Submission to the Financial System Inquiry

Credit Ombudsman Service Limited

The Credit Ombudsman Service Limited (**COSL**) welcomes the opportunity to make a submission to the Inquiry.

What this submission is about

This submission is not about enhancing consumer protection further. Much of the reform agenda has already been executed[1] and should stand in good stead for a number of years.

Instead, this submission is about preserving and supporting an environment that is conducive to financial services providers meeting their legal obligations in terms of dispute resolution in a way that promotes competition and efficiency, and which remains at no cost to the taxpayer.

Specifically, this submission recommends maintaining the current policy setting of having two (or more) external dispute resolution schemes operating in the financial services sector and the benefits that flow from the competitive tension that presently exists between them.

It would be helpful if a statement or, preferably, a recommendation to this effect appeared in the Inquiry's Report to serve as an acknowledgement that competitive markets in the context of industry-funded dispute resolution schemes are also beneficial to the economy as a whole, driving greater discipline to continuously improve services, lower costs to users and improve performance and responsiveness to changes in the market.

Industry-funded Ombudsman schemes

There are essentially two types of Ombudsman schemes in Australia:

1. Statutory Ombudsman schemes: these are created by statute and funded by Government; e.g. the Commonwealth Ombudsman whose office investigates complaints from members of the public about the administrative actions of Australian Government departments and agencies, and

[1] In the credit area, see the National Consumer Credit Protection Act 2009; in the area of privacy, see the Privacy Amendment (Enhancing Privacy Protection) Act 2012; and in the area of investment advice, see the Corporations Amendment (Future of Financial Advice) Act 2012 and the Corporations Amendment (Further Future of Financial Advice Measures) Act 2012 (the FOFA Acts).

2. Industry-based Ombudsman schemes, also known as External Dispute Resolution (**EDR**) Schemes: these are *not* created by statute but are 'approved' by a government body to operate as industry-funded independent dispute resolution schemes which investigate complaints from consumers about members of the schemes.

COSL, like the Financial Ombudsman Service (**FOS**), falls into the second category.

Rationale for EDR schemes

The continued recognition of an industry-based, low-cost EDR mechanism is an acknowledgement by successive Australian Governments of the high costs to consumers of pursuing redress through the courts and, to some extent, of the increased risk and confusion created by a widening of consumer choice of financial products and providers.[2]

Before the establishment of EDR schemes, consumers would have had no effective means of having their complaints against financial services providers (**FSPs**) resolved without resorting to costly and lengthy legal proceedings. The reality is that the cost of legal proceedings is prohibitive and beyond the means of many ordinary Australians.

Without EDR, consumers in regional areas would find it even more difficult to access dispute resolution mechanisms, given that legal and other advisory services are either not available or difficult to access (due to infrequent service delivery or distance).

There is also growing evidence that suggests that some of the most disadvantaged Australians[3] are more likely to experience substantial and multiple problems involving financial services.[4]

Industry-supported EDR schemes play a vital role in the broader financial services and credit regulatory systems. They provide:

- a forum for consumers and FSPs to resolve complaints that is quicker and cheaper than the formal legal system, and
- an opportunity to improve industry standards of conduct and relations between industry participants and consumers.[5]

[2] Financial System Inquiry (Wallis Report) - Stocktake of Financial Regulation Chapter 16.33, p. 652.
[3] including disabled persons, homeless persons, people with a mental illness and Aboriginal and Torres Strait Islander persons
[4] Legal Australia-Wide Survey: Legal need in Australia, Law and Justice Foundation of NSW, Sydney
[5] ASIC Regulatory Guide 139.33

Legislative basis for EDR schemes

In Australia, most FSPs are required by law[6] to join an industry-based EDR scheme approved by the Australian Securities and Investments Commission (**ASIC**).[7] ASIC's approval is subject to an EDR scheme first meeting prescribed criteria.[8]

Further, credit providers (which, under the new definition in the Privacy Act 1988, include trade creditors, commercial lenders and credit reporting bureaus), are now required[9] to join an EDR scheme 'recognised' by the Office of the Australian Information Commissioner (**OAIC**). This is to allow privacy-related complaints made against them to be dealt with by a recognised EDR scheme.

