



FINANCIAL  
SERVICES  
COUNCIL

# Establishing a Compensation Scheme of Last Resort Discussion Paper

FSC submission

February 2020



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## 1 About the Financial Services Council

The Financial Services Council (**FSC**) is a leading peak body which sets mandatory Standards and develops policy for more than 100 member companies in one of Australia's largest industry sectors, financial services.

Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies. Our Supporting Members represent the professional services firms such as ICT, consulting, accounting, legal, recruitment, actuarial and research houses.

The financial services industry is responsible for investing \$3 trillion on behalf of more than 15.6 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange and is the fourth largest pool of managed funds in the world.

## 2 Introduction

The FSC welcomes the opportunity to make a submission to the discussion paper on the establishment of a Compensation Scheme of Last Resort (**CSLR**).

### 2.1.1 A balanced approach to CSLR design

The FSC supports a strong and competitive financial services industry which provides consumer confidence and has the appropriate consumer protections.

The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (**Financial Services Royal Commission**) Final Report (**Final Report**) Recommendation 7.1 supported the establishment of a CSLR to ensure that consumers are compensated for losses where an EDR scheme, Tribunal or Court finds there has been misconduct by a Financial Services Provider (**FSP**) and makes an award in their favour.

### ***A targeted CSLR with Sector Specific Funding and no cross-subsidisation***

In establishing a CSLR the FSC supports a targeted 'mid-coverage'<sup>1</sup> scheme which includes the sectors which have historically had unpaid determinations, namely financial advice, investments and credit. The targeted CSLR should be funded solely by the sector responsible for the unpaid determinations via Sector Specific Funding. Sector Specific Funding should take into account the historical experience of unpaid determinations (that is, whether or not and if so the extent of, historical unpaid determinations in that sector) to identify appropriate funding requirements for each sector, until a fulsome risk-based funding approach can be implemented in the CSLR.

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<sup>1</sup> As referred to in the Establishing a Compensation Scheme of Last Resort Discussion Paper.

## Sector Specific Funding;

- should be deep enough to meet estimated costs including expected variability across different periods;
- does not require cross-subsidisation from other financial services sectors, each sector pays for its respective losses having regard to if there have been, and if so the extent of, any historical unpaid determinations in that sector (e.g. the advice sector pays for advice losses); and
- has the benefit of accountability and responsibility which were very strong objectives of the Financial Services Royal Commission Final Report. This requires each sector to be responsible and accountable to fund that particular sector's experience of, and expected<sup>2</sup>, unpaid determinations whilst at the same time incentivising it to raise standards and address the underlying issues leading to unpaid determinations.

To facilitate Sector Specific Funding and ensure that the CSLR is sustainable it is essential that the outstanding regulatory gaps in the advice licensing regime are addressed, particularly relating to professional indemnity insurance (PI insurance) and capital requirements – see Section 2.1.2 below. This includes capital adequacy requirements for advice licensees (with appropriate transition periods) as well as improved PI insurance arrangements. Current cash needs requirements set out by ASIC only require sufficient cash to meet 12 weeks of liabilities.<sup>3</sup>

The CSLR must also have balanced and sustainable design principles which have the right caps and funding from the outset to limit the need for unexpected levies on each relevant sector (having regard to the historical and expected unpaid determinations in that sector). It should also include a mechanism for 'future proofing' the scheme through regular reviews of the CSLR, with analysis of what is contributing to the underlying consumer claims and unpaid determinations and provides recommendations for changes to reduce future reliance on the CSLR.

### **General Levy Resilience Reserve**

As noted earlier, the FSC strongly encourages the CSLR scheme to have appropriate and sustainable design principles that involves Sector Specific Funding without cross-subsidisation. If the CSLR is designed in such a way that a specific sector is unable to fund potential losses it may suggest that the CSLR is overly generous, and the compensation limits for each claim within the CSLR is too high, or the underlying risks (of failing to meet or being unable to meet awarded determinations) associated with a particular sector have not been addressed. Regulatory gaps need to be addressed as a matter of priority.

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<sup>2</sup> "expected" is referred to in a probability sense, which would have regard to *historical* unpaid determinations and the probability of future unpaid determinations.

<sup>3</sup> See Base level financial requirements are set out in ASIC Regulatory Guide 166: Licensing Financial Requirements at pages 16-20.

Further, a move to cross-subsidisation would be inconsistent with the Future of Financial Advice Reforms and the objectives of the Royal Commission to foster accountability and put in place consequences. Given the data on historical unpaid determinations, any cross-subsidisation of the CSLR would likely result in product, or other financial services sectors, cross-subsidising advice which the reforms, as well as the Royal Commission recommendations, have been designed to move away from.

If the Government is worried about capacity issues within a given financial services sector to meet extremely large losses and makes a decision to implement a cross-subsidised CSLR, then any broader general levy should be funded by all AFCA members and needs to be minimised to the greatest extent possible. A general levy should be intended to be a resilience reserve (**General Levy Resilience Reserve**) which would act as a backstop to Sector Specific Funding.

It would be expected that a General Levy Resilience Reserve would;

- be based on a simple risk-based funding approach at a financial services class level – requiring the sectors with the greatest risk of not meeting determinations to make higher funding contributions to the reserve and those sectors with a history of paying all determinations being required to contribute less;
- be built up over time up to a certain level. Once that certain level is achieved then the need to levy across AFCA members on a cross-subsidised basis would cease;
- not operate as a first point of call when annual levies from Sector Specific Funding have been exhausted. In the normal course, the CSLR should increase the levy for the relevant sector where the Sector Specific Funding has been exhausted and other methods of raising or rationing funds have been considered and exhausted first; and
- be such that the use of the General Levy Resilience Reserve is minimised to the greatest extent possible and should only be called upon for significant unexpected losses or events where the requisite funding is, on judgment, beyond the capacity of a sector.

If the CSLR adopts a General Levy Resilience Reserve or implements a cross-subsidised funding approach then it is even more important that the Government commit to addressing the advice licensing regulatory gaps.

### 2.1.2 Ensuring the scheme is viable by addressing regulatory gaps

Whilst we understand that Treasury does not intend to review the advice licensing regime at present, the FSC maintains the view previously expressed to Treasury that the best consumer protection, to reduce the risk of an unpaid advice determinations, and to ensure a sustainable and viable CSLR is to strengthen the regulatory licensing settings for Advice Licensees. This includes:

- greater oversight of PI insurance requirements by ASIC; and
- introducing appropriate capital requirements for advice licensees.

We note that current cash needs requirements set out by ASIC only require sufficient cash to meet 12 weeks of liabilities.<sup>4</sup>

This latter measure of introducing appropriate capital requirements need not result in prudential supervision. Rather it can simply require minimum cash or liquid capital requirements as part of licence conditions. These assets are then available to meet any consumer claims. This can be built up over time to streamline the introduction of such requirements.

If an FSP has insufficient funds to meet the excess on their PI insurance relating to one or more compensation claims, it is strongly arguable that the entity is in breach of existing financial services laws. There however is no specificity in ASIC regulatory guidance or licensing conditions to link minimum asset/cash requirements with PI insurance excess amounts. Nor does it seem that consideration of these issues is a focus of ASIC in terms of its oversight of the advice industry, for example, whether financial services licensees are providing services efficiently, honestly and fairly, or are failing to have adequate cash or other liquid reserves to meet claims.

We consider that ASIC needs to provide focus to these issues and should review the suitability of existing regulatory guides.

### 2.1.3 FSC Recommendations

The FSC makes the following recommendations in relation to the CSLR:

**Recommendation 1:** Sector Specific Funding - The FSC supports CSLR funding being designed to be sector independent, such that there are no cross-subsidies and each sector pays for their respective CSLR sector costs. For example, all businesses offering financial advice would pay for the unpaid determinations relating to financial advice. Where a sector has paid all determinations this should be reflected in the outcome of the Sector Specific Funding.

**Recommendation 2:** If there is no cross-subsidisation across financial services sectors, the CSLR should be targeted and cover the three sectors where unpaid determinations have historically arisen, namely financial advice, investments and credit (referred to as the 'mid coverage' approach in the Discussion Paper).

