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CONSULTATION PAPER – REVIEW OF COMPENSATION ARRANGEMENTS FOR CONSUMERS OF FINANCIAL SERVICES

The Association of Superannuation Funds of Australia (ASFA) would like to provide this submission in relation to the Consultation Paper by Richard St. John – "Review of Compensation Arrangements for Consumers of Financial Services" - April 2011("Consultation Paper").

About ASFA

ASFA is a non-profit, non-political national organisation whose mission is to protect, promote and advance the interests of Australia's superannuation funds, their trustees and their members. We focus on the issues that affect the entire superannuation industry. Our membership, which includes corporate, public sector, industry and retail superannuation funds, plus self-managed superannuation funds and small APRA funds through its service provider membership, represent over 90% of the 12 million Australians with superannuation.

Executive Summary

The creation of a compensation scheme with respect to consumer losses caused by the breach, fraud or misconduct of an insolvent financial services provider would ensure a substantial improvement in the integrity of, and confidence in, the financial system.

ASFA submits that the scheme **must** be statutory and "last resort" i.e. where the financial services provider whose misconduct caused the loss is insolvent and unable to pay compensation and there is no other avenue for compensation.

In ASFA's view it is critical that, within such a scheme, the providers of financial services and products be segregated into different classes with respect to the types of products or services they provide. In the event that the conduct of an insolvent financial services provider causes a compensable loss, only those financial services providers who supply that service or product should be levied to fund the compensation.

It is also critical that "moral hazard" be addressed by making it **compulsory** that all financial providers have adequate professional indemnity insurance.

Given that superannuation funds: -

- are prudentially supervised and regulated;
- already pay a significant levy for that supervision, as well as other levies;

- have had a relatively low incidence of failure;
- contain SG contributions, effectively representing deferred salary and wages; and
- generally have to pass the cost of the levy through to members

ASFA submits that it would be inappropriate for superannuation funds to be levied other than where misconduct has caused a superannuation fund to fail. Similarly, it would be inappropriate for superannuation funds to have to pay any up-front, annual management levy to the scheme.

It is important, in the calculation of any levy, that the affected financial providers be consulted as to its formulation. The size and composition of financial providers will necessarily change over time and the impact of any levy will be affected by such changes. In each instance the impact on members must be considered.

As such, no single formula can be devised in advance which will guarantee equitable outcomes. Any levy must be determined on a case-by-case basis.

A levy must only be imposed after there is clear evidence of a loss and it is apparent that no other compensation arrangements will be available with respect to the affected consumers.

The compensation scheme must be clear as to the process and the speed with which compensation payments will be paid to consumers. There must also be time to pay in an orderly manner to minimise disruption to returns and cash flows.

Most importantly, in the event of compensation being payable, there must be a full review as to the existence, and extent, of any regulatory gap or issues with the relevant regulator's supervision of the financial product or service concerned which may have resulted in the loss being sustained.

It is becoming an increasing concern across the superannuation industry that it is being seen as a "honey-pot". It should always be borne in mind that any compensation levy comes off members' accounts and this directly impacts retirement outcomes.

The Consultation Paper

ASFA supports the review of the compensation arrangements for consumers of financial services in instances of fraud or misconduct by financial services providers. Compensation arrangements are important to help maintain the integrity of, and confidence in, the financial services industry. We would like to make the following comments with respect to the Consultation Paper: -

1) The current compensation arrangements under Chapter 7 of the *Corporations Act 2001* ("Corporations Act") largely are predicated upon the licensed financial services or product provider ("financial provider") having in place adequate and sufficient professional indemnity insurance ("PII") to assist in meeting a compensation claim. There will be circumstances, however, where PII is inadequate, or unavailable, to respond to a claim for compensation.

