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Senate Standing Committees on Economics
PO Box 6100
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Canberra ACT 2600

By email: economics.sen@aph.gov.au

AFA Submission - Compensation Scheme of Last Resort

The Association of Financial Advisers Limited (**AFA**) has served the financial advice industry for 75 years. Our objective is to achieve *Great Advice for More Australians* and we do this through:

- advocating for appropriate policy settings for financial advice
- enforcing a Code of Ethical Conduct
- investing in consumer-based research
- developing professional development pathways for financial advisers
- connecting key stakeholders within the financial advice community
- educating consumers around the importance of financial advice

With the exception of Independent Directors, the Board of the AFA is elected by the Membership and Directors are practicing financial advisers. This ensures that the policy positions taken by the AFA are framed with practical, workable outcomes in mind, but are also aligned to achieving our vision of having the quality of relationships shared between advisers and their clients understood and valued throughout society. This will play a vital role in helping Australians reach their potential through building, managing and protecting their wealth.

Introduction

We thank you for the opportunity to provide feedback on the Compensation Scheme of Last Resort legislation. We do not propose to make any comment on the Financial Accountability Regime Bill 2021.

The AFA supports a genuine compensation scheme of last resort (CSLR) to address unpaid determinations awarded by the Australian Financial Complaints Authority (AFCA) to protect the interests of consumers who are detrimentally impacted by misconduct and the subsequent insolvency of a financial firm. We also agree that it is appropriate to compensate those who are the subject of unpaid determinations for the period from the commencement of AFCA, in November 2018, through until the start of the CSLR.

There are broader benefits of a CSLR that extends to the entire banking and financial services industry, in that it gives consumers greater confidence to purchase financial products. Whilst we recognise that a CSLR is most likely to be relevant in the case of the failure of small businesses, the benefits of the scheme also flow to bigger businesses. We fully appreciate that banks, insurers and super funds, which are all prudentially regulated, are unlikely to cause unpaid determinations. For this reason, we propose that whilst the direct cost of compensation for unpaid AFCA determinations should be funded by the sectors that generate the unpaid determinations, we believe that there is a role for the broader industry to contribute to the cost of the establishment and administration of the CSLR. Consumers are less likely to appreciate what might drive unpaid determinations, however the CSLR will assist all consumers to have greater confidence.

We are disappointed at the lack of information being shared by the Government with respect to unpaid AFCA determinations and the reason why they have remained unpaid. We are being expected to take the percentage attributed to financial advice, as set out in the earlier proposal paper as fact, when this data could easily have been shared with us. In any case, this is backward-looking data. The scheme should be designed for the future. We suggest that this means there should be more acknowledgement of the professionalisation of the financial advice profession. More recently, we have been advised that financial advice complaints have declined materially in the current financial year, indicating that while financial advice has been a major cause of unpaid determinations in the past, this may no longer be the case.

We are significantly concerned about the cost impact on the financial advice sector of this initiative, particularly when the sector might be expected to predominantly fund the establishment of the CSLR and a capital reserve. We believe that these initial costs should be shared more broadly and that in-scope subsectors should only shoulder the full direct cost of applicable unpaid determinations. Addressing this issue will have a material impact upon the concern that has been generated by which subsectors are considered to be in-scope versus out of scope. The establishment costs and the operational costs set out in the proposal paper earlier in 2021 were excessive and it is not evident that this issue has been addressed.

We have previously addressed concerns about the exclusion of managed investment schemes (MISs). We have never suggested that the MIS sector should pay compensation in the event of poor investment performance. That is not how the External Dispute Resolution regime works and neither is it what should be expected of a CSLR. However, a CSLR might be expected to cover losses that flow from fraud or misrepresentation by an MIS, that results in losses and, ultimately, unpaid determinations. There is also the important issue of timing. It seems that historically MISs have failed very quickly, meaning that clients do not have enough time to submit a successful claim before the business is in liquidation. As a result, these claims are often never considered. This has distorted the historical claims and unpaid determinations data. We therefore recommend that MISs are included in the original scope of the CSLR.

