Compensation Scheme of Last Resort

FSC Submission

August 2021

Contents

1. About the Financial Services Council

The 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 advice licensees 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. Executive Summary

The FSC supports a strong and competitive financial services industry which provides consumer confidence and has the appropriate consumer protections. This includes ensuring that those who are licensed to operate have appropriate financial resources to do so including meeting consumer compensation claims.

The Government should undertake concurrent reform, and ASIC should enforce existing laws, to address the source of unpaid advice determinations and reduce consumer harm.

We continue to be concerned that the source of unpaid determinations in the advice sector are not being addressed. The design of the CLSR doesn't recognise the important role that ASIC has in ensuring companies have sufficient financial requirements and appropriate Professional Indemnity Insurance ("**PI**"), such that they can meet their consumer compensation obligations. We reconfirm the longstanding position that the source of unpaid determinations needs to be addressed to reduce the risk to consumers of unpaid determinations and reduce the overall CSLR costs on the financial advice industry and the financial services industry. The FSC has recommended a number of measures to strengthen advice licensees and reduce the need for well-resourced firms, who do the right thing, are held financial responsible for the misconduct of other financial services providers (see section 4.1 for further information).

This importantly also requires greater ASIC oversight over existing laws that require AFSL's to have appropriate financial resources and compensation arrangements in place. Greater ASIC oversight, through risk-based reviews of a representative sample of advice licensees, will be key for encouraging good practices and provides an overall deterrence effect from poor practices.

To help support sustainable CSLR scheme design measures the FSC requested EY undertake Economic Analysis on a Compensation Scheme of Last Resort ("**EY Research**")[1] on a range of measures which can reduce overall scheme costs to support sustainable CSLR design measures.

Focusing on advice based failures to estimate scheme costs,[2] the EY Research scheme costs are significantly higher than the estimates included in the CSLR Proposal Paper which estimate scheme costs at $8.1m per annum. Rather than business as usual conditions, the EY Research estimates the the potential for low probability and high consequence events (such as econonic recession and finacial crisis failures). EY Research estimates have been noted against the relevant policy measures to demonstrate the significant cost reduction that the measures can achieve if implemented. We note that by implenting a range of measures

[1] The EY Research is confidential.
[2] The FSC asked EY to estimate CSLR scheme costs for advice based failures on the basis that the majority of the historical unpaid determinations have been advice related.

recommended by the FSC, scheme costs can be significantly reduced from $105.7m down to $12.8m. Individual savings for each proposal are outlined below.

In addition to appropriate CSLR design measures, a commitment by the Government and ASIC to strengthen advice licensee capital and insurance arrangements is needed, including ASIC undertaking proactive oversight over appropriate financial arrangements that are already required in law. These measures will help to address the source of the problem and reduce the consumer risk of unpaid determinations.

A well designed regulatory financial system, is one which reduces the risk of consumer that lead to unpaid determinations and not just one which places a safety net beneath it, in the form of a compensation scheme of last resort.

In this regard, and to ensure that the CSLR is as sustainable and equitable as possible, the FSC supports the following measures:

- The Government's proposal to cap claims at $150,000 to contain CSLR costs. EY Research estimates that this measure will significantly lower overall scheme costs and support scheme sustainability, while balancing the provision of compensation to claimants, reducing the cost from $105.7m to $59.2m per annum (saving $46.5m per annum).
- Adequate capital and PI requirements for advice licensees. The CSLR Operator should also have the obligation to pursue third party rights under the scheme (like UK Financial Services Compensation Scheme) to stand in the shoes of the policy holder to pursue recovery under the PI policy, which if used, can significantly reduce CSLR costs. The EY Research estimates that this measure has the capacity to lower overall scheme costs down to $38.8m where the CSLR recovers 50% through insurance where it stands in the shoes of the policy holder, or down to $12.8m where it recovers 100%. Recognising that 100% is ambitious, even a moderate 50% insurance recovery rate would help reduce scheme costs by $20.4m per annum.
- The ability for Ministerial Determination to spread payments over a number of years or lower the amount to help manage large losses such as in the case of Black Swan events;
- To reduce the risk of phoenixing[3], involving the liquidation or winding up a company to avoid debts only to start a new company to continue business, and future unpaid claims owed to consumers, where an AFSL is unable or unwilling to pay an AFCA determination that is paid by the CSLR, those responsible under the licence should be prohibited from obtaining another AFSL in the future. EY Research estimates that legislative controls to stop phoenixing can lower overall scheme costs by $5m;

[3] In the experience of the UK's Financial Services Compensation Scheme (FSCS) financial services providers go out of business, then transfer risk to the FSCS, before re-emerging to provide advice via another entity.

