



**SUBMISSION BY CHOICE  
ON DRAFT REGULATION FOR COMPENSATION  
ARRANGEMENTS FOR FINANCIAL SERVICE  
LICENSEES**

**Wednesday, December 06, 2006**



CHOICE (formerly the Australian Consumers' Association) is a not-for-profit, non-government, non-party-political organisation established in 1959. CHOICE works to improve the lives of consumers by taking on the issues that matter to them. We arm consumers with the information to make confident choices and campaign for change when markets or regulation fails consumers.

CHOICE is independent: we do not receive ongoing funding or advertising revenue from any commercial, government or other organisation. With over 200,000 subscribers to our information products, we are the largest consumer organisation in Australia. We earn the money to buy all the products we test and support our campaigns through the sale of our own products and services.

Our policy voice is widely recognised. We campaign without fear or favour on key consumer issues based on research into consumers' experiences and opinions and the benefit or detriment they face. Our current campaigns cover food, health, financial services, product safety, communications and consumer protection law.

CHOICE conducts research, publishes policy reports and online information, gives presentations and keeps the media informed of our policy views. We provide representatives for many industry and government committees and independent bodies considering matters of concern to consumers.

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Thank you for the opportunity to comment on Compensation Arrangements for Financial Services Licensees Regulatory Impact Statement (RIS) and Draft Regulations.

In previous submissions to Treasury CHOICE/ACA argued for layered and broad compensation arrangements. Where an insurance-based solution is the major element of a compensation scheme we argued two additions were necessary to ensure consumers had the confidence to seek advice from licensees. Prescribed requirements of cover are needed to ensure the scheme meets the objectives of 912B of Corporations Law. In addition, an underlying compensation fund acting as a safety net or top-up is needed for situations (exclusions or inadequate insurance) where PII coverage is not sufficient.

CHOICE is disappointed that the commentary on the draft regulations and RIS express a preference for option 2. The experience of Westpoint demonstrates that PII - without prescription - will fail comprehensively to deliver any effective consumer protection. It is unfortunate that the Federal Treasury has not taken advantage of a unique opportunity to learn from Westpoint and the problems with PII insurance in its wake.

We do not believe that option 2 has any capacity to meet the policy objectives of section 912B of Corporations Law. In particular, option 2 will not protect consumers who have obtained advice from licensed financial service providers. This issue is not about consumers chasing unreasonable returns on their money - it is about the ability of consumers to receive compensation in situations where they have suffered loss despite placing their trust in licensed advisers to professionally manage their financial affairs.

Leaving licensees to take primary responsibility for determining adequate insurance coverage will not meet the policy objectives of providing compensation for consumers who have suffered losses as result of wrongdoing by licensees. Option 2 is a very limited improvement on the current situation in that it will require licensees without PII to seek cover (60% of licensees already have PII).

Comprehensiveness, consistency, and transparency are all important requirements of a successful compensation scheme that works for consumers rather than the insurance industry. Option 2 does not have the capacity to meet these requirements. Moreover the costs of negotiating a minimum level of cover through principles-based regulation will be costly for ASIC, insurers, financial licensees, and most importantly to consumers through investment losses. **Option 2, if implemented, would be an example of regulation that imposes a cost on business yet provides little or no benefit to consumers.**

The RIS is a flawed document. The RIS lacks the rigour and objectivity to provide a sound argument in favour of option 2. It is clear that the costs and benefits of option 2 do not reflect the true costs of the Federal Government's proposal and significantly overstates the benefits. Equally, it dramatically overstates the costs of options 3 and 4 and downplays the benefits. The cost/benefit estimates options 3 and 4, which have



been lumped together for the purpose of convenience, is nothing short of poor regulatory analysis.

In what follows, we comment on the RIS on an option by option basis. CHOICE will not be commenting on the transition arrangements or draft legislation. We do not believe the proposed model has the capacity to protect consumers adequately and will advocate against this model.

## OPTION 1: DO NOTHING

### *Commentary*

Under this option it is up to the licensee to determine adequate arrangements for compensating consumers. CHOICE believes this does not have the capacity to satisfy the requirements of 912B. Without mandating PII as a requirement consumers would be at the prudential discretion and solvency of licensees'. CHOICE also believes that a significant administrative burden would be placed on ASIC trying to achieve consistency in what would be a fragmented and, at best, *ad hoc* system. ASIC would not have the resources or capacity to scrutinise directly all compensation arrangements. On this basis the consumer benefit identified in the RIS is not achievable and should be omitted.