We believe that it is appropriate to raise the following core questions with respect to the design of the CSLR:

1. Has enough been done to minimise the need for a compensation scheme of last resort?
2. Is the scope of the scheme both adequate and fair?
3. Is the proposed cost of the scheme reasonable?
4. Is the proposed structure for the CSLR the most appropriate?
5. Are the various caps and controls appropriate?
6. Is it appropriate to put a cap on the amount paid through a compensation scheme of last resort?

We will address all these issues below.

We are once again very disappointed to see that there is no Regulation Impact Statement. The statement that the "Financial Services Royal Commission Final Report has been certified as being informed by a process and analysis equivalent to a Regulation Impact Statement for the purposes of the Government decision to implement this reform" does not stand scrutiny. The Hayne Royal Commission Final Report included no details on what the CSLR might look like, or what it would cost to operate. It is nothing more than a very short discussion on the Ramsay Inquiry and a message of high-level support. In no way does it remove the important role that a Regulation Impact Statement should play in such an important reform.

We welcome the Government's announcement that they will pay for the costs of the scheme in the first year and we also support the proposal that the largest 10 financial institutions will pay for the outstanding determinations since the establishment of AFCA in November 2018. Both of these measures will help to ensure that clients are appropriately compensated, while ensuring the in-scope subsectors, and specifically financial advisers, will not be overwhelmed by significant additional costs in the short term.

AFA Recommendations

For the reasons outlined, we recommend the following changes to the CSLR design:

- The scope of the CSLR be expanded to include MISs from commencement.
- There should be a mechanism for any genuine unpaid determination, even from an out-of-scope subsector, to be compensated, even if the funding is not obtained until the following year.
- The subsectors responsible for unpaid determinations be required to pay the full direct cost of compensation.
- The cost of the establishment, including the capital reserve for the CSLR, be equitably shared across the full spectrum of participants in the banking and financial services industry through the existing ASIC Funding levy process.
- If the capital reserve was raised across the full industry, then the capital reserve could be raised in just one year, rather than spread out over three years.
- The annual operating costs of the CSLR be equitably shared across the full spectrum of participants in the banking and financial services industry through the existing ASIC Funding levy process.
- The responsibility for the operation of the CSLR be assigned to ASIC or another Government body to avoid the creation of a new company limited by guarantee and the resultant additional costs.

Has enough been done to minimise the need for a compensation scheme of last resort?

We would argue that not enough has been done to address the issue of unpaid determinations. In fact, we would argue that throughout this process, there is not enough visibility of the reasons why EDR determinations are not being paid and there has been little if any focus upon what can be done to reduce the risk of unpaid determinations in the future.

We welcome the Government's decision to undertake an Inquiry to look at the effectiveness of Professional Indemnity Insurance. Capital adequacy is also an important issue, however we believe that capital adequacy for financial firms, and financial advice licensees in particular, is a delicate balancing act as it needs to be structured in a way that does not unreasonably limit the creation of new financial advice licensees.

Through the work we do with complaints, the AFA is aware of unpaid determinations that are outstanding for a long period of time, even whilst a licensee remains operational. Seemingly the full force of the law is not being applied soon enough to get these firms to pay the determinations that have been awarded. We would therefore like to see a stronger enforcement regime.

We are not opposing the establishment of a CSLR, however we believe that it needs to happen in parallel with other measures to reduce the risk of future matters arising and the scheme should be designed on the basis of an expectation of a decline in the number of matters that will arise in the future. An appropriate focus upon the cause of unpaid determinations and relevant solutions, should help to reduce occurrences in the future.

Is the scope of the scheme both adequate and fair?

In our August 2021 submission to Treasury, we highlighted serious concerns about the scope of the CSLR. We have repeated below what we said in August.

