13 August 2021

Mr Chris Lyon
Manager, Financial System Division
Treasury
Langton Crescent
Parkes ACT 2600

via email: CSLR@treasury.gov.au

Dear Mr Lyon

Compensation Scheme of Last Resort

The Australian Banking Association (**ABA**), Australian Finance Industry Association (**AFIA**), Insurance Council of Australia (**ICA**) and Customer Owned Banking Association (**COBA**) jointly express our concerns over the exposure draft legislation published by Treasury on the Compensation Scheme of Last Resort (**CSLR**). Some individual associations have provided separate submissions; however, the purpose of this letter is to outline areas of shared concern for our organisations and respective members.

The draft legislation is intended to enact Recommendation 7.1 of the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (**Royal Commission**), which found that a compensation scheme of last resort should be established in line with the prior findings of the *Supplementary Final Report of the Review of the financial system external dispute resolution and complaints framework* (**Ramsay Review**).

It is clear from his Final Report that Professor Ramsay intended that a CSLR should only be established to the extent that it was "limited and carefully targeted at the areas of the financial sector with the greatest evidence of need".[1] We are supportive of establishing a forward-looking CSLR that is industry-funded, independent and has a targeted yet scalable scope, in line with the findings of the Ramsay Review.

The finance industry is strongly of the view that the Government's current proposal fails to meet the mandate established by the Ramsay Review. We are particularly concerned about the broader scope of proposed scheme, which appears ill-advised given the recent experience of overseas schemes.

We make the following recommendations to revise the scheme:

1. **The CSLR should initially be restricted to financial advice failures, but be scalable**

The Government should adopt Ramsay's recommendation that the CLSR should initially be restricted to financial advice failures. This is because most unpaid determinations arise due to failures in the financial advice sector. For example, in 2017, the Financial Ombudsmen Service

[1] The Australian Government, *Review of the financial system external dispute resolution and complaints framework – Supplementary Final Report*, September 2017

(**FOS**) advised that 92 per cent of the value of its unpaid determinations were attributable to financial planners and advisers.[2]

Moving immediately to a CSLR where a broader set of claims would be eligible for compensation could expose the scheme to significant financial liability and undermine its future sustainability. This has been the experience of comparative overseas schemes. For example, the UK Financial Services Compensation Scheme (**FSCS**) has faced rising costs since its inception. More information on the UK scheme is contained in an appendix to this letter. We also note the work done by the Financial Services Council (**FSC**) on the operation of the FSCS – these lessons should be taken into consideration with the establishment of a scheme in Australia.

The finance industry calls on the Government to publish the evidence that it has relied upon to justify widening the scope of the scheme beyond that proposed by the Ramsay Review. This includes any underlying data on the volume and value of unpaid determinations since September 2017.

2. The Government should implement parallel reforms aimed at the underlying problem

Professor Ramsay noted that it was important to strengthen other regulatory requirements in conjunction with the establishment of the scheme, so that "there may be fewer claims made on a CSLR."[3]

It is important to remember that every person that will utilise the compensation scheme will have suffered a poor outcome that it would have been much better to avoid. A CSLR will not fix the underlying causes of unpaid determinations and may, in some cases exacerbate those causes. For example:

- Some firms could adopt less risk-averse approaches and behaviours in the expectation that, if something goes wrong, the scheme will compensate the client.
- A firm in financial difficulty might worry less about trying to preserve its solvency if it knows that its customers will have recourse to a fund and will not be left entirely out-of-pocket.
- The scheme could incentivise firms to become artificially insolvent in order to transfer their liabilities to the scheme.
- A CSLR may reduce the incentive for compliance with existing compensation arrangements and financial requirements.

The finance industry considers that implementing broader reforms will not only lead to less unpaid determinations but will also mean that the CSLR is more effective, targeted, and sustainable over the longer term. These reforms could include imposing enhanced financial requirements and ensuring that financial services entities hold appropriate levels of professional indemnity insurance.

In addition, ASIC should undertake regular risk-based reviews of licensees to ensure that they have adequate financial and compensation arrangements in place, in compliance with their regulatory and statutory obligations.

3. The Government should ensure the scheme costs are efficient

We are concerned about the projected costs of the scheme, as disclosed in the proposal paper. For example, the Government has estimated that the scheme will cost $6.3 million to establish. This constitutes a 4,000 per cent increase to the estimated costs that were presented to

[2] The Australian Government, *Review of the financial system external dispute resolution and complaints framework – Supplementary Final Report*, September 2017, p. 64.
[3] The Australian Government, *Review of the financial system external dispute resolution and complaints framework – Supplementary Final Report*, September 2017, p. 117.

Australian Banking Association | AFIA | Customer Owned Banking Association | Insurance Council of Australia

Professor Ramsay as part of the consultation process to recommend the establishment of a CSLR.[4]

In addition, the Government has outlined its expectation that administrative costs of the CLSR will account for approximately 45 per cent of its annual ongoing costs. We ask the Government to review the proposed cost structure of the scheme in order to maximise its efficiency.

4. The Government should fund the unpaid determinations that have accumulated prior to the commencement of the scheme.

The Government has proposed that the ten largest financial firms as determined by the Australian Taxation Office (**ATO**) will fund all unpaid AFCA determinations and fees that have accumulated prior to the commencement of the scheme.