### RIS IMPLICATIONS

1. Costs of regulation by ASIC is significantly more than RIS indicates. ASIC's capacity will become stretched and it will impact on other regulatory responsibilities
2. The consumer benefit identified will not eventuate because ASIC will not have the capacity to provide this level of supervision

## OPTION 2: PII WITHOUT PRESCRIPTION

### *Commentary*

The option prescribes PII as the mechanism for complying with section 912B. There are some principles-based requirements that will be worked out with ASIC at a later time. However, the regulations will not prescribe the detail of the insurance required. The licensee would provide a summary of PII coverage in the FSG, with the RIS arguing this disclosure will provide a disciplining mechanism on the market. The monetary costs of the proposal are limited. This is effectively the status quo for 60% of the industry already.

Mandatory PII can provide a mechanism for ensuring that marginal parts of the financial planning industry do not qualify for licences. However, this "industry policy"

# choice

function will not work unless some key elements of PII are clearly prescribed. In the absence of such prescription, this mechanism will not work as marginal players will purchase cheaper and less adequate coverage.

The central weakness of this proposal is that insurers must be willing to provide cover that meets the purpose of 912B. The defects of PII were accurately generalised in the original Treasury discussion paper. They were as follows:

1. While clients' rights are against the insured, action will be against the insurance company, and payment will depend on the manner in which the claim is accepted or contested.
2. If litigated there will be an imbalance in resources and expertise between client and company
3. There is a crisis in the cost and availability of professional indemnity insurance and this is impacting on the availability of important components of the coverage (e.g. run-off cover, fraud and fidelity).

Our experience of PII since the original Treasury discussion paper has shown Treasury's summary of the weaknesses of PII to be prophetic - certainly in light of the Westpoint group's collapse. The experience has implications for accuracy of the RIS.

Since Westpoint's collapse in November 2005 few of the 4,000 affected consumers have received any compensation. We understand three (out of more than 300) low value claims have been settled through FICS and none through the courts. Indeed 12 months after the collapse we are only aware of one legal action<sup>1</sup> involving 22 clients that has commenced. We are aware of one settlement<sup>2</sup> where consumers got back 10 cents and some may get an additional 25 cents in the dollar. It would also be fair to assume some low value claims have been settled through internal dispute resolution systems, although we are not aware of any.

Consumers have found it difficult to commence claims largely because of the widespread and systemic flaws in PII policies that deny consumers the possibility of obtaining compensation. Unfortunately these examples demonstrate that left to the market - without prescription - it is often not in the commercial interests of PII insurers to provide insurance that meets the criteria of 912B.

The sort of reasons we have been informed that denial of claims by insurers have included:

- Westpoint investments were not on approved product lists
- The insured's conduct involved a deliberate disregard for the client's position
- The insured's conduct involved a breach of statute

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<sup>1</sup> IMF against PIS

<sup>2</sup> Bongiorno Financial Advisers



- The insured's advice involved a conflict of interest i.e. arising from the high commission payments
- The insured had not made full disclosure at the outset of the policy e.g. the facts giving rise to the claim occurred prior to the policy and the insured should have known about them
- The claim was not in the appropriate form.

There is also a significant cost to consumers attempting to obtain compensation. PI insurers are traditionally obstructionist as this is the best economic approach to managing claims given the nature of our legal system. They seek to defend claims vigorously with the aim of deterring action or encouraging early settlement on essentially unfavourable terms. These obstructionist tactics increase legal costs for defendants which are ultimately passed onto licencees and then consumers.

In addition to the sorts of inclusions listed above we are aware of policies in Westpoint cases in relation to EDR scheme determinations where the total coverage was for as little as \$200,000 in a single year - yet claims have exceeded \$1million. In other Westpoint cases where claimants are considering using the courts, coverage has been for as little as \$1,000,000 INCLUSIVE of claims management expenses ie legal fees. This means that little money will be available to pay consumers' claims given the intensity with which some of these matters are being defended by insurers. The costs to consumers outweigh the benefits.

