Australian Banking Association

07 February 2020

Mr Chris Lyon
Manager, Redress and Accountability Unit
Financial Services Reform Taskforce
The Treasury
Langton Crescent
PARKES ACT 2600

Via email: CSLR@treasury.gov.au

Dear Mr Lyon

ABA submission: Establishing a Compensation Scheme of Last Resort

The Australian Banking Association (**ABA**) welcomes the opportunity to provide our response to Treasury's discussion paper establishing a Compensation Scheme of Last Resort (**CSLR**).

The ABA is committed to the implementation of the recommendations of the Royal Commission into Misconduct in the Banking, Superannuation, and Financial Services Industry (**Royal Commission**) and welcomes the Government's progress on legislating these important reforms.

The banking industry acknowledges that some customers of financial services and products have suffered losses because of inappropriate advice or poor conduct. In some of these situations, the customers have been unable to seek compensation due to the financial business becoming insolvent.

The ABA recognises the importance of a CSLR to building trust and confidence in the financial services sector and ensure consumers of financial products are treated fairly, have adequate information, and avenues for redress in the event of poor conduct.

Key points

The ABA supports the implementation of Recommendation 7.1 of the Royal Commission to establish a CSLR in order to build trust and confidence in the dispute resolution framework in the financial system.

We support the Government's response to this Royal Commission recommendation in agreeing to establish a forward looking CSLR that is industry-funded, operated by the Australian Financial Complaints Authority (**AFCA**), extends beyond personal advice failures and has design features consistent with the recommendations of the supplementary review of external dispute resolution conducted by a panel headed by Professor Ian Ramsay (**Ramsay Review**).

Key design principles

In order to ensure the success and viability of the CSLR, the ABA recommends that the Government adopt a scheme with the following design principles:

- **Sustainable scope:** the CSLR should be appropriately scoped to ensure that it only covers services and products with the greatest risk of unpaid determinations, as well as ensuring the scheme is affordable and sustainable for participants

Australian Banking Association

- **Prospective:** the CSLR should cover customers who receive an approved AFCA determination in their favour and should apply to unpaid determinations made under AFCA's Rules from 1 November 2018
- **Last resort:** the CSLR should be a scheme of last resort and only relied upon after any alternative compensation arrangements have been fully pursued
- **Industry-wide and mandatory funding:** the CSLR should be funded by all AFCA members and have a clearly defined funding structure that separates funds according to the financial service provided and be designed to avoid any form of cross subsidisation
- **Review of the scheme:** the scope and funding model of the CSLR should be subject to an annual review and be based on more comprehensive data collected through the operation of the scheme over time.

The ABA also submits that it is essential that in conjunction with the establishment of the CSLR, the Government should pursue other important reforms to further protect consumers and reduce unpaid determinations within the financial system, including improvements to the professional indemnity insurance regime and a review of the financial requirements for financial advice licensees.

ABA's proposed model

The ABA's proposed model for establishment of the CSLR has the following key features:

- accept unpaid determination claims relating to financial advice and non-ADI credit assistance and credit providers;
- exclude prudentially regulated entities and Managed Investment Schemes (**MIS**) sold directly to a consumer under a general advice model;
- have two separate claims funding pools for each respective industry (financial advice and non-ADI credit assistance and credit providers); and
- an administration funding pool would cover administrative costs and insurance costs for significant and unexpected events - this would be funded by all AFCA members and based on the AFCA funding model base levy.

We believe that the establishment of the CSLR in line with this proposed model will deliver a sustainable and affordable scheme that meets the Government's stated objectives. Please refer to Appendix A for our responses to the questions in the consultation paper.

Please contact us on (02) 8298 0450 if you would like to discuss any aspects of this submission.

Yours sincerely

Justin Mining
Policy Director

Essam Husaini
Associate Director, Policy

ABA response to the consultation paper on establishing a Compensation Scheme of Last Resort

1. Introduction

The Final Report of the Royal Commission made 76 recommendations designed at improving consumer outcomes, increasing accountability and transparency, and improving culture and governance within the financial services industry.

