



Review of the financial system external dispute resolution framework

FOS Response to the Interim Report

1 February 2017



Contents

| | |
|---|----|
| Glossary | 3 |
| Executive summary | 4 |
| A new industry ombudsman scheme for financial, credit and investment disputes | 6 |
| A new industry ombudsman scheme for superannuation disputes | 32 |
| Accountability and Oversight | 34 |
| Internal Dispute Resolution | 39 |
| Debt management firms | 40 |
| A compensation scheme of last resort | 41 |
| Making it happen – a transition plan for implementation | 42 |
| Illustrative transition plan | 45 |
| Appendix A: | 46 |
| Table of Interim Report’s recommendations, observation and requests for information | 46 |
| Appendix B: Licensing of Authorised Credit Representatives | 52 |
| Appendix C: Consumer Jurisdiction | 54 |
| Appendix D: Small Business Jurisdiction | 70 |
| Appendix E: Why the evidence supports a single scheme | 93 |

Glossary

| | |
|----------------|--|
| FOS | Financial Ombudsman Service |
| CIO | Credit and Investments Ombudsman |
| SCT | Superannuation Complaints Tribunal |
| EDR | External dispute resolution (FOS is an EDR scheme) |
| IDR | Internal dispute resolution |
| TOR | Terms of Reference |
| Interim Report | Review of the financial system external dispute resolution and complaints framework, Interim Report, 6 December 2016 |

Executive summary

FOS welcomes the Interim Report and supports its proposals to strengthen the current financial services dispute resolution arrangements based on the principles of fairness, openness, simplicity and adaptability.

Implementation of the Review's interim recommendations will help deliver on these principles and ensure that the dispute resolution framework remains 'fit for purpose'.

This submission details our response to the Panel's findings, its draft recommendations and requests for additional information. Appendix A provides a summary of FOS's feedback, including a reference to the relevant section in this submission against each recommendation.¹

The system as a whole

The Interim Report identifies shortcomings in the current framework that prevent the system as a whole from operating optimally. Its recommendations propose an integrated suite of reforms to reduce complexity, increase consumer accessibility to redress and enhance accountability and transparency across the system. We endorse these outcomes.

We also strongly support the system-wide approach and analysis that underpins the Interim Report's findings and recommendations. We therefore caution against a piecemeal or partial implementation of the recommendations because, in our view, this would fall short of delivering a dispute resolution system well placed to meet future challenges in the financial system.

Some will argue that no structural change to the current arrangements is required – that the system is not broken – so why change? Others may characterise the proposals as not going far enough and as tinkering with the current system. In our opinion, both these views are mistaken.

As the Interim Report notes, the current arrangements are a product of history rather than design. The changes proposed will be essential if we are to ensure that dispute resolution in the financial sector remains fit for purpose in coming years and able to meet the

¹ This submission has been prepared by the Office of the Chief Ombudsman and does not necessarily represent the views of individual FOS directors. It draws on the experience of FOS and its predecessors in the resolution of disputes about financial services.

challenges of a dynamic financial sector and changing community expectations.

The proposed integrated suite of changes build on the tested attributes of the current industry ombudsman arrangements and will deliver the most fundamental reforms to external dispute resolution since the mandatory membership of an ASIC-approved EDR scheme was implemented in 2001.²

While understandably some members of the current schemes might be comfortable with the status quo, we believe the proposed measures need to be seen through a broader community and consumer lens, and as part of a meaningful package of reforms to rebuild consumer trust and confidence in financial services.

Once the Government has announced its response to the final recommendations of the Ramsay Panel, we are confident that with the goodwill, cooperation and commitment of the current three schemes and their stakeholders, the proposed suite of reforms can be implemented in an effective and timely manner.

Working with our members, the other schemes and our stakeholders, FOS is committed to playing our part in doing so.

² As part of its legislative response to the recommendations of the Wallis Committee.

A new industry ombudsman scheme for financial, credit and investment disputes³

The Interim Report recommends that:

There should be a single industry ombudsman scheme for financial, credit and investment disputes (other than superannuation disputes) to replace FOS and CIO.

We support this recommendation and agree with the Interim Report's findings that:

- multiple schemes with overlapping jurisdictions contribute to consumer confusion and makes it more challenging to achieve comparable outcomes for consumers with similar complaints
- competition and competitive tension between schemes does little to drive innovation and better outcomes for consumers, and
- multiple schemes give rise to unnecessary duplicative costs and inefficient allocation of resources.

Appendix E to this submission sets out in more detail why arguments for competition in EDR are not compelling. FOS accounts for 81 per cent of disputes received by the three EDR bodies (FOS, the CIO and the SCT) in the financial sector. Of the two ASIC-approved EDR schemes (FOS and the CIO), FOS accounts for 87 per cent of all disputes received.⁴

If the schemes remain separate, and other review recommendations are implemented, duplicative costs will be amplified with the establishment of panels across two schemes, two independent assessors, and the overall costs of dispute resolution in the expanded consumer and small business jurisdictions. There would also be a flow-on impact in increased challenges in retaining expertise, making the necessary investments to upgrade IT and

³ Approximately 30 per cent of FOS disputes relate to general insurance matters. While these are financial services, they form a distinct component of the disputes we receive with specific features because most relate to refused claims. Accordingly, we have included specific reference to insurance in the context of the single scheme.

⁴ Using 2014-15 data, 39,431 disputes were received across FOS, CIO and SCT. FOS received 80.9 per cent of these. Of the disputes received by FOS and CIO, FOS received 86.8 per cent.

enhancing stakeholder and community engagement across all jurisdictions and across two schemes.

We support the panel's conclusion that a triage service is not the solution. It is not a substitute for the creation of the proposed single scheme for financial, credit, investment and *insurance*⁵ disputes. As set out in our initial submission, there is no cost-benefit case for the creation of a triage/concierge service. ASIC and the Joint Consumer Submissions expressed similar views.

The Panel's recommendation for a single ombudsman scheme for financial, credit and investment *and insurance* disputes excludes superannuation disputes. And Recommendation 4 proposes a new industry ombudsman scheme for superannuation disputes. However, a number of disputes such as those involving life insurance or the provision of financial advice to superannuation fund members fall within FOS's advice and insurance jurisdictions.

We note that the Panel is yet to address in detail how the existing overlap in disputes currently handled by the SCT and FOS should be dealt with, and we would welcome the opportunity to discuss this so that consumer confusion could be minimised. We cover this issue in more detail later in this submission.

We concur with the high level features of the new scheme described in paragraph 6.17 in the Interim Report, and address aspects of these features in this and subsequent sections of this submission.

Powers and decision making

Powers and approach to decision making⁶

Decisions should bind members but not complainants.

The scheme should retain a focus on fairness with regard to decision making, including incorporating the broadest definition of fairness (currently in FOS's Terms of Reference).

The scheme should operate flexibly, with minimal bureaucracy and policies and processes (including on matters such as when it will use conciliation and panels) should be clear and transparent to users.

⁵ See footnote 3

⁶ Interim Report – table at 6.17, High level features of a single industry ombudsman scheme for financial, credit and investment disputes, p.147

Fairness in all circumstances

FOS's Terms of Reference (TOR) (section 8.2) sets out our dispute resolution criteria stating that:

FOS will do what in its opinion is fair in all the circumstances, having regard to each of the following:

- legal principles
- applicable industry codes or guidance as to practice
- good industry practice, and
- previous relevant decisions of FOS or a predecessor scheme (although FOS will not be bound by these).

The Interim Report noted that some stakeholders wanted greater clarity on what 'fairness in all the circumstances' involved suggesting increased guidance on this issue and greater clarity around decision-making processes generally.

The test in FOS's TOR is consistent with other major ombudsman schemes⁷, has been tested in the courts, and our decision-making processes under our TOR embed the principles of procedural fairness.

As outlined in our first submission to the Panel, our decision making is based on clear processes and criteria set out in our TOR and Operational Guidelines, and is subject to robust quality assurance. Moreover, we provide a variety of avenues for interested parties to understand our approach to dispute resolution and decision making as follows:

- Publishing FOS Approach documents in easy to understand terms.
- Holding regular open forums and meetings with stakeholders where our approach to particular types of disputes is explained.

⁷ For example, section 228 of the UK Financial Services and Markets Act 2000 provides that the UK Financial Ombudsman will determine a complaint by reference to what is, in their opinion, "fair and reasonable in all the circumstances of the case".

And the UK FOS scheme rules (set out in the DISP section of the FCA Handbook) state "in considering what is fair and reasonable in all the circumstances of the case, the ombudsman will take into account the relevant law, regulations, regulators' rules and guidance and standards, relevant codes of practice and, where appropriate, what he considers to have been good industry practice at the relevant time".

- Encouraging financial firms, consumers and consumer organisations who may have concerns about the approach we take in our determinations to raise these concerns directly with the relevant Lead Ombudsman or the Chief Ombudsman, or discuss them during regular industry and consumer meetings.
- Recognising that in limited circumstances there may be value in a more formal review mechanism when current informal mechanisms cannot fully address concerns about our approach in decisions. Introducing a formal cooperative review mechanism to supplement the current informal approaches and test case provisions. The review mechanism does not allow determinations to be re-opened. Under the TOR, determinations are final decisions on specific disputes. The mechanism provides for an assessment of whether FOS should continue to take a particular approach or modify it for future disputes. The formal review mechanism is set out in section 19A of our Operational Guidelines.⁸
- Paragraph 10 of our TOR provides for FOS to place a dispute on hold while a matter is being considered by the courts.⁹ Test case provisions can be used if a financial firm thinks that a dispute involves an issue which may have important consequences for the firm's business (or financial firms generally) or involves an important point of law.

In Part 2 of our first submission to the Panel we also provided an overview of our quality assurance program. This has evolved over the past three years and is well entrenched. We conduct regular audits of closed disputes (about 900 per quarter) against FOS's quality objectives covering timeliness, efficiency, fairness, accuracy and engagement.¹⁰

We support the new single scheme continuing these efforts to inform all stakeholders about the approach to decision making, how dispute resolution processes operate, and in maintaining a robust quality assurance process to support consistent, predictable decision making on disputes within the scheme's jurisdiction.

⁸ [fos.org.au/about-us/terms-of-reference](https://www.fos.org.au/about-us/terms-of-reference)

⁹ Test case provisions in the FOS TOR provide a mechanism for important questions of law to be referred to the courts whose decision serve as precedents and provide guidance to the industry. This serves the same purpose as the relevant provisions in the SCT legislation that enable important matters of law to be referred to the Federal Court

¹⁰ FOS submission to EDR Review- [Part 2](#)

Use of Panels

The Interim Report recommends that:

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.

We support this recommendation and currently use panels for more complex disputes at the discretion of the Chief Ombudsman or Lead Ombudsman. We also support the provision of better information to stakeholders about the approach by the scheme as to when panels will be used to resolve a dispute.

As noted in the Interim Report, FOS uses panels to determine complex investments, life insurance and general insurance disputes and over time has developed criteria to guide decisions about when panels are used.¹¹ Some examples are when:

- There is a need in a particular dispute to bring in the expertise of a specific industry and consumer representative (where that expertise may not be readily available within the EDR scheme) because the dispute involves complex or new financial products
- The amount of loss in a dispute is significant
- Disputes raise complex factual questions or issues involving the law or relevant legislation and expert opinions/reports are required
- Disputes that involve similar circumstances to other disputes where a number of these could be referred to a Panel to provide guidance for future determinations
- Disputes involving alleged fraud.

In supporting this recommendation, however, we note that the use of panels can increase the time taken to resolve a dispute and the cost for the member financial firm.¹² These considerations will need to be taken into account when developing appropriate criteria for the

¹¹ The TOR and our Operational Guidelines (see pages 84 to 86) set out the criteria applied when appointing a Panel to determine certain disputes.

¹² Based on 2016 dispute data on average disputes that are closed by a panel compared to a single Ombudsman take around six to seven weeks longer. This is due to scheduling panel hearings and finalising the written determination with all panel members prior to issuing the determination.

use of panels for complex disputes across jurisdictions and types of disputes.

Powers

The industry ombudsman model in Australia is proven. It has delivered strong consumer protection and access to justice for thousands of consumers who have been unable to resolve their complaints directly with a financial firm.

Every day our decision makers resolve disputes through negotiation and conciliation or when necessary, by issuing a decision which when accepted by a consumer is binding on the financial firm.

Our TOR sets out the obligations of all parties for the provision of information, timeframes, and the joining of parties (where relevant). FOS may require a party to a dispute to do anything else that we consider may help us consider the merits of a dispute. This includes requiring a party to a dispute to attend an interview, an FSP to investigate a dispute further, or appoint an independent expert to report back to FOS on information relevant to the dispute.¹³

The obligations of EDR member firms is established in contract. As a condition of their financial or credit licence, a firm is required to be a member of an ASIC-approved EDR scheme and is contractually bound to abide by the scheme's TOR including decisions of the EDR scheme (if accepted by the applicant).¹⁴ Should one of the parties to a dispute not provide all relevant information to a dispute, the FOS decision maker can draw an adverse inference against that party. Where an applicant does not cooperate with our dispute process, we can decide not to continue to consider the dispute.

Where we identify significant failures by an FSP to provide information or fully cooperate with our dispute process, we would consider this as serious misconduct, and in accordance with our reporting obligations, refer the serious misconduct to ASIC.

The panel made the following information request:

Should schemes be provided with additional powers and, if so, what additional powers should be provided?

How should any change in powers be implemented?

¹³ FOS Terms of Reference section 7

¹⁴ FOS Constitution section 3.7

In our first submission we raised the issue of possible additional powers to obtain information, join parties or take action to enforce determinations based on other models. As a practical matter, these additional powers have not been required under the current ombudsman model to ensure effective resolution of the vast majority of disputes or payment of compensation.¹⁵

In the exceptional circumstance where issues do arise, the current mechanism is to refer matters of serious misconduct to ASIC.

In the first instance, should additional powers be considered helpful, we suggest exploring whether this can be achieved by changes to the scheme's TOR or by strengthening ASIC's powers to take action for failure by an FSP to fully cooperate and participate in the scheme's dispute resolution process under the scheme's ASIC-approved TOR.

For example, we would support strengthening ASIC's licensing powers so that a referral by the scheme of serious misconduct by one of its members would enable ASIC to take quick, timely and proportionate action. Currently, the exercise of the licensing powers by ASIC typically involves action to remove a licence or ban an individual for a period of a time. These actions take considerable time, need to meet a high threshold and may not always be seen as proportionate to achieving the desired co-operation with the scheme's dispute process.

We consider that ASIC should have a more calibrated set of administrative powers. This would enable ASIC to take action short of banning or removal of a licence and help reinforce the contractual provisions of an ASIC-approved EDR scheme and its serious misconduct reporting obligations.

¹⁵ A number of submissions to the Panel's initial consultation paper referred to unpaid determinations as an issue going to the FOS's powers based on a contractual versus statutory model. This is not correct. The issue of unpaid determinations is caused by the incapacity of the firm to pay a determination such as through entering into administration or becoming insolvent. The same issue would arise whether the award of compensation was made pursuant to a contract or under a statutory scheme by court or tribunal. We also reiterate that the overwhelming number of FOS's determinations are paid by FOS's members.

Governance and funding

Governance¹⁶

The board should be independent, and perceived to be independent, of the firms who provide the scheme's funding and membership base, and should take into account input from a range of stakeholders, including small and large members, and consumer and industry stakeholders.

Funding¹⁷

The scheme should be industry funded. A user-pays model which incentivises firms to minimise disputes or to resolve disputes early, including through IDR, should be encouraged as well as policies that support smaller members, such as a 'one free complaint' program.

There should be financial transparency with the scheme required to publish information on its funding arrangements, revenue and expenditure.

Independence of the Board

FOS supports the importance of independence and perception of independence of the scheme's Board and that it take into account the views and interests of a broad range of stakeholders. The current Board structure, with members drawn from consumer and industry stakeholders and an independent chair, is an important element in achieving this.

While directors of FOS are appointed for their expertise in industry or in consumer areas relevant to FOS, their primary duty is to FOS. All directors are committed to ensuring the independence of the dispute handling process in accordance with ASIC's regulatory approval and the scheme's constitution, and are obliged, under the *Corporations Act 2001*, to act in the best interests of FOS.

Recognising the diversity of members

Maintaining awareness of the needs of all members, including small firms, is a common attribute of the governance and funding features of the proposed new EDR scheme.

Arguments put by those in favour of competition in EDR seem to be based on a view that a single scheme cannot take account of the

¹⁶ Interim Report - table at 6.17, High level features of a single industry ombudsman scheme for financial, credit and investment disputes p.147

¹⁷ *ibid*

views of smaller members, or have a funding model that is appropriate for small members. These views are not based on fact.

This is evidenced by FOS's experience:

- FOS's members cover 99 per cent of all financial services conducted by AFSL and ACL holders in Australia and, as the Interim Report shows¹⁸, there is a 70 per cent overlap in jurisdictions between the CIO and FOS, with FOS having 29 per cent exclusive coverage of financial services and the CIO having less than one per cent of exclusive coverage.
- FOS's members include banks, insurers (life and general insurers), credit providers, credit unions, financial advisers and planners, brokers, debt buyers and collectors, accountants and other businesses that provided financial products and services.
- 78 per cent of our members are very small and a further 10 per cent are small. We classify our members by size to ensure that membership fees for small businesses are minimised.
 - The vast majority of our very small members never have a dispute at FOS and therefore pay only our base membership levy of \$335 a year. These members without disputes do not pay dispute fees, nor do they pay a user charge levy.
 - All very small and small members at FOS also have access to one free dispute that goes through to decision if the decision is wholly in their favour. The Board introduced this refund following feedback from our small members about the cost imposition on their business of paying dispute fees when there is no fault on their part.
- FOS's funding structure is based on a user-pays philosophy which provides incentives for early resolution of disputes. Our published financial statements¹⁹ illustrate this, with 80 per cent of our revenue coming from dispute fees. This means that users of our dispute resolution service primarily fund our operations, not members who never, or rarely have a dispute at FOS.

¹⁸ Interim Report paragraph and table at 5.5 p. 95

¹⁹ <http://fos.org.au/events/2016/11/17/531/fos-annual-general-meeting-2016/>

- Our resourcing plans are detailed and take account of the product types and issues we see across the disputes we handle. We track emerging issues and flexibly deploy resources or build new skill sets to ensure our dispute teams have the relevant product knowledge to competently handle disputes across all our member sectors and product types. Our investment in training and technologies is vital in this regard.
- FOS's member engagement is wide-ranging and includes one-on-one meetings, open industry forums across the country where our Ombudsmen present details about our approach to specific disputes, specific forums in conjunction with industry associations or special interest groups, publication of a range of guides (e.g. on effective IDR processes and how to avoid having a dispute at FOS) and the FOS Circular, FOS Approach documents, and fact sheets. Small and large members benefit from this engagement.

The new single scheme would be able to draw on the experience and operations of both current schemes in dealing with members' needs.

Licensing of credit representatives

The panel made the following information request:

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 Panel notes that under the *National Consumer Credit Protection (NCCP) Act 2009*, credit licensees and credit representatives are required to maintain separate membership of an approved EDR scheme, even though the credit licensee is responsible and liable for any conduct of its representative. The Panel further states that requiring credit representatives to maintain separate EDR membership imposes costs on the credit representative and ASIC, and unnecessarily increases regulatory costs of the EDR framework without otherwise enhancing consumer access to EDR.²⁰

²⁰ Interim Report para 5.171 p.134

FOS agrees with this assessment and has consistently held this view. We do not consider that licensing authorised credit representatives (ACRs) adds substantively to consumer protection and the cost of membership outweighs any marginal consumer benefit. Since the NCCP regime was introduced, we have not had any disputes lodged against an ACR. It is unclear from published reporting whether the CIO has managed any disputes against ACRs, particularly where there was an option to lodge against the relevant ACL, or if so, what the rationale for doing so would be. We consider the regime for ACRs should be aligned with that for authorised representatives. Appendix B sets out in more detail our reasons for not supporting the ongoing licensing of authorised credit representatives.

Consumer monetary limits and compensation caps

The Interim Report recommends that:

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.

Further, the panel made the following information request:

Information request

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?

The Panel identifies that the current monetary limit of \$500,000 and the compensation cap of \$309,000 for the individual consumer jurisdiction are inadequate and no longer in line with the values of some financial products that may give rise to disputes, resulting in a gap in EDR coverage.

FOS concurs with this finding and provides analysis to assist the Panel in recommending more appropriate limits and caps. The analysis is summarised below and presented in more detail in Appendix C.