Option 2 completely fails to engage the problem of licensees going into liquidation or handing in their licence. The most recent, and very public, example was the case of Deakin Financial Services (DFS). This occurred soon after its insurers disputed FICS's capacity in the courts to hear claims against it. Over the past few years FICS has seen a rise in the number of licensees remodelling their businesses as part of an overt strategy to avoid liabilities. The practice of establishing phoenix companies to avoid liability is now widespread in the financial services sector and consumers are the losers.

Another problem with the limited insurance policy proposal is that the price and coverage of PII at any point in time is driven by wider economic conditions and the world insurance market and bear no relation to consumers' particular compensation needs. This means that compensation for wrongdoing will vary according the insurance market in which the licensees purchased the policy.

It has never been possible to obtain PII cover for criminal behaviour by a licensee, so **this policy proposal has no capacity to provide compensation for the consumer losses arising from fraud.** It is very likely that some PI insurers will argue that inappropriate advice is criminal and therefore not covered. That would undermine the integrity of the compensation system.

Finally the suggestion in the commentary on the draft regulations that the proposed disclosure requirements will allow retail clients to review the information provided and satisfy themselves that the coverage is adequate is nothing short of absurd. Not

# choice

even appending a copy of the policy to the FSG would achieve this; such is the obscure and vague meaning of insurance terms as evidenced by the sheer amount of litigation that occurs over insurance policy terms.

The fundamental problem with insurance as a compensation mechanism is that it is a product designed to protect the insured not the ultimate beneficiary, who has no control over the adequacy of the policy to protect them. **As Westpoint has shown even licensees had no idea of the inadequacies and limitations of the policies they bought. Summary information about policies will not provide consumers with the capacity to assess the adequacy of the policies. The disclosure provisions will simply not work in the way the RIS suggests.**

## RIS IMPLICATIONS

### Additional costs and benefits to financial services providers

1. Option 2, if implemented, would be an example of regulation that imposes a cost on business yet provides little or no benefit to consumers.
2. The RIS needs to include reputational cost to the industry where there are uncompensated consumer losses. The reputational cost will emerge when there are more Westpoints and more Commercial Nominees. In both of these cases uncompensated consumer losses were high and the reputational costs to the industry - particularly the advising industry in the Westpoint case - have been enormous. There will be other instances of market failure and despite difficulties estimating these costs, a rigorous RIS should make an attempt to estimate them.
3. Licensees will not buy adequate coverage under this option. The cost of this to both licensees (who may be forced into liquidation in the face of claims) and consumers (who do not receive any compensation) has not been factored in to the RIS.
4. While the proposed disclosure provisions will help consumers to be aware that the licensee has PII cover and is therefore welcome, the benefits of proposed disclosure provisions on market discipline are significantly overstated. We reject outright that the proposed disclosure provisions will provide a market discipline, in fact we believe it will have the reverse effect. It is highly unlikely that consumers will select financial advisers that have higher levels of PII coverage on the basis of disclosure. It is unlikely that consumers will understand the degree of coverage in the licensee's financial services guide. Nor will they consider the adverse situations that might arise, despite the disclosure. This will unfortunately create a perverse cost. Consumers will think that they have adequate PII cover. Licensees will discharge their responsibility by disclosing it; however the market incentives between licensees and insurance companies will be weighted toward under insurance and inadequate coverage.

# choice

5. The associated legal costs will also need to be considered in the RIS. In general defendant insurers outspend plaintiffs by about 2 to 1 and in doing so drive up costs, and reduce benefits even for successful consumers. This has costs for licensees whose policy may only cover them up to lower levels of compensation (for example, \$1million inclusive of legal costs) Litigators have told us of examples where costs can run as high as \$600,000. This means insured are exposed at both ends of the policy given the rise in significant deductibles. We are aware that approximately 30 - 50% of PI premium income is spent by insurers on defending claims. This cost to both consumers and industry has not been factored into the RIS.
6. Because of the weakness of PI coverage (without prescription) there will be a perverse effect on competition with financial service licensees. Consumers will be forced, with limited PI coverage, to go larger financial adviser groups for advice. Larger groups will have more resources if something goes wrong, at least they will be able to pay out. This could prevent innovative new financial advisory groups from getting into the market and growing - in turn stifling competition.