It would be difficult, expensive and time consuming for any but the largest, best resourced and mature organised industry group to establish an EDR scheme that would meet the stringent criteria prescribed by ASIC and the OAIC.

Indeed, no new EDR scheme has emerged despite the requirement, since 12 March 2014, for credit providers to join an EDR scheme for privacy-related complaints. Existing EDR schemes were the only ones to apply to the OAIC for recognition.

The barriers to entry for any new scheme are therefore demonstrably almost insurmountable and it is unlikely that new players will emerge in the market. Any consolidation of the two existing EDR schemes will create a monopoly in EDR services with no or little chance of a new entrant emerging.

About COSL

COSL is a not-for-profit public company, limited by guarantee. It receives no government subsidy and its operations are funded entirely by membership and complaint fees levied on its FSP members.

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[6] Corporations Act 2001 and National Consumer Credit Protection Act 2009.

[7] The Wallis Inquiry recommended the establishment of the Corporations and Financial Services Commission (CFSC), now ASIC, to oversee industry-based schemes for complaints handling and dispute resolution.

[8] To maintain this approval, COSL is required and continues to meet the stringent conditions prescribed by ASIC's Regulatory Guide 139, including:

(a) operating independently of the sectors of industry that fall within its jurisdiction and that provide its funding,
(b) acting impartially and fairly in its decision-making and having an overseeing body (board of directors) comprised of an equal number of consumer and industry representatives and an independent chair,
(c) being accountable to stakeholders by regularly reporting on its performance, FSP systemic issues and serious misconduct, and subjecting itself to periodic independent reviews, and
(d) being accessible to consumers by providing a dispute resolution service (even when legal proceedings have commenced) at no cost to the consumer, and actively promoting its services so consumers are aware of its existence.

[9] To the extent that they access the consumer credit reporting system.

COSL's decision-making process is independent. It is not a consumer advocate, nor does it represent industry. The key object of COSL is to provide consumers with a free alternative to legal proceedings for resolving their disputes with participating FSPs, having regard to relevant legal principles, industry codes of practice, good industry practice and fairness in all circumstances.

COSL's membership of about 17,000 FSPs comprises mainly finance brokers, non-bank lenders, mutual banks, credit unions, building societies, time share operators, small amount short term lenders, debt purchasers and some financial advice firms.

COSL's participating FSPs are from the 'small end of town'. More than 90% are sole operators or small businesses comprising less than five individuals.

Should there only be one EDR scheme in the finance sector?

The idea of consolidating the two remaining EDR schemes in the financial services sector - COSL and FOS - has been the subject of speculation off and on over the years.

We submit that any proposal to merge the schemes fails to adequately recognise the benefits of having two or more distinct EDR schemes in the sector. It also belies the fact that the merger of five EDR schemes[10] into FOS more than five years ago has not produced the efficiencies anticipated. Indeed, the recent independent review of FOS by CameronRalph Navigator described the merger-related activities as "productivity-sapping"[11] and concluded that while FOS was effective in meeting the majority of the benchmarks for EDR schemes, it had failed to meet the key benchmark of efficiency and timeliness in handling disputes.[12]

Also concerning to us is the continued assertion by ANZOA, a peak body for Ombudsman schemes in Australia and New Zealand, that there should only be one EDR scheme for any industry or service area and that "it is *inappropriate* to apply concepts of market forces and competition to what are effectively 'natural monopolies'".[13] This is curiously anachronistic language in the modern regulatory environment, and particularly incongruent in the context of

[10] The Banking and Financial Services Ombudsman Limited (BFSO), the Financial Industry Complaints Service Limited (FICS), the Insurance Ombudsman Service Limited (IOS), the Credit Union Dispute Resolution Centre Pty Limited (CUDRC) and the Insurance Brokers Disputes Limited (IBDL).

