure of the business group, including related entities, to all credit providers is $3-$5 million or more. A business would not be small if any one of the conditions was satisfied. The terms of reference of an ASIC-approved EDR should provide for regular indexation.
4	**A new industry ombudsman scheme for superannuation disputes** SCT should transition into an industry ombudsman scheme for superannuation disputes.	The body of this submission proposes principles in relation to simplicity, accessibility and effectiveness of the new EDR and disputes framework. The EDR framework should promote clarity and certainty for consumers by offering a single or simple path to EDR through an overarching gatekeeper, or ensuring clarity for consumers on where to access EDR to resolve a dispute. We note it will be complex to transition the SCT into an industry ombudsman scheme for superannuation disputes. Complexities include: • Affirming the binding nature of determinations and enforcement mechanisms • Reconciling unlimited compensation caps (under SCT) with the principle of EDR hearing smaller, less complex disputes, and • Unwinding the SCT legislation and making provisions for RSEs to be member of EDR. Government will need to be sufficiently resourced to conduct detailed industry consultation and develop the framework for a new superannuation ombudsman.

	Draft recommendation	Industry position
		Consistent with the principle of simplicity, the terms of reference of any new superannuation ombudsman, should avoid overlapping with the jurisdiction of other ombudsmen to provide certainty for customers and avoid confusion arising through multiple forums.
5	**A superannuation code of practice** The superannuation industry should develop a superannuation code of practice.	The ABA has no comment on this recommendation.
6	**Ensuring schemes are accountable to their users** Both new schemes should be required to meet the standards developed and set by ASIC. At a minimum, ASIC's regulatory guidance should require the schemes to: • Ensure they have sufficient funding and flexible processes to allow them to deal with unforeseen events in the system, such as an increase in complaints following a financial crisis or natural disaster; • Provide an appropriate level of financial transparency to ensure they remain accountable to users and the wider public; • Be subject to more frequent, periodic independent reviews and provide detailed responses in relation to recommendations of independent reviews, including updates on the implementation of actions taken in response to the reviews and a detailed explanation when a recommendation of an independent review is not accepted by the scheme; and • Establish an independent assessor to review the handling of complaints by the scheme but not to review the outcome of individual disputes. In addition, ASIC's regulatory guidance should require the new scheme for financial, credit and investment disputes to regularly review and update its monetary limits and compensation caps so that they remain relevant and fit-for-purpose over time.	The ABA supports, in principle, the recommendations to revise ASIC's *Regulatory Guide 139: Approval and oversight of external dispute resolution schemes* [RG139]. Requirements relating to internal governance, such as independent reviews, should allow sufficient flexibility to target resources to address specific risks or issues, and manage costs. ASIC's standards should maintain the character of EDR schemes, in particular that they are industry based and independent.

	Draft recommendation	Industry position
7	**Increased ASIC oversight of industry ombudsman schemes** ASIC's oversight powers in relation to industry ombudsman schemes should be enhanced by providing ASIC with more specific powers to allow it to compel performance where the schemes do not comply with EDR benchmarks.	The ABA supports, in principle, the recommendation for increased ASIC oversight of industry ombudsman schemes. Any enhanced supervision requirements should maintain the character of EDR schemes, in particular that they are industry based and independent.
8	**Use of panels** The new industry ombudsman schemes should consider the use of panels for resolving complex disputes. Users should be provided with enhanced information regarding under what circumstances the schemes will use a panel to resolve a dispute.	The ABA suggests that the further use of panels, as they are currently comprised, be approached with caution. Flexibility should remain to use panels only in relation to some product types and some dispute types. The EDR should maintain transparent criteria or guidance on when panels will be used. As well as additional costs, members have advised anecdotally that panels can affect the timeliness of EDR decisions, impacting efficiency.
9	**Internal dispute resolution** Financial firms should be required to publish information and report to ASIC on their IDR activity and the outcomes consumers receive in relation to IDR complaints. ASIC should have the power to determine the content and format of IDR reporting.	The ABA supports, in principle, the recommendation for FSPs to publish information and report to ASIC on their IDR activity and the outcomes customers receive in relation to IDR complaints. We suggest that the design of any further reporting obligations take into account the recommendations arising from other Government reviews and processes. We also suggest that that the design of any further reporting obligations take into account existing reporting obligations (e.g. CCMC reporting), and seek to utilise existing reporting for this purpose. We note there will be significant complexity and costs to industry in developing systems to provide information in a form determined by ASIC. Noting that there is currently no standardised format for IDR reporting, industry will need sufficient time to both consult on any new form and implement any required changes.