- All advisers should contribute to the funding of advice based CSLR costs, on the basis of a “one in all in” principle and the $1,000 minimum levy threshold should be removed. If this is not adopted, should additional capital be required by the CSLR for advice failures, capital should be raised from those advisers who have not yet contributed to the CSLR. The same approach should apply to Insurance Product Distributors with a “one in all in” approach for the reasons set out in this submission.
- The FSC supports sector specific funding to the greatest extent possible. Additional levies should be funded by the relevant sector as the starting position, and to the greatest extent possible overall.
- Where cross-subsidisation is needed to support CSLR funding requirements the following approach should be taken;
    - Sector specific funding to the greatest extent possible – raising additional levies from the relevant sector in the first instance;
    - Where cross-subsidisation is needed, it should be contained within the five products and services included in the CSLR; and
    - Where funding needs to be sourced from products and services outside the CSLR, there should be broad based coverage, which covers all of the activities that are required to hold AFCA membership. This will lower the cost to all cross-subsidy providers and is the most equitable approach to funding misconduct in other sectors;
- An administratively efficient CSLR scheme operator which is operated by Treasury rather than alongside AFCA. Running the CSLR within Treasury removes the potential conflict of interest that arises from AFCA administering unpaid determinations and recovering unpaid determination costs from a subsidiary with common directors. It also removes the unnecessary costs associated with having a Board for the CSLR operator for essentially an administrative function. This together with obligations requiring the CSLR operator to run the scheme efficiently will serve to reduce overall scheme running costs.

These policy proposals, together with other important recommendations, are set out in further detail below.

3. FSC Recommendations

1. Advice Licensee arrangements need to be strengthened, together with greater ASIC oversight of financial and compensation arrangements, to reduce the risk of unpaid determinations and ensure the CSLR operates as a genuine last resort compensation scheme.

2. The CSLR should be very clear about which products and services are covered by the CSLR and which are not to ensure consumer confidence in the scheme and in financial services more broadly.

3. There should be no "special circumstances" or discretion for the scheme operator to waive the 12 month notification requirement and determine when to pay a claim. If this is not adopted, the alternative recommendation is that what would be eligible as a "special circumstance" be subject to further consultation and defined in the Regulations to provide certainty to consumers and the industry of what is an eligible claim under the CSLR.

4. 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. ASIC should not have discretion whether to suspend or cancel an AFSL where the FSP has not paid their determination and financial liability has been shifted to the rest of the industry through the CSLR. This will reduce the risk of future consumer losses that may arise from the FSP's continued operation.

5. To reduce the risk of phoenixing and future unpaid claims owed to consumers, where an AFSL is unable or unwilling to pay an AFCA determination that is paid by the CSLR, those responsible under the licence should be prohibited from obtaining another AFSL in the future.

6. The FSC supports the proposed compensation caps of $150,000 including the Ministerial ability to determine that lower compensation caps should apply and/or that a class of claims should be paid over more than one financial year.

7. The FSC supports sector specific funding to the greatest extent possible. Additional levies should be funded by the relevant sector as the starting position, and to the greatest extent possible overall.

8. Where cross-subsidisation is needed to support CSLR funding requirements the following approach should be taken:
    - Sector specific funding to the greatest extent possible – raising additional levies from the relevant sector in the first instance;
    - Where cross-subsidisation is needed, it should be contained within the five products and services included in the CSLR; and
    - Where funding needs to be sourced from products and services outside the CSLR, there should be broad based coverage, which covers all of the activities that are required to hold AFCA membership. This will lower the cost

to all cross-subsidy providers and is the most equitable approach to funding misconduct in other sectors.

9. The FSC recommends that the following approach be adopted to funding Personal Advice CSLR levies:

    - The minimum levy threshold should be removed and the Personal Advice levy should be calculated on the basis of all financial advisers paying;
    - If this is not adopted, then the minimum levy should be lowered to $500 before invoices are issued to advice licensees; and
    - Where all advisers are not required to fund the Personal Advice related CSLR costs, any additional funds to be raised should first be drawn from those advisers who have not yet paid.
    - The same approach should also be taken for the Insurance Product Distributor category.

10. We do not support changes to the CSLR scheme cap of $250m being made by Regulations. The CSLR Proposal Paper identifies that this amount is considered high enough to deal with "black swan" events. Any variation to this amount should be by amendment to the relevant Act which is subject to greater parliamentary scrutiny.

11. The regulations should specify the method, or at minimum provide guidelines, for how subsector levies are to be approached or calculated.

12. There is a need for transparency around how levies are calculated and apportioned. Anytime levies are raised, invoices should specify how levies are calculated and apportioned at a sector level and individual firm level.

13. The CSLR operator should have duties, obligations or incentives to keep administration costs as low as possible. This includes outlining in the annual report how it has kept administration costs low.

14. Similarly to the UK Financial Services Compensation Scheme, the CSLR operator should have a duty to pursue recoveries that area reasonably possible and cost effective, including recoveries against third parties such as the professional indemnity insurer of the firm in default.

15. The FSC recommends that the CSLR be administered by a separate unit within Treasury which will reduce conflicts of interest, remove the need and associated costs with appointing a Board and reduce overall costs of the CSLR.

16. The FSC recommends that the periodic reviews of the CSLR take place every three years which focus on the issues specified under the "Periodic Reviews" section of this submission. This includes the CSLR capturing data on the profile of firms and types of claims leading to unpaid determinations and CSLR payments to enable the scheme to move to a risk-based funding approach over time.

4. CSLR Proposals

4.1. Addressing the source of unpaid determinations whilst also providing a consumer safety net

The FSC continues to have concerns that the regulatory gaps, including the lack of oversight and enforcement by ASIC of existing laws, leads to unpaid determinations in the financial advice sector. This means that the source of unpaid determinations is not being addressed and the establishment of the CSLR will not change this.

