AUSTRALIAN BANKERS' ASSOCIATION INC.

Diane Tate
Policy Director

Level 3, 56 Pitt Street
Sydney NSW 2000
Telephone: (02) 8298 0410
Facsimile: (02) 8298 0402

15 June 2011

Mr Richard St. John
Statutory Compensation Review
PO Box 6295
KINGSTON ACT 2604
futureofadvice@treasury.gov.au

Dear Mr St. John,

Compensation arrangements for consumers of financial services

The Australian Bankers' Association (ABA) appreciates the opportunity to provide comments on the *Review of compensation arrangements for consumers of financial services Consultation Paper*.

In the context of the Future of Financial Advice (FOFA) reform package, the ABA welcomes this review of compensation arrangements. We consider that an appropriately targeted compensation framework will deliver consumer protection for retail clients and build trust and confidence in the financial advice industry.

1. Introductory remarks

The ABA supports financial regulation to ensure markets are sound, orderly and transparent (financial market integrity), consumers are treated fairly and have adequate information and avenues for redress (consumer protection) and markets are competitive (competition)[1].

The ABA believes that the introduction of a statutory compensation scheme must only be contemplated in a manner that does not result in unintended consequences, including:

- *Systemic risk*: Risk of moral hazard where consumers and financial advisers behave riskier than otherwise would be the case. We consider that compensation arrangements should not create perverse incentives for licensees or consumers to create market distortions.
- *Commercial risk*: Risk of well capitalised and prudently managed entities cross-subsiding other providers. We consider that compensation arrangements should not transfer commercial risk across the financial services industry.

[1] *The Final Report of the Financial System Inquiry*. March 1997.

- *Regulatory risk*: Risk of unnecessary regulatory duplication and unreasonable cost burden on banking groups which already maintain capital standards and meet additional prudential supervisory arrangements. We consider that compensation arrangements need to balance financial risk and consumer protection and apply only in a way that does not impose additional and unnecessary compliance and financial obligations on banks and their related bodies and subsidiaries.

2. Existing compensation arrangements

The ABA notes the following existing arrangements:

- *Compensation arrangements*: Australian financial services (AFS) licensees are required to meet certain licence conditions depending on the financial products they offer and/or the financial services they provide, including conduct standards, disclosure requirements and other obligations, such as adequate arrangements for managing conflicts of interest; adequate human, technology and financial resources; adequate risk management, supervisory arrangements and dispute resolution mechanisms; and adequate compensation arrangements. Specifically, section 912B of the Corporations Act states that if a financial services licensee provides a financial service to retail clients, the licensee must have arrangements for compensating a retail client for loss of damage suffered because of breaches of the relevant obligations under Chapter 7 by the licensee or its authorised representatives.
- *Capital standards*: Banks, as APRA regulated entities, are required to meet various prudential requirements, including capital adequacy and operational risk management.
- *Financial Claims Scheme (FCS)*: Banks participate in the scheme which covers loss (up to a specified limit) by depositors if a bank or other ADI becomes insolvent.

The ABA believes that the current compensation arrangements have provided adequate protections in the majority of cases – that is, where compensation has been awarded, claims have been met either by financial resources, capital support or PI insurance cover. However, some recent cases highlight some shortfalls within the current system where essentially compensation was not met due to the licensee becoming insolvent. Therefore, we consider that instead of implementing a statutory compensation scheme, limitations with existing arrangements, where these exist, could be addressed by: (1) developing a group PI insurance policy as an addition to existing PI insurance cover; and (2) revising the existing financial requirements of licensees.

3. Proposing a statutory compensation scheme

The ABA recognises there have been some concerns with regards to circumstances in which retail investors have suffered losses which have not been recoverable even where there has been a determination made by an EDR scheme, tribunal or court. In practice, a proposed statutory compensation scheme is effectively an insolvency scheme for financial advisers. We are concerned that the introduction of a compensation scheme would have adverse and unintended consequences, including increased likelihood of moral hazard, cross-subsidisation by providers and sectors, duplication of compensation arrangements (especially banks and their related bodies and subsidiaries), and increased cost of financial products and services (especially financial advice).

Notwithstanding our concerns with the proposal to introduce a statutory compensation scheme, we provide some comments on certain possible design parameters:

- *Jurisdiction*: We believe it should be commensurate with the operation of section 912B of the Corporations Act.
- *Coverage*: We believe that it should only cover retail clients of licensee members of the scheme. The scheme should be designed to allow for situations to be resolved where an EDR scheme, tribunal or court is unable to enforce a determination. Membership conditions should avoid resulting in peculiarities around entities ceasing to trade and/or be licensees.
- *Benefit cap*: We believe that capping claims in percentage and absolute terms will go some way to mitigating moral hazard and cross-subsidisation.
- *Funding model*: We believe that the scheme would require initial and ongoing funding to cover establishment and administrative costs (pre-funding) and projected payment of claims (post-funding). A levy framework should avoid imposing higher costs on larger, well managed licensees or requiring a duplication of obligations or inefficient allocation of capital by well capitalised, prudently managed entities.
- *Governance*: We believe that the terms of reference, operating conditions and rules of the scheme should be transparent and accountable. The scheme should be subject to review and audit.
- *Priority of claims*: We believe that alternative compensation arrangements should be pursued initially, and if there is no or insufficient PI insurance cover, the licensee should meet claims from its own financial resources or capital reserves. The scheme should be a last resort.
- *Interaction with EDR schemes*: We believe that a scheme benefit cap should not be linked to and EDR scheme monetary limit. A compensation scheme and EDR scheme (e.g. FOS) should be separately administered and subject to separate terms of reference. A determination by FOS (regarding liability) is independent of compensation arrangements (regarding whether PI insurance cover is held or whether alternative arrangements are needed).