2) In 2006 the Australian Securities and Investments Commission ("ASIC") engaged Alan Mason of Melzan Pty Ltd to conduct research into the state of the PII market in Australia in relation to licensees ("Report 107").[1] Report 107 stated that: -

   "*Adequacy presents a range of issues which require careful consideration including:*

[1] ASIC – Report 107 - Compensation arrangements for financial services licensees - Research into the professional indemnity insurance market - December 2006 - Prepared for ASIC by Melzan Pty Ltd http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/Report_107_Compensation_arrangements_for_financial_services_licensees_masonreport-compensation.pdf/$file/Report_107_Compensation_arrangements_for_financial_services_licensees_masonreport-compensation.pdf

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- *Cover is bought/sold to cover all of the entity's liabilities for all of its business activities. It must therefore be adequate to cover wholesale as well as retail exposures and activities beyond the scope of the FSRA;*
- *Cover includes for defence costs in defending the licensee against actions brought by a consumer (or others). These need to be assessed in addition to the required 'limit of indemnity' to meet compensation claims.*
- *Consumers have no direct right of access to PII policies.*
- *Insurers are not a party to External Dispute Resolution (EDR) schemes determinations. A licensee's exposure to an EDR scheme is broader than the protection under a PII policy.*
- *Insurer's monetary exposure to EDR scheme determinations is capped by individual claim and in the aggregate.*
- *Excesses are amounts for which the licensee is not insured. These are a standard feature of all contracts. The licensee needs to have the capacity to meet its exposure to paying claims within its excess.*
- *Although cover is widely available, blanket cover is not.*
- *No insurer offers insurance that covers all possible acts or omissions by all possible persons (from employees, directors, sub-contractors and authorized representatives) for which a Licensee may be liable to any number of retail clients.*
- *The terms and conditions vary considerably between insurers. There is no 'standard' cover for licensees, except where an industry association has developed a scheme (as in the case of the National Insurance Brokers Association (NIBA) scheme). A buyer with significant market power is able to negotiate wider PI cover than one that does not.*
- *At present, there is patchwork coverage of some key areas that may leave retail clients exposed: authorized representatives acting outside the scope of their authority, fraud and dishonesty, and many conflicts of interest claims, and claims in respect of products not on an "approved product list".*
- *In addition, there is a many policies provide an inadequate level of cover for specific types of claims. Critically, many policies limit the liability of an insurer for multiple claims arising from one event and may not have sufficiently high liability limits to meet claims for breaches of FSR obligations, in addition to other common law and statutory obligations".*[2]

3) If the financial provider is insolvent, the consumer may be left with a compensation claim which can be satisfied only in part or not at all, leaving the consumer bearing some or all of the loss caused by the breach or misconduct of the financial provider. This can have disastrous financial, personal and social consequences for the consumer, as evidenced in a recent report commissioned by the ASIC Consumer Advisory Panel ("Report 240").[3] The report explores the social impact of investors not being fully compensated when they suffer financial loss because of their licensee's misconduct. To quote Report 240 with respect to its key research findings: -

   "The main finding of this study is that failure to fully compensate investors who lost money because of the conduct of their managed investment scheme or financial planner can cause the investor severe emotional and financial distress. The second key finding is that investors were unable to fully utilise the current compensation system. Thirdly, the loss experience can have a corrosive effect on trust in the financial system".[4]

4) Given that, within the financial sector, the consumer is the least able to withstand the loss caused by a financial provider's breach or misconduct, it would seem apposite to introduce a statutory scheme of last resort to compensate consumers for such losses, in circumstances where the financial provider is insolvent and therefore unable to pay the compensation.

[2] *Ibid*, pages 5 - 6
[3] ASIC - Report 240 - Compensation for retail investors: the social impact of monetary loss - May 2011 http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep240-published-May-2011.pdf/$file/rep240-published-May-2011.pdf
[4] *Ibid*, Page 8

5) ASFA submits that such a scheme should be statutory and should be utilised only as a scheme of "last resort", where the financial provider whose breach or misconduct caused the loss, which gave rise to the successful claim for compensation, is insolvent.

6) Further to this, any consumer who has recourse to the statutory scheme should be required to subrogate any rights which they may have against the financial provider to the scheme.