The law already requires advice licensees to have adequate financial requirements and arrangements in place for compensating clients. There are however no minimum capital requirements for advice licensees. ASIC should also have regard to the PI claims experience to inform its view of adequate arrangements as exclusions and declinations mean the CSLR will be forced to prop up a PI framework that is not meeting requirements.

Whilst the updated 2020 ASIC Regulatory Guide 126 now specifies that in determining whether a licensee has appropriate financial arrangements in place, it should consider how it will cover the insurance excess, and keep records of this assessment,[4] we are not aware of ASIC providing proactive industry oversight over these obligations. Further there should be a relationship between the capital a business holds and the level of PI excess chosen. To ensure existing legal obligations are being met, ASIC needs to undertake regular risk based reviews of licensees (ensuring that they include a representative sample of advice licensees) focusing on licensees having adequate financial and compensation arrangements in place, which will serve two important purposes;

- it will identify those who have inadequate arrangements in place so that ASIC can take appropriate regulatory action and reduce the risk of consumer harm and unpaid determinations; and
- it will encourage licensees right across the industry to ensure they have the right arrangements in place.

Further details of these proposals are set out in the FSC's *Supplementary submission to the Review of the Financial System External Dispute Resolution (EDR) Framework Supplementary Issues Paper* (**Advice Licensee Proposals**) which is included in **Attachment A** to this submission.

The purpose of the Advice Licensee Proposals is to better put licensees in a position that they have capital available to meet consumer compensation obligations. Recognising that advice licensees are being inundated with financial cost pressures, the intention is that the

[4] See page 14 of Regulatory Guide RG 126 Compensation and insurance arrangements for AFS licensees (asic.gov.au)

capital and PI requirements are brought in over time, with a reasonable transition period that balances financial pressures and the need to raise standards.

Having greater rigour around capital and PI insurance arrangements for advice licensees ensures advisers have greater responsibility for their conduct in relation to consumer compensation obligations, which was one of the most important issues identified, which remains unaddressed, from the Richard St John's recommendations in the *Compensation Arrangements for Consumers of Financial Services Report* issued in 2012 (**St John Report**).

The St John Report recommended against establishing a compensation scheme of last resort on the basis that there were limited regulatory measures to protect consumers from licensee insolvency and therefore it would be inappropriate to require more responsible and financially secure licensees to underwrite the ability of other licensees to meet their compensation claims against them. The report recommended that priority first be given to improving standards and placing licensees in a better position where they are responsible for their own conduct, before placing a safety net beneath it.

Greater rigour around having adequate financial arrangements and PI should not only apply to regular risk based reviews of Advice licensees, but also apply in the provision of new AFSL's by ASIC.

The FSC accepts the Financial Services Royal Commission recommendation to establish a Compensation Scheme of Last Resort (and we note that the view on the merit of establishing CSLR included in Attachment A, of not supporting a CSLR, was reflective of the FSC view at the time the submission was made in 2017). The purpose of our feedback is to help support a sustainable, equitable and efficient scheme design principles, as well as to ensure that the CSLR is a genuinely last resort scheme, not a first resort scheme.

The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (**Financial Services Royal Commission**) Final Report (**Final Report**) Recommendation 7.1

We continue to be concerned that failure to strengthen the advice licensing regime, and without greater ASIC oversight over financial and compensation arrangements, will increase the risk of future unpaid determinations that will adversely affect consumers and the advice industry.

Recommendation 1: Advice Licensee arrangements need to be strengthened, together with greater ASIC oversight of financial and compensation arrangements, to reduce the risk of unpaid determinations and ensure the CSLR operates as a genuine last resort compensation scheme.

Failure to address these issues will result in the scheme being a compensation scheme, more generally, instead of a last resort scheme.

4.2. Scope

The FSC supports the targeted scope of the CSLR, excluding Court and Tribunal decisions at scheme commencement, as well as the CSLR excluding voluntary AFCA members. As noted in the CSLR Proposal Paper excluding Voluntary AFCA members will not only continue to encourage providers to voluntarily join AFCA (with the imposition of CSLR funding costs likely to be a disincentive to join AFCA) but it also makes it clear that financial products and services provided by a firm not required by legislation to be AFCA member will not be within the scope of the CSLR.

In this regard, we note that it is important the CSLR be very clear about which products and services and covered by the CSLR and which are not. This clarity is important for consumer confidence in the CSLR and confidence in the financial services industry more broadly.

Recommendation 2: The CSLR should be very clear about which products and services are covered by the CSLR and which are not to ensure consumer confidence in the scheme and in financial services more broadly.

AFCA Scope

We understand that Review of AFCA is still underway, in this regard we note that the wider the scope of AFCA the larger the potential costs under external dispute resolution overall. This would have flow on effects to professional indemnity insurance, which correspondingly may be more expensive and impact the availability and affordability of costs.

Insurance Product Distributors

The proposal paper states that the definitions for the various categories will be consistent with the ASIC Levy categories. The definition of 'insurance product distributor' as detailed in the proposed paper, does not appear to be consistent with the definition used in Reg 70 of the *ASIC Supervisory Cost Recovery Levy Regulations 2017*. The proposed legislation/regulations should ensure that the definitions of 'insurance product distributor' are taken directly from regulation 70 of the *ASIC Supervisory Cost Recovery Levy Regulations 2017* (Cth) to maintain consistency.