	Draft recommendation	Industry position
		The ABA is currently working with our member banks on designing a reporting framework associated with the banking reform program, which includes metrics for the dedicated customer advocate. With a particular focus on improving complaint handling and IDR and access to EDR, we encourage this work to be leveraged with any further reporting obligations.
10	**Schemes to monitor IDR** Schemes should register and track the progress of complaints referred back to IDR.	As above, the ABA supports, in principle, the recommendation for improved reporting on IDR activity. We also suggest that the design of any further reporting obligations take into account existing practice, such as current FOS processes, and seek to utilise existing reporting for this purpose. Consultation will be required on how to operationalise any new requirements.
11	**Debt management firms** Debt management firms should be required to be a member of an industry ombudsman scheme. One mechanism to ensure access to EDR is a requirement for debt management firms to be licensed.	The ABA supports the recommendation for debt management firms to be required to be a member of an industry ombudsman scheme. The role of 'for profit financial difficulty companies' (including debt management firms and credit repair agencies) should be examined to ensure consumers are appropriately represented and protected, including in their representations with EDR schemes but also more broadly. A decision to license debt management firms should be based on a detailed assessment of the benefits to consumers and the proposed detail of the licensing regime. EDR membership may be one outcome of licensing, but should not be the determining driver. Other factors including the benefits and costs of regulation and improved consumer protection should be given close consideration. We would support a review considering licensing for debt management firms, but also suggest the Panel consider other options, at least in the first instance, to require debt management firms to become members of an ASIC-approved EDR scheme.

Appendix 2 – Response to information requests

	Information requests (Members to review and provide written feedback)	Industry response
5.74	Should the national consumer credit protection law be extended to small businesses?	*Improving EDR access for small business* The ABA supports small business customers having appropriate access to EDR. We suggest that the Panel consider all options, to ensure such access, including the merits of requiring non ACL lenders to become members of an ASIC-approved EDR scheme.[6] However, improved access to EDR for small business customers could be achieved without extending the national consumer credit protection (NCCP) law to small business. We support strong competition in the lending market and note that many small businesses are currently well serviced by ACL lenders including banks, credit unions and building societies and a number of equipment leasing and financing businesses. Small businesses may also choose to obtain credit through a non ACL lender. The Panel could also consider requirements to give greater prominence to the fact EDR is not currently available with loans from particular lenders. *Extending NCCP to small business* There are existing consumer protections available to small businesses, including unfair contract term (UCT) protections for small businesses, requirements of the *ASIC Act* and industry standards, including the provisions of the Code of Banking Practice (COBP). Many banks extend some aspect of NCCP to small business customers, such as including the approach to hardship and access to dispute resolution. Any decision to modify the framework for small businesses should identify where concerns or gaps exist and consider specific regulatory responses to address those concerns or gaps. The direct application of retail responsible lending obligations to small businesses would be inappropriate, as it would not take into account the inherently different nature of business lending. In particular, the serviceability assessment, loan suitability and income verification processes each operate differently between retail and small business lending.

[6] We note that the majority of members support non ACL lenders being members of an EDR scheme, some members have policy concerns about this approach to improving EDR access for small business.

	Information requests (Members to review and provide written feedback)	Industry response
		Any decision to extend NCCP to small business should take account of the impact of the complete NCCP framework, including: • Application of responsible lending criteria • More detailed regulated disclosures and documentation • Special provisions for managing loans and the relationship with the creditor (e.g. enforcement, collection and dispute resolution), and • Licensing and regulatory oversight. The decision would also need to weigh up any new consumer protection benefits, against the significant implementation and ongoing compliance costs of extending the regime. Importantly, the NCCP regime was developed to protect the interests of consumers, when obtaining credit for domestic purposes; applying NCCP to small business could trigger significant unintended consequences in relation to the cost and availability of credit to small business. In particular, the responsible lending obligations under NCCP may not be appropriate measures for lending to small businesses. For example, the responsible lending obligations require collection of individuals' income and living expenses as a minimum step for consumer lending, and may not be relevant for small business lending. Furthermore, responsible lending obligations require the assessment and verification of income, which can be challenging from a practical perspective and even irrelevant for start-up businesses or newer small businesses which may require capital for expansion. *Example - Role of security in business lending* In business lending, financial assessment for lending to a newly established business (ie start-ups) is generally based largely on the strength of guarantees and security provided by the founders of such business (ie directors giving a person guarantee and security over their real property). Under the NCCP Act, the value of security is not sufficient for the suitability assessment of a loan and the assessment needs to be based at some point on income (which may be negligible for some time).