Design of a Statutory Compensation Scheme of Last Resort

ASFA would like to make some observations with respect to the following matters: -

a. Who should be entitled to compensation?

The terms of reference and report of the Parliamentary Joint Committee on Corporations and Financial Services with respect to its Inquiry into Financial Products and Services in Australia ("Ripoll Report")[5] frequently referred to "consumer", while the Consultation Paper uses the terms "retail client", "client" and "consumer" interchangeably. The term "retail client" is defined in section 761G of the Corporations Act and is the subject of a separate, now closed, consultation by the Future of Financial Advice Team at Treasury.

In order to target any compensation scheme correctly, to ensure that the right people are compensated, to minimise the risk of moral hazard and to manage the funding impact on financial providers, it will be critical to determine the class of consumers who will be entitled to compensation.

Without wanting to pre-empt the outcome of the review of the definition of "retail client", there would be the benefit of simplicity and consistency if any scheme were to adopt the same, or a suitably modified, definition of "retail client" for the purposes of determining who is entitled to compensation.

Having said that, however, and dependant upon the outcome of the review of the definition of "retail client", there may be equitable or other policy considerations which may indicate that the scheme should adopt a different, possibly narrower, definition of eligibility for the purposes of compensation.

With respect to superannuation, we submit that the following should be considered eligible to receive compensation for loss caused by the breach or misconduct of an insolvent financial provider: -

- members of an APRA regulated superannuation fund;
- trustees of a superannuation fund, including a self managed superannuation fund, approved deposit fund, pooled superannuation trust or public sector superannuation scheme which has net assets of less than $10 million, unless the financial product acquired was over $500,000 in value;
- employers, in circumstances where contributions being remitted to a superannuation fund have been misappropriated by an intermediary financial provider, where the employer's business employs fewer than 20 people or, if the business includes the manufacture of goods, 100 people.

This is consistent with the current definition of "retail client" in section 761G and, from a public policy perspective, represents a reasonable measure of the persons and entities who should be compensated for a loss caused by an insolvent financial provider's breach or misconduct.

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[5] Report of the Parliamentary Joint Committee on Corporations and Financial Services - Inquiry into Financial Products and Services in Australia – November 2009 < http://www.aph.gov.au/Senate/committee/corporations_ctte/fps/report/report.pdf >

b. The need for there to have been a proven breach or misconduct by an insolvent financial provider

The management of any scheme will necessitate the determination of: -

- whether the consumer is eligible for compensation (“eligible consumer”);
- whether there has been a breach of financial services laws or misconduct by a financial provider;
- the extent to which the financial provider’s breach or misconduct caused the loss incurred by the eligible consumer;
- the extent to which the eligible consumer contributed to, or failed to mitigate, the loss;
- the quantum of the (net) loss which is potentially compensable; and
- whether the financial provider is insolvent.

The rules of the compensation scheme will need to specify the basis upon which such determinations can be made.

ASFA submits that, in determining whether there has been a breach of a financial services law or misconduct; the extent to which the breach or misconduct caused the loss and the extent to which the consumer contributed to, or failed to mitigate, the loss, the scheme may take into consideration the following matters: -

- any judgment by any court or other judicial or administrative body;
- any decision of the Financial Ombudsman Service;
- any determination made by the Superannuation Complaints Tribunal;
- any decision of an arbitrator;
- any settlement agreement reached through mediation, conciliation or other means;
- any finding of a regulator (ASIC or APRA) as to the conduct of the financial provider;
- any finding by a professional body;
- any determination by an insurer with respect to PI insurance; and
- any finding of a liquidator, trustee in bankruptcy or insolvency practitioner

with respect to, or which is in any way relevant to, the underlying matters, issues, conduct or behaviour which caused the loss.

c. Governance

ASFA submits that the scheme should be independent of government and industry, established under statute, have a board of directors and report to ASIC. Board appointments should be made by the relevant minister.

d. Quantum of Compensation Payable

Having regard to the risk of moral hazard and the affordability of the scheme, ASFA submits that the amount of compensation should be determined in accordance with a sliding scale up to a maximum compensable loss.