Proposed levy allocation for Insurance Product Distributors

Similar to the earlier recommendation that all advisers should contribute to the CSLR advice related costs, all insurance product distributors should pay for the CSLR costs associated with the insurance product distributor category. The $1,000 minimum levy threshold should be removed. This is the most equitable funding approach which will incentivise the whole sector to have good practices and appropriate regulatory settings to reduce the risk of unpaid claims. This will also reduce the costs for all participants, spreading the CSLR costs across a broader base.

If the concern is the levying all participants will be administratively expensive, administration costs can be reduced by rolling the CSLR levy for this category into the ASIC levy costs. ASIC is already collecting levies from all of these entities.

Failing this approach not being adopted, the levy threshold should be lowered to $500 to encourage more product distributors to contribute to the scheme. Where additional levies need to be raised – those who haven't contributed yet should be called on first to contribute to the next round of funding requirements.

4.3. Paying Claims

The CSLR Proposal Paper sets out the parameters that must be met for a claim to be paid.

The FSC supports the following parameters;

- Having a clear time limit of 12 months from AFCA decision to when unpaid AFCA determinations are in scope of the CSLR – this is critical to providing the industry a relative degree of certainty around CSLR funding requirements as well as providing certainty which helps with a sustainable PI market for financial advisers; and
- Reasonable steps being taken for payment and that the firm is unlikely to be able to pay based on the financial position of the firm;

before the payment of claims from the CSLR. These measures are critical to ensure the scheme is genuinely last resort and not first resort as well as providing funders of the CSLR with a degree of funding and liability certainty.

In relation to "reasonable steps" being taken, Section 1063(2)(b) of the CSLR Bill states that one of the requirements for eligibility for compensation is when there is a "relevant AFCA determination" which includes when AFCA has finished taking reasonable steps to secure payment. We recommend that this be defined by the regulations and consistent with the steps outlined on page 10 of the Proposal Paper.

The CLSR proposals also envisage that the scheme may also have the discretion to waive the 12-month notification requirement in special circumstances. It is unclear what kind of special circumstances would warrant going outside of these parameters. We consider that there should be no discretion for the CSLR to provide payment outside of those explicit parameters already proposed. Allowing claims "under special circumstances" removes certainty for CSLR scheme funders and the industry as to what is a legitimate claim. Further, it is proposed that there be no mechanism of review for payments by the CSLR, thus it is essential that there is certainty around eligibility of claims.

The FSC recommends that there be no "special circumstances" or discretion for the scheme operator to determine when to pay a claim. Should this recommendation not be adopted, it is alternatively recommended that the "special circumstances" be subject to further consultation and clearly defined in the Regulations.

Recommendation 3: There should be no "special circumstances" or discretion for the scheme operator to waive the 12 month notification requirement and determine when to pay a claim. If this is not adopted, the alternative recommendation is that what would be eligible as a "special circumstance" be subject to further consultation and defined in the Regulations to provide certainty to consumers and the industry of what is an eligible claim under the CSLR.

The scheme proposals also envisage that the CSLR operator must notify ASIC of the relevant firm's failure to pay which will allow ASIC to use its power to suspend or cancel the financial firm's licence.

Further to the FSC's submission to the Establishing a CSLR Discussion Paper (**FSC 2020 Submission**) provided to Treasury, we reiterate our position that failure to pay an AFCA determination is a serious breach of consumer and financial services law obligations by the Financial Services Provider (**FSP**). 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.

In this regard we consider that where the CSLR makes a payment for an unpaid determination that ASIC is required, rather than permitted, to use its powers to suspend or cancel the financial firm's licence.

We appreciate that cancelling a licence is a significant step however failing to pay a determination, in the client's favour, arising from misconduct is equally egregious and a breach of the FSP's financial services obligation. To prevent further consumer losses and harm, that may arise should the AFSL be allowed to continue to operate, ASIC should be required to cancel the firm's licence. Furthermore, action should also be taken against the individuals holding those AFSLs, similar to the power APRA has to take action against the trustees responsible for intentional and reckless breaches.

In this regard, where action has not been taken against firms who contribute to unpaid determinations from 1 November 2018, ASIC should be required to do so.

Recommendation 4: 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. ASIC should not have discretion whether to suspend or cancel an AFSL where the FSP has not paid their determination and financial liability has been shifted to the rest of the industry through the CSLR. This will reduce the risk of future consumer losses that may arise from the FSP's continued operation.

We note that the CSLR can pay compensation to eligible consumers prior to the insolvency or administration of a firm, where AFCA demonstrates that it is unlikely that the firm can or will pay. Cancelling an AFSL however can also commonly be a trigger for insolvency. It is envisaged that the CSLR will have subrogation of rights, up to the amount of compensation paid by the CSLR operator, that are assigned to the CSLR operator to pursue against the FSP which did not pay the determination. It is envisaged that this right will be used where it makes economic sense to pursue recovery.

A likely scenario in which the subrogation of rights would generally operate is under an insolvency or administration scenario, where the CSLR can stand in line as a creditor through the insolvency process. Thus, removal of an AFSL, which will likely be a trigger for administration or insolvency, is important to enable the CSLR to recover proceeds for the benefit of the CSLR where it makes economic sense to pursue recovery.