	Information requests (Members to review and provide written feedback)	Industry response
		Application of these rules would severely restrict the ability of the banks to lend to start ups and increase the prevalence of unregulated lenders.
5.152	Should schemes be provided with additional powers and, if so, what additional powers should be provided? How should any change in powers be implemented?	The ABA believes that new powers to compel documents should be approached with caution, having regard to existing duties of confidentiality, privacy laws and other influencing factors, such as confidentiality in situations of financial abuse (elder abuse, family violence). However, we are supportive of the Panel investigating powers consistent with the SCT and UK FOS. In relation to compensation, we believe EDR is a forum to obtain compensation for losses. Consistent with the purpose of EDR, it is not a forum for the award of punitive damages or imposing quasi fines.
5.171	Does EDR scheme membership by credit representatives provide an additional or necessary layer of consumer protection that is not already met through the credit licensee's membership?	The ABA does not believe individual EDR membership by ACRs is necessary for consumer protection. We believe the model should align with the AFS licensing regime, which requires only the AFSL to be a member.
6.22	What should be the monetary limits and compensation caps for the new scheme? Should they be different for small business disputes? What principles should guide the levels at which the monetary limits and compensation caps are set? What indexation arrangements should apply to ensure the monetary limits and compensation caps remain fit-for-purpose?	Our position on eligibility thresholds and compensation caps is set out in the body of our submission (pp4-5). For disputes other than small business credit disputes, the eligibility thresholds and compensation caps should be the same for retail and small business customers. The rationale for monetary limits on both eligibility thresholds and amounts of compensation caps should reflect the intention that EDR is an alternative dispute resolution process for small disputes. The EDR scheme terms of reference should provide for regular indexation of eligibility thresholds and compensation caps against CPI. Semi-regular indexation should also be completed, having regard to factors such as average mortgage size, interest rates, average super balance, etc.
6.66	On what matters should ASIC have the power to give directions? For example, should ASIC be able to give directions in relation to governance and funding arrangements and monetary limits?	The ABA has no comment on this recommendation.

	Information requests (Members to review and provide written feedback)	Industry response
6.76	What IDR metrics should financial firms be required to report on? Should ASIC publish details of non-compliance or poor performance IDR, including identifying financial firms?	As noted above, the ABA supports, in principle, the recommendation for improved reporting on IDR activity. The design of the improved reporting should take into account: • Existing practices, such as FOS benchmarking and CCMC reporting • Current variations in the implementation of RG165 and interpretations of 'complaint' • Metrics that take into account the business context and the size of the business (number of customers, volume of transactions etc.) such a percentages, rather than raw volumes; and • Appropriate implementation timeframes given practical and technology (systems) constraints.

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Appendix 3 – Last Resort Compensation Scheme

The ABA[7] supports establishing a mandatory, prospective compensation fund that covers individuals and small businesses (together 'customers') who have received poor financial advice, and have not been paid a determination made by an ASIC-approved EDR scheme due to the validated insolvency or wind up financial advice businesses, where all other redress avenues have been exhausted (LRCS).

Basis for the banking industry's support for a LRCS

The ABA's support for a LRCS is part of our strong support for the overall reform program to improve the quality of financial advice and rebuild consumer trust and confidence in financial advisers and through that, the financial services industry, more generally.

The ABA believes a LRCS represents the final element of a significant reform program already underway to professionalise the financial advice industry, including implementation of the Future of Financial Advice (**FOFA**) reforms and higher professional, ethical and education standards.

Establishing a LRCS covering financial advice is 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.

The ABA accepts that risks arise in relation to establishing a LRCS, including potential moral hazard, and possible distortions in government and regulator behaviour. We also accept that other steps should be taken to manage the risk of unpaid determinations in relation to financial advisers.

While accepting these arguments, we believe they are outweighed by the industry's support for the professionalisation of financial advice and the need to rebuild consumer trust and confidence in financial advice.

