

Investment Session 7C

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Australia - Financial Industry Complaints Service Limited

Problems encountered by Australian investors include unrated debentures, unsecured notes and promissory notes, provided by Westpoint, Fincorp and ACR. These firms all subsequently failed, resulting in heavy financial losses.

Westpoint issued promissory notes to about 3,500 consumers, resulting in losses of A\$350m. These notes were generally issued through advisers although some customers invested directly with Westpoint, which collapsed in November 2005. It is estimated there are about 1,200 eligible complainants and about 400 have complained to the Service so far. Jurisdiction rules suggest there is still some time before the remainder are 'time-barred' so it is possible the number of complaints will grow.

If directly invested with Westpoint, the investor has no means of pursuing redress but remains a creditor of the firm. Many of the advising intermediaries held inadequate indemnity insurance and some of them have gone into administration as a result.

Fincorp and ACR directed their marketing towards elderly people and whilst investments in all three companies appeared relatively low-risk, the funds received were used for a number of purposes such as debt capital funding, internal property transactions within company groups, debentures, mortgage financing and structured real estate investments. The element of risk was therefore dramatically greater than the impression given to consumers and intermediaries alike. As Australian regulation now allows self-investment for retirement, such apparently secure propositions were popular with older investors, many of whom held little in reserve and were not really in a position to accept risk and illiquidity.

Fincorp issued in the region of 8,000 debentures and losses are estimated at A\$200m. ACR issued 7,000 debentures with estimated losses of A\$340m. Collectively, these investments represent 7% of total deposits and debt securities and 24% of that amount constitutes unlisted and unrated instruments.

The regulator had found some of the advertising to be misleading and had challenged accordingly. It had taken action against a Westpoint Group company over the absence of a prospectus but found the company and its founder to be litigious and adversary. In moves to protect consumers the regulator had issued many general warnings but was unable to ensure its messages were reaching the correct targets. Potential investors and intermediaries alike had been reassured by

the now defunct firms and had been shown the proposed developments that were to be the drivers for investment return.

The Westpoint CEO had gone as far as to blame regulatory intervention for the corporate failure. This particular scandal started in 200/2001 with the raising of 'mezzanine finance'; a police investigation continues into the matter.

There is no direct compensation scheme and the monetary limits of the ombudsman service may not provide adequate redress to cover many investment losses. The legal profession has started to intervene, on a 'no win - no fee' basis.

About 50 complaints have already been settled; eight have been determined in favour of the consumer and two have been paid out. However, the Service is facing a legal challenge on one of its outcomes. Whilst there are allegations of excessive commission earnings by intermediaries, this is difficult to prove. Advisers may only have received a commission rate of 3%, but other deductions and payments may well have been made elsewhere.

To avoid similar recurrences, the regulator is concentrating on benchmarking, along with clearer risk detail and disclosure. Credit ratings will be higher profile and requirements in financial promotions will be stricter and not misleading. The regulator considers investor education is required to minimise the risk of further mis-selling.

A South African delegate highlighted a telephone-sales fraud where many people had responded to promises of guaranteed returns, which actually came to nothing. The regulatory response had been to drill through trusts and corporate identities to establish who was behind such investment offerings and again, to invest in consumer education.

UK - Financial Ombudsman Service

There are many common issues among ombudsman schemes worldwide, not least of which are the vulnerability of the elderly and the apparent attractiveness of possibly unsuitable investments. Generally, the public are under-educated in financial matters and no-one in particular seems to be taking responsibility for improving awareness and knowledge. Who should pay for such an educational programme?

Suitability is usually at the heart of a complaint with risk at the centre of suitability. Misleading literature or wrong advice cause the majority of problems whereby the wrong instrument has been sold to the wrong person.

The surge of endowment mortgage and pension transfer complaints has largely abated and precipice bond and splits cases are nearing completion; there are no major potential problems on the horizon. It was hoped that regulation will prevent repeats of previous problems. Although further issues can be expected, they will hopefully not be on the same scale as in the past.

Investment complaints are very much driven by returns and although the ombudsman would not decide on performance alone, it is often poor market conditions that reveal suitability problems which might otherwise have remained hidden. Exit charge complaints have diminished since markets have generally improved and such penalties have reduced or ceased altogether. Market volatility

tends to reduce investment volume but periods of better performance can inspire investment, thus sowing the seeds for future complaints.

There has been a change in product construction, eg instruments which guarantee capital whilst risking return, rather than products which offered return with capital at risk.

This led to an interesting debate on terminology; Caroline maintained that industry 'nicknames' for products (such as *'precipice bond'*) may lead to different emphasis and risk awareness than more formal descriptions (such as 'structured *capital at risk* product'). In Australia *spread betting* is a more apt description than *contracts of difference*. Merely by including *'betting'* in the title, the customer is reasonably alerted to the nature of the investment and thus may be inclined to raise questions about its suitability and appropriateness.

In future, whilst recognising the potential for future problems, firms will be less likely to sell higher risk plans to lower risk customers and it was hoped that financial promotions will provide a greater balance between risk and reward. Regulatory initiatives such as Principles Based Regulation, Treating Customers Fairly and the Retail Distribution Review, should all make a difference to the way consumers are dealt with and how products are presented and sold.