Summary position

- FOS supports an increase in the consumer claims limit with our analysis clearly supporting an increase from the current \$500k claims limit. The analysis shows a range of between \$634k and \$955k, with about \$730k resulting from indexing from 2002 as the base year. An extrapolation to 2020 would result in a claims limit of about \$890k.
- We support an increase at the higher end of the range to help future proof the claims limit, provide certainty to all participants, and reduce the need to make significant changes within the next three to five years.

- We also support continuation of the current annual indexation of claim limits based on CPI and periodic regular review based on agreed factors.
- We propose that the claim limit would not apply where the applicant's claim is to set aside a guarantee supported by a mortgage or other security over the guarantor's primary place of residence. In our view there should be no limit on the claim cap, provided the loan which is guaranteed was also used to purchase a primary place of residence.
- FOS recommends removing the distinction between the value of existing claim/monetary limits and the compensation cap for the reasons outlined below.

Align the claims limit and compensation cap

FOS recommends removing the distinction between the values of existing claim/monetary limits and the compensation cap because we consider the difference is confusing for consumers and FSPs. An appropriate increase in the compensation cap removes arguments for having two separate limits. These arguments include that an increased monetary limit would allow more consumers to bring a dispute to an EDR scheme and waive their rights to pursue the balance of the claim in another forum if they accept the final outcome at EDR.

Given this recommendation, the following analysis and modelling focuses on the claims limit with the assumption that the compensation cap will be aligned with it.

An increase in the claims limit and compensation cap is warranted

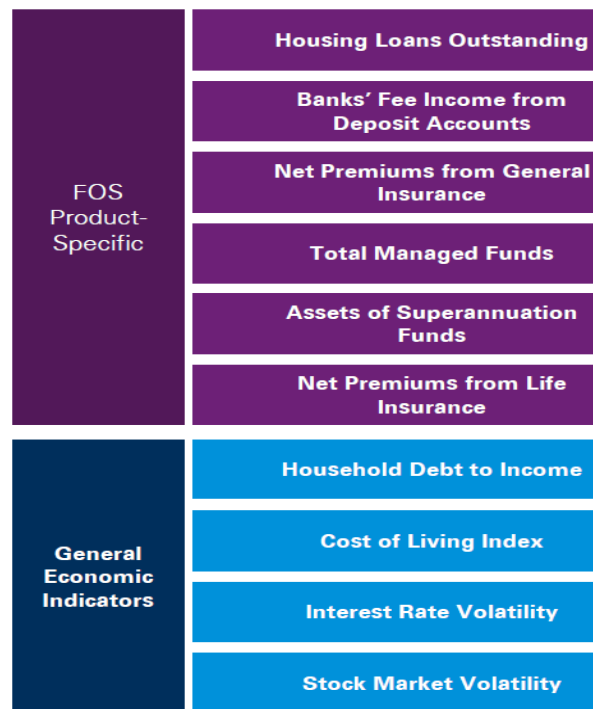
In our first submission we provided some analysis about changes in average weekly earnings and the mean price of residential dwellings to support an increase in monetary limits. Since then, we have completed a more comprehensive review to assist the Panel in its consideration in response to its information request.

With the assistance of KPMG, FOS analysed changes and volatility in the economic market conditions from 2002 to 2016.²¹ Economic parameters have been identified as proxies for each FOS dispute product line, and trends/variations in these proxies were used to propose an upward adjustment in the claims limit.

²¹ 2002 was used as the baseline year for data analysis as this was the first full year post the approval of the Financial Services Reform Act 2001 and also when consistent data for the data sets proposed is available.

The following analysis seeks to transparently set out the logic and assumptions used for consideration and review. We acknowledge that other factors, approaches and considerations could be taken into account in informing a final view on how to set the claim limits and compensation gaps in the general consumer jurisdiction for the new single scheme.

The following economic parameters were used in our analysis:²²



Key insights from the analysis show that the current claims limit of \$500K is significantly below the historical growth of relevant economic indicators:

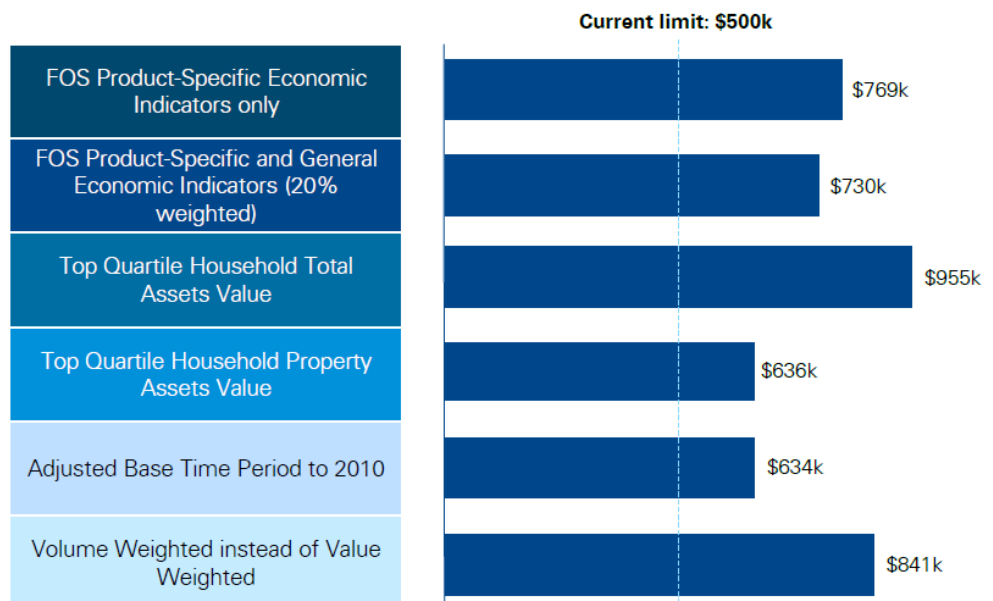
- Based on the value-weighted average of dispute amounts awarded under each of the FOS product lines, the long-term compounded annual growth rate (CAGR) of the FOS product-specific economic indicators is **5.5 per cent p.a.** Factoring in for general economic indicators, the CAGR reduces to **5.12 per cent p.a.**

This growth is about **twice** that compared to annual increases in CPI (approximately **2.54 per cent p.a.**)

²² Data for economic parameters identified are for Australia and Australian households, and are sourced from the Australian Bureau of Statistics.

- Across the Australian economy, the level of financial exposure borne by households and individuals has increased over time:
 - The household debt per capita **has increased three times in the past 15 years**
 - The ratio of household debt to annualised income **has increased by 150 per cent in the past 15 years**
- Interest rates are currently at an historical low. This is encouraging borrowing across households, increasing the overall debt financing
- Recent increases in stock prices has raised overall wealth, leading to higher asset values per household
- The analysis clearly supports increasing the consumer dispute claims limit from \$500k in the range of \$634k and \$955k. Sensitivity analysis of the economic factors used in our modelling is summarised in the table below (for more detail see Appendix C). It shows a range of between \$634k and \$955k, with around \$730k resulting from indexing from 2002 as the base year. A simple extrapolation of the \$730k to 2020 would result in a claims limit of \$890k.
- We support an increase at the higher end of the range to help future proof the claims limit, continue the current annual indexation of claim limits based on CPI, and periodic regular review using agreed factors and framework.

Sensitivity Analysis Performed



Supplementing the analysis performed, increasing the claims limit is justified by:

1. **Exposure:** with an increasing trend in consumer lending and debt exposure, the propensity for higher value claims increases.
2. **Accessibility:** raising the claims limit increases the ability of FOS to service higher value claims, as an efficient alternative to costly and time-consuming litigation.
3. **Future proof:** revising the claims limit now will help future-proof the dispute claims process, ensuring ongoing relevance of EDR for consumers of financial services.

Using a very simple extrapolation of the \$730k claims limit without applying forecast changes to any of the economic parameters i.e. conditions all remain the same, and the CAGR for the claims limit continues to increase by 5.12 per cent year on year, the 2020 claims limit would be \$890k.

Guarantees over primary place of residence

We propose that the claims limit would not apply where the applicant's claim is to set aside a guarantee supported by a mortgage or other security over the guarantor's primary place of residence. In our view, in the consumer jurisdiction, there should be no limit on the claim cap, provided the loan that is guaranteed was also used to purchase a primary place of residence.

Where FOS finds that a guarantee is unenforceable because of a breach of the NCCP Act, unconscionable conduct or because the FSP did not comply with the relevant provisions of an industry code, under the current jurisdiction, FOS is unable to set aside the full amount of the guarantee if the amount outstanding under the guarantee exceeds the level of the general compensation cap under our TOR.

We consider that where there is a finding that the guarantee over a primary place of residence fails to comply with the relevant legislative, common law or code requirements, the FOS determination should be able to set aside the guarantee up to the whole amount of the guarantee.

This could be achieved by amending FOS's TOR to make clear that the general claim limits do not apply where the applicant's claim in the dispute is to set aside a guarantee supported by a mortgage or other security over the guarantor's primary place of residence.

Impact of increased limits on professional indemnity insurance

We are aware that in past reviews of compensation and claim limits, arguments have been put that some members of EDR schemes may have difficulties in arranging sufficient professional indemnity insurance cover. The Productivity Commission considered this issue in 2008 in its review of the consumer policy framework and rejected these arguments as follows:

Reasonable notice of threshold changes should help in most cases. But just as safety standards are not waived for those facing a high cost in meeting them, ongoing difficulties in securing insurance should not be a basis for seeing a lower standard of consumer protection. Rather, the appropriate responses are better supply-side risk management and rationalisation of any excessively risky suppliers.²³

Other claims limits in the FOS TOR

The focus of FOS's analysis has been the general compensation caps and limits that should apply and what considerations should be made in recommending an increase.

Under FOS's TOR there are also specific limits for a few claim types. These are set out in the table below:

²³ Productivity Commission Consumer Policy Framework p. 208

Applicable to all new Disputes lodged with FOS on or after 1 January 2015

The table below specifies according to type of claim the maximum total value of the remedy that may be decided upon by FOS (excluding compensation for costs and interest payments).

| | Type of Claim | Amount per claim |
|----|---|-------------------|
| 1. | <p>Claim on a Life Insurance Policy or a General Insurance Policy dealing with income stream risk or advice about such a contract.</p> <p>If the claim is in excess of this monthly limit, the monthly limit will apply unless:</p> <ul style="list-style-type: none"> the total amount payable under the policy can be calculated with certainty by reference to the expiry date of the policy and/ or age of the insured; and that total amount is less than the amount specified in row 4. <p>If this is the case, then the limit will be the amount in row 4.</p> | \$8,300 per month |
| 2. | Third party claim on a General Insurance Policy providing cover in respect of property loss or damage caused by or resulting from impact of a motor vehicle | \$5,000 |
| 3. | Claim against a General Insurance Broker except where the claim solely concerns its conduct in relation to a Life Insurance Policy (in which case row 1 or 4 applies, whichever is applicable). | \$166,000 |
| 4. | Other | \$309,000 |

We have not been able to undertake a detailed review of these sub-limits within the time available for preparation of this submission. However, our dispute resolution experience indicates that the monthly caps on life insurance are exceeded in some cases, and in future we anticipate this gap will increase.

The current application of FOS’s jurisdictional limits and caps to these types of disputes is complex and confusing to consumers and FSPs. These limits and caps are also not aligned with the jurisdiction that the SCT has for similar disputes.

We consider these matters require further consideration and detailed review once the overall level of compensation caps and limits has been settled. We would be willing to discuss further with the Panel the considerations involved and analysis that may be required.

Small business monetary limits and compensation caps

The Interim Report recommends that:

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 Panel found that small businesses do not have adequate access to EDR because the existing monetary limits are too low and exclude many small businesses from being able to seek redress within the EDR framework. It also acknowledged that FOS is currently reviewing our small business jurisdiction. The Interim Report contained an outline of the proposals on which FOS consulted, and an overview of the range of views in the responses to this consultation.

Information request

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?

In this section we again seek to address the Panel's information request regarding small business monetary limits and caps using feedback we received through our recent consultation process, additional data (albeit limited) from banks, RBA, APRA and Australian Bureau of Agricultural and Resource Economics and Sciences (ABARES) and, with the assistance of KPMG, some additional economic modelling to inform our position on recommended changes to this jurisdiction. This modelling is summarised below and presented in more detail in Appendix D.

As we advised in the consumer jurisdiction analysis above, and given the limitations on data about small business credit facilities, we have tried to look at the issue from a range of perspectives with clear assumptions spelled out to assist the Panel, acknowledging that other factors could be taken into account.

To recap, current limits for small business credit facility disputes at FOS are:

| Small Business Credit Facility (SBCF) element | Description | Current limit | Proposed in the FOS 2016 consultation |
|--|--|----------------------|--|
| Claim limit | FOS cannot consider a dispute with a claim above this amount | \$500k | \$2m |
| Compensation cap | FOS cannot award compensation that exceeds this cap (excludes compensation for costs and interest) | \$309k | \$2m |
| SBCF limit for debt-related disputes | FOS cannot consider a debt-related dispute by a small business when the SBCF is above this amount | \$2m | \$10m |

Summary position

FOS is confident that an analysis of the data supports an increase of the current small business compensation limit of \$309,000 and debt-related dispute credit facility limit of \$2m to at least a \$1m compensation limit and \$5m facility limit. The attached analysis would also support a slightly higher compensation limit between \$1m and \$2m at the outset or based on further experience under an expanded small business jurisdiction.

Ahead of detailing the analysis supporting these limits, our position is:

- The FOS Board would be confident in moving to these new limits as an appropriate immediate extension to our current jurisdiction subject to ASIC approval to changes to our TOR. We consider a commencement date of late 2017 to early 2018 under the current TOR would be feasible if these

changes were approved by ASIC and able to be announced in the near future.

- Given the limitations and gaps in data and information available to us at this stage, beyond these limits there is more uncertainty about the types and appropriateness of matters that might be received by FOS.
- However, the FOS Board accepts there could be grounds to support an increased jurisdiction of \$2m compensation limit and \$10m credit facility claim limit should this be recommended by the Panel, as part of an integrated package of reforms under the new single scheme proposed. As noted above, the data currently available to FOS and views of major industry stakeholders currently provide less clear-cut validation of this increase in jurisdiction. However, there may be other information and factors that would provide the basis to support an increase to these levels.
- We propose that the claim limit would not apply where the small business applicant's claim is to set aside a guarantee supported by a mortgage or other security over the guarantor's primary place of residence. The guarantee would have to be in relation to a loan that is or would be within FOS's small business jurisdiction. This would allow FOS to set aside the guarantee in full where it appropriate to do so.
- Beyond \$2m and \$10m, the FOS Board considers these disputes would be matters of a size and character generally more suited to resolution in the civil jurisdiction of the courts.

An increase in the claims limit and compensation cap for small business credit facility disputes is warranted

In order to determine the appropriate caps and limits that should apply, we need to better understand:

- The size of credit facilities generally provided to businesses with less than 100 employees (the proposed FOS definition of a small business²⁴) to address accessibility issues. That is, will most small business disputes fall within the thresholds we propose?

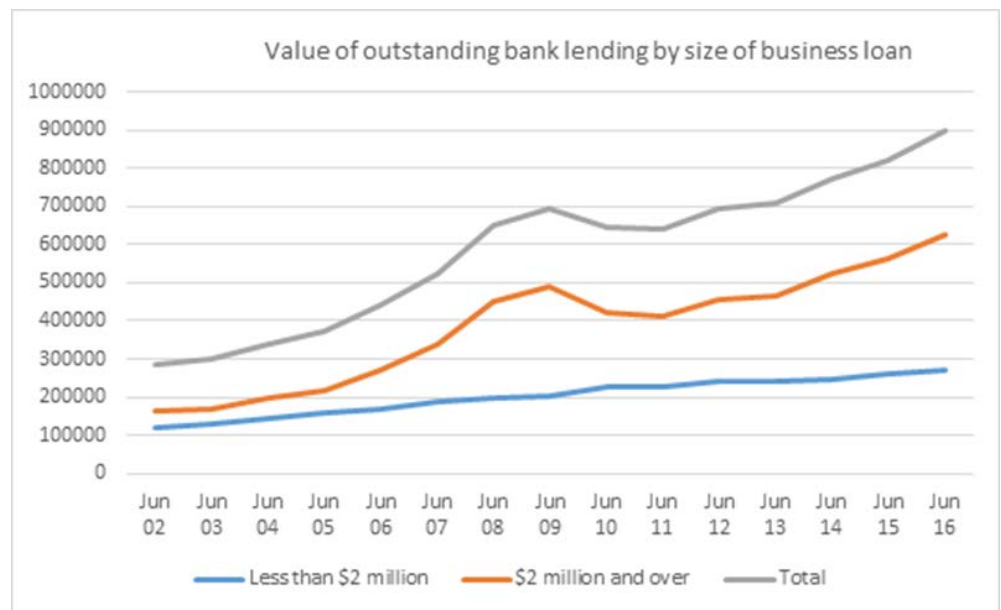
²⁴ Given the feedback from our consultation on the expansion of our small business jurisdiction, the FOS Board reconsidered our definition of small business and considers it should be replaced by a broader one akin to that of the Australian Small Business and Family Enterprise Ombudsman, that is, a business with less than 100 FTE employees. This would improve clarity, simplify the jurisdictional assessment by removing the 'manufacturing' differentiation from the current definition, and increase access to EDR for some small business consumers.

- The appropriate claims limit/compensation cap required to ensure sufficient small business redress coverage across a range of industries.

Credit facilities provided to businesses with less than 100 employees

FOS had discussions with ASIC, Treasury and APRA about the provision of data with limited success in gaining information about the pattern and size of credit facility exposure to small businesses, or indeed for non-institutional business in general.

The RBA's data for business lending is more granular for facilities between \$100,000 and \$2m, but its published data above \$2m is aggregated. The tables are based on data provided to APRA by banks. From the data we can see that overall lending above \$2m is growing in proportion to lending below \$2m, but we do not have transaction numbers, and the above \$2m limits could be skewed by very large transactions. See the graph below²⁵:



We talked to the major banks about the spread of loans to businesses (not only small businesses) in terms of the proportion of customers with loans under \$10m and the proportion of lending below \$10m. While all collect data slightly differently, and subject to a range of caveats in the provision of information they were able to provide, we know from their feedback that broadly, about 98 per cent of business customers have loans under \$5m and most of these are below \$1m; and that broadly about 99 per cent of business customers have loans under \$10m.

²⁵ [Bank Lending to Business- Selected Statistics- RBA Table D8](#)

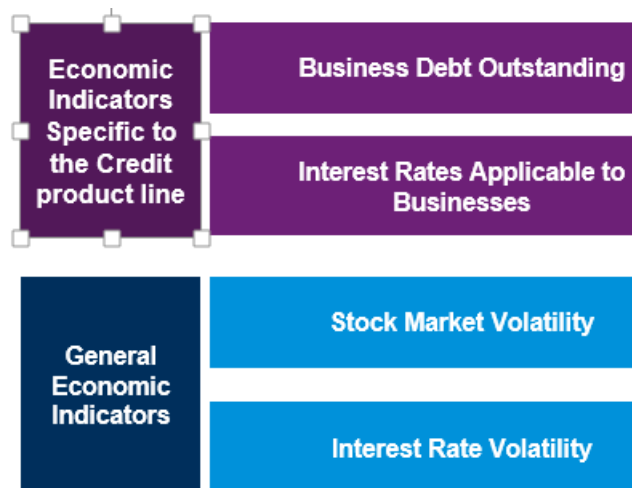
Applying the average interest rate for small business facilities of 7.68 per cent p.a., used in our analysis, the interest paid on a credit facility would be as follows:

- For \$1m credit facility \$6,400 per month
- For \$3m credit facility \$19,200 per month
- For \$5m credit facility \$32,000 per month
- For \$10m credit facility \$64,000 per month.

Using other available data, we sought to determine what size of business by employee count would have credit facilities of \$5m or \$10m. This was to test our proposed definition of a small business for acceptance of disputes at FOS (less than 100 employees) and determine whether a \$5m credit facility limit is sufficient to service a significantly large percentage of small businesses. We were able to satisfy ourselves on both counts. (See Appendix D for the analysis.)

Setting claims limit/compensation cap to ensure adequate small business coverage

In order to assess variations to the small business claims limit and its general trending over time, we used the following economic parameters:



The key insights from our economic analysis show that:

- Business debt has been growing over the past two decades at a rate about 2.7 times greater than inflation
- Furthermore, with interest rates currently at a historical low, businesses are increasingly using debt to finance investments

- The small business interest rate premium differentials are increasing over time.