Furthermore, to stop phoenixing and the risk of prospective consumer harm and future costs being imposed onto the CSLR, those responsible under the licence, (such as Responsible Managers) should also be prohibited from being permitted to obtain another AFSL.

Recommendation 5: To reduce the risk of phoenixing and future unpaid claims owed to consumers, where an AFSL is unable or unwilling to pay an AFCA determination that is paid by the CSLR, those responsible under the licence should be prohibited from obtaining another AFSL in the future.

To encourage AFSL's to honour their financial liabilities owed to customers or clients in the first instance, and to minimise prospective CSLR costs, should the AFSL holder fully reimburse the CSLR within a 12 month period of any compensation paid on their behalf, and fully satisfy their financial obligations to consumers owed under an AFCA determination, such an AFSL should not be prohibited from obtaining a new AFSL in the future. This encourages the right behaviour whilst also enabling those responsible under the AFSL to continue operating in the financial services industry.

4.4. Compensation Caps

We support the proposed compensation caps of up to $150,000 which recognises that the unpaid determinations are being paid by those who have done the right thing and are not responsible for the misconduct related to the unpaid determination. Importantly, this cap also limits moral hazards, with potential reduction in risks taken, and contains the costs of the CSLR.

This amount is proportionate to the amount that the UK Financial Services Compensation Scheme pays relative to the maximum amount the Ombudsman can award. This cap amount will generally help to support principles of sustainability relating to the CSLR, noting that widespread or large losses can result in substantial and unsustainable CSLR costs imposed on industry.

In this regard, we support the Minister being able to determine that a lower compensation cap should apply to a class of CSLR claims and/or that a class of CSLR claims should be paid over more than one financial year. We envisage that these powers would be made where there are sizeable losses and CSLR claims. This will be especially important in years when there is a significant market downturn as levies could increase significantly in severe market downturn when complaint volumes are typically higher. Practices funding the CSLR will suffer a double impact in years when complaints go up due to market downturn (i.e. resolving complaints, paying PI excess and funding the CSLR with additional levies).

Recommendation 6: The FSC supports the proposed compensation caps of $150,000 including the Ministerial ability to determine that lower compensation caps should apply and/or that a class of claims should be paid over more than one financial year.

The powers assigned to the Minister under the CSLR proposals also enable the following determinations to be made; a special levy to be issued to financial firms leviable for that subsector to make up the shortfall or a special levy to be issued to financial firms leviable in relation to other subsectors to make up the shortfall which effectively involves other sectors cross-subsidising the losses of another sector.

Sector Specific Funding

The FSC reiterates the position outlined in our 2020 Submission that we consider CSLR sector specific funding to the greatest extent. The firms engaged in the types of financial services covered by the CSLR should fund the losses within their relevant sector (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.

The CSLR proposal envisages however that there is likely to be some general cross-subsidisation from initial funding, with funds raised from various sectors to be placed into a single pool to be used to fund claims, as well as a $5m capital reserve which is to be used to fund sector shortfalls. The proposal paper notes that where a subsector has experienced a shortfall, where annual levies provided for a particular subsector are insufficient to meet subsector outlays for that subsector during the claim year, that the funds within the pool would be available to be drawn upon to fund all compensation payments made under the scheme. Whilst this amounts to cross-subsidisation, the proposal paper states that it is intended that in the following claim year leviable firms within subsectors who experienced a shortfall would likely be subject to a larger levy as the previous year estimate was insufficient.

We reiterate our position that the sector that is responsible for the unpaid determinations should collectively pay for the losses. Where additional levies need to be raised, the starting position should be that the CSLR raises additional levy from the sub-sector that the shortfall relates to and that gives rise to the need. For example, if unpaid determinations from the advice sector amount to $8m but only $6m has been raised. Additional levies of $2m should be raised from the advice sector.

Recommendation 7: The FSC supports sector specific funding to the greatest extent possible. Additional levies should be funded by the relevant sector as the starting position, and to the greatest extent possible overall.

Cross-subsidisation

Noting that the CSLR proposals envisage a degree of subsidisation, if the Government is concerned about capacity issues within a given financial services sector, the FSC considers that the cross-subsidisation should work as follows:

- Sector specific funding to the greatest extent possible – raising additional levies from the relevant sector in the first instance;
- Where cross-subsidy is needed, it should be contained within the 5 categories of products and services included in the CSLR;
- Where a Ministerial Determination is made, with a view taken that additional funding is required from other sectors not within the CSLR (such as to meet extremely large losses), then the FSC supports a broad coverage approach which covers all the activities and FSPs that are required to hold AFCA membership. A broad coverage approach lowers the cost for all participants and 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 of sectors outside the CSLR is required, it should only apply to a broader general levy funded by all AFCA members as a last resort backstop to CSLR funding.

The broad coverage approach should be underpinned by principles of equity and a "one in all in" approach. This would mean that all the FSPs that are required to hold AFCA membership proportionately share in the cross-subsidy.

Recommendation 8: Where cross-subsidisation is needed to support CSLR funding requirements the following approach should be taken;

- Sector specific funding to the greatest extent possible – raising additional levies from the relevant sector in the first instance;
- Where cross-subsidisation is needed, it should be contained within the five products and services included in the CSLR; and
- Where funding needs to be sourced from products and services outside the CSLR, there should be broad based coverage, which covers all of the activities that are required to hold AFCA membership. This will lower the cost to all cross-subsidy providers and is the most equitable approach to funding misconduct in other sectors.