[11] Page 23 of the 2013 Independent Review - Report to the Board of FOS: http://www.fos.org.au/custom/files/docs/independent-review-final-report-2014.pdf.

[12] Ibid page 8, section 2.1.

[13] Policy statement endorsed by the Members of the Australian and New Zealand Ombudsman Association (ANZOA): http://www.anzoa.com.au/ANZOA_Policy-Statement_Competition-among-Ombudsman-offices_Sept2011.pdf.

organisations whose functions and performance are dependent on private, rather than public, funding.[14]

ANZOA's assertion is also at odds with the fact that the Australian Parliament evinced an intention to permit more than one EDR scheme to be approved by ASIC.[15]

Accordingly, ASIC has set out its criteria for approving an EDR scheme in a regulatory guide.[16] This approach necessarily countenances more than one scheme obtaining approval – which, in the past, has seen ASIC approve seven such schemes (and reject one).[17]

Following industry consolidation, there are now only two ASIC-approved EDR schemes operating in the Australian financial services sector: COSL and FOS.

Any merger of the remaining two EDR schemes would, we submit, inevitably produce a monopoly which, by its very nature, would be potentially anti-competitive and readily lend itself to inefficient outcomes.

We examine below the effect any such merger is likely to have on particular key stakeholders of EDR schemes (namely, FSPs, the regulator and consumers).

Implications for FSPs

A consolidation of the two remaining EDR schemes will mean that FSPs, who are legally required to join an EDR scheme and fully meet the scheme's operating costs, will have no choice as to which scheme they join:

1. FSPs would be concerned that, without the stimulus of competitive tension, turnaround times, service levels, innovation and continuous improvement would suffer and there would be less incentive to keep costs in check and run the scheme efficiently. Monopolies typically result in lower service levels due to the absence of a credible alternative, a burgeoning bureaucracy, an inability to respond quickly and effectively to market changes and increased costs as a result of inefficiencies typically inherent in monopolies.

   The usual argument that mergers provide synergies and generate economies of scale is not persuasive in this context. On reviewing the merger of the five EDR schemes into FOS in 2008, the Productivity

[14] See Thomas DiLorenzo, "The Myth of the Natural Monopoly" (1996) 9(2) *Review of Austrian Economics* 43-58

[15] Section 912A(b)(i) Corporations Act 2001 requires an Australian Financial Services licensee to have a dispute resolution system consisting of membership of "one or more" external dispute resolution schemes that is, or are, approved by ASIC. Similarly, sections 24(1)(i) and 64(5)(c) NCCP Act 2009 require an Australian Credit Licensee and an authorised credit representative of such a licensee to be a member of any approved EDR scheme approved by ASIC.

[16] For both AFS and ACL holders, this is ASIC RG139.

[17] Australian Timeshare and Holiday Ownership Council Limited v Australian Securities and Investments Commission [2008] AATA 62.

Commission suggested in its Draft Report that any possible costs savings and efficiency in the pricing of EDR services could well have already been achieved by the levels of co-operation between the merging entities and all the EDR schemes in the sector.[18]

2. FSPs would also be concerned that they would be denied a key advantage of having more than one scheme to choose from; that is, that they can 'vote with their feet' if they are dissatisfied with service levels.

   To the extent that FSPs compare different schemes and 'shop' them, comparisons are made based on service levels, value and the ease of doing business – not bias to business or perceived laxity.

   Those FSPs that have joined COSL from FOS have done so for a number of reasons: for example, their location in the same city as COSL meant that they can meet with COSL on a regular basis more conveniently and economically; their competitors are existing members of COSL and they are inclined to be in the same scheme as their cohort; or they feel a scheme that was formed essentially for the non-bank sector is more appropriate for them.

   Accordingly, although there is some movement between the two schemes, scheme shopping by FSPs is not a live issue. In any event, to limit any potential abuse, COSL and FOS have entered into a Memorandum of Understanding which allows each scheme, before accepting an applicant as a member, to consult with the other about, among other things, whether the applicant has paid a consumer any compensation that may have been awarded by the scheme.[19]

3. A single merged scheme would be prone to be monopolistic in its behaviour – dictating terms, rather than being responsive to stakeholder concerns about performance.[20] It may also be at risk of being substantially less flexible or capable of responding quickly to changes in the market.