> *We fundamentally question the proposed scope of this scheme. We do not have access to much information on unpaid determinations, however we note the Financial Ombudsman Service (FOS) submission to the Banking Royal Commission on 2 February 2018 that included the following:*

> > *Financial advisors/planners were involved in more than half (55%) of all of these unpaid determinations, followed by operators of managed investments schemes (13%) and credit providers (10%).*
>
> *We accept that financial advisers would need to be part of the scheme, however we are surprised that managed investment schemes have been excluded from the proposed scope of the scheme, particularly given the FOS evidence that they are the second largest contributor.*
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> *The December 2019 discussion paper on "Implementing Royal Commission Recommendation 7.1 – Establishing a Compensation Scheme of Last Resort" included a reference to the UK's Financial Services Compensation Scheme. This scheme includes deposit and investment products. It also includes life insurance and pensions. The UK scheme is much broader than what has been proposed in Australia. The Government has provided no justification for why that is the case.*

We continue to have concerns about the exclusion of the MIS sector, particularly given the history of product failures in this space, and the fact that compensation could be payable in the event of misconduct such as fraud or misrepresentation. We further suggest that there should be a mechanism for the payment of compensation for all out of scope subsectors, even where the funding needs to be obtained through a special levy or through a levy in the subsequent year.

As discussed above, we object to the establishment costs, capital reserve and operating costs being funded by the initial in-scope sectors. We support an outcome where in-scope sectors pay for the full direct cost of unpaid determinations, however we believe that the establishment, capital reserve and operating costs should be fairly allocated across the full regulated community.

To ensure that the stakeholders in the banking and financial services community can have confidence in the scheme and the funding of the CSLR, we believe that it is important that public reporting be made available on the operation of the scheme and the funding of the scheme.

Is the proposed cost of the scheme reasonable?

In our August 2021 submission to Treasury, we highlighted serious concerns about the suggested cost of running the CSLR. It is not evident to us that this has changed and accordingly we have repeated below what we said in August 2021.

> *We note that the Treasurer announced on 4 February 2019 in releasing the Government's response to the Banking Royal Commission final report, that the Government would pay almost 300 consumers compensation totalling around $30 million as a consequence of unpaid determinations for prior misconduct. This clearly suggests that over the course or what we understand to be around 10 years, there were a total of less than 300 impacted consumers. We also assume that a reasonable amount of the $30 million will have related to interest payments on the older unpaid determinations.*
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> *In their submission to the Banking Royal Commission on 2 February 2018, the Financial Ombudsman Service (FOS) noted that they had a total of $14m in unpaid determinations related to 157 determinations and 223 consumers. Noting that whilst FOS were the largest EDR scheme, they were not the only scheme.*
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> *On the basis of this data, we can assume that there were around 200 to 220 determinations that have been left unpaid over a period of approximately 10 years. That presumably suggests around 20 to 25 determinations per year.*

> *The compensation scheme of last resort proposal paper suggests that the annual administration cost will be around $3.7 million. On the basis of 20 to 25 unpaid determinations per year, this would mean a cost of $148,000 to $186,000 per unpaid determination. This is an extravagant amount and totally unjustified. On this basis, we would suggest that there must be a better solution. There is simply no justification for an expense of this scale.*
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> *Tables 2 and 3 show that the ongoing levy would be $8,057,489, so if $3.7 million of this is made up of the annual administration cost, then the amount of compensation that is to be paid out is no more than $4.36 million. It is ridiculous to propose to incur $3.7 million in administration costs to pay out just $4.36 million in compensation payments. This is a cost ratio of at least 85%. Given that there is no review of the merits of the original claim, and it is largely limited to confirming that the determination has not been paid and it complies with the other requirements, this is unbelievably expensive. It is unclear why the board needs five directors, for what is largely an administrative function in the payment of unpaid determinations. We are unsure why the board would need people with actuarial and claims experience given the limited number of matters that are expected to be dealt with each year. In the normal scheme of business, actuarial assessment would not need to be a core part of the process of working out the levies.*
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> *We are also particularly concerned by the suggestion that it should cost $6.3 million to set up a company in order to make 20 to 25 payments per year. How is it possible that it could cost anything like this to set up a company to do so little? There is no explanation of the breakdown of the establishment costs. This is deeply disturbing. How can it possibly cost so much to set up an entity for this purpose? Given that financial advisers will need to pay 76.6% of this, it is very reasonable that they should be asking the difficult questions about such an expensive proposal. The proposed costs are not reasonable; they are excessive.*