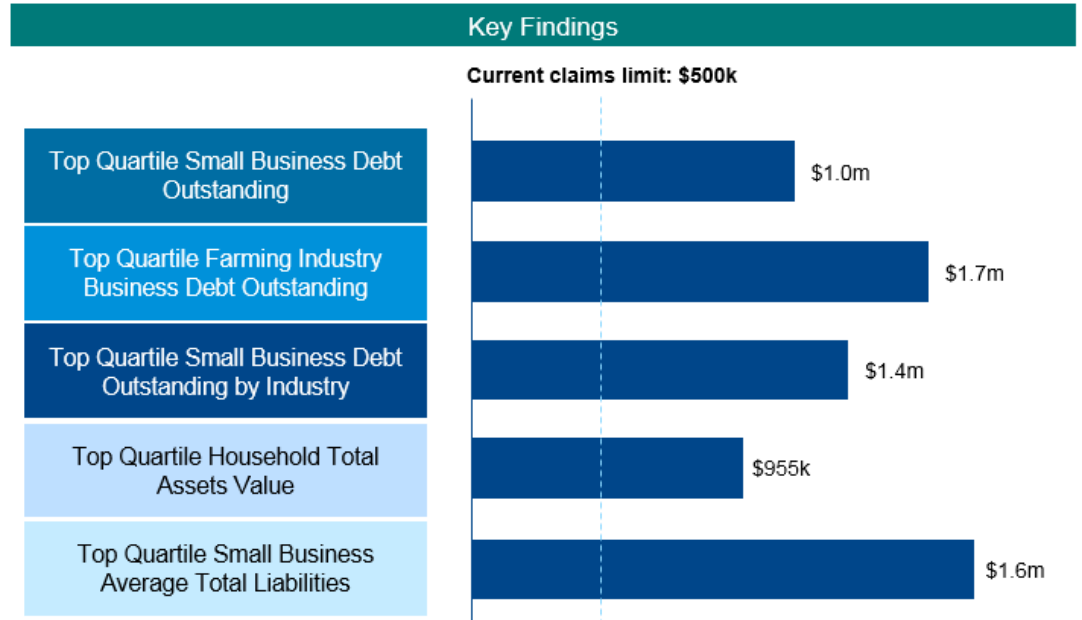
As a result, the increase in business financial risk increases financial exposure, and the potential for business claims of higher financial significance.

A review of accrued interest payments in dispute under a range of case studies of the types of disputes that FOS deals with supports a business claim limit with an estimated range of between \$1m and \$2m.

| Claimant Scenario | Scenario Description | Approximate Dispute Value Calculation | Potential Accrued Interest Payments Under Dispute |
|---|---|---|---|
| Scenario 1: Four Years of Interest Payments Followed by a Default Event | Applicant has a \$5M bill facility with Bank X. After struggling to make repayments for four years, the applicant defaults on 1 November and makes no further payments. The Bank rolls the bill into an unpaid bills account charging 12% interest, plus a customer margin of 2% and a default margin of 4%. Interest is charged at 18% from 1 February. After three months of discussion with the Bank, the applicant lodges a dispute with FOS, saying the loan should not have been given in the first place. FOS agrees that the loan should not have been given and in accordance with its approach to compensation, awards a refund of all interest charged, including the default interest charged between 1 February and 31 July. | Interest paid over 4 years = \$5m X 7.68% X 4 = \$1.54m Non-payment interest accrued = \$5m X 7.68% X 0.25 = \$96k Default interest accrued = \$5m X 18% X 0.5 = \$450k Total interest paid and accrued = \$2.1m | ~\$2.1m |
| Scenario 2: One Year of Interest Payments Followed by a Default Event | Applicant has a \$5M bill facility with Bank X. After struggling to make repayments for a year, the applicant defaults on 1 November and makes no further payments. The Bank rolls the bill into an unpaid bills account charging 12% interest, plus a customer margin of 2% and a default margin of 4%. Interest is charged at 18% from 1 February. After three months of discussion with the Bank, the applicant lodges a dispute with FOS, saying the loan should not have been given in the first place. FOS agrees that the loan should not have been given and in accordance with its approach to compensation, awards a refund of all interest charged, including the default interest charged between 1 February and 31 July. | Interest paid over 1 year = \$5m X 7.68% = \$384k Non-payment interest accrued = \$5m X 7.68% X 0.25 = \$96k Default interest accrued = \$5m X 18% X 0.5 = \$450k Total interest paid and accrued = \$934k | ~\$934k |
| Scenario 3: Financial Services Provider (FSP) – Customer Financial Difficulty Obligations | Applicant has a \$5M bill facility with Bank X. Their business declines and the applicant defaults on 1 November and makes no further payments. The Bank rolls the bill into an unpaid bills account charging 12% interest, plus a customer margin of 2% and a default margin of 4%. Interest is charged at 18% from 1 February. The customer approached the bank in December to ask for financial difficulty assistance. The Bank declines the request as it wants to exit the customer. The Applicant lodges a dispute with FOS who finds that the Bank did not meet its financial difficulty obligations. The bank is required to refund the default interest charged from 1 February to 30 June, but is entitled to charge normal interest, including the compound interest due to non-payment. | Default interest accrued = \$5m X 18% X 5/12 = \$375k Normal interest charges = \$5m X 7.68% X 5/12 = \$160k Non-payment interest accrued = \$5m X 7.68% X 0.25 = \$96k Net refund = \$119k | ~\$119k |

The interest rates applicable to small businesses in the above table is assumed to be 7.68 per cent p.a

We further validated our findings by using alternative economic parameters as proxies for potential claims exposure, and found these to be broadly consistent with our key findings. (See Appendix D for more detailed analysis.)



Our economic analysis indicates that the current FOS small business claims limit is below current appropriate levels based on relevant economic indicators:

- Sensitivity analysis across a range of economic scenarios supports increasing the business claims limit for small businesses from the current \$500k limit
- The five selected economic scenarios analysed have a sensitivity range of \$955k to \$1.7m
- This includes high debt exposure scenarios where top quartile figures are used to obtain a clearer understanding of the highest possible value of business claims.

Farm debt mediation

Our approach to dealing with farm debt mediation under our TOR would be unchanged with any increase in the proposed caps for our small business jurisdiction.

Where a matter is in the process of, or has been through one of the current state-based regimes for farm debt mediation, FOS would not deal with this same matter as a dispute on the basis that it has already been through an alternative dispute resolution process.

The farm debt mediation arrangements in each of the states differ and not all states have schemes in place. A nationally consistent approach has been discussed for some time. We support this initiative because it would help ensure consistency and reduce complexity in access to appropriate alternative dispute arrangements.

Extension of national consumer credit protection law to small businesses

The panel made the following information request:

Should the national consumer credit protection law be extended to small businesses?

FOS is of the view that consideration should be given to extending the responsible lending provisions of the National Consumer Credit Protection (NCCP) Act and Parts 2 to 6 of the National Credit Code (NCC) (relating to disclosure, related mortgages and guarantees, changes to the contract, enforcement and penalties) to small business lenders.

In addition, all small business lenders should be a member of an EDR scheme. Extending these provisions would ensure a level playing field for all small business lenders. Banks and Mutual ADIs that subscribe to a relevant Code have adopted some of the requirements of the NCCP Act and NCC in relation to small business lending.

Applying the provisions of the NCCP Act and NCC to all lenders would ensure more consistent practices across the industry, especially in relation to three main areas: inappropriate lending decisions, changes to the terms and conditions, and enforcement when a loan is in default.

A new industry ombudsman scheme for superannuation disputes

The Interim Report recommends that:

SCT should transition into an industry ombudsman scheme for superannuation disputes.

In principle, we see benefits in this recommendation and in the Panel's view that a two staged transition process is advisable.

FOS is not in a position, however, to comment on the issues related to the impact of the proposed changes on the SCT in regard to its jurisdiction, powers and governance arrangements.

The Panel did not address in detail the existing overlap in disputes currently handled by the SCT and FOS. The recommendation for a single scheme for financial, credit and investment *and insurance* disputes states that this scheme would not deal with superannuation disputes. However, there are a number of disputes such as those involving life insurance or the provision of financial advice to superannuation fund members that fall within FOS's advice and insurance jurisdictions.

Increasingly, superannuation funds are moving to provide financial advice to their members, insurance and other financial products and services. It is important that there be a clear, simple and consistent approach across the financial sector about how disputes relating to these types of services, irrespective of the FSP involved, are handled. A key issue will be the proper definition of a superannuation dispute to differentiate the jurisdictions of the two new schemes proposed.

We would welcome the opportunity to discuss how such disputes would be handled between the new schemes to minimise complexity for consumers. It will be essential that the Panel clearly and appropriately defines the attributes of a 'superannuation dispute' in its final report and associated recommendations.

We look forward to working closely with the SCT in the short term (and the new scheme for superannuation disputes once established) to explore:

- broader consumer and industry engagement initiatives
- systemic issue reporting, and

- opportunities to provide back-office functions, potentially involving co-location and related facilities management, communications and any other shared service arrangements, where appropriate.

A superannuation code of practice

The Interim Report recommends that:

The superannuation industry should develop a superannuation code of practice.

FOS is a strong supporter of industry codes as an avenue to support financial firms to continually improve their services and achieve standards people can trust. Moreover, in making decisions on disputes, FOS has regard to the provisions in a relevant industry code of practice.

These cover banking, general insurance, customer owned banking and insurance brokers codes of practice, and more recently a new life insurance code of practice.

The development of a superannuation code of practice to cover a growing financial services sub-sector is welcome.

Accountability and Oversight

The Interim Report recommends that:

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 Interim Report proposes a range of measures to improve accountability and oversight under the future arrangements set out by the Panel.

We support robust oversight and accountability to help ensure confidence of all stakeholders in any future arrangements.

Funding and flexible processes

We agree that ASIC's regulatory guidance should ensure that it requires schemes to have sufficient funding and flexibility to manage significant events that could create an increase in disputes.

FOS currently has a significant event framework in place to respond to events that could cause a spike in disputes. Our funding framework includes mechanisms that enable resourcing to be scaled up as required such as through dispute fees and levy arrangements.

However, in transitioning to a new single scheme the Board would need to review the proposed funding framework to ensure that there would be an appropriate stable core funding base to:

- ensure the retention of dispute expertise
- continued investment in technical skills development
- continued investment in IT improvements for the benefits of members and to achieve efficient dispute resolution
- ensure robust business continuity and disaster recovery contingency arrangements, and
- buffer funding/reserve policy to meet the uncertainty and volatility in dispute volumes.

Financial transparency

FOS supports transparency of its funding arrangements consistent with current practice. FOS publishes annual financial statements and presents these at the Annual General Meeting which is held in November each year.²⁶ We also consult widely with members on any changes to funding arrangements.

More frequent Independent Reviews

We agree that periodic independent reviews are an important accountability mechanism for EDR schemes. We also agree that schemes should 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. This is in line with FOS's current practice.

For instance, the FOS Board published its detailed response to the last independent review recommendations and its proposed plans to address each of them. The FOS Board also provided a detailed update on the successful implementation of these recommendations.²⁷

We believe that if more frequent periodic reviews are considered an important accountability mechanism then it is important that there be sufficient flexibility to enable the reviews to focus on specific areas rather than mandate a full scope review on each occasion.

²⁶ <http://fos.org.au/events/2016/11/17/531/fos-annual-general-meeting-2016/>

²⁷ <http://fos.org.au/about-us/independent-reviews/>

A full scope independent review of a scheme of the scale and size of FOS (and the new single scheme) is a major, costly, and time consuming exercise.

Accordingly, we consider it important that any more frequent periodic reviews be flexible enough to focus on specific issues. This could be as a follow up to check implementation of previous recommendations, a particular area of current focus, or as an ongoing review of particular areas in depth. This would also enable reviewers with different skills sets to be used depending on the focus of the review. Our understanding is that this is the approach adopted in the UK FOS reviews. The scope of the independent review and selection of independent reviewer would remain subject to ASIC agreement.

Appointment of Independent Assessor

As the Interim Report notes (in 5.143), the FOS Board decided in 2016 that to increase accountability and transparency it would appoint an independent assessor to independently review complaints about service issues in dispute handling. We have begun a recruitment process for this new role. Accordingly, we support the recommendation that the new scheme should appoint an independent assessor based on this model.

ASIC oversight and powers

The Interim Report recommends that:

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.

Further, the panel made the following information request:

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?

In our initial submission we supported ASIC having clear responsibility for oversight of all IDR and EDR across all sectors of the financial industry, subject to the important caveat that in doing so it was important for the schemes to remain and be seen to remain independent of the regulator.

ASIC currently has a range of mechanisms to ensure that the schemes are meeting the conditions of their approval. These include

that key changes to a scheme's jurisdiction, appointment of directors and other significant changes require consultation, or approval by, ASIC. ASIC is consulted about the terms of the independent review and the appointment of the independent reviewer. ASIC obtains information about the scheme via regular reporting and is able to obtain detailed information on specific disputes under notice. In combination, at a practical level these powers provide ASIC with considerable ability to influence the operations of the scheme while respecting the scheme's independence from the regulator and the governance role played by a scheme's Board of Directors.

We support appropriate enhancements to these current powers to enable ASIC to compel performance where the scheme does not comply with the ASIC requirements for a scheme, including the relevant EDR benchmarks. Given the other mechanisms available to ASIC, we would see this very much as a reserve power to be used only as a matter of last resort and after appropriate consultation with the scheme.

The exercise of these directions powers should be subject to proper accountability, including consultation and transparency.

The powers should be drafted so that a direction would be given after formal consultation with the scheme where ASIC forms the view that:

- there has been, or was likely to be, a failure to satisfy one or more of the scheme approval requirements which has serious consequences
- compliance with the direction would ensure that one or more of the scheme approval requirements is satisfied, and
- the approved scheme is capable of complying with the direction.²⁸

It is important in the drafting of any directions powers that the independence of the scheme from the regulator and governance responsibilities of the Board be maintained.

We do not consider it necessary, or appropriate for the directions power to stipulate specific matters such as governance, funding or monetary limits. These matters would be encompassed by the scheme approval criteria.

In addition, we consider it would be inappropriate for ASIC, as the regulator, to have an active involvement in the resolution of individual

²⁸ This is modelled on the powers of the UK FCA under section 296 of the Financial Services and Markets Act 2000 and Rec. 4.6 of the UK FCA Handbook to give directions to a recognised body.

disputes. This would be counter to the independence of the scheme both in terms of governance and decision-making by Ombudsman.²⁹

In addition, RG 139 provides ASIC with the discretion to introduce any further approval criteria for EDR schemes that it considers relevant, after consultation with stakeholders to address any changes in the external environment.

²⁹ This is referred in the Interim Report, p133

Internal Dispute Resolution

The Interim Report recommends that:

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.

And

Schemes should register and track the progress of complaints referred back to IDR

FOS agrees with these recommendations.

In relation to the registering and tracking progress of complaints referred back to IDR from the Scheme, FOS does this through data capture and analysis about the registration and referral of disputes it receives. The analysis is shared with major and mid-tier firms (both individually and through benchmarking reports), peak industry bodies and, when required, with ASIC. The analysis is evidence-based and specific in nature so that firms can act upon it to improve their IDR processes.

Further, the panel made the following information request:

*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?*

We refer the panel to the UK Financial Conduct Authority that collects and publishes consistent, comparable industry data on IDR on a regular basis.³⁰

This level of information would enable ASIC to better monitor trends, identify emerging issues and assess the effectiveness of firms meeting standards set for IDR in RG 165. It would also help policy makers, industry and consumer organisations monitor the effectiveness of IDR.

³⁰ <https://www.fca.org.uk/firms/complaints-data>

Debt management firms

The Interim Report recommends that:

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.

FOS supports this recommendation because no mechanism currently exists for a consumer who has a complaint with an unlicensed debt management firm to seek access to EDR.

FOS does have some members who are debt management firms and has dealt with a small number of disputes involving them.

A compensation scheme of last resort

The Interim Report observed:

The Panel is of the view that there is considerable merit in introducing an industry-funded compensation scheme of last resort.

FOS acknowledges and fully supports the Panel's observations about introducing an industry-funded compensation scheme of last resort. We have been a long-term proponent of a scheme.

Since November last year we have been working with the Australian Bankers' Association and other stakeholders from industry, consumer organisations and government to consider options for a workable and acceptable scheme that will help to fill the structural gap in the existing dispute resolution framework. This occurs when consumers are denied access to justice and awarded financial redress due to a financial firm's lack of resources.

While there still remains a number of differing views across industry, consumer bodies and regulators about the scope (and the need in some quarters) of a scheme, we are encouraged by the collaborative approach across all sectors in understanding the issues, and in framing the problem and possible design solutions against the backdrop of broader industry reform initiatives.³¹

A separate submission on options for a last resort compensation scheme will be lodged with the Panel.

³¹ These include the professionalisation of financial advice, reforms to PI Insurance, and the review of ASIC enforcement powers.

Making it happen – a transition plan for implementation

This section focuses on the establishment of a new single industry ombudsman scheme for financial, credit investment *and insurance* disputes (other than superannuation disputes) to replace FOS and CIO:

- how this can be best achieved
- a broad outline of the steps required to implement the recommendation, and
- a high level implementation timeline.

A collaborative approach to implementation will make the transition to a new EDR scheme easier. However bringing about this important change will be far less complex than the successful merging of the Insurance Ombudsman Service (IOS); the Banking and Financial Services Ombudsman (BFSO); and the Financial Industry Complaints Service (FICS) to create of FOS in 2008.³² That merger was of three schemes with substantially different:

- TOR, jurisdictions, caps and limits
- approaches to dispute resolution, and
- funding models.

This would not be the case with the CIO and FOS:

- FOS and CIO's TOR are substantially similar, with FOS having a broader jurisdiction and a broader definition of fairness – both recommended by the Panel to be adopted by the new single scheme
- While there are some differences in dispute resolution processes between the two organisations, these are essentially a result of FOS's size and transformation of our dispute process in 2015 to achieve more efficient resolution. The new organisation could capitalise on the combined dispute process experience of CIO and FOS
- While there are differences in the proportionality of membership and dispute fees between the organisations, these differences are a product of size and dispute volumes rather than a difference in philosophy or structure of funding models.

³² The merger was followed soon after with the inclusion of two additional schemes – Credit Unions Dispute Resolution Centre and Insurance Brokers Dispute Limited.

Creation of a single scheme

There are a number of legal options for the merger of the two current schemes to create a new single EDR scheme for the financial services industry. We consider that these options should be assessed based on cost, time, minimising disruption to consumers, and legal complexity. The key considerations are to ensure that the cost to industry is minimised and consumers' access to timely dispute resolution is not unduly disrupted. This can best be achieved by leveraging off FOS's current legal and physical infrastructure, while adapting to, and taking into account, the specific features and infrastructure of CIO's operations, in the formation of the new single scheme.

The following table outlines the size and financial resources of the two current schemes.

| Size | FOS | CIO |
|---|---------------------|--------------------|
| Approximate number of disputes per year | 34,000 | 4,760 |
| Financials | | |
| Annual Revenue | \$47m | \$7.4m |
| FTE | 300 | 59.4 |
| Current Assets | \$31m ³³ | \$5m ³⁴ |
| Liabilities | \$12m | \$3.4m |
| Net Assets | \$19m | \$1.5m |
| Surplus | \$1.4m | \$1,986 |

Steps required to create the new body

Based on our experience of the 2008 merger of schemes and the successful implementation of significant organisational change in recent years, we believe a single scheme could be operational by 1 July 2018. This will require early engagement between the schemes, adoption of proven change management techniques, robust project management and utilisation of expert advice as required (legal, accounting, change management).

³³ FOS figures are for the financial year ended 30 June 2016.

³⁴ CIO figures are for the financial year ended 30 June 2015 as 2016 figures are unavailable.

A number of streams of work would need to be managed addressing:

- differences in approach to the merger and views on the process overall
- legal and financial issues – Constitution, TOR, funding models, membership amalgamation
- organisational design including workforce planning, team structures, skills audit and training
- systems integration (case management; membership; HR and finance) including data migration planning and execution
- stakeholder communication – external and internal
- new branding, website, brochures, guides and other information resources.

Strong governance of the change would be required at Board and management levels.

The following high level timeline assumes that the merger is affected using existing FOS and CIO infrastructure and early collaboration and engagement between CIO and FOS.