**Recommendation 3:** Whilst not the subject of the CSLR consultation, the FSC maintains the view previously expressed to Treasury that the Advice Licensing regime should be strengthened to reduce the risk of unpaid determinations and remove any need to contemplate cross-subsidisation in the CSLR.

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<sup>4</sup> See Base level financial requirements are set out in ASIC Regulatory Guide 166: Licensing Financial Requirements at pages 16-20.



**Recommendation 4:** General Levy Resilience Reserve - If the Government proceeds with a cross-subsidised CSLR, the FSC supports Broad Coverage approach to the CSLR which covers all the activities and FSPs that are required to hold AFCA membership. However, such cross-subsidisation should operate as a General Levy Resilience Reserve that is minimised to the greatest extent possible and would act as a backstop (as a last resort after all other means of funding or rationing unpaid determinations have been exhausted) to Sector Specific Funding as further detailed in Recommendation 13.

**Recommendation 5:** When considering the types of Court and Tribunal claims payable by the CSLR in the post implementation review, it is important that these claims are linked to the AFCA Terms of Reference and that the claim relates to an FSP which is an AFCA member.

**Recommendation 6:** The FSC supports a comprehensive risk-based funding approach at an individual firm level being considered by the Government as soon as reasonably practical, as part of the periodic review of the CSLR. The CSLR should collect sufficiently detailed information about the profile of each firm from the outset and the reason for the unpaid determination to enable it to develop a risk-based funding approach in future.

**Recommendation 7:** The FSC supports the CSLR having Sector Specific Funding utilising a simple risk-based funding approach at a **financial services class level** at the outset, requiring those sectors with the greatest risk of unpaid determinations having higher funding costs so as to self-fund sector specific losses. The corollary should apply to sectors which have the lowest or negligible risk of unpaid determinations.

**Recommendation 8:** CSLR administration costs should not be risk-based at the outset and should be:

1. equally funded by each financial services sector within the CSLR; and
2. equally across all financial firms within each sector.

**Recommendation 9:** At commencement of the CSLR, the FSC supports an ASIC levy funding approach being utilised, with a risk-based funding approach at the FSP level to be developed as soon as reasonably practical.

**Recommendation 10:** Advice related CSLR costs should be shared equally on a per adviser basis, such that each of the approximately 23,000 advisers pays the same CSLR related fee.

**Recommendation 11:** The scheme should not be developed based on assessing each individual FSP's ability to pay but rather through a general and broad-based assessment of whether the proposed cost imposition on each FSP is reasonable.

**Recommendation 12:** To meet unexpected costs, in the ordinary course, the CSLR should seek an additional levy from the relevant sector where the Sector Specific Funding has been exhausted. Other mechanisms to address unexpected costs can involve further caps on claims, spreading claims over several years and the CSLR going into deficit.



**Recommendation 13:** Funding and cross-subsidisation (if such a model is adopted) rules for the CSLR should operate as follows:

1. CSLR losses are funded by the relevant sector via Sector Specific Funding.
  - a. This should be sufficiently deep to meet the expected costs as well as meet volatility in unpaid determinations that will arise from time to time.
2. Depending on the size of the losses the Government should also consider:
  - a. The CSLR spreading amounts to be paid to consumers, via instalments, over a period of time; and
  - b. Imposing additional lower compensation limits if there is a large failure. This limit would be set at a lower level than the regular claim limit.  
2 a) and b) are interchangeable and not set out in order of priority. The Government may wish to use either or both of these options at the same time depending on the scale/size of the unexpected loss.
  - c. Finally, and after the first two options have been exhausted, additional levies are raised from the relevant sector (which is the source of the unpaid determinations) via Sector Specific Funding.

Decisions relating to 2 a)-c) should be made by the Government or alternatively based on very clear and specific parameters set in advance by the Government and implemented by the CSLR (with the CSLR having limited discretion), regarding how unexpected costs are funded or dealt with in each of the respective circumstances.

3. Once option 2 has been utilised and it is deemed the funding requirements are beyond the capacity of a sector, the General Levy Resilience Reserve is utilised (cross-subsidisation commences).
4. Treasury should undertake further consultation on the specific parameters relating to the unexpected costs before finalisation of the CSLR.

**Recommendation 14:** Initially, there should be a firm-level cap on CSLR levies until a risk based funding model at the individual FSP level is adopted. We would like to work with Treasury on how a firm level cap may operate. We would be seeking an equitable and proportionate approach for the cap that does not unfairly advantage small or large businesses.

**Recommendation 15:** Additional levies on FSPs to cover a potential CSLR deficit should only be a last resort funding mechanism and should be imposed by decision of the Government or specific parameters set in advance by the Government and implemented by the CSLR.

**Recommendation 16:** The CSLR compensation limits should be set at a maximum of \$150,000 per claim per firm.

**Recommendation 17:** There should be periodic reviews of the CSLR to assess the cost of the CSLR and whether compensation limits are appropriate having regard to the types of claims and FSP risk factors giving rise to unpaid determinations.

**Recommendation 18:** The Government should have the power to allow the CSLR to spread compensation payments over an appropriate period of time, with the limit on the period to be set by the Government, or alternatively should set specific parameters in advance which are then implemented by the CSLR.

**Recommendation 19:** The Government should have the power to impose additional lower compensation limits if there is a large failure. This limit would be set at a lower level than the regular claim limit.

**Recommendation 20:** The CSLR should not pay professional or claims management fees as the scheme is freely accessible, and this is in line with the approach of the UK FSCS.

**Recommendation 21:** The Government should undertake periodic reviews of the CSLR.

**Recommendation 22:** FSPs need to have a continuing obligation to provide information to AFCA in relation to new complaints against the firm to enable AFCA to be properly informed in making a finding.

**Recommendation 23:** An FSP that is unable or unwilling to pay the AFCA determination which is paid out by the CSLR should promptly have their financial services licence cancelled by ASIC.

**Recommendation 24:** It is recommended that Treasury analyse, before the CSLR becomes operational, the unpaid determinations to understand the behaviours and drivers that lead to the unpaid determinations.

**Recommendation 25:** The CSLR should provide regular updates and complete transparency in relation to unpaid determinations, the CSLR levy/money raised and spent, the basis for calculating levies and how much is raised/incurred by each sector, including by reference to the proportion of unpaid determinations sourced from each sector, to give consumers and industry confidence in the CSLR.

**Recommendation 26:** The FSC recommends that Treasury provide a proposed CSLR funding model which the financial services industry can provide feedback on before the CSLR funding model is finalised.

## 3 Discussion Questions

### 3.1 What is the appropriate coverage for the CSLR, beyond the provision of personal advice?

The rationale for a CSLR is to compensate affected consumers where an FSP has an award made against it in a consumer's favour, but is unable to satisfy that award given lack of financial capacity or legal incapacity (such as liquidation or some other form of administration).

As such it makes sense to have a CSLR which covers the sectors which have historically resulted in unpaid determinations, namely financial advice, investments and credit. This is referred to as the 'mid coverage' approach in the Discussion Paper.

### 3.1.1 Sector Specific Funding with no cross subsidy

When considering what is the appropriate coverage of the CSLR however, an important and relevant consideration is how the scheme will be funded.

The FSC considers the CSLR funding should be sector independent, such that there are no cross subsidies across financial services sectors via Sector Specific Funding. The firms engaged in the types of financial services covered by the CSLR should fund the losses within their relevant sector without any cross-subsidisation (for example, businesses offering financial advice pay for unpaid determinations relating to financial advice but are not required to fund unpaid determinations relating to credit). This approach provides the relevant sector, and firms within the sectors, with the interest and incentive to review regulatory settings and make changes to raise standards and reduce the risk of claims within their relevant sector.

For example, if there are large unpaid advice losses arising from the financial advice sector, such that participants in the sector are liable to meet the relevant costs, those same participants may be inclined to support the strengthening of the advice licensing regime, such as requesting greater (or even minimum) capital and financial requirements before a provider is licensed to provide retail financial advice.

The FSC does not support cross-subsidies. Allowing for cross-subsidies would increase the moral hazard inherent in the CSLR, because there is no accountability and no incentive for participants in the relevant sector to remedy the issue and perform to a better standard.