Positive claims experience and reducing future levies

Similar to the principles underpinning sector specific funding, where a sector has a positive claims experience whereby unpaid determinations paid by the CSLR are substantially less than estimated, then less funding should be raised from that sector in future years. We understand from Treasury discussions that the funding estimates are to be based on actuarial recommendations which take a mid-term view and not a short term or year on year view. This would mean if claims are lower than estimated in one year, that this doesn't necessarily mean that levies raised by the industry is less the very next year. In this regard however, should a sector have a positive claims experience for more than one year, accordingly we would expect the CSLR to reduce the levies raised from that sector over time.

4.5. Funding the scheme

Personal Advice on relevant financial products to retail clients ("Personal Advice")

The current CSLR funding approach seems to be based, in part, on an entity's 'ability to pay' and without accounting for the risk posed by the entity's activities. Large financial advice licensees are often better capitalised and have greater capacity to meet their consumer compensation obligations thus presenting less risk to a CSLR.

To ensure that the funding approach is not only equitable but doesn't place undue liability on those least likely to present risk to the CSLR, the funding approach should be as equitable as possible and apply to all advisers equally regardless of the size of the licensee that the adviser is licensed under. Furthermore, all financial advisers will benefit from consumer confidence that arises from the existence of a CSLR and thus should equally contribute to the funding of the scheme.

We recommend that the following approach be adopted in relation to funding Personal Advice;

- Primary Recommendation 1: Contribution to the CSLR should be based on the "one in all in principle". All financial advisers should contribute to the CSLR as part of the Personal Advice category. This means removing the minimum $1,000 levy threshold before firms contribute to the CSLR.

We note this proposed funding approach is consistent with the approach taken by the ASIC levy, which is based on all advisers included to fund their respective ASIC levy category, also the UK Financial Services Compensation Scheme (**FSCS**) where we understand that all advice firms contribute to the FSCS advice related liabilities and is not dependent on minimum levy thresholds before contributions are required. In addition, requiring all advice firms to pay incentivises them to assist in keeping the levies as low as possible by paying their complaint determinations.

If the view is that the reason for not requiring all advisers to pay is on the basis that the cost to administer the invoice is disproportionate to the levy amount, this can be addressed for the advice sector by taking a different levy collection approach via the Financial Adviser Register (**FAR**). The levy can be included via annual registration cost of advisers on the FAR and subsequent levies can also be issued via this mechanism. This way, the administration cost is negligible, but all advisers/licensees are contributing.

We note that by charging the levy to licensees, it merely transfers the administrative burden of on-charging the levy to advisers from Government/ASIC to licensees. It is common practice for advice licensees to pass on costs such as these directly to advisers.

- Recommendation 2: If the recommendation to require all advisers to pay for Personal Advice related CSLR costs is not adopted, then the minimum levy threshold should be lowered to $500 before invoices are issued.
- Recommendation 3: Where all advisers no required to fund the Personal Advice related CSLR costs, it is recommended that any additional funds to be raised should first be drawn from those advisers who have not paid.

Recommendation 9: The FSC recommends that the following approach be adopted to funding Personal Advice CSLR levies:

- The minimum levy threshold should be removed and the Personal Advice levy should be calculated on the basis of all financial advisers paying;
- If this is not adopted, then the minimum levy should be lowered to $500 before invoices are issued to advice licensees; and
- Where all advisers are not required to fund the Personal Advice related CSLR costs, any additional funds to be raised should first be drawn from those advisers who have not yet paid.

The same approach should also be taken for the Insurance Product Distributor category as outlined previously.

Transparency for funding the CSLR

To provide industry confidence in the CSLR funding approach, there is a need for transparency around how levies are calculated and apportioned anytime an invoice is issued and levies are raised. This includes outlining why it is being done that way at a sector level and individual level. This should apply both to the CSLR operator and any levies raised via Ministerial Determination.

Furthermore, there should be an annual report that is publicly available outlining the CSLR costs for the year, both the administration costs and payments made, as well as a basic analysis of the largest sources and contributors of unpaid determinations to help the industry, ASIC and policy makers identify where the problems are. This will enable regulatory gaps or weaknesses to be addressed to reduce future costs to the scheme.

$250m cap

The CSLR Proposal Papers provides that a scheme cap of $250 million will specified in primary legislation and may be varied by regulation. Whilst the Proposal Paper envisages that this would be sufficient to deal with large or “black swan” events, we have concerns that this compensation cap to be paid by the industry in any given year appears very high. This is particularly so when the scheme estimates a general subsector cap of $10m across five products and services, which means an additional $200m can be levied on the industry where it has not expected nor provisioned for such a large payment.

Given the lack of provision by the industry for such a large amount more generally, and the position put forward by the proposal paper that this is “amount is considered high enough” to fund “black swan” events, we do not support the ability of this amount to be varied by regulation.

Any increase to the $250m scheme cap, which is already a significant amount, should be via amendment to the Act which is subject to greater parliamentary scrutiny.