Illustrative transition plan

| | 2016-17 | 2017-18 | | | | 2018-19 |
|----------------------------------|--|--|---|---|--|---|
| | Quarter 4 | Quarter 1 | Quarter 2 | Quarter 3 | Quarter 4 | Quarter 1 |
| Implementation | Establish advisory Board and committees | Implementation plan | Implementation streams of work managed and reported on to Advisory Board and Management | | | |
| Governance | Advisory Board meets forward agenda settled | Draft TOR and amendments to Constitution | Consult on TOR and amendments to Constitution | Consultation on Future funding model | TOR, Constitution and funding model agreed | Commencement of new Scheme, Board, TOR |
| People | | Stocktake of skills across two schemes | Consultation on org design and structure | Skilling staff in new Or changed processes | Settle structure and Employment contracts | Commencement of new structure |
| Process | | Assessment of Dispute process difference | Any process changes agreed and modelled | New guides, training packages and stakeholder Communication conducted | | Commencement of new Dispute process |
| Technology | Stocktake of dispute , membership, HR and Finance systems. Data migration planning commences | Technology changes scoped for dispute process Changes and data migration | | Build and test phase | Data migration commences | New technologies functioning |
| Stakeholder Communication | | Ongoing to members, industry associations, consumer bodies and ASIC. Design new website, branding, brochures etc | | | | Commencement of new Branding, website etc |
| Change Management | Commence as early as possible, staff engagement plans , appointment of change agents/champions frequent interaction and feedback loops | | | | | |

Appendix A:

Table of Interim Report's recommendations, observation and requests for information

| No. | Interim Report draft recommendations and information requests | FOS comments | Page reference |
|-----|---|---|----------------|
| 1 | <p>A new industry ombudsman scheme for financial, credit and investment disputes</p> <p>There should be a single industry ombudsman scheme for financial, credit and investment disputes (other than superannuation disputes) to replace FOS and CIO.</p> | Supported | 6 |
| | <p>Information request</p> <p><i>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?</i></p> | Not in FOS's view. Ongoing licensing of ACRs is not recommended. | 15 & 52 |
| 2 | <p>Consumer monetary limits and compensation caps</p> <p>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.</p> | Agree | 17 |
| 3 | <p>Small business monetary limits and compensation caps</p> <p>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.</p> | Agree | 24 |
| | <p>Information request</p> <p><i>Should the national consumer credit protection law be extended to small businesses?</i></p> | Yes for responsible lending provisions and Parts 2 and 6 of the NCC relating to disclosure, | 31 |

| No. | Interim Report draft recommendations and information requests | FOS comments | Page reference |
|-----|--|--|----------------------------|
| | | related mortgages and guarantees | |
| | <p>Information request</p> <p><i>What should be the monetary limits and compensation caps for the new scheme? Should they be different for small business disputes?</i></p> <p><i>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?</i></p> | See analysis in the submission and Appendices C and D | 17, 24, 54 & 70 |
| 4 | <p>A new industry ombudsman scheme for superannuation disputes</p> <p>SCT should transition into an industry ombudsman scheme for superannuation disputes.</p> | <p>In principle FOS sees benefits in this recommendation, however we are not in a position to comment on the issues related to the impact of the proposed changes on the SCT regarding its jurisdiction, powers and governance arrangements.</p> <p>We are committed to working closely with the SCT in the short term to explore opportunities to reduce duplication and enhance systemic issue reporting and stakeholder engagement.</p> | 32 |
| 5 | <p>A superannuation code of practice</p> <p>The superannuation industry should develop a superannuation code of practice.</p> | Supported | 33 |

| No. | Interim Report draft recommendations and information requests | FOS comments | Page reference |
|-----|---|---|----------------|
| 6 | <p>Ensuring schemes are accountable to their users</p> <p>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:</p> <ul style="list-style-type: none"> 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. <p>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.</p> | <p>Agreed</p> <p>Agreed</p> <p>A full scope independent review is resource intensive. If more frequent reviews are considered an important accountability mechanism they should focus on specific issues such as following up on previous recommendations, a particular area of current focus, or an in-depth review of a particular issue</p> <p>Supported. FOS is currently recruiting an independent assessor</p> <p>Agree</p> | 34 |

| No. | Interim Report draft recommendations and information requests | FOS comments | Page reference |
|----------|---|--|----------------|
| | <p>Information request</p> <p><i>Should schemes be provided with additional powers and, if so, what additional powers should be provided?</i></p> <p><i>How should any change in powers be implemented?</i></p> | <p>Should additional powers be considered helpful, we suggest exploring whether this can be achieved by changes to the scheme's TOR or by strengthening ASIC's powers to take action for failure by an FSP to fully cooperate and participate in the scheme's dispute resolution</p> | <p>11</p> |
| <p>7</p> | <p>Increased ASIC oversight of industry ombudsman schemes</p> <p>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.</p> | <p>We support appropriate enhancements to current directions powers to enable ASIC to compel performance where the scheme does not comply with ASIC requirements or relevant EDR benchmarks.</p> <p>The exercise of these directions powers should be subject to proper accountability, including consultation and transparency.</p> <p>It is important in the drafting of any directions powers that the independence of the scheme from the regulator and governance responsibilities of the Board be maintained.</p> <p>In addition, we consider it would be inappropriate for ASIC, as the regulator, to have an active involvement in the resolution of</p> | <p>36</p> |

| No. | Interim Report draft recommendations and information requests | FOS comments | Page reference |
|----------|--|---|----------------|
| | | individual disputes. This would be counter to the independence of the scheme both in terms of governance and decision-making by Ombudsman. ³⁵ | |
| | <p>Information request</p> <p><i>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?</i></p> | <p>It is important in the drafting of any directions powers that the independence of the scheme from the regulator and governance responsibilities of the Board be maintained.</p> <p>We do not consider it necessary, or appropriate for the directions power to specify specific matters such as governance, funding or monetary limits. These matters would be encompassed by the scheme approval criteria</p> | 36 |
| 8 | <p>Use of panels</p> <p>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.</p> | <p>FOS currently uses panels in certain circumstances.</p> <p>We support the use of panels, at the discretion of the Chief Ombudsman or Lead Ombudsman, for more complex disputes.</p> <p>We do note that the use of panels can increase the time taken to resolve a dispute and</p> | 10 |

³⁵ This is referred in the Interim Report, p133

| No. | Interim Report draft recommendations and information requests | FOS comments | Page reference |
|--------------------|--|---|----------------|
| | | the cost for the member financial firm. | |
| 9 | <p>Internal dispute resolution</p> <p>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.</p> | Supported | 39 |
| 10 | <p>Schemes to monitor IDR</p> <p>Schemes should register and track the progress of complaints referred back to IDR.</p> | Supported, noting this is current practice at FOS | 39 |
| | <p>Information request</p> <p><i>What IDR metrics should financial firms be required to report on?</i></p> <p><i>Should ASIC publish details of non-compliance or poor performance IDR, including identifying financial firms?</i></p> | We refer the panel to the UK Financial Conduct Authority that collects and publishes consistent, comparable industry data on IDR on a regular basis | 39 |
| 11 | <p>Debt management firms</p> <p>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.</p> | Supported | 40 |
| Observation | | | |
| | <p>Compensation scheme of last resort</p> <p>The Panel is of the view that there is considerable merit in introducing an industry-funded compensation scheme of last resort.</p> | Supported | 41 |

Appendix B: Licensing of Authorised Credit Representatives

We do not consider that licensing ACRs adds substantively to consumer protection and that the cost of membership outweighs any marginal consumer benefit. Since the NCCP regime was introduced, we have had no disputes lodged against an ACR. It is unclear from published reporting whether the CIO has managed any disputes against ACRs, particularly where there was an option to lodge against the relevant ACL, or if so, what the rationale for doing so would be. We consider the regime for ACRs should be aligned with that for authorized representatives for the following reasons:

- **Statutory obligations of licensees**

Under NCCP Act 2009, credit licensees are responsible and liable for any conduct of their ACRs, whether or not this conduct was within the granted authority. This mirrors the provisions relating to Australian Financial Services (AFS) Licensees and their authorised representatives, as set out in the Corporations Act 2001. Unlike ACRs, authorised representatives of an AFS Licensee are not required to hold individual EDR scheme membership.

- **Practical inability to meet award obligations**

Both Acts require licensees to hold EDR scheme membership and ensure that adequate compensation arrangements are in place for the protection of consumers. There is no such obligation on authorised representatives or ACRs. It is unlikely that ACRs would have the insurance or capital adequacy to meet consumer compensation awards without the backing of their licensee.

Accordingly, requiring credit representatives to maintain separate EDR membership imposes costs on both the credit representative and ASIC. It unnecessarily increases regulatory costs of the EDR framework without otherwise enhancing consumer access to EDR. In the event of a successful claim at EDR against an ACR, it is unlikely that any award would be paid.

- **Difficulty regarding multiple EDR memberships for different entities**

Under the current regime where there are two competing EDR schemes, there are situations where the Credit Licensee and the ACR are members of two different EDR schemes. ACRs can also be representatives of multiple ACLs.

FOS understands the arguments in support of the current policy rationale to be substantively as follows:

- *Where an ACR is a scheme member, in the event that the licensee is unwilling or unable to meet obligations to the consumer, some recourse may be made to the ACR.*

This is impractical given the lack of adequate compensation arrangements and, in practice, has not happened since the introduction of the NCCP regime.

Further, the vast majority of ACRs in Australia are authorised by prudentially regulated ACLs who are unlikely to experience an insolvency event which would render the ACL unable to meet its obligations. As FOS understands it, the obligation for ACRs to hold EDR scheme membership seeks to address a concern about how to resolve a dispute when the licensee is effectively out of business and information is required from the adviser to try to resolve the dispute.

In those limited circumstances where the ACR should be directly liable for the loss, the licensee can seek a contribution action from its ACR through normal contractual or common law channels.

- *Where an ACR is a scheme member there is greater certainty regarding the ability of the licensee and EDR scheme to obtain relevant information from the adviser/broker*

Given the requirement of licensees to adequately supervise their representatives and have proper reporting and document retention practices in place, this should not be an issue. In practice, FOS relies on the licensee for the provision of information to resolve disputes. If the licensee does enter an insolvency event, these records should be available to the relevant insolvency practitioner.

However, in cases where there has been some breakdown in proper record keeping, our ability under our TOR for FOS to require an FSP to obtain relevant documentation or to make adverse inference from the non-provision of relevant documentation has meant that this has not given rise to any consumer detriment in our experience.

General Consumer Jurisdiction

Financial Ombudsman Service

General Consumer
Jurisdiction

Economic
Modelling

January 2017



Executive Summary

With the upcoming release of the External Dispute Resolution (EDR) report an opportunity exists to propose an increase in the consumer dispute claims limit from \$500k.

Approach

In presenting our recommendation, analysis has been performed of changes and volatility in economic market conditions over the period 2002 – 2016^[1]. Economic parameters have been identified as proxies for each FOS dispute product line. Trends / variations in these proxies have been used to calculate a new claims limit. The economic parameters identified can be categorised into:

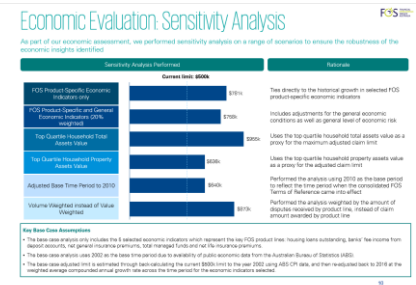
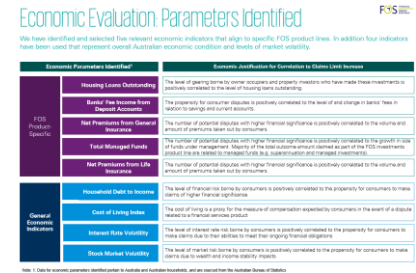
- **FOS product-specific indicators:** that reflect economic conditions that correlate with the growth of specific financial services products
- **General economic indicators:** that represent the overall Australian economic market condition and level of volatility

Findings and Insights

- Based on the economic parameters selected, the long-term CAGR of the relevant economic indicators is 5.12% p.a. (compared to a CPI rate of 2.54%) from the period 2002 - present
- Based on the sensitivity analysis performed, the estimated appropriate claims limit is consistently higher than the current claims limit of \$500k
- Across the Australian economy, the level of financial risk borne by households and individuals has increased over time, exacerbated by low interest rates and higher stock prices
- In conjunction, justification for an increase in the claims limit includes:
 1. **Exposure:** with an increasing trend in consumer lending and debt exposure, the propensity for higher value claims (Credit and Investments) increases
 2. **Accessibility:** Raising the claims limit increases the ability of FOS to service the abovementioned higher value claims, as an efficient alternative to costly and time consuming litigation
 3. **Future Proof:** Revising the claims limit now will help future proof the dispute claims process, ensuring the ongoing relevance of FOS

Conclusions

- The economic analysis indicates that the growth of the current FOS claims limit, when adjusted for CPI annually, is lagging the market when compared against the growth of relevant economic indicators
- The economic analysis performed supports **increasing the consumer dispute claims limit from \$500k**
- The analysis performed identifies an adjusted claims limit of \$730k, with a sensitivity range of \$634k and \$955k. A simple extrapolation based on keeping economic indicators and product weightings unchanged over time, and using the same CAGR of 5.12%, the claims limit in 2020 would be approximately \$892k
- We recommend that further to an increase, the consumer dispute claims limit is raised annually at a defined rate (e.g. CPI) and **reviewed and adjusted every 3 years** to ensure that the limit is still relevant to economic conditions



[1] 2002 was used as the baseline year for data analysis as this was the first full year post the approval of the Financial Services Reform Act 2001

Table of Contents

| | |
|-----------------------|----------------|
| Purpose and Scope | <i>Page 4</i> |
| Approach | <i>Page 5</i> |
| Economic Evaluation | <i>Page 6</i> |
| Insights and Findings | <i>Page 11</i> |
| Sensitivity Analysis | <i>Page 12</i> |
| Appendix | <i>Page 13</i> |

Purpose and Scope

As part of the External Dispute Resolution (EDR) process the Financial Ombudsman Service (FOS) required assistance with performing economic analysis to support an adjustment to the current consumer dispute claims limit.

Purpose

The purpose of this document is to detail:

- **Economic parameters** that can be modelled in order to estimate for changes in economic market conditions and volatility over the defined time period
- **The economic modeling** performed in determining the impact of the economic parameters to dispute claim limits
- **A recommendation** of whether to adjust the consumer claims limit and the method for annual indexation of the claims limits
- **The sensitivity analysis** performed to determine how changing the economic parameters impacts the adjustment, under a given set of assumptions

Scope

The scope of work comprises of the following:

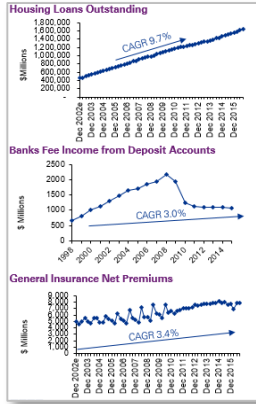
- **Limits:** The compensation claims limits to be assessed is the \$500k maximum claim amount
- **Claimants:** Our analysis is focused on consumer related claims limits
- **Period:** Analysis performed is based on the date range between 2002 and 2016^[1]

^[1] 2002 was used as the baseline year for data analysis as this was the first full year post the approval of the Financial Services Reform Act 2001

Approach

In presenting our recommendation, we have performed a comprehensive analysis and modelling of economic market conditions and historical dispute data, in order to define a revised consumer claims limit.

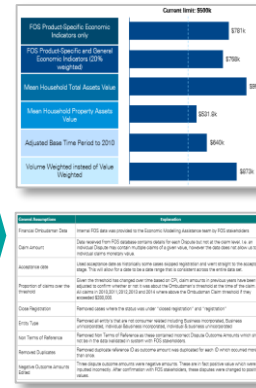
(1) Performed Economic Analysis



We performed an economic analysis based on:

1. The identification and selection of economic indicators that map to the FOS product lines
2. The identification and selection of indicators that represent the current state of Australian households and consumers
3. Volatility indicators as a form of risk measure to adjust for changing economic circumstances

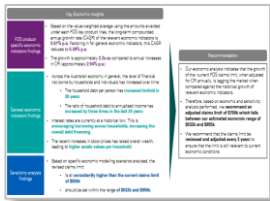
(2) Conducted Sensitivity Analysis



With input from FOS and economic subject matter experts, we conducted sensitivity analysis of the economic modelling. This involved:

1. The use of different proxies in the weightings of the economic indicators
2. The identification and use of alternative methods to arrive at an adjusted claims limit
3. Use of different time periods in performing the analysis

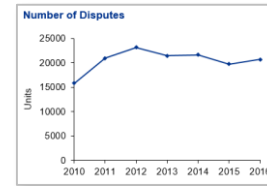
(4) Presented Our Conclusion



Based on the analysis performed we developed a set of insights to arrive at our recommendation on the FOS claims limit adjustment, and sensitivity range. This included:

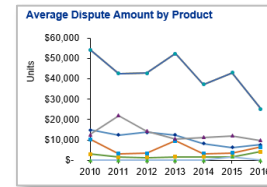
1. The identification of relevant economic indicators that correlate with the FOS product lines
2. Sensitivity analysis performed to validate the robustness of the recommended adjustment range for the claims limit

(3) Analysed FOS Historical Claims Data



In collaboration with FOS we collected and analysed FOS historical disputes and issues data from 2010 to 2016, inclusive of:

1. All product lines
2. Total dispute / issue amounts claimed and outcomes awarded



The data analysed included disputes that have been registered with and reviewed by FOS

Economic Evaluation: Parameters Identified

We have identified and selected six economic indicators that align to specific FOS product lines. In addition four indicators have been used that represent overall Australian economic condition and levels of market volatility.

| Economic Parameters Identified ¹ | | Economic Justification for Correlation to Claims Limit Increase |
|---|---|---|
| FOS Product-Specific | Housing Loans Outstanding | The level of gearing borne by owner occupiers and property investors is positively correlated to the level of housing loans outstanding |
| | Banks' Fee Income from Deposit Accounts | The propensity for higher value consumer disputes is negatively correlated to the level of bank fees in relation to savings and current accounts |
| | Net Premiums from General Insurance | The number of potential disputes with higher financial significance is positively correlated to the volume and amount of premiums taken out by consumers |
| | Total Managed Funds | The number of potential disputes with higher financial significance is positively correlated to the growth in size of funds under management. |
| | Assets of Superannuation Funds | The number of potential disputes with higher financial significance is positively correlated to the growth in size of superannuation funds under management. |
| | Net Premiums from Life Insurance | The number of potential disputes with higher financial significance is positively correlated to the volume and amount of premiums taken out by consumers |
| General Economic Indicators | Household Debt to Income | The level of household debt is positively correlated to the propensity for consumers to make claims of higher financial significance |
| | Cost of Living Index | The cost of living is a proxy for the measure of compensation expected by consumers in the event of a dispute related to a financial services product |
| | Interest Rate Volatility | A reduction in the interest rate will encourage savers to invest in higher risk investment opportunities (e.g. housing and stock markets) therefore increasing the likelihood of claims of higher financial significance |
| | Stock Market Volatility | Increases in the stock market value increases the value of assets that would be in dispute with financial service providers. An increase in stock market volatility increases the likelihood of such claims materializing |

[1] Data for economic parameters identified pertain to Australia and Australian households, and are sourced from the Australian Bureau of Statistics

Economic Evaluation: FOS Product Specific

Each of the below economic indicators has experienced an upward trend, with growth rates consistency above CPI. Indicators closely aligned to household wealth (e.g. housing loans) show an increase in the debt position and financial risk of households.