This would therefore increase the likelihood of claims and in turn potentially increase the cost of the CSLR.

**Recommendation 1: Sector Specific Funding** - The FSC supports CSLR funding being designed to be sector independent, such that there are no cross-subsidies and each sector pays for their respective CSLR sector costs. For example, all businesses offering financial advice would pay for the unpaid determinations relating to financial advice. Where a sector has paid all determinations this should be reflected in the outcome of the Sector Specific Funding.

If there are to be no cross-subsidies within the CSLR, the FSC supports having a targeted scheme which covers the three sectors where unpaid determinations have historically arisen. This would provide consumers with a safety net and would also provide an equitable funding approach, as far as is possible, where each sector is self-funding for unpaid amounts.

An industry funded CSLR by definition results in a level of cross-subsidisation by those who are well resourced to fund those who are not. However, if each sector is solely responsible for funding claims in its sector, this is a more equitable funding approach under a CSLR. The sector responsible for the claims has the collective responsibility to pay for that sector's related losses and has the incentive and influence to raise standards within the sector in order to reduce the risk of future claims in the sector.

**Recommendation 2:** If there is no cross-subsidisation across financial services sectors, the CSLR should be targeted and cover the three sectors where unpaid determinations have historically arisen, namely financial advice, investments and credit (referred to as the 'mid coverage' approach in the Discussion paper).

Separately, we consider there would be value in clarifying the exact meaning of the coverage terms, in particular what 'investments' means.

To ensure that the relevant sectors are able to self-fund their CSLR related costs it is important to have the appropriate regulatory settings in relation to each sector to reduce the risk of unpaid determinations. Whilst we understand that the CSLR consultation is not currently reviewing or seeking to strengthen the advice licensing regime, we maintain the position set out in section 2.1.2 that strengthening the regulatory settings for advice licensees is not only the best way to avoid the need for cross-subsidisation but also the most important mechanism for limiting excessive costs in a future CSLR and most importantly, ensuring determinations are paid in the first instance without the need to resort to a CSLR.

**Recommendation 3:** Whilst not the subject of the CSLR consultation, the FSC maintains the view previously expressed to Treasury that Advice Licensing regime should be strengthened to reduce the risk of unpaid determinations and need for cross-subsidisation in the CSLR.

### 3.1.2 General Levy Resilience Reserve - only in the event that no cross subsidy is achievable

Our members have raised concerns about the inclusion of both superannuation and life insurance funds in the CSLR on the basis that these entities are prudentially regulated, so present far lower to limited risk of non-payment of claims, and are two sectors which have not contributed to the unpaid determinations.

In relation to superannuation funds it is worthy of note that Part 23 of the SIS Act also provides financial assistance to superannuation funds where they have suffered loss due to fraud or theft. In addition, superannuation funds are required to maintain an Operational Risk Financial Reserve (**ORFR**). If the CSLR levy is not a component of the ORFR, the CSLR levy becomes an additional cost to members for no benefit to them and a significant capital obligation for funds.

As noted in Recommendation 3 the FSC does not support cross-subsidisation across financial services sectors to fund CSLR losses. It would hide problems which must be addressed. The moral hazard of applying a general socialised fee would not achieve the Government's or the Royal Commission's objectives of accountability and responsibility. Our primary position is that there should be no cross-subsidisation of sectors and that there be mid-coverage targeted CSLR.

Increased regulatory costs arising from the CSLR are likely to increase the cost of offering products and services and thus are ultimately likely to result in higher costs for consumers. A cross-subsidised scheme may result in double or triple counting for consumers.

Take for example two situations. First, where a consumer has an adviser that recommends an APRA regulated superannuation fund that in turn invests in one or more managed investment products and second, where a consumer without an adviser has an account with a superannuation fund that invests directly into the stock market.

The first member will pay three times under a broad model (e.g. through increased costs for financial advice, increased costs via superannuation and life insurance products), whereas the second member only pays once.

Given the consumer cost implications arising from a CSLR the Government has the responsibility to ensure that;

- CSLR payments are not overly generous and that the scheme is sustainable not only in the ordinary or average claim years but also in the years where there are large unexpected losses;
- the CSLR is truly last resort and the regulatory weaknesses in the advice licensing regime are strengthened by introducing appropriate capital requirements for advice licensees (which can be introduced with appropriate transition periods) and having greater ASIC oversight of professional indemnity insurance requirements for advice licensees. This is essential to reducing the risk of future unpaid determinations arising from financial advice.

If the Government is concerned about capacity issues within a given financial services sector to meet extremely large losses and decides to proceed with a cross-subsidised CSLR however, the FSC considers a cross-subsidised model adopt the following:

The 'Broad Coverage' approach referred to in the Discussion Paper which covers all the activities and FSPs that are required to hold AFCA membership. A Broad Coverage approach is more equitable than a mid-coverage approach, requiring all sectors to help to contribute to the cross-subsidies than merely the narrower group of sectors which are subject to the mid coverage CSLR.

If cross-subsidisation is utilised, it should only apply to a broader general levy funded by all AFCA members where it is intended to be a resilience reserve, referred to as the General Levy Resilience Reserve, which would act as a last resort backstop to Sector Specific Funding.

It would be expected that the General Levy Resilience Reserve would;

- be based on a simple risk-based funding approach at a financial services class level – requiring the sectors with the greatest risk of not meeting determinations to make higher funding contributions to the reserve and those sectors with a history of paying all determinations being required to contribute less
- be built up over time up to a certain level. Once that certain level is achieved then the need to levy across AFCA members on a cross-subsidised basis would cease;

- not operate as a first point of call when annual levies from Sector Specific Funding have been exhausted. In the normal course, the CSLR should increase the levy for the relevant sector where the Sector Specific Funding has been exhausted and other methods of raising or rationing funds have been considered and exhausted first; and
- be such that the use of the General Levy Resilience Reserve is minimised to the greatest extent possible and only be called upon for significant unexpected losses or events where the requisite funding is, on judgment, beyond the capacity of a sector.

If the CSLR adopts a General Levy Resilience Reserve or implements a cross-subsidised funding approach then the Government must also commit to addressing the advice licensing regulatory gaps.

**Recommendation 4:** General Levy Resilience Reserve - If the Government proceeds with a cross-subsidised CSLR, the FSC supports a Broad Coverage approach to the CSLR which covers all the activities and FSP's that are required to hold AFCA membership. However, such cross-subsidisation should operate as General Levy Resilience Reserve that is minimised to the greatest extent possible and would act as a backstop (as a last resort after all other means of funding or rationing unpaid determinations have been exhausted) to Sector Specific Funding, as further detailed in Recommendation 13.

### **3.2 Would there be any unintended consequences from initially excluding court and tribunal decisions or from excluding voluntary members of AFCA from the CSLR?**

As the discussion paper identifies, data is not available on the potential exposure of unpaid awards from Court and Tribunal decisions. Without this information there is no information as to the types of awards made and the potential size and implications of including these awards would have on a compensation scheme of last resort. The FSC therefore supports initially excluding Court and Tribunal decisions from the CSLR. Further it is the FSC's position that as part of the development of the CSLR, the Government should collect and release improved data on this issue and issues relating to unpaid determinations (see discussion in Section 4.4 below).

The FSC supports the following approach outlined in the discussion paper:

- in order to establish the scheme by December 2020, at commencement the CSLR will only pay compensation in relation to unpaid determinations made under AFCA's rules; and
- that consideration will be given to the inclusion of compensation awarded by Courts and Tribunal on a forward-looking basis three years after the CSLR establishment in the context of a post implementation review.

We also consider there would need to be a mechanism to avoid double dipping, so that if a person first seeks an award from AFCA but is unsuccessful, they are not able to try a second time in Court. It is not clear if the Courts would reject such a claim.

### 3.2.1 Court and Tribunal Decisions and the Post Implementation Review

When considering the types of claims payable from a Court or Tribunal in the post implementation review, it is important that these claims are linked to the AFCA Terms of Reference and that the FSP is an AFCA member.

