Credit and financial services targeted at Australians at risk of financial hardship

Inquiry by Senate Economics References Committee

AFCA submission

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afca
Australian Financial Complaints Authority

Contents

Introduction

The Australian Financial Complaints Authority (AFCA) is the new independent external dispute resolution (EDR) scheme for the financial sector. AFCA has replaced the Financial Ombudsman Service (FOS), the Credit and Investments Ombudsman (CIO) and the Superannuation Complaints Tribunal (SCT) for all new disputes from 1 November 2018.[1]

In addition to its role in handling complaints, AFCA has responsibilities to identify and resolve systemic issues and extensive reporting obligations. AFCA reports matters such as serious contraventions of law and failures to pay compensation awarded to consumers, as well as systemic issues, to the relevant regulator.

On 1 May 2018 AFCA was authorised pursuant to the *Corporations Act 2001.* The AFCA Rules, which govern our operations, were approved by the Australian Securities and Investments Commission (ASIC) in September 2018. We began to receive complaints under these rules on 1 November 2018.

The current Royal Commission into financial services has highlighted issues that have a particularly pronounced impact on Australians at risk of financial hardship. It is the responsibility of all participants in the financial sector, including regulators and others, to work harder to identify and address system failures and to ensure they do not reoccur in future. AFCA will play a key role in ensuring that fair, independent and effective solutions are delivered to consumers with financial complaints. Further, AFCA will work with consumers and industry participants to reduce complaints. We will contribute to raising standards, meeting diverse community needs and providing a trusted service to all.

AFCA welcomes the opportunity to contribute to the inquiry by the Senate Economics References Committee into credit and financial services targeted at Australians at risk of financial hardship. This submission[2] is informed by the experience of AFCA's predecessor schemes FOS and CIO. It focusses on issues that go to the effectiveness of EDR as a mechanism of redress for consumers including small businesses.

In response to the Terms of Reference of the inquiry, the key points of our submission are:

- Impact of debt management firms[3]

[1] Appendix 1 provides a brief overview of AFCA, explains how it was established and outlines its complaint resolution process. For comprehensive information about AFCA, see our website www.afca.org.au.
[2] This submission has been prepared by the staff of AFCA and does not necessarily represent the views of individual directors of AFCA.
[3] This submission uses the term 'debt management firm' to refer to an organisation that, for fees, promises to assist consumers in financial hardship or with listings on their credit reports through debt negotiation, advising and

Section 1 provides information about the adverse impact that debt management firms can have on individuals, communities and the broader financial system. AFCA suggests a new framework be established to regulate these firms, as outlined in Section 2.

- Current regulation and possible reform

  Section 2 explains that AFCA supports particular reforms to address issues relating to pay day lenders, consumer lease providers and unlicensed operators such as 'buy now pay later' businesses as well as debt management firms. The reforms could improve consumer protection by increasing access to EDR and raising conduct standards.

  These reforms should form part of a broader reform program in the financial sector. Other elements of this program – also explained in Section 2 – include:

  - introducing an enforceable obligation for financial firms to treat consumers fairly

    We suggest consideration be given to imposing this obligation and using the 'Principles for Businesses' that apply in the United Kingdom (UK) as a model for reforms to impose the obligation.

  - establishing a compensation scheme of last resort

    AFCA strongly supports the establishment of such a scheme. This would address the current problem that some consumers, who are awarded compensation when they take complaints to EDR, are not paid. If EDR can be strengthened by establishing such a scheme, reforms to extend access to EDR can provide more effective consumer protection.

- Financial counselling services

  Section 3 explains the important role that financial counselling services play in the financial sector generally and in EDR in particular. Acknowledging this role, AFCA supports measures to ensure the services are funded adequately now and in future. We suggest that a sustainable funding model be developed and consideration be given to following an approach taken overseas, where an industry levy funds financial counselling.

arranging debt agreements, 'repairing' credit reports and developing and managing budgets. For clarity, we confirm that 'debt management firm' in this submission covers all of the organisations referred to in item (a)(iii) of this inquiry's Terms of Reference.