In the context of the lack of any Regulation Impact Statement, or other documentation on the cost of the CSLR, we assume that the points raised above remain relevant.

Is the proposed structure for the CSLR the most appropriate?

We question the proposal to set up a new and separate company limited by guarantee to be the operator of the CSLR. This just seems to be likely to lead to additional and unnecessary costs. In our view, the CSLR operator does not need to be a separate company and should not require the infrastructure that has been proposed. Why can't the CSLR operator be a unit within ASIC or another Government agency?

The process could work in terms of AFCA passing unpaid determination matters to ASIC to investigate and take appropriate action and then for ASIC to ultimately manage the payment of any compensation and pursue recovery action. ASIC already has the invoicing capacity, the investigative resources and the powers necessary to pursue such matters.

We are supportive of the fact that it is no longer proposed that the CSLR operator should be a subsidiary of AFCA. We support the separation of these two important roles.

Are the various caps and controls appropriate?

We note that there is an initial cap of $10 million per year for in-scope subsectors and then an overall cap of $250 million per year. It is very unclear how the levy could progress from the $10 million cap on the in-scope subsectors, to the total annual cap of $250 million, which is a huge leap. There is still no adequate explanation of why $250 million has been selected as the total cap and we remain very concerned that there could be an expectation that this amount was to be contributed in any one year by one or more of the in-scope subsectors.

The Minister seems to have very broad discretions in the event of a subsector cap being exceeded. It is concerning that this power could be leveraged to make such a large levy on one or more subsectors. We therefore feel that there is a lack of controls and that there should be an absolute maximum cap for any one subsector in any one year.

Is it appropriate to put a cap on the amount paid through a compensation scheme of last resort?

In keeping with the purpose of a compensation scheme of last resort and with the objective of keeping costs to a minimum, we are supportive of a cap on the maximum amount that can be paid as compensation by the CSLR for any one claim. We think that the cap of $150,000 would be most likely to cover the vast bulk of matters. Undoubtedly AFCA would have data to confirm this. This is an effective way to balance the competing priorities of compensating consumers for loss and carefully managing the costs of the scheme.

Other Feedback

We do not accept the need for an actuary to be on the Board. The estimation of costs for the upcoming year is not a projection of the scale of complexity that would warrant having an actuary on the Board. It is a one-year estimate, not a multi-year projection.

We note the time limit of 12 months that has been proposed as the maximum timeframe for a claimant to seek compensation. Whilst we do not disagree with a maximum timeframe, we would also recommend that there is a minimum time period needed to wait for payment, such as four months. The financial firm needs time to make payment, however after this period, it should have reached a point where the non-payment can be escalated within AFCA and reported to ASIC. If it was widely known that there is a trigger point at which the matter is reported to ASIC, at which time they can commence an investigation, then this might help to encourage more timely payment of these determination outcomes.

Concluding Comments

The AFA supports the establishment of a Compensation Scheme of Last Resort, however we do not accept the exclusion of managed investment scheme products from the scope and believe that the cost of establishment and annual administration need to be substantially reduced. We also recommend that the establishment (including capital reserve) and operating costs be allocated more broadly across the regulated population.

We would be happy to discuss this matter further, or to provide additional information if required. Please contact us on (02) 9267 4003.

Yours sincerely,

Phil Anderson
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Association of Financial Advisers Ltd