This is consistent with the approach recommended by the Financial Ombudsman Service (FOS), an AFCA predecessor. The FOS stated that Court awards could be included in a CSLR “as long as it is consistent with EDR jurisdictional limits at the time of the award”<sup>5</sup> by:

*“aligning the claims limit and compensation to the prevailing EDR jurisdictional caps and limits. This would mitigate against exposure for claims beyond the EDR jurisdiction and potential cost increases, providing more certainty around the funding pool for the compensation scheme of last resort.”<sup>6</sup>*

For example, a judgment relating to the provision of poor financial advice which was successfully obtained from a court, but remains unsatisfied, could be considered by the CSLR. However, the amount which could be paid by the CSLR would be determined in accordance with the monetary limits of the CSLR. The CSLR could make this payment as the subject of the claim was a subject which was within AFCA’s terms of reference.

For example, if the court gave judgment in the sum of \$1 million in favour of a claimant for the provision of negligent advice and the CSLR has a maximum payment limit of \$150,000, then the claimant would be paid \$150,000 from the CSLR, as this would be consistent with the maximum amount the CSLR may award. This approach avoids creating two classes of claimant and there would be no differential treatment in compensation amounts based on the avenue in which the claim was pursued.

### 3.2.2 Example where compensation towards an unpaid award from a court decision would not be payable under the CSLR

Non-financial services related issues should be excluded from the CSLR. For example, a Court judgment in favour of an individual for defamation against an FSP would not be covered under AFCA’s Terms of Reference and should be excluded from the scope of the CSLR. Accordingly, if a judgment for defamation remains unsatisfied no claim could be brought under the CSLR.

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<sup>5</sup> Page 9, FOS (2017) [Review of the financial system external dispute resolution framework - FOS response to Supplementary Issues Paper](#)

<sup>6</sup> Page 11, FOS (2017) [Review of the financial system external dispute resolution framework - FOS response to Supplementary Issues Paper](#).



Further, we would expect that only Court or Tribunal judgments or findings against an FSP that is a member of AFCA would be covered by the CSLR. This is because it is FSPs that are AFCA members that help contribute to the cost of the scheme. Negligence or wrongdoing by unlicensed or unregulated entities who are not AFCA members should not be covered by the CSLR.

This is consistent with the approach in the United Kingdom (**UK**) where access to the Financial Services Compensation Scheme (**FSCS**) in relation to a firm in default must be in connection with a regulated activity that the FSCS covers (*e.g. advising on designated investments*).<sup>7</sup>

**Recommendation 5:** When considering the types of Court and Tribunal claims payable by the CSLR in the post implementation review, it is important that these claims are linked to the AFCA Terms of Reference and that the claim relates to an FSP which is an AFCA member.

### 3.3 To what extent should the funding model be based on risk?

#### 3.3.1 Risk-based funding model

The FSC agrees with the view that a robust and well considered risk-based funding model, including detailed risk assessment at the individual firm level, is the preferred approach to funding the CSLR. We note, however, that establishing a risk-based model at the individual firm level from the outset would have its challenges due to a lack of suitable data. That said, the FSC submits that moving to a risk-based model at the firm level should be considered and planned for from the commencement of the CSLR by collecting and analysing suitable data as soon as possible.

The administrative costs of running the CSLR, including calculating the funding requirements for FSPs and sectors, should be efficient and proportionate to the size of the scheme. Implementing risk-based funding at the outset would come at substantial administrative cost, and it would be unreasonable if administration costs in running the CSLR are equivalent to or exceed the total amount of unpaid determinations. Therefore, it is more appropriate to develop and implement a comprehensive risk-based model once suitable data is available.

In order for the CSLR to move towards a risk-based funding model in the future sufficient relevant data on the types of FSPs and the reasons for unpaid determinations should be collected from the outset, and the Government and CSLR using the data should develop a risk profile of FSPs to establish a more comprehensive risk-based funding model.

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<sup>7</sup> See the following link for more information - <https://www.fscs.org.uk/news/protection/summary-note-basis-lcf-claims/>

**Recommendation 6:** The FSC supports a comprehensive risk-based funding approach at an individual firm level being implemented by the Government as soon as reasonably practical, as part of the periodic review of the CSLR. The CSLR should collect sufficiently detailed information about the profile of each firm from the outset and the reason for the unpaid determination to enable it to develop a more comprehensive risk-based funding approach in future.

### 3.3.2 Support for a simple risk-based funding model at financial services class level

It is the FSC's position that a simple risk-based funding model at the financial services class level can be implemented from commencement of the CSLR.

The discussion paper notes that the complexity and regulatory cost may be reduced if the funding model reflected risk at a financial services class level rather than at a financial firm level such that all firms authorised to provide a higher risk financial service (e.g. all firms providing personal financial advice) would be attributed the same higher risk weight in the funding model.

The FSC strongly supports having **Sector Specific Funding** utilising a simple risk-based funding model from commencement which takes into account the potential risk of each financial services class and the likely costs to enable each sector to self-fund CSLR costs. This is consistent with our position that there should not be cross-subsidisation between sectors.

For example, historical unpaid determination data has shown that the largest proportion of unpaid determinations arises from financial advice. Therefore, in order to have sector independent funding, it is envisaged that more funding will need to be raised from the financial advice sector than (say) the investment sector (or APRA regulated entities) to enable each sector to pay for its respective CSLR scheme costs (and where a sector has no unpaid determination their contribution to the scheme costs should reflect this).

**Recommendation 7:** The FSC supports the CSLR having Sector Specific Funding utilising a simple risk-based funding approach at a **financial services class level** at the outset, requiring those sectors with the greatest risk of unpaid determinations having higher funding costs so as to self-fund sector specific losses. The corollary should apply to sectors which have the lowest or negligible risk of unpaid determinations.

This is reflective of the principle that each sector should be responsible for funding unpaid determinations and taking proactive steps to prevent such unpaid determinations in the future.

### 3.4 How should risk be assessed?

Initially, risk should be assessed based on data available from historical unpaid determinations for the financial services class level.

From commencement the CSLR should collect and analyse data to determine the best and most efficient way to move towards a funding model based on risks at the individual firm level.

In assessing sector-based risk, the implicit presumption has been, for example, that all investment products have similar risk of calling on the CSLR, similarly for financial advice and other sectors covered by the CSLR. However, it is arguable that some investment products are more likely to generate claims than other products and certain types of advice are more likely to generate claims. Therefore, there should be consideration of the value of assessing sector-based risk at a more finely grained level.

### **3.5 Should the funding model assess risks at the individual financial firm level or at the financial service class level?**

As is outlined in section 3.3 the simple risk-based funding model should be assessed at the financial service class level initially, to enable each financial service class to self-fund respective CSLR costs without cross-subsidisation from other classes.

In accordance with Recommendation 6 (outlined in Section 3.3), the CSLR should from commencement collect sufficiently detailed and relevant information from each FSP requiring CSLR support, to enable a risk-based funding at the firm level to be developed.

If there is not a longer-term move to risk based funding at the firm level, then the CSLR costs will continue to be disproportionately imposed on low risk FSPs while higher risk FSPs will avoid paying the costs they impose on the scheme. If low risk FSPs are required to continually fund the failings of higher risk FSPs it is likely that low risk FSPs will need to unduly increase their service costs to their customers which in turn could result in consumers moving towards higher risk FSPs, which will further increase the costs of the CSLR and exacerbate the moral hazard problems inherent in the CSLR.

### **3.6 Should a risk-based funding model apply to all CSLR costs?**

The FSC considers the CSLR administration costs should not be risk-based at the outset and should be equally funded by each financial services sector within the CSLR and each FSP within the sector. This would enable administration costs to be equitably shared across all FSPs subject to the CSLR.

**Recommendation 8:** CSLR administration costs should not be risk-based at the outset and should be:

1. equally funded by each financial services sector within the CSLR; and
2. equally across all financial firms within each sector.

A contrary view to this position is that those FSPs who are larger, and potentially have greater financial resources, should fund more of the CSLR administration costs. An important point however noted in the Discussion Paper is that prudentially regulated entities, which are often larger FSPs, are at a lower risk of leaving a consumer or small business with unpaid determinations.

Further, we understand this also to be the case in relation to financial advice related unpaid determinations within FOS which have tended to come from smaller advice licensees. The Discussion Paper also recognises that larger organisations are likely to present less risk to the scheme; noting that a risk-based approach will likely show a [negative<sup>8</sup>] correlation between risk and FSP size.