1. Impact of debt management firms

In recent years the impact of debt management firms has been examined and discussed. Solutions to problems have also been proposed. We draw attention to:

- ASIC Report 465 *Paying to get out of debt or clear your record: The promise of debt management firms*, released in January 2016.

  The report presents findings of research conducted by ASIC in 2014 and 2015. It highlights issues including:

  - problems relating to fees, which may be high, 'front-loaded' or unclear
  - unfair sales techniques
  - inadequate disclosure of risks
  - failure to refer consumers to free services such as financial counselling and EDR.

- The 'Experts Roundtable' held in February 2016.

  About 40 experts participated in the Roundtable, including leading academics and staff of FOS, CIO, consumer advocacy services, industry associations and regulators. A communique released in March 2016 identifies these participants. It also sets out the consensus view reached about the need for action, including introduction of a new regulatory regime with licensing to impose conduct standards for debt management firms and ensure complaints about these firms can be taken to EDR.

- The Ramsay Review completed in early 2017[4]

  The Final Report on the review, released in May 2017, recommended debt management firms be required to maintain membership of AFCA. The review's Recommendation 10 was:

  > Debt management firms should be required to be members of the single EDR body. Further work should be undertaken to determine the most appropriate mechanism by which to impose this requirement.

  The Government's response to the report accepted this and other recommendations made by the review.

The EDR arrangements in Australia enable AFCA to provide a free service to consumers. We base our complaint handling processes on a co-operative approach with our stakeholders. We are concerned that the involvement of paid debt management firms, acting for consumers in complaints, may lead to more adversarial

[4] Review of the Financial System EDR and Complaints Framework by an expert panel chaired by Professor Ian Ramsay.

conduct from all parties to EDR. This would not be consistent with the current approach to EDR in Australia. Fees provide an incentive for debt management firms to pursue complaints that may have no real merit or are not in the interests of the consumers involved.

Case Study 1 – Debt negotiator

The AFCA Rules restrict the action that a financial firm can take to enforce a debt that is the subject of a complaint submitted to AFCA. A similar restriction applied where debt complaints were lodged with FOS and CIO, by virtue of their operating rules.

Through its work in dispute resolution and systemic issues, CIO became aware that a debt negotiator followed this practice regularly:

- The debt negotiator, acting for consumers with debts to CIO members, lodged complaints with CIO relating to the debts.
- The CIO Rules restricted enforcement action. Nevertheless, the debt negotiator charged the debtors substantial fees for what it claimed to be a service of 'keeping enforcement action on hold'.
- The debt negotiator did not inform the debtors that complaints had been lodged with CIO, or that lodgement restricted enforcement action.

This case illustrates how debt management firms can profit unfairly from consumers with debts.

To improve consumer protection and ensure EDR services are not affected adversely, AFCA suggests a new framework be established to regulate debt management firms, including licensing requirements. Further detail is provided in the discussion about reforms in Section 2.

2. Current regulation and possible reform

2.1 Obligation to treat consumers fairly

Australian financial services regulation currently lacks an overarching focus on fair treatment of customers. Instead of providing for separate functional activities, we believe conduct regulation should be more clearly based on the fair treatment of consumers at all stages of what is an increasingly integrated product design, origination and distribution system. This would help ensure the financial system better meets the needs of all users, including individual and small business consumers.

AFCA considers that treating consumers fairly should be made a standalone and enforceable standard for financial services entities and individuals working for them. A detailed explanation of the need for this standard is set out in our submission in

response to the Interim Report of the current Royal Commission into financial services.[5]

The obligation that we propose should apply to all businesses operating in the financial sector – including the businesses that this inquiry is examining. To support this view, we refer to the serious issues relating to debt management firms noted in Section 1. We submit that the need to impose the obligation to treat consumers fairly is greatest in pockets of the industry subject to less rigorous regulation or where regulatory gaps exist.