Purely by way of example, compensation could be payable at the following rates with respect to the eligible loss incurred: -

- 90% of the first $100,000;
- 80% of the next $100,000;
- 70% of the next $100,000
- 60% of the next $100,000; and
- 50% of the next $100,000, up to a maximum of $500,000

which would result in a maximum of $350,000 compensation being payable with respect to claims of eligible loss of $500,000 and above.

Funding

ASFA strongly supports the UK, "segregated", model, where financial providers are grouped into one or more "classes" with respect to the various types of financial products or services which they supply. Compensation for eligible claims against an insolvent member of a particular class is first funded by the other members of that class of financial provider.

This aligns the cost of funding the scheme with the class of financial provider whose breach or misconduct gave rise to the loss and provides an incentive for that class of financial provider to improve their behaviour, conduct, professional standards, education and training.

It is also critical that "moral hazard" be addressed by making it compulsory that all financial providers have adequate professional indemnity insurance.

A scheme which does not segregate financial providers into different classes according to the various services or products they provide, but instead applies a "universal" levy across all financial providers, results in inequitable outcomes whereby inherently risky, or less regulated, financial services and products are cross-subsidised by other less risky ones.

This would especially be the case with respect to prudentially regulated superannuation funds, which have to meet standards with respect to capital; managing the risks of the fund; the adequacy of resources, the fitness and propriety of the trustee directors and the outsourcing of material business activities.

Superannuation funds already pay a supervisory levy to be prudentially regulated and supervised by APRA. As a consequence of prudential supervision, superannuation has enjoyed a relatively low incidence of breaches or misconduct causing loss and insolvency.

It should also be borne in mind that superannuation is mandatory, with Superannuation Guarantee ("SG") contributions effectively representing the deferred salary and wages of members.

As many superannuation funds are operated on an "all-profits-to-members" ("not-for-profit") basis, the cost of meeting such levies often ends up having to be deducted from the superannuation fund itself. This results in the members of the fund bearing the loss, not the trustee as the financial provider.

Given that superannuation funds: -

- are prudentially supervised and regulated;
- already pay a significant levy for that supervision, as well as other levies;
- have had a relatively low incidence of failure;
- contain mandated "superannuation guarantee" contributions, which effectively represent deferred salary and wages; and
- generally have to pass the cost of the levy through to members

we submit that it would be inappropriate for the risks with respect to other, largely discretionary, non-superannuation financial services and products to be mitigated by a levy imposed upon superannuation funds.

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Accordingly, ASFA strongly submits that, in the event of a loss caused by the breach or misconduct of an insolvent financial provider who supplied a particular type of service or product, any compensation levy must first be applied against only those financial providers which supply that type of service or product (the "segregated" model).

Should a "universal" scheme be contemplated, where a levy is imposed against all financial providers, then for the reasons given above we submit that superannuation funds should be exempt from any such levy.

In the context of superannuation, that would see APRA regulated superannuation funds in a class which would only be liable for a levy with respect to an eligible loss caused by an insolvent trustee of a superannuation fund, similar to the regime which applies now under Part 23 of the *Superannuation Industry (Supervision) Act 1993* ("SIS").

If a trustee of a superannuation fund were licensed to provide personal advice then, to the extent that financial advice formed part of their business, the trustee would also be in the relevant "financial advisers" class.

The Financial Services Compensation Scheme ("FSCS") in the UK is designed whereby, should a particular class exceed its annual maximum levy threshold, the other classes are required to contribute "top-up" funding, up to the maximum levy limit of their own class.

Should a model similar to that of the FSCS be considered, ASFA is of the strong view, for the reasons outlined above, that the "superannuation fund" class should be exempted from contributing to any "top-up" funding. Given that superannuation funds represent the deferred salary and wages of employees, it is inappropriate that they be used to cross-subsidise compensation claims for losses caused by the breaches and misconduct of other types of discretionary financial providers.