## **Additional costs to government**

1. The RIS completely downplays the reality of a situation where licensees - particularly the 3,500 smaller players - would demand ASIC provide policy guidance in relation to the regulations.
2. Further given the vague nature of the regulations any policy guidance will be highly contestable through the AAT and the courts. Licensees and their professional associations have already demonstrated their willingness to contest regulators eg ATHOC and ASIC; Masu, AXA and Deakins against FICS. These costs must also be factored into the RIS.

## **Additional costs to consumers**

1. Under this policy consumers will have to obtain legal services to obtain compensation. Such is the technicality that this is an area of law where consumers simply cannot act for themselves. Moreover as previously mentioned, insurance defendants are among the most aggressive litigators as part of an active strategy to reduce claims. The costs to consumers of legal advice and litigation do not feature in the RIS.
2. Opportunity costs resulting from high legal costs will also need to be considered in the RIS. High legal costs mean most consumers will abandon any attempt to obtain compensation or will settle early for as little as 10 - 25 cents in the dollar as we have seen in Westpoint. That is, costs of this approach alone, are so high that consumers will not even try to obtain compensation in the face of wrongdoing.
3. Further according to APRA data the average PI claim takes 5 - 7 years to settle. The dollar and human cost of this to consumers have not been factored in.

# choice

4. PII only works when an insured is solvent. Over the last few years there have been a number of examples of licensees handing in their licenses or going into liquidation to avoid liabilities. In a number of these cases the principals have emerged soon after in other companies. Deakins Financial Services is the latest to go into liquidation in the face of large liabilities to consumers yet at the same time its parent company is posting record profits and buying up other advising businesses<sup>3</sup>.

## OPTION 3 PII WITH DETAILED PRESCRIPTION

### *Commentary*

Option 3, rather than providing principles-based requirements on coverage and adequacy, instead provides detail of acceptable PII. Option 3 prescribes limits and specifics about terms in policies. While this may initially result in a face value price rise of policies the overall costs of compensation arrangements to all stakeholders over time will almost certainly be lower. In particular costs to government will be reduced arising from having clear parameters to develop and enforce policy. Costs to consumers will also be reduced. Consistency in policy terms means far less litigation dollars will be spent determining the scope of individual cover.

Option 3 reduces one of the significant costs of option 2. By prescribing the requirements of policies, a significant consumer cost is reduced. Namely, that the insurance policy does not cover all of the complaints.

While the increased industry costs may be passed on to consumers that would not necessarily be the case for commission-based businesses, whose charges to consumers bear little relationship to their business costs.

While many of the costs to consumers would be as set out above, there is no doubt that greater policy prescription is likely to deliver far greater consumer benefits than the “leave it to industry to sort out” proposal which will continue to result in the same sort of inclusions and avoidance clauses that currently prevent and deter consumers from making claims.

## RIS IMPLICATIONS

1. The RIS does not recognise long term benefits of certainty on clauses and coverage in comparison to option 2. Option 2 contains higher reputational costs and legal costs associated with challenging interpretation of clauses provisions.

<sup>3</sup> See <http://www.moneymanagement.com.au/articles/42/0c046c42.asp> for DKN buys minority stake in Thornton  
<http://www.moneymanagement.com.au/articles/1b/0c03d81b.asp> for DKN profits ahead of dealer shutdown

# choice

2. We do not believe prescription will stifle innovation and competition in the PII industry in relation to policies covering financial service licensees. This cost implies that innovation and competition are already present. The only innovation evident currently is on the generation of new policy exclusions for where PII will not cover loss. This cost should be deleted from the RIS.

## OPTION 4 CENTRALISED FUND

### *Commentary*

Under option 4 licensees would contribute to a central fund. Central funds are not uncommon with a successful ASX and travel industry compensation funds in place. Traditionally this type of fund signals the maturing of a profession. A central fund particularly for the financial planning sector would be an important step in their evolution.

In our view this is the policy option that delivers the greatest benefit to consumers, government and industry and those benefits significantly outweigh the costs. Unfortunately the RIS grossly underestimates these benefits. This is the option that will most significantly reduce consumer losses and aggravation to government and industry from ongoing financial disasters of the likes of Westpoint. A conservative estimate of the costs that consumers will not be compensated for is between \$300 and \$400 million.