UK authorised financial services firms (even those with no direct contact with retail customers) are subject to Principles for Businesses[6] that mandate fairness and good conduct. The principles are:

1. Integrity
A firm must conduct its business with integrity.

2. Skill, care and diligence
A firm must conduct its business with due skill, care and diligence.

3. Management and control
A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.

4. Financial prudence
A firm must maintain adequate financial resources.

5. Market conduct
A firm must observe proper standards of market conduct.

6. Customers' interests
A firm must pay due regard to the interests of its customers and treat them fairly.

7. Communications with clients
A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.

8. Conflicts of interest
A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.

9. Customers: relationships of trust
A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.

10. Clients' assets
A firm must arrange adequate protection for clients' assets when it is responsible for them.

[5] Submission made by AFCA in October 2018 in response to Interim Report of Royal Commission.
[6] The Principles for Businesses are set out in the Financial Conduct Authority's Handbook.

> **11. Relations with regulators**
> A firm must deal with its regulators in an open and cooperative way, and must disclose to the appropriate regulator appropriately anything relating to the firm of which that regulator would reasonably expect notice.

A breach of these Principles for Businesses makes a firm liable to disciplinary action. The Financial Conduct Authority (FCA) can take enforcement action against a firm on the basis of the principles alone.[7] The FCA has stated:

> 'The Principles act as a general statement of the fundamental obligations of firms reflecting our operational objectives. The Principles are then amplified in more detailed rules and guidance ... to address particular circumstances. This combination of Principles, rules and guidance allows us to apply a range of tools and protections that are appropriate in different situations.
>
> The overarching framework of the Principles is necessary because the detailed rules cannot constitute an all-embracing comprehensive code of regulation that covers all possible circumstances. Any code that tried to be exhaustive could be circumvented, could contain provisions which are unsuitable for the many and varied circumstances which arise in financial services and could also stifle innovation. So, even in areas where there are detailed rules, a firm must continue to comply with the Principles.'[8]

For Principle 6 - the fairness principle - the FCA has set six consumer outcomes that firms should strive to achieve, referred to as 'TCF' (Treating Customers Fairly).

- Outcome 1: Consumers can be confident they are dealing with firms where the fair treatment of customers is central to the corporate culture.
- Outcome 2: Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly.
- Outcome 3: Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale.
- Outcome 4: Where consumers receive advice, the advice is suitable and takes account of their circumstances.
- Outcome 5: Consumers are provided with products that perform as firms have led them to expect, and the associated service is of an acceptable standard and as they have been led to expect.

[7] FCA Mission: Approach to Consumers, page 13.
[8] FCA Discussion Paper DP18/5, July 2018, pages 9-10.

- Outcome 6: Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.[9]

AFCA supports principles-based and outcomes-focused regulation. We suggest that consideration be given to:

- the introduction of a standalone enforceable standard requiring consumers to be treated fairly
- using the FCA's Principles for Businesses as a model for reforms imposing the standard.

2.2 Small amount credit contract and consumer lease reforms

AFCA is aware of the increase in the number of small amount credit contract (pay day lending) and buy now pay later providers that have entered the financial sector in the recent past. ASIC enforcement action since 2010 with respect to pay day lending has shown that irresponsible lending practices and misleading advertising in this sector has had a disproportionate impact on financially vulnerable Australians.

While we understand that government regulation of pay day lending is in progress, we anticipate that this sector will continue to grow and with it the need for a well-resourced financial counselling sector.

AFCA would welcome the passage of the proposed small amount credit contract and consumer lease legislation as this would strengthen consumer protection and ensure the standards required of firms participating in this sector are clear.

2.3 Framework to regulate debt management firms

Section 1 provides information about the impact that debt management firms can have. To improve consumer protection and ensure EDR services are not affected adversely, AFCA suggests a new framework be established to regulate debt management firms, including licensing requirements. The framework should:

- require debt management firms to be members of AFCA, to give consumers with complaints against these firms access to free and timely EDR
- impose conduct standards for debt management firms, such as obligations to
  - act in the best interests of consumers
  - clearly disclose to consumers and that the firm operates for profit, as well as disclosing all applicable fees
  - ensure the firm only makes complaints to financial firms or AFCA on behalf of consumers where the complaints have a reasonable basis.