Recommendation 7.1 of the Final Report recommended the establishment of a CSLR. This supports the findings of the Ramsay Review. The review panel accepted that a CSLR should be established to enable consumers and small businesses to recover unpaid EDR determinations and Court judgements. Ramsay made it clear that the CSLR "should be limited and carefully targeted at the areas of the financial sector with the greatest evidence of need".[1]

The ABA supports a CSLR which, in line with the Government's response to the Final report, is:

- forward looking (covering unpaid determinations made under AFCA Rules);
- industry funded;
- has its own independent board;
- is supported by AFCA;
- extends beyond personal advice failures; and
- has design features consistent with the Ramsay Review recommendations.

The banking industry acknowledges that some customers of financial services and products have suffered losses because of inappropriate advice or poor conduct. In some of these situations, the customers have been unable to seek compensation due to the financial business becoming insolvent. The ABA recognises the importance of a CSLR to building trust and confidence in the financial services sector and ensure consumers of financial products are treated fairly, have adequate information, and avenues for redress in the event of poor conduct.

2. Key design principles

To ensure the success and viability of the CSLR, the ABA recommends that the Government adopt a scheme with the following design principles.

2.1 Sustainable scope

The CSLR should be appropriately scoped, to ensure:

- services and products that give rise to the greatest risk of unpaid determinations are included within the scope; and
- the scheme is affordable and sustainable for its participants.

Public trust and confidence will only be improved through a sustainable scheme that can operate over the long term.

The CSLR should pay compensation to retail clients as defined by the *Corporations Act* 2001 where professional indemnity insurance will not respond to meet claims (e.g. where a firm has engaged in fraudulent conduct and fraud is a policy exemption) or the insurance is insufficient, the business is insolvent and an AFCA determination has not been paid. The proposed compensation should be

[1] *Supplementary Final Report: Review of the financial system external dispute resolution and complaints framework* (Ramsay Review) at page 51, available at https://treasury.gov.au/sites/default/files/2019-03/Supplementary-Final-Report-2.pdf.

capped and in line with the current AFCA compensation limits. This will ensure that compensation outcomes are consistent.

2.1.1 Prudentially regulated entities

In the ABA's view, it is not necessary for the CSLR to cover determinations against prudentially regulated entities.

Australian Prudential Regulation Authority (**APRA**) entities are required to manage prudential risks in accordance with standards set by the APRA. This risk management requires meeting capital requirements and APRA regulated entities are some of the most heavily capitalised globally. It is an extremely remote possibility that a customer of a prudentially managed firm will require access to the scheme. The ABA is of the view that these entities should be excluded from the scope of the scheme.

There are also a series of legislated, government-backed claims schemes that relate to prudentially regulated entities and are designed at providing protections in the event of an institution failure. These include:

Superannuation Industry (Supervision) Act 1993 (**SIS Act**) - Part 23 of the SIS Act provides protection for members of a regulated superannuation fund (other than a self-managed superannuation fund or SMSF) or an approved deposit fund, where there has been a loss as a result of fraudulent conduct or theft, causing substantial diminution of the fund leading to difficulties in the payment of benefits.

Financial Claims Scheme for banking institutions - The Financial Claims Scheme (**FCS**) provides protection to deposits in banks, building societies and credit unions. Under this scheme, deposits held are protected up to a limit of $250,000 for each account holder at each bank, building society and credit union that is incorporated in Australia and authorised by APRA in the event of a failure.

Financial Claims Scheme for general insurance – in the event that an insurer has failed, this Government scheme is activated and ensures that most claims made against a general insurer by their policyholders or people with valid claims against the insurer, are covered up to $5,000. Claims above $5,000 are also covered under the FCS for eligible policyholders and certain third parties.

National Guarantee Fund - The National Guarantee Fund (**NGF**) is the compensation fund for certain losses incurred by investors who trade in shares on ASX. The NGF applies only in specific circumstances and does not compensate investors for trading losses including those caused by market events or by investment choices based on poor advice.