| Economic Parameter | Commentary |
|--|--|
| <p>Housing Loans Outstanding</p> <p>The chart displays the value of outstanding housing loans for households in the Australian economy from December 2002 to June 2016. The y-axis represents the amount in millions of dollars, ranging from 0 to 1,800,000. The x-axis shows quarterly intervals. A blue line with markers shows the data points, which generally follow an upward trajectory. A blue arrow indicates a Compound Annual Growth Rate (CAGR) of 9.7% over the period.</p> | <ul style="list-style-type: none"> Over the period December 2002 to September 2016 the value of Outstanding Housing Loans for households in the Australian economy has <i>grown at a compounded annual growth rate of 9.7%</i> The amount in <i>2002 is \$455 billion</i> compared to <i>\$1.6 trillion in 2016</i> The outstanding housing loan figures include <i>both owner occupied and investment housing loans</i> from Banks, Permanent Building Societies and Credit Co-operatives Source: ABS 5609.0 Housing Finance, Australia, Table 12 Housing loan outstanding to households (owner occupation and investment households) |
| <p>Banks Fee Income from Deposit Accounts</p> <p>The chart shows the fee income from deposit accounts for households in the Australian economy from 2002 to 2015. The y-axis is in millions of dollars, ranging from 0 to 2500. The x-axis shows years. The blue line starts at approximately 1300 million in 2002, rises to a peak of about 2200 million in 2008, then drops sharply to around 1100 million by 2010, and remains relatively stable thereafter. A blue arrow indicates a CAGR of -1.4% over the period.</p> | <ul style="list-style-type: none"> Over the period 2002 to 2015 the value of Banks' Fee Income from Deposit Accounts for households in the Australian economy has <i>reduced at a compounded annual growth rate of -1.4%</i> The amount in <i>2002 was \$1.23 billion</i> compared to <i>\$1.08 billion in 2015</i> Deposit account fees comprise mainly of <i>account-servicing and transaction fees</i>, but also fees for overdrawing the account Source: RBA C9 Domestic Banking Fee Income |
| <p>General Insurance Net Premiums</p> <p>The chart illustrates the net premiums for general insurance for households in the Australian economy from December 2002 to June 2016. The y-axis is in millions of dollars, ranging from 0 to 10,000. The x-axis shows quarterly intervals. The blue line shows significant fluctuations, with a notable dip around 2008-2009, but it shows a clear overall upward trend. A blue arrow indicates a CAGR of 3.4% over the period.</p> | <ul style="list-style-type: none"> Over the period December 2002 to September 2016 the value of General Insurance Net Premiums for households in the Australian economy has <i>grown at a compounded annual growth rate of 3.4%</i> The amount in <i>2002 is \$5.02 Billion</i> compared to <i>\$7.9 billion in 2016</i> Source: APRA Statistics Quarterly General Insurance Performance September 2016 |

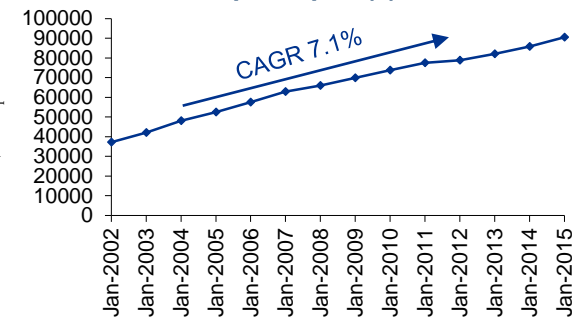
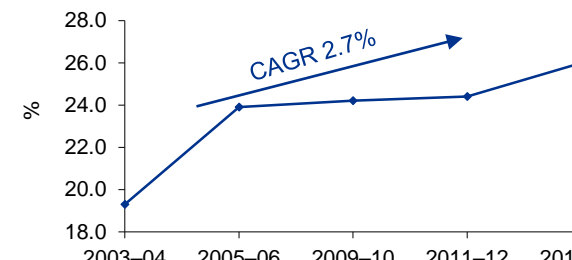
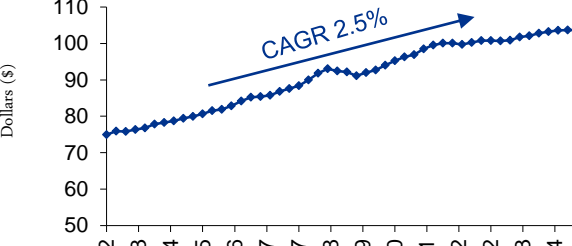
Economic Evaluation: FOS Product Specific

Any negative change in market conditions could lead to an increase in higher value dispute claims. As debt exposure for households increases above the claims limit there is requirement to ensure that FOS remains an accessible and efficient form of financial recourse.

| Economic Parameter | Commentary |
|--|--|
| <p>Assets of Managed Funds Institutions</p> | <ul style="list-style-type: none"> Over the period December 2002 to September 2016 the value of Consolidated Assets of Managed Funds Institutions in the Australian economy has <i>grown at a compounded annual growth rate of 9.1%</i>. The amount in <i>2002 is \$661 billion</i> compared to <i>\$2.2 trillion in 2016</i> Managed funds institutions includes managed funds institutions (e.g. life insurance corporations and superannuation funds) as well as investment or funds manager who provide investment services for managed funds institutions and those with substantial funds to invest. Source: ABS 5655.0 Managed Funds, Australia |
| <p>Assets of Superannuation Funds</p> | <ul style="list-style-type: none"> Over the period December 2002 to September 2016 the value of Unconsolidated Assets of Superannuation funds in the Australian economy has <i>grown at a compounded annual growth rate of 11.3%</i>. The amount in <i>2002 is \$479 billion</i> compared to <i>\$2.1 trillion in 2016</i> Source: ABS 5655.0 Managed Funds, Australia |
| <p>Life Insurance Net Premiums</p> | <ul style="list-style-type: none"> Over the period June 2008 to September 2016 the value of Life Insurance Net Premiums for households in the Australian economy has <i>grown at a compounded annual growth rate of 0.8%</i> The amount in <i>2008 is \$10.6 billion</i> compared to <i>\$11.4 billion in 2016</i> Net premiums is the sum of net policy revenue, premium related fees and net policy revenue recognised as a deposit. Source: APRA Statistics Quarterly Life Insurance Performance September 2016 |

Economic Evaluation: General Economic Indicators

Increases in household debt and cost of living are increasing the financial risk position of households. As the value of assets and debts increases the amount in dispute, and therefore claims value, will increase.

| Economic Parameter | Commentary |
|---|--|
| <p>Household debt per capita (\$)</p>  <p>The chart displays a steady increase in household debt per capita over the period from January 2002 to January 2015. The y-axis represents the amount in dollars per capita, ranging from 0 to 100,000 in increments of 10,000. The x-axis shows the dates from Jan-2002 to Jan-2015. A blue line with markers shows the data points, and a blue trend line with an arrow indicates a Compound Annual Growth Rate (CAGR) of 7.1%.</p> | <ul style="list-style-type: none"> Over the period 2002-2014 the level of Household Debt per Household in Australia has increased at a rate of 7.1% This has increased the interconnectedness between financial institutions and households across Australia. The value of households total liability with the bank has increased therefore increasing the value of the amount that may be in dispute. An increase to the claims limit will allow the Ombudsman to maintain its position as a relevant regulatory body capable of dealing with consumers financially related disputes |
| <p>Household debt with 3 or more times income (%)</p>  <p>The chart shows the percentage of households with debt equal to or more than three times their income from the 2003-04 financial year to the 2013-14 financial year. The y-axis represents the percentage, ranging from 18.0 to 28.0 in increments of 2.0. The x-axis shows the financial years. A blue line with markers shows the data points, and a blue trend line with an arrow indicates a CAGR of 2.7%.</p> | <ul style="list-style-type: none"> Over the period 2003-2014, the proportion of individuals with a level of Household Debt Three or More Times Income has increased at a rate of 2.7% per annum This suggests that the value of household liabilities with financial institutions has increased and therefore the amount in dispute in the event of wrongdoing will also increase Increasing the claims limit should prepare FOS to be able to deal with claims of this nature |
| <p>Cost of living (\$ per day)</p>  <p>The chart illustrates the daily cost of living in Australia from December 2002 to April 2016. The y-axis represents the cost in dollars per day, ranging from 50 to 110 in increments of 10. The x-axis shows the dates from Dec-2002 to Apr-2016. A blue line with markers shows the data points, and a blue trend line with an arrow indicates a CAGR of 2.5%.</p> | <ul style="list-style-type: none"> The Australian Cost of Living per day has increased at a rate of 2.5% over the period 2002-2015 As the cost of living goes up, more consumers will be required to increase their levels of debt in order to maintain previous standards of living This will increase the total value of debt held by consumers, increasing the amount that may be in dispute between the household and the financial institutions An increase in the claim limit will allow FOS to deal with cases of an increased magnitude in keeping with their current product offering |

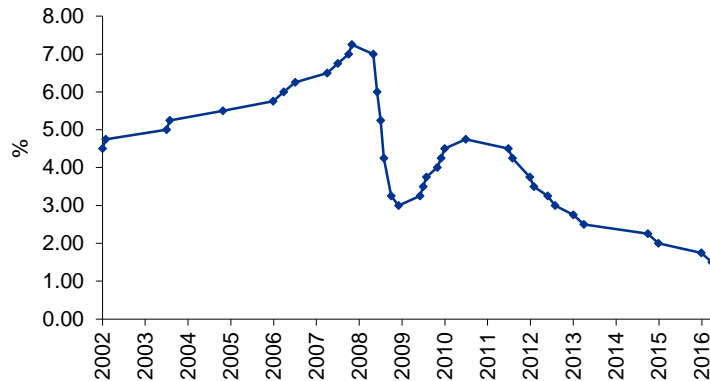
Economic Evaluation: General Economic Indicators

With interest rates at a historical low, households are investing in higher yield / higher risk ventures. Whilst an upward trend in stock market value increases the value of household assets, an increase in volatility increases the likelihood of large dispute claims.

Economic Parameter

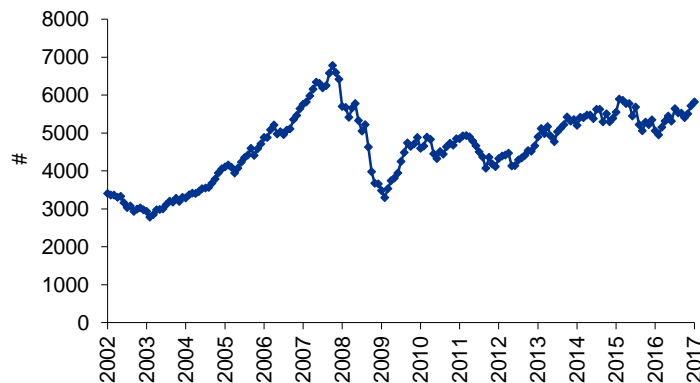
Commentary

Historical Interest Rates (%)



- Over the period 2002-2016 interest rates have decreased from approximately 4.5% to 1.5%. This reduces households propensity to save, and increases the likelihood of engaging with financial institutions, taking advantage of historically low interests rates. Annual interest rate volatility has remained relatively constant throughout the period
- An increase in the level of debt in the economy represents a general increase in households' liabilities with financial institutions. As the total amount of consumers debt increases, so too does the value in potential disputes to be resolved by the Financial Ombudsman Service
- An increase in the claims limit would help to ensure that higher claim amounts can be resolved by FOS

Australian Stock Market (AORD) Index (#)



- Over the period 2002-2016 the stock market index has risen at approximately 3.6% p.a. leading to higher total household wealth amounts. Annual stock market volatility (3.5% p.a. standard deviation) has remained relatively constant throughout the period
- In the event of a significant economic occurrence (e.g. an economic downturn), this will have a large impact on the value of the stock market and will reduce the value of households' stock portfolios. The amount being disputed (i.e. difference between the value of households' portfolio before and after the period of downturn) will be of greater value due to the increased stock values over time
- As such, in order to ensure future claims are within the threshold amount, an increase to the claims limit will be required to enable FOS to service consumers claims effectively

Insights and Findings

Our economic analysis indicates that growth in the current FOS claims limit, when adjusted for CPI annually, is lagging the market when compared against the historical growth of relevant economic parameters. Based on analysis performed, we recommend an increase in the consumer dispute claims limit from \$500k.

Key Economic Insights

FOS product-specific economic indicators findings

- Based on the value-weighted average of dispute amounts awarded under each of the FOS product lines, the long-term compounded annual growth rate (CAGR) of the FOS product specific economic indicators is **5.50% p.a.** Factoring in for general economic indicators, this CAGR reduces to **5.12% p.a.**
- This growth is approximately **twice that** compared to annual increases in CPI (approximately **2.54% p.a.**)

General economic indicators findings

- Across the Australian economy, the level of financial exposure borne by households and individuals has increased over time:
 - The household debt per capita has **increased three times in the last 15 years**
 - The ratio of household debt to annualised income has **increased by 150% in the last 15 years**
- Interest rates are currently at a historical low. This is **encouraging borrowing across households, increasing the overall debt financing**
- The recent increases in stock prices has raised overall wealth, leading to **higher assets values per household**

In summary

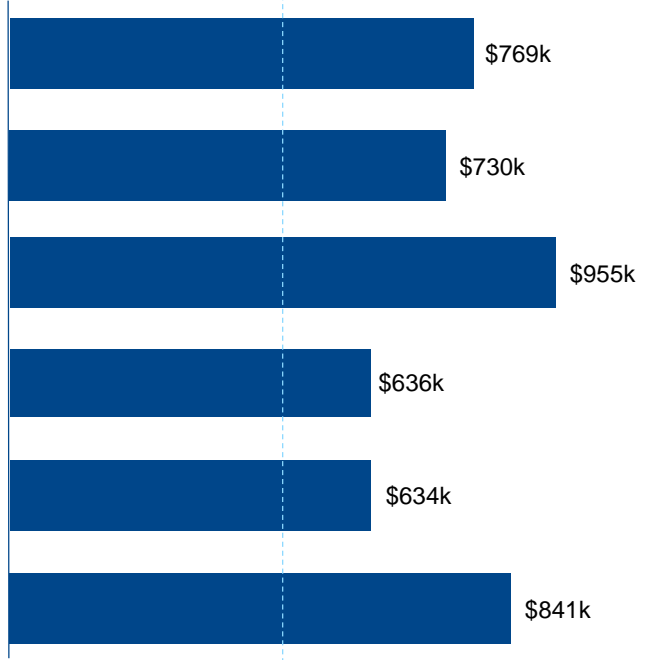
- Based on economic modelling scenarios analysed, the estimated appropriate claims limits **should be set at above the current claims limit of \$500k**

Findings

- Our economic analysis indicates that the growth of the current FOS claims limit is **significantly below the historical growth of relevant economic indicators**
- The economic analysis performed supports **increasing the consumer dispute claims limit from \$500k**
- The analysis performed identifies **an adjusted claims limit of \$730k**, with a **sensitivity range of \$634k and \$955k**. A simple extrapolation based on keeping economic indicators and product weightings unchanged over time, and using the same CAGR of 5.12%, **the claims limit in 2020 would be approximately \$892k.**
- We recommend that the claims limit be adjusted, updated annually with CPI, and **reviewed and adjusted every 3 years** to ensure that the limit is still relevant to economic conditions
- Supplementing the analysis performed, increasing the claims limit is justified by:
 1. **Exposure:** with an increasingly trend in consumer lending and debt exposure, the propensity for higher value claims increases
 2. **Accessibility:** Raising the claims limit increases the ability of FOS to service the abovementioned higher value claims, as an efficient alternative to costly and time consuming litigation
 3. **Future Proof:** Revising the claims limit now will help future-proof the dispute claims process, ensuring ongoing relevance of FOS **11**

Sensitivity Analysis

Sensitivity analysis across a range of economic scenarios supports the increasing of the claims limit from \$500k. Analysis performed identifies a claims limit range of \$634k - \$955k.

| Sensitivity Analysis Performed | Rationale |
|--|--|
| Current limit: \$500k | |
| FOS Product-Specific Economic Indicators only |  <p>\$769k</p> <p>Linked directly to the historical growth in selected FOS product-specific economic indicators</p> |
| FOS Product-Specific and General Economic Indicators (20% weighted) ¹ | <p>\$730k</p> <p>Includes adjustments for the general economic conditions as well as general level of economic risk</p> |
| Top Quartile Household Total Assets Value | <p>\$955k</p> <p>Uses the top quartile household total assets value as a proxy for the maximum adjusted claims limit</p> |
| Top Quartile Household Property Assets Value | <p>\$636k</p> <p>Uses the top quartile household property assets value as a proxy for the adjusted claims limit</p> |
| Adjusted Base Time Period to 2010 | <p>\$634k</p> <p>Performs the analysis using 2010 as the base period to reflect the time period when the consolidated FOS Terms of Reference came into effect</p> |
| Volume Weighted instead of Value Weighted | <p>\$841k</p> <p>Performs the analysis weighted by the number of disputes received by product line, instead of claim amount awarded by product line</p> |

Base Case Assumptions

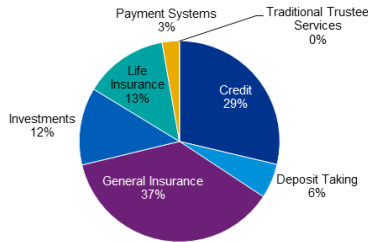
- The base case analysis only includes the 5 selected economic indicators which represent the key FOS product lines: housing loans outstanding, banks' fee income from deposit accounts, net general insurance premiums, total managed funds and net life insurance premiums
- The base case analysis uses 2002 as the base time period as this was the first full year post the approval of the Financial Services Reform Act 2001
- The base case adjusted limit is estimated through back-calculating the current \$500k limit to the year 2002 using ABS CPI data, and then re-adjusting back to 2016, at the weighted average compounded annual growth rate across the time period for the economic indicators selected

[1] A simple extrapolation based on keeping economic indicators and product weightings unchanged over time, and using the same CAGR of 5.12%, the claims limit in 2020 would be approximately \$892k.

Appendix

Detailed Approach Statement

The following slide details the analysis and calculations undertaken in identifying the economic indicators that were used as proxies for movements in the consumer claims limit.

| Action | Description | | | | | | | | | | | | | | | | | | |
|--|--|----------------|-------------------|----------------|-------------------|-----------------|------------------------------|-----------------|------------------------------|-------|----------------------------|-----|----|-----|-----|-----|----|--------|------|
| 1. Data Cleansing | <ul style="list-style-type: none"> Removed Closed Registration, and Registration dispute cases Removed all entities that were not consumer related Removed cases that are Non Terms of Reference Removed duplicate cases (duplicate reference ID) | | | | | | | | | | | | | | | | | | |
| 2. Weighting of FOS product categories based on the total value of claims made. Weightings were based on values in 2016 (as this is the most up to date dataset) | <ul style="list-style-type: none"> Calculated the total value of 2016 claims by product Calculated each products % contribution to total value of 2016 claims <p style="text-align: center;">Detailed Product Breakdown</p>  <table border="1" style="margin-left: auto; margin-right: auto;"> <thead> <tr> <th></th> <th>Credit</th> <th>Deposit Taking</th> <th>General Insurance</th> <th>Investments</th> <th>Life Insurance</th> <th>Payment Systems</th> <th>Traditional Trustee Services</th> <th>Total</th> </tr> </thead> <tbody> <tr> <td>Percentage of Total</td> <td>29%</td> <td>6%</td> <td>37%</td> <td>12%</td> <td>14%</td> <td>3%</td> <td>0.000%</td> <td>100%</td> </tr> </tbody> </table> | | Credit | Deposit Taking | General Insurance | Investments | Life Insurance | Payment Systems | Traditional Trustee Services | Total | Percentage of Total | 29% | 6% | 37% | 12% | 14% | 3% | 0.000% | 100% |
| | Credit | Deposit Taking | General Insurance | Investments | Life Insurance | Payment Systems | Traditional Trustee Services | Total | | | | | | | | | | | |
| Percentage of Total | 29% | 6% | 37% | 12% | 14% | 3% | 0.000% | 100% | | | | | | | | | | | |
| 3. Identified economic indicators specific to each of the key FOS product lines that could be used as a proxy for movements in their underlying position over time | <ul style="list-style-type: none"> Housing Loans Outstanding Banks' Fee Income from Deposit Accounts Net Premiums from General Insurance Total Value Assets in Managed Funds Total Value Assets under Superannuation Funds Net Premiums from Life Insurance <i>NOTE: See slide 6 economic parameter justifications</i> | | | | | | | | | | | | | | | | | | |

Detailed Approach Statement

The following slide details how the economic indicators identified were evaluated and allocated a weighting in order to identify whether the current consumer claims limit should be increased.