The finance industry is concerned that the Government has not provided an estimate of the size of this one-off levy, nor any data on the value and volume of unpaid determinations that underpin it. Furthermore, we note that, given the commencement of the scheme is yet to be determined and the levy is uncapped, the cost is subject to the risk of a 'black swan' event occurring before the CSLR commences. This poses an unacceptable risk to the shareholders of Australia's largest financial firms. Moreover, we question the appropriateness of attributing this amount to firms that face a higher level of regulatory supervision and are very unlikely to become insolvent.

In May 2019, the Federal Government announced its intention to make $30 million available to consumers and small businesses that had unpaid determinations dating back to 2010 due to a financial firm becoming insolvent. We suggest that this was appropriate, given the CLSR was intended to be prospective in nature. In line with this, we recommend that the Government should extend the $30 million funding to cover all unpaid determinations ahead of the commencement of the CSLR.

5. The Government should reconsider the Ministerial powers proposed

The Government has proposed that, in the event where annual compensation paid by the CSLR is expected to exceed the levies recouped, the Minister has powers to direct that:

- a special levy be recouped from all or a subset of AFCA members up to a total cap of $250 million; and/or
- compensation paid to customers be reduced or spread over multiple years.

We submit that this proposed mechanism is not appropriate, as it essentially empowers the Minister to decide to levy an unspecified amount on any firm or to reduce customer's compensation without consultation, an explanation of the decision or a right of redress. The governance of the scheme must be clear and independent – especially as the scheme has the explicit objective of supporting ongoing confidence in the financial system's dispute resolution framework.

A carefully structured scheme that takes account of the above points would, in our submission, achieve the intent of the Royal Commission while leaving scope for an expanded scheme in the future if the evidence warrants it.

Thank you for the opportunity to make a submission. Please contact Jess Boddington (jess.boddington@ausbanking.org.au) or at 0412 646 864 if you wish to discuss this submission in further detail.

---

[4] In November 2016, the Financial Ombudsmen Service and the ABA commissioned Oliver Wyman to conduct a cost-benefit assessment of a CLSR for financial services consumers in Australia. This analysis concluded that establishment costs for such a scheme would be limited to approximately $400,000. Oliver Wyman, *Last Resort Compensation Scheme – Design Proposal*, 6 February 2017

Yours sincerely

Anna Bligh
CEO
Australian Banking Association

Diane Tate
CEO
Australian Finance Industry Association

Andrew Hall
CEO
Insurance Council of Australia

Michael Lawrence
CEO
Customer Owned Banking Association

Appendix: Operation of the UK FSCS

The Financial Services Compensation Scheme is the United Kingdom's statutory compensation scheme of last resort for customers of financial services firms. It is an independent body established under the *Financial Services and Markets Act 2000 (UK)*. Individuals and small business are eligible to make claims to the FSCS. The FSCS will pay compensation when it is satisfied that a firm is unable, or likely to be unable, to pay claims against it and therefore deemed to be 'in default'.

The UK FSCS covers claims for deposits, investments, insurance mediation, general insurance, life insurance and pensions, home finance and debt management. The UK FSCS differs significantly in scope to the proposed CSLR, as the UK scheme encompasses all compensation schemes that pay eligible claims for both insolvency as well as misconduct. For example, the UK FSCS compensates for the same risks addressed by Australia's Financial Claims Scheme (**FCS**).

On 15 July 2021, the Financial Conduct Authority (**FCA**) announced that it would undertake a review of the scope and coverage of the FSCS. [5] This review was motivated by rising costs associated with the scheme over recent years. In particular, the overall bill for redress within the advice market is very high, with the total forecast levy for 2021-22 amounting to £1.04 billion.

Several have noted that these rising costs are, in large part, due to the adverse incentives that the scheme introduces into the market. For example, the UK Personal Investment Management and Financial Advice Association (**PIMFA**) outlined that it has witnessed increasing evidence of market distortion due to the scheme. For example:

> "…we are aware of a number of examples where firms have sought to fold in order to relinquish any tail liabilities they have on high risk markets and investments such as [defined benefit] transfers. Firms are then phoenixing[6] without tail liabilities whilst these liabilities fall on to the FSCS…
>
> We have also received substantial feedback from firms whereby individuals or firms are 'phoenixing' as Claims Management Companies [**CMCs**]. In this construct, firms will 'dissolve' and resurface as a CMC advising and coaching former clients through the claims process..."[7]

Charles Randell, Chair of the FCA, recently noted that they needed to 'redesign the system to ensure that the polluting firms in the financial sector are the ones that pay, not those that have behaved well'.[8] To reduce the reliance on the FSCS for the future, regulators are advocating for firms to have appropriate liquidity and capital reserves to cover outstanding redress liabilities.

---

[5] FCA, *Business Plan 2021/22*, p. 22.

[6] Illegal phoenix activity is when a company is liquidated, wound up or abandoned to avoid paying its debts. A new company is then started to continue the same business activities without the debt.

[7] PIMFA, *A rising tide lifts all boats? A roadmap towards better consumer outcomes and lower levies*, 2020.

[8] Speech by Charles Randell, Chair of the FCA and PSR, to a virtual roundtable of bank chairs hosted by UK Finance, June 2020.