Other initiatives to manage risk for consumers

The ABA believes that managing the risk to consumers of unpaid determinations requires a multifaceted response. The introduction of a LRCS must be accompanied by other measures and reforms to reduce the likelihood of unpaid EDR determinations, both to ensure the LRCS is truly a last resort, and promote the long term viability and success of a LRCS.

An assessment of the root cause of unpaid determinations should consider what complementary risk management measures are required. Such initiatives should improve conduct in financial services, and ensure FSPs are accountable for meeting financial requirements and maintaining adequate compensation arrangements.

The ABA's support for a LRCS is based on a number of risk management measures and reforms intended to improve the regulatory framework. We consider these measures are essential to the proper introduction and functioning of a LRCS.

Some of the complementary measures will also be advocated by the ABA through the ASIC Enforcement Review.

Professionalisation of financial advice

The new legislative framework to raise education, ethical and professional standards for financial advisers should be introduced as an important underpinning of ethical behaviour across the financial services sector. Access to a LRCS, is an important feature of the professionalisation of financial advice and is intended to complement these broader reforms.

[7] 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.

Professional indemnity insurance

Industry should work with professional indemnity (**PI**) insurers to examine improving the cost, availability and coverage of PI insurance, including mandatory run-off cover for licensees, and responses to insolvency, fraud and other misconduct. Industry should introduce additional financial planner education in relation to the duty of disclosure, notification and settlement requirements, and the effect of replacing policies.

Regulation and regulatory activities

ASIC should require an annual assurance statement from all AFS licensees that they meet their licence obligations, including compliance with ASIC's *Regulatory Guide 126: Compensation and insurance arrangements for AFS licensees* [RG126]. ASIC should review the compensation requirements under RG126 to ensure they remain fit-for-purpose.

ASIC should also review the financial requirements for financial advice licensees under *Regulatory Guide 166: Licensing: Financial requirements* [RG 166], to consider whether capital requirements for AFSLs with a financial advice authorisation remain sufficient. Sufficient resources to compensate clients and meet any insurance deductible payments should form part of the resources required for an orderly wind down of a financial advisory business.

AFS licensing criteria

The past conduct of a person as a manager of a financial services business, including whether that business had unpaid EDR determinations, should be part of ASIC's AFS licensing and credit licensing assessment.

Appropriate enforcement powers for ASIC

Establishing the LRCS should be accompanied by additional provisions to:

- Publish the details of licensees that do not comply
- Give appropriate powers for ASIC to take enforcement action against persons responsible for the licensee's failure to comply (this may extend beyond the adviser to directors / managers in certain circumstances)
- Stop non-complying licensees from operating, and
- Prevent those persons from establishing a new financial services or credit assistance business.

Appropriate enforcement powers for ASIC should specifically address the risk of licensees winding up their businesses with the intention of avoiding paying an EDR determination.

Design process, resources and consultation

The design process for a LRCS will be necessarily complex, involve a large number of stakeholders from across industry and government, and will need to be based on detailed financial modelling and sound public policy.

We suggest that any observations or recommendations in relation to a LRCS should include sufficient timeframes and allocation of government resources to drive the right outcomes and ensure the success and long term viability of a LRCS.

Design principles

Consumer focus

The ABA believes that consumers should have a clear understanding of the intent of the LRCS, particularly regarding the type of claims the LRCS will consider and the circumstances in which the LRCS will respond. The purpose of the LRCS should be well communicated to consumers, so it is clear that the LRCS is not intended to cover market-linked investment losses.

The LRCS should provide a meaningful solution for customers, provide certainty with clear terms of reference, and avoid overly legalistic interpretations of financial advice services that exclude some customers without a clear policy basis.

Last resort

The LRCS should operate as a last resort to compensate customers who have received poor financial advice, and have not been paid a determination made by an ASIC-approved EDR scheme due to the validated insolvency or wind up of the financial advice businesses, where all other redress avenues have been exhausted.

Generally, we would expect that a customer would resort to the financial adviser (and through the financial adviser the PI insurer), the financial resources of the financial adviser, and to have explored legal enforcement options. Evidence will be required (possibly from a registered liquidator or administrator) that the assets of the financial advice business will not cover the determination.

Prospectiveness

The LRCS should be prospective, with the design process considering the timing of the effective date of the LRCS and appropriate event and cut-off dates for claims, to minimise distortions in consumer and financial adviser behaviour.