4. COSL's small FSP members (who comprise 95% of its membership) are generally not supportive of being in a single financial services EDR scheme which is, and has historically been, generally geared towards large institutional members such as banks and insurers. Being at the smaller end of town, these FSPs would understandably not want to be treated in the same way (and it may be inefficient to treat them in the same way) as the

[18] Productivity Commission Draft Report of the Inquiry into Australia's Consumer Policy Framework Vol 2 p159.
[19] http://www.cosl.com.au/cosl/assets/File/MOU%20between%20FOS%20and%20COSL.pdf.
[20] Even in the context of a large EDR scheme such as FOS, some FSPs perceive the scheme as 'bureaucratic and slow or insufficient in responding to the needs and issues of FSPs': page 20, section 6.1.1, of the 2013 Independent Review - Report to the Board of FOS: http://www.fos.org.au/custom/files/docs/independent-review-final-report-2014.pdf.

large financial institutions who attract the vast majority of complaints and whose corporate structures and governance bear no resemblance to theirs.

There is no evidence to suggest that the existence of two or more schemes adds unnecessary and inefficient costs to EDR services in the form of inefficient duplication of infrastructure/resources/services/information systems. Indeed, the Australian experience has been to the contrary and, as the Productivity Commission concluded, after examining the cost per contact/case/dispute reported by each scheme, the differences "do not appear to be scale-related, suggesting that physical consolidation might not yield big scale benefits".[21]

Further, duplicity of functions has little, if any, relevance in the present context given COSL and FOS operate in relatively distinct markets and there is not a significant degree of overlap in their respective memberships. As already noted, FOS' members are from the big end of town, while COSL's are from the small end of town and comprise almost whole industry sectors. So for example, COSL's membership includes almost all (or the overwhelming majority of) building societies, lenders mortgage insurers, non-bank lenders, mortgage managers, aggregators, debt purchasers, motor vehicle financiers, finance brokers, small amount lenders and time share operators.

Implications for the regulator

ASIC also benefits from there being two EDR schemes in the finance sector:

1. ASIC is well placed to exploit the natural tension between the two schemes to help drive innovation and improvements. After all, ASIC only has limited levers to use, namely, the continued approval of the schemes.

   Indeed, the existence of more than one EDR scheme has in the past provided ASIC with leverage and 'soft' influencing tools when selecting one scheme's approach over the other as their preferred position.[22]

2. A diversity of EDR approaches allows ASIC to assess the relative merits of different approaches and/or their suitability to different industry sectors. This diversity or competition, as it were, can be most productive for industry and consumers alike in the development of new regulation and the refinement and articulation of existing government policy.

3. Any regulator would be concerned that a single merged scheme may adopt a more bureaucratic approach to dispute resolution.[23] This could lead to a

[21] Productivity Commission Draft Report of the Inquiry into Australia's Consumer Policy Framework Vol 2 p159.
[22] For example, see ASIC Consultation Paper 172: EDR jurisdiction over complaints when members commence debt recovery legal proceedings - Paras 5 and 10(b).
[23] Some stakeholders already perceive FOS as 'bureaucratic, defensive and unresponsive' even though it is not a single scheme monopoly: page 7, section 2, of the 2013 Independent Review - Report to the Board of FOS: http://www.fos.org.au/custom/files/docs/independent-review-final-report-2014.pdf.

reduction in service levels and responsiveness, a complacency about its own performance and the scheme being inwardly focused rather than stakeholder-focused.[24]

4. Multiple sources of high quality data and analysis in relation to financial services disputes and systemic issues can only improve the contribution that EDR schemes can make to policy development in their respective industries. If there is only one conduit to the regulator or the government for such information, through a single EDR scheme, the quality of input into the regulatory process will be diminished.