Recommendation 10: We do not support changes to the CSLR scheme cap of $250m being made by Regulations. The CSLR Proposal Paper identifies that this amount is considered high enough to deal with “black swan” events. Any variation to this amount

should be by amendment to the relevant Act which is subject to greater parliamentary scrutiny.

Transparency regarding Levy methodology in regulations

It is not clear in the AFCA Fees Bill how the unpaid levy will be proportioned to a particular sub-sector. There is a lack of transparency around the levy methodology. The current approach of "reasonably attributable" or "reasonably believes" leaves room for discretion. The regulations should prescribe the method, or at the very least provide guidelines for how subsector levies are approached or calculated, that determines the levy to be paid by a subsector which is proportionate to the amount outstanding for that sub-sector.

Section 1069D, Subdivision C of the CSLR Bill provides that the Minister has power to determine a further levy is payable if claims and costs are exceeded for a sub-sector. As above, the regulations should specify the method, or at the very least provide guidelines, for how the further levy is calculated. For transparency purposes the calculation method should be available to the Minister and transparently disclosed to CSLR funders given there is no right of review.

Further paragraph 2.5 of the EM states that "the annual levy will cover amounts that CSLR operator "believes" will be payable to applicants under the compensation scheme. The annual levy and further levy should be "referrable" to concrete data i.e. an estimate of unpaid determinations and AFCA fees etc. Paragraph 2.6 of the EM notes that amounts payable by individual firms will be worked out in accordance with a method to be prescribed by the regulation and drawn on concepts in place from ASIC's industry funding model.

Table 2 in the Proposal Paper appears to use inconsistent sizing metrics for the minimum threshold in the features section. This needs close examination if the regulations are proposing to use the same metrics to work out the estimated levies for a sub-sector.

Future funding of the scheme should also be based on insights from AFCA and take a risk-based approach to funding i.e. use reporting from AFCA on systemic issues and unpaid determinations to inform which sectors levies should be funded from and which FSP's within the sector present greater risk and thus should provide a greater overall contribution to sector funding.

Recommendation 11: The regulations should specify the method, or at minimum provide guidelines for how subsector levies are to be approached or calculated.

Funding transparency when issuing invoices and via Annual Report

In addition to transparency for the levy methodology in the regulations, there is also a need for transparency around how levies are calculated and apportioned anytime an invoice is issued and levies are raised. This includes outlining why it is being done that way at a sector level and individual level. This should apply both to the CSLR operator and any levies raised via Ministerial Determination.

Furthermore, the CSLR operator should be required to issue an annual report, that is publicly available, providing a breakdown of the CSLR costs for the year, as well as a basic analysis of the largest sources and contributors of unpaid determinations. Disclosing the source of claims will help the industry, ASIC and policy makers identify where the problems are in order to address regulatory gaps or weaknesses and reduce future costs to the scheme.

Recommendation 12: There is a need for transparency around how levies are calculated and apportioned. Anytime levies are raised, invoices should specify how levies are calculated and apportioned at a sector level and individual firm level.

4.6. Governance

CSLR Operation Governance

CSLR Co is proposed to be a subsidiary of AFCA, and given the CSLR operator's power under the AFCA Fees Bill includes collecting unpaid AFCA fees, a conflict of interest can arise when a related body corporate makes decisions on matters that it has a vested interest in. In this regard we do not consider that the CSLR operator as proposed is independent.

The CSLR proposal paper estimates administration costs for running the scheme at $3.7m. In an ordinary year, the annual scheme is also estimated to cost $8.1m. It is concerning that according to these estimates, the administration costs for running the CSLR amount to 46% of the levies paid, and the payments to consumers would amount to 54% of levies raised. This amount is disproportionate to the overall function of the CSLR which is to pay unpaid determination. The CSLR proposal paper fails to outline any mechanisms or incentives to keep administration levies as low as possible. It also fails to provide the CSLR operator with any duties or obligations to keep administration costs as low as possible.

Recommendation 13: The CSLR operator should have duties, obligations or incentives to keep administration costs as low as possible. This includes outlining in the annual report how it has kept administration costs low.

The obligation to keep administration costs as low as possible however also needs to be balanced against the potential benefits to the CSLR in pursuing recoveries for the benefit of the CSLR. For example, it is envisaged the CSLR operator will have a right of subrogation, commensurate with the value of the compensation by the CSLR, where the claimant receives compensation under the CSLR.

The CSLR operator should be obligated to pursue recovery where the CSLR operator "reasonably believes" that it can successfully recover an amount that is greater than the cost incurred in the recovery. For example, if the CSLR operator reasonably believes that it can recover $1.50 at a cost of $1 to the CSLR, the operator should pursue recovery. Amounts recovered by the CSLR operator should then be applied as capital available to fund unpaid determinations.

Furthermore, in addition to the above, the CSLR operator should be similarly empowered via legislation, as the UK FSCS is, to pursue "recoveries against any relevant third parties who may also carry legal responsibility for our customers' losses. These might include, for

example, the professional indemnity insurers of the firm in default."[5] The FSCS has a duty to purse recoveries that are "reasonably possible and cost-effective". We note that recoveries by the FSCS are generally low overall and we question whether this power is being used to the greatest extent possible.