Once a risk based funding model is developed in future, the administration costs should also be risk based.

### 3.7 To what extent should the funding model be based on a firm's ability to pay?

#### 3.7.1 ASIC levy funding approach

The CSLR should be funded based on risk. Each FSP should ensure it has the ability to meet its financial obligations including compensating its customers for any failings if and when required. The CSLR will provide a safety net for consumers however proactive measures should be implemented at the same time to reduce the rate of unpaid determinations in the future. With this in mind an established and simple funding approach could be utilised at the outset such as the one used to fund the ASIC levy. This is a funding approach which is already in place in the industry and spreads the cost across financial services classes and across participants.

The ASIC levy uses a minimum levy plus cost per adviser/AUM, meaning that larger FSPs pay more than smaller FSPs.

While a genuine risk-based funding approach is likely to show that larger FSPs present less risk to the CSLR and arguably should pay less, the FSC supports initially adopting an approach similar to the ASIC levy funding, with a risk-based funding approach at the FSP level to be adopted once practically possible – in particular, once the CSLR has sufficient data to enable such a model to be adopted.

**Recommendation 9:** At commencement of the CSLR, the FSC supports an ASIC levy funding approach being utilised, with a risk-based funding approach at the FSP level to be developed as soon as reasonably practical.

Examples of how the ASIC levy works

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<sup>8</sup> While not explicitly stated in the discussion paper, follow up conversations with Treasury on 22 December 2019 noted that the risk-based approach is likely to show a negative correlation between risk and financial firm size where larger firms have lower risk and smaller firms have a higher risk of unpaid determinations.

Financial advice sector	Revenue	Number of advisers	Number of days authorised	Levy
Licenses that provide personal advice to retail clients on relevant financial products	\$25.031m	2,985	Adjusted number of advisers on the financial advisers register and number of days authorised	Minimum levy of \$1,500 plus \$907 per adviser
Licenses that provide personal advice to retail clients on products that are not relevant financial products	\$1.232m	649	Number of days authorised	\$1,958
Licenses that provide general advice only	\$0.836m	1,012	Flat levy	\$828
Licenses that provide personal advice to wholesale clients only	\$0.855m	1,511	Flat levy	\$566

### 3.7.2 All advisers pay the same individual cost

From a financial adviser perspective, we consider that the advice related CSLR costs should be shared fairly and equally on a per adviser basis, across the approximately 23,000 advisers providing personal advice to retail customers in relation to relevant financial products.

Notwithstanding the above position we note that this approach does however result in FSPs with more advisers paying more than the FSPs most likely to be the source of risk given that the history of unpaid determinations relating to advice indicates that it is the smaller/smallest FSPs that present the greatest risk of non-payment.

The Adviser Register can provide the CSLR with useful information source for confirming how many advisers there are and which FSP the adviser is licensed under.

We consider adviser numbers to be the suitable funding metric for financial advice CSLR levies, such that all advisers pay the same fee.

Revenue generated by a financial advice licensee or Assets Under Management are not particularly meaningful or useful metrics for financial advisers to share in CSLR advice related levies.

Note – we consider that all providers of financial advice should help to contribute to the advice related CSLR costs regardless of whether the financial advice is provided by a stand-alone financial advice firm or through a superannuation fund.

**Recommendation 10:** Advice related CSLR costs should be shared equally on a per adviser basis, such that each of the approximately 23,000 advisers pays the same CSLR related fee.

### 3.7.3 Product providers

We note that an approach similar to the ASIC Levy could be relatively easy to implement for the purposes of funding the CSLR at commencement given it would leverage an established framework and calculation methodology. One of the downsides of the ASIC levy approach however is that Assets Under Management (AUM) approach to financial products may have no bearing on the revenue of the FSP and it also fails to recognise that consumers of FSP's that are subject to stringent capital requirements (such as APRA regulated companies) are extremely unlikely to rely on the CSLR. Although the ASIC Levy approach is not perfect for the CSLR it is the FSC's position that an approach similar to the ASIC levy funding approach is the most pragmatic as the starting point for CSLR funding.

Investment management, superannuation and related services sector				
Superannuation trustees	\$13.725m	139	Adjusted total assets and number of days authorised	Minimum levy of \$18,000 plus \$7.34 per \$1 million of assets above the \$250m threshold
Responsible entities	\$29.621m	471	Adjusted total assets and number of days authorised	Minimum levy of \$7,000 plus \$22.04 per \$1 million of assets above the \$10m threshold
Wholesale trustees	\$10.828m	1,626	Adjusted total assets and number of days authorised	Minimum levy of \$1,000 plus \$18.18 per \$1 million of adjusted total assets
Operators of notified foreign passport funds	-	-	Adjusted total assets and number of days authorised	Minimum levy of \$1,000. Data not available to estimate graduated levy
Custodians	\$1.042m	1,023	Flat levy	\$1,018

### 3.8 How should ability to pay be assessed?

Funding of the CSLR should not be developed based on an assessment of each individual FSP's ability to pay but rather on the general and broad based assessment of whether the proposed cost imposition on each FSP is reasonable.

An assessment should be made to ensure the estimated costs of the CSLR are allocated to the financial services sectors according to the likely cost/risk of each sector, and then spread across industry participants within that sector. If the proposed costs on a sector and individual FSPs seem unreasonable then it seems likely that the proposed CSLR maximum amounts per claim are too high, suggesting the amounts need to be lowered to enable reasonable costs to be incurred by the industry whilst maintaining competition.

The FSC proposes this 'reasonableness-based' approach only be in place at the commencement of the scheme while the ASIC methodology is being utilised to apportion funding across relevant sectors. Once the scheme moves to a more comprehensive risk-based approach at the individual FSP level, the reasonableness approach should be removed so that the funding arrangement reflects the risk posed by industry participants.

**Recommendation 11:** The scheme should not be developed based on assessing each individual FSP's ability to pay but rather through a general and broad-based assessment of whether the proposed cost imposition on each FSP is reasonable.

### 3.9 What are suitable universally available metrics to assess a firm's ability to pay?

See response in 3.8 above.

### 3.10 How should the funding model address unexpected costs?

The FSC considers it prudent to pursue all appropriate measures for the CSLR to avoid having unexpected costs by setting in place the regulatory structure discussed in Section 2.1.2 above, including appropriate PI and capital requirements for advice licensees.

While historical unpaid determinations have been lower than \$5million we note that unpaid determinations did not consider claims which were not addressed by the respective EDR scheme because the FSP was in liquidation or no longer a member of the scheme. This suggests that costs could be higher under the CSLR than the historical unpaid determinations claims experience.



Sufficient funds should be raised from the relevant sectors (which sourced unpaid determinations) via the Sector Specific Funding to meet the costs of the sector with a sufficient buffer to fund volatility that is expected to occur over time. In the ordinary course, the CSLR should seek an additional levy from the relevant sector where the Sector Specific Funding has been exhausted. Other mechanisms to address unexpected costs are further caps on claims, spreading claims over several years, the CSLR going into deficit, and additional industry levies. These options are considered further in the remainder of this submission.

Following the utilisation of the other mechanisms and if, on judgment, the view is taken that the funding requirements exceed the capacity of the relevant sector then the General Levy Resilience Reserve would be utilised.

**Recommendation 12:** To meet unexpected costs, in the ordinary course, the CSLR should seek an additional levy from the relevant sector where the Sector Specific Funding has been exhausted. Other mechanisms to address unexpected costs can involve further caps on claims, spreading claims over several years and the CSLR going into deficit.

### **3.11 Is it better to avoid levy volatility or funds being tied up in a capital base that may not be often used?**

See response in 3.10 above.

### **3.12 If a CSLR capital base is to be established, what is a suitable minimum capital requirement?**

There is insufficient information available to determine what the appropriate minimum capital requirement should be. Treasury should determine the level based on considered financial modelling which takes into account historical unpaid determinations, likely volatility, claims caps and scheme design principles. We reiterate our earlier comments that the losses in the CSLR may be higher than the historical unpaid determinations experience. If levies are to be collected after the CSLR becomes aware of unexpected additional costs, how will financial firms manage this?