If the Government includes prudentially regulated firms this may have a broader negative effect on investor confidence in the Australian prudential system. This risk is particularly acute if the design of the CSLR risks the potential transmission of losses from the CSLR to the prudentially regulated sector.

2.1.2 Managed investment schemes

In the ABA's view, the CSLR should not cover determinations against MIS as this would be counter to the principle of a sustainable and affordable scheme.

The financial risks arising from MIS are fundamentally different from personal advice-based financial harm and could introduce risks to the scheme that cannot be qualified and are material in nature. MIS have varying risk profiles and can include Australian index funds, international share funds, commercial property finds and agricultural ventures.

If MIS were to be included in the CSLR, a risk weighted contribution model should apply to these schemes. This would involve significant complexity and time to design and would significantly impede the introduction of the CSLR. We therefore take the view that the inclusion of MIS would severely hamper the long-term viability and success of this CSLR, and any expansion to this area should only be contemplated in the future following a need identified through careful review.

The ABA notes that as the CSLR will cover personal financial advice, losses related to MIS that are due to inappropriate personal financial advice or conduct by a financial firm are included. However, determinations against MIS sold directly to a consumer under a general advice model should be excluded.

2.2 Prospective

The scheme should cover consumers of financial products who receive an approved AFCA determination in their favour and should apply to unpaid determinations made under AFCA's Rules from 1 November 2018.

2.3 Last resort

The CSLR must be a scheme of last resort. Alternative compensation arrangements should be pursued initially, including resorting to the cash reserves of the AFS licensee or credit licensee. If the initial steps to seek alternative compensation are exhausted, then an applicant could seek a claim through the CSLR. The CSLR should afford applicants a 12 month claim lodgement period.

2.4 Industry-wide and mandatory funding

The scheme should require all AFCA members to contribute to its funding. The funding structure should clearly define and fix pre event and any post event contributions, with a clear separation of funding pools based upon the financial or credit service provided. These funding pools should be capped and designed to avoid any form of cross subsidisation in the event that reserves of a particular pool are exhausted. This would remove any uncertainty for contributors and minimise risk of capital losses which would impact the prudential stability of Authorised Deposit-taking Institutions (**ADIs**)/prudentially regulated firms.

The ABA recommends that the CSLR have a process, that in the event of the exhaustion of the reserve pools, a review of levies would be undertaken to ensure adequate funding moving forward. Provisions should also be made to manage excess funds as they accumulate. Ongoing modelling should be undertaken to understand the prospective exposure of the CSLR and align and fix contributions to that exposure.

2.5 Review of the CSLR

The ABA recognises the need for the CSLR to be subject to an annual review of its scope and funding model, based on data collected through the operation of the scheme over time. Based on this wider evidence base, the Government will be in a better position to assess the areas of acute need in terms of unpaid determinations.

In this respect, this review process would then be able to recommend any necessary changes in the CSLR's scope, operations and funding. It can also ensure it can be effectively extended in the future if the review identifies the need for the scheme to deal with any broader types of consumer losses and additional funding entities.