To ensure that this power meaningfully reduces overall scheme costs, the CSLR operator should have a duty to proactively pursue recoveries that are reasonably possible and cost effective. In this regard, we would consider a pursuit of a claim being cost-effective where $1 is spent to recover $1.20. In this circumstance there would be a net benefit to the scheme. For such a duty to useful, it is important that CSLR operator also be incentivised or required to reasonably use this duty to pursue recoveries.

Recommendation 14: Similarly to the UK FSCS, the CSLR operator should have a duty to pursue recoveries that area reasonably possible and cost effective, including recoveries against third parties such as the professional indemnity insurer of the firm in default.

Different Governance Model proposed – CSLR administered by a Unit within Treasury

The FSC proposes that a more efficient model, with reduced conflicts of interest, would be for a unit within Treasury to administer the CSLR. This would remove the need for the CSLR to have a Board and potentially reduce expensive establishment costs of a CSLR. Given the largely administrative functions proposed for the CSLR operator, it is envisaged that Treasury can perform this role.

Treasury would generally not need to have subjective decision making under the CSLR. For example claims are paid according to clear rules and should be formulaic in nature which is consistent with our position of sector specific funding of any additional levies required and clarification sought in the regulations as to how additional levies are to be raised.

Where additional levies need to be raised, for example where a sector cap of $10m reached, the discretion/subjective decision making then goes to the Minister for a Ministerial determination. This would ordinarily involve a recommendation by Treasury on how that should be approached followed by a decision by the Minister. Thus administering the CSLR from within Treasury is likely to be the most efficient, with the lowest cost and reduced risk of conflicts of interest compared to a new entity being established and a subsidiary of AFCA operating the CSLR.

Recommendation 15: The FSC recommends that the CSLR be administered by a separate unit within Treasury which will reduce conflicts of interest, remove the need and associated costs with appointing a Board and reduce overall costs of the CSLR.

[5] https://www.fscs.org.uk/about-us/funding/recoveries/

Periodic Reviews

It is proposed that there be a review every 5 years to evaluate the effectiveness and efficiency of the CSLR. We consider that a review every 5 years is too long. The FSC considers that the CSLR should be reviewed every 3 years to identify that it is working as intended and address any unexpected but important issues that may have arisen.

The review should include analysis and consideration of the following issues;

- funding requirements;
- whether the methodology and annual estimates are appropriate;
- whether the levies raised annually, as well as any further levies raised, by the CSLR and via Minister Determination, are appropriate, fair and equitable; and
- analysis of the types of payments being made under the CSLR and the profile of firms which are most likely to result in unpaid determinations.

Capturing the requisite data from the commencement of the scheme is not only important for transparency but also important to enable the scheme to move to a risk based funding approach in due course, as well as clearly understanding where the underlying problems are coming from. This will enable policy makers and ASIC to identify any regulatory gaps or areas that require greater oversight.

The CSLR should seek to mitigate poor behaviours and reduce the risk of prospective unpaid determinations, which are socialised and placed on other participants who are not responsible for the misconduct.

Recommendation 16: The FSC recommends that the periodic reviews of the CSLR take place every three years which focus on the issues specified under the “Periodic Reviews” section of this submission. This includes the CSLR capturing data on the profile of firms and types of claims leading to unpaid determinations and CSLR payments to enable the scheme to move to a risk based funding approach over time.

4.7. Other Issues

The Proposal Paper states on page 23 that unpaid AFCA determinations and fees incurred prior to the commencement of the CSLR will be funded by a one-off levy from the top ten financial firms. It is unclear how the legislation has accommodated this, and at what point in time the assessment is made to determine who the top ten financial firms are.

Prior to a decision being made by the Government as to the “top ten financial firms” the Government should advise, specifically and actually, who are the ten firms identified as the top ten financial firms. Without that information, the identified firms are not able to comment or submit on that categorisation.

Commencement of the CSLR

With external pressures to establish the Financial Adviser Standards Education Authority (**FASEA**) as soon as possible, there is anecdotal feedback that an inadequate timeframe was provided to enable FASEA to be properly operational in the first year it commenced

(which included providing sufficient time to establish the new operation, find an office, hire and train relevant staff etc).

To ensure the CSLR achieves its intended purpose of enhancing consumer confidence, it is important that the CSLR be properly established and fully operational when it is deemed to be as such (for example, from the day the CSLR is expected to engage with consumers who have unpaid determinations and the financial services providers who are required to fund it).

Taking the FASEA experience into account, it is important that establishment of the CSLR is not rushed such that it cannot properly function at commencement. Sufficient time is required to hire and "house" staff in relevant premises, have a website up and running and a means of communicating with, as well as having a contact point, for consumers and financial services providers.

Whilst it is common for reforms to commence one year after royal assent of the relevant legislation, we question whether one year is sufficient to achieve the above and properly operationalise the CSLR, as well as issue invoices and enable payment by FSP's into the CSLR. We note in this regard, that consumers with unpaid determinations will have an expectation that the CSLR will have the capacity to pay compensation following commencement. This should be taken into account when considering what is an appropriate period for the CSLR to commence following royal assent of the relevant legislation.

Sufficient time to consult and provide feedback on the regulations

Many of the proposals put forward in the CSLR Proposal Paper are not provided for in the draft legislation, with much of the operational detail to be set out in the related regulations. In this regard we request sufficient time to consult on the draft regulations and for the industry to provide feedback. This will be critical to minimising unintended consequences.