If a statutory compensation scheme is deemed necessary to ensure that retail clients are adequately protected from loss as a result of a breach by a licensee (or its authorised representative) of its statutory obligations, then such a scheme should not be a substitute for the licensees' obligation to maintain adequate compensation arrangements or to replace PI insurance cover. Furthermore, such a scheme should not impose unnecessary compliance and financial obligations on banks and other financial institutions which maintain sufficient assets and capital arrangements and already meet the requirements of similar schemes, such as the FCS.

Specifically, APRA regulated entities and their related bodies and subsidiaries should be exempt from the requirement to contribute to, or be a member of, a statutory compensation scheme. This approach would be consistent with the approach in Regulation 7.06.02AAA(3) and *Regulatory Guide 166: Licensing: Financial requirements* [RG 166] which sets out that APRA regulated entities and licensees that are related to APRA regulated entities are exempt from the financial requirements where there is an alternative arrangement in place; for example, the APRA regulated entity has provided a guarantee that ensures the payment of the obligations of the related licensee to its retail clients to an extent that is adequate, and ASIC has approved the guarantee. We consider it is important to ensure that a bank and their related bodies and subsidiaries are not required to contribute to multiple schemes covering loss because the bank or their related body or subsidiary becomes insolvent.

Additionally, if a statutory compensation scheme is to be introduced, it is vital that the scheme is:

- Well understood by financial services providers so that it does not result in financial advisers, on behalf of their retail clients, taking greater risks;
- Well understood by retail clients so that there is no confusion that the scheme is a last resort and not intended to cover investment losses (i.e. product failure or market conditions);
- Well targeted to areas where the current compensation arrangements are not adequate;
- Well designed so the scheme minimises operational costs and maximises operational clarity and certainty; and
- Accompanied by other measures to improve the:
    - Professional conduct of financial advisers;
    - Financial literacy of consumers;
    - Disclosure of compensation arrangements (i.e. PI insurance);
    - Financial resources of licensees; and
    - Regulation by ASIC (i.e. compliance with licence conditions).

If alternative options to enhance the existing financial requirements are deemed appropriate, then the existing licensee exemption for APRA regulated entities and their related bodies and subsidiaries should remain.

4. Developing group PI insurance

The ABA understands that the primary mechanism for licensees to meet their compensation requirements is through PI insurance. However, we note that there are some deficiencies with current PI insurance cover, including cost and availability of PI insurance, conditions and exclusions in PI insurance policies, disclosures being of limited use for consumers, and consumers losing access to compensation where a licensee ceases to trade and hold an AFS licence.

The ABA believes that a way to address these concerns is to create group PI insurance to top up where existing PI insurance cover is inadequate for financial advisers. Group PI insurance should provide cover in areas where the insurance market is unable to provide cover in PI insurance policies, such as runoff cover, insolvency, fraud and other misconduct. We suggest that the insurance industry should provide explicit details where there is a gap between PI insurance policies available in the market and the features of PI insurance required under RG 166.

The ABA makes the following comments:

- The requirement to take out group PI insurance should be a legal obligation (perhaps licence condition) for all licensees. However, there should continue to be an accompanying exemption for APRA regulated entities and their related bodies and subsidiaries.

- The mechanics of how a group PI insurance arrangement would operate should be subject to further examination and consultation. We note that some issues would include calculation of premiums, recognition of deductibles (i.e. claims experience), exclusions and conditions, claims policy (i.e. last resort), claims limits, claims procedures and payouts, scheme governance, underwriting, EDR issues, and administrator/liquidator issues.

- The requirement to take out group PI insurance should be in addition to the existing requirement to have PI insurance, and therefore should not replace the existing obligation for licensees to hold adequate cover in their own right. This approach would mean that in instances where compensation has not been forthcoming in the past, PI insurance cover would be available and adequate in the future.

5. Revising existing financial requirements

The ABA believes that revising the existing financial requirements of licensees would ensure that licensees have sufficient financial resources or capital support to conduct their financial services business in compliance with the Corporations Act. We consider that requiring licensees to have adequate financial resources minimises moral hazard and ensures incentives to act prudently are aligned with a licensee's statutory obligations. Importantly, this approach does not mean that some financial services providers are cross-subsiding the operations of other financial services providers.

The ABA makes the following comments:

- The requirement to maintain adequate compensation arrangements (i.e. financial resources) should avoid creating significant barriers to entry within the industry.

- The mechanics of how a financial resource requirement would operate should be subject to further examination and consultation. We note that some issues would include identifying risks commensurate with activities as well as a financial resource level that recognises potential barriers to entry.

6. Concluding remarks

The ABA believes that if a statutory compensation scheme is introduced it is essential that the scheme is targeted and well understood. A compensation scheme should not duplicate with other schemes or cause confusion as to jurisdiction or expansion of powers with other schemes.

If the Government is minded to introduce a statutory compensation scheme, we consider that further examination and consultation of the specific design parameters would be necessary.

Yours sincerely

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Diane Tate