Westpoint has clearly demonstrated the failings of PII especially when a licensee hands in its license or otherwise goes out of business. The only mechanism that will provide compensation to consumers in this situation is a last resort compensation fund along the lines of the stock exchange's National Guarantee Fund, our Travel Compensation Fund or the UK's Financial Services Compensation Scheme.

The RIS needs to cost a central fund in a more rigorous manner. There are a number of ways such a scheme could be implemented and the method of implementation will impact on the costs of the proposal. Costs would include the administrative costs of running the scheme and there are a number of ways these can be kept low e.g. grafting the scheme on to an existing structure. A broader compensation scheme could, for example, be grafted on to the National Guarantee Fund or to the Financial Industry Complaints Service, both of which already have effective administrative and governance systems in place. The modification costs would not be excessive.

ASIC already provides oversight of FICS and the additional costs in overseeing a new function would not be great - they would be considerably less than those that the current non prescriptive PII proposal will spawn.

The major costs of a compensation scheme are paying claims. The UK scheme data shows the following costs in millions of pounds.

Year	Claims paid	Recoveries
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01/02	40.9	9.2
02/03	194.4*	46.
03/04	197.6*	106.2
04/05	174.7*	50.25
05/06	201.2*	108.69

\* Reflect size of mortgage endowment payouts

The UK scheme is a broad scheme covering both product issuers and intermediaries ie deposit takers, life and general insurers, mortgage and insurance brokers and investment intermediaries.

The total cost of claims and administering those claims for investment matters has been as follows.

Year	Investment claims and administration expenses (in millions of pounds)	Converted to AUD ( in millions)	Divided by 3 to reflect true cost in economy size of ours
01/02	1.939	4.79	1.596
02/03	6.175	15.255	5.085
03/04	6.7	16.552	5.517
04/05	21.842	53.96	17.986
05/06	53.485	132.136	44.04

The 01 - 06 period in the UK covers the biggest investment disaster in the country's history and the most significant consumer losses arising from investments ever recorded there. The above figures do not include recoveries, which would slightly reduce the overall costs of the scheme, although it is fair to say that recoveries in the investment sector have been proportionately low eg 01/02 only 170,000 was recovered and in 05/06 1.96million.

What these figures reflect is that a relatively modest levy can build a sustainable base for paying consumer claims.

This has been the experience of Australian compensation funds (e.g. the National Guarantee Fund and the Travel Compensation Fund). The NGF has not needed to charge a levy since 1987 as the corpus is completely self sustaining, and the TCF's annual subscription has fallen to \$350.

An initial charge of \$5000 across 3,500<sup>4</sup> licensees would raise \$17,500,000 in the first year. The inflow overtime would become sustainable and together with catastrophe insurance provide a highly effective safety-net

<sup>4</sup> We accept it would be reasonable to exempt APRA regulated entities from the fund

# choice

This year consumers lost \$400 million in the Westpoint collapse. Few have received any compensation. **The cost of a central fund to industry would be significantly less than the cost to consumers as not all claims would be eligible for compensation.**

## IMPLICATIONS FOR THE RIS

1. The RIS needs to cost a central fund in a more rigorous and systematic manner

Additional benefits to consumers that need to be included in the RIS.

2. No cost to making a claim
3. Dramatically increases likelihood of receiving compensation when a licensee has gone out of business which is the major source of uncompensated loss
4. Confidence in the system

Benefits to industry that need to be included in the RIS

5. Increased consumer confidence in market participants.
6. Not only do central funds provide consumer compensation but they can actively prevent default through a range of risk mitigation measures<sup>5</sup> which can extend to their pricing structures. This in itself reduces costs and increases benefits to consumers.
7. Greater consumer confidence will further encourage consumers to seek financial advice from licensees

Benefits to government

8. Greater public satisfaction with government
9. Reduced regulatory costs as the need for crisis management of compensation arrangements of financial disasters as they arise are eliminated

If you require further information or comment please contact Dr. Nick Coates, Senior Policy Officer - Financial Services on [ncoates@choice.com.au](mailto:ncoates@choice.com.au) or 02 95773349.

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<sup>5</sup> The Annual Financial Reports required by the Travel Compensation Fund have dramatically improved business practices among travel agents and have reduced collapses as a result of poor business practices.