3. Broader reforms to manage risk

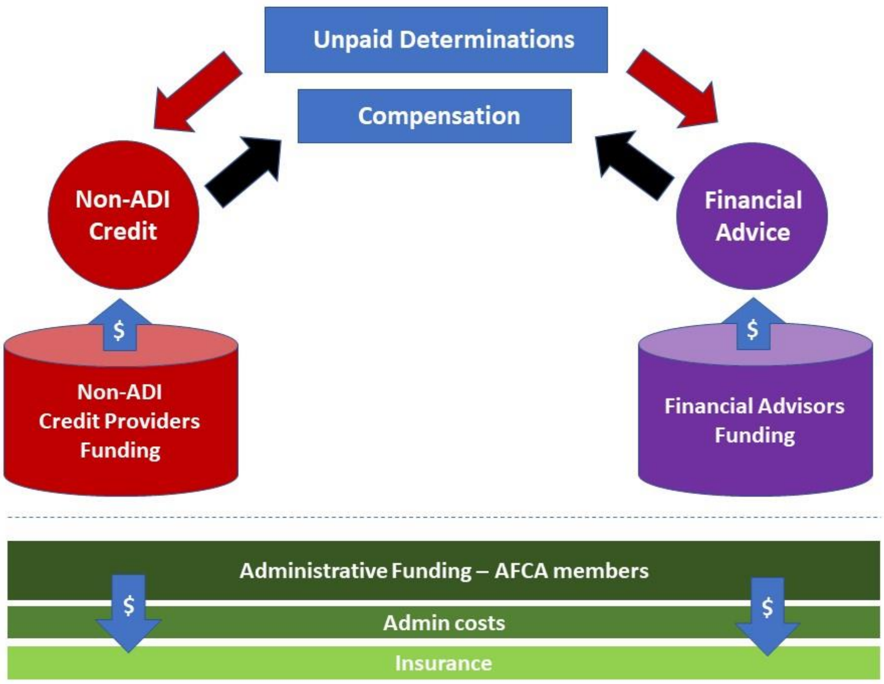
To ensure the effectiveness of the CSLR, the Government should also pursue other reforms, in conjunction with the establishment of the CSLR, designed at improving the quality of advice, providing greater consumer protections, and reducing the number of unpaid determinations within the financial system. The introduction of the scheme should be accompanied by:

- **Improvements to the professional indemnity insurance regime:** the cost, availability and coverage of professional indemnity insurance should be expanded, including run-off cover, insolvency, fraud and other misconduct; and

- **Review of the financial requirements for financial advice licensees:** the review should consider whether cash requirements for AFSLs with a financial advice authorisation remain sufficient. Cash resources to compensate clients and meet any insurance deductible payments should form part of the resources required in a wind down of a financial advisory business.

4. ABA's proposed model for establishment of the CSLR

On the basis of the above design principles and other considerations, the ABA proposes the following model to establish the CSLR. We believe that this option sets out a workable compensation scheme that meets the Government's stated objectives.



4.1 Key features of the proposed CSLR

The proposed model has the following key features:

- accept unpaid determination claims relating to financial advice and non-ADI credit assistance and credit providers;
- exclude prudentially regulated entities and MISs sold directly to a consumer under a general advice model;
- have two separate claims funding pools for each respective industry (financial advice and non-ADI credit providers); and
- an administration funding pool would cover administrative costs and insurance costs for significant and unexpected events. This would be funded by all AFCA members.

4.2 Scope

The scope of the CSLR should extend to unpaid AFCA determinations relating to:

- an Australian Financial Service (**AFS**) licensee, providing Tier 1 financial product advice through authorised representatives listed on ASIC's Financial Advisers Register (which is in line with the final recommendation of the Ramsay Review), and
- non-ADI related credit matters (e.g., mortgage broking and credit offered by non ADI ACL holders).

We support the establishment of caps on the level of compensation that the CSLR can provide and it would be best to align these with the current AFCA caps. The ABA suggests that professional and legal costs not be recoverable through the CSLR, but if the Government's intention is to include the recovery of such costs, they should be aligned with AFCA's $5000 limits.

4.2.1 Basis for including Tier 1 personal advice

The ABA proposes that the CSLR should extend to unpaid determinations relating to an AFS licensee, providing Tier 1 financial product advice through authorised representatives listed on ASIC's Financial Advisers Register. This is in line with the Ramsay Review recommendation as evidence has highlighted that this is the area contributing to the largest share of unpaid determinations.

4.2.2 Basis for including non-ADI credit services

The ABA proposes that non-ADI related credit matters be included in the scope of the CSLR given that this has been one of the areas producing a higher proportion of unpaid determinations. According to Australian Government Actuary data from December 2019, AFCA noted 346 cases of unpaid determinations with the second highest category being non-compliant credit providers at 19% of claims. The inclusion of non-ADI credit providers would encourage better conduct within this industry and ensure better outcomes for consumers.

We further suggest that it is most appropriate for the scope to be restricted to non-ADI related credit providers. As Treasury notes in its consultation paper, there is no evidence of unpaid determinations resulting from ADI credit providers, or other prudentially regulated firms, as these are subject to a robust prudential regime and will be able to compensate customers.