[9] FCA Discussion Paper DP18/5, July 2018, page 37.

2.4 Access to EDR

Financial firms that hold an Australian Credit Licence or an Australian Financial Services Licence are required to maintain membership of AFCA. Consumers with complaints against these licence holders (members of AFCA) can access our EDR services for free.

Some businesses such as 'buy now, pay later' providers, pay day lenders and debt management firms have joined AFCA on the basis that they provide regulated services, or because they have chosen to join voluntarily. However, some businesses can structure their operations so that they do not need to hold licences. Unlicensed businesses are not required to be members of AFCA.

In our view, consumers of these services would not readily understand or appreciate that they are not dealing with a licensed business given that the services provided relate to credit. Nor should consumers have to rely on the business voluntarily deciding to join AFCA, especially when the decision to cease being a member rests with the business rather than the consumer.

Case Study 2 – Short term credit provider

Subsection 6(1) of the National Credit Code states that a loan is not regulated under the Code where the maximum amount of credit fees and charges does not exceed 5% of the loan (and other requirements are met).

A short term credit provider claimed the exemption under subsection 6(1) while a related company acted as a 'broker' and charged consumers substantial fees in relation to the short-term credit contracts. AFCA understands this arrangement was designed to avoid the caps applicable to small amount credit contracts under the Code.

The credit provider refused to co-operate with an investigation by CIO, resigned its CIO membership, and cancelled its Australian Credit Licence. Accordingly, AFCA does not know how many consumers were affected by the credit provider's conduct. We understand this firm continues to operate as an unlicensed credit provider.

Case Study 3 – Credit repair agency

Credit repair agencies are not required to be members of AFCA and, in the past, were not required to be members of FOS or CIO. Some debt management firms have, however, joined FOS or CIO and now AFCA on a voluntary basis.

One credit repair agency agreed to allow CIO to investigate complaints made about its service. Relying on the agreement, CIO was able to:

- obtain a number of positive outcomes for consumers with complaints
- as part of a systemic issues investigation, negotiate the removal of unfair contract terms from the agency's standard terms and conditions.

This case indicates the scope to enhance consumer protection by requiring credit repair agencies and other financial firms to be members of AFCA.

Some of the businesses being examined in this inquiry are not required to be members of AFCA. Consumers with complaints against them can only access our EDR services if the businesses voluntarily maintain AFCA membership. The existing regulatory requirements do not ensure that complaints are handled properly and consumers without access to EDR may not understand that they do not have the same rights as other consumers of comparable financial services.

AFCA suggests that, when examining situations unsatisfactory for consumers, the inquiry considers whether the consumers have access to EDR and possible reforms to increase EDR access.

2.5 Compensation scheme of last resort

Current issue

There is a gap in the current arrangements for EDR in Australia's financial sector because there is no compensation scheme of last resort.

Some consumers who take complaints to EDR are awarded monetary compensation but this is not paid. This occurs typically when the financial firm has gone into liquidation or administration or their compensation arrangements fail to respond. For example, the firm's professional indemnity insurer may deny indemnity if there are a large number of disputes about similar conduct, conduct may fall within a point exclusion or the excess carried by the firm may be too high.

AFCA can respond to a financial firm's default by reporting the firm to ASIC and terminating its membership of AFCA. Neither of these responses assists the unpaid consumer however.

The following table indicates the extent of the problem. It shows the number of financial firms that failed to pay compensation awarded in determinations made by FOS and CIO, the number of consumers affected and the amount of money involved.

Scheme	Number of financial firms	Number of consumers affected	Quantum
FOS	44 during the period 1 January 2010 until 30 September 2018 (52% of these were financial advisors/ planners, 11% were operators of managed investment schemes, 9% were credit providers, 28% were other financial firms)[10]	246 (177 determinations)	$16 million[11]
CIO	7 during the period from 1 December 2014 until 30 September 2018	9 (9 determinations)	$419,209.73

AFCA strongly supports FOS's submission to the Royal Commission of 2 February 2018 that the consumer protection framework needs an effective mechanism to deal with the issue of unpaid EDR scheme determinations.