5. From a regulator's perspective, there is a risk that the quality of case management may be undermined – with more layers of management come more bureaucratic processes and a greater tendency to rely on standard systems.

From ASIC's perspective, a single scheme should, conceptually, lower costs, but the reality appears to be that the workload of ASIC and its cost are driven by domain (financial service categories – e.g. wealth management, mortgage origination), rather than by scheme.

Implications for consumers

Consumers are better served by having at least two EDR schemes in the finance sector:

1. At present, both COSL and FOS are required by ASIC to have their operations reviewed independently on a periodic basis to ensure they meet the benchmarks set by ASIC in its Regulatory Guide 139. The reviews typically compare both schemes and, in so doing, recommend one scheme implement particular improvements seen in the other.

   As a result, each scheme is benchmarked against the other and this exercise results in both schemes striving to improve their performance and meet best practice. This benefits consumers enormously, as it does FSPs, and could not be effectively achieved under a single scheme model.

2. Each ASIC-approved EDR scheme is required to have equal numbers of consumer and industry directors on their board. It follows that an essential avenue for consumer input into regulatory processes[25] is through participation as representatives on the management boards of schemes. The fewer schemes, the less are the opportunities for such important input.

[24] This is the perception held by some FSPs about FOS: Ibid page 37, section 7.5.
[25] In the context of EDR schemes being a part of the overall regulatory landscape in the financial services sector.

3. A plurality of EDR schemes which satisfy the benchmarked criteria developed independently by the regulator allows for numerous sources of policy and interpretative development. Consumer law and consumers can only benefit from such a situation. The alternative - a monopoly of dispute resolution services - facilitates the re-emergence of the failures of old-style regulation: bureaucracy, inflexibility and industry capture. This would not be a good outcome for consumers.

4. There is no evidence of consumer confusion as to which scheme consumers should take their complaints:
    - ASIC's Regulatory Guide 165 requires FSPs to notify their clients of the EDR scheme to which they belong,
    - many of the prescribed documents which legislation requires to be sent to consumers must set out the contact details of the EDR scheme to which the FSP is a member, and
    - each scheme routinely transfers phone calls to the other when an enquiry has been misdirected and, further, under a Memorandum of Understanding between FOS and COSL, each scheme transfers complaint files to the other in the infrequent case of incorrect lodgement.
5. There is no evidence that scheme choice in Australia has resulted in adverse outcomes for consumers due to 'forum shopping'.

<u>A statutory scheme?</u>

It is difficult to see how it would benefit industry, regulators and consumers alike to have a monopoly in EDR services for a sector that represents a significant percentage of the country's GDP, but which would not be subject to real checks and balances or parliamentary or judicial oversight.

Nor would a statutory scheme be the answer because a statutory scheme with a (necessarily) large bureaucracy would:

- create a tax-payer funded right of appeal to the courts, defeating the objective to resolve disputes fairly, cheaply and expeditiously,
- not have the multiplicity of access points for industry and consumer representation that the current structure affords,
- not have specialised industry knowledge required for the sensible resolution of disputes,
- not have the sense of involvement and, therefore, support by the relevant industry and consumer groups,
- be substantially more inflexible, and

- not be capable of responding quickly to changes in relevant markets.

Significantly, a statutory scheme would be more susceptible to judicial review on broader grounds than are available at present. A new "legalism" may creep into scheme processes and decision-making as they "look over their shoulders" at the courts.[26] This may defeat the object of providing an alternative to the formal resolution of disputes through the court system.

Conclusion

COSL is of the view that any consolidation of the two remaining EDR schemes in the finance sector will not deliver sufficient public benefit to overcome the elimination in competition that will result. The sector should continue to have the benefits of a competitive market.

[26] This is a fear expressed in relation to the UK Financial Services Ombudsman by James R and Morris P, "The new Financial Ombudsman Service in the United Kingdom: has the second generation got it right" in Rickett C and Telfer T International Perspectives on Consumers' Access to Justice (Cambridge University Press, 2003), at p 191.