Based on further scoping and analysis by Treasury, it may be appropriate to distinguish between funding pools for credit assistance providers (mortgage brokers) and non-ADI credit providers.

4.3 Out of scope

The ABA proposes that the scope of the CSLR should not extend to unpaid determinations relating to:

- losses related to investment services, including MIS (provided under a general advice model) and all products traded on the ASX and other such markets; and
- prudentially regulated entities.

4.3.1 Managed investment schemes and market linked investments

The ABA is of the view that MIS sold directly to a consumer under a general advice licence should be excluded from the CSLR. The financial risks arising from MIS are fundamentally different to advice-based risk and provision of credit risks. These risks are largely related to the investment models of MIS and are difficult to mitigate against.

By their nature, MIS introduce financial risks for those contributing to the scheme that could be material and are difficult to quantify. The potential exposure of the CSLR to an MIS failure could leave the CSLR exposed to underfunding. This would risk the sustainability of the scheme. It is entirely plausible that an MIS crisis could see contributors come under substantial pressure to ensure the CSLR is adequately capitalised to cover for any unpaid determinations. Such type of liability would have severe implications for the capital requirements of prudentially regulated entities and would bring into question the viability of the scheme. The continued and successful operation of the scheme is critical to the objective of improving consumer trust and confidence and we therefore support the exclusion of MIS.

4.3.2 Prudentially regulated entities

The ABA believes that there is no need to include prudentially regulated entities within the proposed CSLR's scope. Scenarios where a prudentially regulated entity would have an unpaid determination are extremely rare and would only likely occur in the event of an institution failure.

To ensure the stability of the financial system these prudentially regulated entities are required to manage prudential risks through capital requirements. These requirements are designed to ensure that entities are well capitalised and able to withstand significant shocks to the system, as well as also being regularly reviewed by APRA to ensure their adequacy.

4.4 Funding of the scheme

The ABA proposes that funding for the CSLR would be split into separate pools according to the entities involved:

- **Advice pool** (e.g., brokers etc) – advisors to pay a levy into a specific pool and these funds to be allocated to pay for unpaid AFCA determinations on advice matters.
- **Non-ADI credit pool** – non-ADI credit providers to a pay levy into a specific pool and these funds would be allocated to pay for unpaid AFCA determinations on non-ADI credit matters. As noted above, it may be appropriate to separate this into 2 pools for credit assistance providers and non-ADI credit providers.
- **Administration pool** – all AFCA members to a pay levy into a specific pool that can be used to fund ongoing administrative costs of the CSLR and pay for an insurance mechanism. This insurance is intended to cover shortfalls in the reserves of either the advice or non-ADI credit pool if they are exhausted due to a significant and unexpected event. The ABA proposes that the administration funding be based on the AFCA funding model base levy.

We believe that the establishment of this funding model in this way is appropriate given it will mean that all financial services entities that are members of AFCA will fund the scheme, which will help to give it trust and legitimacy, while not relying on cross-subsidisation across industry sectors.

For example, in any year, the advice and non-ADI credit pools could raise a specific amount of funding from levies imposed on entities in those sectors for payment of those sector-specific unpaid determinations.

In conjunction with this, all AFCA members would pay a levy to generate funds for the administrative pool. Generated funds would be used for administrative and operational costs of the CSLR and the costs associated with insurance (e.g. insurance premiums). Claims on the insurance would occur where a large failure exhausts either of the two funding pool reserves.

4.5 Large failures or unexpected costs

The ABA proposes that the CSLR should plan appropriately to fund claims generated by large and unexpected financial failures. These events may mean that the number of claims eligible for compensation through the CSLR in a given year exceeds the scheme’s planned funding level within either the advice or non-ADI related credit funding pools.

We believe that the funds within the administrative pool could be used to provide a mechanism to prepare for any large failures or unexpected costs through an insurance framework. This insurance mechanism will ensure that the CSLR remains viable in the long run and removes any reliance on cross-subsidisation across industry sectors and the risks that are associated with this. This will help to ensure the sustainability of the scheme and reduce volatility for the entities funding the scheme.