| Action | Description | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
|--|---|-------------------|--------------------|-------------------|--------------------|------------------|------------|-------|-----|------------|-------|----------------|------------|-------|-------|------------|-------------------|-----|------------|-------|-------|-------------|-------|-----|------------|-------|----------------|------------|-------|------|------------|------------------------|-----|------------|-------|-------|--------------|-------------|-------------|------------|----------------|----|------------|-------|----|------------|-------|----|------------|
| 4. Identified a set of General Economic Indicators, to determine the financial position and volatility of the Australian economic market | <ul style="list-style-type: none"> Household Debt to Income Cost of Living Index Average Debt per person Households with debt 3 or more times income Interest Rate Volatility Stock Market volatility | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 5. Rebaselined the current consumer claims limit (\$500k) to the 2002 claim amount by adjusting for a CAGR of CPI | <ul style="list-style-type: none"> March 2015 claim limit of \$500k rebaselined by changes to CPI back to 2002 = \$363,094 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 6. Allocated a weighting of 20% to the General Economic Indicators. Multiplied Economic Indicator by the appropriate weighting to give a value-weighted annual change to the consumer claims limit | <p>1 Weight adjusted for FOS product specific economic indicators to be 80% of total weight, allowing for a 20% General Economic Indicator Factor</p> <p>2 Weighted value = Adjusted Weight X Economic Indicator</p> <p>3 Value-weighted annual change to claim limit = 5.12% = Sum of all weighted values</p> <table border="1" data-bbox="948 696 1953 911"> <thead> <tr> <th></th> <th>Weighting</th> <th>Adjusted Weight 1</th> <th>Economic Indicator</th> <th>Weighted Value 2</th> </tr> </thead> <tbody> <tr> <td>Credit</td> <td>29%</td> <td>24%</td> <td>9.7%</td> <td>2.30%</td> </tr> <tr> <td>Deposit Taking</td> <td>6%</td> <td>5%</td> <td>-1.4%</td> <td>-0.06%</td> </tr> <tr> <td>General Insurance</td> <td>37%</td> <td>30%</td> <td>3.4%</td> <td>1.02%</td> </tr> <tr> <td>Investments</td> <td>12%</td> <td>10%</td> <td>10.2%</td> <td>1.04%</td> </tr> <tr> <td>Life Insurance</td> <td>14%</td> <td>11%</td> <td>0.8%</td> <td>0.09%</td> </tr> <tr> <td>General Economic Trend</td> <td>20%</td> <td>20%</td> <td>3.6%</td> <td>0.73%</td> </tr> <tr> <td>Total</td> <td>117%</td> <td>100%</td> <td></td> <td>3 5.12%</td> </tr> </tbody> </table> | | Weighting | Adjusted Weight 1 | Economic Indicator | Weighted Value 2 | Credit | 29% | 24% | 9.7% | 2.30% | Deposit Taking | 6% | 5% | -1.4% | -0.06% | General Insurance | 37% | 30% | 3.4% | 1.02% | Investments | 12% | 10% | 10.2% | 1.04% | Life Insurance | 14% | 11% | 0.8% | 0.09% | General Economic Trend | 20% | 20% | 3.6% | 0.73% | Total | 117% | 100% | | 3 5.12% | | | | | | | | |
| | Weighting | Adjusted Weight 1 | Economic Indicator | Weighted Value 2 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Credit | 29% | 24% | 9.7% | 2.30% | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Deposit Taking | 6% | 5% | -1.4% | -0.06% | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| General Insurance | 37% | 30% | 3.4% | 1.02% | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Investments | 12% | 10% | 10.2% | 1.04% | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Life Insurance | 14% | 11% | 0.8% | 0.09% | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| General Economic Trend | 20% | 20% | 3.6% | 0.73% | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Total | 117% | 100% | | 3 5.12% | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 7. Weighted value (5.12%) applied annually to the \$362,760 2002 consumer claims limit until September 2016 to calculate a revised consumer claim limit | <ul style="list-style-type: none"> Weighted CAGR value (5.12%) applied annually to the original \$362,760 in 2002. This derives a new consumer claims limit of \$730,497 in September 2016 A simple extrapolation based on keeping economic indicators and product weightings unchanged over time, and using the same CAGR of 5.12%, the claims limit in 2020 would be approximately \$892k. NOTE: Diagram under Action 7 (Left) only shows increases to limit from December 2012 – September 2016 as an indication only. <table border="1" data-bbox="1363 1011 1833 1353"> <tbody> <tr><td>5.12%</td><td>\$</td><td>603,545.86</td></tr> <tr><td>5.12%</td><td>\$</td><td>611,276.26</td></tr> <tr><td>5.12%</td><td>\$</td><td>619,105.66</td></tr> <tr><td>5.12%</td><td>\$</td><td>627,035.35</td></tr> <tr><td>5.12%</td><td>\$</td><td>635,066.61</td></tr> <tr><td>5.12%</td><td>\$</td><td>643,200.73</td></tr> <tr><td>5.12%</td><td>\$</td><td>651,439.03</td></tr> <tr><td>5.12%</td><td>\$</td><td>659,782.85</td></tr> <tr><td>5.12%</td><td>\$</td><td>668,233.55</td></tr> <tr><td>5.12%</td><td>\$</td><td>676,792.48</td></tr> <tr><td>5.12%</td><td>\$</td><td>685,461.04</td></tr> <tr><td>5.12%</td><td>\$</td><td>694,240.63</td></tr> <tr><td>5.12%</td><td>\$</td><td>703,132.67</td></tr> <tr><td>5.12%</td><td>\$</td><td>712,138.60</td></tr> <tr><td>5.12%</td><td>\$</td><td>721,259.88</td></tr> <tr><td>5.12%</td><td>\$</td><td>730,497.99</td></tr> </tbody> </table> | 5.12% | \$ | 603,545.86 | 5.12% | \$ | 611,276.26 | 5.12% | \$ | 619,105.66 | 5.12% | \$ | 627,035.35 | 5.12% | \$ | 635,066.61 | 5.12% | \$ | 643,200.73 | 5.12% | \$ | 651,439.03 | 5.12% | \$ | 659,782.85 | 5.12% | \$ | 668,233.55 | 5.12% | \$ | 676,792.48 | 5.12% | \$ | 685,461.04 | 5.12% | \$ | 694,240.63 | 5.12% | \$ | 703,132.67 | 5.12% | \$ | 712,138.60 | 5.12% | \$ | 721,259.88 | 5.12% | \$ | 730,497.99 |
| 5.12% | \$ | 603,545.86 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 5.12% | \$ | 611,276.26 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 5.12% | \$ | 619,105.66 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 5.12% | \$ | 627,035.35 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 5.12% | \$ | 635,066.61 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 5.12% | \$ | 643,200.73 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 5.12% | \$ | 651,439.03 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 5.12% | \$ | 659,782.85 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 5.12% | \$ | 668,233.55 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 5.12% | \$ | 676,792.48 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 5.12% | \$ | 685,461.04 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 5.12% | \$ | 694,240.63 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 5.12% | \$ | 703,132.67 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 5.12% | \$ | 712,138.60 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 5.12% | \$ | 721,259.88 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 5.12% | \$ | 730,497.99 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |

Small Business Jurisdiction

Financial Ombudsman Service

Small Business
Jurisdiction

Economic Modelling
Assistance

January 2017

Executive Summary

With the upcoming release of the External Dispute Resolution (EDR) report an opportunity exists to propose an increase in the business credit facility limit from \$2m, and the business claims limit from \$500k.

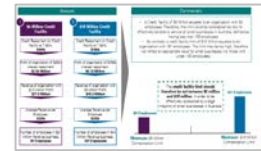
Approach

Analysis has been performed to evaluate economic indicators related to the small business credit facility limit and the claims limits for the FOS Credit product line. The work is based on provisional analysis conducted by FOS on small businesses in Australia. Where possible we have compared the analysis and key findings to benchmarks for the definition of a small business in Australia. The economic parameters identified can be categorised into:

- **FOS Credit product line specific indicators:** that reflect economic conditions that correlate with the growth of credit related financial services products
- **General economic indicators:** that represent the overall Australian economic market condition and level of volatility
- **Benchmark indicators:** that represent the definition of a small business in Australia
- Our findings indicate that on average, a business credit facility of \$5m aligns to businesses with less than 100 employees, which is the current Australian Small Business and Family Enterprise Ombudsman (ASBFEO) definition of a small business¹. Furthermore, sensitivity analysis across selected industries with a high concentration of small businesses supports this conclusion

Findings and Insights

- Across the Australian economy, the level of financial risk borne by businesses has increased over time, with businesses increasingly using debt to finance investments, and using their private assets as a form of debt collateral (e.g. houses)
- Based on sensitivity analysis performed, there is evidence to support increasing the business claims limit above the current \$500k limit
- In conjunction, justification for an increase in the claims limit includes:
 1. **Exposure:** with an increasing trend in business lending and debt exposure, the propensity for higher value claims increases
 2. **Accessibility:** raising the claims limit increases the ability of FOS to service the abovementioned higher value claims, as an efficient alternative to costly and time consuming litigation
 3. **Future Proof:** revising the claims limit now will help future-proof the dispute claims process, ensuring the ongoing relevance of FOS



Conclusion

- Based on economic analysis performed, **our findings suggest increasing the business credit facility limit and claims limit from \$2 million and \$500k respectively**
- The analysis performed supports a credit facility limit of \$5m, and a claims limit range of between \$1m to \$2m, to ensure sufficient small business coverage across a range of industries
- The business credit facility limit and claims limit should ideally be reviewed and adjusted every 3 years to ensure that the limit remains relevant to economic conditions

Note: 1. FOS proposes changing its definition of small business with a broader one akin to that of the Australian Small Business and Family Enterprise Ombudsman (ASBFEO), that is, a business with less than 100 FTE employees because it would improve clarity and jurisdictional assessment by removing the 'manufacturing' differentiation from the current definition and increase some access to EDR for small business consumers.

Table of Contents

| | |
|--------------------------------------|----------------|
| Purpose and Scope | <i>Page 4</i> |
| Overall Approach | <i>Page 5</i> |
| Small Business Credit Facility Limit | <i>Page 6</i> |
| Small Business Claims Limit | <i>Page 10</i> |
| Overall Insights and Key Findings | <i>Page 17</i> |
| Appendix | <i>Page 19</i> |

Purpose and Scope

As part of the External Dispute Resolution (EDR) process, analysis was performed to identify findings in support of adjusting the current small business credit facility limit and dispute claims limit.

Purpose

The purpose of this document is to detail:

- **Economic parameters** that can be modelled in order to develop an understanding of current economic market conditions
- **The economic modeling** performed in determining the impact of the economic parameters to the current small business credit facility limit and dispute claim limit
- **Key findings** of whether to adjust the current small business credit facility limit and claims limit
- **The sensitivity analysis** performed to determine how changing the economic parameters impacts the adjustment, under a given set of assumptions

Scope

The scope of work comprises of the following:

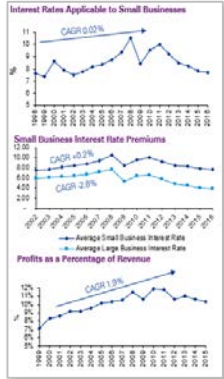
- **Product Line:** Our analysis is focused on the Credit product line only
- **Claimants:** Our analysis is focused on the small business related credit facility limit and claims limit
- **Period:** Analysis performed is based on the date range between 2002 and 2016^[1]
- **Limits:** The analysis has focused on evaluating credit facility limits of \$5m and \$10m. Estimates provided by the four major Australian banks indicate that broadly 98% of business customers have a credit facility limit under \$5m, and broadly 99% of business customers have a credit facility limit under \$10m^[1]. Whilst a majority of credit facilities are below this limit, there is a requirement to ensure that the proposed credit facility limit provides adequate and reasonable coverage to a significant proportion of small business claimants. This includes industries that are susceptible to proportionately higher credit facilities. In conjunction:
 1. For selected industries (e.g. farming) the total credit facility is often well in excess of the outstanding debt figures identified
 2. Research shows that business debt outstanding has been growing over the last two decades, at a rate of circa 2.7 times greater than inflation. As a result, this growth increases financial risk exposure, the potential amounts in dispute, and therefore the value of potential business claims

^[1] This percentage is derived from an aggregation of indicative data provided by the major Banks to FOS on a confidential basis and is subject to a range of limitations and caveats. 4

Overall Approach

In presenting our findings we have performed a comprehensive analysis and modelling of economic parameters, including benchmarking analysis against market definitions of a small business in Australia^[1].

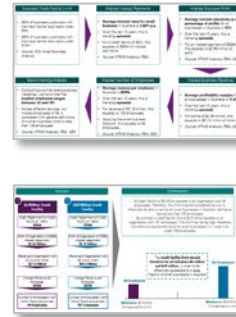
(1) Performed Economic Analysis and Benchmarking



We performed economic analysis based on the identification and selection of economic indicators and benchmarks, which map to the credit facility limit and claims limits for small businesses.

Using a structured financial logic we attempted to validate the hypothesis that the credit facility limit could be aligned to FTE counts, by linking credit to financial performance to FTEs. Our dataset comprises of information provided by FOS and publically available sources.

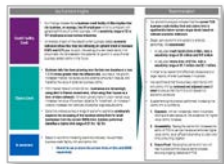
(2) Conducted Sensitivity Analysis



With input from FOS stakeholders and economic experts, we conducted sensitivity analysis of the economic modelling. This involved:

1. The use of different proxies and scenarios in the selection of the economic indicators
2. The identification and use of alternative methods to arrive at key insights regarding the relevant credit facility limit and claims limit
3. An industry cross-sectional analysis to assess estimated ranges, and to identify any outliers

(4) Presented Our Conclusion



Based on the key findings and insights identified we presented our conclusion on the FOS credit facility limit and claims limit including:

1. An indicative limit with a sensitivity range
2. A suggested periodical activity to review the limits to ensure that the limits are still relevant to economic market conditions

(3) Identified Key Findings and Insights



Based on the economic findings and sensitivity analyses conducted, we developed a set of insights in support of increasing the credit facility limit and claims limit. The insights analysed included economic and benchmark data obtained from FOS and various other external sources.

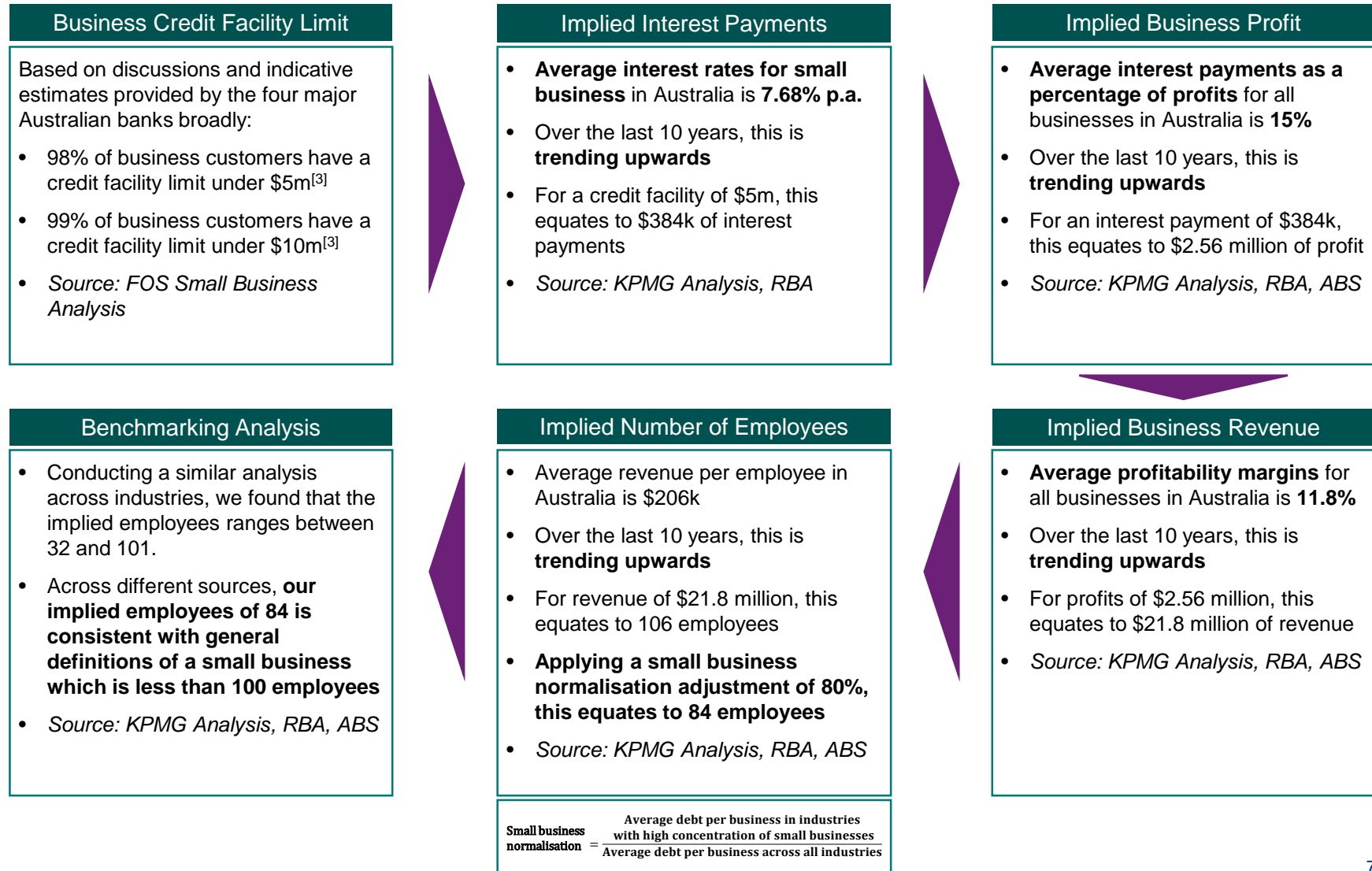
In addition, we outlined further justifications for an increase in both limits consistent with FOS principles of exposure, accessibility and being future proof.

Note: 1. FOS proposes changing its definition of small business with a broader one akin to that of the Australian Small Business and Family Enterprise Ombudsman (ASBFEO), that is, a business with less than 100 FTE employees because it would improve clarity and jurisdictional assessment by removing the 'manufacturing' differentiation from the current definition and increase some access to EDR for small business consumers.

Economic Evaluation Business Credit Facility Limit

Business Credit Facility Limit: Approach

In order to test the validity of the \$5m and \$10m credit facility limits, we leveraged the existing analysis performed by FOS to develop a financial logic^[1] to link the credit facility limit to a market definition of small business, based on FTE count^[2].



Note: 1. The Appendix (slide 21) contains a more detailed account of the methodology. 2 FOS proposes changing its definition of small business with a broader one akin to that of the Australian Small Business and Family Enterprise Ombudsman (ASBFEO), that is, a business with less than 100 FTE employees. 3. This percentage is derived from an aggregation of indicative data provided by the major Banks to FOS on a confidential basis and is subject to a range of limitations and caveats.

Business Credit Facility Limit: Findings & Insights

The analysis performed supports setting a credit facility limit between \$5 million and \$10 million, in order to align to the 100 FTE count definition of small businesses.