An EDR mechanism is clearly not satisfactory if binding awards of compensation are not paid. Consumers must have confidence that when things go wrong, they will be compensated when there is a decision made in their favour. What can often get lost in this discussion is the impact that losses and unpaid compensation awards have on the lives of individual consumers, their families and small businesses.

We consider that there needs to be a workable and acceptable compensation scheme of last resort to provide access to justice for consumers who do not receive awarded compensation for financial loss and fill the structural gap in the existing dispute resolution framework.

There has been extensive consultation with government, industry and regulators about scheme proposals. The Ramsay Review, after thorough consideration, recommended that a scheme be established.

[10] Of the '28% other financial firms' these include a growing default rate among derivatives, foreign exchange and contracts for difference traders. Our experience is these firms very rarely have adequate compensation arrangements that respond to consumer complaints.
[11] The amount is in excess of $16 million and both figures do not include interest.

Reforms

The absence of a compensation scheme of last resort is a gap in the current arrangements for EDR for financial services that results in harm to consumers. If EDR can be strengthened by establishing such a scheme, the reforms to extend access to EDR suggested above can provide more effective consumer protection.

3. Financial counselling services

To provide EDR effectively, AFCA should be accessible to all consumers of financial services in Australia. Accessing EDR is easier for people who are financially literate, are connected to services and information through the internet, and have the knowledge and resources to seek EDR if they have a problem with a financial firm. We are aware that vulnerable and disadvantaged consumers often have difficulties seeking assistance from an EDR scheme however.

Free financial counselling, and other community services, play a very important role in the financial sector. These services connect vulnerable and disadvantaged members of the community to EDR schemes such as AFCA and other support mechanisms. They also raise the standard of financial competency through help with budgeting, dealing with credit issues and other practical financial matters.

Financial counselling services help consumers to avoid financial problems and, where problems do arise, help consumers to pursue and resolve complaints. If these services are not available free to consumers, many vulnerable and disadvantaged consumers may not be able to make complaints to financial firms or escalate complaints to EDR – and may turn to paid debt management firms.

At times, the predecessors of AFCA have seen gaps in the availability of financial counselling services and consumers have indicated that they have encountered long delays when accessing these services. When financial counselling is not available, or only available after long delays, consumers' financial problems are exacerbated and their personal wellbeing suffers.

Financial counselling services form a crucial part of the infrastructure of our financial sector. They provide benefits by, for example:

- helping consumers to resolve financial problems and complaints – alleviating issues that can cause real hardship
- promoting financial capability

- reducing the risk that vulnerable and disadvantaged consumers will be targeted by predatory businesses.[12]

Given the important role that financial counselling services play in the financial sector generally, and in EDR in particular, AFCA supports measures to ensure these services are funded adequately now and in future. We recommend the Government, industry and the community sector work together to develop a sustainable funding model for financial counselling services.

In the UK, debt counselling is provided under the auspices of the Money Advice Service. The service is funded from a levy collected by the FCA from firms that it regulates. Such a model could be considered as an option in Australia.

[12] For more information about the value of free financial counselling services, see public submissions by FOS to the Financial System Inquiry made in April 2014, August 2014 and March 2015.

Appendix 1 – About AFCA

Overview of AFCA

AFCA is a free, fair and independent dispute resolution scheme. AFCA's service is offered as an alternative to tribunals and courts to resolve complaints consumers and small businesses have with their financial firms. We consider complaints about:

- credit, finance and loans
- insurance
- banking deposits and payments
- investments and financial advice
- superannuation.

AFCA's role is to assist consumers and small businesses to reach agreements with financial firms about how to resolve their complaints. We are impartial and independent. We do not act for either party to advocate their position. If a complaint does not resolve between the parties, we will decide an appropriate outcome.