Insurance is preferable to a scheme carrying large reserves or applying post event levies that will be difficult for small and medium providers to provide for. Further detailed modelling is required to understand that nature of the insurance provided and the cost of associated premiums.

4.6 Governance

The ABA proposes that ASIC should have responsibility for regulatory oversight of the scheme to ensure it is fulfilling its objectives similar to the role it plays in relation to AFCA.

We also suggest that the CSLR should be governed by an independent board with an independent chair and an equal number of directors with industry and consumer backgrounds (ideally no more than 5 directors including the chair).

The ABA supports the scheme being subject to an annual review to ensure it is meeting its objectives. Greater data would have been collected through the operation of the scheme and would allow for a more informed analysis of areas of unpaid determinations and the necessary level of funding. We suggest that this would be an appropriate time to consider any necessary changes to, or expansion of, the scheme.

4.7 Need for more robust and accurate data

The ABA notes that there is currently limited data available to support detailed and robust modelling for the establishment of the CSLR. This includes limited evidence on the level of unpaid determinations over time and into the future, as well as the development of appropriate funding models based on factors such as risk and ability to pay.

We submit that this supports the need to develop a limited CSLR to ensure its credibility and sustainability while ensuring that it is scalable to cover an expanded scope of financial services with significant problems in the future.

Further, we also suggest that it is vital that appropriate mechanisms are put into place to ensure that CSLR collects robust and accurate data to support its ongoing work over time. For example, there is a need to ensure that the accuracy of data relating to the classification of financial firms (e.g., financial adviser or credit provider) given we understand that AFCA currently relies on its members self-selecting its status without any further scrutiny.

Australian Banking Association

Appendix A – ABA response to Treasury consultation paper questions

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

The CSLR should cover unpaid determinations from personal advice and non-ADI credit providers.

The ABA supports an annual review of coverage and the funding model to ensure the CSLR is adaptable, viable and responding to any changes in the unpaid determination landscape.

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

The ABA supports the exclusion of court and tribunal decisions in the first instance. Further information is needed about the number of unpaid financial services court and tribunal decisions. This data would need be collected and reviewed before these decisions are included in the scheme.

Voluntary AFCA members should be excluded from the scheme, with the view that they may be captured over time.

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

The funding model should include those industries with the highest number of unpaid determinations. These industries would pay into their respective funding pools.

All AFCA members would equally contribute to an administrative funding pool to fund the operational cost of the CSLR and insurance to cover for unexpected losses to the scheme. The ABA proposes that the administration funding be based on the AFCA funding model, base levy.

How should the funding model address unexpected costs?

The CSLR should acquire insurance designed at insuring against an unexpected event that depletes the funding reserves of either the advice pool or the non-ADI credit provider pool. This insurance would be funded through the administrative pool by all AFCA members.

How should the funding model promote sustainability and affordability?

The sustainability and affordability of the CSLR and its funding model will be best supported through it being established with an appropriately limited scope in the short term. Any expansion of scope should only be considered through careful review to ensure the CSLR remains sustainable and there is a need to respond to any changes in the unpaid determination landscape.

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

The CSLR compensation limits should be aligned with those of AFCA to ensure consistency in the compensation paid out.

How should the CSLR manage claims associated with large unexpected costs?

In relation to a specific event with large unexpected costs, the CSLR should have the power to impose a lower compensation limit for eligible claims so that the associated large losses can be managed in a sustainable way.

How should compensation for legal and professional costs be limited?

The CSLR should exclude compensation for legal and professional costs. Payments from the CSLR should be used to compensate consumers rather than for professional costs. If the Government does include such costs, they should be aligned to those of AFCA's limits for professional costs.

To what extent should the operation of the CSLR be responsive to experience?

The ABA supports an annual review of its scope and funding model, based on data collected through the operation of the scheme over time. This review process would allow the CSLR to adapt to any necessary changes in scope, operations and funding if it is determined to need to deal with any broader types of consumer losses and additional funding entities.