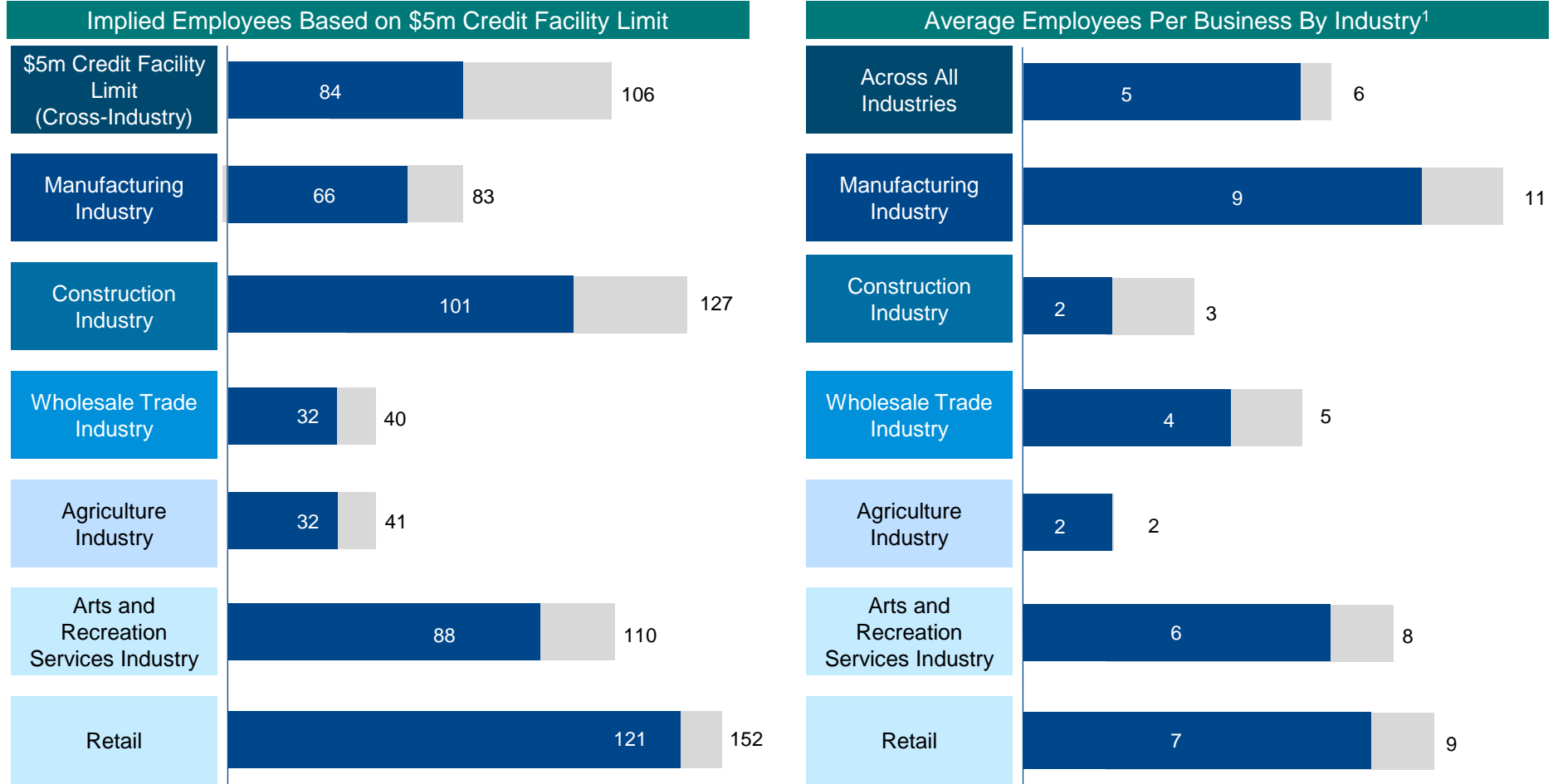
| 1 \$5 Million Credit Facility | |
|--|--|
| Step 1: Average Interest Rate for Small Business: | 7.68% |
| Step 2: Average Interest Repayment on \$5 Million Credit Facility | \$5 Million X 7.68% = \$383,958 |
| Step 3: Identified Total Business Profit in Economy (\$Millions) | \$292,731 |
| Step 4: Identified Total Revenue in Economy (\$Millions) | \$2,490,437 |
| Step 5: Identified Profitability Margin in Economy | Profitability Margin= Profit/Revenue 292,731/2,490,437 = 11.75% |
| Step 6: Identified total interest payments in economy divided by total profits | \$43,917/292,731 = 15% |
| Step 7: Found implied business profit of an organization with a credit limit of \$5,000,000 | \$383,958/15%= \$2,559,282 |
| Step 8: Found implied business revenue of an organization with a credit limit of \$5,000,000 | \$2,559,282/11.75%= \$21,773,343 |
| Step 9: Identified Size of Australian Labor Force December 2016 | 12,093,360 |
| Step 10: Identified revenue per person | \$205,934 |
| Step 11: Implied number of employees for an organisation with a \$5 million credit limit, inclusive of a 20% small business normalisation adjustment | 84 Employees |

| 2 \$10 Million Credit Facility | |
|--|--|
| Step 1: Average Interest Rate for Small Business: | 7.68% |
| Step 2: Average Interest Repayment on \$5 Million Credit Facility | \$10 Million X 7.68% = \$767,917 |
| Step 3: Identified Total Business Profit in Economy (\$Millions) | \$292,731 |
| Step 4: Identified Total Revenue in Economy (\$Millions) | \$2,490,437 |
| Step 5: Identified Profitability Margin in Economy | Profitability Margin= Profit/Revenue 292,731/2,490,437 = 11.75% |
| Step 6: Identified total interest payments in economy divided by total profits | \$43,917/292,731 = 15% |
| Step 7: Found implied business profit of an organization with a credit limit of \$10,000,000 | \$767,917/15%= \$5,118,566 |
| Step 8: Found implied business revenue of an organization with a credit limit of \$10,000,000 | \$5,118,566/11.75%= \$43,546,686 |
| Step 9: Identified Size of Australian Labor Force December 2016 | 12,093,360 |
| Step 10: Identified revenue per person | \$205,934 |
| Step 11: Implied number of employees for an organisation with a \$10 million credit limit , inclusive of a 20% small business normalisation adjustment | 169 Employees |

Our findings indicate that the credit facility limit should be between \$5 million and \$10 million, in order to be accessible to a significant majority of small businesses in Australia. Based on the analysis a credit facility of approximately \$6m would support an employee count of circa 100.

Business Credit Facility Limit: Sensitivity Analysis

Based on a credit limit of \$5m, the implied employees number is significantly higher than the average number of employees per business¹ across all identified industries. This indicates that a \$5 million credit facility limit is sufficient to support a significant proportion of small businesses.



Based on cross-industry analysis performed on the implied and average employees counts, **we find that a \$5 million credit facility limit is sufficient to service a significantly large percentage of small businesses.**

Note: 1. The average employees per business across selected industries are skewed lower due to the following: dormant entities, trusts for beneficiaries, legal structure for certain businesses (e.g. franchises).



Economic Evaluation

Business Claims Limit

Economic Evaluation: Key Parameters Used

In order to assess variations to the estimated small business claims limit and its general trending over time, we have identified relevant economic indicators that are (i) specific to the FOS Credit product line, and (ii) general economic indicators that would have an impact on businesses through macroeconomic changes.

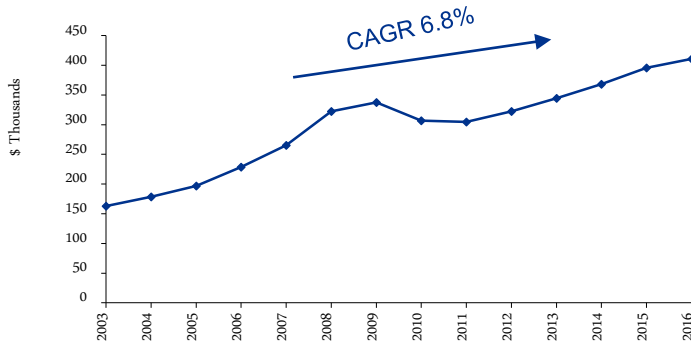
| Key Economic Indicators Used | | Rationale for Selection |
|---|---|---|
| Economic Indicators Specific to the Credit product line | Business Debt Outstanding | The level of gearing borne by businesses is positively correlated to the level of business debt outstanding in Australia |
| | Interest Rates Applicable to Businesses | The level of interest rates applicable to businesses, and any associated interest rate premiums for small businesses, is proportionate to the level of financial risk borne by businesses |
| General Economic Indicators | Stock Market Volatility | Volatility in the stock market is representative of changes in general market conditions, and therefore acts as an indicator for how small businesses are impacted by a changing economic climate |
| | Interest Rate Volatility | Changes in interest rates will impact the ability and appetite of small businesses to take out loans. The lower the interest rate the more likely small businesses are to utilize debt to support their business operations |

Economic Evaluation: Credit Specific Indicators

Outstanding business debt has been growing over the last two decades at a rate of circa 2.7 times greater than inflation. This growth increases financial risk exposure, the potential amounts in dispute, and therefore the value of potential business claims.

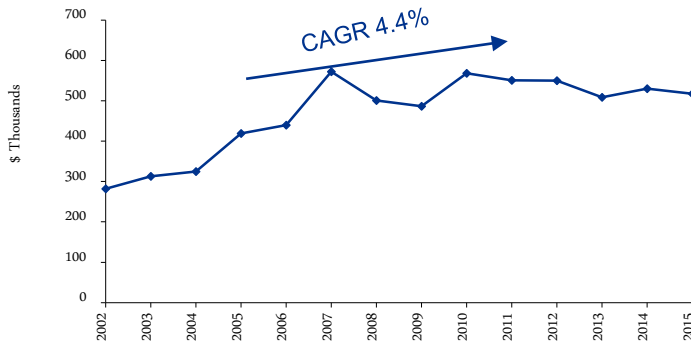
| Economic Parameter | Commentary |
|--------------------|------------|
|--------------------|------------|

Business Debt Outstanding



- The average value of Business Debt Outstanding for a business of any size in the Australian economy has *grown at an annual compounded growth rate of 6.8%*
- The amount of debt has increased from *\$163k in 2003 to \$411k in 2016*^[1]. Overall, the increase has been steady over time, with the exception of the period 2008 - 2009
- Source: RBA D7.3 Bank Lending To Business – Total Credit Outstanding By Size and By Sector; ABS Counts of Australian Businesses, including Entries and Exits, Jun 2003 to Jun 2015

Business Debt Outstanding in the Farming Industry



- The average value of Business Debt Outstanding for the farming industry in the Australian economy has *grown at an annual compounded rate of 4.4%*
- The amount of debt has *increased from \$282k in 2002 to \$517k in 2015*. Overall, the increase has been steady with a noticeable decline in 2008^[2].
- Source: AGSURF data of 'farm business debt at 30 June' and 'population' from 2002 to 2015, provided by the Department of Agriculture and Water Resources; 'The Global Financial Crisis and regional Australia' report from the Parliament of the Commonwealth of Australia, pp. 29-30

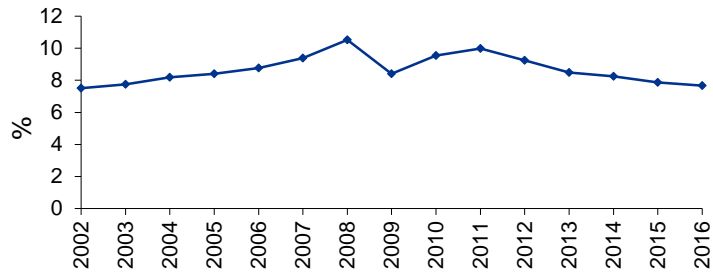
Economic Evaluation: Credit Specific Indicators

The interest rates applicable for small businesses in Australia have a circa 2% premium over interest rates on large businesses, with the premium increasing over time. This premium can lead to increased financial exposure and potentially larger small business related claim values.

Economic Parameter

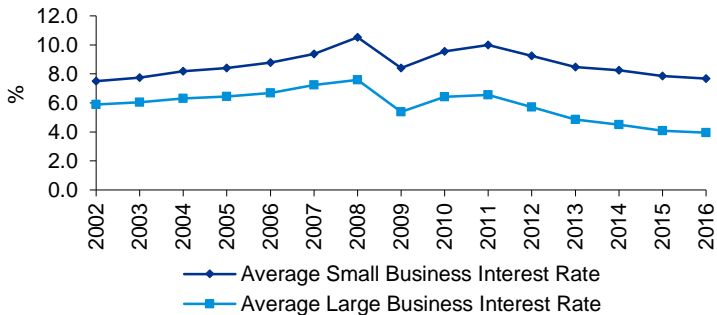
Commentary

Interest Rates Applicable to Small Businesses



- Over the period 2002 to 2016, the average interest rate applicable to small businesses has *grown at an annual compounded rate of 0.121%*
- The average rate *was 7.50% in 2002*, reaching *a peak of 10.53% in 2008*, and the 2016 figure being *7.68%*
- Source: RBA Indicator Lending Rates, F5hist

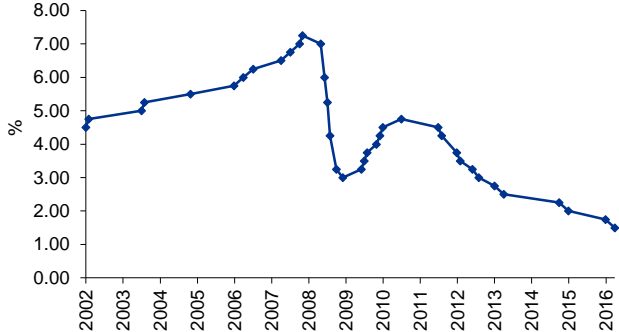
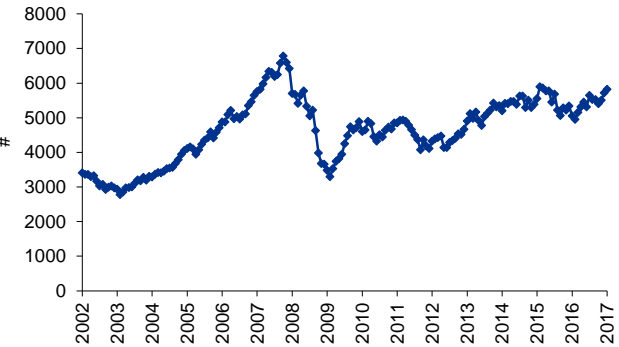
Small Business Interest Rate Premiums



- From 2002 to 2016, small business interest rate premiums increased from *7.5% to 7.68% at a growth rate of 0.2%*
- By contrast, interest rates for large business decreased from 5.89% in 2002 to 3.94% in 2016, at a growth rate of -2.8%
- Source: RBA Indicator Lending Rates

Economic Evaluation: General Economic Indicators

With interest rates at a historical low, businesses are increasingly using debt to finance investments, often using their houses as a form of debt collateral¹. Whilst an upward trend in stock market value increases the value of business' appetite for investment, an increase in volatility increases the propensity for large dispute claims.

| Economic Parameter | Commentary |
|---|--|
| <p>Historical Interest Rates (%)</p>  | <ul style="list-style-type: none"> Over the period 2002-2016 interest rates have <i>decreased from approximately 4.5% to 1.5%</i>. This reduces households propensity to save, and increases the likelihood of taking out loans, taking advantage of historically low interests rates. <i>Annual interest rate volatility has remained relatively constant throughout the period</i> An increase in the level of debt in the economy represents a general increase in liabilities with financial institutions. As the total amount of business debt increases, so too does the value in potential disputes to be resolved by the Financial Ombudsman Service An increase in the claims limit would help to ensure that higher claim amounts can be resolved by FOS |
| <p>Australian Stock Market (AORD) Index (#)</p>  | <ul style="list-style-type: none"> Over the period 2002-2016 the stock market index has <i>risen at approximately 3.6% p.a. Annual stock market volatility (3.5% p.a. standard deviation) has remained relatively constant throughout the period</i> Volatility in the stock market index can be used as a benchmark for volatility throughout the entire economy. Therefore, a downturn in the stock market index can be viewed as a proxy for a downturn in the economic performance of small business. Any downturn in performance may be related to an increase in the propensity and size of claims As such, in order to ensure future claims are within the threshold amount, an increase to the claims limit will be required to enable FOS to service small business claims effectively |

Note: 1. In reference to the Reserve Bank of Australia (RBA) published whitepaper: Small Business Conditions and Finance. Link: <http://www.rba.gov.au/publications/confs/2015/pdf/conf-vol-2015.pdf>

Claims Limit: Sensitivity Analysis

In order to determine the appropriate claims limit we have analysed the below standard claims case studies. The potential accrued interest payments from scenario 1 and 2 support proposing a claims limit of between \$1m and \$2m.

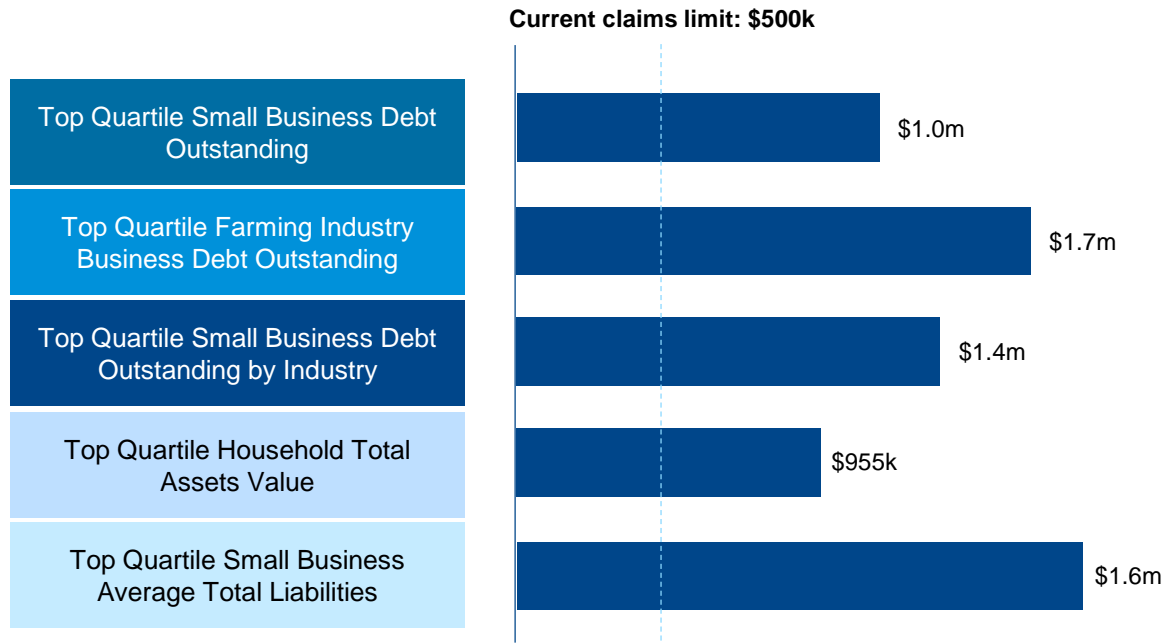
| Claimant Scenario ¹ | Scenario Description ¹ | Approximate Dispute Value Calculation | Potential Accrued Interest Payments Under Dispute |
|--|---|--|---|
| Scenario 1: Four Years of Interest Payments Followed by a Default Event | Applicant has a \$5M bill facility with Bank X. After struggling to make repayments for four years, the applicant defaults on 1 November and makes no further payments. The Bank rolls the bill into an unpaid bills account charging 12% interest, plus a customer margin of 2% and a default margin of 4%. Interest is charged at 18% from 1 February. After three months of discussion with the Bank, the applicant lodges a dispute with FOS, saying the loan should not have been given in the first place. FOS agrees that the loan should not have been given and in accordance with its approach to compensation, awards a refund of all interest charged, including the default interest charged between 1 February and 31 July. | <p>Interest paid over 4 years = $\\$5m \times 7.68\% \times 4 = \\$1.54m$</p> <p>Non-payment interest accrued = $\\$5m \times 7.68\% \times 0.25 = \\$96k$</p> <p>Default interest accrued = $\\$5m \times 18\% \times 0.5 = \\$450k$</p> <p>Total interest paid and accrued = \$2.1m</p> | ~\$2.1m |
| Scenario 2: One Year of Interest Payments Followed by a Default Event | Applicant has a \$5M bill facility with Bank X. After struggling to make repayments for a year, the applicant defaults on 1 November and makes no further payments. The Bank rolls the bill into an unpaid bills account charging 12% interest, plus a customer margin of 2% and a default margin of 4%. Interest is charged at 18% from 1 February. After three months of discussion with the Bank, the applicant lodges a dispute with FOS, saying the loan should not have been given in the first place. FOS agrees that the loan should not have been given and in accordance with its approach to compensation, awards a refund of all interest charged, including the default interest charged between 1 February and 31 July. | <p>Interest paid over 1 year = $\\$5m \times 7.68\% = \\$384k$</p> <p>Non-payment interest accrued = $\\$5m \times 7.68\% \times 0.25 = \\$96k$</p> <p>Default interest accrued = $\\$5m \times 18\% \times 0.5 = \\$450k$</p> <p>Total interest paid and accrued = \$934k</p> | ~\$934k |
| Scenario 3: Financial Services Provider (FSP) – Customer Financial Difficulty Obligations | Applicant has a \$5M bill facility with Bank X. Their business declines and the applicant defaults on 1 November and makes no further payments. The Bank rolls the bill into an unpaid bills account charging 12% interest, plus a customer margin of 2% and a default margin of 4%. Interest is charged at 18% from 1 February. The customer approached the bank in December to ask for financial difficulty assistance. The Bank declines the request as it wants to exit the customer. The Applicant lodges a dispute with FOS who finds that the Bank did not meet its financial difficulty obligations. The bank is required to refund the default interest charged from 1 February to 30 June, but is entitled to charge normal interest, including the compound interest due to non-payment. | <p>Default interest accrued = $\\$5m \times 18\% \times 5/12 = \\$375k$</p> <p>Normal interest charges = $\\$5m \times 7.68\% \times 5/12 = \\$160k$</p> <p>Non-payment interest accrued = $\\$5m \times 7.68\% \times 0.25 = \\$96k$</p> <p>Net refund = \$119k</p> | ~\$119k |

Note: 1. Assuming that the interest rates applicable to small businesses is 7.68% p.a.