A prospective LRCS aligns with other improvements to consumer capability and decision making about financial advice, such as financial capability initiatives from banks and regulatory initiatives such as ASIC's financial advice tool kit.

We do not support the LRCS covering unpaid determinations made before the effective date, including the current unpaid FOS determinations. These determinations are the result of a combination of regulatory and conduct failures which are being addressed through the new professional standards framework and not a direct result of the absence of a last resort compensation scheme.

Simplicity

The design and scope of the LRCS should be simple, to avoid complicated and costly eligibility assessments and promote consumer understanding for the place of the scheme. Assessment based on defined licence conditions and defined classes of financial products should be preferred. This will also enable targeted used of regulated disclosures to explain the availability and role of the LRCS to customers.

The LRCS should also be designed, to the extent possible, to minimise distortions in consumer, adviser and regulator behaviour.

It should also be designed to complement other professional and risk management structures such as a professional scheme for limited liability or maintaining alternative, approved compensation arrangements.

Design features

Scope

The LRCS should cover failures that arise in the context of a relationship where personal advice on Tier 1 products, and / or general advice on Tier 1 products is provided to retail customers. The failure could relate to *Corporations Act* breaches, fraud, negligence, misrepresentation and administrative errors connected with the advice relationship. For example, losses arising from failure by the financial adviser to implement the financial advice where the client clearly instructs their adviser to do so.

The LRCS should cover general advice provided by financial advisers, product manufacturers and robo-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 is not intended to cover 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.

Addressing the biggest risk of unpaid determinations

Advice and investments determinations represent the largest proportion of unpaid determinations. As at October 2016, the top categories of non-compliant FSPs are:

- Financial planners and advisors: 57%
- Operators of Managed Investment Schemes: 11%
- Credit providers: 9%

Additionally, FSPs categorised as Investment and Advice have the lowest determination compliance rate. Unpaid determinations represent more than 18% of all Investments and Advice determinations, whereas overall compliance with FOS determinations is 99.974%. The value of unpaid determinations is almost one-quarter (23%) of the compensation awarded by Investments and Advice.

Simplicity

The scope of financial advice has a clear policy basis, and place in the professional standards framework for financial advisers. We believe that consumers will understand the scope and have certainty if the scheme covers financial advice failures.

Addressing a broader scope of services will involve a broader range of stakeholders, more complexity and may reduce the prospects of the LRCS's success. Where consumer protection issues arise in relation to these other services, other reforms should be considered first to address poor conduct and risk for consumers, rather than extending the LRCS scope as a first move.

Dealing and arranging services and research houses

We note the support from some stakeholders to include research houses and businesses that provide dealing and arranging services, without financial product advice, such as such as securities dealers or derivatives dealers. We do not support the inclusion of research houses nor dealing / arranging businesses as that would be inconsistent with our view that the LRCS is 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.

Registered Managed Investment Schemes

The ABA notes the support from some stakeholders for including registered managed investment schemes (**RMIS**) in the LRCS, and pooling contributions and risk, across financial advice and RMIS. We note the argument that this would require contributions across the 'value chain' and increase the accountability of RMIS operators.

However, we do not support the inclusion of RMIS in the LRCS for the following reasons:

- Inclusion of RMIS is not part of an integrated reform program to improve RMIS. We note recent activity to increase the financial requirements for RMIS and ASIC's recent consultation on risk management practices of responsible entities however the risk of RMIS is primarily based on economic factors, not behavioural ones.
- Advice-based investor harm arises due to behavioural failures and these risks are being mitigated through the professionalisation of financial advice. In contrast, the financial risks arising from RMIS are fundamentally different from advice-based financial harm and are likely to grow with the rise of non-bank financial activity utilising RMIS (for example, peer-to-peer lending). These risks are largely related to the investment models of RMIS and are difficult to mitigate.
- We do not think the exclusion of claims based on investment performance would be sufficient to manage such risks to the LRCS as many claims could be based on maladministration (which is easy to plead).
- The risk profiles of RMIS vary significantly. RMIS can include Australian index funds, international share funds, commercial property finds and agricultural ventures. We believe that a risk weighted contribution model should apply to these schemes, and note that this would involve significant complexity and time to design. This would significantly hamper the introduction of a LRCS in the immediate term.
- Inclusion of RMIS could introduce a new connection between prudentially regulated banks and the investment and shadow banking sector. This could pose a systemic risk to depositors as the LRCS could transmit losses from non-prudentially regulated activities (eg a property downturn during a crisis) to banks. Such connections between shadow banking and regulated banking are a key concern for international policy makers, with a trend towards limiting them, rather than increasing them.
- Related to this, there may be significant operational risk and provisioning required to take account of the exposure of the LRCS (and therefore its contributors) to the failures of RMIS. This has Basel compliance implications that are yet to be fully investigated by the banks. Even if LRCS contributions are capped at the individual contributor level, it is conceivable that the fall-out of a crisis could see contributors come under strong pressure to ensure the LRCS is adequately capitalised to cover all unpaid determinations. This liability could have material implications for the capital requirements of banks.

