



Review of Compensation Arrangements for Consumers of Financial Services – Consultation on Final Report

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We welcome the opportunity to provide feedback on Richard St John's report and findings in relation to the review of compensation arrangements for consumers of financial services.

Professional Investment Services (PIS) is Australia's leading independently-owned network of financial advisers and accountants. As we put forward in our submission to the Statutory Compensation Review appropriate consumer compensation mechanisms, are paramount for consumer confidence and the integrity of the financial services industry.

Current compensation arrangements include licensees meeting claims individually and holding professional indemnity (PI) insurance to help meet claims, unless an exemption from P.I insurance applies. APRA regulated banks and insurers, or an entity guaranteed by an APRA regulated parent company, are exempt from holding professional indemnity insurance.¹ These arrangements are designed to help a licensee's ability to meet claims.

Richard St John's Findings

In reviewing current compensation arrangements, Mr St John identified that 'retail clients are generally able to recover compensation for losses attributable to misconduct by licensees with whom they have dealt'² and in considering the need for a statutory scheme Mr St John 'concluded that it would be **inappropriate, and possibly even counter-productive, to introduce a more comprehensive last resort compensation scheme** to underpin the current...compensation regime.' Mr St John identified that it would be inappropriate to require responsible and financially secure licensees to underwrite other licensees' ability to meet compensation claims.

Report Conclusions Supported

We firmly support Richard St John's conclusion against introducing a last resort compensation scheme. Introduction of such a scheme shifts the burden of risk and financial responsibility on prudent and responsible licensees, who in effect underwrite other provider's inability to meet claims. This disincentivises appropriate risk management practices and as identified by Mr St John it could be counter-productive.

Introducing such a scheme could increase moral hazard as well as the cost of advice. Consumers and financial services providers alike could be encouraged to increase risk taking behaviour knowing there is a last resort compensation scheme in place. Increased risk taking behaviour may in turn magnify client losses.

The effect of introducing such a scheme would also increase the overall cost of advice to consumers. It is important to note that there is already a great degree of disparity between what consumers are prepared to pay for financial advice and what it actually costs to provide that advice. Report 224,

¹ Page iii, Compensation arrangements for consumers of financial services, Report by Richard St John.

² Page iii, Compensation arrangements for consumers of financial services, Report by Richard St John.

Access to Financial Advice in Australia, issued by ASIC in December 2010 showed that the average consumer was prepared to pay \$301 for advice, whereas the average cost of providing advice was between \$2,500 to \$3,500. Given the significant disparity between what consumers are prepared to pay and what it costs, any impact on advice costs must be carefully considered. This includes ensuring that the benefits of any measure, such as introducing a statutory compensation scheme, far outweighs the consequences, such as the risk of moral hazard and increasing cost of advice.

Compensation Scheme Considerations

A compensation scheme can only be effective if it adequately covers the instances and types of losses necessary to compensate clients. As discussed in our submission to the compensation review, we believe **the primary reason** for client loss arises out of **corporate failure, and the insolvency of product providers**, rather than advice based failures. However a client's ability to recover for losses from a product provider are often limited. Mr St John identified the disparity between obligations towards retail clients owed by product providers as against financial advisers and noted that it would be 'timely to review the current relatively light handed regulatory regime for the issue of certain financial products into the market.'³

Whilst we do not support the introduction of a compulsory compensation scheme, should there be further contemplation of such a proposal, it would have to fill the gaps in current compensation arrangements. These gaps include the limited recourse clients have against failed product providers and it would have to cover compensation for both licensee and product provider misconduct, insolvency, fraud (not just conduct limited to licensees). Given the coverage provided by the scheme, as well as to make the scheme equitable and financially manageable, it would require mandatory participation by both product providers and licensees. Neither capital resourcing or APRA regulated exemptions would be appropriate, as such as scheme would still amount to prudent providers underwriting the risks of others and therefore would have to be mandatory for all.

Conclusion

When considering the merits involved with introducing a statutory compensation scheme the consequences must also be considered. Given the risks involved with increasing moral hazard and costs of advice we believe the end consumer in fact would be disadvantaged by such a scheme. They would in fact be paying increased costs of advice to underwrite the risks of other market participants and other client losses which we believe to be disadvantageous to consumers.

We support Richard St John's findings against introducing a statutory compensation scheme.

³ Page iv, Compensation arrangements for consumers of financial services, Report by Richard St John.