Decisions made by AFCA can be binding on the financial firm involved in a complaint. We can award compensation for losses suffered because of a financial firm's error or inappropriate conduct. There are other remedies we can also provide for superannuation complaints. We do not, however, award compensation to punish financial firms or impose fines.

AFCA is not a government department or agency, and is not a regulator of the financial services industry. We are a not-for-profit company, limited by guarantee, governed by a board with equal numbers of industry and consumer representatives. AFCA's Chief Ombudsman is responsible for the management of the organisation.

Establishment of AFCA

The change to a single EDR scheme for financial services in Australia implements the recommendations to Government made in 2017 by the Ramsay Review. The integrated changes recommended by the review build on tested attributes of the industry ombudsman model. These are the most fundamental reforms to EDR since membership of an ASIC-approved EDR scheme was made mandatory for financial services providers in 2001.

AFCA's Board is chaired by the Honourable Helen Coonan (since 4 May 2018) and its Chief Executive Officer/Chief Ombudsman is David Locke (since 25 June 2018). Whilst FOS and CIO staff have transferred their employment to AFCA, new ombudsmen and highly skilled staff have also been recruited to ensure AFCA was fully resourced to deal with disputes from 1 November 2018. This includes recruitment of staff with superannuation experience.

Under transitional arrangements that have been put in place with ASIC's approval, AFCA is currently resolving complaints made to FOS and CIO and will continue to do so until they are resolved. These complaints will be handled in accordance with the FOS Terms of Reference or CIO Rules, as applicable and in force when the relevant complaint was lodged.

AFCA is built upon the work of FOS, CIO and SCT.[13] However, in time, AFCA will develop new approaches informed, but not bound, by those predecessor schemes' approaches to resolving disputes. AFCA's approach will incorporate the lessons from the current Royal Commission into financial services, as well as changes to industry practice and to the legislative and regulatory regime.

AFCA will be reviewed after 18 months of operation. AFCA's approaches and effectiveness will be independently assessed, providing another opportunity to ensure that it is operating an effective mechanism for redress.

AFCA's complaint resolution process

As the single financial complaints handling scheme replacing FOS, CIO and the SCT, AFCA is expecting to deal with over 55,000 complaints per year. It has a broader monetary jurisdiction than FOS and CIO. To manage its workload, AFCA anticipates it will need around 550 staff. This will include a dedicated small business ombudsman and a team with expertise and understanding of the financial firm issues that Australian small businesses face.

AFCA's complaint resolution process has been designed to ensure that it is easy to navigate and takes place quickly and efficiently. There is one case handler and an ombudsman who deal with each complaint.

AFCA encourages cooperation and collaboration by the parties in the resolution of complaints. Financial firms and complainants can engage proactively with AFCA, including by telephone and electronically.

Financial firms receive automated email communications when a complaint is registered and are given an opportunity to resolve the complaint in the first instance. AFCA is easily accessible with financial firms able to submit information and track the progress of a complaint through a secure portal and complainants able to lodge online and over the phone.

AFCA's Rules give it the ability to join another financial firm to a complaint. To date, this has not commonly occurred because of the division of firms between FOS and CIO. It is expected that from 1 November 2018 the joinder powers will enable a more streamlined and efficient ability to resolve complex complaints.

[13] A joint working group headed by Dr Malcom Eady was established and the schemes collaborated to develop AFCA and integrate the superannuation jurisdiction.

AFCA's investigation process involves AFCA assessing the issues and gathering relevant information from the parties. Information is exchanged to ensure that each party can respond to the other's material and that there are no surprises.

AFCA has flexibility under its Rules to resolve complaints using a variety of techniques including negotiation and conciliation and will engage with the parties to find the most effective method for the particular complaint. Not all complaints will be formally determined by an AFCA Decision Maker, such as an Adjudicator, Ombudsman or Panel. For example, after investigating a complaint, AFCA may make a preliminary assessment about how the complaint could be resolved, based on the case manager's evaluation of the information AFCA has obtained. While there is no obligation on the parties to accept a preliminary assessment, AFCA's experience of a similar mechanism under FOS's Terms of Reference is that many complaints do resolve in this way.