There is unlikely to be a uniform approach to this across all financial service firms, so the FSC has encouraged our members to provide direct feedback to the CSLR review on this issue.

In general, the FSC notes that firms are more likely to be able to manage the costs of the CSLR if the scheme is well designed and sustainable.

### **Funding and cross-subsidisation rules**

The FSC has noted its primary position earlier that it supports sector specific self-funding without cross-subsidisation from other sectors. If however, the Government proceeds with a cross-subsidised CSLR – we consider that the cross-subsidisation should only occur to meet large and unexpected costs in the form of a General Levy Resilience Reserve.



As noted in the introduction of this submission it is expected that the General Levy Resilience Reserve would;

- be based on a simple risk-based funding approach at a financial services class level – requiring the sectors with the greatest risk of not meeting determinations to make higher funding costs contribution to the reserve and those sectors with a history of paying all determinations being required to contribute less;
- be built up over time up to a certain level. Once that certain level is achieved then the need to levy across AFCA members on a cross-subsidised basis would cease;
- not operate as a first point of call when annual levies from Sector Specific Funding have been exhausted. In the normal course, the CSLR should increase the levy for the relevant sector where the Sector Specific Funding has been exhausted and other methods of raising or rationing funds have been considered and exhausted first; and
- be such that the use of the General Levy Resilience Reserve is minimised to the greatest extent possible and should only be called upon for significant unexpected losses or events where the requisite funding is, on judgment, beyond the capacity of a sector.

CSLR costs should be raised and utilised in the following order:

1. CSLR losses are funded by the relevant sector via Sector Specific Funding.
  - a. This should be sufficiently deep to meet the expected costs as well as meet volatility in unpaid determinations that will arise from time to time.
2. Depending on the size of the losses the Government should also consider:
  - a. The CSLR spreading amounts to be paid to consumers, via instalments, over a period of time; and
  - b. Imposing additional lower compensation limits if there is a large failure. This limit would be set at a lower level than the regular claim limit.2 a) and b) are interchangeable and not set out in order of priority. The Government may wish to use either or both of these options at the same time depending on the scale/size of the unexpected loss.
- c. Finally, and after the first two options have been exhausted, additional levies are raised from the relevant sector via Sector Specific Funding.

Decisions relating to 2 a)-c) should be made by the Government or alternatively based on very clear and specific parameters set in advance by the Government and implemented by the CSLR (with the CSLR having limited discretion), regarding how unexpected costs are to be funded or dealt with in each of the respective circumstances.

3. Once option 2 has been utilised and it is deemed the funding requirements are beyond the capacity of a sector, the General Levy Resilience Reserve is utilised (cross-subsidisation commences).
4. Treasury should undertake further consultation on the specific parameters relating to the unexpected costs before finalisation of the CSLR.

**Recommendation 13:** Funding and cross-subsidisation (if such a model is adopted) rules for the CSLR should operate as follows:

1. CSLR losses are funded by the relevant sector via Sector Specific Funding.

- a. This should be sufficiently deep to meet the expected costs as well as meet volatility in unpaid determinations that will arise from time to time.
2. Depending on the size of the losses the Government should also consider:
  - a. The CSLR spreading amounts to be paid to consumers, via instalments, over a period of time; and
  - b. Imposing additional lower compensation limits if there is a large failure. This limit would be set at a lower level than the regular claim limit.  
2 a) and b) are interchangeable and not set out in order of priority. The Government may wish to use either or both of these options at the same time depending on the scale/size of the unexpected loss.
  - c. Finally, and after the first two options have been exhausted, additional levies are raised from the relevant sector (which is the source of the unpaid determinations) via Sector Specific Funding.

Decisions relating to 2 a)-c) should be made by the Government or alternatively based on very clear and specific parameters set in advance by the Government and implemented by the CSLR (with the CSLR having limited discretion), regarding how unexpected costs are to be funded or dealt with in each of the respective circumstances.

3. Once option 2 has been utilised and it is deemed the funding requirements are beyond the capacity of a sector, the General Levy Resilience Reserve is utilised (cross-subsidisation commences).
4. Treasury should undertake further consultation on the specific parameters relating to the unexpected costs before finalisation of the CSLR.

### **3.13 Should a maximum cap apply to the annual levies that can be imposed on participating financial firms?**

On balance, the FSC considers an interim firm level cap on annual levies is appropriate until a risk based funding model at the individual FSP level can be adopted. We would be keen to work with Treasury on how a firm level cap may operate. We would be seeking an equitable and proportionate approach for the cap that does not unfairly advantage small or large businesses.

There are clear advantages in limiting the scheme costs. These ensure the scheme is sustainable, the industry remains competitive, and business has some degree of certainty. Limiting scheme costs would also help reduce the risk of the CSLR causing business failures, which would further exacerbate reliance on the CSLR (because a firm that fails due to the CSLR costs could in turn cause additional consumers seeking compensation via CSLR claims) and potentially cause a contagion effect.

There are various ways to do this, including firm-level caps on annual levies, but also designing the regulatory structure to limit claims by having adequate PI and capital requirements, imposing caps on individual claims, and further limiting claims when there are large unexpected costs.

If a firm-level cap is to be imposed, this needs to be designed carefully so that it does not just shift costs from the riskiest FSPs onto the least risky. This is because the most risky FSPs are likely to hit a cap sooner than the less risky FSPs, if the cap does not factor in risk. One way to address this issue could be to have the maximum cap take note of the risk of FSPs, once the overall scheme makes use of risk weighting, see discussion in Section 3.5 above.

We note a need for a firm-level cap is reduced if there is a cap on the total CSLR payments at a sector level, and there are no cross-subsidies. The sector cap effectively replaces the firm-level cap.

Whether or not a cap should be imposed on annual levies on an ongoing basis should be continually assessed as the scheme develops. The FSC therefore considers, on balance, that a firm-level cap should be implemented initially, until a risk based funding model at the individual FSP level can be adopted (see Section 3.3).

**Recommendation 14:** Initially, there should be a firm-level cap on CSLR levies until a risk based funding model at the individual FSP level is adopted. We would like to work with Treasury on how a firm level cap may operate. We would be seeking an equitable and proportionate approach for the cap that does not unfairly advantage small or large businesses.

### **3.14 If a maximum cap is imposed, what is an appropriate metric for this cap (for example, gross revenue from covered financial services)?**

The FSC does not have not adequate data at this stage to be able answer this question in any detail.

In the absence of relevant data, basing the maximum cap on the same base as the usual CSLR levy appears to have merit (see Section 0), but this approach should develop over time with experience of the CSLR. A maximum cap based on revenue, adviser numbers, or FUM should not be the long-term solution as it does not adjust for risk, and a maximum cap unadjusted for risk can just shift costs from the riskiest FSPs to the least risky (see response to question 14).

### **3.15 If a maximum cap is imposed, what should the maximum cap be?**

The FSC does not have not adequate data at this stage to be able answer this question in any detail. See answer to question 15.

### **3.16 If a maximum cap is imposed, what mechanisms should the CSLR have to avoid going into deficit (for example, an ability to raise further levies from financial firms that are yet to reach the maximum cap and/or to further limit compensation so that expenditure is kept under the effective annual maximum for the scheme)?**

The FSC considers the best way to ensure the CSLR does not go into deficit is to have a well-designed scheme from the outset that means this situation does not occur in the first place. This includes ensuring advice FSPs have adequate PI insurance and capital requirements so consumers are less likely to need to rely on the CSLR.

Having appropriate caps on individual CSLR claims is also important. See Section 3.17 below.

If, despite these policies, it appears that the CSLR could be going into deficit, the FSC recommends that there should be further measures capable of being triggered as appropriate. These measures include revised caps on expenditure, and the use of payment of CSLR claims by instalment – see Section 3.20 below. The FSC considers this to be preferable to the CSLR scheme raising further levies or going into deficit.

If an additional levy is imposed on FSPs, the FSC considers this should be a decision of the Government rather than the CSLR.

**Recommendation 15:** Additional levies on FSPs to cover a potential CSLR deficit should only be a last resort funding mechanism and should be imposed by a decision of Government or specific parameters set in advance by the Government and implemented by the CSLR.