In the Consultation Paper there was discussion around the possibility of imposing a "pay-as-you-go", pre-funded management levy to fund the operations of the scheme. Given that, in any particular year, there is little likelihood of a claim being payable with respect to a superannuation fund, we submit that the "superannuation funds" class should be exempted from such a levy.

Superannuation funds should only be required to pay a levy if an APRA-regulated superannuation fund fails and compensation is determined to be payable to the members of that fund, similar to Part 23 of SIS.

Given that all of the members of a self-managed superannuation fund ("SMSF") are all trustees of the fund then the trustee(s) of an SMSF will never be liable to pay compensation to the members. Accordingly, trustees of SMSFs should not be liable to pay a levy.

As the consumer of a financial product or service, however, the trustee of an SMSF should be entitled to claim compensation where it has incurred a loss caused by the fraud or misconduct of a financial provider and the SMSF has net assets of less than $10 million (or such other eligibility criteria as may be devised).

Any levy should be determined as a percentage of one or more financial criteria with respect to the financial service or product supplied by the class of financial provider. In the context of the "superannuation funds" class, that would generally be the funds under management ("FUM") of the superannuation fund as at the end of the previous financial year.

It is important, in the calculation of any levy, that the affected financial providers be consulted as to its formulation. The size and composition of financial providers will necessarily change over time and the impact of any levy will be affected by such changes. In each instance the impact on members must be considered.

As such, no single formula can be devised in advance which will guarantee equitable outcomes. Any levy must be determined on a case-by-case basis.

A levy must only be imposed after there is clear evidence of a loss and it is apparent that no other compensation arrangements will be available with respect to the affected consumers.

The compensation scheme must be clear as to the process and the speed with which compensation payments will be paid to consumers. There must also be time to pay in an orderly manner to minimise disruption to returns and cash flows.

Most importantly, in the event of compensation being payable, there must be a full review as to the existence, and extent, of any regulatory gap or issues with the relevant regulator's supervision of the financial product or service concerned which may have resulted in the loss being sustained.

By way of recent example, a $55 million levy has just been imposed on the superannuation industry with respect to the collapse of Trio Capital. Little, if anything, has been explored to date in relation to the possibility of failure by ASIC or APRA or both with respect to Trio Capital.

It is becoming an increasing concern across the superannuation industry that it is being seen as a "honey-pot". It should always be borne in mind that any compensation levy comes off members' accounts and this impacts retirement outcomes.

There appears to be a growing perception that levies should be applied first and questions asked later. ASFA strongly argued against the levy now being imposed by AUSTRAC. This is an unfair treatment of members of superannuation funds.

e. Relationship to Part 23 of SIS

Part 23 of SIS ("Part 23") provides protection for members of a superannuation fund where there has been a loss as a result of fraudulent conduct or theft, where the loss has caused substantial diminution of the fund leading to difficulties in the payment of benefits. Accordingly, in that it covers fraud or theft perpetuated by a third party other than a financial provider, Part 23 has a broader application than a proposed compensation scheme with respect to financial providers. As such, it would be worthwhile retaining, and possibly amending (narrowing), Part 23 to cover fraud and theft by parties other than financial providers, that would otherwise fall outside of the financial providers' compensation scheme.

A levy to fund financial assistance granted under Part 23 is imposed under the *Superannuation (Financial Assistance Funding) Levy Act 1993* ("superannuation levy"). Regulations to impose a superannuation levy have only been made three times since 1993, in 2003, 2005 and 2011. As the Part 23 superannuation levy is raised relatively rarely (three times in 17 years), there would be negligible incremental or overhead costs involved in retaining a modified (reduced) Part 23 to cover fraud or theft by a party other than a financial provider alongside any universal financial providers' compensation scheme.

We thank you for providing us the opportunity to make this submission and more generally for the opportunity to participate in the consultation process.

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If you have any queries or comments regarding the contents of our submission, please contact me on (02) 8079 0805 or 0433 169 342 or by email pvamos@superannuation.asn.au.

Yours sincerely

Pauline Vamos
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