Claims Limit: Alternative Sensitivity Analysis

In support of our analysis on the accrued interest payments, we further validated our findings through the use of alternative economic parameters as proxies for potential claims exposure. Sensitivity analysis on debt related proxies consistently support increasing the small business claims limit with an estimated range of between \$1m and \$2m.

| Key Findings | Insights |
|--------------|----------|
|--------------|----------|



- Our economic analysis indicates that the current FOS business claims limit is *below current target levels based on relevant economic indicators*
- Sensitivity analysis across a range of economic scenarios *supports increasing of the business claims limit for small businesses from the current \$500k limit*
- All five selected economic scenarios analysed has *a sensitivity range of \$955k to \$1.7m.*
- This includes high debt exposure scenarios where top quartile figures are used in order to obtain a clearer understanding of the highest possible value of business claims.

Key Assumptions

- The analysis covers the 5 selected economic scenarios which represent the amount of debt borne by small businesses in Australia: average business debt outstanding by industry, top quartile business debt outstanding, top quartile farming industry business debt outstanding, top quartile household total assets value and implied business average total liabilities.
- The analysis uses 2015 as the base time period, as this is the most recent data available to ensure a like-for-like comparison across all economic indicators
- Where relevant, the base case is adjusted by 2 standard deviations to obtain top quartile figures; and a normalisation for small business to obtain figures relevant to the small businesses in Australia. The small business normalisation adjustment is calculated as the average discount between average debt per business in industries with high concentration of small businesses, divided by average debt per business across all industries

Overall Insights and Key Findings

Overall Insights and Key Findings

Our economic analysis indicates that growth in the current FOS business credit facility limit and claims limit is below current target levels based on comparisons with relevant economic indicators. Based on analysis performed, our findings indicate that there is an opportunity to increase in the business credit facility limit and claims limit from \$2 million and \$500k respectively.

Key Economic Insights

Credit Facility Limit

Our findings indicate that, on average, a **\$5m small business credit facility implies an employee count marginally below the standard benchmark of 100 employees**

Our findings indicate that the implied employees based on a \$5m credit facility limit are significantly higher than the average number of employees per business across industries with a high concentration of small businesses. This indicates that a **\$5 million credit facility limit is sufficient to service a significantly large percentage of small businesses**

Claims Limit

The key insights from our economic evaluation show that:

- **Business debt has been growing** over the last two decades at a rate circa 2.7 times greater than inflation
- Furthermore, with interest rates currently at a historical low, **businesses are increasingly using debt to finance investments**¹
- The **small business interest rate premium differentials are increasing over time**

As a result, the increase in business financial risk increases financial exposure, and the **potential for business claims of higher financial significance**

A review of accrued interest payments in dispute under different case studies **provides the analysis to support a business claims limit with an estimated range of between \$1m and \$2m**

We further **validated our findings through the use of alternative economic parameters as proxies for potential claims exposure**, which is consistent with our key findings

In summary

Based on economic modelling scenarios analysed, the estimated business credit facility limit and claims limit **should be set at above the current limits of \$2m and \$500k respectively**

Findings

- Our economic analysis supports the hypothesis that the **current FOS business credit facility limit and claims limits are below current target levels based on relevant economic indicators**
- The analysis performed supports:
 - A **credit facility limit of \$5m**, which implies an **employee count marginally below the standard benchmark of 100 employees**
 - An adjusted **claims limit range of between \$1m to \$2m** to ensure **sufficient small business coverage across a range of industries**
- The business credit facility limit and claims limit should ideally be **reviewed and adjusted every 3 years** to ensure that the limit is still relevant to economic conditions
- Supplementing the analysis performed, increasing the claims limit is justified by:
 1. **Exposure:** with an increasing trend in business lending and debt exposure, the propensity for higher value claims increases
 2. **Accessibility:** Raising the claims limit increases the ability of FOS to service the abovementioned higher value claims, as an efficient alternative to costly and time consuming litigation
 3. **Future Proof:** Revising the claims limit now will help future-proof the dispute claims process, ensuring the ongoing relevance of FOS

Note: 1. In reference to the Reserve Bank of Australia (RBA) published whitepaper: Small Business Conditions and Finance. Link: <http://www.rba.gov.au/publications/confs/2015/pdf/conf-vol-2015.pdf>

Appendix

1. Constraints and Assumptions
2. Financial Analysis Methodology
3. Trend Analysis: Benchmark Economic Indicators

Constraints and Assumptions

As part of the FOS business credit facility limit and claim limit review, the analysis was performed based upon the following constraints and assumptions.

| General Assumptions | Explanation |
|--|--|
| Yearly Averages | Where monthly data was provided, a yearly average was calculated in order to arrive at a single yearly figure |
| Relevant Data Source | A combination of datasets from different data sources were used to calculate specific economic indicators or scenarios, in order to obtain the most accurate results. For example, in order to calculate Business Debt Outstanding, data for the total business debt outstanding in Australia was sourced from the Reserve Bank of Australia and the count of the total number of businesses in Australia was sourced from the Australian Bureau of Statistics |
| Count of Businesses Data | Time periods used in the count of businesses data published by the Australian Bureau of Statistics are based on the July to June financial year, where the number of Australian businesses operating at the beginning and at the end of the financial years are recorded. In order to compensate for unavailable data, the assumption was that the number of businesses operating at the beginning of a financial year is the same as the number of businesses operating at the end of the previous financial year |
| Top Quartile Farming Industry Business Debt Outstanding Calculation | In order to identify the top quartile of farming industry debt outstanding, the data for total farming industry debt outstanding by Australian region was sourced, and the average of the top 25% was calculated |
| Top Quartile Calculation | In order to identify the top quartile of economic scenarios, the multiplier between the average and top quartile farming industry debt outstanding was used as a proxy for 2 standard deviations. This proxy was applied because data required to calculate the real top quartile figure is not available, and the farming industry is an appropriate proxy for the small business market due to the high volume of highly geared small businesses |
| Small Business Normalisation adjustment | The small business normalisation adjustment reflects the adjustment required due to larger businesses being included in the dataset available, which would skew the results upwards |
| Small Business Lending Rates | Average value of small business lending is across variable residential secures, residential secured, variable term and variable overdraft |
| Average Interest Repayment on Credit Facility | The assumed maximum draw down amount on a \$5million and \$10million credit facility respectively is used to arrive at the average interest repayments |
| FOS Data from Major Australian Banks | Our analysis assumes that, following FOS dataset assumptions, 98% of business customers with the four major Australian banks have loans under \$5m, and 99% of business customers with the four major Australian banks have loans under \$10m |
| Small Business Interest Rates | The base case analysis assumes an average interest rate applicable for small businesses of 7.68% p.a., and an average interest payments as a percentage of profits for all businesses in Australia of 15% |
| Profitability Margins | The profitability margins and average revenue per employee differs across industries. On average across industries, profitability margins are 11.8% and average revenue per employee is \$206k |

Business Credit Facility Limit: Analysis Methodology

In justifying the proposed small business credit facility limit, we adopted a comprehensive methodology to support a like-for-like comparison with other accepted measures to define a small business in Australia.

| Proxies / Indicators | Steps | Description |
|--|----------|--|
| Business Credit Facility Limits | 1 | We obtained the marginal business credit facility limits from FOS where 98% and 99% of all businesses fall under the limits of \$5m and \$10m respectively. We have assumed the marginal scenario where a business would draw down the maximum amount from their credit facilities, therefore, the credit facility limit is a proxy for debt outstanding |
| Interest Payments | 2 | Based on the average annual interest rates applicable to small businesses, we calculated the annual interest payments from the amount of debt outstanding |
| Operating Profits | 3 | Using average interest paid as a percentage of profit ¹ , we calculated the implied business profits under this scenario |
| Business Revenue | 4 | Using average profitability margins ¹ , we calculated the implied business revenue under this scenario |
| Number of Employees | 5 | Using benchmark data for average revenue per employee for businesses within Australia, we calculated the implied number of employees under this scenario |
| Small business normalisation | 6 | The small business normalisation reflects the adjustment required, due to larger businesses being included in the dataset which would skew the results upwards |
| FOS & Other Benchmarks Comparison | 7 | We compared the implied business revenue and number of employees under this scenario to FOS' and other benchmark definitions for small business in Australia |

[1] Data for economic parameters identified pertain to Australia, and are sourced from the Australian Bureau of Statistics (ABS) and the Reserve Bank of Australia (RBA).

Business Claims Limit: Analysis Methodology

In justifying the proposed small business claims and compensation disputes cap, we have performed a comprehensive analysis and modelling of economic market conditions, in order to define an acceptable estimate and range.

| Proxies / Indicators | Steps | Description |
|-----------------------------------|----------|---|
| Economic Indicators | 1 | Identify economic indicators that are relevant to small business claim and compensation dispute caps. As part of this activity, we considered both specific and general economic indicators |
| Initial Range Estimate | 2 | For specific indicators, we used the most recent estimates to form an initial range of estimates, across multiple indicators, as part of the sensitivity analysis conducted. |
| Revised Range Estimate | 3 | We applied the following multipliers for each indicator, where applicable, to arrive at a revised range estimate: stock market volatility and interest rate volatility |
| Point Estimate | 4 | We determined point estimates based on considerations of multiple factors including correlation of data sets with small businesses and accessibility for a large majority of small businesses |
| FOS Estimate Justification | 5 | We compared the implied point estimate under this scenario to the proposed small business claim and compensation dispute caps |

[1] Data for economic parameters identified pertain to Australia, and are sourced from the Australian Bureau of Statistics (ABS) and the Reserve Bank of Australia (RBA).

Appendix E: Why the evidence supports a single scheme

| Arguments against a single scheme | EDR Panel Response | FOS's experience (as a scheme already covering 87 per cent of disputes) |
|--|---|---|
| <p>Small business would be better served by their own limited scope statutory tribunal for disputes outside the existing remit of EDR schemes</p> | <p>Most stakeholder submissions did not support the establishment of an additional statutory body for dispute resolution in the financial system, expressing concerns that it would increase complexity, would not be accessible, flexible or dynamic and would apply the 'black letter law' approach rather than providing 'fairness in the circumstances'.</p> <p>The Panel notes that small businesses can possess characteristics that mean they face many of the same issues as consumers in dealing with disputes and when seeking redress.</p> <p>The Panel is of the view that small businesses do not have adequate access to EDR because the existing monetary limits are too low and exclude many small businesses from being able to seek redress within the EDR framework, finding that this gap in the framework can be remedied by the new scheme having higher monetary limits and compensation caps relative to the existing limits.</p> <p>The new scheme should ensure that the increase in small business jurisdiction is appropriately resourced, and that the increase jurisdiction does not compromise the scheme's ability to provide effective EDR to other users (such as consumers).</p> | <p>Establishing a small business tribunal will add further complexity for small business.</p> <p>About six per cent of disputes received by FOS relate to small business and over many years FOS has built expertise in handling disputes relating to this sector. FOS has acknowledged that its jurisdictional limits need to be reviewed and increased to address the gap in redress for small businesses and has been consulting with industry and consumers about more appropriate limits.</p> <p>FOS, like the EDR Panel, considers the solution to the existing gaps in redress for small businesses is best achieved by the merger of the two industry ombudsman schemes; expanding the scheme's small business jurisdiction (caps and limits); extending the national consumer credit protection law to small businesses and providing periodic detailed reports to relevant regulatory and policy bodies so that they have robust data, including trend data about small business disputes, to inform regulatory action, advocacy and policy development to achieve better outcomes for small businesses across Australia.</p> |
| <p>The merger of schemes will create a new giant quasi regulatory bureaucracy which will be geared toward large institutional players, such as banks and insurers who attract the vast majority of complaints and not small financial services providers</p> | <p>In practice both existing industry ombudsman schemes have a very high percentage of small members: FOS defines 88 per cent of its members as small or very small, and CIO has indicated that 97 per cent of its members are sole traders, partnerships and small business.</p> <p>Accordingly, both schemes have experience in dealing small firms and it is desirable that practices that have worked to accommodate small firms be incorporated into the new schemes, such as, for example, the 'one free complaint' program that both FOS and CIO have, and that the new scheme continues to maintain and increase industry engagement through a broad range of forums.</p> | <p>FOS has experience in dealing with smaller members and provides a broader range of dispute resolution services. FOS has a depth of understanding about the products and services offered by all member types.</p> <p>FOS actively engages with its members and makes a significant investment in providing our smaller members with details about effective IDR processes and with information about how to avoid having disputes at FOS.</p> <p>Further, FOS ensures that any changes to its scope or approach are not without active consultation with its stakeholders- members (big and small), consumers and the regulator.</p> |

| Arguments against a single scheme | EDR Panel Response | FOS's experience (as a scheme already covering 87 per cent of disputes) |
|---|---|---|
| | <p>Further, the Panel noted that any future scheme should have a board that is independent, and perceived to be independent, of the firms who provide the scheme's funding and membership base, and should take into account input from a range of stakeholders, including small and large members, and consumer and industry stakeholders.</p> | |
| <p>A single scheme is likely to be inefficient in the absence of competitive pressures, complacent about innovation and continuous improvement and incapable of responding quickly to market changes.</p> <p>Having two EDR schemes allows each scheme to benchmark its performance against the other. This produces better outcomes for financial firms and consumers because the schemes are forced to adopt best practice and improve their service offering</p> | <p>Where it is the financial firms (and not the consumers) that have a choice of scheme for dispute resolution, it is not clear that competitive tension drives innovation and better outcomes for consumers.</p> | <p>FOS has significantly evolved over the past eight years and in 2015 re-engineered its dispute process, delivering significant benefits to users.</p> <p>The driver of change at FOS has not been competition. It has been based on feedback from members and consumer organisations, identification of process improvements through our own analysis of dispute volumes and trends, and in response to recommendations from the Independent Review of FOS.</p> <p>The innovation and re-design in our processes and technology enhancements have been achieved through strong collaboration with our stakeholders and best practice in other jurisdictions.</p> <p>FOS has a clear philosophy and track record of continuous improvement.</p> |
| <p>There will be little or no imperative to improve service levels for consumers and keeping costs down for financial services providers</p> | <p>The Panel noted that a significant number of submissions assert that duplication caused by the operation of multiple schemes imposes direct costs on scheme members and limits the capacity to take advantage of potential economies of scale. Stakeholders commented that there is no compelling policy reason for the existence of two schemes.</p> <p>The Panel found that the need to establish and run and, in the case of the regulator, approve and oversee multiple schemes results in unnecessary duplicative costs and an inefficient allocation of resources.</p> <p>The Panel noted that there was a high degree of overlap in the FOS and CIO jurisdiction. In 2015-16 the overlapping jurisdictions (FOS</p> | <p>FOS already covers 99 per cent of the dispute types in the financial services sector and handles 87 per cent of all disputes lodged with CIO or FOS.</p> <p>The existence of two schemes increases costs for members given duplication across a wide range of areas such as IT infrastructure, corporate and communication services and outreach activities, and limits the ability to take advantages of economies of scale. This will only increase as investment in IT will be a key driver of scheme efficiency and effectiveness in meeting users' needs into the future.</p> <p>The FOS Board has a strong focus on cost control and we publish KPIs that track overhead cost ratios. Our fee structure is firmly based on a user pays principle. More than 93 per cent of our</p> |

| Arguments against a single scheme | EDR Panel Response | FOS's experience (as a scheme already covering 87 per cent of disputes) | | | | | | | | | | | | |
|--|--|---|----------------|----------------------------|-------------------------------|--------|-------------|--|--------|-------------|-------------------------------|-----|-------------|---|
| | and CIO) accounted for 70 per cent of all disputes. 29 per cent was jurisdiction exclusive to FOS and less than 1 per cent exclusive to the CIO. | members who do not have a dispute with FOS pay an annual membership fee and for 91 per cent of our members this is less than \$350 p.a. | | | | | | | | | | | | |
| Competition has led to a number of favourable consumer outcomes. | <p>The Panel is not convinced that competition between industry ombudsman schemes is appropriate or provides the most effective outcomes for all users.</p> <p>The Panel found where it is the financial firm (and not the consumers) that have a choice of a scheme for dispute resolution, it is not clear that competitive tension drives innovation and better outcomes for consumers.</p> | <p>Both existing schemes have responded to regulatory changes in innovative ways. Consultation with the regulator, industry and consumer organisations has been a feature in designing innovative solutions for the benefit of consumers.</p> <p>Further, there have been a number of FOS initiatives, such as FOS's major process changes in 2015, which were implemented as a result of feedback received from stakeholders, recommendations from the independent review and as a result of our own continuous improvement work, and not as a result of competition.</p> <p>The new single scheme would be able to harness the innovative and best practice ideas based on the experience in the two schemes.</p> | | | | | | | | | | | | |
| A separate small scheme could focus on non-bank and small financial services provider markets. | <p>There is a high degree of overlap in the FOS and CIO jurisdiction in particular, as show in the table below, which based on dispute numbers for 2015-16:</p> <table border="1" data-bbox="582 933 1323 1286"> <thead> <tr> <th></th> <th>No of disputes</th> <th>per cent of total disputes</th> </tr> </thead> <tbody> <tr> <td>Jurisdiction exclusive to FOS</td> <td>11,987</td> <td>29 per cent</td> </tr> <tr> <td>Overlapping jurisdiction (FOS and CIO)</td> <td>28,333</td> <td>29 per cent</td> </tr> <tr> <td>Jurisdiction exclusive to CIO</td> <td>359</td> <td><1 per cent</td> </tr> </tbody> </table> | | No of disputes | per cent of total disputes | Jurisdiction exclusive to FOS | 11,987 | 29 per cent | Overlapping jurisdiction (FOS and CIO) | 28,333 | 29 per cent | Jurisdiction exclusive to CIO | 359 | <1 per cent | <p>FOS already covers 99 per cent of the dispute types in the financial services sector.</p> <p>The 2008 merger of Schemes into FOS has proven how mergers of industry-specific expertise can be achieved to bring benefits to consumers and financial firms. Our Ombudsman and case workers share knowledge and experience to build dispute resolution expertise across the organisation whether they work primarily on banking and finance, general insurance or investment and advice matters.</p> <p>A merged scheme will see CIO and FOS staff bring their skills to the single body and there will be opportunities for staff from both schemes to benefit from each other's expertise.</p> <p>Most importantly, financial firms across the sector, and consumers of their products, will be key beneficiaries of an efficient, streamlined and well skilled single EDR scheme.</p> |
| | No of disputes | per cent of total disputes | | | | | | | | | | | | |
| Jurisdiction exclusive to FOS | 11,987 | 29 per cent | | | | | | | | | | | | |
| Overlapping jurisdiction (FOS and CIO) | 28,333 | 29 per cent | | | | | | | | | | | | |
| Jurisdiction exclusive to CIO | 359 | <1 per cent | | | | | | | | | | | | |

| Arguments against a single scheme | EDR Panel Response | FOS's experience (as a scheme already covering 87 per cent of disputes) |
|--|---|--|
| <p>A single scheme would mean financial firms who are dissatisfied with service levels or costs can't vote with their feet.</p> | <p>The Panel notes that competition generally benefits the person or entity that has the choice. In the current EDR framework this is the financial firm and not the consumer. In general terms this means that there could be potential for a scheme to provide a service that is valued by the firms, but that does not align what is in the consumer's best interests.</p> | <p>We concur with the views expressed by the Panel in the Interim Report.</p> |
| <p>About 75 per cent of FOS's funding comes from complaint fees. This means that funding is more variable from year to year, being more dependent on the overall number of complaints received. A financial firm with multiple or more complex complaints before FOS will pay higher fees.</p> | <p>The Panel noted that one of the features of the new scheme ought to be a user-pays model which incentivises firms to minimise disputes or to resolve disputes early, including through IDR, should be encouraged, as well as policies that support smaller members, such as a 'one free complaint' program.</p> | <p>The principles that underpin FOS's funding model include:</p> <ul style="list-style-type: none"> • having a 'user pays' system that recognises the level of use of FOS services • recognising the varied size and resources of members • rewarding members who have low or no disputes. <p>FOS handles six times the disputes that the other scheme handles and so it is no surprise that 75 per cent of funding is dispute generated. Nor is it surprising that a financial firm with multiple or more complex disputes will pay more. We consider appropriate that those who make the most call on the scheme should pay more for its services.</p> <p>The vast majority (93 per cent) of our members who do not have a dispute at FOS pay only an annual membership fee. We believe FOS membership fees are comparable or below that of the other scheme.</p> |