### **3.17 How should compensation limits be used by the CSLR to balance the interests of consumers and those funding the scheme?**

Compensation limits should be used to make the scheme viable and sustainable such that competition and consumer access to products and services is maintained. It is important to ensure the costs required to operate the CSLR are not excessive as these costs may ultimately need to be passed onto consumers. As noted previously excessive costs on FSPs could increase the risk of business failures which could further increase reliance on the CSLR.

For this reason, the FSC supports the CSLR taking a similar approach that has been adopted in the UK where compensation amounts under the FSCS are lower than those provided by the UK Financial Ombudsman Service (**UK FOS**). The UK compensation scheme has raised £532m or approximately AUD \$1bn for the 2019–20 year<sup>9</sup>. Annual levies raised by FSCS since 2009–10 to this year range between £532m at the lowest end to £1,141m in a single year.<sup>10</sup> These are extraordinary costs for the financial services sector and in turn for consumers of financial services.

Further, and what is important to note, is that the scheme costs are more than AUD \$1bn in a single year even where compensation amounts paid under the UK's FSCS were capped at £50,000 or about AUD\$96,000 until last year and are now at £85,000 a claim or about AUD \$160,000. That is, even where scheme claim caps are not excessive, collective scheme costs are very high. Given this experience it is important that Australia take a similar approach to ensure that the scheme remain sustainable not only initially but also in the face of economic downturns which could increase the claims experience.

### **3.18 If the CSLR compensation limits are to be lower than AFCA's claim limits, what limit would be appropriate?**

The CSLR compensation limits should be set at a maximum of \$150,000 per claim per FSP.

As noted in 4.18 of this paper the CSLR should take a similar approach adopted by the UK with the **FSCS** paying a proportionate amount of what the UK **FOS** can award.

Until recently FSCS claims were capped at a maximum of £50,000 per claim against a firm which was one-third of the award payable by the UK FOS, which was able to order payment up to a maximum amount of £150,000.

In April 2019, there were increases to both the FSCS Compensation caps and the UK FOS (to £85,000 and £350,000 respectively). With these limits the compensation cap payable by the FSCS represents 24% of the maximum UK FOS award payable.

This increase in the FSCS caps has been applied after 18 years of operation and with the benefit of a long track record of known claims experiences and payments. This is relevant to understanding of the likely cost implications of potential increases.

We recommend that a similar approach be taken in Australia and that the CSLR can award no more than 30% of the AFCA determination level. AFCA can award up to \$500,000, and it is appropriate for the CSLR to pay up to \$150,000 maximum for a claim per firm.

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<sup>9</sup> <https://financefeeds.com/uk-financial-services-compensation-scheme-to-levy-firms-532m-in-2019-20/>

<sup>10</sup> <https://www.fscs.org.uk/globalassets/levy-information/20170810-levies-raised-since-2009-10.pdf>

Setting an appropriate cap will help maintain competition in financial services sectors (by reducing the likelihood that CSLR costs act as barriers to entry or expansion) and will help to ensure viability of the scheme.

There should be periodic reviews of the CSLR to assess the cost and claims experience of the CSLR and whether compensation limits are appropriate.

**Recommendation 16:** The CSLR compensation limits should be set at a maximum of \$150,000 per claim per firm.

**Recommendation 17:** There should be periodic reviews of the CSLR to assess the cost of the CSLR and whether compensation limits are appropriate having regard to the types of claims and FSP risk factors giving rise to unpaid determinations.

### **3.19 How should the CSLR manage claims associated with large unexpected failures?**

As stated earlier, the best way to manage CSLR claims relating to large unexpected failures is by having other regulations that reduce the risk and size of CSLR claims relating to these failures occurring, specifically for advice FSPs to be required to have adequate PI insurance and capital requirements.

If nevertheless the CSLR is subject to substantial claims from these failures, the options available for use include spreading compensation payments over time (see section 3.20 below) and imposing additional lower claim limits (see Section 3.21 below).

The FSC considers the Government should be the body deciding if these additional options are taken. Alternatively, the Government should establish very clearly defined rules for how additional levies can be raised including the maximum that can be raised in any given year.

Further, to limit the amount that needs to be raised in any one year, the Government can lend funds to the CSLR to help fund unexpected failures.

The FSC considers these options to be preferable to the raising of additional levies from FSPs.

### **3.20 Should the CSLR be able to spread compensation payments over time and, if so, what would an appropriate maximum time period be?**

As noted above, the need to spread claims over time is reduced or removed if the scheme is well designed and is complemented by other regulatory settings that reduce the likelihood of this happening, including ensuring advice FSPs have adequate PI insurance and capital requirements so the CSLR is less likely to receive large unexpected claims.

If the scheme is facing costs that mean it is likely to go into deficit, the FSC considers it would be worthwhile to allow compensation to be spread over time.

The FSC generally considers this decision is more appropriate for the Government to make in the first instance or via specific parameters set by the Government and then implemented by the CSLR.

The FSC does consider there is no need to set a maximum time period initially, but this may need to be considered as the scheme develops.

**Recommendation 18:** The Government should have the power to allow the CSLR to spread compensation payments over an appropriate period of time, with the limit on the period to be set by the Government, or alternatively the Government should set specific parameters in advance which are then implemented by the CSLR.

### **3.21 Should the CSLR be able to impose an additional compensation limit to unpaid determinations associated with a single specific large failure and, if so, what would an appropriate limit be?**

The FSC considers it prudent to make use of additional compensation limits to avoid the scheme going into deficit or requiring additional levies on FSPs.

It is the FSC's view that it is most appropriate for the Government to hold the power to make this decision rather than the operator of the CSLR.

The FSC does not have sufficient data to be able to state the appropriate additional claim limit, but this limit would be lower than the limit on regular claims. It is the FSC's view that the regular claims should be capped at \$150,000, as discussed in Section 3.18 above.

**Recommendation 19:** The Government should have the power to impose additional lower compensation limits if there is a large failure. This limit would be set at a lower level than the regular claim limit.

### **3.22 How should compensation for legal and professional costs be limited?**

The purpose of the CSLR is to provide consumers with a reasonable safety net where compensation has not or is not able to be provided by their FSP

The FSC considers that the CSLR should take the same approach to the recovery of legal and professional costs as the UK FSCS which does not pay professional or claims management fees on the basis that consumers can access the compensation scheme directly at no cost.<sup>11</sup>

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<sup>11</sup> <https://www.fscs.org.uk/your-claim/claim-management-companies/>



In relation to the proposed Australian scheme, consumers should be able to make a claim for compensation directly with the CSLR at no cost to them. A lawyer or professional is not required to access the scheme and as such the FSC recommends that legal and professional costs should be excluded from the CSLR.

Whilst the discussion paper notes the Ramsay Review position that consumers and small businesses be allowed to recover their reasonable legal costs through the CSLR, this recommendation was not expressly included in Royal Commission Final Report Recommendation 7.1 which supported the three principal recommendations to establish a CSLR by the Ramsay Review (and does not include recovery of legal fees).<sup>12</sup>

Providing consumers and small business with recovery of legal costs through the CSLR raises the risk of inappropriate incentives that can undermine the primary purpose and sustainability of the CLSR, as was identified in the Ramsay Report.<sup>13</sup> Consumers can naturally make use of legal services; however, these costs should not be funded through the CSLR.

This reason supported the position taken in the Ramsay Review which recommended that litigation funders should be excluded from directly accessing a CSLR.<sup>14</sup> In relation to consumer and small businesses which have used litigation funders, the Ramsay Review stated that because some may not have had their dispute heard without the support of a litigation funder, the Panel considers that the consumer or small business should be able to

*use any compensation received to satisfy any obligations they have under a litigation funding agreement' and... 'given the uncertainty about how the private sector litigation funding market could respond to a CSLR, a CSLR should have the discretion to issue clear guidelines on this issue.*<sup>15</sup>

As noted above the FSC does not support legal or professional claims management fees from being included in the CSLR on the basis that the scheme is accessible at no cost to consumers. If the scheme does however provide consumers and small business with recovery of legal and professional costs, then such costs must be limited to ensure the sustainability of the scheme by aligning the recovery of legal and professional costs to the AFCA limit of no more than \$5,000.