Tier 1 financial products

Financial advice covered by the scheme should be on Tier 1 financial products.[8] These are more complex investment products, which can have the greatest impact on the financial outcomes for a customer.

Compulsion

The LRCS should require all AFS licensees who offer financial product advice to a retail client to be a member and contribute to the LRCS. The LRCS should be mandatory. Compulsion should be underpinned by a legislative or regulatory requirement, and the operation of the LRCS itself should be industry based.[9]

[8] As defined in ASIC RG146, http://download.asic.gov.au/media/1240766/rg146-published-26-september-2012.pdf

[9] 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.

Jurisdiction

The LRCS should pay compensation in respect of unpaid determinations of ASIC-approved EDR schemes.[10] The size of disputes and quantum of compensation awards considered by the LRCS should align with, or be no greater than, EDR jurisdictional limits.

In principle, the LRCS should be designed to avoid distortions. This would lend to the LRCS being able to pay claims in respect of unpaid court awards. However, we do not support including court awards as:

- The number of potentially impacted customers is estimated to be small, yet will require complex rules to cater for them, compromising simplicity
- The exposure is hard to quantify and may compromise the quality of financial modelling and ultimately the success of the LRCS
- The LRCS may be opened up to unpaid class action awards, which are based on claims that would not otherwise go through EDR.

Structure, governance and processes

The structure of the LRCS should be developed through flexible, industry based processes, with appropriate legislative underpinning to ensure all financial advisers contribute to the LRCS. A largely industry based process will ensure the LRCS can be established in a timely way, and to enable flexibility to adjust its remit, terms of reference and processes over time.

The governance arrangements should include:

- A board, with representation including an independent chair, a legal expert and an equal number of industry and consumer representatives
- A claims management / assessment panel, and
- Sufficient resources to respond to claims as they arise, but not to operate on a full time basis or have remit for additional works.

The LRCS should have discretion to review cases to ensure they fit within the LRCS's scope and terms of reference (which may differ from the EDR scheme) but should not have discretion to review the merits of the claim or reduce the amount of compensation awarded by the EDR.

The establishment of the LRCS should be mindful of the overall findings about the EDR system, and appropriately fit together with an improved EDR framework.

If the EDR framework moves to one ASIC approved EDR scheme, we support further investigating the EDR scheme providing the administrative services for the LRCS and collecting funding levies. Suitable arrangements can be developed to manage any actual or perceived conflicts of interest.

Funding

Levies

Broadly, the ABA supports the levy structure proposed by the FOS[11] comprising:

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

[10] Approved in accordance with the Corporations Regulations and ASIC Regulatory Guide 139: *Approval and oversight of external dispute resolution schemes*.

[11] Updated Proposal to Establish a Financial Services Compensation Scheme, FOS, May 2015

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 exceed reserves, including proportionally reducing compensation and staggering distributions overtime.

The LRCS terms of reference and remit of the 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.

We do 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.

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.

Intersection with other professional and risk management structures

The introduction of a scheme should work in an integrated way with other regulatory, professional and risk management structures, so as to actively encourage improved practice and professionalism at the level of individual advisers and practices.

Specifically, the scheme should be designed to complement intersecting regulatory regimes that strengthen consumer protection, including the possible approval of a professional standards scheme (limiting liability) that would then bring regulatory assistance under Professional Standards Legislation, or from a commercial perspective, the possible creation of discretionary mutual funds by groups of market participants that might bring certainty to compensation for advice based consumer losses. One complementary measure would be to provide a discount on levies for participants in a regulated professional standards scheme or contributors to an approved discretionary mutual fund.