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<sup>12</sup> Pages 484 and 485 (2019) Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry Final Report, Volume 1.  
<https://www.royalcommission.gov.au/sites/default/files/2019-02/fsrc-volume-1-final-report.pdf>

<sup>13</sup> Paragraph 4.185, Ramsay Review. <https://treasury.gov.au/sites/default/files/2019-03/Supplementary-Final-Report-2.pdf>

<sup>14</sup> Paragraph 4.183, Ramsay Review. <https://treasury.gov.au/sites/default/files/2019-03/Supplementary-Final-Report-2.pdf>

<sup>15</sup> Paragraph 4.186, Ramsay Review. <https://treasury.gov.au/sites/default/files/2019-03/Supplementary-Final-Report-2.pdf>

Any higher amount could lead to the legitimate and notable concern raised by the Ramsay Review, that excessive legal fees could exhaust the CSLR's resources and defeat the very purpose of the CSLR. The CSLR will not have any consumer benefit if the compensation simply ends up paying legal and professional fees.

If the CSLR adopts the Ramsay Review position which allows consumers to use the compensation they receive to satisfy obligations they may have under a litigation funding agreement, then it is critical that the CSLR issues clear guidance on what maximum amount that the consumer or small business can utilise from their compensation award to pay for litigation costs.

The CSLR should ensure that design principles and the incentives created by the scheme enable the scheme to achieve its purpose of compensating the consumer for loss or damage suffered because of the breach of a financial firm's legal obligations instead of becoming a scheme which simply funds legal or litigation funding fees.

**Recommendation 20:** The CSLR should not pay professional or claims management fees as the scheme is freely accessible, and this is also in line with the approach of the UK FSCS.

### **3.23 What aspects of the design and operation of the CSLR should be determined by the CSLR and what aspects should be prescribed in legislation?**

The FSC considers the appropriate course would be for the scheme to be established in a similar way to AFCA and its governance arrangements to also be similar; given that the CSLR will operate as an adjunct largely to AFCA.

As stated in recommendations above, it is the FSC view that key decisions of the scheme should be made by the Government not the CSLR. This includes the following decisions: imposing additional lower compensation caps, the decision to borrow, the decision to impose additional levies on FSPs, and the decision to spread compensation over time.

Alternatively, the Government could provide very clear rules around each of the circumstances which direct the CSLR on when money can be borrowed, when and how additional levies can be imposed and when and how compensation is to be spread over time.

## **4 Further Considerations**

### **4.1 Periodic review of the CSLR**

The FSC recommends that there be periodic reviews of the CSLR to consider scheme impact, sustainability and consumer outcomes.

It is recommended that each periodic review consider the following:

1. an analysis of what is contributing to unpaid determinations including an analysis of underlying factors and risks giving rise to consumer claims and the inability for particular FSPs to meet their financial obligations as and when required;
2. whether regulatory strengthening is needed to reduce the risk of unpaid determinations in a given sector and make recommendations for proposed reform to address weaknesses and gaps (whether required in ASIC guidance or legislative change);
3. any new or proposed regulatory changes at the relevant time to ensure the CSLR reflects and complements regulatory reform and does not complicate or hinder measures being taken to strengthen the industry and reduce the rate of consumers seeking to rely on the CSLR;
4. an assessment of the impact of the scheme by;
  - a) considering the economics and viability of funding the scheme (including analysis of current and potential future impact).
  - b) considering the impact of the CSLR on competition and industry viability perspective; and
5. considering how the scheme is performing from consumer outcome perspective.

**Recommendation 21:** The Government should undertake periodic reviews of the CSLR.

## 4.2 Unpaid determinations and ensuring due process

Where an FSP goes into liquidation or ceases to be a member of AFCA, there is the risk that the FSP will not continue to cooperate with AFCA for requests of information where there is a new consumer claim within AFCA. In circumstances where AFCA is unable to obtain and consider all relevant information at the appropriate time there is a risk that AFCA's determination may not reflect the complete circumstances of the original claim. This creates the risk of increasing costs to the CSLR.

In establishing the CSLR, it is important that FSPs have a continuing obligation to provide information to AFCA in relation to new complaints against the firm to enable AFCA to be properly informed in making a finding.

**Recommendation 22:** FSPs need to have a continuing obligation to provide information to AFCA in relation to new complaints against the firm to enable AFCA to be properly informed in making a finding.

### 4.3 Unpaid determinations and the FSP's right to retain financial service licence

It is a serious breach of consumer and financial services law obligations where an FSP is unable to meet their financial services obligations to compensate clients where there has been a failure to comply with those obligations. In this instance it is clear that the FSP is unable to demonstrate that they have adequate financial arrangements in place to compensate clients and meet their obligations.

FSPs falling into this position should be prohibited from continuing to offer financial services and should promptly have their licence cancelled by ASIC.

**Recommendation 23:** An FSP that is unable or unwilling to pay the AFCA determination which is paid out by the CSLR should promptly have their financial services licence cancelled by ASIC.

### 4.4 Understanding the basis for unpaid determinations to reduce future risk of unpaid determinations and strengthen the system

The Ramsay review outlines in general terms where uncompensated losses have arisen:

*2.44. The types of financial firms that are responsible for unpaid EDR determinations are spread unevenly across the different sectors of the financial services industry. The three leading categories of non-compliant financial firms at FOS are:*

- *financial planners and advisers (51 per cent);*
- *operators of managed investment schemes (13 per cent); and*
- *credit providers (10 per cent).*

*2.45. While these figures reflect the percentage of unpaid determinations by type of financial firm, in terms of the value of unpaid determinations, financial planners and advisers account for approximately 92 per cent of unpaid FOS determinations.*

There is not much public information or analysis available on the factors that contributed to the non-payment. For example, what was the size of the firm, did the PI insurance cover the service and if not, why, was the claim below the excess and what was the excess level? What was the failure to satisfy obligations? For example, was this grounded in fraud, negligent advice, or advice that failed to satisfy best interests obligations? Or was it due to a high risk investment recommendation?

The FSC considers this is important missing information, and further analysis needs to be taken as a priority, preferably before the CSLR becomes operational.

**Recommendation 24:** It is recommended that Treasury analyse, before the CSLR becomes operational, the unpaid determinations to understand the behaviours and drivers that lead to the unpaid determinations.

#### 4.5 Government must commit to addressing the source of unpaid determinations as a prerequisite to establishing the CSLR

We note in section 3.7 above that the regulatory gaps should be addressed to reduce the risks of consumers ending up with unpaid determinations and the potential future costs on a CSLR. Establishing appropriate PI insurance and capital requirements to enable advice licensees to better meet their consumer obligations and external dispute resolution determinations are key to strengthening consumer outcomes and reducing the risk of unpaid determinations. It is important that this action is taken before the CSLR becomes operational.

#### 4.6 Administration of payment of CSLR levy

There are, or will shortly be, multiple levies imposed on FSPs. For advice FSPs, this includes ASIC, FASEA, the new disciplinary body for advisers, AFCA and the CSLR.

The FSC considers there is merit in having a unified and central approach to collecting these levies, to reduce administration and compliance costs for FSPs.

Further it is also important that there is transparency around unpaid determinations, how the CSLR funds are utilised (both administrative costs and payment of unpaid determinations) and the basis for calculating levies and how much is raised by each sector.

**Recommendation 25:** The CSLR should provide regular updates and complete transparency in relation to unpaid determinations, the CSLR levy/money raised and spent, the basis for calculating levies and how much is raised/incurred by each sector to give consumers and industry confidence in the CSLR.

#### 4.7 Opportunity to provide feedback on proposed funding model

As noted in the introductory comments, the discussion paper provides no information on the estimated financial model for the administration costs and the funding costs for the CSLR. It is difficult to provide feedback in relation to funding of the scheme without a proposed funding model.

We request that Treasury provide a proposed CSLR funding model that the industry can provide formal feedback on before the CSLR funding model is finalised.

**Recommendation 26:** The FSC recommends that Treasury provide a proposed CSLR funding model which the financial services industry can provide feedback on before the CSLR funding model is finalised.